

CORPORATE INSURANCE LAW

Expert Analysis

Direct Loss Requirement in Fidelity Insurance Bonds

On the evening of Feb. 26, 2008, a commodities broker affiliated with MF Global's Memphis office began trading commodities futures on the Chicago Mercantile Exchange (CME) from his personal trading account using MF Global's electronic trading system. The broker entered into a large number of sell contracts for May wheat, far exceeding his authorized margin credit. At the close of overnight trading, the broker's aggregate position in May wheat showed a significant prospective gain. However, when trading opened again in the morning, the price of May wheat rose dramatically and, by the time the broker's trades were closed out, the final loss on the transactions was in excess of \$141 million. Under the rules of the CME, as a clearing member, MF Global was legally obligated to cover the loss.

Due to the magnitude of the loss, the CME requested an intraday settlement from MF Global. By the afternoon of Feb. 27, 2008, MF Global had transferred sufficient funds from its settlement bank to the CME Clearing House to cover the loss. MF Global recorded a \$141 million loss on its books as a bad debt and then submitted a claim to its insurers to recover the loss under the terms of its fidelity insurance bond. The primary and excess insurers denied coverage and ultimately commenced a lawsuit against MF Global seeking an order confirming their disclaimer position.¹

Insurers' Motion

New Hampshire Insurance Company, the primary insurer, filed a motion for summary judgment seeking a ruling upholding its denial of coverage on the grounds that MF Global did not incur a "direct loss" as required by the terms of the fidelity insurance bond. The excess insurers had issued fidelity bonds that generally followed form to the primary policy and joined in New Hampshire's position on the motion.

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Under the terms of the primary fidelity bond, New Hampshire agreed to provide coverage for loss sustained for "(i) any wrongful act committed by any employee...which is committed with the intent to cause [MF Global] to sustain a loss or with the intent to obtain financial gain for [the employee]..."² Loss is defined in the bond as "the direct financial loss sustained by [MF Global] as a result of any single act, single omission or single event, or a series of related or continuous acts, omissions, or events."³ A wrongful act is defined as "any...dishonest...act committed with the intent to obtain improper financial gain for...an employee."⁴

The moving insurers argued that the loss sustained by MF Global was not a direct loss, primarily because the broker had not directly embezzled money from MF Global's accounts. The insurers also pointed out that the policy expressly excluded indirect or consequential loss. In support of their position, the insurers relied on case law precedent interpreting the term "direct financial loss" in a manner favorable to the their position.

Court Rules for MF Global

The trial court, in an opinion issued by Judge Bernard J. Fried, rejected the insurers' reliance on these cases, finding both the factual scenario and the policy language distinguishable. According to the trial court, "[t]he problem with all the cases relied upon by Insurers is that in all those matters, the alleged loss incurred to another party first, and only subsequently, upon voluntary or involuntary action as the case may be, to the insured. Here, the exact

opposite situation obtains: the alleged loss was directly incurred by Global, and the loss incurred was never due from [the broker]. It is [the broker] who has incurred an indirect loss, not Global."⁵

Judge Fried explained that the claims in the cases relied upon by the insurers arose from frauds against the general public, which gave rise to third-party claims against the insureds and which in turn resulted in loss paid by the insureds to third parties. Fried found that, in contrast, the MF Global loss was direct: "... [the broker's] actions resulted in the direct incurrance of debt by Global: CME never sought to collect from any other party, because [the broker] was an 'associated person' of Global. The loss was that of Global, not of any third party. Finally, [the broker's] actions were not a fraud on the public, but rather, a series of acts that created a debt for Global."⁶

Fried further explained that his conclusions were supported by the affidavit of MF Global's Managing Director of Risk Management, whose testimony emphasized that, had MF Global refused to pay the intraday settlement demanded by the CME Clearing House, "the Clearing House would have declared MF Global to be in default and deducted those amounts from the performance bond, Guaranty Fund and other assets that MF Global had pledged to the Clearing House."

The First Department found that the trial court "properly concluded that MF Global's loss constituted a 'direct financial loss' within the meaning of the New Hampshire primary policy."

Fried also discussed the distinction between the policy language in the New Hampshire fidelity insurance bond and the terms of the fidelity bonds at issue in the cases relied upon by the insurers. For example, in *Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co.*,⁷ a case that arose out of

the insider trading schemes of Ivan Boesky and his associates, the bond language contained additional requirements not present in the New Hampshire fidelity bond. In that case, relied on by both the insurers and MF Global, the bond required that the employee demonstrate both an intent to cause loss to the insured and to gain improper personal financial benefit. In contrast, under the New Hampshire bond, a wrongful act intended to either cause loss to the insured or to obtain financial gain is sufficient to trigger coverage. Further, the bond at issue in *Aetna Cas. & Sur. Co.* contained an express exclusion for trading losses not present in the New Hampshire bond.⁸

In sum, Judge Fried concluded that the New Hampshire bond provided coverage for MF Global's loss: "[b]y the simple language of the contract therefore, coverage is indicated: [the broker] committed a wrongful act (he made unauthorized trades beyond his margin), he was an employee of Global, and he did so for financial gain." Consequently, even though MF Global had not filed a cross-motion for summary judgment, Fried used his authority to search the record and, in addition to denying the insurers' motion for summary judgment, he also affirmatively granted summary judgment to MF Global.⁹

