

THE COMPENSABILITY OF THIRD-PARTY LOSSES UNDER FIDELITY BONDS

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I. Introduction

An employer's potential risk of loss from employee dishonesty extends beyond embezzlement of the employer's money and property. The employer also bears significant exposure when an employee misappropriates a customer's or third party's property in the employer's possession and control, or otherwise perpetrates a fraud on a third party. Although the employer may be entirely innocent and have received no benefit from the employee's fraud, it may nonetheless be held vicariously liable to its customer for resulting losses.

In such a circumstance, the employer might seek indemnity for its liability under its financial institution bond or commercial crime policy. Fidelity bonds, however, cover only the direct loss of money or other property. They are not liability policies, and do not provide blanket coverage for an insured's vicarious liability to a third party.

Whether a third-party loss ultimately will be covered by the employer's fidelity bond depends upon the nature of the loss. It is important to distinguish between claims based upon the insured's liability for damages caused by an employee's perpetration of fraud on a third party, and claims based upon the employee's misappropriation of a third party's property while in the possession of the insured. The former are not covered. While there was a split of authority under pre-1980 fidelity bonds over the compensability of losses resulting from an insured's liability to a third party, the 1980 revisions resolved the dispute by limiting coverage to direct losses. Because the insured's liability arises incidentally under a theory of vicarious liability, any losses resulting therefrom constitute an indirect loss which is outside the scope of coverage.

That said, although fidelity bonds do not cover an insured's liability to a third party, they likely will (subject to other defenses) cover the misappropriation of a third party's property while in the possession and control of the insured. Such claims are covered not because the insured may be liable to the owner for the misappropriation of its property, but rather because the ownership provision in standard form fidelity bonds extends coverage to the property itself while the possession and control of the insured.

While commentators have analyzed this issue from diverse perspectives over the past few years, those papers have focused on specific bond forms or certain

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limited issues.¹ This article will survey these issues and provide a comprehensive overview of both the substantive and procedural issues impacting compensability of third-party claims under financial institution bonds and commercial crime policies. Section II of this article addresses the compensability of claims based upon an insured's vicarious liability for an employee's fraud on a third party. Section III addresses the compensability of claims arising from an employee's misappropriation of a third party's property while in the possession and control of the insured. Section IV analyzes a third party's standing to pursue an independent claim for indemnity under a fidelity bond.

II. Insured's Vicarious Liability for an Employee's Fraud on a Third Party

Employers commonly face exposure resulting from criminally-minded employees. Direct communication with an insured's customers and access to property and sensitive information provides such employees with ample opportunity to defraud third parties. Consider this scenario: An overzealous employee, in an effort to earn additional commissions and increase the employer's market share, bribes a customer's purchasing manager to induce him to purchase the insured's products at inflated prices, causing the customer substantial damage.

When the customer uncovers the salesman's fraud and seeks recovery for its damages, the employer "may not hide behind the cloak of an unfaithful employee defense."² On the contrary, the employer is vicariously liable for its employee's tortious or fraudulent misconduct committed during the performance of his duties. The employer may be "subject to liability although [it] may be entirely innocent, has

¹There have been a number of excellent articles addressing this issue over the past few years. See, e.g., Paul R. Devin & R. Allan Fryer, *Third Party Claims Against the Insured*, in *HANDLING FIDELITY BOND CLAIMS* (Michael Keeley & Timothy M. Sukel eds., 1999); Lisa Block & Dirk E. Ehlers, *Aetna v. Kidder Peabody: Trend or Anomaly?* (unpublished paper presented at the annual meeting of the American Bar Association, Toronto, Canada, 1998); Joseph J. Brenstrom, *Third Party Losses: Causational Approach to Resolving Claims on Fidelity Bonds and Other Common Crime Coverages Based Upon Losses To An Insured Arising Out of Claims Against the Insured By Third Parties* (unpublished paper presented at the annual meeting of the Surety Claims Institute, Miami, Florida, June 1997); Mark S. Gamell, *Third Party Claims and Losses Under the Financial Institution Bond*, in 1 *FID. L.J.* 75 (1995); Karen Wildau, *Evolving Law of Third-Party Claims Under Fidelity Bonds: When is Third-Party Recovery Allowed?*, 25 *TORT & INS. L.J.* 92 (1989); John W. Bassett, *Direct Loss Under the Fidelity Insuring Agreement of the Financial Institution Bond*, 54 *DEF. COUNS. J.* 487 (1987); Duncan L. Clore, *Suits Against Financial Institutions: coverages and Considerations*, 20 *FORUM* 83 (1984).

²*Commodity Futures Trading Comm'n v. Premex, Inc.*, 655 F.2d 779, 784 (7th Cir. 1981) (under respondeat superior, a principal is liable for the deceit of its agent, if committed in the business the agent was appointed to carry out, even though the agent's specific conduct was carried out without the knowledge of the principal).

received no benefit from the transaction, and the agent acted solely for his own purposes.”³

Although the salesman’s conduct might be characterized as fraudulent or dishonest and the employer’s liability to its customer might result in an out-of-pocket loss to the employer, the loss is not covered by the employer’s financial institution bond or commercial crime policy. Fidelity bonds cover only loss of :

[M]oney or other covered property . . . misappropriated from the insureds, irrespective of the capacity in which the insureds holds it. That the insureds may be liable to a third party for a loss of money resulting from employee dishonesty does not transform a policy covering the insureds against a direct loss into one indemnifying against liability.⁴

The employer’s liability to its customer, even if the result of an employee’s misconduct, is outside the scope of coverage.

A. COMPENSABILITY OF THIRD-PARTY LOSSES UNDER FINANCIAL INSTITUTION BONDS AND COMMERCIAL CRIME POLICIES

During the last fifty years, financial institution bonds⁵ and commercial crime policies⁶ have undergone a number of revisions.⁷ While each amendment impacted the scope of coverage in different respects, no amendment affected the compensability

³RESTATEMENT (SECOND) OF AGENCY § 261 cmt. a (1996); *see also* *Guess v. Bethlehem Steel Corp.*, 913 F.2d 463, 465 (7th Cir. 1990); *Williams Elec. Games, Inc. v. Barry*, 42 F. Supp. 2d 785, 796 (N.D. Ill. 1999) (“A principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit fraud upon third persons is also subject to liability to such third persons [for such] flagrant fraud.”).

⁴175 East 74th Corp. v. Hartford Accident & Indem. Co., 435 N.Y.S.2d 584, 587-88 (N.Y. App. Div. 1980); *see also* *Drexel Burnham Lambert Group, Inc. v. Vigilant Ins. Co.*, 595 N.Y.S.2d 999, 1007 (N.Y. App. Div. 1993).

⁵This article will, unless otherwise noted, analyze the compensability of third-party claims under the 1986 edition of a Standard Form No. 24 Financial Institution Bond. Predecessor bond forms provided substantively identical coverage. The Financial Institution Bond, Standard Form No. 24 (revised to April 1986), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (Surety Ass’n of America) [hereinafter Financial Institution Bond].

⁶Most standard form commercial crime policies contain substantively analogous provisions. This article will, for clarity and conciseness, analyze the compensability of third-party claims under the ISO standard form commercial crime policy. Commercial Crime Policy, Form No. 00 01 10 90 (Insurance Services Office, Inc. 1990), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (Surety Ass’n of America) [hereinafter Commercial Crime Policy].

⁷For a detailed discussion of the history and evolution of financial institution bonds and commercial crime policies, *see* Norbert Wegerzyn & John Morrissey, *Fidelity Insurance Policies: Yesterday, Today and Tomorrow*, in *HANDLING FIDELITY BOND CLAIMS* (Michael Keeley & Timothy M. Sukel eds., 1999), Edward G. Gallagher, James L. Knoll & Linda M. Bolduan, *A Brief History of the Financial Institution Bond*, in *FINANCIAL INSTITUTION BONDS* (Duncan L. Clore ed., 1998).

of losses resulting from an insured's vicarious liability to a third party as significantly as the 1980 revisions.

Before 1980, fidelity bonds covered losses "through" employee dishonesty,⁸ but because that term was undefined there was a split of authority over the compensability of losses resulting from an insured's vicarious liability to a third party. In 1980, the fidelity industry implemented changes to "strengthen the concept of coverage for direct loss only."⁹ It did so by substituting a new definition of dishonesty for the "through" standard,¹⁰ and by implementing the indirect loss exclusion¹¹ and consequential damage exclusion.¹² These revisions resolved the judicial split of authority under predecessor policies by codifying the direct loss requirement.¹³

Although there are inherent differences in the nature and scope of coverage afforded by financial institution bonds and commercial crime policies, the issues relating to the compensability of losses due to an insured's vicarious liability for an employee's fraud on a third party are, with a few limited exceptions discussed below, substantively identical under both bonds. There is, however, a distinction concerning

⁸See Financial Institution Bond, Standard Form No. 24 (revised to April 1969), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA; Comprehensive Dishonesty Disappearance and Destruction Policy (revised to March 1940), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (Surety Ass'n of America).

⁹Statement of Changes, Financial Institution Bond, Standard Form No. 24 (revised to April 1980); *see also* Robin Weldy, *A Survey of Recent Changes in Financial Institution Bonds*, 12 FORUM 895 (1977).

¹⁰Instead of covering all losses "through" employee dishonesty, the definition of dishonesty limits coverage to losses "resulting directly" from dishonest and fraudulent acts committed by an employee with the "manifest intent: (a) to cause the Insured to sustain such loss; and (b) to obtain financial benefit for the Employee or another person or entity . . ." Commercial Crime Policy, Insuring Agreement A; *see also* Financial Institution Bond, Insuring Agreement A.

¹¹Financial Institution Bond, Exclusions, § 2(w) (bond excludes coverage for "indirect and consequential loss of any nature"); Commercial Crime Policy, General Exclusions, § A(3) ("We will not pay for . . . [l]oss that is an indirect result of any act or 'occurrence' covered by this insurance . . .").

¹²Financial Institution Bond, Exclusions, § 2(u) (bond excludes coverage for "damages of any type for which the Insured is legally liable, except direct compensatory damages arising from a loss covered under this bond"); *see also* Commercial Crime Policy, General Exclusions, § A(3)(a) ("We will not pay for loss that is an indirect result of any act of 'occurrence' covered by this insurance, including, but not limited to, loss resulting from . . . [p]ayment of damages of any type for which you are legally liable. But, we will pay compensatory damages arising from a loss covered under this insurance.").

¹³The definition of dishonesty, the indirect loss exclusion and the consequential damage exclusion were first offered by rider in 1976. The Financial Institution Bond, Definition of Dishonesty – Exclusions (SR 6019), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (revised to April 1976), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (Surety Ass'n of America). These provisions were thereafter incorporated into the Standard Form No. 24 in 1980. The Financial Institution Bond, Standard Form No. 24 (revised to April 1980), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA.

the compensability of such losses under employee theft policies, which will be addressed in Section B.¹⁴

1. Pre-1980 Edition: The “Through” Standard

The 1969 edition of the Standard Form No. 24 Financial Institution Bond provided coverage for “[l]oss through any dishonest or fraudulent act of any of the Employees, committed anywhere and whether committed alone or in collusion with others, including loss, though any such act or any of the Employees, or Property held by the Insured for any purpose or in any capacity and whether so held gratuitously or not and whether or not the Insured is liable therefor.”¹⁵

That edition, and other pre-1980 bond forms, did not define the term “through.” Although courts generally recognized that the “through” standard required proof of a causal connection between purportedly dishonest conduct and the claimed loss, they disagreed as to whether it provided coverage for indirect losses resulting from an employee’s fraudulent misconduct. This disagreement resulted in a split of authority over the compensability of claims based upon an insured’s vicarious liability for an employee’s fraud on a third party.¹⁶

a. Majority View – Third Party Claims Are Covered. Although recognizing that losses resulting from an insured’s vicarious liability for an employee’s misconduct constitute an indirect loss, a majority of courts refused to inject a direct loss requirement into fidelity bonds and found the “through” standard broad enough to encompass indirect losses.¹⁷ These courts reasoned that the “through” standard was sufficiently broad to cover both direct and indirect losses, meaning that claims based upon an insured’s vicarious liability to a third party were, subject to other defenses, covered under fidelity bonds.¹⁸

¹⁴Some fidelity insurers have in the last few years offered new employee theft policies as an alternative to standard form “manifest intent” policies. Given the infancy of such coverage, there is no standard form policy at this point. For a detailed discussion of employee theft policies, see Toni Scott Reed, *Employee Theft v. Manifest Intent: The Changing Landscape of Commercial Crime Coverage*, 36 TORT & INS. L. J. 43 (2000).

¹⁵The Financial Institution Bond, Standard Form No. 24 (revised to April 1969), reprinted in STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (Surety Ass’n of America). Analogously, the 1958 edition of the Blanket Crime Policy provided coverage for “[l]oss of Money, Securities and other property which the Insured shall sustain *through* any fraudulent or dishonest act or acts committed by any of the Employees, acting alone or in collusion with others.” Blanket Crime Policy, Insuring Agreement I (revised to October 1958) (emphasis added).

¹⁶John W. Bassett, *Direct Loss Under The Fidelity Insuring Agreement of the Financial Institution Bond*, 54 DEF. COUNS. J. 487 (1987).

¹⁷*Id.* at 495-97.

¹⁸*E.g.*, Cont’l Sav. Ass’n v. United States Fid. & Guar. Co., 762 F.2d 1239 (5th Cir. 1985); Fid. & Dep. Co. of Md. v. Smith, 730 F.2d 1026 (5th Cir. 1984); Cont’l Cas. Co. v. First Nat’l Bank of Temple, 116 F.2d 885 (5th Cir. 1941); First State Bank of Rocksprings, Tex. v. Standard Acc. Ins. Co. of Detroit, Mich., 94 F.2d 726 (5th Cir. 1938); Great Am. Bank v. Aetna Cas. & Sur. Co., 662 F. Supp. 363 (S.D.

The first modern case addressing this issue was the Minnesota Supreme Court's 1929 decision in *Citizens State Bank v. New Amsterdam Casualty Co.*¹⁹ In that case, an employee induced third parties into purchasing worthless securities and the employer reimbursed the third parties for their losses. The employer then brought a declaratory judgment action seeking indemnity under its bankers blanket bond, which provided coverage for losses "through" employee dishonesty. The insurer argued that the employer's vicarious liability was an indirect loss outside the scope of coverage, but the Minnesota Supreme Court disagreed.

