Introduction

Fidelity bond coverage is a specific and defined coverage that is designed to protect an insured company against the loss of its own property as a result of theft or dishonest acts by its employees. To ensure that fidelity bonds are applied consistent with this intent, they contain three important requirements: (1) the property at issue must be “covered property,” which is generally defined to refer only to the employer’s property; (2) the employee’s conduct must have caused a “direct loss” to the insured; and (3) the employee must have had a “manifest intent” to cause injury to the insured. Of course, employees may engage in all sorts of other conduct that is unlawful and that creates liability for the employer—for example, negligent supervision, negligent misrepresentation, or breach of fiduciary duty—but fidelity bonds are not intended to cover such risks.

In a case decided a few months ago, however, the Sixth Circuit Court of Appeals in First Defiance Financial Corp. v. Progressive Casualty Insurance Co. stretched all of these core requirements to find coverage under a fidelity bond where an employee stole money from non-custodial customer accounts. This article discusses the holding in First Defiance and how it portends an effort by courts to expand fidelity bonds to afford coverage for risks they were not intended to cover.

First Defiance

In First Defiance, an insurer issued a fidelity bond to a bank covering “loss resulting directly from dishonest or fraudulent acts committed by an Employee, acting alone or in collusion with others.” The bank hired as employees investment advisers who managed discretionary brokerage accounts for the bank’s clients. The investment advisers traded securities through a third-party broker-dealer, while a fourth institution, which was not an insured, held each client’s assets in individual accounts accessible only to the bank’s investment advisors.

In April 2007, the bank learned that one of its investment advisors had transferred over $850,000 from his clients’ brokerage accounts into his own bank account. The bank reimbursed the stolen money, plus an additional $72,000 to cover lost interest and unrealized client income, and filed a proof of loss under its fidelity bond, claiming over $900,000 in covered losses. When the insurer denied coverage, the bank filed suit. The district court held that the bank’s losses were covered under the bond as a matter of law, and the Sixth Circuit affirmed in a 2-1 decision. As discussed below, that decision misconstrued critical fidelity bond provisions.

Covered Property

The First Defiance court first confronted the question whether the money stolen from the bank’s customers was covered “loss of property… owned and held by someone else under circumstances which make the insured responsible for the property prior to the occurrence of the loss.” The insurer contended that the bank was not responsible for the stolen money because the funds were held by a separate, non-insured institution and were not guaranteed by the bank. The majority, however, rejected this argument. The court reasoned that the bank had a fiduciary duty to its customers to manage their assets that pre-dated the thefts, making the bank responsible for the property prior to the occurrence of the loss.

In a case decided a few months ago, however, the United States Court of Appeals for the Sixth Circuit in First Defiance Financial Corp. v. Progressive Casualty Insurance Co. stretched all of these core requirements to find coverage under a fidelity bond where an employee stole money from non-custodial customer accounts. This article discusses the holding in First Defiance and how it portends an effort by courts to expand fidelity bonds to afford coverage for risks they were not intended to cover.
property by virtue of the fact that the bank was responsible for a breach of fiduciary duty after the breach. But that does not establish that the bank had responsibility prior to the loss when the funds were held by a third party, not the bank.

Unlike First Defiance, other courts have held that fidelity bonds extending coverage to property “for which the insured is legally liable” do not cover settlements between insured employers and third parties that have been harmed by the dishonest actions of employees, reasoning that such interpretation would expand fidelity bond policies beyond their intended purpose. For example, in Lynch Properties, Inc. v. Potomac Insurance Co. of Illinois, an insured company discovered that its employee, a bookkeeper, had misappropriated money from personal bank accounts held by the company president.4 Although the president had paid the insured to perform the bookkeeping services, the personal bank accounts were separate from company funds. The insured reimbursed the president and filed a claim under its employee dishonesty policy, which limited coverage to property “that you own or hold” or “for which you are legally liable.”5 The Fifth Circuit held that the policy did not cover the misappropriated funds because the insured was not “legally liable” for the funds prior to the theft, but instead became vicariously liable for the employee's actions after the fact. The court reasoned that its acceptance of the bank's argument would mean that “[t]he policy would cover any loss where an employee takes a customer's property in the course of their employment responsibilities, regardless of whether the employer had any interest in the property itself” and “would transform this policy, which insures property loss... into a policy insuring any vicarious liability arising from an employee's dishonesty.”6 As the dissent in First Defiance noted, the industry responded to Lynch and similar decisions by adopting the key requirement that the employer’s responsibility for the loss vest “prior to the occurrence of the loss.”7 The Sixth Circuit opinion, however, abrogates that language.

