

**THIRD-PARTY CLAIMS
AND LOSSES UNDER THE
FINANCIAL INSTITUTION BOND**

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The fidelity industry has been the beneficiary of much recent and thorough scholarship regarding the evolution of the law pertaining to the treatment under fidelity bonds of claims asserted, and losses incurred, by entities other than the insured.¹ This paper will take advantage of that fine base of scholarship by not repeating it. Rather, the purpose of this paper is to focus upon selected topics, cases, and certain provisions in the current financial institution bond, as they particularly relate to the handling and analysis of claims based upon an insured's liability to third parties. Familiarity with the basic Form 24 Financial Institution Bond is assumed.

THE EVOLVING BOND FORM

There perhaps has been no area of fidelity claims activity that has been more greatly affected by the 1980 and 1986 revisions of the financial institution bond form than the handling and analysis of claims based upon the insured's alleged liability to third parties.²

The 1980 inclusion of the "manifest intent" definition of dishonesty in the fidelity insuring agreement (added to some policies by amendatory rider commencing in 1976) narrowed the range of potentially covered losses arising from claims by third parties against insureds based upon frauds committed by employees.

Also commencing with a 1976 rider, the phrase "loss through" that had been used with respect to covered risks in the insuring agreements was replaced with the phrase "loss resulting directly from," which change was later incorporated into the bond itself in 1980,³ together with the addition of the "indirect or consequential loss" exclusion (first added to the bond form as "w" in 1980, redesignated "v" in the 1986 revision) and the "noncompensatory damages" (or "legal liability") exclusion (first added to the bond as "u" in 1980, redesignated "t" in the 1986 revision).

1. See e.g., Wildau, *Evolving Law of Third-Party Claims Under Fidelity Bonds: When is Third-Party Recovery Allowed?*, 25 Tort & Ins. Law Journal 93 (1989); C. David Hailey, *Legal Liability For Third-Party Losses Under Commercial Crime Policies*, (unpublished paper presented at American Bar Association, Tort & Insurance Practice Section, Fidelity & Surety Law Committee January, 1995 Mid-Winter Program, New York, N.Y.); John A. Nocera, *Third Party Claims Under Fidelity Bonds*, (unpublished paper presented at Surety Claims Institute 1995 Annual Meeting, Williamsburg, Va.); Gary J. Valeriano and Carleton R. Burch, *Fidelity Claims and Bankruptcy* (unpublished paper presented at Surety Claims Institute 1995 Annual Meeting, Williamsburg, Va.).

2. The following discussion of the 1980 and 1986 revisions to the financial institution bond form 24 is taken from the relevant sections of Tort and Insurance Practice Section, American Bar Association, *Annotated Bankers Blanket Bond* (1980), its First Supplement (1983) and Second Supplement (1988).

3. See Bassett, *Direct Loss Under The Fidelity Insuring Agreement of the Financial Institution Bond*, 54 Defense Counsel Journal 487 (October, 1987).

In 1986, as the securities activities of banks began their steady increase, the importation into Form 24 from the Stockbrokers Blanket Bond of exclusion “w” (the securities laws violation exclusion) foreclosed any attempted broadening of the scope of coverage for third party securities laws claims against banks beyond that already provided by the insuring agreements, and placed the burden on the insured of proving that a loss involving violation of securities laws or regulations would have constituted a covered loss in the absence of the law, rule or regulation.

The 1986 revision also jettisoned the “Court Costs and Attorneys’ Fees” General Agreement, replacing it with a new General Agreement “F”, “Notice of Legal Proceedings Against Insured - Election to Defend.” At the same time, prior exclusion “v” was reworded as new exclusion “u,” expressly deleting coverage for defense fees, costs and expenses incurred by the insured in any legal proceeding. These changes completely removed from the bond any coverage for defense costs, except at the insurer’s own option, thus taking fidelity insurers out of the defense business. Added and reworded provisions of the new general agreement also solved many of the “timing” issues regarding notice, proofs of loss and suit against the insured that had bedeviled third-party litigation coverage situations.

It is crucial for both the claims analyst and outside counsel to be aware of these changes, for many of the least helpful decisions regarding coverage of third-party claims were based upon forms of commercial fidelity coverage or bankers or stockbrokers blanket bond coverage that lacked one or more of the current financial institution bond’s narrowing and clarifying provisions. Thus, while the fundamental legal principles regarding the “purpose” and “essential nature” of fidelity coverage remain relevant, much of the prior case law is likely to be distinguishable not only on its facts, but even more fundamentally on the policy form itself.

It is especially important to scrutinize case law involving third-party claims, regardless of how recent, for the identity, version and year of the bond form involved, due to the extreme length of time that may elapse before a third party claim dispute is presented to a court for the determination of coverage issues. For example, *Manley, Bennet, McDonald & Co. v. St. Paul Fire and Marine Ins. Co.*,⁴ decided by the U.S. District Court for the Eastern District of Michigan in 1992, involved bond forms issued in 1975 which do not contain the “manifest intent” definition. The resolution of the issue in that case, namely whether the insured’s expenditures for defense and settlement of litigation brought by third parties was covered, was not decided until 1992 due to the duration of the insured/third party litigation. Therefore, what would appear to be relatively recent precedent (and not

4. 792 F. Supp. 1070 (E.D. Mich. 1992).

particularly helpful to the insurance industry) is, upon careful examination, a decision based upon contract language that has not been in use for almost 20 years.

THE IMPACT OF THE NEW FIDELITY INSURING
AGREEMENT ON THIRD PARTY CLAIMS COVERAGE

Prior to the alterations made to the financial institution bond by rider in 1976 and in the 1980 bond form itself, the scope of coverage for losses occasioned by employee fraud directed against third parties for which the insured was vicariously liable was broader under the financial institution bond than under commercial crime coverage. This difference was attributable, in part, to the difference between the language used in the insuring agreements themselves: whereas the financial institution bond fidelity insuring agreement insured against “loss through any dishonest or fraudulent act of any of the employees ...,” the “3-D” or “blanket crime bonds” issued to commercial enterprises had more limited insuring agreements that generally referred to “loss of property” or “loss of money, securities and other property,” with definitions of money, securities and property provided.⁵ Thus, prior to the 1976 revisions, the relatively broad language of the financial institution bond led courts to find coverage for all manner of third-party losses occasioned through fraud by dishonest employees, even if no embezzlement or misappropriation of the insured’s property was involved and the insured’s only loss was through vicarious liability for the employee’s fraudulent acts.⁶

The changes wrought to the financial institution bond in 1976, 1980 and 1986 were intended, in large measure, to curtail the expansive range of third-party claims for which the courts had found coverage under the bond. Although the road to narrowing coverage for such losses has not been a smooth one, several cases reflect the impact of the new, post-1976 fidelity insuring agreement, including its “manifest intent” definition of dishonesty and its requirement that the loss “result directly from” the risk, on the coverage of third-party claims based on employee fraud.

