

KEY ISSUES WITH EMPLOYEE DISHONESTY AND EMPLOYEE THEFT COVERAGE

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INTRODUCTION

This paper will address the most frequently litigated and often commented upon coverage requirements of the Employee Dishonesty Insuring Agreement of fidelity bonds. Although the requirements may be stated slightly differently depending on the bond form, they include:

- Direct Loss
- Manifest Intent
- Loss
- Collusion
- Financial Benefit or Improper Gain

The purpose of this paper is to introduce the reader to the issues that arise when dealing with these requirements. For further references, please contact either of the above authors.

THE “DIRECT LOSS” REQUIREMENT¹

In the majority of standard form Financial Institution Bonds, coverage begins with the phrase “Loss resulting directly from,” a relevant coverage clause. This phrase has become known as the “direct loss” coverage requirement. The purpose behind the requirement is to ensure proof that (1) the insured sustained a loss – measurable economic harm; and (2) the insured has shown, assuming all other coverage requirements are met, a direct loss – meaning a direct and immediate connection between the covered act and the claimed economic harm.

I. The Purpose and Development of a Financial Institution Bond – The Reason for the “Direct Loss” Coverage Requirement

Understanding the importance and meaning of the “direct loss” coverage requirement appropriately begins with a review of the purpose and historical development of fidelity – or financial institution – bonds. The most common scenario presenting the direct loss issue after an insured suffers a loss as a result of a dishonest employee.

To begin, an important distinction to recognize concerning a fidelity bond is that it is not a liability policy. *Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co., Inc.*, 676 N.Y.S.2d 559 (N.Y. App. Div. 1998), *appeal denied* 711 N.E.2d 643 (1999). “The difference turns on what is defined as the risk.” *Id.* at 565. Whereas “[i]nsurance covers the liability of the insureds to a

¹ The authors wish to acknowledge the contribution of Russell Ponessa, Partner with the Minneapolis office of Hinshaw & Culbertson LLP to this section of the paper.

third-party,...fidelity bonding covers the loss of property owned by the insured or held by the insureds, as a consequence of employee dishonesty.” *Id.* This distinction between a fidelity bond and a liability insurance policy is well recognized in the law. *See, e.g., First Mountain Mortg. Corp. v. Citizens Ins. Co.*, 2008 4604689, *3 (Mich. App. Ct. Oct. 9, 2008) (“employee dishonesty policies are not liability policies.”); *Fireman’s Fund Ins. Co. v. Puget Sound Escrow Closers, Inc.*, 979 P.2d 872, 876 (Wash. App. Ct. 1999) (“a fidelity bond indemnifies only against proven losses suffered by the insured; it does not indemnify the insured against liability.”).

What was originally called a Banker’s Blanket Bond was revised in 1980, and again in 1986, and is now generally known as a Financial Institution Bond. *See Wildau, Evolving Law of Third Party Claims Under Fidelity Bonds: When is Third Party Recovery Allowed*, 25 Tort & Ins. L.J. 92, 93-94 (1989). The post-1980 versions of the financial institution bond contain several relevant important coverage revisions. *Id.* The pre-1980 revision, however, restricted the bond’s language to provide coverage only for “[l]oss resulting directly from dishonest or fraudulent acts” of employees. *Id.* at 94.

The inclusion of the language “loss resulting directly from” in place of the language “loss through a fraudulent or dishonest act” was deliberate. The drafters of the language, the Surety Association of America (in coordination with the American Bankers Association) wanted to make it clear that Insuring Agreement A only covered first party losses the insured sustained as a result of the dishonesty of its employees – that is, the drafters wanted to make it clear that the bond was not providing liability insurance to the insured to cover its liability to third parties. *See Duncan L. Clore, Financial Institution Bonds* 23-24 (2d ed. 1998). The drafters felt compelled to change the language and provide clarity because certain courts had misinterpreted fidelity bonds as covering an insured’s liability to third parties arising out of the fraud or dishonesty of the insured’s employees. *See Kidder*, 676 N.Y.S.2d at 565. Another key change was also made at that time to the standard form fidelity bond that is relevant here – the exclusion for “indirect or consequential loss of any nature” was added. Wildau, 25 Tort & Ins. L.J. at 117.

These changes to the financial institution bond were intended to ensure that the coverage language would not be construed by courts as providing indemnity for the insured’s liability to third parties. *Lynch Props., Inc. v. Potomac Inc. Co.*, 140 F.3d 622, 627 (5th Cir. 1998). After the “resulting directly from” language was put into the financial institution bonds, many courts have confronted the issue of whether coverage is provided for an insured’s liability to third parties. In the vast majority of those decisions, the courts have held that a fidelity bond with the “loss resulting directly from” coverage language did not cover the insured’ liability to third parties arising out of the dishonest or fraudulent conduct of its employees.

II. The “Direct Loss” Coverage Requirement Is Unambiguous With a Plain and Ordinary Meaning Which Precludes Coverage for Losses from Third Party Liabilities.

The majority of courts that have considered the “direct loss” coverage language have found it to be “unambiguous” with a “plain and ordinary” meaning which precludes coverage for damages from third party liabilities. For instance, in *Direct Mortgage Corp. v. Nat’l Union Fire Ins. Co. of Pittsburgh, P.A.*, the Utah Supreme Court made its first pronouncement concerning

“direct loss” and fidelity coverage under Utah law. 625 F.Supp.2d 1171 (D. Utah 2008). In *Direct Mortgage*, an employee of an insured wholesale lending company falsified documents to enable otherwise unqualified loan applicants to obtain mortgages. *Id.* at 1173. The mortgages were then sold by the lending company to third party financial institutions including CitiMortgage, Countrywide Home Loans, GMAC Mortgage, and Washington Mutual. *Id.* When the fraud was discovered, the financial institutions demanded that the lending company buy back the fraudulent mortgages. *Id.* After doing so, the lending company sought coverage for the payments it made to the financial institutions from its insurer – National Union – under its employee dishonesty coverage. *Id.*

National Union denied the claim on the basis that coverage did not extend to an insured’s third party liabilities. *Id.* The U.S. District Court of Utah reviewed the history of fidelity bonds and noted the split among jurisdictions as to whether “direct loss” coverage should be reviewed under a proximate cause analysis or what has been referred to as the “direct means direct” approach. *Id.* 1174-75. The Court ultimately adopted the “direct means direct approach,” reasoning that the plain language of the fidelity bond demonstrates that it is not a liability insurance policy and the insured’s alleged losses were too contingent to be direct. *Id.* at 1175-78. The Court explained:

the cause of [the lender’s] actual financial loss was third parties’ enforcement of the warranty and buy-back provisions. The losses were not immediate or readily ascertainable at the time of [the employee’s] actions. And if the third parties never discovered the fraud or if they chose not to enforce the clauses, [the lender] would not have suffered the loss it now claims.

