

Straight Answers On “Direct Loss” in Fidelity Claims

By Edward J. Stein

The financial services industry is uniquely exposed to the risk of employee dishonesty. There may be practical limits to employee dishonesty losses in other sectors; only so much merchandise can be smuggled from a stockroom. But banks, brokers, and other financial service firms deal in digits, not widgets, and sheer ingenuity may be the only limit to what determined employees can steal.

Given this unique exposure, prudent financial institutions seek not only to limit their risk of employee dishonesty, through careful hiring and controls, but also to transfer it, through fidelity insurance. Like all insurance, though, fidelity insurance may be undermined by an insurance company’s skewed interpretation of policy wording when claims are presented. Thus, prudence also dictates careful analysis and forceful advocacy on fidelity claims.

One of the most commonly asserted insurance defenses is that the policyholder’s loss was not a “direct loss” within policy coverage. Policyholders should be encouraged by recent decisions which confirm the limited application of this defense.

“Direct Loss” Defense

Policyholders prevailed against “direct loss” defenses in two recent noteworthy decisions. In *Scirex Corp. v. Federal Ins. Co.*, 313 F.3d 841 (3d Cir. 2002), the policyholder was a testing laboratory which ran trials for drug companies and had to replicate several studies, at no charge, when it found that its nurses had routinely submitted false observations reports. Instead of observing patients for the full required time during drug tests, the nurses released patients early and “pre-recorded” their “observations,” making the initial studies unreliable and unsuitable for the clients’ purposes. The insurance company denied coverage, arguing that the cost of re-doing the studies was an ordinary operating expense, not a “direct loss” from employee dishonesty. The Third Circuit rejected that argument, reasoning that the employees’ false reporting of clinical observations was the proximate cause of the funds lost in replicating the drug tests.

Likewise, in *Building One Service Solutions, Inc. v. National Union*, No. 02-311-A (U.S.D.C. E.D. Va. 11/26/2002), a federal district court reached a similar result on “direct loss,” also applying a proximate cause analysis. The court in *Building One* agreed with the policyholder that employee dishonesty insurance covered not just the amounts directly embezzled by an employee, but also the policyholder’s losses on contracts fraudulently

ANDERSON KILL & OLICK, P.C.
1251 Avenue of the Americas
New York, NY 10020-1182
(212) 278-1000 Fax: (212) 278-1733

ANDERSON KILL & OLICK, P.C.
1600 Market Street
Philadelphia, PA 19103
(215) 568-4202 Fax: (215) 568-4573

ANDERSON KILL & OLICK, P.C.
One Gateway Center, Suite 901
Newark, NJ 07102
(973) 642-5858 Fax: (973) 621-6361

ANDERSON KILL & OLICK, L.L.P.
1275 K Street, N.W., Suite 1101
Washington, DC 20005
(202) 218-0040 Fax: (202) 218-0055

ANDERSON KILL & OLICK
190 South LaSalle Street, Suite 800
Chicago, IL 60603
(312) 857-2500 Fax: (312) 857-0122

ANDERSON KILL & OLICK, P.C.
Two Sound View Drive, Suite 100
Greenwich, CT 06830
(203) 622-7668 Fax: (203) 622-0321

www.andersonkill.com



who's who

Edward J. Stein is an attorney in the New York office of Anderson

Kill & Olick, P.C. Mr. Stein has represented policyholders in general liability, marine, fidelity, D&O, and E&O litigation throughout the nation. Mr. Stein also has represented a broad range of business clients in commercial litigation and environmental litigation and compliance matters.

The author regularly advise policyholders with regard to insurance coverage and litigation issues and represent policyholders in insurance coverage disputes.

For more information on these or other Financial Services matters, please contact one of the lawyers listed, each of whom are members of Anderson Kill's Financial Services Industry Coverage Group.

© Copyright 2003 Anderson Kill & Olick, P.C.

To subscribe to this or any of the Anderson Kill and Olick Newsletters and Alerts, visit us at:

www.andersonkill.com/subscribe

entered by the employee as part of the embezzlement scheme. The dishonest employee in *Building One* purposely underbid on contracts awarded to the policyholder, in order to create additional accounts which he used to cover up the embezzlement. The insurance company sought to pay only the directly embezzled amounts, not the losses on the resulting contracts, claiming that business judgments and market were conditions also contributed to the loss. The trial court found disputes of fact as to causation and therefore denied the defense motion for summary judgment, after which the insurance company, facing the threat of trial, settled the claim.

The proximate cause analysis in *Scirex* and *Building One* is consistent with many other decisions. Losses resulting from employee dishonest need not result immediately or be isolated from all other causes to be covered under fidelity insurance. The losses which can result "directly" from employee dishonesty are as varied as employee dishonesty itself, and can include not only contract fulfillment, as in *Scirex* and *Building One*, but also loan losses and even judgments or settlements in favor of third parties.

Conclusion

The risks transferred by modern fidelity insurance policies may be much broader than insurance companies admit when claims arise. Policy language varies, but the cases show that fidelity insurers often assert defenses which have no support in the policy language or rely on ambiguous language that, if challenged, will be construed in favor of coverage. Prudent financial institutions should vigorously dispute those defenses. If legitimate fidelity claims are not accepted and paid, then policyholders have transferred only premium, not risk. ■

Anderson Kill & Olick, P.C. created the Financial Services Insurance Coverage Group to serve its various clients in the financial industry and to focus its coverage expertise on the insurance issues common to broker/dealers, commercial banks, investment banks, investment advisors, hedge funds and financial institutions including mutual funds.

The information appearing in this newsletter does not constitute legal advice or opinion. Such advice and opinion are provided by the Firm only upon engagement with respect to specific factual situations. For more information contact one of the attorneys listed.

Eugene R. Anderson	(212) 278-1751	eanderson@andersonkill.com
Robert Chung	(212) 278-1039	rchung@andersonkill.com
Mark Garbowski	(212) 278-1169	mgarbowski@andersonkill.com
Robert M. Horkovich	(212) 278-1322	rhorkovich@andersonkill.com
Nicholas M. Insua	(215) 568-4711	ninsua@andersonkill.com
R. Mark Keenan <i>Co-Chair</i>	(212) 278-1888	mkeenan@andersonkill.com
Pablo Quiñones	(212) 278-1034	pquiones@andersonkill.com
David M. Schlecker <i>Co-Chair</i>	(212) 278-1730	dschlecker@andersonkill.com
Mark Silverschotz	(212) 278-1870	msilverschotz@andersonkill.com
Edward J. Stein	(212) 278-1745	estein@andersonkill.com