The best of the cases stand for the proposition that the current financial institution bond form provides no coverage for loss incurred as a result of claims against the insured by third parties where the insured was exposed to loss as a consequence or indirect result of an employee’s fraud that was

5. See, generally, King, *Coverage Under Fidelity Bonds For Third-Party Claims Not Involving Loss of Property*, 13 *The Forum* 507 (1978).

6. See, e.g., *First Nat. Bank of Bowie v. Fidelity & Casualty Co. of N.Y.*, 634 F.2d 1000 (5th Cir. 1981), in which the Fifth Circuit affirmed and approved of the District Court’s analysis that a pre-1976 form of bankers blanket bond “covers indirect losses that result from vicarious liability created by an employee’s dishonest or fraudulent action against a third person.”

directed at the third party and not the insured, or that was intended to reap benefit for the insured employer. In particular, two recent New York decisions⁷ have applied this reading of the bond to dismiss actions against insurers seeking coverage for substantial claims made against the insureds by third parties who were victimized by admittedly dishonest employees.

The first element of the manifest intent requirement is that the insured's loss be the direct result of an employee's dishonest or fraudulent act committed with the "manifest intent to cause the insured to sustain such loss."⁸ A striking example of the manner in which this "new" definition was held to substantially narrow the prior coverage for third party claims arising from "dishonest and fraudulent acts" was presented in the oft-cited 1983 Illinois decision, *Mortell v. Insurance Co. of North America*.⁹ *Mortell* is especially instructive because it dealt with claims under a fidelity policy that covered periods both before and after the new definition of dishonesty was added to the policy by amendatory rider.

In *Mortell*, the plaintiff-insured was a futures commodity merchant. It faced claims by customers and regulatory agencies by reason of alleged dishonest and fraudulent conduct on the part of its sales personnel in dealing with purchasers or prospective purchasers of commodities. Until an amendment of its fidelity policy on January 8, 1977, providing the "new" definition of dishonesty, *Mortell's* policy simply insured against loss "through any dishonest or fraudulent act" of any of its employees (i.e., the 1969 formulation of fidelity coverage). Relying upon a 1963 Illinois decision, *Home Indemnity Co. v. Reynolds & Co.*,¹⁰ *Mortell* contended that in order to recover under the policies for its third-party liability it was sufficient to establish that the dishonest employee's acts were "manifestly unfair to the employer and palpably subject him to the likelihood of a loss" or "indicate a reckless disregard of the interest of the employer."¹¹

7. *Continental Bank, N.A. v. Aetna Casualty & Surety Co.*, 626 N.Y.S.2d 385 (Sup. Ct., N.Y. Co. 1995), and *Drexel Burnham Lambert v. Vigilant Ins. Co.*, 157 Misc.2d 198, 595 N.Y.S.2d 999 (Sup. Ct., N.Y. Co. 1993), discussed *infra*.

8. The particular interpretation of the "manifest intent" phrase adopted by the jurisdiction in which a claim is presented will necessarily affect the degree to which that language will limit the insurer's liability where the target of the employee's fraud is a third party. For recent discussions of the current and often contradictory interpretations of the term "manifest intent" that have been adopted by the courts, see Keeley, *Employee Dishonesty Claims: Discerning The Employee's Manifest Intent*, 30 Tort & Ins. Law Journal 915 (1995); Kirwan, *Mischief or "Manifest Intent"? Looking For Employee Dishonesty In The Uncharted World of Fiduciary Misconduct*, 30 Tort & Ins. Law Journal 183 (Fall 1994); Norman Carpenter, *The Catch 22 of Manifest Intent: Inferring the Obvious* (August, 1995) (unpublished paper presented to the 1995 Annual Meeting, American Bar Association, Tort & Insurance Practice Section, Fidelity & Surety Law Committee, Chicago, Illinois).

9. 120 Ill.App.3d 1016, 458 N.E.2d 922 (1st Dist. 1983).

10. 38 Ill. App. 2d 358, 187 N.E.2d 274 (Ill. App. 1963).

11. 455 N.E.2d at 927.

The defendant insurer did not contest this standard for recovery under its policy prior to the amendment, and the appellate court held that such standards did establish “dishonesty” under the pre-amendment language of the policy.¹² However, with respect to the post-amendment claims for identical acts, the trial court held that these claims were not covered under the terms of the amended policy due to the requirement of “financial benefit” and the exclusion from that term of “commissions,” the only personal benefit shown to have been gained by the allegedly dishonest trader. The appellate court sustained that aspect of the summary judgment in favor of the insurer. After setting forth the amendment to the policy, the court stated:

[Defendant] argues that the amendment was part of an industry-wide response to the confusion created by the undefined dishonesty terms in bonds such as the bond at issue in Home Indemnity. [Defendant] asserts that by the plain language of the amendment there must be proof of a manifest intent first to harm the employer and second to obtain financial benefit for the employee other than the benefits earned in the normal course of employment such as commissions. [Defendant] also points out that it is presumed that a policy holder has read the policy he signs [citation omitted].

* * *

The terms of the amendment are unambiguous and must be given effect as written. [citation]. The trial court did not err in entering summary judgment for [defendant] with respect to customer claims discovered after the amendment was signed.¹³

Outside the third-party claim context, the “new” definition was held to bar claims where the employee’s allegedly dishonest activities were intended *make* money rather than to cause the employer a loss. For example, *Municipal Securities, Inc. v. Insurance Co. of North America*,¹⁴ a first-party loss case, the insured broker-dealer had established a \$2 million limit as a maximum amount of government securities that one of its traders, Hargraves, could hold in inventory for the insured’s own account without the written approval of her supervisor. Hargraves incurred trading losses and, in an attempt to conceal them, keep her commissions and her job and, hopefully, recoup the losses, she failed to report millions of dollars of unauthorized bond purchases and submitted fictitious reports of bond sales that had not taken place. When her unauthorized activities and false reports were uncovered, she had accumulated an unauthorized inventory of \$56 million of government securities, which the insured had to close out at a loss in excess of \$950,000. Hargraves also had received over \$14,600 in commissions to which she was not entitled because her trades had in fact resulted in losses. The

12. 458 N.E.2d at 928.

13. 425 N.E.2d at 929.