Id. at 1178. In a footnote, the Court further stated that, “[t]he law is relatively clear that fidelity bonds do not create third party beneficiaries and that such individuals who suffer loss may not maintain direct claims against the insurance company.” *Id.* at 1178, n.9. Accordingly, the Court dismissed the claim against the insurer. *Id.* at 1178-79.

Many other courts are in accord with the *Direct Mortgage* decision in holding that the plain and ordinary meaning of the bond language at issue does not cover third party liability losses arising from the conduct of a dishonest employee. In *First Mountain Mort. Corp. v. Citizens Ins. Co.*, the Michigan Appellate Court considered whether an insurer was liable to its insured after the insured was found liable to a third-party for non-economic damages caused by the fraud of its employees in connection with a mortgage for purchase of a house. 2008 WL 4604689 *1 (Mich. App. Oct. 9, 2008). The Court held that the policy was not a third-party liability policy and did not cover employers for the tortious acts committed by their employees against third-parties. *Id.* at *3. The Court explained, “[e]mployee dishonesty policies insure against the risk of property loss through employee dishonesty and, while the policies may cover the loss of third-party property possessed by an insured, they are not liability policies and do not protect employers against tortious acts that their employees commit against third parties.” *Id.*

In a decision from Minnesota concerning a “standard fidelity provision”, the Court in *Cargill, Inc. v. Nat’l Union Fire Ins. Co., et al.*, held:

[T]he provision unambiguously covers only [the insured's] direct losses, not claims arising from a third party's direct losses, and requires that the insured's loss – and not the third party's claim – be directly caused by employee theft in order for coverage to become available. "That the insureds may be liable to a third-party for loss of money resulting from employee [theft] does not transform a policy covering the insureds against a direct loss into one indemnifying against liability.

2004 WL 51671 *10 (Minn. App. Jan. 13, 2004) (quoting *Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co., Inc.*, 676 N.Y.S.2d 559, 564 (N.Y. App. Div. 1998), *appeal denied* 711 N.E.2d 643 (1999)).

Similarly, in an Illinois decision, the Court in *RBC Mortg. Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, stated that the phrase "loss directly from" for purposes of fidelity bond coverage means that an insured's consequential losses resulting from third party liabilities are not covered. 812 N.E.2d 728, 737 (Ill. App. 2004). The Court explained:

A "direct loss" must be afforded its plain and ordinary meaning. (citation omitted). To equate "loss resulting directly from" with "loss proximately caused by" requires a strained reading of "direct loss" which is much narrower concept than "proximately caused loss." This is because a proximate cause "need not be the sole cause nor the last or nearest cause. It is sufficient if it concurs with some other cause acting at the same time, which, in combination with it, causes the injury." (citation omitted).

Id. at 736-37.

Wisconsin courts are also in agreement. For example, in *Tri-City National Bank v. Federal Insurance Co.*, the Wisconsin Appellate Court applied the plain and ordinary meaning of a fidelity bond to hold that the plaintiff's losses from third party settlements were outside the fidelity bond's coverage. 674 N.W.2d 617 (Wis. Ct. App. 2003). The Court explained:

Tri-City's losses – the settlements with the mortgage companies – are not the direct result of the employee's dishonesty; the employees were dishonest by permitting financially inappropriate people to obtain mortgages from other entities, not the employer bank. Thus, the bank initially lost nothing as a result of their dishonesty. It was only after the unsuitable mortgagees defaulted on their loans and the mortgage company sued Tri-City that 'losses' resulted.

Id. at 626.

III. The Proximate Cause Approach to the Direct Loss Requirement

Some courts have interpreted the "direct loss" coverage requirement in a way as to allow a more liberal "proximate cause" standard. A careful reading of those decisions demonstrates they are often attributable to a mistaken reliance on inapplicable precedent (pre-1980 "any loss" fidelity bond and casualty insurance coverage cases) or from an improper borrowing of tort law principles (i.e. the tort law in many states equates "direct cause" with "proximate cause"). Other

decisions seem to misidentify the actual loss at issue, while others can only be explained as result oriented.

In *Graybar Electric Co., Inc. v. Federal Ins. Co.*, the Eastern District Court of Missouri stated that fidelity policies reviewed under Missouri law would be subject to “a proximate cause analysis to determine if a loss was a direct result of an action.” 2007 WL 1365327 *5 (E.D. Mo. May 9, 2007). *Graybar* concerned losses arising from an alleged marketing and distribution agreement between the insured – a distributor of electronic and telecommunication products – and a third party distributor of office supplies. *Id.* at *2-3. The office supplier alleged that one of the insured’s employees entered into an agreement to jointly market and sell their products. *Id.* at *3. After upgrading its infrastructure and raising capital for the partnership, the insured represented that the alleged agreement was fraudulently entered into and refused to perform under the agreement. *Id.* Underlying litigation resulted in the insured paying the office supplier \$1,775,000.00. *Id.* The insured then submitted this claim to its fidelity insurer for payment. *Id.* at *4. Coverage was extended to some, but not all of the losses and suit was filed to recover the remainder. *Id.*

The Court noted that, under Missouri law, “direct is a synonym of proximate.” *Id.* at *6 (citing *John Drennon & Sons Co. v. New Hampshire Ins. Co.*, 637 S.W.2d 339, 341 (Mo. Ct. App. 1982)). Finding no exclusionary language in the fidelity policy, the Court denied motions for summary judgment and held that “any losses that are proximately caused by the forgery are covered.” *Id.* at *7.

