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FIDELITY COVERAGE:
THE UNABATED "DIRECT LOSS" DEBATE CONTINUES

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I. INTRODUCTION

The narrow focus of this paper is a review of the development of the "direct loss" requirement in Fidelity coverage[1] in which the Fidelity insurer is asked to indemnify its insured for losses sustained by third parties. In one common scenario, a dishonest employee participates in conduct which causes loss to a third party, which in many cases is a customer of the insured. In these cases the insured pays the third parties' loss, either voluntarily or involuntarily, and then seeks indemnity from its Fidelity insurer. This representative fact pattern, and the legal issues it presents, comes up time and again, and the results from courts continue to be mixed.

"Direct loss" cases of this nature are, therefore, not surprisingly a common topic at meetings such as this.[2] Accordingly, this paper will address the case law developments during the past 10 years or so, with particular emphasis on the trend of recent decisions.

II. CAUSATION

Once a loss by an insured has been established, the next step in the coverage analysis is to determine whether the loss was directly caused by the dishonest employee. That is, is there a direct causal link between the dishonest conduct of the employee and the economic loss to the insured. While this sounds straightforward, and easy to apply in principle, it has proven to be anything but that. At the heart of the debate between insurers and the insureds over the meaning of "direct loss" in the context of third party losses, is the question of what level of causation is required to invoke coverage.

A. Insurers' View.

Fidelity insurers have both long intended and contended that employee dishonesty coverage be restricted to the act of embezzlement, and a small group of closely associated dishonest acts,[3] that cause a direct economic loss to the insured's assets, not those of third parties. In short, the Fidelity bond is intended only to impose on the insurer an obligation to indemnify the insured, and not to provide it with a liability insurance policy to protect it against the claims of third parties. A number of courts have adopted the insurer's position. Illustrative are the following cases:

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[1] The standard language found in most commercial Fidelity policies, with some differences in wording, provides that the insurer will pay for "loss resulting directly from" the conduct of a dishonest employee.

[2] See for example More "Illinois Court Rejects Coverage for Third Party Losses and Proximate Cause Standard in Fidelity Cases" Fall, 2004 Fidelity and Surety Committee Newsletter; and Wood and Ramos "Does Direct Really Mean Direct? A Survey of 'Direct Loss' Cases Under Traditional Fidelity Bonds", presented at the 2003 Southern Surety and Fidelity Claims Conference.

[3] CEGRBC Mortgage Company v. National Union Fire Insurance Company of Pittsburg, 812 N.E.2nd 728, 732 (App. Ct. Ill. 2004) (insurer contends that for losses to be "direct" they must be "immediate, definite, and ascertainable, such as in cases of theft or embezzlement.").

1. Tri City National Bank v. Federal Insurance Company, 675 N.W.2d 617 (Wis. Ct. App. 2003), where the state court stated:

> [W]e pause to explain the differences between Fidelity bonds and liability insurance policies. As noted, a Fidelity bond is a form of insurance . . . . but, a Fidelity bond is not a liability insurance policy. A Fidelity bond differs from a liability policy of insurance because of the risk being insured. . . . A Fidelity bond is an indemnity contract that 'guarantees reimbursement for losses sustained by the insured resulting from the dishonesty of the insured's employees.' . . . 'Insurance covers the liability of the insureds to a third party, while a Fidelity bond covers the loss of property owned by the insureds or held by the insureds, as a consequence of employee dishonesty'.

2. Cargill, Inc. v. National Union Fire Insurance Company of Pittsburgh, 2004 WL51671 (Minn. Ct. App. 2004):

> A Fidelity bond is not ordinarily liability insurance which covers third parties who have been injured by the insured's conduct. . . . The difference between liability insurance and Fidelity bonding is that 'insurance covers the liability of the insureds to a third party, while Fidelity bonding covers a loss of property owned by the insureds or held by the insureds, as a consequence of employee dishonesty.'

3. Fireman's Fund Insurance Company v. Special Olympics International, Inc., 346 F.3d 259 (1st Cir. 2003):

> Courts interpreting Fidelity policies similar to those at issue in this litigation have consistently concluded that the insured does not suffer a loss unless the insured's assets, and not those of a third party, are reduced because of the offending employee's wrongful conduct.