14. 829 F.2d 7 (6th Cir. 1987).

defendant fidelity insurer declined to pay the claim, asserting that the loss was not covered under its policy because there was no “manifest intent” to cause a loss to the insured, and that the only financial benefit to the employee — the improper commissions paid to Hargraves — were excluded from the bond’s definition of “financial benefit.”

Based upon the bond’s definition of dishonesty, the U. S. District Court (W.D. Tenn.) entered summary judgment in favor of the insurer, and the Court of Appeals for the Sixth Circuit affirmed, stating:

[Defendant] argues first that Ms. Hargraves had no ‘manifest intent’ to ‘cause the Insured to sustain’ the loss of \$956,931.39. We agree. *Ms. Hargraves’ manifest intent was to make money, not to cause her employer to lose money. She intended to violate her standing orders, to be sure, but not for the purpose of causing a huge loss.* Ms. Hargraves’ deposition testimony established without contradiction that her purpose was to eradicate the losses, not increase them. (emphasis added)¹⁵

The Second Circuit Court of Appeals’ 1989 decision in *Glusband v. Fittin Cunningham & Lauzon, Inc.*¹⁶ applied a similar analysis in a third-party loss context. In *Glusband*, an employee had defrauded third parties for the benefit of his employer (thus triggering potential vicarious liability for the employer), but in which the employee had received no “financial benefit” as defined in the bond. Starbuck, the sole owner, director and shareholder of an investment management corporation organized a limited partnership, with his company as general partner, to invest in securities. Starbuck induced investors to place their money with the limited partnership with false promises that the partnership would follow a conservative investment strategy when, in fact, Starbuck’s investment strategy was reckless and he was inexperienced in the field.

To conceal the partnership’s mounting losses, Starbuck misrepresented the status of the investors’ accounts, and the venture eventually collapsed. However, while Starbuck lied to and cheated the investors, he apparently did so without personal financial benefit other than salary, and only in order to keep the insured, his company, afloat.¹⁷

At the trial of the action brought by the receiver of Starbuck’s company on the firm’s Form 14 stockbrokers blanket bond (with “manifest intent”

15. 829 F.2d at 9. *See also, e.g., In re J.T. Moran Financial Corp.*, 147 B.R. 335 (Bankr. S.D.N.Y. 1992) and cases cited therein (“That a trader may have violated the insured’s established policy or standing orders or committed a grave breach of the broker’s fiduciary duty does not mean that such conduct falls within the operative language of the fidelity bond, *where the faithless employee simply wanted to make money rather than cause the employer to lose money.*”)(emphasis added).

16. 892 F.2d 208 (2d Cir. 1989).

17. *Id.* at 209.

rider annexed), the Magistrate refused to give the jury instructions on the “manifest intent” clause, apparently under the impression that the “rider” did not apply, or that if it did it was up to the jury to decide what it meant. Understandably, the jury returned a verdict against the insurer for \$500,000.

The Second Circuit reversed, and instead of remanding for a new trial, directed a verdict for the insurer based upon its own finding that there was insufficient evidence adduced to satisfy the manifest intent requirement. The Court stated:

[A]s to the first element – manifest intent to cause a loss – the evidence indicated that Starbuck intended to benefit [the limited partnership], no matter how reckless and imprudent his conduct may have been. As to the second element - manifest intent to obtain financial benefit - there was no evidence that Starbuck ever misappropriated any of the funds for his own benefit or even received such funds except for salaries or commissions exempted from the definition by the rider. Thus, the evidence is insufficient to support the requisite finding of manifest intent.¹⁸

The court indicated that it was applying the same analysis that it had used in a first-party loss case decided the prior year, *Leucadia, Inc. v. Reliance Ins. Co.*,¹⁹ in which the court had held that “[b]ecause the employee misguidedly hoped to benefit his employer and received no personal gain from the transaction, we held that the requisite manifest intent had not been shown.”²⁰

Two recent New York State court decisions now extend this reasoning to situations where the employee did receive personal financial benefits, declining to find coverage where the employee either stole from third parties for the benefit of the insured employer, or where the target of the employee’s fraud was a person or entity other than the insured.

The first of these two cases, *Drexel Burnham Lambert v. Vigilant Ins. Co.*, 157 Misc.2d 198, 595 N.Y.S.2d 999 (N.Y. Co. 1993), concerned a staggering \$25 billion in suits and claims against the insured brokerage firm by third parties allegedly defrauded through the activities of Dennis Levine, a Managing Director of Drexel, and Michael Milken, head of the Drexel’s High Yield (or “Junk”) Bond Division. Drexel’s Chapter 11 estate had tentatively arranged for the settlement of those claims, contingent upon the estate’s realizing substantial recoveries under successive stockbroker’s blanket bonds (and excess layers) issued over the 1986-1990 period.

18. *Id.* at 210.

19. 864 F.2d 964 (2d Cir. 1988), *cert. denied*, 490 U.S. 1107, 109 S.Ct. 3160, 104 L.Ed.2d 1023 (1989).

20. *Glusband*, 892 F.2d 208 at 211.

As narrated by the Court, the underlying facts were that in 1985, Dennis Levine provided Ivan Boesky, a non-Drexel employee, with insider information developed by and/or belonging to Drexel, and in joint trading Levine and Boesky made vast profits. Levine was indicted in 1986 for securities fraud and other crimes, to which he pleaded guilty. Boesky also pleaded guilty to securities fraud charges, and implicated Michael Milken. Milken and other Drexel employees were then charged with having committed securities frauds from 1984 to 1986, including insider trading, stock parking and manipulation.

Drexel itself was also charged with criminal responsibility, and in September, 1989 pleaded guilty to six counts of securities and mail fraud, agreed to pay fines and penalties of \$300 million and to disgorge \$350 million to help pay claims of the victims of the fraud. In 1990, Milken pleaded guilty to several of the felony charges against him, including conspiracy, securities fraud and mail fraud, agreed to pay \$200 million in fines and \$400 million to defray claims against him.

When Drexel filed for relief under Chapter 11 of the Bankruptcy Code in 1990, a “veritable deluge” of claims and suits was brought against it by the victims of these frauds, including the FDIC and RTC as receivers and liquidators of failed savings and loan associations that had sustained \$6.8 billion in losses in the junk bond market as a result of Drexel’s manipulations. A potential settlement of the third-party claims had been negotiated, contingent upon Drexel recovering substantial amounts under the stockbroker’s blanket bonds.

