

The Interplay Of Fidelity, Director & Officer, And Errors & Omissions Insurance Policies

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I. Introduction

As indicted CEOs and claims of securities fraud, accounting malpractice, and false corporate financial records increasingly dominate the daily news, there is a heightened interest in finding insurance to cover any related losses and liabilities. This article will provide an overview of three types of insurance often implicated in claims involving allegations of corporate and financial wrongdoing, explore the interplay between these coverages, and address certain related salvage issues.

II. The Three Types Of Coverage

A. FIDELITY COVERAGE

Fidelity insurance provides coverage for loss resulting directly from dishonest or fraudulent acts of the insured's employees.¹ A typical fidelity insuring agreement, such as that found in Insuring Agreement (A) of the 1986 Bond, provides coverage for "[l]oss resulting directly from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others."² Typically, fidelity policies do not provide liability coverage; instead, the policies indemnify the insured for its own losses.³ The fidelity policy may define "employee" by category, as in the case of the 1986 Bond,⁴ or by using

¹ See, e.g., Financial Institution Bond, Standard Form No. 24 (rev'd January 1986), reprinted in STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA 1995) [hereinafter 1986 Bond].

² 1986 Bond, Insuring Agreement (A).

³ See, e.g., FDIC v. Ins. Co. of N. Am., 105 F.3d 778, 785 (1st Cir. 1997) (recognizing that fidelity bonds are not liability insurance policies but, instead, provide first party coverage for employee dishonesty); Dixie Nat'l Bank v. Employers Commercial Union Ins. Co. of Am., 759 F.2d 826 (11th Cir. 1985) (where the bank brought an action against its fidelity insurer to recover on its bond for an embezzlement loss caused by the defalcations of a former cashier). See also LEE R. RUSS, ET AL., 11 COUCH ON INSURANCE § 160:7 (3d ed. 1998) (explaining that insureds can recover for direct losses inflicted by employee dishonesty).

⁴ The 1986 Bond defines employee to include:

- (1) an officer or other employee of the Insured, while employed in, at, or by the Insured's offices or premises covered hereunder, and a guest student pursuing studies or duties in any of said offices or premises;
- (2) an attorney retained by the Insured and an employee of such attorney while either is performing legal services for the Insured;
- (3) a person provided by an employment contractor to perform employee duties for the Insured under the Insured's supervision at any of the Insured's offices or premises covered hereunder;
- (4) an employee of an institution merged or consolidated with the Insured prior to the effective date of this bond;

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the traditional criteria of direction and control, as in the Commercial Crime Standard Form CR 10 00 0695.⁵ The Standard Form 24 Financial Institution Bond includes officers and attorneys in its definition of employee, but excludes directors.⁶

Until 1976, the insured merely had to establish that a covered employee acted dishonestly in order to obtain coverage under the most commonly used fidelity policies.⁷ However, beginning in 1976, in response to adverse court decisions broadly interpreting dishonesty, fidelity policies were issued containing a new manifest intent requirement.⁸ Under this new policy language, insureds are required to show that the employee acted dishonestly and that “his dishonest acts have been committed with the manifest intent to cause the insured to sustain a loss, and to obtain a financial benefit for the employee or another person or entity.”⁹

Fidelity bonds are discovery, not claims made policies.¹⁰ As such, the insured’s discovery of the loss triggers the bond’s application. Courts have increasingly held that

⁵ The Crime General Provisions Form CR 10 00 0695 (rev’d 1994) is a form jointly published by the Surety Association of America and the Insurance Services Office, Inc. and is reprinted in STANDARD FORMS, *supra* note 1. This form defines employee as:

- a. Any natural person:
 - (1) While in your service (and for 30 days after termination of service); and
 - (2) Whom you compensate directly by salary, wages or commissions; and
 - (3) Whom you have the right to direct and control while performing services for you; or
- b. Any natural person employed by an employment contractor while that person is subject to your direction and control and performing services for you excluding, however, any such person while having care and custody of property outside the “premises”.
But “employee” does not mean any:
 - (1) Agent, broker, factor, commission merchant, consignee, independent contractor or representative of the same general character; or
 - (2) Director or trustee except while performing acts coming within the scope of the usual duties of an employee.

For a discussion of the definition of employee, see Armen Shahinian & Scott D. Bacon, *Who is a Covered “Employee” Under the Financial Institution Bond*, in FINANCIAL INSTITUTION BONDS 103, 105 (Duncan L. Clore ed., 2nd ed. 1998); see also *Bird v. Centennial Ins. Co.*, 11 F.3d 228 (1st Cir. 1993); *Bank of Cumberland v. Aetna Cas. & Sur. Co.*, 956 F.2d 595 (6th Cir. 1992).

⁶ 1986 Bond, Conditions & Limitations, § 1(g). A fidelity policy may also define “employee” as including directors, but only if they are also officers. See *In Re: World Hospitality Ltd.*, 983 F.2d 650 (5th Cir. 1993); *Charm Promotions, Ltd. v. Travelers Indem. Co.*, 447 F.2d 607 (7th Cir. 1971); *Fletcher L. Yarbrough, et al., Director and Officer and Professional Liability Insurance Issues*, C880 ALI-ABA 535, 573 (1994).

⁷ See, e.g., Michael Keeley, *Employee Dishonesty Claims: Discerning the Employee’s Manifest Intent*, 30 TORT & INS. L.J. 915 (1995); Michael Keeley & Harvey C. Koch, *Employee Dishonesty: The Essential Elements of Coverage Under Insuring Agreement*, in FINANCIAL INSTITUTION BONDS 41, 47 (Duncan L. Clore ed., 2d ed. 1988).

⁸ See *Resolution Trust Corp. v. Fid. & Deposit Co.*, 205 F.3d 615, 638 (3d Cir. 2000); Keeley & Koch, *supra* note 7, at 45-6.

⁹ Keeley & Koch, *supra* note 7, at 47.

¹⁰ See Discussion II(B), (C), *infra*; Director and officer and errors and omissions insurance policies are typically “claims made” policies, being triggered only when a claim is made by a third party against an insured.

the determination of when a loss is discovered should be based on an objective reasonable person test, so that discovery occurs at the earliest date a reasonable person would assume that a covered loss has been or will be incurred.¹¹ In general, discovery may be made by any employee not in collusion with the wrongdoer and general principles of agency apply.¹² Mere suspicion of a loss does not constitute discovery.¹³

The timing of the discovery is critical. When the insured discovers the loss before the commencement of the bond period, such discovery will preclude recovery.¹⁴ Similarly, with respect to claims made by regulators, the issue is often whether the insured actually discovered the claimed loss prior to the failure of the financial institution, thereby triggering the termination of coverage provisions in the standard financial institution Bond.¹⁵

B. DIRECTOR AND OFFICER COVERAGE

Director and officer insurance¹⁶ affords coverage for a corporation's directors and officers in connection with liabilities incurred as part of the corporation's business operations.¹⁷ Although there is no standard policy form as in the case of fidelity policies,

¹¹ See *Royal Trust Bank, N.A. v. Nat'l Union Fire Ins. Co.*, 788 F.2d 719, 721 (11th Cir. 1986) ("discovery occurred when the bank became aware of facts that would cause a reasonable person to assume that a loss covered by the bond had been or would be incurred"); *Utica Mut. Ins. Co. v. Fireman's Fund Ins. Cos.*, 748 F.2d 118, 121-22 (2d Cir. 1984) ("Courts have consistently held that a loss is discovered once an insured has obtained facts that would cause a reasonable person to recognize that there had been dishonesty or fraud resulting in loss."); *Drexel Burnham Lambert Group, Inc. v. Vigilant Ins. Co.*, 595 N.Y.S.2d 999, 1006 (N.Y. App. Div. 1993); *Duncan L. Clore, et al., Issues Arising Out of Claims Against Financial Institution Bonds and Directors and Officers Liability Policies Involving Failed Institutions*, C767 ALI-ABA 101, 109 (1992).

¹² See *City State Bank in Wellington v. United States Fid. & Guar. Co.*, 778 F.2d 1103, 1109, 1110-111 (5th Cir. 1985); *Clore, supra* note 11, at 111.

¹³ *Gulf USA Corp. v. Fed. Ins. Co.*, 259 F.3d 1049, 1058 (9th Cir. 2001); *Resolution Trust Corp. v. Fid. & Deposit Co.*, 205 F.3d at 630 ("the discovery definition requires that the insured possess more than mere suspicions of employee dishonesty or fraud"); *FDIC v. Fid. & Deposit Co.*, 45 F.3d 969, 974 (5th Cir. 1995); *FDIC v. Oldenburg*, 34 F.3d 1529, 1542 (10th Cir. 1994) ("Discovery requires that the insured have more than 'mere suspicion' of loss"); *FDIC v. Aetna Cas. & Sur. Co.*, 903 F.2d 1073, 1079 (6th Cir. 1990) ("discovery of loss does not occur until the insured discovers facts showing that dishonest acts occurred and appreciates the significance of those facts; suspicion of loss is not enough."); *Utica Mut.*, 748 F.2d at 123 ("mere suspicions do not trigger the notice requirement").

