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The Termination Provision in Fidelity Insurance Policies: Practitioners Discuss a Split in Authority

This month, Bloomberg Law Reports®–Commercial Insurance asked leading insurance coverage practitioners to weigh-in on the applicability of the termination provision in fidelity insurance policies.

Courts are split over the applicability of the termination provision in commercial crime policies. Some courts hold that the termination provision applies only if a manager becomes aware of an employee's dishonest conduct during the policy period. (*See Waupaca Northwoods, LLC v Travelers Cas. & Sur. Co. of Am.*, No. 10-C-459, 2011 BL 109466 (E.D. Wis. Apr. 25, 2011). Other courts, such as the Appellate Division of the Supreme Court of New York, Third Department, have held that a policy terminates upon inception as to the particular employee, if the manager knew of prior dishonest acts at the time the policy was issued. (*See Capital Bank & Trust Co. v. Gulf Ins. Co.*, 2012 NY Slip Op 00451 (App. Div. Jan. 26, 2012). Which is the more sound holding?

Joseph A. Oliva
GOLDBERG SEGALLA LLP

While there appears to be a split in the applicability of termination provisions in commercial crime policies, it appears a court's interpretation will be based on the exact language of the provisions and the policy as a whole. As with every insurance policy issue, the drafting of the policy's language must embrace the actual intent of the contract and must be drafted with particular attention to its intent. The "more sound holding" must be drawn from the very purpose of the termination provision. The purpose of the termination provision is clear: It is to place the risk of employing an individual known to have previously acted in a dishonest manner on the actual employer, not the insurer. Employers are free to hire and retain persons in positions of trust even when they are aware of previous patterns of dishonest behavior or bad acts. There is, however, a reasonable expectation that employers, after due diligence, will not hire dishonest personnel.

The termination provision puts the insured on notice that the insurer will not provide coverage for losses caused by employees whom the insured knew or discovered committed a prior dishonest act. Insurers should not provide coverage and certainly should not agree to insure possible acts of dishonesty by personnel who have a history of such behavior. With that in mind, the insured should ensure it will conduct the necessary due diligence in its hiring practices and will also ensure proper supervision of its employees, since the insured is in the best position to monitor its employees. Otherwise, to follow a view different from New York's Appellate Division Third Judicial Department would allow insureds to obtain insurance against the dishonest acts of employees it knows were dishonest prior to employment. Allowing insureds to hire rogue employees without any concern because the insured has insurance coverage appears to be unreasonable. Questions would arise as to what insurer would actually agree to take on a risk that would very well increase because of the personnel's history of dishonest acts.

Joseph A. Oliva, a partner at Goldberg Segalla LLP, has headed the insurance coverage investigation of numerous employee dishonesty, embezzlement, and fraud claims.

Mark Hersh
ReedSmith

In *Waupaca Northwoods, LLC v. Travelers Casualty & Surety Co. of America,* No. 10-C-459, 2011 BL 109466 (E.D. Wis. Apr. 25, 2011), in a thoughtful and well-reasoned opinion, the court held that a fidelity bond termination provision could apply based on the discovery of employee dishonesty only where the insured learned of the dishonesty during the policy period, not before. At least two other courts have reached the same conclusion. *See C.A. White, Inc. v. Travelers Cas. & Sur. Co. of Am.*, 2009 Ct. Sup. 6446, 47 Conn. L. Rptr. 687 (Conn. Super. Ct. Apr. 9, 2009), *aff'd on reargument* No. NNH-CV-08-5023551-S, (Docket No. 11320) (Conn. Super. Ct. May 23, 2011), and *Home Savings Bank v. Colonial Am. Cas. & Sur. Co.,* 598 S.E.2d 265 (N.C. Ct. App. 2004). In all three cases, the court found it was reasonable to presume that a bond must first incept before it could be terminated, and therefore termination may occur only when the insured learns of employee dishonesty or fraud during the period of the bond. They noted that the relevant policy language had a temporal aspect–termination occurred "as soon as" the insured learned of, or "immediately upon discovery" of the employee dishonesty–that was linguistically at odds with the insurers' argument that the bond could be terminated before or as it began. The courts found that since the insured's interpretation of the policy language was reasonable, the language was ambiguous and had to be construed in the insured's favor.

The logic of these decisions is compelling. It is hornbook law that if policy language is susceptible to two different and reasonable interpretations, then the language is ambiguous and must be construed in favor of the insured. The interpretation of bond termination language articulated in *Waupaca Northwoods* and the other cases is at least reasonable, and arguably the most reasonable interpretation available. If insurers contend that this result will unfairly require them to provide coverage for employees already known by the insured to be dishonest, the court in *Waupaca Northwoods* properly noted that the solution to this problem is to change the policy language or require the insured to disclose prior employee dishonesty in the insurance application.

By contrast, the opinion in *Capital Bank & Trust Co. v. Gulf Insurance Co.*, 2012 NY Slip Op 00451 (App. Div. Jan. 26, 2012) contains no analysis of the question whether a fidelity bond must incept before it can terminate, presumably because the parties did not raise the issue. The court simply held, without discussion, that where discovery of an employee's dishonesty occurred prior to inception of the bond, coverage as to that employee "terminated immediately upon inception of the bond." There is little or no textual support for this construction of the bond termination language, but even assuming that it is a reasonable construction, the decision fails to account for the fact that there is an alternative reasonable construction, and therefore the language is ambiguous and the insured must prevail. For these reasons, the holding in *Waupaca Northwoods* is much sounder than the holding in *Capital Bank & Trust Co.*

Mark Hersh, a partner at Reed Smith LLP in Chicago, represents policyholders in insurance coverage disputes, primarily D&O, E&O, and fidelity insurance. He is a former federal prosecutor with a J.D. from Stanford University School of Law.

