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INDIRECT LOSSES ARE STILL NOT COVERED UNDER FIDELITY POLICIES—EVEN AFTER GENTILINI: HOW GENTILINI GOT IT WRONG ON INDIRECT LOSS

PRESENTED BY:

TIM KRSUL
TRAVELERS INSURANCE COMPANY
EDWARD J. COMEY
SHUMAKER, LOOP & KENDRICK, LLP
Bank of America Plaza
101 East Kennedy Boulevard
Tampa, Florida 33602
(813) 229-7600
(813) 229-1660

Indirect Losses Are Still Not Covered Under Fidelity Policies—Even After *Gentilini*: How *Gentilini* Got It Wrong on Indirect Loss

By EDWARD J. COMEY
SHUMAKER, LOOP & KENDRICK, LLP
Tampa, Florida

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TIM KRSUL
TRAVELERS INSURANCE COMPANY[1]

INTRODUCTION

Often times seemingly inconsequential acts can trigger a chain of events that ultimately have a profound impact on our lives. In chaos theory, that phenomenon is known as "sensitive dependence on initial conditions," which posits that small variations of the initial condition of a dynamical system may produce large variations in the long-term behavior of the system.[2] In simpler terms, the phenomenon is known as the "butterfly effect," a name derived from the idea that the flap of a butterfly's wings might create tiny changes in the atmosphere, which, in turn, ultimately may lead to a chain of events resulting in a large-scale phenomenon, such as a tornado.[3]

The seventeenth century poet, George Herbert, perhaps best captured the essence of the "butterfly effect" in his poem "All For the Want of a Nail":

For want of a nail, the shoe was lost;
For want of a shoe, the horse was lost;
For want of a horse, the rider was lost;
For want of a rider, the battle was lost;
For want of a battle, the kingdom was lost;
All for the want of a nail.

Herbert's poem rings true because anecdotal evidence of the "butterfly effect" surrounds us in our daily lives.

For instance, in his book, *More of Paul Harvey's The Rest of the Story*, Paul Harvey, Jr. tells how seemingly minor events kept all eighteen members of the West Side Baptist Church's choir from showing up on time for choir practice one night over fifty years ago.[4] At 7:30 p.m.

[1] **Note**: The views expressed in this article are those of the authors and do not necessarily reflect the views of Travelers Insurance Company or any of its affiliated insurance companies. This article is for general informational purposes only. None of it constitutes legal advice, nor is it intended to create any attorney-client relationship between you and the author. You should not act or rely on this information concerning the meaning, interpretation, or effect of particular contractual language or the resolution of any particular demand, claim, or suit without seeking the advice of your own attorney.
[2] http://en.widipedia.org/wiki/Butterfly_Effect.
[3] *Id.*
[4] Paul Harvey, Jr., *More of Paul Harvey's The Rest of the Story* 3 (Lynne Harvey ed. Bantam Books 1980). The excuses ranged from cars not starting, to the pianist oversleeping, to the pastor's watch being five minutes slow.

on March 1, 1950, the very moment choir practice was to begin that night, a natural gas leak ignited the church's furnace (which, incidentally, was located directly below the choir loft), leading to an explosion that demolished the church.[5] Because of the seemingly minor events that led to each of the choir members being late, none of the choir members were present when the church exploded.[6]

Of course, the "butterfly effect" is not just the subject of poems and short stories, nor is it limited to philosophical debates. The "butterfly effect" has real life implications. Courts and the legal system, for instance, have struggled with the extent to which liability should be imposed (or, perhaps more to the point, not imposed) against individuals whose seemingly minor—albeit wrongful—acts result in substantial harm.[7] Well-known legal scholar William Keeton highlighted this problem when he observed, "[I]n a philosophical sense, the consequences of an act go forward to eternity, and the causes of an event go back to the dawn of human events, and beyond."[8] To provide some limits on liability, courts developed the concept of "proximate cause," which provides a mechanism for determining whether an injury for which damages were being sought was sufficiently related to the initial cause to hold a person liable for the damages incurred.[9]

Similarly, underwriters wrestled for years with how to limit coverage under the Standard Form 24 Financial Institution Bond for third-party losses and consequential damages, the "butterfly effect" that often results from the dishonest or fraudulent acts of an insured's employees. Underwriters ultimately settled on the "direct loss" requirement thirty years ago to compel courts to require insureds to prove a stronger causal link between the dishonest conduct of its employees and the loss suffered by the insured in order for the insured to obtain coverage under the bond. The past thirty years, however, have seen what could be viewed as a gradual erosion by some courts of that causal link through courts' application of a "proximate cause" analysis in lieu of the "direct loss" analysis.

