The Fidelity Law Journal

published by
The Fidelity Law Association

Volume XI, October 2005

Cite as XI Fid. L.J. ___ (2005)

The Fidelity Law Journal is published annually. Additional copies may be purchased by writing to: The Fidelity Law Association, c/o Wolff & Samson PC, One Boland Drive, West Orange, New Jersey 07052.

Who's On First—The Fidelity Insurer's Rights to First Recoveries

C. David Hailey

Most, if not all, modern fidelity bonds contain a provision allocating recoveries in the event of a covered loss and payment by the insurer. Generally, both commercial fidelity bonds and Financial Institution Bonds provide that recoveries, net of the expenses associated with obtaining them, should first go to the insured to the extent the insured has suffered a loss in excess of the policy's limitation of liability. Once the insured's excess loss, if any, has been satisfied, or if the amount of the insured's covered loss was within the policy's limitation of liability, net recoveries go to the insurer to the extent of its payment under the bond. Finally, should the insured recover its excess loss and the insurer recover its payment under the bond, any further recoveries go to the insured to cover the deductible amount.

While this road map for the allocation of recoveries seems straightforward, its real world application can be challenging. It is not unusual for an insured to receive recovery funds before the claim has been paid. When this occurs, the insured is not always willing to voluntarily apply the recovery in reduction of the covered loss. Similarly, an insured may continue to receive recovery funds after the claim has been paid. Once the recovery funds are in hand, the insured may be reluctant to part with them, sometimes relying solely on the theory that "possession is nine-tenths of the law." The insured's reluctance to part with recovery funds after the claim has been settled is sometimes enhanced if the insured did not receive an amount it considered adequate in settlement of the claim, if the insured had significant losses that were not covered, or if the insured incurred significant costs during the investigation of the claim, such as accountants' fees, attorneys' fees or internal costs.

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Over the years, insureds have asserted several creative arguments in an effort to avoid the proper allocation of recovery funds under applicable policy language. Most of these arguments are based on general principals designed to protect insureds in other areas of insurance law. The primary challenges include the "uncovered loss" issue,[1] the "collateral source" rule[2] and the "made whole" doctrine.[3] All of these arguments stem from the basic proposition that an insured should be fully compensated for its loss, or made whole, before the insurer should recover any of its payment on the claim.

This article will review and discuss the evolution of the "salvage" or "recovery" language and the general allocation scheme for recoveries, as envisioned by the policy drafters and as embodied in applicable policy language. Next, this article will explore the various challenges insureds have raised to the clear and unambiguous recovery language in the policy. In addition, this article will discuss several cases which illustrate efforts by insureds to keep more of the recovery funds by interpreting the "costs incurred in obtaining the recovery" language in a broad fashion. Finally, this article will conclude with some practice pointers and suggested release language to avoid disputes after settlement of the claim.

I. Recovery Language

The recovery language in earlier bond forms was generally referred to as "salvage" language and did not always express the allocation scheme in the great detail. For example, the recovery language at issue in *City Trust & Savings Bank of Kankakee v.*

[1] *See generally* City Trust & Sav. Bank v. Underwriting Members of Lloyds at London, 109 F. 2d 110 (7th Cir. 1940); Graydon-Murphy Oldsmobile v. Ohio Cas. Ins. Co., 16 Cal. App. 3d 53 (Cal. Ct. App. 1971).

[2] *See generally* FDIC v. Union Pac. Ins. Co., 20 F.3d 1070 (10th Cir. 1994); FDIC v. Mmahat, 907 F.2d 546 (5th Cir. 1990).

[3] *See generally* St. Louis Fed. Sav. & Loan Ass'n v. Fid. & Dep. Co. of Md., 654 F. Supp 314 (E.D. Mo. 1987); Dist. No. 1—Pac. Coast Dist. v. Travelers Cas. & Sur. Co., 782 A.2d 269 (D.C. 2001).

Underwriters Members of Lloyds at London,[4] a 1940 decision by the Court of Appeals for the Seventh Circuit, provided as follows:

> In case of recovery, the Assured shall be entitled thereto until fully reimbursed, the excess (if any) to be paid to the Underwriters, except that the Underwriters shall be reimbursed from such recovery for actual expenses (if any) incurred by them in obtaining recovery.[5]

Although this particular recovery language is not a model of clarity, the Court of Appeals held that it was sufficiently clear to withstand an attack by the insured.[6]

In 1969, the new version of the Financial Institution Bond presented the following "salvage" language, which was much clearer than the language in the *City Bank* case:

> If the Insured shall sustain any loss covered by this bond which exceeds the amount of coverage provided by this bond plus the Deductible Amount, if any, applicable to such loss, the Insured shall be entitled to all recoveries made after payment by the Underwriter of loss covered by this bond, except from suretyship, insurance, reinsurance, security and indemnity taken by or for the benefit of the Underwriter, by whomsoever made, less the actual cost of effecting such recoveries, until reimbursed for such excess loss; and any remainder, or, if there be no such excess loss, any such recoveries shall be applied first in reimbursement of the Underwriter and thereafter in reimbursement of the Insured for that part of such loss within such Deductible Amount. The

[4] 109 F.2d at 110.
[5] *Id.* at 111.
[6] *See id*.

> insured shall execute all necessary papers to secure to the Underwriter the rights herein provided for.[7]

While this language is somewhat cumbersome, it sets forth the basic allocation scheme in detail.[8] First, the net recovery goes to the insured to the extent that it has a covered loss which exceeds the limitation of liability.[9] Any remainder goes first to cover the insurer's payment, then to cover the insured's deductible amount. Notably, in describing the "excess loss" concept, the 1969 version of the recovery language refers to "any loss covered by this bond",[10] rather than the "insured's loss."[11] This distinction is noticeably absent in many bond forms and gives rise to some of the arguments asserted by insureds.

The 1980 version of the Financial Institution Bond maintained the same basic recovery allocation scheme, albeit with significantly different language.[12] Also, the recovery language was combined with other provisions of the bond in Section 7, which is titled "ASSIGNMENT–SUBROGATION–RECOVERY–COOPERATION."[13] Subsection (c) of Section 7 contains the "Recovery" language, which provides as follows:

> Recoveries, whether effected by the Underwriter or by the Insured, shall be applied net of the expense of such recovery first to the satisfaction of the Insured's loss in excess of the amount paid under this bond, secondly, to the Underwriter as reimbursement of amounts paid in settlement of the Insured's claim, and thirdly, to the Insured in satisfaction of any Deductible Amount.

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[7] BANKERS BLANKET BOND, STANDARD FORM NO. 24 (revised Apr. 1969), ***reprinted in*** ANNOTATED FINANCIAL INSTITUTION BOND, 651 (Michael Keeley ed., 2d ed. 2004).

[8] ***Id.***

[9] ***Id.***

[10] ***Id.***

[11] BANKERS BLANKET BOND, STANDARD FORM NO. 24 (revised Jul. 1980), ***reprinted in*** ANNOTATED FINANCIAL INSTITUTION BOND, 629 (Michael Keeley ed., 2d ed. 2004).