¹⁴ Compare *Royal Trust Bank*, 788 F.2d at 721 (where discovery occurred prior to the effective date of the bond, there was no coverage for the claimed loss) with *Home Sav. & Loan v. Aetna Cas. & Sur. Co.*, 817 P.2d 341, 348-51 (Utah Ct. App. 1991) (where the court held that "discovery" for coverage purposes did not occur until after the bond went into effect); *Clore, supra* note 11, at 110.

¹⁵ Section 12 of the 1986 Bond provides for termination of the bond as to any employee as soon as the insured learns of dishonest or fraudulent conduct by that Employee. See also *FDIC v. Aetna*, 903 F.2d at 1079; *California Union Ins. Co. v. Am. Diversified Sav. Bank*, 948 F.2d 556, 563-65 (9th Cir. 1991); *Clore, supra* note 11, at 110. The timing of discovery is also critical as discovery triggers the insured's notice and proof of loss obligations. See *Resolution Trust v. Fid. & Deposit Co.*, 205 F.3d at 631, n.8; *Utica Mut.*, 748 F.2d at 121-22.

¹⁶ Hereinafter D&O insurance.

¹⁷ Wayne E. Borgeest, *Directors and Officers Liability Insurance: A Primer*, 629 PLI/Lit 135, 137 (2000).

traditionally, a D&O policy provided two types of insuring agreements: (1) the corporate reimbursement agreement, which underwrites the corporation's indemnification obligations to its directors and officers; and (2) the director and officer agreement, which affords liability coverage to individual directors and officers for claims against them, in their capacity as directors and officers of the insured corporation, when indemnification from the corporation is not available.¹⁸

D&O policies provide liability coverage for the wrongful acts of directors and officers.¹⁹ An example of a D&O policy definition of wrongful acts is "any breach of duty, neglect, error, misstatement, misleading statement, omission or other act done or wrongfully attempted by the Directors or Officers or any of the foregoing so alleged by any claimant or any matter claimed against them solely by reason of there being such Directors or Officers."²⁰ D&O policies generally pay for loss to the insured arising from third-party claims, loss being typically defined as damages, judgments or settlements (with the prior written consent of the insurer) and defense costs incurred by the insured in defending the legal proceeding.²¹

The traditional D&O policy did not afford coverage for the insured's liability and defense costs. As a result, when the corporation itself was sued along with the individual directors and officers, insureds and insurers would dispute allocation of covered and non-covered loss and covered and non-covered parties. In turn, courts grappled with arguments regarding coverage allocation, as insurers sought, for example, to allocate a portion of a settlement fund to the uninsured corporate entity.²²

¹⁸ *Id.* at 139; William F. Campbell, *Basic Insurance Under Directors' and Officers' Liability Policies*, 454 PLI/Comm 439, 443 (1988); Judy J. Hlafesak, *The Nature and Extent of Subrogation Rights of Fidelity Insurers Against Officers and Directors of Financial Institutions*, 47 U. PITT. L. REV. 727, 733 (1986).

¹⁹ *See, e.g.*, *Wayne County Neighborhood Legal Services v. Nat'l Union Fire Ins. Co.*, 971 F.2d 1 (6th Cir. 1992); *Bank of Commerce & Trust Co. v. Nat'l Union Fire Ins. Co.*, 651 F. Supp. 474, 476 (N.D. Okla. 1986); *Berenson v. World Jai-Alai, Inc.*, 374 So. 2d 35 (Fla. Dist. Ct. App. 1979), *disapproved on other grounds by Tamiami Trail Tours, Inc. v. Cotton*, 463 So. 2d 1126 (Fla. 1985); *Hack v. Standard Accident Ins. Co.*, 88 N.W.2d 424 (Mich. 1958). *See also* Campbell, *supra* note 18, at 450; Yarbrough, *supra* note 6, at 544-45.

²⁰ *Wayne County*, 971 F.2d at 3.

²¹ *See* Paul D. Krause, *Professional Liability Insurance "E&O" and "D&O" Policies*, 673 PLI/Lit 77, 88-9 (2002).

²² In *Nordstrom, Inc., v. Chubb & Son, Inc.*, 54 F.3d 1424 (9th Cir. 1995), for example, the corporation sued its D&O insurer seeking reimbursement for the full amount of a settlement to the plaintiffs in a securities fraud class action brought against both the insured directors and officers and the uninsured corporation. The court held that the D&O insurer was obligated to pay the full settlement amount, but noted that the insurer could thereafter exercise its rights to bring an action for contribution or indemnification. *Id.* at 1433-36. However, in *Pepsico, Inc. v. Continental Cas. Co.*, 640 F. Supp. 656 (S.D.N.Y. 1986) (questioned by *Waltuch v. Conticommodity Servs. Inc.*, 88 F.3d 87 n.8 (2d Cir. 1996)), the court held to the contrary, concluding that the D&O policy required allocation of the settlement costs between those attributable to the insured directors and officers and those attributable to the uninsured corporate entity and its third party accountants. *Id.* at 661-62. *See also* *Atlantic Permanent Fed. Sav. & Loan Ass'n v. Am. Cas. Co.*, 839 F.2d 212 (4th Cir. 1988); *Farmers & Merchants Bank v. Home Ins. Co.*, 514 So. 2d 825 (Ala. 1987); Campbell, *supra* note 18, at 448-49.

However, in the mid-1990's, insurers began writing entity liability coverage. Entity coverage typically provides that the corporation itself is insured under the policy for its own defense costs and liabilities for settlements and judgments with respect to securities claims.²³ Securities claims is a defined term in D&O policies, but essentially comprise legal actions brought pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934.²⁴ Although entity coverage originally was limited to securities claims, insurers now may be extending entity coverage to other types of liability claims.

Unlike fidelity policies, D&O insurance is written on a claims made basis.²⁵ As such, in order to trigger coverage under a D&O policy, a claim against an insured must first be made during the policy period and reported to the insurer in accordance with the policy's terms.²⁶ Generally, a claim is a judicial or other proceeding filed against an insured or a written demand for money damages.²⁷

C. ERRORS AND OMISSIONS COVERAGE

Professional liability insurance also is known as errors and omissions insurance.²⁸ Although there is no standard E&O policy form, in general, an E&O policy affords liability coverage to a person or entity against claims made by third parties alleging acts, errors, or omissions in the rendering of, or failure to render, professional services. Professional services may be defined as "services performed by one in the ordinary course of practice of [one's] profession on behalf of another."²⁹ Not every job is a profession and not all job duties constitute professional services, which have been described as:

[s]omething more than an act flowing from mere employment or vocation . . . [t]he act or service must be such as exacts the use or application of special learning or attainments of some kind. The term "professional" . . . means something more than mere proficiency in the performance of a task and implies intellectual skill as contrasted with that used in an occupation for production or sale of commodities. A "professional" act or service is one arising out of a vocation, calling,

²³ Borgeest, *supra* note 17, at 148; Stacey Kalberman, *Director and Officer Liability: An Overview of Corporate and Insurance Indemnification*, 7 No. 4, ANDREWS SEC. LITIG. & REG. REP. 17 (2001).

²⁴ 15 U.S.C. § 77x-1 (2000); 15 U.S.C. § 78j (2000). *See* Kalberman, *supra* note 23; Borgeest, *supra* note 17, at 148.

²⁵ Nat'l Union Fire Ins. Co. v. Willis, 296 F.3d 336 (5th Cir. 2002); Kalberman, *supra* note 23; Yarbrough, *supra* note 6, at 559.; Campbell, *supra* note 18, at 467; Joseph P. Monteleone, *1996 Coverage Issues Under Commercial General Liability and Directors' and Officers' Liability Policies*, 18 W. NEW ENG. L. REV. 47, 65-66 (1996).

²⁶ *Nat'l Union Fire*, 2002 WL 1369092, at *2 (citing *Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653, 658-59 & n.2 (5th Cir. 1999)); *Resolution Trust Corp. v. Ayo*, 31 F.3d 285, 289 (5th Cir. 1994); *Resolution Trust Corp. v. Artley*, 24 F.3d 1363, 1367-68 (11th Cir. 1994); *Am. Cas. Co. v. Cortinasio*, 17 F.3d 62, 67-69 (3d Cir. 1994).

²⁷ Monteleone, *supra* note 25, at 66.

²⁸ Hereinafter E&O insurance.

