

Policyholders Get Digital Fraud Coverage Boost At 8th Circ.

By **Jeff Sistrunk**

Law360, Los Angeles (May 23, 2016, 9:30 PM ET) -- The Eighth Circuit's finding Friday that a bank employee's failure to secure a computer network doesn't nix insurance coverage for a fraudulent transfer loss caused by a hacker bolsters policyholders seeking coverage for digital fraud by laying blame at the hacker's feet despite the employee's negligence, experts say.

In a published opinion, a panel of the appeals court ruled Friday that BancInsure Inc. must foot the bill for a loss suffered by Minnesota-based State Bank of Bellingham after a hacker broke into the bank's computer network and orchestrated a fraudulent transfer to an overseas account.

BancInsure had argued that an exclusion in Bellingham's financial institution bond for employee-caused losses applied to bar coverage for the bank's claim stemming from the fraudulent transfer. But a Minnesota district court ruled, and the Eighth Circuit panel agreed, that even if employee negligence was a contributing factor to the loss, it is still covered because the hacker's illegal activities were the primary cause.

"We agree with the district court's conclusion that 'the efficient and proximate cause' of the loss in this situation was the illegal transfer of the money and not the employees' violations of policies and procedures," U.S. Circuit Judge Bobby E. Shepherd wrote for the panel.

According to experts, the Eighth Circuit's decision is good news for policyholders because it rebuffs a common argument made by insurance carriers in disputes over fidelity bonds and commercial crime policies: that negligence on the part of a policyholder's employees converts a covered loss caused directly by a third party's criminal acts into an indirect, uncovered loss.

"A key point in the decision was the court's finding that even if employees were negligent, that doesn't convert a direct loss into an indirect loss," said Barnes & Thornburg LLP partner Scott Godes. "That holding should help policyholders secure coverage for computer and funds transfer fraud losses around the country."

The coverage dispute between Bellingham and BancInsure stemmed from an October 2011 incident in which a hacker who had infected the Minnesota bank's computer system with a virus carried out a pair of fraudulent transfers of funds to accounts in Poland. Bellingham was unable to reverse one of the transfers, resulting in a \$485,000 loss, according to court documents.

To execute wire transfers, the bank used a specialized Federal Reserve system that required employees

to insert physical tokens into a desktop computer and then enter individual usernames and passwords, court papers said. The fraudulent transfers occurred after a Bellingham employee left tokens inserted in the computer overnight, according to court documents.

Banclnsure, which had issued Bellingham a fidelity bond covering claims resulting from computer system fraud, refused to cover the bank's loss, citing exclusions in the bond for employee-caused loss, theft of confidential information and mechanical breakdown of a computer system. Bellingham proceeded to sue Banclnsure in Minnesota federal court in April 2013, alleging that the insurer's failure to cover its claim constituted a breach of contract.

In September 2014, the district court found that the Banclnsure bond covered the fraudulent transfer because the hacker's illegal actions were the primary cause of the loss. Though a bank employee may have been negligent, it was not a "foreseeable and natural consequence" that a hacker would make a fraudulent wire transfer, the lower court held.

The Eighth Circuit panel **agreed** with the lower court's rationale, saying that the Bellingham employee may have failed to follow proper security protocols, but the overriding cause of the bank's loss was still the hacker's criminal conduct.

"Even if the employees' negligent actions 'played an essential role' in the loss and those actions created a risk of intrusion into Bellingham's computer system by a malicious and larcenous virus, the intrusion and the ensuing loss of bank funds was not 'certain' or 'inevitable,'" Judge Shepherd wrote.

The appellate panel's opinion shuts down popular positions that insurance carriers have asserted in coverage battles over fraudulent transfers and other losses tied to computer fraud, experts say. In many cases, insurers have cited policyholders' failure to maintain adequate security measures or sufficiently vet wire transfer requests as grounds for denying coverage.

"An effort to blame the victim for allowing losses circumvents the entire point of this kind of insurance," Godes said. "The purpose of this type of policy is to provide coverage where a company falls victim to a fraudulent scheme or cyberattack or both. To assert that the policyholder loses coverage because the employees were somehow negligent could vitiate the coverage."

Anderson Kill PC shareholder Joshua Gold pointed out that in most instances of computer fraud, insurers can always argue with 20/20 hindsight that the policyholder could have safeguarded money, securities or property better than it actually did. However, if courts accepted those arguments, banks and other policyholders could often have their crime coverage negated, he said.

"That kind of argument, if allowed to stand, would make coverage illusory in too many theft situations," Gold said.

The Eighth Circuit panel's analysis was largely based on its application of Minnesota's concurrent-causation doctrine, which states that when a policyholder's loss results from a combination of covered and excluded risks, the loss is covered unless an excluded risk is the "overriding cause" of the loss.

Banclnsure had contended that the concurrent-causation doctrine doesn't apply to fidelity bonds because the bonds require a policyholder to initially show that the loss directly resulted from dishonest or criminal conduct. According to Banclnsure, if the doctrine was applied to fidelity bonds, it would be impossible for an insurer to show that an excluded risk was the overriding cause of the loss.

But the appellate panel disagreed, rejecting Banclinsure's contention that Bellingham's fidelity bond imposes a higher standard of proof than the concurrent-causation doctrine. Applying the doctrine, the panel determined that the primary cause of the bank's loss was the illegal transfer of money, which is covered under Banclinsure's bond.

The panel's decision is a "nice, clear statement" that the concurrent-causation doctrine applies to fidelity bonds, according to Reed Smith LLP partner Traci Rea.

"That's the right analysis — policyholders purchase these bonds to cover incidents like what happened here," Rea said.

The Eighth Circuit panel also rebuffed Banclinsure's argument that the bond's exclusions for loss due to the theft of confidential information or the mechanical failure of a computer were written to avoid application of the concurrent-causation doctrine.

The insurer had argued that the language of the two provisions indicates that they apply where either of the excluded perils indirectly cause a loss. But the appellate panel said the exclusions' use of the term "indirectly" is not enough to defeat application of the concurrent-causation doctrine.

"Parties may include 'anti-concurrent causation' language in contracts to prevent the application of the concurrent-causation doctrine; however, in those cases where courts have found the contract contains an anti-concurrent causation clause, the language used is clear and specific," Judge Shepherd wrote.

The opinion should make it difficult for insurers to fight the application of the concurrent-causation doctrine unless they have included language in their policies clearly precluding the use of the doctrine in determining coverage, Greg Podolak, head of Saxe Doernberger & Vita PC's cyber risk practice.

"This will be a case that, given the context, will serve as a great example for policyholders to refer to in order to challenge wrongful denials when carriers are trying to advance an anti-concurrent cause position," Podolak said.

Senior U.S. Circuit Judge William J. Riley and U.S. Circuit Judges Lavenki R. Smith and Bobby E. Shepherd sat on the Eighth Circuit panel.

Joseph Arthur Nilan of Gregerson & Rosow argued the case for Banclinsure.

Jonathan Millea Bye of Lindquist & Vennum argued the case for State Bank of Bellingham.

The case is State Bank of Bellingham v. Banclinsure Inc. n/k/a Red Rock Insurance Co., case number 14-3432, in the U.S. Court of Appeals for the Eighth Circuit.

--Editing by Christine Chun and Philip Shea.