[The insurer] urges that the bond covers only loss of money and property belonging to plaintiff bank and money or property for which the bank is responsible, and should not be held to cover acts of the employee which might result in legal liability of the employer to third persons because of the relation of principal and agent or employer and employee. Indemnity contracts or bonds are subject to the same general rules of construction as contracts of insurance and construed in favor of the assured when fairly and reasonably susceptible of such construction. The provision of the bond, that the [insurer] binds itself to pay to the plaintiff such pecuniary loss as it shall sustain of money or property through fraud, dishonesty, etc., or any other dishonest or criminal act or omission of the employee, is broad enough, when fairly and reasonably construed, to cover loss by dishonest or fraudulent acts and conduct of the employee whereby the [insured] is rendered liable to third parties. The loss is of the [insured's] own money when it is compelled to pay on account of the liability so created.²⁰

Finding sufficient evidence that the principal was indeed dishonest within the meaning of the bond, the court affirmed judgment in favor of the insured.²¹

Relying upon *Citizens Savings Bank*, the federal district court for the Western District of Kentucky reached the same conclusion in *Hooker v. New Amsterdam Casualty Co.*²² As in *Citizens State Bank*, an insured sought indemnity under a bankers blanket bond for losses resulting from its settlement of a third-party claim. The insurer moved to dismiss, arguing that the insured's vicarious liability to a third party was outside the scope of coverage. Denying the motion, the district court held

Fla. 1986); *Hooker v. New Amsterdam Cas. Co.*, 33 F. Supp. 672 (W.D. Ky. 1940); *Southside Motor Co. v. Transamerica Ins. Co.*, 380 So.2d 470, 472 (Fla. Ct. App. 1980); *Phoenix Ins. Co. v. Aetna Cas. & Sur. Co.*, 169 S.E.2d 645 (Ga. Ct. App. 1969), *after remand*, 241 S.E.2d 445 (Ga. App. 1978); *Farmers & Merchants State Bank of Pierz v. St. Paul Fire & Marine Ins. Co.*, 242 N.W.2d 840, 843 (Minn. 1976); *Citizens State Bank of St. Paul v. New Amsterdam Cas. Co.*, 224 N.W. 451 (Minn. 1929).

¹⁹224 N.W. 451 (Minn. 1929).

²⁰*Id.* at 453-4.

²¹*Id.*

²²33 F. Supp. 672 (W.D. Ky. 1940).

that “[t]he payment of a legal liability caused by the dishonest act of the employee is a ‘loss of money’ to the same practical effect as it would be if the employee actually took the money out of the till.”²³

Thereafter, a majority of courts continued to hold that “through” policies covered third-party claims, relying principally upon *Citizens Savings Bank and Hooker*.²⁴ In fact, the Fifth Circuit affirmed this notion as recently as 1985, in *Continental Savings Ass’n v. United States Fidelity & Guaranty Co.*²⁵ In that case, an employer, after it successfully defended a lawsuit which alleged that its employee had engaged in fraudulent conduct, brought an action against its fidelity insurer seeking reimbursement for attorneys’ fees incurred in defending the claim. The district court entered summary judgment in favor of the insurer, finding that the insured’s liability to a third party was an indirect loss outside the scope of coverage, but the Fifth Circuit reversed. Because the bond did not specifically exclude coverage for indirect losses, the Fifth Circuit refused to imply a direct loss requirement. “[The insured’s] potential liability to [the third party], had it obtained, would clearly have . . . ‘constituted a valid and collectible loss under the terms of the bond.’”²⁶

b. Minority View – Third Party Claims Are Not Covered. Despite *Citizens Bank* and its progeny, a minority of courts rejected the notion that fidelity bonds must cover indirect losses simply because they did not exclude such losses,²⁷ holding that the inherent nature of coverage afforded by fidelity bonds prohibited coverage for indirect losses.²⁸

The minority view evolved in large measure from the seminal decision in *Ronnau v. Caravan International Corp.*²⁹ In that case, after the insured was held

²³*Id.* at 675.

²⁴*See* First Nat’l Bank of Bowie v. Fid. Cas. Co. of N.Y., 634 F.2d 1000, 1003 (5th Cir. 1981) (“The fidelity clause of the bond covers indirect losses that result from vicarious liability created by an employee’s dishonest or fraudulent action against a third party); Southside Motor Co. v. Transamerica Ins. Co., 380 So.2d 470, 472 (Fla. App. 1980) (“a bond insuring against loss sustained by reason of dishonesty, fraud, embezzlement, etc., covers losses imposed by the creation of liability to third persons”); Farmers and Merch. State Bank of Pierz v. St. Paul Fire & Marine Ins. Co., 242 N.W.2d 840, 843 (Minn. 1976) (bankers blanket bond is “broad enough to cover loss by dishonest or fraudulent acts and conduct of the employee whereby the employer is rendered liable to third parties”).

²⁵762 F.2d 1239 (5th Cir. 1985).

²⁶*Id.* at 1243.

²⁷*See* Bassett, *supra* note 16, at 493-95.

²⁸*E.g.*, Hartford Acc. & Indem. Co. v. Weil Bros., 41 F.2d 171 (5th Cir. 1930); Nat’l Sur. Co. v. Fletcher Sav. & Trust Co., 169 N.E. 524 (Ind. 1930) (fidelity bond); Bralko Holdings v. Ins. Co. of N.A., 483 N.W.2d 929 (Mich. 1992) (brokers blanket bond); Omaha Bank for Coop. v. Aetna Cas. & Sur. Co., 301 N.W.2d 565 (Neb. 1981) (bankers blanket bond); Bank of Mead v. St. Paul Fire & Marine Ins. Co., 275 N.W.2d 822 (Neb. 1979) (bankers blanket bond); Foxley Cattle v. Bank of Mead, 244 N.W.2d 205 (Neb. 1976) (bankers blanket bond); KAMI Kountry Broad. Co. v. United States Fid. & Guar. Co., 208 N.W.2d 254 (Neb. 1973) (fidelity bond); New Mexico Livestock Bd. v. Dose, 607 P.2d 606 (N.M. 1980).

²⁹468 P.2d 118 (Kan. 1970).

vicariously liable for the fraudulent acts of its employee, the judgment creditor sought to garnish the insured's fidelity bond. Affirming judgment in favor of the insurer, the Kansas Supreme Court stated:

Manifestly, it would not seem from the nature of a fidelity bond that uninsured third parties should be allowed to recover. Nowhere in the language of the bond do we find that [the insurer] assumed an obligation to respond to liability of [the insured] to third persons, such as the [plaintiff] here. The obligation expressed is to indemnify [the insured] against loss of money or other property of a described class. The obligation of the bond runs to [the insured], to respond to actual loss it sustains, not the loss of third persons. Under no reasonable construction of the bond can it be said to insure against [the insured's] liability to third persons, nor can it be considered to be a third party beneficiary contract.³⁰

Although the *Ronnau* court did not specifically hold that an insured's liability to a third party could never be covered under the bond, neighboring jurisdictions interpreted it as so holding. For example, in *KAMI Kountry Broadcasting Co. v. United States Fidelity & Guaranty Co.*,³¹ the insured's employee forged a note, causing a third party to sustain a loss. Upon discovery of the fraud, the insured repurchased the note and sought indemnity for its losses under its bankers blanket bond. The insurer moved to dismiss on the ground that the insured's liability to a third party was an indirect loss outside the scope of coverage. Relying upon *Ronnau*, the Supreme Court of Nebraska affirmed the district court's dismissal of the insured's declaratory judgment action.³² The court noted:

The alleged facts disclose that [the insured] suffered no direct loss as a result of the fraudulent acts of [the principal]. The pleadings indicate that this fraud was directed at the [third party] and that it was the one defrauded by the acts of [the insured's] manager. [The insured] lost only when it determined to pay the bank The original loss suffered by the bank in this case is not, under the facts alleged, converted into a direct loss by the insured because it determined to pay the bank³³

The Nebraska Supreme Court reaffirmed *KAMI Kountry* in 1981, in *Omaha Bank for Cooperative v. Aetna Casualty & Surety Co.*³⁴ In that case, a bank sought

³⁰*Id.* at 122-3.

³¹208 N.W.2d 254 (Neb. 1973)

³²*Id.*; *see also* *Foxley Cattle Co. v. Bank of Mead*, 244 N.W.2d 205, 207 (Neb. 1976) ("Under no reasonable construction of the bond can it be said to insure against [insured's] liability to third persons.").

³³*KAMI Kountry Broad. Co.*, 208 N.W. 2d at 255-7.

³⁴301 N.W.2d 565 (Neb. 1981).

indemnity for losses resulting from its vicarious liability to a third party for the fraudulent acts of an employee. The insurer argued that the bond did not provide such indemnity, even if the loss resulted from the fraudulent or dishonest conduct of an employee. Affirming the grant of summary judgment, the court held that a “banker’s bond, indemnifying against dishonest, fraudulent acts or failure to perform faithfully, does not insure the Bank against the consequences of its own torts,” even if committed by an employee otherwise covered under the bond.³⁵

2. 1980 Revisions: The Elimination of Coverage for Third-Party Losses

The Surety Association of America’s 1980 revisions to Standard Form No. 24 Financial Institution Bond, and the corresponding revisions to the commercial crime policy, resolved the split of authority relating to coverage for indirect losses.³⁶ By substituting a new definition of dishonesty for the “through” standard,³⁷ and by incorporating the indirect loss³⁸ and the consequential damage exclusions,³⁹ the fidelity industry reinforced the concept that fidelity bonds only cover direct loss.

These revisions eliminated coverage for losses resulting from an insured’s liability to a third party in three respects. First, the revisions reaffirmed that fidelity bonds are not liability policies and do not provide indemnity for losses resulting from an insured’s liability to a third party. Second, the definition of dishonesty limited coverage to losses resulting from dishonest conduct committed with the manifest intent to cause the insured a loss, which typically is not the employee’s intent when defrauding a third party. Third, the substitution of the “resulting directly” standard for the “through” standard, and the incorporation of the indirect loss and consequential damage exclusions, obviated coverage for indirect losses, including an insured’s liability to a third party.

a. Fidelity Bonds Are Not Liability Policies. As recognized under the minority interpretation of the pre-1980 bonds, fidelity bonds are indemnity, not liability, policies. “The difference turns on what is defined as the risk. [Liability] insurance covers the liability of the insureds to a third party, while fidelity bonding covers the loss of property owned by the insureds or held by the insureds, as a consequence of employee dishonesty.”⁴⁰

³⁵*Id.* at 569.

³⁶Financial Institution Bond, Exclusions, § 2(w); Commercial Crime Policy, General Exclusions, § A(3).

³⁷Financial Institution Bond, Insuring Agreement A; Commercial Crime Policy, Insuring Agreement A.

³⁸Financial Institution Bond, Exclusions, § 2(w); Commercial Crime Policy, General Exclusions, § A(3).

³⁹Financial Institution Bond, Exclusions, § 2(u); Commercial Crime Policy, General Exclusions, § A(3)(a).

⁴⁰*Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co. Inc.*, 676 N.Y.S.2d 559, 566 (N.Y. App. Div. 1998).

Fidelity bonds “do not purport to defend and indemnify the assured every time a claim is made against it because it may be responsible to others for the acts of its employees. The loss covered is the loss to the insured, not the losses sustained by the outside world.”⁴¹ An insured’s liability to a third party, even if premised upon dishonest and fraudulent conduct by its employee, is outside the scope of coverage.⁴²

*City of Burlington v. Western Surety Co.*⁴³ illustrates the distinction between fidelity and liability coverage. In that case, the city’s fire department inadvertently lost the master key to all of the school buildings in the local school district. The city replaced all of the locks on the school district’s buildings and sought recovery of this expense under a public employees blanket bond. Affirming summary judgment in favor of the insurer, the Iowa Supreme Court stated:

A fidelity bond must be distinguished from a liability policy [The insured’s] potential liability for the [third party’s] expenses or damages merely caused an *indirect* loss to the [the insured]. [citation omitted] To interpret the fidelity bond as covering this indirect loss would be to convert the bond into a policy of liability insurance. Such was clearly not the intent of the parties as evidenced by the absence of any language indicating that the policy’s coverage encompassed the City’s liability to third persons.⁴⁴

That the insured may be held liable for an employee’s fraudulent or dishonest conduct does not convert a fidelity bond into a liability policy. As the Superior Court of Connecticut noted in *ITT Hartford Life Insurance Co. v. Pawson*:

This type of bond is a contract of indemnity against loss, as opposed to a contract against liability. . . . ‘That the insured may be liable to a

⁴¹*Drexel Burnham Lambert Group, Inc. v. Vigilant Ins. Co.*, 595 N.Y.S.2d 999, 1007 (N.Y. App. Div. 1993); *see also* *City of Burlington v. W. Sur. Co.*, 599 N.W.2d 469, 472 (Iowa 1999) (“Although employee dishonesty policies may cover the loss of third-party property in the possession of the insured, [citation omitted], these policies do not serve as liability insurance to protect employers against tortious acts committed against third-parties by their employees.”).

⁴²*E.g.*, *Lynch Prop., Inc. v. Potomac Ins. Co. of Ill.*, 140 F.3d 622, 629 (5th Cir. 1998); *City of Burlington*, 599 N.W.2d at 471-2; *ITT Hartford Life Ins. Co. v. Pawson*, No. CV 940361910S, 1997 WL 345345 (Conn. Super. Ct. June 16, 1997); *Travelers Ins. Co. v. P.C. Quote, Inc.*, 570 N.E.2d 614, 621 (Ill. App. Ct. 1991); *Central Nat. Ins. Co. of Omaha v. Ins. Co. of N.A.*, 522 N.W.2d 39, 43-4 (Iowa 1994); *Kidder, Peabody, Inc.*, 676 N.Y.S.2d at 563; *Kriegler v. Aetna Cas. & Sur. Co.*, 485 N.Y.S.2d 1017, 1017 (N.Y. App. Div. 1985).

⁴³599 N.W.2d 469 (Iowa 1999)

⁴⁴*Id.* at 472-3 (emphasis added); *see also* *Central Nat. Ins. Co. of Omaha*, 522 N.W.2d at 43-4 (Iowa Supreme Court rejected an insured’s claim for indemnity for losses stemming from its vicarious liability to a third party because while “policy language clearly insures [the insured] for actual losses to [the insured], [it] does not indemnify the losses third parties may sustain because of the wrongful actions of [the insured] or its employees”); *Drexel Burnham Lambert*, 595 N.Y.S.2d at 1007 (“[t]he insurance policies here involved are fidelity blanket bonds, not liability insurance policies”).

third party for a loss of money resulting from employee dishonesty does not transform a policy covering the insured against a direct loss into one indemnifying against liability.”⁴⁵

b. Manifest Intent to Cause the Insured a Loss. The definition of dishonesty also narrowed coverage for loss caused by employee dishonesty and reinforced the absence of coverage deriving from third-party liability. Instead of covering all losses “through” employee dishonesty, the definition of dishonesty limited coverage to losses resulting directly from dishonest and fraudulent acts committed by an employee “with the manifest intent: (a) to cause the Insured to sustain such loss; and (b) to obtain financial benefit for the Employee or another person or entity.”⁴⁶

By restricting coverage to losses resulting from acts committed with the manifest intent to cause the insured to sustain a loss, the new definition precluded coverage for losses due to “bad business judgment, whether that be characterized as ‘reckless and imprudent. . . or just plain poor.’”⁴⁷ “Courts universally recognize that for ‘there to be [coverage], there must be something more than negligence, mistake, carelessness, or incompetence.’”⁴⁸

An employee’s intent to cause the insured to sustain a loss (absent extenuating circumstances) can generally be inferred when he embezzles money directly from the insured because for the employee to win, the employer must lose. Inferring such an intent becomes more difficult, however, when the employee targets a third party.⁴⁹

An employee does not necessarily intend to cause the insured to sustain a loss when he defrauds a third party, especially when the employee’s primary purpose is to induce customers to conduct business with his employer to increase his commissions

⁴⁵*Pawson*, 1997 WL 345345, at *2-3; *see also Lynch Prop., Inc.*, 140 F.3d at 629 (Fifth Circuit rejected claim for indemnity against losses resulting from an insured’s liability to a third party because fidelity bonds “do not serve as liability insurance to protect employers against tortious acts committed against third parties by their employees”); *Kriegler*, 485 N.Y.S.2d at 1017 (affirming dismissal, finding that a 3D Policy does not provide indemnity against third-party claims because it “is not a liability policy”).

