

The Rule of *Contra Proferentem* and the Interpretive Impact of Making Changes to Standard Fidelity Bond Forms

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I. Introduction—Standard Bond Forms

Traditionally, courts have considered the wide variety of insurance policies to have been drafted by an insurer with markedly greater bargaining power over the insured. Courts, therefore, have reflexively applied the doctrine of *contra proferentem* to construe ambiguities or inconsistencies against the insurer and in favor of coverage.¹ Although this rule has been widely applied to almost all forms of insurance for decades, courts are beginning to realize that the rule does not apply to fidelity bonds because fidelity bonds (whether financial institution bonds, bankers' blanket bonds, credit union bonds, or commercial crime policies), unlike other types of insurance policies, are the product of negotiations between the surety industry and various trade associations.

The Financial Institution Bond is an excellent example. While the bond is drafted by the Surety Association of America,² the American Bankers Association has an established committee that meets to discuss

¹ The full name of the rule is “*verbis fortius accipienda contra proferentem*,” meaning “words must be construed strongly against the drafter.” James A. Knox, Jr., *Construction and Interpretation*, in ANNOTATED FINANCIAL INSTITUTION BOND 17, 19 (Michael Keeley ed., 2d ed. 2004).

² Hereinafter SSA. For an excellent discussion on the history of the Financial Institution Bond, see Edward G. Gallagher et al., *A Brief History of the Financial Institution Bond*, in FINANCIAL INSTITUTION BONDS 1 (Duncan L. Clore ed., 1998).

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and propose revisions to financial institution bonds.³ This committee enables financial institutions to be active participants in the drafting process and ensures that the bond satisfies their evolving risks.⁴

This article examines the rule of *contra proferentem* and the evolution of the view that the doctrine lacks relevance to standard fidelity bonds and discusses how an ambiguity in a standard bond form should be resolved. Section II reviews the law concerning when a policy is “ambiguous.” Section III discusses the trend away from mechanically applying the rule of *contra proferentem* in the commercial insurance context. Section IV considers the inapplicability of the rule of *contra proferentem* to fidelity bonds. Section V addresses how perceived ambiguities in standard fidelity bonds should be resolved—by looking to the drafting history of the bond forms. Section VI discusses how the rule of *contra proferentem* is similarly inapplicable to manuscript policies and broker-drafted endorsements.

II. When Is a Bond or Policy Term Considered “Ambiguous”?

A. A MERE DISAGREEMENT DOES NOT RENDER A POLICY PROVISION AMBIGUOUS.

A provision is not ambiguous simply because the parties disagree about its meaning.⁵ A contract provision is “ambiguous” only if it is

³ See Matthew Horowitz, *Wallowing in Ambiguous Coverages - Should Ambiguities in a Surety Bond or a Fidelity Policy Necessarily be Construed Against the Surety or Fidelity Carrier?* unpublished paper presented at N.E. Surety & Fidelity Claims Conference 7 (2003).

⁴ Edward G. Gallagher, *A Concise History of Standard Form No. 24, 1986 Edition*, in ANNOTATED FINANCIAL INSTITUTION BOND 5, 6-7 (Michael Keeley ed., 2d ed. 2004). It should be noted that standard form commercial crime policies have not had as wide acceptance in the marketplace. Paul A. Briganti, *Issues in the Third Circuit: Inside the Mind of the Reasonable Person: Determining When Discovery of Loss Has Occurred Under a Fidelity Bond in the Third Circuit*, 46 VILL. L. REV. 801, 827 n.26 (2001) (citation omitted).

⁵ *Employers Reinsur. Corp. v. Mid-Continent Cas. Co.*, 358 F.3d 757, 764 (10th Cir. 2004).

“susceptible to more than one reasonable interpretation.”⁶ In other words, an ambiguity exists when the contract language is capable of more than one meaning, when viewed objectively by a reasonably intelligent person who has examined the context of the entire agreement and who is cognizant of the customs, practices, usages, and terminology as generally understood in the particular trade or business.⁷ As one court explained, an “ambiguity exists . . . where the phrasing of the policy is so confusing that the average policyholder cannot make out the boundaries of coverage.”⁸ Courts generally are to read policy terms to avoid ambiguity “and not torture language to create them.”⁹

For example, in *Cincinnati Insurance Co. v. Becker Warehouse, Inc.*,¹⁰ the insurer issued a commercial general liability (“CGL”) policy with a broad pollution exclusion that pertained to “any solid, liquid, gaseous or thermal irritant or contaminant”¹¹ The term “Pollutants” was defined as including, but not being limited to, “substances which are generally recognized in industry or government to be harmful or toxic to persons, property or the environment.”¹² The insured was a warehouse that stored food manufactured by others. During the course of construction on the warehouse, stored food was spoiled by fumes from a sealant. The insured made a claim against the CGL policy, which the insurer denied in reliance upon the pollution exclusion.

The insured sued, arguing that the pollution exclusion was ambiguous because it was intended to apply only to environmental pollution claims. The court rejected this argument. It held that the

⁶ See, e.g., *Burlington N. & Santa Fe Ry. Co. v. Kan. City S. Ry. Co.*, 73 F. Supp. 2d 1274, 1279 (D. Kan. 1999); *Wagner v. Clifton*, 62 P.3d 440, 442 (Utah 2002) (citations omitted).

⁷ See *Int’l Multifoods Corp. v. Commercial Union Ins. Co.*, 309 F.3d 76, 83 (2d Cir. 2002) (citations omitted).

⁸ *Resolution Trust Corp. v. Fid. & Deposit Co.*, 205 F.3d 615, 643 (3d Cir. 2000).

⁹ *Franklin v. Gen. Elec. Capital Assurance Co.*, No. 02-3359, 2004 WL 220855, at *3 (E.D. Pa. Jan. 6, 2004).

¹⁰ 635 N.W.2d 112 (Neb. 2001).

¹¹ *Id.* at 119.

