IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY, *et al.*, Plaintiffs, v. CERTAIN UNDERWRITERS AT LLOYD'S OF LONDON SUBSCRIBING TO BOND NUMBERS B0391/FD020720g AND B0391/FD020730g, *et al.*, Defendants.	))))))))))))	C.A. No. 4791-VCL

MEMORANDUM OPINION

Date Submitted: June 22, 2010
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LASTER, Vice Chancellor.

The plaintiffs claim coverage under two insurance towers. The first tower consists of a primary fidelity bond (the "Primary Bond") and excess bonds that generally follow form to the primary bond (the "Bond Tower"). The second tower consists of a primary directors and officers' liability insurance policy (the "D&O Policy") and excess policies that generally follow form to the primary D&O Policy (the "D&O Tower"). One group of defendants comprises the underwriters who issued the bonds in the Bond Tower (the "Bond Underwriters"). A second group of defendants comprises the insurers who issued the policies in the D&O Tower (the "D&O Insurers"). The Bond Underwriters have moved to dismiss the complaint for failure to state a claim on which relief can be granted. Their motion is denied.

I. FACTUAL BACKGROUND

The facts at this stage of the proceeding derive from the well-pled allegations of the second amended complaint (the "Complaint") and from documents it incorporates by reference, such as the Primary Bond. The parties have submitted public filings from related litigation, and I take judicial notice of those documents. The non-movant plaintiffs receive the benefit of all reasonable inferences.

A. The Plaintiffs And Their Investments With Bernard L. Madoff

The fourteen plaintiffs (the "Assureds") contend they are entitled to coverage under the Primary Bond. Five of the Assureds are investment funds: (i) the Rye Select Broad Market Fund, L.P., (ii) the Rye Select Broad Market Insurance Fund, L.P., (iii) the Rye Select Broad Market Prime Fund, L.P., (iv) the Rye Select Broad Market XL Fund, L.P., and (v) the Rye Select Broad Market Portfolio Limited (collectively, the "Rye

Funds”). The first four Rye Funds are Delaware limited partnerships. The fifth is a Cayman Islands company.

The Rye Funds invested with Bernard L. Madoff. Altogether, the Rye Funds entrusted approximately $3.1 billion to Madoff, making them his second largest investor.

As is now widely known, rather than investing the money that was entrusted to him, Madoff stole it. For years, Madoff operated a Ponzi scheme in which funds from new investors were used to pay off earlier investors, with millions diverted into Madoff’s pockets. Although Madoff claimed to be trading securities in the market, he never bought or sold a single stock. In December 2008, the Ponzi scheme fell apart and Madoff’s thievery came to light. The Rye Funds lost their entire investment as a result of Madoff’s fraud.

In the wake of the revelation of Madoff’s crimes, some thirty-two lawsuits were filed and four demands made against different combinations of the Rye Funds and their affiliates (collectively, the “Underlying Actions”). The different complaints name a variety of parties as defendants, including different Rye Funds, different entities affiliated with the Rye Funds, and various individuals who served as directors or officers of the Rye Funds or their affiliates. According to the Complaint, the nine plaintiffs other than the Rye Funds are Assureds who have been named as defendants in some combination of the Underlying Actions (collectively, the “Additional Assureds”). The nine Additional Assureds are Tremont Partners, Inc.; Tremont Group Holdings, Inc.; Tremont (Bermuda) Limited; Tremont Market Neutral Fund, L.P.; Tremont Opportunity Fund III, L.P.;

Oppenheimer Acquisition Corp.; Oppenheimer Funds, Inc.; Mass Mutual Holding LLC; and Massachusetts Mutual Life Insurance Co. ("MassMutual").

The Complaint does not describe the relationships among the Additional Assureds or delineate their connections with the Rye Funds. The Primary Bond and the few filings from the Underlying Actions indicate that MassMutual is the ultimate parent of all of the entities. It appears that Tremont Partners managed the Rye Funds and served as the general partner of the four Rye Funds that were Delaware limited partnerships. Tremont Partners in turn appears to be owned and controlled (in ascending order) by Tremont Group Holdings, Oppenheimer Acquisition, Oppenheimer Funds, Mass Mutual Holding, and MassMutual. Tremont Market Neutral Fund, L.P., Tremont Opportunity Fund III, L.P., and Tremont (Bermuda) Limited appear to be feeder funds that held limited partnership interests in the Rye Funds.

B. The Claims Asserted In The Underlying Actions

The Complaint alleges generally that the Underlying Actions seek to hold the Assureds liable for losses suffered as a result of Madoff's fraud, including for compensatory damages. The Complaint incorporates by reference a list of the Underlying Actions. According to the Complaint, "[t]hese lawsuits generally allege misrepresentation, breach of fiduciary duty, mismanagement, and a failure to supervise on the part of one or more of the [Assureds] in connection with the multi-billion dollar Ponzi scheme and multiple thefts perpetrated by Bernard L. Madoff and related enterprises." Compl. ¶ 4. The Bond Underwriters have submitted complaints from three of the Underlying Actions. If the three are representative, then the Assureds face a

complex and variegated web of claims brought under the statutory and common law of multiple jurisdictions. The three complaints alone contain some forty-three different counts asserting legal theories under the statutory and common law of Massachusetts, Connecticut, and New York. And there are thirty-five other complaints and demands that I have not yet seen.

C. The Complaint In This Action

The Assureds claim coverage for the Underlying Actions under both the Bond Tower and the D&O Tower. The Assureds assert that all of their current and future defense costs are covered by the Bond Tower and the D&O Tower. They contend that the D&O Insurers have accepted responsibility for only a small percentage of the defense costs, while the Bond Underwriters have refused to pay any defense costs. They further contend that the Bond Underwriters have failed to pay for any of the losses suffered by the Assureds to date and have refused coverage for any additional losses that may be suffered in the future.

To remedy these and other alleged contractual wrongs, the Complaint asserts six counts. Count I seeks a declaratory judgment equitably apportioning defense costs between the Bond Tower and D&O Tower. Count II asserts a claim for breach of contract against the Bond Underwriters for failing to pay the defense costs covered by the Bond Tower, subject to any equitable apportionment under Count I. Count III asserts a claim for breach of contract against the Bond Underwriters for failing to indemnify the Assureds for losses suffered to date and for refusing to cover losses to be incurred in the future as a result of Madoff's thefts. Count III thus seeks not only defense costs in the

Underlying Actions but also the money Madoff actually stole and any additional losses that result from judgments or settlements in the Underlying Actions. Count IV asserts a claim for breach of contract against the D&O Insurers for failing to pay the defense costs covered by the D&O Tower, subject to any equitable apportionment under Count I. Count V seeks a declaration that Madoff's thefts constituted multiple losses under the Bond Tower. Count VI seeks a declaration that together, the Bond Underwriters and D&O Insurers must indemnify the plaintiffs for all eventual settlements or judgments in the Underlying Actions (or pay those settlements or judgments on behalf of the plaintiffs) to the extent of the respective limits of liability that apply under the D&O Tower and the Bond Tower and subject to any equitable apportionment.

II. LEGAL ANALYSIS

The Bond Underwriters have moved to dismiss the Complaint in its entirety, contending that it fails to state a claim under the Primary Bond. A motion to dismiss for failure to state a claim should be denied unless the "plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances susceptible of proof." *Savor, Inc. v. FMR Corp.*, 812 A.2d 894, 897 (Del. 2002). "Dismissal is appropriate only if 'it appears with reasonable certainty that, under any set of facts that could be proven to support the claims asserted, the plaintiff would not be entitled to relief.'" *King Constr., Inc. v. Plaza Four Realty, LLC*, 976 A.2d 145, 151-52 (Del. 2009) (quoting *Gantler v. Stephens*, 965 A.2d 695, 703 (Del. 2009)).

A. Applicable Principles of Massachusetts Law

The Primary Bond provides that "any dispute concerning this Bond shall be subject to the law of the State of Massachusetts . . . ." Primary Bond at 56 (Rider Number 7 ("Choice of Law and Jurisdiction")); *accord id.* at 8 (Risk Details – "Choice of Law & Jurisdiction"). The Assureds' claims are therefore governed by Massachusetts law.

The Primary Bond is a fidelity bond. A fidelity bond is a specialized two-party agreement "whereby one for consideration agrees to indemnify the insured against loss arising from want of integrity, fidelity, or honesty of employees or other persons holding positions of trust." 11 Lee R. Russ & Thomas F. Segalla, *Couch on Insurance* § 160:7 (3d ed. 1995 & Supp. 2010) [hereinafter *Couch on Insurance*]. Under Massachusetts law, "[t]he language of fidelity bonds is generally construed according to the same rules as insurance contracts." *Commerce Bank & Trust v. St. Paul Mercury Ins. Co.*, 2005 WL 4881101, at *3 (Mass. Super. June 7, 2005).

Massachusetts treats the construction of an insurance policy as an issue of law for the court. *Cody v. Conn. Gen. Life Ins. Co.*, 439 N.E.2d 234, 237 (Mass. 1982). A court must construe "words of the policy according to the fair meaning of the language used, as applied to the subject matter." *Jacobs v. U.S. Fid. & Guar. Co.*, 627 N.E.2d 463, 464 (Mass. 1994). When the words of the policy are "plain and free from ambiguity they must be construed in their usual and ordinary sense." *Hanover Ins. Co. v. Ramsey*, 539 N.E.2d 537, 538 (Mass. 1989).

"[A]mbiguity exists in an insurance contract when the language contained therein is susceptible of more than one meaning." *Lumbermens Mut. Cas. Co. v. Offices Unlimited, Inc.*, 645 N.E.2d 1165, 1168 (Mass. 1995). "[W]ords, which are clear by themselves, may become ambiguous when read in the context of an insurance policy." *Id.* at 1169. "When the written agreement, as applied to the subject matter, is in any respect uncertain or equivocal in meaning, all the circumstances of the parties leading to its execution may be shown for the purpose of elucidating, but not of contradicting or changing its terms." *Affiliated FM Ins. Co. v. Constitution Reinsurance Corp.*, 626 N.E.2d 878, 880 (Mass. 1994) (internal quotation and citations omitted).

