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ALERT

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The Rogue Trader: Don't Sit on Your Insurance—Demand Recovery For the Losses Caused By His Fraudulent "Trading"

By R. Mark Keenan and Pablo Quiñones

The rising star of your Arbitrage Unit, who has "faithfully" worked for the company for the last ten years, has abruptly absconded with $50 million of embezzled customer funds, after years of phony securities trading.

The company delays reporting the embezzlement. Why?

Despite shelling out hundreds of millions of dollars in premiums to insure against such losses, a recent study showed that only 20 percent of the victims pursue insurance coverage for their criminal losses. Why?

In many instances, there is a simple answer. The policyholder is embarrassed. After all, it might be shown that the company was negligent in allowing the dishonest acts to occur in the first place.

But the simple truth is that (1) policyholder claims can, by agreement, be kept *confidential* and (2) negligence or inattention is *not* a valid defense to an insurance claim based upon the dishonest conduct of an employee.

Policyholder Negligence

Insurance companies often prey upon a policyholder's guilt after a fraud loss by pointing to failures in the policyholder's internal controls. However, there *is no negligence exclusion*. The failure of internal controls is not a reason to disclaim coverage.

Courts repeatedly have held that negligence is not a defense to fidelity bond coverage: "[N]either negligence nor inattention, nor any failure to discover what by diligence might have been discovered, nothing, in fact, short of actual discovery by the [policyholder] of dishonesty or a positive breach of an operative condition, will defeat claims for loss caused by that dishonesty, unless it is otherwise provided in the contract." *United States Fidelity & Guar. Co. v. Commercial Nat. Bank*, 62 F.2d 718, 719-720 (5th Cir. 1933). Indeed, the "[m]ere negligence of the insured in failing to discover the default of a bonded employee is one of the risks covered by the fidelity insurance, and for that reason such negligence is no defense to payment on a bond." *First Nat. Bank v. Lustig*, 1990 U.S. Dist. LEXIS 7457, 6 (E.D. La. 1990).

The Trading Loss "Exclusion"

Some fidelity bonds contain a "trading loss" exclusion, which excludes from coverage losses resulting from trading in a customer's account. One standard form trading loss exclusion states: " This bond does not cover . . . loss resulting directly or indirectly from trading, with or without the knowledge of the Insured, whether or not represented by any indebtedness or balance shown to be due the Insured on any customer's account, actual or fictitious. . . ." Financial Institution Bond 452 (Duncan L. Clore

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ed., 1995) (quoting from Financial Institution Bond, Standard Form No. 24, rev. Jan. 1986). The objective of the trading loss exclusion is to remove from the risk any loss due to ordinary business transactions by the customer or losses caused by the vagaries of the market. If the loss is due to a conversion, dishonesty, fraud, embezzlement or the like, the loss is covered. *See e.g. Insurance Co. of N. Am. v. Gibralco, Inc.*, 847 F.2d 530, 532 (9th Cir. 1988); *Glusband v. Fittin, Cunningham & Lauzon, Inc.*, 892 F.2d 208, 212 (2d Cir. 1989).

Obviously, the trading exclusion—however limited—makes little sense when the policyholder is a broker/dealer. As a result, *in the financial institution industry, the trading exclusion is deleted* and the following language is frequently added, often by endorsement to the insuring agreement:

> [I]t is agreed that with regard to . . . Trading this bond covers . . . loss resulting directly from dishonest or fraudulent acts committed by an Employee. . . .

Therefore, trading losses are directly covered if they are the direct result of fraud or dishonesty.

The Securities Violation Exclusion

The exclusion for securities violations contains an exception if the "acts which caused the said loss involved fraud or dishonest conduct which would have caused a loss to the Insured" notwithstanding the securities violation. In *Aetna v. Kidder Peabody & Co.*, 676 N.Y.S.2d 559, 564 (1st Dep't 1998), the court found that "a fair reading of this . . . phrasing is that if there is a compensable loss (i.e. it arises from a covered risk) to the policyholder, the insurance company may not rely on possible illegality as a means of avoiding coverage."

In other words, if the losses are caused by dishonest and fraudulent trading (which is no more than a mechanism to commit theft or fraud), the fact that the dishonest trading is also a securities violation (which it invariably is) *does* not form a basis to exclude coverage.

Conclusion

The Financial Services Industry has paid millions of dollars in premiums to protect themselves from dishonest trading by its employees. Neither negligence nor the common policy exclusions will defeat coverage.

Brokers/Dealers that experience the misfortune of suffering through a fraudulent trading loss should not inflict further needless injury upon themselves by giving up on their insurance coverage.

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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. **Mr. Keenan** is co-chair and **Mr. Quiñones** is a member of the AKO Financial Services Insurance Coverage Group. For more information, please contact: *mkeenan@andersonkill.com* or *pquinones@andersonkill.com*

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