In *Frontline Processing Corp. v. American Economy Ins. Co.*, the Montana Supreme Court applied a proximate cause analysis to determine the extent of losses under a fidelity policy. 149 P.3d 906, 335 Mont. 192 (Mont. 2006). In *Frontline*, an insured credit card processing company’s employee responsible for paying the insured’s taxes forged checks and failed to pay the company’s payroll and corporate income taxes. *Id.* at 908. The insured hired several companies to investigate the extent of its losses, including companies for forensic computer examinations, forensic handwriting analysis and financial analysts. *Id.* The insured then submitted the costs of these companies and the costs, penalties, interest, and fees assessed by the Internal Revenue Service resulting from the unpaid taxes to its insured for payment under an employee dishonesty policy. *Id.*

Under the proximate cause standard, the Court held that all of these costs were incurred by the insured as a consequential loss from an employee’s theft rather than third party losses. *Id.* at 910. The Court reasoned, “[the insured’s] claims are not the result of lawsuits by or settlements made to third parties. Rather,...they arise from costs incurred to investigate the extent of [the employee’s] dishonest conduct and to mitigate and remedy the discovered damage.” *Id.*

Similarly, in *Auto Lenders Acceptance Corp. v. Gentilini Ford*, the New Jersey Supreme Court reversed what was a favorable decision of the appellate division on meaning of direct loss. 854 A.2d 378, 181 N.J. 245 (N.J. 2004); *see also* 816 A.2d 1068, 358 N.J. Super 28 (N.J. App. Ct. 2003). The Supreme Court held that traditional principles of proximate cause should be used in determining whether an insured sustained a direct loss under employee dishonesty coverage. The facts involved a dishonest employee of the insured automobile dealer who falsified loan

applications for the buyers of vehicles, causing a third party lender to advance credit. The fraud was discovered, and the dealer had to make good on the loans under its agreement with the lender. The dealer's employee dishonesty policy covered a "direct loss of" business property, money, and securities caused by employee dishonesty.

The appellate division decided the case based on the nature of the loss. It viewed the dealer's having to pay the lender as having to satisfy a claim made by a third party – not a direct loss of the dealer's own property. The supreme court, however, ignored the nature of the loss, and instead looked at how it occurred. It then held that if the dealer's loss was "proximately" caused by employee dishonesty, it was "directly" caused by that dishonesty.

IV. The "But For" or "Cause-In-Fact" Approach to the Direct Loss Requirement

One final approach courts have considered in direct loss analysis, include the "but for" or "cause-in-fact" approach. In *First National Bank v. Lustig*, an insured bank's employee made misrepresentations in connection with loans issued based on fraudulent reports. 961 F.2d 1162 (5th Cir. 1992). The insurer argued that losses resulted from the decline in the general real estate market. *Id.* at 1167. In considering whether such alleged losses were direct, the U.S. Court of Appeals for the Fifth Circuit applied Louisiana law to state that "[a] loss is directly caused by the dishonest or fraudulent act within the meaning of the Bond where the bank can demonstrate that it would not have made the loan in the absence of the fraud." *Id.* at 1167-68. The Court further explained:

The [sureties] would have us read the requirement that the loss be directly caused by the dishonest or fraudulent act narrowly. Such a reading would, however, all but eliminate coverage for loans made because of dishonest or fraudulent acts. There will always be some intervening cause for the failure of these loans to be repaid; otherwise the bank would suffer no loss.

Id. at 1168. Accordingly, the Court held that "the decline in the real estate market did not preclude a finding of causation under the Bond." *Id.* at 1167.

In conclusion, courts have generally taken two approaches to defining "direct loss." The majority of courts have defined "direct loss" as unambiguous, and therefore, have precluded coverage for damages resulting from such things as third party liabilities because "direct means direct." However, a minority of courts have allowed the more broad "proximate cause" definition of "direct loss." Courts adopting this standard seem to mistakenly rely on inapplicable precedent regarding cases pre-1980, or on an improper borrowing of concepts from tort law. Finally, a few courts have applied a "but for" approach to direct loss. It is important to understand the jurisdictional split on this issue before proceeding in any litigation.

THE "MANIFEST INTENT" REQUIREMENT

Under the law, the definition of "intent" differs pending on the legal context. For example, under criminal law, crimes can be committed with either "general" or "specific intent." General intent is represented by acts done by a defendant for which they know the result would be "practically certain or substantially certain to occur." Duncan L. Clore, *Financial Institution Bond*, 57 (3d Ed. 2008). Specific intent is demonstrated where a "defendant actually intend[s] or

desire[s] the results of his actions.” *Id.* at 58. Under the model penal code, specific intent is more akin to “purposeful” conduct whereby a party acts with a “conscious desire” for a particular result. *Id.* at 59. Acts done “knowingly” is akin to general intent whereby a person acts with awareness “that a result is practically certain to follow from his conduct.” *Id.* (quoting *U.S. v. Bailey*, 444 U.S. 394, 404 (1980)). Finally, tort law constructions of intent are based on the concept that an “actor desires to cause the consequences of his act, or that he believes that the consequences are substantially certain to result from it.” *Id.* at 61 (quoting Restatement (Second) of Torts § 8A(1977)). These different interpretations of the term “intent” have also crossed over into different courts analysis of what “manifest intent” means under fidelity policies.

In order for coverage to apply under the employee dishonesty coverage of many fidelity policies today, one requirement an insured must prove is that their employee acted with a “manifest intent” to both cause the insured to sustain a loss and obtain a financial benefit for himself or another. For example, the Crime Protection Policy of the Surety Association of America, March 2000 edition, includes the following coverage provision:

1. Employee Dishonesty

We will pay for loss of, and loss from damage to, money, securities and other property resulting directly from dishonest acts committed by an employee, whether identified or not, acting alone or in collusion with other persons, and with the manifest intent to:

- a. cause you to sustain a loss; and also
- b. obtain financial benefit (other than employee benefits earned in the normal course of employment, including: salaries, commission, fees, bonuses, promotions, awards, profit sharing or pensions) for:
 - (1) the employee; or
 - (2) any person or organization intended by the employee to receive that benefit.

