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NEWSLETTER

Dishonesty Exclusion Bars Coverage for Claim that Title Company Negligently Supervised Bookkeeper Who Embezzled

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The United States Court of Appeals for the Fourth Circuit has held that an E&O policy's dishonesty exclusion barred coverage for a claim alleging that a title company negligently supervised a bookkeeper who embezzled from escrow accounts. *Gulf Underwriters Ins. Co. v. KSI Services, Inc.*, 2007 WL 1280665 (4th Cir. May 1, 2007). Wiley Rein LLP represented the insurer in this case.

Between 1999 and 2003, the bookkeeper embezzled approximately $1.4 million from escrow accounts maintained by the title company in connection with a real estate developer's transactions. After recovering and returning a portion of the embezzled funds, the title company went out of business, leaving the developer with substantial losses. The developer sued the company for negligent supervision of the bookkeeper and breach of contract, and was granted a default judgment on both counts when the company did not respond to the complaint. The developer then sued the title company's E&O insurer to recover its default judgment on the negligent supervision count as a third-party beneficiary of the policy issued to the company.

The policy provided specified coverage for damages incurred in connection with claims made against the company as a result of a wrongful act. It contained a dishonesty exclusion that barred coverage for damages "for or arising directly or indirectly out of . . . [a]n act or omission that a jury, court or arbitrator finds dishonest, fraudulent, criminal, malicious or was committed while knowing it was wrongful."

The developer argued that its negligent supervision claim was not excluded because it was a wrongful act distinct from the embezzlement that fell within the policy's grant of coverage. The Fourth Circuit rejected this argument, finding that the dishonesty exclusion contemplated that there could be multiple causes of loss, and that the operation of the exclusion was not limited to instances in which a criminal act was the direct, sole, proximate, or primary cause of the loss. Finding that the bookkeeper's embezzlement was just as important a cause of the developer's damages as the alleged negligent supervision, the Court held that the dishonesty exclusion barred coverage for the claim.

The Fourth Circuit also noted that the title company had recovered for the embezzlement under a fidelity bond issued by another carrier. It stated that "[g]enerally, protection from dishonest or criminal acts is provided by fidelity bonds, not by errors and omission policies that exclude damages arising out of dishonest or criminal acts."