[12] ***Id.***

[13] ***Id.***

> Recovery on account of loss of Securities as set forth in the second paragraph of Section 6 or recovery from reinsurance and/or indemnity of the Underwriter shall not be deemed a recovery as used herein.[14]

Unlike the recovery language in the 1969 version of the Financial Institution Bond, this language does not refer to "covered loss" in connection with the "excess loss" concept.[15] Instead, the recovery provision in the 1980 version of the Financial Institution Bond simply refers to the "Insured's loss."[16] Also, instead of referring to the policy's limitation of liability in defining the concept of "excess loss," the 1980 version of the Financial Institution Bond refers to the "insured's loss in excess of the amount paid under this bond."[17] The reasons for these changes are not explained in the "Statement of Change" that accompanied the 1980 version of the Financial Institution Bond.[18]

The recovery language of the 1986 version of the Financial Institution Bond[19] is similar to the 1980 version, but not identical. In this regard, Section 7(c) of the 1986 version of the Financial Institution Bond contains the following language:

> Recoveries, whether effected by the Underwriter or by the Insured, shall be applied net of the expense of such recovery first to the satisfaction of the Insured's loss which would otherwise have been paid but for the fact that it is in excess of the Single or Aggregate Limit of Liability, secondly, to the Underwriter as reimbursement of amounts paid in settlement of the Insured's claim, and thirdly, to the Insured in satisfaction of any Deductible

[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] STATEMENT OF CHANGE, BANKERS BLANKET BOND, STANDARD FORM NO. 24 (revised to July 1980), ***reprinted in*** ANNOTATED FINANCIAL INSTITUTION BOND, 638 (Michael Keeley ed., 2d ed. 2004).
[19] Financial Institution Bond, Standard Form No. 24 (revised Jan. 1986), ***reprinted in*** ANNOTATED FINANCIAL INSTITUTION BOND, 607 (Michael Keeley ed., 2d ed. 2004).

> Amount. Recovery on account of loss of Securities as set forth in the second paragraph of Section 6 or recovery from reinsurance and/or indemnity of the Underwriter shall not be deemed a recovery as used herein.[20]

Unlike the 1980 version, this recovery provision refers to the limit of liability, rather than the amount paid on the bond, in defining "excess loss."[21] However, this version of the recovery language still refers to the "Insured's loss", rather than the "covered loss" in defining the concept of "excess loss."[22] The Statement of Change for the 1986 version of the Financial Institution Bond does not provide any explanation for this change.[23]

Although there are some variations in commercial fidelity bonds, the Commercial Crime Policy contains recovery language similar to the recovery language used in Financial Institution Bonds. The recovery language in the Commercial Crime Policy states:

> (1) Any recoveries, less the cost of obtaining them, made after settlement of loss covered by this policy will be distributed as follows:
>
> a. To you, until you are reimbursed for any loss that you sustain that exceeds the Limit of Insurance and the Deductible Amount, if any;
>
> b. Then to us, until we are reimbursed for the settlement made; and
>
> c. Then to you, until you are reimbursed for that part of the loss equal to the Deductible Amount, if any.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] STATEMENT OF CHANGE, FINANCIAL INSTITUTION BOND, STANDARD FORM NO. 24 (revised Jan. 1986), ***reprinted in*** ANNOTATED FINANCIAL INSTITUTION BOND, 611 (Michael Keeley ed., 2d ed. 2004).

(2) Recoveries do not include any recovery:
  a. From insurance, suretyship, reinsurance, security or indemnity taken for our benefit; or
  b. Of original "securities" after duplicates of them have been issued. [24]

Recoveries go first to the insured to the extent that its covered losses exceed the bond's limit of liability.[25] Recoveries then go to the insurer to cover its payment under the bond and, lastly, to the insured to cover its deductible.

This recovery language, in one form or another, has been in place for decades, and is generally accepted in the industry. Despite this fact, insureds have asserted numerous arguments attempting to circumvent the clear and unambiguous intent of the language. Fortunately, most of the arguments have met with little success.

II. Uncovered Loss

The most popular argument raised by insureds is the "uncovered loss" argument.[26] Simply stated, some insureds argue that they should be allowed to retain recoveries to offset any losses not covered by the policy, even if the covered loss is within the limitation of liability set forth in the policy.[27] Fortunately, this argument has been addressed in

[24] Form CR 00 22 07 22 at § E(u) (ISO PROPERTIES, INC. 2001), ***reprinted in*** COMMERCIAL CRIME POLICY 691 (Randall I. Marmor & John J. Tomaine eds., 2d ed. 2004); Form CR 00 23 07 02 at § E(v) (ISO PROPERTIES, INC. 2001), ***reprinted in*** COMMERCIAL CRIME POLICY 691 (Randall I. Marmor & John J. Tomaine eds., 2d ed. 2004) (loss sustained form).

[25] Form CR 00 22 07 22 at § E(u) (ISO PROPERTIES, INC. 2001), ***reprinted in*** COMMERCIAL CRIME POLICY 691 (Randall I. Marmor & John J. Tomaine eds., 2d ed. 2004); Form CR 00 23 07 02 at § E(v) (ISO PROPERTIES, INC. 2001), ***reprinted in*** COMMERCIAL CRIME POLICY 691 (Randall I. Marmor & John J. Tomaine eds., 2d ed. 2004) (loss sustained form).

[26] ***See, e.g.***, ***Graydon-Murphy***, 16 Cal. App. 3d at 56; ***City Trust & Sav. Bank***, 109 F. 2d at 111.

[27] ***See, e.g.***, FDIC v. Fid. & Dep. Co. of Md., 827 F. Supp. 385, 387 (D. La. 1993), ***aff'd***, 45 F.3d 969 (5th Cir. 1995); James B. Lansing Sound, Inc. v. Nat'l Union Fire Ins. Co., 981 F.2d 1549 (9th Cir. 1986); Lumbermens Mut.

several reported decisions, with the weight of authority in favor of the insurance industry.[28]

A relatively early "uncovered loss" argument arose in *City Trust & Savings Bank v. Underwriting Members of Lloyds at London*, a 1940 decision by the Court of Appeals for the Seventh Circuit.[29] As noted earlier, the financial institution bond at issue in the *City Trust* case provided the following "salvage" language, which is somewhat cryptic by today's standards:

> In case of recovery, the Assured shall be entitled thereto until fully reimbursed, the excess (if any) to be paid to the Underwriters, except that the Underwriters shall be reimbursed from such recovery for actual expenses (if any) incurred by them in obtaining recovery.[30]

The *City Trust* case involved thefts by a principal identified only as St. John, the insured's bookkeeper and teller.[31] The Lloyds' policy provided $25,000.00 in coverage for a one year policy period beginning on February 28, 1936, and ending on February 28, 1937.[32] During Lloyds' policy period, St. John stole $15,014.57, all of which was covered.[33] However, St. John had stolen an additional $37,677.70 prior to the effective date of the Lloyd's policy, only $25,000.00 of which was covered by a prior policy.[34] The difference between the $25,000.00 limitation of liability on the prior policy and the $37,677.70 loss during

Cas. v. State of Iowa Dep't of Revenue & Fin., 564 N.W.2d 431 (Iowa 1997); *Graydon-Murphy*, 16 Cal. App. 3d at 56; *City Trust & Sav. Bank*, 109 F. 2d at 111.

[28] *See FDIC v. Fid. & Dep. Co. of Md*., 827 F. Supp. at 387; *James B. Lansing Sound*, 981 F.2d 1549; *Graydon-Murphy*, 16 Cal. App. 3d at 56; *City Trust & Sav. Bank*, 109 F. 2d at 111; *but See Lumbermens*, 564 N.W.2d at 431 (denying the insurer a right of subrogation against recovered funds).

[29] 109 F.2d at 110.

[30] *Id.* at 111.

[31] *Id.* at 110.

[32] *Id.* at 111.