In fact, the New Jersey Supreme Court, in *Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.*, used a "proximate cause" analysis to extend fidelity coverage to reimburse an insured for amounts the insured paid to settle a claim brought by a third party.[10] On the one hand, insurers can dismiss *Gentilini* as a poorly reasoned decision by a results-driven court in one jurisdiction. On the other hand, poorly reasoned decisions by results-driven courts in one jurisdiction can become the law in other jurisdictions if insurers are not careful.

In other words, the legal system has its own version of the "butterfly effect," and insurers can be certain that insureds will rely on *Gentilini* to argue that courts should apply a "proximate cause" analysis when determining whether the insured has suffered a "direct loss," thereby potentially expanding fidelity coverage under the Standard Form 24 Financial Institution Bond to include third-party losses. Consequently, insurers must be prepared to combat *Gentilini*. To

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Id. at 304. Interestingly, that was the only night that each and every choir member had been late for practice on the same evening. *Id.* at 4.

[5] *Id.* at 4-5.

[6] *Id.* at 5.

[7] W. Keeton, *Prosser and Keeton on the Law of Torts* 263, 264 (5th ed. 1984) (discussing the development of proximate cause in tort law).

[8] *Id.*

[9] *Id.* at 263 (explaining that proximate cause requires a reasonable connection between the act or omission of a defendant and the damage the plaintiff has suffered).

[10] 854 A.2d 378 (N.J. 2004).

do so, it is imperative that insurers understand why *Gentilini* "got it wrong" in applying a "proximate cause" analysis.

The first step in understanding why *Gentilini* "got it wrong" is reviewing the history of the "direct loss" requirement. Insurers must then examine the substantial body of case law applying a strict "direct loss" analysis in the context of claims for third-party losses. A thorough understanding of that body of case law, combined with an understanding of the bond-drafting history, reveals that *Gentilini* is based on shaky underpinnings. Taking this approach, insurers should be able to prevent *Gentilini* from having a profound impact down the road—namely, expanding fidelity coverage to include third-party losses in other jurisdictions.

HISTORY OF THE DIRECT LOSS REQUIREMENT

David C. McCullough once remarked that "[h]istory is a guide to navigation in perilous times. History is who we are and why we are the way we are."[11] Although McCullough certainly was not thinking of the Standard Form 24 Financial Institution Bond when expressing his sentiments, insurers and courts alike would do well to heed McCullough's advice. Indeed, it is only by understanding, and more importantly, relying on the bond-drafting history that insurers will be able to demonstrate to courts that applying a "proximate cause" standard undermines the very purpose of the "direct loss" requirement.

The Original "Loss Through" Requirement

The Standard Form 24 Bankers Blanket Bond was first introduced by the Surety Association of America ("SAA") in 1941.[12] Like the 1986 Standard Form 24 Financial Institution Bond, the 1941 Standard Form 24 Bankers Blanket Bond provided coverage for, among other things, (i) fidelity losses; (ii) on-premises losses; (iii) transit losses; (iv) forgery or alteration losses; and (v) losses resulting from forged or counterfeit securities.

Not surprisingly, the initial 1941 Bankers Blanket Bond has seen a number of changes during the past sixty-five years.[13] One of the more significant changes was an amendment to the bond's causation requirement. The initial 1941 Standard Form 24 Bankers Blanket Bond provided coverage for any "*[l]oss through* any dishonest or fraudulent act of any of the" insured's employees. The "loss through" language, which was incorporated into the bond's other insuring clauses as well, remained in effect until 1976, when the SAA introduced Rider SR 6019.[14]

[11] http://en.thinkexist.com/quotes/david_c._mccullough.

[12] For a discussion of the history of the Standard Form 24 Financial Institution Bond, see Edward G. Gallagher, *A Brief History of the Financial Institution Bond*, *in Financial Institution Bonds* 1, 14-38 (Duncan L. Clore ed. 1998) [hereinafter Gallagher, *Brief History*].

[13] *See* Gallagher, *Brief History*, *supra* note 12, at 14; *see also* Robin V. Weldy, *History of the Bankers Blanket Bond and the Financial Institution Bond Standard Form 24 with Comments on the Drafting Process*, in *Second Supplement: Annotated Bankers Blanket Bond*, Ch. 1, at 3 (Harvey C. Koch ed., 1988) [hereinafter Weldy, *Drafting Process*]; Robin V. Weldy, *The Evolution of the Financial Institution Bond: A New Perspective*, at 1 (unpublished paper submitted at the International Association of Defense Counsel mid-winter program in New York, NY on January 26, 1991) [hereinafter Weldy, *Evolution of the Financial Institution Bond*].

[14] *See* Gallagher, *Brief History*, *supra* note 13, at 24-25.