¹² *Id.*

exclusion was unambiguous, as on its face the language was subject to only one meaning. The inclusion of the term “environment” in the definition of “pollutants” could not reasonably be construed as limiting the exclusion to environmental pollutants. “[T]o find otherwise would read meaning into the policy that is not plainly there.”¹³

*Pablo v. Moore*¹⁴ involved terms in a CGL policy. The plaintiffs were injured in a car accident involving an employee of one of the defendants. The policy provided coverage for “those sums that the insured becomes legally obligated to pay as damages because of bodily injury or property damage to which this insurance applies.”¹⁵ The policy excluded coverage for losses “arising out of the use of” an automobile. When the plaintiffs asserted claims of negligent hiring, training, supervision, and failure to warn, the insurer denied coverage based upon this exclusion. The court held that the phrase “arising out of” was ambiguous because it was “reasonably subject to more than one interpretation.”¹⁶

In *Guerrier v. Mid-Century Insurance Co.*,¹⁷ the court addressed ambiguity in an automobile insurance policy. The policy stated that the insurer would “pay reasonable expenses for necessary medical expenses.” The definitions of “reasonable expenses” and “necessary medical expenses” both said that the insurer would “reimburse” the insured for expenses “already paid by [the insured].”¹⁸ The insurer’s position was that the pertinent provisions unambiguously obligated it only to reimburse the insured for his out-of-pocket expenses and to pay his providers directly. The insurer argued that it did not have any obligation to pay others for expenses paid on behalf of the insured. The court rejected this argument, holding that the relevant language was ambiguous because it was subject to more than one reasonable interpretation. It construed the ambiguity in favor of the insured, concluding that the language reasonably could be interpreted to “merely

¹³ *Id.* at 120.

¹⁴ 995 P.2d 460 (Mont. 2000).

¹⁵ *Id.* at 461.

¹⁶ *Id.* at 462.

¹⁷ 663 N.W.2d 131 (Neb. 2003).

¹⁸ *Id.* at 133-34.

express one manner in which [the insurer's] unconditional obligation may be fulfilled.”¹⁹ The ambiguity led the court to require the insurer to reimburse expenses that had been paid by a third party.

B. ALLEGATIONS OF AMBIGUITY IN THE FIDELITY BOND CONTEXT ARE UNCOMMON

A simple search reveals that cases involving findings of ambiguity in fidelity bonds are far less prevalent than cases involving other types of insurance. The overwhelming majority of cases conclude that fidelity bond language is not ambiguous.

For example, in *Humboldt Bank v. Gulf Insurance Co.*,²⁰ the court held that the subject bond's loan loss exclusion language was unambiguous and should be enforced according to its terms. In *Alpine State Bank v. Ohio Casualty Insurance Co.*,²¹ the Seventh Circuit held that the bond's standard forgery provision was “clear on its face.”²² The Illinois appellate court held that typical “direct loss” language—providing coverage for loss “resulting directly from” the insured's dishonesty—was clear and unambiguous in *RBC Mortgage Co. v. National Union Fire Insurance Co.*²³ A similar conclusion was reached in *Cargill, Inc. v. National Union Fire Insurance Co.*²⁴ In *BancInsure, N.A. v. Marshall Bank, N.A.*,²⁵ the court held that the requirement that the insured have “actual physical possession” of the “original” forged document was unambiguous. In *Pine Bluff National Bank v. St. Paul Mercury Insurance Co.*,²⁶ the court held that the bond's definition of “negotiable instrument” was unambiguous. The Maryland appellate court, in *ABC Imaging of Washington, Inc. v. The Travelers Indemnity*

¹⁹ *Id.* at 135.

²⁰ 323 F. Supp. 2d 1027 (N.D. Cal. 2004), *aff'd*, No. 04-16424, 2006 WL 1933092 (9th Cir. July 12, 2006) (mem. op.).

²¹ 941 F.2d 554 (7th Cir. 1991).

²² *Id.* at 559.

²³ 812 N.E.2d 728 (Ill. App. Ct. 2004).

²⁴ No. A03-187, 2004 WL 51671 (Minn. Ct. App. Jan. 13, 2004).

²⁵ 400 F. Supp. 2d 1140 (D. Minn. 2005), *aff'd*, No. 05-4454, 2006 WL 1971959 (8th Cir. July 17, 2006).

²⁶ 346 F. Supp. 2d 1020 (E.D. Ark. 2004).

*Co.*²⁷ stated that a fidelity bond “containing the standard industry exclusion . . . clearly and unambiguously excludes from coverage the acts of an employee who fraudulently or dishonestly obtains salary or commissions.”²⁸

Notwithstanding the “majority” view that fidelity bond terms are unambiguous, there are a few decisions concluding that certain terms in a fidelity bond are ambiguous. In *Karen Kane, Inc. v. Reliance Insurance Co.*,²⁹ for example, the Ninth Circuit held that a commercial crime policy’s Occurrence and Limit of Liability provisions were ambiguous because, in the court’s view, the language was unclear as to whether the term “occurrence” referred to a single act or a series of acts within a single policy period or across multiple periods.³⁰ This rationale was rejected in a recent decision from the Pennsylvania Superior Court.³¹

In *Filor, Bullard & Smyth v. Insurance Co. of North America*,³² the Second Circuit found that the term “forgery” in that brokers’ bond was ambiguous because of “conflicting decisional law . . . reflecting ambiguity in the term ‘forgery.’”³³ Subsequent decisions from courts in the Second Circuit have since distinguished *Filor*.³⁴ In *Southside Motor Co. v. Transamerica Insurance Co.*,³⁵ a Florida court held that a commercial crime policy’s definition of the word “loss” was ambiguous because it was unclear whether the definition of “loss” included liability to third parties. This “ambiguity” has been resolved by revisions to such bonds to provide coverage for “direct loss.”

²⁷ 820 A.2d 628 (Md. Ct. Spec. App. 2003), *cert. denied*, 827 A.2d 112 (Md. 2003).

²⁸ *Id.* at 635.

²⁹ 202 F.3d 1180 (9th Cir. 2000).

³⁰ *Id.* at 1187.

