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**DOES DIRECT REALLY MEAN DIRECT?
A SURVEY OF "DIRECT LOSS" CASES
UNDER TRADITIONAL FIDELITY BONDS**

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I. INTRODUCTION

In theory, fidelity coverage is designed to offer indemnity for loss of specific property by the insured and not for loss arising from liability to third-parties for covered acts under the policy. Put another way, modern fidelity coverage is designed to limit an insurer's indemnity obligations to “direct” losses of covered property by the insured. Modern commercial fidelity policies are first-party indemnification contracts between an insurer and its insured, providing fidelity coverage to protect insureds against the risk of “direct loss” to specifically covered property caused by the dishonesty of their employees. As such, fidelity bonds and commercial crime policies are generally not intended to cover third-party losses; however, because “loss” is often not specifically defined in such policies, claimants continue to pursue attempts to expand the scope of covered losses, seeking coverage for claims where the only sustained “loss” being pursued is often experienced by an insured-employer after having reimbursed a third-party for damages caused to that third-party by the dishonesty of the insured's employee. This paper seeks to analyze the existing case law to determine whether such attempts by claimants to expand the definition of “direct loss” have been successful, and whether in the view of the courts “direct” really means direct.

A review of all aspects of claims made under modern fidelity policies, or a review of the entire body of case law dealing with such coverage is beyond the scope of this paper.¹ A significant portion of the decisions in this area deal with assertion of third-party loss claims under commercial crime policies, however, there are also decisions dealing with financial institution bonds and other fidelity instruments. The focuses of this paper will be on the “causation” element of such claims, the particular policy provisions limiting a fidelity insurer's liability to “direct losses,” and an analysis of the insurer's threatened liability for third-party losses, either as claimed damages from its insured's perspective resulting from judgments or settlements paid by the insured to third parties. Attempts by third-parties to assert direct liability against the insurer for such claims will also briefly be reviewed.

II. TYPES OF CLAIMS GENERALLY

Generally in these matters there are four types of claims asserted for employee dishonesty or other coverage under commercial fidelity instruments: (1) theft of tangible personal property of the insured; (2) embezzlement and/or misuse of the insured's money; (3) assisting dishonest

¹ A comprehensive study of this entire area can be found in Franklin, Christopher J., *Legal Liability for Third-Party Losses Under Commercial Crime Policies*, ABA Fidelity and Surety Law Committee of the Tort and Insurance Practice Section, 1995 Midyear Meeting Program. Other excellent resources (not comprehensive) on this topic include Gallagher, Edward ., *Claims By Persons Other Than The Insured*, Handling Fidelity Bond Claims, ABA TIPS, 1999, 467; Devin, Paul R. and Fryer, Alan, R., *Third Party Claims Against The Insured*, Handling Fidelity Bond Claims, ABA TIPS, 1999, 359; Wildau, Karen, *Evolving Law of Third-Party Claims Under Fidelity Bonds: When is Third Party Recovery Allowed?*, 25 Tort & Ins. L.J. 92 (1989).

third-parties in the securing of credit to which they might not otherwise be entitled; and (4) the sale of services or products of the employer for amounts not substantiated by the value of those goods. A key element in any claim analysis is the determination that a “loss” has occurred. The term “loss” continues to be undefined by most commercial crime policies or other commercial fidelity bond instruments, leaving some room for judicial discretion with respect to defining the scope of coverage intended by the loss requirement. A careful review of particular policy provisions is necessary in order to make a proper analysis of whether any of these schemes has resulted in the loss of “covered property” by the insured. While the focus of this paper is on the “causation” element of any claim, cases generally deal with loss of “covered property” and causation together as important issues in making any coverage determination; therefore, the issue of what constitutes a loss of “covered property” is often as important in any analysis as the causation element.

The “direct loss” issue and the fidelity insurer’s legal liability for third-party losses generally arises in the context of an insured’s claim based upon (1) a judgment entered against the insured and in favor of a third-party, (2) a settlement reached by the insured with a third-party, or (3) direct third-party claims asserted against the insurer. Legal determinations regarding coverage for claims involving losses to third-parties are extremely dependent upon the facts of each particular case. While the courts in some states, notably Kansas and Nebraska, have traditionally excluded coverage for such third-party losses outright, it is not necessarily a foregone conclusion in some jurisdictions that there will be a finding of no coverage for such third-party losses. Most decisions appear to turn on causation, and the policy language in the employee dishonesty coverage form or similar language in financial institution bonds limiting coverage to “loss resulting directly from” covered acts. As demonstrated in more detail below, any “trend” discernable from the extant case law seems to favor a finding of no coverage for such third-party losses.²

A number of different theories and/or legal mechanisms have been used (or at least attempted) by third-parties asserting claims directly against an commercial fidelity bond, including (1) intended third-party beneficiary theory, (2) assignment, (3) garnishment, and (4) direct action statutes. As a general rule, a third-party cannot maintain a direct action under a commercial fidelity bond for two primary reasons: (i), a typical fidelity bond requires that the “insured” rather than a third-party suffer the loss, and (ii) most fidelity bonds specifically state that the bond is for the insured’s benefit only. A review of the existing case law indicates that third-party claimants have not enjoyed a significant amount of success in this regard; however, these theories have occasionally provided third-parties a remedy where none seemed to exist under the policy language itself.

III. BOND PROVISIONS APPLICABLE TO THIRD-PARTY LOSS AND DIRECT THIRD-PARTY CLAIMS ANALYSIS

Virtually all modern commercial fidelity products incorporate language similar to the 1986 edition of the Employee Dishonesty Coverage Form, which provides that:

We will pay for loss of, and loss from damage to, Covered Property

² (See e.g., *Aetna Casualty & Surety Company v. Kidder Peabody & Company, Inc., et al.*, 676 N.Y.S. 2d 559 (1998); *Peoples Bank & Trust Company of Madison County v. Aetna Casualty & Surety Company*, 113 F.3d 629 (6th Cir. 1997); and *Lynch Properties, Inc. v. Potomac Insurance Company of Illinois*, 962 F. Supp. 956 (N.D. Texas 1996).

resulting directly from the Covered Cause of Loss.

(emphasis added)

The Financial Institution Bond form also emphasizes “direct loss” within nearly all of its insuring clauses. The Bond form generally states:

The Underwriter, in consideration of an agreed premium and subject to the Declarations ... agrees to indemnify the Insured for:

(A) DISHONESTY OF EMPLOYEES Loss resulting directly from...

(B) ON PREMISES BURGLARY, ROBBERY, MISPLACEMENT, ETC. Loss of Property resulting directly from...

(C) IN-TRANSIT Loss of Property resulting directly from ...

FORGERY, ALTERATION AND FRAUDULENT INSTRUCTIONS Loss resulting directly from ...

(emphasis added). Moreover, these provisions discuss the loss to the Insured or the act against the Insured and not to or against a third-party.³

Coverage is generally further modified by several important exclusions and conditions, including the “Indirect Loss” exclusion and the Ownership of Property condition. The “Indirect Loss” exclusion is particularly applicable to any discussion of third-party losses. It provides that there will be no coverage under the Bond for:

Loss that is an indirect result of any act or “occurrence” covered by this insurance including, but not limited to, loss resulting from:

- a. Your inability to realize income that you would have realized had there been no loss of, or loss from damage to, Covered Property.
- b. Payment of damages of any type for which you are legally liable. But we will pay compensatory damages arising directly from a loss covered under this insurance.
- c. Payment of costs, fees or other expenses you incur in establishing either the existence or the amount of loss under

³ In Clause (A), for example, the dishonest or fraudulent acts committed by an Employee must be done with the intent “to cause the Insured [not the third-party] to sustain such a loss.” Moreover, “if some or all of the Insured’s loss (emphasis added) results directly from” loans or trading “that portion of the loss is not covered unless the Employee: (i) acted with the intent to cause the Insured [once again, not the third party] to sustain a loss....” This is a consistent theme throughout the bond’s insuring clauses.

this insurance.