⁴⁶Financial Institution Bond, Insuring Agreement A; *see also* Commercial Crime Policy, Insuring Agreement A.

⁴⁷*FDIC v. St. Paul Fire & Marine Ins. Co.*, 942 F.2d 1032, 1036 (6th Cir. 1991); *see also* *Portland Fed. Employees Credit Union v. Cumis Ins. Soc., Inc.*, 894 F.2d 1101, 1105 (9th Cir. 1990) (“[i]n other words, bad business decisions are not covered”); *In re J.T. Moran Fin. Corp.*, 147 B.R. 335, 339-40 (Bankr. S.D. N.Y.1992) (“Fidelity bonds of this nature are not issued to cover reckless or improvident [behavior], but only to limit protection under the bond to losses due to embezzlement or embezzlement like acts.”).

⁴⁸*Eglin Nat’l Bank v. Home Indem. Co.*, 583 F.2d 1281, 1285 (5th Cir.1978); *see also* *First United Fin. Corp. v. United States Fid. & Guar. Co.*, 96 F.3d 135, 138 (5th Cir. 1996); *Progressive Cas. Ins. Co. v. First Bank*, 828 F. Supp. 473, 477 (S.D. Tex. 1993) (“To be within the terms of the fidelity bond, liability for dishonesty must be something more than bad judgment, whether called negligence, mistake, carelessness, or incompetence”); *FDIC v. CNA Cas. of Puerto Rico*, 786 F. Supp. 1082, 1087 (D.P.R.1991).

⁴⁹*FDIC v. Nat’l Union Fire Ins. Co.*, No. CIV A. 96-2575, 2001 WL 53367 (D.N.J. May 18, 2001).

or bonuses. On the contrary, in such cases, the employee's intent is to benefit his employer (not cause it a loss) because the scheme, by its very nature, could not benefit the employee unless the employer profited as well. Either both win or both lose.⁵⁰

In *Aetna Casualty & Surety Co. v. Kidder Peabody & Co., Inc.*,⁵¹ an employee conducted illegal trades using confidential inside information relating to proposed mergers and acquisitions. The insured initially earned significant profit from the transactions, but, the shareholders of the disaffected corporations brought a class action suit against the insured, claiming that the insider trading drove up the price of the stock. The insured ultimately settled the claims for more than \$185 million for which it sought recovery under its stockbrokers blanket bond. The insurer argued that the loss was not covered because the employee did not defraud the shareholders with the intent to cause the insured to sustain a loss, but rather the intent to benefit the insured. The court agreed:

By their clear terms, the fidelity bonds require that the unfaithful employee must intend to cause the employer a loss directly and solely relating to the faithless act, classically describing embezzlement or another type of theft from the employer . . . or even retaliation against an employer that benefits a third-party in collusion with the employee. An embezzler, at one end of the continuum, necessarily intends to cause the employer the loss, since the employee's gains are directly at the employer's expense. [citation omitted]. At the other end of the continuum, not triggering fidelity coverage, is the situation where the employee's dishonesty at the expense of a third party is intended to benefit the employer Under such circumstances, even if the employer [ultimately] suffers a loss, fidelity coverage is not triggered⁵²

While an insured may argue that the employee's intent can be inferred from the recklessness of his conduct, courts have generally refused to so infer when the employee defrauds a third party unless the insured can produce evidence demonstrating that the employee knew that his scheme would likely be uncovered *and* evidence that he knew or suspected that the insured would ultimately be held liable for losses resulting from his conduct.

⁵⁰*E.g.*, Peoples Bank & Trust Co. v. Aetna Cas. & Sur. Co., 113 F.3d 629 (6th Cir. 1997); FDIC v. St. Paul Fire & Marine Ins. Co., 942 F.2d at 1035; Glusband v. Fittin Cunningham & Lauzon, 892 F. 2d 208 (2nd Cir. 1989); Leucadia v. Reliance Ins. Co., 864 F.2d 964 (2nd Cir. 1988).

⁵¹676 N.Y.S.2d 559 (App. Div. 1998).

⁵²*Kidder, Peabody*, 676 N.Y.S.2d at 563; *see also Central Nat. Ins. Co. of Omaha*, 522 N.W.2d at 43-4 (“[A] financial institution bond only covers “actual losses” to the insured. It does not indemnify the losses third parties . . . may sustain because of wrongful actions by [the insured] or its employees.”); *Kriegler*, 485 N.Y.S.2d at 1017 (insured's vicarious liability to a third party is not covered under a comprehensive dishonesty, disappearance and destruction policy because “is not a liability policy”).

The Sixth Circuit addressed the insured's burden of proof in *Peoples Bank & Trust Co. v. Aetna Casualty & Surety Co.*⁵³ In that case, the bank's officers fraudulently induced third parties to purchase a restaurant. The business failed, the purchaser sued the bank, and the bank sought indemnity under its financial institution bond. The insurer maintained that the officers did not have the manifest intent to cause the insured to sustain a loss, but rather consciously defrauded the third parties in an effort to earn a profit for the bank.⁵⁴ The insured argued that the officers' intent could be inferred from the fact that they knew or should have known that the third parties would uncover the fraud and seek recovery from the bank. Affirming summary judgment in favor of the insurer, the Sixth Circuit stated:

As a practical matter, losses resulting from frauds on third parties will rarely be covered by Standard Form 24. These policies will cover a loss suffered by a third party only where the dishonest employees intended to cause the third party loss, and knew or expected that the loss would migrate to the bank. The migratory route would need to be short, certain, and obvious to support such an inference (in the absence of direct evidence) that dishonest employees harbored such knowledge or expectation.⁵⁵

Absent evidence that the employee intended to get caught and impose liability on his employer, an insured's claim for indemnity based upon an employee's fraud on a third party is not covered.⁵⁶ While there may be instances when the insured will be able to produce such evidence, *Glusband v. Fittin Cunningham & Lauzon*⁵⁷ illustrates the practical difficulty in doing so.

In that case, the owner of an investment management firm to follow a conservative investment strategy. Instead, he put the third parties' money in risky investments, resulting in significant losses. The receiver appointed to liquidate the insured claimed that the owner's fraudulent solicitations and risky investments constituted a covered loss. Affirming a verdict in favor of the insurer, the Second Circuit held that the bond did not cover such losses because the owner did not have the manifest intent to cause the firm to suffer a loss. His fraudulent solicitation of clients "was intended to benefit" the firm, not cause it to suffer a loss.⁵⁸

⁵³113 F.3d 629 (6th Cir. 1997).

⁵⁴*Id.* at 633.

⁵⁵*Id.* at 634.

⁵⁶*See* *Williams Elec. Games v. Barry*, No. 97 C 2743, 2000 WL 106672, at *1 (N.D. Ill. Jan. 13, 2000) ("To be covered under this policy, [the employee] must have intended [the insured] to pay to [the customer] all of [its] profits resulting from [the employee's] actions. Any argument that [the employee] intended that would have to be based on the absurd assumption that [the employee] intended that his actions be discovered by [the customer], which is the only way [the customer] could ever make claim to the profits. Clearly, [the employee] had no such intent.").

⁵⁷892 F. 2d 208 (2nd Cir. 1989).

⁵⁸*Id.* at 210.

c. Direct Loss Requirement. Fidelity coverage is only “meant to insure . . . against immediate harm from employee dishonesty but not for any obligations [the insured] might have to others as a result of that dishonesty.”⁵⁹ To this end, the bond limits coverage to losses directly resulting from the dishonest or fraudulent acts of an employee.⁶⁰ It does not cover “indirect and consequential loss of any nature”⁶¹ or “damages of any type for which the insured is legally liable, except direct compensatory damages arising from a loss covered under this bond.”⁶²

An insured’s liability to a third party, even if premised upon an employee’s dishonest or fraudulent conduct, does not directly result from employee dishonesty. When an employee targets a third party, the third party is the only one that suffers a direct loss as a result of the fraud.⁶³ Because the insured’s liability arises incidentally under a theory of vicarious liability, a settlement of a claim or payment of a judgment is an indirect loss outside the scope of coverage.⁶⁴

In *Kidder, Peabody & Co., Inc.*, a stockbroker paid millions of dollars to settle shareholder class action lawsuits arising from insider trading conducted by its employee. Initially, the insured earned significant profit from the employee’s misconduct. The court unanimously affirmed the dismissal of Kidder’s claim under its stockholders blanket bond because Kidder’s settlement was an indirect loss:

[F]idelity bonds do not describe indirect or consequential injuries to the employer resulting from legal settlements with third parties who were the actual targets of the employee’s acts [T]he putative loss to [the insured] arises in part from a settlement with third parties, but the settlement was not the direct result of the employee’s dishonest conduct; the employee’s dishonesty only caused pricing irregularities in the stock, which, themselves, caused losses to the customers, which then led to litigation concluding in settlement. In this sense, the settlement would not constitute a covered loss The logical extension of [the insured’s] argument . . . would create the potential for almost any loss, not initially direct to the insureds, to become a direct loss, a subterfuge that would render the [indirect loss] exclusion in this case clearly meaningless.⁶⁵

⁵⁹*Lynch Prop., Inc. v. Potomac Ins. Co. of Ill.*, 962 F. Supp. 956, 964 (N.D. Tex 1996), *aff’d*, 140 F.3d 622 (5th Cir. 1998).

⁶⁰Financial Institution Bond, Insuring Agreement A.

⁶¹*Id.* at Exclusions, § 2(w); Commercial Crime Policy, General Exclusions, § A(3).

⁶²Financial Institution Bond, Exclusions, § 2(u); *see also* Commercial Crime Policy, General Exclusions, § A(3)(a).

⁶³*Kidder, Peabody*, 676 N.Y.S.2d at 563.

⁶⁴*Cont’l Bank, N.A. v. Aetna Cas. & Sur. Co.*, 626 N.Y.S.2d 385 (N.Y. Sup. Ct. 1995); *Drexel Burnham Lambert*, 595 N.Y.S.2d at 1005.

⁶⁵676 N.Y.S. 2d 556, 564 (N.Y. App. Div. 1998).

The Fifth Circuit reached the same conclusion in *Lynch Properties, Inc. v. Potomac Insurance Co. of Illinois*.⁶⁶ The insured managed the funds of a customer which were deposited in a checking account in the insured's control. An employee embezzled money from the account by writing unauthorized checks. After replacing the missing funds, the insured brought a declaratory judgment action against its insurer for indemnity under its fidelity bond. The insurer asserted that the insured's liability to its customer, though premised upon employee dishonesty, was an indirect loss outside the scope of coverage. The district court disagreed:

The indirect loss exclusion, which is 'not limited to' indirect losses in the form of liability to third parties, reinforces the conclusion that the policy meant to insure [the insured] only against immediate harm from employee dishonesty but not for any obligations [the insured] might have to others as a result of that dishonesty. Because [the insured] suffered only an indirect loss in this case, and because the policy's language clearly excludes such losses from coverage, [the insurer] properly denied [the insured's] claim.⁶⁷

B. EMPLOYEE THEFT POLICIES

Fidelity insurers have over the last few years begun offering new employee theft policies as an alternative to standard form commercial crime policies. Although still providing coverage for the loss of money, property and securities, these policies do not contain the same definition of dishonesty.⁶⁸ Rather than requiring proof that an employee acted with the manifest intent to cause the insured a loss and obtain a financial benefit for himself or a third party, these policies provide coverage for losses resulting from the "theft by any employee of any Insured acting alone or in collusion with others."⁶⁹

Although a number of carriers have issued commercial crime policies containing what will generally be referred to in this article as the "theft" language, there is, given the infancy of these policies, no standard form. Typically these policies define theft as "the unlawful taking, including by violence or threat of violence, of assets to the direct deprivation of the Insured."⁷⁰ In addition to the basic principle that that commercial crime policies do not, as indemnity policies, cover an insured's liability to a third party, analyzing whether employee theft policies cover an insured's vicarious liability to a third party raises two other coverage issues. First, does an insured's vicarious liability to a third party constitute an "unlawful taking of

⁶⁶962 F. Supp. 956 (N.D. Tex. 1996), *aff'd*, 140 F.3d 622 (5th Cir. 1998).

⁶⁷962 F. Supp. at 964. The Fifth Circuit thereafter affirmed the district court's ruling, holding "[t]hese policies do not serve as liability insurance to protect employers against tortious acts committed against third-parties by their employees. 140 F.3d at 629.

⁶⁸Reed, *supra* note 14.

⁶⁹*Id.* at 46.

⁷⁰*Id.* at 51-54.

assets” within the meaning of the policy? Second, is an insured’s vicarious liability to a third party a loss “to the direct deprivation” of the insured?

1. Unlawful Taking

Although employee theft policies provide a clear definition of theft, the policy forms are relatively new, so questions remain regarding the scope of coverage. While one could argue that because the policies do not expressly limit coverage to thefts of the *insured’s* property, the policy is broad enough to cover an insured’s vicarious liability for an employee’s theft of a *third party’s* property, regardless of whether the property is held by the insured at the time of its misappropriation, that argument is not persuasive. Theft policies do not cover an insured’s vicarious liability for an employee’s theft of a third party’s property, because “theft” is defined, in part, as the “unlawful taking of assets . . . to the *direct* deprivation of the insured.” Coverage is, therefore, limited to employee embezzlement.⁷¹

The federal district court for the Northern District of Illinois came to the precise conclusion in *Williams Electronic Games v. Barry*.⁷² In that case, the insured’s employee bribed a customer’s purchasing manager into purchasing electronic components from the insured at inflated prices. The customer brought an action to recover damages caused by the employee’s misconduct, and the insured filed a third-party complaint seeking indemnity under a commercial crime policy which provided coverage for employee theft, defined as “the unlawful taking of assets to the direct deprivation of the Insured.”⁷³

The insurer moved to dismiss, arguing that assuming the allegations in the complaint were true, the claim nonetheless was not covered because the employee’s conduct did not amount to an “unlawful taking,” within the meaning of the policy. Granting the motion, the district court agreed. “Even if [the insured] is required to pay to [the third party] all of [its] gross profits on sales it made pursuant to the scheme, that loss can not be said to amount to an ‘unlawful taking’ Accordingly, because [the employee’s] actions do not amount to theft as defined in the policy, the claimed loss is not covered by the [employee theft] policy in question.”⁷⁴

⁷¹One might also argue that an employee’s theft of a third party’s property while in the possession of the insured should be covered under an employee theft policy. Standard form commercial crime policies and financial institution bonds typically cover these losses because the definition of ownership includes property held by the insured. See *infra* Section III. If presented with this issue, it is important to analyze the bond carefully to discern whether the policy extends coverage to the loss of property held by the insured, or whether the bond limits coverage to the loss of the insured’s property.

