Evolution of the Trading Loss Exclusion

By Kelli Biggam Fleming and Amber Oleson LaFevers

Practitioners faced with a claim that may implicate the exclusion should understand the purpose of the exclusion and how courts interpret "trading."

Corporate scandals are prevalent, and the incidence and costs of fraud are rising, and in turn driving up companies' sense of vulnerability. *See* Knoll 2012/2014 Global Fraud Report (Oct. 17, 2012). We are frequently shocked by media reports of employee dishonesty and calculated Ponzi schemes involving fraudulent investments. Notably, since 2010, intense legal battles have resulted from Bernard L. Madoff's criminal activities, and the Scott Rothstein Ponzi scheme, among others, all of which give credence to the old adage "if it's too good to be true, then it probably is."

Fidelity insurance has been defined as an agreement to indemnify an employer against a loss arising from lack of integrity or honesty of "an employee or of a person holding a position of trust, such as a loss from embezzlement." Black's Law Dictionary (8th ed. 2004). As more companies become exposed to fraud and rocked by high profile corporate scandals, the more frequently victimized companies turn to their fidelity insurers to recover insurance proceeds for losses associated with employees' misdeeds or theft. However, not all of the losses may be covered by the policies, such as losses resulting directly or indirectly from the trading of securities. Accordingly, it is important to examine closely the scope of the fidelity insurance available and the types of damages covered under the policies.

In doing so, it is critical for an attorney representing an insurance company or policyholder to consider the history of relevant policy exclusions in analyzing coverage and assessing the likelihood of success in insurance coverage litigation. In the fidelity bond context, policies often include a provision commonly referred to as the "trading loss exclusion" stating that coverage is not provided for loss "resulting directly or indirectly from trading." This article will first discuss the trading loss exclusion's background and consider how the exclu-

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sion has evolved over the years. Next, it will highlight how courts have defined the term "trading" when determining whether the trading loss exclusion applies to certain fidelity-related losses. The article will also address the challenges that courts have faced when analyzing the exclusion in the context of employee dishonesty-related losses. Of significant importance is the interplay between losses resulting from an employee's dishonest conduct, which is typically covered by a fidelity bond, and losses involving trading activity, which the bond may not cover due to a trading loss exclusion. Finally, this article will provide an in-depth discussion of the cases addressing this issue so that a practitioner can become versed in how a court potentially may interpret a trading loss exclusion when a case also involves an employee's dishonesty.

History of the Trading Exclusion

Trading loss exclusions have a long history: "Versions of the Trading Loss Exclusion have been incorporated in financial fidelity bonds since 1918." *Mass. Mut.* Life *Ins. Co. v. Certain Underwriters at Lloyd's of London*, No. 4791-VCL, 2010 Del. Ch. Lexis 156, at *44 (Del. Ch. July 23, 2010) (citing Peter I. Broeman, *An Overview of the Financial Institution Bond, Standard Form 24,* 110 Banking L.J. 439, 464–65 (1993)). The trading loss exclusion was intended to bar coverage for losses related to the buying and selling of securities. *See Shearson/American Express, Inc. v. First Cont'l Bank & Trust Co.*, 579 F. Supp. 1305, 1310 (W.D. Mo. 1984). The historical context surrounding the trading loss exclusion is critical because it established the foundation for how the trading exclusion is applied when companies victimized by corporate scandal seek coverage from their fidelity insurers. Moreover, the scope of the exclusion continues to challenge courts and practitioners.

Stockbroker Blanket Bonds

One of the first cases to interpret the trading loss exclusion involved a stockbroker blanket bond. *Harris v. Nat'l Sur. Co.,* 258 Mass. 353, 155 N.E. 10 (Mass. 1927). In *Harris,* a brokerage partnership sought coverage from its fidelity insurer for market losses suffered as a result of a dishonest employee's unauthorized trading in and manipulation of a customer's account. *Harris,* 258 Mass. at 353, 155 N.E. at 11. The bond contained the following provision:

> This bond does not cover loss directly or indirectly from trading, actual or fictitious, whether in the name of the Insured or otherwise, and whether or not within the knowledge of the Insured, and notwithstanding any act or omission on the part of any employee in connection therewith, or within any account recording the same.