The standard Ownership of Property condition provides:

The property covered under this insurance is limited to property:

- a. That you own or hold; or
- b. For which you are legally liable.

However, this insurance is for your benefit only. It provides no rights or benefits to any other person or organization.⁴

As discussed in more detail below, although perhaps the strongest evidence of the insurers' intent to avoid liability to (or for) third-party losses, the last two sentences of the Ownership of Property condition quoted above remain surprisingly untested in published case law.

IV. LEGAL LIABILITY FOR THIRD-PARTY CLAIMS GENERALLY

The issue of an insurer's legal liability for third-party losses under modern commercial fidelity products generally arises in the context of (1) an insured's claim based upon a judgment entered against it and in favor of a third-party or a settlement reached by the insured with a third-party, or in the context of (2) direct third-party claims asserted against the insurer. Each will be reviewed separately.

A. INSURED'S CLAIMS FOR THIRD-PARTY LOSSES.

Leading treatises in the insurance law area appear to differ on an insurer's liability to its insured for damages paid by the insured to a third-party harmed by the dishonest acts of the insured's employees. In a section entitled "Loss Through Creation of Liability of Employer to Third Person", the Couch On Insurance treatise states that:

the loss covered by an employee's fidelity bond is not necessarily limited to loss directly resulting from the employee's act, such as embezzlement. To the contrary, it may include liability on the part of the insured resulting from the application of the principals of vicarious liability. In other words, a bond insuring against loss sustained by reason of dishonesty, fraud, embezzlement, etc., covers losses imposed by the creation of liability to third persons. To illustrate, it

⁴ General Agreement E of the Bond, the ownership provision, has been expanded in the upcoming bond. The modified version still contains the provisions above and, notably, the final sentence of that paragraph, "This Bond shall be for the sole use and benefit of the Insured named in the Declarations."

It adds:

At the Written request of the Insured, any payment in satisfaction of loss covered by this Bond involving Money or other Property in which the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, Government National Mortgage Association, a quasi-governmental authority or another legal entity has an interest, shall be paid by an instrument issued to such organization and the Insured as joint loss-payees....

has been held that a loss may be suffered by the insured through being required to make good an obligation to a third person created by the fraud of its employee perpetrated on such third person.

Anderson, 13 Couch on Insurance, 2d § 46:101 (1982) at 89 (Citations omitted).⁵

In contrast, Appleman's Insurance Law and Practice finds that “[n]ewer [authority holds] that the liability of the insured-employer to third parties based upon the fraudulent or dishonest act of an employee does not constitute a loss under the Employers’ Fidelity Policy.”⁶ The view of Appleman's Insurance Law appears to coincide with the language in most modern policies and, in particular, the exclusions provided under the Section A.3 “Indirect Loss” exclusion, which specifically provides that there would be no coverage for any loss resulting from “payment of damages of any type for which [the insured is] legally liable.”

Minority View – No coverage

A few jurisdictions have taken the view that any claimed losses by an insured, which resulted from a fraudulent or dishonest act of its employees and gave rise to the insured’s liability, are never covered. Courts in Kansas and Nebraska have traditionally excluded such coverage outright. The leading cases for this “minority” view among the courts are *Ronnau v. Caravan International Corp.*, 468 P.2d 118 (Kan. 1970) and *Omaha Bank for Cooperatives v. Aetna Casualty Insurance Company*, 301 NW 2d 564 (Neb. 1981). The *Ronnau* case is a “direct” garnishment action by a third-party to the commercial fidelity bond, and will be discussed in more detail below in the discussion on such direct third-party actions.

In the *Omaha Bank* case, a bank employee made fraudulent representations to a third-party customer. The customer sued the bank for damages resulting from the fraudulent representations. While the customer’s case was pending, the bank sued its blanket fidelity bond insurer seeking a declaratory judgment that any judgment in favor of the customer in the underlying suit would be a “covered loss” under the fidelity bond. The court in *Omaha* found that any judgment paid by the bank to a third-party would not be covered. The court noted that because the insured bank was vicariously liable due to its employee’s act, the bank itself had committed the tort. Therefore, the court found that the fidelity bond would not insure the bank for consequences of its own torts, even when a bank employee actually committed the tort. The

⁵ Couch is itself arguably internally inconsistent. A leading case in the body of case law rejecting third-party liability under fidelity bonds, *Ronnau v. Caravan International Corp.*, 205 Kan. 154, 468P. 2d 118 (1970), relied on language found elsewhere in Couch, and which has been preserved in the revised edition of the treatise. That language, at §46-219 states as follows:

The contract of fidelity insurance is a contract against loss. It is a contract of indemnity on which the insurer is liable only in the event of loss sustained by the obligee in consequence of conduct of nature specified in the contract. It has been held that there can be no recovery on a fidelity bond in the absence of loss or damage to the insured, and lack of any pecuniary loss by the obligee from the alleged wrongful act constitutes a good defense, in such a case no recovery can be had.

⁶ 9A Appleman's Insurance Law and Practice (1981 & Supp. 1994) 6, §5666 (Citations omitted).

Supreme Court of Nebraska also noted that where third-party claims result in loss to the insured, there is no coverage under the bond whether the claim is pursued by the insured directly or by a third-party in a garnishment or similar proceeding.

Majority View – Focus on Causation and Specific Policy Language

Although the minority view certainly favors the position of bonding companies, it has not been widely followed outside of Kansas or Nebraska, and the majority view appears to be that, subject to careful analysis of the terms and conditions of each particular policy, an insurer may be answerable to its insured for certain losses sustained by the insured as a result of its payment (whether through settlement or judgment) to third-parties, based upon claims related to the fraudulent conduct of its employees. While the “majority view” may be that coverage for such third-party losses is possible, it does not follow that insurers are liable for all such third-party losses relating to the dishonesty of its employees, and an increasing number of cases center on the focus of this paper, i.e., the bond’s requirement that such losses be the “direct” result of covered acts under the policy.

Cases Denying Coverage

A series of cases over a number of years, while acknowledging the fact that the minority view expressed in *Ronnau* and *Omaha Bank* may not be the law of the land, have nonetheless found coverage lacking for third-party losses under a variety of different theories. An often cited case supporting the “direct loss” requirement under modern commercial fidelity products is *Lynch Properties, Inc. v. Potomac Insurance Company of Illinois*.⁷ Lynch Properties, Inc. was in the business of owning and managing commercial real estate and investing in private companies. Mrs. Martha Lynch was the mother of Harry Lynch, who was the president of Lynch Properties, Inc. Mrs. Lynch hired Lynch Properties, Inc. for both their business and personal bank accounts. A bookkeeper working at Lynch Properties, Inc., Eva Bartlett, was assigned the responsibility of keeping the books for the 87 year-old Mrs. Lynch’s investment portfolio and her personal bank accounts. A fee for these services was paid by Mrs. Lynch, as part of an overall fee paid by Mrs. Lynch for Lynch Properties, Inc. to manage her investment.