²⁹ *Jensen v. Snellings*, 841 F.2d 600, 613 (5th Cir. 1988) (quoting *Aker v. Sabatier*, 200 So. 2d 94, 97 (La. Ct. App. 1967)).

occupation, or employment involving specialized knowledge, labor, or skill, and the labor or skill involved is predominantly mental or intellectual, rather than physical or manual. In determining whether a particular act is of a professional nature or a “professional service” we must look not to the title or character of the party performing the act, but to the act itself.³⁰

Typical E&O insureds include law firms, accounting firms, architectural firms, medical practices, and “individuals who provide professional services on behalf of that business entity.”³¹ Historically, professional liability insurance was designed for learned professionals, namely, attorneys, accountants, physicians, and other professions that require both an advanced academic degree and a license to practice. Now, however, this insurance has expanded to include occupations as diverse as technology consultants and mental health and substance abuse counselors.³²

E&O insurance does not usually include activities of an officer or director, as such, within the scope of professional services, and will exclude from coverage claims arising out of the professional’s activities with any entity other than the insured.³³ If an insured professional is a director or officer of another entity, then claims against that professional will be covered by the E&O policy only where the performance of the professional services for the insured entity is the proximate cause of the harm alleged.³⁴

As with D&O policies, E&O policies are issued on a claims-made basis and therefore afford coverage as to claims first made against an insured during the policy period and reported to the insurer within that same policy period.³⁵ A claim is generally defined as any demand received by the insured for money damages or any suit or arbitration proceeding.³⁶ Unlike D&O policies, E&O policies typically contain a duty to defend clause providing that if any covered claim is made against an insured, the insurer

³⁰ Harad v. Aetna Cas. & Sur. Co., 839 F.2d 979, 984 (3d Cir. 1988) (quoting Marx v. Hartford Accident & Indem. Co., 157 N.W.2d 870, 871-72 (Neb. 1968)); Curtis Ambulance of Florida, Inc. v. Board of County Commrs., 811 F.2d 1371, 1379-80 (10th Cir. 1987); Horn v. Burns & Roe, 536 F.2d 251, 255 (8th Cir. 1976); St. Paul Fire & Marine Ins. Co. v. Three "D" Sales, Inc., 518 F. Supp. 305, 310 (D.N.D. 1981); Noyes Supervision, Inc. v. Canadian Indem. Co., 487 F. Supp. 433, 438 (D. Colo. 1980).

³¹ Krause, *supra* note 21, at 79.

³² Edward J. Zulkey & Ronald L. Ohren, *An Introduction to Commercial and Professional Liability Insurance*, in COMMERCIAL AND PROFESSIONALS LIABILITY INSURANCE 1 (2002).

³³ Yarbrough, *supra* note 6, at 545-46. In turn, D&O policies typically exclude from coverage professional errors and omissions. *Id.* at 546.

³⁴ See Yarbrough, *supra* note 6, at 546. See generally Potomac Ins. Co. v. McIntosh, 804 P.2d 759 (Ariz. Ct. App. 1990) (discussing “proximate cause” of the loss suffered). See also Bowie v. Home Ins. Co., 923 F.2d 705 (9th Cir. 1991) (discussing capacity issues where the insured corporation’s directors were also former directors and officers of an uninsured entity; holding that the individuals were not covered under the E&O policy at issue as they were not sued in their capacity as professionals of the insured entity, but only in their capacity as former directors and officers of the uninsured entity).

³⁵ See Checkrite Ltd. v. Illinois Nat’l Ins. Co., 95 F. Supp. 2d 180 (S.D.N.Y. 2000); Gulf Ins. Co. v. Dolan, Fertig & Curtis, 433 So. 2d 512 (Fla. 1983); Krause, *supra* note 21, at 81; Zulkey & Ohren, *supra* note 32.

³⁶ Krause, *supra* note 21, at 82.

has a duty to defend the entire claim – even if a non-covered claim is also made against the insured.³⁷

E&O policies may soon enjoy the litigation spotlight that D&O insurance came to experience in the 1990's. For example, a high profile case was reported in *The Wall Street Journal* in June 2002, in which Credit Suisse First Boston claimed approximately \$45 million from a group of insurers under its E&O policies.³⁸ As reported, Credit Suisse sought to recoup penalties it paid to regulators when settling charges that it improperly split IPO profits with its customers during the dot.com bubble.³⁹ Similarly, recent announcements by Enron, WorldCom, and other high-profile Wall Street companies of the need to restate their financials, as audited by independent accountants, may also drive E&O insurance into the forefront of insurance litigation.

Finally, federal legislation enacted this past summer in reaction to high profile corporate scandals may give rise to an increase in E&O as well as D&O claims. The Sarbanes-Oxley Act⁴⁰ enhances corporate responsibility, financial disclosure requirements, and corporate fraud accountability to public shareholders. With these heightened requirements and increased culpability, professionals will likely be exposed to the risk of more prolific litigation should they fail to meet these requisite standards.⁴¹

III. Interplays Among These Coverages

A. FIDELITY BONDS AND D&O INSURANCE

When a corporation has both fidelity and D&O coverage, the issue may arise whether and under what circumstances both types of coverage might apply to the same claim, especially as to losses resulting from multiple causes. The issue is presented by the apparently mutually exclusive language of the two policies. As summarized above, fidelity insurance covers loss resulting from intentionally dishonest or fraudulent acts committed by an employee of the insured. The acts of directors acting as such are specifically excluded. In contrast, D&O policies cover essentially negligent acts of directors and officers only and exclude coverage for dishonesty.

³⁷ *Id.* at 86. See *R.C. Bigelow, Inc. v. Liberty Mut. Ins. Co.*, 287 F.3d 242 (2d Cir. 2002) (recognizing that the duty to defend is much broader than the duty to indemnify and does not depend upon whether the plaintiff will successfully maintain a cause of action against the insured but, instead, on whether the complaint has alleged facts which bring the claim within the scope of coverage); *United States Fid. & Guar. Co. v. Federated Rural Elect. Ins. Co.*, 286 F.3d 1216 (10th Cir. 2002); *Charter Oak Fire Ins. Co. v. Hedeem & Cos.*, 280 F.3d 730 (7th Cir. 2002) (duty to defend is broader than duty to indemnify because it is triggered by arguable, as opposed to actual, coverage); *Lawyers Title Ins. Corp. v. JDC (Am.) Corp.*, 52 F.3d 1575 (11th Cir. 1995).

³⁸ Randall Smith, *CS First Boston Sues To Recoup Fines*, WALL ST. J., June 3, 2002, at C1.

³⁹ As reported, CS First Boston brought suit in New York State Court, New York County. *Id.* at C1.

⁴⁰ Pub. L. No. 107-204, 116 Stat. 745-809 (to be codified in scattered sections of 15, 16, 17, and 18 U.S.C.) (July 30, 2002).

⁴¹ See, e.g., Sarbanes-Oxley Act of 2002, § 302 116 Stat. at 777 (to be codified at 15 U.S.C. § 7241); § 1102, 116 Stat. at 807 (to be codified at 18 U.S.C. § 1512); § 802(a), 116 Stat. at 800 (to be codified at 15 U.S.C. § 1519).

The first and pinnacle case addressing the issue of whether the coverages afforded under a fidelity bond and a D&O policy are mutually exclusive was *Eglin National Bank v. Home Indemnity Co.*⁴² Elgin National Bank sued under the fidelity insuring agreement of its banker's blanket bond for loss sustained when its former president, Lewie Tidwell, issued two letters of credit without authorization and without following proper bank procedures.⁴³ Home Indemnity Company denied coverage, alleging that Tidwell's acts were not dishonest or fraudulent within the meaning of its bond, but were merely errors of judgment, bad banking practices, or carelessness.⁴⁴ Home filed a third-party complaint against Tidwell and Tidwell's D&O insurer, International Insurance Company.⁴⁵

The relevant provisions of Home's bond stated that Home would indemnify the bank for "(l)oss through any dishonest or fraudulent act of any of the Employees" of the bank. International's D&O policy insured Tidwell himself (not the bank) for any claims against him for defined wrongful acts.⁴⁶ International's D&O policy specifically excluded from coverage, however, any claims against Tidwell for "active and deliberate dishonesty committed . . . with actual dishonest purpose and intent."⁴⁷

In affirming the district court's decision that the exclusion in the D&O policy was co-extensive with the coverage provided by the bond so that, as a matter of law, every loss covered by the bond is by definition excluded from coverage by the D&O policy, the Fifth Circuit noted that case law has "universally recognized that for there to be liability on the bond, there must be something more than negligence, mistake, carelessness, or incompetence."⁴⁸ Rather, there must be "willfulness and an intent to deceive . . . for an employee's acts to be 'dishonest and fraudulent'" under the bond.⁴⁹

Consequently, the Fifth Circuit determined that for Home to be liable, a jury must determine that Tidwell's acts were done willfully and with the intent to deceive the bank. Such a finding by the jury would thereby trigger the exclusion contained in International's D&O policy because, "[a] finding of liability against Home requires a finding of dishonesty because Home's blanket bond covered only dishonesty. Thus, International automatically excludes liability for acts which must be present for recovery against Home."⁵⁰ In short, the Fifth Circuit found the fidelity and D&O policies to be mutually exclusive.

At least one commentator has suggested that the coverage analysis in *Eglin* should not apply to claims involving dishonest conduct by one or more individuals, coupled with

⁴² 583 F.2d 1281 (5th Cir. 1978).

⁴³ *Id.* at 1283.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 1284.

⁴⁸ *Id.* at 1285.