⁷²No. 97 C 3743, 2000 WL 106672 (N.D. Ill. Jan. 13, 2000).

⁷³*Id.* at *1.

⁷⁴*Id.*

2. Direct Loss Requirement

In addressing whether an insured's vicarious liability to a third party is a covered loss under a theft policy, it is also necessary to assess whether such liability is a loss to the direct deprivation of the insured. An insured might argue that the payment or settlement of a third-party claim constitutes a loss to the direct deprivation of the insured because the payment causes a direct loss to the insured, but courts have rejected that notion. Rather, consistent with the interpretation of manifest intent policies, courts have concluded that the direct deprivation requirement limits coverage to direct losses, meaning that an insured's liability to a third party is not covered under an employee theft policy.

In *Vons Cos. v. Federal Insurance Co.*,⁷⁵ Vons was insured under a commercial crime policy which covered "direct loss of Money" caused by employee theft. Vons sought indemnity for losses resulting from its settlement of a multi-million dollar suit brought by investors defrauded by its employee. The district court entered summary judgment for the insurer, holding:

[The insured] plainly knew that it had suffered no 'direct loss' under the policy, as evidenced by the fact that it did not make a claim or file a proof of loss with [the insurer] when [the employee's] activities were discovered in 1991. Only later when the [the underlying] actions were settled did [the insured] attempt to shoehorn that payment into the terms of the policy. In short, [the insured] adopted a 'wait and see' posture, even when the actions were filed in 1993. This fact, in itself, illustrates the 'conditional nature' of the loss, taking it out of the policy.⁷⁶

The Ninth Circuit Court of Appeals affirmed: "We hold that 'direct' means 'direct' and that in the absence of a third party claims clause, [the insured's] policy did not provide indemnity for vicarious liability for tortious acts of its employee."⁷⁷

C. EXPANDING COVERAGE: THE INSURED'S RESPONSE

Despite the near avalanche of cases upholding insurers' denial of coverage, an insured who might not appreciate the intricacies of coverage may be surprised to learn that its fidelity bond does not cover their vicarious liability for an employee's fraud on a third party. Faced with substantial liability, an insured may try to obtain coverage by citing aberrant or distinguishable cases, attempting to avoid the express terms of the bond on public policy grounds, or distorting the bond's general provisions to expand coverage. A careful review demonstrates the fundamental flaws in these arguments.

⁷⁵57 F. Supp. 2d 933 (C.D. Cal. 1998), *aff'd*, 212 F.3d 489 (9th Cir. 2000).

⁷⁶57 F. Supp. 2d at 944.

⁷⁷212 F.3d at 492-93.

1. Distinguishable Cases

While the vast majority of courts have recognized that fidelity bonds do not cover an insured's vicarious liability to a third party, there are two aberrant decisions in which the courts found coverage. An insured may raise these cases to undermine the wealth of authority to the contrary. These decisions, however, are distinguishable because they were decided under manuscript policies which did not limit coverage to direct losses, involved unusual facts, or were subsequently overruled.

Insureds commonly cite *Northbrook National Insurance Co. v. NEHOC Advertising Services*⁷⁸ for the proposition that commercial crime policies provide indemnity against third-party claims. The policy at issue in *NEHOC*, however, did not require proof of a direct loss. Rather, it provided general coverage for loss of money, security or other property. Adopting the majority interpretations of the old "through" standard, the *NEHOC* court held that since the bond did not expressly limit coverage to direct losses, the insured's agreement was broad enough to cover an insured's vicarious liability to a third party.

Given the substantial difference between the *NEHOC* bond and a standard form fidelity bond, *NEHOC* arguably has no precedential value. In fact, the Illinois Appellate Court did not discuss or even cite *NEHOC* in a later case which addressed the compensability of an analogous loss under a bond which did limit coverage to direct losses. In *Travelers Insurance Co. v. P.C. Quote, Inc.*,⁷⁹ the insured sought indemnity for its liability to a third party under a commercial crime policy. Finding that the policy limited coverage to direct losses, the court ignored *NEHOC* and held that the losses resulting from an insured's vicarious liability to a third party were outside the scope of coverage.⁸⁰

In another case, *First American State Bank v. Continental Insurance Co.*,⁸¹ an officer of the insured bank approved fraudulent loans to customers who, in turn, lent the funds to him. When the officer defaulted on his loans, the customers refused to pay their bank loans and threatened suit against the bank. The bank settled the claims arising from its officer's fraudulent transactions and canceled the customers' debts to the bank. The insured sought indemnity under a 1980 edition of the Standard Form No. 24 Financial Institution Bond. The insurer argued that the insured's potential liability to a third party was not covered under the bond. Relying upon *Merchants-Produce Bank v. United States Fidelity and Guaranty Co.*,⁸² the Eighth

⁷⁸554 N.E.2d 251 (Ill. App. Ct. 1990).

⁷⁹570 N.E. 2d 614, 620 (Ill. App. Ct. 1991).

⁸⁰*Id.*; see also *Williams Elec. Games*, 2000 WL 106672, at *1 (distinguished *NEHOC* and held that commercial crime policy did not cover an insured's vicarious liability to a third party, even if premised upon conduct which might be characterized as fraudulent or dishonest).

⁸¹897 F.2d 319, 322-23 (8th Cir. 1990).

⁸²305 F. Supp. 957 (W.D. Mo. 1969).

Circuit, interpreting Iowa law, concluded that the loss was covered. “[The insurer’s] position that the bond did not provide coverage for [the insured’s] settlement costs is contrary to established case law and the purpose of fidelity bank bonds. Fidelity bonds were intended to cover losses derived from vicarious liability.”⁸³ The court affirmed judgment in favor of the insured.

The *First American* decision is incorrect. Although it said that the insurer’s position was contrary to established law, the court never cited any relevant authority in support of its position and never explained its analysis. The court mistakenly relied upon *Merchants-Produce*, a case was decided under the old “through” standard and therefore irrelevant to the interpretation of a 1980 financial institution bond.⁸⁴

As discussed earlier, since the 1980 revisions, courts construing the Standard Form No. 24 Financial Institution Bond have consistently held that the bond does not afford coverage for such third party claims. The error of the *First American* court is demonstrated by the fact that no other court has ever positively cited or relied upon it. Indeed, *First American* was impliedly overruled by the Iowa Supreme Court in *Central National Insurance* and *City of Burlington*, in which the court twice held that an insured’s vicarious liability to a third party is not covered under a fidelity bond.⁸⁵

2. Definition of Ownership

Fidelity bond coverage typically is not limited to the loss of property owned by the insured. Fidelity bonds may also cover the loss of property held by the insured in any capacity or for which the insured is legally liable.⁸⁶ The ownership provision, however, is not intended to extend coverage to losses resulting from an insured’s legal liability to a third party, but rather to extend coverage to the loss of a third party’s property while in the possession and control of the insured.⁸⁷

Insureds trying to obtain coverage for losses resulting from their legal liability to a third party sometimes misconstrue the “legally liable” prong of the ownership provision. Since the bond covers the loss of property for which the insured is legally liable, insureds sometimes argue that the fidelity bonds cover their legal liability to a third party. This argument “misunderstands” the terms of the bond and the scope of coverage thereunder for two reasons.

⁸³897 F. Supp. at 326.

⁸⁴*Id.*

⁸⁵*City of Burlington*, 599 N.W.2d at 471-2 (“To interpret the fidelity bond as covering this indirect loss would be to convert the bond into a policy of liability insurance. Such was clearly not the intent of the parties as evidenced by the absence of any language indicating that the policy’s coverage encompassed the [insured’s] liability to third persons.”); *Central Nat’l Ins.*, 522 N.W.2d at 43-4.

⁸⁶Financial Institution Bond, Ownership, § 10; *see also* Commercial Crime Policy, Ownership of Property, § 14 (“The property covered under this insurance is limited to property: (a) that you own or hold; or (b) for which you are legally liable.”).

⁸⁷*Vons Cos., Inc. v. Fed. Ins. Co.*, 212 F.3d 489, 491 (9th Cir. 2000); *Lynch Prop., Inc. v. Potomac Ins. Co. of Ill.*, 140 F.3d 622 (5th Cir. 1998).

First, the ownership provision is a general agreement, not a part of the insuring agreement. As such it is widely recognized that the scope of coverage of an insuring agreement may not be expanded by the terms of an exclusion⁸⁸ or general agreement.⁸⁹ As the court noted in *Vons*, “[t]he problem with the [insured’s] argument is that it is founded on the interest clause of the policy (‘ownership’), not the insuring clauses.”⁹⁰ Since the insuring agreement does not provide coverage for an insured’s liability to a third party, the insured cannot manufacture coverage through the ownership provision.⁹¹

Second, assuming that the ownership provision were relevant, it does not extend coverage to an insured’s vicarious liability to a third party. Rather, it covers loss of property as to which, *prior* to its misappropriation, the insured had possession and legal responsibility. It does not, however, extend coverage for that liability.⁹²

Lynch illustrates the distinction. The insured sought indemnity under its commercial crime policy resulting from its employee’s misappropriation of a third party’s money. Seizing upon the ownership provision, the insured argued that since the bond covered property for which the insured was legally liable, the bond must necessarily cover its legal liability to a third party. The Fifth Circuit distinguished between property for which the insured is liable before its misappropriation and the insured’s claim for its vicarious liability arising from the embezzlement:

[The insured] does not argue . . . that it was legally liable for the funds prior to their theft. Instead, it argues only that once [the principal] misappropriated the funds, it became liable to [the third party] to replace those funds and that [the insurer] must indemnify it for that reimbursement because [the principal] stole the funds in the course of her duties at [the insured]. While [the insured] thereby argues how it may be vicariously liable for [the principal’s] acts, this argument fails to show how it was ‘legally liable’ for the stolen property itself, that is, for the funds in [the customer’s] account. Acceptance of [the insured’s] argument would mean that [the insured’s] policy would cover any loss where an employee takes a customer’s property in the course of their employment responsibilities, regardless of whether the employer had any interest in the property itself. Furthermore, it would transform this policy, which insures *property loss* for which [the insured] is legally liable, into a policy insuring any vicarious liability arising from an employee’s dishonesty. This argument is foreclosed by

⁸⁸*E.g.* Cont’l Cas. Co. v. Pittsburgh Corning Corp., 917 F.2d 297, 300 (7th Cir. 1990) (“an exclusion from insurance coverage cannot create coverage”).

⁸⁹*Vons*, 57 F. Supp. 2d at 944.

⁹⁰*Id.* at 491.

⁹¹*Id.*

⁹²*Id.*; *Lynch Prop., Inc.*, 140 F.3d at 628-9.

the plain language of the [ownership] provision, which requires that the employer have some interest in the misappropriated property, whether that be because the employer owns, holds, or is legally liable for the property.⁹³

The Ninth Circuit reached the same conclusion in *Vons*. As in *Lynch*, the insured argued that since the ownership provision extended coverage to property for which it is legally liable, the policy must necessarily cover its legal liability to a third party. Relying upon *Lynch*, the Ninth Circuit held:

A direct loss to [the insured] may, of course, be caused by its employee's theft of property for which it is legally liable, the typical case being where the insured is a bailee or trustee of property [The insured's] reliance on [the ownership provision] is inapposite because the claim against it does not arise from the theft of property for which it is legally liable. Instead, the loss [the insured] suffered resulted from the threat of vicarious liability for [the principal's] tort which caused damage to third parties.⁹⁴

3. General Agreement (F): Court Costs and Attorneys' Fees

An insured may also argue that a financial institution bond provides coverage for an insured's liability to a third party because under General Agreement (F) an insurer has discretion to assume the defense of third party claims brought against the insured "which, if established, would constitute a collectible loss under this bond."⁹⁵ Some insureds surmise that the underlying claims must inherently be covered under the bond, but they misperceive the purpose of the General Agreement (F).

That an insurer has discretion to defend some claims does not imply coverage for vicarious liability resulting from third-party claims. Moreover, General Agreement (F) was not intended to apply to employee dishonesty claims, but rather extends to the insurer the right to defend claims which might be covered under other insuring agreements, such as Insuring Agreement D (e.g., claims based upon the insured's acceptance and negotiation of a check bearing a forged endorsement).⁹⁶

In *Omaha Bank*, the insured argued that an insurer's duty to reimburse it for attorneys' fees and court costs incurred in defending a third-party claim made for an implication that such claims were covered under the bond.⁹⁷ Noting that the provision

⁹³140 F.3d at 629.

⁹⁴212 F.3d at 491.

⁹⁵This argument should not apply to commercial crime or employee theft policies which do not have a court costs and attorneys' fees provision equivalent to General Agreement (F).

⁹⁶*Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co., Inc.*, 676 N.Y.S. 559, 564 (N.Y. App. Div. 1998); *Omaha Bank for Coop. v. Aetna Cas. & Sur. Co.*, 301 N.W.2d 564, 568 (Neb. 1981).

⁹⁷*Omaha Bank* involved the interpretation of a pre-1980 financial institution bond, which obligated the insurer to indemnify the insured for court costs and attorneys' fees incurred to defend an action

applied only to losses otherwise covered under the bond, the Nebraska Supreme Court rejected the insured's position:

The [insured's] second claimed distinction arises from the provision of the bond providing for payment of costs and attorney fees in defending third party claims. It argues that this provision is meaningless unless there can be liability to a third party [However,] the coverage involved here is that under coverage provision A which we have previously quoted. There are other provisions in the bond at issue under which the insured would be liable to third parties.⁹⁸

The *Kidder, Peabody* court reached the same conclusion. As in *Omaha Bank*, the insured argued that the insurer's option to defend third-party claims under General Agreement (F) was inconsistent with its position that the bond did not cover third-party claims. Because General Agreement (F) provided the insurer with discretion to defend claims against the insured, the insured reasoned that its liability to a third party must likewise be covered. Relying upon the plain language of the bond, the court held as follows:

[The insured] argues that the attorneys' fees provisions in the bonds either directly infer broad third party coverage, or are so inconsistent with the statement of risks covered that the inconsistency must be construed in favor of the insureds to create coverage. These arguments are unavailing. The attorneys' fees provisions are carefully couched in terms of the bonds' basic coverage. That is, if there is 'a collectible loss under this bond' . . . or 'a valid and collectible loss sustained by the insureds under the terms of this bond,' then [the insured] would be indemnified for costs and fees incurred in defending a suit against a third party. This provision is applicable in terms of the risks for which coverage specifically applies vis-a-vis third party property held by the insureds. The provision neither extends the

brought against the insured, "which, if established against the Insured, would constitute a collectible loss under this bond" The 1986 edition effected a series of major changes in coverage for court costs and attorneys' fees incurred in defense of an action brought by a third party against the insured. The most significant change related to the optional nature of the coverage. Under the 1986 edition, the company no longer had any obligation to indemnify the insured for court costs and attorneys' fees unless it opted to defend the third party action. The Financial Institution Bond, Standard Form No. 24 (Revised to April, 1986), reprinted in STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA. This distinction, however, does not undermine the relevance of *Omaha Bank* because under both policies General Agreement F only applied if the underlying claim was covered under the bond.