[33] *Id.*

[34] *Id.*

the prior policy period, specifically $12,667.70, was not covered by either policy.[35]

In December 1936, which was during the coverage period of the Lloyds' policy, St. John stole $3,600.00 in cash and placed it in a safe deposit box.[36] After the loss was discovered, the insured recovered the money from the safe deposit box.[37] Even though the money was clearly part of the funds stolen during Lloyds' policy period, and even though the insured had been fully reimbursed for its loss during Lloyds' policy period, the insured refused to credit the recovered funds against the loss during Lloyds' policy period.[38] Instead, the insured argued that the money should be applied to its "uncovered loss" of $12,667.70 from the prior policy period.[39] Lloyds, in turn, argued that the money should be used to reduce the loss during its policy period and paid the insured $11,414.57, which sum represented the $15,014.57 loss during Lloyds' policy period, less the $3,600.00 recovery.[40]

The insured argued that the recovery language of the bond supported its position that it should be allowed to apply the $3,600.00 recovery to its "uncovered" loss from the prior policy period.[41] In this regard, the insured noted that the policy language provided that the "Assured" should be "fully reimbursed" before Lloyds was entitled to any recoveries. Since the insured had a prior loss that was not covered by insurance, it had not been "fully reimbursed," as required by the policy language.[42]

The Seventh Circuit summarily rejected this argument. The court, without any elaboration, simply stated that "[i]t is obvious that the

[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.* at 111-12.

clause refers to reimbursement for losses sustained during the period of the policy in suit and none other."[43]

The *City Trust* case is interesting because the salvage language in the policy did not limit its application to the policy period in question and did not differentiate between covered and uncovered losses.[44] The court appeared to be persuaded by the fact that the cash in the safe deposit box could be traced directly to cash taken during Lloyds' coverage period.[45] In fact, it was exactly the same cash. Therefore, the court held that the recovery reduced the insured's loss and thus Lloyds' liability under the bond.[46]

This "uncovered loss" argument was raised again in *Graydon-Murphy Oldsmobile v. Ohio Casualty Insurance Co.*, a 1971 California State Court decision.[47] In the *Graydon-Murphy* case, Ohio Casualty provided Graydon-Murphy with a $10,000.00 commercial fidelity policy, effective January 28, 1964.[48] During the three year period prior to the effective date of the Ohio Casualty policy, Dixie Mayson, an employee of Graydon-Murphy, embezzled $33,436.00.[49] During the effective dates of Ohio Casualty's policy, she stole an additional $14,750.00.[50]

After discovering the loss, Graydon-Murphy sued Mayson, obtained a judgment, and collected $20,600.00.[51] The recovery arose from two cash payments totaling $600.00 and the sale of some property for $20,000.00.[52] Unlike in *City Bank*, the recovered cash could not be directly traced to the embezzled funds. The property recovered had been owned by Mayson since 1950 and was not purchased with any of the

[43] *Id.* at 112.
[44] *See id.* at 110.
[45] *See id*.
[46] *See id.* at 112.
[47] 161 Cal. App. 3d 53, 56 (Cal. Ct. App. 1971).
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*

embezzled funds.[53] Additionally, while the decision is not completely clear on this point, it appears that the $600.00 in payments were from some source other than the embezzled funds.[54]

The recovery section of the policy at issue in the *Graydon-Murphy* case provided as follows:

> If the insured shall sustain any loss covered by this Policy which exceeds the applicable amount of insurance thereunder, the insured shall be entitled to all recoveries [except from suretyship, insurance, reinsurance, security or indemnity taken by or for the benefit of the company] by whomsoever made, on account of such loss under this Policy until fully reimbursed, less the actual cost of effecting the same; and any remainder shall be applied to the reimbursement of the company.[55]

The insured argued that all the recovery should be applied to that portion of its loss which pre-dated the effective date of Ohio Casualty's policy, which loss was not covered by any policy.[56] Quoting from the policy language, the insured reasoned that none of the recovery was "on account of such loss under the policy" and thus should not be applied to reduce the covered loss.[57] The insured's argument on this point appeared to stem from an effort to avoid the holding in the *City Trust* case,[58] where the funds could be traced directly to the embezzlement.

Ohio Casualty argued that the recovery language in the policy was "clear and unambiguous" and required the insured to credit "all recoveries" to the loss covered by the policy.[59] Since $20,600.00 had

[53] *Id.* at 58.
[54] *Id.* at 58-59.
[55] *Id.* at 57.
[56] *Id.* at 57-58.
[57] *Id.*
[58] *City Trust & Sav. Bank*, 109 F.2d at 110-11.
[59] *Graydon-Murphy*, 16 Cal. App. 3d at 58.

been recovered and since the covered loss was only $14,750.00, Ohio Casualty denied coverage.[60]

The court, again without any meaningful discussion of the policy language, resolved the issue by allocating the loss.[61] If the money could have been traced to a particular period of time or source, the court probably would have followed the Seventh Circuit's decision in *City Trust*.[62] However, since the source of the recovered funds could not be tied directly to any part of the underlying fraud, whether covered or uncovered, the court allocated the recovery based on the extent to which the loss was covered.[63] Since the total loss was $48,186.00 and the loss during the policy period was $14,750.00, the Court allocated 30.61 percent of the loss to Ohio Casualty.[64] Thus, the court reasoned, Ohio Casualty should receive the benefit of 30.61 percent of the recovery.[65]

After deciding upon this allocation scheme, the court correctly followed the recovery language by first using the recovered funds to cover the $4,750.00 portion of the loss that would have been covered except for the limit of liability during Ohio Casualty's coverage period.[66] Then, Ohio Casualty was given credit against its $10,000.00 in coverage for the remainder of the recovery.[67]

The uncovered loss issue arose again in *James B. Lansing Sound, Inc. v. National Union Fire Insurance. Co.*, a 1986 decision by the Court of Appeals for the Ninth Circuit involving the application of

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[60] *Id.*

[61] *Id.* at 58-59 ("Since the recovery was obtained solely from collateral sources, we hold that the doctrine of apportionment be applied and the recovery prorated.").

[62] *Compare City Trust & Sav. Bank*, 109 F.2d at 110-11 (finding that the insurer's liability was reduced in a case where the recovery was tied directly to the theft), *with Graydon-Murphy*, 16 Cal. App. 3d at 58-59 (applying the doctrine of apportionment where no the recovery was obtained solely from collateral sources).

[63] *Graydon-Murphy*, 16 Cal. App. 3d at 58-59.

[64] *Id.* at 59.

