

POTENTIAL CONFLICTS BETWEEN FIDELITY
INSURERS AND INSURED:
PARALLEL PROCEEDINGS, INTERVIEWING WIT-
NESSES, AND ACTIONS AGAINST THIRD PARTIES

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I. INTRODUCTION

The relationship between a fidelity bond insurer and its insured can give rise to a myriad of issues in addition to the ultimate question of whether a claim is covered. Those issues often implicate the interests of others, such as the accused wrongdoer and state and local governmental agencies. This article addresses some of the more frequently occurring problems and sources of potential conflict between the insured and its fidelity insurer. The issues can be grouped in three general categories.

The first category includes problems which can arise in the context of parallel civil and criminal proceedings, such as access to witnesses and documents, assertions of Fifth Amendment privilege by witnesses (including the accused wrongdoer), the admissibility of criminal convictions or guilty pleas, and forfeiture and restitution statutes. It is in this area in particular that the interests of an insured and its fidelity bond insurer can be greatly influenced by the interests of the accused and state and federal prosecutorial authorities.

The second category includes potential conflicts which may arise when a fidelity insurer seeks to interview current or former employees of the insured. Here, a fidelity insurer's right to interview current employees is largely

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governed by the terms of the bond, and the right to interview former employees is largely shaped by the controlling law of the relevant jurisdiction. In all cases, a fidelity insurer should be mindful of the potential for retaliatory litigation by the accused wrongdoer based upon the insurer's disclosure or "re-publication" of the insured's allegations of dishonesty.

The third category involves issues relating to a fidelity insurer's interest in actions brought by an insured against third parties and whether a fidelity insurer should join third parties in an action filed against it by the insured. Responses to these issues are often dictated by the specific factual circumstances of the claim, as well as the controlling case law. Recognizing and anticipating the following potential areas of conflict hopefully will enable a fidelity insurer to handle claims more promptly and efficiently.

II. PARALLEL CRIMINAL AND CIVIL PROCEEDINGS

Due to the nature of fidelity coverage, acts giving rise to a claim for loss resulting from employee dishonesty often constitute state or federal crimes, so the investigation and litigation of a fidelity claim often occurs simultaneously with criminal proceedings. These so-called "parallel" proceedings can, in turn, give rise to several issues that highlight the competing interests between the insured, its fidelity insurer, the accused wrongdoer, and even the government.¹ This paper examines those competing interests in several contexts, including the practical considerations in obtaining and developing information related to the claim, the government's ability to stay civil proceedings, the effect criminal convictions and guilty pleas can have on a fidelity claim, and how forfeiture statutes and criminal restitution statutes can affect salvage considerations.

A. Practical Considerations

As a practical matter, the existence of a parallel criminal proceeding may influence the insured's or the insurer's willingness or ability to immediately proceed with investigation and litigation of a fidelity claim. First, depending upon the nature of the claim and the status of the criminal proceedings, the insured and the insurer may wish to defer investigation of the claim until the criminal proceedings have concluded. As commentators have recently suggested, there may be reasons why both the insured and its fidelity insurer may wish to postpone investigation or litigation of a fidelity claim until the criminal proceedings have concluded, including when documentary evidence is inconclusive and outcome of key issues will depend upon the credibility of

¹ This article only addresses parallel criminal proceedings involving the federal government because analysis of the often differing state rules may lead to differing results. Analysis of federal proceedings provides an overview of the important issues.

witnesses.² In that regard, the parties may wish to enter into a standstill agreement.

Second, the initiation of criminal proceedings may facilitate obtaining additional sources of information. As an initial matter, financial institutions are required to file “suspicious activity reports” (formerly known as “criminal referral forms”) upon discovery of certain activity. Even though financial institutions are supposed to keep the reports confidential, they sometimes attach them to the proof of loss. Unfortunately, the regulations do not contain a mechanism for obtaining the reports, unlike the case with certain regulatory reports.³ The parties may be able to utilize guilty pleas or convictions (or the lack thereof) rendered in the criminal action, even though such results are not necessarily dispositive with respect to the fidelity claims. The parties may also be able to obtain copies of transcripts of, and exhibits used by the prosecutor and defense counsel in, the criminal trial.

Third, conversely, obtaining documents may be made more difficult if the insured produces voluminous documents to prosecutors, often without retaining copies. By and large, prosecutors often do not prevent a fidelity insurer from access to the insured’s copies of documents produced for use in the criminal case, but due to chain of custody and grand jury secrecy issues, obtaining the originals of such documents may be made more difficult by reason of parallel proceedings. Consequently, a fidelity insurer’s response to these types of issues is necessarily dictated by the circumstances and nuances of the particular claim.

B. Prosecutor’s Stay of Civil Proceedings

Even if the parties wish to proceed with a civil case before the conclusion of a criminal investigation or litigation, they should be mindful that the government can stay civil proceedings if the prosecutors can show that the civil case is interfering with the criminal proceeding. With that in mind, it is important to understand why prosecutors may seek a stay of civil proceedings (or at least curtail discovery), what interests the prosecutors are seeking to protect, and how civil litigants can proceed without inviting governmental intervention, or at least how to resist attempts by prosecutors to stay civil proceedings.

² Hugh E. Reynolds, Jr., *Litigation Strategy From the Insured’s Viewpoint*, in FINANCIAL INSTITUTION BONDS 595 (2d ed., Duncan L. Clore ed., 1998).

³ See 12 C.F.R. § 21.21 (1999). For a primer on how to obtain regulatory reports, see Mark E. Wilson, *Federal Regulatory Reports: Getting Them and Using Them in a Financial Institution Bond Case* (unpublished paper presented at the meeting of the Chicago Surety Claims Association, Chicago, Ill., Jan. 10, 1995) (on file with author).

1. Primer on Grand Jury Secrecy

In large part, the potential for the interests of civil litigants to conflict with the interests of criminal prosecutors exists in connection with grand jury proceedings, which must remain secret under penalty of civil and criminal sanctions. The basis for non-disclosure of matters occurring before a grand jury is set forth in Rule 6 of the Federal Rules of Criminal Procedure. In relevant part, Rule 6(e)(2) states that “matters occurring before the grand jury shall not be disclosed by persons covered by this rule.” Persons covered by the rule, and thus prohibited from disclosing grand jury matters, include attorneys for the government, the grand jurors themselves, court reporters, typists who transcribe recorded testimony, interpreters, and government personnel assisting the prosecutor.⁴

The reasons for secrecy include preventing subornation of perjury or tampering with witnesses who may testify before the grand jury and later appear at the trial of those indicted by it, encouraging free and full disclosure by persons who have information with respect to the commission of the crime, and protecting the innocent from disclosure of the fact that he or she has been under investigation.⁵ The reasons for the secrecy rules are not obviated by the dismissal of the grand jury because, for example, persons called upon to testify before a grand jury should not be influenced by the possibility that their testimony may one day be disclosed to outside parties.⁶

In addition to the secrecy imposed by Rule 6 of the Federal Rules of Criminal Procedure, employees and agents of certain financial institutions and even insurance companies are prohibited from disclosing certain information to subjects of grand jury subpoenas. For example, under the Right to Financial Privacy Act, certain persons affiliated with a financial institution are prohibited from notifying the subject of a subpoena (i.e., the customer of the bank) about the existence of the subpoena for records or about the information furnished to the grand jury.⁷ The statute applies to a number of crimes, including crimes against a financial institution or an agency in charge of supervising financial institutions. In addition, obstruction of criminal investigation statutes prohibit anyone affiliated with a financial institution from notifying, with or without intent to obstruct a judicial proceeding, any person about the existence of a grand jury subpoena for records or information

⁴ FED. R. CRIM. P. 6(e)(2).

⁵ See, e.g., *United States v. Proctor & Gamble Co.*, 356 U.S. 677 (1958).

⁶ *Douglas Oil Co. v. Petrol Stops Northwest*, 441 U.S. 211 (1978).

⁷ 12 U.S.C. § 3420(b) (1989 & West Supp. 1999).

furnished to the grand jury.⁸ Perhaps more significantly, the statute prohibits anyone affiliated with an *insurance business* whose activities affect interstate commerce from notifying any person about the existence of a subpoena or information furnished to the grand jury with intent to obstruct a judicial proceeding.⁹

Despite what appears to be a daunting impediment to a fidelity claim investigation, it should be noted that grand jury witnesses are specifically excepted from the secrecy imposed by Rule 6(e). Rule 6(e)(2) states that no obligation of secrecy will be imposed on any person except in accordance with the rule.¹⁰ Consequently, disclosure by the witness of his or her testimony is at the witness's option. A target of a grand jury investigation has no right to require a witness to divulge the information.¹¹ Upon a showing of a compelling need, however, the government may request a protective order compelling a witness's silence.¹²

Thus, persons who happen to be grand jury witnesses and who are also witnesses in parallel civil proceedings are not covered by the secrecy requirements imposed by Federal Rule of Criminal Procedure 6(e). In that regard, since civil discovery permits litigants to discover relevant matter reasonably calculated to lead to discovery of admissible evidence,¹³ a party in a civil proceeding may subpoena a grand jury witness for deposition in order to compel the witness to reveal not only what he or she has told the grand jury, but also other information the witness learned from the grand jury experience and even the direction of the investigation.¹⁴ An involuntary participant in a civil proceeding, such as a defendant or third-party witness, cannot invoke the right of secrecy if subpoenaed unless the witness obtains a court order. Even though the courts have recognized that they should give

⁸ 18 U.S.C. § 1510(b)(1)&(2) (1984 & West Supp. 1999). These sections apply to investigation of crimes potentially relevant to a fidelity claim, including false reporting (18 U.S.C. §§ 1956 & 1957 (West Supp. 1999)), mail and wire fraud (18 U.S.C. §§ 1341 & 1343 (1984 & West Supp. 1999)), bank fraud (18 U.S.C. §§ 656 & 657 (1976 & West Supp. 1999)), and bribery (18 U.S.C. § 215 (1969 & West Supp. 1999)).

⁹ 18 U.S.C. § 1510(d)(1) (1984 & West Supp. 1999). This section specifically applies to investigations for false financial reporting under 18 U.S.C. § 1033. The statute is broadly written and would appear to apply not only to subpoenas a fidelity insurer may receive, but also any grand jury subpoenas it may learn about.

¹⁰ See *United States v. Sells Engineering, Inc.*, 463 U.S. 418 (1983).

¹¹ *In re Butterworth v. Smith*, 494 U.S. 624 (1990)(the witness is free not to divulge testimony); *Kamasinski v. Judicial Review Council*, 797 F. Supp. 1055 (D. Conn. 1992).

¹² See, e.g., *In re Grand Jury Subpoena Duces Tecum*, 797 F.2d 676 (8th Cir. 1986); *Black v. Sheraton Corp. of Am.*, 564 F.2d 531 (D.C. Cir. 1977); *Pontarelli Limo., Inc. v. Chicago*, 652 F. Supp. 1428 (N.D. Ill. 1987).

¹³ Fed. R. Civ. P. 26(b)(1).

¹⁴ See *Sells Engineering*, 463 U.S. at 418.

substantial weight to the public's interest in law enforcement when balancing a civil litigant's right to a prompt determination of his or her civil claims,¹⁵ a civil litigant (like an accused wrongdoer) may not file a lawsuit as a pretense to access information he was not entitled to in criminal discovery; and the plaintiff in a civil action cannot use his role as a grand jury witness as a shield to protect him from participating in the discovery process in a case the witness initiated.¹⁶

Not only may witnesses testify as to their testimony before the grand jury, but not all documentary records are considered "matters occurring before the grand jury." While not defined in the Rule, there is a body of case law discussing the various issues in detail. Whether certain documents are subject to the secrecy obligations of Rule 6 varies among jurisdictions. Interpretations of the Rule vary from the "per se" approach, which does not classify documents as "matters occurring before the grand jury,"¹⁷ to the opposite approach in which the courts treat documents as protected from disclosure,¹⁸ to the "effect" approach, which seeks to determine whether disclosure would reveal some secret aspect of the inner workings of the grand jury.¹⁹ Other courts have adopted a "rebuttable presumption" approach, which presumes that documents are within the scope of the Rule but permit the moving party to rebut the presumption by showing that the information is public or was not obtained through coercive means, or that disclosure of the material would be otherwise available by civil discovery and would not reveal the nature, scope, or direction of the grand jury investigation.²⁰

In addition, information obtained from a source independent of the grand jury, even if presented to the grand jury, is not included within the scope of Rule 6(e); but the fact that such material has been presented to the grand jury

¹⁵ *Campbell v. Eastland*, 307 F.2d 478 (5th Cir. 1962); *Board of Governors of Fed. Reserve System v. Pharaon*, 140 F.R.D. 642 (S.D.N.Y. 1991).

¹⁶ *United States v. Stewart*, 872 F.2d 957 (10th Cir.1989); *United States v. Tison*, 780 F.2d 1569 (11th Cir. 1986).

¹⁷ *Ballas v. United States*, 62 F.3d 1175 (9th Cir. 1995); *United States v. Dynavac, Inc.*, 6 F.3d 1407 (9th Cir. 1993); *United States v. Weinstein*, 511 F.2d 622 (2d Cir. 1975); *In re Grand Jury Investigation of VenBFuel*, 441 F. Supp. 1299 (M.D. Fla. 1977).

¹⁸ *In re Grand Jury Proceedings*, 827 F.2d 868 (2d Cir. 1987); *Texas v. United States Steel*, 546 F.2d 626 (5th Cir. 1977).

¹⁹ *In re Grand Jury Subpoena*, 920 F.2d 235 (4th Cir. 1999); *Noske v. United States*, 27 F.3d 571 (8th Cir. 1994); *In re Special March 1981 Grand Jury*, 753 F.2d 575 (7th Cir. 1985); *In re Grand Jury Matter*, 682 F.2d 61 (3d Cir. 1982); *Fund for Constitutional Government v. National Archives & Records Serv.*, 656 F.2d 856 (D.C. Cir. 1981); *Ajluni v. FBI*, 947 F. Supp. 599 (N.D.N.Y. 1996); *Pontarelli Limo., Inc. v. Chicago*, 652 F. Supp. 1428 (N.D. Ill. 1987).

²⁰ *In re Grand Jury Proceedings*, 851 F.2d 860 (6th Cir. 1988).

is within the scope of the Rule.²¹ In that regard, documents subpoenaed by the grand jury may not be considered matters within the scope of the Rule, even when the documents have been examined by the grand jury, so long as disclosure does not reveal that there were exhibits.²² Thus, the party to whom the documents belong, such as the insured, is free to disclose them to anyone, even if the same documents are subpoenaed and requested in discovery in a civil case.

