CAUSATION - - THE OVERLOOKED INGREDIENT TO COVERED LOSS

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I. *Introduction*

An essential but often overlooked link between the perils specified in the Commercial Crime Policy ("CCP"), and the insured's loss is *causation*. Causation is the critical connector between the acts (typically, dishonest or fraudulent acts of employees) and the insured's damage (described in the policy as "loss"). Most fidelity/crime insurance products now available on the marketplace underscore the causation component of coverage. Indemnity is owed only where the insured suffers a loss *resulting directly* from employee dishonesty. Yet, insureds and certain courts have failed to adequately address, and at times have entirely overlooked, the clear message from the CCP that only those losses that were actually *caused by* employee dishonesty are covered.

There are a limited number of case decisions which address causation within the context of the CCP or in connection with other Commercial Crime Forms ("CCF"). Several decisions do address causation in Financial Institution Bond ("FIB") disputes. For this reason, this paper will track CCF and FIB decisions toward the end of more clearly isolating, and exploring, causation as a component of a fidelity/crime claim.

This chapter will first briefly discuss the evolution of the CCF because such will serve to demonstrate the intent of the drafters that causation is a true condition to coverage under a CCP. The concept of loss under the CCF will be briefly addressed because loss and causation are linked in determining coverage under a CCP. Common "loss" issues are, as necessary, explored. Such issues involve discernment of *actual*, as opposed to the theoretical or paper loss. Of course, coverage is generally limited to the insured, not a third party, but third party implications frequently arise. Then, causation issues will be addressed. Specifically, instances where courts have incorrectly used tort standards to decide causation issues under fidelity/crime insurance policies will be cited and contrasted with situations in which courts have recognized that the causation standard under such policy requires something more than mere tort analysis. Other causation issues will as well be addressed, including the intent requirement found in a CCP, all toward the end of providing a well-rounded examination of pertinent causation issues.

II. *History of the Development of the Current CCF Causation Language*

In the late 1970's and early 1980's the causation language of "fidelity bonds" underwent a significant change. A series of changes in policy language were, in part, in reaction to the increasing efforts by insureds and certain courts to broaden the scope of fidelity coverage beyond that which the underwriters intended. As a result of this shift in policy language, several new areas of case law and legal scholarship have resulted.

As far back as the early 1900's, fidelity policies of insurance provided for coverage for "Any loss **through** any dishonest or fraudulent act of any of the Employees including loss of Property through an such act of any of the Employees."[1] This "loss through" language, stated the causation requirement under the policy, and it remained fairly standard wording until the mid-1970's.[2] Equally important, these older versions of fidelity policies of insurance did not provide for a definition of the fraudulent or dishonest acts that constituted employee dishonesty.

However, over time the loss "through" language associated with employee dishonesty coverage was being broadly construed by the courts to find coverage for the insured in situations where the underwriters did not intend for coverage to exist.[3] The courts were willing to interpret this causation requirement in a very broad sense, often beyond the reasonable scope of the intended coverage. Similarly, the fact that employee dishonesty was not defined in the policies, permitted the courts to find coverage for acts where coverage was not intended, as instances of a general lack of trustworthiness or gross negligence by an employee were found to meet the requirements for coverage under the fidelity/crime policies. As this shift in judicial tendencies in interpreting this key policy language took place, the industry realized that an appropriate response was needed in order to "tighten" the language of the policies to bring back coverage for those acts and losses for which coverage was intended.

Therefore, in the 1976, a first major wording change took place relating to causation. No longer did the notion of employee dishonesty go undefined. Rather, an express definition of the employee dishonesty was set forth, whereby coverage was limited to dishonest or fraudulent acts committed by the employee with the "manifest intent":

(a) to cause the Insured to sustain such loss; and
(b) to obtain financial benefit for the Employee or any other person or entity.

This explicit definition of employee dishonesty forced courts to recognize the intent of the drafters of the policies to restrict coverage to certain intended acts by employees. On the heels of this change, the 1980 Commercial Blanket Bond introduced the small, yet extremely important

change to the causation language of the policy. The loss "through" language of the policy was

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[1] Insurance Companies' Blanket Bond Standard Form No. 25 (8/43 ed.) (emphasis added).

[2] *See*, *e.g.*, Savings and Loan Blanket Bond, Standard Form 22, revised in the 1960's to provide for coverage for, "Any loss **through** any dishonest, fraudulent or criminal act of any of the Employees." (Emphasis added.)

[3] *See*, *Fidelity & Deposit of Md. v. USAFORM Hail Pool*, *Inc.*, 523 F.2d 744, 757 (5th Cir. 1975) (which completely disregarded the "loss through" requirement in stating, "nothing in the language of the Bond itself . . . requires a causation *per se* as an element of recovery").

modified to provide that coverage is only found for loss "resulting directly from" one or more acts of employee dishonesty. This loss "resulting directly from" language was quickly adopted into most forms of insurance providing coverage for employee dishonesty. The current versions of the CCF, along with other fidelity insurance policies, maintain these two important critical changes.[4] This shift in the causation language, and adoption of the "manifest intent" definition of employee dishonesty, emphasizes the underwriters' intent that coverage only exist where there is a direct link between the loss and the specified conduct.[5]

This shift in policy language created some uncertainty, but courts have for the most part found the changes to be clear and enforceable. A few courts have incorrectly allowed an insured recovery for losses which were only the indirect result of the covered conduct at issue. Often these courts have taken tort theories of causation, and applied them in this contractual context, which is an incorrect methodology for determining whether the loss sustained by the insured is covered.

III. *Loss Requirement Under a CCP*

As noted previously, the loss requirement is a fundamental part of any claim on a CCP. This requirement is also one that must be discussed together with the concept of causation, as the two ideas are related to one another in evaluating any claim on a CCP, and hence warrants treatment in this chapter.[6] The CCF requires a "loss of, and loss from damage to, Covered Property resulting directly from the Covered Case of Loss,"[7] thus making "loss" central to any

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[4] The CCF replaced the Comprehensive Dishonesty, Disappearance and Destruction Policy, the Commercial Blanket Bond and the Blanket Crime Policy. For further discussion of this issue *see*, Paul R. Devin & Lauren D. Song, *Loss & Causation: The Alpha and Omega of Fidelity Claims Analysis, in* Commercial Crime Policy, Ch. 15, at 15-5 (Gilbert J. Schroeder ed., 1996).

[5] *See, e.g.,* Michael Keeley, *Critical Loan Loss Issues Under Insuring Agreement (A)* (unpublished paper submitted at the A.B.A. Tort and Insurance Practice Section Fidelity and Surety Law Committee mid-winter meeting in New York, NY on January 29, 1993); Christopher J. Franklin, *Applying Causation in the Financial Institution Bond* (unpublished paper submitted at the A.B.A. Tort and Insurance Practice Section Fidelity and Surety Law Committee mid-winter meeting in new York, NY on January 29, 1993); *Leucadia, Inc. v. Reliance Ins. Co.*, 864 F.2d 964, 966 (2d Cir. 1988) ("for a loss to be covered, it must have been the 'direct result' of a 'dishonest or fraudulent act' of an employee or agent").

[6] While a discussion of loss issues is an important tool for better understanding the requirements of causation under a CCP, a more in depth discussion of these issues can be found in the chapter of this book authored by Scott Schmookler.

[7] *See,* Master Appendix Exhibit G.

recovery under the CCF, however, "loss" is not defined by the CCF or the FIB. Since the term is not defined, judicial construction of the term is the only means by which the boundaries of "loss" have been established. Courts have focused on various aspects in attempting to define the boundaries of a "loss" that will find coverage in a CCP, including whether an actual loss has been sustained by the insured and whether the necessary linkage between a covered loss and employee dishonesty has been established.

A. The Insured Must Sustain a Loss of "Covered Property"

As a preliminary matter, in order for the insured to find coverage under the CCF, there must be a loss to certain enumerated items. Specifically, coverage is restricted under the Commercial Crime Coverage Form A, Section A, to loss of, or loss from damage to, "covered property."[8] "Covered property" is enumerated as "money", "securities", and "property other than money and securities."[9] Such terms are further defined in the Crime General Provisions as follows:

> C. General Definitions
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> **2. "Money"** means:
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> a. Currency, coins and bank notes in current use and having a face value; and
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> b. Travelers checks, register checks and money orders held for sale to the public.
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> **3. "Property Other Than Money and Securities"** means any tangible property other than "money and "securities" that has intrinsic value but does not include any property listed in any Crime Coverage Form as Property Not

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[8] Contrast the rather restrictive definition from the CCF to that of most liability policies, which generally provide for "loss" as **any** amount that the insured is obligated to pay.

[9] *See,* Master Appendix Exhibit G. These three enumerated items are substantially similar to those found in other versions of the CCP which require a loss or of damage to "money", "securities" and "other property." *See,* Master Appendix Exhibits A, B, and C.