[65] *Id.*

[66] *Id.*

[67] *Id.*

California law.[68] The insured, James B. Lansing Sound, Inc. ("JBL") was a manufacturer and seller of stereo equipment and speakers.[69] Russell Mott was JBL's exclusive sales representative for California and Nevada.[70] Mott received a seven percent commission for all sales in his territory.[71] Richard Barnal, another JBL employee, worked in the accounting area.[72] Mott, with Barnal's assistance, devised a scheme which allowed them to sell JBL's equipment at discounted prices to Japanese dealers.[73] They accomplished the scheme by establishing a company which appeared to be operating in Mott's territory, but which was really a shell company used solely for the purpose of selling equipment to Japanese dealers.[74] The scheme resulted in unauthorized sales to Japanese dealers by Mott at reduced prices, thereby undercutting what would have been authorized sales by JBL to Japanese dealers.[75] Mott's phony company received payments for the equipment from the Japanese dealers and, in turn, remitted the payments to JBL, albeit at the discounted rate.[76]

JBL had fidelity coverage with both National Union Fire Insurance Company of Pittsburgh, Pennsylvania ("National Union") and Insurance Company of North America ("INA") during the relevant time period.[77] The district court divided the coverage into four distinct time periods. During the first period (Period A), National Union's policy was the only coverage and thus the court found that National Union had coverage for all the loss during Period A.[78] During the second period (Period B), both INA and National Union had coverage with identical limits of liability.[79] Thus, the court found National Union and INA

[68] 801 F.2d 1549, 1561 (9th Cir. 1986).
[69] *Id.* at 1562.
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.* at 1562-63.
[74] *Id.*
[75] *Id.* at 1563.
[76] *Id.*
[77] *Id.* at 1562.
[78] *Id.*
[79] *Id.*

equally liable for the losses during Period B.[80] During the third time period (Period C), both National Union and INA had coverage, but with different limits of liability.[81] The district court allocated liability for the loss during Period C based on the respective limits of liability, which resulted in National Union having 80 percent of the coverage and INA having 20 percent of the coverage.[82] During the last time period (Period D), INA was the only carrier and thus the district court found that it had 100 percent of the coverage.[83]

Mott's phony company sold JBL's inventory to Japanese dealers and received payments from said Japanese dealers during all four of the coverage periods outlined in the court's decision.[84] The district court found that the payments Mott's phony company received from the Japanese dealers and, in turn, remitted to JBL, were recoveries.[85] Having decided that the payments were recoveries, the court then allocated the recoveries to the four policy periods in question based on the invoices which corresponded to the payments.[86] Thus, if JBL received a payment from Mott's phony company for an invoice that was issued in Period A, the district court allocated the payment to Period A, thereby reducing the loss for that coverage period.[87]

JBL settled its claim against INA for less than the full amount of its losses during the coverage period solely covered by INA (Period D).[88] Because the settlement with INA was for less than the loss amount during Period D, JBL argued that it had "uninsured and unrecoverable losses."[89] Then, JBL argued that the payments JBL received from Mott's phony company during those periods when National Union had coverage should first be applied to JBL's "uninsured and unrecoverable

[80] *Id.* at 1563-64.
[81] *Id.* at 1562.
[82] *Id.* at 1563-64.
[83] *Id.*
[84] *Id.* at 1562-64.
[85] *Id.* at 1568.
[86] *Id.*
[87] *Id.*
[88] *Id.* at 1563.
[89] *Id.* at 1568.

losses" during Period D.[90] JBL argued "equitable principles" in support of its argument that recoveries should first be applied to uncovered or uninsured losses.[91]

Both the district court and the Ninth Circuit rejected JBL's argument.[92] First, the Ninth Circuit noted that JBL did cite to a number of subrogation cases to support its argument.[93] However, the court ruled that the law of subrogation did not apply in this case since the insurer had not paid the loss.[94] The issue in this case was, instead, whether the insured had suffered a loss at all.[95]

The Ninth Circuit then found that JBL had no authority for its position and ruled in favor of National Union.[96] The court followed the earlier decisions in *Graydon-Murphy*[97] and *City Trust*[98] in finding that the recovery should be allocated to appropriate time periods and divided proportionately by the parties suffering the covered loss.[99] JBL also tried to use the recoveries to offset the deductible, arguing that the deductible should not apply to reduce the loss because it would result in JBL absorbing its net uninsured losses.[100] The Ninth Circuit summarily rejected this argument as well.[101] Finally, JBL argued that the recoveries during National Union's coverage period should first go to cover

[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.* "This is not a situation where an insurer is entitled to step into the shoes of the insured and be subrogated to amounts owed by the insured's debtor. Rather, the issue of Mott's payments involves the determination of what loss JBL suffered." *Id.*
[95] *Id.*
[96] *Id.* "JBL complains that the district court 'cited no authority for its conclusions' . . . . It is JBL, however, that provides no authority for its contentions." *Id.*
[97] 16 Cal. App. at 53.
[98] 109 F.2d at 110.
[99] *James B. Lansing Sound*, 801 F.2d at 1568-69.
[100] *Id.* at 1569.
[101] *Id.*

uncovered losses, such as attorneys' fees and costs. [102] The Ninth Circuit rejected this argument, finding that attorney's fees and costs were not recoverable under the policy.[103]

Next, the uncovered loss issue was addressed in ***FDIC v. Fidelity & Deposit Co. of Maryland***, a 1993 decision by United States District Court for the Middle District of Louisiana.[104] The case involved a series of fraudulent loans by Allie Ray Pogue, the Chief Lending Officer for Capital Bank & Trust Company ("Capital Bank").[105] The Financial Institution Bond under consideration in the case was issued by Fidelity and Deposit Company of Maryland ("F&D").[106] The FDIC took over Capital Bank & Trust Company shortly after the loss was discovered.[107] The F&D bond in question contained recovery language consistent with the 1980 version of the Financial Institution Bond, which provided as follows:

> Recoveries, whether effected by the Underwriter or by the Insured, shall be applied net of the expense of such recovery first to the satisfaction of the Insured's loss in excess of the amount paid under this bond, secondly, to the Underwriter as reimbursement of amounts paid in settlement of the Insured's claim, and thirdly, to the Insured in satisfaction of any Deductible Amount. [108]

After discovery of the loss, the FDIC received payments on several of the loans in question.[109] The FDIC argued that the payments should be applied first to interest, then to principal.[110] F&D argued that

[102] *Id.*
[103] *Id.* at 1571.
[104] 827 F. Supp. 385 (D. La. 1993), ***aff'd,*** 45 F.3d 969 (5th Cir. 1995).
[105] *Id.* at 387.
[106] *Id.*
[107] *Id.*
[108] *Id.* at 389.
[109] *Id.*
[110] *Id.*

interest was not covered by the bond and thus any payments should be applied first to principal.[111]

The court began its analysis by noting that the recovery language referred to the "insured's loss" and thus the court had to interpret the meaning of that phrase.[112] The court first stated that the phrase could have several meanings.[113] Initially, the court noted that "loss" could be interpreted to mean "only those losses within the coverage of the bond."[114] Alternatively, the court noted that "loss" could be interpreted to include "any loss, including those not within the purview of the bond."[115]

The court ultimately held that "loss" as it appeared in the recovery section of the bond, referred to "losses which are covered by the bond,"[116] not any loss resulting from dishonest conduct. The court based its ruling on the fact that the parties "intended for the insured to be indemnified only for losses which come within the scope of its agreement."[117] Thus, the court reasoned, the recovery provision should be interpreted similarly.[118]

After reaching this decision, the court then analyzed the question of whether interest was covered by the bond. After concluding that it was barred by the "potential income exclusion,"[119] the court found that the loan payments should be applied to principal, not interest.[120] In essence, the court found interest to be an "uncovered loss" and ruled that

[111] *Id.*
[112] *Id.* at 390.
[113] *Id.*
[114] *Id.*
[115] *Id.*
[116] *Id.*
[117] *Id.*
[118] *Id.*
[119] *Id.* The Bond did not cover "potential income," which was defined as "including but not limited to interest and dividends, not realized by the insured." *Id.* The district court, therefore, concluded that the "potential income exclusion explicitly exclude[d] interest payments from coverage under the Bond." *Id.*
[120] *Id.*

this "uncovered loss" was not an "excess loss" within the meaning of the recovery language of the policy.[121] The court then correctly applied the loan payments to the covered loss (principal) to the extent that the covered loss exceeded the policy's limitation of liability, then to the covered loss, then to the deductible.[122]

