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GENTILINI FORD - THREE YEARS WORTH OF HISTORY

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In 2004, the New Jersey Supreme Court rendered its decision in *Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.*, 181 N.J. 245, 854 A.2d 378, 2004 WL 1811429 (N.J. August 16, 2004). Gentilini Ford had an employee who falsified credit information in connection with 27 automobile sales transactions. Auto Lenders had a contract to fund the installment sales contracts; however, that contract contained a recourse provision and when the fraud was discovered, Auto Lenders sued Gentilini, who, in turn, filed a third party demand against the insurer that issued its employee dishonest coverage.

The trial court granted a summary judgment in favor of the plaintiff; however, that decision was reversed by the Court of Appeals that granted judgment in favor of the insurer. The New Jersey Supreme Court heard the case and considered three issues: (1) whether there was a direct loss; (2) whether, as required by the policy, the employee had the manifest intent to cause his employer to sustain a loss; and, (3) whether each of the 27 transactions constituted a separate loss. The New Jersey Supreme Court reversed and remanded the case.

On the “direct loss” issue, *Gentilini Ford* was a case of first impression in New Jersey. Relying on what it viewed as the majority of the federal courts to have considered the issue, the New Jersey Supreme Court held that a proximate-cause analysis was appropriate to determine whether a loss is direct under a fidelity insurance policy. The Court went on to conclude that any loss to Gentilini Ford result from the default of the 27 purchasers was proximately and, therefore, directly the result of the dishonest conduct of the employee.

Next the Court addressed “manifest intent.” After discussing the three tests (objective approach; subjective or specific-intent approach; and substantial certainty), the Court held that the “manifest-intent standard was satisfied either by proof that it was an employee’s purpose or desire to cause the insured to sustain a loss and to obtain a financial benefit at the insured’s expense, or by proof that the employee knew the aforesaid loss and benefit were substantially certain to result from his or her conduct.” 181 N.J. at 267-8

The final issue considered by the Court was whether the dishonest acts of the employee constituted a single occurrence or multiple occurrences. The policy language seemed quite clear, and stated that all loss or damage caused by one or more persons or involving a single act or series of related acts is considered a single occurrence. The Court apparently agreed that the policy language was clear; however, it stated that the policy language, read literally, would largely vitiate the coverage afforded by the policy and, instead, concluded that a fair reading of the provision “simply means that for each loss of property covered by the policy there can be only one recovery, regardless of the number of employees that may have caused the loss.” 181 N.J. at 276. The Court concluded that although the loan transactions involved the same manner of financing and the fraud was perpetrated by the same dishonest employee, each was a separate occurrence because the transactions occurred at separate times, involved different borrowers, were for different purposes and had separate collateral.

The purpose of this paper will be to examine what has happened to *Gentilini Ford* in the three years since it was rendered.

DIRECT LOSS

Interestingly, since *Gentilini Ford*, there are as many decisions on this issue which have not discussed the case as there are which have discussed the case.

In *Commerce Bank & Trust v. St. Paul Mercury Insurance Company*, 2005 WL 4881101 (Mass. Super. June 7, 2005), an employee of Vulcan Industries, using a signature stamp of one of its officers, which she had the authority to use, improperly drew checks payable to Commerce Bank which she negotiated and used to pay down her home equity line of credit which the employee had at Commerce Bank. Vulcan had no relationship to Commerce. Notwithstanding, Commerce Bank argued that the loss sustained by Vulcan as a result of its employee's actions was a direct loss because Commerce Bank contingently incurred liability when it accepted the checks. The Massachusetts Superior Court did not discuss *Gentilini Ford* and reached the opposite conclusion. This case contains some language differentiating between liability insurance and a fidelity bond and refers to the direct loss language as indicating an intent to limit coverage. The court concluded that "...the policy's intent not to cover indirect losses is made crystal clear by both the insuring and exclusionary clauses." 2005 WL 4881101 at *4. The court went on to discuss the only other Massachusetts case dealing with the issue as well as cases from other jurisdictions which supported its decision.

One week later, another Massachusetts court in *Atlas Metals Products Co., Inc. v. Lumberman's Mutual Casualty Company*, 63 Mass. App. Ct. 738, 829 N.E. 2d 257 (Appeals Court of Massachusetts, Worcester, 2005) in a case dealing with somewhat similar facts, reached the same conclusion. In that case, an employee of Atlas concocted a fraudulent scheme involving the cashing of checks from a separate business, R & R Realty Trust. The employee had access to the R & R checking account because of an arrangement between Atlas and R & R under which Atlas provided administrative services for the processing and payment of R & R bills. In that process, the Atlas employee wrote checks on the R & R checking account payable to herself. The court concluded that,

Where an employee dishonesty fidelity policy has provisions such as appear in this Lumbermans-Atlas EDP, which limit coverage to direct property losses and exclude both indirect losses and the payment of damages to third parties, the policy cannot be deemed to cover general legal liability for damages due to independent third-party entities. This is so even if the insured may have exposure in damages to such entities.

