WHAT IS LOSS? THE QUANTIFICATION OF LOSS

I. INTRODUCTION

A threshold requirement to potential coverage under a fidelity bond or policy, and one that may often be taken for granted, is the insured actually suffering a loss. Over time, the development and evolution of case law and the language used in fidelity policies created certain basic tenants when evaluating loss. For example, an actual, pecuniary loss is typically a prerequisite to potential coverage, as opposed to a hypothetical or subjective loss to property the insured never owned or held.[1] Hoped-for or anticipated profits are often expressly excluded, as are bookkeeping losses. Fidelity policies are also intended to provide coverage for first-party loss, and typically do not cover third-party loss or liability to others.[2] In many ways, fidelity insurance is more similar to property insurance than liability insurance.[3]

Despite the bedrock principle that the insured must suffer a loss to potentially implicate coverage, the term "loss" is almost universally undefined in fidelity policies. Therefore, issues have arisen as to whether an insured has actually suffered a loss, when the loss occurred for purposes of fidelity insurance,[4] how to value such loss, and whether the loss resulted directly from the covered peril.[5] Although the term "loss" is undefined, commentators have noted that "the various provisions of the [fidelity policy] addressing the concept and elements of loss provide the necessary framework for analyzing the term."[6] Courts have often relied upon dictionary definitions and a "common sense" approach to determining whether (and when) an insured suffered a loss. The majority of courts have concluded that loss means a net, "out-of-pocket" loss – "outgo minus income."[7]

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[1] David T. DiBiase & David J. Billings, "*Loss? What Loss?": Unique Claims on Crime Policies/Fidelity Bonds*, XIV FID. L.J. 271, 273 (2008).

[2] Hilary R. Hoffman et al., *Valuing the Insured's Loss/Limits of Liability, in* HANDLING FIDELITY BOND CLAIMS 439, 442 (Michael Keeley ed., 3d ed. 2019).

[3] *Id*.

[4] For purposes of fidelity insurance, loss is often deemed to have occurred at the time of a dishonest employee diverting or embezzling the funds. However, as discussed in Section IV of this article, it is less clear when a loss occurred in a lending context, as there may be a delay between disbursing the proceeds of a fraudulent loan and an actual default on said loan. *See generally* Patrick T. Ryan & Brian M. Gibbons, *What is Loss and When Does it Occur?*, XXVI FID. L.J. 85, 103 (2020).

[5] There are numerous scholarly articles addressing the meaning of "resulting directly from" in the context of a fidelity policy or financial institution bond. *See, e.g.*, Bogda M.B. Clarke, Patricia H. Thompson, Michael A. Shafir, *"Loss Resulting Directly From ….": Causation Under the Financial Institution Bond and Similar Insurance Forms*, IX FID. L.J. 25 (2003). An exhaustive discussion of "direct loss" or "direct causation" is beyond the scope of this article. However, fidelity practitioners should be aware that jurisdictions have not uniformly interpreted "resulting directly from," and identical facts and identical policy language may therefore implicate coverage in certain jurisdictions but not others. Most cases addressing "direct loss" diverge on whether the court holds that "direct" means "immediate," or equates "direct" with a traditional proximate cause analysis seen in tort cases. *See, e.g.*, First State Bank of Monticello v. Ohio Cas. Ins. Co., 555 F.3d 564, 570 (7th Cir. 2009) ("Indeed, loss causation has been a sometimes-misunderstood concept in the caselaw interpreting financial-institution bonds.").

[6] Maura Z. Pelleteri et al., *Loss, Valuation & Limits of Liability Under the Financial Institution Bond*, *in* FINANCIAL INSTITUTION BONDS 727, 727 (Michael Keeley ed., 4th ed. 2016).

[7] *Id*.

One goal of this article is to address the different perspectives in evaluating loss. In the world of fidelity insurance, the meaning of loss as addressed by the policy can be significantly different than loss as professed by an accountant following the American Institute of Certified Public Accountants ("AICPA") standards.[8] In addition, the concepts regarding how the loss is quantified can vary significantly. This article explores the divergent perspectives between accounting and fidelity insurance. This article delves into the meaning of loss in American accounting history and offers a comparison to the criminal sphere and the fidelity bond. Conversely, this article considers how they complement each other when defining and quantifying the loss for the fidelity industry. After a walkthrough of accounting history, this paper undertakes a number of case studies to illustrate the potential approaches to quantifying fidelity losses. Along with each case, the treatment by courts of similar situations will be deliberated upon and discussed. An objective of this paper is to provide a practical and functional compendium of measuring and analyzing the loss quantum in fidelity claims.

II.
FUNDAMENTAL PRINCIPLES OF LOSS IN FIDELITY INSURANCE CONTEXT

There have been a number of revisions and edits to fidelity policy language and financial institution bonds over the decades. It would therefore "be reasonable to assume that the drafters have considered whether it is necessary to define the terms loss."[9] However, because the term is undefined courts have used a variety of tools to interpret whether an insured has suffered a loss. For example, legal dictionaries define loss to include: (1) "The failure to maintain possession of a thing," (2) "a decrease in value," and (3) "[t]he amount of financial detriment . . . ."[10]

A. The Insured Must Suffer an Actual Depletion of Funds

The general rule adopted by courts is that loss is limited net, out-of-pocket loss to the insured.[11] "Loss under a fidelity policy or bond refers to actual loss, as distinguished from a theoretical or bookkeeping loss."[12] Courts and commentators have noted that loss requires "an actual depletion of funds."[13] The Eight Circuit has observed, "Dishonesty in the abstract cannot be compensated in damages, and in a suit to recover on the bond the dishonesty must have resulted in pecuniary loss."[14]

There are cases decided under various facts supporting the notion that an actual depletion of funds is a prerequisite for loss. In *Jack Daniels Motors, Inc. v. Universal Underwriters Ins. Co.*,[15] the court held that coverage was not implicated when the insured lost an opportunity to

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[8] AMERICAN INSTITUTE OF CPAS, https://www.aicpa.org/ (last visited May 11, 2020).
[9] Pelleteri, *supra* note 6, at 730-31.
[10] *Loss*, BLACK'S LAW DICTIONARY (11th ed. 2019).
[11] *See, e.g.*, Cincinnati Ins. Co. v. Star Fin. Bank, 35 F.3d 1186, 1191 (7th Cir. 1994).
[12] 11 LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE § 160:7 (3d ed. 1997).
[13] Hoffman, *supra* note 2, at 446.
[14] Am. Emp'rs' Ins. Co. v. Roundup Coal Mining Co., 73 F.2d 592, 595 (8th Cir. 1934).
[15] No. 10-05376, 2011 WL 346500, at *3 (D.N.J. Feb. 1, 2011), *aff'd* 446 F. App'x 504 (3d Cir. 2011).

receive a performance bonus based upon misconduct by an employee. The "lost opportunity . . . does not equate to a loss of 'currency' actually 'owned' or 'held' by Plaintiff."[16] Although the insured "had an expectancy interest in the performance bonus, an anticipated profit is not 'money.'"[17]

In *Oriental Fin. Group v. Fed. Ins. Co.*,[18] the insured's employees manipulated financial accounts, causing the insured to lose track of transactions. The insured ultimately could not balance its accounts and wrote off millions of dollars.[19] At trial, the insured presented evidence that "arbitrarily matched credits and debits without verifying their relation."[20] The unresolved transactions totaled $3.4 million that the insured could not identify or connect to any supporting documentation.[21] The insured asserted that it suffered a loss, as it was "unable to realize its assets because it could not obtain the supporting documentation to properly reconcile the accounts."[22] Notably, the insured did not directly allege that its employees embezzled funds; instead, the insured focused on the purported accounting manipulation as causing the loss.[23]

A jury found in favor of the insurer, and the court affirmed.[24] The court noted that while the insured may have suffered a loss in the form of a write-off, the claim lacked evidence of an actual depletion of funds.[25] "Under a fidelity bond, bookkeeping or theoretical losses that are not accompanied by actual withdrawals of cash or other such pecuniary loss, are not recoverable."[26] In addition, "false or negligent accounting entries can only result in a loss under a fidelity bond if, as a result of them, money leaves the bank."[27]

Another oft-cited case instructive on this issue is *BancInsure, Inc. v. Peoples Bank of the South*.[28] A borrower named Danny McKey was defaulting on a legitimate loan he owed to the insured.[29] A dishonest bank officer "created fictitious loans from other customers and used the proceeds to pay off McKey's loan."[30] The office subsequently used other fictitious loans to pay off *those* fictitious loans, but after the insured discovered this scheme it created a new, legitimate loan to McKey.[31] McKey was allegedly unaware his original loan had been paid off, began making