⁴⁹ *Id.*

⁵⁰ *Id.* at 1288.

negligent conduct by others.⁵¹ This same argument was raised in *Fidelity National Bank of Baton Rouge v. Aetna Casualty & Surety Co.*⁵² Fidelity National Bank filed an action against Aetna on its fidelity bond to recover losses incurred by the bank allegedly caused by the fraudulent activities of a third party, Great American Distributing Co.⁵³ Aetna denied coverage under several policy exclusions. Aetna also filed a third-party demand against the bank's D&O liability insurer, MGIC Indemnity Corporation.⁵⁴ Aetna alleged that the bank's loss was caused, in part or in whole, by the negligence of the bank's own officers and directors, who should have anticipated the fraudulent activities of GADC, prevented them, or at least discovered the fraud earlier to prevent additional loss.⁵⁵

The *Fidelity National* court rejected any application of the Fifth Circuit's decision in *Eglin* to the facts at issue. In so ruling, the court noted that the *Eglin* court was considering the activities of only one tortfeasor whose actions must necessarily have been classified as either fraudulent or negligent.⁵⁶ In *Fidelity National*, however, the loss was alleged to have been caused by the actions of two separate groups of tortfeasors, the fraudulent activities of GADC and the negligent activities of the bank's officers and directors. In noting this distinction, the court went on to state that if the negligent acts of the bank's officers and directors "either by themselves or combined with the activities of some other person, caused the loss to the Bank, then the MGIC policy [would] provide coverage for that loss."⁵⁷

Apart from the issue of whether fidelity and D&O coverages overlap or are mutually exclusive, there may be instances in which neither policy will cover losses caused by wrongful acts of corporate officers or employees. For example, an officer may commit a dishonest act, but not with the "manifest intent to cause the insured to sustain a loss, and to obtain a financial benefit for the employee or another person or entity."⁵⁸ Under those circumstances, it would seem that the officer would not be afforded coverage under the D&O policy, as the dishonesty exclusion would prohibit such coverage. At the same time, the officer's acts would not be covered under a fidelity policy containing manifest intent language as that requirement would not be met.⁵⁹

⁵¹ Gilbert J. Schroeder, *Handling the Complex Fidelity or Financial Institution Bond Claim: the Liability of the Insured's Officers and Directors and Their D&O Carrier*, 21 TORT & INS. L.J. 269, 276 (1986).

⁵² 584 F. Supp. 1039 (M.D. La. 1984).

⁵³ Hereinafter GADC.

⁵⁴ Hereinafter MGIC.

⁵⁵ *Id.* at 1042.

⁵⁶ *Id.* at 1050 n.18.

⁵⁷ *Id.*

⁵⁸ 1986 Bond, Insuring Agreement (A). See, e.g., *Gen. Analytics Corp. v. CNA Ins. Co.*, 86 F.3d 51 (4th Cir. 1996) (viewing question of whether wrongdoer had the "manifest intent" as determinative of fidelity policy coverage); *Resolution Trust Corp. v. Fid. & Deposit Co.*, 205 F.3d at 637-44; Schroeder, *supra* note 51, at 276-77; and *Keeley & Koch*, *supra* note 7, at 47.

⁵⁹ See *Clore*, *supra* note 11, at 126; *Schroeder*, *supra* note 51, at 288; Theodore A. Boundas, *D&O Coverage*, C456 ALI-ABA 363, 392-93 (1989).

B. COVERAGE UNDER D&O AND E&O INSURANCE POLICIES

An interesting interplay between D&O and E&O insurance policies might occur when an insured is not only a director or officer of the corporation, but also a professional under an E&O policy, such as a corporate general counsel who is also a director. D&O policies cover only those wrongful acts committed by a director or officer in his or her capacity as such.⁶⁰ E&O policies cover wrongful acts committed within the scope of one's professional services.⁶¹ As such, both policies arguably would cover the director/general counsel, although capacity arguments would certainly be raised by both insurers.

Though not precisely these facts, a similar scenario implicating these two types of policies was discussed in *Federal Savings & Loan Insurance Corp. v. Mmahat*.⁶² In *Mmahat*, the FSLIC, as receiver of Gulf Federal Savings Bank, brought an action to recover damages incurred by the bank as a result of conduct by the bank's former officers, directors and lawyers. At issue was the conduct of John Mmahat individually and his law firm, Mmahat & Duffy. Mmahat had been the bank's attorney and one of its directors.

Among the issues submitted to the court for consideration was the application of the two insurance policies in question: a professional liability policy issued by New England Insurance Company⁶³ to Mmahat & Duffy, and a D&O policy issued by American Casualty to the bank.⁶⁴ Both policies contained a dishonesty exclusion which the insurers argued precluded recovery.

The court first focused on the New England E&O policy and its application to Mmahat's conduct. A jury had found Mmahat in breach of his fiduciary duties as an attorney. When determining the application of the dishonesty exclusion within that policy, the court found that breach of a fiduciary duty was a dishonest act within the meaning of the policy. The court further found that Mmahat's wrongful acts were deliberate and intentional. Consequently, the court held that no coverage was afforded to Mmahat under the New England E&O policy.⁶⁵

The court then focused on the American Casualty D&O policy. Mmahat argued that the jury's finding of breach of fiduciary duty as an attorney foreclosed a finding that he likewise breached his duties as a director of the bank to vitiate coverage under the American Casualty policy. The court disagreed. The American Casualty policy, like the

⁶⁰ See, e.g., *Bank of Commerce & Trust Co. v. Nat'l Union Fire Ins. Co.*, 651 F. Supp. 474 (N.D. Okla. 1986); *Berenson v. World Jai-Alai, Inc.*, 374 So. 2d 35 (Fla. Dist. Ct. App. 1979), *disapproved on other grounds by Tamiami Trail Tours, Inc. v. Cotton*, 463 So. 2d 1126 (Fla. 1985); *Hack v. Standard Accident Ins. Co.*, 88 N.W.2d 424 (Mich. 1958). See also *Campbell*, *supra* note 18, at 450; *Yarbrough*, *supra* note 6, at 544-45.

⁶¹ *Jensen v. Snellings*, 841 F.2d 600, 613 (5th Cir. 1988).

⁶² 97 B.R. 293 (E.D. La. 1988), *aff'd in part, remanded in part*, 907 F.2d 546 (5th Cir. 1990).

⁶³ Hereinafter New England.

⁶⁴ 97 B.R. at 297.

⁶⁵ *Id.* at 298-99.

New England policy, contained a dishonesty exclusion which the court found applicable to Mmahat's conduct. The court further found that "Mmahat's dishonesty as [a] director was an integral part of his dishonesty as [a] lawyer. He clearly used his position on the board in furtherance of his legal business to an extent beyond any legally acceptable point."⁶⁶ The court further explained:

Because Mmahat's liability herein arises in the context of his dual role as a director and attorney for [the bank], the Court also questions whether the loss at issue arises "solely" from his capacity as [a] director. From the size of its verdict, it is apparent the jury found the full extent of the losses here at issue attributable to the actions of Mmahat and the law firm as attorneys. Thus, the losses here at issue cannot be said to have arisen solely from Mmahat's actions as a director Because the Court concludes that Mmahat committed a dishonest act with deliberate purpose and intent, the Court concludes a denial of coverage under the New England policy and *a fortiori* under the American policy is appropriate under *Eglin National Bank v. Home Indemnity Co.*⁶⁷

Consequently, although the *Mmahat* court entertained the notion that both of the E&O and D&O policies could have covered Mmahat given his dual roles, it ruled that the intentional nature of his conduct triggered similar exclusions in each policy.⁶⁸

Dual capacity officers, directors and professionals seeking coverage under both D&O and E&O policies would likely face allocation issues as a result of the policies' "other insurance" clauses. Both D&O and E&O policies typically contain exclusions for losses in connection with any claim made against an insured if the loss is insured by any other existing, valid policy or policies under which payment of the loss is actually made. While there seem to be no reported cases dealing with the interplay between other insurance clauses in D&O and E&O policies, numerous decisions have addressed this issue in the context of other types of coverage, including competing E&O policies.⁶⁹ The reasoning in these decisions should provide guidance on how a court would resolve competing other insurance clauses in the context of D&O and E&O policies.⁷⁰

⁶⁶ *Id.* at 299.

⁶⁷ *Id.*

⁶⁸ See also *Bowie v. Home Ins. Co.*, 923 F.2d 705 (discussing capacity issues where the directors of the insured entity under an E&O policy were also former directors and officers of an uninsured entity, holding that the directors were not entitled to coverage under the E&O policy as they were not sued in their capacity as professionals of the insured entity).

⁶⁹ See, e.g., *Allstate Ins. Co. v. Chicago Ins. Co.*, 676 So. 2d 271 (Miss. 1996) (competing "other" insurance clauses in two professional liability policies); *St. Paul Mercury Ins. Co. v. Pennsylvania Cas. Co.*, 642 F. Supp. 180 (D. Wy. 1986). See also *Home Ins. Co. v. St. Paul Fire & Marine Ins. Co.*, 229 F.3d 56 (1st Cir. 2000) (where competing clauses in two professional liability policies were between an "other" insurance clause and a "prior acts" clause with "other insurance" language).

⁷⁰ These clauses have been addressed, for example, in the context of competing medical malpractice insurance policies (*Penton v. Hotho*, 601 So. 2d 762 (La. Ct. App. 1992)); general liability insurance policies (*Fireman's Fund Ins. Co. v. Maryland Cas. Co.*, 65 Cal. App. 4th 1279 (Cal. Ct. App. 1998)); and

When construing other insurance clauses, courts frequently hold that if both applicable policies contain similar other insurance clauses providing that the risk should be apportioned *pro rata*, then there is no conflict between the policies and coverage is apportioned between the policies on a *pro rata* basis.⁷¹ If both policies contain excess other insurance clauses, then courts find those clauses mutually repugnant and the clauses are disregarded. In such cases, the loss at issue will again be apportioned *pro rata* between the policies.⁷²

However, there is a split among the circuits in cases where one policy contains an excess other insurance clause and the other policy a *pro rata* other insurance clause.⁷³ Some courts find that the policy containing the *pro rata* clause should be applied first, up to its stated limit, and the policy with the excess other insurance clause should be applied only after the former has been exhausted. For example, the Tenth Circuit reached this conclusion in *Fireman's Fund Insurance Co. v. Underwriters Insurance Co.*⁷⁴ by giving full effect to the language of both the excess and *pro rata* clauses of the two applicable insurance policies.⁷⁵ The Tenth Circuit held that the *pro rata* policy should be used until its limit of liability was exhausted and held that the insurer with the excess clause was absolved of liability until the first policy was exhausted.⁷⁶

Other courts resolve the issue of conflicting other insurance clauses by following what has become known as the Oregon Rule.⁷⁷ That rule derives from *Lamb-Weston*,

property insurance policies (*Fireman's Fund Ins. Co. v. Underwriters Ins. Co.*, 389 F.2d 767 (10th Cir. 1968)).

