

UNIQUE FIDELITY COVERAGE ISSUES  
PRESENTED BY CLAIMS INVOLVING  
BRIBES, KICKBACKS AND ILLICIT PROFITS

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I. INTRODUCTION

If there is such a thing as a *garden variety* fidelity claim, it is the situation where an employee has committed an outright theft of assets from an employer. The intent to cause loss to the employer and to wrongfully benefit the dishonest employee is readily apparent from the unfaithful act itself. The loss is direct and usually consists of an immediate diminution in the capital or earned income of the insured rather than the loss of a potential business opportunity. The loss is readily measurable by the net amount of cash other property that the employee has wrongfully taken. It does not take the form of illicit fees or commissions, and it is not subject to future contingencies such as market fluctuations or the default on a loan.

Contemporary forms of fidelity coverage under the financial institution bond and commercial crime bond have been designed to provide cover for the archetypal situation where the employee has placed his or her hands in the employer's till, cash box, warehouse, or vault and absconded with the insured's money or property. Limitations embodied in the manifest intent wording, exclusionary provisions relating to "potential income," "trading" and "consequential loss", and case law limiting recovery to net out-of-pocket pecuniary loss and "direct loss" have created substantial obstacles for fidelity claims that do not consist of outright theft by an employee. This lodestar coverage scenario has been recognized by the Second Circuit, which noted that fidelity coverage containing manifest intent wording and the trading exclusion "limit[s] protection under this bond to losses due to embezzlement or embezzlement-like acts."<sup>1</sup>

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<sup>1</sup> Glusband v. Fittin Cunningham & Lauzon, Inc., 892 F.2d 208, 212 (2d Cir. 1989).

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While outright embezzlement may be the quintessential form of employee dishonesty, there are numerous other forms of criminal conduct that an employee can engage in that may result in the realization of improper benefits by the employee coupled with substantial adverse financial consequences to the employer. Of these, the payment of bribes and kickbacks to an employee by a customer or vendor of the insured is perhaps the most common and the most serious. This situation may arise whenever an employee is entrusted with engaging in financial transactions with a third party on behalf of the insured or a customer of the insured. It often occurs in the context of the sale or purchase of securities, goods or services, the issuance of a loan or extension of credit, or virtually any situation where the employee is transferring cash or property of the insured, or making binding commitments on behalf of the insured to a third party. Another closely related scenario is the situation where the dishonest employee violates fiduciary duties owed to the insured by assuming and profiting from business opportunities that should rightfully have been presented to and realized by the employer.

While the payment of bribes and kickbacks to a dishonest employee and the theft of corporate opportunities by a faithless employee may pose substantial fidelity risks to the insured, there are serious questions as to whether those risks, and the losses arising from them, are covered by the financial institution bonds and crime policies currently on the market. As a Utah court stated in an early and widely followed decision interpreting the manifest intent provisions of a fidelity bond, "[c]learly, the coverage provided . . . is quite narrow. The paradigmatic scheme that would be covered . . . is an embezzlement."<sup>2</sup> Most fidelity bonds currently on the market simply do not provide coverage for all forms of dishonest conduct perpetrated by an employee. This paper will attempt to explore whether the current forms of fidelity coverage are "broad enough" to cover loss arising from the payment of bribes and kickbacks to an employee and the wrongful assumption of corporate opportunities by a faithless employee.

## II. ISSUES RAISED BY THE FIDELITY INSURING AGREEMENT

### *A. Manifest Intent Wording*

#### 1. Bribes Disguised as Fees and Commissions

Most forms of fidelity coverage utilizing manifest intent provisions not only require proof that the employee has committed a dishonest or fraudulent act with the manifest intent "to obtain financial benefit for the Employee," but also limit the types of improper financial benefits the employee must receive

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<sup>2</sup> *Verex Assur., Inc. v. Gate City Mortgage Co.*, No. C-83-0506W, 1984 WL 2918, at \*2 (D. Utah Dec. 4, 1984).

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in order to trigger coverage. In general, most bonds exclude "salaries, commissions, fees, bonuses, promotions, awards, profit sharing, pensions or other employee benefits earned in the normal course of employment" from the category of qualifying improper financial benefits. Variants of this exclusionary language include "salary, commissions, fees or other emoluments."

If the bond excluded all "fees" and "commissions" of any nature, claims for loss arising from bribes and kickbacks would probably be excluded in their entirety. In most bonds, however, the exclusion only applies to fees and commissions "earned in the normal course of employment" or constituting "other emoluments." Although the payment of bribes and kickbacks to an employee can be made under a variety of guises, the courts have drawn a clear distinction between illicit payoffs that are made by third parties directly to the dishonest employee and those that are filtered through an otherwise legitimate compensation system sponsored by the insured. The exclusion has been found to be limited to the latter category of claims.

Perhaps the leading decision in this area is the *Morgan, Olmstead* decision<sup>3</sup> from the Second Circuit. In that case, the insured was a securities broker-dealer who alleged that its employee had been induced to enter into a fraudulent scheme with an outside vendor to loan securities to other broker-dealers and financial institutions. The arrangement exposed the insured to grave financial risk and ultimately caused it to sustain substantial loss. The scheme allowed the employee to fraudulently increase his income under a profit-sharing formula contained in his employment contract. The insured argued that the arrangement was in the nature of a bribe and that the loss was covered under the bond. The court found that the receipt of the improper payment through a compensation scheme authorized by the insured caused the loss to be excluded, regardless of whether the fraud could be characterized as a bribery scheme. The court stated:

In view of [the employee's] apparent belief that he would benefit from the scheme, [the outside vendor's] offer to bring business to [the employee's] department might be loosely termed a "bribe." But since the money [the employee] received came from his employer and not from [the outside vendor], [the insured] gains little by pointing out that the hypothetical cash bribe scenario . . . falls within the bond's coverage.<sup>4</sup>

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<sup>3</sup> *Morgan, Olmstead, Kennedy & Gardner, Inc. v. Federal Ins. Co.*, 637 F. Supp. 973 (S.D.N.Y. 1986), *aff'd*, 833 F.2d 1003 (2d Cir. 1986).

