Coverage for Third-Party Losses Under Fidelity Bonds is a Fact Sensitive Analysis

When an employee misappropriates property belonging to a third-party through embezzlement, theft or fraud, an employer may be vicariously liable for the employee's actions, even if the employer played no role in the wrongdoing. In this circumstance, insured employers often seek coverage under Fidelity Bonds for resulting claims. The following is a brief review of issues which commonly arise related to "direct loss" and "owned property" impacting insurers' obligation to cover third-party claims under Fidelity Bonds.

"Direct Loss"

Courts generally recognize that Fidelity Bonds are not intended to cover an insured's liability to third-parties (vicarious or otherwise), even if premised upon employee theft or dishonesty, the rationale being that Fidelity Bonds are not "liability policies" and are intended to insure against "direct loss" to third parties. "Direct loss" in the context of Fidelity Bonds, occurs when an employee causes direct harm to his or her employer. With respect to third-party losses, the insured's liability is considered an "indirect" loss and outside of the intended coverage of the bond. Complications occur however, when an employee misappropriates property held by the insured employer but a claim is pursued by a third party for whose benefit the employer held the property/funds. In this respect, the employer/insured may argue it was "directly harmed" due to its liability exposure to the third party and by virtue of the fact that the insured was in possession and control of the property/funds when misappropriated.

Fidelity coverage is "meant to insure... against immediate harm from employee dishonesty but not for any obligations [the insured] might have to others as a result of that dishonesty." *Lynch Properties, Inc. v. Potomac Insurance Co. of Illinois, 962 F. Supp. 956 964 (N.D. Tex. 1996)*, aff'd 140 F. 3rd. 622 (5th Cir. 1998). When an employee misappropriates property or funds from a third party the third party suffers the loss. If the insured is found liable under a vicarious or similar liability theory resolution of the claim or payment of a judgment would likely be considered an "indirect loss" outside of the scope of coverage. *Cont'l Bank, N.A. v. Aetna Cas & Sur. Co.*, 626 N.Y.S. 2nd 385 (N.Y. Sup.Ct. 1995).

Under these circumstances, a fact intensive review of the claim is essential. It is critical to review any proof of loss submitted by the insured and/or pleadings from an underlying litigation (whether it be a FINRA arbitration, a civil litigation or otherwise) to determine the nature of the claims being asserted. The key factor will be the circumstance under which the property/funds were held by the insured (if at all) when misappropriated by the employee.

"Owned Property"

While an insured's vicarious liability to a third-party is typically not covered under a Fidelity Bond, coverage may nonetheless exist if the loss of a third-party's funds or property occurred while in the "possession and control" of the insured. Fidelity Bonds often include an "Owned Property" provision which dictates that the bond applies to "the loss of property held by an insured in any capacity for which the insured is legally liable." The "Owned Property" provision however, is not intended to extend coverage to losses resulting from an insured's legal liability to a third party, but "rather to the loss of a third-party's property while in the possession and control of the insured" *Vons Cos. v. Fed. Ins. Co.*, 212 F. 3rd 489, 491 (9th Cir. 2000), and for losses of property for which, prior to the misappropriation, the insured had possession and legal responsibility. *Lynch Properties supra*. at 628-629. This can be a very nuanced distinction and the coverage obligation of the insurer issuing the Fidelity Bond will revolve around fact sensitive determinations as well as the applicable common law of the state in which coverage is sought.

The case of *First Defiance Fin. Corp. v Progressive Cas. Ins. Co.*, 688 F. 3rd 265 (6th Cir. 2012) is instructive. In First Defiance, three financial institutions sued a Fidelity Bond insurer to recover $3 million misappropriated by an employee from client brokerage accounts. The District Court ruled in favor of the financial institutions and held that the policy covered the losses. On appeal, the Circuit Court affirmed, determining that the losses constituted "covered property" because it was held "under circumstances that make the insured responsible for the property." *Id* at 269. In so holding, the Court considered the type and nature of the accounts, whether the banks had "authority" over the accounts and whether a fiduciary duty to the client arose prior to the loss. Critical to the court's analysis was that the clients agreed to appoint an investment advisor jointly employed by First Defiance and a broker dealer, as the exclusive agent to act for and on behalf of the client's accounts and the advisor had the authority to give custodian instructions for the purchase, sale or retention of any security or case equivalent for the accounts. *Id*. Under these circumstances, the Court concluded that the losses constituted "covered property."

In contrast to the First Defiance decision, these types of claims will often involve factual backgrounds where at the time of embezzlement, none of the third-party's investments were held or managed by the insured in any capacity, none of the purported fraudulent investments were sold by the insured, the insured had no knowledge of the fraudulent investments and the misappropriation took place after a point in time when the insured had possession or control of the property. Such circumstances would suggest that the misappropriated property/funds would not be considered "owned property" and would not fall within the control of the insured.

In summary, claims based upon an insured's potential vicarious liability for its employees' malfeasance must be distinguished from claims involving the misappropriation of third-party property in the possession or control of the insured. An insured's vicarious liability for an employee's malfeasance will typically be outside of the scope of coverage of a Fidelity Bond, however a bond may cover the misappropriation of a third-party's property, if it is established that the third-party's funds/property constituted "owned property" in the possession or control of the insured. These types of cases are fact intensive and require close scrutiny due to the nuances involved in handling Fidelity Bond claims.