B. Insured's View.

In contrast to the position taken by Fidelity insurers on the restrictions that the "direct loss" requirement places upon the scope of coverage, insureds invariably argue that when it is held accountable to a third party as a direct result of improper conduct by its dishonest employee, a "direct loss" has occurred. In other words, the employee's conduct directly and proximately results in the loss to the insured, which is the normal proximate cause standard adopted by most courts in tort actions.

Not surprisingly, a number of courts have adopted the insured's position as well. Illustrative, are the following cases:

1. Federal Deposit Insurance Corporation v. National Union Fire Insurance Company of Pittsburgh, 205 F.3d 66 (2d Cir. 2000):

> The FDIC was entitled to recover under the bond because the FDIC showed that the bank would not have issued its second loan if it had known of [the employee's] wrongdoing.

2. Resolution Trust Corporation v. Fidelity & Deposit Company, 205 F.3d 615, 656 (3d Cir. 2000):

> The phrase 'losses resulting directly from' requires, for purposes of indemnification, that the losses be 'proximately caused by' the fraudulent or dishonest acts of the employee which form the basis of the insured's coverage claim.

3. First National Bank of Louisville v. Lustig, 961 F.2d 1162, 1167 (5^{th} Cir. 1992):

> A loss is directly caused by the dishonest or fraudulent act within the meaning of the Bond where the bank can demonstrate that it would not have made the loan in the absence of the fraud.

C. Middle View.

Some courts have managed to find a middle position between the competing extremes urged by insureds and insurers on this issue.

1. A good example is found in Peoples Bank & Trust Company v. Aetna Casualty and Surety Company, 113 F.3d 629, 634 (6^{th} Cir. 1997), where the court stated:

> As a practical matter, however, 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 an inference (in the absence of direct evidence) that dishonest employees harbored such knowledge or expectation.

2. Another example of this view is found in Shoemaker v. Lumberman's Mutual Casualty Co., 176 F. Supp. 2d 449, 458 (W.D. Pa. 2001) where the court stated:

> In Peoples Bank, the court declined to adopt a "categorical holding" that "fraudulent activities toward a third party" can never "be equated with 'manifest intent' to harm the" insured … this court too declines to make such a blanket ruling, as it agrees with Peoples Bank that coverage could conceivably attach where strong evidence exists that the employee "knew or expected that the loss would migrate to" the insured.

III. RECENT TREND

Within the last 15 year period there has been no shortage of cases addressing the "direct loss" requirement in Fidelity policies as it relates to third party losses. While there are probably marginally more cases siding with the insurer's position, finding no coverage, as can be seen both in the number of cases and recency of the decisions, no clear-cut trend lines appear.

A. No Liability. Among the more recent cases finding no coverage for third party losses are the following:

1. RBC Mortgage Company v. National Union Fire Insurance Company of Pittsburgh, 2004 WL 1469417 (Ill. App. Ct. 2004). This is not only a very recent decision, but also an excellent result for the Fidelity insurance industry. In this case an employee of a mortgage broker contrived to create false documents for himself and others. These included forged loan packages. The insured then caused these loans, along with many others, to be syndicated. The mortgage broker, itself, did not lend any money and was not exposed in the event of nonpayment of the loans. The mortgage company did, however, warrant that the information submitted in the loan packages was accurate and undertook an indemnity obligation to the parties purchasing the mortgages for losses that were occasioned by false statements. After the subject loans went into default, the fraud was eventually discovered and the third party purchaser made a claim against the mortgage brokerage company. The mortgage brokerage company ultimately settled the cases and then sought indemnity against its Fidelity insurer. The trial court granted the insurer's motion to dismiss.