<sup>4</sup> *Id.* at 978.

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Accordingly, under the *Morgan, Olmstead* analysis, "bribe-like" payments that are funneled through an otherwise legitimate and authorized compensation scheme will be excluded from coverage under the bond.<sup>5</sup>

In a more recent case, a salesman at an auto dealership entered into improper deals with customers in which he sold cars at unauthorized discounts and furnished unauthorized warranties that exposed the insured to chargebacks from the manufacturer. The employee's actions increased his commissions under his compensation agreement with the insured, but he received no other financial benefit. The loss was found to be excluded.<sup>6</sup> The same result has been reached where employees conspired with third parties to create fraudulent and fictitious sales orders that generated unauthorized commissions.<sup>7</sup> It has even been held that where an employee obtains an improper commission payment under an employer-created commission structure and then uses a portion of that commission to pay a kickback to a third party co-conspirator, that kickback also falls under the employee benefits exclusion since the kickback money originated as a commission payment.<sup>8</sup>

As discussed above, the exclusion contained in the manifest intent wording does not apply to the entire universe of "fees" paid to an employee, but only to fees earned pursuant to some type of preordained employer-authorized compensation scheme where the employee works a scam to derive more income than he or she rightfully deserves. Accordingly, where a dishonest bank officer caused the bank to pay him "executive committee fees" but where the insured's board of directors had not authorized any plan to pay such fees, the court found that the president's receipt of the fees constituted a covered loss falling outside the exclusion of "employee benefits earned in the normal course of employment."<sup>9</sup> Accordingly, it would appear that bribes, kickbacks or unauthorized fees paid or received outside the structure

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<sup>5</sup> See *Heller Int'l. Corp. v. Sharp*, 974 F.2d 850, 858 (7th Cir. 1992), *First Nat'l Bank of Louisville v. Lustig*, 961 F.2d 1162, 1167 (5th Cir. 1992); *Glusband*, 892 F.2d at 210; *Municipal Securities, Inc. v. Insurance Co. of N. Am.*, 829 F.2d 7, 9-10 (6th Cir. 1987); *Koch Industries, Inc. v. National Union Fire Ins. Co. of Pitt., Pa.*, No. 89-1158-K, 1989 WL 158039, at \*16 (D. Kan. Dec. 21, 1989); *Verex Assur.* 1984 WL 2918, at \*2, *Mortell v. Ins. Co. of N. Am.*, 458 N.E.2d 922, 929 (Ill. App. Ct. 1983); *Benchmark Crafters, Inc. v. Northwestern Nat'l Ins. Co. of Milwaukee*, 363 N.W.2d 89, 91 (Minn. Ct. App. 1985); *Dickson v. State Farm Lloyd's*, 944 S.W.2d 666, 668 (Tex. Ct. App. 1997).

<sup>6</sup> *Auburn Ford Lincoln Mercury v. Universal Underwriters Ins. Co.*, 967 F. Supp. 475 (M.D. Ala. 1997), *aff'd*, 130 F.3d 444 (11th Cir. 1997).

<sup>7</sup> *James B. Lansing Sound, Inc. v. National Union Fire Ins. Co. of Pitt., Pa.*, 801 F.2d 1560 (9th Cir. 1986).

<sup>8</sup> *Hartford Accident and Indem. Ins. Co. v. Washington Nat'l Ins. Co.*, 638 F. Supp. 78 (N.D. Ill. 1986).

<sup>9</sup> *Federal Deposit Ins. Corp. v. St. Paul Fire and Marine Ins. Co.*, 738 F. Supp. 1146, 1159-61 (M.D. Tenn. 1990), *partially vacated on other grounds*, 942 F.2d 1032 (6th Cir. 1991).

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of any pre-established compensation scheme will not be affected by the employee benefits exclusion in the manifest intent wording.

## 2. Intent to Cause Loss to the Insured

In order to trigger coverage for employee dishonesty loss under standard manifest intent provisions of the fidelity insuring agreement, the insured must establish that its faithless employee committed dishonest or fraudulent acts with the manifest intent "to cause the insured to sustain such loss." In most cases, the bond also requires that the loss incurred be a "direct" one.

The issue of whether an employee has acted with the requisite manifest intent to cause the insured to sustain a loss has been the subject of numerous decisions with respect to loan/credit loss<sup>10</sup> and trading loss claims.<sup>11</sup> The intent requirement has been found to be satisfied where the evidence suggested the existence of an actual subjective intent on the part of the faithless employee to cause the loss or where the employee acted with gross indifference to the interests of the employer and a loss was substantially certain to follow.<sup>12</sup> On the other hand, where it is uncertain that a covered loss to the insured will immediately ensue from the wrongful conduct of the employee, courts have demonstrated a reluctance to find coverage.<sup>13</sup> This is particularly true where the employee has directed the fraud against a customer of the insured, resulting in only a contingent liability claim against the insured that may or may not ripen into an actual loss.<sup>14</sup> The "direct loss" language found in most fidelity coverages has been interpreted in conjunction with the manifest intent provisions to impose a requirement that the loss to the insured be