Before 1976, a showing of “manifest intent” was not required in Commercial Crime or Financial Institution Bond policies. Exemplified in the Bankers Blanket Bond Form 24, revised in 1969, the bond provided coverage for:

loss through any dishonest or fraudulent act of any of the employees, committed anywhere and where committed alone or in collusion with others, including loss, although any such act of any of the employees, of the Property held by the Insured for any purpose or in any capacity and whether so held fortuitously or not and whether or not the Insured is liable therefore.

However, these earlier bonds did not contain a specific definition of dishonest or fraudulent acts and thus forced litigants to look to the courts to provide an appropriate definition.

Early court cases interpreting the dishonesty language defined dishonesty as “a want of integrity,”² or which is “manifestly unfair to the employer,”³ and in later cases “recklessness.”⁴ Eventually, the courts interpreted this coverage without any reference to the intent of the employee to harm the employer. This broad interpretation of dishonesty led to a finding of coverage for claims that were never intended to be covered by the insurers.

Therefore, in response to the courts’ broad interpretation, the Employee Dishonest coverage was first modified by rider and then eventually by modification of the Financial Institution Bond in the 1980 revision of Standard Form Number 24 to include the manifest intent requirements. The language was later adopted by various Commercial Crime policies in 1986. The purpose of the revision was to restrict coverage to only those claims where an employee intended to cause a loss to the employer and a financial benefit to himself and others.

I. Three Interpretations of “Manifest Intent”

In interpreting the manifest intent language, the courts have taken essentially three approaches which can best be characterized as, “the Specific Intent test or Subjective test,” the “Objective test” and the “Substantial Certainty test.”

A. Specific Intent or Subjective Test

Courts applying the Specific Intent or Subjective Test focus on the true or actual intent of the employee, and whether the employee specifically intended to cause the employer a loss. *Oriental Financial Group v. Federal Insurance Co.*, is a case illustrative of this approach. 309 F.Supp.2d 216, 220 (D. Puerto Rico 2004). In *Oriental*, an insured bank brought a claim to recover under a fidelity bond after an employee fraudulently and dishonestly manipulated bank accounts, ledgers and mortgage loans. In making a “subjective evaluation of [the employee’s] motivation,” the U.S. District Court for Puerto Rico examined deposition statements taken by the employee to determine whether he intended to cause the bank a loss. *Id.* at 221. Although the employee stated that he never intended to cause a loss to the bank, the Court stated that such statements alone were insufficient to prove that the requisite intent did not exist. *Id.* Rather, “[t]he employee’s intent to cause a loss to [the insured] may be substantiated via circumstantial evidence and ‘a claim by an employee that he intended no loss to the bank is not conclusive.’” *Id.* (citing *FDIC v. United Pacific Ins. Co.*, 20 F.3d 1070, 1078 (10th Cir. 1994)).

Another example is the case of *General Analytics Corporation v. CNA Ins. Co.*, an employee altered purchase orders to indicate that a customer had ordered one brand of parts, when in fact he had ordered a different brand. 86 F.3d 51 (4th Cir. 1996). The employer suffered a loss when the customer would not accept delivery of the altered brand of parts. *Id.* at 52-53. The question before the U.S. Court of Appeals for the Fourth Circuit was whether the employee, when altering the purchase orders, had a manifest intent to cause the loss suffered by the employer. *Id.* at 53. The Court held that in order to establish manifest intent, the employee had to have acted with a specific intent. *Id.* at 54. In order to determine that specific intent, the

² United States Fidelity & Guaranty Co. v. Bank of Thorsby, 46 F.2d 950, 951 (5th Cir. 1931).

³ London & Lancashire Indemnity Co. of America v. Peoples Nat. Bank Trust Co., 59 F.2d 149, 157 (7th Cir. 1932).

⁴ Home Indem. Co. v. Reynolds & Co., 187 N.E.2d 274, 277 (Ill. Ct. App. 1963).

Court stated that it was necessary to analyze both the words and conduct of the actor, as well as all the surrounding circumstances, in order to determine the employee's true purpose. *Id.* The Court then gave the following example to illustrate its point:

Thus, for example, the mere fact that a person discharges a firearm, killing a bystander, does not establish that the person holding the firearm shot the bystander with the intent to kill him. On the other hand, evidence that the person had just quarreled with the bystander (motive), that the person said, after shooting the bystander, 'he deserved it' (subjective expression), and that the person was seen aiming the firearm at the bystander (conduct) tends to establish the person's intent to kill the bystander.

Id. Until resolution of such issues, summary judgment was precluded. *Id.*

B. Objective Test

The Objective test looks to the natural consequences of an employee's actions, and presumes that the employee intended those consequences. In the recent case of *Oriental Financial Group, Inc. v. Federal Ins. Co.*, an insured financial holding company filed losses under a fidelity policy after some of its employees were alleged to have committed dishonest or fraudulent acts in connection with reconciling various banking accounts. 598 F.Supp.2d 199, 203 (D. P.R. 2008). The insured's fidelity policy only required a showing of intent, rather than "manifest" intent and was stated as follows:

The underwriter agrees to indemnify the Insured for loss resulting solely or directly from one or more dishonest acts by an Employee, whether committed alone or in collusion with others, which acts are committed with *intent*: (1) to cause the Insured to sustain such loss, or (2) to obtain financial benefit for the Employee.

Id. at 202 (emphasis added).

