

**FIFTEENTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
CONFERENCE**

**St. Pete Beach, Florida
APRIL 15th-16th, 2004**

**MANIFEST INTENT AND THE FINANCIAL
BENEFIT REQUIREMENT IN INSURING AGREEMENT A**

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**MANIFEST INTENT AND THE FINANCIAL BENEFIT
REQUIREMENT IN INSURING AGREEMENT A**

By: David T. Knight

This article addresses the history and subsequent case law developments in respect to the financial benefit required in order to invoke coverage under Insuring Agreement A in the standard form of fidelity insurance policies currently in use today.

A. HISTORICAL BACKGROUND.

In 1976, in response to case law that was finding employee dishonesty coverage in cases far beyond the bounds of embezzlement and related schemes for which coverage was intended, the Surety Association of America introduced a new bond form, providing employee dishonesty coverage for:

Dishonest or fraudulent acts as used in this Insuring Agreement shall mean only dishonest or fraudulent acts committed by such employee with the manifest intent:

- a. To cause the Insured to sustain such loss; and
- b. To obtain financial benefit for the Employee, or for such other person or organization intended by the Employee to receive such benefit, other than salaries, commissions, fees, bonuses, promotions, awards, profit sharing, pensions or other employee benefits earned in the normal course of employment.

It was hoped that this new bond form would ameliorate the effect of previous cases in which courts expanded the concept of employee dishonesty to the point where the term included any act of the employee (or any failure to act), regardless of motive. Resolution Trust Corporation v. Fidelity and Deposit Company of Maryland, 205 F. 3rd 615, 638 (3rd Cir. 2000). The new bond form was adopted with the hope that the revised language would clarify the Surety Association's long standing intent to limit losses to claims in which the culpable employee acted with the intent or purpose to gain a financial benefit at the expense of his employer. Id.

In 1986, Form 24 of the Financial Institution Bond was adopted, and added the following wording to the new "manifest intent" standard adopted ten years earlier:

However, if some or all of the Insured's loss results directly or indirectly from Loans, that portion of the loss is not covered unless the Employee was in collusion with one or more parties to the transactions and has received in connection therewith, a financial benefit with a value of at least \$2,500.00.

B. EARLY CASES.

Following the industry's adoption of the new "manifest intent" bond form a series of early cases addressed the issue of what conduct was required in order to satisfy the financial benefit requirement under Insuring Agreement A. In order of decision, these cases are:

1. *Mortell v. Insurance Company of North America*, 458 N.E. 2d 922 (Ill. App. 1983).

In this case, a licensed futures commodity merchant hired an individual to be the manager of its Dallas branch office. Under this manager's direction, certain commodities were sold in which it was alleged that customers were given false and deceptive representations about profit expectations, as well as being encouraged to buy immediately so as to take advantage of favorable market prices. A number of customers sued and the commodities firm then sought to obtain indemnity from its fidelity bond insurer for the amounts paid in settlement of these customers' claims.

Discovery showed that the firm's salesman did not gain anything except commissions from the unauthorized trading alleged in the customers' complaints. As a consequence, the court affirmed a summary judgment which had been entered in favor the fidelity insurer.

2. *Benchmark Crafters, Inc. v. Northwestern National Ins. Co. of Milwaukee*, 363 N.W. 2d 89 (Minn. App. 1985).

In this case, the employer was a manufacturer of stuffed animal toys. It hired a national marketing and sales manager who submitted approximately \$350,000 worth of false orders from various different accounts. This was discovered and a claim against the fidelity bond was filed for losses sustained by the employers in working to fulfill these orders. The court held that the manufacturer's argument that the employee's tenure of employment before the fraud was discovered constituted the "financial benefit" which satisfies subparagraph (b) of the policy was misplaced because "the terms of the insurance contract clearly exclude this argument."

3. *Morgan, Olmstead, Kennedy & Gardner, Inc. v. Federal Insurance Co.*, 637 F. Supp. 973 (S.D. N.Y. 1986).

A securities brokerage firm sought coverage under its fidelity bond for losses sustained as a result of the allegedly fraudulent and dishonest acts of one of its employees. In this case, the language used in the bond form was slightly different than the standard form Insuring Agreement A, providing coverage for:

“Any dishonest act or acts committed by any Employee for the purpose of making an improper personal financial gain or such Employee, where ever committed and whether committed alone or in collusion with others.A salary, commissions, fees or other emoluments, including raises and promotions associated with employment received from the Assured by an Employee, Partner or Processor, shall not constitute improper personal financial gain.”

One of the brokerage firm’s employees allegedly engaged in a scheme to inflate earnings by failing to mark certain lines to the market price in a somewhat complicated transaction. In so doing, the Employee was able to overstate the profits of the loan department in which he worked, and thereby increase his compensation under the profit sharing arrangement he had with his employer.

The Court determined that the only reward obtained by the employee for engaging in this scheme was an “emolument” within the meaning of the exclusionary language of the bond, and therefore found no coverage for the loss.