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<sup>10</sup> See *First Federal Sav. & Loan Ass'n of Salt Lake City v. Transamerica Ins. Co.*, 935 F.2d 1164 (10th Cir. 1991); *Good Lad Co. v. Aetna Cas. & Sur. Co.*, No. 92-5678, 1995 WL 393964, at \*5-8 (E.D. Pa. June 30, 1995); *Federal Deposit Ins. Corp. v. St. Paul Fire and Marine Ins. Co.*, 738 F. Supp. 1146, 1159-61 (M.D. Tenn. 1990), *partially vacated on other grounds*, 942 F.2d 1032 (6th Cir. 1991); *Citizens State Bank v. Capitol Indem. Corp.*, No. C1-95-321, 1995 WL 421672, at \*1 (Minn. App. Ct. July 18, 1995); *Susquehanna Bancshares, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 659 A.2d 991, 996-97 (Pa. Super Ct. 1995).

<sup>11</sup> *Glusband*, 892 F.2d at 209; *Municipal Securities*, 829 F.2d at 9; *In re J.T. Moran Fin. Corp.*, 147 B.R. 335, 339-41 (Bankr. S.D.N.Y. 1992); *Continental Bank, N.A. v. Aetna Cas. & Sur. Co.*, 626 N.Y.S.2d 385, 387 (N.Y. Sup. Ct. 1995).

<sup>12</sup> See *First Nat'l Bank of Louisville v. Lustig*, 96 F.3d 1554, 1556-57 (5th Cir. 1996); *Heller Int'l. Corp. v. Sharp*, 974 F.2d 850, 858 (7th Cir. 1992); *Good Lad Co.*, 1995 WL 393964, at \*4-5; *Citizens State Bank of Big Lake v. Capitol Indemn Corp.*, 1995 WL 421672, at \*2; *Susquehanna Bancshares*, 659 A.2d at 996-97.

<sup>13</sup> See *First Federal Sav. & Loan*, 935 F.2d at 1166-67; *Glusband*, 892 F.2d at 209; *Municipal Securities*, 829 F.2d at 9; *Good Lad Co.*, 1995 WL 393964 at \*4-5; *In re J.T. Moran Fin. Corp.*, 147 B.R. at 339-41; *Federal Deposit Ins. Corp. v. St. Paul Fire and Marine Ins. Co.*, 738 F. Supp. at 1159-61.

<sup>14</sup> *ITT Hartford Life Ins. Co. v. Pawson Associates, Inc.*, No. 940361910, 1997 WL 345345, at \*2-3 (Conn. Super. Ct. Jun. 16, 1997).

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immediate rather than remote or contingent.<sup>15</sup> The Sixth Circuit recently interpreted these provisions to restrict coverage as follows:

As a practical matter . . . losses resulting from frauds on third parties will rarely be covered by Standard Form 24. These policies will cover a loss suffered by a third party only where the dishonest employees intended to cause the third-party loss, and knew or expected that the loss would migrate to the bank. The migratory route would need to be short, certain, and obvious to support an inference (in the absence of direct evidence) that dishonest employees harbored such knowledge or expectation.<sup>16</sup>

Similar scenarios can arise with respect to claims involving the payment of bribes or kickbacks to an employee. On one end of the spectrum, a purchase or sales agent of the insured may knowingly purchase or sell goods at above or below fair market prices in exchange for a bribe or kickback from a vendor or customer.<sup>17</sup> An employee who uses the insured's funds to knowingly overpay for goods or services in exchange for a bribe or kickback arguably satisfies the "intent to cause loss" requirements of the bond as well as the direct loss requirements.

At the opposite end of the spectrum are situations where the insured's employee purchase goods, services or securities at fair market prices but the vendor kicks back a portion of his or her authorized commission in order to maintain the business relationship. Under those circumstances, it becomes more difficult for the insured to establish that its employee intended to cause it to suffer a loss since the insured essentially received the benefit of the bargain. In addition, the insured will have difficulty establishing that it sustained an out-of-pocket pecuniary loss on the transaction since, at best, it lost only "potential income" – an issue that is discussed in further detail below. At least one court has found that the kickback of a portion of a broker/agent's commission to a State employee on a transaction where an insurance policy was purchased by the State at fair market value not constitute a compensable loss under a fidelity bond.<sup>18</sup>

Further complications can arise where the tainted purchase or sale relates to a transaction in a customer's account as opposed to that of the insured. An employee with discretionary trading authority over a customer's securities or mutual fund account might receive bribes or kickbacks to purchase or sell securities at above or below market prices, causing an immediate loss to the customer of the insured but only a contingent liability

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<sup>15</sup> *Id.*

<sup>16</sup> *Peoples Bank & Trust Co. of Madison County v. Aetna Cas. & Sur. Co.*, 113 F.3d 629, 634 (6th Cir. 1997).

<sup>17</sup> See *James B. Lansing Sound*, 801 F.2d at 1565 (9th Cir. 1986); *Koch Industries*, 1989 WL 158039.

<sup>18</sup> *Commonwealth v. Insurance Co. of N. Am.*, 436 A.2d 1067 (Pa. Commw. Ct. 1981).