The ***FDIC v. Fidelity & Deposit*** case is significant because it appears to be the only reported decision that expressly addresses the issue of whether the phrase "insured's loss," as it appears in the recovery language of a fidelity bond, means all losses suffered by the insured or just covered losses.[123] The court specifically found that the term is limited to covered losses, which is clearly the intent of the policy language.[124]

Unfortunately, the ***FDIC v. Fidelity & Deposit*** case should be read in connection with ***First National Bank v. Lustig,*** a 1996 decision by the Court of Appeals for the Fifth Circuit. [125] In ***Lustig***, the insured bank recovered $10 million from the sale of collateral on loans involved in the claim.[126] The bank argued that it should be allowed to apply the collateral proceeds to interest rather than the principal.[127] The Fifth Circuit noted that the interest on the loans was not covered based on the "potential income" exclusion.[128] However, the Fifth Circuit refused to hold that the policy required the bank to apply the proceeds from the sale of the collateral to the principal or "covered" loss.[129]

In rejecting the insurer's argument, the ***Lustig*** court noted that the recovery language of the bond provided for recoveries to be applied "first to satisfaction of the Insured's loss in excess of the amount paid

[121] ***See id.*** at 389-90.
[122] ***Id.*** at 390.
[123] ***See id.*** at 389-90.
[124] ***Id.***
[125] 96 F.3d 1554 (5th Cir. 1996), ***aff'g*** 847 F. Supp. 1322 (E.D. La. 1994).
[126] ***See id.*** at 1560.
[127] ***See id.*** at 1569.
[128] ***See id***.
[129] ***See id.*** at 1569-60.

under this bond."[130] Since the insurer had not paid anything under the bond, the court reasoned that the recovery provision should not apply.[131]

The problem with the *Lustig* decision is the court's reliance on the timing of the recovery rather than the intent of the policy. Presumably, had the insurer in *Lustig* paid the claim before the collateral was liquidated, the insurer would have been entitled to the proceeds from the sale of the collateral to reduce the covered loss, rather than the unpaid interest on the loans. If the Fifth Circuit was not willing to apply the recovery provision of the policy prior to payment of the claim it should have adopted the reasoning of the Ninth Circuit in *James B. Lansing Sound*[132] and held that the recoveries from the sale of the collateral should be applied to reduce the amount of the covered loss.

The uncovered loss issue was addressed again in *Lumbermens Mutual Casualty Co. v. Iowa Department of Revenue & Finance*, a 1997 decision by the Supreme Court of Iowa.[133] The *Lumbermens* case involved the embezzlement of $692,468.00 from the Iowa Department of Revenue and Finance ("IDRF") by Lisa Leslie and her accomplices.[134] Lumbermens paid the claim, less the $100,000.00 deductible.[135] IDRF, after discovering the loss and receiving full payment of the claim from Lumbermens, issued "jeopardy assessments"[136] to Leslie and her accomplices based on their collective failure to pay Iowa state income taxes on the embezzled funds.[137] Under Iowa law, embezzled funds are treated as income for tax purposes.[138] Iowa further allows the director of IDRF to issue immediate assessments if he believes the assessment or

[130] *See id*. at 1569.
[131] *See id*.
[132] 801 F.2d 1549, 1561 (9th Cir. 1986).
[133] 564 N.W.2d 431 (Iowa 1997).
[134] *Id.* at 433.
[135] *Id.*
[136] *Id.* The "jeopardy assessments" were issued pursuant to IDRF's taxing authority codified in Iowa Code § 422.30 (1993).
[137] *Lumbermens*, 564 N.W.2d at 433.
[138] *Id*; *accord* James v. United States, 366 U.S. 213 (1961).

collection of taxes will be jeopardized by delay in issuing the assessment in the normal course.[139]

When Leslie and her co-conspirators failed to pay the taxes, IDRF filed liens and seized assets.[140] Based on its collection efforts, IDRF recovered $145,000.00.[141] In the process IDRF depleted substantially all of the funds immediately available for reimbursement to Lumbermens or to satisfy the related award of criminal restitution.[142]

After discovering IDRF's collection efforts, Lumbermens filed a declaratory judgment action in an effort to establish its right to reimbursement for monies collected by IDRF from Leslie and her accomplices.[143] Lumbermens argued that its subrogation rights under the policy had been violated and that IDRF had been unjustly enriched by the recoveries IDRF received through the special assessments.[144]

Somewhat surprisingly, the trial court granted IDRF's motion for summary judgment, concluding that Lumbermens had no right of subrogation against funds collected for delinquent taxes and no claim for unjust enrichment.[145] Even more surprisingly, the Supreme Court of Iowa affirmed the lower court ruling in all respects.[146] The basis for the court's holding was its finding that IDRF had suffered two losses, the embezzlement loss and a tax loss on the embezzled funds.[147] The court noted that the policy limited Lumbermens rights to reimbursement to "any loss [the Department] sustained and for which [Lumbermens] paid or settled," quoting from the assignment provision of the bond, not the recovery provision.[148] The court did not specifically address the recovery provision, assuming the bond actually contained such

[139] *See Lumbermens*, 564 N.W.2d at 433.
[140] *Id.*; IOWA CODE §§ 422.26, 421.9(3).
[141] *Id.*
[142] *Id.*
[143] *Id.*
[144] *Id.*
[145] *Id.*
[146] *Id.* at 436.
[147] *Id.* at 434.
[148] *Id.*

provision. Nevertheless, it seems clear that the court would have limited the impact or scope of the recovery provision in a similar fashion.

In another recent case, ***District No. 1—Pacific Coast District, Marine Engineers' Beneficial Ass'n v. Travelers Casualty & Surety Co.***, the District of Columbia Court of Appeals addressed the uncovered loss issue, albeit in a slightly different context.[149] In the ***Pacific Coast*** case, Travelers provided a "faithful performance bond" to a labor union.[150] The policy contained a general limitation of liability in the amount of $100,000.00 for all employees, along with excess coverage in the amount of $400,000.00 each for certain named employees.[151]

The claim was based on the fact that certain union officials fraudulently procured their election as officers of the union, extorted money from union members and embezzled roughly $2 million as "severance pay" in connection with the merger of their union with another union.[152] The union submitted a fidelity claim based on the fraudulent severance pay, which Travelers admitted was covered.[153] In addition, the union submitted a claim for the salaries received by the union officers during their terms based on the fact that they had been elected fraudulently.[154] Travelers denied coverage for this "salary" portion of the claim.[155]

The severance pay portion of the claim was covered in full for all the union officers involved in the fraud except one, C. E. DeFries, the union's president. DeFries received $909,662.37 in fraudulent severance pay, only $500,000.00 of which was covered.[156] Thus, the union had an excess loss of $409,662.37 as to DeFries.[157]

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149 782 A.2d 269, 271 (D.C. 2001)
150 *Id.*
151 *Id.*
152 *Id.*
153 *Id.* at 272.
154 *Id.*
155 *Id.*
156 *Id.* at 275.
157 *Id.*

Travelers and the union ultimately entered into a settlement agreement for the exact amount of the severance pay loss, less the excess loss associated with DeFries.[158] The settlement agreement, in relevant part, provided as follows:

> [Travelers] and the Insured acknowledge and agree that [Travelers] has certain subrogation rights by reason of having made the aforesaid payment pursuant to the terms of the Bond. The Insured also agrees that, in return for the aforesaid payment, it assigns all rights, title and interest, except as limited in the next numbered paragraph, in all claims for the amount of the aforesaid payment which it may have against its officers, officials and employees and any other parties who acted in concert therewith by reason of conduct upon which its claims against [Travelers] have been made and pursuant to which [Travelers] makes the aforesaid payment.[159]