Direct Loss
The Sixth Circuit’s decision in First Defiance also highlights a split in the courts as to whether to read fidelity bonds to require a “direct” loss—as the language reads—or to rewrite the language to allow for coverage based on a showing of proximate causation. The bond at issue in First Defiance insured against “loss resulting directly from dishonest or fraudulent acts committed by an Employee, acting alone or in collusion with others.”8 The Sixth Circuit held that it “makes no difference whether the phrase ‘direct loss’... establishes a proximate cause standard or something more exacting[.]”9 According to the majority, because the employee stole what qualified as “covered property,” the employee was automatically deemed to have “directly” caused the loss. As the dissent noted, however, this reasoning effectively grafts a proximate cause standard onto direct loss language. Any responsibility on the part of the bank arose after the fact from its vicarious liability for the employee's theft, not from a “direct” loss.

In addition to the Sixth Circuit, the Third Circuit and the Supreme Courts of Montana and New Jersey have adopted the proximate cause approach.10 The flaw with this approach is that it reads the word “direct” out of the policy. The employee did not steal from the bank—thereby causing a direct loss—but rather from the bank’s customers. Although the customers may have then had a viable claim against the bank for breach of fiduciary duty, that is not direct causation.

Other courts, including the Seventh and Ninth Circuits, have adopted a more stringent standard, described as the “direct means direct” approach.11 This approach requires that the loss be the direct or immediate result of the dishonest conduct. Unlike the proximate cause standard, this approach is consistent with the traditional nature and language of fidelity bonds, which generally exclude coverage for compensatory damages owed due to an indirect loss.

A recent case decided by the United States Court of Appeals for the Seventh Circuit, Universal Mortgage Corp. v. Württembergische Versicherung AG, illustrates the proper application of the “direct means direct” approach.12 In Universal Mortgage, a mortgage banker caused an insured bank to fund substandard mortgages in exchange for a kickback. The bank sold the loans, unaware that they were substandard. When the investors realized what they had purchased, they exercised their contractual right to force the bank to repurchase the loans, causing the bank to suffer substantial financial loss. After coverage litigation ensued, the district court held that the bank’s fidelity bond did not cover the loss, and the Seventh Circuit affirmed. The court reasoned that the bank’s contractual repurchase obligation, not the employee misconduct, was the direct cause of the financial loss, even though the contract liability itself arose from the employee’s misconduct. According to the court, “the [bank] recouped [its] loss in full when it resold the noncompliant loans to investors. The loss for which [the bank] seeks coverage arose later when investors exercised their contractual resale rights.”13

Manifest Intent
Finally, the Sixth Circuit’s decision in First Defiance expands the core fidelity bond requirement that the employee must have had a “manifest intent” “(1) to cause the Insured to sustain such loss, and (2) to obtain an improper financial benefit for the Employee or another person or entity.”14 Harkening again back to the bank’s purported “responsibility,” the majority in First Defiance reasoned that the employee had a “manifest intent” to cause the bank to sustain a loss because the fiduciary relationship between the bank and its clients made the bank responsible for the misappropriated property, such that the theft would be “substantially certain” to cause a loss. The majority reached this conclusion
despite the lack of any contractual provision requiring the bank to reimburse its clients in such situations.

The Seventh and Tenth Circuits and the Supreme Court of New Jersey have likewise adopted the “substantially certain” approach, which allows for a finding of manifest intent even if the employee did not actively wish for or desire a particular result. The problem with this approach is illustrated by the First Defiance opinion. The employee was clearly reckless, and may have even suspected that the bank might face future liability on account of his actions, but there was no evidence suggesting that the employee intended to cause a loss to the bank, as opposed to its customers. The dissent agreed, noting that the majority’s opinion ran counter to the fidelity bond’s manifest intent requirement.

The Second, Third, and Fourth Circuits, in contrast, have adopted the “specific intent” approach, which requires that the insured establish that the employee acted with the specific purpose, object, or desire to cause a loss to the employer, as in when an employee steals money from the employer. This approach is a closer approximation to the manifest intent language of fidelity bonds because the term “intent” indicates that a person has acted “purposefully,” as opposed to merely “knowingly” or “recklessly.” Although courts generally permit objective evidence of the employee’s subjective intent, an employee’s recklessness or knowledge will not, in and of itself, satisfy the bond language.

**Conclusion**

The industry should continue to monitor courts’ divided treatment of these key fidelity bond issues. If courts continue to expand the reach of fidelity bonds to afford coverage for risks they were not intended to cover, insurers may want to consider modifying bond language to ensure that fidelity bonds are still read to indemnify against employee theft from the employer and are not expanded into policies that cover other employee conduct, such as breaches of fiduciary duty.

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