In June, 1990, Drexel filed a proof of loss, subsequently supplemented, which detailed over \$1 billion in losses already paid in settlement of federal, state and private claims, together with millions of dollars in attorneys’ fees and related litigation costs. The insurers rejected the proof of loss and declined to pay Drexel’s claim. Drexel then commenced an action involving 51 bonds, covering the period 1986-1990, to recover its past, continuing and future losses under the employee dishonesty provisions of the policies. The Court granted the insurers’ motion to dismiss the complaint, holding, *inter alia*, that there was no coverage under the bonds for dishonesty directed against third parties rather than against the insured.

It is important to note that the Court’s holding is based upon the essential nature of fidelity coverage rather than upon particular bond provisions. Due to the difficulty of setting forth the provisions of 51 separate policies issued over a five-years period, the Court stated that these “Bankers and Brokers Blanket Bonds” were all “similar in their essential nature” despite differing definitions of coverage, varying exclusions and conditions.²¹ While

21. 595 N.Y.S.2d at 1004.

describing the bond of defendant Vigilant, the original movant, as “typical,” providing coverage for losses sustained by reason of employee dishonesty committed “for the purpose of making an improper personal financial gain,” the court acknowledged that the exclusions in the bonds varied.²² However, the court concluded that little would be gained from analyzing the exact terms of the 51 bonds “for they are sufficiently similar, and the principles to be applied in determining whether there is an arguable right to recovery thereunder are over-arching and universally determinative.”²³

The Court determined that coverage was absent in this “unique” case because:

While Milken, Levine *et al.* were engaged in dishonest acts, their frauds were not committed against Drexel, but against members of the investing public, the companies they manipulated, and the federal regulatory agencies. In short, they did not steal *from* the company, they stole *for* the company.²⁴

The Court then reiterated that the bonds were not intended to indemnify Drexel against claims made against it by third parties defrauded by its employees:

The insurance policies here involved are fidelity blanket bonds, not liability insurance policies. They do not purport to defend and indemnify the assured every time a claim is made against it because it may be responsible to others for the acts of its employees. The loss covered is the loss to the insured, not the losses sustained by the outside world. Hence, the exclusions for “consequential damages.”²⁵

The second major ground for the Court’s decision was its determination that Drexel’s corporate guilty plea estopped it from seeking coverage. The Court noted that “Milken et al were not working at cross-purposes with Drexel, but for their mutual benefit.”²⁶ Drexel’s contention that the criminal charges lodged against it, to which it had pled guilty, were based upon mere vicarious liability for Levine and Milken’s criminal acts was rejected, and the Court found that Drexel had been charged with wilful and intentional wrongdoing and had received vast profits from the fraud until it was exposed. Reciting once again the dialectic phrase used in its coverage discussion, the Court found that having accepted the benefits of the misdeeds of its employees, it was estopped to complain about the resultant losses due

22. *Id.* at 1005.

23. *Id.*

24. *Id.* at 1007.

25. *Id.* In a footnote to this passage, the Court included the following cryptic statement:

It is noted that the Vigilant policy covers costs and attorneys’ fees incurred in defense of any claims. Does this include third-party claims?”

26. *Id.* at 1009.

to the activities of “individuals who stole *for* the company and not *from* it.”²⁷

The Court additionally held that where employee dishonesty concerns not defalcation or embezzlement, but illegal trading activities and violations of securities laws, coverage is not contemplated by fidelity insurance policies, especially where the employees’ activities accrued to the benefit of the company. Holding that resultant claims against the employer are “indirect,” the Court provided yet a third reason why the losses were not within the coverage provided:

Much of what Drexel seeks recovery for is indemnification for the claims of third persons who may have suffered as a result of the activities of Drexel and its employees. However, as previously pointed out, the policies covered only direct loss to the insured and excluded loss attributable to consequential damages.²⁸

The Drexel decision, while a tremendous result for the fidelity insurers involved and certainly correct in its outcome, is a mixed blessing in terms of providing a foundation for future decisions. The Court’s focus on the “essential nature” of the employee dishonesty coverage gives the opinion of potentially universal application. However, in cases where a Court is focusing upon particular bond language, Drexel may be of more limited utility. In addition, the “unique” circumstance of the corporate insured’s guilty plea to criminal charges implicating it as a knowing participant in the employees’ dishonest acts tends to make the case distinguishable.

A substantially identical equation was used two years later in 1995 by another judge of the same New York trial level court to defeat a claim under a stockbroker’s bond in a case that does not present the “uniqueness” of *Drexel*. However, the fact pattern is rather involved.

In *Continental Bank, N.A. v. Aetna Casualty & Surety Co.*,²⁹ the brokerage firm of Moore & Schley had been insured by Aetna and National Union under standard form stockbrokers bonds substantially identical to the Surety Association of America’s forms. In 1988, two Moore & Schley brokers, Militano and Sonneberg, cornered and manipulated the market in the stock of Chase Medical Corporation. The brokers made unauthorized purchases in customer accounts and moved (*i.e.*, “sold”) the stock from one customer’s account to another (without the customers’ knowledge) to extend the settlement dates and avoid having to fund the purchases. The manipulation was

27. *Id.*

28. *Id.* at 1009-1010. The *Drexel* opinion also involves additional issues that are beyond the intended scope of this paper, including the cancellation of coverage for an employee upon discovery of his dishonesty; the time of discovery and the scope of various exclusions.

29. 626 N.Y.S.2d 385 (Sup. Ct. N.Y.Co. 1995).

part of a “war against the shorts,” *i.e.*, an effort to become the sole source of the stock and drive up the price in order to enable Moore & Schley to take huge profits from those traders who had sold Chase Medical stock “short” (*i.e.*, sold stock they did not own in the anticipation that when, at a later date, they had to “buy in” to cover the sale, the stock price would have fallen).

During four months, Militano and Sonneberg had succeeded in raising the stock price in Chase Medical from a little over \$5 to \$13 per share, and they had accumulated 113% of the public float of the stock. However, their trading activity was noticed by the American Stock Exchange, which halted trading in the stock and reported the matter to the S.E.C. and led to the collapse of the scheme. In 1991, Militano and Sonneberg pleaded guilty to conspiracy to commit securities fraud, and the S.E.C.’s civil action against them resulted in a disgorgement order. However, unlike Drexel, no criminal or civil proceedings were brought against Moore & Schley itself arising from the affair.