63 Mass. App Ct at 262, 829 N.E. 2d at 745. This case also contained no discussion of *Gentilini Ford*.

The United States District Court for the Eastern District of Michigan, in *Flagstar Bank, FSB v. Federal Insurance Company*, 2006 WL 3343765 (E.D. Michigan Nov. 17, 2006) rejected the argument that it should construe the "resulting directly from" language to mean "proximately caused by." Flagstar entered into a warehousing credit agreement with Amerifunding/Amerimax

Realty Group, Inc. Flagstar would advance funds to a title company pending the closing. However, the underlying mortgage transactions never took place and the promissory notes submitted by Amerifunding to secure funding bore forged signatures. The court concluded that Flagstar not only had to show that the forgeries caused it to enter into the transactions but that the forgeries directly caused its loss. *“The failure of the security was not because they were counterfeit or forged, but solely because the assets purportedly represented thereby were non-existent. This loss falls upon the Bank and not the bonding company by the terms and intent of the bond.”* 2006 WL 3343765 at *11. There was no discussion of *Gentilini Ford*.

In *Citibank Texas, N.A. v. Progressive Casualty Insurance Company* 2006 WL 3751301 (N.D. Tex. Dec. 21, 2006) the United States District Court for the Northern District of Texas, without citing *Gentilini Ford*, reached the same conclusion as the Supreme Court of New Jersey. Citibank allowed sixteen checks payable to its customer Golden Life/Richardson, L.P. and endorsed by the president of Golden Life’s corporate general partner to be deposited into an account held by that officer in the name of his sole proprietorship. Progressive argued that Citibank’s losses resulted from the actions of the officer of Golden Life’s corporate general partner, not from those of Citibank and that they were indirect and, thus not covered. The court rejected that argument on the basis that it would render coverage illusory.

The last of the cases involving the direct loss issue which does not discuss *Gentilini Ford* is *Citizens Bank, N.A. v. Kansas Bankers Surety Company*, 149 P. 3d 25 2007 WL 45946 (Kan. App. Jan. 5, 2007). A personal as well as business customer of Citizens was trustee of a trust for his aunt. Citizens permitted deposits to the customer’s personal and business account from the trust account. Judgment was awarded in favor of the trust and against Citizens on the basis that it had taken all of the instruments with notice of the trust’s claim by reason of the breach of trust which had occurred. The appellate court overruled the district court’s “but for” analysis as to the cause of Citizens loss and concluded that although the customer’s theft ultimately resulted in a loss to Citizens, there was no loss until Citizens paid the judgment rendered against it and that loss was not direct.

Turning to the cases which have addressed the direct loss issue and have discussed *Gentilini Ford*, the first of those cases is *Tri City National Bank v. Federal Insurance Company*, 268 Wis.2d 785, 674 N.W. 2d 617 (Ct. of Apps., Wisc., 2003). Tri City sought to recover from Federal monies it paid to two mortgage companies in the form of settlements because of fraudulent acts of two of its employees. The Surety Association of America submitted an amicus brief. There is an excellent discussion of the history of the fidelity bond. The court rejected the insured’s ambiguity argument, stating,

Our reading of the bond satisfies us that the bond is not ambiguous. First, the bond clearly restricts indemnification to those losses that occur as a direct result of an employee’s dishonest acts. This language is not susceptible to more than one meaning. Here the loss was not direct. It was only after the mortgage defaults occurred, some three years after the employees’ deceitful actions, that Tri City’s liability to the mortgage companies came into being. The losses did not ‘result directly from dishonest or fraudulent acts committed by employe[es]’ as the losses did not exist until the unsuitable mortgage holders defaulted on their loans and the mortgage companies sued Tri City.

268 Wis. 2d at 799, 674 N.W. 2d at 623.

The Wisconsin court cited the intermediate appellate decision in *Gentilini Ford* to support its conclusion.

The intermediate appellate decision in *Gentilini Ford* was also cited in *RBC Mortgage Company v. National Union Fire Insurance Company of Pittsburgh*, 349 Ill App.3d 706, 812 N.E. 2d 728 (App. Ct. of Ill., 1st Dist. 2004). RBC owned First City Financial Corporation. A First City employee fabricated documents to support loan closings. First City brokered the loans to a company which funded the loans and ultimately sold them to third party investors. The brokerage company that sold the loans to third party investors sought indemnification from First City for the losses which resulted. In turn, First City sought coverage under its fidelity bond. National Union denied coverage on the basis that the losses of its insured did not result directly from the fraud. The circuit court dismissed the claims against National Union and an appeal followed. The appellate court concluded that,

If 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.'