Covered.[10]

4. **"Securities"** means negotiable and non-negotiable instruments or contracts representing either "money" or other property and includes:

a. Tokens, tickets, revenue and other stamps (whether represented by actual stamps or unused value in a meter) in current use; and

b. Evidence of debt issued in connection with credit or charge cards, which cards are not issued by you;

but does not include "money."[11]

There are no reported cases discussing and interpreting "covered property" under the current CCF, which indicates that the attempt by the drafters to be specific and enumerative as to the property covered by the CCF, and eliminate many of the ambiguities previously found in the definitions, has been largely successful.

B. The Insured Must Sustain the Loss

Beyond demonstrating that there has been a loss of "covered property", a CCP necessarily requires that the insured demonstrate that it, and not a third party, sustained the loss, as a CCP is a first-party indemnification policy and not a third party liability policy. In furtherance of this notion, an "ownership" clause can be found in the CCF. Prior versions of the "ownership" clause led to extensive litigation over the scope of coverage provided to the insured, which generally was decided in favor of the insured,[12] therefore, the clause was modified to its current form, which reads:

The property covered under this insurance is limited to property:

(a) that you own or hold; or

(b) for which you are legally liable.

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[10] Other commercial crime policies use the term "other property" which is defined in substantially the same manner. *See*, Master Appendix Exhibits A, B, and C.

[11] *See*, Master Appendix Exhibits E and F.

[12] Paul R. Devin & Lauren D. Song, *Loss & Causation: The Alpha and Omega of Fidelity Claims Analysis, in* Commercial Crime Policy, Ch. 15, at 15-8 (Gilbert J. Schroeder ed., 1996).

> However, this insurance is for your benefit only. It provides no rights or benefits to any other person or organization.[13]

In order to further demonstrate that a CCP is designed to provide only first-party indemnification coverage, indirect losses are also expressly excluded from coverage unless they are, "compensatory damages arising directly from a loss covered under this insurance."[14] The explicit exclusion of coverage for indirect losses, enacted concurrently with the current form of the "ownership" clause, only serves to reinforce the fact that the CCP is a first-party indemnification policy, and not a liability policy designed to provide coverage for third party losses.[15]

The adoption of the current "ownership" clause, as well as the explicit exclusion of indirect losses were accomplished with the purpose of ensuring that coverage was properly restricted only to losses sustained by the insured. The particular disclaimer that the policy confers no benefits to third parties clearly highlights the intent of the drafters to curb courts' willingness to find ambiguity in the former policy language in favor of coverage. Such clear and concise language had an immediate effect, as courts took heed of the new language in finding that the right to recover under a fidelity/crime policy belongs only to the name insured.[16]

1. Third Party Loss Generally Construed as "Indirect," and Thus Not Covered

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[13] *See*, Master Appendix Exhibits A, B, C, E, and F.

[14] Crime General Provisions, Section A(3)(b) (*See,* Master Appendix Exhibits E and F). *See also,* Master Appendix Exhibits A, B, and C, specifically the exclusions contained therein.

[15] It should be noted that this language changes followed close in time with the adoption of the loss "resulting directly from" causation language standard, as well as the insertion of the manifest intent requirement, as discussed in Section II of this chapter.

[16] *See, RTC v. Moskowitz,* 845 F.Supp. 247, 250 (D.N.J. 1994), *vacated in part on other grounds*, 1994 WL 475811 (D.N.J. 1994), *and on reconsideration in part on other grounds*, 868 F.Supp. 634 (D.N.J. 1994) (acknowledging revisions to the bond language, and looking to the language of bond indicating that it was "for the sole use and benefit of the Insured named in the Declarations" in rejecting a third party beneficiary argument advanced by allegedly dishonest employee in finding that coverage only extends only to the named insured); *see also, Vons Companies, Inc. v. Federal Ins. Co.*, 212 F.3d 489, 491 (9th Cir. 2000) ("A direct loss to Vons may, of course, be caused by its employee's theft of property for which it is legally liable, the typical case being where the insured is a bailee or trustee of property"); *Lynch Properties v. Potomac Ins. Co.,* 140 F.3d 622, 626-629 (5th Cir. 1998) (holding that fidelity policy at issue only covered loss to property that the insured "held," "owned" or for which the insured was "legally liable," thus the insured was not liable for the personal property of the plaintiff, as it was not acting as a bailee or trustee with respect to the plaintiff's property).

As discussed above, a CCP is designed to be a first-party indemnification policy, and not a general liability policy. The policy covers losses sustained by the insured due to employee dishonesty, and recovery by the insured is predicated on the insured's ability to establish by a preponderance of the evidence that the insured has sustained an actual loss due to the dishonest acts of an employee.[17] Therefore, a CCP is not designed to cover losses sustained solely by third parties.[18] In spite of the fact that a CCP is not designed to cover losses sustained by third parties, it should be noted that there have been some judicial efforts to expand the scope of coverage for loss to instances where the only loss sustained by the insured is indirect loss in the form of reimbursement to third-parties for employee dishonesty.[19]

The majority of courts have correctly understood that coverage for fidelity/crime losses is only to be extended when the insured has sustained a direct loss; the clear trend is to find coverage lacking where the loss is the "indirect" result of employee dishonesty.[20] However, since the CCF expressly extends coverage to include loss of any property held by the insured, courts have correctly extended coverage to the insured for payments made to third-parties to compensate them for loss of property held by the insured that was lost due to employee dishonesty while in

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[17] Paul R. Devin & Lauren D. Song, *Loss & Causation: The Alpha and Omega of Fidelity Claims Analysis, in* Commercial Crime Policy, Ch. 15, at 15-9 (Gilbert J. Schroeder ed., 1996).

[18] 11 Couch on Insurance 3d § 160:56 (1998) ("Loss must be actually suffered by the employer in order to warrant recovery on a bond conditioned against the dishonesty of an employee."); *see also, Id.* at 160:60 ("The contract of fidelity insurance is a contract against loss. It is a contract of indemnity on which the insurer is liable only in the event of loss sustained by the obligee in consequence of conduct of the nature specified in the contract. It has been held that there can be no recovery on a fidelity/crime policy in the absence of loss or damage to the insured, and lack of any pecuniary loss by the obligee from the alleged wrongful acts constitutes a good defense, since in such case no recovery can be had.").

[19] *See,* Paul R. Devin & Lauren D. Song, *Loss & Causation: The Alpha and Omega of Fidelity Claims Analysis, in* Commercial Crime Policy, Ch. 15, at 15-9 (Gilbert J. Schroeder ed., 1996), *citing to,* James J. Moran, *Loss and Causation*, *in* The Annotated Commercial Blanket Bond, Ch. 3, § 2 (William F. Haug ed. 1985).

[20] *Auto Lenders Acceptance Corp. v. Gentilini Ford*, 358 N.J.Super. 28, 816 A.2d 1068 (2003); *Vons Companies, Inc. v. Federal Ins. Co.*, 212 F.3d 489 (9th Cir. 2000); *Lynch Properties v. Potomac Ins. Co.,* 140 F.3d 622 (5th Cir. 1998); *Aetna Casualty & Surety Co. v. Kidder, Peabody & Co., etc., et al.*, 676 N.Y.S.2d 559 (1998); *Bralko Holdings, Ltd v. Insurance Co. of N. Am.*, 483 N.W.2d 929 (Mich. App. 1992); *Continental Corp. v. Aetna Cas. & Sur. Co.*, 892 F.2d 540, 543 (7th Cir. 1989); *Anderson v. Employers Ins. of Wausau*, 826 F.2d 777, 780 (8th Cir. 1987); *Hartford Acc. & Indem. Co. v. Washington Nat'l Ins. co.* , 638 F.Supp. 73 (N.D.Ill. 1986); *Commercial Bank v. St. Paul Fire & Marine Ins. Co.*, 336 S.E.2d 552 (W.Va. 1985).

the insured's possession.[21] In applying this principle, courts have correctly conditioned recovery on the third-party loss being directly caused by a covered act of employee dishonesty.[22] Furthermore, even before the policy language was changed to reflect that property held in the possession of the insured was covered, many courts found coverage for the insured for payment made by the insured to cover legal liability to a third-party due to employee dishonesty.[23]

2. Voluntary Settlement Loss is Generally Not Covered

The general rule is that the insured cannot properly seek recovery on a fidelity policy until it can demonstrate that it has suffered an actual loss within the meaning of the policy. CCF forms are indemnity, not liability coverages. Actual loss foundationally requires that the

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[21] *Bralko Holdings*, 483 N.W.2d 929; *Falcon v. Beverly Hills Mortgage Corp.*, 802 P.2d 1010 (Ariz. 1990), *vacated on other grounds*, 815 P.2d 896 (Ariz. 1991); *Foster v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 902 F.2d 1316 (8th Cir. 1990), *abrogated by Salve Regina College v. Russell,* 499 U.S. 225 (1991) (holding that court of appeals should review *de novo* a district court's determination of state law); *Achor Equities, Ltd. v. Pacific Coast Am.*, 737 P.2d 532 (N.M. 1987); *Whitaker Corp. v. Pacific Indem. Co.,* 171 Cal.Rptr. 557 (Cal.App.1981) (ordered unpublished); *Omaha Bank for Coops. v. Aetna Cas. & Sur. Co.,* 301 N.W.2d 564 (Neb. 1981); *175 East 74th Corp. v. Hartford Acc. & Indem. Co.*, 416 N.E.2d 584 (N.Y.1980); *Foxley Cattle Co. v. Bank of Mead*, 244 N.W.2d 205 (Neb. 1976); *American Nat'l Ins. Co. v. United States Fid. & Guar. Co.,* 215 So.2d 245 (Miss. 1968); *Alberts v. American Cas. Co. of Reading*, 200 P.2d 37 (Cal.App. 1948).