Harris, 258 Mass. at 355–56, 155 N.E. at 10. Finding the early trading exclusion unambiguous, the court applied it to bar coverage for the market losses. *Harris,* 258 Mass. at 359, 155 N.E. at 12.

While the *Harris* court found that the trading loss exclusion precluded coverage for losses involving a dishonest employee, at least one early decision found that the exclusion was not intended to preclude coverage under those circumstances. *See Paddleford v. Fid. & Cas. Co. of N.Y.,* 100 F.2d 606 (7th Cir. 1939). In fact, the court held that the exclusion was intended not to limit coverage for losses sustained through an employee's dishonest acts, but to limit it for acts that were not dishonest, such as negligent conduct. *Id.* at 613.

The *Paddleford* decision was soon rejected by the Third Circuit in *Roth v. Maryland Cas. Co.* when the court analyzed a fidelity bond that excluded coverage for "any loss resulting directly or indirectly from trading." 209 F.2d 372, 373 (3d Cir. 1953). The court concluded that the trading loss exclusion precluded recovery of trading losses regardless of whether the trades were the result of dishonest acts otherwise covered by the bond. *Id.* at 374. According to the *Roth* court, the *Paddleford* approach, which distinguished between honest and dishonest trading, finding that losses suffered due to the latter were covered did violence to the plain meaning of the insurance contract. The Seventh Circuit later overruled *Paddleford* in *Continental Corp. v. Aetna Cas. & Sur. Co.*, 892 F.2d 540 (7th Cir. 1989).

The *Harris, Paddleford,* and *Roth* decisions demonstrate that a clear tension existed even initially regarding the scope of the exclusion when an insured sustained losses as a result of employee dishonesty when trading also may have been involved.

Trading Loss Exclusions Incorporated into Banking Blanket Bonds

By the 1970s, fidelity insurers were beginning to incorporate the trading loss exclusion in other fidelity policies, such as bankers blanket bonds. There was a need to include this exclusion into these bonds because financial institutions had started to engage in trading more frequently, which created higher risks compared to the banks' usual business activities. *Shearson/American Express,* 579 F. Supp. at 1310 (citing *Digest of Bank Insurance,* 35 (3rd ed. 1977)). Moreover, employee dishonesty-related trading losses rose. *Id.*

While the *Harris* court found that the trading loss exclusion precluded coverage for losses involving a dishonest employee, at least one early decision found that the exclusion was not intended to preclude coverage under those circumstances.

In 1976, the Surety Association of America (Surety Association) increased bond premiums and decided to establish a separate charge for coverage for employee dishonesty trading losses, following the precedent established in connection with stockbroker blanket bonds. *Id.* At this point in time, the trading loss exclusion was generally added with a rider, and the language paralleled the stockbroker wording. David K. Kerr, *The Potential Income and Principal Other Exclusions* in Financial Institution Bonds, 484 (Duncan L. Clore, ed., ABA Publishing 2008) (1995); *Shearson/American Express,* 579 F. Supp. at 1310 (cit-

ing *Digest of Bank Insurance,* 35 (3rd ed. 1977)). The Surety Association's decision completely excluded all trading loss unless forgery was involved and unless a bond included a provision to buy back coverage for employee dishonesty trading losses. *Shearson/American Express,* 579 F. Supp. at 1310 (citing *Digest of Bank Insurance,* 35 (3rd ed. 1977).

In addition to trades made by an insured on behalf of a customer, trading loss may also be excluded by the trading loss exclusion when the trades were conducted on behalf of the insured.