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exposure to the insured. Before the adoption of manifest intent wording, such faithless conduct was considered to be covered dishonesty; and the focus of the coverage dispute was on whether coverage was defeated by the trading loss exclusion.<sup>19</sup> Where such claims arise under manifest intent wording, however, issues may arise as to whether the employee intended the insured (as opposed to the customer) to sustain a loss, whether the employee's exposure of the insured to a contingent liability is sufficient to satisfy the "direct loss" requirements of the bond, and whether the claim is defeated by the "consequential loss" exclusion of the bond.<sup>20</sup>

### *B. Theft Wording*

Commercial crime policies frequently cover losses arising from "theft" by an employee in lieu of using manifest intent wording in their fidelity coverage agreement. "Theft" is often defined as "[t]he unlawful taking of Money, Securities or other property to the deprivation of the Insured." The Ninth Circuit has expressed the view that an employee who accepts a bribe in exchange for purchasing securities at an inflated price commits an act of covered "Theft." In *Research Equity*,<sup>21</sup> a faithless investment advisor received bribes from third parties for recommending the purchase of certain securities at prices which the advisor knew to be manipulated. As a result of the advisor's recommendations, the insured fund purchased several securities at artificially inflated prices and suffered losses in selling them when the scheme was discovered. The Ninth Circuit stated:

[I]t is our opinion that when an employee knowingly pays more for an item than it is worth with the intention of enriching the person for whom the purchase is made, this is theft as surely as if the employee had given the other person the money directly. Disguising the theft as a purchase does not make it any less a theft.<sup>22</sup>

### *C. Broad Form Dishonesty Wording*

Prior to the adoption of manifest intent wording, many fidelity insuring agreements provided coverage for loss arising from "dishonest or fraudulent acts" by an employee, where the term "dishonest or fraudulent acts" was not defined in the policy. The acceptance of bribes or kickbacks by an employee has been found to constitute a "dishonest or fraudulent act" under such coverage.<sup>23</sup>

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<sup>19</sup> See *Insurance Co. of N. Am. v. Gibrasco, Inc.*, 847 F.2d 530, 533 (9th Cir. 1988); *Research Equity Fund, Inc. v. Insurance Co. of N. Am.*, 602 F.2d 200, 202 (9th Cir. 1979); *Index Fund, Inc. v. Insurance Co. of N. Am.*, 580 F.2d 1158, 1163 (2d Cir. 1978).

<sup>20</sup> See *Drexel Burnham Lambert Group, Inc. v. Vigilant Ins. Co.*, 595 N.Y.S.2d 999, 1006 (N.Y. Sup. Ct. 1993).

<sup>21</sup> *Research Equity Fund, Inc. v. Insurance Co. of N. Am.*, 602 F.2d 200 (9th Cir. 1979).

<sup>22</sup> *Id.* at 204.

<sup>23</sup> See *Boston Sec., Inc. v. United Bonding Ins. Co.*, 441 F.2d 1302, 1304 (8th Cir. 1971).

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### III. ISSUES RAISED BY THE TRADING EXCLUSION

#### *A. Loss Arising "Indirectly From Trading"*

Most financial institution bonds and commercial crime policies on the market today contain some form of trading exclusion. Although they assume a variety of forms, most exclude coverage for "loss resulting directly or indirectly from trading." A typical "full blown" version of the trading exclusion will bar recovery for the following:

Any loss resulting directly or indirectly from trading, including all transactions involving the purchase, sale or exchange of securities, with or without the knowledge of the insured, in the name of the insured or otherwise, whether or not represented by any indebtedness or balance shown to be due the insured on any customer's account, actual or fictitious, and notwithstanding any act or omission on the part of any employee in connection with any account relating to such trading, indebtedness, or balance.

The key words in such trading exclusions are "loss resulting directly or indirectly from trading." There are two components of the trading exclusion that have been the subject of judicial debate. One concerns the meaning of the term "loss resulting . . . from trading." The other relates to the effect that the qualifying term "directly or indirectly" has upon the exclusion.

With respect to the meaning of the term "loss resulting . . . from trading", virtually all courts recognize that a loss resulting from the adverse movement of market forces constitutes a "trading loss." The Second Circuit has stated that "[t]he obvious purpose of the trading exclusion is to exempt from coverage losses caused by market forces [and] misjudgments of those forces by buyers and sellers of securities . . ." <sup>24</sup> The Ninth Circuit echoed these views when it decided that "[t]rading losses are generally understood to be market losses sustained by firms as a result of ill-advised, unauthorized, or simply unlucky trading decisions made in the purchasing, selling, or trading of securities." <sup>25</sup>

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<sup>24</sup> *Glusband*, 892 F.2d at 211.

<sup>25</sup> *Gibraltar*, 847 F.2d at 533.

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Where the loss is caused by adverse market movements, most courts have applied the trading exclusion to bar recovery, even where an employee acted improperly, without authority or concealed losses in the course of executing trades.<sup>26</sup>

In addition to excluding "loss resulting ... from trading," most forms of the trading exclusion exclude "loss resulting ... indirectly from trading." This raises the question of whether employee fraud perpetrated under the guise of a trading scheme is barred where all or part of the loss arises from embezzlement rather than purely from the adverse movement of market forces.

Losses can arise through customer or employee fraud in the course of executing trades which have nothing to do with the adverse movement of market forces. It is these types of losses that the courts have struggled with in terms of deciding whether they constitute trading losses and whether they result at least "indirectly from trading."

