

ALERT

Fraud Exclusion in D&O Policy Triggered by Employee's Misconduct; But Fidelity Bond Responds to the Resulting Judgment Against Insured Bank

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Applying Minnesota law, a federal district court has held that a fraud exclusion bars coverage under a D&O policy for a judgment against a bank arising out of its employee's participation in an "advance-fee scheme." *Avon State Bank v. Banclinsure, Inc.*, 2014 WL 1048503 (D. Minn. Mar. 18, 2014). The court, however, also concluded that the bank's fidelity bond issued by the same insurer afforded coverage for the resulting loss.

A bank employee became involved in a scam in which individuals were promised portions of a fictional estate if the individuals wired money to help transfer the fictional estate from Senegal to the United States. The employee wired his own funds, but received no return on his investment. He then recruited others to invest in an attempt to cover his losses when he began to doubt the legitimacy of the scheme. The individuals he recruited wrote checks to the bank, and the employee used the bank to wire the funds to offshore accounts. When the individuals received no return on their investments, they demanded that the bank return their money and threatened litigation. The individuals subsequently brought suit against the bank for fraudulent misrepresentation, contending that the bank was vicariously liable for the misconduct of its employee.

The insurer denied coverage under the D&O policy based on an exclusion for losses resulting from fraudulent acts. In the coverage litigation that followed, the court agreed with this position and rejected the bank's reliance on the policy's severability clause for the

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argument that the exclusion applied only to the extent that bank itself acted fraudulently. The severability clause provided that "[n]o fact pertaining to any Insured Person shall be imputed to any other Insured Person for the purposes of applying the exclusions," and the court held that the bank's interpretation would render the fraudulent acts exclusion meaningless because the bank could only act through its employees, officers, and directors. Here, according to court, because the employee was acting within the scope of his employment with respect to the fraudulent scheme, his fraudulent misrepresentations were attributable to the bank.

The bank's fidelity bond provided certain specified coverage for loss resulting from the misconduct of an employee in connection with property of a third party held by the bank. In this regard, the court concluded that the bank held the property of the individuals who invested in the fraudulent scheme because the employee represented that the bank would be handling the funds. The court also rejected the insurer's argument that the bank should have provided notice under the bond when the bank president first learned of the scheme and the possibility of employee's involvement. According to the court, because the notice provision in the bond did not identify a specific recipient for notice, it was sufficient that the bank provided timely notice to the insurer in connection with reporting the circumstances under the D&O policy. The court also found, in any event, that the insurer waived the notice requirement when the insurer initially agreed to defend the suit under the D&O policy pursuant to a reservation of rights because the insurer caused the bank to believe that the matter was covered under that policy and therefore it was futile to pursue coverage under the bond.