⁹⁸301 N.W.2d at 568.

covered risks to third party claims, *carte blanche*, nor is inconsistent with the general terms of coverage.⁹⁹

4. Statutory Bonds

Financial institutions and corporations in other regulated industries often are required by statute to maintain a certain level of fidelity coverage. Such requirements are imposed to protect the public or the state or federal government from bearing losses resulting from employee fraud or other risks typically covered by fidelity bonds.

Bonds required by statute or regulation are strictly construed in accordance with statutory requirements.¹⁰⁰ The provisions of the statute or regulation constitute a part of the bond, and bond terms which are inconsistent with the statute are denied legal effect.¹⁰¹ Seizing upon this principle, an insured may argue that any provision excluding coverage for an insured's vicarious liability to a third party is invalid because it is inconsistent with the intent of the underlying statute or regulation – to protect the public and parties who do business with the insured.¹⁰²

In *Foster v. National Union Fire Insurance Co.*,¹⁰³ the insured's owner defrauded investors. Upon discovery of the owner's misconduct, the investors sought indemnity under a bond required by the Arkansas Security Act. The district court entered judgment in favor of the investors. On appeal, the investors conceded that the bond excluded coverage for third-party losses, but argued that the exclusion was unenforceable because it conflicted with the statutory mandate to maintain coverage for losses sustained by the insured's customers. The Eighth Circuit affirmed, holding that the bond's provisions excluding coverage for the investors' losses were unenforceable because "[t]he fidelity bond was one statutorily required and should be

⁹⁹*Kidder, Peabody*, 676 N.Y.S.2d at 564.

¹⁰⁰*E.g.*, *Walker Machinery Co. v. Stgauben, Inc.*, 230 S.W. 2d 818 (W. Va. 1976).

¹⁰¹*Index Fund, Inc. v. Ins. Co. of N. Am.*, 580 F. 2d 1158 (2d Cir. 1978); *Am. Cas. Co. of Reading, Pa. v. Irvin*, 426 F.2d 647, 650 (5th Cir. 1970); *Estate of Jordan v. Hartford Acc. & Indem. Co.*, 844 P.2d 403 (Wash. 1993); *see also* Gary J. Valeriano, *Statutory Fidelity Bonds - Do They Mean What They Say?* (unpublished paper presented at the Mid-Winter Meeting of the Fidelity & Surety Law Committee of the Tort & Insurance Practice Section of the American Bar Association in New York, New York, Jan. 27, 1989).

¹⁰²*E.g.*, *Foster v. Nat'l Union Fire Ins. Co.*, 902 F.2d 1316 (8th Cir. 1990) (brokers blanket bond obtained pursuant to Arkansas securities statute); *Anchor Equities, Ltd. v. Pac. Coast Am.*, 737 P.2d 532 (N.M. 1987) (fidelity bond obtained pursuant to New Mexico Escrow Company Act); *United States Fid. & Guar. Co. v. Poetker*, 102 N.E. 372 (Ind. 1930) (fidelity bond obtained pursuant to banking statute); *but see* *Sch. Emp. Credit Union v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 839 F. Supp. 1477 (D. Kan. 1993) (disagreeing with *Foster*, the court concluded that the statute's reference to bonds promulgated by the Surety Association of America indicated that the legislature's understanding that bonds prohibited third party standing).

¹⁰³902 F.2d 1316 (8th Cir. 1990).

liberally interpreted to carry out the purposes of the statute, the protection of the investing public.”¹⁰⁴

The *Foster* court’s statutory analysis is suspect.¹⁰⁵ Although courts must consider the underlying statute or regulation when interpreting a statutory bond, they may not void the terms of the bond based upon a broad notion of public policy. “Were courts free to refuse to enforce contracts as written on the basis of their own conceptions of the public good, the parties to contracts would be left to guess at the content of their bargains and the stability of commercial relations would be jeopardized.”¹⁰⁶ Unless the bond contradicts an express provision in the underlying statute or regulation, it should be enforced according to its plain terms.

The rationale of *Foster* was subsequently rejected by the Tenth Circuit construing same statute, in *School Employees Credit Union v. National Union Fire Insurance Co.*¹⁰⁷ The insured, citing *Foster*, argued that the exclusion of coverage for third-party losses in a fidelity bond issued pursuant to the Arkansas Securities Act, was unenforceable because it conflicted with the act’s requirement that the insured maintain such coverage. Finding *Foster* “neither clear nor persuasive,” the district court held that the bond’s provisions excluding coverage for third-party losses were not void because the act neither required the insured to maintain coverage for these losses nor mandated that the bond company provide it.¹⁰⁸

On appeal, the Tenth Circuit likewise rejected *Foster*.¹⁰⁹ Finding the district court’s decision in *Foster* incorrect, the Tenth Circuit held that the bond’s provisions excluding coverage for third-party losses did not violate public policy or the Arkansas Securities Act because the Act did not expressly require the insured to maintain coverage for such losses.¹¹⁰

5. Insured’s Expectations About Coverage.

When faced with an otherwise noncovered loss, an insured may seek to avoid the effect of the express terms of a fidelity bond by arguing that the terms contradict the insured’s own reasonable expectations about coverage. Arguing that they always assumed that their losses would be covered, insureds may argue that any provisions contradicting their understanding of coverage are unenforceable.

¹⁰⁴*Id.* at 1320.

¹⁰⁵In addition to being substantively incorrect, *Foster* was subsequently overruled on procedural grounds in *Salve Regina College v. Russell*, 499 U.S. 225 (1991).

¹⁰⁶*FDIC v. Aetna Cas. & Sur. Co.*, 903 F.2d 1073, 1077 (6th Cir. 1990); *see also* *Cont’l Casualty Co. v. Allen*, 710 F. Supp. 1088, 1099 (N.D. Tex. 1989).

¹⁰⁷ 839 F. Supp. 1477 (D. Kan. 1993).

¹⁰⁸*Id.* at 1481-3.

¹⁰⁹*Foster*, Nos. 93-3402 and 94-3008, 1995 WL 231370 (10th Cir. 1995).

¹¹⁰*Id.* at * 2.

While many jurisdictions consider an insured's reasonable expectations when construing ambiguous provisions, an insured's purported expectation that its fidelity bond provides indemnity against losses sustained from liability to a third party should not create coverage for two reasons. First, an insured "bears the burden of knowing the contents of [its] insurance policies."¹¹¹ Where the policy is clear and unambiguous, "[c]ourts must enforce an unambiguous contract by its plain meaning, even if the result limits the insured's coverage" or contradicts the insured's expectations about the scope of coverage.¹¹² As noted above, since 1980, courts almost uniformly have enforced the provisions of standard form financial institution bonds without finding ambiguities relating to exclusions or loss resulting from third-party claims.

Second, an insured's expectations of coverage are irrelevant when a "review of the express language [would have] reveal[ed] that such an expectation was unreasonable."¹¹³ Given an express exclusion of coverage for all indirect losses, any expectation of coverage for liability to a third party is inherently unreasonable.

III. Coverage for an Employee's Misappropriation of a Third Party's Property While in the Insured's Possession

Even with the strictest internal controls, employers who take possession of a third party's property during the normal course of business bear a significant risk of loss. For example, a real estate agent who holds a purchaser's money in escrow pending sale bears a risk that a faithless employee may embezzle the money. One might expect, based upon the cases, that courts would reject coverage in such a case, but that is not necessarily so. While an insured's vicarious liability to a third party generally is not covered, bonds may well cover the loss of a third party's property while in the possession and control of the insured.¹¹⁴

It is important to distinguish between claims involving property loss and claims based upon an insured's liability to a third party. Coverage for the misappropriation of a third party's property while in the insured's possession is not based upon the insured's liability to the owner of the property. Rather, coverage exists because the ownership provision in standard form fidelity bonds extends coverage to the property itself. So, in the forgoing example, the misappropriation of a third party's money while in the insured's escrow account, subject to other potential

¹¹¹Granite State Ins. v. Degerlia, 925 F.2d 189, 193 (7th Cir.1991); Perry v. Economy Fire & Cas. Co., 724 N.E.2d 151, 152 (Ill. App. Ct. 1999).

¹¹²E.g., Schenkel & Shultz v. Homestead Ins., 119 F.3d 548, 551 (7th Cir. 1997); O'Brien v. United States Fid. & Guar. Co., 669 A.2d 1221 (Conn. 1996); LeMars Mut. Ins. Co. v. Joffer, 574 N.W.2d 303 (Iowa 1998).

¹¹³State Farm v. Trousdale, 673 N.E.2d 1132, 135 (Ill. App. Ct. 1996); see also Granite State Ins. v. Degerlia, 925 F.2d 189, 193 (7th Cir. 1991).

¹¹⁴Financial Institution Bond, Conditions and Limitations, § 10; Commercial Crime Policy, General Provisions, § 14.

defense, would be covered under a fidelity bond because the bond covers property held by the insured.¹¹⁵

In *Nelson v. ITT Hartford Fire Insurance Co.*,¹¹⁶ the insured administered real estate closings. The insured's agent misappropriated a client's money from the insured's escrow accounts, and the clients sued to recover the loss from the insured. The insured sought indemnity under its fidelity bond. The Tenth Circuit held that, since the insured held the money at the time of its misappropriation, the insurer would be "liable to pay those claims for losses against the [insured] as they are established by the defrauded client/creditors."¹¹⁷

While the misappropriation of a third party's property may present a compensable loss, at least three additional issues should be considered when analyzing such claims: First, did the insured sustain an out-of-pocket loss? Second, is the insured's settlement of a third-party claim or payment of a judgment conclusive proof of the existence and quantum of the loss? Third, was the loss discovered and/or sustained during the bond period?

A. DID THE INSURED SUSTAIN A LOSS?

A fidelity bond is a contract for indemnity under which the insurer is liable only to the extent the insured sustains a pecuniary loss. The insured must demonstrate that it sustained an actual loss, as opposed to a theoretical or bookkeeping loss.¹¹⁸ The "[l]ack of any pecuniary loss by the insured from the alleged wrongful acts constitutes a good defense, since in such case no recovery can be had."¹¹⁹

Although not typically an issue in an embezzlement-type case, the lack of a pecuniary loss may be a significant issue when the insured is bankrupt or otherwise insolvent. While the misappropriation of a third party's property in the possession and control of the insured debtor is a loss for certain purposes,¹²⁰ the mere

¹¹⁵*Nelson v. ITT Hartford Fire Ins. Co.*, No. 99-6275, 2000 WL 763772 (10th Cir. 2000); *Fid. & Dep. Co. v. USAFORM Hail Pool, Inc.*, 523 F.2d 744, 753-54 (5th Cir. 1975); *Elmer Fox & Co. v. Comm'l Union Ins. Co.*, 274 F. Supp. 235, 239-40 (D. Colo.1967); *Alberts v. Am. Cas. Co.*, 627 P.2d 37, 39-41 (Cal. Ct. App. 1948); *Am. Employers' Ins. Co. v. Johnson*, 47 S.W.2d 463, 464 (Tex. Civ. App. 1932).

¹¹⁶No. 99-6275, 2000 WL 763772 (10th Cir. 2000).

¹¹⁷*Nelson*, 2000 WL 763772 at * 2-3.

¹¹⁸*E.g.*, *Cincinnati Ins. Co. v. Star Fin. Bank*, 35 F.2d 1186, 1191 (7th Cir. 1994); *In re: Ben Kennedy & Assoc.*, 40 F.3d 318 (10th Cir. 1994).

¹¹⁹*FDIC v. United Pac. Ins. Co.*, 20 F.3d 1070, 1080 (10th Cir. 1994).

¹²⁰*Comm'l Bank of Bluefield v. St. Paul Fire & Marine Ins. Co.*, 336 S.E.2d 552 (W. Va. 1985) ("a 'loss' occurs generally under an employee fidelity insurance policy when money or other covered property is misappropriated from the insured through employee dishonesty or fraud"); *Am. Nat'l Ins. Co. v. United States Fid. & Guar. Co.*, 215 So. 2d 245 (Miss. 1968).

misappropriation of such property, without a corresponding claim and finding of liability against the insured for that loss, is not compensable under the bond. Common sense dictates that if the third party fails to pursue a claim against the insured or the insured successfully defeats the claim, the insured cannot profit from its employee's misconduct by asserting a bond claim.¹²¹

In *Spears v. St. Paul Fire Insurance Co.*,¹²² the insured's employee defrauded the insured's customers of more than \$235,000. The insured repaid about \$20,000, and then filed for bankruptcy. The customers did not pursue timely claims in the bankruptcy proceeding, but the estate nonetheless filed an action for recovery of the \$100,000 policy limits. Affirming summary judgment for the insurer, the Tenth Circuit held that the estate's compensable loss was limited to the amount which the insured had refunded to customers before the bankruptcy:

This fidelity policy insures against the loss of property due to employee dishonesty. In general, an insurer's obligation to indemnify against loss attaches only when the insured sustains an actual loss. In this factual context, where [the insured] was in possession of, but did not own, the money that was lost, the requirement that it suffer a resulting actual loss before its insurer would become liable on the policy is closely linked with the fundamental requirement that [the insured] . . . have an insurable interest in the subject matter of the policy. [The insured's] insurable interest in the loss of its clients' money while in its possession could only extend as far as the financial detriment it would suffer as a result of that loss. To allow [the insured] to recover \$100,000 on this fidelity policy without a corresponding financial detriment to [the insured] would amount to allowing an insured to wager on the loss of others' property in its possession, and might foster a temptation for similarly situated insureds to 'lose' such property for economic gain . . . [The estate's] recovery under its fidelity policy is therefore limited to reimbursement of its actual out-of-pocket expense resulting from the loss of its clients' money due to its employee's dishonesty.¹²³

While the insured may not pursue a claim if it is no longer legally liable for the misappropriated property, there is a split of authority as to whether an insured is required to reimburse the owner of the property before pursuing a claim on the bond. Most courts have held that an insured may not pursue a bond claim until it has satisfied the underlying claim or judgment because otherwise it could potentially profit from its employee's misconduct.¹²⁴ Recognizing that the insured's insolvency may

¹²¹*E.g.*, *Nelson*, 2000 WL 763772, at * 2; *Spears v. St. Paul Ins. Co.*, 40 F.3d 318 (10th Cir. 1994).

¹²²40 F.3d 318 (10th Cir. 1994).

¹²³*Id.* at 319-20; *see also Nelson*, 2000 WL 763772, at * 2.