4. *Hartford Accident & Indemnity Insurance. Co. v. Washington National Ins. Co.*, 638 F. Supp. 78 (N.D. Ill. 1986).

In this case, two employees of a life insurance company sold policies and received commissions. The percentage of commissions received in the first year could equal or exceed one hundred percent of the first year’s annual premium. In a scheme, two of the insurance company salesmen sold policies to individuals and assisted them in making payments of the first year’s premiums.

The scheme was ultimately uncovered and the insurance company suffered a significant loss. The issue was whether the bond “excludes coverage for losses from an employee’s intent to receive ‘commissions’, also excludes coverage for losses from an employee’s intent to receive ‘commissions not earned in the normal course of employment.’”

Both parties apparently agreed that the salesmen’s intent was to receive commissions not in the normal course of employment. The court then spent a great deal of time analyzing the issue and ultimately determined that the commissions were excluded.

5. *James B. Lansing South, Inc. v. National Union Fire Ins. Company of Pittsburgh, PA.*, 801 F.2d 1560 (9th Cir. 1987).

In this case, a California manufacturer and seller of stereo equipment and speakers hired an individual as its sales representative. He was paid a commission for sales that he made. The employee engaged in a fraudulent scheme concerning the sales of products, and received a 7% commission on those sales.

The employer attempted to argue that the fraudulent sales of equipment were “not in its normal course of business”, but the court observed that under this theory the exclusion of commissions would have no meaning or effect because fraud or dishonest acts are not usually part of a normal course of business. The court then proceeded to hold that the commission payments were excluded by the unambiguous provisions of the policy.

6. *Municipal Securities, Inc. v. Insurance Company of North America*, 829 F.2d 7 (6th Cir. 1987).

In this action, Municipal Securities, Inc. was a broker/dealer specializing in government bonds. It hired an employee to serve as a trader. Her job was to buy government securities and locate buyers who would purchase them. In order to minimize the company’s exposure to loss from fluctuations in the market prices the company fixed \$2 million as the maximum amount of securities that the employee could hold in inventory, without the written approval of a supervisor. She then proceeded to far exceed the limit without approval, and in fact, concealed it from her employer by failing to report certain purchases and reporting sales that had not yet occurred. The court stated that “her evident motive was to cover up – and eventually recoup – trading losses that might threaten her job security and affect her commissions.” By the time her misdeeds were discovered, she had run up a position of some \$56 million in securities, which were closed out at a loss of almost \$1 million.

The Sixth Circuit agreed with INA’s position that the employee had no “manifest intent” to “cause the Insured to sustain” a loss. Her manifest intent was to make money, and not cause her employer to lose money. Furthermore, with respect to commissions she had earned, but to which she was not entitled by virtue of her infidelity, the court found that the definition of “dishonest or fraudulent” acts only extend to those dishonest or fraudulent acts committed with the “manifest intent ... to obtain financial benefit for the Employee ... other than commissions ... earned in the normal course of employment.” By virtue of this, the court found that the policy language explicitly excluded “dishonest or fraudulent acts intended to enhance the employee’s regular compensation.”

C. CASE LAW DEVELOPMENT IN THE 1990’S.

As can be seen from the preceding section, after a sluggish start in the early 1980’s, followed by a burst of activity beginning in the mid-1980’s, the case law development of the issue of financial benefit continued apace during the 1990’s. Those decisions, in order are:

1. *Federal Deposit Ins. Corp. v. St. Paul Fire & Marine Ins. Co.*, 738 F. Supp. 1146 (M.D. Tenn. 1990), aff’d in part, vacated in part by 942 F.2d 1032 (6th Cir. 1991).

In this case, a bank was taken over by the FDIC, who then filed claims against the bank's fidelity insurer on several matters. One of these claims involved a scheme, whereby the bank's president made consulting payments to another company for consulting services regarding marketing and insurance programs which were never performed. The outside entity was owned by the bank's president and another individual, who also was a shareholder of the holding company of the bank. Once the monies were received by the third party, they were then split between the two individuals. The bank president testified that he authorized the payments to the consulting corporation because he was personally and financially indebted to the other shareholder of the holding company. The bank's board was unaware of these payments. With respect to this scheme, the Court observed the policy language excluding coverage for "salaries, commissions, fees, bonuses, promotions, awards, etc. only applies when two conditions exist: (a) the employer knowingly pays funds directly to the employee; and (b) the employee defrauds the employer into believing that the employee has earned the funds as compensation for his work." Applying this test, the court found that there was coverage because the bank board did not knowingly pay the consulting fees in question directly to the president, nor was it aware that the president had any beneficial interest in the consulting corporation. As a consequence, the Court found that the board "could not have believed that the payments had been earned ... as compensation." Thus, the payments did not constitute "salary, commissions, fees,"