In considering whether the intent standard was satisfied, the U.S. District Court for Puerto Rico stated the proof required "that the employees acted with intent to cause the bank to sustain such loss, or to obtain financial benefit to themselves." *Id.* at 214. The insured argued that the employee's acts were intentional because they did not comport with professional regulations required of all accounting employees and because the employees testified that they intentionally committed the acts with the understanding that it was possible that the bank would suffer losses resulting from non-reconciled accounts. *Id.*

Although the Court ultimately held that the insured's inability to prove the existence of a loss also precluded their ability to demonstrate intent, the Court reasoned that intent could otherwise be shown if a person "desires to cause the consequence of his acts or knows that the result is the natural and probable consequence of his actions." *Id.* at 215. Accordingly, "even if a person does not desire to cause the consequences of his actions, if he knows that his actions will naturally or probably cause said consequences, then he is deemed to have acted with intent to cause them." *Id.*

In *Bancinsure, Inc. v. BNC Nat'l Bank, N.A.* an insured bank's loan officer extended several loans and lines of credit to a third party production company that obtained such loans through inaccurate financial documentation. 263 F.3d 766 (8th Cir. 2001). The employee's husband also formed a company with the owner of the production company and later the employee and her husband bought out the owner's interest. *Id.* at 769. After many of the loans and lines of credit were never repaid and were insufficiently secured, the bank submitted a loss claim to its fidelity insurer. *Id.*

In subsequent litigation over payment of the loss, the U.S. Court of Appeals for the Eighth Circuit considered whether the employee had the requisite manifest intent to cause a loss to the bank. *Id.* In its analysis, the Court affirmed the district court's application of the following jury instruction defining "manifest intent" under North Dakota law:

You may consider any statement made or act done or omitted by a party whose intent is in issue, and all of the facts and circumstances which indicate his state of mind. You may consider it reasonable to draw the inference and find that a person intends the natural and probable consequences of acts knowingly done or knowingly omitted.

Id. at 770-71. The Court concluded that the jury's finding of manifest intent to cause the bank a loss was supported because the employee "involved herself in such a way as to secure her own rights [regarding her company's interests] at the expense of the bank's security" by extending loans to the production company to in order to receive benefits to her company from the owner.

Other courts, such as those in *Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.*, 854 A.2d 378 (N.J. 2004) and *Transamerica Ins. Co. v. FDIC*, 465 N.W.2d 713 (Minn. Ct. App. 1991) *rev'd on other grounds*, 489 N.W.2d 224 (Minn. 1992), have also held that a person is deemed to have intended the natural consequences of his actions. The test does not look to the actual intent of the actor, but focuses primarily on the results of his actions. Therefore, an employee may be acting with the best of intentions, but if he engages in reckless conduct, the natural consequence of which is a loss to the employer, the Objective test would find that he acted with a manifest intent to cause the loss.

C. Substantial Certainty Test

Courts adopting this approach may look to evidence of the specific intent of the actor, but such intent is not controlling. A court also looks at all of the circumstances surrounding the loss to determine whether or not the loss to the employer was substantially certain to result from the actions of the employee. Accordingly, this approach can produce differing results depending on how the court weighs evidence of actual intent.

In *Phillip R. Seaver Title Co., Inc. v. Great Amer. Ins. Co.*, an insured title company's escrow closing agent responsible for receiving client money and placing it into appropriate escrow accounts began embezzling money for personal use. 2008 WL 4427582, *1 (E.D. Mich. Sept. 30, 2008). To cover up the scheme, the agent transferred money between accounts to cover shortfalls in other accounts. *Id.* After discovering the scheme, the title company replenished funds from the escrow accounts affected and submitted a claim to its insurer under a Crime

Protection Policy that covered losses for employee dishonesty. *Id.* The insurer denied coverage for claims relating to money the title company paid into its escrow account. *Id.*

The U.S. District Court for the Eastern District of Michigan first held that the losses for replenishing client accounts were direct, rather than third party losses because the title company's "overall funds were directly impacted" by the dishonest employee's acts. *Id.* at *3. Thereafter, the Court considered whether the employee acted with the requisite intent, stating "the concept of 'manifest intent' does not necessarily require that the employee actively wish for or desire a particular result, it does require more than a mere probability." *Id.* at *4 (quoting *F.D.I.C. v. St. Paul Fire & Marine Ins. Co.*, 942 F.2d 1032, 1035 (6th Cir. 1991)) (internal quotations omitted). "Manifest intent exists when a particular result is 'substantially certain' to follow from conduct." *Id.* (quoting *Peoples Bank & Trust Co. of Madison County v. Aetna Cas. & Sur. Co.*, 113 F.3d 629, 635 (6th Cir. 1997)) (internal quotations omitted). Accordingly, the Court stated that it would not "delve into [the employee's] mind to determine whether she intended to harm [the title company]," but concluded "as a matter of law, based on [the employee's] conduct, there was substantial certainty [the title company] would face a financial loss as a result of her embezzlement." *Id.* at *5.

Similarly, the U.S. Court of Appeals for the Tenth Circuit, in *FDIC v. United Pacific*, stated:

Manifest intent does not require that the employee actively wish for or desired a particular result; rather, manifest intent exists when a particular result is substantially certain to follow from the employee's conduct. Manifest intent to cause loss may be inferred from an employee's reckless conduct and other circumstantial evidence. Direct evidence of the employee's intent is not required, and a claim by an employee that he intended no loss to the bank is not conclusive.

20 F.3d 1070, 1078 (10th Cir. 1994).

II. The Future of Manifest Intent

The *Oriental* reading of manifest intent comports with the latest revision of the Surety Association of America Financial Institution Bond Form 24, which has replaced "manifest intent" with the terms "active and conscious purpose." In adopting this language, the Surety Association stated its reasoning as follows:

The change was made in light of the fact that some judicial decisions misinterpreted the meaning of 'manifest intent.' In those cases[,] courts applied a tort concept of intent and found that the employee intended the natural and probable consequences of his acts or intended a result substantially certain to occur. The drafters of the language intended a stricter meeting of a conscious object to cause the result. 'Active and conscious purpose' is meant to restore that standard.

Letter from Robert J. Duke, Director – Underwriting of the Surety Association of America dated December 24, 2003 to Alabama Commissioner of Insurance.

Whether or not this wording will be adopted by more carriers is yet to be seen. Competitive issues will certainly play a role in the ultimate decision.

Overall, courts have taken three different approaches in interpreting “manifest intent” which include: the “Specific Intent or Subjective test,” the “Objective test,” and the “Substantial certainty test. Because of these different interpretations, the Surety Association of America Financial Institution Bond Form 24 has replaced “manifest intent” with the terms “active and conscious purpose” in order to reiterate the policies true objectives. Only time will tell if this new language will be adopted by insurers and thus will help the courts interpret the policy as the drafters intended.