When trading in Chase Medical was halted in January 1989, a huge number of Chase Medical shares had purportedly been purchased on margin by customers of Moore & Schley in trades executed through Moore & Schley’s clearing broker, Securities Settlement Corp. (“SSC”). The Moore & Schley customers whose accounts Militano & Sonneberg had used disavowed the purchases and refused to pay the margin calls made on their accounts. Moore & Schley did not have the capital to cover the purchases, and thus SSC, as the clearing broker, was forced to pay for the over 1 million shares of Chase Medical involved (which ultimately became worthless) at a cost of over \$11 million, for which it looked to Moore & Schley.³⁰

In 1989, Moore & Schley assigned to SSC “all proceeds” of the Aetna and National Union bonds relating to claims arising out of the Chase Medical fraud, and SSC in turn assigned those rights to Continental Bank. After filing under Chapter 11 of the Bankruptcy Code in early 1990, Moore & Schley submitted proofs of loss to the insurers based upon the dishonesty of Militano and Sonneberg, and the claim was denied. Moore & Schley’s bankruptcy proceedings were thereafter converted to Chapter 7, and Continental Bank (as assignee) brought suit against Aetna and National Union in its own name and, with permission of the bankruptcy trustee, that of Moore & Schley. When Continental Bank moved for partial summary judgment seeking \$4,250,000, the Court granted the defendant insurers’ cross-motion for summary judgment dismissing the complaint.

30. Therefore, Militano and Sonneberg’s scheme appeared to have injured many categories of third parties, including Moore & Schley’s customers, Moore & Schley’s clearing broker and, quite probably, Chase Medical itself.

The Court found that coverage was not triggered for two reasons, both of which illustrate the importance of the new terminology of the fidelity insuring agreement: Militano and Sonneberg lacked the required “manifest intent” to cause Moore & Schley a loss, and Moore & Schley did not suffer a “direct” loss.

Regarding manifest intent, the court found that “the manifest intent of these scoundrels was to make money, not to cause Moore & Schley to lose money,” stating:

The key words [of the fidelity insuring agreement] are manifest intent. “The manifest intent provision ... limit[s] protection under the bond to losses due to embezzlement or embezzlement-like acts.” *Glusband v. Fittin Cunningham & Lauzon, Inc.*, 892 F.2d 208, 212 (2d Cir. 1989). Militano and Sonneberg did not display a manifest intent to cause Moore & Schley to sustain a loss. They targeted the short sellers of Chase Medical stock, not Moore & Schley. The last thing they wanted was for their scheme to fail. As stated by plaintiffs in their memorandum (p.9), “[p]ersonal profit motivated the scheme of Militano and Sonneberg.” The manifest intent of these scoundrels was to make money, not to cause Moore & Schley to lose money. Cf. *Municipal Securities, Inc. v. Insurance Co. of North America*, 829 F.2d 7, 9 (6th Cir. 1987).³¹

The court also found that since Moore & Schley merely had an unpaid alleged liability to SSC, the loss alleged was not a covered “direct” loss. The court apparently recognized that it was SSC, not the insured, that had borne the loss. In this manner, while upholding the assignment of the proceeds of the bonds from the insured to SSC, the court relied upon the “loss resulting directly from” limitation found in the insuring agreement itself to deny coverage:

Coverage was not triggered because Moore & Schley did not suffer a direct loss. Under the Assignment of Insurance Proceeds agreement, Moore & Schley assigned to SSC “all proceeds of the Bonds in respect of any claim or claims ... [that] ... arise out of ... activities relating to the shares of common stock of Chase Medical Group, Inc.” The Bonds, which provide in pertinent part that “[t]he underwriter agrees to indemnify the insured for ... (A.) [l]oss resulting directly from dishonest or fraudulent acts committed by an Employee ...,” insure against an actual loss. The fact “[t]hat the insured may be liable to a third party for a loss of money resulting from employee dishonesty does not transform a policy covering the insured against a direct loss into one indemnifying against liability....” *175 East 74th Corp. v. Hartford Acc. & Indem. Co.*, 51 N.Y.2d 585, 593, 435 N.Y.S.2d 584, 416 N.E.2d 584; see also 13 Couch,

31. 626 N.Y.S.2d at 387.

on *Insurance 2d*, Fidelity & Guarantee Contracts §§ 46.2 at 10, 46.219 at 163 and 46.220 at 164.³²

The Seventh, Eighth and Tenth Circuits have interpreted the phrase “loss resulting directly from” in the same manner as did the New York court in *Continental Bank, i.e.*, as requiring the actual loss or depletion of the insured’s funds.³³ While not engaging in the in-depth analysis of the New York court in *Continental Bank*, a 1994 California federal opinion reaches a similar conclusion based upon the plain language of the fidelity insuring agreement. In *Fireman’s Fund Ins. Co. v. National Bank for Cooperatives*,³⁴ the bank had agreed to make loans to a company based upon inventory certificates to be issued by employees of the borrower, apparently under the supervision of Lawrence Systems, the insured under coverage provided by Firemen’s Fund including what was apparently a commercial crime policy. Lawrence also agreed to bond the fidelity of the borrower’s employees who would be responsible for certifying the quantity and value of the inventory of the borrower, and to compensate the bank for any actual loss the bank sustained up to \$10 million in reliance upon misrepresentations made by the bonded employees.

When the borrower corporation filed for bankruptcy, the inventory certificates were found to have substantially overstated the value of the borrower’s inventory, and the bank was left with a loss of in excess of \$10 million. The bank recovered an arbitration award, reduced to judgment, against Lawrence’s successor corporation which found, among other things, that Lawrence had deceived the bank, and Lawrence’s successor also filed for bankruptcy. In Firemen’s Fund’s declaratory judgment action against the bank, the bank argued, *inter alia*, that as assignee of Lawrence the bank was entitled to recover its loss under Firemen’s fidelity coverage, which contained the “manifest intent” definition of dishonesty.³⁵ The court, without reference to case law but based upon the plain terms of the coverage,

32. 626 N.Y.S.2d at 387-388. It should also be noted that as a third basis for the denial of coverage, the Court found that the transactions alleged were excluded by the “transactions in a customer’s account” exclusion.

33. See, e.g., *Cincinnati Ins. Co. v. Star Financial Bank*, 35 F.3d 1186, 1191 (7th Cir. 1994) (in connection with a third-party claim involving alleged forgery); *F.D.I.C. v. United Pacific Ins. Co.*, 20 F.3d 1070, 1080 (10th Cir. 1994) (involving fidelity insuring agreement); *First American State Bank v. Continental Ins. Co.*, 897 F.2d 319, 325 (8th Cir. 1990) (interpreting both the bond and Iowa law, as discussed *infra*). But, see *Jefferson Bank v. Progressive Casualty Ins. Co.*, 965 F.2d 1274, 1280-82 (3rd Cir. 1992) (equating the phrase as used in Insuring Agreement “E” and under Pennsylvania law as meaning “proximately caused by”). See also, *Hartford Accident & Indemn. Ins. Co. v. Washington National Ins. Co.*, 638 F.Supp. 78, 85-86 (N.D. Ill. 1986) (holding that language required direct causation between the “financial benefit” required in the “manifest intent” clause and the loss that resulted to the insured).