Fidelity insurers formally added the trading loss exclusion to the bankers blanket bond, now known as Standard Form No. 24, in 1980, to "deal with the insurance problem caused by losses resulting from the buying and selling of securities." *Shearson/American Express,* 579 F. Supp. at 1310–11; Annotated Bankers Blanket Bond (2004), cmt. on exclusion (i), at 383; *Mass. Mut.,* 2010 Del. Ch. Lexis 156, at *14. The 1980 bankers bond form adopted the trading loss exclusion contained in stockbrokers' blanket bonds and encompassed all loss resulting from trading except to the extent that such loss was covered under Insuring Agreements (D) (Forgery or Alteration) or (E) (Securities). *See* Annotated Bankers Blanket Bond, *supra,* cmt. on exclusion (i), at 384.

The standard trading loss exclusion in the 1980 form, and in the modified financial institution bond form, which was introduced in 1986, stated:

> Section 2. This bond does not cover…
> (i) loss resulting directly or indirectly from trading, with or without the knowledge of the insured, whether or not represented by any indebtedness or balance shown to be due the insured on any customer's account, actual or fictitious, and notwithstanding any act or omission on the part of any Employee in connection with any account relating to such trading, indebtedness, or balance, except when covered under Insuring Agreements (D) or (E);

Kerr, *supra,* at 484. Neither the 1980 bankers blanket bond form nor the 1986 financial institution bond form defined the term "trading." *See* Annotated Bankers Blanket Bond, *supra,* cmt. on exclusion (i), at 384; Financial Institution Bonds, Standard Form 24 (rev. July 1980 and Jan. 1986), at 689, 706.

The United States District Court for the Western District of Missouri considered the bankers blanket bond exclusion for the first time in *Shearson/American Express, Inc.* 579 F. Supp. 1305 (W.D. Mo. 1984). The *Shearson/American Express* litigation involved a dishonest employee of the insured who engaged in securities speculation while falsely representing that he was doing so on behalf of the policyholder. *Id.* at 1307. The insured sought coverage from its fidelity insurer for losses that it suffered in connection with its employee's unauthorized trading activity and for improper payments for securities. *Id.* at 1308. The court focused on the trading loss exclusion, which barred coverage for losses "resulting directly or indirectly from trading" and found it applicable. *Id.* at 1308, 1310–11. In reaching this conclusion, the court held that the exclusion was not ambiguous. *Id.* The court also concluded that the plain meaning of the exclusion was to deny coverage for losses resulting from the buying and selling of securities, regardless of whether the trades were legal. *Id.* at 1311.

A few years after the *Shearson/American Express* lawsuit, the Second Circuit weighed in on the purpose of the trading loss exclusion when employee fidelity coverage was implicated. In *Glusband v. Fittin Cunningham & Lauzon,* the court stated that "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." 892 F.2d 208, 211 (2d Cir. 1989).

The most recent revision to the financial institution bond form was in 2004. *Mass. Mut.,* 2010 Del. Ch. Lexis, at *14. The trading loss exclusion contained in the 2004 Standard Form No. 24 of Financial Institution Bond reads:

> (i) loss resulting directly or indirectly from trading, with or without the knowledge of the Insured, whether or not represented by any indebtedness or balance shown to be due the Insured on any customer's account, actual or fictitious, and notwithstanding any act or omission on the part of any Employee in connection with any account relating to such trading, indebtedness, or balance, except when covered under Insuring Agreements (A), (D) or (E);

Handling Fidelity Bond Claims 701 (Michael Keeley and Sean Duffy ed., ABA Publishing 2005) (1999).

While the trading loss exclusion continues to evolve, the exclusion's purpose remains the same. Courts, however, will continue to analyze and reexamine the intent behind this exclusion when determining its applicability, especially as the frequency of large corporate scandals and Ponzi schemes increase. Accordingly, we anticipate that this exclusion will remain an important component of fidelity insurance.