THE LOSS REQUIREMENT

When determining whether a loss occurred under a typical fidelity institution bond the threshold question presented is was there an actual loss. Bradford Carver, *Handling Fidelity Bond Claims* 364 (Michael Keely and Sean Duffy eds., ABA Publishing (2d ed. 2005)). Addressing the first question, most financial institution bonds do not define the word “loss” and thereby leave it to the courts to do so. *Id.* at 365. In *Cincinnati Insurance Co. v. Star Financial Bank*, the U.S. Court of Appeals for the Seventh Circuit defined “loss” as an “actual present loss, as distinguished from a theoretical or bookkeeping loss.” 35 F.3d 1186, 1191 (7th Cir. 1994). This definition of loss was recently applied in *Oriental Financial Group, Inc. v. Federal Insurance Co., Inc.*, where employees of an insured financial holding company fraudulently reconciled customer bank accounts. 598 F.Supp.2d 199, 203. This allegedly prevented the insured from reconciling accounts to the extent of creating a \$3.4 million loss. *Id.* at 208. The U.S. District Court for Puerto Rico stated:

Loss under a fidelity bond refers to actual loss, as distinguished from a theoretical or bookkeeping loss. A recoverable loss is a direct loss, or the actual depletion of funds, i.e. cash, caused by the employee’s dishonest acts. Bookkeeping or theoretical losses, not accompanied by actual withdrawals of cash or other such pecuniary loss, are not recoverable losses.

Id. at 209. The Court further stated that loss could be proved through circumstantial evidence as the insured did “not need to prove its loss with mathematical precision or certainty, or to identify the specific items that make up the loss.” *Id.*

The insured alleged that it suffered losses by its inability “to realize its assets because it could not obtain the supporting documentation to properly reconcile the accounts.” *Id.* The Court stated that such might represent loss if it was proved that “more likely than not, [the insured] would have realized assets upon complete reconciliation of the pending transactions.” *Id.* Because the transactions that made up the unreconciled amounts could not be identified, the Court held that no actionable loss occurred under the insured’s fidelity bond because it was unable to prove that “money left the bank or that it could not realize assets it otherwise would have.” *Id.* at 210. Further, the Court explained that “[e]ven if there was a write-off, the evidence show[ed] that more likely than not, the write-off was an accounting adjustment not based on actual loss.” *Id.*

In *Fireman's Fund Insurance Co. v. Special Olympics International, Inc.*, an insured charity filed a claim under its fidelity policy after its employee conducted an unauthorized fund-raising scheme to raise over \$1 million that was used by the employee for personal expenses. 249 F.Supp.2d 19, 23 (D. Mass. 2003). The employee deposited the donations in a bank account fraudulently opened using the insured's name and other business documentation. *Id.* The insured argued that its "loss" was comprised of the contributions fraudulently obtained through use of the its name as the employee's misconduct was allegedly "tantamount to his taking checks from [the charity's] mailbox, from its authorized accounts, or from its petty cash supply." *Id.* at 27-28. The U.S. District Court for Massachusetts disagreed, stating that "donations," made without [the insured's] knowledge and deposited into an account over which [the insured] had no knowledge or control, were not consummated gifts,...[and thus], were not included in [the insured's] assets." *Id.* at 28. The Court concluded that the donors, rather than the insured, were the parties to have suffered a loss of tangible assets from the fraudulent scheme. *Id.* at 29.

Other instances where courts have found losses to occur are, *First State Bank of Monticello v. Ohio Casualty Insurance Co.*, the U.S. Court of Appeals for the Seventh Circuit which applied Illinois law to find that a loss occurred when dishonest employee "repeatedly exchanged bad checks for the [insured bank's] money orders," resulting in dishonor of the insured's attempt to cash the checks. 555 F.3d 564, 569 (7th Cir. 2008). Similarly, in *FDIC v. United Pacific Insurance Co.*, the U.S. Court of Appeals for the Tenth Circuit applied Utah law to rule an insured bank suffered losses when acts of its dishonest employee actually caused it to disburse a \$4.5 million loan that could not be recovered. 20 F.3d 1070, 1080 (10th Cir. 1994); *see also Amer. Trust & Sav. Bank v. U.S. Fidelity & Guar. Co.*, 418 N.W.2d 853, 855 (Iowa 1988) ("loss'...refer[s] to the actual depletion of bank funds caused by the employee's dishonest acts and not the eventual personal liability of the employee to the bank.").

These cases underscore the point that a loss will not be deemed to occur unless the answer is "yes" to the colloquial question, "has any money left the doors of the insured?" Carver, 365. Bookkeeping and other indirect or theoretical losses normally do not qualify as loss. In determining the ultimate amount of loss other issues such as the method of computation of loss and how recoveries are to be applied also come into play. Carver, 367-369. These issues are more fully addressed by Bradford R. Carver in *Handling Fidelity Bond Claims* referenced above.

THE COLLUSION REQUIREMENT

Often, disputes concerning the requirement of collusion under fidelity policies arise out of a situation where another employee has knowledge of a dishonesty employee's conduct, but remains silent. Michael Keely, Lisa A. Block, *Loan Loss Coverage Under Financial Institution Bonds* 59 (Gilbert J. Schroeder and John J. Tomain, eds. ABA Publishing (2007)). In such instances, courts have considered whether the silent employee is colluding with the dishonest employee for purposes of coverage under a loan loss. *Id.* This area of the law, however, has not been the subject of a significant amount of litigation over the years.

In *Adair State Bank v. American Casualty Company of Reading Pennsylvania*, the chairman of an insured bank's board of directors engaged in a check-kiting scheme by writing checks that would normally overdraft his account but for his practice of writing checks from

another overdrawn account at a separate bank to cover up the insufficient balance the chairman had on his account with the insured bank. 949 F.2d 1067, 1069-70 (10th Cir. 1991), *overruled on other grounds*, *Stauth v. Nat'l Union Fire Ins. Co.*, 236 F.3d 1260 (10th Cir. 2001). Three of the insured bank's officers knew of the chairman's scheme, but did not disclose the fraudulent transactions for various reasons. *Id.* Two of the officers – a vice president and a secretary/cashier of the insured bank – were cousins of the chairman, one of which remained silent due to worry about “relatives inside and outside of the bank and about the effect on the family name if her cousin were exposed.” *Id.* The third officer to discover the scheme was the president of the insured bank and also a half-brother of the chairman. *Id.* at 1070. The president confronted the chairman about the scheme, but in return was threatened with financial ruin and loss of income and livelihood should he disclose the fraudulent transactions. *Id.* The chairman's scheme was later discovered during an FDIC examination. *Id.* at 1071.