[22] *Continental Corp. v. Aetna Cas. & Sur. Co.*, 892 F.2d 540, 548 (7th Cir. 1989) (in which the court did not find coverage for the losses sustained by a third-party, as such did not occur while the principal was an employee of the insured and the settlement of the third-party's loss did not "result directly from" the principal's conduct as an employee of the insured)

[23] *See, e.g.*, *Manley Bennett, McDonald & Co. v. St. Paul Fire & Marine Ins. co.*, 792 F.Supp. 1070 (E.D. Mich. 1992), *rehearing denied*, 807 F.Supp. 1287 (1992); *First Am State Bank v. Continental Ins. Co.*, 897 F.2d 319 (8th Cir. 1990) (applying Iowa law in holding, in spite of manifest intent requirement of bond, that a covered loss occurred when the insured was vicariously liable for the conduct of its officer in not being able to enforce fraudulently executed notes against he customers and having to "settle" the claims by advancing funds to its customers to pay the notes); *In re Baker & Getty Fin. Servs.*, 93 B.R. 559 (Bankr. N.D. Ohio 1988); *Continental Sav. Ass'n v. United States Fid. & Guar. Co.*, 762 F.2d 1239 (5th Cir. 1985); *Exeter Banking Co. v. New Hampshire Ins. co.*, 438 A.2d 310 (N.H. 1981); *Southside Motor Co. v. Transamerica Ins. Co.*, 380 So. 2d 470 (Fla. App. 1980).

insured's payment is for a recognized legal liability.[24] However, some courts have not recognized this general rule, concluding instead that the insured has suffered a loss under the policy when payment is demanded from them, not when it is actually made.[25] Courts that recognize liability to third parties as a covered loss under a CCF will likely refuse to find such coverage for the insured unless there has been a determination of legal liability.[26] Stated more succinctly, the insurer has no duty to reimburse the insured for voluntary settlements it effectuates, as fidelity coverage extends indemnification, if at all, only to legal liabilities of the insured.[27]

In deciding whether or not the insured should be found vicariously liable for the acts of its employee, courts almost always focus on whether the dishonest acts of the employee occurred within the scope of the employee's employment, and not in an independent context outside the scope of employment. A few courts have recognized that where the insured maintains a "statutory bond" imposed upon the insured by the state, settlement payments to a third party

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[24] *School Employers Credit Union v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 839 F.Supp. 1477 (D. Kan. 1993), *aff'd*, 52 F.3d 338 (10th Cir. 1995) (insurer has no obligation to indemnify the insured unless, and until, the insured has made a payment that it was legally obligated to make to a third-party).

[25] *Fidelity & Dep. Co. of Maryland v. President of Georgetown College*, 483 F.Supp. 1142 (D. D.C. 1980) (where a third party suffers a loss for which the insured is legally obligated to pay, the loss to the insured accrues at the moment when the third party demands payment); *Estate of K.O. Jordan v. Hartford Acc. & Indem. Co.*, 844 P.2d 403 (Wash. 1993); *Continental Sav. Ass'n v. United States Fid. & Guar. Co.*, 762 F.2d 1239 (5th Cir. 1985), *modified in part on other grounds*, 768 F.2d 89 (5th Cir. 1985).

[26] *Aetna Casualty & Surety Co. v. Kidder, Peabody & Co., etc., et al.*, 676 N.Y.S.2d 559, 564 (1998) (in finding settlement funds not to be covered under a fidelity policy the court stated "[t]he logical extension of Kidder's argument, that a settlement with a third party under the factual circumstances of this case constitutes a direct loss to the insureds would create the potential for almost any loss, not initially direct to the insureds, to become a direct loss, a subterfuge that would render the exclusion in this case clearly meaningless"); *Drexel Burnham Lambert Group, Inc. v. Vigilant Ins. Co.*, 595 N.Y.S.2d 999 (N.Y. Super. Ct. 1994) (finding that settlements paid to third parties did not find coverage under the fidelity/crime policies at issue, as the court noted that the policies were not liability policies and were not designed to ensure that defense and indemnity was provided to the assured every time a claim was made against it because it might be responsible for the acts of its employees).

[27] *See, e.g., Vons Companies, Inc. v. Federal Ins. Co.*, 212 F.3d 489, 492-493 (9th Cir. 2000); *Aetna Casualty & Surety Co. v. Kidder, Peabody & Co., etc., et al.*, 676 N.Y.S.2d 559, 564 (1998); *Continental Corp. v. Aetna Cas. & Sur. Co.*, 892 F.2d 540, 548 (7th Cir. 1989).

under such a bond may constitute a covered loss.[28] Other courts have applied the principle of *in pari delicto*[29] to limit recovery for third-party liabilities when an employee of the insured colludes or conspires with an employee of the third party in furtherance of the employee fraud or dishonesty.[30]

3. Claims by Third Parties on Fidelity/Crime Policies Have Not Been Permitted

Third parties, that is, non-insureds, have on occasion attempted to make direct claim on a fidelity/crime policy of another entity. Such efforts have generally failed. Even jurisdictions that recognize the ability of an insured to recover for legal liability to third parties, do not allow such to create a right for a third party to maintain a cause of action directly against the insurer.[31] When faced with the situation in which a third party is seeking to proceed directly against the insurer, the majority of courts have correctly discerned that allowing the third party to recover

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[28] *First Am. State Bank v. Continental Ins. Co.*, 897 F.2d 319 (8th Cir. 1990) (applying Iowa law in holding, in spite of manifest intent requirement of bond, that a covered loss occurred when the insured was vicariously liable for the conduct of its officer in not being able to enforce fraudulently executed notes against its customers and having to "settle" the claims by advancing funds to its customers to pay the notes. Despite the manifest intent requirement of the bond, requiring the wrongful employee conduct to be directed at the insured, settlement payments to third-party customers were determined to be losses under the bond since the bond was determined to be a statutory bond required by state law, thus presumably indicating it was for the benefit of third parties.).

[29] Defined in Black's Law Dictionary as, "Equally at fault <courts usually deny relief when parties have made an illegal agreement and both stand *in pari delicto*>."

[30] *See, e.g., Lawrence Warehouse Co. v. Dove Creek State Bank*, 470 P.2d 838 (Colo. 1970).

[31] *RTC v. Moskowitz*, 845 F.Supp. 247, 250 (D. N.J. 1994); *Louisiana v. Acadia Parish Police Jury*, 631 So. 2d 611 (La. App. 1994); *Three Garden Village Ltd. Partnership v. United States Fid. & Guar. Co.*, 567 A.2d 85, 93 (Md. 1989) ("it has been held that a third party which has suffered a loss as a result of the dishonest of an employee of the insured may not predicate a claim against the fidelity insurer solely on the fact that he dishonesty rendered the insured legally liable to the third party."); *Hatch v. Reliance Ins. Co.*, 758 F.2d 409 (9th Cir. 1985), *cert. denied*, 474 U.S. 1021 (1985).

would effectively transform the first party CCP into a third party liability policy.[32] Similarly, third parties have had very little success in bringing coverage under a fidelity policy within the scope of a "direct action" statute, as such generally only apply to liability policies of insurance.[33]

C. The Insured Must Sustain an Actual Loss as Theoretical Losses are not Covered

Any coverage analysis requires that the insurer confirm that the insured has sustained an actual, rather than a theoretical, loss. A CCP is a contract of indemnity, not a liability policy. As such, it is a settled rule for recovery under a contract for indemnification, in contrast with coverage under a liability policy, that the insured may not recover unless it has either sustained an actual loss or that one has occurred.[34] Particular to this context, the insured must demonstrate that the claimed loss was "accompanied by actual withdrawals of cash or other such pecuniary loss."[35] Thus, given that there exists an "actual loss" requirement, the mere fact that an

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[32] However, the rule has exceptions, one of which is where the bond at issue was a "statutory" bond, which is arguably required by the law to protect the public. *See, Louisiana v. Acadia Parish Policy Jury*, 631 So.2d 611 (La. App. 1994); *Estate of K.O. Jordan v. Hartford Acc. & Indem. Co.*, 813 P.2d 1279 (Wash. App. 1991); *Thornsberry v. Western Sur. Co.*, 738 F.Supp. 209 (E.D. Ky. 1990); *Everhardt v. Drake Mgt. Co.*, 627 F.2d 686 (5th Cir. 1980).