> Valid usages known to contracting parties, respecting the subject matter of an agreement, are by implication incorporated therein, unless expressly or impliedly excluded by its terms, and are admissible to aid in its interpretation, not as tending in any respect to contradict or vary a contract, but upon the theory that the usage forms a part of the contract.

Id. at 882 (internal quotations and citations omitted). "There is no requirement that an agreement be ambiguous before evidence of a usage of trade can be shown, nor is it required that the usage of trade be consistent with the meaning the agreement would have apart from the usage." Restatement (Second) of Contracts § 222, cmt. (b), *cited in Affiliated FM*, 626 N.E.2d at 882 n.9.

Although generally construed like an insurance policy, a financial institution fidelity bond is a unique form of suretyship agreement with its origins in the early twentieth century. *See* Robert J. Duke, *A Brief History of the Financial Institution Bond, in Financial Institution Bonds* 1, 1-3 (Duncan L. Clore, ed., 3d ed. 2008). "The rapid growth of the banking industry in the early 1900s, which required the hiring of many yet

largely inexperienced employees," resulted in the need for employee dishonesty coverage. *Id.* at 3. Banks also needed coverage for robbery, theft, and other perils. At the time, insurance regulators did not permit multi-peril policies, and banks had to purchase a number of separate bonds and policies to be fully covered. *Id.*

In 1911, Lloyd's of London began marketing a multi-peril policy to banks designed to cover employee dishonesty, loss of property on premises or in transit through robbery or theft, and other named perils. In 1912, the Surety Association of America (now called the Surety & Fidelity Association of America (the "Surety Association")) obtained permission from the New York Commissioner of Insurance to develop a competing multi-peril bond. In 1916, the Surety Association began marketing the Banker's Blanket Bond, Standard Form No. 1, a multi-peril policy prepared with the assistance of the American Bankers Association. *See* Samuel J. Arena, Jr., *et al.*, *The Manifest Intent Handbook* 4 (2002); Peter I. Broeman, *An Overview of the Financial Institution Bond, Standard Form 24*, 110 Banking L.J. 439, 442-43 (1993); Edward Gallagher & Robert J. Duke, *A Concise History of Fidelity Insurance*, *in Handling Fidelity Bond Claims* 1, 3-4 (Michael Keeley & Sean Duffy eds., 2d ed. 2005).

Since 1916, the Surety Association has revised and updated its standard form bond on a regular basis. *See* Duke, *supra*, at 5-28 (chronicling revisions through present day). The current enumeration, known as Standard Form No. 24, was produced in 1941. *Id.* at 8. But although the number of the form has not changed since then, its contents have. Revisions were made in 1946, 1951, 1969, 1980, and 1986 "to clarify insuring agreements, add commonly used riders, and generally ensure that the bond conformed to

the current banking practices of the day." *Id.* at 9. The latest revision was completed in 2004. *Id.* at 21. The bond's name has changed as well. In 1986, the Banker's Blanket Bond was re-branded as the "Financial Institution Bond" to avoid any suggestion that "blanket" contemplated broad coverage. *Id.* at 17-18.

Because fidelity bonds are instruments of commerce with relatively standardized terms, their language should be construed with appropriate regard for the value of uniform interpretation. *See Concord Real Estate CDO 2006-1, Ltd. v. Bank of Am. N.A.*, ___ A.2d. ___, 2010 WL 2011616, at *5 (Del. Ch. May 14, 2010). "Courts enhance stability and uniformity of interpretation by looking to the multi-decade efforts of leading practitioners to develop model . . . provisions. . . . While these materials obviously are no substitute for construing the agreement, they provide powerful evidence of the established commercial expectations of practitioners and market participants." *Id.*[1] Virtually all of the language of the Primary Bond parallels language that has appeared in one of the iterations of Standard Form No. 24, and it is therefore appropriate to rely on

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[1] *Concord Real Estate* involved a bond indenture, an instrument where the importance of uniform interpretation and stable commercial expectations has been widely recognized. *E.g., Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982) ("Uniformity in interpretation is important to the efficiency of capital markets.") (Winter, J.); *Kaiser Aluminum Corp. v. Matheson*, 681 A.2d 392, 398-99 (Del. 1996) (discussing importance of certainty in interpretation to standard provisions); *San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.*, 983 A.2d 304, 314 (Del. Ch. 2009) (same), *aff'd*, 981 A.2d 1173 (Del. 2009) (TABLE). The point applies equally to other standardized instruments.

the development and interpretation of Standard Form No. 24 when interpreting the Primary Bond.[2]

But while much of the Primary Bond follows form to language found in one or more iterations of Standard Form No. 24, other language departs from form. The Complaint alleges that several of the differences result from negotiation between the Assureds and the Bond Underwriters and that the meaning of those provisions is context-dependent. Commentators observe that fidelity bonds are often individually tailored.[3] Just as the adoption of standardized contractual language carries interpretive significance, a departure from standardized language can as well.

B. The Independent Broker Exclusion Is Ambiguous.

The Bond Underwriters say that an exclusion in the Primary Bond disposes of the entire case. Rider Number 6 provides that, "notwithstanding anything contained herein, this Bond specifically excludes any loss arising directly or indirectly from independent brokers, except when acting in collusion with any other Employee." Primary Bond at 55

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[2] Referring to Standard Form No. 24 is difficult because of the many revisions to that instrument. Because most of the pertinent case law and authorities draw on Standard Form No. 24 as it appeared after the 1986 revision, references in this opinion are to that version unless otherwise noted.

[3] Broeman, *supra*, at 441 ("It is quite usual for many of the provisions of the bond to be altered by endorsements tailored to the needs of a particular insured. Similarly, additional coverage not otherwise contemplated by the bond may be added by endorsement."); Gallagher & Duke, *supra*, at 23 ("[F]idelity standard forms have always been subject to negotiation, and insureds or their brokers routinely ask for and receive changes."); John J. Morrisey, *The Insured's Point of View*, *in Handling Fidelity Bond Claims*, *supra*, at 25, 30 ("Gone are the days when brokers or agents negotiated policies containing little else but standard form language.").

(the "Independent Broker Exclusion"). The Bond Underwriters argue that Madoff conducted his illegal activities through Bernard L. Madoff Investment Securities LLC ("BMIS"), a registered broker-dealer for which Madoff was the sole principal. BMIS was independent of the Assureds, and the Bond Underwriters say the Independent Broker Exclusion clearly applies. Although the Bond Underwriters' position may ultimately prevail, it is not the only reasonable reading. At this stage of the case, the Independent Broker Exclusion does not mandate dismissal.

The term "Independent Broker" is not defined in the Primary Bond. It does not appear in Standard Form No. 24. In contrast to other provisions, the parties have not cited, and I have not found, industry materials or cases suggesting that the Independent Broker Exclusion is a form exclusion or standardized term.

The Complaint asserts that the Independent Broker Exclusion was the result of specific bargaining between the Assureds and the Bond Underwriters. According to the Assureds, the term "Independent Broker" does not refer to stockbrokers or broker-dealers like BMIS, but rather to participants in a particular distribution channel for life insurance company products. MassMutual sells its insurance products through a network comprised of two types of agents: "career agents" under contract to MassMutual who primarily sell MassMutual products, and "independent brokers" who are authorized to sell MassMutual products but who routinely also sell other companies' products. According to the Assureds, the Independent Broker Exclusion differentiates between the two channels and excludes the latter group from coverage.

Massachusetts case law supports the distinction between insurance agents and insurance brokers on which the Assureds rely.[4] So do treatises and black-letter sources. *See, e.g.*, 3 *Couch on Insurance* at § 45:1; 43 Am. Jur. 2d *Insurance* § 123 (2010). Consistent with this reading of the term "independent broker," the Primary Bond elsewhere specifically uses the term "stockbroker." *See* Primary Bond at 27 (contemplating that funds would be covered if stolen from the offices of a "stockbroker"). If the Independent Broker Exclusion were intended to encompass stockbrokers, as the Bond Underwriters argue, then it might have used that term. Conversely, if "Independent Broker" were read to extend to stockbrokers, then the Independent Broker Exclusion would eliminate coverage that the Primary Bond otherwise extends expressly to "stockbrokers."

There is a rational business reason why the Bond Underwriters could have contracted to exclude coverage for "Independent Brokers" in the sense advocated by the Assureds. Although an independent broker represents the insured, courts have held that the independent broker may be deemed to be acting as the agent of the insurer or as a

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[4] *See Hudson v. Mass. Prop. Ins. Underwriting Ass'n*, 436 N.E.2d 155, 158 (Mass. 1982) ("[an] insurance agent is the representative of the company and the insurance broker is ordinarily the agent of the insured") (internal quotations and citation omitted); *Foisy v. Royal Maccabees Life Ins. Co.*, 356 F.3d 141, 150 n.10 (1st Cir. 2004) (noting "[t]he industry distinction between 'broker' and 'agent,'" but also that the industry terms may not be determinative of the legal question of agency); *Markel Am. Ins. Co. v. Madonna*, 448 F. Supp. 2d 234, 239 (D. Mass. 2006) (explaining that where a broker is "employed to procure insurance, he is the agent of the person for whom the insurance is procured insofar as matters in connection with the procurement are concerned") (internal quotations and citation omitted).

dual agent for both the insured and the insurer. *See generally* 3 *Couch on Insurance* at §§ 45:1, 45:5; Colin Sammon, Comment, *Insurance Agent and Broker Liability: Crossing the Two Way Street*, 29 Ohio N.U. L. Rev. 237, 240, 251-54 (2002); *cf.* Mass. Gen. Laws Ann. ch. 175, § 169 (West 2010) (deeming insurance broker to be agent of the insurance company "for the purpose of receiving any premium therefor"). If an independent broker embezzled premiums, the Bond Underwriters might face a claim under the Primary Bond. *See, e.g., Hurt & Quin, Inc. v. St. Malyon*, 68 S.E.2d 213, 216-17 (Ga. Ct. App. 1951) (holding that local agent's diversion of insurance premiums constituted direct loss within coverage of insurer's fidelity bond). To limit their risk, the Bond Underwriters could well have sought to insure only MassMutual's career agents.