The subrogation rights set forth in this general paragraph were limited by the following two specific provisions:

> a. Subject to the excess loss provision set forth in the Bond, [Travelers] and the Insured will share in the recovery of any monies not exceeding the amount of the aforesaid payment received either through the Court, from the United States Government, or directly from Messrs. C. E. DeFries, Clyde Dodson and Claude Daulley, with [Travelers] receiving 75% and the Insured receiving 25% of any monies so recovered until [Travelers] has received 75% of the aforesaid payment to the Insured.
>
> b. It is expressly understood that the preceding sharing agreement does not apply to the first $409,662.37 of any recovery of monies from C. E. DeFries. Such amount will be the sole property of the Insured. If additional

[158] *Id.* at 272.
[159] *Id.*

> monies beyond the $409,662.37 are recovered for C. E. DeFries[,] . . . the sharing agreement specified in the preceding paragraph . . . will be applicable to such additional recovery. [160]

The union noted that this portion of the settlement agreement specifically incorporated the "excess loss provisions set forth in the Bond," which provided as follows:

> If the Insured shall sustain any loss covered by this bond which exceeds the amount of indemnity provided by this bond, the Insured shall be entitled to all recoveries . . . by whomsoever made on account of such loss under this bond until fully reimbursed, less the actual cost of effecting the same; and any remainder shall be applied to the reimbursement of the Underwriter.[161]

Based on this recovery language, the union argued that it was entitled to keep all monies recovered until it was fully reimbursed for all its losses, including the salary losses which Travelers claimed were not covered and which were not included in the amount Travelers paid on the claim.[162] Travelers argued that the intent of the settlement agreement was clear and that the recovery language of the policy did not call for a different result simply because the language in the settlement agreement that set forth how recoveries were to be allocated was "subject to the excess loss provisions of the bond."[163]

The court ruled in favor of Travelers on this issue, based primarily on its interpretation of the settlement agreement.[164] Specifically, because the agreement provided that the union would receive first recoveries on the excess loss related to the fraudulent severance payments to DeFries, the court concluded that the parties intended for the concept of excess loss to relate specifically to the

[160] *Id.*
[161] *Id.* at 273.
[162] *Id.*
[163] *Id.* at 274.
[164] *See id.* at 275-76.

severance payments, which were covered, not the salaries, which were not covered. [165]

While the *Pacific Coast* decision primarily concerns the interpretation of a settlement agreement, as opposed to the recovery language in the bond, it is another example of a court refusing to allow an insured to apply recoveries to cover losses which are not covered by the policy, in this case salaries paid to the principals.[166] Also, the case is helpful because the settlement agreement was subject to the "excess loss provisions of the bond."[167] While the court did not specifically discuss the recovery language in the bond, the court did not use the recovery language as a basis for reaching a different result, thereby implying that it would have reached the same decision under the recovery language of the bond.

While we do not have a considerable body of case law on this "uncovered loss" issue, some general trends seem to emerge from the cases that have been decided. First, if the funds that have been recovered can be traced directly to the embezzlement, the carrier has an excellent chance of convincing the court that it should be allowed to receive credit for the funds against the loss or to recover said funds from the insured if the loss has already been paid.[168] While the district court in the *James B. Lansing* case[169] seems to make a distinction between the right to offset the payments prior to payment and the law of subrogation after the payment, this distinction,[170] which should be viewed as nothing more than a timing issue, should not result in a different outcome, particularly given the modern recovery language in most policies.

Next, if the funds cannot be traced directly to embezzled funds and a portion of the loss is not covered because it occurred outside the

[165] ***Id.*** at 275.

[166] ***See id.*** at 274-76.

[167] ***Id.*** at 272.

[168] ***See, e.g.,*** City Trust & Sav. Bank v. Underwriting Members of Lloyds at London, 109 F. 2d 110 (7th Cir. 1940).

[169] James B. Lansing Sound, Inc. v. Nat'l Union Fire Ins. Co., 981 F.2d 1549 (9th Cir. 1986).

[170] ***Id.*** at 1568.

policy period, the courts tend to look for an equitable way to allocate the recovery.[171] This seems to be the case regardless of policy language providing that all recoveries should go first to the insurer unless there is an excess loss.[172] The courts seem to view the concept of "excess loss" as including a loss that would be covered by the policy, but was not covered because of a lack of coverage during another policy period.

If the insured is attempting to recover losses that are clearly not covered, such as attorneys' fees, accountants' fees, or interest, the courts seem reluctant to distort the recovery language in the policy and allow the insured to retain any portion of the recoveries.[173] There is, of course, a modern trend to include additional coverage in fidelity policies for "investigative costs." In policies which contain this additional coverage, which usually has a separate and much smaller limit of liability, the insured would have a better argument that any such costs, to the extent they exceed the separate policy limit, should be considered an excess loss under the recovery language.

Finally, if the case is pending in state court, and if the state in which the case is pending is also the insured, the recovered funds probably are going to stay in the coffers of the state government, especially if the funds were seized to cover taxes.[174]

III. Collateral Source Rule

Numerous states have adopted some version of what is generally referred to as the "collateral source rule." This rule, in its basic application, prevents the proceeds from an insurance policy purchased

[171] ***See, e.g.***, Graydon-Murphy Oldsmobile v. Ohio Cas. Ins. Co., 16 Cal. App. 3d 53 (Cal. Ct. App. 1971); ***James B. Lansing Sound***, 981 F.2d at 1568 ("An insured's recovery from a dishonest employee must be apportioned between the time that the insurer's policy was in effect and the time when it was not in effect.").

[172] ***See*** FDIC v. Fid. & Dep. Co. of Md., 827 F. Supp. 385 (D. La. 1993), ***aff'd***, 45 F. 3d 969 (5th Cir. 1995); Dist. No. 1—Pac. Coast Dist. v. Travelers Cas. & Sur. Co., 782 A.2d 269 (D.C. 2001).

[173] ***See James B. Lansing Sound***, 981 F.2d at 1571.

[174] ***See*** Lumbermens Mut. Cas. Co. v. Iowa Dep't of Revenue & Fin., 564 N.W.2d 431, 434 (Iowa 1997).

by an injured party from reducing the liability of the tortfeasor who caused the injuries. For example, if a person is injured in an automobile accident through the fault of another driver and the injured person's health insurance pays for some of the medical treatment, the negligent driver cannot use the health insurance to offset his or her liability.