³¹ *Reliance Ins. Co. v. IRPC, Inc.*, No. 3350 EDA 2004, 2006 WL 1738047 (Pa. June 27, 2006).

³² 605 F.2d 598 (2d Cir. 1978), *cert. denied*, 440 U.S. 962 (1979).

³³ *Id.* at 602.

³⁴ *See, e.g.*, *French Am. Banking Corp. v. Flota Mercante Grancolumbiana, S.A.*, 752 F. Supp. 83, 89 n.7 (S.D.N.Y. 1990), *aff’d*, 925 F.2d 603 (2d Cir. 1991).

³⁵ 380 So. 2d 470 (Fla. Dist. Ct. App. 1980).

III. Resolving Ambiguities in the Commercial Insurance Context

For many years, the rule of *contra proferentem* governed the interpretation of all types of insurance policies. Anyone who went to law school knows the rule—ambiguities are construed against the drafter. Courts imposed this rule because they viewed insurance policies as contracts of adhesion and believed that the insurer had stronger bargaining power over the insured.³⁶ As one court explained:

The insurer . . . is the entity in control of the process of articulating the terms [of an insurance contract]. The other party . . . usually has very little to say about those terms except to take them or leave them or to select from limited options offered by the insurer. . . . Therefore, it is incumbent upon the dominant party to make the terms clear. Convolved or confusing terms are the problem of the insurer[,] not the insured. . . . Due to the insurer's dominant position, when an ambiguity is found in insurance policy language, we must construe the language against the insurer [. . .]. And therefore, unlike with other types of contracts, we need not inquire into the parties' actual intent.³⁷

The view of insurance policies as contracts of adhesion led to rather blind application of the rule of *contra proferentem* (including in the context of standard fidelity bond forms), irrespective of the circumstances of the drafting of the bond. Courts were quick to construe supposedly ambiguous provisions against the insurer, without any consideration of the insured's level of sophistication or of its involvement in the policy's drafting, and without any attempt to discern

³⁶ *New Castle County v. Nat'l Union Fire Ins. Co.*, 243 F.3d 744, 755 (3d Cir. 2001).

³⁷ *Id.* at 750.

what the parties intended.³⁸ These decisions assumed that the insurer could unilaterally change the terms of the bond to cure the ambiguity.³⁹

Perhaps in recognition of that rote application of the rule of *contra proferentem* that often distorted the intended meaning of a policy term,⁴⁰ courts have become more reluctant to apply the rule of *contra proferentem* and now attempt to discern the actual intent of the sophisticated parties. Applying the “modern” trend, courts now consider the language of the ambiguous phrase in the context of the transaction, extrinsic evidence of the parties’ negotiations, knowledge, and sophistication, custom and usage of the pertinent terms in the industry, and public policy, in order to discern the true intent of the parties.⁴¹ Under this “modern” trend, reflexive application of the rule is discouraged, and courts only resort to the rule to “break the tie” if it cannot determine the parties’ intent:

The rule of *contra proferentem*, when applicable, requires that ambiguity in a particular term of a contract be strictly construed against the drafter. But that doctrine, sometimes called a rule of “last resort,” applies only where other secondary rules of interpretation have failed to elucidate the contract's meaning. Therefore, it is not a mechanistic device to be deployed whenever ambiguity arises. Rather, the doctrine’s utility hinges

³⁸ See, e.g., *First Nat'l Bank v. Ins. Co. of N. Am.*, 495 F.2d 519 (5th Cir. 1974).

³⁹ See, e.g., *Filor, Bullard & Smyth*, 605 F.2d at 602 (“The defendant in its large illuminated lettering and in its application could have added proper, unambiguous words or a definition . . . thus removing the ambiguity or equivocal character of the invitation to insure, of the application for insurance and the contract of insurance itself.” (citation omitted)).

⁴⁰ See Horowitz, *supra* note 3, at 4-5.

⁴¹ Scott G. Johnson, *Resolving Ambiguities in Insurance Policy Language*, THE BRIEF 33 (Winter 2004).

upon the extent to which it is helpful in divining the intent of the contracting parties.⁴²

The sophistication of the insured has become one of the primary considerations. As mentioned above, the rule of *contra proferentem* arose from the view of insurance policies as adhesion contracts. An adhesion contract necessarily requires that the parties have unequal bargaining power. As Professor Williston explained:

The fundamental reason which explains this and other examples of judicial predisposition toward the insured is the deep-seated, often unconscious but justified feeling or belief that the powerful underwriter, having drafted its several types of insurance contracts with the aid of skillful and highly paid legal talent, from which no deviation desired by an applicant will be permitted, is almost certain to overreach the other party to the contract. The established underwriter is magnificently qualified to understand and protect its own selfish interests. In contrast, the applicant is a shorn lamb driven to accept whatever contract may be offered on a “take-it-or-leave-it” basis if he or she wishes insurance protection. In other words, insurance policies, while contractual in nature, are certainly not ordinary contracts, and should not be interpreted or construed as individually bargained for, fully negotiated agreements, but should be treated as contracts of adhesion between unequal parties. This is because, except perhaps in the case of group insurance, or other policies negotiated

⁴² *Wilmington Firefighters Ass’n, Local 1590 v. City of Wilmington*, No. 19035, 2002 WL 418032, at *9 (Del. Ch. Mar. 12, 2002). The “modern” trend in policy interpretation has not been adopted universally. *See, e.g.*, *Am. Nat’l Fire Ins. Co. v. Rose Acre Farms, Inc.*, 107 F.3d 451, 457-58 (7th Cir. 1997) (applying Indiana law) (ambiguity construed against insurer unless ambiguity is “latent”, i.e., terms of policy are unambiguous but not applicable to circumstances presented, under which circumstances extrinsic evidence can be considered); *Charter Oil Co. v. Am. Employers’ Ins. Co.*, 69 F.3d 1160, 1167-68 (D.C. Cir. 1995) (applying Missouri law) (broad extrinsic evidence can be considered only where a “latent” ambiguity in policy term is present).

between large companies and insurers, insurance contracts are generally not the result of the typical bargaining and negotiating process between roughly equal parties that is the hallmark of freedom to contract.⁴³

Professor Williston's language should make readily apparent why the rule of *contra proferentem* has little application to the interpretation of insurance policies issued to large, sophisticated insureds.