The Advent of the "Direct Loss" Requirement

Rider SR 6019 was promulgated in 1976 to emphasize the concept of "direct loss" in the context of fidelity claims, as well as to limit liability for all consequential damages arising from dishonest of fraudulent acts of the insured's employees.[15] Specifically, Rider SR 6019 provided that the Standard Form 24 Bankers Blanket Bond provided coverage for any "[l]oss *resulting directly* from one or more dishonest or fraudulent acts of" the insured's employees. Thus, after 1976, it was no longer sufficient for an insured to show that it had suffered a "loss through" the dishonest or fraudulent acts of its employees; instead, the insured had to show a "direct" causal link between the loss sustained by the insured, on the one hand, and the dishonest or fraudulent conduct by its employees, on the other hand.

In 1980, the "loss resulting directly from" language contained in Rider SR 6019 was incorporated into all of the Standard Form 24 Bankers Blanket Bond's insuring agreements. The 1980 amendment was a direct response to the "judiciary's reluctance to *enforce a strong causal link as a condition to recovery*" under the bond.[16] Underwriters were also concerned that courts were viewing causation from a tort perspective.[17] By amending the Standard Form 24 Bankers Blanket Bond, then, underwriters sought to "compel the courts to follow a contract view of causation in dealing with fidelity bond cases," rather than a torts view of causation.[18]

INCONSISTENT APPLICATION OF THE "DIRECT LOSS" REQUIREMENT

Getting the "Direct Loss" Requirement Right

Subsequent to the 1980 amendment to the Standard Form 24 Bankers Blanket Bond, numerous courts adhered to the new "direct loss" requirement.[19] In doing so, those courts have recognized that "[f]idelity [policies] are a form of first party coverage, indemnifying the obligee for its loss and are not a form of third-party coverage, indemnifying the insured for its liability to third persons."[20] For that reason, courts have held that a fidelity policy cannot be deemed to cover general liability for damages owed to independent third-party entities where the fidelity provision at issue limits coverage to "direct losses."[21] To construe fidelity coverage otherwise would be to "transform [an] employee dishonesty fidelity policy into a general liability

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[15] *Id.* at 24; *see also* Robin V. Weldy, *History of Financial Institution Bonds*, in *Bankers and Other Financial Institution Blanket Bonds* 1, 7 (1979) [hereinafter Weldy, *History of Financial Institution Bonds*].
[16] William T. Bogaert & Andrew F. Caplan, *Clause (E): Loss and Causation Under the Financial Institution Bond*, *in Financial Institution Bonds* 381, 382 (Duncan L. Clore ed. 1998) (emphasis added) [hereinafter Bogaert & Caplan*, Loss and Causation*].
[17] *See* Bogaert & Caplan, *Loss and Causation*, *supra* note 16, at 382.
[18] *Id.* (citing James F. Crowder, *On Premises Coverage*, in *Financial Institution Bonds*, § E at 2 (1992 ABA National Institute, Harvey C. Koch and Duncan L. Clore eds.))
[19] *See, e.g., RBC Mortgage Co. v. Nat'l Union Fire Ins. Co.*, 812 N.E.2d 728 (Ill. App. Ct. 2004) *United Gen. Title Ins. Co. v. Am. Int'l Group, Inc.*, 51 Fed. Appx. 224, 2002 WL 31554048 (9th Cir. 2002); *Bonds Cos., Inc. v. Federal Ins. Co.*, 212 F.3d 489 (9th Cir. 2000); *Lynch Props., Inc. v. Potomac Ins. Co.*, 140 F.3d 622 (5th Cir. 1998); *Peoples Bank & Trust Co. v. Aetna Casualty & Surety Co.*, 113 F.3d 629 (6th Cir. 1997). For a discussion of cases applying the "direct loss" requirement to hold that third-party losses are not recoverable under fidelity policies, see David T. Knight, *Fidelity Coverage: The Unabated "Direct Loss" Debate Continues*, Sixteenth Annual Southern Surety and Fidelity Claims Conference (April 2005).
[20] *Three Garden Village L.P. v. United States Fidelity & Guar. Co.*, 567 A.2d 85, 93 (Md. Ct. App. 1989).
[21] *Atlas Metals Prods. Co. v. Lumberman's Mutual Cas. Co.*, 829 N.E.2d 257, 262 (Mass. App. Ct. 2005); *see also Fireman's Fund Ins. Co. v. Special Olympics Int'l, Inc.*, 346 F.3d 259, 263 (1st Cir. 2003) (holding that "courts typically deem third-party losses as outside the coverage of fidelity policies").

policy, spreading risk exposure to a class of independent third-party business entities and persons far beyond the single named insured signatory to the policy."[22]