In a second scheme, the president caused subordinates to issue to him payments in the amount of \$10,000 per month as "executive committee fees." Those bank officers that were aware of this practice were the bank's comptroller and the vice president. Nevertheless, neither of these individuals knew that the payments were unauthorized. Moreover, the president later admitted in testimony that he constituted the entire "executive committee, and he performed no services for the bank beyond those for which he was compensated as bank president." Again, the fidelity insurer sought to bar recovery regarding this claim based upon the exclusion from the bond's coverage for "salaries, commissions, fees" As with the first claim, the Court applied the test articulated above and found that since the bank board was unaware that the president was the recipient of the funds paid as "executive committee fees", it could not knowingly have authorized the payments to increase the president's compensation. Accordingly, the receipt of the "executive committee fees" constituted pure embezzlement, and was not within the exclusion of "employee benefits earned in the normal course of employment."

2. *North Jersey Savings and Loan Association v. Fidelity and Deposit Company of Maryland*, 660 A. 2^d 1287. (Sup Ct N.J. 1993).

In this case, a savings and loan association entered into a servicing arrangement with another institution which had obtained a series of high risk mortgages, paying interest at the rate of 18%. Under the arrangement between the savings and loan and the servicer, the servicer sold the mortgages to the savings and loan association and agreed to pay it 13.75% interest, while the servicer would retain the "spread" between that amount and the 18% payable under the mortgage as its fee.

After a substantial number of defaults and losses occurred with respect to these mortgages, the savings and loan association accused the servicer of engaging in a scheme to defraud it by virtue of establishing inappropriate loan to value ratios for the loans and either misrepresenting or concealing this information from the savings and loan association. In addition, it was alleged that the servicing company in connection with obtaining the mortgage loans had violated several provisions of state and federal law.

The savings and loan association had a "servicing contractor's rider" on its fidelity insurance company policy, and made a claim under that policy. After surveying a number of cases around the country that had generally addressed the question of the financial benefit necessary to find coverage, the court found that under the servicing contractor's rider the savings and loan association needed to show a manifest intent of "the servicing contractor to cause a loss to the insured and to obtain a financial benefit for itself or another." The court further found that the financial benefit for the servicing contractor had to be something more than the normal compensation to which it was entitled pursuant to its contractual arrangement with the savings and loan association.

Applying this standard, the court found that the serving contractors only financial benefit was the "spread" it received between the contracted rate of interest under the mortgage and the lesser amount of interest which it had agreed to pay to the savings and loan association. As a consequence, the court found that this did not invoke coverage under the fidelity policy.

3. *Estate of Jordan v. Hartford Accident and Indemnity Co*, 844 P. 2d 403 (Wash. En Banc1993).

In this case a professional escrow agent company, licensed as such under the state of Washington law, employed a vice president who was also a shareholder of the company. This individual was charged with overseeing accounts that were being administered on behalf of various individuals, estates and guardianships. During the course of his employment, this individual embezzled money from some of the trust accounts under his supervision and diverted those funds into the company's operating account in order to cover general operating expenses of the company. His scheme was eventually uncovered, forcing his company into bankruptcy. The bankruptcy trustee pursued a claim against the fidelity insurer.

One of the defenses raised by the fidelity insurer was that the vice president in question did not embezzle the trust funds for the purpose of obtaining a financial benefit for himself, apart from his normal employment benefits. The Washington Supreme Court, sitting En Banc, disagreed. It found that the exclusionary language did not apply for two reasons. First, the vice president was personally liable for some of the debts of his employer, for which monies were being diverted from trust accounts to operating

accounts in order to satisfy. Thus, he benefited from the embezzlement in ways other than normal employment benefits. Secondly, "his embezzlement helped keep [his employer] afloat, and benefited [employee] in his role as a shareholder of the company." As a consequence, the court found that the theft of the trust funds provided a financial benefit to the employee other than his normal employee benefits.

4. *Auburn Ford Lincoln Mercury, Inc. v. Universal Underwriters Ins. Co.*, 967 F. Supp. 475 (N.D. Ala. 1997).

In this case, a Ford dealership employed a fleet manager to sell fleet cars. One of the programs that was being administered by the manufacturer dealt with government entities, and allowed qualifying government entities to purchase cars for a lower price. The fleet manager improperly entered into a number of transactions in which he sold vehicles pursuant to this program to people who were not authorized to participate. As a consequence, substantial chargebacks were made to the account of the car dealership by Ford. The car dealership then filed a claim against its fidelity insurance carrier.

Based upon the evidence, the court found that the allegedly dishonest acts of the fleet manager only served to increase his commissions. He received no other financial benefit. The dealership argued, however, that the fleet manager would not have received the additional commissions "in the normal course of his employment." The court disagreed, finding that the phrase, "in the normal course of employment" only serves to define the type of excluded benefits. The court quoted with approval from *Hartford Accident*, 638 F. Supp. at 83-84:

Unearned salaries and commissions are nevertheless still salaries and commissions and therefore belong to the generic category of employee benefits that are normally earned in the course of employment.