Where a customer of an insured broker-dealer has fraudulently induced the assured to part with its money or securities in the course of executing a trade, the courts have shown a general willingness to apply the trading exclusion to bar recovery under the premises or transit insuring agreements, even though the loss had nothing to do with adverse market movements.<sup>27</sup>

On the other hand, where an employee embezzles funds in the course of executing a trade and the claim is brought under the fidelity insuring agreement, the courts have shown a general reluctance to characterize the loss as one arising "indirectly from trading." Accordingly, where an employee of an insured broker-dealer fraudulently induced customers to open trading

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<sup>26</sup> See *Glusband*, 892 F.2d at 209; *Lincoln Grain, Inc. v. Aetna Cas. & Sur. Co.*, 756 F.2d 75, 77-78 (8th Cir. 1985); *Bass v. American Ins. Co.*, 493 F.2d 590, 591 (9th Cir. 1974); *Roth v. Maryland Cas. Co.*, 209 F.2d 371, 373-74 (3d Cir. 1954); *Stargatt v. Avenell*, 434 F. Supp. 234, 249 (D. Del. 1977); *Earl v. Fidelity & Deposit Co. of Maryland*, 32 P.2d 409, 411-13 (Cal. App. Ct. 1934); *Rath v. Indemnity Ins. Co.*, 8 P.2d 435, 436 (Cal. App. Ct. 1934); *Hepler v. Fireman's Fund Ins. Co.*, 239 So.2d 669 (La. Ct. App. 1970); *Harris v. National Sur. Co.*, 155 N.E. 10, 11-12 (Mass. Dist. Ct. 1927); *Continental Bank*, 626 N.Y.S.2d at 387; *Columbia Equities, Ltd. v. Underwriters at Lloyds, London*, 589 N.Y.S.2d 411, 412 (N.Y. App. Div. 1992); *Flushing Nat'l Bank v. Transamerica Ins. Co.*, 491 N.Y.S.2d 793, 793-94 (N.Y. App. Div. 1985).

<sup>27</sup> See *Sutro Bros. & Co. v. Indemnity Ins. Co. of N. Am.*, 386 F.2d 798, 801 (2d Cir. 1967); *Degener v. Hartford Accident & Indem. Co.*, 92 F.2d 959, 961 (3d Cir. 1937); *Sutro Bros. & Co. v. Indemnity Ins. Co. of N. Am.*, 264 F. Supp. 273 (S.D.N.Y. 1967), *aff'd*, 386 F.2d 798 (2d Cir. 1967); *Sade v. National Sur. Corp.*, 203 F. Supp. 680, 685-86 (D.D.C. 1962), *aff'd*, 314 F.2d 286 (D.C. Cir. 1963); *Condon v. National Sur. Corp.*, 254 N.Y.S.2d 620, 625 (N.Y. App. Div. 1964), *aff'd*, 209 N.E.2d 819 (N.Y. 1965); *Kean v. Maryland Cas. Co.*, 223 N.Y.S. 373 (N.Y. App. Div. 1927), *aff'd*, 162 N.E. 514 (N.Y. 1927). But see *First Federal Sav. and Loan Ass'n of Toledo v. Fidelity and Deposit Co. of Maryland*, 895 F.2d 254, 260-61 (6th Cir. 1990) (holding that third party's failure to make payment on a securities trade was not a trading loss because it did not result from an adverse market movement).

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accounts with the firm which the employee proceeded to plunder, the Ninth Circuit refused to accept the insurer's argument that the loss arose "indirectly from trading."<sup>28</sup> A similar result was reached by an Illinois court which justified its refusal to apply the trading exclusion by stating: "Crime has not yet been dignified by the name of trade."<sup>29</sup>

### *B. Kickback and Bribery Schemes Involving Trading*

The situation where an employee is paid a bribe or kickback in order to execute a trade at above or below market prices has presented special difficulties for the courts and has resulted in a split in the authorities.

In *Index Fund*,<sup>30</sup> a Second Circuit case dating back to 1978, the president of an insured investment company bought and sold securities on behalf of the fund. He was allegedly bribed by and entered into conspiracy with certain third parties to purchase securities at prices which the president knew to be manipulated. He purchased certain securities for the fund at inflated prices totaling \$98,870. The securities were sold, after the prices had fallen, for \$36,698, leaving a total loss of \$62,172. The court found that where the insured is a regulated investment company, rather than a broker, the fraudulent purchase of securities for the company by the covered employee at a manipulated price may well be considered outside the contemplated meaning of "trading." It went on to state that even if "trading" were ordinarily read to include activities such as the president's, the bond at issue was a so called "statutory bond." The insured was permitted to recover its net loss, even though that loss consisted of a mix of adverse market movements and the original overpayment for the securities.

In *Research Equity*, the Ninth Circuit dealt with a virtually identical set of facts a year later and reached the opposite result.<sup>31</sup> In that case, an employee investment advisor received bribes from third parties for recommending the purchase of certain securities to a management investment company at prices he knew to be manipulated. As a result of these recommendations, the insured purchased several securities at artificially inflated prices and suffered losses in selling them when the scheme was discovered. The court found that the loss arose at least indirectly from trading and denied recovery. It emphasized that the assured had the option to "buy-back" trading coverage and declined it.

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<sup>28</sup> *Gibralco*, 847 F.2d at 532.

<sup>29</sup> *American Investment Co. v. United States Fid. & Guar. Co.*, 267 Ill. App. 370 (Ill. App. Ct. 1932); *see also* *In re Schluter, Green & Co.*, 93 F.2d 810 (4th Cir. 1938); *Shearson/American Exp., Inc. v. First Continental Bank and Trust Co.*, 579 F. Supp. 1305, 1310-12 (W.D. Mo. 1984); *Cohon v. United States Fid. & Guar. Co.*, 13 N.Y.S.2d 976 (N.Y. Sup. Ct. 1939).

<sup>30</sup> *Index Fund, Inc. v. Insurance Co. of N. Am.*, 580 F.2d 1158 (2d Cir. 1978).

<sup>31</sup> *Research Equity*, 602 F.2d at 202.