812 N.E. 2d at 733.

In addition to the intermediate appellate decision in *Gentilini Ford*, the court relied on the *Tri City National Bank* case discussed above.

The United States District Court for the Eastern District of Arkansas agreed with the conclusion of the New Jersey Supreme Court in *Gentilini Ford*. *Pine Bluff National Bank v. St. Paul Mercury Insurance Co.*, 346 F. 2d 1020 (E.D. Ark. 2004) involved an Insuring Agreement (E) case. A customer of Pine Bluff established a revolving line of credit which was based upon lease agreements the customer had with various state agencies. Pine Bluff would advance funds based upon the value of the lease agreements. After the loan went into default, it was discovered that the lease terms were not 60 months as represented but for only 12 or 36 months. For coverage to exist, Pine Bluff had to show that there was a loss which directly resulted from the insured having in good faith extended credit on the faith of an original security agreement which bears a forged signature of a lessee. Without much discussion, and citing *Gentilini Ford*, the court found a direct loss is one proximately caused by the hazard insured against and moved on to other issues.

Rothschild Investment Corp. v. Travelers Casualty and Surety Company of America, 2006 WL 1236148 (N.D. Ill. May 4, 2006) involved a claim on a securities dealer fidelity bond. After receiving notice from a customer that Profit Sharing Plan assets were missing, Rothschild notified Travelers of a potential loss. An employee of the sponsor of the Profit Sharing Plan had embezzled substantial sums from the assets held or managed by Rothschild. The Profit Sharing Plan sued Rothschild and the case was ultimately settled. Rothschild then sued Travelers. With respect to the direct loss issue, the court declined to follow *RBC Mortgage*, the only Illinois case on point, because it was not persuaded that the Illinois Supreme Court would follow the *RBC*

Mortgage rationale. The court also noted that *RBC Mortgage* relied on the intermediate appellate decision in *Gentilini Ford*, which had been reversed.

In *Frontline Processing Corp. v. American Economy Insurance Co.*, 335 Mont. 192, 149 P. 3d 906 (Mont. 2006), the Supreme Court of Montana held, in a case of first impression, that direct loss means loss proximately caused by an employee's dishonest act. The case was before the Court on a certified question from the United States District Court for the District of Montana and the issue was whether direct loss included consequential damages (investigative expenses) caused by an employee's dishonesty. In reaching its conclusion, the Court relied upon and quoted extensively from *Gentilini Ford*. In answering the certified question, the Court stated,

We are persuaded that a proximate cause analysis is appropriate in determining whether a loss is 'direct' under a fidelity insurance policy. Such a position comports, as well, with our tradition of applying a causation standard to various types of losses claimed under insurance policies.

335 Mont. at 199.

To date, although *Gentilini Ford* has influenced other courts around the country, the case has clearly not been universally accepted. When handling a case involving a direct loss issue, the importance of educating the courts with respect to the coverage, as was done in *Tri City National Bank*, cannot be overemphasized.

MANIFEST INTENT

Interestingly, *Gentilini Ford* does not appear to have been cited for the manifest intent issue. In fact, during the time period covered by this paper, there have been very few reported decisions involving the manifest intent issue.

The case of *Investors Trading Corporation v. Fidelity & Deposit Company of Maryland*, 2004 WL 3045196 (N.D. Tex.), was decided after *Gentilini Ford*, but did not cite the case. The plaintiff, a retail securities brokerage firm, sought coverage under a Financial Institution Bond that insured losses arising from dishonest or fraudulent acts of its employees. Two employees engaged in trading for their personal accounts which their employer's policies prohibited. The computer software did not generate timely margin calls and over a period of days both of the personal accounts went into a negative balance. When margin calls were issued, the employees were unable to meet them, the positions were liquidated and a loss of \$650,000.00 was sustained. The FIB had the standard manifest intent language. The court cited *First Nat'l Bank of Louisville v. Lustig*, 961 F.2d 1162 (5th Cir. 1992) and *Continental Bank, N.A. v. Aetna Casualty & Surety Company*, 164 Misc.2d 885, 626 N.Y.S.2d 385 (N.Y. Sup. Ct. 1995) in reaching its decision to grant the insurer's motion for summary judgment.

[K]nowledge that an employer will bear responsibility for losses an employee sustains in excess of his resources is not the same thing as intending to cause a loss to an employer. In this case, the undisputed facts are that neither Taherian nor Robinson desired to cause a lost to Oxford...On the contrary, both employees wanted to make money off their trading activities...The knowledge that Oxford would

bear the losses, if any, simply created a security blanket for them to allow them to engage in the trades.

