Cleaning up in the Wake of a Ponzi Scheme: Insurance Coverage for Financial Crime Claims

Contributed by Mary-Pat Cormier and Alexander G. Henlin, Edwards Wildman Palmer LLP

When a tsunami's waves recede, they leave behind the flotsam and jetsam that have been caught in their tumultuous path. So too with global financial crises. When the waters of the global financial tidal wave of 2008 receded, they revealed and left in their wake all manner of risky, ill-advised, and downright illegal financial schemes and scams. Among those most colorful and destructive are the Ponzi schemes, big and small, that were caught in the net of law enforcement officials, regulators, bankruptcy trustees, and plaintiffs' counsel.

By now, so much has been written about the mechanics of the biggest Ponzi schemes and their perpetrators' successful efforts to avoid detection by the Securities and Exchange Commission that those interested in the details may find a wealth of information. Bernard Madoff's scheme is one that lingers in the public imagination, to say nothing of separate schemes perpetrated by Robert Allen Stanford, Tom Petters, Scott Rothstein, Marc Dreier, Barry Tannenbaum, Beau Diamond, and Danny Pang. One of the most important topics in connection with these schemes and restitution for them are the powers and prosecutions of the various bankruptcy trustees. As those trustees' claw-back efforts have targeted banks and pension funds, those targets have asserted claims against their fund managers, investment advisers, accountants, and others that steered investments to various Ponzi schemes. Those defendants, in turn, are making demands upon their insurers for a defense against the claims, as well as indemnification.

Fidelity Insurance

Claimants and insureds alike have sought to recoup Ponzi-related losses from fidelity insurance, which most financial institutions are required to purchase.[1] Based on the argument that a transgressing employee knowingly caused an employer-policyholder to invest its own or a client's funds in a Ponzi scheme, policyholders have been known to submit claims for their own losses, as well as for their liability to third parties whose funds they invested or advised be invested in the scheme.

Before proceeding further, an observation should be made. The very term "fidelity insurance" is itself something of a misnomer. Properly understood, fidelity insurance is a bond that banks and other financial institutions purchase to cover losses as a result of employee fraud or dishonesty. A typical fidelity bond contains language that reads:

> [This fidelity bond] covers:
>
> (A) Loss resulting directly from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others.

> Such dishonest or fraudulent acts must be committed by the Employee with the manifest intent:
>
> (a) to cause the Insured to sustain such loss; and
>
> (b) to obtain financial benefit for the Employee or another person or entity.[2]

Fidelity bonds have been the subject of extensive negotiation between the insurance industry and the financial industry, and are written carefully so as to cover only certain types of risks.[3] Courts understand that fidelity bonds are not liability insurance policies. Indeed, they recognize that a fidelity bond differs from a liability policy because of the risk being insured.[4] A fidelity bond is an indemnity contract that guarantees reimbursement for losses sustained by the insured, which losses result from the dishonesty of the insured's employees.[5] A classic example of a claim covered by a fidelity bond is when a bank's employee embezzles funds from customer accounts.[6] By contrast, true *insurance* policies cover the liability of the insured to third parties.[7]

Like insurance products, fidelity bonds are construed by courts so as to give reasonable meaning to every provision that the bond contains.[8] Courts may not construe an insurance policy to bind the insurer to a risk that it did not contemplate, and for which it received no premium.[9] Accordingly, because fidelity bonds were the product of lengthy negotiations between sophisticated parties—bankers and financiers, on the one hand, and insurers, on the other—courts have expressed a willingness to abandon rules calling for the strict construction of policy ambiguities against the insurer.[10]

Carriers have advanced several objections to coverage when presented with Ponzi-related loss claims under fidelity bonds. First, some carriers argue that the losses do not result "directly" from the dishonest or fraudulent acts of an employee but, rather from those of the principal of the Ponzi scheme.[11] Of course, the success of that argument will turn upon how the bond defines an "employee," which, with respect to financial institutions, can be quite broad, and may, for example, include sub-advisors associated with hedge funds or feeder funds.

In a case in Massachusetts, the federal district court considered a situation where an employee of Special Olympics fraudulently induced third parties to make donations to the charity.[12] The employee of the charity was alleged to have concealed certain donations and stolen the proceeds. Rejecting a claim under the fidelity bond, the district court held that the loss to Special Olympics was not of a direct nature. Rather, the donors had been deceived into making donations that they believed would benefit Special Olympics. Accordingly, the court reasoned, Special Olympics had suffered only an indirect loss, in the form of reputational damage, or a *potential* decrease in future donations. It was not sufficient for the employee's dishonest acts to increase the insured's liabilities; rather, the insured's assets had to be *actually diminished* because of the employee's acts, in order to trigger the bond's coverage. In the absence of that direct causal link to the loss sustained, the bond had no obligation to respond, according to the court.[13] The court similarly ruled that the insured could not recover from the bond as a subrogee of the defrauded third parties if the insured were to reimburse them their losses, because the losses still would not be "direct" losses to the insured.[14] This sort of analysis may be important in Ponzi-related losses where the stolen funds were those of thirdparty investors which were then invested by the insured financial institution with the Ponzi scheme—as opposed to the funds of the financial institution itself.