On appeal the insureds argued that their losses were a direct result of the loan officer's dishonest conduct. The appellate court rejected this, reasoning that the loss did not directly flow from the employee's conduct, but rather from the breach of warranty which the mortgage company extended to the purchaser to whom it sold the mortgages. In its analysis of decisions on this issue from other jurisdictions, the court noted that they were "resoundingly uniform on this issue" in finding no coverage. Finally, the court also specifically noted decisions which had reached a contrary result, and rejected those as being a minority view. Specifically, the court rejected decisions that had adopted a "proximate cause" analysis as "simply . . . too broad to capture accurately the intent behind the phrase 'loss resulting directly from'".

2. Cargill, Inc. v. National Union Insurance Company of Pittsburgh, 2004 WL 51671 (Minn. Ct. App. 2004). In this case an employee of Cargill copied certain types of agricultural products which were apparently the intellectual property of a competing company. Based on the record, there was apparently a great deal of evidence to the effect that Cargill was well aware of the illegality of its practices, but continued them anyway. Ultimately Cargill sold the unit of business that was involved in this matter to Monsanto. Following this sale, the competing business, whose intellectual property had been misappropriated, filed suit against both Cargill and Monsanto. Monsanto, naturally, sought indemnity from Cargill. Cargill eventually settled both claims for an amount in excess of $400 Million. It then sought indemnity against its Fidelity insurer. The claim was denied, following which Cargill filed suit. The Fidelity insurer, National Union, eventually filed a motion for summary judgment, which was granted by the trial court. Cargill's principal contention was that the Fidelity bond provided general liability coverage indemnifying it for indirect losses incurred in defending and settling its claims. The Minnesota court rejected Cargill's position, and affirmed the summary judgment, stating "we conclude that the provision ['direct loss'] unambiguously covers only Cargill's direct losses, not claims arising from a third party's direct losses, and requires that the insured's loss – and not the third party's claim – be directly caused by employee theft in order for coverage to become available. That the insureds may be liable to a third party for a loss of money resulting from employee [theft] does not transform a policy covering the insureds against a direct loss into one indemnifying against liability".

3. Fireman's Fund Insurance Company v. Special Olympics International, Inc., 249 F.Supp.2d 19 (D. Mass. 2003), aff'd on other grounds 346 F.3d 259 (1st Cir. 2003). In this case, an organization designed to raise funds for the Special Olympics employed a manager who conducted unauthorized and fraudulent fund raising over a 7 year period, during which the employee raised over $1 Million which he diverted to his personal use. The Special Olympics organization made a claim against its Fidelity insurer, who then instituted a declaratory judgment action. The Fidelity insurer moved for summary judgment seeking a declaration that its denial of coverage was proper under the terms of the Fidelity policy. The district court granted the insurer's motion for summary judgment on the basis that the insured had not suffered a "direct loss" within the meaning of the Fidelity policy. The court observed that the "paradigmatic example" of a direct loss is when "an employee of the insured . . . embezzles money directly from the insured." In ruling against the Special Olympic Committee, the court stated that "in order to trigger coverage, the assets of the insured must be diminished as a result of the dishonest act of the insured's employee." The court found that the courts had "consistently concluded that the insured does not suffer a direct loss unless the insured's assets, and not those of a third party, are reduced because of the offending employee's wrongful conduct." Since the dishonest employee was diverting contributions made by third parties, the court concluded that it was the third parties who had suffered a loss, and that no diminution in the insured's assets had occurred.