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[16] *Id*.
[17] *Id*.; *see also* Tactical Stop-Loss, LLC v. Travelers Cas. & Sur. Co. of Am., No. 08-0962, 2010 WL 2802203 (W.D. Mo. July 14, 2010), *aff'd* 657 F.3d 757 (8th Cir. 2001) (recognizing that funds transferred by a dishonest employee from trust accounts to insured's operating account was not a depletion of funds, and not an actual loss to insured).
[18] 598 F. Supp. 2d 199 (D.P.R. 2008).
[19] *Id.* at 209.
[20] *Id.* at 204.
[21] *Id.*
[22] *Id*. at 202.
[23] *Id*.
[24] *Id.* at 227.
[25] *Id.* at 210.
[26] *Id.* at 202.
[27] *Id.*
[28] 866 F. Supp. 2d 577 (S.D. Miss. 2012).
[29] *Id*. at 588.
[30] *Id*.
[31] *Id.*

payments and was current on the new loan.[32] The court therefore held that coverage was not implicated for these transactions.[33] "[I]t is clear to the court that [the officer] merely shifted money around on the Bank's books, with the result that there was only a bookkeeping or theoretical loss, which is not a loss covered under the terms of the Bond."[34]

B. Disgorgement, Restitution, and Similar Payments do not Qualify as Loss

Fidelity policies are also not intended to cover purported "loss" that is simply the disgorgement or return of ill-gotten gains to which the insured is not legally entitled. There are numerous reported cases, most often in the context of D&O or liability policies, holding that payments by an insured that are akin to restitution, or that constitutes monies the insured wrongfully obtained and is required to obtain, do not qualify as loss.[35] For example, in *Philadelphia Indem. Ins. Co. v. Sabal Ins. Group, Inc.*,[36] the insured suffered a co-called "loss" when it entered into a settlement agreement whereby it paid $300,000 in exchange for a release of criminal charges. A coverage dispute ensued, with the district court holding that the payment was "clearly restitutionary in nature," and therefore did not qualify as "loss."[37] According to the district court, "Payments made to resolve this claim can only be said to disgorge Defendants of property to which they were allegedly not legally entitled."[38]

C. "Cash-out-the-Door" – How Loss Should be Calculated

Even if an insured establishes a loss, a dispute may arise as to the total amount of the loss or how the loss should be calculated. As noted above, in the fidelity context loss is intended to be limited net, "out-the-door" loss. In the context of loan loss claims, a dispute often arises as to

[32] *Id.*
[33] *Id.*
[34] *Id.*; *see also* Fireman's Fund Ins. Co. v. Special Olympics Int'l, Inc., 249 F. Supp. 2d 19 (D. Mass. 2003) (holding that the insured was not entitled to coverage for a dishonest employee who launched an unauthorized "fundraising campaign" and pocketed the funds, because the "donations" were made without the insured's knowledge and did not result in a diminution of in the insured's monies).
[35] *See, e.g.*, *Level 3 Commc'ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 911 (7th Cir. 2001) ("An insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return."); *Ryerson, Inc. v. Federal Ins. Co.*, 676 F.3d 610, 613 (7th Cir. 2012) (agreeing with *Level 3* and holding that thieves should not be permitted to obtain insurance to cover the return of funds they stole); *Reliance Group Holdings, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 594 N.Y.S.2d 20, 24 (N.Y. App. Div. 1993) (reasoning that the repayment or disgorgement of profits obtained by fraud is not a covered loss); *CNL Hotels & Resorts v. Houston Cas. Co.*, 505 F. Supp. 2d 1317, 1324-25 (M.D. Fla. 2007) (recognizing that a settlement payment constituted the disgorgement of ill-gotten gains, which is uninsurable and does not implicate coverage); *In re TransTexas Gas Corp.*, 597 F.3d 298, 310-11 (5th Cir. 2010) (applying Texas law and holding that an insured's payment of $2 million judgment based upon a fraudulent transfer theory was not a "loss," as the return of funds due to a fraudulent transfer was in the nature of restitution or the disgorgement of ill-gotten gains); *Zayed v. Arch Ins. Co.*, 932 F. Supp. 2d 956 (D. Minn. 2013) (judgment for the return of a fraudulently obtained investment funds is not insurable and does not qualify as a "loss"; to hold otherwise would result in a "moral hazard—that is, the risk that, if a particular type of wrongful conduct can be insured, people will engage in more of that type of wrongful conduct.").
[36] No. 16-62168, 2017 WL 4310700 (S.D. Fla. Sept. 28, 2017).
[37] *Id*. at *4.
[38] *Id*.

whether unpaid or capitalized interest constitutes a loss. The case of *Citizens Bank & Trust Co. v. St. Paul Mercury Ins. Co.*,[39] is instructive on how loss should be viewed by the courts. In *Citizens Bank*, the insured submitted a loss of $1,452,010.94 involving thirty-nine (39) fraudulent loans issued by William Hunt, a branch vice-president. Of the $1,452,010.94 claimed loss, it was determined that Hunt had "depleted the net cash amount of $884,000 from the Bank's Loan Proceeds checking accounts over the course of his scheme."[40] The remainder of the claimed loss ($568,010.94) constituted accrued interest on the fraudulent loans that were capitalized or rolled over as principal into new fraudulent loans. The district court held that this capitalized interest was only a theoretical, or bookkeeping, loss that was not covered.

The district court agreed with the insurer "that the 'direct loss' is determined by calculating the amount of the theft (the 'cash-out-the-door'), and that the satisfaction of old notes with new fraudulent loans was merely 'bookkeeping.'"[41] Rolling over accrued interest into new fraudulent loans "did not cause any new direct losses to the bank, because no additional funds were depleted."[42]

In awarding summary judgment to the insurer, the district court held that:

> Direct loss requires "an actual present loss, as distinguished from a theoretical or bookkeeping loss. In other words, some action which reduced the available assets in the hands of these employees as against its liabilities to depositors, creditors, and stockholders."
> ***
> In other words, only "actual withdrawals of cash or other such pecuniary loss" are recoverable under a fidelity bond like the one at issue here.[43]

Many newer forms of financial institution bonds have expressly set forth the "cash-out-the-door" procedure for calculating loss by including language such as:

> The value of any loss or that portion of any loss resulting from a Loan shall be the amount actually disbursed by the insured to a borrower under such Loan, reduced by all monies received by the insured in connection with such Loan whether applied as principal, interest, and/or fees.

Under this provision, if an insured issued a $100,000 loan and received $5,000 in principal and $5,000 in interest, the loss for purposes of a fidelity claim is $90,000 (even though the outstanding principal balance is $95,000).

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[39] No. CV305-167, 2007 WL 4973847 (S.D. Ga. Sept. 14, 2007).
[40] *Id.* at *1.
[41] *Id.* at *3.
[42] *Id.*
1. [43] *Id. at *4 (quoting Cincinnati Ins. Co. v. Star Fin. Bank, 35 F.3d 1186, 1191 (7th Cir. 1994); Cont'l Cas. Co. v. First Nat'l Bank of Temple, 116 F.2d 885, 887 (5th Cir. 1941)); see also M&C Holdings Delaware, P'ship v. Great Am. Ins. Co., No. 1:20-cv-121, 2020 WL 4365635, at *6 (S.D. Ohio July 30, 2020) ("[A]n actual disbursement of funds is the critical element in determining an actual loss").*

a.

There are multiple cases in which courts have been required to address loss involving Ponzi schemes. In *Jacobson Family Invs., Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh PA*,[44] the insured unfortunately invested with Bernie Madoff. Account statements reflected balances of $123 million, with a substantial portion of that figure constituting gains that "Madoff infamously conjured out of thin air."[45] Despite the non-existent gains, due to prior withdrawals the insured's realized approximately $3 million in actual gains once the scheme collapsed. The insured sought coverage for the approximately $107 million in fictitious gains, but the court ruled in favor of the insurer on the basis that there was no loss. According to the court, "no insurance policy can be interpreted to compensate the insured for something that, unbeknownst to the parties, only appeared to exist because of someone else's fraud."[46]

In *3M Co. v. Nat'l Union Fire Ins. Co.*[47] and *Cooper Ind. Ltd. v. Nat'l Union Fire Ins. Co.*[48] the insured(s) sought to recover lost investment gains from employee benefit plans. In both cases, the benefit plan invested money with a company that was running a Ponzi scheme. Although both insureds were able to recover their lost principal, they sought to recover the amount they would have earned had their funds been properly invested. The respective insurers denied both claims on the grounds that lost or unearned gains were not "owned" by the insured.