For example, the Ninth Circuit Court of Appeals, in *The Vons Cos., Inc. v. Federal Insurance Co.*, held that the "direct loss" requirement contained in an employee dishonesty policy prevented an insured from recovering amounts due to a third party.[23] In that case, the insured sought to recover amounts it paid to a third party pursuant to a settlement agreement between the insured and the third party.[24] The settlement agreement arose out of a lawsuit filed by the third party against the insured to recover losses the third party sustained as a result of a fraudulent scheme perpetrated by one of the insured's employees.[25]

The executive protection policy in *Vons* provided coverage for (i) "direct losses of Money . . . caused by Theft or forgery by any Employee" of the insured and (ii) "direct losses caused by forgery" of certain covered documents.[26] The insured in *Vons* argued that it was entitled to recover its losses because section 11 of the Policy specifically provided that "coverage shall apply only to Money, Securities, or other property owned by the Insured or *for which the Insured is legally liable*."[27]

The *Vons* court, however, expressly rejected the insured's argument. The *Vons c*ourt initially noted that the "legally liable" language was contained in the policy's interest clause, not the insuring clauses.[28] By contrast, the insuring clauses provided that the insurer was only liable for "direct losses" to the insured caused by the employee's dishonesty, not for vicarious liability for losses suffered by others arising from the insured's employee's tortious conduct.[29] The *Vons* court went on to hold that "'direct' means 'direct' and that in the absence of a third party claims clause, [the insured's] policy did not provide indemnity for vicarious liability for tortious acts of its employees."[30]

The Other Approach: What Direct Loss Requirement?

"Let's not and pretend we did" are undoubtedly words all children have heard from their parents at some point in their lives in response to a request to which the child's parents do not want to be bothered—usually a request that the parents believe is not in the best interests of the child. Unfortunately, those words could just as easily be the response by a number of state and federal courts to insurers' insistence that courts apply the "direct loss" requirement in fidelity bond cases. Indeed, several courts have opted to apply a "proximate cause" standard for determining causation under the guise of applying the required "direct loss" analysis.

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[22] *Atlas Metal Prods.*, 829 N.E.2d at 262.
[23] 212 F.3d 489, 492-93 (9th Cir. 2000); *see also RBC Mortgage Co. v. Nat'l Union Fire Ins. Co.*, 812 N.E.2d 728 (Ill. Ct. App. 2004) (stating that "[i]f an employee's dishonesty causes losses to a third party, which then leads to litigation concluding in a judgment or settlement, the insured has not incurred a 'direct loss' under a fidelity bond; the insured's loss is 'indirect' and the third party's loss is 'direct'").
[24] *Id.* at 492-93.
[25] *Id.* at 491.
[26] *Id.*
[27] *Id.* (emphasis added).
[28] *Id.*
[29] *Id.*
[30] *Id.*; *see also RBC Mortgage Co.*, 812 N.E.2d at 737 (holding that "[t]o equate 'loss resulting directly from' with 'loss proximately caused by' requires a strained reading of 'direct loss,' which is a much narrower concept than 'proximately caused loss'").

Few courts, however, have been as bold as the court, in *Jefferson Bank v. Progressive Casualty Insurance Co.*, in eschewing the "direct loss" requirement in favor of a "proximate cause" analysis.[31] *Jefferson Bank* involved an insured's attempt to recover losses under Insuring Agreement (E) of the Standard Form 24 Financial Institution Bond. The losses sustained in *Jefferson Bank* centered around a purported first mortgage on real property that an individual borrower pledged as security for a loan the individual obtained from the insured.[32] At closing, the individual borrower brought along a woman claiming to be a notary to notarize the borrower's signature on the mortgage.[33] It later turned out that the borrower had pledged the same property as security for several other loans, and the woman accompanying the individual borrower was not in fact a notary.[34]

When the borrower defaulted on the loan, the bank filed a claim against its banker's blanket bond, claiming that the bank was entitled to recover under Insuring Agreement (E) because the forged notary signature prevented the bank from recording the mortgage, thereby preventing the bank from gaining priority as a first mortgage lienholder over a preexisting mortgage holder.[35] The insurer, on the other hand, argued that the forgery did not cause the bank's loss because the mortgage was worthless given the prior mortgage.[36]

On appeal, the *Jefferson Bank* court considered whether the insured's losses resulted directly from the forged notary signature. The *Jefferson Bank* court initially observed that:

> [a]lthough the precise contours of the causation standard applied by the district court are unclear, it appears that it required the plaintiff not only to prove proximate cause, but *also some additional closeness in space and time between the loss and the cause of the loss*.[37]

The *Jefferson Bank* court then "acknowledged that the phrase 'resulting *directly* from' in the policy does suggest a stricter standard of causation than mere 'proximate cause.'"[38] The *Jefferson Bank* court further noted that:

> [a]rguably, the words "resulting directly from" suggest a requirement beyond that the cause be substantial, for the words imply that the loss must flow "immediately," either in time or space, from the forged signature.[39]

So far, so good for the insurer at this point. After all, the insured had argued that the proper causation standard was actually broader than the "proximate cause" standard, while the insurer contended that the "direct loss" standard was narrower than the "proximate cause" standard.