The majority view is that Rule 6(e) does not apply to witness interview memoranda, even though the contents are later reported to the grand jury or repeated to the grand jury by the witness.²³ Several courts have treated interview memoranda that were later presented to the grand jury as the same as transcripts of grand jury testimony, which are subject to Rule 6(e).²⁴ Similarly, “proffer” memoranda, wherein a witness proffers that he or she will present certain testimony, are generally treated like interview memoranda. Since such memoranda contain information obtained without subpoena by a grand jury, they are often considered to be outside the scope of Rule 6(e); but a few jurisdictions still view documents that reveal what will happen before the grand jury in the future as covered by Rule 6(e).²⁵

Despite the secrecy obligations imposed by Rule 6(e), disclosure of matters covered by the Rule may be obtained if a court so directs in connection with a judicial proceeding.²⁶ This includes situations such as bankruptcy cases, civil cases, and administrative agency actions. The movant must show that the information is for use directly related to some identifiable litigation and that the litigation is more than a remote contingency.²⁷ A court may permit

²¹ See, e.g., *Woodward v. Tynan*, 757 F.2d 1085 (10th Cir. 1985); *Stump v. Gates*, 777 F. Supp. 796 (D. Colo. 1991).

²² *Senate of Puerto Rico v. United States Dept. of Justice*, 823 F.2d 574 (D.C. Cir. 1987); *In re Grand Jury Investigation*, 630 F.2d at 96; *Weinstein*, 511 F.2d at 622; *Rosenglick v. IRS*, No. 97-747-CIV-DRL-18A, 1998 U.S. Dist. LEXIS 3920 (M.D. Fla. March 10, 1998); *Capital Info. Group v. Office of the Governor*, 923 P.2d 29 (Alaska 1996).

²³ *Blalock v. United States*, 844 F.2d 1546 (11th Cir. 1988); *In re Grand Jury Matter*, 862 F.2d at 61; *Anaya v. United States*, 815 F.2d 1373 (10th Cir. 1987); *McQueen v. United States*, 5 F. Supp. 2d 473 (S.D. Tex. 1998); *Metro Med. Sup. v. Shalala*, 959 F. Supp. 799 (M.D. Tenn. 1996).

²⁴ *In re Grand Jury Matter*, 697 F.2d 511 (3d Cir. 1982); *In re Special February, 1975 Grand Jury*, 662 F.2d 1232 (7th Cir. 1981), *aff'd sub nom. United States v. Baggot*, 463 U.S. 478 (1983); *In re Grand Jury Proceedings (Daewoo)*, 613 F. Supp. 672 (D. Or. 1985).

²⁵ See, e.g., *Grand Jury Investigation*, 610 F.2d 202 (5th Cir. 1980); *In re Potash Antitrust Litig.*, 896 F. Supp. 916 (D. Minn. 1995); *United States v. Armco Steel*, 458 F. Supp. 784 (W.D. Mo. 1978).

²⁶ FED. R. CIV. P. 6(e)(3)(C)(1).

²⁷ See, e.g., *United States v. Baggot*, 463 U.S. 418 (1983).

disclosure only when the requesting party shows a “particularized need” for the information. The moving party must show that the material is required to avoid a possible injustice, the need for disclosure is greater than the need for the continued secrecy, and the request is narrowly tailored. When considering the effect of the disclosure, the court must consider not only the immediate effect upon the grand jury, but also the potential effect on the functioning of future grand juries.²⁸ The court may require that any disclosure include protective limitations on the use of the disclosed material, and the burden of proof is on the party seeking disclosure.²⁹ The most important issue that a court will examine in weighing the factors is whether the grand jury investigation has been completed.³⁰ That being said, it is extremely difficult to obtain disclosure of the grand jury materials. In determining whether the moving party has met its burden, a district court is vested with substantial discretion; and its decision will not be overturned absent a showing of an abuse of discretion.³¹ An action against an accused wrongdoer may be an appropriate circumstance to seek disclosure of a grand jury transcription or other protected matter.

2. Staying the Proceedings

With that background in mind, it is easier to understand why the government may seek to limit or stay parallel civil proceedings during the pendency of the criminal case. Despite the secrecy obligations imposed by Rule 6 and other relevant statutes, there may be other, more practical reasons why a prosecutor may seek to limit or stay civil proceedings. The potential targets of criminal investigations may seek to exploit civil discovery to obtain information which may be unavailable under criminal rules of procedure.³² Moreover, civil depositions of witnesses whose testimony is material to an ongoing grand jury investigation can create potential problems for prosecutors if the witnesses are intimidated or their accounts tampered with in light of the prospect of cross examination or the possibility of confrontation or easy access to the testimony by a target of a criminal investigation. Even depositions of witnesses who may be marginally relevant to a civil proceeding can pose problems for prosecutors. For example, even if counsel’s interests

²⁸ *United States v. Sells Engineering, Inc.*, 463 U.S. 418 (1983); *Douglas Oil Co. v. Petrol Stops Northwest*, 441 U.S. 211 (1978). While not particularly irrelevant to a fidelity insurer, the secrecy concerns are reduced when disclosure is sought by a public body for public purpose.

²⁹ *Id.*

³⁰ *See, e.g., United States v. Moreno*, 181 F.3d 206 (2d Cir. 1999); *see also United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940).

³¹ *See, e.g., In re Grand Jury Investigation*, 55 F.3d 350 (8th Cir. 1995). The mechanics for obtaining a disclosure order are specifically set forth in Rule 6(e).

³² *Campbell v. Eastland*, 307 F.2d 478 (5th Cir.1962).

are aligned with the government's, counsel in a civil proceeding may not have the same incentive as the criminal prosecutor to prepare the witness and may likely not have necessary information about the pending criminal investigation to anticipate areas of inquiry. Prosecutors may fear that inadequate preparation of the witness for a civil matter will impact the witness's testimony in a later criminal trial.

Should a prosecutor become uneasy about the status of civil proceedings, the prosecutor will as a practical matter seek to stay discovery in a civil case by asserting the government's investigatory or law enforcement privilege.³³ Prosecutors may be required to narrow the scope of the protection to limit disclosure of grand jury information and not stay the civil proceeding as a whole.³⁴ Nonetheless, courts have discretion to limit the scope of depositions or stay the entire civil proceeding.³⁵ Government requests for stays of civil proceedings are frequently granted when it can be shown that a pending grand jury investigation or criminal trial might be in jeopardy absent the stay.³⁶ To be sure, courts have recognized that they should give substantial weight to the public's interest in law enforcement when balancing a civil litigant's right to a prompt determination of his or her civil claims.³⁷

It is well established that the courts have the discretion to accord substantial weight to the possible negative effect on a pending criminal proceeding in ruling on motions to stay discovery in related civil proceedings.³⁸ Indeed, courts are more likely to grant a prosecutor's request to stay a civil proceeding once the individual has been indicted and is required to defend the criminal matter. This is especially true in the context of a fidelity claim, when both civil and criminal proceedings arise from the same or related transactions. Courts have recognized that premature disclosure of evidence relating to a criminal proceeding could impede a criminal investigation, causing potential witnesses

³³ See, e.g., *United States v. Winner*, 641 F.2d 825 (10th Cir. 1981); *Association for Women in Science v. Califano*, 566 F.2d 339 (D.C. Cir. 1977); *Pontarelli Limo., Inc. v. Chicago*, 652 F. Supp. 1428 (N.D. Ill. 1987).

³⁴ See, e.g., *United States v. Reynolds*, 345 U.S. 1 (1953); *Black v. Sheraton Corp. of America*, 564 F.2d 531 (D.C. Cir. 1977).

³⁵ See, e.g., *Mitchum v. Foster*, 407 U.S. 225 (1972).

³⁶ See, e.g., *In re Ivan F. Boesky, Sec. Litig.*, 128 F.R.D. 47 (S.D.N.Y. 1989); *R.J.F. Fabrics, Inc. v. United States*, 651 F. Supp. 1437 (Ct. Int'l Trade 1986); *United States v. One 1964 Cadillac Coupe De Ville*, 41 F.R.D. 352 (S.D.N.Y. 1966).

³⁷ See, e.g., *Campbell*, 307 F.2d at 478.

³⁸ See, e.g., *id.* at 478; see also *United States v. Telink, Inc.*, 910 F.2d 598 (9th Cir. 1990); *United States v. Stewart*, 872 F.2d 957 (10th Cir. 1989); *Afro-Lecon, Inc. v. United States*, 820 F.2d 1198 (Fed. Cir. 1987); *Securities & Exch. Comm'n v. Dresser Indus.*, 628 F.2d 1368 (D.C. Cir.) (*en banc*); *Founding Church of Scientology v. Kelley*, 77 F.R.D. 378 (D.D.C. 1977).

to fear disclosure or allowing a potential defendant to hide or destroy evidence.³⁹ Courts have also recognized that the resolution of a criminal investigation may very well moot, clarify, or otherwise affect various factual issues in a pending civil proceeding.⁴⁰

In summary, the parties to a fidelity bond claim obviously cannot control what a prosecutor may do in response to investigation or litigation of a fidelity bond claim. Most often, parallel proceedings do not result in meaningful conflict. Yet anticipating a prosecutor's concerns may assist the parties in either obviating or responding to the government's attempts to limit or stay civil proceedings.

C. Fifth Amendment Issues

An important issue related to parallel proceedings is the prospect that the accused wrongdoer will refuse to cooperate or give testimony by invoking his or her protection against self-incrimination provided by the Fifth Amendment of the United States Constitution or similar state law privilege.⁴¹ While it is almost a matter of common knowledge that a jury in a criminal trial may not draw an adverse inference against a criminal defendant who invokes his or her Fifth Amendment right not to testify, the issue which is most relevant to a fidelity insurer is whether the alleged wrongdoer's invocation of the Fifth Amendment can be used against the fidelity insurer in a civil proceeding. Recent case law suggests that an insured may indeed introduce into evidence in a civil proceeding the accused wrongdoer's invocation of the Fifth Amendment, as well as invocation of the Fifth Amendment by non-employees of the insured accused of colluding with the wrongdoer.

It has been well established that while it is a matter of constitutional error for a court to instruct a jury in a criminal trial that it may draw an inference of guilt from the defendant's failure to testify,⁴² a jury in a civil trial may draw adverse inferences against a *party* to a civil action when it refuses to testify in response to probative evidence offered against the party.⁴³ The issue of whether a civil jury can draw an adverse inference against a party to the litigation upon a "non-party's" invocation of the Fifth Amendment is not as

³⁹ See, e.g., *United States v. Sells Engineering, Inc.*, 463 U.S. 418 (1983); *Douglas Oil Co. v. Petrol Stops Northwest*, 441 U.S. 211 (1978).

⁴⁰ *United States v. Mellon Bank, N.A.*, 545 F.2d 869, 873 (3d Cir. 1976).

⁴¹ The Fifth Amendment states in relevant part that "[n]o person ... shall be compelled in any criminal case to be a witness against himself."

⁴² *Griffin v. California*, 380 U.S. 609 (1965).

⁴³ *Baxter v. Palmigiano*, 425 U.S. 308 (1976).

clear, and the issue of whether such evidence is admissible is made on an *ad hoc* basis.⁴⁴

In determining whether to admit against a party evidence of a non-party's invocation of the Fifth Amendment, courts have held that the evidence and inferences drawn therefrom should be admitted when there is some type of relationship between the witness and the party against whom the inference is sought to be drawn, such as a former employment relationship.⁴⁵ Relying upon that principle, the court in *Ralph Hegman Co. v. Transamerica Insurance Co.*⁴⁶ permitted the plaintiff to introduce as evidence against Transamerica the accused wrongdoer's invocation of the Fifth Amendment privilege on the basis that, as fidelity insurer, Transamerica assumed responsibility for the employee's acts. The court reasoned that a special "relationship" existed which permitted the jury to draw an inference adverse to Transamerica.

In a more recent case, the court in *FDIC v. Fidelity & Deposit Co. of Maryland*⁴⁷ held the trial court did not abuse its discretion by permitting the insured to introduce against the insurer evidence of a *non-employee*, nonparty witness's invocation of the Fifth Amendment. The witness was accused of colluding with the alleged wrongdoer. As a result, the *FDIC v. Fidelity & Deposit Co. of Maryland* case is a significant departure from the holding of *Hegman* and prior case law because it is difficult to say that a fidelity insurer has a "special" relationship with a non-employee.

In so holding, the court refused to adopt a rule that would categorically bar a party from calling a non-party with no special relationship to the party for the purpose of having the witness exercise his or her Fifth Amendment privilege.⁴⁸ Rather, the court reasoned that, because there was no constitutional bar to the admission of evidence of a non-party's invocation of the Fifth Amendment, such evidence is admissible if it is relevant and not other-

⁴⁴ *FDIC v. Fidelity & Deposit Co. of Md.*, 45 F.3d 969 (5th Cir. 1995); *see also* *Cerr Gordo Charity v. Fireman's Fund Am. Life Ins.*, 819 F.2d 1471 (8th Cir. 1987); *RAD Servs., Inc. v. Aetna Cas. & Sur. Co.*, 808 F.2d 271 (3d Cir. 1986); *Kontos v. Kontos*, 968 F. Supp. 400 (S.D. Ind. 1997). For an excellent discussion of the evidentiary issues related to the Fifth Amendment privilege, *see* George R. Fair, *Confessions, Convictions, and the Fifth Amendment*, 20 THE BRIEF 22 (Spring 1991).

⁴⁵ *FDIC*, 45 F.3d at 978 (citing *Cerr Gordo Charity*, 819 F.2d at 481; *RAD Servs.*, 808 F.2d at 274-79; *Brink's Inc. v. City of New York*, 717 F.2d 700, 707-10 (2d Cir. 1983)(employer and employees were defendant and third-party defendant in the action)); *see also* *Kontos*, 968 F. Supp. at 408 (adverse inference cannot be drawn against party from her sister's invocation of Fifth Amendment absent allegation of agency relationship).

⁴⁶ 198 N.W.2d 555 (Minn. 1972).

⁴⁷ 45 F.3d 969 (5th Cir. 1995).

⁴⁸ *Id.* at 978.

wise prohibited by the rules of evidence.⁴⁹ The court reasoned that evidence of the non-party's invocation of the Fifth Amendment could lead a jury to determine that the witness who allegedly colluded with the wrongdoer asserted his or her Fifth Amendment rights to avoid disclosing that collusion, and as such the evidence is admissible unless its probative value is substantially outweighed by the danger of unfair prejudice.⁵⁰ The court also noted that other courts have held that the absence of an opportunity to cross-examine a witness is not a reason to *per se* exclude the evidence.⁵¹ The court held that the insurer did not identify how the specific invocations of the Fifth Amendment privilege would result in *unfair* prejudice.