Both trial courts concluded that the insureds did not have an ownership interest in their lost earnings, and that the ownership provisions precluded coverage. Both rulings were affirmed on appeal. In *3M*, the Eighth Circuit noted that "until the point at which earnings were distributed to the [insured], the earnings . . . were owned by the [investment company] and not by" the insured."[49] Similarly, in *Cooper* the Fifth Circuit held that once the insured relinquished ownership of the funds by loaning them to the investment company, all it held was a promissory note and it no longer owned the funds.[50]

III.
DEFINING LOSS FROM ACCOUNTING PERSPECTIVE

From an accounting perspective, the definition of the term "loss" has had a curious journey. The public often hears comments such as income loss for taxes and profits for stockholders for the same event. The comments include "paper losses" and "actual losses." Let's explore in this portion of the paper the history of losses from an accountant's viewpoint, using the concepts from certified public accounting in the United States. This section of the paper explores the definition of loss

[44] 955 N.Y.S.2d 338 (N.Y. App. Div. 2012).
[45] *Id*. at 341-42.
[46] *Id*. at 346.
[47] 858 F.3d 561 (8th Cir. 2017).
[48] 876 F.3d 119 (5th Cir. 2017).
[49] 858 F.3d at 565.
[50] 876 F.3d at 131 ("The 'loss,' however, did not occur when [the insured] loaned the funds . . . , but when [the funds were] stole[n] after the loan had been made. By that time, title had passed . . . .").

according to the AICPA and its predecessors through American history. The exploration of loss from the tax perspective will not be addressed in detail.[51]

The fundamental concepts are that the loss must be realized, incurred, and have economic substance. The ability to measure and be tangible are relative to quantifying a fidelity loss. The Internal Revenue Service ("IRS") indicates, "When money is stolen, the theft is the amount stolen."[52] The unique event of the IRS and insurance complementing each other is the element of realized, incurred, and immediate. The unrealized and speculative losses for insurance and for taxes are not recognized as addressed for fidelity insurance[53] or as tax deductible. Here the tax concepts of loss complement the insurance quantification of loss, according to ISO Commercial Crime Policy Form CR 00 23 11 15.

The IRS Master Guide[54] indicates:

> A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the law of the state where it occurred and it must have been done with criminal intent. You don't need to show a conviction for theft. Theft includes the taking of money or property by the following means.
>
> - Blackmail.
> - Burglary.
> - Embezzlement.
> - Extortion.
> - Kidnapping for ransom.
> - Larceny.
> - Robbery.
>
> The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law.

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[51] However, the tax approach should not be ignored because taxes consider the loss must be realized, incurred, and have economic substance. These concepts also play a role in the insurance industry.

[52] U.S. MASTER TAX GUIDE ¶ 1101 (101st ed. 2017). A taxpayer may generally deduct losses which have not been compensated for by insurance or otherwise. 26 U.S.C. § 165(a) (2017); 26 C.F.R. § 1.165-1 (1977). In order to be deductible, a loss generally must be evidenced by a closed and completed transaction and fixed by an identifiable event during the tax year, such as a sale, foreclosure, or condemnation. *Id.* However, any loss arising from theft is treated as sustained during the tax year in which the taxpayer discovers the loss. U.S. MASTER TAX GUIDE ¶ 1123 (101st ed. 2017). In addition, a special election exists for determining the year to deduct a loss attributable to a federally declared disaster. U.S. MASTER TAX GUIDE ¶ 1133 (101st ed. 2017). Only a bona fide loss sustained by the taxpayer may be deducted, and the substance of a transaction, not its form, governs whether there is a deductible loss. Thus, a loss deduction may be disallowed for a transaction that lacks economic substance and is entered into solely for tax benefits.

[53] Please note, the authors indicate "complement" not define.

[54] *Id.* at 547.

> **1127. Amount of Casualty or Theft Loss**. The amount of a casualty loss (¶ 1121) which is deductible for business and income-producing property or nonbusiness property is the *lesser* of:
>
> - the fair market value (FMV) of the property immediately before the casualty reduced by
>
>   its FMV immediately after the casualty, or
> - the adjusted basis of the property immediately before the casualty (Reg. §1.165-7(b)).
>
> If business or income-producing property is totally destroyed and the property's FMV immediately before the casualty is less than its adjusted basis, then the casualty loss is the adjusted basis of the property.
>
> The amount of a theft loss (¶ 1123) which is deductible is the fair market value or the adjusted basis of the property stolen (Reg. §1.165-8(c)). When money is stolen, the theft loss is the amount stolen. The amount of a theft loss in the case of nonbusiness property other than money is the lesser of the value of the property or its adjusted basis. In the case of stolen business or income-producing property, the theft loss is the adjusted basis of the property stolen.[55]

The IRS does <u>not</u> consider the speculative, not-out-of-pocket, as a loss, similar to the ISO Commercial Crime Policy Form CR 00 21 11 15:

> **A. Insuring Agreements**
>
> Coverage is provided under the following Insuring Agreements for which a Limit Of Insurance is shown in the Declarations and applies to loss that you sustain resulting directly from an "occurrence" taking place during the Policy Period shown in the Declarations, except as provided in Condition E.1.k. or E.1.l., which is "discovered" by you during the Policy Period shown in the Declarations or during the period of time provided in the Extended Period To Discover Loss Condition E.1.g.:
>
> **1. Employee Theft**
>
> We will pay for loss of or damage to "money", "securities" and "other property" resulting directly from "theft" committed by an "employee", whether identified or not, acting alone or in collusion with other persons.

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[55] *Id.* at ¶ 1127.

For the purposes of this Insuring Agreement, "theft" shall also include forgery.

E. Conditions

The following conditions apply in addition to the Common Policy Conditions:

1. Conditions Applicable To All Insuring Agreements

s. Valuation - Settlement

The value of any loss for purposes of coverage under this insurance shall be determined as follows:

(2) Securities

Loss of "securities" but only up to and including their value at the close of business on the day the loss was "discovered".

(3) Property Other Than Money And Securities

(a) Loss of or damage to "other property" or loss from damage to the "premises" or its exterior for the replacement cost of the property without deduction for depreciation. However, we will not pay more than the least of the following:

(i) The Limit of Insurance applicable to the lost or damaged property;

(ii) The cost to replace the lost or damaged property with property of comparable material and quality and used for the same purpose; or

(iii) The amount you actually spend that is necessary to repair or replace the lost or damaged property.

(b) We will not pay on a replacement cost basis for any loss or damage to property covered under Paragraph s.(3)(a):

(i) Until the lost or damaged property is actually repaired or replaced; and

(ii) Unless the repair or replacement is made as soon as reasonably possible after the loss or damage.

If the lost or damaged property is not repaired or replaced, we will pay on an actual cash value basis.

F. Definitions

23. "Theft" means the unlawful taking of property to the deprivation of the insured.

The aforementioned cursory comparison of the United States Tax Code and the ISO Crime Forms illustrate how definitions of loss can be complimentary. However, moving forward in history, there was the advent of the federal income tax on corporations, other businesses, and individuals. The Revenue Act of 1936 established an "undistributed profit tax" on corporations in the United States.[56] The Revenue Bill of 1941 permanently set corporate tax rates at top rates from 24% to 31%.[57] These notions of taxations that allowed Congress under the 16th Amendment to levy income tax on corporations became a fixture. As such, there was an incentive for corporations to have taxable income that differed significantly from book income. The differences were derived from timing, tax deduction, and as to what is taxable.

Throughout history, there has been the yin and yang of balancing the desire of:

> 1. Obtaining and reflecting the least amount of loss or the greatest possible profit to attract investors or even obtain surety performance bonds. Throughout history, it has been the AICPA's goal to strive for attributes in the presentations of financial statements, including but not limited to:
>
> - *Objectivity.* The framework is free from bias.
> - *Measurability.* The framework permits reasonably consistent measurements.
> - *Completeness.* The framework is sufficiently complete so that those relevant factors that would alter a conclusion about the financial statements are not omitted.
> - *Relevance.* The framework is relevant to financial statement users.[58]

Compare this to the desire of paying the least amount of taxes. The tax code provides a number of opportunities for tax avoidance and restrictions to prevent tax evasions, which can cause the taxable income to be significantly different from recorded income (profit) shared with investors.

The increasing tax rates and taxation acts encouraged additional concepts of what constituted a loss. While accountants cannot control the IRS and lawmakers, and the taxes used for revenue generation and social change, accountants do endeavor to ensure published (audited and reviewed) financial statements are consistent and conservative. There became a demand for uniformity and conformity in the definition and use of terms by government, banks, stock markets, users of financial statements, and the auditors of financial statements. It became necessary for

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[56] H.R. Res. 12395, 74th Cong. (1936) (enacted).
[57] H.R. Res. 5417, 77th Cong. (1941) (enacted).
[58] FINANCIAL REPORTING FRAMEWORK FOR SMALL- AND MEDIUM SIZED ENTITIES V (AICPA ed., 2017).

accounting practitioners and users to create concepts and standards as to when revenues, expenses, and losses could be or should be recognized.