34. 849 F.Supp. 1347 (N.D. Cal. 1994).

35. 849 F.Supp. at 1362.

rejected the bank's claim, holding that coverage was provided not for deception practiced by Lawrence employees upon the bank, but only for deception practiced upon Lawrence by its employees, stating:

CoBank does not have a claim within the dishonesty coverage since there is no evidence that any employee committed dishonest acts in connection with the inventory control agreement with the manifest intent to (1) cause *Lawrence* to sustain loss and (2) obtain financial benefit for the employee or another person. It is therefore irrelevant whether CoBank is the assignee of Lawrence. The arbitration award was for Lawrence's deception of CoBank, not for the deception of Lawrence by one of its employees. CoBank's claim does not come within the dishonesty coverage of Firemens' Fund's policy. (emphasis in original)³⁶

Unfortunately, some recent decisions involving third-party claims and the "manifest intent" clause have essentially ignored the changes clearly intended to be wrought by the new language, some of them using a state statutory basis for so doing. In *First American State Bank v. Continental Insurance Co.*,³⁷ the Eighth Circuit held that a form 24 bankers blanket bond (apparently the 1969 revision with the 1976 "manifest intent" rider attached) covered loss incurred by the insured bank as the result of a fraudulent loan and commodities account manipulation scheme by the bank's chief agricultural loan officer, Clawson, involving two clients of the bank. Clawson persuaded the bank's clients to draw upon the unused portion of their credit lines, and then to loan the proceeds back to Clawson, who gave the customers his own promissory notes to evidence his debt. Clawson also engaged in unauthorized commodity speculation with funds of one of the customers that were to have been used as a hedging account for his cattle business. The Court noted that "Clawson's schemes created potential bank liability."³⁸

When Clawson could not repay the money, the customers threatened the bank and its board of directors with suit for compensatory and punitive damages. The bank's board of directors was advised by counsel that the bank would probably be held liable for Clawson's acts. The bank then filed a proof of loss with the defendant insurer, which denied coverage.

In order to avoid potential liability in the customers' threatened suits, the bank settled with the two customers by discounting the customers' liability to the bank by more than \$643,000 (the amount of the customers' loans to Clawson), and by restructuring some of their debt. The bank then filed a "final" proof of loss with the insurer, which was apparently also declined. The U.S. District Court for the Northern District of Iowa awarded

36. *Id.*

37. 897 F.2d 319 (1990).

38. 897 F.2d at 322.

judgment for the bank in the total amount of its claimed loss, less recoveries, together with attorneys' fees expended by the bank in negotiating the settlements.

In affirming, the Eighth Circuit quoted at length the bond's fidelity insuring agreement (as set forth in the "manifest intent" rider to the Form 24 bond then in use). However, the court held that the bond was a "statutory bond" since Iowa law required a bank to obtain a fidelity bond to cover certain losses incurred as a result of "any act or acts of fraud, dishonesty, forgery, theft, larceny, embezzlement, wrongful abstraction, misapplication, misappropriation or other wrongful act" by any officer or employee. The Court then effectively replaced the bond's insuring agreement with the much broader statutory language, relying on Iowa state court decisions expansively interpreting the statutory terms "fraud" and "dishonesty." Having thus rewritten the bond, the court held that the bank's settlement of its vicarious liability for Clawson's fraud upon the customers was covered.³⁹

Also troublesome is the Supreme Court of Washington's 1993 decision in *Estate of Jordan v. Hartford Accident and Indemnity Co.*,⁴⁰ in which the court similarly relied upon a state statutory scheme to rewrite the terms of the bond. The insured company, Lakeside, was an escrow agent, licensed and regulated under a state statutory scheme. A Lakeside employee, who was also a shareholder, director and vice-president of the company, diverted \$180,000 from the escrow trust accounts of several Lakeside customers into Lakeside's operating account to cover general corporate expenses.

Lakeside filed for relief under Chapter 7 of the Bankruptcy Code, and Lakeside's trustee filed a claim against the insurer under the fidelity bond that Lakeside had been required to secure under the relevant statute.⁴¹ The insurer denied the claim on the ground that Lakeside had suffered no loss because the stolen funds were diverted to Lakeside's use, and the employee's actions were not "fraudulent" under the manifest intent definition.

39. 897 F.2d at 325-326. It is hard to understand the court's commitment to the notion that the bank had a legal liability to the third parties, who appear to have been arguably in *pari delicto*, having given Clawson blank, signed promissory notes to assist him in the scheme. A possible explanation may lie in the court's characterization of the entire loan scheme as a method for Clawson to obtain loans of bank funds in circumvention of state banking regulations. 897 F.2d at 325. Query whether the Supreme Court of Iowa's 1994 decision in *Central National Insurance Co. v. Insurance Co. of North America*, 522 N.W.2d 39 (1994), discussed *infra*, affects the validity of the Eighth Circuit's analysis.

40. 120 Wash. 2d 490, 844 P.2d 403 (Wash. 1993).

41. The statute required "a primary commercial blanket bond or its equivalent" but went on to provide that such bond "shall provide fidelity coverage for any fraudulent or dishonest acts committed by any one or more of the employees or officers as defined in the bond, acting alone or in collusion with others."

The cheated customers obtained judgments against Lakeside in Bankruptcy Court, and Lakeside's trustee assigned to them all of Lakeside's rights under the fidelity bond. The customers then sued on the fidelity bond in the state court.