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[31] 965 F.2d 1274 (3d Cir. 1992).
[32] *Id.* at 1275.
[33] *Id.*
[34] *Id.* at 1276.
[35] *Id.* at 1284.
[36] *Id.*
[37] *Id.* at 1281 (emphasis added).
[38] *Id.* (emphasis in original).
[39] *Id.*

But, after first acknowledging that the "direct loss" does suggest a stricter causation requirement, the *Jefferson Bank* court then read the "direct loss" requirement out of the bond and, in its place, substituted a "proximate cause" standard. The *Jefferson Bank* court initially justified its substitution of "direct loss" for "proximate cause" by noting that Pennsylvania state courts, despite the acknowledged difference between "proximate cause" and "immediate cause," have "construed 'direct cause of a loss' in the language of an insurance policy as meaning 'proximate cause of a loss.'"[40] As additional support, the *Jefferson Bank* court explained that:

> "direct cause" or "immediate cause" is a nebulous and largely indeterminate concept, and one that does not enjoy favor under Pennsylvania law. As we have suggested, Pennsylvania, consistent with general notions of proximate causation, requires that plaintiffs in negligence cases show substantiality, rather than immediacy, in order to demonstrate proximate cause. Not only has Pennsylvania failed to adopt the immediate cause standard in tort, but commentators have demonstrated the nearly universal rejection and unworkability of that standard. [41]

The glaring problem with the court's analysis, of course, is that *Jefferson Bank* was not a tort claim, but rather a claim under a financial institution bond. The *Jefferson Bank* court, however, solved that problem by concluding that although two parties might contract for coverage under a standard not recognized under Pennsylvania law, the parties in that case did not intend for an "immediate cause" standard given the "difficulty and confusion" that results from application of such a standard.[42]

GENTILINI: FURTHER EROSION OF THE "DIRECT LOSS" REQUIREMENT?

Since *Jefferson Bank*, a number of courts have erroneously applied a "proximate cause" analysis in place of the required "direct loss" analysis, including in cases where the insured is seeking to recover third-party losses.[43] *Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.* is the most recent in this line of cases.[44] *Gentilini* involved an insured's attempt to recover amounts it paid to a third party to settle a third party's tort and breach of contract claims against the insured.

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[40] *Id.*

[41] *Id.* The court's claim that "proximate cause" should be substituted in place of "direct loss" because, according to the court, "direct loss" is "a nebulous and largely indeterminate concept" is curious. After all, Professor Keeton, in commenting on "proximate cause," noted that "[t]here is perhaps nothing in the entire field of law which has called forth more disagreement, or upon which the opinions are such a welter of confusion. Nor, despite the manifold attempts which have been made to clarify the subject, is there yet any general agreement as to the best approach" *See* Keeton, *Law of Torts*, *supra* note 7, at 263 (citations omitted).

[42] *Id.*

[43] *Brady Nat'l Bank v. Gulf Ins. Co.*, 94 Fed. Appx. 197 (5th Cir. 2004); *Scirex Corp. v. Fed. Ins. Co.*, 313 F.3d 841 (3d Cir. 2002); *Resolution Trust Corp. v. Fidelity & Deposit Co. of Maryland*, 205 F.3d 615 (3d Cir. 2000). *See also* Knight, *Fidelity Coverage, supra* note 19, at 8-11 (discussing case law permitting recovery of third-party losses).

[44] 854 A.2d 378 (N.J. 2004).

Factual Background

The facts of *Gentilini* are straightforward. Gentilini Ford, Inc. ("Gentilini") was a Ford dealership located in New Jersey.[45] As part of its business, Gentilini entered into a "Dealer Agreement" with Auto Lenders Acceptance Corporation ("Auto Lenders"), pursuant to which Auto Lenders had the option to finance certain installment sales contracts.[46] Customers seeking financing for automobile purchases submitted credit applications to Gentilini, which Gentilini then forwarded to Auto Lenders for approval.[47] If Auto Lenders approved the customer's credit application, Gentilini would enter into a retail sales installment contract with the customer, and Auto Lenders would advance to Gentilini the face amount of the promissory note that the customer executed in favor of Gentilini.[48] In exchange for advancing the face amount of the promissory note, Auto Lenders would take assignment of Gentilini's rights under the retail sales installment contract.[49] The Dealer Agreement between Gentilini and Auto Lenders gave Auto Lenders an absolute right of recourse against Gentilini if any of the information provided by Gentilini to Auto Lenders in connection with any credit application was untrue or falsified.[50]