The "collateral source rule" is most often raised in casualty cases. It is rarely raised in first-party insurance cases and even more rarely raised in fidelity cases. Nevertheless, the FDIC did assert the collateral source rule in an unsuccessful effort to exclude evidence of a related recovery in ***FDIC v. United Pacific Insurance Co***.[175] In the *United Pacific* case, the FDIC filed the action as receiver for Heritage Bank & Trust, claiming losses for a loan made by Heritage's former loan officer.[176] The jury concluded that the officer acted with the requisite manifest intent to cause the bank to sustain a loss and awarded judgment in favor of the FDIC.[177]

In advance of the trial, the court made several preliminary rulings related to recoveries. One such ruling related to a recovery by the FDIC against an attorney who was involved in the underlying loan transaction.[178] United Pacific argued that the evidence of this related recovery should have been admitted and that the jury should have been allowed, if not required, to offset this recovery against the loss.[179] The FDIC argued that the recovery was from a "collateral source" and should not be admitted under the "collateral source rule."[180]

The district court granted the FDIC's motion in limine on this issue and excluded any evidence of the settlement with the attorney.[181] Fortunately, the Tenth Circuit Court of Appeals reversed.[182] The reasoning by the circuit court is instructive on this issue. In rendering its

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[175] 20 F.3d 1070, 1082-83 (10th Cir. 1994).
[176] *Id.* at 1072.
[177] *Id.*
[178] *Id.* at 1082.
[179] *Id.*
[180] *Id.*
[181] *Id.*
[182] *Id.* at 1083-84.

opinion, the court noted that the rationale behind the collateral source rule is that a "benefit that comes to the Plaintiff should not be shifted so as to become a windfall to the wrongdoer."[183] Based on this general understanding of the collateral source rule, the court saw no justification for extending the scope of the rule to prevent an insurer in a fidelity bond claim from receiving credit for a settlement between the insured and a separate party.[184]

In so holding, the Tenth Circuit followed the decision by the Fifth Circuit in ***FDIC v. Mmahat***.[185] The ***Mmahat*** case involved another attempt by the FDIC to use the collateral source rule in a nontraditional way.[186] In the ***Mmahat*** case, the FDIC already had recovered funds from several directors and officers allegedly responsible for certain losses.[187] However, the FDIC also was pursuing claims against an attorney for what appeared to be the same losses.[188] The Fifth Circuit held that the FDIC could not recover from an attorney in a malpractice action to the extent that the FDIC had already been compensated for the same loss by certain officers and directors.[189] However, the court limited its holding to those situations where the damages are "common" and remanded the case for further findings on this issue.[190]

At least for now it appears that fidelity carriers are safe on this "collateral source" issue, as long as the insured is seeking to recover for the same loss from different sources. Fidelity carriers are not the "wrongdoers" or "tortfeasors" in a fidelity claim. If the collateral source rule has any application in the fidelity context it should be to prevent the principal from reducing his liability based on recoveries from other parties who may be liable for the loss under principles of negligence, such as a bank that accepted checks for deposit without authorization or

[183] ***Id.*** at 1083; ***see also*** Kassman v. American Univ., 546 F.2d 1029 (D.C. Cir. 1976).

[184] ***Id.***

[185] 907 F.2d 546 (5th Cir. 1990)

[186] ***Id.*** at 549.

[187] ***Id.*** at 550.

[188] ***Id.***

[189] ***Id.***

[190] ***Id.***

an accounting firm that failed to detect the embezzlement scheme in a timely manner.

IV. Made Whole Doctrine

The "made whole doctrine" generally provides that "if an insurer pays less than the insured's total loss, the insurer cannot exercise a right of reimbursement or subrogation until the insured's entire loss has been compensated."[191] This doctrine has been adopted in numerous states, primarily in the context of personal injury claims.[192] However, in some instances the doctrine has been extended to include other insurance claims, including first party claims. Some states have gone so far as to hold that the "made whole" doctrine overrides policy language to the contrary.[193]

The made whole doctrine has been asserted by at least one insured in a fidelity bond case in an effort to retain recoveries that would otherwise go to the insurer under the policy language. In the *Pacific Coast* case,[194] discussed earlier in connection with the uncovered loss issue, the insured argued that the insurer should recover nothing until the insured had been "made whole" for all its losses, including those not covered by the policy.[195] The court summarily rejected the argument based on the parties' right to enter into a contract providing otherwise.[196] The contract under consideration in the *Pacific Coast* case was a settlement agreement, as opposed to the fidelity bond itself.[197] However, the recovery provisions of the settlement agreement were "subject to the

[191] 782 A.2d 269 (D.C. 2001). *See* COUCH ON INSURANCE § 61:64 (2d ed. 1983).

[192] *See generally* Copeland Oaks v. Haut, 209 F.3d 811 (6th Cir. 2000); Sanders v. Scheideler, 816 F. Supp. 1338 (D. Wis. 1993).

[193] *See* Midland Bank & Trust Co. v. Fid. & Deposit Co. of Md., 442 F. Supp. 960 (D.N.J. 1977).

[194] 782 A.2d 269 (D.C. 2001).

[195] *Id.* at 276.

[196] *Id.*

[197] *Id.* at 271.

excess loss provision set forth in the Bond,"[198] thus making the decision at least arguably applicable to the recovery section of the bond.

In another fidelity case, ***St. Louis Federal Savings & Loan Ass'n v. Fidelity & Deposit Co.***,[199] the court impliedly rejected the made whole doctrine, even though the doctrine itself is not mentioned in the opinion.[200] In ***St. Louis Federal Savings,*** the insured released the principal for claims related to the loss before providing any notice of the loss to the insurer.[201] The carrier denied coverage on the basis that its subrogation rights had been imperiled.[202] The insured argued that the insurer had no subrogation rights to impair because the loss exceeded the policy limits and thus, even if F&D paid its policy limits, the total loss would not have been paid.[203] Without significant discussion, the court rejected the insured's argument, holding that Missouri law would not support such a result.[204]

The insured in the ***St. Louis Federal Savings*** case relied upon ***Midland Bank & Trust v. Fidelity & Deposit Company of Maryland***,[205] a 1977 decision by the United States District Court for the District of New Jersey. In the ***Midland Bank*** case the insurer argued that the insured, by settling certain claims and releasing certain third parties, had destroyed its subrogation rights, thereby releasing the insurer for all liability under the bond.[206] The district court rejected this argument based on the fact that the loss, even after reducing the amount to reflect recoveries, was still roughly $1 million in excess of the policy's limit of liability.[207] The court then stated that the insurer's "right to subrogation would not arise until Midland has been reimbursed for the total amount of its loss where,

[198] *Id.* at 272.
[199] 654 F. Supp. 314 (E.D. Mo. 1987).
[200] *Id.* at 316.
[201] *Id.* at 315.
[202] *Id.*
[203] *Id.*
[204] *Id.* at 316.
[205] 442 F. Supp 960 (D.N.J. 1977).
[206] *Id.* at 962.
[207] *Id.* at 972.

as here, the loss exceeded the amount of coverage provided by the bond."[208]

The *Midland Bank* case is troublesome in that it interprets the recovery section of the policy in such a way that the insurer has no subrogation rights as long as there is an excess loss,[209] which is clearly contrary to intent of the provision and the rights of the insurer. The court seemed to be influenced by the large amount of the excess loss, even after the application of the recoveries.[210] Perhaps the decision would have been otherwise if the amount of the excess loss had been less or if the insurer had presented evidence of additional sources of recovery that could have eliminated the excess loss entirely.

V. Denial Of Coverage

Insureds have tried, in several cases, to avoid the traditional application of the recovery provision based on the insurer's denial of liability.[211] In essence, insureds have argued that the insurer should not be allowed to participate in recoveries at all, having initially denied coverage and later been found liable. Fortunately for insurers, this argument has been unsuccessful.[212] The courts used recoveries to offset losses and the insurer's liability, "notwithstanding that the insurer denied liability and refused to pay."[213] In *Pacific Enterprises v. Federal*

[208] *Id.* The court further noted that, "as subrogation is basically an equitable principle, equity would not be served if F&D were permitted to escape liability under the bonds because Midland tried to mitigate its losses." *Id.*

[209] *See id*.

[210] *Id.* Midland's loss totaled $3,011,138.28. Through various collection efforts, Midland was able to reduce its loss to $2,634,027.77. The total coverage afforded by the fidelity bonds was $1,750,000.00. Therefore, even after payment by F&D of the policy limit, Midland still faced a loss of almost $1,000,000.00.