First Department

On appeal, the First Department panel unanimously affirmed in part and reversed in part the trial court's ruling. The First Department found that the trial court "properly concluded that MF Global's loss constituted a 'direct financial loss'" within the meaning of the New Hampshire primary policy.¹⁰

The appellate ruling noted that the case law has drawn an analogy between the direct financial loss requirement and proximate cause, and explained that the broker's making of authorized trades beyond his margin was the direct proximate cause of MF Global's loss: "[the broker's] trading activity resulted in a near instantaneous shortfall for which MF Global, as a Clearing Member, was automatically and directly responsible. To ensure the integrity of the market, MF Global was obligated to promptly pay the CME Clearing House for the loss. In light of the immediacy of the payment, which was made only hours after the discovery of [the broker's] trading, and the regulatory scheme upon which it was premised, MF Global's loss cannot fairly be viewed as simply satisfying a contractual liability to the CME. Contrary to plaintiffs' view, the payment to the CME is not a third-party loss for which MF Global is liable, but rather a direct loss to MF Global under the bonds."¹¹

The First Department also adopted the trial court's view of the case law precedent, finding that the cases, including *Aetna Cas. & Sur. Co.*, did not address the fact pattern presented by

MF Global: "[i]n *Aetna*, we addressed whether the fidelity bonds at issue covered litigation settlement payments made by Kidder Peabody to third-party investors who sustained losses as a result of insider trading schemes conducted by a Kidder Peabody employee.... The settlement payments were made by Kidder Peabody years after the employee's misconduct.... We concluded that the settlements were not direct losses because they were not the direct result of the employee's dishonest conduct.... Instead, the losses stemmed from the employee's misconduct, which caused pricing irregularities in the stock, which led to losses to investors, which led to litigation, which concluded in a settlement years after the employee's misconduct."¹²

The First Department parted ways with the trial court on the determination of whether the broker was an employee within the meaning of the fidelity insurance bond.

In contrast, the broker's trading in May wheat did not result in harm to third parties who in turn brought claims against MF Global. Rather, MF Global immediately bore responsibility for the losses on its trading system and paid for the losses within hours of the misconduct.

Remand on Employee Issue

The First Department, however, parted ways with the trial court on the determination of whether the broker was an employee within the meaning of the fidelity insurance bond. As the First Department explained, in order to grant summary judgment to MF Global, the trial court had to also find that the broker was an employee of MF Global. In addressing this issue, the trial court determined that, by virtue of scarcely addressing the issue in their motion papers, the insurers had relinquished the claim that the broker was not an employee. The trial court further found that the broker was under an implied contract of employment and under the supervision of MF Global. The First Department disagreed, finding that the trial court's ruling was premature.

The New Hampshire fidelity bond defined an employee as follows: "(i) a person under an implied contract of employment or services with the insured; (ii) a person working under the direct control and supervision of the insured; or (iii) a person who is paid by the insured under their payroll system." The fidelity bond also contained an exception to the definition, providing that "[t]he term employ-

ee does not mean any independent broker... remunerated on a sales or commission basis unless specifically agreed by the insurer and endorsed to this bond."¹³

The First Department noted that the broker did not receive a regular salary from MF Global, but instead was paid by commission with payment recorded on a 1099 form. Although MF Global argued that, as an "associated person," the broker was under MF Global's supervision, the First Department concluded that there was an insufficient record to resolve this issue as a matter of law. Therefore, citing the need for discovery and principles of fairness (because the issue had been resolved without notice to the parties), the First Department reversed in part and remanded the case to the trial court for further discovery and proceedings to address whether the broker was an employee within the meaning of the New Hampshire fidelity insurance bond.

Looking Forward

According to the court docket, proceedings in the trial court to address whether the broker was an employee are continuing. If the employee issue is resolved in favor of MF Global, we can expect the insurers to again seek appellate review. In the event that the First Department affirms a ruling in favor of MF Global, we can expect the insurers to try to take the case to the Court of Appeals, where they would then be permitted to argue the employee issue as well as to again argue that MF Global did not sustain direct loss within the meaning of the fidelity bond. Therefore, absent a settlement, the Court of Appeals may ultimately have the last word on this dispute.

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1. *New Hampshire Ins. Co. v. MF Global*, 29 Misc.3d 1207(A), 958 N.Y.S.2d 309, 2010 WL 3927114 (New York Co., Sept. 28, 2010).
 2. *Id.*
 3. *Id.*
 4. *New Hampshire Ins. Co. v. MF Global*, 108 A.D.3d 463, 970 N.Y.S.2d 16 (1st Dept. July 16, 2013).
 5. *New Hampshire Ins. Co. v. MF Global*, 29 Misc.3d 1207(A), 958 N.Y.S.2d 309, 2010 WL 3927114.
 6. *Id.*
 7. *Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co.*, 246 A.D.2d 202, 676 N.Y.S.2d 559.
 8. *Id.*
 9. *New Hampshire Ins. Co. v. MF Global*, 29 Misc.3d 1207(A), 958 N.Y.S.2d 309, 2010 WL 3927114.
 10. *New Hampshire Ins. Co. v. MF Global*, 108 A.D.3d 463, 970 N.Y.S.2d 16.
 11. *Id.*
 12. *Id.*
 13. *Id.*

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