[33] *RTC v. Moskowitz*, 845 F.Supp. 247, 250 (D. N.J. 1994); *Louisiana v. Acadia Parish Police Jury*, 631 So. 2d 611 (La. App. 1994); *Anderson v. Employers Ins.*, 826 F.2d 777 (8th Cir. 1987); *175 East 74th Corp. v. Hartford*, 416 N.E.2d 584 (N.Y. 1980). *But see, Anchor Equities, Ltd. v. Pacific Coast Am.*, 737 P.2d 532 (N.M. 1987).

[34] Paul R. Devin & Lauren D. Song, *Loss & Causation: The Alpha and Omega of Fidelity Claims Analysis, in* Commercial Crime Policy, Ch. 15, at 15-5 (Gilbert J. Schroeder ed., 1996), *citing to*, George A. Locke, *"Fraudulent or Dishonest Act" by an Employee Covered by Fidelity Bond*, 13 Am. Jur. Proof of Facts 3d 55, 597 (A "plaintiff seeking recovery from an insurer on a fidelity/crime policy must do more than prove that an employee covered by the bond committed an act of fraud or dishonesty. There can be no recovery on a fidelity/crime policy contract unless it is established that an actual loss has occurred."); *see also*, 11 Couch on Insurance 3d § 160:60 (1998) ("It has been held that there can be no recovery on a fidelity/crime policy in the absence of loss or damage to the insured, and lack of any pecuniary loss by the obligee from the alleged wrongful acts constitutes a good defense, since in such case no recovery can be had.").

[35] *Cincinnati Ins. Co. v. Star Fin. Bank*, 35 F.3d 1186, 1191 (7th Cir. 1994) (bond does not cover "bookkeeping or theoretical losses, not accompanied by actual withdrawals of cash or other such pecuniary loss."); *FDIC v. United Pacific Ins. Co.*, 20 F.3d 1070, 1080 (10th Cir. 1994) ("A fidelity insurance contract indemnifies against loss, and the insured under a fidelity bond has the burden of proving that it suffered an actual loss by a preponderance of the evidence"); *In Re Ben Kennedy & Assoc.*, 40 F.3d 318 (10th Cir. 1994) (applying Oklahoma law) (the court read a requirement of actual loss to the insured into the Bond, thereby barring the insured from recovering for losses suffered by third parties due to the insured's employee's

employee may have been dishonest is not sufficient to form the basis for recovery. Rather, as expressed by the court in *American Employers' Insurance Co. v. Roundup Coal Mining, Inc.,*[36] "Dishonesty in the abstract cannot be compensated in damages, and in a suit to recover on the bond the dishonesty must have resulted in pecuniary loss."[37] This actual loss requirement was further explained by another court, "A fidelity insurance contract indemnifies against loss, and the insured under a fidelity bond has the burden of proving that it suffered an actual loss by a preponderance of the evidence."[38]

Since recovery on a fidelity/crime policy is premised on the insured sustaining an "actual loss," theoretical or bookkeeping losses are not covered by a fidelity/crime policy bond, as fidelity/crime policies are indemnification policies which do not insure against such forms of loss.[39] The mere shifting of internal liabilities, without a corresponding reduction in the insured's net assets, will not find coverage under a fidelity/crime policy.[40] The state of Washington is the only jurisdiction that has failed to recognize this principle when faced with

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dishonesty, even though the Bond purported to indemnify the insured without regard to whether the insured suffered financial detriment); *Banco de San German, Inc. v. Maryland Casualty Co.*, 344 F.Supp., 496, 505 & n. 10 (D. P.R. 1972) (citing *First Nat'l Bank of Temple v. Continental Casualty Co.*, 133 F.2d 197, 198 (5th Cir.), *cert. denied*, 313 U.S. 575 (1943); *Continental Casualty Co. v. First Nat'l Bank of Temple*, 116 F.2d 885, 887 (5th Cir. 1941), *cert. denied*, 313 U.S. 575 (1941); and *First Nat'l Bank of Temple v. Continental Casualty Co.*, 100 F.2d 308, 310 (5th Cir. 1938); *Everhardt v. Drake Mgmt., Inc.*, 627 F.2d 686, 691 (5th Cir. 1980) (bookkeeping or theoretical losses are not recoverable); *Fidelity & Deposit Co. of Maryland v. USAform Hail Pool, Inc.*, 463 F.2d 4, 6-7 (5th Cir. 1972) (same); *Leader Clothing Co. v. Fidelity & Casualty Co. of New York*, 237 F.2d 7, 9 (10th Cir. 1956), *cert. denied*, 313 U.S. 575 (1941); *Transamerica Ins. Co. v. Federal Deposit Ins. Corp.*, 489 N.W.2d 224 (Minn. 1992).

[36] 73 F.2d 592 (8th Cir. 1934).

[37] *Id.* at 595.

[38] *United Pacific*, 20 F.3d at 1080.

[39] *See*, *Cincinnati Ins. Co.,* 35 F.3d at 1191 (bond does not cover "bookkeeping or theoretical losses, not accompanied by actual withdrawals of cash or other such pecuniary loss"); *United Pacific*, 20 F.3d at 1080 ("A bookkeeping loss involves only entries on the book, without any accompanying disbursements of funds").

[40] *See, Transamerica Ins. Co. v. FDIC*, 489 N.W.2d 224, 230 (Minn. 1992); *Towne Mgmt. Corp. v. Hartford Acc. & Indem. Co.*, 627 F.Supp. (D. Md. 1985); *Puget Sound Nat'l Bank v. St. Paul Fire & Marine Ins. Co.*, 645 P.2d 1122 (1982); *Everhardt v. Drake Mgt., Inc.*, 627 F.2d 686, 691 (5th Cir. 1980); *Fidelity & Dep. Co. of Maryland v. USAFORM Hail Pool, Inc.*, 463 F.2d 4 (5th Cir. 1972), *vacated and remanded on other grounds*, 523 F.2d 744 (1975); *In re Schluter, Green & Co.*, 93 F.2d 810 (4th Cir. 1938).

such a dilemma. In *Estate of K.O. Jordan v. Hartford Accident & Indemnity Co.,*[41] the Washington Supreme Court decided to follow its 1933 decision in *White & Bollard, Inc. v. Standard Accident Insurance Co.,*[42] in holding that there is a loss within the meaning of a fidelity/crime policy when an employee diverts funds from various client accounts to other client accounts to conceal a shortage due to the employee's theft of client funds prior to the commencement of bond coverage. Thus, during the time of coverage under the bond, there was no actual diminution in the insured's assets. The court in *Estate of K.O. Jordan* dismissed the overwhelming authority from other jurisdictions on the issue in deciding to uphold the decision in *White & Bollard*, and reached its conclusion with no discussion of the issue in stating, "The reasoning of *White & Bollard* is as sound today as it was in 1933, and we find that reasoning controlling."[43] While the decision by the State of Washington to follow a line of thinking long discredited is puzzling, it remains the only jurisdiction where such is the case, as every other court, when confronted with this issue, has correctly recognized that the intent of the restrictive provisions governing "loss" in a fidelity/crime policy are designed to limit the insured's recovery to actual, out-of-pocket losses. Thus, in situations were there has been a diversion of funds or other property to cover legitimate corporate obligations, courts have refused to find a covered loss due to the internal shifting of liabilities, as such is purely theoretical or bookkeeping, and does not involve an actual net loss to the insured.

IV. *Causation Requirement Under a CCP*

Meeting the causation requirement is an essential element of any claim on a CCP. As briefly explained earlier, in order for the insured to find coverage from the CCF, the loss must be one "resulting directly from" the act of dishonesty by an employee. Such language was first adopted in the 1980 version of the Commercial Blanket Bond and the Banker's Blanket Bond to curb the willingness of courts to expand the causation standard under the prior language (which only required a loss "through" the dishonest acts of an employee) in favor of the insured to cover a scope broader than intended by the drafters. This more precise language was drafted with the intent to eliminate from coverage remote, distant, or indirect damages suffered by the insured.

Rather, such language clearly indicates the requirement that the loss must flow immediately in time or space from the specified conduct or peril. This explicit language also precludes from

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[41] 844 P.2d 403 (Wash. 1993).

[42] 27 P.2d 123 (Wash. 1933).