The court reasoned further that any danger the jury might have found the alleged wrongdoer had committed dishonest acts merely from his association with witnesses who had invoked the Fifth Amendment (which the court acknowledged could result in an unfair prejudice to the insurer) was avoided by the trial court's instruction that the jury was not to find liability absent evidence *corroborating* the relationship between the alleged wrongdoer and the witness asserting his Fifth Amendment privilege.⁵²

The insurer also argued that the trial court erred by not cautioning the jury that the Fifth Amendment privilege may be invoked by an innocent party, a statement contained in model jury instructions. The court rejected the insurer's argument, reasoning that an appellate court will not reverse a verdict if it believes, "based upon the entire record, that the challenged instruction could not have affected the outcome of the case."⁵³

In conclusion, it has been noted, as a practical matter, counsel "should make every effort by pretrial motion to keep a witness who is likely to invoke the Fifth Amendment privilege from ever taking the stand."⁵⁴ Given the court's holding, this indeed may be a difficult task. In practice, such witnesses usually invoke the Fifth Amendment privilege to questions which may be even remotely related to facts which may support a criminal conviction. In that regard, a fidelity insurer may be able to support an argument that the probative value of such a witness's testimony is slight and therefore outweighed by potential prejudice. If the witness is permitted to testify, counsel may wish to ask innocuous questions of the witness to elicit assertion of the

⁴⁹ See FED. R. EVID. 402.

⁵⁰ *FDIC*, 45 F.3d at 978 (citing FED. R. EVID. 403).

⁵¹ *Id.* (citing *RAD Servs.*, 808 F.2d at 276).

⁵² *Id.*; see also *Kontos*, 968 F. Supp. at 408-09 (party seeking to introduce evidence of nonparty's invocation of Fifth Amendment privilege must produce independent corroborative evidence to support negative inference beyond invocation of privilege).

⁵³ *Id.* at 979 (quoting *FDIC v. Mijalis*, 15 F.3d 1314, 1318 (5th Cir. 1994)).

⁵⁴ H. Bruce Shreves & Charles C. Coffee, *Proof of Dishonesty*, in COMMERCIAL CRIME POLICY 16 (Gilbert J. Schroeder ed., 1996) [hereinafter COMMERCIAL CRIME POLICY].

privilege, which may demonstrate to the jury that the witness's testimony is of no value because he or she asserts the Fifth Amendment to every question.

D. *Effect of Principal's Criminal Conviction or Guilty Plea*

Another important issue relating to parallel proceedings is whether a criminal conviction or guilty plea can be used by an insured to prove its fidelity claim in a civil action. The issue usually arises in connection with the insured's burden to prove that the wrongdoer acted with the requisite manifest intent. In short, the general rule is that a party may introduce into evidence proof of a criminal conviction or guilty plea, but such evidence is not conclusive. Recently, one court admitted evidence of a plea of guilty even under circumstances in which it appeared that the insured influenced prosecutors to include statements in the plea which were not elements of the crimes alleged against the wrongdoer to assist the insured to prove its civil action against its fidelity insurers. Finally, it should be noted that when an *insured* pleads guilty, it may be prevented from recovering under a fidelity policy for loss resulting from the conduct which is the subject of the plea.

By way of background, the first question is whether evidence of a criminal conviction or guilty plea is admissible at all. The Federal Rules of Evidence and the rules of evidence of a majority of state jurisdictions have excepted from the hearsay rule evidence of convictions or pleas of guilty for crimes.⁵⁵

Nonetheless, important issues still exist as to whether the evidence would be relevant to an action against the fidelity insurer and the relative weight to be accorded a particular conviction or guilty plea. In general, a criminal conviction is not considered conclusive evidence of the facts necessary to prove a fidelity claim, such as manifest intent.⁵⁶ In that respect, while admissible, a

⁵⁵ Rule 803(22) of the Federal Rules of Evidence provides:

Judgment of previous conviction. Evidence of a final judgment, entered after a trial or upon a plea of guilty (but not upon a plea of *nolo contendere*), adjudging a person guilty of a crime punishable by death or imprisonment in excess of one year, to prove any fact essential to sustain the judgment, but not including, when offered by the Government in a criminal prosecution for purposes other than impeachment, [*sic*] judgments against persons other than the accused. The pendency of an appeal may be shown but does not affect admissibility.

In that regard, judgments entered upon pleas of *nolo contendere* generally are not admissible. *See, e.g., Powers v. Bayliner Marine Corp.*, 855 F. Supp. 199 (W.D. Mich. 1994), *on subsequent appeal*, 88 F.3d 789 (6th Cir.).

⁵⁶ *See, e.g., FDIC v. Oldenburg*, 34 F.3d 1529 (10th Cir. 1994); *In re Waddell Jenmar Sec., Inc.*, 991 F.2d 792 (4th Cir. 1993) (Table) (guilty plea considered along with other evidence); *First Nat'l Bank of Louisville v. Lustig*, 961 F.2d 1162 (5th Cir. 1992), *after remand*, 832 F. Supp. 1058 (E.D. La. 1993), *later case*, 96 F.3d 1954 (1996) (withdrawn plea of guilty not conclusive); *Fidelity and Dep. Co. of Maryland v. Reliance Fed. Sav. & Loan Ass'n*, 795 F.2d 42 (7th Cir. 1986); *Lloyd v. American Export Lines, Inc.*, 580 F.2d 1179 (3d Cir.), *cert. denied sub nom. Alvarez v. American Export Lines, Inc.*, 439 U.S. 969 (1978); *Semler v. Psychiatric Inst. of Washington, D.C.*, 538 F.2d 121 (4th Cir.), *cert. denied sub nom. Folliard v. Semler*, 429 U.S. 827 (1976). *Cf. Transamerica Premier Ins. Co. v. Miller*, 41 F.3d 438 (9th Cir. 1994) (guilty plea fulfilled non-standard form bond's "conviction" requirement).

wrongdoer's conviction or guilty plea *technically* may not be as prejudicial to a fidelity insurer as one might think. Practically speaking, however, if the wrongdoer is convicted, it "gives the employer one of the strongest elements of proof that can be used against the surety."⁵⁷ The key issue relating to the admissibility of a conviction or plea is whether the probative value of the evidence is outweighed by unfair prejudice.

In determining whether a conviction is relevant, fidelity insurers and their attorneys must pay particular attention to the underlying criminal indictment or information which forms the basis of the conviction or guilty plea.⁵⁸ Under the federal rules, the conviction or plea must be for a felony, *i.e.*, punishable by more than one year in prison. In addition, the conviction is admissible to prove any fact "essential to sustain a judgment." At least one court has treated a wrongdoer's conviction as dispositive of important facts, such as the wrongdoer's status as an employee of the insured and his "willful misapplication" of bank funds.⁵⁹ If the wrongdoer pleads guilty to a lesser charge or the plea or conviction is for the theft of a minimal amount, introduction of the conviction may be of little value in establishing the amount of the insured's loss.⁶⁰ Further, if the statute upon which a plea or conviction is based only requires proof of an intent to deceive, evidence of the plea or conviction may be insufficient to prove manifest intent in a particular jurisdiction.⁶¹ Similarly, if a conviction is based upon a general verdict, the evidence of the conviction may not be relevant to whether the wrongdoer acted with the manifest intent required by modern financial institution bond and commercial crime policy forms.⁶²

Recently, however, a court permitted the introduction of evidence of a guilty plea even though the insured was actively involved in drafting the

⁵⁷ Shreves & Coffee, *supra* note 54, at 13.

⁵⁸ See *FDIC v. St. Paul Fire & Marine Ins. Co.*, 738 F. Supp. 1146 (M.D. Tenn. 1990) (the court held that a plea for willfully *misapplying bank funds* is irrelevant to issue of wrongdoer's intent in making allegedly *fraudulent loans*).

⁵⁹ *Luzerne Nat'l v. Hanover Ins. Co.*, 49 Pa. D. & C.3d 399 (Pa. Ct. Com. Pleas 1988). In addition, courts have held that a prior criminal conviction is conclusive evidence when it would prevent a wrongdoer from profiting from his own conduct, *i.e.*, in a salvage action. *Hardin v. Aetna Cas. & Sur. Co.*, 384 F.2d 718 (5th Cir. 1967), *cert. denied*, 391 U.S. 971 (1968); *United States v. Killough*, 848 F.2d 1523 (11th Cir. 1988); *United States Fid. & Guar. Co. v. Moore*, 306 F. Supp. 1088 (N.D. Miss. 1969).

⁶⁰ Shreves & Coffee, *supra* note 54, at 18.

⁶¹ *Oldenburg*, 34 F.2d at 1540 (intent to *deceive* regulators may support conviction for misapplying bank funds under 18 U.S.C. § 657; prosecutors need not prove intent to cause a loss). For a detailed discussion of this issue, see Fair, *supra* note 44, at 25.

⁶² It should be noted, however, that, if a court can determine from the record and pleadings what facts were being established, it has been held that the trial court should so instruct the jury as a matter of law. See, *e.g.*, *Emich Motors Corp. v. General Motors Corp.*, 340 U.S. 558 (1971).

information against the wrongdoer. In *First National Bank of Louisville v. Lustig*,⁶³ the Fifth Circuit Court of Appeals held that the trial court did not abuse its discretion by admitting into evidence a guilty plea, even though it was clear that the insured was heavily involved in drafting the information to include language not required to state a criminal charge, but which addressed elements necessary to prove a bond claim. The court rejected the fidelity insurers' argument that the plea was so tainted as to be inherently unreliable. The appellate court noted that the trial court instructed the jury the guilty plea was not conclusive evidence and permitted the fidelity insurers to introduce correspondence and testimony of conversations between the insured and prosecutors.⁶⁴ The court so held even though the insured had previously represented that it was not involved in drafting the information. The court said, however, that it was not condoning the insured's conduct in attempting to influence a federal prosecutor in a criminal case for its own advantage in a parallel civil case.⁶⁵

An interesting variation of the traditional case law regarding the effect of criminal convictions arose in *Drexel Burnham Lambert v. Vigilant Insurance Co.*⁶⁶ In that case, the insured itself had pleaded guilty to mail fraud and securities fraud. The court held in substance that Drexel was estopped from seeking indemnification for loss resulting from its own criminal conduct.⁶⁷

In summary, parallel proceedings may ultimately give rise to issues relating to the whether a conviction or guilty plea can be admitted into evidence in a civil proceeding. Since most jurisdictions have excepted convictions and pleas from the hearsay rule, the dispute will be whether the conviction or plea is relevant and whether its probative value is outweighed by unfair prejudice.

E. Criminal Forfeiture Statutes

The increasingly frequent use by the federal government of criminal and civil forfeiture proceedings gives rise to another potential source of conflict between prosecutors, and insureds and their fidelity insurers. This section of the paper for the most part discusses civil forfeiture.⁶⁸ Civil forfeiture is generally filed as a separate action against property which "constitutes or is derived from proceeds traceable to" a number of criminal offenses, including

⁶³ 96 F.3d 1954 (5th Cir. 1996), *aff'g* 832 F. Supp. 1058 (E.D. La. 1993).

⁶⁴ 96 F.3d at 1574.

⁶⁵ *Id.* at 1573-74.

⁶⁶ 595 N.Y.S.2d 999 (N.Y. Sup. Ct. 1993).

⁶⁷ *Id.* at 1010.

⁶⁸ For an in-depth discussion of criminal forfeiture, see Randall I. Marmor, *Criminal Restitution and Forfeiture — An Alternative to Traditional Salvage?* (unpublished paper presented at the annual meeting of the Surety Claims Institute, Hershey, Pa., June 24, 1999)(on file with author).

bank fraud and mail and wire fraud,⁶⁹ crimes which often give rise to fidelity claims. As a result, the government's use of civil (and criminal) forfeiture proceedings can pose a significant impediment to a fidelity insurer's potential salvage opportunities.⁷⁰ The civil forfeiture statutes currently impose a significant burden upon an innocent owner to recover seized property.⁷¹ In the summer of 1999, however, legislation was introduced in Congress amending the civil forfeiture statutes to restrict the government's ability to forfeit property which otherwise might be available to reimburse an insured and its fidelity insurer, to make it easier for owners of property to contest forfeiture of property, and to hold the government liable for damage to property while it is in the government's custody.

Under the current law, any real or personal property is subject to seizure and forfeiture if it is "involved in such offense" or is "traceable" to property involved in certain offenses. The initial burden is placed upon the government to show probable cause, that the property is subject to forfeiture.⁷² The government may obtain forfeiture by proving the elements by a preponderance of the evidence. The government need not obtain a criminal conviction or even charge the owner with a crime. Property is subject to forfeiture if the government merely shows that a reasonable connection exists between the illegal activity and the property subject to forfeiture.⁷³ The government need only prove the property subject to forfeiture has a tenuous nexus to the alleged crime.⁷⁴ Importantly, the government can seek forfeiture of other property of equal value through the seizure of "substitute assets."⁷⁵ Since

⁶⁹ 18 U.S.C. § 981 (1976 & West Supp. 1999).

⁷⁰ One commentator has recently stated that "[d]espite its penal intent, criminal forfeiture sometimes deprives innocent victims, insurers and other creditors access to their only means of recovery." Marmor, *supra* note 68, at 12 (citing 1991 U.S. Dept. of Just., Ann. Rep. of the Dept. of Just. Asset Forfeiture Prog. 56 (reporting a surplus of \$78.8 million)). While federal current forfeiture statutes do not apply to all federal felonies, it is important to note that criminal forfeiture statutes do apply to most crimes affecting federally insured financial institutions, including bank fraud. See 18 U.S.C. § 1344 (1984 & West Supp. 1999).

⁷¹ A criminal, as opposed to civil, forfeiture may be initiated by including elements of the forfeiture in the indictment. A civil forfeiture proceeding can be filed as an independent action. In that regard, it is considered a "parallel" proceeding to a criminal proceeding, thereby invoking many of the issues concerning grand jury secrecy as between government attorneys prosecuting the criminal and separate forfeiture proceedings. Fed. R. Civ. P. 7(c)(2); *see also* United States v. Cauble, 706 F.2d 1322 (5th Cir. 1983).

⁷² *See, e.g.* United States v. A Single Family Residence & Real Property Located at 900 Rio Vista Blvd., Ft. Lauderdale, Fla., 803 F.2d 625 (11th Cir. 1986); United States v. \$12,390, 956 F.2d 801 (8th Cir. 1992).

⁷³ *See, e.g.*, United States v. One Parcel of Real Estate at 1012 Germantown Road, Palm Beach County, Fla., 963 F.2d 1496 (11th Cir. 1992).