The Fifth Circuit's seminal decision of *Eagle Leasing Corp. v. Hartford Fire Insurance Co.*⁴⁴ was one of the earliest to consider the sophistication of the insured in the interpretation of an insurance policy:

We do not feel compelled to apply, or, indeed, justified in applying the general rule that an insurance policy is construed against the insurer in the commercial insurance field when the insured is not an innocent but a corporation of immense size, carrying insurance with annual premiums in six figures, managed by sophisticated business men, and represented by counsel on the same professional level as the counsel for insurers. In substance the authorship of the policy is attributable to both parties alike.⁴⁵

⁴³ 16 Richard Lord, WILLISTON ON CONTRACTS § 49:15 (4th ed. 2000).

⁴⁴ 540 F.2d 1257 (5th Cir. 1976).

⁴⁵ *Id.* at 1260-61. A number of other courts have adopted the Fifth Circuit's reasoning. *See, e.g.,* Koch Eng'g Co., Inc. v. Gibraltar Cas. Co., Inc., 878 F. Supp. 1286 (E.D. Mo. 1995), *aff'd*, 78 F.3d 1291 (8th Cir. 1996); Industrial Risk Insurers v. New Orleans Public Serv., Inc. 666 F. Supp. 874 (E.D. La. 1987); ITC Investments, Inc. v. Employers Reinsur. Corp., 2000 WL 1996233 (Conn. Super. Ct. 2000). Of course, not every state has jumped on this bandwagon. *See, e.g.,* Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 390 (D. Del. 2002) ("Generally speaking, however, Delaware and Illinois courts continue to strictly construe ambiguities within insurance contracts against the insurer and in favor of the insured in situations where the insurer drafted the

Some courts, however, have opined that the insured's sophistication is not important; the consideration is simply whether the parties negotiated or jointly drafted the policy.⁴⁶ Viewing policy interpretation as depending solely upon whether the parties negotiated or jointly drafted the policy, irrespective of the insured's sophistication, seems misplaced. If the reason courts interpret insurance policies against the insurer is because most policies are considered to be contracts of adhesion, then where an insured is a large, sophisticated entity, the policy by rule cannot be an adhesion contract and the rule of *contra proferentem* should not apply. That a large, sophisticated insured elected not to avail itself of its significant bargaining power and participate in the drafting process should not inure to the insurer's detriment, at least absent extenuating circumstances.

While cases involving the "modern" trend of bond/policy interpretation are more prevalent in other insurance contexts,⁴⁷ the "modern" trend has presented itself in cases involving the interpretation of non-standard fidelity bonds. A recent example is *A.B.S. Clothing Collection v. Home Insurance Co.*⁴⁸ *A.B.S. Clothing* involved the interpretation of the "Non-cumulation" and "Prior Loss" provisions of a commercial crime policy. The insured argued that the provisions were ambiguous. Instead of mechanically construing the supposedly ambiguous terms against the fidelity insurer, the California appellate court explained how ambiguous terms in a fidelity bond should be construed:

Words used in the contract are ordinarily given their common and popular meaning. Each clause of the contract must be considered with reference to every other relevant clause and the clauses construed together in order to ascertain the intent of the parties. Similarly,

language that is being interpreted regardless of whether the insured is a large sophisticated company.").

⁴⁶ See, e.g., *Stryker Corp. v. XL Ins. Am., Inc.*, No. 4:01-CV-157, 2006 WL 1997142 (W.D. Mich. 2006); *Pittston Co. Ultramar Am. Ltd. v. Allianz Ins. Co.*, 124 F.3d 508, 521 (3d Cir. 1997).

⁴⁷ For a discussion of such cases, see Johnson, *supra* note 41, at 34-36.

⁴⁸ 41 Cal. Rptr. 2d 166 (1995).

in construing the meaning of a specific policy provision we do not view the provision in isolation but in the context of other relevant policy provisions. If the policy language is clear and explicit, it governs. If, on the other hand, the provision is susceptible to two or more reasonable constructions, it must be construed in accordance with the objectively reasonable expectations of the insured. Finally, if applying the foregoing rules does not eliminate or resolve any alleged ambiguity, the ambiguity is resolved against the insurer in favor of liability under the policy.⁴⁹

The reference to construing a policy or bond “in accordance with the objectively reasonable expectations of the insured” raises an important issue. The court’s statement is commonly known as the “rule of reasonable expectations.” Fidelity insurers—and all other insurers—may have seen language to this effect in correspondence from insureds in support of their claim; insureds asserting that they “should be provided with the coverage they expected,” for example. The “rule of reasonable expectations” seems to be, in reality, another way for courts to read bonds and insurance policies in a way that affords coverage—an extension or corollary to the rule of *contra proferentem*—even though possibly unambiguous terms of the bond or policy may bar coverage.⁵⁰ Despite the fact that the “rule” seems inherently contradictory to basic principles of common law, more than half of the states have adopted the rule in one form or another.⁵¹

⁴⁹ *Id.* at 170; *see also* *City of Burlington v. W. Sur. Co.*, 599 N.W.2d 469 (Iowa 1999) (intent of parties controls interpretation of fidelity bond).

⁵⁰ Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961 (1970) (“The objectively reasonable expectations of the applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provision would have negated those expectations.”).