[43] *Estate of K.O. Jordan,* 844 P.2d at 409.

compensation losses that coincide in time and circumstances with the insured peril, but were brought about by other uninsured causes.[44]

In spite of the seemingly clear intent of the drafters in changing the language to only cover losses "resulting directly from" the covered acts of employees, courts have not consistently applied this strict **contractual** standard of causation. Rather, courts have routinely misapplied tort concepts of causation in assessing coverage under a fidelity/crime policy, which is contrary to the intent of the drafters and the parties entering into the insurance arrangement. In doing such, several courts have found the causation requirement of loss "resulting directly from" to mirror the proximate causation standard from tort law, while still other courts have required only factual causation. Taken separately, neither of these two concepts is sufficient to form the necessary causal nexus that is to be applied to the contractual standard of causation established by the "resulting directly from" language of the CCF.

In order to properly understand the various means by which the "resulting directly from" requirement of the CCF has been interpreted by the courts, one must first examine the cases that are incorrectly decided applying either tort theory of causation. After identifying the errors committed by these courts, the correct methodology for evaluation of contractual causation will be discussed. Consistent with this discussion, a brief section concerning the "manifest intent" requirement of the CCF will be set forth. Finally, various miscellaneous causation issues will be addressed, including the role of the insured's own negligence in the causation analysis.

A. Tort Causation

In order to understand the difference between tort theories of causation and the distinct contractual theory of causation desired by the drafters of the CCF, a discussion of the concepts that form tort causation theory is pertinent. Necessarily included in this discussion are the cases that have wrongly decided claims under a fidelity policy, where causation was at issue, by looking to tort concepts of causation.

1. Factual Causation

In order for recovery to be found in tort, a fundamental element is that the tortfeasor actually cause the injury to the victim (i.e., "cause-in-fact", "but for cause" or "factual causation"). However, this analysis leads to a slippery slope, whereby every preceding action is a "but for" cause of the tort, because without such the tort would never have happened (i.e., without being born the tortfeasor could not have committed the tort, therefore being born was the cause of the tort). This concept is relatively straightforward and one that generally does not merit extended discussion.

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[44] William T. Bogaert & Andrew F. Caplan*, Loss and Causation Under the Financial Institution Bond, in* Financial Institution Bonds Second Edition, Ch. 11, at p. 415-416 (Duncan L. Clore ed. 1998).

However, in one notable instance this standard was the *sole* standard by which causation was determined under a fidelity/crime policy. The court in *First National Bank of Louisville v. Lustig*[45] chose to ignore the contract concept of causation, as well as any notions of proximate causation, instead deciding that the causation standard of the fidelity/crime policy was met by the fact that the act was the "but for" cause of the injury.

In *Lustig*, a claim arose due to numerous misrepresentations and fraudulent reports issued by an employee in connection with the credit approval process for several large construction loans.[46] Loss resulted to the insured when the real estate market experienced a severe recession in the states in which these construction loans were made, and the construction projects attached to the loans could not generate enough revenue to pay the loans, sending them into default.[47] The court was faced with a question of deciding whether, as argued for by the insurer, the decline in the real estate market was the true cause of the loss rather than the misrepresentations and fraud by the employee. In reaching its conclusion that the latter was the cause of the loss, the court stated:

> The Sureties would have us read the requirement that the loss be directly caused by the dishonest or fraudulent act narrowly. Such a reading would, however, all but eliminate coverage for loans made because of dishonest or fraudulent acts. There will always be some intervening cause for the failure of these loans to be repaid, otherwise the bank would suffer no loss. A loss is directly caused by the dishonest or fraudulent act within the meaning of the Bond where the bank can demonstrate that **it would not have made the loan in the absence of the fraud**. The Bond does not require the bank to rule out all reasons the loan was not repaid before it can obtain coverage.[48] (Emphasis added.)

This interpretation of the requirement that a loss be "resulting directly from" an act of employee dishonesty clearly is erroneous, as it not only ignores the fact that it is interpreting a contract, but also applies only the "but for" or "factual cause" standard from tort theory (therefore failing to address ideas of proximate causation). The court does not even acknowledge the fact that the language of the policy calls for the loss to be the direct result of the act of employee dishonesty.

Subsequently, in an unpublished opinion, the Fifth Circuit addressed these concerns when denying the insurer's petition for a rehearing.[49] The court attempted to clarify its prior

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[45] 961 F.2d 1162 (5th Cir. 1992).

[46] *Id.* at 1164.

[47] *Id.*

[48] *Id.* at 1167-1168.

[49] *First Nat'l Bank of Louisville v. Lustig*, No. 90-3820, 1992 U.S. App. LEXIS 14873 (Denial of Petition for Rehearing) (5th Cir., June 29, 1992) (per curiam).

decision concerning causation under the bond, as the insurer inquired as to the causation standard for a covered loss in light of the court's rejection that the loss was not proximately caused by the employee dishonesty, but instead was caused by the decline in the real estate market. In addressing such concerns, the court undercut the strong language from the initial decision, stating, "We do not intend to suggest that the bank can establish liability without proving loss proximately caused by employee fraud as defined by the bond."[50] Clearly this discussion by the court indicates a movement away from the factual causation standard established by the initial decision for the loss "resulting directly from" language of the policy. Furthermore, in denying the insurer's petition for a rehearing, the court noted that certain intervening causes, besides the decline in the real estate market, could defeat coverage for the insured.[51] This admission, along with the discussion about proximate cause by the court in its opinion, indicates that the factual causation standard established in the initial decision was not entirely accurate or correct.

2. Proximate Causation

Defining proximate causation has long befuddled legal commentators and judicial scholars. It creates an artificial boundary within which the "but for" cause must fall in order for the tortfeasor to be found liable.[52] Stated in the context of a fidelity policy of insurance, in order to be the proximate cause of the loss, the insured must be establish that the alleged fraudulent or dishonest act was sufficiently immediate in spatio-temporal relation to the loss, that without some intervening cause, a covered loss would result therefrom.[53] Although proximate causation, as will be demonstrated later, is an element of contract causation, some courts have considered it equivalent to the causation standard required by the loss "resulting directly from" language of fidelity policies.

One notable decision to do such is *Hanson PLC v. National Union Fire Ins. Co. of Pittsburgh.*[54] In the case, the court equated the "resulting directly from" causation language of

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[50] *Id.*

[51] *Id.*

[52] Perhaps the most notable discussion of proximate cause was the dissent of Justice Andrews in *Palsgraf v. Long Island Railway Co.*, 162 N.E. 99 (N.Y. 1928), where he wrote:

What we do mean by the word "proximate" is, that because of convenience, of public policy, of a rough sense of justice, the law arbitrarily declines to trace a series of events beyond a certain point. This is not logic. It is a practical politics . . . We may regret that the line was drawn just where it was, but drawn somewhere it had to be.

[53] Paul R. Devin & Lauren D. Song, *Loss & Causation: The Alpha and Omega of Fidelity Claims Analysis, in* Commercial Crime Policy, Ch. 15, at 15-15 (Gilbert J. Schroeder ed., 1996).

[54] 794 P.2d 66 (Wash. Ct. App. 1990).

the bond at issue to be equivalent to the tort notion of proximate cause, holding that the language meant that the dishonest or fraudulent acts had to be the proximate cause of the loss to find coverage.[55] In doing such, the court upheld the jury instruction that defined proximate cause as follows:

> The term "proximate cause" means a cause which in a direct sequence, unbroken by any independent cause, produces the injury complained of and without which such injury would not have happened.[56]

Other courts, when faced with the same issue, have presented various definitions, that do provide some insight into the appropriate boundaries of proximate causation.[57]

Another case typical of cases in which the court has accepted loss "resulting directly from" the employee's act to be equivalent to the tort theory of proximate causation is *Jefferson Bank v. Progressive Casualty Insurance Co.*[58] In *Jefferson Bank* the court decided that loss "resulting directly from" merely required application of a proximate cause standard. In the case, the court was faced with determining if Jefferson Bank could recover under Insuring Agreement E of the Banker's Blanket Bond issued to it by Progressive Casualty Insurance Company. Specific to this discussion, Jefferson Bank needed to demonstrate that it had incurred a loss "resulting directly from" its extension of credit in good faith reliance on the mortgage that bore the forged signature of a notary. The court stated that in order to decide whether the fraudulent notary's signature caused Jefferson Bank's loss, so as to find coverage under the bond, it would first have to determine the correct definition of loss "resulting directly from" under Insuring Agreement E. The court then stated that the district court had applied a strict interpretation of the phrase, concluding that the loss must be "directly caused" by the forgery. The court disagreed with using a strict interpretation, stating:

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[55] *Id.* at 73.

[56] *Id.*

[57] *See, e.g., Mid-America Bank of Chaska v. American Cas. Co. of Reading, Pa.*, 745 F.Supp. 1480, 1485 (D.Minn. 1990) ("Under classic proximate cause analysis, if a loss is caused by an act which played a substantial part in bringing about or actually causing the loss and the loss was a reasonably probable consequence of the act the loss is proximate or direct. That more than one factor may operate at the same time either independently or together to cause damage does not prevent each factor from being considered a proximate or direct cause."); *Federal Deposit Ins. Corp. v. Reliance Ins. Corp.*, 714 F.Supp. 1001, 1004 (E.D. Ky 1989) ("where a specified peril specifically insured against sets others causes in motion which, in an unbroken sequence and connection between the act and final loss, produces the result for which recovery is sought, the insured peril is regarded as the proximate cause of the entire loss.").