⁷⁴ *See id.*; United States v. Voigt, 89 F. 3d 1050 (3d Cir. 1996).

⁷⁵ Voigt, 89 F.3d at 1084.

dishonest employees do not typically segregate stolen funds or document which property was purchased with the stolen funds, the government's ability to forfeit "substitute assets" can be a powerful tool.⁷⁶ Thus, the government's power to seek forfeiture of an accused wrongdoer's assets is an obvious threat to a fidelity insurer's salvage opportunities.

The current statutory scheme provides that an "innocent owner" can seek relief from civil forfeiture. The statute provides as follows: "No property shall be forfeited under this section to the extent of the interest of an owner or lienholder by reason of any act or omission established by that owner or lienholder to have been committed without the knowledge of that owner or lienholder."⁷⁷ A number of courts require that an owner must prove that it had done all that could reasonably be expected to *prevent* the illegal use of the property.⁷⁸ Such a standard has led to obvious abuses.

For example, in one publicized case, prosecutors seized a hotel in Houston even though there were no allegations that the hotel owners participated in any crimes. Hotel personnel called the police to the property to report suspected drug-related activity in the hotel rooms. The government's position was that the hotel deserved to be seized and forfeited because management had failed to implement all of the "security measures" which law enforcement personnel had dictated in response to the calls. The government eventually dropped its forfeiture proceedings after the owners agreed to undertake certain security measures. In the meantime, the owners had lost use of the hotel for several months, allegedly suffered loss of good business reputation and were forced to hire (and pay) counsel to defend the government's forfeiture proceeding.⁷⁹

Responding to what Congress has perceived as prosecutorial abuse of the forfeiture laws, Congress is now considering the Civil Asset Forfeiture Reform Act,⁸⁰ which would amend the current law to make civil forfeiture procedures more fair and to give innocent owners more opportunity to recover their property and to be made whole after a wrongful government

⁷⁶ See Marmor, *supra* note 68, at 12-13.

⁷⁷ 18 U.S.C. § 981(a)(2) (West Supp. 1999).

⁷⁸ See, e.g., *United States v. One Parcel of Property Located at 755 Forest Road, Northford, Ct.*, 985 F.2d 70 (2d Cir. 1993); *One Parcel of Real Estate Located at 1012 Germantown Road, Palm Beach County, Fla.*, 963 F.2d at 1496.

⁷⁹ Deborah Tedford, *Hotel Owners Agree to Beef Up Security*, HOUSTON CHRON., July 18, 1998, available in 1998 WL 3588939; Steve Brewer, *Seizure of Hotel Sets Precedent*, HOUSTON CHRON., March 7, 1998, available in 1999 WL 3560989; Deborah Tedford, *No Vacancy for Drug Dealers: Feds Seize Hotel*, HOUSTON CHRON., Feb. 18, 1998, available at 1998 WL 3560989; see also H.R. REP. NO. 106-192, at 8 (1999).

⁸⁰ Hereinafter Reform Act.

seizure.⁸¹ Under the Reform Act, the government would be required to prove by clear and convincing evidence that the property is subject to forfeiture.⁸² A property owner would still have the burden of proving affirmative defenses, such as the “innocent owner” defense, by a preponderance of the evidence.⁸³ Under the Reform Act, an owner would still be required to show in substance that it was unaware of the criminal conduct and, upon learning of it, did all that could reasonably be expected to terminate use of the property,⁸⁴ which is normally the case in the context of a fidelity claim.

The Reform Act also provides, among other things, for the appointment of counsel, immediate release of the property upon a showing of hardship, elimination of a cost bond, compensation for damages to property while in the government’s possession, interest, and additional time for filing a claim contesting forfeiture.⁸⁵ It would appear that this latter amendment is important from a fidelity insurer’s prospective. The bill provides an owner thirty days to file a claim.

Importantly, the Reform Act defines “owner” as a person with an ownership interest in the specific property, including a “valid assignment of an ownership interest,” but does not include a person with only a general, unsecured interest in or claim against the property or estate of another.⁸⁶ As a result, it is unclear whether a fidelity insurer may make a claim under the new law if it receives an assignment from its insured. The legislative history is silent on this aspect of the change in the definition of owner. Under the current law, a fidelity insurer would have to be a judgment creditor (i.e., lienholder) at the time of forfeiture to challenge the government’s forfeiture of the property.

In summary, under the current scheme, federal forfeiture laws can pose a serious impediment to a fidelity insurer’s salvage rights. While it appears from the case law that most of the government’s aggressive attitude towards asset forfeiture is focused upon narcotics offenses, one commentator has recently suggested that the ability of the government to quickly seize assets

⁸¹ H.R. REP. NO. 106-192, at 8.

⁸² H. R. 1658, 106th Cong. § 2 (1999). *See also* Department of Law Enforcement v. Real Property, 588 So. 2d 957 (Fla. 1991) (Florida Constitution requires proof by clear and convincing evidence).

⁸³ 83. H.R. REP. NO. 106-192, at 11.

⁸⁴ 84. H.R. REP. NO. 106-192, at 11; H.R. 1658 § 7. Under the current law, an owner is charged with the burden of showing that it did all that could reasonably be expected to prevent illegal use of the property. *See, e.g.*, United States v. One Parcel of Property Located at 755 Forest Rd., Northland, Ct., 985 F.2d 70 (2d Cir. 1993).

⁸⁵ H.R. REP. NO. 106-192, at 13-15; H.R. 1658 §§ 2 & 3.

⁸⁶ H.R. 1658 § 2.

may be a benefit to a fidelity insurer.⁸⁷ Nonetheless, the passage of the Civil Forfeiture Reform Act should make it easier for innocent owners of property, such as a insured, to contest civil forfeiture.

F. Restitution Statutes

Despite all the potential pitfalls described above in connection with parallel civil and criminal proceedings, a fidelity insurer may be able to take advantage of criminal restitution statutes. In the event that the wrongdoer and any conspirators are federally prosecuted, federal statutes generally require the sentencing court to order the defendants to pay restitution to direct victims of the crime, which in certain circumstances can include fidelity insurers.⁸⁸

The Mandatory Victim's Restitution Act,⁸⁹ enacted in 1996, imposes mandatory restitution for victims of certain property offenses, which includes conduct giving rise to coverage under commercial or financial institution bonds. Although the MVRA defines "victim" narrowly, as including persons "directly and proximately harmed as a result of the commission of the offense for which restitution may be ordered,"⁹⁰ one court has held that the FSLIC was a "victim" entitled to receive restitution, even though the FSLIC acquired the claims of a defunct savings and loan.⁹¹ The MVRA also states that, if the parties agree in a plea agreement, the court shall order that restitution be paid to persons other than the "victim" of the offense.⁹²

Additionally, the MVRA provides that, in the event a victim, such as an insured, has received compensation from insurance or any other source, res-

⁸⁷ Edward G. Gallagher, *Barriers to the Exercise of the Fidelity Insurer's Subrogation Rights with Emphasis on Conflicts Involving Federal Forfeiture Statutes*, 1 FID. L. ASS'N J. 38, 50-51 (1995).

⁸⁸ This paper focuses exclusively upon federal restitution statutes. For an excellent discussion of state restitution statutes, see Marmor, *supra* note 68 (discussing legal issues associated with the various state victim's rights legislation, compiling state criminal restitution statutes, and collecting cases).

⁸⁹ Hereinafter MVRA.

⁹⁰ 18 U.S.C. § 3663A(a)(2) (West Supp. 1999).

⁹¹ *United States v. Smith*, 944 F.2d 619 (9th Cir.), *cert. denied*, 503 U.S. 951 (1991); *but see United States v. Baker*, 25 F.3d 1452 (9th Cir. 1994) (the court held a successor to a defrauded bank was not a "victim" absent a showing that, in the process of the takeover, the successor acquired all of the defrauded bank's claims against the third parties).

⁹² 18 U.S.C. § 3663A(a)(3) (West Supp. 1999). It should also be noted that the predecessor to the MVRA, the Victim Witness Protection Act of 1982 (VWPA), which was amended by the MVRA, states that the court may order restitution under such circumstances.

titution shall be paid to the person who provided the compensation, but only if the victim has been fully reimbursed.⁹³ The courts frequently order criminal defendants to pay restitution to fidelity insurers.⁹⁴ Even though the statutes entitle the victim to first recovery, some courts have ordered that restitution be paid proportionately to the victim and its fidelity insurer.⁹⁵

The procedures for obtaining a restitution order are set forth in the MVRA. In substance, the probation department is required to include in its presentencing report an accounting of the losses incurred by each victim and information relating to the economic circumstances of the defendant. The government has the burden of demonstrating the amount of the loss sustained by each victim, and the defendant has the burden of demonstrating his or her financial resources (or lack of them) and financial needs of his or her dependants.⁹⁶ While the statutes require the court to order restitution to each victim in the full amount of the victim's loss, if the court finds that the defendant's economic circumstances prevent him or her from satisfying a restitution order under any reasonable schedule, the court may order the defendant make nominal periodic payments.⁹⁷ Nonetheless, a defendant is required to notify the Attorney General of any material changes in the defendant's economic circumstances that might affect his or her ability to pay restitution.⁹⁸ Finally, a restitution order is considered a judgment, meaning that it may be enforced as such.⁹⁹

In summary, due to the nature of fidelity coverage, parallel criminal proceedings can, and often do, clarify the competing interests of the insured, its fidelity insurer, the accused wrongdoer, and federal or local governments. If the accused wrongdoer asserts the Fifth Amendment or is convicted (or acquitted), these developments may directly impact the strength of the claim. The way in which these competing interests interact is largely dependent upon the nature and strength of the claim. In larger, more complex claims, the government's ability to stay civil proceedings is likely to be more beneficial to one of the parties, depending upon who is most eager to press ahead. When the claim appears covered or is of a smaller amount, parallel criminal

⁹³ *Id.* § 3664(j)(1) (1985 & West Supp. 1999).

⁹⁴ *See, e.g.,* United States v. Cloud, 872 F.2d 846 (9th Cir.), *cert. denied*, 493 U.S. 1002 (1989); United States v. Boyle, 10 F.3d 45 (7th Cir. 1993).

⁹⁵ United States v. Arnold, 984 F. Supp. 326 (E.D. Pa. 1997). In so doing, the court concluded that both employer and the fidelity insurer were "victims" under the statute.

⁹⁶ 18 U.S.C. § 3664 (1985 & West Supp. 1999).

⁹⁷ 18 U.S.C. § 3664(f)(3)(b) (1985 & West Supp. 1999).

⁹⁸ *Id.* § 3664(k).

⁹⁹ *Id.* § 3664(m)(1)(B).

proceedings may provide a cost-effective salvage opportunity for the insured and its fidelity insurer.

III. INTERVIEWING EMPLOYEES AND FORMER EMPLOYEES AND RETALIATORY LITIGATION

Separate and apart from parallel proceedings, another potential area of conflict can occur when a fidelity insurer seeks to interview “employees” of the insured, who must be categorized into two groups. First, issues may arise when a fidelity insurer wishes to interview the insured’s current employees, such as its officers. A fidelity insurer’s right to conduct interviews of an insured’s employees is usually expressly set forth in the bond under which the claim is being made. The second category of “employees” are former employees of the insured. Generally, a fidelity insurer may interview former employees of the insured, but its attorneys should be aware of ethical considerations when interviewing witnesses and potential adversaries. When related to interviewing any witnesses, a fidelity insurer should be mindful of the potential for retaliatory litigation against it by the wrongdoer.

A. Current Employees

Modern commercial fidelity and financial institution bonds specifically require the insured not only to cooperate with a fidelity insurer, but also to submit to examinations under oath when so requested. For example, commercial crime policies contain several provisions which either specifically require or imply an insured’s cooperation. Section B(5) of the Crime General Provisions of commercial crime policies state that the insured must “[s]ubmit to examination under oath at our request and give us a signed statement of your answers.”¹⁰⁰ Commercial crime policies require the insured to keep records of all covered property so the fidelity insurer can verify the amount of any loss.¹⁰¹ Importantly, the 1995 version of the Crime General Provisions of a standard form commercial crime policy also includes a provision stating that the insurance is void in the case of any fraud committed by the insured or if the insured, at any time, intentionally conceals or misrepresents material facts concerning the insurance, covered property, the insured’s interests in covered property, or a claim under the policy.¹⁰²

¹⁰⁰ See, e.g., Form CR 10 00 06 95 (INSURANCE SERVICES OFFICES, INC. 1995), *reprinted in* COMMERCIAL CRIME POLICY. The identical provision is contained in the 1986, 1988, and 1990 versions of the form, except it is located in Section B(4). This section also states that the insured is to cooperate with the fidelity insurer in its investigation and settlement of any claim.

¹⁰¹ Form CR 10 00 06 95 at B(16). An identical provision is contained in Section B(14) of the 1986, 1988, and 1990 versions of the form.

¹⁰² CR 10 00 06 95 at B(1)(INSURANCE SERVICES OFFICES, INC. 1995), *reprinted in* COMMERCIAL CRIME POLICY. This clause is significant because not all jurisdictions have statutes or common law requiring forfeiture of coverage under such circumstances.

Similarly, financial institution bonds usually provide:

(d) Upon the Underwriter's request and at reasonable times and places designated by the Underwriter the Insured shall:

- (1) submit to examination by the Underwriter and subscribe to the same under oath; and
- (2) produce for the Underwriter's examination all pertinent records; and
- (3) cooperate with the Underwriter in all matters pertaining to the loss.¹⁰³

There do not appear to be any cases specifically construing such provisions in commercial fidelity or financial institution bonds.¹⁰⁴ A recent case decided under what appears to be a property policy is, however, instructive.

In *Tran v. State Farm Fire & Casualty Co.*,¹⁰⁵ an insured made a claim for loss of property and income from an alleged burglary. The insurer requested the insured complete an inventory and return it with certain documentation, including canceled checks, receipts, invoices, and other documents establishing the value of the items in the inventory. The insured did not provide the requested information and did not appear for an interview. The insurer became suspicious and broadened its investigation to determine whether the insured had motive to submit a fraudulent claim. The insurer then requested certain personal and business financial records. The insured never provided some of the documentation requested by the insurer, including the personal and business financial records, and in an interview declined to answer any questions regarding his personal or business finances.

The insurer denied coverage and the insured filed a declaratory action. The Supreme Court of Washington held as a matter of law that the insured forfeited coverage by failing to cooperate with the insurer. After analyzing cooperation clauses similar to those contained in commercial crime and financial institution bonds, the court concluded that the insurer's inquiries were material to the circumstances giving rise to its liability.¹⁰⁶ The court held that the insured's failure to cooperate with the insurer was prejudicial to the in-

¹⁰³ Financial Institution Bond, Standard Form No. 24 (rev'd. January 1986), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA) [hereinafter STANDARD FORMS].