The Bond Underwriters respond to the Assureds' reasonable reading with one of their own. They start from the premise that "broker" means any kind of broker, and BMIS was a broker-dealer. They match the contrast between "Independent Broker" and "stockbroker" by noting that the Primary Bond elsewhere deploys the term "Insurance Broker." Primary Bond at 25. They also provide a plausible business rationale for their interpretation. According to the Bond Underwriters, MassMutual and the other Assureds make extensive use of broker-dealers for securities transactions, including large outfits like Fidelity Investments and Charles Schwab & Co. The Bond Underwriters say they wanted to eliminate any suggestion that coverage might extend to those institutions.

On a motion to dismiss, a court cannot choose between reasonable interpretations. *VLIW Tech., LLC v. Hewlett-Packard Co.*, 840 A.2d 606, 615 (Del. 2003). At the present

stage of the case, the Independent Broker Exclusion does not entitle the Bond Underwriters to dismissal.

C. The Complaint States A Claim Under The Fidelity Clause.

The Complaint invokes insuring clause (A) of the Primary Bond, which states:

> **<u>THE LOSSES COVERED BY THIS BOND ARE AS FOLLOWS:</u>**
>
> **<u>FIDELITY</u>**
>
> (A) i) Loss resulting directly from one or more dishonest or fraudulent acts of an Employee or general agent of the Assured, committed anywhere and whether committed alone or in collusion with others, including loss of Property resulting directly from such act of an Employee or general agent.

Primary Bond at 26 (the "Fidelity Clause"). As discussed in greater detail below, the Primary Bond defines "Employee" to include an "investment advisor." *Id.* at 23-24.

In considering this claim, I distinguish between the Rye Funds and the Additional Assureds. The two groups are situated differently because, as discussed below, the Rye Funds owned the actual money that was entrusted to Madoff. As a matter of entity law, taking as true the facts pled in the Complaint, Madoff stole money from the Rye Funds. The Additional Assureds did not invest directly with Madoff, did not own the stolen funds, and must advance more attenuated theories of coverage that depend on the Underlying Actions.

With respect to the Rye Funds, the Complaint pleads a *prima facie* case of coverage under the Fidelity Clause for the money Madoff stole. The Complaint adequately alleges that the Rye Funds are Assureds. The Primary Bond defines "Assured" as MassMutual, any entity listed on the Schedule of Assureds, and "any

interest now or hereafter owned, controlled or operated by any one or more of those named as Assured." Primary Bond at 22. Tremont Partners appears on the Schedule of Assureds, as do the other entities in the Tremont Partners ownership chain culminating with MassMutual itself. Tremont Partners was the general partner or manager of each of the Rye Funds. The Rye Funds therefore qualify as an Assured because they were "owned, controlled or operated by any one or more of those named as Assured."

The Complaint adequately alleges that the Rye Funds retained Madoff and BMIS as their investment advisor. The Complaint further alleges that the Rye Funds entrusted Madoff and BMIS with hundreds of millions of dollars that belonged to the Rye Funds with the understanding that Madoff and BMIS would invest the money on behalf of the Rye Funds. Rather than investing the money, Madoff stole it. As a direct result of the theft, the Rye Funds lost their property. These allegations present a straightforward claim under the plain language of the Fidelity Clause.

1. The Complaint Sufficiently Alleges That Funds Lost By The Rye Funds Actually Belonged To The Rye Funds.

To defeat coverage under the Fidelity Clause, the Bond Underwriters contend that the Rye Funds did not own the money that Madoff stole. Most stridently, they say the money belonged to third-party investors, not to the Rye Funds. According to the Bond Underwriters, any losses therefore were suffered by those third-party investors, and not by the Rye Funds.[5] Alternatively, they say that when the Rye Funds invested with

[5] *See* Primary Bond Underwriters' Opening Brief ("DOB") at 3-4 ("The losses occasioned by Mr. Madoff's scheme as alleged in the Underlying Litigation were

Madoff, the funds ceded title to their cash in return for a proportionate ownership stake in an investment fund operated by Madoff. Under this theory, the Rye Funds did not suffer any loss because they still hold the same property – their ownership stake in Madoff's fund. DOB at 12 n.11; DRB at 6 n.8. The first argument conflicts with elementary precepts of entity law. Both arguments conflict with the allegations of the Complaint.

The Complaint alleges that four of the five Rye Funds are limited partnerships. The fifth – Rye Select Broad Market Portfolio Limited – is an off-shore corporation. Qualified investors purchased equity interests in the Rye Funds and became limited partners or shareholders. Under the organizational documents of these entities, the money the investors paid became the property of the Rye Funds. This quite common fund structure has been described in many Delaware decisions.[6]

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suffered by the plaintiffs' customers—the limited partners of the Rye Funds—and not 'directly' by plaintiffs.") (citing Primary Bond at 35); *accord id.* at 12; Primary Bond Underwriters' Reply Brief ("DRB") at 5-6.

[6] *See, e.g., Brown Inv. Mgmt., L.P. v. Parkcentral Global, L.P.*, 2010 WL 2091176, at *1 (Del. Ch. May 24, 2010) (describing hedge fund structured as Delaware limited partnership in which investors owned limited partnership interests in fund entity); *Global Link Logistics, Inc. v. Olympus Growth Fund III, L.P.*, 2010 WL 338214, at *1 (Del. Ch. Jan. 29, 2010) (describing private equity fund structured as Delaware limited partnership); *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872, 878 (Del. Ch. 2009) (describing hedge fund complex including feeder funds organized as Delaware limited partnerships); *Alliance Data Sys. Corp. v. Blackstone Capital P'rs V L.P.*, 963 A.2d 746, 752 (Del. Ch. 2009) (describing private equity fund operating as Delaware limited partnership); *Schuss v. Penfield P'rs, L.P.*, 2008 WL 2433842, at *1-2 (Del. Ch. June 13, 2008) (describing hedge fund structured as Delaware limited partnership in which investors own limited partnership interests in fund entity); *Flynn v. Bachow*, 1998 WL 671273, at *2 (Del. Ch. Sept. 18, 1998) (describing fund organized as limited partnership in which institutional investors purchased limited partnership interests).

The property of a limited partnership belongs to the partnership as an entity, not to its individual partners.[7] As a matter of Delaware law, the money invested by the Rye Fund limited partnerships belonged to the Rye Funds. The Bond Underwriters' contention that funds invested in the Rye Fund limited partnerships continued to belong to the third-party investors ignores the separate existence of the limited partnerships as entities. It is flatly contrary to Delaware law.

The property of a corporation likewise belongs to the corporation. *See* 8 *Del. C.* § 122(4). Admittedly the Rye Select Broad Market Portfolio Limited is alleged to be a Caymans Islands corporation, and no one has provided pertinent Cayman Islands authority. But the concepts of corporate separateness and limited stockholder liability are fundamental, and the Caymans Islands is a British Overseas Territory with a legal system based on English common law principles. Preliminary research indicates (and it is reasonable to infer at this stage of the proceeding) that the Cayman Islands does not embrace a heretical notion of the corporation in which stockholders own corporate

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[7] 6 *Del. C.* § 15-201(a) ("A partnership is a separate legal entity which is an entity distinct from its partners unless otherwise provided in a statement of partnership existence or a statement of qualification and in a partnership agreement."); 6 *Del. C.* § 15-203 ("Unless otherwise provided in a statement of partnership existence or a statement of qualification and in a partnership agreement, property acquired by a partnership is property of the partnership and not of the partners individually."); 6 *Del. C.* § 15-501 ("Unless otherwise provided in a statement of partnership existence or a statement of qualification and in a partnership agreement, a partner is not a co-owner of partnership property and has no interest in specific partnership property."); *McGovern v. Gen. Hldg, Inc.*, 2006 WL 4782341, at *18 (Del. Ch. June 2, 2006) ("Under Delaware law, 'property acquired with partnership funds is partnership property' unless the Partnership Agreement explicitly provides otherwise, which in this case the Agreement does not." (quoting 6 *Del. C.* § 1508(b)).

property directly and the corporate form is ignored. *Cf.* Companies Law (2009 Rev.), § 8 (Cayman Is.) (providing limited liability for members of a "company limited by shares"); *id*. §§ 54(1), 87, 99, and 103(3)(b) (referring to property owned by the corporate entity).

The Bond Underwriters' alternative argument only runs afoul of the allegations of the Complaint. In this version, the Bond Underwriters contend that that when the Rye Funds invested with Madoff, the Rye Funds received an ownership stake in a separate investment fund. The Bond Underwriters thus claim that the Rye Funds' investments with Madoff were structured in the same manner as the Rye Funds themselves. If that were the case, then the invested (and lost) funds would not have belonged to the Rye Funds, just as the funds invested with the Rye Funds no longer belonged to their third-party investors. But that is not what the Complaint alleges.

According to the Complaint, BMIS was retained as an investment advisor (or investment manager) to manage funds belonging to the Rye Funds. The relationship with BMIS was structured along the lines of a traditional client-stockbroker relationship in which the stockbroker has discretionary authority to trade. Under this framework, the brokerage opens an account in the client's name, and the account proceeds and securities are held beneficially for the client.

This is a materially different relationship than the fund structure used by the Rye Funds. As alleged in the Complaint, the Rye Funds retained ownership of the funds they invested with Madoff. The Complaint alleges that the Rye Funds suffered a direct loss of funds that they owned.

2. The Complaint Sufficiently Alleges That Madoff Falls Within The Definition Of "Employee" Used In The Primary Bond.

The Bond Underwriters next contend that Madoff cannot qualify as an "Employee" under the Primary Bond. The Bond Underwriters argue for a narrow interpretation paralleling the common law definition of an employee, and they explain how Standard Form No. 24 traditionally followed this approach. The Primary Bond, however, contains a far more expansive definition, and the Complaint adequately alleges that Madoff falls within its scope.

The Primary Bond definition initially defines the term "Employee" narrowly:

> "Employee and Employees", whenever used in this bond, shall be deemed to mean, respectively, one or more of the officers, clerks and other natural persons in the service of the Assured while employed in, at or by any of the Assured's offices while covered under this bond during the currency of this bond and who are compensated by salary, wages or commissions, and whom the Assured has the right to govern and direct at all times in the performance of such service, but not to mean brokers, sub-agents, loan agents, fiscal agents, property management agents, real estate agents, or other representatives of the same general character.