[211] *See, e.g.*, James B. Lansing Sound, Inc. v. Nat'l Union Fire Ins. Co., 981 F.2d 1549 (9th Cir. 1986); Graydon-Murphy Oldsmobile v. Ohio Cas. Ins. Co., 16 Cal. App. 3d 53 (Cal. Ct. App. 1971); Pac. Enters. v. Fed. Ins. Co., 18 Fed. Appx. 626 (9th Cir. 2001).

[212] 981 F.2d at 1561.

[213] *James B. Lansing Sound*, 981 F.2d at 1568.

Insurance Company,[214] another case decided by the Ninth Circuit, the court cites to both ***James B. Lansing Sound***[215] and *Graydon-Murphy*[216] for the same proposition.[217] The court, once again, rejected an argument that the insurer's right to recoveries should be jeopardized by its earlier denial of coverage. All of these cases strongly imply that an insurer's initial denial of coverage does not bar it from participating in recoveries after the court finds it liable under the policy.[218]

VI. Costs Of Obtaining Recovery

There seems to be general agreement in the industry that the costs of obtaining the recovery are netted out of the recovery proceeds before application of the recovery language of the policies.[219] The Commercial Crime Policy specifically provides that "any recoveries, less the cost of obtaining them . . . will be distributed."[220] Similarly, the Financial Institution Bond states "Recoveries . . . shall be applied, net of the expense of such recovery . . . ."[221] Thus, if the insured incurs costs in obtaining the recovery, these costs are used to reduce the recovery before the insurer is entitled to any payment.[222]

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[214] 18 Fed. Appx. at 627.

[215] 981 F.2d at 1568.

[216] 16 Cal. App. at 58.

[217] *Pac. Enterprises*, 18 Fed. Appx. at 630.

[218] *See id.; see also James B. Lansing Sound*, 981 F.2d at 1568; *Graydon-Murphy*, 16 Cal. App. 3d 53 (Cal. Ct. App. 1971).

[219] *See, e.g.,* FDIC v. United Pac. Ins. Co., 152 F.3d 1266 (10th Cir. 1998); Miami Nat'l Bank v. Pennsylvania Ins. Co, 314 F. Supp. 858, 859 (1970).

[220] Form CR 00 22 07 22 at § E(u) (ISO PROPERTIES, INC. 2001), *reprinted in* COMMERCIAL CRIME POLICY 691 (Randall I. Marmor & John J. Tomaine eds., 2d ed. 2004); Form CR 00 23 07 02 at § E(v) (ISO PROPERTIES, INC. 2001), *reprinted in* COMMERCIAL CRIME POLICY 691 (Randall I. Marmor & John J. Tomaine eds., 2d ed. 2004) (loss sustained form).

[221] Financial Institution Bond, Standard Form No. 24 at § 7(c) (revised Jan. 1986), *reprinted in* ANNOTATED FINANCIAL INSTITUTION BOND, 607 (Michael Keeley ed., 2d ed. 2004).

[222] *United Pac. Ins. Co.*, 152 F.3d at 1266.

This issue does not appear to be the subject of much litigation. However, there are a couple of cases where the insured appears to be extending the concept of "costs" in an effort to recoup a higher percentage of the recovery proceeds.[223] For example, in the ***United Pacific*** case, the FDIC successfully offset its administrative expenses associated with obtaining various settlements from third parties who were potentially liable on the loans in question.[224] The administrative expenses at issue were not discussed in any detail in the opinion[225] so it is difficult to criticize the result. However, the apparent general nature of the expenses and the lack of discussion are troublesome and could set a dangerous precedent to be used by creative insureds to retain more of the recoveries as a "cost of obtaining the recovery."

Similarly, in a somewhat dated case, ***Miami National Bank v. Pennsylvania Insurance Co.***,[226] the United States District Court for the Southern District of Florida ruled that various general expenses could be deducted from the recovery in determining the amount of the loss under a Financial Institution Bond.[227] In the ***Miami National Bank*** case, the bank was successful in obtaining recoveries from the liquidation of collateral related to the loans in question.[228] The bank's expenses included outside accounting fees, salaries for internal employees and officers, and costs associated with repossessing and disposing of collateral.[229] The court allocated all of these expenses against the recovery in arriving at the net amount of the loss.[230]

It was not clear from the ***Miami National Bank*** opinion whether the insurer argued against any of these expenses. The court did not refer to any case law or any language in the bond as support for its decision. However, the case illustrates the extent to which the insured can claim

[223] ***See e.g. id***.; ***Miami Nat'l Bank***, 314 F. Supp. at 859.
[224] 152 F.3d at 1276.
[225] ***Id.***
[226] 314 F. Supp. at 859.
[227] ***Id.*** at 866-67.
[228] ***Id.***
[229] ***Id.***
[230] ***Id.***

"costs", including general internal costs such as salaries and expenses, if not properly contested.[231]

VII. Summary And Practice Suggestions

In general, the arsenal of weapons devised by insureds in an effort to avoid the clear and unambiguous intent of the recovery language has been largely unsuccessful.[232] The "covered loss" argument has been rejected by most courts in favor of an allocation of recoveries or a specific application of the recoveries to the specific loss, if the recovery can be so traced.[233] The made whole doctrine, while troublesome, has not been applied in the context of a fidelity bond or used to override the specific recovery language of a fidelity bond.[234] However, the growing popularity of this doctrine should not be overlooked. Similarly, the collateral source rule has been rejected by at least one court in the context of a recovery from an attorney for "common damages."[235]

Despite the success insurers have enjoyed on this issue, care should be taken in settlement negotiations. To the extent possible, release language should be drafted with these potential arguments in mind. If the insured has not suffered a loss in excess of the policy limit, good practice would dictate a representation that the insured has been "made whole" with the exception of its deductible. If the insured has suffered significant uncovered losses, which is almost always the case in bank losses and any substantial commercial losses, the release should address this issue clearly. Additionally, it is sound practice to include

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[231] *See id.* at 860-67.

[232] *See e.g.,* FDIC v. United Pac. Ins. Co., 152 F.3d 1266 (10th Cir. 1998).

[233] *See e.g.,* City Trust & Sav. Bank v. Underwriting Members of Lloyds at London, 109 F.2d 110 (7th Cir. 1940); James B. Lansing Sound, Inc. v. Nat'l Union Fire Ins. Co., 981 F. Supp 1549 (9th Cir. 1986); Graydon-Murphy Oldsmobile v. Ohio Cas. Ins. Co., 156 Cal. App. 3d 53 (Cal. Ct. App. 1971).

[234] *See* Dist. No. 1—Pac. Coast Dist. v. Travelers Cas. & Surety Co., 782 A.2d 269 (D.C. 2001).

[235] *See* FDIC v. Mmahat 907 F.2d 546, 549 (5th Cir. 1990).

language in the release broadly defining the scope of "recoveries" which are subject to the recovery language in the policy.

Finally, the insured's right to retain criminal restitution payments can be a source of dispute. Because the court sometimes orders criminal restitution payments be made to the victim, as opposed to the carrier, or to both based on an allocation of the loss, an insured will sometimes take the position that the court has ordered that it should receive the money, despite language in the policy, or in a carefully drafted policy release, to the contrary. For this reason, we suggest using a specific provision in the policy release whereby the insured agrees that criminal restitution payments are considered "recoveries" within the applicable language of the policy.