¹⁰⁴ The court in *Mercedes-Benz of N. Am., Inc. v. Hartford Acc. & Indem. Co.*, 974 F.2d 1542 (9th Cir. 1992) (Table), implicitly recognized that compliance with a cooperation clause in a commercial fidelity bond is a condition precedent to coverage.

¹⁰⁵ 961 P.2d 358 (Wash. 1998).

¹⁰⁶ *Id.* at 363-65.

surer as a matter of law because it was unable to complete its investigation into whether the claim was fraudulent, thereby obviating coverage.¹⁰⁷

In addition, there is a well-developed body of case law involving other types of policies, primarily liability and fire policies, which is instructive on the issues of the insured's duty to cooperate generally, duty to produce its employees for deposition, and duty to produce documents, including those prepared by the insured's attorneys and other agents.¹⁰⁸ It has been held, for example, that the failure to submit a sworn statement required by the policy constitutes a breach of a cooperation clause sufficient to obviate coverage.¹⁰⁹ It has also been held that, when the insured appears but refuses to answer relevant questions, such conduct is no different than not appearing at all and is sufficient to obviate coverage.¹¹⁰

Consequently, an insured is required to honor requests by its fidelity insurer to interview employees. As a practical matter, an insured's cooperation may facilitate prompt payment of claims.¹¹¹

B. Former Employees

Different issues exist with respect to former employees of the insured. The insured likely has no right to compel their cooperation with a fidelity insurer. Rather, the issue is whether a fidelity insurer may interview former employees without the consent of the insured and its counsel. The majority rule is that a fidelity insurer may have *ex parte* contact with former employees of the in-

¹⁰⁷ *Id.* at 365-67 (in so holding, the court rejected the argument that the insurer would only be prejudiced if it paid money or lost subrogation rights).

¹⁰⁸ See, e.g., *Hayes v. United Fire & Cas. Co.*, No. ED 75178, 1999 WL 672562 (Mo. Ct. App. 1999); *Tran*, 961 P.2d at 367; *Creek v. Harder Constr., Inc.*, 961 P.2d 1240 (Kan. Ct. App. 1998); *Wolverine Ins. Co. v. Sorrough*, 177 S.E.2d 819, 822 (Ga. Ct. App. 1970); but see *Bean v. State Farm Mut. Auto Ins. Co.*, 265 F.2d 151 (6th Cir. 1959) (cooperation clause is not a condition precedent to coverage). For a comprehensive discussion of cooperation clauses in the context of production of documents by an insured potentially subject to the work product doctrine and attorney-client privileges, see Michael Keeley, *The Attorney-Client Privilege and Work Product Doctrines: The Boundaries of Protected Communications Between Insureds and Insurers*, 33 TORT & INS. L.J. 1169 (Summer 1998). (It should be noted, however, that portions of *EDO Corp. v. New York Ins. Co.*, 145 F.R.D. 18 (Conn. 1992), cited therein, may be of limited precedential value in light of the subsequent decision by the Supreme Court of Connecticut in *Metropolitan Life Ins. Co. v. Aetna Cas. & Sur. Co.*, 730 A.2d 51, 59 (Conn. 1999), decided on May 25, 1999).

¹⁰⁹ See Keeley, *supra* note 108, at 1198 (and cases cited therein).

¹¹⁰ *Id.* at 1199 (citing *Wood v. Allstate Ins. Co.*, 21 F.3d 741 (7th Cir. 1994)); see also *Tran*, 961 P.2d at 363-65.

¹¹¹ Indeed, an insured should view requests to interview employees as an expected exercise by the fidelity insurer to confirm the existence and amount of the claim. See Mark E. Wilson, *How to Prepare and Present a Fidelity Claim: Advice for the Insured*, 28 THE BRIEF 54 (Spring 1999).

sured. The scope of *ex parte* contacts with former employees is generally governed by the rules of professional conduct in effect in the relevant jurisdiction. While earlier courts held that potential litigants such as fidelity insurers could not have *ex parte* contacts with former employees, the recent trend is to permit such contacts “so long as the contacts are not deceptive in content and there is no intrusion upon the employer’s attorney-client privilege.”¹¹² It appears that the modern trend has been fueled by a recent opinion by the American Bar Association expressing its views that such contacts should be permitted.

The issues surrounding interviews of former employees arises out of Model Rule of Professional Conduct 4.2, which states as follows: “In representing a client, a lawyer shall not communicate about the subject of representation with a party whom the lawyer knows to be represented in the matter by another lawyer, unless the lawyer has consent of the other lawyer or is authorized by law to do so.”¹¹³

Even though the rule does not define “party,” the official comment to the rule suggests that it may apply to former employees. The comment lists three types of agents as employees: (1) persons with managerial responsibilities, (2) “any other person whose act or omission in connection with the matter may be imputed to the organization for purposes of civil or criminal liability,” and (3) persons whose statements may constitute an admission on the part of the organization.

In 1991, the ABA issued a formal opinion stating that Rule 4.2 does not extend to former employees, even managerial employees or those whose conduct might be the basis for imputing liability to the employer or whose statement could be admitted in evidence as an admission by the employer.¹¹⁴ Numerous courts have supported the majority rule that interviewing former employees

¹¹² Matthew M. Horowitz, *Ethical Considerations in Interviewing Third-Parties in the Course of a Surety Investigation* (unpublished paper presented at the annual meeting of the Surety Claims Institute, Lansdowne, Va., June 26, 1997). Although Mr. Horowitz’s article focuses upon investigation by a contract surety, the article contains an in-depth discussion of many issues which are applicable to investigations by fidelity insurers.

¹¹³ In those jurisdictions that adopted the Code of Professional Responsibility, Disciplinary Rule 7.104(a)(1) (predecessor to Rule 4.2) states:

During the course of his representation of a client, a lawyer shall not ... [c]ommunicate or cause another to communicate with a party [the lawyer] knows to be represented by a lawyer in that matter unless he has a prior consent of the lawyer representing such other party authorized by law to do so.

¹¹⁴ ABA Formal Op. 91-359 (Mar. 22, 1991); *see also* Illinois St. B. Op. 85-12 (April 4, 1986), *reprinted in* 1986 ILL. B. J. 514.

does not violate Rule 4.2.¹¹⁵ Some jurisdictions have interpreted Rule 4.2 to prohibit communication with a former employee, but these cases were decided before the ABA issued its opinion.¹¹⁶

Other jurisdictions permit *ex parte* contacts but impose a number of potential limitations and qualifications like those set forth in the comment to Rule 4.2. For example, some courts have held that former employees may not be contacted if information provided by the former employee would impute liability to the former employer.¹¹⁷ Some courts have held that a former employee may not be contacted if the employee had access to privileged or confidential information.¹¹⁸ Other courts have held that a former employee who continues to serve as a director or member of a corporate-control group may not be interviewed without consent of the other party's counsel.¹¹⁹ Similarly, it has been held that former employees who had been in a managerial position or had belonged to a corporate-control group during their former

¹¹⁵ See, e.g., *Orlowski v. Dominick's Finer Foods*, 937 F. Supp. 723, 727 (N.D. Ill. 1996)(former employees, including former managers, are not encompassed by Rule 4.2 and may freely engage in communications with counsel); *Aiken v. Business & Indus. Health Grp., Inc.*, 885 F. Supp. 1474, 1476 (D. Kan. 1995)("Unless one were to broadly construe the term 'party,'s the language of Rule 4.2 does not on its face involve, or in any way prohibit, *ex parte* contact with former employees."); *Brown v. St. Joseph County*, 148 F.R.D. 246, 252 (N.D. Ind. 1993)("If the 'party' referred to in Rule 4.2 is a corporation, then a former employee who no longer has any relationship with that corporation cannot be equated with that 'party.'"); *Breedlove v. Tele-Trip Co.*, No. 9-C 5702, 1992 WL 202147 (N.D. Ill. Aug. 14, 1992)("Former employees, unlike current ones, cannot be construed as parties or agents of a corporate party and, thus, are not within the scope of the Rule."); see also *Terra Int'l, Inc. v. Mississippi Chem. Corp.*, 913 F. Supp. 1306 (N.D. Iowa 1996); *H.B.A. Mgt., Inc. v. Estate of Schwartz*, 693 So. 2d 541 (Fla. 1997); *Ahern v. Board of Educ. of City of Chicago*, No. 92-C4074, 1995 WL 680476 (N.D. Ill. Nov. 14, 1995); *Shamlin v. Commonwealth Edison Co.*, No. 93-C2149, 1994 WL 148701 (N.D. Ill. April 20, 1994); *Shearson Lehman Bros., Inc. v. Wasatch Bank*, 139 F.R.D. 412, 414 (D. Utah 1991).

¹¹⁶ See, e.g., *Public Serv. Elec. & Gas Co. v. Associated Elec. & Gas Ins. Serv., Ltd.*, 745 F. Supp. 1037 (D.N.J. 1990); *Porter v. Arco Metal Co.*, 642 F. Supp. 1116 (D. Mont. 1986).

¹¹⁷ *Armsey v. Medshares Mgt. Servs., Inc.*, 184 F.R.D. 569 (W.D. Va. 1998); *Curley v. Cumberland Farms, Inc.*, 134 F.R.D. 77 (D.N.J. 1991); *PPG Indus. Inc. v. BASF Corp.*, 134 F.R.D. 118, 121 (W.D. Pa. 1990); *Chancellor v. Boeing Co.*, 678 F. Supp. 250, 253 (D. Kan. 1988); *Lang v. Superior Court*, 826 P.2d 1228 (Ariz. Ct. App. 1992).

¹¹⁸ *Camden v. State of Maryland*, 910 F. Supp. 1115 (D. Md. 1996); *Dillon Cos., Inc. v. Sico Co.*, Civ. A. No. 92-1512, 1993 WL 492746 (E.D. Pa. Nov. 24, 1993); *Lang*, 826 P.2d 1228; see also *Terra Int'l, Inc.*, 913 F. Supp. at 1306 (cautioning that attorneys may not inquire into privileged attorney-client communications because the privilege belongs to the organization and it alone may waive the privilege); *MMR/Wallace Pwer & Indus., Inc. v. Thames Assoc.*, 764 F. Supp. 712 (D. Conn. 1991) (former employee's participation as a consultant to litigation made him off-limits to opposing counsel's *ex parte* communications).

¹¹⁹ *Mills Land & Water Co. v. Golden West Refining Co.*, 186 Cal. App. 3d 116 (4th Dist. 1986).

employment may not be interviewed without consent of counsel for the party.¹²⁰ Obviously, former employees who are represented by the former employer's counsel may not be contacted without consent.¹²¹ When interviewing former employees who might become an adverse party, such as the accused wrongdoer, counsel should at least advise the former employee of the identity of his/her client at the outset and should otherwise not deceive or misrepresent to the former employee. When dealing with the accused wrongdoer, counsel should first inquire whether the former employee has retained counsel.¹²² Some courts have even gone so far as to require counsel to give *Miranda*-type warnings to a witness who may become an adversary by informing the witness that he or she may obtain counsel before answering questions.¹²³ Those courts appear to misconstrue Rule 4.3 of the Rules of Professional Conduct, which only provides that counsel shall not state or imply that it is disinterested and should make reasonable efforts to correct any misunderstandings the witness may have about counsel's role.¹²⁴

Counsel should also be mindful that they cannot circumvent the ethical rules by delegating such tasks to laypersons, such as investigators, because courts have ruled that interviews conducted by investigators retained or controlled by attorneys are subject to the same rules.¹²⁵ Unfortunately, such rulings could lead fidelity insurers to conduct investigations without the advice of counsel. Violation of the rules may result in penalties, including the

¹²⁰ *In re Prudential Ins. Co. of America Sales Practices Litig.*, 911 F. Supp. 148 (D.N.J. 1995); *Curley*, 134 F.R.D. at 77; *Porter*, 642 F. Supp. at 1116; *Erickson v. Winthrop Laboratories*, 592 A.2d 22 (N.J. Super. 1991).

¹²¹ *See, e.g., Terra Int'l, Inc.*, 913 F. Supp. at 1306.

¹²² *See, e.g., Upjohn Co. v. Aetna Cas. & Sur. Co.*, 768 F. Supp. 1186 (W.D. Mich. 1991).

¹²³ *E.g., University Patents, Inc. v. Kligman*, 737 F. Supp. 325 (E.D. Pa. 1990); *Bey v. Arlington Heights*, No. 88-C5479, 1989 WL 103387 (N.D. Ill. Aug. 29, 1989); *but see FSLIC v. Hildenbrand*, Civ. A. No. 89-A535, 1989 WL 107377 (D. Colo. Sept. 8, 1989) (FSLIC attorneys not required to warn witness he could become litigant or advise witness of right to counsel). *See generally, Horowitz, supra* note 112.

¹²⁴ Rule 4.3 of the Rules of Professional Conduct states:

In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding.

¹²⁵ Rule 8.4 of the Rules of Professional Conduct states in pertinent part: "A lawyer shall not: ... induce another to engage in conduct, or give assistance to another's conduct, when the lawyer knows that the conduct will violate these Rules." *See, e.g., Miano v. AC&R Advert., Inc.*, 148 F.R.D. 80, 81-83 (S.D.N.Y. 1993); *Monsanto Co. v. Aetna Cas. & Sur. Co.*, 593 A.2d 1013 (Del. 1990).

suppression of wrongfully obtained evidence and/or the disqualification of the offending counsel.¹²⁶

Consequently, while the broadly stated majority rule permits *ex parte* contacts, whether a particular individual may be contacted without the consent of the other party's counsel must be examined in light of the case law of the relevant jurisdiction, the subject matter of the questioning, and the potential information possessed by the former employee.

C. Defamation and Retaliatory Litigation

When interviewing current and former employees, a fidelity insurer should be mindful of the potential for retaliatory litigation, usually in the form of a defamation action, by the accused wrongdoer.¹²⁷ Generally, an insured's potentially defamatory statements to its fidelity insurer are qualifiedly privileged. A key issue from the fidelity insurer's perspective is whether it is subject to liability for communicating the contents of the proof of loss to third parties. There are no fidelity cases discussing the issue, but there are several recent cases which shed some light on this long-considered issue. The cases suggest that a fidelity insurer's communications are qualifiedly privileged if the communication is made to a person who is in a position to give legitimate assistance and if the scope of the communication is reasonable. Nonetheless, a fidelity insurer should be careful to whom it discloses contents of the proof of loss.