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Where an employee receives a bribe or kickback in exchange for purchasing securities or commodities at inflated prices and the insured's loss is later exacerbated by a drop in the value of the items acquired, there is another method of adjusting the loss that was apparently not considered by the courts in either *Index Fund* or *Research Equity*. The insured could have been awarded the net amount by which its employee overpaid for the securities and excluded that portion of the loss representing a drop in market values.

In a recent New York case, the insured employees had engaged in insider trading in collaboration with third parties. The insured itself had pleaded guilty to criminal charges relating to the insider trading. Without discussing its rationale, the court found that the trading exclusion barred recovery, along with other exclusions in the bond.<sup>32</sup>

### *C. Excluding Non-Theft Loss In Customer Accounts*

A seemingly broader form of trading exclusion has begun to appear in many financial institution bond and commercial crime products. This exclusion frequently states as follows:

This bond does not directly or indirectly cover:

loss resulting from transactions in a customer's account, whether authorized or unauthorized, except loss resulting from the unlawful withdrawal and conversion of Money, Securities or precious metals directly from a customer's account and provided such unlawful withdrawal and conversion is covered under [the Fidelity Insuring Agreement].

In a recent New York case, the exclusion was held to defeat coverage for loss arising from fraudulent trading transactions in a customer's account where money or securities were never actually withdrawn or converted from the account.<sup>33</sup> The court stated:

The [b]onds provide in pertinent part that a "loss resulting directly or indirectly from transactions in a customer's account, whether authorized or unauthorized" is excluded from coverage. [The insured's] loss resulted from [the employee's] unauthorized transactions in the customer accounts ....<sup>34</sup>

This type of trading exclusion would appear to be very problematic for an insured whose employee received bribes or kickbacks in return for conducting unauthorized transactions in a customer's account. Unless the insured can establish that there has been an actual unlawful withdrawal and conversion of money, securities or precious metals from the customer's

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<sup>32</sup> *Drexel Burnham*, 595 N.Y.S.2d at 1007.

<sup>33</sup> *Continental Bank*, 626 N.Y.S.2d at 388.

<sup>34</sup> *Id.*

account that would otherwise be covered under the fidelity insuring agreement, the loss will be excluded.

#### IV. ISSUES RELATED TO THE SCOPE OF COVERED LOSS

##### A. *The Meaning Of Loss*

In most cases, the term "loss" is not specifically defined in commercial crime and financial institution products. Whether defined or not, however, it generally has been held that the bond only covers out-of-pocket pecuniary loss. As the Tenth Circuit has recently stated:

This fidelity policy insures against the loss of property due to employee dishonesty. In general, an insurer's obligation to indemnify against loss attaches only when the insured sustains an actual loss.... [The insured's] recovery under its fidelity policy is ... limited to reimbursement of its actual out-of-pocket expense resulting from the loss of its clients' money due to its employee's dishonesty.<sup>35</sup>

There is a split in authority as to whether the undefined term "loss" under a fidelity bond includes the loss of potential income and business opportunities resulting from covered dishonesty or whether it is restricted to actual out-of-pocket diminution in the existing assets of the insured.

In a 1950 Maryland case,<sup>36</sup> the court was called upon to decide whether an insured merchandise wholesaler could recover for its lost profits where an employee had secretly set up his own business in competition with the insured and diverted customer orders to that business. The court found that lost profits were not the type of property that was insured under the bond:

It seems to be quite clear that, whether the word "profits" is used ... or whether the word "proceeds" is used, what was actually lost by [the insured] was the profit they would have made had their employee not engaged in competition with them, or the prospective profit they would have had in the diverted contracts. [The insurer] did not insure them against the loss of all kinds of property, intangible or otherwise, but only against the loss of money, certain specified kinds of personal property or evidences of personal property, and "other personal property...." The insurer did not insure against loss of profits.<sup>37</sup>

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<sup>35</sup> *In re Ben Kennedy and Associates, Inc.*, 40 F.3d 318, 319-20 (10th Cir. 1994); *see also* *Federal Deposit Ins. Corp. v. United Pacific Ins. Co.*, 20 F.3d 1070, 1080 (10th Cir. 1994); *Continental Cas. Co. v. First Nat'l Bank of Temple*, 116 F.2d 885, 887-88 (5th Cir. 1941); *Banco De San German, Inc. v. Maryland Cas. Co.*, 344 F. Supp. 496, 505 (D. P. R. 1972).

<sup>36</sup> *Levy v. American Mut. Liability Ins. Co.*, 73 A.2d 892, 893-94 (Md. 1950).

<sup>37</sup> *Id.*

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Other courts have similarly held that the bond does not compensate for the loss of potential income or business opportunities resulting from faithless acts of an insured's employees.<sup>38</sup>

In the same year that Maryland determined that covered property under the bond did not encompass potential income, the Fifth Circuit reached the opposite result in a factual scenario where the faithless employee used the insured's credit to purchase steel in the insured's name but then transferred the orders to a personal account where he realized secret profits.<sup>39</sup> The court permitted the insured to recover the lost profits that the employee realized through his unlawful competition with his own employer. Other courts have similarly permitted the insured to recover lost income as well as the profits realized by dishonest employees on transactions where they have unlawfully competed with their employers.<sup>40</sup>

### *B. The Potential Income Exclusion*

#### 1. Diversion of Business Opportunities

The potential income exclusion was first included in the Bankers Blanket Bond by rider in the 1970s and began appearing as a standard exclusion in the 1980s. The exclusion typically states that the bond does not cover "potential income, including but not limited to interest and dividends, not realized by the insured."

