

## Case Notes

### Virginia Federal Court Limits Coverage Defenses to Commercial Fraud Claim

By Marc S. Mayerson

In addressing key issues that are raised in any commercial fidelity claim, the U.S. District Court for the Eastern District of Virginia has limited the defenses to coverage for claims involving employee dishonesty. *Building One Services Solutions Inc. v. National Union Fire Insurance Co. of Pittsburgh, PA*, Civil No. 02-311-A (E.D. Va., Nov. 26).

Companies purchase fidelity insurance policies to cover themselves against the risk of loss from employee dishonesty. Fidelity coverage generally is divided into two types: financial fidelity, which covers banks and other financial institutions, and commercial fidelity, which covers other types of businesses. Regarding financial fidelity, there is significant standardization of policy forms; regarding commercial fidelity, there is less standardization in the policy language, even though it often springs from the Surety Association of America or the Insurance Services Office.

Generally speaking, two key issues are presented in any commercial fidelity claim: Is the misconduct covered and, if so, for how much does the policy pay? The first question typically involves whether the employee acted with "manifest intent" to benefit himself (or someone else) and to harm his employer. The manifest-intent concept was introduced in 1976 and has spawned 25 years of litigation (and increasingly the manifest-intent concept is being abandoned by policy draftsmen). Less attention has been paid to the scope of the indemnification provided insureds for the "loss of money, securities or other property."

The *Building One* case involved a manager of a subsidiary who essentially hijacked it for the personal enrichment of himself and his cronies. A key aspect of the operation was to have the parent company pay for costs and expenses through regular requisitions from the subsidiary.

Unbeknownst to the parent company, the subsidiary submitted requisitions for fabricated expenses and for previously paid expenses. Payments for the fabricated expenses and false charges were remitted to dummy corporations controlled by the manager or by his associates. (In this way, the money was siphoned out of the company.)

To cover up the submission of these false expenses, the manager cooked the books of the subsidiary by shifting on paper the costs associated with one job to other jobs, so as to make the older jobs appear profitable. A key component of the claim was the insured's contention that the subsidiary aggressively took on more and more work (often below cost) in order to have additional cost centers against which to transfer real and fake invoices, all to cover up, perpetuate, and facilitate the theft and embezzlement from the parent company.

Building One timely submitted its sworn proof of loss to National Union in October 2000. By March 1, 2002, National Union had yet to pay on the claim, and Building One initiated suit for coverage, including seeking an award of its attorney fees on the grounds that the carrier denied coverage unreasonably and in bad faith. National Union's fundamental contention was that the policy indemnified the insured only for the amounts it could prove were embezzled. Shortly before the trial was to begin, the court denied National Union's motion for summary judgment and adopted the rulings on the meaning of the policy sought by the insured. (After the summary judgment decision, the case settled.)

As to manifest intent, the court held that questions of fact precluded summary judgment in the insurer's favor. The court next addressed the insurer's contention that the losses suffered by Building One were not "sustained" resulting directly from "the employee's bad acts. The court held that "direct losses" covered by the Blanket Crime

Policy at issue included all amounts of monetary loss that were proximately caused. After holding that the covered loss of money is whatever the insured shows to be proximately caused from the covered misconduct of its employee, the court found that factual disputes barred summary judgment.

The court then addressed two final arguments made by the insurance company. First, the court found that the insurance policy covers the money lost by the insured in performing the contracts entered into by its subsidiary (contracts that it would not have entered had it known the true facts). As the court held, "in rejecting National Union's motion for summary judgment on this issue, the Court rejects National Union's argument that simply because the contracts themselves were not misappropriated or created fraudulently, losses deriving therefrom are noncompensable under the insuring agreement. Although the 'resulting directly' language of the insuring agreement limits the scope of the insurer's risk significantly, it does not limit that risk solely to the money that is eventually found in the embezzler's pocket." This ruling was significant because the amounts lost by Building One were "far more extensive than the gains [the employee] received."

Second, the court rejected the application of Exclusion (m), which bars coverage for "damages of any type for which the Insured is legally liable, except direct compensatory damages arising from a loss covered under this Policy." In construing this provision, though the court recognized that third-party claims standing alone were insufficient to trigger coverage, once coverage was triggered, "the exception to Exclusion (m) provides enough latitude that all compensatory damages associated with the employee's dishonesty are covered, not just the amounts the employee embezzled, but also those proximately related to the entire scheme."

In short, the court recognized that "Employee Dishonesty" coverage is not artificially limited to employee embezzlement and instead affords coverage for whatever "Loss of Money...the Insured shall sustain resulting directly from" covered misconduct, as long as the requisite causal link is shown between the actual money loss and the employee's misconduct.

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