By way of background, to maintain an action for defamation, there must be a publication of a communication, either orally or in writing, which is false and malicious. It is a matter of hornbook law that the publication of a statement that an employee is dishonest or fraudulent is *per se* defamatory because it contains a statement that impugns the employee's good name, impeaches his or her integrity, and injures his or her reputation.¹²⁸ Malice is presumed as a matter of law with respect to a statement that a person has committed a crime.¹²⁹

¹²⁶ *Rentclub, Inc. v. Transamerica Rental Fin. Corp.*, 811 F. Supp. 651 (M.D. Fla. 1992), *aff'd*, 43 F.3d 1439 (11th Cir. 1995); *Esser v. A.H. Robbins Co., Inc.*, 537 F. Supp. 197 (D. Minn. 1982). *See generally*, Horowitz, *supra* note 112.

¹²⁷ *See, e.g.*, John Joseph Petro, *Duty to Investigate, Retaliatory Litigation and Set-off (ERISA) Problems*, in *COMMERCIAL CRIME POLICY* (Gilbert J. Schroeder ed., 1996). For a discussion of the practical aspects of avoiding defamation when interviewing third parties, see Harvey C. Koch, *Retaliatory Litigation*, in *HANDLING FIDELITY BOND CLAIMS* (Michael Keeley & Timothy M. Sukel eds., forthcoming 1999).

¹²⁸ W. PAGE KEETON, ET AL., *PROSSER AND KEETON ON THE LAW OF TORTS* § 111 (5th ed. 1971); *see also* *Ramos v. Henry C. Beck Co.*, 711 S.W.2d 331 (Tex. App. 1986); *Ripps v. Herrington*, 1 So. 2d 899 (Ala. 1941). *See generally* *RESTATEMENT (SECOND) OF TORTS* § 593 (1977).

¹²⁹ *Id.*

A communication is not actionable if it is true or if the publication is privileged. Generally, a communication is privileged if it is made in good faith on any subject matter in which the party making the communication has an interest or in reference to which it has a duty, either public or private, legal, moral, or social, if made to a person having a corresponding interest or duty.¹³⁰ A publication of what may otherwise be a defamatory statement is considered to be qualifiedly privileged when made by an employer to its fidelity insurer.¹³¹ The privilege is based on the notion that an insured should be able to freely communicate with its insurance company on issues in which it has a legal or moral interest or duty to which the communication reasonably relates.¹³² Obviously, an employer obtains fidelity coverage for the purpose of protecting it from loss resulting from employee dishonesty, and the policies often have notice and proof of loss requirements. Because the privilege is qualified, a party cannot publish a defamatory statement which proves to be false if the publication is made with "actual malice," which is with knowledge that the statement is false or with reckless disregard as to the truth of the statement.¹³³

As noted above, the truth of the statement is an absolute defense to a defamation action. The burden of proving the truth of the statement is borne by the publisher. The publisher need only prove the statement is substantially true and not that it is true in every respect.¹³⁴

In order to establish the qualified privilege, the insured bears the burden of proving that the communication was within the scope of the qualified privilege. The insured must show that a commonality of interest exists between it and its fidelity insurer and that the communication was of a kind reasonably calculated to protect or further that interest.¹³⁵ Once the insured establishes that the statement falls within the scope of the privilege, then the burden shifts to the plaintiff to prove that the statement was made with malice.

Not surprisingly, there are several cases in which former employees have brought defamation actions against their former employers based upon state-

¹³⁰ *Tacket v. Delco Remy Div. of Gen. Motors Corp.*, 678 F. Supp. 1397 (S.D. Ind. 1987).

¹³¹ *See, e.g., Gelmin v. Quicke*, 638 N.Y.S.2d 132 (N.Y. App. Div. 1996); *Ripps*, 1 So. 2d at 899.

¹³² *Id.*, KEETON, *supra* note 128, § 115; RESTATEMENT, *supra* note 128, § 593. In addition, publications which may otherwise be defamatory are qualifiedly privileged when made in other contexts, such as in the reporting of crimes. *See* 31 U.S.C. § 5318(g) (Supp. 1999).

¹³³ *See, e.g., Hanan v. Corso*, No. Civ. A. 95-0292TPJMF, 1999 WL 320858 (D.D.C. May 18, 1999).

¹³⁴ *See, e.g., Downer v. Amalgamated Meatcutters & Butcher Workmen of N. Am.*, 550 S.W.2d 744 (Tex. Ct. App. 1977).

¹³⁵ *See, e.g., Baraket v. Matz*, 648 N.E.2d 1033 (Ill. App. Ct. 1995); *Ripps*, 1 So. 2d at 899.

ments contained in a proof of loss in support of a fidelity claim.¹³⁶ As might be expected, the courts follow the general rule that an allegation of dishonesty contained in a proof of loss is qualifiedly privileged when submitted to a fidelity insurer.¹³⁷

Obviously, an important issue for fidelity insurers is whether they can be at risk for republishing an alleged defamatory statement contained in a proof of loss. There are no reported decisions involving fidelity carriers on this issue.¹³⁸ Under general principles of defamation law, however, it is generally clear that a party who republishes a defamatory statement is liable for the damages caused by the republication. A republisher cannot avoid liability by claiming that it is merely repeating the words of another.¹³⁹ This obviously poses a problem for a fidelity insurer because it is duty-bound to investigate fidelity claims and as a result will normally communicate the allegedly defamatory statement to its agents, such as accountants, investigators, or attorneys.¹⁴⁰ Communicating the allegedly defamatory statements to agents acting on the insurer's behalf should not be actionable.¹⁴¹

Probably the most practical issue is whether a communication to the allegedly dishonest employee is actionable. Generally, a publication for purposes of defamation does not occur unless the allegedly defamatory statement is

¹³⁶ *First State Bank of Corpus Christi v. Ake*, 606 S.W.2d 696 (Tex. Ct. App. 1980); *Amalgamated Meatcutters*, 550 S.W.2d at 744; *Gallagher v. Albert Woodley Co.*, 315 N.Y.S.2d 99 (N.Y. App. Div. 1970); *Ripps*, 1 So. 2d 899; *Interstate Elec. Co. v. Daniel*, 151 So. 463 (Ala. 1933); *Sunley v. Metro Life Ins. Co.*, 232 Iowa 123 (1906).

¹³⁷ *See, e.g., Gelmin*, 638 N.Y.S.2d at 135; *see also Ake*, 606 S.W.2d at 696 (malice shown); *Roegelien Provision Co. v. Mayen*, 566 S.W.2d 1 (Tex. Ct. App. 1978)(no malice shown); *Ripps*, 1 So. 2d at 899 (plaintiff must show malice); *Schlaf v. State Farm Mut. Auto Ins. Co.*, 145 N.E.2d 791 (Ill. 1957)(statement qualitatively privileged; no malice shown).

¹³⁸ In *Amalgamated Meatcutters*, 550 S.W.2d at 744, an alleged wrongdoer filed an action against his former employer and its fidelity insurer, contending that the fidelity insurer republished the defamation when it issued a draft in payment of the claim and sent a transmittal letter forwarding the draft to the employer. Finding the allegations of this dishonesty to be true, the court never addressed the issue of whether the fidelity insurer could be liable for republishing an alleged defamatory statement.

¹³⁹ As such, “‘ Talebearers are as bad as talemakers.’” *Petro, supra* note 125, at 18-6 (quoting *Cavalier v. Original Club Forest*, 59 So. 2d 489 (La. Ct. App. 1952)).

¹⁴⁰ Modern Commercial Crime and financial institution bonds do not require a fidelity insurer to keep a proof of loss and its contents confidential. For a discussion of confidentiality issues, see Wayne Everson, *Confidentiality Issues Confronting Fidelity Insurers*, (unpublished paper presented to the annual meeting of the Surety Claims Institute, Lansdowne, Va., June 26, 1997)(on file with author).

¹⁴¹ *See, e.g., Baraket*, 648 N.E.2d at 1033 (communications to insurer by its consultant are qualifiedly privileged because of common interest in investigating insurance claim); *see also Petro, supra* note 127, at 18-6.

made to a recipient other than the person defamed.¹⁴² Nonetheless, there is a split of authority as to whether a party could be liable if it is foreseeable that the communication of the allegedly defamatory statement is communicated to a third party. There are several cases in which the courts have held that a party may be subject to liability if it is foreseeable that the defamed person would be under a “strong compulsion” to disclose the defamatory statement.¹⁴³ Other courts have held that the test is whether it is foreseeable that the allegedly defamed person would “likely” disclose the statement.¹⁴⁴ In one case, an employee who was terminated for dishonesty brought an action for defamation, contending that a publication of the defamation occurred because she was required to state the reason for her termination to prospective employers. The court held that a publication may occur if the party can prove it was foreseeable to the party making the defamatory statement that the same party would be under a “strong compulsion” to publish this statement.¹⁴⁵

Next, it is likely that a fidelity insurer may interview third parties, such as co-workers of the alleged wrongdoer, potential co-conspirators, or other third parties, and in the course thereof communicate the insured’s allegations in some fashion to them. Any such communication may be facially actionable,¹⁴⁶ but the fidelity insurer should be protected even if the allegation of dishonesty proves to be false, so long as the recomunication falls within a qualified privilege, as it virtually always will.¹⁴⁷ As one commentator has suggested, if a communication were qualifiedly privileged when initially published, then it should remain so when republished by a fidelity insurer because the fidelity insurer is discharging a legal duty to the insured when conducting an investigation.¹⁴⁸

Although there are no fidelity cases directly addressing the issue, recent case law suggests that a fidelity insurer’s communication to third parties is qualifiedly privileged if communicated to a person who is in a position to

¹⁴² *Dano v. Royal Globe Ins. Co.*, 453 N.Y.S.2d, 328 (N.Y. App. Div. 1982) (communication from insurer’s counsel to insured’s counsel); *see also Churchy v. Adolph Coors Co.*, 759 P.2d 1336 (Colo. 1988); *Ake*, 606 S.W.2d at 696.

¹⁴³ *Starr v. Pearle Vision, Inc.*, 54 F.3d 1548 (10th Cir. 1995); *Downs v. Waremart, Inc.* 903 P.2d 888 (Or. Ct. App. 1995); *McKinney v. County of Santa Clara*, 169 Cal. Rptr. 89 (Cal. Ct. App. 1980).

¹⁴⁴ *Ake*, 606 S.W.2d at 696.

¹⁴⁵ *Churchey*, 759 P. 2d at 1344.

¹⁴⁶ *Petro*, *supra* note 127, at 18-7.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* Some courts have held that statements may be qualifiedly privileged when made in connection with reasonable efforts to recover stolen property and to discover and prosecute the thief. *See, e.g., Klinck v. Colby*, 46 N.Y. 427 (1871); *see generally KEETON, supra* note 128, § 115 (and cases cited therein).

give legitimate assistance in the investigation and if the scope of the communication is reasonable.¹⁴⁹ For example, courts have held that an insurance company's statements to a physician's patients exceeded the limited purpose the company may have had in investigating claims when the statements imputed the physician's lack of ability or integrity.¹⁵⁰ Other courts have held that an employer loses a qualified privilege when it acts recklessly and makes communications to persons who do not have legitimate interests therein.¹⁵¹ Similarly, a former employee brought an action against his former employer and its agent based upon accusations contained in a letter delivered to the accountant of the customer of the former employer whose complaint had given rise to suspicions regarding the former employee.¹⁵² The court held that the employer lost its qualified privilege to publish the letter because the customer's accountant did not have a legitimate interest.

These cases clearly suggest that a fidelity insurer's communications are qualifiedly privileged if they are limited in scope and made to persons who can assist the insurer in investigating the truth of the allegations. Because a fidelity insurer has no way of knowing at the time of its investigation whether the allegations in the proof of loss are true, it is prudent for a fidelity insurer to exercise extreme caution when interviewing potential witnesses.¹⁵³

IV. ACTIONS AGAINST THIRD PARTIES

Another potential source of conflict can occur when the insured brings an action against a third party, such as the accused wrongdoer or other parties potentially responsible for the loss. A fidelity insurer's response to such a lawsuit or — the converse, inaction by the insured to protect its rights against third parties — depends largely upon the circumstances of the claim, the status of the investigation, the parties against whom the action has been commenced or contemplated, and the controlling law of the relevant jurisdiction. The issues can be examined from the viewpoint of the status of the claim, such as (1) before the insured submits the claim or during the investigation

¹⁴⁹ See, e.g., *Masso v. United Serv. Am.*, 884 F. Supp. 610 (D.C. Mass. 1995)(communications privileged when between control group of employees); *Nasr v. Connecticut Gen. Life Ins. Co.*, 632 F. Supp. 1024 (N.D. Ill. 1986); *Gibby v. Murphy*, 325 S.E.2d 673 (N.C. Ct. App. 1985); *Dano*, 453 N.Y.S.2d at 530 (letter from insurer's counsel to insured's counsel sent under duty to investigate claim); *Moore & Assoc. v. Metropolitan Life Ins. Co.*, 604 S.W.2d 487 (Tx. Ct. App. 1980).

¹⁵⁰ *Nasr*, 632 F. Supp. at 1029.

¹⁵¹ *Masso*, 884 F. Supp. at 622.

¹⁵² *Gibby*, 325 S.E.2d at 673.

¹⁵³ For a discussion of the practical aspects of avoiding defamation claims, see Koch, *supra* note 127.

of the claim, (2) after the fidelity insurer denies the claim, and (3) after the fidelity insurer settles the claim. The first and third time frames are discussed together because many of the same issues are relevant during these time frames. The second time frame is discussed separately because denial of a claim may give rise to separate issues if litigation ensues. While a number of factors and technical considerations enter into the equation, during all three time frames a fidelity insurer should always consider its potential salvage rights and available opportunities.

A. Prior To and During the Claim Investigation and After Payment or Settlement

Important issues permeating all phases of the insured-insurer relationship but which lend themselves to analysis during the pre-claim and investigative and post-payment/settlement phases are salvage and allocation of recoveries. During the pre-claim and investigative phases, a fidelity insurer should determine whether the insured has preserved its, and its fidelity insurer's, rights against third parties. Some courts have held that an insured's failure to preserve its rights against third parties may be a breach of a condition precedent to coverage, and another has held that such a failure may be raised as an affirmative defense. In practice, it is less likely that an insured will prejudice its fidelity insurer's salvage rights after payment or settlement. During this time frame, the fidelity insurer will more likely address practical issues, such as whether third parties are viable sources of recovery.

A related issue is allocation of recoveries. Modern commercial crime and financial institution bonds contain provisions addressing allocation of recoveries. There are several cases in which the courts have attempted to apply a coherent theory of allocation of resources, but one court has recently caused some confusion by misconstruing the plain language of the bond language at issue and ignoring general principles of contract law and equitable subrogation.