Ultimately, it was discovered that Bartlett had begun stealing from Mrs. Lynch’s personal account over a three-year period. Eventually, \$19,000.00 of Mrs. Lynch’s property maintained in her personal account was embezzled by Bartlett. Upon discovery of the embezzlement, Lynch Properties, Inc. transferred funds from its own accounts into Mrs. Lynch’s accounts to reimburse her for the stolen funds and then filed a claim for reimbursement under its employee dishonesty insurance policy. It is important to note that no funds were taken from any of the investment accounts managed by Lynch Properties, Inc.; rather all funds were taken from Mrs. Lynch’s personal account, held by Lynch Properties, Inc. The carrier denied coverage and suit ensued by Lynch Properties, Inc. In affirming the carrier’s denial, the trial court found that any “loss” sustained by Lynch Properties, Inc. was actually a loss of Mrs. Lynch’s personal funds, and that any alleged loss by Lynch Properties, Inc. was the “indirect result” of its replacement of Mrs. Lynch’s personal funds. In affirming the trial court’s decision, the appellate court placed great emphasis on the need to tie the owned property provision of the policy and the direct loss portions of the policy. It rejected any contention by Lynch Properties, Inc. that it somehow “held” the

⁷ 140 F.3d 622 (5th Cir. 1998) affirming 962 F. Supp 956 (N.D. Tx. 1996)

property in Mrs. Lynch's personal account or was otherwise "legally liable" for that account, as the term was intended in the bond. The court specifically recognized that the "interest covered" section of the bond limited property loss coverage to "property that you own or hold or . . . for which you are legally liable." Inasmuch as it concluded that Lynch Properties, Inc. was not a bailee or trustee for Mrs. Lynch's account, it determined that the funds stolen by Bartlett were the property of Mrs. Lynch, and not of the insured.

In the following quoted analysis from the court, the court points out the key distinction found in many third-party claims and emphasizes the difference between fidelity coverage and liability coverage, i.e., fidelity coverage generally offers indemnity for loss of specific property and not loss arising from liability for covered acts:

In this case, the policy stated that "the property covered under this insurance is limited to property . . . for which you are legally liable." Lynch Properties argues that it was legally liable for the misappropriation because Bartlett was responsible for writing checks, having Harry Lynch sign them, and balancing Mrs. Lynch's separate personal accounts. It does not argue, however, that it was legally liable for the funds prior to their theft. Instead, it argues only that once Bartlett misappropriated the funds, it became liable to Mrs. Lynch to replace those funds and that Potomac must indemnify it for that reimbursement because Bartlett stole the funds in the course of her duties at Lynch Properties. While Lynch Properties thereby argues how it may be vicariously liable for Bartlett's acts, this argument fails to show how it was "legally liable" for the stolen property itself, that is, for funds in Mrs. Lynch's account. Acceptance of Lynch Properties's argument would mean that Potomac's policy would cover any loss where an employee takes a customer's property in the course of their employment responsibilities, regardless of whether the employer had any interest in the property itself. Furthermore, it would transform this policy, which insures *property loss*, for which Lynch Properties is legally liable, into a policy insuring any vicarious liability arising from an employee's dishonesty. This argument is foreclosed by the plain language of the "interest covered" provision, which requires that the employer have some interest in the misappropriated property, whether that be because the employer owns, holds, or is legally liable for the property.

140 F.3d 622 at 529. Equally as important, the court found that "inclusion of the words 'resulting directly from' indicates an intent to limit the coverage available and is especially significant because the language appears in the section of the policy that specifically addresses the scope of coverage." (From the trial court's decision, cited at 962 F.Supp. 956, 961 (N.D. Texas 1996)). A number of cases have taken up the lead of the *Lynch Properties* decision in concluding that the Direct Loss language in modern commercial fidelity products must be read in conjunction with and in context with the sections dealing with property interest covered. These decisions are instructive for the fidelity claims practitioner, and include *The Vons Companies, Inc.*

*v. Federal Insurance Company*⁸ and *ITT Hartford Life Insurance Company v. Pawson Associates, Inc.*⁹

In *Vons*, the loss to the insured arose out of a settlement paid by it to resolve claims against it brought by so-called investors in a Florida ponzi scheme known as Premium Sales. The Vons Company, Inc. (“Vons”), a grocery chain, employed an independent contractor to assist it in the purchase of wholesale grocery products, health, and beauty aids for resale in its supermarkets. The independent contractor employed by Vons, Stanford Trading, Inc., acted as a broker in this market. One of Stanford Trading, Inc.’s employees, Gene Shirley, was concurrently involved in the Premium Sales ponzi scheme. His role in the ponzi scheme was to falsely confirm the transactions were being made, which would lead to the “investors” funding the these fictitious transactions, ostensibly allowing them to go forward. However, because the transactions were fictitious, the funds were not used to purchase actual products, but rather to pay off former investors. Ultimately, the scheme collapsed on itself and Shirley’s fraudulent conduct came to light in 1993, at which Stanford Trading, Inc. terminated him. Shirley thereafter went to work directly for Premium Sales. The Premium Sales ponzi scheme ultimately unraveled in 1993, resulting in the loss of several hundreds of millions of dollars. No loss had been suffered by any “investor” of Premium Sales prior to the Summer of 1993.

In a strained attempt to find a source of recovery, the Premium Sales investors and the trustee for Premium Sales sued the various grocery companies with whom Premium Sales dealt, including Vons, for amounts exceeding \$300 million. The claimants argued that Vons and any other supermarkets were liable to them based on theories of agency, and because Vons did not report the knowledge it had of Shirley’s dishonest conduct to the criminal authorities and continued to do business with Premium Sales in spite of Vons’s knowledge of kickbacks being paid to Shirley. Vons elected to settle the claims asserted against it for \$10 million, and then sought to recover the settlement payments from Federal Insurance Company under its Employee Dishonesty Policy. █

Federal obtained summary judgment at the trial; court level on the theory that the “loss” suffered by Vons in the form of the payment of \$10 million in settlement to the “investors” was not a “direct loss” under the Federal policy. Vons appealed the district court’s decision arguing that it erred in rejecting Vons’ claim that the policy provided liability coverage, based on Section 11 of the policy which provided that coverage “shall apply only to Money, Securities or other property owned by the Insured or *for which the Insured is legally liable*, or held by the Insured....”¹⁰ Under Vons argument, because it was “legally liable” for the \$10 million settlement payment related to its employee’s dishonesty, there should be coverage. The court of appeals rejected Vons’ argument finding that there was coverage only for direct loss attributed to employee’s dishonesty, but “not for vicarious liability for losses suffered by others arising from its employee’s tortious conduct.”¹¹ In a strong ruling favoring the insurance industry, the court held that the Federal policy provided coverage for “direct losses” that were “caused by” employee theft or forgery, and did not provide coverage for third party claims.

⁸ 212 F.3d 489 (9th Cir. 2000).

⁹ No. CV 940361910S, 1997 WL 345345 (Conn.Super.Ct. June 16, 1997.)

¹⁰ 212 F.3d at 491.

¹¹ *id.*

In *ITT Hartford Life Insurance Company v. Pawson & Associates*, Pawson & Associates was an insurance agency selling annuity contracts for ITT Hartford Life Insurance Company (“Hartford”), and suffered a loss when one of its employees, Donnelly, sold five annuity contracts but kept the annuity premium payments for himself. Hartford immediately reimbursed the annuity buyers upon learning of Donnelly’s actions and sought recovery of the payments from Pawson in a legal action. Pawson then made a claim on its fidelity insurer, Aetna, by way of a third-party complaint. In granting Aetna’s Motion to Strike Third-Party Complaint, the court found that any loss Pawson might suffer if Hartford were to recover from it was not a “direct loss” covered by the Aetna policy, due to the fact that Pawson itself never actually possessed or was entitled to possess the annuity premiums at issue. It also recognized that the Aetna bond provided indemnity against loss as opposed to indemnity for liability, and held that any payment ultimately made by Pawson & Associates as a result of the Hartford suit could not properly be characterized as a “direct loss” under the policy. It is important to note that the court’s decision was rendered in response to the motion to strike the pleadings and is, therefore, somewhat incomplete in its analysis. Nonetheless, it is part of a consistent trend which runs counter to any attempt to expand theories of “direct loss” and is consistent with the line of cases under *Lynch* where direct loss language is read in context with property interest language in policies.