⁷¹ See, e.g., *Home Ins. Co. v. St. Paul Fire & Marine Ins. Co.*, 229 F.3d at 61; *Tarolli v. Continental Cas. Co.*, 581 N.Y.S.2d 510 (N.Y. App. Div. 1992).

⁷² See, e.g., *Home Ins. Co. v. St. Paul Fire & Marine Ins. Co.*, 229 F.3d at 61; *Fireman's Fund Ins. Co. v. Maryland Cas. Co.*, 65 Cal. App. 4th 1279 (Cal. Ct. App. 1998); *Allstate Ins. Co. v. Chicago Ins. Co.*, 676 So. 2d 271 (Miss. 1996); Howard M. Garfield, *Other Insurance and Operations of Limits and Deductibles*, 454 PLI/Comm 503, 507-08 (1988).

⁷³ David P. Van Knapp, Annotation, *Resolution of Conflicts, in Non-Automobile Liability Insurance Policies, Between Excess or Pro-Rata "Other Insurance" Clauses*, 12 A.L.R. 4th 993, 997 (1982); Garfield, *supra* note 72, at 508-09.

⁷⁴ 389 F.2d 767 (10th Cir. 1968).

⁷⁵ *Id.* at 768.

⁷⁶ See, e.g., *P. L. Kanter Agency, Inc. v. Cont'l Cas. Co.*, 541 F.2d 519 (6th Cir. 1976); *Fireman's Fund Ins. Co. v. Underwriters Ins. Co.*, 389 F.2d 767 (10th Cir. 1968); *St. Paul Mercury Ins. Co. v. Penn. Cas. Co.*, 642 F. Supp. 180 (D. Wyo. 1986) (where competing E&O policies were at issue, court held that the "excess" coverage clause of one policy would be given effect over the "pro rata" clause in the other policy); *Ins. Co. of N. Am. v. Am. Home Assurance Co.*, 391 F. Supp. 1097 (D. Colo. 1975); *Early Settlers Ins. Co. v. Selected Risks Ins. Co.*, 346 F. Supp. 1272 (E.D. Va. 1972); *United States Fid. & Guar. Co. v. Slifkin*, 200 F. Supp. 563 (N.D. Ala. 1961); *General Aviation Supply Co. v. Ins. Co. of N. Am.*, 181 F. Supp. 380 (E.D. Mo. 1960), *aff'd*, 283 F.2d 590 (8th Cir. 1960); *Arkansas Grain Corp. v. Certain Underwriters at Lloyd's*, 402 S.W.2d 118 (Ark. 1966); *Jones v. Medox, Inc.*, 430 A.2d 488 (D.C. 1981); *Spink v. Mercury Ins. Co.*, 260 S.W.2d 757 (Mo. Ct. App. 1953); *Atlantic Mut. Ins. Co. v. Continental Nat'l Am. Ins. Co.*, 302 A.2d 177 (N.J. Super. Ct. Law Div. 1973); *New Jersey Asphalt & Paving Co. v. Mutual Boiler Ins. Co.*, 88 A.2d 680 (N.J. Super. Ct. Law Div. 1952); *State Farm Fire & Cas. Co. v. St. Paul Fire & Marine Ins. Co.*, 268 N.W.2d 147 (S.D. 1978); *General Ins. Co. v. State Farm Ins. Co.*, 449 P.2d 391 (Wash. 1969); *General Ins. Co. of Am. v. Rocky Mountain Fire & Cas. Co.*, 423 P.2d 537 (Wash. 1967); *Farmers Home Ins. Co. v. Ins. Co. of N. Am.*, 583 P.2d 644 (Wash. Ct. App. 1978).

⁷⁷ Van Knapp, *supra* note 73, at 1007.

Inc. v. Oregon Auto Insurance Co.,⁷⁸ where the court held that when two insurers' respective other insurance clauses conflict, "regardless of the nature of the clause, they are in fact repugnant and each should be rejected in toto."⁷⁹ As a result, the Oregon Rule dictates that when two applicable policies contain such other insurance clauses, the conflicting policies will both provide coverage in their respective proportionate shares.⁸⁰

C. CLAIMS ON ALL THREE POLICIES

There are, of course, circumstances where the same facts could trigger all three coverages. While invoking multiple insurance policies creates the potential for making additional policy limits available, it also adds complexity to a coverage analysis and may position policies against each other.

If the policies are with different insurers, there is the potential for disputes between carriers, who may resort to declaratory judgment actions seeking contribution from each other and resolution of allocation claims between covered and non-covered loss, and covered and non-covered parties.⁸¹ Multiple policies and multiple carriers could also raise a question as to which and how much of the deductibles an insured should pay under these policies. For example, each insurer would certainly argue that its deductible applied in full, regardless of the insured's other deductibles.

⁷⁸ 341 P.2d 110 (Or. 1959).

⁷⁹ *Id.* at 119.

⁸⁰ Courts following the Oregon Rule include *Home Ins. Co. v. St. Paul Fire & Marine Ins. Co.*, 229 F.3d 56 (1st Cir. 2000); *Lincoln Elec. Co. v. St. Paul Fire & Marine Ins. Co.*, 210 F.3d 672 (6th Cir. 2000); *Am. Alliance Ins. Co. v. IARW Ins. Co., Ltd.*, 165 F.3d 558 (7th Cir. 1999); *St. Paul Mercury Ins. Co. v. Lexington Ins. Co.*, 78 F.3d 202 (5th Cir. 1996); *Gen'l Accident Fire & Life Assur. Corp. v. Cont'l Cas. Co.*, 287 F.2d 464 (9th Cir. 1961); *Housing Group v. Gerling Am. Ins. Co., Inc.*, 107 F. Supp. 2d 1185 (N.D. Cal. 2000); *Attorneys Liab. Protection Soc. v. Reliance Ins. Co.*, 117 F. Supp. 2d 1114 (D. Kan. 2000); *United States Fid. & Guar. Co. v. Treadwell Corp.*, 58 F. Supp. 2d 77 (S.D.N.Y. 1999); *Colony Ins. Co. v. Pinewoods Enters., Inc.*, 29 F. Supp. 2d 1079 (E.D. Mo. 1998); *Galen Health Care, Inc. v. Am. Cas. Co.*, 913 F. Supp. 1525 (M.D. Fla. 1996); *St. Paul Mercury Ins. Co. v. Lexington Ins. Co.*, 888 F. Supp. 1372 (S.D. Tex 1995); *Schwinn Cycling & Fitness, Inc. v. Hartford Accident & Indem. Co.*, 863 F. Supp. 784 (N.D. Ill. 1994); *Pac. Indem. Co. v. Bellefonte Ins. Co.*, 95 Cal. Rptr. 2d 911 (Cal. Ct. App. 2000); *Fireman's Fund Ins. Co. v. Maryland Cas. Co.*, 77 Cal. Rptr. 2d 296 (Cal. Ct. App. 1998); *Allstate Ins. Co. v. TIG Ins. Co.*, 711 So. 2d 84 (Fla. Dist. Ct. App. 1998); *Home Ins. Co. v. Liberty Mut. Ins. Co.*, 641 N.E.2d 855 (Ill. Ct. App. 1994); *Penton v. Hotho*, 601 So. 2d 762 (La. Ct. App. 1992); *Pioneer State Mut. Ins. Co. v. TIG Ins. Co.*, 581 N.W.2d 802 (Mich. Ct. App. 1998); *Carter-Wallace, Inc. v. Admiral Ins. Co.*, 712 A.2d 1116 (N.J. 1998); *In re Liquidation of Midland Ins. Co.*, 709 N.Y.S.2d 24 (N.Y. App. Div. 2000); *New York Convention Ctr. Operating Corp. v. Morris Cerullo World Evangelism, Inc.*, 704 N.Y.S.2d 211 (N.Y. App. Div. 2000); *Nat'l Union Fire Ins. Co. v. Hartford Ins. Co.*, 677 N.Y.S.2d 105 (N.Y. App. Div. 1998); *Am. Cas. Co. v. PHICO Ins. Co.*, 702 A.2d 1050 (Pa. 1997); *Oelhafen v. Tower Ins. Co.*, 492 N.W.2d 321 (Wis. Ct. App. 1992).