4. Tri City National Bank v. Federal Insurance Company, 675 N.W.2d 617 (Wis. Ct. App. 2003). In this case, two employees of the insured bank conspired with an outsider to fraudulently obtain mortgage loans for insufficiently funded borrowers who did not otherwise qualify for the loans. The scheme operated by having the outsider recruit a buyer for property owned by him or one of his businesses and having the buyer apply for a mortgage loan with one of two mortgage companies. The conspiring employees would then send a phony verification to the mortgage company indicating that the buyer had an account at the bank with sufficient sums to cover the down payment. Once the mortgage was approved, one of the two conspiring bank employees would issue bank cashier's checks for the recruited borrower to use at the closing, despite the lack of sufficient funds at the bank, giving the false impression that the borrower was using personal funds for the down payment. Once the closing took place, the outside co-conspirator took the loan proceeds to the bank, paid for the cashier's check, and paid off the bank employees. At least 75 loans were procured in this fashion. Following the detection of the fraudulent scheme, the mortgage companies sued the bank to recover their losses. The bank settled the claims by the mortgage companies for $4.25 million, and then sought reimbursement from its Fidelity insurer. In that subsequent action, the court rejected the bank's principal contention that the language "direct loss" is ambiguous, and held that the loss in question was not direct. The court observed that it was only after the mortgage defaults occurred, some 3 years after the employees' deceitful actions, that the bank's liability to the mortgage companies came into being. "The losses did not result directly from dishonest or fraudulent acts committed by the employees, as the losses did not exist until the unsuitable mortgage holders defaulted on their loans." In some industry friendly *dicta*, the court also reviewed the history of the revisions to the Standard Form 24 Financial Institution Bond and found that "given the history of Fidelity bonds and the reasons behind the revisions, a reasonable banker would not expect coverage for these [third party] losses."

5. Ernst & Young, LLP v. National Union Fire Insurance Company of Pittsburgh, 758 NYS.2d 304 (App. Div. 2003). In this case, Ernst & Young had an employee who stole many millions of dollars in client funds held by Ernst & Young that were being held by it in order to satisfy their clients' tax liabilities. While the insurer paid approximately $4.2 million to its insured, in order to cover the amount of funds actually embezzled, the insurer refused to pay $2.9 million in consequential damages which the insured claimed. These related to interest, penalties, attorneys' fees, internal business costs and other similar elements of damage. Ernst & Young argued that all of these expenses were "direct losses" within the meaning of the policies. The court ultimately rejected this argument and held that these losses were not "a direct loss" of the employee's dishonesty.

6. United General Title Insurance Company v. American International Group, Inc., 51 Fed. Appx. 224, 2002 WL 31554048 (9th Cir. 2002). In this case, a title insurance company employed a title agent who misappropriated escrow account funds. The California Department of Insurance placed the title agent into a conservatorship, and demanded that the title insurance company make good the shortfall in escrow accounts. The title insurance company complied, and then demanded payment from its Fidelity insurer. The relevant policy provision provided coverage to the title

insurance company for a "loss resulting directly from dishonest or fraudulent acts committed by a Title Agent." National Union refused the invitation to indemnify its insured, and the litigation ensued. The California District Court granted the insurance company's motion for summary judgment and the issue went up on appeal to the Ninth Circuit. There, the court concluded that this case was controlled by its earlier decision in Bonds Companies, Inc. v. Federal Insurance Company, 212 F.3d 489 (9th Cir. 2000), and affirmed. Specifically, the court found that "the shortfalls in the escrow account of Universal Title caused injury to third parties", and not to title insurance company.

7. Bonds Companies, Inc. v. Federal Insurance Company, 212 F.3d 489 (9th Cir. 2000). In this case, the insured sought coverage for a $10 Million payment it made to settle two lawsuits in which it was sued under vicarious liability principles for the tortious actions of one of its employees. Those lawsuits were brought by investors who suffered losses due, in part, to the employee's fraud. The Fidelity insurer defended on the basis that the losses suffered by its insured were not "direct losses . . . caused by . . . [the] employee." While the court found that a direct loss to the employer may be caused by the employee's theft of property from the employer, this was not the case in this action. Rather, the loss the employer "suffered resulted from the threat of vicarious liability" for the employee's tort which caused damage to third parties. The court concluded that the Fidelity policy "did not provide coverage for third party claims", and that 'direct' means 'direct' and that in the absence of a third party claims clause did not provide indemnity for vicarious liability for tortious acts of its employee."

8. Williams Electronics Games, Inc. v. Barry, 2000 WL 106672 (N.D. Ill. 2000). In this action, one of the insured's employees bribed an employee of another company in order to have it purchase component parts from the insured at inflated prices. The victimized company sued the insured, who in turn brought his Fidelity insurer into the case seeking a declaration that whatever sums the plaintiff was seeking against it were covered losses under the policy. The district court ruled against the insured, finding that a covered loss is one that involves the direct deprivation of the insured resulting from the unlawful taking of money held by the insured. Under this analysis, the court concluded that any monies the insured was found to owe to the plaintiff would not constitute an unlawful taking of money held by the defendant.