After finding that the customers had standing to sue as assignees of Lakeside, the Supreme Court of Washington addressed the issue of loss. The court held that a statutorily mandated bond must be interpreted in light of the requirements of the relevant statute, that the intent of the statute in question was "to protect clients of escrow agents," and that "Tinsley's embezzlement of \$180,000 from the trust account constitute[d] a loss of funds that Lakeside held in its capacity as trustee * * *." Thus, the court concluded that a "loss" as defined under the *statute* had occurred (even though Lakeside itself had received the benefit of the stolen escrow funds), but, in doing so, effectively changed the named insured from Lakeside to "Lakeside as trustee." The court relied on a 1933 precedent⁴² and dismissed out-of-hand the well-reasoned Fifth Circuit decision in *Fidelity & Deposit Co. v. USAFORM Hail Pool, Inc.*⁴³

The court also found that the bond's "manifest intent" provision conflicted with the statute's requirement of a bond insuring against "any fraudulent or dishonest acts."⁴⁴ Thus, the court read out of the bond the "manifest intent" clause and, instead, used the statute's much broader language to define coverage. The court went on to state that, even had it permitted the manifest intent requirement to govern, it would have held that the employee possessed the required manifest intent to cause Lakeside a loss "because he knew that his embezzlement of funds from the trust account was substantially certain to result in a loss to Lakeside in its capacity as trustee * * *." 844 P.2d at 412-413, 120 Wash. 2d at 506 (emphasis added). This dicta merely restates the Court's determination - based upon the statute, not the bond - that a "loss" had occurred, and ignores that fact that, even if Lakeside had repaid the stolen funds to its customers, it would not have suffered a loss since it would have merely disgorged property to which it had no entitlement.⁴⁵

42. *White & Bollard, Inc. v. Standard Accident Ins. Co.*, 175 Wash. 174, 27 P.2d 123 (1933). In that case, an employee stole a client's money prior to the beginning of the bond's coverage and, after inception of the coverage, diverted funds from various other clients' accounts to cover up the theft. There was no diminution of the insured's assets during the term of the bond, but the court nonetheless held that "wrongfully diverting the money was a misapplication of funds that amounted to a loss."

43. 463 F.2d 4 (5th Cir. 1972).

44. 844 P.2d at 412, 120 Wash. 2d at 504.

45. See, generally, Cynthia Young, *Interpreting "loss" Under the Financial Institution Bond from the Industry's Perspective* (August 1995) (unpublished paper presented to the Annual Meeting of the American Bar Association, Tort & Insurance Practice Section, Fidelity & Surety Law Committee, Chicago, Illinois).

In this regard, it is encouraging to note *First Dakota National Bank v. St. Paul Fire & Marine Ins. Co.*⁴⁶ in which the Eighth Circuit held that the fact that a bankers blanket bond was statutorily required under South Dakota Law did not invalidate the “manifest intent” provisions that were contained in the bonds but not provided for in the statute. The court expressly noted that the South Dakota Director of Banking and Finance had approved the bond as written, and that the additional “manifest intent” requirements were not inconsistent with the purposes of the state law mandating the bonds.⁴⁷

Another case involving the embezzlement of trust funds held by the insured and diverted to its own operating needs by employees is *In re Leedy Mortgage Co., Inc.*⁴⁸ However, the form of fidelity bond at issue was not similar to the financial institution bond form, but appears to have been a Lloyd’s of London form that lacked the “manifest intent to cause the insured to sustain such loss” clause.⁴⁹

THIRD PARTY’S RIGHT TO SUE OR GARNISH INSURER

Recent cases decided under the financial institution bond have denied third parties the right to sue the insurer directly, whether under a direct action statute or otherwise, to recover loss incurred by the third party due to allegedly dishonest acts by the insured’s employee. In *First National Bank of Louisville v. Lustig*,⁵⁰ the court held that a “standard-form Savings and Loan Blanket Bond” in which the insurer agreed to “indemnify the Insured for * * * loss resulting directly from dishonest or fraudulent acts of an Employee” was a contract of indemnity only, and that a lender to the insured who had been defrauded by one of the bank’s employees could not bring suit under the bond under Louisiana’s direct action statute. The Court held that no cause of action against the insurer accrued under the bond when liability

46. 2 F.3d 801 (8th Cir. 1993).

47. 2 F.3d at 808.

48. 76 Bankr. 440 (Bankr. E.D. Pa. 1987).

49. 76 Bankr. at 443 (quoting bond insuring agreement). The Leedy court was also apparently motivated by the fact that funds that were held in trust by the insured for third parties had been diverted, which was also a motivating factor in the *Estate of Jordan v. Hartford Accident and Indemnity Co.*, discussed *supra*. However, the “trust” nature of funds diverted from third parties did not have any effect upon the court in *In re Ben Kennedy and Assoc., Inc.*, 40 F.3d 318 (10th Cir. 1994), decided under Oklahoma law, in which the court held that the theft by an employee of money held in trust did not present an “actual loss,” would only be covered to the extent of the insured’s out-of-pocket expenses in satisfying the defrauded customers, and stated that “where [the insured] was in possession of, but did not own, the money that was lost, the requirement that it suffer a resulting actual loss before its insurer would become liable on the policy is closely lined with the fundamental requirement that [the insured] have an insurable interest in the subject matter of the policy.” 40 F.3d at 319.

50. 975 F.2d 1165 (5th Cir. 1992).

attached to the insured, and gave particular weight to the use of the word “sustained” in the manifest intent clause.⁵¹

*School Employees Credit Union v. National Union Fire Insurance Co.*⁵² involved a fidelity bond described by the district court as being “substantially similar, in form, to the Stockbrokers’ Blanket Bond promulgated by the Surety Association of America [SAA] in 1986 and 1987.”⁵³ The district court granted the defendant insurer’s motion for summary judgment dismissing an action by a third party who had been injured by the dishonesty of the now-defunct insured’s employees, holding that the bond was not within the purview of the Arkansas direct action statute since it provided indemnity, not liability, coverage.⁵⁴ The court’s discussion of the general law regarding fidelity bonds included the statement that “[u]nder a fidelity bond, the insurer need not indemnify the insured unless and until the insured has made payment to a third party,” citing *Hatch v. Reliance Ins. Co.*⁵⁵

Some courts appear recently to have gone beyond merely restricting or limiting coverage under various fidelity bonds for third party claims against an insured, and have indicated that they join the minority of courts holding that such coverage is not afforded at all. In *Bralko Holdings, Ltd. v. Insurance Co. of North America*,⁵⁶ the plaintiff had obtained a consent judgment against a brokerage firm for the amount of commissions illegally collected by the broker in the sale of limited partnership interests, and sought to collect the judgment by garnishing the broker’s blanket bond issued to the broker/judgment-debtor by INA. The Michigan Court of Appeals affirmed the lower court’s holding that there was no debt from INA to the broker which could be garnished since the bond provided indemnity against loss and not against liability, following the leading case of *Ronnau v. Caravan Int’l. Corp.*⁵⁷ Of interest is the statement by the Bralko court that “[a]t most,

51. Insuring Agreement A of the bond is question provided that “dishonest or fraudulent acts... shall mean [such acts] committed ... with the manifest intent to cause the Insured to sustain such loss.” 975 F.2d at 1167. The Court stated, “[t]he requirement that a loss be ‘sustained’ further denotes an indemnity agreement.” *Id.*

52. 839 F. Supp. 1477 (D. Kan 1993), *aff’d*, 1995 U.S. App. LEXIS 8254 (10th Cir. April 7, 1995)(10th Cir. affirmance not binding precedent and may only be cited under the terms and conditions of the Court’s general order filed November 29, 1993. 151 F.R.D. 470).