Primary Bond at 23. The Primary Bond then expands the definition significantly by providing that "Employee and Employees shall also be deemed to mean respectively," followed by a list of eleven numbered categories. Four are illustrative:

> 1. All consultants used and supervised by the Assured as well as any person, firm or corporation appointed by the Assured to serve as its agent to do or perform any act which the Assured in the normal conduct of business would do or perform.
>
> * * *
>
> 5. Any officer, partner or Employee of
>
>   (a) an investment advisor,

(b) an underwriter (distributor),

(c) a transfer agent or shareholder accounting record keeper, or

(d) an administrator authorised [sic] by written agreement to keep financial and/or other required records

for an Investment Company named as Assured while performing acts coming within the scope of the usual duties of an officer or Employee of any Investment Company named as Assured herein, or while acting as a member of any committee duly elected or appointed to examine or audit or have custody of or access to the Property of any such Investment Company, provided that only Employees or partners of a transfer agent, shareholder accounting record keeper or administrator which is an affiliated person as defined in the Investment Company Act of 1940, of an Investment Company named as Assured or is an affiliated person of the adviser, underwriter or administrator of such Investment Company, and which is not a bank, shall be included within the definition of Employee.

* * *

8. Any general agent, Servicing Agent or Soliciting Agent whilst performing duties on behalf of the Assured.

* * *

11. Individuals retired under the Mass Mutual Agent Pension Plan who currently hold a Broker Contract.

Id. at 23-24. The Complaint alleges that Madoff fits into categories (1) and (5).

The Complaint adequately alleges that the Rye Funds retained Madoff and BMIS as their agents for the limited purposes of holding and managing assets for investment purposes, an act which the Rye Funds otherwise would do in their normal course of business. This satisfies category (1), which plausibly encompasses not only general agents, but also limited agents retained for a particular purpose. Such a reading finds support in the contrast between category (1), which speaks of "[a]ll consultants . . . and . .

. any person, firm or corporation appointed by the Assured to serve as its agent," and category (8), which specifically refers to "[a]ny general agent . . . performing duties on behalf of the assured." The specific use of "general agents" in category (8) implies that the use of "agent" in category (1) has a different and broader meaning. Elsewhere the Primary Bond uses inclusive terminology suggesting that both general and limited agents would be covered. The "Risk Details" summary for the Primary Bond refers to a $1 million deductible applying to "each and every loss in respect of all types of Agents, Representatives and Registered Representatives." *Id.* at 8. Rider Number 5 repeats this language, stating: "In respect of all types of agents, representatives and registered representatives and the like, the Single Loss Deductible under all Sections hereunder shall be USD 1,000,000 each and every loss." *Id.* at 54.

The Bond Underwriters respond that the Primary Bond requires an agency relationship in the common law sense, *viz.*, a "fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." Restatement (Third) of Agency § 1.01 (2006); *Theos & Sons, Inc. v. Mack Trucks, Inc.*, 729 N.E.2d 1113, 1119 (Mass. 2000) ("An agency relationship is created when there is mutual consent, express or implied, that the agent is to act on behalf and for the benefit of the principal, and subject to the principal's control."). The Bond Underwriters say that the Complaint does not allege sufficient facts to establish common law agency.

The definition of "Employee" in the Primary Bond does not clearly limit itself to common law agency relationships. The definition initially suggests a common law approach and broadly excludes "brokers, sub-agents, loan agents, fiscal agents, property management agents, real estate agents, or other representatives of the same general character." Primary Bond at 23. The definition then blurs these boundaries by identifying eleven broad categories of persons that the definition "shall also be deemed to mean . . . ." These categories extend the definition into hazier realms, such as "consultants used and supervised by the Assured," "any person, firm or corporation appointed by the Assured to serve as its agent," certain "investment advisor[s]," certain "underwriter[s]," and "[i]ndividuals retired under the Mass Mutual Agent Pension Plan who currently hold a Broker Contract."

The Primary Bond falls short of pellucid clarity in its use of agency terms. It is not clear at this stage of the case to what extent terms like "consultant," "agent," and "representative" are used interchangeably or in a limited common law sense. The circumstances of contracting and trade usage may shed light on the plain meaning of these terms. *See Affiliated FM*, 626 N.E.2d at 880. Alternatively, I may conclude at a later date that the language is ambiguous and look to extrinsic evidence or canons of construction. The Complaint alleges that there has been a course of dealing between MassMutual and the Assureds, and that during the past fourteen years the parties agreed to expand the definition of "Employee" on at least three occasions. For present purposes, the Rye Funds have pled that Madoff falls within category (1).

The Complaint also alleges that Madoff falls under category (5) because he was an "officer, partner or Employee . . . of an investment advisor [BMIS] . . . for an Investment Company named as Assured [the Rye Funds] while performing acts coming within the scope of the usual duties of an officer or Employee of any Investment Company named as an Assured herein [the Rye Funds]." Compl. ¶ 85. Again the plaintiffs plausibly allege that BMIS and Madoff were hired to perform acts coming within the usual duties of an officer or Employee of the Rye Funds, namely managing the funds' investments.

To cut off coverage under category (5), the Bond Underwriters assert that the Rye Funds are not "Investment Compan[ies]," arguing that this term must refer to companies governed by the Investment Company Act of 1940 ("the 1940 Act"). The Primary Bond does not define "Investment Company," whether by reference to the 1940 Act or otherwise. Moreover, according to the SEC, hedge funds like the Rye Funds are *private* investment companies.[8] They meet the definition of "investment company" that is set forth in the 1940 Act, although they are excluded from many of the 1940 Act's requirements.[9] The Complaint alleges that some insurance policies specifically limit the

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[8] *See* SEC, *Investment Company Registration and Regulation Package*, http://www.sec.gov/divisions/investment/invcoreg121504.htm (last visited July 21, 2010) ("Some private investment companies are commonly known as 'hedge funds.'") (citing *Staff Report to the [SEC]: Implications of the Growth of Hedge Funds* (2003) at Section III.A. (available at http://www.sec.gov/news/studies/hedgefunds0903.pdf)); *see also United States v. Harris*, 490 F.3d 589, 595 (7th Cir. 2007) (rejecting the argument that a hedge fund is not an "investment company").

[9] *See* 15 U.S.C. § 80a-3(a)(1)(A) (defining "investment company" as any entity that "holds itself out as being engaged . . . in the business of investing, reinvesting or trading securities"); 15 U.S.C. § 80a-3(c)(7)(D) ("An issuer that is excepted under this

term "Investment Company" to investment companies that are registered under the 1940 Act, while others define the term expansively to include registered and unregistered companies. At a minimum, the term "Investment Company" is sufficiently uncertain and equivocal in the context of the Primary Bond to merit denying the motion to dismiss. *See Affiliated FM*, 626 N.E.2d at 880. As with the Primary Bond's free-wheeling use of agency terms, the circumstances of contracting and trade usage may shed light on the plain meaning of "Investment Company," or the term may well prove ambiguous. The plaintiffs have proffered a reasonable reading, which is all that is required at the motion to dismiss stage.

The Bond Underwriters other response to category (5) is hyper-technical. According to the Bond Underwriters, category (5) only can be invoked by an entity "named as Assured" in the Primary Bond. *See* Primary Bond at 24 (defining category in terms of "an Investment Company named as Assured"). The Bond Underwriters maintain that the Primary Bond distinguishes between "Assureds" and those entities "named as Assured." The latter ostensibly means an entity actually identified by name in the Primary Bond or on the Schedule of Assureds. The former encompasses any entity meeting the definition of "Assured," regardless of whether it appears by name.

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paragraph shall nonetheless be deemed to be an investment company [for specifically identified purposes]"); *Commc'ns Workers of Am. v. Rousseau*, 2008 WL 3876032, at *13 (N.J. Super. Ct. App. Div. Aug. 22, 2008) ("We recognize that as a general matter private equity funds and hedge funds are investment companies that fall within one of the 1940 Act's many exemptions.").

The language of the Primary Bond does not support this distinction; instead it treats the two concepts as equivalent. The Preamble defines "Assured" as:

> MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY and as per the Schedule of Assureds and any interest now or hereafter owned, controlled or operated by any one or more of those named as Assured; and any pension plan, profit sharing plan under the sponsorship of the Assured which may be required to be bonded under the terms of the Employee Retirement Income Security Act of 1974, . . .
>
> *hereinafter referred to as Assured* . . . .

Primary Bond at 22 (emphasis added). The Declarations define "Assured" similarly:

> Item 1. Name of Assured *(herein called Assured)*.
>
> MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY and as per the Schedule of Assureds and any interest now or hereafter owned, controlled or operated by any one or more of those named as Assured; and any pension plan, profit sharing plan under the sponsorship of the Assured which may be required to be bonded under the terms of the Employee Retirement Income Security Act of 1974.

Id. at 19 (emphasis added). Both definitions use the phrase "named as Assured," then equate the result with "Assured."

The Schedule of Assureds further contradicts the Bond Underwriters' distinction. After listing eighteen pages of entities and separate accounts by name, the Schedule of Assureds concludes with the following catch-all category, printed in bold type:

> And all subsidiaries and affiliates of Massachusetts Mutual Life Insurance Company, all employee and/or agency benefit plans offered by Massachusetts Mutual Life Insurance Company, and all separate investment accounts and funds advised by Massachusetts Mutual Life Insurance Company, which have been in existence at any time, and which shall be created during the term of this bond.

Id. at 79. The Rye Funds fall within this catch-all category. Were I to accept the Bond Underwriters' position and treat the Schedule of Assureds as defining the universe of

those "named as Assureds," then the Rye Funds would fall within that term. I instead regard the catch-all category as a further reason to reject the Bond Underwriters' interpretation.

Given these provisions, the Primary Bond cannot reasonably be read as creating a substantive distinction between an "Assured" and those "named as Assured." The plaintiffs have pled a claim that Madoff and BMIS fall within category (5).