Definition of "Trading"

In analyzing coverage or the likelihood of success in litigation, it is helpful for the practitioner to consider the courts' historical interpretation of the meaning of the word "trading" as applied in the context of the trading loss exclusion. The most basic definition of "trading" in fidelity cases in which the term is not expressly defined is the "buying and selling of securities." *E.g., Shearson/American Express,* 579 F. Supp. 1305 (W.D. Mo. 1984); *Sutro v. Indem. Ins. Co.*, 264 F. Supp. 273, 289 (S.D.N.Y. 1967). Through the years, courts have expanded this definition to encompass specific trading conduct.

In *Bass v. American Ins. Co.*, the Ninth Circuit found that the sale of municipal bonds, the servicing of the customers, and the underwriting of the municipal bonds were activities within the meaning of the term "trading." 493 F.2d 590, 592 (9th Cir.

1974). Later, the Ninth Circuit found that "[t]rading 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. *Ins. Co. of N. Am. v. Gibralco,* 847 F.2d 530, 533 (9th Cir. 1988). In *First Federal v. Fidelity,* the Sixth Circuit found that trading loss is loss which results "from fluctuations in market value of the securities purchased." 895 F.2d 254, 260 (6th Cir. 1990). Relying on this definition, the court rejected the notion that trading includes non-market losses such as loss resulting from missing securities underlying repurchase agreements. *Id.*

One court also recently found that loss sustained by an insured for the purchase of shares in a mutual fund was precluded under the trading loss exclusion.

Trading may also encompass trades made by a policyholder on behalf of its customers. *Harris,* 155 N.E. at 10. In addition to trades made by an insured on behalf of a customer, trading loss may also be excluded by the trading loss exclusion when the trades were conducted on behalf of the insured. *Lincoln Grain, Inc. v. Aetna Cas. & Sur. Co.*, 756 F.2d 75 (8th Cir. 1985).

Courts have also found that "trading" does not need to be authorized or legal trading to fall within the trading loss exclusion. In *Shearson/American Express,* the court found that the trading loss exclusion precludes coverage regardless of whether the losses resulted from legal or illegal trading. 579 F. Supp. at 1305. In *Roth,* 209 F.2d at 373, the court rejected the argument that the office manager of the insured broker did not engage in "trading" through his unauthorized purchasing and selling securities for customers. Similarly, in *Straz v. Kansas Bankers Sur. Co.*, No. 97-4245, 1998 U.S. App. Lexis 20537, at * 9 (7th Cir. Aug. 18, 1998), the court found that the trading loss exclusion applied despite the fact that the insured engaged in risky securities trading that was not authorized by its customer.

In 2010, the *Massachusetts Mutual* court addressed the trading loss exclusion in the context of the infamous Madoff Ponzi scheme. *Mass. Mut. Life Ins. Co.*, No. 4791-VCL, 2010 Del. Ch. Lexis 156, at *14 (D. Del. June 22, 2010). In doing so, the court highlighted that this exclusion may not bar coverage when the losses involve fictitious trading. The court held that Madoff was a thief and did not lose money through reckless, improvident, or even dishonest trading. *Id.* Because he engaged in embezzlement or embezzlement-like acts, the exclusion did not apply. *Id.*

One court also recently found that loss sustained by an insured for the purchase of shares in a mutual fund was precluded under the trading loss exclusion. *Methodist Health Sys. Found v. Hartford Fire Ins. Co.*, 834 F. Supp. 2d 493, 494 (E.D. La. 2011). The insured invested in shares in a mutual fund, and the mutual fund then invested in a hedge fund that invested a portion of its holdings in Madoff's company. *Id.* at 494–95. Due in part to Madoff's Ponzi scheme, the hedge funds suffered losses, which caused the mutual fund in which the insured had invested to sustain losses. *Id.* The insured sought coverage under the computer fraud insuring clause of its commercial crime policy, and the insurer declined coverage on the basis of the policy's trading loss exclusion, among other reasons. *Id.* at 497. The court found that "trading" had the "same meaning it ha[d] in any mercantile business, namely, the buying and selling of commodities." *Id.* at 497. The court rejected the insured's argument that the insured's acts in investing in the mutual fund did not constitute trading because "the purchase of shares in a mutual fund [was] equivalent to the buying and selling of securities." *Id.*

