Interplay between the adverse interest rule and misrepresentations in the fidelity bond application

Scott Schwartz
Clyde & Co.

Under almost all fidelity and crime insurance policies[1] issued in the United States, a loss must be "discovered" during the bond period. While applying for a bond, the company must affirmatively disclose any fidelity losses it is aware of, or risk rescission of the bond. Most commonly, "discovery" occurs when the insured itself discovers the loss, and knowledge of the directors and officers of the insured are generally imputed to the insured itself. In order to ensure that fidelity bonds still provide coverage for the thefts and embezzlements of officers and directors, courts apply the "adverse interest rule" for the imputation of knowledge. Although the exact contours of the rule differ from state to state, it generally states that an officer or director's knowledge will not be imputed to the company where the officer or director was acting entirely adversely to the company, and was therefore incentivized not to reveal the knowledge.[2]

What happens, however, when the defalcating officer or director was also the individual who signed the application for the fidelity bond? Insureds will argue that the adverse interest rule still applies, such that the individual's knowledge cannot be imputed to the insured, whereas insurers will argue that they cannot be expected to honor a fidelity bond that was procured through misrepresentations.

The two most recent cases to discuss this issue are *Everest Nat'l Ins. Co. v. Tri-State Bancshares, Inc.,* 2016 WL 5062155, at *1 (W.D. La. Aug. 2, 2016) and *Nat'l Credit Union Admin. Bd. v. CUMIS Ins. Soc'y, Inc.*, 241 F. Supp. 3d 934, 941 (D. Minn. 2017).

In *Everest*, the Vice-President of Operations at Tri-State Bancshares, Inc. ("Tri-State"), Jim Scott, embezzled over $1.5 million from Tri-State over his 20 years as an employee. Tri-State sought recovery from Everest National Insurance Co. ("Everest") under a fidelity bond. Everest rejected Tri-State's claim, and sought rescission of the fidelity bond, because Scott had signed the fidelity bond application himself, which represented that that Tri-State had no knowledge of any thefts, even though Scott himself was actively stealing from the bank at the time.

The court noted that neither party disputed that Scott had lied on the application with the intent to deceive Everest; the only question was whether the adverse interest doctrine should be applied to prevent Scott's knowledge from being applied to Tri-State. The court ruled that the adverse

[1] Because this issue applies equally to both fidelity bonds and commercial crime policies, this article will simply refer to both types of policies as "fidelity bonds."
[2] *Center v. Hampton Affiliates, Inc.*, 66 N.Y.2d 782, 784-785 (1985) ("To come within the exception, the agent must have totally abandoned his principal's interests and be acting entirely for his own or another's purposes.").

exception prevented Scott's knowledge from being imputed to Tri-State, and rejected Everest's arguments that Scott's signature allowed rescission of the contract.

In *Nat'l Credit Union Admin. Bd.*, St. Francis Campus Credit Union ("St. Francis") discovered one of its managers, Margurite Cofell, had embezzled more than $3 million from St. Francis. St. Francis made a claim under its fidelity bond. Cofell had, of course, signed St. Francis's application for the fidelity bond in which she did not disclose the existence of her own theft. The court ruled that adverse interest exception applied, finding, "the only reason that Cofell did not disclose the existence of her theft was for her own benefit and to the detriment of the company. . . . Thus, the adverse interest exception applies to Cofell's misrepresentation on the insurance application." *Id.* at *940-41.

Notably, the court distinguished *Pioneer Indus., Inc. v. Hartford Fire Ins. Co.*, 639 F.3d 461, 466 (8th Cir. 2011), in which the dishonest employee failed to disclose his own thefts and made misrepresentations regarding the company's internal controls to catch theft. The court explained that, because those misrepresentations were not directly related to concealing the employee's own fraud, they did not trigger the adverse interest exception.[3]

Although the *Everest* court correctly noted that "the overwhelming majority of courts nationwide employ the adverse interest exception," it is less clear that the adverse interest exception applies where the defalcating employee is the individual who signed the fidelity bond application. On this issue, the *Nat'l Credit Union Admin. Bd.* court observed that "courts are split, with the issue turning on which party the court decides is best able to bear the risk of loss." Most prominently, in *Pereira v. Aetna Cas. & Surety Co. (In re Payroll Express Corp.)*, 186 F.3d 196 (2d Cir. 1999), the Second Circuit Court of Appeals ruled that the adverse interest exception did not apply to allow a party to "disavow an act of an agent while simultaneously taking advantage of the benefits of the fraudulently procured bargain."[4] The *Everest* court distinguished *Payroll* due to the Second Circuit's reliance on New Jersey law, which had not "ascertain[ed] the operation and scope of the adverse interest doctrine."[5] The *Payroll* court, however, explicitly noted that, regardless of whether the New Jersey law recognized the exception, an insured could not enforce a contract its agent had procured through fraud.[6]