> Accounting language must be consistent with the facts and realities of commercial life. The determination of costs and the matching costs against income are being made more and more difficult each day because of governmental policy, tax laws, and sumptuary legislation. The end of accounting is being manipulated to purposes which were not formerly intended. Here language is not the goal, but is subordinated to other ends which are more fundamental for the survival of the organization. Tax savings become more important than the development of an art. Present inventory evaluations are unrealistic compared with present market and replacement values because of the last-in first-out principle. Buildings and equipment are undervalued according to realistic principles, because of the rapid depreciation policies instituted by management and sanctioned by the government. After World War II literally acres of buildings and machinery having a book value, of zero, even today can be used for some other purpose than military production for another twenty-five or fifty years. Unless more scientific means are established for allocating costs among products, departments, and territories, the first thing that the accounting profession learns is that principles based on arbitrary decisions will be the rule rather than the exception. Sometimes arbitrary principles can be justified with thought and research but again too many discretionary decisions will lead the layman to regard such language as tinged with sophistry and deception. He will be justified in referring to accounting as the 'phantom art.'[59]

The historical need for consistent and accurate presentations of financial results dates from the Roman empire. According to Guy de la Bédoyère, author of Praetorian: The Rise and Fall of Rome's Imperial Bodyguard:

> The Praetorian Guard – a special group of solders *supposedly* loyal to the emperor Pertinax – assassinated the aforementioned emperor and held an auction to sell the Roman empire to the highest bidder. That man was Julianus, with an astronomical bid of 250,000 sestertii for each soldier in the army. The guards had sold something that wasn't theirs, effectively amounting to financial fraud. Julianus was never recognized as emperor and was quickly deposed, leading to a period of civil war in the empire and a period of time known as the year of the five emperors.[60]

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[59] Harold A. Avery, *Accounting as a Language*, 28 ACCT. REV. 83, 85 (1953).
[60] GUY DE LA BÉDOYÈRE, PRAETORIAN: THE RISE AND FALL OF ROME'S IMPERIAL BODYGUARD 217 (2017).

Julianus, who was greedy and indulgent, lacked the personal funds to make the payment, thus laying barren the treasury and leading to Julianus's execution.[61] This is one of the oldest financial frauds, and illustrates the necessity of the AICPA objectives to strive to prevent fraud by providing accurate and financial reporting. The ability to have accurate and consistent financial statements is the ability to have comparability of financial records. Thus, the desire to overstate revenues and understate liabilities to increase desirability to investors is the basis of auditors' and accountants' trepidation and unease. It is necessary to facilitate the consistency of financial terms and definitions based on the matching concept crafted by A.C. Littleton.

In 1931, the American Institute of Accountants, the predecessor of AICPA, drafted the following definitions, per the organization's Special Committee on Terminology:

> **Loss, Gross**: The excess of cost of goods sold over the selling price. It is the reverse of "gross profits" (*q.v.*) and is determined by the same methods. Note that "gross loss" is smaller than "net loss." The term is undesirable and not often used.
>
> **Loss, Net**: The reverse of "net profits" (*q.v.*).[62]
>
> **Gross**: A total amount which is subject to certain deductions.[63]
>
> **Net**: The result of some deduction, *e.g.*, net earnings, net sales (*q.v.*) as differentiated from gross (*q.v*).[64]

Dr. Richard Schroeder in *Accounting Theory* summarizes the concepts and impact of Dr. A.C. Littleton's matching conceptualization:[65]

> The determination of when costs are of no future benefit and should therefore be charged against revenue depends on the definitions of the terms *cost*, *expense,* and *loss*. These terms are defined as follows:
>
> *Cost – the amount given in consideration of goods received or to be received. Costs can be classified as unexpired (assets), which are applicable to the production of future revenues, and expired, those not applicable to the production of future revenues and thus deducted from revenues or retained earnings in the current period.*[66]

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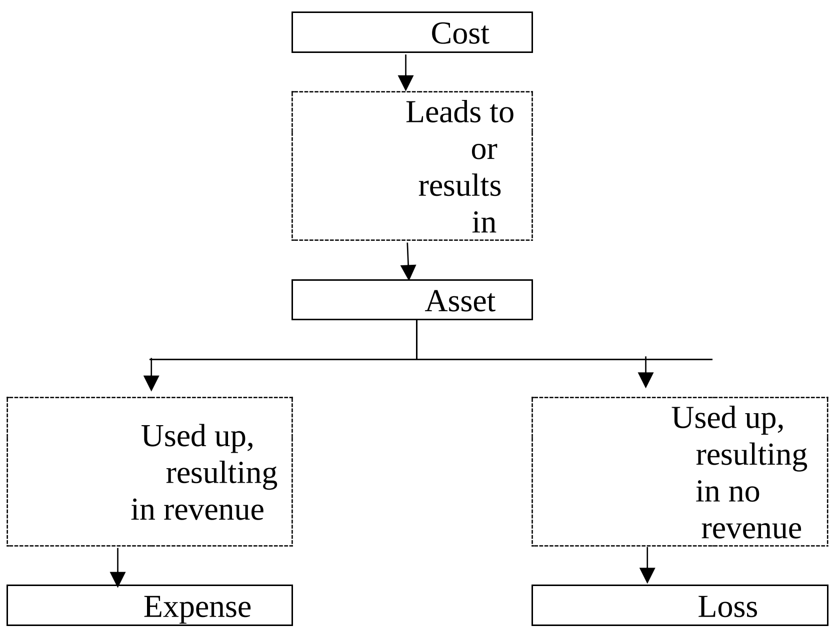
[61] *Id.* at 218-19.
[62] ACCOUNTING TERMINOLOGY 62 (A.P. Richardson ed., 1931).
[63] *Id.* at 67.
[64] *Id.* at 83.
[65] Norton M. Bedford and Richard E. Ziegler, *The Contributions of A. C. Littleton to Accounting Thought and Practice*, 50 ACCT. REV. 434, 440, 40 (1975).
[66] William A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards*, *in* MONOGRAPH NO. 3 (Am. Acct. Ass'n 1940).

> *Expense – outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.*[67]
>
> *Loss – decreases in equity (net assets) from peripheral or other incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.*[68]
>
> In other words, expenses are revenue-producing cost expirations while losses are non-revenue-producing cost expirations.

The definitions are illustrated as follows[69]:



Historically, accountants have notated an asset must exist to experience a loss. Limitations of insurance loss may not consider the historical accounting concepts of matching. However, insurance does consider the concept of depletion of assets, as discussed above. It is the various changing concepts of loss in accounting history that can support and can contradict the fidelity insurance industry.

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[67] CONCEPTS AND STANDARDS RESEARCH STUDY COMMITTEE 368-72 (Am. Acct. Ass'n 1964).
[68] AMERICAN INSTITUTE OF CPAS, COMMITTEE ON TERMINOLOGY, ACCOUNTING TERMINOLOGY BULLETIN NO. 4 (1953).
[69] RICHARD G. SCHROEDER, MYRTLE W. CLARK & JACK M. CATHEY, FINANCIAL ACCOUNTING THEORY AND ANALYSIS 145 (8th ed. 2005).

In common law countries, historically, accountants have strived to establish a strong accounting profession wherein accounting is respected as independent and reliable.[70] Accountants endeavor to provide accurate information to decisionmakers and have the goal of providing exact and useful information.

> Although there are important differences of detail, accounting oversight bodies broadly agree upon the following:
>
> (1) That financial reports are intended to serve *users* and that equity investors and lenders are important components of the user constituency.
> (2) That the balance sheet and the income statements (or profit and loss account), supplemented by a flow of funds statement (or possibly a statement of cash flows) are the *fundamental financial statements*.
> (3) That users are concerned with *economi*c evaluation and decision-making. This implies that measurement should strive to reflect actual economic opportunities and steers us towards current valuation and the estimation of future prospects, rather than historical cost valuation and concentration on past transactions. Insofar as disclosure is concerned, it implies disclosure of all matters which are material to economic decisions and evaluation.[71]

With newer financial statement formats, there is additional information and insight as to operations. The goals of accountants in the future of financial reporting are to provide answers such as:

a. Where did the profits go?
b. Why weren't dividends larger?
c. How was it possible to distribute dividends in the presence of a loss?
d. Why are current assets down when there was a profit?
e. Why is extra financing required?
f. How was the expansion financed?
g. Where did the funds from the sale of securities go?
h. How was the debt retirement accomplished?
i. How was the increase in working capital financed?[72]

[70] SHAHROKH M. SAUDAGARAN, INTERNATIONAL ACCOUNTING: A USER PERSPECTIVE 9 (2001).
[71] GEOFFREY WHITTINGTON, PROFITABILITY, ACCOUNTING THEORY AND METHODOLOGY 325 (2007).
[72] SCHROEDER, CLARK & CATHEY, *supra* note 69, at 225.

It is through continuous advances in the reporting of accounting that external accounting goals will be improved, and achievements of goals obtained to avoid the concepts of "creative accounting."[73] Creative accounting concepts include, but are not limited to:

1) Unrecorded off balance sheet financing
2) Inaccurate contingent contract reporting
3) Overvalue goodwill
4) Complex capital issues

In summary, the outside financial accounting profession has a multitude of goals and objectives that do not always align with the fidelity insurance. Those differences should be remembered when financial information is used and presented in the fidelity insurance arena.