[58] 965 F.2d 1274 (3d Cir. 1992).

> An analysis of Insuring Agreement E in light of Pennsylvania law persuades us, however, that conventional proximate cause is indeed the correct standard and that requiring "immediacy" is inappropriate.[59]

The court based its conclusion that "resulting directly from" required only a proximate cause analysis on two items. First, the court examined other insurance cases where the policy contained the language "direct cause of a loss," and such was interpreted to mean the "proximate cause of a loss." By analogy, the court interpreted "resulting directly from" to be "proximately caused by" under Insuring Agreement E. Second, the court discussed the idea that "direct cause" or "immediate cause" was a very nebulous concept, and one that did not enjoy "favor under Pennsylvania law." It further explained that Pennsylvania had adopted a "substantiality" standard, rather than an "immediacy" standard for proximate causation.[60] On this basis, the court concluded:

> Given the difficulty and confusion that results from applying a "nearest cause" or "immediate cause" standard, we do not believe that the parties intended to contract for it. Instead, we believe that in this contract "resulting directly from" means "proximately caused by."[61]

This analysis is flawed. The court was requested to interpret a term in the insurance contract at issue. Therefore, the court's analysis should have been guided by principles of contract law and contract construction. Rather, the court focused on tort principles in Pennsylvania to reach its conclusion that a proximate causation standard was appropriate for addressing the meaning of the loss "resulting directly from"causation language of the bond. Proximate causation is a tort concept, and is not one which was adopted in the insurance contract to define the scope of coverage being purchased. In *Jefferson Bank* the Court effectively ignored the words chosen in the contract and substituted different words, as a result of which it reached an incorrect result.

As *Hanson* and *Jefferson Bank* serve to indicate, courts have been willing to disregard any concept of contractual causation, instead frequently choosing to incorrectly examine the facts of the case solely under the tort concept of proximate causation. If such an analysis was what the parties to the insurance contract desired, they could have contracted for such a

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[59] *Id.* at 1281.

[60] *Id.* at 1281.

[61] *Id.* at 1282.

standard.[62] Therefore, it seems self-evident that principles of contract interpretation would dictate that while proximate causation might play a role in causation analysis, it was not intended as the exclusive means by which the courts should determine if an insured's loss is caused by a covered act and hence finds coverage under a CCP.

B. Contract Causation

While courts have frequently applied tort principles in interpreting the causation requirement under a fidelity policy of insurance, and such principles have a place in causation analysis, alone they do not suffice. Rather, a contractual analysis of the element of causation should be applied in order to correctly determine if such is met by the insured's claim. Contract law is based on the premise that the parties are bound by their written word.[63] If an explanation of the written words is required, the courts look to the intent of the parties in entering into the contract to better understand the language of the contract.[64] In this vein, the notions of public policy are largely irrelevant, as the intentions of the parties to the contract are all that the court should be focused on. As explained by Judge Cardozo in *Bird v. St. Paul Fire and Marine Ins. Co.*[65] when discussing the determination of causation in contacts generally, and insurance contracts specifically:

> General definitions of a proximate cause give little aid. Our guide is the reasonable expectation and purpose of the ordinary businessman when making an ordinary business contract. It is his intention, expressed or fairly to be inferred, that counts. There are times when the law permits us to go far back in tracing events to causes. The inquiry for us is how far the parties to this contract intended to go. . . . The question is not what men ought to think of as a cause. The question is what they do think of as a cause.[66]

Therefore, in interpreting the causation standard embodied in the CCF, courts should necessarily look to the intent of the parties in entering into such an agreement. Such an intent clearly embodies the two tort principles of causation, factual causation and proximate causation, but also requires something further. Therefore, in order to find recovery, the insured must first demonstrate that "but for" the acts of its employee, the loss would not have been sustained.

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[62] For example, the language of the insurance contract could be modified to express this intent (i.e., loss "proximately caused by"), rather than having the narrowly tailored loss "resulting directly from" causation language that is actually present.

[63] Bradford R.Carver, *Loss and Causation, in* Handling Fidelity Bond Claims, Ch. 11, at 347 (Michael Keeley & Timothy M. Sukul, eds. 1999).

[64] *Id.*

[65] 120 N.E. 86 (N.Y. 1918)

[66] *Id.* at 89.

Second, the insured must show that the employee's dishonest act, motived by the manifest intent to benefit herself or some third party and to make the insured suffer the loss, was sufficiently immediate in time and space in connection to the loss as to justify attachment of legal responsibility for the resulting loss.[67]

1. Factual Causation Issues

As a preliminary matter, the insured must establish that factual causation is present in order for there to be recovery under the contract of insurance. Even though the insured has sustained a loss, the CCF does not provide fidelity coverage unless each component of the loss was "directly" caused by the dishonest acts of an employee.[68] The majority of courts when faced with this issue have correctly found that an insured can only recover on the losses, or components thereof, which could be directly traced to a dishonest act of an employee.[69]

While seemingly a straightforward principle, courts have still strayed from it and allowed recovery without a direct tracing of the acts to the loss. Most notably, the Firth Circuit permitted recovery without establishing a direct link between the dishonesty and losses sustained by the insured in *FDIC v. Fidelity & Deposit Co. of Maryland.*[70] In the case, the court relied on *Fidelity & Dep. Co. of Maryland v. USAFORM Hail Pool, Inc.*[71] in stating that in the Fifth Circuit "a general pattern of dishonesty, rather than a dishonest act for each loan is sufficient" to meet the insured's burden of proving factual causation element of a fidelity/crime policy claim.[72] The court's reliance on *USAFORM* is clearly misplaced, as the court in *USAFORM* was basing its decision on a bond that contained the former loss "though" language, and not the loss "resulting directly from" language present in the bond at issue in *FDIC v. Fidelity & Deposit Co. of Maryland*. Furthermore, the court in *FDIC v. Fidelity & Deposit Co. of Maryland* completely

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[67] Paul R. Devin & Lauren D. Song, *Loss & Causation: The Alpha and Omega of Fidelity Claims Analysis, in* Commercial Crime Policy, Ch. 15, at 15-12 (Gilbert J. Schroeder ed., 1996).

[68] William T. Bogaert & Andrew F. Caplan, *Loss and Causation: Often Ignored Prerequisites to Recovery*, *in* Financial Institution Bonds Ch. 11, at 271 (Duncan L. Clore, ed. 1995).

[69] *Cambridge Trust Co. v. Commercial Union Ins. Co.*, 591 N.E.2d 1117, 1120 (mass. App. 1992); *Fidelity Sav. & Loan Ass'n v. Aetna Life & Cas. Corp.*, 440 F.Supp. 862 (N.D. Cal. 1977); *United States Fid. & Guar. Co. v. Empire State Bank*, 448 F.2d 60, 367 (8th Cir. 1971); *Danal Jewelry Co. v. Fireman's Fund Ins. Co.*, 264 A.2d 320, 325 (R.I. 1970); *Lipman Bros. v. Hartford Accident & Indem. Co.*, 149 Me. 199, 216-217 (1953); *American Sur. Co. v. Capital Bldg. & Loan Ass'n*, 50 P.2d 792 (Colo. 1935).

[70] 45 F.3d 969 (5th Cir. 1995).

[71] 523 F.2d 744, 757 (5th Cir. 1975), *cert. denied,* 425 U.S. 950 (1976).

[72] *FDIC v. Fidelity & Deposit Co. of Maryland*, 45 F.3d at 969.

failed to identify and discuss the clearly dated language from *USAFORM*, as is evidenced by the court's statement, "nothing in the language of the bond itself . . . requires a causation *per se* as an element of recovery."[73] Clearly the decision in *FDIC v. Fidelity & Deposit Co. of Maryland* is not one that comports with the general weight of authority on this subject, however it still remains good law.

A second issue that arises in the context of the insured necessarily demonstrating that its loss meets the requirements of factual causation, so as to necessarily move forward in establishing that it is one that resulted "directly" from the act of an employee, is that of a superceding or intervening cause. If a superceding or intervening cause is present, such will break the causal chain and prevent the insured from recovering on a CCP. One example of such, in the context of a fidelity policy of insurance, is the case in which there is insolvency of a borrower subsequent to the forgery of security for a loan. In such a case, the covered cause of loss, the forgery, was not directly responsible for the insured's inability to collect on the notes, and therefore the intervening or superceding cause - the insolvency of the borrower - broke the causal chain and prohibits the insured from finding recovery under the Policy.[74] Stated differently, for there to be recovery, the loss must be directly dependent on the covered fraud or dishonesty, and not issue from an intervening factor.[75] Since a superceding or intervening cause breaks the causal chain, when one is present there is no need to proceed forward with the analysis to determine if the other elements of contractual causation are met.