Second, other carriers presented with Ponzi-related losses have questioned whether the required “manifest intent” was present to cause loss to an employer. This, too, was a focus of the appellate court’s decision in the Special Olympics case, which further expanded upon the district court’s holding. The appeals court noted that, unlike the classic case of embezzlement, in which the dishonest employee converts the employer’s existing funds, the employee who perpetrated the donation scheme generated new funds that Special Olympics had not anticipated, and which were subsequently stolen for the benefit of the employee alone.[15] Confronted with similar claims, some courts may conclude that the employee’s desire for self-enrichment would not reflect an expectation that his dishonesty would inflict a loss on his employer. Accordingly, a court may well hold that a fidelity bond would not be obligated to respond to this type of claim.[16] Likewise, the perpetrator of a Ponzi scheme may be found to be more motivated by his own financial gain as opposed to possessing a “manifest intent” to cause loss to the financial institution.

In the case of Ponzi-related losses, however, those arguments may not be as compelling as they were in the Special Olympics case. First, given the breadth of the terms of the specific fidelity bond coverage in issue, and depending on the nature of the Ponzi-related allegations, there could be a persuasive argument for coverage under these bonds. Second, it would be a stretch to say that the institutions that entrusted funds to the malefactors did not suffer a “direct” loss as a result of those actions. And, third, although intent is always a thorny factual issue, a court may tend to take the motivations of those involved in the Ponzi scheme into consideration before deciding the question of coverage.

Directors and Officers (D&O) Liability Insurance

Separately, carriers have been presented with claims for Ponzi scheme losses under D&O policies. Assuming that the claim complies with all of the applicable conditions precedent, whether the policy must respond will turn on whether the claim is covered. A standard D&O policy may define the term “claim” as:

> (1) a written demand for monetary, non-monetary or injunctive relief;
>
> (2) a civil, criminal, administrative, regulatory or arbitration proceeding for monetary, non-monetary or injunctive relief . . . ; or
>
> (3) a civil, criminal, administrative or regulatory investigation of an Insured Person . . . .[17]

Whether an informal agency investigation or a subpoena issued by a Ponzi-related trustee would qualify as a “claim” will depend upon the specific language used in the policy.

Also, as a general matter, D&O policies provide coverage for “loss” that the insureds must pay as a result of any “claim.” The term “loss” may be defined as:

> [A]ny amount which the Insureds are legally obligated to pay for a claim or claims made against them for Wrongful Acts, and shall include but not be limited to damages, judgments, settlements and costs, cost of investigation . . . and defense of legal actions, claims or proceedings and appeals therefrom, cost of attachment or similar bond; providing always, however, such subject of loss shall not include fines or penalties imposed by law, or matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed.[18]

In this typical definition, the term "loss" does not include fines or penalties, nor does it include any amount deemed uninsurable by law, such as punitive damages, restitution, or the return of so-called ill-gotten gains, awarded under the laws of particular jurisdictions. Because damages in a Ponzi-related case could involve some or all of these categories, there would not be coverage for that portion of loss—and possibly defense costs incurred—in these types of matters.

Finally, because the allegations in a claim for a Ponzi-related loss tend to focus on the insured's professional services, there may not be coverage under the D&O policy's insuring agreement. But even if the terms of the insuring agreement are met, a professional services or fees exclusion may bar coverage for the claim. Then, in addition, other D&O policy exclusions may have bite in connection with Ponzi-related claims, such as the misconduct exclusions; the exclusions for fraud, dishonesty, and personal profit or gain would be a bar to recovery of indemnity, albeit typically only after adjudication. The acts that give rise to these exclusions could, however, be severable by an insured who is found not to have committed any of the acts covered by a misconduct exclusion.

Errors & Omissions (E&O) Liability Insurance

Claims related to Ponzi-scheme losses have also been asserted against professional financial advisors, such as fund managers, accountants, and investment advisors.[19] E&O coverage comes in a variety of forms, and may be referred to as malpractice insurance, professional liability insurance, or management liability insurance, for example. Typically, these policies are designed to protect individuals and entities alike against claims made by clients for negligent errors or omissions in the performance of their professional services — like financial advising or financial management.

E&O policies have misconduct exclusions similar to those in D&O policies. The definitions of "loss" and "claim" are also similarly limited. Some policies issued to financial institutions and investment advisers may contain specific broker-dealer exclusions, which bar coverage for claims arising out of acts of broker-dealers or the insolvency of a broker-dealer. To the extent that some of the most spectacular Ponzi-schemes involve a broker-dealer—like Madoff, for example—these exclusions could have a significant impact on the availability of coverage.