The court stated that the phrase does not mean that "allegedly dishonestly obtained commissions are included within the policy." As a result, the court found that the claim was excluded by the terms of the policy.

5. *Dickson v. State Farm Lloyds*, 944 S.W. 2d 666 (App. Ct. Tex. 1997).

In this case, a physician filed suit against his fidelity carrier based upon the claim that several of his employees had lied about the number of hours they worked in order to collect extra salary. Finding that the "uncontradicted summary judgment evidence established that Dickson's claims were based on employee dishonesty aimed only at obtaining additional wages by lying about the time they had worked...", the court found that "this loss was clearly outside the coverage of the present policy."

6. *First Philson Bank v. Hartford Fire Insurance Co.*, 727 A. 2d 584 (Sup. Ct. Pa. 1999).

In this case, a bank extended a floor plan financing loan to an automobile dealership. The dealership, however, engaged in a scheme to defraud the bank by misrepresenting cars that had been purchased by the dealership and in some cases, created wholly fictitious vehicles. It was alleged that one of the bank's employees colluded with the dealership. A claim was asserted against the bank's fidelity insurer.

The Pennsylvania court of appeals affirmed a summary judgment in favor of the insurer with respect to the claim regarding the bank employee's collusion with the car dealership, finding that there was not sufficient evidence of a financial benefit to the bank employee. Specifically, the court rejected the bank's allegations that the employee received the requisite financial benefit by virtue of his receipt of bank stock through his employee stock option plan, salaries and bonuses from the bank, because the employee "earned his ESOP stock, salary and bonuses in the normal course of his employment," and because "these employee benefits are clearly excluded from Bond coverage, Bank's claim lacks merit."

D. RECENT DECISIONS.

The pace of decisions in this area has, if anything, accelerated since 2000, with seven new reported cases. These decisions, in order are:

1. *Resolution Trust Corp. v. Fidelity & Deposit of Maryland*, 205 F. 3d 615 (3d Cir. 2000).

In this action, certain employees of a bank were employed by the wholly-owned subsidiary of the bank, and were tasked with overseeing the lending relationship with various customers of that subsidiary. The employees learned that the bank was in the process of selling the wholly-owned subsidiary, and to induce the employees to stay with the wholly-owned subsidiary through the closing, the bank entered into an arrangement whereby it provided a "golden handcuff" agreement to each of the employees, which paid them a substantial bonus for remaining employed through closing of the sale. In addition, these bank employees were also attempting to secure employment contracts with the prospective purchaser. Thereafter, it became apparent that one of the major customers of the bank was experiencing very significant problems in meeting its loan obligations, and in fact, had admitted to these bank employees that it had "relocated" some of the collateral that was supposedly securing the bank's loans. This information was allegedly concealed from the bank until after the closing of the sale of the wholly-owned subsidiary. At that closing, the employees in question received substantial one-time payments pursuant to the "golden handcuff" agreements.

Later events revealed that the loan customer in question defaulted on its loan obligations and caused the bank to suffer a very substantial loss.

The bank was taken over by the FDIC and a claim was pursued against the fidelity insurance carrier. After a lengthy analysis of the “manifest intent” standard, in which the court was called upon to predict the interpretation that the Supreme Court of New Jersey would give to the language, it sided with the Second, Fourth and Fifth circuits in adopting the standard that the term “manifest intent” as used in the fidelity provisions of the bond requires “the insured to prove that the employee engaged in dishonest or fraudulent acts with the specific purpose, object or desire, both to cause a loss and obtain a financial benefit.” After finding that a fact issue existed with respect to whether there had been a sufficient showing that the employee acted with the requisite manifest intent to cause the employer a loss, the court turned its attention to subsection (b) of the fidelity bond coverage – whether the employee’s misconduct was undertaken with the manifest intent to obtain a financial benefit for the employee or a third person.

In this case, the plaintiff, RTC, first contended that the employees in question committed their fraudulent or dishonest acts because they were motivated by a desire to obtain the golden handcuff payments. The Court reviewed the district court’s decision in which it had held that payments of this type were not the type of financial benefits excluded under subsection (b). The district court had found that “the uniquely final ‘one-time only’ nature of these payments prevents them from being classified as bonuses” which meant that the “handcuff payments” certainly do not fall within the category of the types of compensation excluded from coverage under subsection (b).

The Third Circuit disagreed with the district court’s finding and found that one-time payments, such as the golden handcuff payments, fall squarely within the definition of “bonuses” or “awards” or alternatively qualify “as a type of benefit ‘earned in the normal course of employment’.”

In reaching this decision, the Court specifically found that the phrase “earned in the normal course of employment” cannot be viewed as a limitation on the exclusion. Rather, it was intended to provide a broader exclusion as has been found by most of the cases deciding the issue. In summary, the Court found that:

We understand the exclusion found in subsection (b) to eliminate coverage where the insured’s theory is that the employees’ purpose in engaging in the misconduct that caused the loss was to receive some kind of financial benefit that, generally speaking, the insured provides knowingly to its employees as part of its compensation scheme, and as a result of the employment relationship.