2. Direct/Proximate Causation Issues

As discussed previously, courts frequently equate the tort concept of proximate causation with the contractual causation standard sought by the drafters of fidelity insurance policies. While this standard can have a place in the analysis, it should not be the sole method by which causation, or the second aspect of contract causation, is determined. Rather, the moral and policy judgments inherent in any proximate causation analysis are largely irrelevant to the discussion of contract causation. Instead, the principles of contract interpretation should serve to

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[73] *USAFORM*, 523 F.2d at 757.

[74] *See, Piedmont Fed. Sav. & Loan Ass'n v. Hartford Acc. & Indem. Co.*, 307 F.2d 310 (4th Cir. 1962); *Fidelity Sav. & Loan Ass'n v. Aetna Life & Cas. Corp.,* 440 F.Supp. 862, 866 (N.D. Cal. 1977), *aff'd*, 647 F.2d 933 (9th Cir. 1981).

[75] Paul R. Devin & Lauren D. Song, *Loss & Causation: The Alpha and Omega of Fidelity Claims Analysis, in* Commercial Crime Policy, Ch. 15, at 15-14 (Gilbert J. Schroeder ed., 1996); *but see, United States Fid. & Guar. Co. v. Empire State Bank*, 448 F.2d 360 (8th Cir. 1971) (notwithstanding fact that depreciation wold have occurred even if dishonesty had not been present, holding that bank's loss included depreciation of collateral securing dishonestly given loans).

determine the scope of the parties' liability for damages based upon their stated intentions. This approach was recognized in the general context of insurance policies by the court in *Spearman Indus., Inc. v. St. Paul Fire & Marine Ins. Co.*[76] In the case, the plaintiff sought summary judgment in its favor on its causation argument based on proximate causation. The court recognized that proximate causation was not the correct methodology for determination of causation under an insurance policy, stating, "the importation of tort principles of proximate cause into the construction of insurance policies is inappropriate. Rather, in Illinois, insurance polices are interpreted in accordance with contract principles - not tort principles - to give effect to the intent of the parties."[77]

This statement from the court makes clear what is already self-evident, a insurance agreement is a contract between the insurer and the insured. Since a CCP is a form of insurance, it seems axiomatic that contract principles would apply to its interpretation. As such, the doctrine of foreseeable consequences should serve to limit the scope of a party's liability for contractual damages.[78] As stated in the Restatement (Second) of Contracts, "Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made."[79] Therefore, the requirement of foreseeability, which is inherently a more severe limitation of liability than the requirement of proximate causation in the case of an action sounding in tort law, plays a role in contract interpretation.[80] Furthermore, courts also limit the availability of contract damages by looking to the intentions of the parties at the time they contracted with each other. To ascertain the intent of the parties, courts examine, "the language of the contract in light of the facts, including the nature and purposes of the contract."[81]

There is no reason why these contract interpretation principles should not be used to determine if contract causation is present under a CCP. It seems proper in light of these interpretation principles to more narrowly construe the loss "resulting directly from" language of the CCF than would be required under ordinary proximate causation standards. Furthermore, the CCF explicitly excludes indirect acts from coverage:

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[76] 138 F.Supp.2d 1088 (N.D.Ill. 2001).

[77] *Id.* at 1100-1101 (citations omitted).

[78] *See, Vanderbeek v. Vernon Corp.*, 50 p.3d 866 (Colo. 2002) (discussing foreseeability as element of contract measure of damages).

[79] Restatement (Second) of Contracts § 351 (1981).

[80] *See,* Restatement (Second) of Contracts § 351 cmt. a (1981); *Inchaustegui v. 666 5th Ave. Ltd. Partnership*, 706 N.Y.S.2d 396, 400 (App. Div. 2000) (stating that "[w]hile tort damages are expansive, focusing on the full spectrum of the harm caused by the tortfeasor, damages for a breach of contract are restrictive").

[81] 22 Am.Jur.2d *Damages* § 460 (2003).

Indirect Loss: Loss that is an indirect result of any act or "occurrence" covered by this insurance including, but not limited to, loss resulting from:

a. Your inability to realize income that you would have realized had there been no loss of, or loss from damage to, Covered Property.
b. Payment of damages of any type for which you are legally liable. But, we will pay compensatory damages arising directly from a loss covered under this insurance.
c. Payment of costs, fees or other expenses you incur in establishing either the existence of the amount of loss under this insurance.

This unequivocal exception to a CCP leaves little room for doubt that the correct methodology for interpretation of the causation standard is application of contract principles, rather than proximate causation analysis, as one can envisions situations in which a claimed loss would fall under this exception, yet still would find coverage if proximate causation was the only analysis applied by the court. Therefore, this exclusion should help to provide courts with direction in determination of causation issues under a fidelity policy of insurance.

In spite of the seemingly relative ease with which it can be demonstrated that contract principles should guide an analysis of causation under a CCP, the practical application of such a standard is difficult to clearly elucidate. Although discussed previously in this chapter, the court's decision in *Jefferson Bank*[82] is an excellent starting point at understanding this difficulty. First, the court identified that the district court, in construing the loss "resulting directly from" a covered act language of the financial institution bond at issue, "required the plaintiff not only to prove proximate cause, but also some additional closeness in space and time between the loss and the cause of the loss."[83] The court further stated:

> We begin our analysis by acknowledging that the phrase, "resulting *directly* from" in the policy does suggest a stricter standard of causation than mere "proximate cause." Under Pennsylvania tort law, a cause is proximate if it is merely a "substantial cause" of the harm. Arguably, the words, "resulting directly from" suggest a requirement beyond that the cause be substantial, for the words imply that the loss must flow "immediately," either in time or space, from the forged signature.[84]

The court further acknowledged that a "'direct cause' or 'immediate cause' is a nebulous and largely indeterminate concept."[85] Thus, in partial reliance on this fact, and as discussed

[82] 965 F.2d 1274 (3d Cir. 1992)

[83] *Id.* at 1280.

[84] *Id.* at 1281.

[85] *Id.*

previously in this chapter, the court concluded that a loss "resulting directly from" merely required a proximate cause analysis.[86] However, one must query the strength of the conclusion reached by the court in *Jefferson Bank*, if one of the factors used to reach it truly was the fact that a requirement of directness or immediacy in time or space was too nebulous or indeterminate for the court to grapple with, because, as discussed previously in this chapter, the tort concept of proximate causation has long befuddled many a legal scholar.[87]

In spite of the reluctance of the court in *Jefferson Bank* to look to the contractual intent of the parties, other courts have recognized the distinction between the contractual causation requirements of a fidelity policy of insurance and tort proximate causation. Notably, the court in *Continental Corp. v. Aetna Casualty & Surety Co.*,[88] used contract interpretation principles, and not tort principles, in interpreting the causation requirement of Insurance Companies Blanket Bond Form. No. 25 (1986 ed.). First, the court correctly recognized that the loss "resulting directly from" causation language of the bond required more than "but for", or factual causation, alone.[89] It then concluded that the causation argument advanced by the party seeking to find coverage under the bond required a "tortious causal chain"that was not supported by the bond, as "the bond clearly requires a 'direct' causal connection."[90] This close reading of the causal requirements of the bond more correctly demonstrates the proper approach to causation analysis under the loss "resulting directly from" language of the CCF.[91]

Another decision that is equally cognizant of the contractual causation requirements inherent in a fidelity policy of insurance requiring loss "resulting directly from" a covered act is the unpublished case *United Sec. Bank v. Fidelity & Dep. Co.*[92] In the case, the plaintiff was advocating that the "loss resulting directly from" language of the fidelity/crime policy issued to it by the defendant should be construed to mean "loss proximately caused by." The court found this to be a strained argument and "agree[d] with the many cases which reason that 'direct' means 'direct.'"[93] In so concluding, the court reasoned that the direct loss language of the bond

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[86] *Id.* at 1281-1282.

[87] *See*, Section IV.A.2., *infra*.

[88] 892 F.2d 540 (7th Cir. 1989).

[89] *Id.* at 548.

[90] *Id.* at 549.

[91] For another analysis that strictly interprets the requirement of a "direct" loss, *see, Hartford Accident & Indem. Co. v. Washington Nat'l Ins. Co.*, 638 F.Supp. 78 (N.D.Ill. 1986).

[92] 125 F.3d 860, 1997 WL 632606 (9th Cir. 1997).

[93] *Id.*

required a much narrower construction than the proximate cause reading argued for by the plaintiffs.