These cases demonstrate that "trading," in its most basic form, involves the buying and selling of securities, bonds, or commodities. Courts have expanded the definition to include the underwriting of municipal bonds, the servicing of customers, and the purchase of shares of a mutual fund. Trading within the meaning of the exclusion may encompass trades conducted for customers or trades conducted on behalf of a policyholder. Courts have also made clear through the years that unauthorized or illegal trading still falls within the exclusion's definition of "trading." Recently, however, one court found that fictitious trading did not fall within the ambit of the trading loss exclusion.

Trading Loss Versus Employee Dishonesty-related Loss

For nearly a decade, courts throughout the nation have struggled in deciding whether an insured's losses involving both employee dishonesty and trading acts are excluded from coverage under the trading exclusion. The conflict will arise because fidelity bonds typically include an insuring agreement covering loss arising from the dishonest acts of an insured's employee. Policyholders argue that employee dishonesty coverage is eviscerated if the trading loss exclusion applies to these losses because a single act of trading could preclude coverage for an employee's clearly dishonest acts. On the other hand, insurers argue that the courts must apply the unambiguous language of the trading loss exclusion to preclude any losses arising directly or indirectly from trading irrespective of whether a loss involves employee dishonesty.

When a practitioner assesses coverage on the basis of the trading loss exclusion in a case that also involves employee dishonesty, it is crucial that the practitioner considers the possibility that a court may deem trading activity to be ancillary to an employee's dishonest conduct. Courts have continued to apply the trading loss exclusion broadly to preclude coverage when a loss results from trading. Courts in several cases, however, have analyzed the principal cause of the loss and concluded that the loss arose principally from employee dishonesty and not from trading loss. An insurance coverage practitioner should closely analyze the facts of the particular case to assess whether a court could potentially deem the insured's loss to be solely the result of the employee's dishonest conduct.

Paddleford and Its Progeny

As mentioned, *Paddleford* was one of the earliest cases that addressed the struggle between employee dishonesty coverage and the trading loss exclusion.100 F.2d at 606. In that case, the insured brokerage business engaged in the buying and selling of stocks, bonds, and grains for customers. An employee of the insured ordered that unauthorized trades were made on behalf of customers, when the trades were "fictitious and fraudulent." *Id.* at 609. The insurer issued a bond containing an insuring agreement covering employee dishonesty, but excluding loss "resulting directly or indirectly from trading." *Id.* at 608. The court concluded that the trading loss exclusion was not intended to exclude loss incurred through a "dishonest act," but the exclusion only excluded coverage for trading loss resulting from negligence or an error of the employee. In reaching this holding the court stated that "it borders on preposterous to say that it was the intention of the parties to indemnify plaintiffs against the loss occasioned by a dishonest employee and at the same time make this indemnity unavailing if the loss was occasioned while engaged in trading." *Id.* at 613. Accordingly, the court concluded that the trading loss exclusion was not intended to preclude coverage for a loss that resulted from an employee's dishonesty. *Id.*

In *Roth v. Maryland,* however, the court rejected the holding in *Paddleford* and found that an employee's alleged misappropriation of funds was excluded from coverage under the trading loss exclusion. 209 F.2d at 374. The insured securities broker sought coverage under its broker's blanket bond after its employee engaged in unauthorized trades on behalf of the broker's customers, which resulted in loss. The insurer argued that there was no coverage on the basis of the policy's trading loss exclusion for "loss resulting directly or indirectly from trading with or without the knowledge of the Insured." *Id.* at 373. The insured argued that the exclusion did not apply to the alleged dishonest acts of the employee because the

> protection against losses arising from acts of dishonesty in trading is the main object of this type of insurance and… [coverage] for the dishonesty of his employees should not be limited by excluding trading losses resulting from dishonesty, since to do so would deny the broker the very protection he contracted for.