The Litigation

Unbeknownst to Auto Lenders, a Gentilini employee falsified twenty-seven credit applications during an eleven-month period in 1997 to help secure loans for individuals who were otherwise not creditworthy.[51] Auto Lenders later discovered the fraud in early 1998 when it investigated numerous credit applications that it had accepted from Gentilini, and after several of the suspect loans went into default, Auto Lenders sued Gentilini seeking to force Gentilini to repurchase all outstanding installment contracts.[52]

Gentilini, in turn, filed a third-party claim against its insurer Ohio Casualty Company ("Ohio Casualty") seeking to recover under an employee dishonesty extension of the proper insurance section of its commercial coverage insurance policy.[53] The employee dishonesty extension provided coverage for "direct loss of or damage to Business Personal Property and 'money' and 'securities' resulting from dishonest acts committed by any of [Gentilini's] employees."[54] Gentilini sought a defense to Auto Lenders suit and indemnification for its alleged losses.[55] Gentilini and Auto Lenders subsequently entered into a settlement, pursuant to which Gentilini agreed to pay Auto Lenders the total sum of $215,000 in full satisfaction of Auto Lenders suit to enforce Gentilini's contractual repurchase obligation.[56] Gentilini then proceeded on its claim against Ohio Casualty.

[45] *Id.* at 381.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *Id.* at 381-82.
[50] *Id.* at 382.
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.* at 383.
[55] *Id.* at 382.
[56] Id.

Both parties eventually moved for summary judgment, and the trial court entered summary judgment in favor of Gentilini, finding, among other things, that Gentilini suffered a "direct loss" under the employee dishonesty policy by virtue of having to pay Auto Lenders the amounts due under the parties' settlement agreement.[57] Ohio Casualty appealed the entry of summary judgment in favor of Gentilini to the intermediate appellate court.[58]

The Initial Appeal

On appeal, the intermediate appellate court reversed the trial court's entry of summary judgment in favor of Gentilini. In doing so, the appellate court first explained that "'fidelity bonds require that the unfaithful employee must intend to cause the employer *a loss directly and solely relating to the faithless act*.'"[59] The appellate court, adopting the Fifth Circuit Court of Appeal's reasoning in *Lynch Properties, Inc. v. Potomac Insurance Co.*, further explained that:

> [e]mployee dishonesty policies insure against the risk of property loss through employee dishonesty. Liability policies, by contrast, require an insurer to discharge an obligation of the insured to a third party for some act of the insured or its employee. Although employee dishonest 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.[60]

The appellate court then turned its attention to the express language of the policy in rejecting the "proximate cause" analysis for causation proposed by Gentilini. In particular, the appellate court noted that the language of the policy provides coverage to "employers for losses sustained as a *direct result of the illegal acts of employees, without any intervening act*," and courts are required to afford the words "direct loss" their plain and ordinary meaning.[61] Accordingly, the appellate court held that in that context:

> payment by the insured to settle a third party claim does not constitute a direct loss triggering coverage under the policy's "Employee Dishonesty" provisions. To find coverage under these circumstances would convert this direct loss policy into a third party indemnity policy. This was not the risk the insurer agreed to cover nor the coverage purchased by the insured.[62]

Importantly, in rejecting the "proximate cause" analysis and holding that the employee dishonesty policy did not cover third party losses, the appellate court noted that "none of the cases cited by the dissent used a proximate cause analysis to transform direct loss coverage into a third party indemnity policy."[63]

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[57] *Id.*
[58] *See Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.*, 816 A.2d 1068 (N.J. Sup. Ct. App. Div. 2003).
[59] *Id.* at 1072 (quoting *FDIC v. Nat'l Union Fire Ins. Co.*, 205 F.3d 66, 72 (2d Cir. 2000)) (emphasis added).
[60] *Id.* at 1072-73 (quoting *Lynch Props., Inc. v. Potomac Ins. Co.*, 140 F.3d 622, 629 (5th Cir. 1998)).
[61] *Id.* at 1073 (emphasis added).
[62] *Id.* at 1073; *see also RBC Mortgage Co. v. Nat'l Union Fire Ins. Co.*, 812 N.E.2d 728, 733 (Ill. Ct. App. 2004).
[63] *Gentilini*, 816 A.2d at 1074.