Finally, the Court rejected the argument that the exclusion precludes coverage only for losses caused by an employee’s desire to obtain “honestly” earned commissions, finding that the term “earned” encompasses financial benefits both fraudulently obtained and honestly earned from the employer.

As a second position, the RTC argued that the employees in question engaged in their dishonest and fraudulent acts with a manifest intent to secure “future lucrative employment opportunities” from the bank that was acquiring the wholly-owned subsidiary. The Court did find that the factual issues existed with respect to this argument, because there was evidence that the employees acted “with the purpose of obtaining for themselves more lucrative employment elsewhere, including large salaries and bonuses with the prospective purchaser.” Since this type of motivation was not excluded under subsection (b) the Court found that it could provide a basis for coverage.

2. *Klyn v. Travelers Indemnity Co.*, 709 N.Y. S. 2d 780 (S. Ct. 2000).

In this case, an employer’s comptroller embezzled funds from a payroll account over which he had sole control by secretly and fraudulently paying himself “unauthorized and excessive salary, commissions and bonuses.” The Court specifically rejected the fidelity insurer’s contention that recovery under the policy was barred because of the subsection (b) provisions excluding coverage for “salaries, commissions, fees, bonuses, ... or other benefits earned in the normal course of employment.” In so finding, the Court found that the employer “did not knowingly make the payments to the comptroller as compensation for his employment.” The Court based its decision on the Third Circuit’s opinion in *Resolution Trust Corp. v. Fidelity & Deposit Co. of Maryland*, 205 F.3d 615, 649 (3d Cir. 2000), as well as *FDIC v. St. Paul & Marine Insurance Co.*, 738 F. Supp. 1146 (M.D. Tenn. 1990) wherein it quoted with approval from that case that:

Where the employer does not knowingly pay funds to its employee under the belief that the funds have been honestly earned, but is instead unaware of the employees’ receipt of the funds or paid as the lost funds for some purpose other than the employees’ compensation, the employee has committed pure embezzlement, which is recoverable under the [policy].

3. *Cincinnati Ins. Co. v. Tuscaloosa County Parking & Transit Authority* 827 So. 2d 765 (Ala. 2002).

In this case, the County Parking & Transit Authority was a public organization created to receive federal funding for operating a public transportation agency in an Alabama community. Among others, the authority employed an executive director and assistant director. These employees engaged in various schemes to steal money from their employer. The one at issue in this case, concerned the employees’ issuing payroll checks to themselves in excess of their agreed upon salaries. These checks were co-signed by a member of the Board of Directors. The Court made a point of noting that the directors of the Authority served on a “volunteer basis,” presumably without compensation.

The trial court entered summary judgment in favor of the Authority on its claim against its fidelity insurer. The Alabama Supreme Court affirmed this, and rejected the fidelity insurer's claim that these funds were paid under the guise of "salaries" and therefore excluded under the policy provisions.

Interestingly, like virtually every other court which considered this policy language, the Alabama Supreme Court found that the language in question was not ambiguous. Nevertheless, it reached a very different conclusion from the majority of the cases concerning the issue. In this regard, the Court engaged in a tedious process of analyzing the definition of key words within the policy.

First, it examined the word "salary" and after looking at the dictionary definition concluded that the funds in question were not "salary" because those funds exceeded the fixed "salary" which was to have been paid to these employees. Next, the Court considered the term "earn" in the context of the language that "salaries" are "employee benefits earned in the normal course of employment." Again, looking to the dictionary definition, the Court concluded that these payments in question were not "earned," rather they were "stolen." In this regard, this Court stated that this clause, "as read by an ordinary person, draws the distinction between 'employee benefits earned in the normal course of employment,' which are not covered by the policy, and things such as embezzlements, kick-backs, payoffs, and general theft, which are covered."

It is clear from the decision that the Court was well aware of the body of decisions throughout the country that differed with their view. These were dismissed as being either "not relevant," or failing to "consider the plain meaning of the word 'salaries'."

4. *Jamie Brooke, Inc. v. Zurich-American Insurance Co.*,
748 N.Y. S. 2d 5 (S. Ct. 2002).

In this case, the insured was in the business of manufacturing clothing. One of its employees forged purchase orders for garments that were never ordered by plaintiff's customers. The garments were manufactured, and upon learning of the false orders, the manufacturer had to sell the garments below cost, thus sustaining a loss. A claim was then filed against the fidelity insurance policy. The fidelity insurer defended based upon the language in the policy which excluded coverage for "salaries, commissions, fees, etc."

Based upon the evidence presented, the Court found that the employees' dishonesty was motivated by a desire to obtain a bonus, and since the employees' dishonesty was apparently motivated by the hope of obtaining some form of extra compensation for the extra volume, the exclusion applies, and denied coverage.