¹²⁴*E.g.*, *Fid. & Dep. Co. of Md. v. USAFORM Hail Pool, Inc.* 463 F.2d 4 (5th Cir. 1971); *Cont. Cas. Co. v. First Nat'l Bank*, 116 F.2d 885 (5th Cir. 1941); *School Employees Credit Union*, 839 F. Supp. at

preclude an otherwise innocent third party from obtaining full recovery of its loss, a minority of courts have refused to deny recovery and have held that the insured may pursue a claim upon entry of judgment.¹²⁵

B. IS A JUDGMENT AGAINST THE INSURED OR SETTLEMENT OF AN OTHERWISE COVERED THIRD-PARTY CLAIM BINDING ON AN INSURER?

Upon entry of a judgment or execution of a settlement agreement, insureds may look to their fidelity insurers for indemnity. Insureds may assert that the entry of the judgment or the settlement of an otherwise covered third party claim conclusively establishes the existence and quantum of their loss, but that is not necessarily so. Typically, unless an insurer has defended the underlying action, it is not bound by a judgment against the insured or the insured's voluntary settlement of a claim.

In connection with claims under financial institution bonds, General Agreement (F) resolves this issue:

If the Underwriter elects to defend the Insured, in whole or in part, any judgment against the Insured on those counts or causes of action which the Underwriter defended on behalf of the Insured or any settlement in which the Underwriter participates and all attorneys' fees, costs and expenses incurred by the Underwriter in the defense of the litigation shall be a loss covered by this bond.¹²⁶

If the insurer elects not to defend or is not given the opportunity to defend the underlying action, "neither a judgment against the Insured, nor a settlement of any legal proceeding by the Insured, shall determine the existence, extent or amount of coverage under this bond for loss sustained by the Insured."

The binding effect of judgments and settlements is less clear in connection with claims under commercial crime policies because they do not contain an analogue to General Agreement (F). One might assume, since all ambiguities must be construed against the insurer, that court's would be inclined to find a judgment or

1479; *Comm'l Bank of Bluefield*, 336 S.E.2d at 554; *Cary v. Nat'l Sur. Co.*, 251 N.W. 123 (Minn. 1933).

¹²⁵*Cont'l. Sav. Ass'n v. United States Fid. & Guar. Co.*, 762 F.2d 1239 (5th Cir. 1985), *modified in part on other grounds*, 768 F.2d 89 (5th Cir. 1985); *Fid. & Dep. Co. of Md. v. President of Georgetown College*, 483 F. Supp. 1142 (D. D.C. 1980); *Estate of K.O. Jordan v. Hartford Acc. & Indem. Co.*, 844 P.2d 403 (Wash. 1993).

¹²⁶Financial Institution Bond, General Agreement (F). See Gilbert J. Schroeder, *Court Costs and Attorneys' Fees*, in FINANCIAL INSTITUTION BONDS (Duncan L. Clore ed., 1998).

settlement binding upon an insurer, but courts generally have not reached that conclusion.¹²⁷

In *KAMI Kountry Broadcasting Co. v. United States Fidelity & Guaranty Co.*,¹²⁸ the insured sought indemnity for losses sustained as a result of its vicarious liability for an employee's fraud on a third party. The insurer moved to dismiss, arguing that the claim was not covered because there was no adjudication of liability against the insured in the underlying third-party action. The insured argued that the insurer was bound by the settlement of the underlying action, but the Supreme Court of Nebraska disagreed: because the insured had a valid defense to the underlying action, its claim failed as a matter of law.¹²⁹

Courts have been more reluctant to allow insurers to contest the merits of the underlying third-party claim when they had an opportunity to participate in the defense of that claim, but refused to do so. While recognizing that the underlying judgment or settlement is not binding, courts in these cases have held that the judgment or settlement is presumptive evidence of the insured's loss, which the insurer must then rebut.¹³⁰

In *H.S. Equities, Inc. v. Hartford Accident & Indemnity Co.*,¹³¹ for example, the insured's employee defrauded customers by churning their accounts. Faced with multiple lawsuits, the insured notified its insurer, which declined the request for defense of the litigation and denied coverage. The insured settled the underlying claims and filed suit for indemnity under its brokers blanket bond. The insurer maintained that the insured's settlement did not give rise to coverage because the allegations in those claims had not been proven. Recognizing that the insurer should not be punished for exercising its contractual right not to defend the underlying claims, the court held that the settlement was not binding upon the insured. Rather, the court held, the settlement created a rebuttable presumption of employee misconduct and of the insured's loss.¹³²

¹²⁷*E.g.*, *First Nat'l Bank v. Aetna Cas. & Sur. Co.*, 309 F.2d 702 (6th Cir. 1962); *KAMI Kountry Broad. Co.*, 208 N.W.2d at 255 (Neb. 1973).

¹²⁸208 N.W.2d 254 (Neb. 1973).

¹²⁹*Id.*

¹³⁰*E.g.*, *H.S. Equities, Inc. v. Hartford Acc. & Indem. Co.*, 609 F.2d 669 (2nd Cir. 1979); *Nat'l Sur. Corp. v. Rauscher, Pierce & Co.*, 369 F.2d 572, 588 (5th Cir. 1966) (insured's settlement of a third party claim was binding because the insurer was given an opportunity to defend the claim, but elected not to do so); *First Nat'l Bank of West Hamlin v. Md. Cas. Co.*, 354 F. Supp. 189 (S. D. W. Va. 1973).

¹³¹609 F.2d 669 (2nd Cir. 1979).

¹³²*Id.* at 701; *but see Nat'l Sur. Corp.*, 369 F.2d at 588 (insured's settlement of a third party claim was binding because the insurer was given an opportunity to defend the claim, but elected not to do so); *Nat'l Bank of West Hamlin*, 354 F. Supp. at 195 (since insurer would only be bound if it was given notice of the claim and an opportunity to defend, the district court denied summary judgment and ordered an evidentiary hearing on the insured's notice to the insurer).

C. WAS THE LOSS DISCOVERED AND/OR SUSTAINED DURING BOND PERIOD?

Historically, financial institution bonds have been written on a discovery basis, while commercial crime policies have been written on a loss-sustained basis. While this distinction is important in connection with most fidelity claims, it is especially so in connection with third-party losses, because in many instances the employee misconduct occurs significantly before the resulting loss manifests itself. In such cases, whether the bond is written on a discovery basis or a loss-sustained basis may affect compensability.

1. Financial Institution Bonds: Discovery Bonds

Before 1954, financial institution bonds, like commercial crime policies, were written on a loss-sustained basis. In 1954, the Surety Association of America converted the Standard Form No. 24 Financial Institution Bond and several related coverage into "Loss Discovery" forms. Under the discovery forms, coverage was afforded for loss which occurred at any time, provided the loss was first discovered during the term of the bond. This conversion changed the scope of coverage because, under the revised bonds, the date of discovery of the loss, not the date the loss was sustained, determined coverage. In cases involving losses occurring during successive bonds, the change impacted which bond would afford coverage, and where the bonds were issued by different carriers, which carrier was responsible for the loss. The date of discovery also became the trigger for the bond's notice, proof and suit limitations.¹³³

a. When Does An Insured Discover a Loss? An insured discovers a loss when it "becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred, even though the exact details of the loss may not then be known."¹³⁴ Not without some struggle, courts have typically held that discovery occurs when at the earliest date a reasonable person would assume that a covered loss has been or will be incurred, regardless of the insured's subjective beliefs.¹³⁵

However, in the context of third-party claims, an insured may contend that discovery did not occur until it resolved the underlying claim because until it had an opportunity to investigate the third party's allegations, it did not know whether its employee had engaged in any misconduct. While this may be true, the insured's questions about the merits of the underlying claim do not toll its discovery of the loss.

¹³³Edward G. Gallagher, James L. Knoll, & Linda M. Bolduan, *A Brief History of the Financial Institution Bond*, in FINANCIAL INSTITUTION BONDS (Duncan L. Clore ed. 1998).

¹³⁴Financial Institution Bond, Conditions & Limitations, § 4.

¹³⁵*E.g.*, FDIC v. Oldenburg, 34 F.3d 1529, 1542 (10th Cir. 1994); *see also* Duncan L. Clore & Michael Keeley, *Discovery of Loss: The Contractual Predicate to the Claim*, in FINANCIAL INSTITUTION BONDS (Duncan L. Clore ed. 1998).

On the contrary, the definition of discovery specifically provides that, regardless of when the insured assumed that it has or will sustain a covered loss, discovery occurs no later than when the insured first becomes aware of the underlying claim. “Notice to the Insured of an actual or potential claim by a third party which alleges that the Insured is liable under circumstances which, if true, would create a loss under this bond constitutes such discovery.”¹³⁶ Therefore, regardless of whether the insured questioned the merits of the underlying claim, it is deemed to have discovered the loss (at the latest) upon receiving notice of the underlying claim.

b. Timeliness of the Insured’s Claim. Discovery of loss by the insured triggers the bond’s notice, proof and suit limitations requirements. An insured is usually required to give notice of a potential claim “at the earliest practicable moment, not to exceed 30 days, after discovery of the loss”¹³⁷ The insured has six months from discovery to file a proof of loss and two years to pursue a “legal proceeding” for coverage.¹³⁸

When the insured’s claim is based upon a legal proceeding which, if established, would constitute a covered loss, the bond extends the notice, proof and suit limitations.¹³⁹ Instead of being triggered by discovery of a loss, General Agreement (F) provides that the bond’s notice, proof and suit limitations do not begin until the settlement of or entry of judgment in the legal proceeding. In such cases, an insured is not required to give notice of the loss until thirty days after the settlement or entry of judgment or to file a proof of loss until sixty days after the judgment or settlement. The insured may pursue a claim for coverage within two years thereafter.¹⁴⁰

In applying the conditions in General Agreement (F), the threshold issue is whether the claim is based upon a legal proceeding. This issue is not disputed, because most third-party claims are not resolved until after the initiation of litigation or other legal proceeding, thereby triggering the extended notice, proof and suit limitations in General Agreement (F). However, when the insured settles the underlying claim before the initiation of litigation, an issue may arise whether the pre-suit negotiations constitute a legal proceeding. In other contexts, courts have held

¹³⁶Financial Institution Bond, Conditions & Limitations, § 4.

¹³⁷*Id.*, § 5(a).

¹³⁸*Id.*, §§ 5(b) and (c).

¹³⁹The insured’s responsibilities with respect to filing a proof of loss and instituting suit against the insured (Sections 5(b) and 5(d) of the bond, respectively), as they relate to third party action against the insured, are not set forth in General Agreement F. Under predecessor policies, however, there was no such provision, meaning that an insured was arguably required to file a proof of loss within six months of discovery, regardless of whether the loss involved a third party action. This gave rise to cases such as *First National Bank of Bowie v. Fidelity & Casualty Co. of New York*, 634 F.2d 1000 (5th Cir. 1981), which questioned the applicability of the proof of loss requirement to factual situations where the insured sustained no out-of-pocket loss, absent an unsuccessful defense of the third party litigation.

¹⁴⁰Financial Institution Bond, General Agreement (F).

that legal proceedings only encompass lawsuits, mediation, arbitration or other formally initiated proceedings, not pre-suit negotiations.¹⁴¹

The only case interpreting the definition of legal proceedings under General Agreement F, however, reached the opposite conclusion. In *First American State Bank* discussed earlier, the insured sought indemnity under its financial institution bond for attorneys' fees incurred during the pre-suit negotiation of settlement of a third-party claim. The insurer maintained that the pre-suit negotiations did not constitute a legal proceeding within the meaning of General Agreement (F). Although finding that the term was not ambiguous, the Eighth Circuit, construing Iowa law, held that it did encompass pre-suit negotiations because that was what the insured expected.¹⁴²

The court reached that questionable conclusion even though under Iowa law, when a policy is clear and unambiguous, a court is required to enforce the policy according to its plain and ordinary meaning, regardless of the insured's expectations of coverage.¹⁴³ Had the *First American* court applied the appropriate standard, the insured's pre-suit negotiations would not have constituted a legal proceeding withing the meaning of General Agreement (F).

2. Commercial Crime Policies.

Unlike a financial institution bond, commercial crime policies are written on a loss sustained basis, meaning that a loss is covered only if it is "sustain[ed] through acts committed or events occurring during the Policy Period"¹⁴⁴ and discovered "no later than one year from the end of the policy period."¹⁴⁵ When loss is sustained, the insured must notify the insurer as soon as possible,¹⁴⁶ file a proof of loss within 120 days,¹⁴⁷ and pursue a legal action for coverage within two years.¹⁴⁸

The conditions of coverage under commercial crime policies, therefore, focus primarily upon when the loss was sustained. In the case of a claim or lawsuit by a third party, insureds may argue that the loss was not sustained until it became legally liable for the third party's property as a result of a settlement or judgment. They may so contend, for example, if the policy in effect at the time of the settlement or judgment higher policy limits than the coverage in place when the misconduct

¹⁴¹E.g., *In Re Emslie*, 102 F. 291 (2nd Cir. 1900); *R.D. Merrill Co. v. State*, 969 P.2d 458 (Wash. 1999).

¹⁴²*First Am. State Bank*, 897 F.2d at 326.

¹⁴³E.g., *LeMars Mut. Ins. Co. v. Joffer*, 574 N.W.2d 303 (Iowa 1998).

¹⁴⁴Commercial Crime Policy, General Conditions, §15.

¹⁴⁵*Id.*, § 4.

¹⁴⁶*Id.*, § 7.

¹⁴⁷*Id.*, § 5(b).

¹⁴⁸*Id.* at § 7(c).

occurred, or if the insured neglected to provide timely notice or proof of loss following the occurrence of the fraudulent or dishonest acts.

Courts have uniformly rejected such efforts by insureds, finding that, in cases involving third-party claims, the loss is sustained at the time of the underlying dishonest conduct, not when the insured is ultimately adjudicated liable for the loss.¹⁴⁹ Tying the sustaining of loss to the date of settlement or judgment could have illogical or unfair consequences. For example, if an employee defrauded multiple third parties, the compensability of the claims would depend upon how quickly the underlying claims were resolved, although the underlying misconduct occurred at the same time.

In *Reserve Insurance Co. v. General Insurance Co.*,¹⁵⁰ the insured, a surety, was insured under successive fidelity bonds issued by different carriers. During the term of the first bond, the insured's employee sold unauthorized surety bonds. The insured suffered a loss by paying claims on the unauthorized bonds.¹⁵¹ Those payments were made during the term of the second bond. The insured sought reimbursement under both bonds, and both insurers denied coverage, arguing that the claim was covered by the other bond. Finding coverage under the earlier bond, the Illinois Appellate Court held that "[i]n the case of successive fidelity bonds, the bond in force at the time of the acts of dishonesty which caused the loss applies to cover the loss, and not the bond in force at the time the loss was actually suffered."¹⁵²

IV. Direct Claims by Persons Other than the Insured

When an insured employee defrauds a third party, the third party sometimes seeks to recover its loss directly from the insured's fidelity carrier. Such claims may arise, for example, if the insured is insolvent or otherwise unable to satisfy a judgment. Since there is no privity of contract, the third party generally may not seek recovery of its loss under the bond. Third parties sometimes try to obtain coverage by asserting purported common law or statutory rights of action. Fidelity bonds, however, are not liability policies and, therefore, unless a direct action is expressly authorized by statute or the insured assigns its claim, third parties generally are prohibited from pursuing claims under a standard form fidelity bond.