9. Lynch Properties, Inc. v. Potomac Insurance Company of Illinois, 140 F.3d 622 (5th Cir. 1998). In this case, the insured discovered that a bookkeeper employee had misappropriated money from the separate personal bank account of a relative of the insured's president, who was also a customer of the insured. Once it discovered the fraud, the insured reimbursed its customer (i.e., "Mom") for the amounts taken from her, and then sought coverage under its Fidelity policy. The district court granted the insurer's motion for summary judgment, concluding that the insured had not suffered a direct loss under the policy.

On appeal, the court observed that "although employee dishonesty policies may cover the loss of third party property in the possession of the insured, . . . these policies do not serve as liability insurance to protect employers against tortious acts committed against third parties by their employees."

10. Aetna Casualty & Surety Co. v. Kider, Peabody & Co., Inc., 676 N.Y. Supp. 2d 559 (App. Ct. NY 1998). In this case, the issue presented was whether a securities brokerage firm was covered under fidelity bonds for third parties claims arising out of the misconduct of its employees in divulging confidential information relating to corporate takeovers and mergers of the brokerage firm's clients, which resulted in massive insider trading and losses to third parties. The plaintiffs in the underlying action were public shareholders of companies that were the subject of the brokerage firm's insider trading, alleging that they would not have sold at the prices at which the securities were sold if they had the same insider information. The brokerage firm ultimately settled these claims for approximately $200 million, and then sought indemnity from its fidelity insurers. The insurers then commenced a declaratory judgment action, claiming among other things, that the bonds were not liability policies and therefore did not provide coverage for losses sustained by non-insured third parties, and therefore, that no "direct losses" were suffered by the insured. Affirming a summary judgment in favor of the fidelity insurers, the appellate court stated:

> By their clear terms, the fidelity bonds require that the unfaithful employee must intend to cause the employer a loss directly and solely relating to the faithless act, classically describing embezzlement or another type of theft from the employer … . At the other end of the continuum, not triggering fidelity coverage, is the situation where the employee's dishonesty at the expense of a third party is intended to benefit the employer, since the employee's gain results from the employer's gain. Under such circumstances, even if the employer suffers a loss, fidelity coverage is not triggered.

11. Peoples Bank & Trust Company of Madison County v. Aetna Casualty & Surety Company, 113 F.3d 629 (6th Cir. 1997). In this action several officers and directors of the insured bank cheated two bank customers in a business transaction. The customer sued the bank for fraud, and in the fullness of time obtained a large settlement. The bank then sued to recover that loss from its Fidelity insurer. The district court entered summary judgment in favor of the Fidelity insurer. On appeal the court affirmed and stated "as a practical matter . . . losses resulting from frauds on third parties will rarely be covered by Standard Form 24. These policies cover a fraud 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."

B. Liability Found

Among those more recent cases finding coverage for third party losses are the following:

1. Brady National Bank v. Gulf Insurance Company, 94 Fed. Appx. 197, 2004 WL 734884 (5th Cir. 2004). In this case an individual created a Ponzi scheme that eventually defrauded investors of more than $50 Million. Before being arrested he opened a personal checking account with a bank and deposited into it many of the millions of dollars he

had collected from investors. He then purchased certificates of deposit which he used as collateral for various obligations he owed to the bank. The Federal Government arrested the individual, and seized his CDs in foreclosure proceedings. The bank intervened in order to protect its interest in the CDs. Later, the defrauded investors sued both the customer and the bank. The bank ultimately settled with these investors and then sought indemnity from its Fidelity insurance carrier. The district court granted the bank's motion for summary judgment, and an appeal ensued. The Fidelity insurer argued that the harm suffered by the bank resulted from the settlement of the investors' claims instead of its reliance on the stolen CDs. The court rejected this argument finding that "mere settlement of a claim resulting from a harm that would be covered by an insurance policy does not mean the loss came from the settlement as opposed to the covered harm." In other words, the losses were directly caused by the theft because if the CDs had not been stolen when the bank extended credit, the bank would not have had to pay the value of the CDs in settlement with the defrauded investors.