5. *Mortgage Associates, Inc. v. Fidelity & Deposit of Maryland*, 129 Cal. Rptr. 2d 365 (App. Ct. 2002).

In this case, a mortgage lender's employees and third parties entered into a scheme, whereby the mortgage lender made loans for more than the value of the mortgaged properties. The employer concluded that two of its employees were knowing participants in the scheme and "believed" that they had received "significant financial benefits" as payment for their participation in the fraudulent scheme.

The fidelity insured denied coverage and stated that the mortgage company had no evidence to support its claim that its employees had received a financial benefit independent of their regular compensation. By way of response, the mortgage company contended that the financial benefit requirement is an exclusion rather than a limitation on coverage, and that it was therefore the burden of the insurance company to prove that the exclusion applied.

After analyzing the policy language, the Court found that the financial benefit requirement is plainly part of the insuring agreement, not an exclusion, and saw no ambiguity in the language of the bond.

6. *ABC Imaging of Washington, Inc. v. The Travelers Indemnity*, 820 A.2d 628 (Md. App. Ct. 2003).

In this case, the insured was engaged in the business of printing, blue-printing and graphics. As a result of a data entry order, a clerk of the company erroneously entered the pay rate of another employee in the company records. The generation of payroll checks was outsourced and the payroll company, based upon the erroneous information, issued payroll checks to the employee that far exceeded his approved compensation.

When the company discovered the error, management confronted the employee in the matter "whereupon [he] ran from the premises, never to return." Needless to say, he did not voluntarily pay the money back. A claim was made against the fidelity insurer, who denied coverage stating that the funds came into the employee's possession within the "salary" exclusion of the policy.

The Court stated that there are two elements of proof required in order to recover under the employee dishonesty features of the bond: "First, there must be proof of the employee's 'manifest intent' to cause loss to the employer, and second, that the employee, by his dishonest actions, did obtain a benefit for himself 'other than salaries, etc.'" The Court found that even assuming that the employee's actions were dishonest, the dishonesty "was not in the creation of the over-payments, but rather in his retention of the funds with the knowledge that he was not entitled to the excess payments."

The Court ultimately found that there was no coverage and in the process analyzed a number of cases from other jurisdictions dealing with the subject. In distinguishing the *Klyn* case from New York (709 N.Y. S. 2d 780), the Court agreed with the fidelity insurer's contention that unlike the New York case, this case involved monies paid to the employee that were not the result of an overt dishonest act by the employee, but the result of an error by the employer or its agent, substituting the weekly pay rate for the hourly rate. Whether the court would have reached a different result under facts like those in *Klyn*, where the employer was not aware of the fraudulent payments being made to the employee, is not clear. It is clear, however, that the Court specifically rejected the decision of the Alabama Supreme Court in *Cincinnati Insurance Co. v. Tuscaloosa County Parking & Transit Authority*, 827 So. 2d 765 (Ala. 2002), dismissing it as standing "for what is clearly the minority view."

7. *Performance Autoplex II, Ltd. v. Mid-Continent Casualty Co.*,
322 F.3d 847 (5th Cir. 2003)

In this case, a company that operated a number of new car dealerships discovered a fraudulent scheme by one of its employees. This employee embezzled funds by giving herself and another employee unauthorized pay increases. The pay increases should have been approved by the general partner and general manager, but no such approval was ever sought. From the court's opinion it is not clear if the employee had control over the payroll process to the exclusion of her superiors.

The employer made a claim against its fidelity insurance carrier, which declined the claim because the benefit the employee received was a salary increase, thus falling outside the scope of coverage. In reviewing the issue, the Court made a survey of cases on both sides of the issue. Fortunately for the fidelity carrier, one of the cases supporting its denial was a Texas appellate decision, *Dickson v. State Farm Lloyds*, 944 S.W. 2d 666 (Tex. App. 1997). The Court concluded that the Texas Supreme Court would likely adopt this reasoning if it were to consider the issue. Accordingly, the Court adopted its reasoning, but went further stating:

Looking at the plain language of the policy, the interpretation rejecting coverage makes sense. If 'in the normal course of employment' means 'not obtained through employee dishonesty' the policy excluding salaries would become mere surplusage. That is, the language excluding salaries presumes that there are acts of employee dishonesty that result in increased employee benefits that the insured and insurer agreed to exclude from coverage. Further, as one court said, 'unearned salaries and commissions are nevertheless still salaries and commissions and therefore belong to the generic category of employee benefits that are normally earned in the course of employment.'

E. RECONCILIATION.

Now for the hard part – how can we reconcile or harmonize these decisions? Most are easy, but several present real challenges. There are four separate groupings into which these cases seem to fall.