As noted by one commentator, the intent of the exclusion was to reaffirm that the bond only covers out-of-pocket losses consisting of a reduction in the insured's existing assets.<sup>41</sup> The potential income exclusion can have possible applicability in a variety of factual settings and has received disparate treatment by the courts, depending on the context in which it has arisen.

Where employees have been bribed or have received kickbacks to divert corporate opportunities to third parties at the expense of the insured, the courts have generally applied the potential income exclusion to deny recovery. In a Fifth Circuit case, the insured made a claim for lost profits and

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<sup>38</sup> See *First American State Bank v. Continental Ins. Co.*, 897 F.2d 319, 329 (8th Cir. 1990); *Shearson/American Exp.*, 579 F. Supp. at 1313-14; *America Trust & Sav. v. United States Fid. & Guar. Co.*, 418 N.W.2d 853, 855-56 (Iowa 1988).

<sup>39</sup> *Eagle Indem. Co. v. Cherry*, 182 F.2d 298, 299-300 (5th Cir. 1950); see also *National Sur. Corp. v. Rauscher, Pierce & Co.*, 369 F.2d 572, 578-79 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967).

<sup>40</sup> See *Boston Securities*, 441 F.2d at 1304; *American Ins. Co. v. First Nat'l Bank in St. Louis*, 409 F.2d 1387, 1391 (8th Cir. 1969); see also *Rauscher*, 369 F.2d at 578-79; *M.B.A.F.B. Federal Credit Union v. Cumis Ins. Soc. Inc.*, 507 F. Supp. 794 (D.C.S.C. 1981), *aff'd*, 681 F.2d 930 (4th Cir. 1982); *H.S. Equities, Inc. v. Hartford Accident & Indem. Co.*, 464 F. Supp. 83, 87 (S.D.N.Y. 1978), *aff'd*, 609 F.2d 669 (2d Cir. 1979).

<sup>41</sup> ANNOTATED BANKERS BLANKET BOND 42 (F. Skillern ed. Supp. 1983).

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expenses incurred where its faithless employees were secretly involved in competitive businesses which outbid the insured on certain projects. The court permitted the insured to recover lost travel expenses that the faithless employees had charged to the insured in furtherance of the scheme, as well as salaries for diverted time, telephone services, corporate facilities and overhead. However, the court denied recovery for lost profits based upon the potential income exclusion.<sup>42</sup>

Similarly, an Illinois court found that the potential income exclusion barred recovery where an employee stole a trade secret (sealant formula) and "sold" it to a competitor.<sup>43</sup> The potential income exclusion has also been held to bar the insured from recovering lost profits due to insider trading by its employees.<sup>44</sup>

In general, the potential income exclusion has been found to defeat claims relating to the complete diversion of a business opportunity from the insured to the dishonest employee or a third party.

## 2. Recovery Of Lost Profit Margin On Goods

If an employee of an insured sells the insured's goods to a third party at below market prices either in return for a bribe or kickback or pursuant to some other fraudulent scheme, the insured will frequently make claim for its "list" price on the goods, a figure that normally includes a "profit margin." Under those circumstances, the issue has arisen as to whether the potential income exclusion limits the insured's recovery to its actual out-of-pocket manufacturing costs or whether it is permitted to recover its "list" price for the goods.

When that issue arose in a case before the Ninth Circuit, the court held that the potential income exclusion did not defeat recovery for the lost profit margin.<sup>45</sup> It based its findings on the valuation clause of the policy, which it found to conflict with the potential income exclusion, thus rendering the exclusion ambiguous. The Valuation-Payment-Replacement clause of the policy provided:

In case of damage to the Premises or loss of property other than Securities, the Company shall not be liable for more than the actual cash value of such property, or for more than the actual cost of repairing such Premises or property or of replacing same with property or material of like quality or

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<sup>42</sup> *Diversified Group, Inc. v. Van Tassel*, 806 F.2d 1275, 1277 (5th Cir. 1987).

<sup>43</sup> *United States Gypsum Co. v. Insurance Co. of N. Am.*, 1985 WL 3514, at \*1 (N.D. Ill. 1985).

<sup>44</sup> *Drexel Burnham*, 595 N.Y.S.2d at 1007.

<sup>45</sup> *James B. Lansing Sound*, 801 F.2d at 1565; *see also Koch Industries*, 1989 WL 158039, at \* 17-19.

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value. The Company may, at its election, pay such actual cash value, or make such repairs or replacements.<sup>46</sup>

The insurer argued that the proper measure of loss under the valuation clause was the insured's cost of remanufacture. The court, however, stated that the policy did not define what was meant by "actual cash value" and did not indicate whether the "actual cost" of replacement under the clause was to be measured by the insured's actual cost of remanufacture or the cost of purchasing similar goods on the open market from a third party (which would have included the vendor's profit margin). The court found that "actual cash value" meant fair market value, which it equated to the insured's wholesale list price, and measured the loss on that basis.<sup>47</sup>

It should be noted that the court found the potential income exclusion to be ambiguous because of the perceived conflict between that exclusion and the valuation clause.<sup>48</sup> If the claim had involved one for loss relating to the value of securities or services where the valuation clause was inapplicable, or if the language of the valuation clause had been reconciled with that of the potential income exclusion, the court could have found that the portion of the claim consisting of lost profit margin was excluded.

### *C. The Proper Measure Of The Loss*

#### 1. Price Differential Of Goods or Services

Where an insured's employee has accepted a bribe or kickback in exchange for willfully selling the insured's goods, services or securities at below market prices or for willfully purchasing goods, services or securities from third parties at above market prices, issues have arisen as to how the insured's loss is to be measured.