2. Auto Lenders Acceptance Corporation v. Gentilini Ford, Inc., 2004 WL 1811429 (N.J. 2004). In this action an automobile dealership employed an individual who submitted fraudulent applications to a company in order to induce it to finance automobile purchasers by high risk customers. The employee fabricated credit information of the purchasers under the terms of its contract with the finance company; the automobile dealership would be responsible if any of the credit information provided to the financing company was false. After the fraud was discovered, the financing company sued the automobile dealership, who settled the case and then pursued a claim for indemnity against its Fidelity insurer.

The trial court granted summary judgment for the dealer, but the court of appeals reversed finding that there was "no direct loss". The appellate court stated that "to find coverage under these circumstances would convert this direct loss policy to a third party indemnity policy. This was not the risk the insurer agreed to cover nor the coverage purchased by the insured."

From there, the automobile dealership appealed to the New Jersey Supreme Court. While the supreme court found that there were fact issues precluding summary judgment for either side, it held that "resulting directly from" only requires a proximate cause standard. Thus, in an appropriate case a fidelity insurer may be liable for losses to third parties which were caused by the dishonest employee's conduct.

3. Scirex Corporation v. Federal Insurance Company, 313 F.3d 841 (3d Cir. 2002). In this case, the insured was a firm specializing in clinical testing for new drugs. Under one of its contracts for clinical trials, the insured was required to have its nurses observe patients for 8 hours and record their observations every 30 minutes. In many cases, the nurses sent patients home early after as little as an hour, yet they recorded and submitted observations allegedly covering the full 8 hours. These misrepresentations rendered the clinical trials absolutely worthless. Upon learning of the fraud, the insured was required to replicate the studies at no charge to its client. This cost the company $1.2 million which it then sought from its Fidelity carrier. The Third Circuit Court of Appeals reversed the trial judge's finding that there was no "dishonesty" within the meaning of the policy. The court found that the nurses conduct was "ineluctably and irrefutably" dishonest. The court did, however, agree with the district court's finding that the nurses' actions directly caused the insured's loss. In so finding, the court relied on one of its earlier decisions which held that "direct cause of a loss" does not have to be the "sole cause" or "immediate cause", but need only need be a proximate

or substantial cause. Applying this test, the court found that the insured suffered damages in the form of lost salaries of employees that conducted the ruined studies as well as the cost of office space and supplies allocated to the studies, etc. Therefore, the losses sustained by the employer was of its own property, and not that of a third party.

4. Federal Deposit Insurance Corporation v. National Union Fire Insurance Company of Pittsburgh, 205 F.3d 66 (2d Cir. 2000). In this case, a bank entered into limited partnership agreements with a third party concerning real estate developments. Unbeknownst to the bank, one of the principal bank employees, responsible for guiding and protecting the bank in real estate ventures, was a partner with the third party in two separate real estate ventures. In connection with some of these unrelated ventures, the bank employee was told by the third party's employees that the third party had been engaged in improper and illegal activities in real estate projects, including theft from the project which was a joint venture with the bank. The bank employee did not disclose any of this information, nor his affiliation with the third party, to his employer. After litigation was instituted by the FDIC, a successor to the bank, it successfully moved for summary judgment. On appeal, the Second Circuit Court of Appeals affirmed. While the court noted that the bond provided coverage for "loss resulting directly from dishonest or fraudulent acts", and further excluded coverage for "indirect or consequential loss of any nature" the court still found that the direct loss requirement was met. The court distinguished the cases finding no liability in the third party loss context by observing that the loss in the present case is the bank's issuance of its own money, in the form of a loan, and not the replacement of funds to a third party who had sued the bank for an employee's improper actions. The court also appeared to adopt the finding by the Lustig decision by the Fifth Circuit Court of Appeals that a loss is directly caused by the dishonest or fraudulent act within the meaning of the bond where a bank can demonstrate that it would not have made the loan in the absence of the fraud.