A recent unpublished opinion further confirms that the loss "resulting directly from" language of a fidelity policy of insurance should not be analyzed using tort proximate causation concepts. In *RBC Mortgage Co. v. National Union Fire Ins. Co. of Pittsburgh*[94] plaintiffs sought to recover from defendant pursuant to the fidelity/crime policy issued by the defendant. Specifically, they sought to recover under Insuring Agreement (A) of the bond, which provided coverage for losses resulting directly from acts of employee dishonesty. The losses claimed by plaintiffs related to fraudulent loan packages put together by an employee of the plaintiffs and sold, unknowingly by plaintiffs, to third parties. Plaintiffs argued that the determination of whether their losses found coverage under the fidelity/crime policy issued by defendant should be governed by proximate cause. The court thoroughly rejected this idea, stating:

> proximate cause analysis simply is too broad to capture accurately the intent behind the phrase "loss resulting directly from." A "direct loss" must be afforded its plain and ordinary meaning. To equate "loss resulting directly from" with "loss proximately caused by" requires a strained reading of "direct loss," which is a much narrower concept than "proximately caused loss."[95]

While these decisions both make clear that loss "resulting directly from" a covered act requires more than proximate causation, none explain with any clarity what a contractual analysis to the causation language entails. As explained earlier by the court in *Jefferson Bank,* the notions contained in applying such an analysis are nebulous and indeterminate. Therefore, it is difficult for there to be a bright-line rule defining with clarity and certainty what the causation requirements are under the loss "resulting directly from" language found in a CCP.

In spite of the difficulty found in precisely defining how contract causation analysis differs from proximate causation analysis, one trait appears common to causation cases in which the insurer has been victorious compared with those in which the insured has prevailed. In the cases where the insurer has prevailed there has been a pronounced tendency by the court to emphasize the language of the bond in reaching its conclusion.[96] In the cases involving

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[94] 2004 WL 1469417 (Ill.App. 1 Dist.)

[95] *Id.*

[96] *See, e.g., United Sec. Bank v. Fidelity & Deposit Co. of Md.*, 125 F.3d 860, 1997 WL 632606 (9th Cir. 1997) ("Considering the plain meaning of 'direct loss' and that authority, we conclude that 'direct loss' is much narrower than proximately caused loss"); *French Am. Banking v. Flota Mercante Grand Colom.*, 752 F.Supp. 83, 91 (S.D.N.Y. 1990) ("The language of the Financial Institution Bond is clear that in order for FABC to recover the claimed loss must have resulted directly from . . ." the covered event); *Reliance Ins. co. v. Capital Bancshares,*

causation issues under a fidelity policy of insurance where the insured has prevailed, there has been a decided trend by the courts to shift their analysis away from the policy terms, embracing tort proximate causation principles.[97] This is a clear indication that when a causation issue arises in a case under a CCP, it is important to emphasize the loss "resulting directly from" language of the fidelity policy to ensure that proper contract causation analysis is undertaken.

Given the difficulty in establishing the exact boundaries of contract causation, beyond knowing that contract causation requires more than proximate causation, an understanding of proximate causation is a useful tool in the analysis of an insured's claim. If the insured cannot even meet the standards of a proximate cause analysis, it should be impossible for the insured to meet the heightened standards of contract causation. Furthermore, other causation issues, such as intervening or superceding causes and the negligence of the insured, are directly tied to a proximate cause analysis, therefore, in spite of the fact that a contractual analysis of causation under the CCF is the proper means for determining if the alleged loss of the insured is covered, a proximate cause analysis has a place in determining if the insured meets even the minimum threshold for coverage. Furthermore, given courts' willingness to solely use proximate cause analysis in their determination of causation under a fidelity policy of insurance, it seems wise to be prepared to intelligently discuss such an analysis should a court wish to progress down that path.

C. "Manifest Intent" Requirement

Beyond the contractual causation requirements already addressed, that an insured needs to meet in proving that its loss finds coverage under the CCF, a CCP also requires that the acts of the employee be carried out with a specific intent. This intent found its way into the policy to help clarify that a CCP is designed to provide protection to an employer against loss due to employee dishonesty. Specifically, the Surety Association in 1976 introduced a definition of "employee dishonesty,"[98] that was designed to better reflect the intent of insurers to limit coverage to employee embezzlement-type situation. This response was necessary, as courts were increasingly frustrating this intent by finding coverage for situations not envisioned by the

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Inc., 685 F.Supp. 148, 141 (N.D. Tex. 1988), *aff'd,* 912 F.2d 756 (5th Cir. 1990) ("The language of the Insuring Agreement (E) makes it clear . . ." that a loss must result directly from the covered event); *Liberty Nat'l Bank v. Aetna Life & Cas. Co.*, 568 F.Supp. 860, 863 (D.N.J. 1983) ("This loss falls upon the Bank and not the bonding company by the terms and intent of the Financial Institution Bond.").

[97] *See, e.g., Jefferson Bank v. Progressive Cas. Ins. Co.*, 965 F.2d 1274, 1282 (3d Cir. 1992) ("We believe that in this contract 'resulting directly from' means 'proximately caused by'"); *Hanson PLC v. National Union Fire Ins. Co. of Pa*., 794 P.2d 66 (Wash. Ct. App. 1990); *Daniel Grocer Co. v. new Amsterdam Cas. Co.*, 266 N.E. 2d 365 (Ill. Ct. App. 1971).

[98] Frank L. Skillern, *The New Definition of Dishonesty in Financial Institution Bonds*, 14 Forum 339, 344 (1978).

drafters or the insurers. Therefore, employee dishonesty was (and is) limited to employee conduct motivated by the "manifest intent" to:

> **(1)** Cause you to sustain a loss; and also
>
> **(2)** Obtain financial benefit (other than employee benefits earned in the normal course of employment, including: salaries commissions, fees, bonuses, promotions, awards, profit sharing or pensions) for:
>
> > **(a)** The "employee"; or
> >
> > **(b)** Any other person organization intended by the 'employee' to receive that benefit.[99]

However, since its introduction, the "manifest intent" language has created many conflicting opinions on what standards are used to judge the employee's intent, with no clear consensus being reached.[100]

D. Did the Insured Cause Its Own Loss and Other Miscellaneous Causation Issues

When discussing causation issues under a fidelity insurance policy, it would be remiss not to discuss the effect of an insured's own negligence on the issue of causation under the policy. Specifically, when faced with such an issue courts have routinely held that the insured's own negligence will serve to bar recovery on a policy, but only where such negligence breaks the causal chain required by the proximate cause analysis.[101] Illustrative of this principle is *Empire Bank v. Fidelity & Dep. Co. of Maryland,*[102] where the court held that losses that a bank sustained due to its own negligence, when it allowed the corporate president, in violation of bank operating procedures, to cash checks payable to the corporation without first demonstrating existence of a corporate resolution authorizing him to cash corporate checks, were not the result of president's illegal acts, but rather of the bank's employees' negligence in disregarding internal

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[99] Commercial Crime Coverage Form A (1990), Sections A & D(3)(a).

[100] For a recent discussion on the manifest intent language and the various ways courts have interpreted such language, *see* Samuel J. Arena, Jr., et al., *The "Manifest Intent" Handbook* (2002).

[101] *See, Alpine State Bank v. Ohio Cas. Ins.* Co., 941 F.2d 554 (7th Cir. 1991); *Mitsui Manufacturers Bank v. Federal Insurance Co.*, 795 F.2d 827 (9th Cir. 1986); *Compare, First Federal Sav. & loan Ass'n v. Aetna Ins. Co. of Hartford*, 431 F.2d 267 (8th Cir. 1970).

[102] 828 F.Supp. 675 (W.D. Mo. 1993), *aff'd*, 27 F.3d 333 (9th Cir. 1994).

operating procedures for the bank.[103] Therefore, the bank was barred from recovery on its blanket banker's bond. However, this situation can be contrasted with one in which two causes operate concurrently to cause the insured to suffer the loss. If one of the causes is covered, and the other does not find coverage, so long as the uncovered cause is not determined to be the sole proximate cause of the loss, coverage will be found for the insured.[104] In such a situation, an apportionment of the loss between the two causes is appropriate.

V. *Conclusion*

In the final analysis, insureds and courts need to be reminded that principles of contract interpretation, not principles of tort law, should apply with regard to causation issues on fidelity/crime claims. An insurer is well within its rights to point to causation as a required component of covered loss where an insured's loss was not actually *caused* by employee dishonesty. It is not only necessary that the loss result from employee dishonesty, but that it result *directly* from employee dishonesty. "Resulting directly" is a phrase which makes up the "belt and suspenders" of causation. Coverage cannot be presumed simply because employee dishonesty is established and a loss has been suffered. It is necessary that the loss be caused by (i.e., result directly from) dishonesty in order to trigger the insurer's duty to indemnify.

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[103] *Id.* at 678.

[104] *Leucadia, Inc. v. Reliance Ins. Co.*, 864 F.2d 964, 966 (2d Cir. 1988); *J.R. Norton Co. v. Fireman's Fund Ins. Co.*, 569 P.2d 857 (Ariz. App. 1977); *Daniel Grocer Co. v. new Amsterdam Cas. Co.*, 266 N.E.2d 365 (Ill. App. 1971); *State v. Maryland Cas. Co.*, 1 S.E.2d 516 (S.C. 1939).