

Fidelity Policies Appear Flexible In 6th Circ. Theft Ruling

By **Bibeka Shrestha**

Law360, New York (August 06, 2012, 8:51 PM ET) -- The Sixth Circuit ruled Wednesday that Progressive Casualty Insurance Co. owed coverage under a fidelity policy to a bank holding company for an employee's theft from clients' brokerage accounts, boosting arguments that the traditional boundaries of these policies can be stretched to cover third-party claims, experts say.

In a 2-1 ruling, the appeals court sided with First Defiance Financial Corp. in a coverage dispute that arose after the company doled out nearly \$1 million to reimburse customers who had their money stolen by a First Defiance broker-dealer who managed their stocks, bonds and other investments.

The majority determined that the stolen funds counted as "covered property" under First Defiance's fidelity policy because the bank and its rogue employee had taken responsibility for the money in the clients' discretionary brokerage accounts, even though another company owned and held the assets for First Defiance's clients.

David Klein, an Orrick Herrington & Sutcliffe LLP partner who represents policyholders, pointed out that fidelity coverage is typically designed to cover an insured's own losses from an employee's dishonesty instead of claims paid out to third parties. But Wednesday's decision shows policyholders can suffer the "direct loss" required under fidelity policies when an employee steals property they have been entrusted with, he said.

"This case could be cited not only in circumstances where the exact policy language is at issue, but also for the more general proposition that notwithstanding the name 'fidelity,' policies may well cover a broader class of losses," Klein said Monday.

According to Joshua Gold, an Anderson Kill & Olick PC shareholder who also represents policyholders, the decision deals a blow to frequent arguments by insurers that coverage for claims involving third parties are automatically barred under fidelity policies because they don't count as direct losses.

"The Sixth Circuit says that's not the first consideration," Gold said. "We have to actually analyze the circumstances, read the policy language and understand what the nature of the loss is to determine whether it's covered or uncovered."

But insurers will find ways to limit the impact of the Sixth Circuit ruling on coverage of third-party claims, according to Mary-Pat Cormier, the co-chair of Edwards Wildman Palmer LLP's coverage and claims practice group.

"There are situations where the same policy language is not used," Pat-Cormier said. "You can bring in other facts that may have a bearing on whether or not responsibility did rest with the broker-dealer ... it's going to turn on the actual contractual relationship between the parties."

The majority determined that First Defiance was responsible for the stolen money because the bank and its employees owed a fiduciary duty to their clients the moment the clients gave the funds to the bank to manage.

In a dissent, U.S. Circuit Judge Deborah Cook insisted there was no direct loss to First Defiance as required under the policy, criticizing the majority for adopting a "simplistic" interpretation of the policy terms and disregarding important coverage limitations.

"First Defiance's fiduciary status arises by operation of law, either by statute or by common law duty; it does not flow from its investment agreements or the fidelity bond," Judge Cook said. "If the word 'responsible' encompasses such implied legal duties, then it does not matter whether the insured assumed such responsibility prior to the loss, as the policy requires."

According to Judge Cook, both the language in First Defiance's policy and the history of fidelity coverage ran counter to the majority's view. While First Defiance could be vicariously liable for its employee's misconduct, that kind of loss is more appropriately covered by a general liability policy rather than a fidelity policy, she said.

Klein acknowledged that the First Defiance policy's definition of covered property may not be the norm for fidelity policies, but said the language still substantially widened the scope of coverage for the bank. Courts will focus on policy language while determining whether third-party claims are covered, he said.

"The dissent in this instance puts a lot of emphasis on the purpose for which the fidelity policies were written and certain ideas about where fidelity policies normally fit in the context of insurance," Klein said. "Everything it says about what is normally the case is fundamentally correct, but the majority put a great more deal of emphasis on what the policy actually says and of course, what the policy actually says governs."

Attorneys for First Defiance and Progressive were not immediately available for comment Monday.

Judges Richard Suhrheinrich, Jeffrey Sutton and Deborah Cook sat on the panel for the Sixth Circuit.

First Defiance is represented by William Pohlman of Vorys Sater Seymour and Pease LLP.

Progressive is represented by Scott Schmookler of Gordon & Rees LLP.

The case is First Defiance Financial Corp. et al. v. Progressive Casualty Insurance Co., case numbers 10-3943 and 10-3944, in the U.S. Court of Appeals for the Sixth Circuit.

--Editing by John Quinn and Lindsay Naylor.

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