A subsequent Connecticut court relied, in part, on the *Pawson* decision, in a more detailed and reasoned opinion strengthening the insurers’ position on this issue, at least in Connecticut. In *Finkel v. St. Paul Fire and Marine Insurance Company*,¹² found in favor of St. Paul on its Motion for Summary Judgment. The Bankruptcy Trustee for the insured KPM, Inc., sought coverage under KPM’s fidelity insurance policy and ultimately brought suit against St. Paul in an attempt to recover for losses sustained when KPM’s director and sole shareholder, David Kast, misappropriated millions of dollars of KPM’s customer funds, held by KPM in trust for remittance to the Internal Revenue Service. Kast used the embezzled funds both to cover his scheme (paying customers’ interest and penalties on taxes that KPM should have paid in the first place), to for personal living expenses, and to pay gambling debts. Kast filed for personal bankruptcy and pleaded guilty to a variety of federal crimes, for which he was sentenced (among other things) to pay restitution. KPM became insolvent and filed for bankruptcy protection as well.

The issue on summary judgment was whether St. Paul owed money for the legal liability of KPM caused by its employee’s dishonest act, which St. Paul argued was an “indirect loss” excluded under the policy, and whether the Employee Dishonesty Protection Rider limited coverage to indemnification of KPM for direct loss of its property. St. Paul took the position that coverage was triggered only when KPM sustained a direct loss from employee dishonesty, and that because the “loss” being asserted resulted from claims made against the bankruptcy estate from former customers, the loss was “indirect” and not covered. The trial court agreed, holding that the policy limited coverage to indemnification of the insured entirety for a direct loss from employee dishonest, and did not insure against the legal liability of KPM third parties. The court stated conclusively, “Simply put, the EDR is not a liability policy, but an indemnity policy.”

¹² 2002 WL 1359672 (D. Conn., June 6, 2002)

In *Continental Bank, N.A. v. Aetna Casualty & Surety*¹³, two stockbrokers executed a number of unauthorized transactions in customer accounts in a scheme to defraud the customers, the clearing broker, and their own employer. When the scheme ultimately failed and collapsed, the clearing broker and the employer were forced to repurchase the stock at an inflated price, resulting in losses exceeding \$11 million (based on the repurchase of stock that was ultimately worthless). The clearing broker ultimately made a claim on stockbrokers' employer, which in turn made a claim on its policy. The court, in rejecting the claim under the policy, reasoned that coverage was not appropriate because the insured "did not suffer a direct loss." The decision also deals with the employee's manifest intent to cause the employer a loss, and focused on a "customer account" exclusion also contained in the policy. Nevertheless, the portion of the decision focusing on the requirement of a "direct loss" being suffered by the insured cannot be discounted.

In *Peoples Bank & Trust Company of Madison County v. Aetna Casualty & Surety Company*¹⁴, the court of appeals ruled in favor of the insured based on "direct loss" language contained in a financial institution bond to limit an insured's claim arising from third-party losses. Two senior executives from Peoples Bank & Trust Company of Madison County agreed to split a finder's fee offered by several directors of the bank seeking to sell a restaurant they jointly owned. One of the senior executives found a purchaser and assisted the purchaser in securing a SBA guaranteed loan on the purchaser's behalf. Subsequent to consummating the loan transaction, the purchaser stopped making loan payments and ultimately filed for bankruptcy. The SBA forced the bank to repay the loan and the bank made a claim under its financial institution bond.

In deciding the case, the 6th Circuit Court of Appeals specifically addressed the question of whether or not a financial institution bond was answerable to a settlement paid by a bank in a lender liability action involving allegations that the bank had fraudulently induced the borrowers to enter into a loan. While the focus of the 6th Circuit's decision was on the issue of whether or not the senior officers' conduct amounted to dishonesty as defined in the bond and whether or not they acted with the manifest intent to cause the bank a loss, the court nonetheless made its position clear with respect to the viability of such third-party claims:

As a practical matter . . . losses resulting from frauds on third-parties will rarely be covered by Standard Form 24. These policies will cover a loss suffered by a third-party only where the dishonest employees intended to cause the third-party loss, and knew, or expected that the loss would migrate to the bank. The migratory route would need to be short, certain, and obvious to support the inference (in the absence of direct evidence) that dishonest employees harbored such knowledge or expectation.

In *Aetna Casualty & Surety Company v. Kidder Peabody & Company, et al.*¹⁵, the insured sought indemnity for settlement amounts paid related to security actions brought based on insider trader allegedly conducted by the now infamous Ivan Boesky. The court held that because the insurance employees did not actually steal money from their employer, or property

¹³ 164 Misc.2d 885 (S.Ct. of N.Y. Cty 1995)

¹⁴ 113 F.3d 629 (6th Cir. 1997)

¹⁵ 676 NYS 2d 559 (1998)

of customers entrusted to their employer, such as securities or funds in the physical custody of the employer, any loss paid in settlements as a result of the employees' dishonesty was not a "direct loss" of "covered property".

The fidelity bonds [in this case] protect only against a direct loss to Kidder. They do not cover payments made by Kidder to settle losses sustained by a former Kidder client for which care was allegedly liable. The nature of the bonds as fidelity bonds and not liability policies, and the "direct loss" language in Insuring Agreement (A), warrant this conclusion.¹⁶

As with a similar, earlier decision in *Drexel Burnham Lambert Group, Inc. v. Vigilant Insurance Company*¹⁷, the Kidder employees were found not to be stealing from the company, but rather were essentially stealing for the company. The *Drexel* case arose out of the demise of the junk bond empire created by Michael Milken and others in the 1980's. After settlement with numerous third-parties as a result of the activities of its employees, *Drexel* asserted claims under several of its fidelity bonds to cover such settlements. Although not going into great detail as to the basis of the rejections, the trial court judge rejected all claims of *Drexel*, finding that the policies at issue were fidelity bonds and not general liability insurance policies and that they did "not purport to defend and indemnify the insured every time a claim is made against it because it may be responsible for the acts of its employees."¹⁸

A fairly recent case out of Vermont, *Patrick v. St. Paul Fire and Marine Insurance Company*¹⁹ reviews a number of the leading cases in this area and succinctly states the case for finding that "direct" means "direct" when analyzing claims under modern fidelity policies. *Patrick* involved a somewhat complicated factual scenario leading to the assertion of a claim by an assignee of Independent Bankgroup Inc. ("IBG"), the principal under a financial institution bond issued by St. Paul. In short summary. Patrick claimed to have been fraudulently induced into buying IBG stock by employees and/or agents of IBG and several of its affiliates. Patrick lost money on the \$500,000 investment (which was financed by loans from the IBG affiliates) and failed to repay the loans. IBG ultimately failed as an institution and filed for bankruptcy. Its successor proceeded against Patrick, forcing him into bankruptcy, where the IBG continued its legal action against Patrick. Patrick brought a third-party action against IBG in the bankruptcy court and obtained a judgment against the IBG estate, awarding him \$25,000 on his fraudulent misrepresentation claim, \$200,000 on his negligent misrepresentation claim, and \$50,000 on his negligent failure to disclosure claim. IBG's estate settled with Patrick by assigning him its rights under the Bond with St. Paul. Patrick brought suit against St. Paul under the bond.

In ruling against Patrick, the court found that neither Patrick nor IBG had suffered a direct loss which was covered by the bond. In reaching its conclusion, the court reviewed many of the leading direct loss cases in the country. It found that as the policy at issue was a fidelity bond, it was a first party indemnity insurance contract, whereby one agrees to indemnify the insured against loss arising from the dishonesty of its employees or other persons holding positions of trust and it was not a bond running to the benefit the public potentially harmed by the misconduct

¹⁶ 676 NYS 2d at 662.