The Appeal to the New Jersey Supreme Court

That, however, is not the end of the story. Gentilini appealed the intermediate appellate court's decision to the New Jersey Supreme Court, and the New Jersey Supreme Court took a dramatically different position with respect to the "direct loss" requirement.[64] Taking a page from the *Jefferson Bank* Court's decision, the *Gentilini* court observed that several New Jersey courts previously used a "proximate cause" analysis where an insurance policy required a "direct loss."[65] Of course, the *Gentilini* court recognized that none of the cases upon which it relied involved fidelity coverage. Thus, the *Gentilini* court looked outside of New Jersey:

> New Jersey courts have not considered whether the use of a proximate-cause test for evaluating the nature of a loss is appropriate under an employee dishonesty policy that requires a direct loss. However, the majority of federal courts that have addressed this question have concluded that the term "direct loss" or its equivalent does, in fact, call for the application of a proximate-causation standard.[66]

Based on its reading of the applicable case law, the *Gentilini* court concluded that "[t]here being no sound reason why a proximate cause analysis should not be employed when determining whether a loss is direct under a fidelity insurance policy, we apply that approach to such policies, including the policy at issue in this appeal."[67]

Why *Gentilini* "Got it Wrong"[68]

Contrary to the *Gentilini* court's reasoning, there are plenty of sound reasons why the "proximate cause" standard should not be applied. The most obvious, of course, is that the express language of the Standard Form 24 Financial Institution Bond requires a "direct loss," and courts have widely recognized the difference between "direct loss" (and "immediate cause"), on the one hand, and "proximate cause" on the other hand.[69] Furthermore, the underwriters amended the Standard Form 24 Financial Institution Bond to include the "direct loss" requirement for the very purpose of forcing courts to use a contract view of causation, rather than a torts view of causation (i.e., abandon the "proximate cause" analysis), in determining the scope of fidelity coverage. Thus, the *Gentilini* court needed to look no further

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[64] *Gentilini*, 854 A.2d at 385-87.

[65] *Id.* at 385-86 (citing *Stone v. Royal Ins. Co.*, 511 A.2d 717 (N.J. Sup. Ct. App. Div. 1986); *Karadontes v. Cont'l Ins. Co.*, 354 A.2d 696 (N.J. Sup. Ct. App. Div. 1976)).

[66] *Id.* at 386 (citing *Scirex Corp. v. Fed. Ins. Co.*, 313 F.3d 841, 850 (3d Cir. 2002); *FDIC v. Nat'l Union Fire Ins. Co.*, 205 F.3d 66, 76 (2d Cir. 2000); *Jefferson Bank v. Progressive Cas. Ins. Co.*, 965 F.2d 1274, 1281-82 (3d Cir. 1992)).

[67] *Id.* at 386.

[68] *Gentilini* "got it wrong" for numerous reasons. This paper, however, focuses solely on *Gentilini*'s flawed "direct loss" analysis. For an excellent critique of *Gentilini* on other issues, see Scott D. Baron and Andrew S. Kent, *A Dishonest Employee: A Single Cause of Loss or A Man of a Thousand Occurrences? An Analysis of Single Loss Limitations in Modern Crime Policies in the Wake of Auto Lenders Acceptance Corporation v. Gentilini Ford, Inc.*, http://wolffsamson.client.tagonline.com/news/articles/publish/article_46.shtml.

[69] *See RBC Mortgage Co. v. Nat'l Union Fire Ins. Co.*, 812 N.E.2d 728, 737 (Ill. Ct. App. 2004) (holding that "[t]o equate 'loss resulting directly from' with 'loss proximately caused by' requires a strained reading of 'direct loss,' which is a much narrower concept than 'proximately caused loss'").

than the bond-drafting history to determine the sound reasons for not applying a "proximate cause" analysis, and the *Gentilini* Court's failure to do so is a serious flaw in its analysis.

Gentilini, however, is flawed for yet another reason: the case law upon which the *Gentilini* court relies does not support its holding. For instance, the *Gentilini* Court claims that the majority of federal courts addressing the "direct loss" requirement have concluded that the "direct loss" requirement calls for use of a "proximate cause" analysis. None of the cases upon which the *Gentilini* court relies, however, involve coverage for third party losses—the very issue involved in *Gentilini*. Moreover, at least one of the cases upon which the *Gentilini* court relies—*Jefferson Bank*—does not involve an employee-dishonesty claim, and yet another case—*Federal Deposit Ins. Corp. v. National Union Firs Ins. Co.*—does not even mention the words "proximate cause," much less apply a "proximate cause" standard. Perhaps more important, the *Gentilini* court fails to distinguish any of the cases holding that the "proximate cause" standard is inappropriate in evaluating the "direct loss" requirement in fidelity cases.[70]

Why It Matters That Gentilini "Got it Wrong"

Notwithstanding that the *Gentilini* court's application of the "proximate cause" standard to determine the existence of a "direct loss" is inconsistent with the bond-drafting history and prior case law, a close review of *Gentilini* begs the question: did *Gentilini* ultimately get to the right result for the wrong reason? After all, the *Gentilini* court noted that it was unclear whether Gentilini's settlement with Auto Lenders was an "accurate measure of Gentilini's losses."[71]