The insured's fidelity bond covered “loss resulting directly from dishonest or fraudulent acts of an Employee committed alone or in collusion with others.” *Id.* at 1072. During litigation over a coverage dispute, both the insured and insurer agreed that fraudulent or dishonest acts were committed by the chairman with the requisite manifest intent to cause the bank a loss and to obtain a financial benefit. *Id.* A remaining issue was whether the chairman's acts were committed in “collusion” with the officers. *Id.* The president honored checks written by the chairman while knowing there was insufficient funds in his account and attempted to borrow money to place in the chairman's account to hide the scheme during the FDIC investigation. *Id.* at 1073. The vice president, responsible for internal control of the insured bank, submitted reports to the board of directors that hid the chairman's actions and even attempted to sell her shares in the insured bank before the chairman's actions were discovered. *Id.* at 1073-74. The secretary had no conversations with the chairman about the scheme, but was still responsible for submitting reports to the board of directors that neglected to report the chairman's actions.

Because the policy did not define the term, the U.S. District Court applied a plain and ordinary definition of “collusion” from Black's Law Dictionary to make a finding of collusion. *Id.* at 1075. The Court held:

An agreement between two or more persons to defraud a person of his rights by the forms of law, or to obtain an object forbidden by law. It implies the existence of fraud of some kind, the employment of fraudulent means, or of lawful means for the accomplishment of an unlawful purpose....A secret combination, conspiracy, or concert of action between two or more persons for fraudulent or deceitful purpose.

Id. (quoting *Black's Law Dictionary* 240 (5th ed. 1979)). On appeal, the U.S. Court of Appeals for the Tenth Circuit only addressed whether the District Court's ruling that the secretary was in collusion with the chairman was correct. *Id.* The Court affirmed the ruling and, by its silence as to the other officers, implicitly agreed that the dictionary definition and application of collusion was correct as to the remaining officers. *Id.* at 1075-76.

Similarly, in *FDIC v. Aetna Casualty & Surety Co.*, 947 F.2d 196, 210 (6th Cir. 1991), the U.S. Court of Appeals for the Sixth Circuit affirmed the following jury instruction defining “collusion” over the insurer's argument that the instruction equated silence with collusion when

it stated: “In determining whether a director or officer was in collusion with [the dishonest employee], you may consider the silence of that person or his or her failure to report the dishonesty to the Board of Directors or regulatory authorities as evidence of collusion.” The U.S. District Court for Tennessee explained that “[t]he instruction does not equate silence with collusion; it simply states the logical conclusion that silence may be considered as evidence of such collusion.” *Id.* The Sixth Circuit considered this rationale sound because the district court’s charge further stated that “someone who colludes with another is one who enables, participates with or otherwise aids and abets his dishonest act by action or inaction.” *Id.*

In many cases, the insured argues that collusion is presumed to have occurred between, for example, a loan officer of a bank and a borrower. This is not always the case, as it was demonstrated in *Standard Chartered Bank v. Milus*, 826 F.Supp. 310, 311 (D. Ariz. 1990). In this case, an insured bank’s vice president and chief credit officer gave two illiquid borrowers undercollateralized loans for millions of dollars. *Id.* The loans were intended to keep the borrowers from defaulting with the bank since the borrowers ran a business that the vice president owned shares in through a stock option plan. *Id.* The term “collusion” was not defined in the bank’s fidelity policy, but the Court stated that it was agreed “that the term collusion is synonymous with the term conspiracy as it is used in the criminal context.” *Id.* at 312. The insured argued that collusion was present in the transaction because the approval of the bank loans were under such “egregious circumstances” that the borrowers must have known they were being approved for the vice president’s own purposes. *Id.* at 312.

The U.S. District Court for Arizona disagreed, stating that “[t]he fact that the loans were allegedly supported by worthless collateral does not support an inference that [the borrowers] knew of or intended to promote [the vice president’s] scheme, because there is no allegation that [the borrowers] engaged in activity knowingly designed to encourage the *unauthorized* lending of funds.” *Id.* at 313 (emphasis in original). The Court further explained that the “gist of conspiracy” is “intent...given effect by overt act.” *Id.* (quoting *Direct Sales v. U.S.*, 319 U.S. 703 (1943)) (internal quotations omitted). Without evidence of “clear and unequivocal” knowledge, “allegations of conspiracy [would be] made by piling inference upon inference.” *Id.*; see also *Progressive Casualty Ins. Co. v. First Bank*, 828 F.Supp. 473 (S.D. Tex. 1993) (insured’s allegation that dishonest employee violated bank policies in loans given to personal friends not enough to establish collusion without satisfying bond’s requirement that “there must be collusion, at least inferable, from the banker’s personal secret gain.”).

Overall, these cases demonstrate that mere silence alone will not be enough to implicate an otherwise honest employee’s conduct with a dishonest employee’s conduct for purposes of establishing “collusion” under a fidelity bond. Evidence to implicate the other employees as colluding with a dishonest employee needs to include facts suggesting active participation in the fraudulent scheme or affirmative neglect in correcting known errors that assist the dishonest employee in further perpetrating fraud.

THE FINANCIAL BENEFIT OR IMPROPER GAIN REQUIREMENT

The Employee Dishonesty Insuring Agreement requires that for coverage to apply the employee must not only have a manifest intent to cause a loss to the insured, but also a manifest intent to obtain a financial benefit for himself or for another person or organization to whom the

benefit is intended. The coverage grant parenthetically excepts from the term “financial benefit,” “employee salaries, commissions, fees, bonuses, promotions, awards, profit sharing and pensions or other employee benefits earned in the normal course of employment.” The question arises whether or not fraudulently obtained employee benefits are also excluded by the parenthetical language. The majority of courts have found that employee benefits, whether or not obtained by fraud, are excluded from the financial benefit requirement.