Id. This argument was cast off as contrary to "the plain meaning of the insurance contract" because "the words employed leave no doubt" that losses resulting from trading are excluded irrespective of whether the trading resulted from employee dishonesty. *Id.* at 374. The court rejected the decision in *Paddleford* and found that the plain meaning of the exclusion did not require the loss to result from negligent or mistaken trading but could also encompass dishonest trading. *Id.* at 373–74.

Later, in *Continental Corp*, the Seventh Circuit overruled *Paddleford* to conclude that employee dishonesty claims may fall within the purview of the trading loss exclusion. 892 F.2d at 546–47. In *Continental*, the insured's employee engaged in a real estate scheme during which he intentionally omitted encumbrances on various properties when issuing title insurance. While the bond in *Continental* did not exclude loss arising from trading, the district court likened the trading loss exclusion to an exclusion in the bond for losses "resulting from (a) liability of the insured under contracts of insurance… or (b) liability of the insured because of an inspection, title search, survey or report…." *Id.* at 5421. The district court relied on *Paddleford* to conclude that the exclusion did not apply because the employee's conduct was dishonest. The Seventh Circuit reversed the holding of the district court. The court found that after "fifty years of evolution of the fidelity insurance business" the reasoning in *Paddleford* was "fundamentally flawed" and overruled *Paddleford*. *Id.* at 545–46.

Loss Resulting from Trading

After *Paddleford*, courts often applied the trading loss exclusion broadly to find that the exclusion precluded recovery of trading losses despite the existence of employee dishonesty. In several notable cases, loss involved an employee's alleged improper conduct. One example of an early case finding that coverage existed for conduct that can be construed as dishonest is *Bass*, 493 F.2d at 590.

In *Bass*, a company that engaged in the purchase and sale of municipal bonds was insured under a fidelity bond that covered "loss through any dishonest, fraudulent or criminal act of any [employee]" but excluded "loss resulting directly or indirectly from trading with or without the knowledge of the insured." 493 F.2d at 591. The company filed for bankruptcy, and the trustee sought recovery under the bond related to the alleged conduct of the company's president in purchasing delinquent bond coupons, among other reasons. The bond coupons were purchased by another company in which the president and the principal shareholder of the company held personal interests. The Ninth Circuit affirmed the trial court's finding that the coupon purchase was a "trading loss" that was excluded from coverage despite the arguably dishonest acts of the company's president in purchasing the coupons. *Id.* at 593.

Policyholders argue that employee dishonesty coverage is eviscerated if the trading loss exclusion applies to these losses because a single act of trading could preclude coverage for an employee's clearly dishonest acts.

Research Equity Fund v. Ins. Co. of N.A., 602 F.2d 200 (9th Cir. 1979), also involved conduct that could fall within the policy's employee dishonesty insurance clause. The insured investment firm sustained losses after its portfolio manager was bribed to make unprofitable trading recommendations. The firm engaged in the recommended securities trades, suffered losses as a result, and then sought coverage under its fidelity bonds. While the portfolio manag-

er's conduct could be construed as dishonest, the court found that the bond's trading loss exclusion, which precluded coverage for "loss resulting directly or indirectly from trading," clearly excluded coverage for the loss. *Id.* at 203.

Despite the potential implication of the bond's employee dishonesty insuring clause, these courts appear to have interpreted the meaning of the language "resulting directly or indirectly from trading" to preclude coverage for any loss resulting from trading irrespective of whether the claim involved an employee's dishonest conduct. Through the years, however, several other courts examined whether it is the trading activity or the employee's dishonest conduct that actually caused the loss in assessing the trading loss exclusion's applicability.

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Loss Resulting from Employee Dishonesty?

In the post-*Paddleford* world, courts continued to grapple with the applicability of the trading loss exclusion to loss arising from employee dishonesty. While *Roth* and *Continental* established that dishonest acts committed by an employee may be excluded under the trading loss exclusion, courts later confronted cases in which, based on the facts, they determined that a loss arose solely from an employee's dishonest conduct. In those cases, courts have found that the trading loss exclusion does not apply despite the existence of ancillary "trading" activity.