Even if there ultimately is no coverage for indemnity in connection with a Ponzi scheme, defense costs in these cases can be staggering, given the losses claimed, the number of claimants, and the number of matters involved (*i.e.*, adversary proceedings, securities class actions, derivative actions, regulatory investigations, and law enforcement proceedings). As a result, even if a carrier never pays a penny on indemnity, its obligations on defense can be monumental.

Conclusion

Given the magnitude of losses associated with the many large and small Ponzi schemes that have come to light in the past few years, it will take considerable time for the courts to resolve all of the outstanding claims and the novel legal issues sometimes presented by these claims. In the meantime, the coverages implicated by these schemes—which extend to third-party financial advisers, money managers, banks, and other financial institutions that were caught up in the wave of the Ponzi schemes' illusory success—will likewise face challenges that are novel.

Mary-Pat Cormier is a partner in the Insurance and Reinsurance Department of Edwards Wildman Palmer LLP, practicing in the firm's Boston office. She can be reached at mcormier@edwardswildman.com. A Boston-based attorney in the firm's Insurance and Reinsurance Department, Alexander Henlin can be reached at ahenlin@edwardswildman.com.

---

1 *See*, *e.g.*, 12 C.F.R. § 7.2013 (2003) (requiring that federally-chartered banks have adequate fidelity coverage).

2 *See Tri City Nat'l Bank v. Fed. Ins. Co.*, 268 Wis. 2d 785, 797, 674 N.W.2d 617, 623 (Wis. 2003).

3 *See*, *e.g.*, *Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co.*, 246 A.D.2d 202, 676 N.Y.S.2d 559 (App. Div. 1998).

4 *See Foster v. National Union Fire Ins. Co.*, 902 F.2d 1316, 1318 (8th Cir. 1990); *Aetna*, 676 N.Y.S.2d at 565; *Tri City*, 674 N.W.2d at 622.

5 *See Continental Corp. v. Aetna Cas. & Sur. Co.*, 892 F.2d 540, 543 (7th Cir. 1989); *Tri City*, 674 N.W.2d at 622.

6 *See Aetna*, 676 N.Y.S.2d at 563.

7 *See id.* at 565, *accord Tri City*, 674 N.W.2d at 622.

8 *See Tri City*, 674 N.W.2d at 620, *accord Frost v.. Whitbeck*, 257 Wis. 2d 80, 654 N.W.2d 225 (Wis. 2002).

9 *See Tri City*, 674 N.W.2d at 621; *see also Shelley v. Moir*, 138 Wis. 2d 218, 222, 405 N.W.2d 737 (Ct. App. 1987).

10 *See Tri City*, 674 N.W.2d at 621-22.

11 *See*, *e.g.*, *Fireman's Fund Ins. Co. v. Special Olympics Int'l*, 249 F. Supp. 2d 19 (D. Mass. 2003); *see also*, *e.g.*, *F.D.I.C. v. United Pac. Ins. Co.*, 20 F.3d 1070, 1080 (10th Cir. 1994) (discussing difference between a "direct loss" and theoretical loss); *Continental Cas. Co. v. First Nat'l Bank of Temple*, 116 F.2d 885, 886-87 (5th Cir. 1941), *cert. denied* 313 U.S. 575 (1941) (discussing what constitutes "direct loss" in context of employee dishonesty case).

12 *Special Olympics Int'l*, 249 F. Supp. 2d 19 (D. Mass. 2003), *aff'd on other grounds* 346 F.3d 259 (1st Cir. 2003).

13 *See Fireman's Fund*, 249 F. Supp. 2d at 26-27, *accord Central Nat'l Ins. Co. of Omaha v. Insurance Co. of N. Am.*, 522 N.W.2d 39 (Iowa 1994); *Ronnau v. Caravan Int'l Corp.*, 468 P.2d 118 (Kan. 1970).

14 *See Fireman's Fund*, 249 F. Supp. 2d at 25, *accord Central Nat'l*, 522 N.W.2d at 42-43.

15 *See Fireman's Fund Ins. Co. v. Special Olympics Int'l*, 346 F.3d 259, 263-64 (1st Cir. 2003).

16 *See id.*

17 *See AT&T Corp. v. Faraday Capital Ltd.*, 918 A.2d 1104, 1107 n.7 (Del. 2007) (ellipses in original).

18 *See*, *e.g.*, *Polychron v. Crum & Forster Ins. Cos.*, 916 F.2d 461, 462 n.4 (8th Cir. 1990) (ellipsis in original).

19 *See*, *e.g.*, Complaint, *S.E.C. v. Stanford Int'l Bank, Ltd.*, *et al.*, No. 3:09-cv-00298-N, Docket No. 302 (N.D. Tex. Apr. 15, 2009) (receiver's complaint naming specific financial advisors as relief defendants in connection with efforts to recoup over $40 million in connection with the Stanford Financial Ponzi scheme).