53. 839 F. Supp. at 1478.

54. *School Employees* thus overturns *Foster v. National Union Fire Ins. Co.*, 902 F.2d 1316 (8th Cir. 1990), which had construed the same Arkansas statute as permitting a direct action against a fidelity bond insurer.

55. 758 F.2d 409, 411-13 (9th Cir.), *cert. denied*, 474 U.S. 1021, 106 S.Ct. 571, 88 L.Ed.2d 555 (1985). In *Hatch*, defrauded third parties had obtained a default judgment against the insured, Heritage Trust Company, and sought to garnish the amount of their default judgment against the proceeds of Reliance’s fidelity bond upon which the receiver of Heritage had made claim.

56. 483 N.W.2d 929 (Mich. App. 1992).

57. 205 Kan. 154, 468 P.2d 118 (1970).

the policy insures against the loss sustained when a judgment is paid.” In a footnote to that comment, the court cautioned that it actually did not read the policy as extending to indemnification against payment of judgments, and indicated that the court interpreted the bond as providing no coverage for losses by third parties at all, even after reduced to judgment and paid by the insured.⁵⁸

In *Commercial Bank of Bluefield v. St. Paul Fire and Marine Ins. Co.*,⁵⁹ a case apparently involving a commercial crime coverage, the West Virginia Supreme Court of Appeals indicated that the term “loss” as used in fidelity policies required the direct misappropriation of the insured’s funds by an employee.⁶⁰ The court also indicated that in a situation where there was no misappropriation of the insured employer’s property, but only a judgment against the insured in favor of a third party injured through the misrepresentations of the insured’s employee, no coverage would be provided under fidelity policies generally.⁶¹ However, the court did indicate that in certain circumstances, a judgment creditor could seek to garnish an insurer’s liability for a covered loss to its insured under a fidelity policy.

In 1994, the Supreme Court of Iowa held in *Central National Insurance Co. v. Insurance Co. of North America*,⁶² that an injured third party could not bring a direct suit against the insurer under a commercial blanket bond pursuant to Iowa’s direct action statute because the policy meets neither of the criteria set by that statute: it neither insures against liability to third parties “nor indemnifies an insured for payments the insured makes to third parties.”⁶³ Iowa thus appears to have joined Nebraska⁶⁴ in holding that fidelity bonds, as a general proposition, provide no coverage at all for claims against the insured by third parties, even where that liability is reduced to judgment and paid by the insured.

Another recent case raises the specter of attempted garnishment through collusive behavior between the insured and third party claimants. In *Falcon*

58. 483 N.W.2d at 931, n.3 (“We caution that this is *not* the interpretation of the policy that we draw. As explained in the text of the opinion, our interpretation is much narrower.”)

59. 175 W. Va. 588, 336 S.E.2d 552 (W. Va. 1985).

60. 336 S.E.2d at 556.

61. *Id.*

62. 522 N.W.2d 39 (Iowa 1994).

63. 522 N.W.2d at 44.

64. *See Omaha Bank for Cooperatives v. Aetna Casualty and Surety Co.*, 207 Neb. 782, 301 N.W.2d 564 (Neb. 1981), in which the Supreme Court of Nebraska held that a form of bankers blanket bond (although apparently not patterned after the financial institution bond form) would not provide coverage for the insured’s liability to third parties that had been defrauded by the insured’s employees, even if the insured itself were to be found vicariously liable to the third parties and even if the liability were reduced to judgment. The court indicated that whether or not the insured paid the judgment would be irrelevant.

*v. Beverly Hills Mortgage Corp.*⁶⁵ Lloyd's of London had issued a "primary bond policy" to a mortgage banking company containing both errors and omissions and fidelity coverage. The President, who also was the sole owner of the company, was accused of having fraudulently induced several investors to place money with the company by falsely promising that the money would be invested in promissory notes secured by mortgages or deeds of trust. The mortgage company filed for bankruptcy, and the automatic stay was lifted to permit the investors' suit against the mortgage company and its President to proceed. Following a "trial" lasting about two hours which was not preceded by any discovery, the judge entered a judgment against both defendants based upon findings of fact and conclusions of law that had apparently been agreed upon by the parties to the suit. The investor/judgment-creditors then attempted to garnish the proceeds of the bond based upon the judgment, claiming that a debt was due to the mortgage company by virtue of the fidelity coverage and findings of the trial judge.

Relying in large measure upon the Restatement (Second) of Judgments § 57,⁶⁶ the Supreme Court of Arizona held that even had the insurer been properly "vouched in" to the underlying action by having been given appropriate notice, it would not be bound by the judgment obtained against the insured where the insurer could show that the insured had not defended the underlying action with due diligence, but had in fact "rolled over and played dead" on the basis of an apparent agreement with the plaintiffs.⁶⁷

65. 168 Ariz. 527, 815 P.2d 896 (Ariz. 1991).

66. According to the Arizona Court's opinion, the Restatement (Second) of Judgments § 57, in pertinent part, provides:

When one person (the indemnitor) has an obligation to indemnify another (the indemnitee) for a liability of the indemnitee to a third person, and an action is brought by the injured person against the indemnitee and the indemnitor is given reasonable notice of the action and an opportunity to assume or participate in its defense, a judgment for the injured person has the following effects on the indemnitor in a subsequent action by the indemnitee for indemnification:

- (a) The indemnitor is estopped from disputing the existence and extent of the indemnitee's liability to the injured person; and
- (b) The indemnitor is precluded from relitigating the issues determined in the action against the indemnitee if:

* * *

- (ii) The indemnitee defended the action with due diligence and reasonable prudence.

67. General Agreement F (1986 version) to the financial institution bond also provides assistance in protecting against collusive judgments or settlements. The pertinent language provides that should the insurer elect not to defend any causes of action contained in legal proceedings brought against the insured, then "neither a judgment against the Insured, nor a settlement of any legal proceeding by the Insured, shall determine the existence, extent or amount of coverage under this bond for loss sustained by the Insured...."

CONCLUSION

In handling claims under the financial institution bond that involve claims against the insured by third parties, the vast changes made in the bond over the past fifteen years must be carefully borne in mind in evaluating the impact of precedent. Disputed claims under bonds issued following the 1986 revision will now become the more frequent subject of decisional law, and the full effect of those revisions will slowly unfold in the next decade. However, it does appear that the courts have recognized that the new language and provisions employed following the 1980 revisions significantly narrow the scope of coverage afforded for third party claims against insureds.