Gibralco is a prime example. The insured municipal bond brokerage firm obtained a broker's blanket bond covering loss resulting from employee dishonesty and excluding coverage for "loss resulting directly or indirectly from trading." 847 F.2d at 531. The insured's employee maintained two unauthorized trading accounts and engaged in unauthorized trading of bonds in accounts in the name of real and fictitious customers. The employee kept some of the bonds. The employee also sold some of the bonds and used the proceeds for his personal benefit. The insurer declined coverage on the basis of the trading loss exclusion, but the Ninth Circuit found that the losses were not caused by the employee's trading, but instead were caused by his dishonesty. The court noted that the actual losses were not sustained by the insured when the trading of the bonds occurred, but later when the employee wrongfully retained the sale proceeds and stole the bonds. The court specifically noted that the trading loss exclusion did not preclude coverage

> if a trade occurs anywhere in the chain of events resulting in a loss to the insured. The broad application of the trading loss exclusion urged by [the insurer] would eviscerate the employee dishonesty coverage provisions of the Bond in every case where a trade might occur in the course of an employee's dishonest scheme."

Id. at 533.

In reaching its decision, the *Gibralco* court distinguished *Research Equity* and *Bass*, finding that the trading loss exclusion precluded coverage in those cases because they involved "classic trading losses sustained in the course of regular trading activities" and the losses in those cases were "sustained as a direct result of trading." *Id.* at 533.

Relying on the reasoning in *Gibralco*, the court in *Home Sav. & Loan v. Aetna Cas. & Sur. Co.*, 817 P.2d 341 (Utah App. Ct. 1991), concluded that that the trading loss exclusion did not apply to the facts before it. The insured mortgage lender issued loans to purchasers of securities, but it did not obtain an ownership interest in the securities, and the insured's employee's acted dishonestly in processing the loans. The insured sought coverage under its fidelity bond for loss sustained related to the loans and argued that the policy's trading loss exclusion for "loss resulting directly or indirectly from trading" precluded coverage. *Id.* at 360. The parties agreed that "trading" referred to "trading in securities." *Id.* The insured argued that the trading loss exclusion did not apply because the insured did no more than lend money to customers who, in turn, invested in securities. The court relied upon the "sound approach" to the trading exclusion in *Gibralco* and concluded that the employee's dishonest conduct in processing the loans, rather than the purchaser's securities purchases, was the ultimate cause of the loss. *Id.* at 362. The court concluded that the employee's conduct included no representation that he was "engaging in securities trading in a manner that the trading exclusion is intended to discourage" and the fidelity bond coverage "should not be defeated by an expansive interpretation of the trading loss exclusion. *Id.*

Gibralco and *Home Savings* demonstrate that that a court may find that the trading loss exclusion does not apply to claims when employee dishonesty, separate and apart from trading activity, caused a loss. In *Gibralco*, the court found that the insured did not sustain a loss until the employee wrongfully stole the bonds and retained the sale proceeds of the bonds. Therefore, the fact that the employee obtained a benefit from the bonds did not implicate the trading loss exclusion because the trades occurred before the insured sustained a loss. Similarly, in *Home Savings,* the court found that the dishonest conduct causing the insured's loss could be clearly separated from the trading activity. There, the dishonest conduct that caused the loss, the improper loan processing, occurred before the purchaser invested in securities.

One recent case discussed the applicability of the trading loss exclusion to on-premises theft coverage related to loss sustained by the insured in the Bernie Madoff Ponzi scheme. In *Massachusetts Mutual,* the court found that the fidelity bond provided coverage despite the existence of an exclusion for loss "resulting directly or indirectly from trading." 2010

Del. Ch. Lexis 156, at *42. The court noted that Madoff "claimed to be trading securities in the market, [but] he never bought or sold a single stock." *Id.* at *5. As a result, the court found that Madoff did not lose money through trading, but instead engaged in "outright theft," which was not excluded. *Id.* at *45.