1. Straightforward Analysis. In this group, the cases were clear and little analysis was required.

a. *Mortell v. Insurance Company of North America*, 458 NE. 2d 922 (Ill. App. 1983.) In this case the salesman did not gain anything from the defrauded brokerage firm customers other than commissions. Accordingly, the claim was denied.

b. *Benchmark Crafters, Inc. v. Northwestern National Insurance Co. of Milwaukee*, 363 N.W. 2d 89 (Minn. App. 1985). In this case false orders were placed by a salesman. The court rejected arguments of the employer that the employee's continued compensation was a covered financial benefit.

c. *Morgan, Olmstead, Kennedy & Gardner, Inc. v. Federal Insurance Co.*, 637 F. Supp. 973 (S.D. N.Y. 1986). A securities brokerage firm employee who falsely inflated his department's earnings in order to be entitled to bonuses was not a covered claim.

d. *Municipal Securities, Inc. v. Insurance Company of North America*, 829 F.2d 7 (6th Cir. 1987). The employee of a broker-dealer of government securities, who only received commissions for purchases of bonds exceeding her authority did not present a claim for which coverage was available.

e. *North Jersey Savings and Loan Association v. Fidelity and Deposit Company of Maryland*, 660 A. 2^d 1287. (Sup Ct N.J. 1993). A securities trader that exceeded her authorized trading limit was motivated by earning additional commissions, and did not present a covered claim.

f. *Dickson v. State Farm Lloyds*, 944 S.W. 2d 666 (App. Ct. Tex. 1997). A claim stemming from dishonest employees who lied about their hours in order to collect more salary was not covered under the fidelity bond.

g. *First Philson Bank v. Hartford Fire Insurance Co.*, 727 A. 2d 584 (Sup. Ct. Pa. 1999). A claim that a dishonest employee, whose financial benefit was to receive more employee stock options, salaries and bonuses from his employer, was not a covered claim.

h. *Jamie Brooke, Inc. v. Zurich-American Insurance Co.*, 748 N.Y. S. 2d 5 (S. Ct. 2002). A claim that a dishonest employee who forged purchase orders for merchandise that were never ordered in order to obtain bonuses, was not a covered claim.

i. *ABC Imaging of Washington, Inc. v. The Travelers Indemnity*, 820 A.2d 628 (Md. App. 2003). A claim wherein an employee received excessive salary compensation because of a mistake by a data entry clerk and who refused to return the money when confronted, did not present a valid claim.

2. Case which have considered the policy language concerning benefits that where normally earned in the normal course of employment. This group of cases analyzed the bond terms concerning whether the exclusionary language applied to dishonestly obtained benefits.

a. *Hartford Accident & Indemnity Insurance. Co. v. Washington National Ins. Co.*, 638 F. Supp. 78 (N.D. Ill. 1986). The court found that “unearned salaries and commissions are nevertheless still salaries and commissions and therefore belong to the generic category of employee benefits that are normally earned in the course of employment.” Thus, the court concluded that “because the word ‘commissions’ includes ‘unearned commissions,’ the losses due to an employee’s ‘unearned commissions’ are excluded from indemnification.”

b. *James B. Lansing South, Inc. v. National Union Fire Ins. Company of Pittsburgh, PA.*, 801 F.2d 1560 (9th Cir. 1987). Here, the court rejected the argument that the dishonest employee’s fraudulent sales of equipment, for which he only received his authorized compensation, were not in the normal course of business, and therefore subject to indemnity.

c. *Auburn Ford Lincoln Mercury, Inc. v. Universal Underwriters Ins. Co.*, 967 F. Supp. 475 (N.D. Ala. 1997). In this case, the employer argued that even though a dishonest employee’s acts were motivated by a desire to increase his compensation, he would not have received the commissions “in the normal course of his employment.” The court rejected this argument because that phrase “serves only to define the type of excluded benefits. This phrase does not mean that allegedly dishonestly obtained commissions are included within the policy.”

d. *Resolution Trust Corporation v. Fidelity and Deposit Company of Maryland*, 205 F. 3rd 615, 638 (3rd Cir. 2000). Here, a dishonest employee whose alleged financial benefit was receipt of a one-time “goal and handcuff” bonus to remain working until his employer merged with another company, was a type of benefit earned “in the normal of employment.” In so ruling the court stated that this phrase is not a limitation of the exclusionary language. The court further stated that the intent of the exclusionary language is to exclude claims where “the employees’ purpose in engaging in the misconduct that caused the loss, was to receive some kind of financial benefit that, generally speaking, the insured provides knowingly to its employees as part of its compensation scheme, and as a result of the employment relationship.” The court rejected the argument that the exclusionary language only applies to cases where the employee honestly earned the compensation he was paid, finding the term “earned” encompasses both benefits fraudulently and honestly obtain.

e. *Cincinnati Ins. Co. v. Tuscaloosa County Parking & Transit Authority* 827 So. 2d 765 (Ala. 2002). In this case, the Alabama Supreme Court took an entirely different approach to the analysis of the exclusionary language in subsection (b), in a case where the executive and assistant directors of a public transit authority caused unauthorized and excessive compensation checks to be paid to themselves. Like other courts addressing the same language, the court found the language to be unambiguous. From that point, the Alabama Supreme Court took a marked departure from existing case law. It focused on the dictionary definitions of “salaries” and “earned,” finding that these terms meant a “fixed compensation” that was paid “for the performance of service, labor or work.”