3. The Additional Assureds Are Differently Situated.

Although the Rye Funds have stated a claim under the Fidelity Clause to recover the funds Madoff stole, the Additional Assureds are differently situated. The Complaint does not allege that any of the Additional Assureds invested funds directly with Madoff and BMIS. The same concept of corporate separateness that allows the Rye Funds to state a claim prevents the Additional Assureds from doing so. To the extent the Additional Assureds are entitled to coverage under the Fidelity Clause, it depends on the degree to which coverage is available for the Underlying Actions. *See* Part E, *infra*.

D. The Complaint States A Claim Under The On Premises Clause.

The Complaint alternatively invokes insuring clause (B) of the Primary Bond. This clause provides coverage for:

> Any loss of Property through robbery, burglary, common-law or statutory larceny, theft, false pretenses, hold-up, misplacement, mysterious unexplainable disappearance, damage or destruction (whether effected with or without violence or with or without negligence on the part of any of the Employees, general agents of the Assured, Soliciting Agents or Servicing Agents) and any loss of subscription, conversion, redemption or deposit privileges through the misplacement or loss of Property, *while the Property is (or is supposed to be) within any of the Assured's offices covered under this bond, or within any office of any (a) general agent of the Assured, (b)*

> *Soliciting Agent or (c) Servicing Agent, or within the offices of any banking institutions, stockbrokers, investment bankers or any financial institution or clearing houses wherever located, or within any recognized places of safe deposit wherever located . . . .*

Primary Bond at 27 (emphasis added) (the "On Premises Clause"). Compared to comparable language in Standard Form No. 24, the On Premises Clause is strikingly broad. *See Financial Institution Bonds, supra*, at 984 (covering "[l]oss of Property resulting directly from . . . theft, false pretenses, common-law or statutory larceny, *committed by a person present in an office or on the premises of the insured, while the Property is lodged or deposited within offices or premises located anywhere*") (emphasis added).

The Complaint pleads a *prima facie* case of coverage under the On Premises Clause. The Complaint adequately alleges that the plaintiffs are Assureds. The Complaint adequately alleges that the Assureds entrusted hundreds of millions of dollars to Madoff and that the funds should have been within Madoff's offices or "within the offices of any banking institutions, stockbrokers, investment bankers or any financial institution or clearing houses wherever located" in connection with the Assureds transaction of business. While the funds were there, Madoff stole them.

To defeat coverage, the Bond Underwriters rely on an exclusion from coverage for "[a]ny loss resulting directly or indirectly from trading, whether in the name of the Assured or otherwise, in a genuine or fictitious account." Primary Bond at 35 (the "Trading Loss Exclusion"). The Trading Loss Exclusion does not apply to Insuring

Clauses (A), (D) or (E). *Id.* The On Premises Provision is insuring clause (B) and hence subject to the Trading Loss Exclusion.

Versions of the Trading Loss Exclusion have been incorporated in financial fidelity bonds since 1918. Broeman, *supra*, at 464. "The obvious purpose of the trading exclusion is to exempt from coverage losses caused by market forces, misjudgments of those forces by buyers and sellers of securities, or various errors or omissions – *e.g.*, a failure to execute an order – in the course of trading." *Glusband v. Fittin Cunningham & Lauzon, Inc.*, 892 F.2d 208, 211 (2d Cir. 1989).[10] The exclusion limits protection under the bond to "embezzlement and embezzlement-like acts." Broehman, *supra*, at 464-65 (quoting *Glusband*, 892 F.2d at 212).

The Trading Exclusion does not apply to the losses alleged in the Complaint. Madoff did not lose money through reckless, improvident, or even dishonest trading.

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[10] *Accord First Fid. Sav. & Loan Ass'n. v. Fid. & Deposit Co.*, 895 F.2d 254, 260-61 (6th Cir. 1990) (construing trading exclusion to cover "market losses" and agreeing with "the common sense interpretation [of] 'trading losses' [as] those losses which result from fluctuations in market value of securities purchased"); *Ins. Co. of N. Am. v. Gibralco, Inc.*, 847 F.2d 530, 533 (9th Cir. 1988) ("Trading losses are generally understood to be market losses sustained by firms as a result of ill-advised, unauthorized, or simply unlucky trading decisions made in the purchasing, selling, or trading of securities."); *see Roth v. Md. Cas. Co.*, 209 F.2d 371, 373-74 (3d Cir. 1954) (holding that trading exclusion applied to market losses suffered by customers as a result of broker's unauthorized trading); *Shearson/Am. Express, Inc. v. First Cont'l Bank and Trust Co.*, 579 F. Supp. 1305, 1311 (W.D. Mo. 1984) (holding that trading loss exclusion covered "a loss resulting from the purchase or sale of securities"); *Harris v. Nat'l Sur. Co.*, 155 N.E. 10, 11 (Mass. 1927) (applying trading exclusion to bar coverage for market losses suffered as a result of employee's unauthorized trading in customer's account).

Madoff was a thief. He engaged in embezzlement and embezzlement-like acts. The trading exclusion does not apply to outright theft.

The Bond Underwriters also attempt to defeat coverage under the On Premises Clause by arguing the Complaint "fail[s] to allege facts demonstrating a loss through theft or false pretenses." DRB at 21. They further contend "[t]hat a loss of Property occurred through theft is not possible because the Rye Funds intentionally and voluntarily gave Mr. Madoff their customers' investments." *Id.* at 21-22. In light of what is known about Madoff's *modus operandi*, this is a particularly aggressive argument. Indeed, in support of one of their other arguments, the Bond Underwriters ask me to take judicial notice of the transcript of Madoff's sentencing hearing, during which Madoff admitted that he knowingly caused false trading confirmations and client account statements to be prepared and sent to clients, that those documents reflected bogus transactions and positions, and that the clients had no way of knowing the information was false. The Complaint appropriately alleges that Madoff stole hundreds of millions of dollars of Rye Fund assets and did so under false pretenses.

E. The Complaint States A Claim For Losses Resulting From Third-Party Lawsuits.

The Complaint asserts that the Primary Bond covers losses that the Assureds will suffer as a result of the Underlying Actions. Under Massachusetts law, evaluating such a claim requires measuring each claim asserted in the Underlying Actions against the coverage provided by the Primary Bond. *See Cont'l Cas. Co. v. Gilbane Bldg. Co.*, 461 N.E.2d 209, 213 (Mass. 1984).

The parties have not attempted the labor-intensive task of measuring claims against policy language. Consistent with notice pleading under Rule 8, the Complaint alleges that coverage generally exists for the Underlying Actions, leaving the particularized showing for a later stage of the case. For their part, the Bond Underwriters argue that the Underlying Actions cannot qualify for coverage because a third-party claim cannot ever give rise to "loss resulting directly from one or more dishonest or fraudulent acts," as the Fidelity Clause requires.[11]

The Bond Underwriters are largely but not entirely correct.

> It is important to distinguish between claims based upon the insured's liability for damages caused by an employee's perpetration of fraud on a third party, and claims based upon the employee's misappropriation of a third party's property while in the possession of the insured. The former are not covered. . . . Because the insured's liability arises incidentally under a theory of vicarious liability, any losses resulting therefrom constitute an indirect loss which is outside of the scope of coverage.
>
> That said, although fidelity bonds do not cover an insured's liability to a third party, they likely will (subject to other defenses) cover the misappropriation of a third party's property while in the possession and control of the insured. Such claims are covered not because the insured may be liable to the owner for the misappropriation of its property, but rather because the ownership provision in standard form fidelity bonds extends coverage to the property itself while [in] the possession and control of the insureds.

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[11] DOB at 12; *see id.* at 14 ("the fidelity bond responds only to a direct loss to the insured, not to circumstances that caused damage to a third-party"); *id.* at 18 ("Any holding that plaintiffs have or will have incurred losses covered by the Bond by reason of the claims asserted by third-party investors in the Underlying Litigation would render [the indirect loss exclusion] meaningless . . . .").

Scott L. Schmookler, *The Compensability of Third-Party Losses Under Fidelity Bonds*, 7 Fidelity L.J. 115, 115 (2001).[12]

Third-party litigation plays a central role in establishing the scope of coverage when a third party's property has been misappropriated.

> [T]he mere misappropriation of such property, without a corresponding claim and finding of liability against the insured for that loss, is not compensable under the bond. Common sense dictates that if the third party fails to pursue a claim against the insured or the insured successfully defeats the claim, the insured cannot profit from its employee's misconduct by asserting a bond claim.

Id. at 140-41. A fidelity bond covers the third-party litigation over the loss of the third party's property because, if the claim is successful, it could give rise to a loss under the bond. A fidelity bond also might cover a third-party loss under other circumstances, such as if "dishonest employees intended to cause the third-party loss, and knew or expected

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[12] *Accord Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co.*, 676 N.Y.S.2d 559, 565 (N.Y. App. Div. 1998) (noting that a third-party claim can give rise to coverage when "the employee acted dishonestly and the [third party's] property is taken from or lost by the insureds/employer that has custody of the property"). For decisions addressing this scenario, *see*, *e.g.*, *Nelson v. ITT Hartford Fire Ins. Co.*, 2000 WL 763772, at *1-2 (10th Cir. June 13, 2000) (holding that where employee of real estate closing administrator misappropriated client funds from administrator's escrow account, administrator's fidelity bond insurer "liable to pay those claims for losses against the [insured] as they are established by the defrauded clients/creditors"); *Fid. & Deposit Co. v. USAFORM Hail Pool, Inc.*, 523 F.2d 744, 753-54 (5th Cir. 1975) (holding that fidelity coverage was available where insureds' employees wrongfully withdrew monies held in trust for third parties); *Elmer Fox & Co. v. Commercial Union Ins. Co.*, 274 F.Supp. 235, 237-39 (D. Colo. 1967) (finding that misappropriation of funds belonging to accounting clients of insured constituted loss under fidelity bond); *Alberts v. Am. Cas. Co.*, 200 P.2d 37, 41 (Cal. Ct. App. 1948) (construing insurance policy to cover liability for funds in custody of insured's employee); *Am. Empl. Ins. Co. v. Johnson*, 47 S.W.2d 463, 464, 466 (Tex. Civ. App. 1932) (treating funds entrusted to insured and lost through fraudulent act of employee as insured's loss).

that the loss would migrate to the [insured]," but only if the migratory route were "short, certain, and obvious." *Peoples Bank & Trust Co. v. Aetna Cas. & Sur. Co.*, 113 F.3d 629, 634 (6th Cir. 1997).