First, before a formal claim is made against a fidelity insurer and during the pendency of a claim, a fidelity insurer generally does not have the right to bring an action against the wrongdoer or other third parties.¹⁵⁴ Nonetheless, a fidelity insurer's two concerns during this time frame should be (1) whether

¹⁵⁴ See, e.g., *Aetna Cas. & Sur. Co. v. Phoenix Nat'l Bank & Trust Co.*, 285 U.S. 209 (1932) (payment is a precondition to right of subrogation).

the insured is preserving all of its rights against third parties, and (2) whether the insured is protecting the fidelity insurer's rights. Toward that end, modern commercial crime¹⁵⁵ and financial institution¹⁵⁶ bonds contractually require an insured to protect its rights against a third party for the benefit of the fidelity insurer. Some courts have held that insureds have an affirmative duty to protect their rights against third parties for the benefit of a fidelity insurer.

For example, the court in *Winthrop and Weinsteine, P.A. v. Travelers Casualty & Surety Co.*¹⁵⁷ held that the insured was barred from recovery under a commercial fidelity bond when it foreclosed its right of recovery against certain financial institutions which may have been liable to the insured because it failed to provide affirmative notice to the financial institutions as required by the Uniform Commercial Code.¹⁵⁸ The insured did not contest that the fidelity insurer was prejudiced by its failure to notify the financial institutions, but it contended that the amount of recovery lost by its failure to so comply should be a deduction from the amount of coverage and should be asserted by the fidelity insurer as an affirmative defense. The court rejected that argument, reasoning that under Minnesota law actual prejudice to the insurer operates as a bar to recovery when the insured breaches a condition of an insurance policy. As a result, the court granted summary judgment in

¹⁵⁵ See Form CR 10 00 06 95 at B(19) (INSURANCE SERVICES OFFICES, INC. 1995) reprinted in COMMERCIAL CRIME POLICY, which states:

Transfer of Your Rights of Recovery Against Others to Us: You must transfer to us all your rights of recovery against any person or organization for any loss you sustained and for which we have paid or settled. You must also do everything necessary to secure those rights and do nothing *after loss* to impair them. (Emphasis added.)

The identical provision is contained at Section B(17) of the 1986, 1988, and 1990 versions of the form.

¹⁵⁶ See Financial Institution Bond, section 7, which states, in relevant part:

(a) In the event of payment under this bond, the Insured shall deliver, if so requested by the Underwriter, an assignment of such of the Insured's rights, title and interest and causes of action as it has against any person or entity to the extent of the loss payment.

(b) In the event of payment under this bond, the Underwriter shall be subrogated to all of the Insured's rights of recovery therefor against any person or entity to the extent of such payment.

....

(e) The Insured shall execute all papers and render assistance to secure to the Underwriter the rights and causes of action provided for herein. The Insured shall do nothing *after discovery of loss* to prejudice such rights or causes of action. (Emphasis added.)

¹⁵⁷ 993 F. Supp. 1248 (D. Minn. 1998).

¹⁵⁸ *Id.* at 1255 (citing MINN. STAT. § 336-4-406(f) (providing for a one-year notice provision, which the court characterized as a limitation period)).

favor of the fidelity insurer, holding that the insured's failure to protect the fidelity insurer's subrogation rights was a breach of a precondition to coverage.¹⁵⁹

Similarly, in *Premier Electrical Construction Co. v. USF&G*,¹⁶⁰ the insurer asserted as an affirmative defense to a claim under a commercial fidelity bond that the insured failed to mitigate its loss because it failed to recover from the alleged wrongdoer proceeds of a settlement the alleged wrongdoer obtained in an unrelated lawsuit filed against a third party. The court held that a mitigation defense is legally sufficient in the context of a fidelity claim.

These cases stand for the proposition that an insured must take affirmative steps to protect its, and therefore the fidelity insurer's, rights against third parties. The insured's failure to do so may be a precondition to coverage or an affirmative defense. Whether a fidelity insurer will want to rely upon the insured and its counsel to protect such rights depends upon a number of factors, including the strength of the claim, the amount of the potential salvage, and the sophistication of the insured's counsel. In the event that the fidelity insurer wishes to control the litigation, it may consider entering into a claim cooperation agreement or loan agreement prior to actually resolving and paying the claim.¹⁶¹ The strategic considerations and specifics of such an agreement necessarily will depend upon the law of the relevant jurisdiction.

Second, as a general matter, once a fidelity insurer pays a claim, it is subrogated to the rights of its insured to the extent of payment; and in most situations the insurer will require the insured to execute a release and assignment. Whether and to what extent a fidelity insurer seeks recovery from third

¹⁵⁹ *Id.* at 1255-46. It should be noted, however, that the court held that the fidelity insurer was also prejudiced because the insured had assigned its rights against the financial institution to another fidelity insurer. *See also* Republic Nat'l Life Ins. Co. v. United States Fire Ins. Co., 589 S.W.2d 737, 742 (Tex. Ct. App. 1979), *rev'd on other grounds*, 602 S.W.2d 527 (Tex. 1980).

¹⁶⁰ No. 80-C6689, 1987 U.S. Dist. LEXIS 5588 (N.D. Ill. June 19, 1987).

¹⁶¹ *See, e.g.*, T.S.I. Holdings v. Buckingham, 885 F. Supp. 1457 (D. Kan. 1995); *see generally* V. Woerner, *Insurance: Validity and Effect of Loan Receipt or Agreement Between Insured and Insurer for a Loan Repayable to Extent of Insured's Recovery From Another*, 13 A.L.R. 3d 42 (1967 & Supp. 1999); James A. Knox, Jr., *Salvage*, in FINANCIAL INSTITUTION BONDS 501 (2d ed., Duncan L. Clore ed., 1998).

parties depends on a number of factors, including the financial viability of the potential defendants. Because modern commercial crime¹⁶² and financial institution¹⁶³ bonds contain salvage provisions which refer to allocation of recoveries after a fidelity insurer makes payment, there should be little dispute that the salvage provision in the bond should apply after settlement of the claim or payment of a judgment. Indeed, several courts have applied similar salvage provisions as written.¹⁶⁴ In the event that an insured has an excess or uncovered loss, it may be prudent for a fidelity insurer to prepare a detailed agreement which sets forth the rights of the parties in light of the relevant salvage provision and applicable case law.

Third, disputes can arise not only when an insured fails to take action, but also when an insured does take action against third parties. The issue then becomes how to allocate the recovery. Insureds will want to allocate the recovery to its uncovered loss, and insurers will want to allocate the recovery to covered loss. Apparently, the first court to address the issue held that recoveries should be traced to a specific covered loss, and then so applied.¹⁶⁵ Other courts have held that, when recoveries cannot be traced to a specific

¹⁶² Modern commercial crime policies state in relevant part:

17. Recoveries:

a. Any recoveries, less the cost of obtaining them, made after settlement of loss covered by this insurance will be distributed as follows:

- (1) To you, until you are reimbursed for any loss that you sustain that exceeds the Limit of Insurance and the Deductible Amount, if any;
- (2) Then to us, until we are reimbursed for the settlement made;
- (3) Then to you, until you are reimbursed for that part of the loss equal to the Deductible Amount, if any.

Form CR 10 00 06 95 (INSURANCE SERVICES OFFICES, INC. 1995).

¹⁶³ 163. Modern financial institution bonds state in relevant part:

Section 7.

...

(c) Recoveries, whether effected by the Underwriter or by the Insured, shall be applied net of the expense of such recovery first to the satisfaction of the Insured's loss which would otherwise have been paid but for the fact that it is in excess of either the Single or Aggregate Limit of Liability, secondly, to the Underwriter as reimbursement of amounts paid in settlement of the Insured's claim, and thirdly, to the Insured in satisfaction of any Deductible Amount. Recovery on account of loss of securities as set forth in the second paragraph of Section 6 or recovery from reinsurance and/or indemnity of the Underwriter shall not be deemed a recovery as used herein.

Financial Institution Bond, Standard Form No. 24, *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA).

¹⁶⁴ *See, e.g.,* Commercial Std. Ins. Co. v. Liberty Plan Co., 283 F.2d 893 (10th Cir. 1960); Graydon-Murphy Oldsmobile v. Ohio Cas. Ins. Co., 93 Cal. Rptr. 684 (1971).

¹⁶⁵ City Trust & Sav. Bank v. Underwriting Members of Lloyds at London, 109 F.2d 110 (7th Cir. 1940).

covered loss, they should be prorated between covered and uncovered loss.¹⁶⁶ Some courts have held that recoveries obtained prior to payment by a fidelity insurer should be applied to reduce the amount of the insured's covered loss.¹⁶⁷

Recently, in *First National Bank of Louisville v. Lustig*,¹⁶⁸ the court held, with little discussion, that an insured could allocate recoveries, in the form of proceeds from the sale of loan collateral, first to uncovered loss of interest and then to the covered principal amount of the loans. The court reasoned that the allocation of recoveries section in the financial institution bond form at issue¹⁶⁹ did not apply to recoveries made by the insured *before* payment of the loss because the clause stated that it applied to the satisfaction "of the amount paid" under the bond. In support, the court mistakenly concluded that Subsection 7(e) of the bond, stating "[t]he Insured shall do nothing *after discovery of loss* to prejudice" the fidelity insurer's right to obtain reimbursement, "clearly refers to activities after the insurer makes payments pursuant to the terms of the bond."¹⁷⁰ The court also concluded that the phrase "[i]nsured's loss in excess of the amount paid under this bond" did not require that recoveries be allocated first to "excess" loss which would otherwise be covered but for the amount of coverage.¹⁷¹

¹⁶⁶ *James B. Lansing Sound, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 801 F.2d 150 (9th Cir. 1986); *Commercial Std. Ins. Co.*, 282 F.2d at 893; *Graydon-Murphy Oldsmobile*, 93 Cal. Rptr. at 684.

¹⁶⁷ *FDIC v. United Pacific Ins. Co.*, 20 F.3d 1070 (10th Cir. 1994), *after remand*, 152 F.3d 1266 (10th Cir. 1998); *First Am. State Bank v. Continental Ins. Co.*, 897 F.2d 319 (8th Cir. 1990).

¹⁶⁸ 96 F.3d 1554 (5th Cir. 1996), *aff'g* 847 F. Supp. 1322 (E.D. La. 1994).

¹⁶⁹ The clause in the 1980 Bankers Blanket Bond stated, in relevant part, at Section 7(c), "[r]ecoveries, whether affected by the Underwriter or by the Insured, shall be applied net of the expense of such recovery first to the satisfaction of the Insured's *loss which would otherwise have been paid but for the fact that it is in excess of either the Single or Aggregate Limit of Liability*, secondly, to the Underwriter as reimbursement of amounts paid in settlement of the Insured's claim" (Emphasis added.)

It should be noted, however, that in another case decided in the same circuit, the trial court held that recoveries obtained prior to settlement should first be applied to loss which would have otherwise been covered but exceeded the amount of the insurance, reasoning that the term "loss" in a salvage provision referred to covered loss only. *FDIC v. Fidelity & Dep. Co. of Maryland*, 827 F. Supp. 385 (N.D. La. 1993), *aff'd on other grounds*, 45 F.3d 1969 (5th Cir. 1995).

¹⁷⁰ 96 F.3d at 1554 (emphasis added). In so doing, the court ignored precedent, holding that salvage provisions in modern commercial crime and financial institution bonds apply to recoveries obtained before settlement of a claim. *United Pacific*, 20 F.3d at 1070.

¹⁷¹ *Id.* For a discussion of this opinion and the district court's two opinions addressing the issues, see Mark E. Wilson, *The Legal Boundaries of "Loss" Under Fidelity and Financial Institution Bonds: Toward a Coherent Theory of Set-off and Allocation of Losses and Recoveries* (unpublished paper presented at the annual meeting of the National Bond Claims Association, Pinehurst, N.C. Oct. 3, 1996) (on file with author).

Unfortunately, the holding of the court of appeals raises more questions than it answers. Read literally, the court's holding appears to encourage insureds to "maximize" their covered loss, a notion which must be reconciled with case law in which the courts have held that a party to a contract is required to mitigate its damages.¹⁷² Further, the court's holding must be reconciled with cases in which the courts have held that an insured may obviate coverage when it enters into a settlement with a third party to the substantial prejudice of its insurer.¹⁷³

Another potential area for dispute is the related issue of whether any profit realized by the insured should be allocated to reduce the amount of the insured's covered loss. There is a split of authority on this issue. In two older cases, the courts, somewhat astonishingly, held that a fidelity insurer is not permitted to set off against a loss the profits generated by a wrongdoer's conduct.¹⁷⁴ The most recent court addressing the issue reasoned, however, that it should consider the sum total of the effects of the wrongdoer's dishonest conduct.¹⁷⁵ The court concluded that to hold otherwise would result in an inequitable double recovery.¹⁷⁶ This is obviously the better rule because allowing an insured to recover under its fidelity bond while at the same time it accepts the benefits of the conduct it claims is dishonest is not only illogical but results in a windfall to the insured.

In summary, during the pre-claim and investigation and post-payment or settlement phases of the insured-insurer relationship, protection of the insured's rights against others and allocation of recoveries are important issues. The law is somewhat unsettled as to whether an insured can obtain recoveries pre-payment and apply them to the detriment of its fidelity insurer. Yet, permitting an insured to allocate recoveries any way it sees fit ignores not only the language and intent of modern commercial crime and financial institution bonds, but also general principles of the law of contracts and equitable subrogation. To avoid some of these issues when settling a claim, it may be helpful for a fidelity insurer to address any potential salvage issues in the settlement documentation. Typically, the provisions and nuances of such an agreement will be dictated by the particulars of the claim.

¹⁷² See 11 SAMUEL WILLISTON & WALTER H. E. JAEGER, A TREATISE ON THE LAW OF CONTRACTS § 1353 (3d ed. 1960 & Supp. 1999); JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 14-15 (4th ed. 1998); see also *United Pacific*, 20 F.3d at 1079-81.

¹⁷³ It is well established that an insured's release of a third party may obviate coverage. See, e.g., *Barr Co. v. Safeco Ins. Co.*, No. 83-C2711, 1988 U.S. Dist. LEXIS 6869 (N.D. Ill. June 14, 1988); *M.F.A. Mut. Ins. Co. v. Cheek*, 363 N.E.2d 809 (Ill. 1977). See generally 6A APPLEMAN, INSURANCE LAW & PRACTICE § 4093 (1972 & Supp. 1998).

¹⁷⁴ *HS Equities, Inc. v. Hartford Acc. & Indem. Co.*, 609 F.2d 669 (2d Cir. 1979); *Nat'l Sec. Corp. v. Rauscher, Pierce & Co.*, 369 F.2d 572 (5th Cir. 1969).