¹⁷ 157 Misc. 2d 198, 595 NYS 2d 999

¹⁸ *Id.*, at 209.

¹⁹ 2001 WL 828251 (D.Vt. Feb. 15, 2001)

of the covered individuals. It also found that just because Patrick had recovered a judgment against IBG, it did not necessarily equate to a “direct loss” covered by the bond, and that even as an assignee of IBG, Patrick was only entitled to recover what IBG could have recovered as a direct loss under the bond. Because IBG never paid any damages, until the judgment was paid by IBG Patrick’s judgment represented a potential, indirect, loss to the insured, which was explicitly excluded from policy coverage. In closing the court quoted from the *Vons* decision out of California to the effect that “direct” means “direct” under such fidelity policies.

Cases Finding Coverage

Unfortunately, not all recent cases have strengthened the position of insurers under modern fidelity policies. In *First American State Bank v. Continental Insurance Company*,²⁰ the Court found in favor of the insured for “losses” resulting from the insured’s duty to settle with customers due to its vicarious liability for the dishonest act of its employees. At issue in *First American* was a fraudulent loan and commodity trading scheme operated by the bank’s chief agricultural loan officer. Several customers of the bank borrowed money against their lines of credit and loaned the money back to the agricultural loan officer. The loan officer also improperly managed commodity accounts in a cattle feeding operation in the name of one of the customers, taking improper commissions and failing to properly share in the losses suffered in the account. The loan officer was ultimately unable to pay the notes he had executed to the two customers. Facing perceived liability to its two customers based upon the actions of its employee, the bank elected to “settle” all claims by its customers through advancement of funds to the customers in order to allow them to “pay” the notes.

Although aware that the policy contained manifest intent language that required that the wrongful conduct of its employee be directed toward the insured in order to constitute a “loss” under the policy, the Court did not discuss that issue. Instead, the Court found that the bond was a “statutory” bond due to the fact that the bank was required to have such a bond by Iowa statute, and, therefore, the bond had to be liberally construed. Under the Court’s “liberal” construction of the bond language, the bank-insured was found to have sustained a loss as a result of each dispersal of loan funds under the scheme, as well as any settlement payments to third-party customers.

In *Commercial Bank of Bluefield v. St. Paul Fire and Marine Insurance*,²¹ the insured’s employee misappropriated funds, causing losses directly to the insured and to a third-party customer of the insured. The third-party sued the insured and obtained a default judgment. The court in *Bluefield* found that the fidelity bond insurer was liable to its insured for the direct losses suffered by the insured, and further held that the third-party judgment creditor could garnish the insurance proceeds that the fidelity bond insurer owed its insured.²² However, in so finding, the *Bluefield* court also held that the insured’s legal liability to the third-party customer resulting from the employee dishonesty was not a covered loss. *Id.* at 556.

²⁰ 897 F.2d 319 (8th Cir. 1990).

²¹ 336 S.E.2d 552 (W.Va. 1985).

²² *Id.*, at 556 - 557.

The Third Circuit recently found coverage for a seemingly indirect loss in *Scirex v. Federal Insurance Company*²³. Scirex is a firm specializing in clinical testing of new products for pharmaceutical companies. Scirex nurses running some of the clinical studies sent patients home in violation of test protocols and entered falsified information regarding their observations of the patients testing the drugs. Upon discovery of the fraud by its employees, Scirex replicated the studies at its own cost, with no charge to its clinical sponsors. It then sought to recover its costs under its Blanket Employee Dishonesty Policy with Federal Insurance Company based upon the dishonest acts of its employees. It brought suit against Federal seeking indemnification for losses sustained when it was forced to repeat clinical drug trials at a cost of \$1.2 million. Federal defended on several grounds, including an argument that the \$1.2 million expended by Scirex was not a direct loss, rather it resembled ordinary business expenses from failed business ventures rather than potentially covered losses, such as false claims of working overtime due directly to employee dishonesty. Following a bench trial, the court disagreed with Federal's argument that the losses were not "direct losses" covered by the policy, but found in favor of Federal on grounds that the conduct of the nurses did not rise to the level of dishonesty contemplated by the policy. On appeal by Scirex, Federal again argued that the losses suffered by Scirex were indirect and thus not covered, and it argued that such losses were not to "money, securities or other property" covered by the policy. The Court of Appeals reversed, concurring with the trial court that the losses suffered were "direct losses" and finding that the nurses conduct constituted covered dishonesty under the policy.

The effect of the *Scirex* case can be limited in several important ways. First, the "fraudulent or dishonest acts" provision of the Federal policy at issue in *Scirex* is obsolete and not in the current bond form. Second, the current bond form also inserts a requirement that the employee have the manifest intent to cause the insured a loss and obtain a personal financial benefit. Under the current bond form employed by most, if not all insurers today, the nurses in *Scirex* may easily have been found not to have the requisite intent needed to sustain a claim. Lastly, it is important to note that the insured incurred the claimed expenses, not because of any particular liability to a third-party (contractual or otherwise), but because of its own expense in having to re-do the tests involved. While it remains a disappointing case from an Insurer's perspective, *Scirex* is not the precedent setting case it appears and can be limited to its particular facts.

Settlement as a Factor

Numerous reported cases exist wherein an insurer has been found liable for a claim by its insured resulting from a settlement paid to a third-party by the insured for damages allegedly resulting to the third-party as a result of the dishonesty of the insured's employee. Critical to any analysis of such claims by the insurer are the following issues: (1) whether there was actually a "loss" sustained by the insured; (2) whether the underlying claim by the third-party would have led to legal liability of the insured; and (3) whether the insurer was prejudiced by a voluntary settlement entered into prior to any notice to, or involvement by, the insurer.

Several early cases dealing with the insurer's liability for claims settled by the insured found the existence of a "loss" by the insured through somewhat strained reasoning. In *Hooker v. New*

²³ 313 F.3d 841 (3rd Cir. 2002)

Amsterdam Casualty Company,²⁴ the claim at issue involved misappropriation of county funds by the bank's President who was also treasurer of McCracken County. The county ultimately filed suit against the bank, which was resolved by settlement. The bank then made a claim under its fidelity bond. The Court rejected the insurer's argument that there was no "physical property" losses by the insured, and that the only loss was of a "depositor" and therefore not covered. In rejecting this argument, the Court found that the "payment of a legal liability caused by the dishonest act of the employee is a 'loss of money' to the same practical effect as it would be if the employee actually took the money out of the till."²⁵ The decision in *Hooker* appears to be based on rather broad language in the bond obligating the insurer to indemnify the insured "and hold it harmless from and against any loss of money . . .".²⁶

Other early cases found coverage for settlements based on the insured's "loss of bargain" or "depletion of pecuniary value". In *National Surety Corp. v. Rausche Pierce and Co., Inc.*,²⁷ the insured brought a claim under a broker's fidelity bond for settlements ultimately reached with several of its customers. The settlements were the result of claims asserted by the customers for losses stemming from misrepresentations by an employee of the insured in an offering circular. The insured suffered a "loss of the bargain" on the original sale of the securities to such customers.²⁸ In a somewhat tortured analysis, the 5th Circuit found that the insurer's "loss of the bargain" was essentially equivalent to a judgment being obtained by a third-party. In a rather liberal interpretation of lost property, the Court found that if the insured was "worse off" as a result of the settlement, a loss of property had occurred. The fact that such a loss had resulted from the insured's liability to a third-party was not directly considered by the Court.²⁹ In rejecting claims based upon an insured's settlement with a third-party, several courts have properly focused judicial inquiry on the issue of whether the insured was legally liable for the claim that led to the settlement for which recovery was sought. In *KAMI Kountry Broadcasting Co. v. USF&G*,³⁰ an employee of the insured forged signatures of the insured's president on a promissory note in favor of a local bank. Under applicable Nebraska law, the insured was clearly not liable for the acts of its dishonest employee. Notwithstanding the lack of legal liability, the insured elected to pay the note in order to maintain relations with the bank, which also happened to be an important customer of the insured. After paying the note, the insured filed a claim under its fidelity bond.