¹⁴⁹*First Am. Title Ins. Co. v. St. Paul Fire and Marine Ins. Co.*, 971 F.2d 215 (9th Cir. 1991); *Leucadia, Inc. v. Reliance Ins. Co.*, 864 F.2d 964 (2nd Cir. 1988); *Reserve Ins. Co. v. General Ins. Co.*, 395 N.E.2d 933 (Ill. App. Ct. 1979).

¹⁵⁰395 N.E.2d 933 (Ill. App. Ct. 1979).

¹⁵¹*Id.* at 939.

¹⁵²*Id.* at 938 (quoting COUCH ON INSURANCE 2D, § 46:179); see also *First Am. Title Ins. Co.*, 971 F.2d at 219 (loss is sustained at the time of the underlying dishonesty, not when judgment was entered in third party action against the insured).

A. THIRD-PARTY'S STATUTORY RIGHT TO PURSUE CLAIM UNDER THE BOND.

Third parties sometimes invoke statutory authority to legitimize their claims. Relying upon direct action statutes and/or public policy, these parties attempt to persuade courts to ignore the bond's prohibition against third-party claims. While these arguments have some facial appeal, the vast majority of courts, absent a specific statutory right of action, have enforced the bond as written and refused to extend coverage to third parties.

1. Direct Action Statutes

Direct suits by third parties against insurers "contravene the common law due to an absence of privity."¹⁵³ Some states, therefore, have enacted statutes allowing direct actions against liability insurers, meaning that someone have a claim against an insured can bring suit directly against the insured's carrier. The claimant is not required to first reduce the claim to judgment in a suit against the insured and then, if the judgment is not satisfied, to pursue an independent action against the insured's carrier.¹⁵⁴

Direct action statutes typically fall into one of two categories: pure direct action statutes and judgment direct action statutes. Pure direct action statutes allow injured claimants to sue the insurer first, either with or without the insured as a named party, and create a separate cause of action that the injured claimant may pursue at its election.¹⁵⁵ In contrast, judgment direct action statutes permit direct actions only if a judgment against the insured is first returned unsatisfied, typically because of insolvency.¹⁵⁶

The distinction between pure direct action statutes and judgment direct action statutes is irrelevant when evaluating the propriety of a direct action on a fidelity bond, because both types of direct action statutes apply only to liability policies. Since standard form fidelity bonds provide property coverage and not liability

¹⁵³JOHN A. APPLEMAN & JEAN APPLEMAN, *INSURANCE LAW AND PRACTICE*, § 4861, at 568 (1981).

¹⁵⁴See N.Y. INS. LAW § 3420 (McKinney 1985); WIS. STAT. ANN. §§ 632.24 (West 1995); MD. CODE ANN., Ins. §§ 19-102 (1997); CAL. INS. CODE § 11580 (West 1988); PA. STAT. ANN. tit. 40, § 117 (West 1992); VT. STAT. ANN. tit. 8, § 4203 (1993); LA. REV. STAT. ANN. § 22:665 (West 1995); P.R. LAWS ANN. tit. 26, § 2003 (1996); ARK. CODE ANN. § 23-79-210, 23-89-101, 23-89-102 (Michie 1992).

¹⁵⁵See WIS. STAT. ANN. §§ 632.24 (West 1995); CAL. INS. CODE § 11580 (West 1988); LA. REV. STAT. ANN. § 22:665 (West 1995); P.R. LAWS ANN. tit. 26, § 2003 (1996); ARK. CODE ANN. § 23-79-210, 23-89-101, 23-89-102 (Michie 1992).

¹⁵⁶See N.Y. INS. LAW § 3420 (McKinney 1985); MD. CODE ANN., Ins. §§ 19-102 (1997); PA. STAT. ANN. tit. 40, § 117 (West 1992); VT. STAT. ANN. tit. 8, § 4203 (1993).

insurance, direct action statutes may not be evoked to permit coverage for claims by third parties.¹⁵⁷

In *Three Garden Village*, property owners whose money had been misappropriated by the director of an apartment management company brought suit against the company's fidelity carrier. The insurer argued that the property owners lacked standing. The owners argued that they had a right of action under Maryland's direct action statute, but the Maryland Court of Appeals disagreed. Affirming summary judgment for the insurer, the court held that "direct action statutes applicable to liability policies do not authorize actions by third parties against sureties on fidelity bonds even where the dishonesty of the obligee's employee has caused the insured employer to become liable to the third party claimant."¹⁵⁸

The Eighth Circuit reached the same result while interpreting the Iowa direct action statute in *Anderson*. In that case, judgment creditors of the insured sought recovery under the insured's bond for damages attributable to misconduct by the insured's employee. The judgment creditors argued that the Iowa direct action statute provided a statutory right of action, but the Eighth Circuit disagreed, holding that while the direct action statute did provide a right of action to judgment creditors, it applied only to liability policies. The insured's fidelity bond was an indemnity policy, not a liability policy, and so the direct action statute did not apply.¹⁵⁹

2. Statutory Bonds

When financial institutions and other regulated businesses are required by statute to maintain minimum levels of fidelity coverage, a conflict between the underlying statute and the terms of the bond must be construed in favor of the statute. Relying upon that general principle, third parties commonly argue that any bond provision eliminating their right of direct action is void because it defeats the underlying purpose of the statute – to protect members of the public who conduct business with the insured.

¹⁵⁷See, e.g., *First Nat'l Bank of Louisville v. Lustig*, 975 F.2d 1165 (5th Cir. 1992); *Anderson v. Employers Ins. of Wausau*, 826 F.2d 777 (8th Cir. 1987); *Fid. Nat. Bank of Baton Rouge v. Aetna Cas. and Sur. Co.*, 584 F. Supp. 1039 (M.D. La. 1984); *Central Nat'l Ins. Co. v. Ins. Co. of N. Am.*, 522 N.W.2d 39 (Iowa 1994); *State v. Acadia Parish Police Jury*, 631 So. 2d 611 (La. Ct. App. 1994); *Killingsworth v. United Merchantile Bank*, 623 So. 2d 1384 (La. Ct. App. 1993); *Three Garden Village Ltd. Partnership v. U.S. Fid. & Guar. Co.*, 567 A.2d 85 (Md. 1989); *175 E. 74th Corp. v. Hartford Acc. & Indem. Co.*, 435 N.Y.S.2d at 587-8; *but see Black v. First City Bank*, 642 So. 2d 151 (La. 1994) (court misinterpreted non-standard policy as a liability policy and therefore subject to direct action statute); *Sun Bank of Miami v. Ins. Co. of N. Am.*, 452 So. 2d 579 (Fla. Dist. Ct. App. 1984) (same).

¹⁵⁸*Three Garden Village, Ltd.*, 567 A.2d at 94.

¹⁵⁹*Anderson*, 826 F.2d at 779-80; *see also 175 E. 74th Corp.*, 435 N.Y.S.2d at 587-88 (fidelity bond covering losses resulting from the fraudulent or dishonest acts of the insured's policy was not liability insurance and thus the plaintiff could not maintain a direct action against the insurer under the New York direct action statute).

Courts are not free to void the terms of a bond based solely upon public policy. Absent a direct conflict between the underlying statute and the bond, the bond must be enforced according to its plain and ordinary terms. Therefore, unless the statute contains an express provision enabling third parties to assert a direct action on the bond, the bond's prohibition of such actions must be enforced.¹⁶⁰ The threshold issue is whether the bond contradicts the express terms of the underlying statute or regulation.¹⁶¹

In *School Employees*, the court held that fidelity bonds issued pursuant to the Arkansas Securities Act did not require direct actions on fidelity bonds. The insured argued that the court's ruling frustrated the purpose of the Arkansas statute, but the court refused to override the clear terms of the bond on a public policy basis because the act did not specifically provide third parties with a right of action. Since the bond did not conflict with an express provision in the underlying statute, the court held that the bond should be enforced according to its plain terms.¹⁶²

While the rule of law is clear, courts nonetheless have occasionally been sympathetic to third-party claimants, allowing them to pursue a direct action on the bond even where the statute does not expressly provide such a right of action.¹⁶³ Such decisions are typically motivated by the desire to protect the public, rather than a coherent interpretation of the applicable statutes and contracts. Indeed, the seminal decisions applying public policy to permit a direct action by a third party, *Foster* and *Anchor Equities*, were thereafter rejected in *School Employees*.¹⁶⁴ Absent a direct conflict between the bond and the statute, the bond should be enforced as written.

B. COMMON LAW RIGHT TO PURSUE A DIRECT CLAIM UNDER THE BOND.

Claimants who are not named insureds may attempt to extend coverage by arguing that they have a common law right of action under the bond. Successors-in-interest (*e.g.*, a bankruptcy trustee or a regulator which has taken over a defunct insured) are typically permitted to pursue a claim on behalf of the insured. However,

¹⁶⁰*Index Fund, Inc. v. Ins. Co. of N. Am.*, 580 F.2d 1158 (2nd Cir. 1978); *Estate of Jordan v. Hartford Acc. & Indem. Co.*, 844 P.2d 403 (Wash. 1993); *see also* Gary J. Valeriano, *Statutory Fidelity Bonds – Do They Mean What They Say?*, (unpublished paper presented at the Mid-Winter Meeting of the Fidelity and Surety Law Committee of TIPS in New York, New York, Jan. 27, 1989).

¹⁶¹*E.g.*, *Estate of K.O. Jordan*, 844 P.2d at 407; *Lindsay v. Standard Acc. Ins. Co.*, 173 So. 53 (Ala. 1937); *but see* *First Dakota Nat'l Bank v. St. Paul Fire & Marine Ins. Co.*, 2 F.3d 801 (8th Cir. 1993); *Sch. Employees Credit Union v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA.*, 839 F. Supp. 1477 (D. Kan. 1993).

¹⁶²*Id.* at 1481.

¹⁶³*In re: Lloyd Sec., Inc.*, 153 B.R. 677 (Bankr. E.D. Pa. 1993); *Foster v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA.*, 902 F.2d 1316 (8th Cir. 1990); *Anchor Equities, Ltd. v. Pacific Coast Am.*, 737 P.2d 532 (N.M. 1987); *Three Garden Village*, 567 A.2d at 94-5.

¹⁶⁴*Sch. Employees Credit Union*, 839 F. Supp. at 1480 (finding the *Foster* decision "neither clear nor persuasive").

attempts by other claimants to claim a right of action under alternative common law theories have generally failed.

1. Successor-in-Interest

The Standard Form No. 24 Financial Institution Bond expressly provides that “[n]o suit, action or legal proceedings shall be brought hereunder by anyone other than the named Insured.”¹⁶⁵ Under that provision, even the insured’s successors-in-interest would appear to be precluded from pursuing a claim because they are not technically insureds under the bonds. While courts generally have enforced the terms of the bond to preclude claims by independent third parties, they have not applied these provisions to defeat claims by successors-in-interest. On the contrary courts have allowed the insured’s successors-in-interest to pursue claims without commenting on the propriety of standing.¹⁶⁶

The termination provision in a financial institution bond impliedly acknowledges that successors-in-interest may assert the insured’s rights under the bond. Under Section 12, coverage terminates upon takeover of the insured “for any loss sustained by such Insured which is discovered after the effective date of such termination.”¹⁶⁷ By implication, the bond contemplates that a receiver or liquidator would be entitled to pursue claims in connection with any losses discovered before the effective date of termination.¹⁶⁸

2. Third Party Beneficiaries

A third parties who is unable to characterize itself as a successor-in-interest may argue that because the bond provides coverage for the loss of a third party’s property while in the possession of the insured, it is an intended third party beneficiary of the bond. Although this argument fails under the plain language of modern fidelity bonds, it is important carefully to review the precise language in the bond before responding to such claims.

Before 1980, standard form commercial crime policies and financial institution bonds did not expressly prohibit third-party claims on the bond. Third parties commonly argued that they were obviously intended third-party beneficiaries, because

¹⁶⁵Financial Institution Bond, General Agreements, § 5(f).

¹⁶⁶*E.g.*, *Mutual Sec. Life Ins. Co. v. Fid. & Dep. Co. of Md.*, 659 N.E.2d 1096 (Ind. App. 1996) (court allowed liquidator to pursue a claim under a Standard Form No. 25 Financial Institution Bond for losses discovered before the takeover); *FDIC v. Nat’l Sur. Corp.*, 425 F. Supp. 200, 203 (E.D.N.Y.1977) (trustee in bankruptcy may pursue a claim under a fidelity bond on behalf of the debtor); *Ok. Morris Plan Co. v. Sec. Mut. Cas. Co.*, 455 F.2d 1209, 1212 (8th Cir.1972) (successor to named insured succeeds to that party’s right to sue under fidelity bond).

¹⁶⁷Financial Institution Bond, Conditions & Limitations, § 12 (emphasis added).

¹⁶⁸*RTC v. Fid. & Dep. Co.*, 205 F.3d 615 (3rd Cir. 2000); *FDIC v. Aetna Cas. & Sur. Co.*, 903 F.2d 1073, 1077 (6th Cir. 1990); *FDIC v. Fid. & Dep. Co. of Md.*, No. 95-CV-1094, 1997 WL 560616 (N.D. Tex. 1997).

the bond covers the loss of a third party's property while in the possession of the insured. Otherwise, third parties would argue that their right of compensation, in the case of an insolvent insured, might turn on whether the insured chose to pursue a claim on the bond.

A majority of courts rejected these claims, finding that third parties may not pursue a claim on the bond simply because they might derive some incidental or consequential benefit from its enforcement.¹⁶⁹ A minority of courts, however, held that because bond provided coverage for the loss of a third party's property while in the possession of the insured, the third party was an intended beneficiary and could pursue a claim for indemnity, especially since such an action would not expand coverage because the loss would be covered if the insured itself had pursued a claim.¹⁷⁰

The 1980 revisions to the commercial crime policy and the financial institution bond resolved this split of authority. The revised bond forms expressly prohibit direct claims by third parties.¹⁷¹ Enforcing this provision according to its plain terms, courts have recently distinguished the older cases which permitted third party claims, and have held that a third party may not pursue a direct claim on the bond, even if only to seek indemnity for the misappropriation of its property while in the possession of the insured.¹⁷²

C. THIRD PARTY'S RIGHT TO PURSUE A CLAIM ON BEHALF OF THE INSURED.

When a third party is unsuccessful in asserting either a statutory or common law right of action, the third party may attempt to step into the insured's shoes and assert its claim under an assignment, through a garnishment proceeding, or through a derivative action. While courts have generally rejected third parties' attempts to pursue claims through garnishment or derivative actions, they have been willing to enforce the assignment of an insured's right of action, absent an express prohibition of such an assignment in the bond itself.