⁸¹ *See, e.g., Am. Simmental Ass'n v. Coregis Ins. Co.*, 282 F.3d 582 (8th Cir. 2002) (allowing an E&O insurer to recover sixty percent of its payment on a contribution claim against the insured's commercial general liability carrier); *Am. Cont'l Ins. Co. v. Am. Cas. Co.*, 86 Cal. Rptr. 2d 560 (Cal. Ct. App. 1999) (where American Continental paid a settlement on behalf of its insured and then brought an action for declaratory relief seeking reimbursement from American Casualty for a portion of that settlement); *Allstate Ins. Co. v. Chicago Ins. Co.*, 676 So. 2d 271 (Miss. 1996) (where insurers sought declaratory judgment when both had competing E&O policies with "excess" other insurance clauses).

If the policies are with the same insurer, then the insurer will likely cite to the common policy exclusions which limit the application of each policy, such as E&O and D&O policies which specifically exclude from coverage those claims covered under a fidelity bond. The decision in *SEC v. Credit Bancorp, Ltd.*,⁸² illustrates one court's analysis of the interplay between fidelity, D&O, and E&O coverage issued by a single insurer. In *SEC v. Credit Bancorp*,⁸³ Lloyd's provided Credit Bancorp with a blended policy combining these three types of coverage. The SEC had filed a complaint against CBL, its former chairman and CEO, and others, alleging fraud which resulted in significant loss to CBL customers. A receiver was appointed to marshal CBL's assets and the receiver filed a third-party complaint against Lloyds and CBL's excess insurers. In answering the complaint, the insurers raised numerous affirmative coverage defenses and later sought summary judgment on several coverage issues.

On the issue of fidelity coverage, Lloyd's argued that coverage did not extend to CBL's former chairman and CEO, because he was CBL's alter ego rather than an employee, because he could not be governed and directed.⁸⁴ The court, following the clear and unambiguous terms of the policy, noted that the definition of employee in the policy did not require that CBL have the right to govern and direct the employee, nor did it exclude employees from coverage if they controlled CBL. In holding that the alter ego defense failed as a matter of law, the court further noted that if Lloyd's had wanted to add the govern and direct language to the policy, it could have done so.⁸⁵

Lloyd's also sought a dismissal of the D&O and E&O claims.⁸⁶ Lloyd's argued that all "losses arising out of any intentional conduct" are excluded, by definition, from the type of wrongful act covered by the D&O and E&O sections of the policy.⁸⁷ The issue was whether non-excluded, non-negligent conduct was covered under these two insuring agreements.⁸⁸ Again, the court looked to the policy's clear language.⁸⁹ The court found that the E&O coverage provision expressly excluded certain intentional conduct, thereby implying that other intentional conduct – i.e., non-negligent conduct – was not excluded. The court explained,

There would be no need for these specific exclusions if all intentional acts were excluded by the "Wrongful Act" definition. As one court has found with respect to similar policy language, "[t]he presence of these exclusions covering specific types of intentional conduct suggests [the insurance

⁸² 147 F. Supp. 2d 238 (S.D.N.Y. 2001).

⁸³ Hereinafter CBL.

⁸⁴ 147 F. Supp. 2d at 258.

⁸⁵ *Id.* at 261.

⁸⁶ *Id.* at 263.

⁸⁷ *Id.*

⁸⁸ *Id.* at 264.

⁸⁹ *Id.* at 263-65.

company] understood other types of intentional misconduct to be covered by the policy.⁹⁰

The court also determined that the D&O and E&O sections contained non-imputation clauses; that is, no wrongful act of one shall be imputed to another for purposes of determining the applicability of certain exclusions.⁹¹ Therefore, the court rejected Lloyd's attempt to extend exclusions to other insureds whose conduct did not, for example, give rise to the level of fraud.⁹² Consequently, the insured was allowed to proceed under all three types of coverage provided by the blended policy.

IV. Salvage Issues Presented By Multiple Coverages

A. RECOVERY BY THE FIDELITY INSURER AGAINST DIRECTORS AND OFFICERS

To the extent a fidelity insurer makes payment under its bond, it may want to pursue reimbursement from the persons or entities that actually caused the covered loss. A fidelity insurer's salvage rights may arise by any of three theories: assignment,⁹³ subrogation⁹⁴ or indemnity.⁹⁵ When the persons causing the loss are the insured's own officers and directors, the surety's salvage rights under these theories of recovery vary depending on the jurisdiction and the nature of the directors or officers' wrongdoing.

Although fidelity policies often provide for assignment of the insured's claims to the insurer,⁹⁶ such an assignment is not always enforceable. Some states follow the rule that prior to judgment, only a cause of action which is not based on a personal tort is assignable.⁹⁷ Other courts distinguish between tort claims, which are not assignable, and contract claims, which are.⁹⁸ Yet other jurisdictions allow assignment of claims for injury to property but not personal injury claims.⁹⁹ Elsewhere, all claims are freely assignable.¹⁰⁰ Clearly, the assignability of an insured's dishonesty or fraud claims against its employers will be a matter of local law, the nuances of which are beyond the scope of this article.

⁹⁰ *Id.* at 264 (quoting *Indep. Sch. Dist. No. 697, Eveleth v. St. Paul Fire & Marine Ins. Co.*, 515 N.W.2d 576 (Minn. 1994)).

⁹¹ *SEC v. Credit Bancorp, Ltd.*, 147 F. Supp. 2d at 265.

⁹² *Id.* at 265-66.

⁹³ Section 7(a) of the 1986 Bond expressly requires the insured to assign its rights and causes of action to the insurer upon payment of covered claims.

⁹⁴ Section 7(b) of the 1986 Bond acknowledges that the insurer is subrogated to all of the insured's recovery rights.

⁹⁵ *See, e.g., Fid. & Deposit Co. v. Williams*, 699 F. Supp. 897, 899-900 (S.D. Ga. 1988).

⁹⁶ *See, e.g., Section 7(a) of the 1986 Bond.*

⁹⁷ *See Aaron v. Allstate Ins. Co.*, 559 So. 2d 275, 277 (Fla. Dist. Ct. App. 1990).

⁹⁸ *Akman Services Corp. v. Samuel H. Bullock, P.C.*, 925 F. Supp. 252, 257, *aff'd*, 124 F.3d 185 (D.N.J. 1996).

⁹⁹ *Zabelle v. Coratolo*, 816 F. Supp. 115, 116 (D. Conn. 1993).

¹⁰⁰ *See, e.g., Aetna Cas. & Sur. Co. v. Pendleton Detectives*, 969 F. Supp. 415, 419 (S.D. Miss. 1997).

A fidelity insurer's potential indemnity rights against the insured's dishonest employees result from the historical, suretyship roots of fidelity insurance.¹⁰¹ Consequently, just as sureties have a right of indemnification from their defaulting principals, some courts have held that fidelity insurers are entitled to indemnity from unfaithful employees and principals for amounts paid on their fidelity bonds.¹⁰²

Subrogation is a more commonly used theory of recovery for a fidelity insurer. However, there is a split in authority as to when a subrogated fidelity insurer can recover from the insured's officers and directors. A majority of the courts have held that a fidelity insurer has no right of action against the insured's individual directors and officers absent evidence of fraud, dishonesty, or bad faith by these individuals. These cases focus on a balancing of the equities and on which party has superior equities. "Emphasizing the equitable nature of subrogation, these courts reason that, as between the negligent third party and the compensated surety, equity does not require that the surety be allowed to proceed."¹⁰³

One of the early decisions using this approach is *First National Bank of Columbus v. Hansen*.¹⁰⁴ First National Bank filed suit to recover under two fidelity bank bonds. In turn, the bank's insurers filed third-party subrogation claims against the bank's directors and officers who responded with motions to dismiss. The court acknowledged that subrogation "rests on the equitable principle that one, other than a volunteer, who pays for the wrong of another should be permitted to look to the wrongdoer." The court also agreed that "upon payment of the loss caused by the wrongful acts of a bonded employee, a fidelity insurer becomes subrogated to any right of action the employer may have against the defrauding employee."¹⁰⁵ However, the court observed that generally, a fidelity insurer will not be subrogated to the rights of its insured unless the equities favor the insurer.¹⁰⁶

Whereupon, the court in *Hansen* ruled that the balance of the equities would not permit the fidelity insurers to enforce the bank's claim of negligence against its own officers and directors. The court explained,

¹⁰¹ See James A. Knox, Jr., *Salvage*, in FINANCIAL INSTITUTION BONDS 501, 510-11 (Duncan L. Clore ed., 2d ed. 1988) (citing RESTATEMENT (THIRD) SURETYSHIP AND GUARANTY §§ 1(3)(a), (b), Comment q (1996)); see also *FDIC v. Ins. Co. of N. Am.*, 105 F.3d 778, 786 (1st Cir. 1997) (recognizing the difference between a "classic insurer and that of surety/guarantor" is that an insurer must bear the ultimate loss while a surety is entitled to indemnity).

¹⁰² See, e.g., *Fireman's Fund Ins. Co. v. Nizdil*, 709 F. Supp. 975, 976-77 (D. Or. 1989) (sureties on public official fidelity bonds were entitled to indemnity against the principal for the amounts they paid) (citing *Commercial Ins. Co. of Newark, N.J. v. Pacific-Peru Constr. Corp.*, 558 F.2d 948, 953 (9th Cir. 1977) (allowing surety to be reimbursed under the terms of an indemnity agreement)); *Fid. & Deposit Co. v. Williams*, 699 F. Supp. 897, 899-900 (N.D. Ga. 1988) (fidelity insurer was entitled to indemnification from the insured's dishonest employee for the amount it had paid on its fidelity bond).