The *KAMI* Court found in favor of the insurer based on the theory that the insured had suffered no "loss" due to the fact that it could not have been found legally liable to the bank. The Court also implied that there would have been no coverage even in the event of legal liability to the bank due to the fact that the fraud of the employee was directed at the third-party and not the insured. The *KAMI* Court was clearly influenced by the voluntary nature of the insured's payment, and the applicability of this case to other cases where there is clear liability of the insured to a third-party is, at best, questionable.

²⁴ 33 F.Supp. 672 (W.D. KY 1940).

²⁵ *Id.*, at 673.

²⁶ *Id.*

²⁷ 369 F.2d 572 (5th Cir. 1966).

²⁸ *Id.*, at 578.

²⁹ See also *Imperial Insurance, Inc. v. Employer's Liability Assurance Corp.*, 442 F.2d 1197 (D.C. Cir. 1970) (loss through settlement by insured was a "pecuniary depletion" of insured's assets and, in that sense, a loss of its property and therefore covered under the general expression "other property" in the policy).

³⁰ 190 Neb. 330, 208 N.W.2d 254 (1973).

In *First American State Bank v. Continental Insurance*,³¹ the court found the insurer liable for a claim by its insured bank under a blanket fidelity bond where the insured's claim arose from payment of money to settle with third-parties injured by the dishonest act of the bank's president. In *First American*, the blanket bond at issue stated that the insurer would pay for dishonest acts of the bank's employees "whether or not the Insured is liable therefor".³² Language such as this is much broader than the standard language now employed in the "Indirect Loss" provisions of Commercial Crime Policies and, therefore, makes this case distinguishable from cases brought under traditional, modern policies.

A number of courts have seemingly refused to recognize the distinction between general liability policies and fidelity bonds in order to find coverage for third-party losses. For example, in *Manley, Bennett, McDonald v. St. Paul Fire & Marine*,³³ the court held the insurer liable under a stockholder's partnership bond and a stockholder's blanket bond, where the asserted claim resulted from the insured's settlements with third-parties harmed by the dishonesty of its partners and employees. Although characterized as a bond, the court found the language of the policy sounded more in "liability insurance" than in fidelity bond, stating:

the [insurer] will indemnify the Insured against court costs and reasonable attorneys fees incurred and paid by the Insured in defending any suit or legal proceeding brought against the Insured to enforce the insurance liability or alleged liability on account of any laws, claim or damages, which, if established against the insured, would constitute a valid and collectible loss sustained by the insured under the terms of this bond.³⁴

The language was found to be ambiguous as to the issue of whether it covered any legal liability paid by the insured, resulting in a decision in favor of the insured.

A Florida case also presents some countervailing authority against insurers in this area. In *Southside Motor Corp. v. TransAmerica Insurance*,³⁵ the court held that a fidelity bond insurer must pay its insured's claim arising from the insured's settlement with a third-party harmed by the dishonesty of one of the insured's employee. In finding that the fidelity bond language was ambiguous as to covered losses, the court construed coverage broadly based on its feeling that the "clause at issue involves extension of coverage rather than exclusion of coverage, [and therefore] must be liberally construed in favor of the insured."³⁶ The court implied that while coverage provisions need to be liberally construed, coverage exclusions need not be liberally construed in the insured's favor. In a somewhat truncated opinion, the *Southside Motor Corp.* case makes no mention of the possible exclusion for payments made by the insured for damages for which it is "legally liable", as generally exists in the standard Commercial Crime Policy now in use.

³¹ 897 F.2d 319 (8th Cir. 1990).

³² *Id.*, at 325.

³³ 792 F.Supp 1070 (E.D. Mich. 1992).

³⁴ *Id.*, at 1072.

³⁵ 380 So.2d 470 (Fla. App. 1980).

³⁶ *Id.*, at 471.

Hopefully more modern courts will continue to recognize the distinction between general liability policies and fidelity bonds in deciding cases involving insured's settlements with third-parties. The policy provisions added in the 1980 amendments to such policies should assist the courts in that regard, and lead to more decisions rejecting claims based upon settlements reached with third-parties for losses sustained by someone other than the actual insured.

B. LEGAL LIABILITY FOR DIRECT THIRD-PARTY CLAIMS

The issue of whether a third-party can itself successfully maintain an action against an insurer under a Commercial Crime Policy, although often presenting itself in the same factual context, is different from the issue of whether an insured's legal liability to such a third-party is a "covered loss" under such a policy. Any number of policy provisions in modern fidelity policies lead to the logical conclusion that there would be no legal liability under such policies to third-parties, and therefore, no right of direct action by such third-parties. Most modern courts rejecting third-party claims have taken one or more of the provisions set out above and found that claims by such third-parties are not covered under the bond. Litigants have generally advanced one or more of several theories in support of direct third-party claims against insurers under fidelity bonds. Those theories include: (1) third-party beneficiary liability; (2) Statutory Bonds and Direct Action Statutes; (3) Garnishment; and (4) Assignment theories. Cases under each theory, to the extent they exist, will be reviewed and analyzed.

Third Party Beneficiary Theory

One of the earliest theories often put forward for direct action by a third-party under a fidelity bond is the theory of "third-party beneficiary" liability of the insurer. Most courts which have even entertained the "third-party beneficiary" theory for purposes of evaluating potential liability for third-party losses have refused to imply a direct right of action in favor of such a third-party in connection with a fidelity bond. The primary reason given for such refusals is the belief that to do so would in effect judicially transform a first party indemnity contract of insurance into a general liability policy.

In *Thomas Cumis Insurance Society, Inc. v. Republic National Bank of Dallas*,³⁷ the third-party beneficiary theory was again successful. Cumis insured two credit unions under identical bonds. Republic National Bank, a third-party not party to either bond, delivered blank travelers check to each of the credit unions, which were subsequently stolen, filled in and negotiated. Republic paid the travelers checks and then sued Cumis directly on its bonds issued to the credit unions based upon the theory that it was a third-party beneficiary of the Cumis bond. The theory of recovery centered on the bond's definition of "property" which identified specific items in which the credit union insured's had a "pecuniary interest or which are held by the Insured in any capacity, and whether or not the Insured is liable therefor."³⁸ The Court found that the credit unions held the travelers checks as bailees, therefore, the bank did not have to first establish the credit unions liability before Cumis would be liable to someone. Notwithstanding the *Cumis* decision, a majority of the Courts have found that fidelity bonds are not contracts for the benefit of third-parties and have rejected any "third-party beneficiary" theories.

³⁷ 480 S.W.2d 762 (Tex.Civ.App. 1972).

³⁸ *Id.*, at 763.