IV.
IN THE FIDELITY CONTEXT, WHEN DOES LOSS OCCUR?

An additional issue that must be investigated and determined by fidelity practitioners is when the loss is deemed to have occurred. That issue is first relevant to determining which policy(ies) may provide potential coverage. Certain fidelity policies are issued on an "occurrence" basis – the alleged dishonesty or other bad acts must occur during the applicable policy period. Misconduct that occurred before the policy became effective, or after the policy expires, will not implicate coverage. Other policies are written on a "discovery" basis – at issue is when the insured discovered the loss, regardless of when the bad acts occurred.

In a straightforward claim involving employee embezzlement, determining when the loss occurred is rarely difficult or controversial. The dishonest act and loss occur simultaneously, when the funds are diverted or stolen by the employee.[74] In *Pac.-S. Mort. Tr. Co. v. Ins. Co. of N. Am.*,[75] the California Court of Appeals held that treating the loss as occurring when the bad acts occur "makes sense in the majority of cases where the dishonest acts and the loss occur at the same time such as when the loss is due to forged instruments or embezzlement." In one of the older reported fidelity cases, the court in *Fitchburg Savings Bank v. Massachusetts Bonding & Ins. Co.*[76] held:

> Loss means the deprivation or dispossession of money or property of the bank due to the dishonest, criminal, or fraudulent acts of its officers, regardless of the security the bank has for the loss . . . .[77]

In cases involving third-party claims for property held by the insured, for purposes of evaluating coverage the loss occurs at the time of the bad acts (or when the property is stolen), as

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[73] WHITTINGTON, *supra* note 71, at 326.
[74] Scott Schmookler et al., *Causation and Third-Party Loss*, *in* HANDLING FIDELITY BOND CLAIMS 569 (Michael Keeley ed., 3d ed. 2019).
[75] 212 Cal. Rptr. 754, 757 (Cal. Ct. App. 1985).
[76] 174 N.E. 324 (Mass. 1931).
[77] *Id*. at 328.

opposed to when the insured indemnifies the third-party.[78] In *RBS Dain Rauscher, Inc. v. Fed. Ins. Co.*,[79] a broker's registered representative initiated an unauthorized wire transfer of funds from a client's account. The district court held that the broker suffered a loss when the unauthorized transfer was made, as opposed to when the broker settled the client's lawsuit years later.

Having said that, in claims involving fraudulent or dishonest loans determining when a loss occurred is more difficult (and is subject to different interpretations by courts). Consider the situation in which a loan is issued by an insured and it is later determined that the dishonest loan officer misrepresented the collateral, the borrower's creditworthiness, or another key factor in the insured's decision to issue the loan. Although the alleged dishonesty has been discovered, if the borrower has not defaulted on the loan has the insured lender suffered a loss? Some courts have held that a loss is "merely anticipated," and does not occur until the loan defaults.[80] In *Fremont*, an insured issued loans based upon dishonest conduct committed by a former employee. When considering cross-motions for summary judgment, the district court first had to determine whether the insured had suffered a loss.

> [Insured] argues that loss means the parting of funds from the insured in any way. Under a fidelity bond or policy of the type presented here loss must occur the moment the loans are disbursed in reliance on that fraud or forgery. Therefore, it suffered an actual loss upon disbursement in the amount of the loan disbursements regardless of any subsequent selling, repayment, discharge, or settlement of the loans.[81]

Conversely, the insurers assert that " loss cannot be measured at disbursement and does not occur until a loan in some way does not perform as expected."[82] The district court conceded that "The rule is not universal," and held that a loss did not occur until the loan(s) defaulted.[83] The court cited with approval to *Pac.-S. Mort. Tr. Co. v. Ins. Co. of N. Am.*,[84] which held that:

> [I]n the case of a secured loan made because of fraudulent misrepresentations, the fraud and the loss do not necessarily occur at the same time. The loss may occur much later *or not at all* since the debtor may eventually become creditworthy or the underlying property may appreciate in values so that no actual loss is ever suffered.

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[78] *Id*.
[79] 370 F. Supp. 2d 886, 890 (D. Minn. 2005).
[80] *See, e.g.,* Fremont Reorganizing Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, No. 10-00310, 2012 WL 13014960, at *7 (C.D. Cal. Jan. 5, 2012).
[81] *Id*. at *6.
[82] *Id*.
[83] *Id*. The district court did note one (1) exception to its holding – one of the subject loans was issued in exchange for "worthless forgeries" and had no valid security. In that instance, the district court held that the loss occurred upon funding, as it was a certainty the loan would not be repaid. *Id*. at *8.
[84] 166 Cal. 3d 703, 710 (1985) ; *see also* Direct Mortg. Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, 625 F. Supp. 1171, 1178 (D. Utah 2008) (finding a loss was merely theoretical prior to a loan defaulting).

Other courts have reached a contrary conclusion. For example, in *F.D.I.C. v. United Pac. Ins. Co.*,[85] the Tenth Circuit Court of Appeals stated that "In terms of loss with respect to the making loans, a bank suffers a loss when funds are disbursed due to the employee's wrongful conduct." Under this theory, funds repaid to the insured (either via liquidation of collateral or directly from a borrower or guarantor) are treated similar to salvage or recovery, which could result in the unusual situation of a court finding coverage to be implicated on a loan that never defaults and is paid in full.

V.
ACCOUNTING PARAMTERS ON LOSS, COMPARED TO FIDELITY POLICIES

Some of the (non-exhaustive) parameters for the fidelity insurance loss (in general, based on individual policy language) include, but are not limited to[86]:

1. Tangible assets,
2. Direct in proximity without interceding actions,
3. Direct as in known amount, not speculative in nature, and
4. Realized and recognized.

By reviewing the accounting concepts and the accounting challenges for each of the above parameters, the layperson can better understand why crime insurance policies cannot address loss from an actuarial concept or measurable concept.

A. Tangible Assets

Tangible assets, not intangible assets, are addressed by crime insurance. A loss of intangible assets can occur. However, the quantum of loss would be speculative, at best.

> Generally Accepted Accounting Principles (GAAP) place limits on management's ability to record intangible assets…
>
> Hampering these efforts is a gap in our knowledge of the determinants of the accounting choice to record intangible assets. While we know contracting and signaling can influence the choices in some contexts, thus far, another fundamental question is largely unaddressed. This question is the extent that managements' choices to record intangible assets are based on their insights into the underlying economics of their firm…
>
> Intangible assets are difficult for outsiders to observe and monitor. This characteristic leads to concerns that the wider discretion called

[85] 20 F.3d 1070, 1080 (10th Cir. 1994).
[86] ISO COMMERCIAL CRIME POLICY FORM CR 00 23 11 15 (2015).

> for by some commentators, will open the floodgate for accounting manipulations.[87]

The speculative nature and desire of what client lists, secret recipes are worth are innate to the individual owner(s).[88]

B. Direct in Proximity Without Interceding Actions

The concept in insurance is to address direct losses, not the subsequent incurred amount. An example may include, but not be limited to, a car dealer that has an employee, a salesperson, falsifying documentation, such as indicating a customer is eligible for a military discount. With the $1,000 rebate, the salesperson completes the sales and receives $400 in commission. The manufacturer arrives six months later to confirm the accuracy of the deal jacket information. The manufacturer finds the customer was not eligible for the discount and requires the dealer to return the entire commission (dealer portion and salesperson portion). Thus, the dealership returns the $1,000 to the manufacturer as required by the contract. The potential fidelity insurance loss, depending on the policy, is only the portion given directly to the salesperson.[89]

C. Direct, as in Known Amount, Not Speculative

This tenet is to ensure a known amount that is measurable is addressed by the fidelity policy. A typical fidelity policy illustrates the desire to exclude the speculative nature in a number of portions of the policy, including but not limited to:

> **D. EXCLUSIONS**
>
> 1. This Policy does not cover:
> 2. Insuring Agreement A.1. does not cover:
>
>   a. Inventory Shortages
>
>   Loss, or that part of any loss, the proof of which as to its existence or amount is dependent upon:
>
>   (1) An inventory computation;
>
>   (2) A profit and loss computation.
>
>   However, where you establish wholly apart from such computations that you have sustained a loss, then you may

[87] Anne Wyatt, *Accounting Recognition of Intangible Assets: Theory and Evidence on Economic Determinants*, 80 ACCT. REV. 967, 968 (2005).
[88] For a detailed discussion of the concept of coverage within the fidelity coverages, see Adam P. Friedman & Mark E. Nikolsky, *Intellectual Property Claims – Fitting a Square Peg into a Round Hole*, VIII FID. L.J. 91 (2002).
[89] For a detailed discussion of the potential fidelity insurance loss in this scenario, see Adam D. Cornett & Andrew S. Kent, *Who Can Recover Under a Fidelity Policy?* XX FID. L.J. 139 (2014) (addressing the nature of fidelity insurance as providing first-party indemnity coverage, not third-party liability coverage).

