

ANDERSON KILL POLICYHOLDER ADVISOR

The Policyholder Law Firm



MF Global Wins One for Fidelity Insurance Policyholders

By Edward J. Stein

In recent times, commercial crime victims have had to add the “direct loss” defense to the simple certainties of death and taxes. Whenever the chain of causation involves more than a perpetrator simply pocketing cash from the company register, the response from a commercial crime or fidelity insurance claim is a reservation of rights or outright denial on direct loss grounds. In other words, insurance companies argue that the loss does not result directly from a covered cause and therefore falls under an exclusion for indirect loss, or that it fails to meet a direct loss requirement in insuring agreements or definitions. The insurance industry’s favored formulation that “direct means direct” has succeeded in certain instances involving particularly attenuated facts, but policyholders should know that other courts rightly reject that circular reasoning. The question of what constitutes a direct loss remains a fact-specific problem with ambiguous policy language that should be construed in favor of coverage when more than one interpretation is viable.

A recent high-profile, high-stakes decision by a New York intermediate appellate court bears this out. In *New Hampshire Insurance Company v. MF Global, Inc.*, __ N.Y.S.2d __, 2013 WL 3584068 (N.Y. App. Div., 1st Dep’t, July 16,

2013), the Appellate Division of the state Supreme Court unanimously affirmed summary judgment for the policyholder, rejecting an AIG insurance company’s direct loss defense in connection with a loss the policyholder had to pay to a third party.

The policyholder, the bankrupt commodity and derivatives broker MF Global, had been compelled by the rules of an exchange on which it traded to transfer approximately \$150 million to the exchange’s clearinghouse, in order to settle losses on trades in the personal account of a broker associated with one of its offices. When MF Global submitted a claim under fidelity bonds issued by AIG at the primary level and excess bonds that followed form, the insurers denied coverage and sued for declaratory judgment that MF Global did not sustain a “direct financial loss,” as required by the bond’s definition of covered “Loss.” Like many other forms of fidelity or commercial crime policies, the AIG policy also excluded coverage for “indirect or consequential loss.”

New York Appellate Decision: Direct Means “Proximate”

The trial court granted summary judgment for the policyholder against the direct loss de-

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fense, and the appellate court's affirmance on that issue rejected typical insurance company arguments. (The appellate court reversed in part on an unrelated issue, whether the broker whose trading caused the loss was an "employee" covered under the bond.) Noting that a "direct loss" for insurance purposes has been analogized with "proximate cause," it found that the broker's unauthorized trades were the direct and proximate cause of MF Global's loss, because those trades resulted in a nearly immediate shortfall that the policyholder, as a member of the exchange's clearinghouse, was automatically and directly responsible to compensate by payment to the clearinghouse.

The appellate court rejected the insurance companies' contentions that payment to the clearinghouse merely satisfied a contractual liability and that there were intervening events that resulted in a protracted causal chain. The court noted that the trading did not result in harm to a third party that subsequently sought redress, but rather had an immediate and direct effect because the policyholder was responsible for losses on its trading system and made good on those losses promptly.

Other Contexts for a "Proximate Cause" Standard

While this reasoning may have limited practical benefit in the brokerage context because many brokers' policies contain a trading loss exclusion not found in the MF Global policy, it can apply in many other contexts. For example, many businesses retain vast amounts of customer personal and financial data, the theft of which can result in immediate losses through required response measures. In *Retail Ventures, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 691 F.3d 821, 831 (6th Cir. 2012), the U.S. Court of Appeals for the Sixth Circuit held that these were costs "resulting directly from" a covered cause of loss, rejecting the insurance companies' direct loss defense. The decision found that coverage existed for the losses suffered by the retailer for, among other things, reimbursing others for fraudulent credit card charges and expenses for addressing a Federal Trade Commission inquiry. The Sixth Circuit found that the promise to cover loss "resulting directly from" the "theft of Insured property

by Computer Fraud" imposes a traditional proximate cause standard, which, in this case, would encompass liability where the policyholder holds or is responsible for property or information entrusted to it by other parties. (The policyholder in *Retail Ventures* was represented by Joshua Gold of Anderson Kill.)

The causation analysis in *MF Global* and *Retail Ventures* is consistent with many other decisions and with the reasonable expectations of policyholders looking for the protection they were promised. In *Scirex Corp. v. Federal Ins. Co.*, 313 F.3d 841 (3d Cir.2002), the policyholder was a testing laboratory that ran trials for drug companies and had to replicate several studies, at no additional charge, when it found that its nurses had routinely submitted false observations reports. Instead of observing patients for the full, required time during drug tests, the nurses released patients early and "pre-recorded" their "observations," making the initial studies unreliable and unsuitable for the clients' purposes. The insurance company denied coverage, arguing that the cost of redoing the studies was an ordinary operating expense, not a "direct loss" from employee dishonesty. The Third Circuit rejected that argument, reasoning that the employees' false reporting of clinical observations was the proximate cause of the funds lost in replicating the drug tests.

Losses resulting from employee dishonesty, computer hacking, forgery, or other covered causes need not result immediately or be isolated from all other causes to be covered under fidelity insurance. The losses that can result "directly" from crime and dishonesty are as varied as crime and dishonesty itself, which unfortunately but inevitably will continue to evolve. Policyholders should advocate forcefully to their insurance companies and, if needed, to the courts to ensure that coverage evolves commensurately.▲

About Anderson Kill

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