¹⁷⁵ *Kinzer v. Fidelity & Dep. Co. of Md.*, 652 N.E.2d 20 (Ill. App. Ct. 1995).

¹⁷⁶ *Id.* at 26-27.

B. After Denial of Coverage

The other relevant time frame arises in the event a fidelity insurer denies a claim. During this time frame, a fidelity insurer should still be mindful of its potential salvage rights. When a fidelity insurer is sued by its insured, the insurer must determine whether it wishes to join third parties, such as the accused wrongdoer or third parties who are or may be liable to the insured. The latter issues essentially are a matter of trial strategy.

The same issues regarding salvage and allocation of recoveries discussed above apply during this time frame. It should be noted, however, that some courts have held that if a fidelity insurer denies coverage then an insured can allocate recoveries as it sees fit.¹⁷⁷ Nonetheless, these cases must be reconciled with other cases deciding similar issues relating to the law of contracts and equitable subrogation. For example, courts have held that a party seeking recovery for breach of contract must itself comply with the terms of the contract.¹⁷⁸ In addition, the courts' rulings ignore the distinction between a dispute over the terms of a contract and a repudiation of the contract.¹⁷⁹ The courts' rulings lead to the conclusion that the insureds terminated the contracts, potentially leaving them uninsured for additional losses. Further, it is well established that upon payment an insurer is subrogated to the rights of its insured, even when compelled to pay by reason of a judgment.¹⁸⁰ If an insured may allocate recoveries to the detriment of its insurer and releases a third party in the process, the insurer may be prejudiced even though it denies the claim.

In addition to salvage issues, a fidelity insurer must also decide a number of other practical issues related to trial strategy. For example, a fidelity insurer must determine whether it wishes to join the accused wrongdoer. From a procedural standpoint, a fidelity insurer may implead the accused wrongdoer even though it has not paid the claim.¹⁸¹ More often than not, this decision will have been made by the insured, who normally sues the fidelity insurer and the accused wrongdoer at the same time. The decision to join the accused

¹⁷⁷ See *FSLIC v. Transamerica Ins. Co.*, 661 F. Supp. 246 (C.D. Cal. 1987); *Mutual Trust Life Ins. Co. v. Wemyss*, 309 F. Supp. 1221 (S.D. Mass. 1970).

¹⁷⁸ See, e.g., *Hoopla Sports & Enter., Inc. v. Nike, Inc.*, 947 F. Supp. 347 (N.D. Ill. 1996).

¹⁷⁹ See generally *WILLISTON*, *supra* note 170, 1305 & 1306 (and cases cited therein); *CALAMARI*, *supra* note 172, § 11.18 (and cases cited therein).

¹⁸⁰ See, e.g., *National Union Fire Ins., Co. of Pittsburgh, Pa. v. FDIC*, 887 F. Supp. 262 (D. Kan. 1995); *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Southeast Bank, N.A.*, 476 So. 2d 776 (Fla. Dist. Ct. App. 1985). See generally *APPLEMAN*, *supra* note 173, § 6551-80.

¹⁸¹ *National Union Fire Ins. Co. of Pittsburgh, Pa.*, 887 F. Supp. at 262; *FDIC v. National Sur. Corp.*, 434 F. Supp. 61 (E.D.N.Y. 1977); *Monarch Indus. Corp. v. American Motorists Ins. Co.*, 276 F. Supp. 972 (S.D.N.Y. 1967).

wrongdoer obviously depends upon a myriad of factors, the most important of which would appear to be the relative strength of the claim, because the wrongdoer's conduct obviously is linked to the fidelity insurer's liability. If the claim is weak and the accused wrongdoer would make a good witness, then it may be good strategy to implead the wrongdoer. If, on the other hand, the accused wrongdoer will make a poor witness, or has asserted the Fifth Amendment in a deposition, or has been convicted of a crime or pleaded guilty, then impleading the accused wrongdoer may not be a good strategy. From a practical standpoint, impleading the accused wrongdoer may not be bad strategy if the jury is made aware that, if it determines the fidelity insurer is liable, then it must also find that the accused wrongdoer is liable to the fidelity insurer. If an accused wrongdoer is sympathetic, this may alleviate problems with a jury deciding against an insurer in one action and deciding in favor of the accused wrongdoer in a subsequent action.

The same considerations apply in deciding whether to join other third parties who may be liable to the insured. Courts have also held that a fidelity insurer may implead third parties who have either caused or contributed to the loss.¹⁸² The list of potential third parties usually includes co-conspirators of the wrongdoer, the insured's accountants, the insured's directors and officers, and other financial institutions if the claim involves negotiable instruments.

First, if the insured conspired with others, such co-conspirators may be potential targets. Under theories of civil conspiracy, a co-conspirator is liable for all of the loss caused by the conspiracy, even if he or she directly participated in some of the conduct.¹⁸³ This can be a powerful advantage over a financially viable co-conspirator.

Second, the insured's accountants can, on occasion, also provide a source of recovery for the subrogated fidelity insurer. Fidelity losses often occur because the wrongdoer's cover-up scheme to hide the fraud from the insured's management succeeded. Management frequently responds that it paid good money to its accountants to handle the particular management function that should have detected the fraud, that the accountants negligently performed that duty, and that therefore they should bear some or all of the loss. While the law across the country differs, accountants generally are indeed liable to the insured and, therefore, to the insurer in a subrogation action, in certain circumstances.

¹⁸² See, e.g., *Morgan, Olmtead, Kennedy & Gardener, Inc. v. Federal Ins. Co.*, 637 F. Supp. 973 (S.D.N.Y.), *aff'd*, 833 F.2d 1002 (2d Cir. 1986).

¹⁸³ See generally 15A C.J.S. *Conspiracy* § 18 (1967 & Supp. 1999) (and cases cited therein).

Accountants' liability depends on many factors, including the nature of the work performed. Accounting work can generally be placed into three different categories: compilations, reviews, and audits.¹⁸⁴ Compilations present financial statements that are the representation of management and that involve no effort by the accountant to perform any tasks to confirm the accuracy of those statements.¹⁸⁵ In a review, by contrast, the accountant performs certain tasks designed to determine the accuracy of the financial statements.¹⁸⁶ The highest level of accounting work is the independent audit, which imposes significant responsibility on the accountant. In the audit report, the accountant expresses a formal opinion on the financial statements based on the audit.¹⁸⁷ The report further must state that the accountant conducted the audit in accordance with Generally Accepted Auditing Standards (GAAS), which include standards that require the planning and performance of an audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.¹⁸⁸

It can be difficult for the subrogated insurer to assert a malpractice claim against the accountant for the negligent preparation of a compilation or a review, although some authority indeed exists for such claims.¹⁸⁹ Audits present much more possibilities for potential subrogation claims. Two common types of claims are available to the fidelity insurer. First, auditors are required to assess the internal control structure of the insured.¹⁹⁰ Certain

¹⁸⁴ See generally Stephen E. Silver, *Compilations, Reviews, and Audits/The Audit Process*, in 1 ACCOUNTANTS' LIABILITY LITIGATION 99 (ALI-ABA Program on Accountants' Liability Litigation, Washington, D.C., Jan. 29, 1998).

¹⁸⁵ CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Standards for Accounting and Review Services No. 1 (Am. Inst. of Certified Pub. Accountants 1976).

¹⁸⁶ *Id.*; see also Stephen E. Silver, *supra* note 184, at 103-04 (discussing the difference between reviews and compilations).

¹⁸⁷ CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Standards for Accounting and Review Services No. 58 (Am. Inst. of Certified Pub. Accountants 1993).

¹⁸⁸ *Id.*

¹⁸⁹ *Robert Wooler Co. v. Fidelity Bank*, 479 A.2d 1027 (Pa. Super. Ct. 1984); *Spherex, Inc. v. Alexander Grant & Co.*, 451 A.2d 1308 (N.H. 1982). *Accord* *Ryan v. Kanne*, 170 N.W.2d 395 (Minn. 1969) (accountants can be liable when performing services less than a full audit); *Bonhiver v. Graff*, 248 N.W.2d 291 (1976) (same); *Seedkem, Inc. v. Safranek*, 466 F. Supp. 340 (D. Neb. 1979). See also *Zupnick v. Thomson Parking Partners*, Fed. Sec. L. Rep. (CCH) & 95,388 (S.D.N.Y. 1990) (acknowledging that accountants have some duties in performing a compilation, although much less extensive than in connection with a full audit).

¹⁹⁰ CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 55 (Am. Inst. of Certified Pub. Accountants 1988). See generally COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, INTERNAL CONTROL B INTEGRATED FRAMEWORK (Am. Inst. of Certified Pub. Accountants 1994) (comprehensively addressing the auditor's internal control assessment).

internal control deficiencies that the auditor discovers in the audit, or otherwise, must be brought to management's attention in a report to management. Thus, if an auditor detected or should have detected an internal control deficiency and then failed to so inform management, the auditor could be liable for malpractice. Second, under recent changes to GAAS, auditors have specific responsibilities with regard to fraud.¹⁹¹ The new standard imposes an obligation to detect material misstatements on financial statements caused by fraud and imposes certain documentation and communication requirements regarding that assessment.¹⁹² In defense, auditors will often claim that the materiality requirement absolves the auditor from detecting the fraud.¹⁹³ Defenses of lack of causation, lack of reliance, and contributory negligence are also frequently available.¹⁹⁴

Third, another potential source of recovery involves directors or officers of the insured. Virtually every covered loss, while inherently caused by some covered conduct, is also contributed to by negligence on the part of officers, and sometimes directors, of the insured.¹⁹⁵ There is an approximately equal split of authority as to whether a fidelity insurer can recover from them.¹⁹⁶ All courts permit such recovery when the officers or directors actively colluded with the principal. The split arises when their conduct was "merely" negligent. The cases are at best confused when their conduct arguably falls between

¹⁹¹ CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 82 (Am. Inst. of Certified Pub. Accountants 1997).

¹⁹² Bradford R. Carver & D.M. Studler, *The Auditor's Responsibility to Detect Fraud: Recently Issued SAS No. 82 and Its Potential Effect on Fidelity Claims*, IV FID. L. ASS'N J. 89, 95-96 (1998).

¹⁹³ *Id.* at 94.

¹⁹⁴ Richard P. Swanson, *Theories of Liability*, in 1 ACCOUNTANTS' LIABILITY LITIGATION 1, 36-39 (ALI-ABA Program on Accountants. Liability Litigation, Washington, D.C., Jan. 29-30, 1998) (collecting authority regarding these defenses).

¹⁹⁵ Gilbert J. Schroeder, *Handling The Complex Fidelity or Financial Institution Bond Claim: The Liability of the Insured's Officers and Directors and Their D & O Carrier*, 21 TORT & INS. L. J. 269 (1986).

¹⁹⁶ Courts which have permitted such an action include: *United American Bank in Memphis v. Aetna Cas. & Sur. Co.*, No. 84-2225 GB (W.D. Tenn. 1986); *Germantown Savings Bank v. United Pacific Ins. Co.*, (E.D. Pa. filed Jan. 10, 1986) (bench opinion Judge Donald W. Vanartsdalen); *Fidelity Nat'l Bank of Baton Rouge v. Aetna Cas. & Sur. Co.*, 584 F. Supp. 1039 (N.D. La. 1984); *Manufacturers Bank & Trust Co. of St. Louis v. Transamerica Ins. Co.*, 568 F. Supp. 790 (E.D. Mo. 1983); *Community Fed. Sav. & Loan Ass'n v. Transamerica Ins. Co.*, 559 F. Supp. 536 (E.D. Mo. 1983); *FDIC v. National Sur. Corp.*, 434 F. Supp. 61 (E.D.N.Y. 1977); *Luzerne Nat'l Bank v. Hanover Ins. Co.*, No. 3600-C (Court of Common Pleas of Luzerne County, Pennsylvania November 22, 1988). Courts which do not permit such an action include: *Home Indem. Co. v. Shaffer*, 860 F.2d 186 (6th Cir. 1988); *Dixie Nat'l Bank of Dade County v. Employers Ins. Co. of America*, 759 F.2d 826 (11th Cir. 1985); *Employers Ins. of Wausau v. Doonan*, 664 F. Supp. 1220 (C.D. Ill. 1987), *later case*, 712 F. Supp. 1368 (C.D. Ill. 1989); *FSLIC v. Aetna Cas. & Sur. Co.*, 696 F. Supp. 1190 (E.D. Tenn. 1988); *FDIC v. Aetna Cas. & Sur. Co.*, No. 1-85-797 (E.D. Tenn. 1986); *First Nat'l Bank of Columbus v. Hansen*, 267 N.W.2d 367 (Wis. 1978).

those extremes (grossly negligent or wilful and wanton conduct). Some insurers are reluctant to subrogate against their own insured's officers or directors, but as reflected by the referenced cases, many others are not.¹⁹⁷

Fourth, if the loss involved negotiable instruments, financial institutions may be potential candidates for impleader as well. Because losses involving negotiable instruments can involve many different aspects of the Uniform Commercial Code, the numerous permutations of a financial institution's potential liability are beyond the scope of this paper.¹⁹⁸

IV. CONCLUSION

The insurer-insured relationship can give rise to numerous potential conflicts wholly apart from the issue of whether the claim is covered. The potential for conflict exists even before the insured makes a claim and continues until after the insurer makes payment. Conflicts most often arise when parallel criminal proceedings threaten to impede investigation and litigation of a claim, when the insurer seeks to interview current and former employees of the insured, and when the insured fails to preserve its rights against third parties or allocates recoveries to the detriment of its fidelity insurer. By recognizing potential sources of disagreement, a fidelity insurer should be able to handle and resolve claims more promptly and efficiently.

¹⁹⁷ Some insurers are particularly reluctant to do so if they also write the directors and officers liability insurance for the insured. This is, or at least should be, for "policy" reasons, and justifiably so; but it should not be based on liability concerns because, per *National Sur. Corp.* 434 F. Supp. at 61, the only basis for such an action is subrogation. Since every D&O policy nowadays has an insured v. insured exclusion and the insurer is pursuing the corporate insured's claim, that subrogation action will not be covered by D&O insurance anyway, a fact with its own obvious upsides and downsides.

¹⁹⁸ For excellent discussions of the issues, see Mark E. Wilson, *Banking Industry Standards Relevant to Coverage and Recoveries Under the Revised Uniform Commercial Code*, V FID. LJ. (forthcoming 1999); Stephen L. Baskind, *Who Ultimately Bears the Loss — Assignment, Subrogation, and Risk Allocation Pursuant to the Uniform Commercial Code* (unpublished paper presented to the annual mid-winter meeting of Fidelity and Surety Law Committee of TIPS, New York, N.Y., Jan. 26, 1996).