> offer your inventory records and actual physical count of inventory in support of the amount of loss claimed.[90]
>
> **E. Conditions**
>
> 1. Conditions Applicable To All Insuring Agreements
>
> y. Valuation - Settlement
>
> The value of any loss for purposes of coverage under this Policy shall be determined as follows:
>
> (3) Property Other Than Money And Securities
>
> (a) Loss of or damage to "other property" or loss from damage to the "premises" or its exterior for the replacement cost of the property without deduction for depreciation. However, we will not pay more than the least of the following:
>
> (i) The Limit of Insurance applicable to the lost or damaged property;
>
> (ii) The cost to replace the lost or damaged property with property of comparable material and quality and used for the same purpose; or
>
> (iii) The amount you actually spend that is necessary to repair or replace the lost or damaged property.
>
> (b) We will not pay on a replacement cost basis for any loss or damage to property covered under Paragraph y.(3)(a):
>
> (i) Until the lost or damaged property is actually repaired or replaced; and
>
> (ii) Unless the repair or replacement is made as soon as reasonably possible after the loss or damage.
>
> If the lost or damaged property is not repaired or replaced, we will pay on an actual cash value basis.[91]

For example, a manufactured item is stolen. The known cost is the raw material, direct labor to create, and the other direct variable costs incurred to create the items. The speculative cost is the estimated full absorption cost, which would include expenses such as management sales and rent

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[90] ISO COMMERCIAL CRIME POLICY FORM CR 00 23 11 15, at D.1 (2015).
[91] ISO COMMERCIAL CRIME POLICY FORM CR 00 23 11 15, at E.1 (2015).

proportional to the units produced. Full absorption costs include costs that will not be incurred to remake the item. Thus, full absorption costs are not addressed in a policy that is usually limited to the least of the cost to actually replace the lost items.

D. Realized and Unrealized

The concept of realized and unrealized amounts is often addressed in fidelity bonds and policies. For example, a fidelity policy may indicate:

> **clusions**
> is policy does not cover:
> tential income, including but not limited to interest and dividends, not realized by you or your "customer".[92]

In 1964, the American Accounting Association Committee on Realization recommended the concept of realization could be improved with the application of the following criteria: (1) Revenue must be capable of measurement, (2) the measurement must be verified by an external market transaction, and (3) the crucial event must have occurred. The key element in these recommendations is the third criterion. The crucial-event test states revenue should be realized upon the completion of the most crucial task in the earning process. This test results in the recognition of revenue at various times for different business organizations.[93]

If the item stolen is not realized and not recognized, it cannot be an asset owned by the insured. In concept, the not realized amount is not an asset that can be depleted. A revenue event can be recognized but not received. Such an example would be outstanding accounts receivable that in an accrual accounting may recognize the revenue due from the customer. The amount due is known but actual cash is not collected (realized). Thus, the cash may not be collected, thus not realized. The cash amounts are not realized and can be speculative.

There is also the expected selling price. It is estimate or speculative that:

1. The sale may never occur, and
2. What the actual sales price may be.

In this example of outstanding accounts receivable, a business understands not all outstanding accounts receivable may be collected. A business may know what is due but understands the amount of cash realized and the amount of outstanding accounts receivable that may be written off is speculative. It is these rationales a crime policy must consider to avert the incentive of profit making under the insurance forms.

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[92] ISO COMMERCIAL CRIME POLICY FORM CR 00 23 11 15, at D.4 (2011).
[93] American Accounting Association, *The Matching Concept,* 40 ACCT. REV. 368, 370 (1965).

VI.
UNPAID OR LOST RECEIVABLES DO NOT QUALIFY AS LOSS

An increasingly common scheme, in particular as computer crime claims continue to proliferate, is that in which a wrongdoer receives funds (typically, receivables or funds due and owing) intended to be transmitted to an insured. The claim is submitted by the insured, who has not suffered a traditional first-party loss of property it owns or holds. Instead, money the insured is owed is diverted to fraudsters. Three (3) recent cases have all held that fidelity coverage is not implicated for the insured under these facts.[94]

In *Posco Daewoo America Corp. v. Allnex USA, Inc.*,[95] the plaintiff/insured, a chemical importer/exporter, was owed money by co-defendant Allnex. In early 2016, a fraudster posing as an employee of the plaintiff transmitted fraudulent emails to Allnex requesting wire payments to accounts that were controlled by the fraudster (and not by the plaintiff). Allnex complied, and over $630,000 was wired to the wrongdoer. Allnex refused to make payment to the plaintiff and contended that the wire payments to the fraudster satisfied its obligations to the plaintiff. The plaintiff sued Allnex and the plaintiff's fidelity insurer.

The insurer filed a motion to dismiss based upon the fidelity policy's ownership clause, which stated:

> 5. Ownership of Property; Interests Covered
>
> a. The property covered under this Crime Policy except as provided in 5.b. below is limited to a property:
>
> i. that the Insured owns or leases;
>
> ii. that the Insured holds for others:
> (a) on the Insured's Premises or the Insured's Financial Institution Premises; or
> (b) while in transit and in the care and custody of a Messenger; or
>
> iii. for which the Insured is legally liable, except for property located inside the Insured's Client's Premises or the Insured's Client's Financial Institution Premises.[96]

The federal district court granted the insurer's motion to dismiss based upon the ownership clause. The court first held:

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[94] However, fidelity practitioners would be wise to insist that the non-insured entity transferring funds to the wrongdoers seek coverage under its fidelity bond. Depending upon the precise facts and policy language, it is possible the transferring entity would have coverage and could later remit payment to the insured.
[95] No. 17-483, 2017 WL 4922014 (D.N.J. Oct. 31, 2017).
[96] *Id*. at *3.

> As stated above, the plain language of the Policy's Ownership provision limits covered property to three scenarios. The first is when Daewoo holds property for others. This provision is inapplicable here. The second is property for which Daewoo is "legally liable." Again, this is inapplicable. The final provision concerns property that Daewoo "owns or leases." Leased property is not at issue, so Daewoo only has coverage if it "own[ed]" the property, that is, if Daewoo owned the money that Allnex wired to the Wells Fargo accounts.[97]

The district court next held that the money at issue was not "owned" by the insured/plaintiff. The fidelity policy did not define the term "own." The court, therefore, considered the definition in Black's Law Dictionary.

> Black's Law Dictionary defines "own" as meaning "[t]o rightfully have or possess as property; to have legal title to." (10th ed. 2014). Plaintiff has not plausibly pled sufficient facts for the Court to find that it rightfully had, possessed, or had legal title to the money Allnex transferred into the Wells Fargo accounts. Plaintiff's strongest claim to owning that money stems from Allnex's intention. The parties do not dispute that Allnex intended Plaintiff to receive the wired money as payment for a debt . . . . However, a party's intention of transferring legal title does not equate to an actual transfer of legal title without more.[98]

The court found that a client or customer being tricked into transferring funds intended for the insured to a fraudster does not result in the insured "owning" the funds. The court continued:

> The Court agrees with Travelers that before Daewoo actually received the monies due, Daewoo owned a receivable, or a right to payment, as well as a potential cause of action for payment if it was not made. *See* Travelers Rep. at 6 (indicating that at best, Daewoo has an "inchoate chose-in-action" as to the money owed by Allnex). In other words, Daewoo did "own" something of value, but it was not the cash in the Wells Fargo accounts. It owned a receivable and a potential cause of action if Allnex did not pay.[99]

In *Posco Daewoo*, the motion to dismiss was granted without prejudice, and the insured was permitted to file an amended pleading. After the amended pleading was filed, the insurer again moved to dismiss the complaint and the motion was again granted.[100] The second motion to dismiss was granted with prejudice. The court expressly rejected three (3) new arguments raised by the

[97] *Id*. at *6.
[98] *Id*. at *7.
[99] *Id*.
[100] No. 17-483, 2018 WL 6077983 (D.N.J. Nov. 19, 2018).

insured. First, the court held that the insured did not own the stolen funds because Allnex had taken the position that it does not owe the insured any additional money. Allnex's characterization of who owned the funds was irrelevant as to whether the policy covers the alleged loss.

Second, the insured argued that it owned a receivable, which should qualify as "tangible property" under the policy. A receivable is considered a tangible asset for accounting purposes, and according to the insured should also qualify as tangible property it owns. The court held that a definition for "accounting purposes" did not control how to interpret the policy. Moreover, the court held that a receivable is intangible property, which does not implicate coverage.[101]

Finally, the insured argued that once Allnex placed the funds into a financial institution's funds transfer system, it had a right to impose a constructive trust over the funds and therefore "owned" them. The court disagreed, stating:

> Daewoo's constructive trust argument is unavailing to establish that Daewoo has ever owned the funds. Constructive trusts are an equitable remedy used to prevent unjust enrichment or fraud. A constructive trust can be imposed when "the holder of the legal title may not in good conscience retain the beneficial interest" of the property. … A constructive trust is an equitable remedy which courts may compel following adjudication; the remedy does not mean that Daewoo owned the funds in the first instance.[102]

The *Posco Daewoo* opinions are favorable for the fidelity industry and clarify that lost receivables may be covered under the transferring party's fidelity bond, but are not intended to be covered under the insured's fidelity bond.