A bribe or kickback, in and of itself, does not represent an actual loss to the insured.<sup>49</sup> The money is being paid by a third party to an employee of the insured. If the bribe or kickback is being paid to induce the dishonest employee to purchase or part with goods or services at "rigged" prices, the real loss to the insured is not the bribe or kickback but rather the fact that goods or services are being purchased by it at an inflated price or are being sold by it at below market rates.

Where the insured has been able to prove the difference between the actual market value of its goods or services and the amounts at which its faithless employee sold or purchased them, the courts have accepted such

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<sup>46</sup> *James B. Lansing Sound*, 801 F.2d at 1564.

<sup>47</sup> *Id.* at 1565-66.

<sup>48</sup> *Id.* at 1565.

<sup>49</sup> See *Commonwealth v. Insurance Co. of N. Am.*, 436 A.2d at 1069-1071.

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evidence as a proper manner of measuring the insured's loss.<sup>50</sup> Where the insured employee has been engaged in purchasing goods from a third party, the insured has been permitted to calculate its loss based upon the difference between what the insured paid for the goods and what they were actually worth.<sup>51</sup>

On the other hand, where the bribed employee has been engaged in selling goods, services or securities on behalf of the insured, the loss will generally be derived from the fact that the goods are being sold at below their actual market value. As noted above, depending upon whether the bond is found to contain a valuation clause that conflicts with the potential income exclusion, issues can arise as to whether the insured is entitled to recover the difference between the fraudulently discounted price and the insured's list price, which includes a profit mark-up, or whether it may only recover the difference between the discounted price and the manufacturing cost of the goods.<sup>52</sup> In either case, however, the loss is measured by the difference in the value of the goods, and not by the amount of the bribe or kickback.

## 2. Loss Measured By Bribe Or Kickback

Courts have sometimes permitted the insured to measure its loss based upon the amount of bribes or kickbacks that were paid to its faithless employee. Recovery is permitted not on the theory that bribes or kickbacks represent a loss to the insured, but rather on the basis that they represent a rough yardstick of the amount of loss suffered by the insured.<sup>53</sup>

The approach arguably has merit in situations where the evidence clearly demonstrates that the bribe or kickback was paid in consideration for a corresponding offset in the price of the goods being purchased or sold. Under that scenario, the third party dealing with the bribed employee is generally only interested in his net cost or profit. That cost or profit is represented by what the third party pays or receives for the goods or services, less what he has to pay to the faithless employee as a bribe or kickback. The insured's loss is incurred on the sale or purchase of goods or services, but it is measured by the amount of the bribes or kickbacks.<sup>54</sup>

It should be noted, however, that a variety of motivations may exist for the payment of bribes and kickbacks to an employee of an insured and such

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<sup>50</sup> See *James B. Lansing Sound*, 801 F.2d at 1565; see also *Koch Industries*, 1989 WL 158039, at \* 19-20.

<sup>51</sup> See *Hanson PLC v. National Union Fire Ins.*, 794 P.2d 66, 73 (Wash. Ct. App. 1990).

<sup>52</sup> See *James B. Lansing Sound*, 801 F.2d at 1565; see also *Koch Industries*, 1989 WL 158039, at \* 19.

<sup>53</sup> See *Commonwealth v. Insurance Co. of N. Am.*, 436 A.2d at 1070-71.

<sup>54</sup> See *Boston Securities*, 441 F.2d at 1303; see also *Oshawa Group v. Great Am. Ins. Co.*, O.R.2d 36, 424 (1982).

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improper payments do not always translate into an out-of-pocket depletion of the insured's existing assets. As noted above, a third-party vendor may agree to kick back a portion of his or her authorized commission to a purchasing agent of the insured in order to maintain a profitable business relationship while continuing to supply goods, services or securities at fair market prices. While the insured may legitimately complain that its employee has breached fiduciary duties and has failed to fulfill duties to secure purchases at the best possible prices, the loss would appear to amount to no more than a loss of excluded potential income.

### 3. Double-Dipping Is Not Permitted

Permitting the insured to recover *both* its net actual loss *and* the amount of any bribe or kickback paid to its employee would represent a double recovery. While courts will usually permit insureds to recover the difference in price between the actual value of its goods or services and the fraudulently created price, and may sometimes permit the insured to measure its loss by the amount of the bribe or kickback, they will not allow the insured to recover both.<sup>55</sup>

## V. CONCLUSION

Despite the fact that the fidelity insuring agreements of most commercial crime and financial institution products currently on the market appear designed to protect the insured only from pure embezzlement-type losses, the products also seem to cover certain types of claims involving bribes and kickbacks paid to employees of the insured in exchange for fraudulent modifications in the purchase or sale price of goods or services. In order to be covered, however, the claims must satisfy the rigorous manifest intent requirements of the bond (where that form of coverage is employed), must constitute a direct loss to the insured, and must steer clear of the consequential loss exclusion, the trading exclusion and the potential income exclusion. Lastly, the insured must prove that it has sustained an actual out-of-pocket pecuniary depletion in its assets as a result of the scheme, and must prove the amount of that loss.

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<sup>55</sup> See *James B. Lansing Sound*, 801 F.2d at 1566 (denying recovery for illicit commission payments where insured was awarded damages based on the ordinary list prices of its goods); see also *Howard, Weil, Labouisse, Fredrichs, Inc. v. Insurance Co. of N. Am.*, 397 F. Supp. 1279, 1284 (E.D. La. 1975), *aff'd*, 557 F.2d 1055 (5th Cir. 1977).