Dodging the "Direct Loss" Bullet

by Edward J. Stein

Diligent and prescient risk managers can seek to combat corporate fraud, but hopefully none would take offense at a reminder that fraud reduction, not outright prevention, is all that reasonably can be expected. Because the greed and creativity of white collar criminals seems to inevitably find an outlet, some risk managers will be forced to submit claims under fidelity bonds and commercial crime insurance policies. As greater prevention leads to more creative criminals, the direct loss defense will continue to be a focus of such claims.

Whenever the chain of causation involves more than a perpetrator simply pocketing cash from the company coffers, commercial crime or fidelity bond insurance companies typically reserve rights or deny coverage. The insurance company will contend that the loss does not result directly from a covered cause and therefore fails to meet the definition of "loss" or comes within an exclusion for indirect loss. 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.

A recent New York appellate decision bears this out. In New Hampshire Insurance Company v. MF Global, Inc., the court unanimously affirmed summary judgment for the policyholder, rejecting a direct loss defense in connection with a loss the policyholder had to pay to a third party. The policyholder, the broker MF Global, was compelled by the rules of an exchange on which it traded to transfer approximately $150 million to a clearinghouse to settle losses on trades in the personal account of a broker. When MF Global submitted a fidelity bond claim, its insurance companies sued for declaratory judgment that it did not sustain a "direct financial loss," citing the bond's definition of covered "loss" and an exclusion of coverage for "indirect or consequential loss." The trial court granted summary judgment for the policyholder, and the appellate court affirmed. 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, immediately and directly responsible to compensate.

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., the U.S. Court of Appeals for the Sixth Circuit held that these were costs "resulting directly from" a covered cause. The court found coverage for losses suffered by the retailer through, among other things, reimbursing others for fraudulent credit card charges and expenses for addressing an FTC 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 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. For example, in BJ Servs. S.R.L. v. Great Am. Ins. Co., it was determined that if employees acted with apparent authority in obtaining loans in policyholder's name and taking the proceeds of those loans for their own personal purposes, the policyholder sustained a "direct loss" when it incurred liability to repay the loans. In Scirex Corp. v. Federal Ins. Co., a drug testing laboratory that replicated studies at no additional charge after finding that nurses had routinely submitted false observations reports was found to have sustained "direct loss" from employee dishonesty.

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 argue forcefully to their insurance companies and, if needed, to the courts to ensure that are covered.

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