There is a clear split amongst the U.S. courts that have addressed this question, highlighting the tension between the adverse interest doctrine and the doctrine preventing a principal from benefitting due to the fraud of its agent. Along with *Everest* and *Nat'l Credit Union Admin. Bd*, the following courts in Florida, Washington, and Kentucky have ruled that the adverse interest

[3] The *Pioneer* court never addressed the adverse interest exception.
[4] Id. at 208.
[5] Id. at 207-208.
[6] Id. ("As between the innocent Insured and the innocent Insurer, the former should shoulder the burden created by any falsehoods made by the agent which it chose to represent it in the transaction.").

exception allows an insured to recover on a fidelity bond even though the employee who signed the bond was aware of thefts at the time of signature: *Certain Underwriters at Lloyd's v. Coastal States Mortg. Corp.*, 2014 U.S. Dist. LEXIS 186058 (S.D. Fla. Apr. 17, 2014); *Puget Sound Nat'l Bank v. St. Paul Fire and Marine Ins.*, 645 P.2d 1122 (Wash. App. 1982); In *BancInsure, Inc. v. U.K. Bancorporation Inc./ United Kentucky Bank of Pendleton Cty., Inc.*, 830 F. Supp. 2d 294 (E.D. Ky. 2011). Courts in New Jersey and Pennsylvania, however, have agreed with Payroll that where the dishonest employee also signed the application for coverage, the insured cannot recover. *See Great Am. Ins. Cos. v. Subranni (In re Tri-State Armored Servs.)*, 332 B.R. 690, 714 (Bankr. D.N.J. 2005); *In re Lloyd Sec.*, 153 B.R. 677, 683-684 (E.D. Pa. 1993).[7]

This split is best illustrated by changes to the Restatement of Agency. In Comment C of § 280, the Restatement (Second) of Agency explicitly notes that an insured can recover on a fidelity bond procured by an employee who made misrepresentations on the application regarding his own thefts. However, this comment was removed in the Restatement (Third) of Agency and replaced with an explanation that this is an unclear area of law, citing to both *Payroll* and *Puget Sound*.[8]

Ultimately, insurers must be aware that this is an uncertain legal issue with many competing interests, and there is a risk of more courts agreeing with the *Everest* and *Nat'l Credit Union Admin. Bd* decisions. Indeed, the four most recent cases to decide this question across multiple jurisdictions all issued rulings in favor of the insured. One way insurers could avoid the situation where they are required to pay on fidelity bonds where the signer of the bond application is later found to be a thief is to modify the language of the application itself. The language of the fidelity bonds in the above cases allow rescission based on the knowledge of the *insured*, not the knowledge of the *signer*.[9]

For example, in *Everest*, the application stated:

> No statement made by, or on behalf of, the Insured, whether contained in the Application or otherwise, shall be deemed to be a warranty of anything except that it is true to the best of the knowledge and belief of the Insured. . . . However, notwithstanding the above, any omission, concealment, or incorrect statement in

[7] Note that *In re Lloyd Sec.*, 153 B.R. 677, 683-684 (E.D. Pa. 1993)'s discussion of the issue is dicta, and the court ultimately did allow recovery by the insured. However, the court explicitly noted that *Gordon v. Continental Casualty Co.*, 319 Pa. 555, (1935), in which the Pennsylvania Supreme Court found that the adverse interest doctrine does not apply to an agent purchasing fidelity insurance, remains the controlling law in Pennsylvania.
[8] Restatement (Third) of Agency § 5.04.
[9] Some applications are even more explicit, and specifically state that false statements made by the person who signs the application for the insured are not imputed to the insured. *See Phoenix Sav. & Loan, Inc. v. Aetna Cas. & Sur. Co.*, 427 F.2d 862, 870-871 (4th Cir.1970) ("The application, by its terms, however, excludes the knowledge of the signer as to his personal acts from the representations made therein.").

> the Application or otherwise, shall be grounds for the rescission of this bond provided that such omission, concealment or incorrect statement is material.

2016 U.S. Dist. LEXIS 104534 at *8 (emphasis added). Notably, the above language only refers to the knowledge and belief of the insured, not the knowledge of the insured's agent signing the application, such that the signer's knowledge must be imputed to the insured before the application allows rescission. Minor changes to this language, such as requiring the application to be true to the best knowledge of both the insured and the agent signing the policy or requiring the insured to explicitly agree the signer's knowledge could be imputed to the insured, could prevent insureds from hiding behind the adverse interest exception to recover on fraudulently procured policies.[10]

[10] To date, no court has a ruled on whether a fidelity bond with such language could be rescinded for false statements made by the signer that were unknown to the insured.