In *American Empire Insurance Company of South Dakota vs. Fidelity and Deposit Company of Maryland*,³⁹ the insured was a clearing house for insurance companies responsible for collection of premiums and payment of claims. A number of irregularities were discovered by pool participants, who, in turn, brought an action against the insured's fidelity bond carrier claiming they were third-party beneficiaries on the bond. In rejecting the third-party's claims, the court in *American Empire* correctly interpreted the fidelity insurance contract as being designed solely to reimburse the named insured for losses sustained by it and found that "[a] distinction must be drawn between indemnity and property insurance. The fidelity bond was an indemnity insurance contract. The insurer's liability does not arise until the insured has suffered a proven loss. . . . We are of the firm view that [the insurer's contract] meant just exactly what it clearly said, that is, that it insured the named corporations and those corporations only, against the defalcations of their employees."⁴⁰ The court's decision to refuse to extend Florida's liberal rule permitting third-party beneficiaries to sue directly on liability insurance contracts to fidelity bonds was aided by the facts of the case itself. In reviewing the evidence before it, the court paid particular attention to correspondence between the insured and the insurer indicating the pool participants' interest in having coverage extended to provide them with direct protection, and, more importantly, the fidelity insurer's express refusal to extend that coverage. The pool participants also focused their arguments on the "ownership clause" in the policy which provided for coverage to "property as respects which the insured is legally liable", which they argued operated to protect third-parties and should therefore enable such third-parties to bring action under the bond. The court rejected this argument as well, finding that losses of property suffered by its insured were covered, whether the insured was liable for such losses or not.⁴¹

The Fifth Circuit again rejected the "third-party beneficiary" theory in a subsequent case entitled *Everhart vs. Drake Management, Inc.*⁴² In *Everhart*, the insured was in the business of providing funding service for construction and general mortgage loans. The third-party bank was injured when funds forwarded by it to the insured for a specific construction project were used by the insured to cover other debts. A third-party bank then filed a direct claim against the insured's fidelity bond. In rejecting the third-party claim, the Fifth Circuit again distinguished fidelity bonds from general liability insurance contracts, finding that a "blanket fidelity bond issued by Insurer protects against losses sustained by [the insured] due to fraudulent acts or omissions of its own employees . . . fidelity insurance undertakes to protect the insured against loss incurred by the insured or any predetermined specified group . . . cases extending coverage under a liability policy [are] not applicable to fidelity bond contracts where the parties, whose losses are insured, are readily defined, specified and predictable."⁴³ The court also found that the insured had sustained no "loss" covered under the bond at issue. Equally important in the area of rejecting third-party claims under fidelity bonds, the court noted that the "legal liability of the insurer to the [third-party] bank cannot be predicated on one owed by [the insured] to the bank."⁴⁴

A more recent case arising in Florida adopted the analysis of both *American Empire* as well as *Everhart*. In *Gasslein vs. National Union Fire Insurance Company of Pittsburgh*,⁴⁵ the plaintiff,

³⁹ 408 F.2d 72 (5th Cir. 1969).

⁴⁰ 408 F.2d at 77.

⁴¹ 408 F.2d at 76.

⁴² 627 F.2d 686 (5th Cir. 1980).

⁴³ *Id.*, at 691-92.

⁴⁴ *Id.*, at 690.

⁴⁵ 918 F.Supp. 373 (M.D. Fla. 1995).

Patricia Gasslein, was injured through the fraudulent activity of a broker employed by American Pacific Securities Corporation. American Pacific was insured by National Union Fire Insurance Company of Pittsburgh under a fidelity insurance policy. Gasslein first sought and obtained an arbitration panel award against American Pacific for \$338,342.94 plus attorneys' fees. Unfortunately for Gasslein, American Pacific had filed bankruptcy and the arbitration award therefore could not be enforced. Subsequent to obtaining the award, in order to obtain a judgment confirming the arbitration award, Gasslein entered into a stipulation with American Pacific's bankruptcy counsel whereby she agreed not to seek any relief against American Pacific in order that she could "pursue any and all rights . . . she has . . . against [American Pacific's] securities dealer blanket bond issued by [National Union], but only to the extent that there are insurance proceeds for any alleged liability of [American Pacific]."⁴⁶

The bond at issue provided specifically that it was for the use and benefit only of the insured, and that National Union would not be liable "for loss sustained by anyone other than the Insured unless the Insured, in its sole discretion and at its option, shall include such loss in the Insured's proof of loss."⁴⁷ Gasslein brought an action against National Union, suing as a third-party beneficiary under the fidelity insurance policy, asserting a right to proceed against National Union in the place of American Pacific. National Union raised several defenses to the claim of Gasslein including (1) the fact that Gasslein was neither a party to the agreement nor a named beneficiary, (2) American Pacific did not suffer any "loss" due to the fact that it did not have to pay any money to Gasslein, and (3) the fact that Gasslein's loss was not discovered during the period of time in which American Pacific's policy with National Union was in effect.

Based on the fact that the National Union policy was a "fidelity bond", the court found the decisions in *American Empire* and *Everhart* controlling. In so ruling, the court rejected Gasslein's argument that because security dealers are required by law to maintain fidelity bonds, the case should be decided under standards applied to "statutory bonds", generally finding in favor of insurance. The court rejected Gasslein's one case in support of that theory finding that it dealt with a statutorily required liability insurance policy rather than a statutorily required fidelity bond.⁴⁸ Unfortunately, the court's decision to reject Gasslein's final theory on the ground that their legal authority applied only to statutorily required liability insurance policies leaves open the possibility that the court could find in favor of direct action by a third-party in the case of a statutorily required fidelity bond.

Statutory Bonds

In straining to find coverage where seemingly none would otherwise exist, Court's have often resorted to finding that a particular fidelity bond is "statutory" in nature, and therefore entitled to liberal interpretation in favor of coverage. A relatively recent case finding in favor of a third-party demonstrates just how far Court's have been willing to go. In *Anchor Equities Limited v. Pacific Coast American*,⁴⁹ the Supreme Court of New Mexico found coverage in favor of a third-party under a fidelity policy where no coverage appeared to exist based upon the theory that the bond at issue was "statutory" in nature. In *Anchor Equities*, the third-party at issue transferred

⁴⁶ *Id.*, at 374.

⁴⁷ *Id.*, at 375.

⁴⁸ *Id.*, at 376, rejecting *Pickett vs. Carolina Casualty Insurance Company*, 734 F.2d 792 (11th Circuit 1984).

⁴⁹ 737 P.2d 532 (1987).

money to the insured escrow company to finance the purchase of certain real property. Unfortunately for the third-party, the escrow agent misappropriated the funds. Without asserting a claim or filing suit against the escrow agent itself, the third-party filed a direct action against the fidelity bond carrier. The court found that a direct action by the third-party was proper, applying a three part test typically limited to general liability policy cases. Under the test, the court found third-party action to be proper due to the fact that (a) the insurance was procured as a result of statutory requirement, (b) the public was an intended beneficiary of the required insurance, and (c) there was no language in the enabling statute prohibiting direct action by third-parties.

Another “direct action” case relying on the “statutory” nature of bonds that held in favor of the insurer is *Hatch v. Reliance Insurance Company*.⁵⁰ In *Hatch*, the third-party plaintiff was an investor in the insured, and asserted a claim based on alleged fraud by employees of the insured. Hatch sought and obtained a default judgment against the insured, which, subsequently, was placed into receivership. Thereafter a receiver appointed for the insured filed a claim seeking to recover losses due to the fraud of the insured’s various employees. Hatch filed a garnishment action against the insurer claiming priority on the bond proceeds based on his prior judgment. Somewhat involved litigation ensued requiring numerous re-hearings and re-filing of suit. All of which ultimately led to the third-party Hatch’s right to sue being terminated.