Because the Bond Underwriters' categorical no-coverage position is incorrect, I deny the motion to dismiss. This is not to suggest that all or even many of the claims in the Underlying Actions are covered. If the three complaints submitted by the Bond Underwriters are representative of the Underlying Actions, it appears that few (if any) of the claims could trigger coverage. But those are determinations that I need not make now and will not make without targeted briefing from the parties.

1. The Primary Bond Provides First-Party Property Coverage, Not Third-Party Tort Liability Coverage.

The analysis of coverage for third-party claims necessarily starts with the insuring clauses in the Primary Bond. The parties have focused on the Fidelity Clause, which provides coverage for "[l]oss *resulting directly from* one or more dishonest or fraudulent acts of an Employee or general agent of the Assured, committed anywhere and whether committed alone or in collusion with others, including loss of Property *resulting directly from* such act of an Employee or general agent." Primary Bond at 26 (emphasis added). The phrase "resulting directly from" has critical implications for the scope of coverage for third-party claims.

Whether a fidelity bond covers losses resulting from third-party claims has been litigated repeatedly over the decades across multiple jurisdictions. Generally speaking, courts have read the scope of coverage more broadly than bond underwriters believed

warranted, and the Surety Association responded to adverse rulings by tinkering periodically with the language of its form. Policy evolution accelerated during the ten years from 1969 to 1979, when the Surety Association "developed a number of riders to amend the standard bond language that eventually were incorporated into the 1980 revision of Standard Form No. 24." Duke, *supra*, at 12-13. The primary purpose of the 1980 revision was "to address broad judicial interpretation of the form and reflect changes in the nature of the banking industry." *Id.* at 13. "[N]o amendment affected the compensability of losses resulting from an insured's vicarious liability to a third party as significantly as the 1980 revisions." Schmookler, *supra*, at 117-18.

Prior to the 1980 revision, the overwhelming majority of courts held that "a suit by a third party against the insured for damages due to an employee's dishonest acts is a 'loss of money or property' under the bond." Frank Mays Hull, *Surety's Liability for Attorneys' Fees and Court Costs Under Fidelity Bonds*, 14 Forum 634, 641 (1978-1979); *see generally* Arthur C. Bailey, *The Insurer's Dilemma When Tendered Defense of a Suit Containing Allegations of Fraud or Regulatory Violations*, 8 Forum 354 (1972-1973) (discussing problems created by rule for bond underwriters in deciding whether to assume defense of case). Shortly after the 1980 revision, another commentator summarized the law as follows:

> Generally, courts have tended to find coverage where the legal liability of the insured is based on the third party's damage resulting from an act which, if directed against the insured, would have resulted in a covered loss. . . . [T]he bulk of such third-party claims involve the bond's 'dishonesty' coverage.

Duncan L. Clore, *Suits Against Financial Institutions: Coverage and Considerations*, 20 Forum 84, 85 (1984). Only California and Nebraska followed the then-minority rule that "coverage for losses resulting from third-party claims [is] simply never available under fidelity bonds." Karen Wildau, *Evolving Law of Third-Party Claims Under Fidelity Bonds: When is Third Party Recovery Allowed?*, 25 Tort & Ins. L.J. 92, 95 (1989); *see generally* Schmookler, *supra*, at 118-23 (discussing pre-1980 revision case law).

In an effort to restrict coverage for losses resulting from third-party claims, the 1980 revisions made three major changes to Standard Form No. 24. The most significant was a new definition of dishonesty under which the employee must act with "manifest intent" to cause the insured to sustain a loss and to obtain a financial benefit. Duke, *supra*, at 13.

The 1980 revision also added three exclusions providing that coverage would not be available for:

> (i) Potential income . . . including but not limited to interest and dividends, not realized by the Insured because of a loss covered under this bond.
>
> (ii) All damages of any type for which the Insured is legally liable, except compensatory damages arising from a loss covered under this bond.
>
> (iii) All costs, fees and other expenses incurred by the Insured in establishing the existence of or amount of loss covered under this bond.

Id. at 14-15. When the Surety Association first rolled out these provisions as standard form riders, the Assistant Secretary of the Association wrote an article explaining that they were designed to address "[t]hree specific instances of consequential damage[s]." Robin V. Weldy, *A Survey of Recent Changes in Financial Institutions Bonds*, 12 Forum

895, 898 (1977). The first emphasized that a fidelity bond "does not guarantee the profits to the financial institution." *Id.* Loss is limited to out-of-pocket loss. *Id.* The second emphasized that "the surety is not responsible for any punitive or exemplary damages assessed against an insured institution by reason of tortious or dishonest conduct of an employee involving a third party." *Id.* The third addressed a specific type of consequential damages by excluding coverage for audit fees and investigatory fees. *Id.*

What received the least attention from contemporaneous commentators was an additional change in the causational language of the fidelity clause. The new causational phrase "directly resulting from" replaced the old phrase "loss resulting through." Duke, *supra*, at 15. This change was intended "to emphasize that the Form 24 covered only direct loss." *Id.* The change has proved pivotal.

As cases involving the revised bond language moved through the courts, a new majority rule emerged under which coverage generally is unavailable for third-party claims.[13] The now prevailing approach starts from the indisputable proposition that fidelity bonds provide indemnification against first-party property loss, not protection

[13] Cases following the majority rule include *First State Bank v. Ohio Cas. Ins. Co.*, 555 F.3d 564, 570–71 (7th Cir. 2009); *Vons Cos., Inc. v. Fed. Ins. Co.*, 212 F.3d 489, 492–93 (9th Cir. 2000); *FDIC v. Nat'l Union Fire Ins. Co.*, 205 F.3d 66, 76 (2d Cir. 2000); *Lynch Props., Inc. v. Potomac Ins. Co.*, 140 F.3d 622, 629 (5th Cir. 1998); *Direct Mortgage Corp. v. Nat'l Union Fire Ins. Co.*, 625 F. Supp. 2d 1171, 1175–76 (D. Utah 2008); *RBC Mortgage Co. v. Nat'l Union Fire Ins. Co.*, 812 N.E.2d 728, 733 (Ill. App. Ct. 2004); *Kidder, Peabody*, 676 N.Y.S.2d at 564-65.

against third-party liability.[14] "The difference turns on what is defined as the risk. [Liability] [i]nsurance covers the liability of the insureds to a third party, while fidelity bonding covers the loss of property owned by the insureds or held by the insureds, as a consequences of employee dishonesty." *Kidder, Peabody*, 676 N.Y.S.2d at 565. "Although employee dishonesty policies may cover the loss of third-party property in the possession of the insured, these policies do not serve as liability insurance to protect employers against tortious acts committed against third parties by their employees." *Lynch Props.*, 140 F.3d at 629 (citation omitted); *accord Vons*, 212 F.3d at 492; *City of Burlington v. W. Sur. Co.*, 599 N.W.2d 469, 472 (Iowa 1999); *Travelers Ins. Cos. v. P.C. Quote, Inc.*, 570 N.E.2d 614, 621 (Ill. App. Ct. 1991).

Courts following the new majority rule also rely heavily on the "resulting directly from" language, interpreting it as requiring an immediate causal connection between the dishonest or fraudulent conduct and the loss. Fidelity coverage is "meant to insure . . . against immediate harm from employee dishonesty . . . ." *Lynch Props. Inc. v. Potomac*

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[14] *See, e.g.,* Bogda M.B. Clarke *et al.*, *"Loss Resulting Directly From ....": Causation Under the Financial Institution Bond and Similar Insurance Forms*, 9 Fidelity L.J. 25, 27 (2003) ("The Financial Institution Bond, from its inception, has been a first-party indemnity contract . . . ."); Kevin J. Russel, *It Depends on What the Meaning of "Direct" Is: The Direct Loss Requirement Under Fidelity Policies*, 47 No. 9 DRI For Def. 53, 53 (2005) ("One thing is clear: employee dishonesty coverage is not liability coverage. Rather, it is first-party indemnity coverage."); Schmookler, *supra*, at 115 ([Fidelity bonds] . . . are not liability policies, and do not provide blanket coverage for an insured's vicarious liability to a third party."); Gary J. Valeriano & Carleton R. Burch, *The Interpretation of a Direct Loss Under Liability Bonds*, 33 Brief 32, 38 (2004) ("The clear trend among courts is to recognize that a fidelity bond is an indemnity policy, not a liability policy, and that these policies generally do not provide coverage for third-party losses.").

Ins. Co., 962 F. Supp. 956, 964 (N.D. Tex. 1996), *aff'd*, 140 F.3d 622 (5th Cir. 1998). Many of the cases simply pronounce that "direct means direct."[15] When employee fraud or dishonesty targets a third party, it is the third party that suffers the direct loss as a result of the fraud. *See Kidder, Peabody*, 676 N.Y.S.2d at 564. The insured's liability arises indirectly through the doctrine of vicarious liability or another tort theory. *See id.* Although the Massachusetts Supreme Court has not yet spoken, courts applying Massachusetts law have followed the new majority rule.[16]

The Fidelity Clause in the Primary Bond employs the same causal language as Standard Form No. 24. It should be interpreted consistently with cases interpreting

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[15] *See First State Bank*, 555 F.3d at 570–71 ("direct means direct"); *Vons*, 212 F.3d at 492–93 ("We hold that 'direct' means 'direct' . . . ."); *Direct Mortgage*, 625 F. Supp. 2d at 1175–76 ("direct means direct"). The minority approach interprets "direct loss" as incorporating the concept of proximate cause, which is a marginally broader standard that more readily encompasses some losses imposed by third-party claims. *See Scirex Corp. v. Fed. Ins. Co.*, 313 F.3d 841, 850 (3d Cir. 2002); *Jefferson Bank v. Progressive Cas. Ins. Co.*, 965 F.2d 1274, 1284-85 (3d Cir. 1992); *First Am. State Bank v. Cont'l Ins. Co.*, 897 F.2d 319, 326 (8th Cir. 1990); *Graybar Elec. Co., Inc. v. Fed. Ins. Co.*, 567 F. Supp. 2d 1116, 1127 (E.D. Mo. 2008); *Frontline Processing Corp. v. Am. Econ. Ins. Co,* 149 P.3d 906, 911 (Mont. 2006); *Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.*, 854 A.2d 378, 385-86 (N.J. 2004).