An analogous decision was reached in *RealPage, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA,*[103] in which two insurers were awarded summary judgment when the district court held that funds diverted from the bank account of a third-party payment processor were not covered property as prescribed by the "ownership" provision in the subject fidelity policy. The Insured provides a service to owners and operators of residential properties whereby tenants can go online and arrange for their rental and other payments to be made by credit card or ACH bank transfer. The tenants' payments are deposited in a bank account belonging to Stripe, Inc. ("Stripe"), a third-party company contracted by the insured for payment processing and related functions. After receiving payment, Stripe directs its bank to transfer most of the funds to bank accounts belonging to the insured's customers.[104]

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[101] *See also* Morris Kirschman & Co. v. Hartford Fire Ins. Co., No. 03-1743, 2004 WL 1934848, at *1 (E.D. La. Aug. 30, 2004) (reasoning that an account receivable is intangible property, and therefore not covered in the fidelity context). Receivables also generally qualify as a "payment intangible" under the Uniform Commercial Code. U.C.C. § 9-102(a)(61) (Am. Law Inst. & Unif. Law Comm'n 2010) (defining "payment intangible" as "a general intangible under which the account debtor's principal obligation is a monetary obligation.").
[102] *Morris Kirschman & Co.*, No. 03-1743, 2004 WL 1934848, at *5.
[103] No. 3:19-CV-1350, 2021 WL 718366 (N.D. Tex. Feb. 24, 2021), *appeal docketed*, No. 21-10299 (5th Cir. Mar. 26, 2021).
[104] *Id*. at *1-2.

According to the district court, in May 2018 wrongdoers utilized an email phishing scheme to obtain the security credentials of an employee of the insured. The wrongdoers used the credentials to change the account information for the insured's customers for transfers from Stripe's bank account.[105] Over $10 million intended to be transferred from Stripe to the insured's customer was instead transferred to the wrongdoers. Although some of the funds were recovered, the insured's customer ultimately suffered a total loss in excess of $6 million, which was reimbursed by the insured.[106]

The fidelity policy included a standard "ownership" provision, limiting potential coverage to property owned, leased, or held by the insured. Thus, the primary coverage issue was whether the insured was entitled to coverage for the loss of funds, held in an account controlled by a non-insured third-party (Stripe), that were intended to be transferred by Stripe to the insured's customers.

During the coverage dispute, the insured argued that it "held the funds by virtue of its authority to direct Stripe's transfer to the insured's customer."[107] The district court disagreed, holding that the insured did not "own or hold" the funds at issue.[108] The court concluded that "funds that are maintained in a commingled account in a third party's name, at a third-party bank, which the insured can direct but not access, are not funds 'held' by the insured."[109] Relatedly, because the insured did not "hold" the funds, the court held that the loss resulted from its decision to reimburse its customers. The insured therefore did not suffer a direct loss, as required by the fidelity policy.[110]

VII.
QUANTIFY LOSS IN FIDELITY BONDS – THE ACCOUNTING PERSPECTIVE

Quantifying losses from the accounting perspective is a much narrower scope under the fidelity forms than the Generally Accepted Accounting Principles ("GAAP"), taxes, and criminal charges. There are a multitude of facts that must exist for a loss to be defined and measured as a loss for the fidelity bond. This portion of the paper is to discuss and define possible approaches and measurement of loss due to employee theft or employee dishonesty under a fidelity crime product. The authors have categorized the potential claimed losses into four basic categories. Fidelity losses consist primarily of four categories: (1) Incoming monies, (2) outgoing monies, (3) assets, and (4) other.

This article will define the four basic categories, based on the premise principals steal something that personally financially benefits them. An entity (profit, non-profit, or government) has incoming monies, outgoing monies, and assets. These are a few components of financial statements. Other components include categories such as liabilities. The principal does not desire

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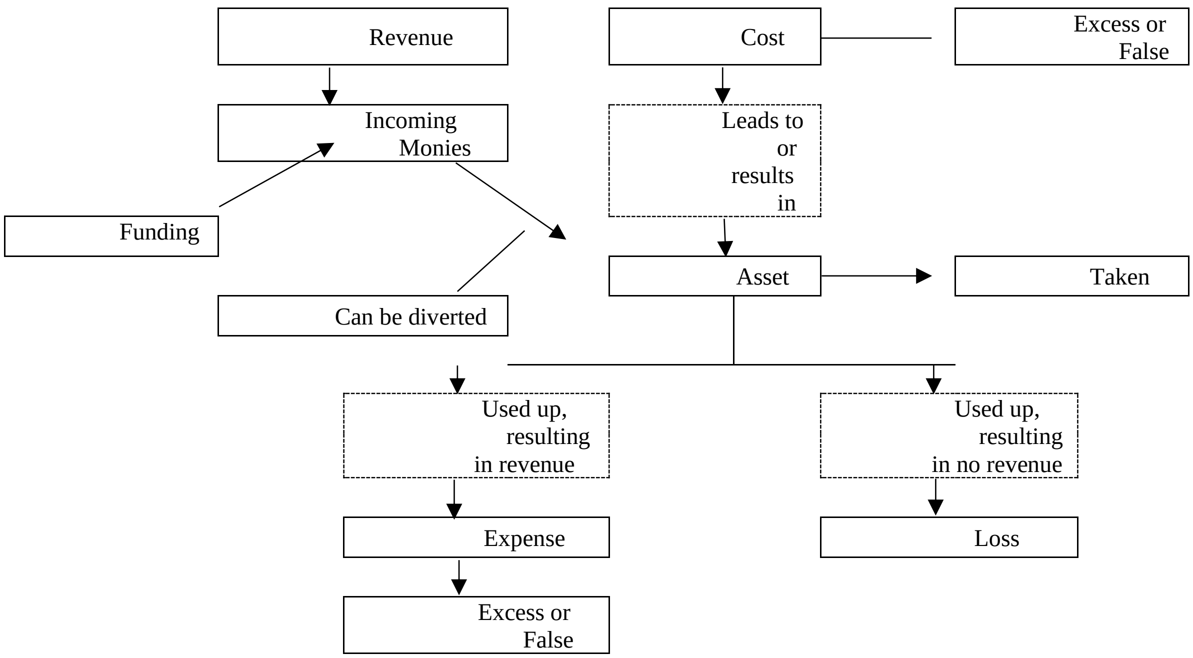
105 *Id*. at *3.
106 *Id*.
107 *Id*. at *3-4.
108 *Id*. at *4.
109 *Id*. at *11.
110 *Id*. at *11-12.

to relieve or take on an insured's liability burden, but the principal would be interested in diverting incoming monies from a loan.

It is from these three categories the majority, if not all, direct employee theft and employee dishonesty losses can be categorized. The fourth category of "other" is for the rare manuscript forms that may address consequential losses such as business income.

The opportunity of employee theft and employee dishonesty presents itself in the previous chart as follows:



The following portion of this article discusses an array of examples of employee theft and employee dishonesty from each category both from a measuring, quantifying, and legal perspective.

A. Incoming Monies

A business will collect monies to operate. The monies may come in many forms: cash, credit cards, checks, etc. To measure the loss, one first must obtain an understanding of the business and individual circumstances of the loss. For incoming monies, it is useful to understand if the loss is before recording or after initial recording the monies. In other words, the monies were realized and recognized. For example, consider a loss occurring at a bar (alcohol/drink establishment). The bartender, when selling a drink should:

a) Take the order,
b) Record the order,

c) Make the order (drink),
d) Receive payment for the order, and
e) Ensure the payments are used for the insured's benefit.

In this hypothetical scenario, assume the bartender is stealing. We must try to quantify the loss. To quantify the loss as defined by the fidelity policy, we must know what was stolen and when it was stolen in the above process. For our first scenario, let's imagine there is video evidence the bartender has a number of friends stopping by for drinks, for which the friends do not pay. The friends are receiving drinks for free. In this scenario, there is no completed arm's length transaction. The AICPA defines an arm's length transaction as, "a transaction conducted on such terms and conditions between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests."[111] The direct loss is the taking of the alcoholic drinks. The drinks cost approximately $1 and the selling price should be $5. The loss in this scenario is $1. Please note, this is not a loss of incoming monies, as no monies were exchanged in an arm's length transaction. This loss would be a direct loss of assets. The alcohol is the inventory, thus, asset of the bar. This is not a loss of incoming monies.