5. Resolution Trust Corporation v. Fidelity and Deposit Company of Maryland, 205 F.3d 615 (3d Cir. 2000). In this case, a bank entered into a warehouse credit line with a mortgage company who originated residential mortgage loans and sold them to investors. Certain employees of the bank were aware that the credit line was experiencing serious problems, but did not pass along this information to their superiors. Successive revelations were made indicating the rapidly deteriorating position of this line of credit. It was later alleged by the RTC, after the bank failure, that certain employees of the bank failed to disclose this information, and acted with an intent to obtain or preserve lucrative employment opportunities. The court found that issues of fact existed on whether the subject employees acted dishonestly or with the requisite manifest intent. Turning to the "direct loss" issue, the court noted that the district court had construed the causation language – "resulting directly from" – as meaning the bond covered losses that would not have occurred "but for" the dishonest conduct. In commenting on this, the Third Circuit referred to one of its earlier decisions and concluded that "the conventional proximate cause standard" is "the correct formulation".

6. First National Bank of Louisville v. Lustig, 961 F.2d 1162 (5th Cir. 1992). In this action, a young bank employee assembled various construction loan applications and presented them to his supervisors. In doing so, he misrepresented several facts about these loans, most often falsifying the credit records of borrowers and guarantors. There was also evidence that he misrepresented the identity of permanent lenders, the number of pre-sold

condominiums in the project, exaggerated the size of the borrower's contributions, and falsified various loan related documents. After the fraud was discovered, the bank made a claim against its Fidelity insurer for over $20 million in losses from eight bad loans caused by the dishonest acts of the employee. The district court granted summary judgment in favor of the bank, which was later reversed on appeal. In addressing the issue of causation, the court stated that "[a] loss is directly caused by the dishonest or fraudulent act within the meaning of the Bond where the bank can demonstrate that it would not have made the loan in the absence of the fraud." In other words, if the bank would not have made the loan had it been aware of the true facts misrepresented by its employee, then a "direct loss" occurs.

7. First American State Bank v. Continental Insurance Company, 897 F.2d 319 (8th Cir. 1990). In this case a bank's chief agricultural loan officer engaged in fraudulent loan and commodity/cattle schemes involving two of the bank's customers. False financial statements, falsified loan documents and elaborate withdrawal methods were used to conceal the nature of the transactions. In connection with these transactions, the bank customers borrowed money against their lines of credit and loaned the money back to the agricultural loan officer. The loan officer was unable to repay the loans from the customers, and the customers then threatened legal action against the bank. The bank's counsel advised the bank of its probable liability to the customers, and the bank settled these claims. It then sought indemnity from its Fidelity carrier for its losses, principally involving the unpaid amount of the loans that had been extended to its two customers. The Eighth Circuit Court of Appeals found that the bank had sustained a direct loss as a result of each disbursal of funds under the fraudulent loan scheme engineered by the employee. The court further found that the bank also incurred a loss when it expended funds to effect a settlement with the customers. The court concluded that a "settlement precipitated by claims of fraud or dishonesty and paid to a third party by the insured is a covered loss under Iowa law."

IV. RECONCILIATION.

Is it possible to reconcile these disparate rulings, and from them synthesize a rule that accommodates all viewpoints? In a word, “No.” But can we come close? “Yes.” While not a perfect fit in every case, a large number of the cases finding liability against the fidelity insurers are explainable under the rubric generally followed by the cases finding “no liability” - i.e., the bond only covers the loss of the insured’s assets, and not the assets of some third party. In Scirex, the losses were solely those sustained by the insured – its salaries to the dishonest employees, overhead and expenses. No component of the claim involved the reimbursement to the insured of monies it was required to pay to third parties.

Similarly, in the cases of bank losses from bad loans or related activities, (Brady National Bank, FDIC v. National Union, RTC v. F&D, First National Bank v. Lustig, and First American State Bank), it was the bank’s own money that was lost in the form of extensions of loans of the banks’ monies that would not have been made “but for” the fraud of an employee. This is neatly explained within the framework of the “no liability” cases.

So, we are not really so far apart after all.