Recognizing the importance of analyzing the actual cause of a loss, the court in *Straz* distinguished *Gibralco's* ruling due to the *Straz* facts, which involved a trading loss exclusion in a directors and officers liability policy precluding coverage for loss "resulting directly or indirectly from the trading...." *Straz,* 1998 U.S. App. Lexis 20537 (7th Cir. Aug. 18, 1998). In *Straz*, the insured improperly purchased high risk securities on behalf of a customer in violation of the customer's instructions, and the securities lost value. The customer sued the insured, and the insurer denied coverage on the basis of the trading loss exclusion. The court found that there was no coverage because the losses that the customer allegedly suffered resulted directly or indirectly from trading in securities, even though the trading was unauthorized. In so holding, the court found that it "is only where the loss has no connection to actual trading that the exclusion has no application." *Id.* at *8. The court distinguished *Gibralco* on the basis that the trader's theft of client funds for personal use in that case did not result from trading activity—the loss was separate. *Id.* at *8–9. Notably, the *Straz* insured argued that at least a portion of the alleged loss did not result from trading because the complaint alleged loss arising from the insured's breach of fiduciary duty. The *Straz* court rejected this argument, however, finding all other losses "were at least indirectly related to the drop in the value of the derivative securities" because the customer would not have sustained damages if the value of the securities had not fallen. *Id.* at *9.

In *Lincoln Grain*, discussed above, the court found that coverage was excluded for loss that arguably arose from both employee dishonesty and trading activity. 756 F.2d at 79. The insured company bought and sold grain contracts on its own behalf and on behalf of customers. The insured's employee altered financial reports documenting grain trading and hedges to show a profit when the insured actually sustained trading losses. The company sought coverage under a fidelity bond that insured against fraudulent or dishonest acts of employees but excluded coverage for losses "resulting directly or indirectly from trading." *Id.* at 76. Specifically, the company claimed that the loss resulted from the employee's dishonest conduct because the company would have closed the trading division before sustaining increased losses if the employee had provided accurate financial reports. *Id.* The court found that the employee's conduct resulted in trading losses and certain losses were excluded from coverage because the "losses resulted from poor judgments in buying and selling of grain delivery contracts." *Id.* at 77.

While the courts in *Gibralco, Home Savings,* and *Massachusetts Mutual* interpreted the ultimate cause of the insureds' losses to be an employee's dishonest activity or theft, and not trading, those cases involved factual scenarios in which employee's acts separate and apart from the trading activity caused the loss. *Bass, Research Equity, Straz* and *Lincoln Grain* demonstrate that loss that directly or indirectly results from trading may still be excluded from coverage under the trading loss exclusion. It is of critical importance for practitioners to distinguish between (1) claims for which a loss results solely from employee dishonesty or theft, and (2) claims for which a loss wholly or partially results from trading. In the latter situation, the trading loss exclusion may be implicated because the trading activity cannot be separated from the employee's dishonest conduct.

Conclusion

As more and more companies experience fraud and suffer employee misdeeds, the evolution of the trading loss exclusion will inevitably continue. Practitioners faced with a claim that may implicate the exclusion should understand the purpose of the exclusion and how courts interpret "trading." "Trading" in its most basic form means the buying and selling of securities, bonds, or commodities, but courts have expanded the definition over the years, especially as new and different corporate scandals surface. Trading may now include unauthorized trades, underwriting of municipal bonds, servicing of customers, and the purchase of shares of a mutual fund.

Practitioners should be careful when analyzing the trading loss exclusion's application to facts that involve both employee dishonesty and trading activity. From the perspective of an insurer's counsel, interpreting a loss that results partially from trading as covered would ignore the plain language of the trading loss exclusion, which precludes loss "resulting directly or indirectly from trading." Practitioners representing policyholders should recognize this potential argument when analyzing coverage and litigating cases involving the trading loss exclusion.

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