In *Mortgage Associates, Inc. v. Fidelity & Deposit Co. of Maryland*, the California Appellate Court provided an extensive discussion of the importance of the “financial benefit” requirement under fidelity bonds. 129 Cal. Rptr. 2d 365 (Cal. Ct. App. 2002). The Court stated:

The financial benefit requirement protects the insurer from claims where the employee’s motivation is either undeterminable or intangible. The employee must, instead, have acted dishonestly with the intent or motivation to receive financial gain for himself or for some third party. It is this additional financial motivation which implicates coverage under the employee dishonesty coverage provisions. Not only does the financial benefit requirement limit coverage to that intended under the policy or bond, it also helps to focus coverage on truly dishonest conduct and not conduct which is merely improper, negligent, or incompetent. An employee [who] causes his employer to incur a loss without receipt of any financial benefit rarely acts with the intent or malice which is implicit in the employee dishonesty coverage.

Id. at 379 (citing Armentrout & Price, *Financial Benefit Requirement* 4 (unpublished paper presented at 2002 Annual Midwinter Meeting of the Fidelity & Surety Law Committee of the ABA, New York, New York, January 2002)).

Recently, in *Palm Hills Properties, L.L.C. v. Continental Ins. Co.*, an insured property company’s employee, who was responsible for showing and renting various apartments, began misrepresenting the status of apartment rentals in order to collect bonuses in addition to her salary and commissions. 2008 WL 4303817 (M.D. La. July 23, 2008). After the company filed a loss claim under its fidelity policy, the U.S. District Court for the Middle District of Louisiana considered whether the employee demonstrated a manifest intent to obtain a financial benefit. *Id.* at *4. The insured’s policy, precluded “employee benefits earned in the normal course of employment, including: salaries, commissions, bonuses, promotions, awards, profit sharing or pensions.” *Id.* Accordingly, the Court held that the “plain language of the policy clearly exclude[d]” coverage for the alleged financial benefits resulting from the employee’s salary and bonuses. *Id.*

In perhaps an exceptional case, the U.S. District Court of Colorado in *F.D.I.C. v. St. Paul Companies*, denied summary judgment to an insurer which argued that bonuses resulting from fraud were precluded “financial benefits” under a fidelity policy. 634 F.Supp.2d 1213 (D. Col. 2008). The case involved an insured bank and third party that entered into a marketing and processing agreement whereby the third party sold travel memberships and offered its customers a bank-issued credit card to make their initial travel charges. Although the third party agreed to purchase the bank’s delinquent accounts, it began to re-age such accounts to make them appear

current. *Id.* at 1217. After discovering the scheme, certain bank employees began participating in the scheme and collecting bonuses therefrom. *Id.*

Under the insured's Fidelity Insuring Agreement, "financial benefit" did not include "any employee benefits earned in the normal course of employment, including: salaries, commissions, fees, bonuses, promotions, awards, profit sharing or pensions." *Id.* at 1221. The bank argued that the employees received financial benefits from the third party in addition to the bonuses. *Id.* Additionally they argued that the bonuses were derivative of embezzlement rather than the normal course of employment. *Id.* Moreover, the bank stated that the agreement covered financial benefits obtained for other persons such as the third party. *Id.* After taking note of testimony that the employees' relationships with the third party was "very valuable," the Court held that an issue of fact existed as to whether or not the employees obtained a financial benefit other than the bonuses. *Id.* at 1222.

Other courts have been more clear regarding the financial benefit requirement. For example, in *Performance Autoplex II Limited v. Midcontinent Casualty Co.*, an employee of an auto dealer obtained an unauthorized pay increase for herself and another person. The insured sought coverage under the policy arguing that the pay increase was not "earned" and was not obtained "in the normal course of employment," and, therefore, the exclusionary language would not apply. 322 F.3d 847 (5th Cir. 2003). The Court disagreed with the insured's argument and found no coverage, stating:

Looking at the plain language of a policy, the interpretation of rejecting coverage makes sense. If 'in the normal course of employment' means 'not obtained through employee dishonesty' the policy language excluding salaries would become mere surplusage. That is, the language excluding salaries presumes that there are acts of employee dishonesty that result in increased employee benefits that the insured and insurer agreed to exclude from coverage.

Id. at 858; see also *First Bank of Marietta v. Hartford Underwriters Mutual Ins. Co.*, 997 F.Supp. 934 (S.D. Ohio 1998) (court denying alleged financial benefits obtained by a dishonest employee consisting of "enhancement in the eyes of the local community and enhancement in the eyes of [the insured.]"); *Municipal Securities, Inc. v. Ins. Co. of North America*, 829 F.2d 7, 9-10 (6th Cir.1987) (No financial benefit was found in where a securities dealer made trades beyond the insured's inventory limit and committed other intentional reporting errors in order to obtain unearned commissions because they were obtained in the normal course of employment regardless of the fraudulent circumstances.).

There are a minority of cases holding to the contrary, including *Cincinnati Ins. Co. v. Tuscaloosa County Parking and Transit Auth.*, 827 S.2d 765 (Ala. 2002) and *Klyn v. Travelers Indemnity Co.*, 709 N.Y.S.2d 780 (N.Y. App. Div. 2000) holding that unauthorized salary increases due to employee dishonesty would be covered losses, as they are not employee benefits earned in the normal course of employment.

To summarize, for coverage under most Employee Dishonesty Insuring Agreements, the employee must not only have a manifest intent to cause a loss to the insured, but also a manifest intent to obtain a financial benefit to himself or to another person or organization to whom the

benefit is intended. The majority of courts have found that employee benefits, whether or not obtained by fraud, are excluded from the financial benefit requirement. The court in *Performance Autoplex II Limited* most succinctly summed up the majority opinion, when they held, “[i]f ‘in the normal course of employment’ means ‘not obtained through employee dishonesty’ the policy language excluding salaries would become surplusage.” 322 F.3d at 858. Despite the majority position, a minority of courts have held that an unauthorized salary increase due to an employee’s dishonesty would be covered.

The overall conclusion that can be drawn from the foregoing discussion of the issues arising under the Employee Dishonesty Insuring Agreement, is that the analysis is dependent on the law of the appropriate jurisdiction. Therefore, it is imperative that one consider the varying results that can derive depending on the law of the jurisdiction which is being applied.