2004 WL 3045196 *2.

The Court of Appeal, Sixth Circuit, in *Century Business Services, Inc. v. Utica Mutual Insurance Company*, 122 Fed Appx. 196, 2005 WL 96839 (C.A.6 (Ohio)), considered a manifest intent issue; however, its consideration was limited to whether there was a sufficiency of evidence to justify the findings of the jury. The case did not cite *Gentilini Ford*.

In *Five Star Real Estate, LLC v. Kemper Casualty Insurance Company*, 2006 WL 1294238 (Ct. Of Apps., Mich., May 11, 2006) the court dealt with the manifest intent issue in a very perfunctory manner and did not cite *Gentilini Ford*.

CUMULATION OF LIMITS

Of the four cases which have addressed this issue since *Gentilini Ford*, not one has discussed the case.

Glaser, et al v. Hartford Casualty Insurance Company, 364 F.2d 529 (Md. 2005) involved an endorsement which provided employee dishonesty coverage. The insured sustained losses over three policy years. Hartford paid a single limit and the insured sued alleging that he was entitled to a policy limit for each of the seven acts of embezzlement which occurred in three separate policy years. Relying on a Colorado decision, the court held that the determinative question was not whether the employee's methods were related but whether the cause of loss was related, i.e., a series of related acts of one employee. The court did find an ambiguity in the policy language because the definition of occurrence did not indicate whether a series of acts included acts occurring outside of the policy term. In the court's view, the non-cumulation provisions of the policy did not eliminate that ambiguity and construed that language against the insurer.

The same result was reached in *Acid Piping Technology, Inc. v. Great Northern Insurance Company*, 2005 WL 3008512 (E.D. Mo. Nov. 9, 2005). The court noted that there was no policy language which explained the relationship between "occurrence" and "loss."

Although disagreement as to policy meaning and a lack of definition may not be enough to find a provision ambiguous, I find no surrounding or related clauses that clarify the language in this policy.

2005 WL 3008512 at *3.

In this case of first impression in the Eight Circuit as well as in Missouri, the court held that the insured was entitled to coverage for each fraudulent invoice (92) submitted by its employee, up to the \$5,000.00 limit, less the deductible for each such loss.

The Superior Court of Pennsylvania in *Reliance Insurance Company v. IRPC, Inc.*, 900 A.2d 912 (Sup. Ct. Of Pa., 2006) affirmed a summary judgment granted to Reliance by the trial court and held that the bonds at issue represented a continuous scheme with a single limit of

insurance for employee dishonesty, rather than multiple contracts. The insured cited *Karen Kane, Inc. v. Reliance Insurance Company*, 202 F.3d 1180 (9th Circuit. 2000), arguing that it was entitled to multiple limits. The court noted a significant factual difference between the two cases. In *Karen Kane*, Reliance conceded that it sold separate one year policies to the insured. In the case before the court, the evidence was that Reliance had issued a one year policy and, thereafter, the coverage was maintained in effect by annual endorsements. The mere fact that the original bond had to be renewed annually was not dispositive of whether there was a continuous bonding scheme as opposed to multiple contracts. Further, the court was not persuaded that the fact that the parties failed to complete the cancellation of prior insurance provision at the time of each renewal proved that the insured had purchased multiple bonds.

The United States District Court for the Southern District of Mississippi reached the same conclusion in *Madison Materials Company, Inc. v. St. Paul Fire and Marine Insurance Company*, 2006 WL 2792390 (S. D. Miss., Sept. 27, 2006). In 2003, following discovery, the insured gave notice to St. Paul and subsequently discovered that it had sustained loss of almost \$1.5 million over the period from 1992 through 2002 as the result of embezzlement by an employee. During the entire period the insured had fidelity coverage through St. Paul. St. Paul tendered the policy limit, \$350,000.00, for the policy period (January 26, 2000 to January 26, 2003) in which the loss was discovered. The insured argued that eleven policies, each with a separate limit of \$350,000.00, was triggered, citing *Universal Underwriters Insurance Company v. Buddy Jones Ford*, 734 So. 2d 173 (Miss.1999), in which the Mississippi Supreme Court found that all of the policies in effect between 1984 and 1985 had been triggered by 175 different instances of employee dishonest during that period and that each incident constituted an occurrence. The policy language in the two cases was apparently very similar; however, the St. Paul policy did have clearly worded language that stated that multiple acts or a series of related act could be treated as one occurrence of loss. That turned out to be a deciding factor in the mind of the court. The court also found the non-cumulation language of the policy to be clear. Accordingly, the court granted St. Paul's motion for summary judgment and denied the motion for summary judgment filed by the insured.

CONCLUSION

Gentilini Ford has not proved to be the force that many in the industry feared. What can be said is that, at best, the reaction of courts around the country to *Gentilini Ford* has been mixed. It is, after all, the ruling of a state supreme court which, while it may be argued as persuasive authority, has no precedential value outside of the state of New Jersey.

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