⁵¹ *See* Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 827-38 (1990). According to the author, as of 1990, ten jurisdictions had adopted the rule (Alabama, Alaska, Arizona, California, Iowa, Montana, Nebraska, Nevada, New Hampshire, New Jersey), and a number of other jurisdictions had adopted a form

A number of states have declined to adopt the “rule of reasonable expectations.”⁵² The primary basis for the rejection of the rule is best explained by the Michigan Supreme Court in *Wilkie v. Auto-Owners Insurance Co.*:⁵³

The rule of reasonable expectations clearly has no application to unambiguous contracts. That is, one's alleged: “reasonable expectations” cannot supersede the clear language of a contract. Therefore, if this rule has any meaning, it can only be that, if there is more than one way to reasonably interpret a contract, i.e., the contract is ambiguous, and one of these interpretations is in accord with the reasonable expectations of the insured, this interpretation should prevail. However, this is saying no more than that, if a contract is ambiguous and the parties' intent cannot be discerned from extrinsic evidence, the contract should be interpreted against the insurer. In other words, when its application is limited to ambiguous contracts, the rule of reasonable expectations is just a surrogate for the rule of construing against the drafter.

....

In sum, the rule of reasonable expectations clearly has no application when interpreting an unambiguous contract because a policyholder cannot be said to have reasonably expected something different from the clear language of the contract. Further, it is already well established that ambiguous language should be construed against the drafter, i.e., the insurer. Therefore, stating that ambiguous language should be interpreted in

of the rule (Colorado, Connecticut, Delaware, Georgia, Hawaii, Indiana, Kansas, Kentucky, Louisiana, Maine, Michigan, Minnesota, Mississippi, New Mexico, North Carolina, Rhode Island, West Virginia, Wisconsin).

⁵² See *id.* (Idaho, Illinois, Massachusetts, North Dakota, Ohio, Oklahoma, Washington, Wyoming).

⁵³ 664 N.W.2d 776 (Mich. 2003).

favor of the policyholder's reasonable expectations adds nothing to the way in which Michigan courts construe contracts, and thus the rule of reasonable expectations should be abolished.⁵⁴

As the Michigan Supreme Court explained, the "rule of reasonable expectations" is little more than the rule of *contra proferentem* stated another way. Moreover, in the context of standard fidelity bonds, one would imagine that the history of the bond's drafting and negotiation would readily reflect the coverage the insured reasonably expected would exist. In light of these considerations, should these rules be employed against the fidelity insurer, even if merely used as a "tie breaker"? The reasons why the answer to this question should be "no" follow.

IV. The Rule of Contra Proferentem Should Not Apply to Standard Form Fidelity Bonds

The mere fact that courts have pushed the rule of *contra proferentem* to the end of the line does not mean that fidelity bonds and insurance policies no longer are interpreted against the insurer. Courts simply consider other evidence before turning to construing the ambiguous term against the insurer.⁵⁵ A collateral effect of the "modern" trend, however, is that, by examining the circumstances surrounding the drafting of the standard fidelity bond, courts have held that the rationale for the rule of *contra proferentem* does not apply to fidelity bonds.

As discussed above, the rule of *contra proferentem* arises from the concept of the "adhesion contract" and the unequal bargaining power between the insurer and the insured. It is simply an attempt to "level the playing field between insured and insurer" without consideration of "the most sensible interpretation of the policy or bond terms."⁵⁶ These concerns do not apply to standard form fidelity bonds because they are

⁵⁴ *Id.* at 781.

⁵⁵ See, e.g., *Hugo Boss Fashions, Inc. v. Fed. Ins. Co.*, 252 F.3d 608, 615 (2d Cir. 2001) ("unresolvable ambiguities in insurance contracts are construed in favor of the insured") (emphasis added).

⁵⁶ Horowitz, *supra* note 3, at 4.

the product of negotiation between the fidelity insurers and industry trade associations. Both sides participate in the negotiation and drafting of the bond.⁵⁷ It is far from the “take it or leave it” adhesion contract scenario the *contra proferentem* rule is intended to address.⁵⁸ Courts thus have come to recognize that the rule should not apply to fidelity bonds.

As early as 1974, the Wisconsin appellate court refused to apply the rule of *contra proferentem* to a fidelity bond because “[t]hese bonds are not the usual contracts of adhesion and the familiar rule of interpreting a contract strictly against the insurer and liberally in favor of the insured should not apply.”⁵⁹ Two years later, the Fifth Circuit adopted this holding in *Calcasieu Marine National Bank v. American Employers’ Insurance Co.*:⁶⁰

[T]he banker’s blanket bond being construed was drafted by a joint effort of the American Bankers’ Association and the American Surety Association. . . [and the rationale that] it would be unjust to construe an ambiguous provision in favor of the party that drafted it [i.e., the insurer] may not be applicable.⁶¹

Over the past two decades, an increasing number of courts have reached the same conclusion and have refused to apply the rule of *contra proferentem* to standard fidelity bonds. In *Sharp v. Federal Savings & Loan Insurance Corp.*,⁶² which involved a Savings and Loan Blanket

⁵⁷ There are courts that have rejected this argument, on grounds such as that the insured did not individually participate in the drafting of the bond or that the insured was not a member of the applicable trade group. See *First Nat’l Bank v. Ins. Co. of N. Am.*, 424 F.2d 312, 317 (7th Cir.), *cert. denied*, 398 U.S. 939 (1970); *First Nat’l Bank v. U.S. Fid. & Guar. Co.*, 416 F.2d 52, 56 (5th Cir. 1969); *Fed. Sav. & Loan Ins. Co. v. Transamerica Ins. Co.*, 661 F. Supp. 246, 250 (C.D. Cal. 1987); *Shoals Nat’l Bank v. Home Indem. Co.*, 384 F. Supp. 49 (N.D. Ala. 1974); see also Horowitz, *supra* note 3, at 7 n.27.

⁵⁸ See, e.g., *Employers Reinsur. Corp.*, 358 F.3d at 762.

⁵⁹ *State Bank of Viroqua v. Capital Indem. Corp.*, 214 N.W.2d 42, 44 (Wis. 1974).

⁶⁰ 533 F.2d 290 (5th Cir. 1976).

⁶¹ *Id.* at 295.

⁶² 858 F.2d 1042 (5th Cir. 1988).