[16] *See Fireman's Fund Ins. Co. v. Special Olympics Int'l, Inc.*, 346 F.3d 259, 263 (1st Cir. 2003) (stating that "courts typically deem third-party losses as outside the coverage of fidelity policies"); *Atlas Metals Prods. Co. v. Lumbermans Mut. Cas. Co.*, 829 N.E.2d 257, 262 (Mass. App. Ct. 2005) ("To extend the insurance coverage as Atlas advocates would, in effect, transform this employee dishonesty fidelity policy into a general liability policy . . . ."); *Commerce Bank*, 2005 WL 4881101, at *4 (distinguishing a first-party fidelity bond from a third-party liability insurance policy); *see also Stop & Shop Cos. v. Fed. Ins. Co.*, 946 F. Supp. 99, 106 (D. Mass. 1996), *rev'd on other grounds*, 136 F.3d 71 (1st Cir. 1998) (holding under Massachusetts law that "direct loss" refers to immediate damage resulting from covered cause and that "directly" means "immediately").

Standard Form No. 24. Because Massachusetts follows the new majority rule, the "directly resulting from" language in the Fidelity Clause generally bars coverage for third-party claims seeking to impose loss on the insured because of the tortious acts of its employees and representatives.

2. Other Provisions In The Primary Bond Provide First-Party Coverage for Loss Resulting From A Third-Party Claim.

There are several provisions in the Primary Bond that on their face relate to third-party actions. The Assureds argue that these provisions demonstrate that the Primary Bond covers third-party claims, or at least render the Primary Bond ambiguous. These provisions do govern third-party actions, but only to the limited extent that the resulting loss could trigger coverage under one of the insuring clauses. The provisions do not contemplate third-party liability coverage. Their purpose is to address claims arising out of the misappropriation of a third party's property while in the insured's possession, a scenario where the Primary Bond provides first-party coverage. *See* Schmookler, *supra*, at 133-34.

The Fidelity Clause defines coverage in terms of a "loss," including "loss of Property." Two other provisions address what can be lost. The first defines the term "Property." The second defines the interest that the insured must have in the Property for it to be covered by the policy. *See* 1A *Couch on Insurance* at § 17:8 (noting requirement of insurable interest for property insurance). Both provisions contain phrases that might suggest coverage for third-party claims, but which courts have interpreted narrowly and consistent with first-party coverage. These provisions are "not intended to extend

coverage to losses resulting from an insured's legal liability to a third party, but rather to extend coverage to the loss of a third party's property while in the possession and control of the insured." Schmookler, *supra*, at 133.

The definition of "Property" states:

> "Property", wherever used in this bond, shall be deemed to mean money, currency, coin, bank notes, Federal Reserve notes, postage and revenue stamps, U.S. Savings Stamps, bullion, precious metals of all kinds and in any form and articles made therefrom, jewellery [sic], watches, necklaces, bracelets, gems, precious and semi-precious stones, bonds, securities, evidences of debts, debentures, scrip, certificates, receipts, warrants, rights, transfers, coupons, drafts, bills of exchange, acceptances, notes, checks, withdrawal orders, money orders, travelers' letters of credit, bills of lading, abstracts of title, insurance policies, deeds, mortgages upon real estate and/or upon chattels and upon interest therein, and assignments of such policies, mortgages and instruments, and other valuable papers and documents, and all other instruments similar to or in the nature of the foregoing, *in which the Assured has an interest or which are held by the Assured for any purpose or in any capacity and whether so held gratuitously or not and whether or not the Assured is liable therefor, and chattels which are not hereinbefore enumerated and for which the Assured is legally liable.*

Primary Bond at 23 (the "Property Definition") (emphasis added).

The Property Definition identifies two broad types of property. The first type, exemplified by a long list of items notable for their portability and high degree of moneyness, qualifies as "Property" (i) if "the Assured has an interest" in it or (ii) if the Assured held it "for any purpose or in any capacity and whether so held gratuitously or not and whether or not the Assured is liable therefore." *Id.* The second type – "chattels which are not hereinbefore enumerated" – qualifies as "Property" if the Assured is "legally liable" for it. *Id.*

The interest provision, entitled "Ownership" states:

> This bond shall apply to loss of Property (1) owned by the Assured, (2) held by the Assured in any capacity, or (3) for which the Assured is legally liable. This bond is for the sole use and benefit of the Assured named in the Declarations.
>
> However, coverage provided under the Insuring Agreements of this bond shall be deemed to include amounts which the Assured is legally liable to pay a third party as a direct result of loss otherwise meeting the conditions and limitations of this bond.

Primary Bond at 41-42 (the "Ownership Provision"). The first two sentences of the Ownership Provision track language that appeared in Standard Form No. 24 prior to the 2004 revision. *Financial Institution Bonds, supra*, at 988.[17] The third sentence does not appear in the standard form, and the Complaint alleges that it was specifically bargained for by the Assureds. *See id.* at 983-88.

Both the Property Definition and the Ownership Provision employ the phrase "legally liable." The Property Definition uses it twice. Money and money-like instruments not owned by the Assured qualify as Property if held "for any purpose or in any capacity . . . *and whether or not the Assured is liable therefor*." Primary Bond at 23. Other chattels qualify as Property only if "the Assured is legally liable." The Ownership Provision speaks in similar terms by extending coverage to Property not owned by the

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[17] *Compare Financial Institution Bonds, supra*, at 988 (Section 10, Ownership, in 1986 version) *and id.* at 1001 (Section 10, Ownership, in 1980 version) *with id.* at 973 (Section 12, Covered Property, in 2004 version). The 2004 revisions eliminated the phrase "legally liable" from the Financial Institution Bond. The new interest provision states: "This bond shall apply to loss of Property (1) owned by the Insured, (2) held by the Insured in any capacity, or (3) owned and held by somebody else under circumstances which make the Insured responsible for the Property prior to the occurrence of the loss." *Id.* at 973.

Assured if it is "held by the Assured in any capacity" or "for which the Assured is legally liable." *Id.* at 41.

To a reader unversed in first-party insurance law, or to an insured looking for a textual hook for third-party coverage, the phrase "legally liable" might be thought to encompass liability imposed in a third-party action. But when used in an interest provision like the Ownership Provision, the terms "liable" and "legally liable" come laden with the accumulated interpretations of decades of precedent. Courts during the nineteenth and early twentieth centuries regularly considered claims by bailees who held goods and took out insurance on property "for which the insured is liable." *See* 11 *Couch on Insurance* at § 154:34. When a loss occurred, insurers relied on this language to deny coverage unless the insured had been judicially determined to be responsible for the loss, *i.e.*, "legally liable." Courts rejected the insurers' interpretation, holding that the terms did not refer to any fixed legal liability to respond in damages, but rather were used in a generic sense to denote responsibility for the property.[18]

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[18] 11 *Couch on Insurance* at § 154:34 ("the term 'liable,' as used in the policy, was not intended to describe a particular fixed legal liability which would require a showing that the insured was responsible by contract or in tort for the fire loss, but, instead, referred to his liability or 'responsibility' as a bailee"); 43 Am. Jur. 2d *Insurance* § 197 ("Policy provisions covering property contained in specified places and 'for which the insured is liable' insure against loss of the property, and do not indemnify the insured against his or her legal responsibility in tort or by contract to the owners of the property . . . ."); *see, e.g., Paktank Louisiana, Inc. v. Marsh & McLennan, Inc.*, 688 F. Supp. 1087, 1090-91 (E.D. La. 1988) ("the phrase 'the property of others for which the Insured may be liable' is an unambiguous phrase providing property damage coverage for the property of others where [the insured] has a present and existing general responsibility by virtue of a bailment"); *Folger Coffee Co. v. Great Am. Ins. Co.*, 333 F. Supp. 1272, 1274 (W.D. Mo. 1971) ("the courts have almost uniformly held that if, from the contract construed in

Courts have followed these precedents when interpreting fidelity bonds. The leading case is *Lynch*. There, a bookkeeper employed by Lynch Properties, Inc., enjoyed access to the personal bank account of Martha Lynch, the mother of the company's president. 140 F.3d at 625. By oral agreement, Lynch Properties managed Ms. Lynch's property and investments, kept track of her personal bank account, and paid her personal bills. *Id.* The bookkeeper misappropriated Ms. Lynch's funds. When Lynch Properties discovered the theft, it reimbursed Ms. Lynch and made a claim under its fidelity policy, which covered property "[f]or which you are legally liable." *Id.* at 626. Lynch Properties

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its entirety, the fair interpretation and construction of the insurance contract is that it was intended primarily to cover the property held by the insured, then 'liable,' as used within the policy, does not refer to any fixed legal liability of the insured to respond in damages, but should be construed more broadly to mean 'responsible'"); *Penn v. Commercial Union Fire Ins. Co.*, 101 So.2d 535, 537 (Miss. 1958) (interpreting "liable" in interest clause to mean "responsible" and cover loss of customers' property due to fire without regard to whether the insured was liable in tort to its customers for the fire that caused the loss). Some courts required a prior judicial determination of liability as an additional requirement for coverage. *See, e.g., Millers' Mut. Fire Ins. Ass'n v. Warroad Potato Growers Ass'n,* 94 F.2d 741, 742 (8th Cir. 1938); *Orient Ins. Co. v. Skellet Co.*, 28 F.2d 968, 969 (8th Cir. 1928); *Washburn-Crosby Co. v. Home Ins. Co.*, 85 N.E. 592, 592 (Mass. 1908). The underlying insurable interest nevertheless rested on "legal liability" in the sense of responsibility for the property prior to the lawsuit. *See Winters v. State Farm Fire & Cas. Co.*, 73 F.3d 224, 227 (9th Cir. 1995) (holding that language like "liable" or "legally liable" "affords coverage only to the extent of the value of the bailed property, and does not cover liability to third parties in tort or contract"); *Globe & Rutgers Fire Ins. Co. v. United States*, 202 F.2d 696, 697 (5th Cir. 1953) ("the phrase 'provided the insured is legally liable therefor,' when considered in connection with these policy provisions providing insurance on property, should be considered to refer to the present and existing liability of the custodian generally and not restricted to liability which was the consequence alone of a fire"); *see generally* D.E. Bucker, *Fire Policy on Contents or the Like as Covering Property of Insured's Customers or Bailors*, 67 A.L.R.2d 1241 (1959 & Supp. 2010) (discussing different interpretations of provisions referring to insured's "liability" or "legal liability").

argued that because its employee stole funds from Mr. Lynch, it was vicariously liable for the theft and "legally liable" for the funds. *Id.* at 629.

