AKO POLICYHOLDER ADVISOR
The Policyholder Law Firm

Volume 10 Number 1 www.andersonkill.com January 2001

The Rogue Trader:

Can His Personnel File "Kill" Your Insurance Coverage For His Thefts?

R. Mark Keenan
Robert Chung

Calvin Clean, star trader in your arbitrage department, capable of leaping tall buildings in a single bound—also is secretly capable of stealing massive amounts of money from customer accounts of the firm and leaping to foreign sites unknown. In fact, that is just what has happened. Calvin Clean didn't live up to his image or his name.

A claim is filed with the insurance company that sold you what is commonly known as a Financial Institutions Bond.

You wait and wait and finally the insurance company issues a "reservation of rights" letter or even worse, a flat out denial of coverage. The purported ground is that 15 years earlier, Calvin Clean got into a little trouble with the NASD and was fined for a relatively minor violation in a settlement agreement with the NASD. Under its explicit terms, Calvin entered into the settlement "without admitting or denying the allegations". Since 1985, Calvin's Form U-4 record has been absolutely clean.

Twelve years later, in 1997, Calvin joined your firm with only this one blemish on his Form U-4 personnel record.

Three years later, Calvin commits the securities fraud of the century.

This is why you buy insurance—right?

Of course! In fact the Financial Institutions Bond expressly covers losses "resulting directly from dishonest or fraudulent acts committed by an employee . . . ."

But, the insurance company—while happy to sell you the insurance policy for a healthy premium—now says: Oh no, we aren't going to cover any of these losses caused by this recent fraud because you knew (by reason of the 1985 NASD consent decree in his personnel file) that Calvin Clean was dishonest.

Our years of experience in this area has taught us that insurance companies often argue that their insurance terminates as to any one employee the very second the policyholder "learns" or becomes "aware" that he or she has engaged in "dishonest " or "fraudulent" acts and that such "termination" precludes coverage for any loss caused by that employee *after* the policyholder became aware of the dishonesty.

The insurance company's rationale behind such "termination" or "cancellation" provision is that if the policyholder becomes aware that his or her employee has committed dishonest or fraudulent acts (no matter when those acts took place) *and* the policyholder decides to let the employee remain with the company—the risk of any future losses caused by that employee should be borne by the employer, *not* the insurance company.

The relevant policy provision states that coverage is terminated as to any employee:

> . . . as soon as any Insured or any director or officers not in collusion with such person learns of any dishonest or fraudulent act committed by such person at any time, whether in the employment of the Insured or otherwise whether or not of the type covered under [the Policy] . . .

The vagueness of this provision can only cause trouble for the policyholder. The provision is commonly abused by the insurance companies

AKO ANDERSON KILL & OLICK

that often take an "expansive" view of what constitutes a "dishonest or fraudulent act":

- lying about your golf handicap?
- cheating on an eighth grade spelling test?
- reporting "highly aggressive" tax deductions?
- running a red light?

Courts, however, have limited the applicability of the provision—the policyholder must have *substantial evidence* of previous dishonesty to trigger the termination clause. Knowledge of inefficient business practices, accounting irregularities and discrepancies, or mistakes does not constitute discovery of previous dishonesty to terminate the coverage.

Mere suspicion or rumor of previous dishonesty by an employee does *not* suffice.

In *First Hays Banshares, Inc. v. Kansas Bankers Sur. Co.*, it was held:

> . . . the provision requires actual knowledge and not mere suspicion or a reason to know of the wrongdoing. [M]ere negligence by the insured does not absolve the insurer from liability under a fidelity bond.

See also Mid-America Bank of Chaska v. American Cas. Co. of Reading, Pa., (suspicions of fraud or dishonesty insufficient to establish that plaintiff discovered the fraud).

What about Calvin Clean's settlement with the NASD?

Calvin signed a Letter of Acceptance, Waiver and Consent ("AWC") with the NASD in settlement of alleged rule violations. The agreement explicitly states that Calvin accepts certain facts *"without admitting or denying the allegations"*.

Such agreements or consent decrees, which neither admit nor deny allegations of wrongdoing, cannot provide—in and of themselves—a policyholder with "actual knowledge" of wrongdoing. Settlements which neither admit nor deny that a party engaged in conduct complained of, do *not* constitute evidence of prior wrongdoing. *See, e.g., U.S. v. Cook*, (consent injunction in which defendant neither admitted nor denied findings does not constitute "evidence of crimes, wrongs, and other acts offered to prove that a person had previously acted in a particular manner").

In *In re Adler, Coleman Clearing Corp.*, the trustee for an estate commenced litigation for an order upholding his determinations respecting the claims of customers of an introducing broker, which the debtor cleared. The customers sought to preclude evidence of the introducing broker's fraud and other wrongdoing under the Federal Rules of Evidence. Among the evidence sought to be precluded were NASD reports, a Decision and Order of Acceptance of Offers of Settlement issued by the NASD, and SEC reports of proceedings instituted against various brokers, all of which specified numerous allegations of wrongdoing by the introducing brokers. The Adler court excluded that evidence on the basis that the introducing brokers neither admitted nor denied the findings therein:

> Because the [introducing brokers] referred to in those Exhibits neither admitted nor denied the findings made by the NASD Market Regulation Committee and the SEC in accepting their offers of settlement, those documents cannot be admitted to show that they actually engaged in the conduct alleged.

When governmental authorities such as the SEC are involved, there are constitutional ramifications to this issue. As the Supreme Court noted in *U.S. v. Armour & Co.*:

> Because the defendant, by the [consent] decree, waived his right to litigate the issues raised, a right guaranteed to him by the Due Process Clause, the conditions upon which he has given that waiver must be respected, and the instrument must be construed as it is written and not as it might have been written had the plaintiff established his factual claims and legal theories in litigation.

Accordingly, a court (at the insurance company's request) is not free to expand or constrict those terms or to impose unagreed-to remedies.

When your insurance company hits you with this type of defense—(1) consult an attorney with experience in these matters, (2) review your employee's entire personnel file, and (3) don't be afraid to call the carrier's bluff.

The simple fact is that a consent agreement which neither admits nor denies the allegations of wrongdoing cannot be used as evidence of that wrongdoing at trial much less as a basis to terminate coverage.

Calvin Clean may be in jail and the fraudulently obtained funds long gone but your company's insurance claim should be alive and well—and paid. ■

Mr. Keenan is a shareholder in the New York office of Anderson Kill & Olick, P.C. and Co-Chair of the Financial Services Insurance Coverage Group. Mr. Chung is a shareholder in the New York office of Anderson Kill and a member of the Financial Services Insurance Coverage Group. Anderson Kill regularly represent policyholders in insurance coverage actions. Besides New York, the firm also has offices in Chicago, IL, Newark, NJ, Philadelphia, PA and Washington, D.C. Mark Keenan can be reached at (212) 278-1888 or **mkeenan@andersonkill.com**. Robert Chung can be reached at (212) 278-1039 or **rchung@andersonkill.com**