Bond (Standard Form No. 22), the Fifth Circuit opined that, because the bond “was in fact a joint effort of both insurers and the insureds, the principle [of *contra proferentem*] need not apply.”⁶³ In *FDIC v. Insurance Co. of North America*,⁶⁴ the First Circuit rejected the application of *contra proferentem* to a standard financial institution bond: “The presumption against the insurer is not applied where the policy language results from the bargaining between sophisticated commercial parties of similar bargaining power.”⁶⁵ Similarly, in *French American Banking Corp. v. Flota Mercante Grancolombiana, S.A.*,⁶⁶ the court rejected the rule of *contra proferentem* on the ground that Form 24 is a standard form negotiated with the American Bankers Association.⁶⁷

One of the more recent decisions on this issue is *Tri City National Bank v. Federal Insurance Co.*,⁶⁸ from the Wisconsin Court of Appeals. In this case, Tri City, the insured bank, argued that the language in the standard financial institution bond regarding “direct loss” was ambiguous. Tri City sought coverage for payments it made in settlement of third-party claims arising from a fraudulent scheme wherein employees of Tri City obtained mortgage loans from third-party lenders for unqualified borrowers. While the court ultimately concluded that the “direct loss” language was not ambiguous,⁶⁹ it held that the rule of *contra proferentem* does not apply to a standard financial institution bond. The court considered the history of the drafting of the bond—particularly the joint involvement of both the insurance and banking industries—and concluded as follows:

⁶³ *Id.* at 1046. The Fifth Circuit echoed this conclusion in *U.S. Fire Ins. Co. v. Fed. Deposit Ins. Corp.*, 981 F.2d 850, 851 (5th Cir. 1993) (“[T]he language the court is being asked to construe was the result of a collaborative effort between the American Bankers Association and the American Surety Association, there is no reason to construe the term against U.S. Fire even if it were ambiguous.”).

⁶⁴ 105 F.3d 778 (1st Cir. 1997).

⁶⁵ *Id.* at 786-87.

⁶⁶ 752 F. Supp. 83 (S.D.N.Y. 1990), *aff’d*, 925 F.2d 603 (2d Cir. 1991).

⁶⁷ *Id.* at 89 n.7.

⁶⁸ 674 N.W.2d 617 (Wis. Ct. App. 2003).

⁶⁹ *Id.* at 622.

[T]he rules of construction strictly against the insurer where ambiguities are found are not applicable since the terms of the standard bond were negotiated between parties with relatively equal bargaining power. . . . Thus, should there be any ambiguity, the wording of fidelity bonds is not construed strictly against the drafter because the justification behind the rule—unequal bargaining power—has been eliminated.⁷⁰

The Eastern District of Wisconsin adopted this rationale in *First National Bank in Manitowoc v. The Cincinnati Insurance Co.*,⁷¹ which appears to have involved a variation of the standard financial institution bond. While *First National Bank* did not produce a favorable result for the insurer, it is a positive case for purposes of this article for its approval of *Tri-City*:

In the usual insurance coverage case, interpretation of a policy favors the insured and doubts about the meaning of ambiguous contract terms are to be resolved in favor of coverage. But because the bankers blanket bond is an industry-standard policy, negotiated between parties of relatively equal bargaining power, the normal rules of insurance contract interpretation do not apply. Instead, if terms prove ambiguous they are simply to be construed without a presumption in favor of either party by attempting to discern the intent of the parties when they agreed to be bound to the contract.⁷²

The Illinois Appellate Court adopted *Tri-City in RBC Mortgage Co. v. National Union Fire Insurance Co.*⁷³ The court held as follows:

First City is engaged in the business of mortgage brokering, and RBC, its parent company, is a corporate entity responsible for both mortgage brokering loans, as

⁷⁰ *Id.* at 621-22.

⁷¹ No. 03-C-241, 2005 WL 2460719 (E.D. Wis. Oct. 5, 2005).

⁷² *Id.* at *2.

⁷³ 812 N.E.2d 728 (Ill. App. Ct. 2004).

well as mortgage banking. In this capacity, RBC's bargaining power is not disparate from that of National Union, and is undeserving of the usual rules of construction. The history of Standard Form No. 24, the form at issue here, further compels this conclusion. Therefore, despite RBC's protestations that it had a reasonable expectation of coverage for this type of loss, and that it would not have "purchased such useless protection" had it been aware that National Union "intended to limit coverage it afforded RBC to the paradigmatic cases of theft and embezzlement," the policy will be applied as written.⁷⁴

Courts have applied this rationale in other commercial insurance contexts, either where the insured participated in the negotiation of the policy or where the parties enjoy substantially even bargaining power. In *American Home Assurance Co. v. Merck & Co.*,⁷⁵ the court, in interpreting a policy of transit insurance, stated as follows:

Normally, any ambiguities in an insurance contract are to be construed against the insurer, but this maxim does not apply where, as here, large corporations, advised by counsel and having equal bargaining power, are the parties to a negotiated policy.⁷⁶

In *Employers Reinsur. Corp. v. Mid-Continent Casualty Co.*,⁷⁷ the Tenth Circuit held that the rule of *contra proferentem* was not applicable in the context of reinsurance contracts because of the parties' comparable bargaining power.⁷⁸ In *Pittston Co. Ultramar America Ltd. v. Allianz Insurance Co.*,⁷⁹ a case involving marine liability insurance, the Third Circuit held that the rule of *contra proferentem* should not be

⁷⁴ *Id.* at 735 (citations omitted).

⁷⁵ 386 F. Supp. 2d 501 (S.D.N.Y. 2005).

⁷⁶ *Id.* at 512 (citations omitted).

⁷⁷ 358 F.3d 757 (10th Cir. 2004).

⁷⁸ *Id.* at 767.