The court concluded that the excessive “salary” received by the dishonest employees was not consistent with the dictionary definition of “salary” because it “excluded the fixed compensation that was to be paid for the services provided,” and that the term “earned” connoted honestly earned benefits. As a consequence, the Alabama Supreme Court dismissed the existing body of case law to the contrary as being either irrelevant or failing to consider the plain meaning of the words in the bond.

f. *Performance Autoplex II, Ltd. v. Mid-Continent Casualty Co.*, 322 F.3d 847 (5th Cir. 2003). In this case an employee embezzled funds by giving herself and another employee unauthorized pay increases. The court rejected an argument that these moneys were not paid in the normal course of employment stating that “the language excluding salaries presumes that there are acts of employee dishonesty that result in increased employment benefits that the insured and insurer agreed to exclude from coverage.

3. Instances in which the person receiving the extra compensation “controlled” the payment process without the knowledge of his superiors. This group of cases deals with situations in which the dishonest employees control the payroll process and are able to pay themselves unauthorized compensation without the knowledge of their superiors.

a. *Federal Deposit Ins. Corp. v. St. Paul Fire & Marine Ins. Co.*, 738 F. Supp. 1146 (M.D. Tenn. 1990)., aff’d in part, vacated in part by 942 F.2d 1032 (6th Cir. 1991). This is a case where the president of a bank, without the knowledge or consent of the bank’s board of directors, caused fraudulent payments to be made to himself for extra duties he did not perform, and to a consulting firm of which he was part owner. The court found that this presented a valid claim, adopting the test that recovery is only barred when two conditions are present:

- ii. The employer knowingly pays funds directly to the employee;
- and
- ii. The employee defrauds the employer into believing that the employee has earned the funds as compensation for his work.

b. Resolution Trust Corporation v. Fidelity and Deposit Company of Maryland, 205 F. 3rd 615, 638 (3rd Cir. 2000). Although dicta, the 3d Circuit Court of Appeals made a broad statement that the intent behind the subsection (b) exclusionary language is to bar claims where “the employee’s purpose in engaging in the misconduct that caused the loss, was to receive some kind of financial benefit that, generally speaking, the insured provides **knowingly** to its employees as a part of its compensation scheme...” (emphasis added).

c. *Klyn v. Travelers Indemnity Co.*, 709 N.Y. S. 2d 780 (S. Ct. N.Y. 2000). In this case, a dishonest comptroller of a company embezzled funds from a payroll account over which he had sole authority by secretly paying himself unauthorized and excess salary, commissions and bonus. Because the employer did not “knowingly” make the payments, the court found that the exclusionary language in subsection (b) did not apply.

d. *Cincinnati Ins. Co. v. Tuscaloosa County Parking & Transit Authority* 827 So. 2d 765 (Ala. 2002). In this case, the executive and assistant directors of a public entity dishonestly paid themselves unauthorized and excessive compensation by issuing payroll checks to themselves. Although the checks were co-signed by a member of the board of directors, the court took pains to point out the board members served as “volunteers,” and presumably served without compensation. Although the court did not articulate as a specific reason for its decision that the supposedly uncompensated, volunteer board members could not fairly be considered effective guardians of the authority’s finances, as would usually be found with directors of for profit corporations, that is likely a significant reason behind the court’s decision finding that coverage existed because the unauthorized portions of the compensation were not “earned”.

4. Benefits falling outside of those enumerated in the exclusionary language. This group of cases deals with situations where the financial benefit derived by the dishonest employee is considered to be just outside of the exclusionary language, and appears, at least in some of the cases, to represent some good lawyering by the insured’s counsel.

a. *Estate of Jordan v. Hartford Accident and Indemnity Co.*, 844 P. 2d 403 (Wash. En Banc1993). Here, the court found that a dishonest employee that embezzled funds from trust accounts that his company was administering, and placed them in the Company’s operating accounts to pay company obligations, was motivated by a desire:

- i. to pay company debts, for which the employee also had personal liability, and
- ii. to keep the company solvent, in order to protect the employee's stock ownership in the company.

In these circumstances, the court found that the exclusionary language was inapplicable.

b. Resolution Trust Corporation v. Fidelity and Deposit Company of Maryland, 205 F. 3rd 615 (3rd Cir. 2000). In this case, a dishonest employee who was motivated by a desire to secure "future lucrative employment opportunities" from the company that was acquiring his employer, and the court held that this fell outside of the exclusionary language, and therefore presented an appropriate claim under the fidelity coverage.

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