Jim's Perspective…

A Cyber Security Insurance Coverage Case

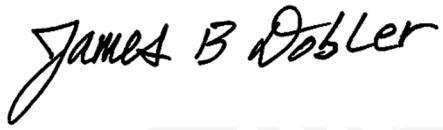
Recently, the federal Ninth Circuit Court of Appeals issued an opinion regarding coverage for a cyber security loss that I thought might be of interest to agents (Ernst & Haas Mgmt. Co., Inc. v. Hiscox, Inc. 23 F.4th 1195 (9th Cir. 2002). The facts in this case involve what I think is becoming a familiar occurrence. Ernst's accounts payable clerk received several e-mails from her supervisor instructing her to pay some invoices. Unbeknownst to the clerk, these e-mails did not originate with her supervisor, but were actually part of a fraudulent scheme to elicit fraudulent bank transfers. The clerk paid off hundreds of thousands of dollars in "invoices" before becoming suspicious, but, by then, the damage was done. Ernst submitted a claim to Hiscox. Hiscox is an insurance company domiciled in Bermuda. It also is an underwriter with Lloyd's of London. It writes a lot of small business commercial insurance in the United States.

Hiscox's insurance coverage for Ernst included a commercial crime policy that provided coverage for "computer fraud" and "funds transfer fraud." Hiscox denied coverage because Ernst's own employee had initiated the wire transfer funds. The Federal District Court found in favor of Hiscox, and held there was no coverage because the policy's language required that the loss or damage "result directly" from the fraudulent activity. Because the clerk was the one who initiated the wire transfer, the court reasoned that the loss resulted directly from an authorized act by the clerk, and not the fraudulent e-mails. Based on this point of view, policyholders would not be covered unless a third party actually hacked the insured's system and initiated a transfer themselves. An innocent employee used as a conduit to perpetrate fraud would not be covered.

Ernst appealed this decision to the Ninth Circuit Court of Appeals which reversed the District Court decision for a number of reasons.

- The District Court narrowed the "computer fraud" provision's language, interpreting a direct loss to be limited to "unauthorized computer use, like hacking." The District Court reasoned that Ernst's loss did not "result directly" from computer fraud because the clerk authorized its bank to initiate the wire transfer. But, the appellate court said this could not be the law because it "eliminates the possibility of coverage whenever an employee is defrauded into taking action." The Ninth Circuit relied on a decision from the Sixth Circuit, and held that Ernst's loss was indeed a "result directly" from the computer fraud and there was no intervening event that was not covered. This claim involved a loss that resulted directly from the clerk acting pursuant to fraudulent instructions.
- Hiscox argued there was no coverage because the loss did not "result directly" from *fraudulent instructions* to a *financial institution*. The perpetrator instructed the accounts payable clerk to transfer the money, not the bank. The Ninth Circuit, however, felt that the e-mail to the clerk directing her to transfer funds to the perpetrator, providing wire details, and providing fraudulent authorization was done with the sole purpose of initiating a wire transfer. Thus, the e-mail should be construed as a direct instruction to the bank.

This case boils down to a factual determination of what caused the loss. In Nebraska, our Supreme Court has held that it is up to the jury to determine the "proximate cause of loss." The Nebraska Supreme Court has adopted this standard for determining the cause of loss even if the policy specifically requires "loss caused directly" by a covered peril. While a Nebraska coverage case involving facts similar to this Ninth Circuit case may not hinge on the terms "loss caused directly," I think this Ninth Circuit case is still a good one to keep in mind if a policyholder has an employee who transfers money from the business bank account pursuant to fraudulent instructions from some criminal third-party.



Jim Dobler, CPCU
PIA Legislative Coordinator
Questions or Comments? Please email jbdobler@outlook.com