⁷⁹ 124 F.3d 508 (3d Cir. 1997).

applied where the insured is “a sophisticated corporate entity” and the policy was “negotiated, jointly drafted or drafted by the insured.”⁸⁰

Research has not located any recent reported decisions in which a court analyzed the underpinning of the rule of *contra proferentem* and expressly concluded that the rule should be applied to a standard form fidelity bond. There are, however, several recent decisions that simply have applied the rule to fidelity bond interpretation, without discussion as to whether the rule should apply. *Spartan Iron & Metal Corp. v. Liberty Insurance Corp.*,⁸¹ for example, involved a dispute in which the insured contended that an employee dishonesty policy's language relative to policy limits was ambiguous. In describing how the bond should be interpreted, the Fourth Circuit simply stated, without any analysis, that under South Carolina law “ambiguities in a contract for insurance are interpreted against the insurer.”⁸² *BancInsure, Inc. v. Marshall Bank, N.A.*⁸³ was a favorable decision for the insurer. Yet, when laying the ground rules for interpreting what the court noted was a “standard form” financial institution bond “created with input from the Surety Association of America and the American Bankers’ Association,”⁸⁴ it blindly said that any ambiguity in the bond would be “construed against the insurance company as the drafter of the contract.”⁸⁵ Bereft of rationale as to why the rule of *contra proferentem* applied, these decisions appear to be of little value to either insurers or insureds and can be distinguished by reference to cases discussed in this article.

⁸⁰ *Id.* at 521.

⁸¹ 6 Fed. Appx. 176 (4th Cir. 2001).

⁸² *Id.* at 178. It is unclear whether the bond involved in *Spartan Iron* was a standard form.

⁸³ 400 F. Supp. 2d 1140 (D. Minn. 2005), *aff'd*, No. 05-4454, 2006 WL 1971959 (8th Cir. July 17, 2006).

⁸⁴ *Id.* at 1141.

⁸⁵ *Id.* at 1142. While the *BancInsure* case was very recently affirmed by the Eighth Circuit, the appellate decision, unfortunately, does not discuss the rules for interpretation of standard bond forms. *BancInsure, Inc. v. Marshall Bank, N.A.*, No. 05-4454, 2006 WL 1971959 (8th Cir. July 17, 2006).

***V. Looking to Revisions to Standard Bond Forms to Assist
in the Interpretive Process***

Under the “modern” trend of policy interpretation, the “holy grail” is determining the intent of the parties. Because standard bond forms generally have a lengthy and well-documented history of drafting and revision, discerning the parties’ intention may be readily ascertainable. Each revision to a bond form comes with a lengthy pedigree explaining the reasons for the revision and what the parties intended to accomplish.⁸⁶ Thus, a revision to a bond form can play an important role in deciphering the parties’ intent and resolving an ambiguity, thereby allowing a court to avoid application of the rule of *contra proferentem*.⁸⁷

*Aetna Casualty & Surety Co. v. Kidder, Peabody & Co.*⁸⁸ illustrates the interpretive impact of revisions on standard bond forms. In the *Kidder* case, the insured sought coverage under its standard form blanket bond for losses paid to settle various class action suits arising from fraudulent trading activities of its employees. The insurer denied coverage, asserting that the losses were not “direct” losses as required by the bond. The brokerage argued that either the bond expressly provided coverage for these damages or was ambiguous and that the ambiguity had to be construed in its favor.

⁸⁶ See Horowitz, *supra* note 3, at 7 (“[T]here is a documented history of a collaborative process between the two industries in connection with the text of the [FIB].”).

⁸⁷ While it theoretically is possible that an insured could argue that a revision of a bond form creates an ambiguity in an older bond form that is the subject of the insured’s claim, research did not locate a single reported decision involving a standard fidelity bond in which an insured so argued. This paper thus does not address this circumstance. For a discussion thereof, see Jacqueline R. Griffin, *Practical Consequences of Making Changes in Fidelity Form Contracts*, in 1982 Annual Mid-Winter Meeting of the Fidelity and Surety Law Committee of the Tort and Insurance Practice Section of the American Bar Association.

⁸⁸ 676 N.Y.S.2d 559 (App. Div. 1998), *appeal denied*, 711 N.E.2d 643 (N.Y. 1999).

In determining that coverage did not exist, the New York appellate court conducted a detailed analysis of the history of the bond form and relied in large part on the various revisions that had been made to the provisions regarding “direct” loss. The court relied heavily upon the parties’ negotiation of revisions to the bond:

The standard-form bonds that provided the basic language of the present bonds were drafted during the 1970’s. At that time, a joint committee of the stock exchange and insurance industry communities reviewed fidelity bonding concerns in light of claims by underwriters that the increasing loss ratio of the bonds was reducing the attractiveness of fidelity coverage. The express intent of the underwriters was to refine the meaning of employee dishonesty under the bonds as a means of addressing judicial decisions expanding coverage beyond that originally contemplated, while ensuring that employers who had the misfortune of hiring potential embezzlers (although not necessarily limited to embezzlement) could purchase such protection. The point was to protect employers from employee thieves who steal from the employers, but not from the consequences of unauthorized trading activity, for which other coverage could be purchased. Other memoranda indicate that fidelity coverage also contemplated risks of loss to the employer resulting from the employee’s theft or misappropriation of a third party’s property, such as securities or funds, in the physical possession or custody of the employer. The standard terms of coverage and exclusions therefrom were discussed again between both communities during the 1980’s in order to further refine these terms. The renewed negotiation led to several standard-form riders, including those relevant in this case. Nothing in the history of these particular bonds, which comports with an historical understanding of what fidelity coverage is, indicates that the employee infidelity being covered as a

risk could reach the employee's dishonesty toward third parties, absent an intent to cause a loss to the employer.⁸⁹

The *Kidder* court considered strongly the history of the pertinent revisions to the language of the bond form in order to discern the parties' intent and to conclude that the reasonable insured could not have expected coverage for losses paid to settle third-party claims.

Tri City is also illustrative. As mentioned above, *Tri City* similarly involved a claim for reimbursement of amounts paid to settle third-party claims. As in *Kidder*, the *Tri City* court relied upon the underlying history of pertinent revisions to the bond—to address judicial decisions that expanded coverage beyond the scope contemplated—in concluding that a reasonable bank would not expect coverage for indirect loss.