¹⁶⁹*Fid. & Dep. Co. of Md. v. USAFORM Hail Pool, Inc.*, 318 F. Supp. 1301 (M.D. Fla. 1970, *aff'd in part and vacated in part*, 463 F.2d 4 (5th Cir. 1971), *appeal after remand*, 523 F.2d 744 (5th Cir. 1975); *Am. Empire Ins. Co. v. Fid. & Dep. Co. of Md.*, 408 F.2d 72 (5th Cir. 1969); *Three Garden Village*, 567 A.2d at 94-5.

¹⁷⁰*See United States Fid. & Guar. Co. v. Slifkin*, 200 F. Supp. 563 (N.D. Ala. 1961); *Burgioni v. Md. Cas. Co.*, 382 S.W.2d 707 (Mo. 1964); *Cumis Ins. Soc. v. Rep. Nat'l Bank*, 480 S.W.2d 762 (Tex. Ct. App. 1972);

¹⁷¹Financial Institution Bond, § 10 (“[t]his bond shall be for the sole use and benefit of the Insured named in the Declarations”); Commercial Crime Policy, Common Policy Conditions, § F.

¹⁷²*E.g.*, *Gasslein v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 918 F. Supp. 373 (M.D. Fla. 1995); *RTC v. Moskowitz*, 845 F. Supp. 247 (D. N.J. 1994); *Sch. Employees Credit Union*, 839 F. Supp. at 1480; *Thornsberry v. W. Sur. Co.*, 738 F. Supp. 209 (E.D. Ky. 1990); *Killingsworth v. United Merchantile Bank*, 623 So. 2d 1384 (La. Ct. App. 1993); *Texas Pac. Indem. Co. v. Atl. Richfield Co.*, 846 S.W.2d 580 (Tex. Ct. App. 1993).

1. Assignment

At common law, an insurance policy was not assignable.¹⁷³ Courts eventually relaxed this prohibition as to certain policies, but indemnity policies remain “so personal in nature that no assignment can be made before loss has occurred, without the consent of the insured, especially where the assignment is expressly prohibited by the policy.”¹⁷⁴ However, once the insured sustains a loss, most courts, absent an express provision in the policy to the contrary, have permitted assignments of the insured’s claim, reasoning that a chose of action, not the actual policy, is being transferred.¹⁷⁵

To avoid assignment of claims, commercial crime policies expressly prohibit the assignment or transfer of any claims or rights under the policy. Section F of the Common Policy conditions provides that the insured’s “rights and duties under this policy may not be transferred without [the insurer’s] written consent except in the case of death of an individual named insured.”¹⁷⁶ Enforcing this anti-assignment provision as written, courts have refused to allow the assignment of claims under commercial crime policies, even after the insured sustained a loss.¹⁷⁷

Financial institution bonds provide that only an insured may pursue a claim on the bond,¹⁷⁸ but they do not expressly prohibit the assignment of claims. Courts, therefore, have been more willing to apply the general common law rule that an insured may assign a claim after sustaining a loss. Courts have treated third parties asserting a claim pursuant to an assignment as a “successor-in-interest” and have allowed them to pursue the claim.¹⁷⁹

It is important to remember, however, that an assignee stands in the shoes of the insured and may assert only the insured’s losses, not its own losses. If the insured has not sustained a loss, then there is nothing for the assignee to assert. If the insured has sustained a loss, the assignee may be able to assert a claim for that loss, subject to any defenses which could have been asserted against the insured.¹⁸⁰

¹⁷³*E.g.*, *Provident Mt. Life Ins. Co. v. Bennett*, 58 F. Supp. 72 (D. Iowa 1944).

¹⁷⁴COUCH ON INSURANCE 3D, § 34:25 et seq.

¹⁷⁵*Id.*

¹⁷⁶Commercial Crime Policy, General Conditions, § F.

¹⁷⁷*See, e.g.*, *Texas Pac. Indem. Co. v. Atl. Richfield Co.*, 846 S.W.2d 580 (courts enforced anti-assignment provision in 3-D Policy and rejected contention that federal bankruptcy code preempted anti-assignment provision).

¹⁷⁸Financial Institution Bond, Conditions and Limitations, § 5(f).

¹⁷⁹*Hartford Fire Ins. Co. v. Conestoga Title Ins. Co.*, 746 A.2d 460 (N.J. Super. Ct. App. Div. 2000).

¹⁸⁰*Id.* at 463 (As a judgment creditor of . . . [the plaintiff] is essentially in the position of an assignee, and as such its rights can rise no higher than those of the assignor); *see also* Michael Keeley & Toni Scott Reed, “*Superpowers*” of *Federal Regulators: How the Banking Crisis Created an Entire Genre of Bond Litigation*, 31 TORT & INS. L. J. 817 (1996).

2. Garnishment

Third parties sometimes try to circumvent the bond's prohibition against third party claims with a garnishment action. While certain courts have allowed creditors to garnish a debtor's liability insurance on the basis that the policy provides coverage for such judgments, such actions have typically failed in the fidelity context because fidelity bonds cover loss, not liability. Until the insured satisfies the third party claim, the insurer is not liable on the bond and, therefore, there is nothing to garnish.¹⁸¹

The landmark decision in *Ronnau v. Caravan International Corp.* illustrates the point.¹⁸² In that case, a judgment creditor of the insured filed a garnishment proceeding against the insured's fidelity carrier, seeking to recover damages sustained as a result of the dishonest conduct of the insured's employee. In addition to contesting the compensability of the loss, the insurer also argued that the policy was not subject to garnishment because the insured had not sustained a loss. Affirming judgment in favor of the insurer, the Kansas Supreme Court held:

The bond upon which the [creditor] is attempting to recover is a personal insurance contract running between [the insurer] and [the insured], which indemnifies only the insured. As we have seen, the terms of such a bond are not broken until the insured . . . has sustained an actual loss. No loss of money or property was sustained by [the insured] as a result of the judgment, and [the insured] was under no obligation to the [creditor].¹⁸³

The creditor therefore could not garnish the proceeds of the bond, unless and until the insured sustained an actual loss and established its claim.¹⁸⁴

The Michigan Appellate Court adopted *Ronnau* in *Bralko Holdings v. Insurance Company of North America*.¹⁸⁵ Judgment was entered against the insured for improperly charged commissions, and the judgment creditor sought to garnish the bond to satisfy its judgment. The insurer moved for summary judgment, arguing that the bond was not subject to garnishment because the insured had not sustained a loss. The court agreed:

We hold that a blanket or fidelity bond, such as the one at issue here, insures against loss, but not against liability. Accordingly, the relevant inquiry is whether the insured has suffered a loss, not whether the

¹⁸¹Central Nat'l Ins. Co. v. Ins. Co. of N. Am., 522 S.W.2d 39 (Iowa 1994); *Ronnau v. Caravan Int'l Corp.*, 468 P.2d 118 (Kan. 1970); *Bralko Holdings, Ltd. v. Ins. Co. of N. Am.*, 483 N.W.2d 929 (Mich. Ct. App. 1992); *Foxley Cattle Co v. Bank of Mead*, 244 N.W.2d 205 (Neb. 1976).

¹⁸²468 P.2d 118 (Kan. 1970).

¹⁸³*Id.* at 123.

¹⁸⁴*Id.*

¹⁸⁵483 N.W.2d 929 (Mich. Ct. App. 1992).

insured is liable to a third party. Because there has been no showing of a loss by the insured in this case, [the insurer] was not liable on the fidelity bond to the insured and, therefore, the bond was not subject to garnishment by [the third party creditor] in its collection efforts with regard to its judgment against the insured.¹⁸⁶

Although not expressly discussed in the cases addressing this issue, *Ronnau* and its progeny imply that a creditor of the insured might be able to garnish a fidelity bond only the insured submitted and established its claim, but before the insurer made payment. As a practical matter, however, it is unlikely that this scenario would arise because to establish a claim, the insured would have to have reimbursed the third party for its loss, which in turn would eliminate the need for the garnishment proceeding.

3. Derivative Action

Common sense dictates that when the persons in control of the insured are themselves the alleged wrongdoers, they are unlikely to pursue a claim to recover the losses resulting from their misconduct.¹⁸⁷ If the insured is insolvent, its successor-in-interest will pursue a claim on behalf of the insured and its creditors.¹⁸⁸ However, when the insured is not insolvent or the successor-in-interest refuses to pursue the claim, the insured's shareholders may attempt to pursue a "derivative action" against the insured's fidelity carrier.

While the shareholders may protest that they only seek indemnity for the insured's losses, the shareholders may not pursue a direct action on the bond. While some courts historically have allowed shareholders to pursue claims on fidelity bonds, these cases were decided under old policy forms which did not expressly prohibit third party claims on behalf of the insured.¹⁸⁹

Current commercial crime policies and financial institution bonds expressly prohibit third party claims on behalf of the insured and provide that only the first named insured may pursue a claim on the bond. For example, financial institution bonds provide that "[n]o suit, action or legal proceedings shall be brought hereunder by anyone other than the named Insured."¹⁹⁰ Courts have enforced that provision and

¹⁸⁶*Id.* at 931; *see also Foxley Cattle Co.*, 244 N.W.2d at 209 ("since [the creditor's] judgment was not a loss sustained by [the insured] within the contemplation of [a fidelity] bond, no indebtedness or liability existed on the part of [the insurer] to the [insured] which could be garnished by the [creditor]").

¹⁸⁷Losses caused by the owners of the insured raise obvious alter ego questions. For a thorough discussion of the alter ego defense, *see* Gilbert J. Schroeder & Cole S. Kain, *Loss Caused by Owners of the Insured: The Alter Ego Defense*, in *HANDLING FIDELITY BOND CLAIMS* (Michael Keeley & Timothy M. Sukel eds., 1999).

¹⁸⁸For a discussion of the propriety of such actions, *see infra* Section III.B.1.

¹⁸⁹*See* *Guerrino v. Ohio Cas. Ins. Co.*, 423 F.2d 419 (3rd Cir. 1970); *Phoenix Ins. Co. v. Aetna Cas. & Sur. Co.*, 169 S.E.2d 645 (1969); *Levy v. Jamison*, 82 F.2d 958 (4th Cir. 1936).

¹⁹⁰Financial Institution Bond, General Agreements, § 5(f).

are likely to reject shareholder derivative claims, other than by a successor-in-interest. Otherwise, an insurer may be subject to conflicting or inconsistent claims or to the expense of dealing with multiple claims by numerous stockholders.

V. Conclusion

The 1980 revisions to financial institution bonds and commercial crime policies resolved any dispute about the compensability of losses resulting from an insured's liability to a third party for an employee's fraud under predecessor policies.

Fidelity bonds are not liability policies. While the employee's conduct might be characterized as fraudulent or dishonest and the employer's liability to its customer might result in an out-of-pocket loss, the loss is an indirect loss outside the scope of coverage.

It is important, however, to distinguish between claims based upon an insured's liability to a third party and claims based upon the misappropriation of a third party's property while in the possession and control of the insured. While the former is not covered, the latter may be covered. The loss is not covered because of the insured's liability to the owner of the property, but rather because the ownership provision in standard form fidelity bonds extends coverage to the property itself.

APPENDIX A

CASES ADDRESSING COMPENSABILITY OF THIRD-PARTY LOSSES

FEDERAL COURT CASES

I. Court of Appeals Cases

A. Second Circuit

1. *Glusband v. Fittin Cunningham & Lauzon*, 892 F. 2d 208 (2nd Cir. 1989);
2. *Leucadia v. Reliance Ins. Co.*, 864 F.2d 964 (2nd Cir. 1988);
3. *H.S. Equities v. Hartford Acc. & Indem. Co.*, 609 F.2d 669 (2nd Cir. 1979);
4. *Index Fund, Inc. v. Ins. Co. of N. Am.*, 580 F. 2d 1158 (2nd Cir. 1978);

B. Fifth Circuit

1. *Lynch Prop. v. Potomac Ins. Co. of Ill.*, 140 F.3d 622 (5th Cir. 1998);
2. *Cont'l. Sav. Ass'n v. United States Fid. and Guar. Co.*, 762 F.2d 1239 (5th Cir. 1985), *modified in part on other grounds*, 768 F.2d 89 (5th Cir. 1985);
3. *Fid. & Dep. Co. of Md. v. Smith*, 730 F.2d 1026 (5th Cir. 1984);
4. *First Nat'l Bank of Bowie v. Fid. Cas. Co. of N.Y.*, 634 F.2d 1000 (5th Cir. 1981);
5. *Fid. & Dep. Co. v. USAFORM Hail Pool, Inc.*, 523 F.2d 744 (5th Cir. 1975);
6. *Pioneer Nat'l Title Ins. Co. v. Am. Cas. Co. of Reading, Pa.*, 459 F.2d 963 (5th Cir. 1972);
7. *Am. Cas. Co. of Reading, Pa. v. Irvin*, 426 F. 2d 647 (5th Cir. 1970);

8. *Nat'l Sur. Corp. v. Rauscher, Pierce*, 369 F.2d 572 (5th Cir. 1966);
9. *Hartford Acc. & Indem. Co. v. Weil Bros.*, 41 F.2d 171 (5th Cir. 1930);
10. *Cont'l Cas. Co. v. First Nat'l Bank of Temple*, 116 F.2d 885 (5th Cir. 1941);
11. *First State Bank of Rocksprings, Tex. v. Standard Acc. Ins. Co. of Detroit*, 94 F.2d 726 (5th Cir. 1938).

C. Sixth Circuit

1. *Peoples Bank & Trust Co. v. Aetna Cas. & Sur. Co.*, 113 F.3d 629 (6th Cir. 1997);
2. *FDIC v. St. Paul Fire & Marine Ins. Co.*, 942 F.2d 1032, 1036 (6th Cir. 1991);
3. *First Nat'l Bank v. Aetna Cas. & Sur. Co.*, 309 F.2d 702 (6th Cir. 1962).

D. Eighth Circuit

1. *First Dakota Nat'l Bank v. St. Paul Fire & Marine Ins. Co.*, 2 F.3d 801 (8th Cir. 1993);
2. *First Am. State Bank v. Cont'l Ins. Co.*, 897 F.2d 319 (8th Cir. 1990);
3. *Foster v. Nat'l Union Fire Ins. Co.*, 902 F.2d 1316 (8th Cir. 1990);
4. *Anderson v. Employers Ins. of Wausau*, 826 F.2d 777 (8th Cir. 1987).

E. Ninth Circuit

1. *Vons Companies v. Fed. Ins. Co.*, 212 F.3d 489 (9th Cir. 2000).

F. Tenth Circuit

1. *Nelson v. ITT Hartford Fire Ins. Co.*, No. 99-6275, 2000 WL 763772 (10th Cir. 2000)
2. *In re: Ben Kennedy & Assoc.*, 40 F.3d 318 (10th Cir. 1994).

II. District Court Cases

- A. *Williams Elec. Games v. Barry*, No. 97 C 2743, 2000 WL 106672, at *1 (N.D. Ill. Jan. 13, 2000);
- B. *Sch. Emp. Credit Union v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 839 F. Supp. 1477 (D. Kan. 1993);
- C. *Great Am. Bank v. Aetna Cas. & Sur. Co.*, 662 F. Supp. 363 (S.D. Fla. 1986);
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