In fact, the court, in parts of its opinion, seems to suggest that the loss resulting from the dishonest acts of Gentilini's employees was exchanging automobiles for promissory notes executed by non-creditworthy borrowers—not the amounts Gentilini paid to Auto Lenders. Specifically, the court stated:

> In sum, the measure of the direct loss caused by Carpenter's fraudulent acts, which deprived Gentilini of twenty-seven automobiles, is the loss Gentilini suffered for having undertaken installment sales contracts at higher-than-acceptable levels of risk. The losses it incurred as a result of each fraudulent act, however, depend on whether Gentilini still has an interest in those contracts that have entered default, and Gentilini's ability to mitigate its losses through repossession.[72]

The *Gentilini* Court appears to view that loss, or at least *Gentilini* can be read to limit that loss, to the actual loss "resulting from the default of the purchasers on the sale of the automobiles" to non-creditworthy buyers.[73] Of course, insureds will almost certainly read *Gentilini* much broader based on the court's observation that the dishonest conduct by Gentilini's employees

[70] For example, *RBC Mortgage Co. v. Nat'l Union Fire Ins. Co.*, 812 N.E.2d 728 (Ill. Ct. App. 2004), which was decided nearly two months before *Gentilini*, provides an excellent analysis of the "direct loss" requirement in the context of a claim similar to the claim in *Gentilini*, and *RBC Mortgage* also distinguishes many of the cases relied on by the *Gentilini* Court.
[71] *Id.* at 398.
[72] *Id.* at 399.
[73] *Gentilini*, 854 A.2d at 387.

disrupted the financing arrangement between Gentilini and Auto Lenders, which the court viewed as crucial to the operation of Gentilini's business.[74]

In short, it is certainly open to debate whether the amounts paid to Auto Lenders would have satisfied the "direct loss" requirement had the Gentilini court applied the proper standard. What is not open to debate is that the Gentilini court applied the wrong standard in the first place (i.e., the "proximate cause" standard in lieu of the "direct loss" standard). In the end, it is the improper application of the "proximate cause" standard—not the actual outcome of the case—that should trouble insurers.

CONCLUSION

There is a tendency by insurers and lawyers alike to dismiss bad appellate court decisions as merely being the product of results-driven courts, particularly if the decision is one by a court in a different jurisdiction. After all, bad judicial decisions are everywhere, and *Gentilini* certainly is not the first time—nor will it be the last time—that a court decides there is coverage under an insurance policy before deciding how it will justify that result. Insurers, however, must resist any temptation to casually dismiss *Gentilini* and other cases holding that coverage exists under fidelity policies for third-party losses.

That is not to say that insurers should be fearful: indirect losses are still not covered under fidelity policies, notwithstanding *Gentilini*. Insurers must recognize, however, that *Gentilini* has the potential to gradually expand fidelity coverage to include third-party losses by weakening the strong causal link underwriters intended to make a condition precedent to fidelity coverage by amending the Standard Form 24 Financial Institution Bond to include a "direct loss" requirement.

To combat *Gentilini*, insurers would be wise to heed the advice of David McCullough and use the bond history to navigate courts through the "direct loss" analysis. In particular, insurers should emphasize to courts that underwriters' included the "direct loss" language to force courts to follow a contract—rather than tort—view of causation in dealing with fidelity bond claims. With the bond drafting history as a backdrop, insurers will be better suited to convince courts that the "direct loss" requirement is narrower than a "proximate cause" standard and, as a consequence, that the "proximate cause" standard is too broad to be applied in fidelity bond claims. If successful, insurers can keep a seemingly minor case from having a profound impact.

[74] *Id.*

Edward J. Comey is an associate in the Tampa, Florida office of Shumaker, Loop & Kendrick, LLP. Mr. Comey is a graduate of the University of South Florida (B.A., 1998) and the Florida State University College of Law (J.D., 2001). His areas of practice include fidelity and surety litigation, construction litigation, transportation law, and commercial landlord/tenant litigation. Mr. Comey is a member of the Florida Bar and the American Bar Association, and he is admitted to practice in all Federal Courts in Florida. Mr. Comey can be reached by e-mail at ecomey@slk-law.com.

Tim Krsul is a claim attorney with the Financial Professional Services (FPS) Specialty Claim Group for Travelers. Mr. Krsul was in private practice for eleven years prior to joining the FPS Specialty Group where his practice involved commercial litigation and insurance coverage. He currently works on claims involving financial institution bonds, directors and officers liability policies, lawyers professional liability policies, lender liability and employment practices liability policies.