The *Lynch* court rejected this argument, distinguishing between liability for the property (in the sense of responsibility) before the theft and liability in tort for damages as a result of the theft:

> [Lynch Properties] does not argue . . . that it was legally liable for the funds prior to their theft. Instead, it argues only that once [the bookkeeper] misappropriated the funds, it became liable to Mrs. Lynch to replace those funds and that Potomac must indemnify it for that reimbursement because [the bookkeeper] stole the funds in the course of her duties at Lynch Properties. While Lynch Properties thereby argues how it may be vicariously liable for [the bookkeeper's] acts, this argument fails to show how it was "legally liable" for the stolen property itself, that is, for the funds in Mrs. Lynch's account. Acceptance of Lynch Properties' argument would mean that Potomac's policy would cover any loss where an employee takes a customer's property in the course of their employment responsibilities, regardless of whether the employer had any interest in the property itself. Furthermore, it would transform this policy, which insures *property loss* for which Lynch Properties is legally liable, into a policy insuring any vicarious liability arising from an employee's dishonesty. This argument is foreclosed by the plain language of the "Interest Covered" provision, which requires that the employer have some interest in the misappropriated property, whether that be because the employer owns, holds, or is legally liable for the property.

Id. at 629 (footnote omitted); *accord Vons*, 212 F.3d at 491.

The Massachusetts Supreme Court has not spoken on this issue either; however, courts applying Massachusetts law have followed *Lynch*. *See Atlas Metals*, 829 N.E.2d at 259 n.4, 262; *see also Fireman's Fund Ins. Co. v. Special Olympics Int'l, Inc.*, 249 F. Supp. 2d 19, 28 (D. Mass. 2003) (applying Massachusetts law; noting that parties had not relied on the "legally liable" language in fidelity bond but expressing view that *Lynch* interpreted language correctly), *aff'd on other grounds,* 346 F.3d 259 (1st Cir. 2003).

The phrase "legally liable" in the Property Definition and the Ownership Provision therefore cannot be read to extend coverage to losses resulting from the imposition of tort liability through a third-party action. The phrase instead extends coverage to property which, prior to its misappropriation, was the legal responsibility of the Assureds. *See* Schmooker, *supra*, at 135 ("the ownership provision . . . covers loss of property as to which, prior to its misappropriation, the insured had possession and legal responsibility"); Valeriano & Burch, *supra*, at 36 ("For the insured to be legally liable for the property, its legal liability must attach before the acts complained of had occurred or independent of those acts").

This leaves the third sentence of the Ownership Provision, which states: "However, coverage provided under the Insuring Agreements of this bond shall be deemed to include amounts which the Assured is legally liable to pay a third party as a result of loss otherwise meeting the conditions and limitations of this bond." Primary Bond at 42. Unlike the first two sentences of the Ownership Provision, which track the form language of the pre-2004 versions of Standard Form No. 24, the third sentence cannot be found in the standard forms. But the sentence does not appear crafted out of whole cloth. It rather sets forth in the affirmative the scope of coverage described in the negative by Section I(l) of the Primary Bond. This exclusion states: "**THIS BOND DOES NOT COVER:** ... (l) All damages of any type for which the Assured is legally liable, except direct compensatory damages arising from a loss covered under this bond." Primary Bond at 35 (the "Indirect Loss Exclusion").

As noted, the Indirect Loss Exclusion was one of three exclusions added to Standard Form No. 24 in 1980 to limit coverage to direct compensatory damages. *See* Duke, *supra*, at 15; Clore, *supra*, at 86-87. The three exclusions sought to eliminate any potential exposure to consequential damages, statutory damages (including doubling and trebling), punitive damages, or penalties. Clore, *supra*, at 86-89. Compensatory damages are "defined as 'such damages as will compensate the injured party for the injury sustained, and nothing more; such as will simply make good or replace the loss caused by the loss or injury.'" *Id.* at 90 (quoting *Black's Law Dictionary* 467 (4th ed. 1968)).

When an insured holds or is legally responsible for a third party's property at the time of loss, a fidelity bond covers the property to the extent of the loss. As noted, "the mere misappropriation of such property, without a corresponding claim and finding of liability against the insured for that loss, is not compensable under the bond." Schmookler, *supra*, at 140-41. A loss only exists if the third party is successful on its claim. But in succeeding, the third party may obtain a judgment awarding more than the value of the misappropriated property at the time of the loss. Depending on the nature of the claim and the insured's culpability, the third party might be awarded statutory damages, penalties, or punitive damages. Even an award of compensatory damages can include additional, non-covered components.

> Compensatory damages have long been divided into two categories: those which are direct, also referred to as general damages; and those which are indirect and consequential, traditionally referred to as special damages. Direct damages are those which follow immediately from the breach or occurrence. Consequential damages are those which are reasonably foreseeable, but which do not result directly from the act of a party; rather from the consequences of the act.

Clore, *supra*, at 90-91 (footnotes omitted).

The Indirect Loss Exclusion and the third sentence of the Ownership Provision limit coverage under the Primary Bond to the direct, compensatory damages recovered by the third party. The provisions "exclude from coverage not only punitive, but also all indirect and consequential damages for which the insured may be liable under a judgment." *Id.* at 91; *accord* Wildau, *supra*, at 117-18 (summarizing and adopting Clore's view); *see Commerce Bank*, 2005 WL 4881101, at *4 n.3 (analogizing the requirement of direct loss under a fidelity bond to the distinction between direct and consequential damages in a breach of contract action).

The Assureds contend that they bargained specifically for the third sentence of the Ownership Provision, that it was intended to cover third-party actions, and that it must have additional meaning because it does not appear in Standard Form No. 24. The plain language of the provision does not plausibly support these arguments, particularly given the close textual relationship between the third sentence and the Indirect Loss Exclusion. The third sentence instead reads as belt-and-suspenders language. Through this addition, the drafters sought to eliminate any implication that the second sentence of the Ownership Provision ("This bond is for the sole use and benefit of the Assured named in the Declarations.") might eliminate coverage for a loss that otherwise would be covered by the first sentence ("This bond shall apply to loss of Property . . . (3) for which the Assured is legally liable."). Primary Bond at 41-42.

The Primary Bond's use of the phrase "legally liable" does not create generalized coverage for losses resulting from the imposition of tort liability in third-party actions. It

instead reaffirms that the Primary Bond contemplates coverage for losses resulting from a narrow category of third-party claims, principally those in which the insured held or was legally liable for a third party's property at the time of the loss.

3. The Need For Further Proceedings

As noted, the parties have not addressed the Underlying Actions in the claim-specific manner necessary to determine whether coverage exists. This decision should provide guidance as to how I will approach that analysis. The Assureds and the Bond Underwriters shall confer and determine how to present any claims where they cannot agree about coverage. If rulings are necessary, the issues should be presented in an efficient and targeted way, such as by grouping similar causes of action into categories or by seeking rulings on representative claims. In connection with briefing on any disputed claims, the Bond Underwriters collectively will be limited to a single brief or set of briefs. If particular Bond Underwriters believe that their bonds do not follow form to the Primary Bond and present a unique defense to coverage, then they may request leave to file a separate brief limited to their specific issue.

F. The Complaint States A Claim For Court Costs And Attorneys' Fees.

The Complaint seeks to recover court costs and attorneys' fees incurred in the Underlying Actions. The relevant language of the Primary Bond, which is not designated with a separate section or subsection reference, states:

COURT COSTS AND ATTORNEYS' FEES
(Applicable to all Insuring Clauses now or hereafter
forming part of this bond)

> The Underwriters will indemnify the Assured against court costs and reasonable attorney's fees incurred and paid by the Assured in defending any suit or legal proceeding brought against the Assured to enforce the Assured's liability or alleged liability on account of any loss, claim or damage which, if established against the Assured, would constitute a valid and collectible loss sustained by the Assured under the terms of this bond. Such indemnity shall be in addition to the amount of this bond.

Primary Bond at 33 (the "Defense Costs Provision"). This provision has been interpreted consistently as requiring the insurer to indemnify the insured for reasonable costs of defense in connection with a suit that, if successful, would result in relief that would qualify as a loss under the Primary Bond.[19] Because I cannot yet resolve the claims for coverage as to any of the Underlying Actions, I also cannot dismiss the claims under the Defense Costs Provision.

III. CONCLUSION

The Bond Underwriters' motions to dismiss are denied. IT IS SO ORDERED.

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[19] *E.g., First Am. State Bank*, 897 F.2d at 326 (holding that a settlement with third parties was a covered loss under fidelity bond and that it constituted a "legal proceeding" triggering recovery of reasonable attorneys' fees); *Nat'l Sur. Corp. v. Rauscher, Pierce & Co.*, 369 F.2d 572, 574, 579 (5th Cir. 1967) (affirming award of court costs and reasonable attorneys' fees incurred in defending suits arising out of fraudulent acts of an employee which were covered under fidelity bond); *Nat'l Sur. Corp. v. First Nat'l Bank*, 431 S.W.2d 353, 355 (Tex. 1968) ("liability for court costs and attorneys' fees is by the plain and unambiguous language of the bond very clearly limited to situations in which they are incurred in suits or legal proceedings in which liability or alleged liability of the insured, if established, would constitute a valid and collectible loss under other loss provisions of the bond"); Hull, *supra*, at 639 (interpreting identically worded provision; "the surety . . . specifically indemnifies the insured for attorneys' fees and court costs spent in defending claims causing losses covered by the Bond"); *see* Bailey, *supra*, at 354-56 (noting that provision obligates surety for attorneys' fees and costs in third-party action in addition to amount of coverage under the bond).