In *Foster v. National Union Fire Insurance Company*,⁵¹ the 8th Circuit found in favor of a third-party asserting a direct claim under a brokerage firm’s fidelity bond under the “statutory bond” analysis. In *Foster*, the court found that Arkansas public policy and law dictated that fidelity coverage be provided to third-parties and thus direct action was appropriate. Notwithstanding the fact that the plain and unambiguous language of the bond precluded such action by third-parties, the court found that the “language of the bond, however clear, cannot control where it is contrary to the law.”⁵²

In contrast to *Foster* and the other “statutory bond” decisions cited above, at least one court has disallowed the theory in favor of insurers. In *School Employees Credit Union v. National Union Fire Insurance Company*,⁵³ a Kansas District Court rejected a direct action filed by a third-party under the school’s fidelity bond noting that fidelity bonds indemnify the insured only, not third-parties, from losses. The third-party claimant was a credit union claiming to have been defrauded by a securities dealer in connection with the purchase and sale of certain securities. A direct action was filed by the credit union against the fidelity bond carrier for the securities dealer. The court noted that securities dealers were required to provide a “surety bond” to protect third- parties, unless certain professional requirements were met. Under such circumstances, a fidelity bond could be substituted, so it would afford the necessary protection. Securities dealers who met the pre-conditions to the requirement of having a surety bond were automatically recipients of insurance coverage provided through various professional organizations. Accordingly, the court reasoned the fidelity bond requirement was not designed to protect the public and the *Foster* court’s “public policy” analysis and “statutory bond” analysis were rejected.⁵⁴

⁵⁰ 758 F.2d 409 (9th Cir. 1985).

⁵¹ 902 F.2d 1316 (8th Cir. 1980).

⁵² 902 F.2d at 1319.

⁵³ 839 F.Supp 1477 (D. Kan. 1993).

⁵⁴ Another theory of recovery by third-parties under fidelity bonds is so-called “direct action” statutes existent in many states. In most cases, such statutes were promulgated for purposes of covering direct action under general liability insurance policies and not fidelity bonds. The latter, being policies of indemnity, have been found by a number of

Garnishment

An often used theory of recovery for direct third-party claims is “garnishment”. In fact, one of the earliest cases discussing, and rejecting an insurer’s liability for third-party losses involved garnishment. In *Ronnau v. Caravan International Corp.*,⁵⁵ the court reviewed a claim involving losses sustained by a third-party due to the fraudulent representations of an employee of the insured. The third-party had filed a lawsuit against the insured and obtained a default judgment. The third-party claimant then obtained an order of garnishment against the insurer that had denied liability under the original bond. The third-party claimant argued that the fidelity bond was, at least in part, a general liability policy based upon the language in the policy which provided coverage for losses of property for which the insured was “legally liable”.⁵⁶ The court in *Ronnau* rejected the argument finding that third-party losses were not covered under the policy, relying on the language from Couch on Insurance, discussed above.

Numerous cases have since adopted the *Ronnau* decision in support of rejecting similar claims. In *Foxley Cattle Co. v. Bank of Meade*,⁵⁷ a claim was asserted by a third-party who had been injured by the false representations of the President of the Bank of Meade regarding the ownership and location of certain cattle. After obtaining a jury verdict against the Bank of Meade, and thus firmly establishing legal liability of the insured, the third-party filed a garnishment action against the insurer. The Supreme Court of Nebraska, quoting extensively from *Ronnau*, rejected the garnishment action.⁵⁸

A more recent case from the State of Michigan also rejected the “garnishment” theory. In *Bralko Holdings Limited v. Insurance Company of North America*,⁵⁹ the third-party had previously obtained a consent judgment against the insured for illegal commissions paid in connection with the sale of certain partnership interests by the insured. The third-party then filed a garnishment action against the broker’s fidelity bond, arguing that the policy language which provided that the insurer would “indemnify and hold harmless” the insured from any losses due to fraudulent and dishonest acts by its employees gave rise to coverage for third-party losses. Relying on the *Ronnau* decision, the Michigan Court of Appeals rejected this argument. The court also flatly rejected the third-parties’ claims that the bond’s “hold harmless” language somehow transformed a fidelity bond into a general liability policy. However, the court made a troubling statement in its opinion to the effect that “at most” the bond would insure against a loss sustained only when a judgment was actually paid.⁶⁰ Standing alone, the court’s statement could be argued to stand for the proposition that recovery for third-party losses was possible once a judgment had been paid.

states not to be covered by such statute. See, e.g., *Three Garden Village vs. United States Fidelity and Guarantee*, 318 Md. 98, 567 A.2d 85 (1989) (Maryland); *175 East 74th Corporation vs. Hartford*, 51 NY 2d. 585, 416 NE 2d. 584, 435 N.Y.S. 2d. 584 (NY App. (1980)) (New York); *Anderson vs. Employers Insurance*, 826 F.2d. 777 (8th Circuit 1987) (Iowa); and *LaCour vs. Merchants Trust and Savings Banks*, 153 So.2d. 599 (LA. APP. 1963) (Louisiana).

⁵⁵ 205 Kan. 154, 468 P.2d 118 (1970).

⁵⁶ *Id.*, at 121.

⁵⁷ 196 Neb. 587, 244 N.W.2d 205 (1976).

⁵⁸ Interestingly, the Bank of Meade ultimately paid the judgment owed to the third-party and, thereafter, filed its own claim under the subject bond. The Court rejected the insured’s claim that the prior actions filed by the third-party had dealt only with the right to garnishment as opposed to the Bank’s right to assert a claim under the bond, and dismissed its case based upon the doctrine of *res judicata*.

⁵⁹ 193 Mich. at 157, 483 N.W.2d 929 (1992).

⁶⁰ *Id.*, at 161.

The court, however, specifically rejects any such interpretation in a related footnote.⁶¹ In sum, the *Bralko* decision appears to stand for the proposition that third-party losses resulting from an insured's liability to others are not covered based upon the narrow interpretation of the bond coverage provisions, as well as ownership language deemed to cover property in the insured's custody and possession regardless of the insured's liability therefor.

Assignment

Assignment is a method sometimes used by strangers to a fidelity bond in an attempt to obtain recovery where it would otherwise be disallowed. Anti-assignment provisions in fidelity bonds, including modern Commercial Crime Policies, are generally upheld. However, in the event no such provision is included in a bond, assignment may prove to be a successful theory of recovery for a third-party claimant in a direct action against the insurer.

An older case supporting direct action by a third-party based upon an assignment is *Fidelity and Deposit Company of Maryland v. Reid*.⁶² In *Reid*, stock was purchased by a customer of the insured but never delivered to her. In fact, the stock was stolen by one of the insured's employees. The customer sued the insurer on the grounds that its bond obligated the insurer to hold the insured harmless against direct loss. The customer initially prevailed at the first trial; however, the insurer successfully appealed based on the theory that "as a general rule the only party entitled to sue on [a fidelity bond] is the indemnitee or some one [sic] in his right, such as his assignee."⁶³ Although the insured had subsequently filed bankruptcy, following appeal of the first trial, the third-party sought and obtained an assignment of the insured's right of action under its bond from the bankruptcy trustee. Thereafter, the third-party amended her pleadings and restated a claim against the insurer based upon her assignment rights. The third-party ultimately prevailed based upon the theory of "assignment" as described by the appellate court in its earlier decision, with the trial court also finding that the insured had sustained a recoverable "loss" due to the fact that it was unable to deliver the stock to the customer as required by contract.

VI. CONCLUSION

In order to successfully make a claim under most modern fidelity bonds, an insured must establish that any loss it suffered is a "loss" of its own covered property as defined in the policy, and that the loss was suffered as a direct result of a risk insured against under the bond. While other aspects of the bond's provisions may be of importance in analyzing any claim, careful analysis of the causation element cannot be overlooked as a significant tool in properly closing any claim. Despite several aberrational cases finding coverage for seemingly indirect losses, a review of the cases in this area appears to continue to support the intentions of the drafters of modern fidelity products that, in analyzing third-party losses, "direct' means 'direct' and ... in the absence of a third party claims clause [such policies do] not provide indemnity for vicarious liability for tortious acts of [insureds'] employees."⁶⁴

⁶¹ *Id.* at 161, Note 3.

⁶² 150 S.W.2d 836 (Texas Civ. App. 1941).

⁶³ *Id.*, at 837.

⁶⁴ *Vons Companies v. Federal Insurance Company*, 212 F.3d at 492.

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