For another hypothetical, we will assume that the bartender is receiving orders and collecting monies from arm's length transaction customers. The bartender is taking the orders but not recording the orders. The theft of monies (usually cash) before being recorded is one of the most challenging in the fidelity industry to resolve as to quantifying the amount of loss. There are a multitude of evidentiary issues to overcome to measure the loss. First, is there evidence wholly apart from a computation?

The ISO Crime Form CR 00 23 11 15 indicates:

D. EXCLUSIONS

2. Insuring Agreement A.1. does not cover:

   a. Loss, or that part of any loss, the proof of which as to its existence or amount is dependent upon:

      (1) An inventory computation;

      (2) A profit and loss computation.

      However, where you establish wholly apart from such computations that you have sustained a loss, then you may offer your inventory records and actual physical count of inventory in support of the amount of loss claimed.[112]

An insured will either provide a profit or loss computation or an inventory loss computation. For arm's length transactions whereby the sales amount was intended for the insured and received by the bartender in an arm's length transaction, the monies received were stolen. It is

[111] AMERICAN INSTITUTE OF CPAS, GENERALLY ACCEPTED ACCOUNTING STANDARDS AU-C § 550.11 (2019).
[112] ISO COMMERCIAL CRIME POLICY FORM CR 00 23 11 15, at D.2 (2015).

up to the individual carrier based on its inventory exclusion language whether evidence besides the computation, if any, is necessary to address the loss.

Theft of monies after recording is usually easier, as there is a trail to validate the amount of monies received. The quantification is then needed to determine how much is removed, often through: (1) Excess refunds, overrings, no sales, (2) not depositing monies, and/or (3) refunding the credit card sales to the employee's personal credit cards. The subsequent methods of concealment (refunds, overrings, etc.) to avoid detection should not be a distraction to the actual amount of loss.

Another ancillary theft through the incoming monies is selling items and receiving a kickback. Selling with a kickback often occurs when an employee sells an insured's products for less than the employee should. The sales agent of the insured knowingly sells goods below fair market value in exchange for a kickback from the customer. The insured may have difficulty establishing that it sustained an out-of-pocket loss on the transaction, at best, if it lost only anticipated profit or other "potential income."

> At the opposite end of the spectrum are situations where the insured's employee purchases goods, services or securities at fair market prices but the vendor kicks back a portion of his or her authorized commission in order to maintain the business relationship. Under those circumstances, it becomes more difficult for the insured to establish that its employee intended to cause it to suffer a loss since the insured essentially received the benefit of the bargain. In addition, the insured will have difficulty establishing that it sustained an out-of-pocket pecuniary loss on the transactions since, at best, it lost only "potential income . . . ." At least one court has found that the kickback of a portion of a broker/agent's commission to a State employee on a transaction where an insurance policy was purchased by the State at fair market value may not constitute a compensable loss under a fidelity bond.[113]

B. Outgoing Monies

Outgoing monies claims represent a way to remove monies, not as revenues, but when monies are outgoing, usually as expenses. The employees for outgoing expenses will typically Create expenditures that do not exist to obtain a personal benefit, including but not limited to, travel expenses or false invoices. In other instances, the employee may overstate expenses as another method to conceal theft or other misconduct. There are a multitude of methods as to how to conceal overstated expenses, including but limited to: (1) Overstated payroll, (2) overstated travel expenses, and/or (3) overstated invoices.

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[113] Joseph K. Powers, *Unique Fidelity Coverage Issues Presented By Claims Involving Bribes, Kickbacks, and Illicit Profits*, IV FID. L.J. 1, 6 (1998).

To measure and quantify overpaid expenses requires the knowledge and proof from the insured of what the amount should have been and proof the employee unlawfully took monies. Excess or overstated payroll would have to have evidence of the amount of payroll the employee should have been paid. Without evidence, the quantification becomes difficult. The author was once provided with a hiring contract that indicated a $1,000 bonus was to be provided. Regrettably, the contract did not indicate if the bonus was to be every two-week pay period or annually. Thus, the discord between the insured and the employee.

Another payroll expense claimed is overpaid payroll. Overpaid payroll is a method to conceal stealing monies. Often related to the unlawful taking of net payroll is the consequential payment of payroll taxes. The payroll taxes are consequential costs of the stolen monies. An employer is also not liable for payroll taxes on stolen assets disguised as payroll.[114] The employee is liable for income taxes on their ill-gotten monies. Payroll taxes are recoverable up to 36 months. Calculating the excess net pay is the basis of quantifying the loss.

Overpaid invoices are one of the most discussed schemes, which can be accomplished by: (1) Bid rigging, (2) kickbacks, and (3) man-in-the-middle scams. The first step in the analysis is to determine if a third party is involved or if the named employee created the company. For the man-in-the-middle, the employee usually creates a company whereby the employee buys the goods through their company and resells to the insured for a markup. It is a requirement to show the intent to show an employee knowingly paid more with the intent to enrich the person from whom the purchases were made.[115] As of the date of this article, there has been an uptick in employees being pressured by vendors to buy excess or unnecessary parts and supplies. A vendor (scammer) will sell goods to the insured and give a nominal gift card to the employee placing the order. After a few orders and gift cards, the vendor persuades the employees to buy excess and unnecessary items, such as 30,000 key fobs, or they will tell the insured's employee the employee has been accepting gift cards. By exploiting and threatening the employee, the employee is pressured into buying excess and unnecessary parts and supplies. The insured receives the goods and the insured did not overpay for the goods. At this time, there is no depletion of assets. The benefit the employee received was gift cards. The gift cards are the costs of the vendor, not the insured. Depending on the circumstances and policies, the gift cards may be the loss to the insured.

C. Assets

The quantifying of assets for GAAP, taxes, and criminal charges is much different than the asset definition under the fidelity insurance form. Again, depending on the end user perspective, the consideration of valuations and definition of asset can differ. The ISO Commercial Crime Form and Financial Institution Bond indicate the asset has to be tangible. The concept of goodwill is a much discussed and debated topic in GAAP. Goodwill is real in that reputation and brand recognition add to the value of the stock. However, even if the goodwill is diminished because of employee theft, the valuation amount of goodwill is speculative. Goodwill is intangible. Goodwill is informational. Thus, the value in monies, securities, and tangibility is non-existent.

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[114] Amy Borbely, *The Logistics of Payroll Tax Recovery*, FSLC NEWSLETTER, Winter 2017, at 9.
[115] Powers, *supra* note 114.

The valuation of assets for insurance purposes is to be the value of actual costs incurred without realization of income or profit. Basic sources of information to value assets are: (1) Original purchase invoices, (2) replacement costs less useful life depreciation, (3) fair market value to replace with like kind (the internet makes this easier to determine), and (4) the variable costs to replace.

While valuing assets by policy language, local codes, and statutes, it is good for adjusters, attorneys, and accountants to understand ranges and estimations of amounts in calculating the losses. Whether an asset is inventory, a fixed long-term asset, or current asset that becomes obsolete quickly can make a difference in the valuation approach. For example, beef stolen from a meat processor plant over a five-year period will have cost variations depending on costs at the time the beef is replaced to fulfill orders. The costs incurred will also include the variable costs of processing and the stage at which the beef was stolen. The cost of "a side of beef" will have less variable labor cost then a tenderloin in a vacuum sealed package. It is these considerations that present a challenge in addition to the other conditions and exclusions of the policies.

In summary, employees steal monies (also an asset), securities, and assets. Employees do not steal liabilities. It is imperative to understand the theft versus the concealment. The concealment prevents discovery. Concealment does not cause the loss. The unlimited ways to conceal and obfuscate challenge us in measuring the true quantum of a defined direct loss under the fidelity policies. One takeaway from the article for quantifying a loss is to picture what the principal is really taking, if anything, from all the claim actions. What is the principal really putting in their pocket or in the trunk of their car?

VIII.
CONCLUSION

When confronted with a fidelity loss, neither insurers nor accountants should assume a "loss" – as considered by the fidelity policy – has occurred. As evidenced by case law, insureds frequently seek coverage for indirect loss, consequential loss, or loss relating to property that it did not own, lease, or hold. Non-pecuniary loss, as well as a hypothetical or bookkeeping loss, is also not intended to be covered. Having said that, when the insured has suffered a covered loss, the "valuation" language in the fidelity policy, as well as general accounting principles, should be utilized to determine the amount of potential coverage.

The outcome of fidelity bond coverage disputes continues to be highly dependent on the jurisdiction whose law applies. Despite efforts by insurers to craft these policies to limit third-party coverage essentially to property held by the insured as a bailment, in a trust or in some other way in which the insured was legally liable for the property before the loss occurred, some jurisdictions have expanded coverage to many instances of vicarious liability. Courts in a number of jurisdictions have determined that the term "resulting directly from" extends coverage to a range of losses proximately caused by a covered risk. For the foreseeable future, or until there is a "perfect" fidelity bond that anticipates and addresses all imaginable potential losses, there will be a continuing flow of judicial decisions addressing fidelity bond causation and covered property issues.