

Dishonesty Exclusion Bars Coverage for Embezzlement

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The United States District Court for the Eastern District of Virginia, interpreting Virginia law, has granted an insurer's motion for summary judgment, holding that an E&O policy's dishonesty exclusion barred coverage for a claim arising out of the embezzlement of escrow funds by an employee of the insured title company. *Gulf Underwriters Ins. Co. v. KSI Services, Inc.*, ___ F. Supp. 2d. ___, 2006 WL 382146 (E.D. Va. Feb. 16, 2006). Wiley Rein & Fielding LLP represented the insurer in this case.

Between 1999 and 2003, the company's bookkeeper embezzled approximately \$1.4 million from escrow accounts maintained by the company for a client. After recovering and returning a portion of the embezzled funds, the company went out of business, leaving the client with substantial losses. The client 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. The client then sued the company's E&O insurer, seeking to recover its default judgment on the negligent supervision count as a third-party beneficiary of the policy issued to the title company.

The E&O policy provided specified coverage for damages incurred in connection with claims made against the company as a result of a wrongful act. The insurer moved for summary judgment based on the policy's dishonesty exclusion, which precluded 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 client argued in response that the dishonesty exclusion could only be triggered by dishonest conduct on the part of an insured—which was defined to include employees of the company, but only for wrongful acts within the scope of their duties—and that the bookkeeper was not an insured because the embezzlement was outside the scope of her duties.

The court rejected the client's argument. The court noted that two approaches have emerged nationally for determining whether conduct is deemed to be within the scope of an employee's duties: (1) the employee motivation approach, under which conduct is generally deemed to be within the scope of employment if it is motivated by a desire to benefit the employer and (2) the totality of the circumstances approach, under which conduct is generally deemed to be within the scope of employment if it is sufficiently related in time, place and substance to the employee's duties to be attributable to the employer's business. The court decided that

the Supreme Court of Virginia most likely would follow the totality of the circumstances approach. Applying that approach, the court held that the embezzlement was within the scope of the bookkeeper's employment because she "used the access and authority inherent in her office to accomplish her embezzlement scheme."

Having determined that the embezzlement was within the scope of the bookkeepers' duties, and that the bookkeeper was therefore an insured in connection with a claim arising out of the embezzlement, the court ruled that the dishonesty exclusion precluded the recovery sought by the client.