¹⁰³ Yarbrough, *supra* note 6, at 575.

¹⁰⁴ 267 N.W.2d 367, 371 (Wis. 1978).

¹⁰⁵ *Id.* at 370.

¹⁰⁶ *Id.* at 371.

We think the equitable principles which deny an insurer the right of subrogation against its own insured are also applicable here. In this case the negligence of the bank in permitting Hansen's wrongful acts to go undiscovered is but the negligence of its officers and directors whose duty is to supervise the operations of the bank. Since the bonding companies have no claim based on negligence against the bank, we hold that equity will not permit the fidelity insurer to avoid that result by suing the officers and directors individually Though the bonding companies do not here assert the negligence of these officers and directors as a defense to liability upon the bond, the fact that the negligence of the bank's agents is a risk assumed by the fidelity insurer in exchange for the premium also enters into the balance of equities in determining whether a right of subrogation is appropriate. The bonding companies have assumed the risk of that negligence which is imputable to the bank, and we conclude, therefore, that the bonding companies may not avoid that risk simply by paying on the bond and suing these officers and directors as individuals thereafter.¹⁰⁷

The *Hansen* court concluded by noting that the bonding companies had not alleged that the directors participated in the wrongdoing or that their neglect of duty was tantamount to fraud or bad faith. If the directors had been proven guilty of more than mere negligence, or if the directors received some benefit as individuals from the wrongdoer, then the court opined that the balance of the equities would shift to the fidelity insurer and a right of subrogation against the offending director(s) would have been proper.¹⁰⁸ Absent such proof, the "lack of ordinary care by the directors and officers of the insured does not give the fidelity insurer, who is paid to assume this risk, an equitable position superior to that of the officers and directors of the bank."¹⁰⁹

The *Hansen* decision has been influential. For example, in *Dixie National Bank of Dade County v. Employers Commercial Union Insurance Co. of America*,¹¹⁰ the Eleventh Circuit relied upon *Hansen* to hold that a bank's fidelity insurer could not recover from the bank's individual directors or the directors' insurer under a D&O policy in the absence of actual knowledge on the part of the directors of the underlying embezzlement, dishonest purpose, or furtive design that caused the fidelity loss.

After certifying questions to the Florida Supreme Court, which agreed with the *Hansen* decision and adopted its equitable principles,¹¹¹ the Eleventh Circuit in *Dixie National* affirmed a summary judgment in favor of the directors of the bank and the D&O carrier. The court held that "[e]ven if the directors were grossly negligent in failing to

¹⁰⁷ *Id.* at 372.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ 759 F.2d 826 (11th Cir. 1985).

¹¹¹ *Dixie Nat'l Bank v. Employers Commercial Union Ins. Co.*, 463 So. 2d 1147 (Fla. 1985).

detect and/or prevent the embezzlement," the fidelity insurer would not be able to recover.¹¹²

A minority of courts have declined to follow the *Hansen* rationale and have allowed a surety to pursue subrogation claims against the insured's negligent directors and officers. For example, in *Manufacturers Bank & Trust Co. of St. Louis v. Transamerica Insurance Co.*,¹¹³ the court allowed the surety to bring an action against two bank officers for their negligent handling of loan transactions. Rejecting the balancing of the equities approach set forth by *Hansen*, the court simply refused to deny the surety its ordinary recourse as a subrogee, stating "[c]learly the Bank has a cause of action against the negligent acts of its directors and officers. Denying subrogation would confuse the Bank as a corporate entity with its agents."¹¹⁴

The court in *Manufacturers Bank* then held that the better reasoning, permitting subrogation, was that expressed in *Federal Deposit Insurance Corp. v. National Surety Corp.*,¹¹⁵ which allowed a subrogated surety to pursue third parties "whose wrongs have compelled the surety or insurance company to make payment."¹¹⁶ As the *National Surety* court stated:

This principle is sound, for if an insurance company pays on a bond it should "step into the shoes" of the corporation and should be able to assert claims of the corporation against third parties. To hold otherwise would mean that if the bonds covered the total loss of the corporation, no one would have a cause of action against third parties such as the directors who may have contributed to the loss. The corporation could not sue because it would be fully reimbursed, and the insurance companies could not sue because they would have no standing.¹¹⁷

A salvage claim by a fidelity carrier against the insured's directors or officers may, of course, raise D&O coverage issues. Whether the directors and officers will be covered by their D&O insurance for such a claim depends not only upon the precise nature of the dishonesty or fraud at issue, but also upon the Insured v. Insured exclusion contained in D&O policies. That exclusion serves to prohibit coverage for those claims brought by one insured, or the subrogated fidelity insurer standing in the shoes of the insured corporation, against another insured, the individual directors and officers. Consequently, the Insured v. Insured exclusion has been applied to preclude D&O insurance coverage for actions brought by the FDIC, standing in the shoes of a bank,

¹¹² 759 F.2d at 828. See also *Home Indem. Co. v. Shaffer*, 860 F.2d 186 (6th Cir. 1988); *Employers Ins. v. Doonan*, 712 F. Supp. 1368 (C.D. Ill. 1989); *FSLIC v. Aetna Cas. & Sur. Co.*, 696 F. Supp. 1190 (E.D. Tenn. 1988); *Employers Ins. v. Doonan*, 664 F. Supp. 1220 (C.D. Ill. 1987).

¹¹³ 568 F. Supp. 790 (E.D. Mo. 1983).

¹¹⁴ *Id.* at 792.

¹¹⁵ 434 F. Supp. 61, 63 (E.D.N.Y. 1977).

¹¹⁶ *Id.* at 63.

¹¹⁷ *Id.*

against the bank's directors and officers, and by a bankruptcy trustee, standing in the shoes of the debtor corporation, against that corporation's directors and officers.¹¹⁸

There appear to be no reported cases addressing the application of the Insured v. Insured exclusion in the context of a salvage claim by a fidelity insurer. At least one commentator, however, has realized the potential application of this exclusion and opined that it may be a serious obstacle to the directors and officers successfully obtaining coverage for a fidelity insurer's claim.¹¹⁹

B. RECOVERY BY THE FIDELITY INSURER AGAINST PROFESSIONALS

It is becoming increasingly common for fidelity insurers to seek reimbursement from the insured's accountants, auditors, attorneys and other third party professionals for losses caused, in part, by these professionals. Such claims may arise by virtue of the insurer's status as subrogee or assignee, or may accrue to the insurer directly and independently of the insurer's derivative rights.

Community National Bank v. Fidelity & Deposit Co. of Maryland,¹²⁰ was an early case to recognize a fidelity insurer's direct right of action against third persons whose tortious conduct was a proximate cause of the insured's loss.¹²¹ In so ruling, the court summarized the test for determining when an insurer has an independent and direct cause of action against a third party for injury suffered by the surety as a result of that third party's wrongful acts.¹²²

The principal policy considerations are: "the foreseeability of harm to the plaintiff, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, the policy of preventing future harm, the extent of the burden to the defendant

¹¹⁸ See, e.g., *Fid. & Deposit Co. v. Conner*, 973 F.2d 1236, 1245 n.27 (5th Cir. 1992) (recognizing that a number of courts have held that an insured bank and its receiver, when both are suing the bank's directors and officers, share equivalent status under the Insured v. Insured exclusion) (citing cases). *But see* *FDIC v. Zaborac*, 773 F. Supp. 137 (C.D. Ill. 1991) (holding that the Insured v. Insured exclusion did not apply to the FDIC acting in its corporate capacity as receiver of an insolvent bank), *aff'd*, 998 F.2d 404 (7th Cir. 1993); *Fid. & Dep. Co. v. Zandstra*, 756 F. Supp. 429 (N.D. Cal. 1990). See also *Nat'l Union Fire Ins. Co. v. Olympia Holding Corp., et al.*, Case No. 1:94-cv-2081 (N.D. Ga. 1995) (recognizing that the trustee for the bankrupt estate stands in the shoes of the debtor corporation when prosecuting a cause of action belonging to the debtor and holding that the Insured v. Insured exclusion contained in the D&O policy barred coverage for the trustee's claims against the debtor's former directors and officers), *aff'd without opinion*, 148 F.3d 1070 (11th Cir. 1998); *Reliance Ins. Co. v. Weis*, 148 B.R. 575 (E.D. Mo. 1992), *aff'd, in part*, 5 F.3d 532 (8th Cir. 1993), *cert. denied*, 510 U.S. 1117 (1994). *But see* *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D. Del. 2002) (holding that Insured v. Insured exclusion did not apply to claims brought by the bankruptcy estate representative on behalf of creditors against the former executives of the debtor-insured).

¹¹⁹ See *Knox*, *supra* note 101, at 525 n.82.

¹²⁰ 563 F.2d 1319 (9th Cir. 1977).

¹²¹ *Id.* at 1320, 1322.