[G]iven the extensive history of fidelity bonds in the banking business, a reasonable banker would be charged with the knowledge of the fidelity bond restrictions and not expect coverage for indirect losses. In determining coverage, one looks to what a reasonable person in the position of the insured would have understood the words of the policy to mean.⁹⁰

Thus, according to the *Tri City* court, an insured apparently is deemed to have its industry's knowledge of the history of the standard form bond, perhaps even though it was not in existence at the time of the prior versions.⁹¹ Such a holding can be of substantial assistance to fidelity insurers in combating claims of ambiguity in standard bond forms and avoiding application of the rule of *contra proferentem*.

⁸⁹ *Id.* at 565.

⁹⁰ *Tri City*, 674 N.W.2d at 624.

⁹¹ See also *Oritani Sav. & Loan Ass'n v. Fid. & Deposit Co.*, 989 F.2d 635, 642 (3d Cir. 1993) (review of relevant drafting history of bankers' blanket bond yielded conclusion that policy language was not ambiguous and that "average banking institution would not reasonably expect coverage").

VI. *The Rule of Contra Proferentem Similarly Should Not Apply to Broker-Drafted Language and Manuscript Policies*

To this point, this article has focused on why the rule of *contra proferentem* does not apply to standard form fidelity bonds. A related issue is whether the rule applies to the interpretation of broker-drafted policies or manuscript policies. Large insurance brokers have the leverage to propose their own policy language and pressure insurers to accept it.⁹² Similarly, large insureds with unique needs may work with an insurer to customize a manuscript policy specifically tailored to address those needs (in fact, such language may be drafted by the broker).

As with standard forms drafted by or through negotiation with trade groups, such bonds and policies are not the product of the insurer. Instead, they are more appropriately considered to be either “joint” products or products of insureds. While manuscript policies may be on the decline,⁹³ more limited broker-drafted language is becoming increasingly prevalent in other insurance contexts, and one can reasonably expect that language drafted by brokers will make its way into fidelity bonds, if this is not already happening with any regularity.

Research did not locate any reported decisions addressing the interpretation of ambiguities in fidelity bond language drafted by the particular insured or its broker. Cases in other insurance contexts reveal that the rule of *contra proferentem* does not apply in these situations. *Newport Associates Development Co. v. Travelers Indemnity Co.*⁹⁴ illustrates the point. *Newport* concerns a dispute about the scope of coverage of an insurance policy for a marina. The pertinent policy provisions were drafted by the broker, shopped to several insurers, and ultimately issued by the defendant verbatim.

⁹² See Johnson, *supra* note 41, at 36.

⁹³ See Kenneth S. Wollner, *A Vote Against Broker-Drafted Manuscript Policies (in Most Cases)*, <http://www.irmi.com/Expert/Articles/2003/Wollner04.aspx> (April 2003).

⁹⁴ 162 F.3d 789 (3d Cir. 1998).

In the dispute concerning whether the policy language covered the subject loss, one of the arguments the insured raised was that the policy language should be construed against the insurer. The Third Circuit rejected the argument, holding that the rule did not apply because the insured's broker drafted the language:

[T]he crucial fact is that [the insurer] did not unilaterally impose the policy on [the insured]. As we recently observed in a case applying New Jersey insurance law, the doctrine of *contra proferentem* is based on the fact that insurance contracts are in most instances "nonnegotiable" since they tend to be drafted solely by the insurance industry. When a contract is drafted by the insured or jointly negotiated, the doctrine does not apply.

Here, the insurance policy was drafted by an independent broker who was hired by [the insured] and acted in consultation with [the insured's] employees. The drafted policy was then shopped to at least two different insurance companies. [The insured] selected [the defendant] after reviewing its proposed policy, and [the defendant] adopted the broker's policy language without any changes to the provisions at issue. Under these circumstances, we believe the contract was either drafted by [the insured] or jointly drafted, and the doctrine of *contra proferentem* does not operate in [the insured's] favor.⁹⁵

*Buckeye Cellulose Corp. v. Atlantic Mutual Insurance Co.*⁹⁶ involved a marine cargo insurance policy that was largely drafted by the insured's agent. The insured argued that the policy should be read against the insurer. As in *Newport*, the court held that the rule of *contra proferentem* was not applicable:

The policy is not to be construed strictly against the insurer when the language in question was supplied by

⁹⁵ *Id.* at 794-95 (citation omitted).

⁹⁶ 643 F. Supp. 1030 (S.D.N.Y. 1986).

the insured or by his broker. At any rate, the rule for the determination of an ambiguity in a manner favorable to the insured loses much of its force where the contract of insurance is prepared by the insured.⁹⁷

Indeed, thirty years ago in *Eagle Leasing*, the Fifth Circuit, in strong language, recognized that the rule has no relevance to manuscript policies:

Significantly, the policy in question is not the usual printed form but is what is known as a “manuscript” policy, containing some standard printed clauses but confected especially for [the insured]. It is true, of course, as the trial judge observed, “scriveners of insurance policies are acutely aware of the meaning and effect of the language”. We comment: So too, are counsel for large companies carrying fleet insurance with annual premiums in six figures. There is no purpose in following a legal platitude that has no realistic application to a contract confected by a large corporation and a large insurance company each advised by competent counsel and informed experts.⁹⁸

An insurer may be able to use such law to support an argument that, as with standard forms, the rule of *contra proferentem* does not have any application where the insured’s broker or agent drafted the pertinent bond provisions.⁹⁹

VII. Conclusion

The days of ambiguities automatically being construed against the fidelity insurer are dwindling. Courts have begun to reconsider the underpinnings of the rule of *contra proferentem* and the history of the

⁹⁷ *Id.* at 1037-38 (quoting 2 Mark S. Rhodes, COUCH ON INSURANCE 2d § 15:78 at 389 (2d ed. rev. 1984)).

⁹⁸ *Eagle Leasing*, 540 F.2d at 1261.

⁹⁹ See also Johnson, *supra* note 41, at 36-37 and cases discussed therein.

standard bond forms in resolving ambiguities, in an attempt to do justice to the intentions of the parties. In most cases, consideration of such factors demonstrates that the rule of *contra proferentem* has no place in the interpretation of standard fidelity bonds. These decisions may ultimately lead to the abrogation of the rule in the context of standard fidelity bond forms.