¹²² *Commercial Standard Ins. Co. v. Bank of Am.*, 129 Cal. Rptr. 91 (Cal. Ct. App. 1976).

and consequences to the community of imposing a duty to exercise care with resulting liability for breach and the availability, cost and prevalence of insurance for the risk involved.”¹²³

Fidelity insurers’ claims against the insured’s professionals are usually derivative, rather than the type of direct action envisioned in *Community National*. For example, subrogation claims by fidelity insurers against their insured’s negligent accountants are proving to be successful avenues for recovery. In one such case, *Federal Insurance Co. v. Arthur Andersen & Co.*,¹²⁴ the Court of Appeals of New York expressly allowed a fidelity insurer to proceed as a subrogee against an accountant who failed to discover the insured’s employee’s defalcations. Federal Insurance Company sued Arthur Andersen alleging negligence in its failure to discover defalcations of an employee. That failure, Federal alleged, caused its insured to sustain a loss which Federal had to pay pursuant to its policy.

In holding that Federal, as the fidelity insurer, had subrogation rights against Arthur Andersen, the court noted that, unlike “contractual subrogation where the subrogee’s rights are defined in an express agreement between the insurer-subrogee and the insured-subrogor, the rights of an insurer against a third party as equitable subrogee rise independent of an agreement.”¹²⁵ The court went on to find that the insurer’s rights “accrue upon payment of the loss and are based upon the principle that, in equity, an insurer which has been compelled under its policy to pay a loss, ought in fairness to be reimbursed by the party which caused the loss.”¹²⁶

The court also found that the insurer’s rights as an equitable subrogee were preserved under agreements between the insurer and the insured and the insured and the accountant.¹²⁷ Finally, the court held that the doctrine of superior equities did not bar Federal’s recovery against Arthur, Andersen.¹²⁸

More recently, in *National Union Fire Insurance Co. of Pittsburgh, Pennsylvania. v. KPMG Peat Marwick*,¹²⁹ a Florida appellate court also held that a bank’s fidelity insurer, National Union Fire Insurance Company,¹³⁰ was entitled to assert malpractice claims against the bank’s independent auditor, KPMG Peat Marwick,¹³¹ as the bank’s assignee and subrogee. In so holding, the court reversed the trial court’s judgment entered in favor of KPMG and found that National Union could proceed against KPMG.

¹²³ 563 F.2d at 1322 (quoting *Rowland v. Christian*, 69 Cal. 2d 108, 113 (1968) (*superseded by statute on other grounds as stated in Calvillo-Silva v. Home Grocery*, 19 Cal. 4th 714 (1998))).

¹²⁴ 552 N.E.2d 870 (N.Y. 1990).

¹²⁵ *Id.* at 372.

¹²⁶ *Id.*

¹²⁷ *Id.* at 371-72.

¹²⁸ *Id.* at 377-78.

¹²⁹ 742 So. 2d 328 (Fla. Dist. Ct. App. 1999).

¹³⁰ Hereinafter National Union.

¹³¹ Hereinafter KPMG.

On the issue of the insurer's subrogation rights, the *KPMG* court had a three-part ruling. First, the court found the bank's assignment of its claims against KPMG to be enforceable.¹³² Second, the court found that National Union could be equitably subrogated to the rights of its insured, because the auditor's negligence contributed to the loss ultimately paid by National Union. Citing to the Florida Supreme Court decision in *Dixie National Bank v. Employers Commercial Union Insurance Co.*,¹³³ and the New York decision in *Federal Insurance*,¹³⁴ the Florida court found it "entirely fair and logical that insurer National Union might prove itself to have superior equities over KPMG, because otherwise KPMG would escape financial responsibility for its negligent accounting."¹³⁵ And third, the court certified the question of whether the Florida Supreme Court decision in *Dantzler Lumber & Export Co. v. Columbia Casualty Co.*,¹³⁶ was still good law so as to permit a claim of an independent auditor's professional malpractice to be asserted by an insurer/assignee and/or insurer/subrogee.¹³⁷

In *KPMG Peat Marwick v. National Union Fire Insurance Co. of Pittsburgh, Pennsylvania*,¹³⁸ the Florida Supreme Court answered the *KPMG* court's certified question, affirmed the appellate court's rulings and specifically held that a claim of an independent auditor's professional malpractice can be asserted by a fidelity insurer as assignee or subrogee.¹³⁹ In so ruling, the Florida Supreme Court found that the bank's claim against its auditor was not a personal claim, therefore it could be assigned.¹⁴⁰ The court distinguished accountants from attorneys, reiterating its prior holdings that the attorney-client relationship is deemed to be so unique and confidential that attorney malpractice claims are considered too personal to be assignable.¹⁴¹

An obvious question when considering such third party professional liability claims is the impact on the professional's E&O insurer. Issues raised in the D&O context (discussed above) would also seemingly apply to the E&O insurance policy – i.e., the application of the dishonesty or fraud exclusion to the conduct at issue and the application of the Insured v. Insured exclusion. However, the Insured v. Insured exclusion might not apply to the extent the insurer could assert its own direct independent claims, rather than those derived from its insured. No cases were found addressing this issue, so it remains open for debate.

¹³² 742 So. 2d at 333.

¹³³ 463 So. 2d 1147 (Fla. 1985).

¹³⁴ *Fed. Ins. Co. v. Arthur Anderson & Co.*, 552 N.W. 2d 870.

¹³⁵ 742 So. 2d at 333.

¹³⁶ 156 So. 116 (Fla. 1934).

¹³⁷ *Federal Ins.*, 742 So. 2d at 330-31. Other courts permitting such subrogation claims against the insured's accountants include courts in Kansas and Michigan. See *West Sur. Co. v. Loy*, 594 P.2d 257 (Kan. Ct. App. 1979); *Maryland Cas. Co. v. Cook*, 35 F. Supp. 160 (E.D. Mich. 1940). See also *Nat'l Sur. Corp. v. Lybrand*, 9 N.Y.S.2d 554 (N.Y. App. Div. 1939).

¹³⁸ 765 So. 2d 35 (Fla. 2000).

¹³⁹ *Id.* at 39.

¹⁴⁰ *Id.*; see also *First Cmty. Bank & Trust v. Kelly, Hardesty, Smith & Co.*, 663 N.E. 2d 218, 223 (Ind. App. 1996).

¹⁴¹ *KPMG*, 765 So. 2d at 39; see also *Forgione v. Dennis Porth Agency, Inc.*, 701 So. 2d 557, 559 (Fla. 1997); *Am. Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 485 (Tex. 1992); cf. *Richter v. Analex Corp.*, 940 F. Supp. 353, 358 (D.D.C. 1996).

C. D&O AND E&O INSURER SALVAGE CLAIMS

Courts have also acknowledged the subrogation rights a D&O or E&O insurer may have against third party professionals such as attorneys or accountants. In *Caterpillar, Inc. v. Great American Insurance Co.*,¹⁴² the Seventh Circuit recognized that the insurer, as subrogee of the directors and officers, under a D&O policy, could pursue contribution claims.¹⁴³ Similarly, in *Nordstrom, Inc. v. Chubb & Son, Inc.*,¹⁴⁴ the Ninth Circuit recognized the insurer's ability to "exercise its right to bring an action for contribution or indemnification."¹⁴⁵ Both *Caterpillar* and *Nordstrom* cited to the Supreme Court decision in *Musick, Peeler & Garrett v. Employers Insurance of Wausau*,¹⁴⁶ when recognizing a D&O insurer's subrogation rights. In *Musick*, the insurers of settling defendants in a securities fraud class action brought an action for contribution against the insured's attorneys and accountants. The Supreme Court passed on addressing the merits of a claim for contribution in the case and held that the defendants in a 10b-5 class action had the right to seek contribution as a matter of law against other responsible third parties, including attorneys and accountants.¹⁴⁷

With respect to E&O Insurers, the Supreme Court of Arkansas has allowed an E&O insurer to be subrogated against a responsible third party. In *St. Paul Fire & Marine Insurance Co. v. Murray Guard, Inc.*,¹⁴⁸ the court allowed the E&O insurer to recover against the third party tortfeasor after paying the business operation loss of the insured agency's client. By allowing such a claim, the court approved of a two-step subrogation claim where the E&O insurer, who had insured an insurance agency's liability for failing to obtain business interruption coverage for a client, was subrogated to the client's claim.¹⁴⁹

IV. Conclusion

Fidelity, D&O, and E&O policies provide coverages that can be complementary, conflicting and even overlapping. Case law and source materials have grappled with the interplay of these coverages for years. Many issues concerning these coverages and how they inter-relate remain unresolved. However, recent pronouncements by high profile companies regarding restated earnings and financial instability and heightened public scrutiny of corporate conduct will surely give rise to increased claims activity and

¹⁴² 62 F.3d 955 (7th Cir. 1995).

¹⁴³ *Id.* at 962, n.6.

¹⁴⁴ 54 F.3d 1424 (9th Cir. 1995).

¹⁴⁵ *Id.* at 1436.

¹⁴⁶ 508 U.S. 286 (1993).

¹⁴⁷ *Id.* at 287.

¹⁴⁸ 37 S.W.3d 180 (Ark. 2001).

¹⁴⁹ The client was a victim of a fire and the insurer had paid its business interruption loss under the insurer's E&O policy issued to the agency. *Id.* at 182-83. Other courts recognizing an E&O insurer's subrogation claims against third parties include the Southern District of New York. *See Greenwood v. Koven*, 880 F. Supp. 186 (S.D.N.Y. 1995).

litigation regarding these policies, which may resolve some of the unanswered questions identified in this article and undoubtedly raise new ones.