Max H. Stern
DuaneMorris®

The *Capital Bank & Trust* decision enforcing a fidelity bond's termination provision reflects the majority rule that there is no fidelity coverage for loss from an employee's acts when the employer knows in advance of the loss of past dishonesty on the part of that employee. Its holding is more sound than that of *Waupaca Northwoods*, which found the provision ambiguous in a crime policy with respect to knowledge of pre-policy inception dishonesty and thus unenforceable to bar coverage for acts by a known dishonest employee. The difference between these two case holdings illustrates the difference between applying a provision as written, on the one hand, and straining to find ambiguity in order to create coverage, on the other hand. The judge who authored the *Waupaca Northwoods* decision makes clear his sympathy for an employer who purchased a company that seemed to have two bad apples, one of whom knew of the other's prior termination for knowingly misusing the predecessor company's resources when he rehired the other as a plant manager for the new company. However, while sympathy for an employer (as opposed to an insurer) is not too surprising to insurance coverage practitioners, sympathy does not make for soundly decided precedent.

The guiding principle in insurance interpretation is whether there are two reasonable ways to read the provision, in context. In the context of fidelity insurance products, the majority rule makes clear that going forward neither employer policyholders nor insurers reasonably expect coverage for acts of employees once that employee's past dishonesty is known to the employer. The termination provisions state that coverage for that employee "terminates" upon such knowledge. The *Capital Bank & Trust* decision enforces the provision as written, straightforwardly concluding that where an employer had pre-inception knowledge of an employee's falsifying signatures for loan documents, coverage as to that employee "terminated immediately upon inception." The *Waupaca Northwoods* decision, on the other hand, concluded that the word "terminates" reasonably can be read as requiring some period of coverage before being terminated. The problem with this holding is that such a reading is not reasonable in context; it is not supported by the words or by reasonable expectations. The words do not say that coverage has to be in force for some period of time before being terminated, and there is nothing inherently unintelligible or unexpected about coverage terminating at inception for an employee known to be dishonest. By straining to create ambiguity where none exists, the *Waupaca Northwoods* decision departs from sound precedent regarding the enforcement of the termination provision in fidelity insurance policies and bonds.

Max H. Stern is the head of the Insurance Division of Duane Morris LLP. He represents commercial and specialty line insurers. This reflects the author's opinion, and not that of the firm or of any client.

Edward J. Stein

Anderson Kill & Olick, P.C.

The divergent results in *Waupaca* and *Capital Bank* follow from their particular facts and policy wordings. However, prudent policyholders should consider not only the fine print, but also the broader risk of continuing to employ any person known to have engaged in dishonesty.

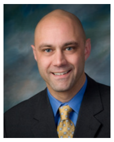
In *Waupaca*, the court denied an insurance company's motion for summary judgment under a commercial crime policy, based on a clause terminating employee theft coverage as to any employee "*as soon as*" any management or supervisory employees "not in collusion with the Employee becomes aware of any dishonest or fraudulent employment related act." The court reasoned that because the termination clause applied "as soon as" the policyholder learned of dishonest conduct, it implied that the dishonesty, or at least its discovery, must occur while the policy is in effect, not beforehand. Thus, a vice president's knowledge prior to the policy period that an employee was accused of dishonesty by a prior employer did not defeat coverage (especially since the VP had also worked for the prior employer and was thought to be in collusion with the employee there).

In contrast, *Capital Bank* involved a "known dishonesty" exclusion of coverage for "loss arising out of or in connection with any circumstances or occurrences known to [the policyholder] prior to the [bond's] inception." The court granted summary judgment dismissing a bank's claim for losses resulting from an employee's forgery, because the bank's president admitted that before the bond took effect, he discovered that the officer was forging signatures, and the officer admitted to forgeries and was warned about violating company policy. The insurance company also cited a termination clause similar to the clause in *Waupaca*. However, any argument that termination "as soon as" dishonesty was discovered required discovery during the policy (as in *Waupaca*) would have been futile, given the express exclusion for known dishonesty.

W*aupaca* better reflects policyholders' reasonable expectations and the settled principle of resolving ambiguities in favor of coverage. The *Waupaca* court correctly noted that underwriters could more precisely state any intent to exclude knowledge of dishonesty prior to the policy period (e.g., through the language at issue in *Capital Bank*). Underwriters also could use insurance applications to require disclosure of known dishonesty .

While policyholders should understand the contours of their own coverage, they should also recognize that if they knowingly continue to employ persons who have been dishonest, it may be at their own peril. Brokers might assist by procuring policies with more favorable language. For example, underwriters could be persuaded to clarify that "knowledge" of dishonesty does not include knowledge of persons colluding with a dishonest employee, and that the "knowledge" exclusion (and "discovery" trigger) requires knowledge or discovery by specified individuals or departments. Such clarifications would help large organizations avoid forfeiting coverage for employee dishonesty that may be known to lower-level or remote personnel, but not those responsible for risk management and insurance matters.

Edward J. ("Ted") Stein (estein@andersonkill.com) is a shareholder of Anderson Kill, admitted to practice in New York, Massachusetts, and California. His practice concentrates on insurance recovery, including fidelity insurance recovery, exclusively on behalf of policyholders.



Gordon S. Woodward
Schnader Attorneys at Law
Schnader Harrison Segal & Lewis LLP

The more sound holding was articulated in *Capital Bank & Trust Co. v. Gulf Insurance Co.*, 2012 NY Slip Op 00451 (App. Div. Jan. 26, 2012). The policy should terminate upon inception as to the particular employee if a manager knew of prior dishonest acts at the time the policy was issued.

To hold otherwise creates a circumstance in which the policy may insure known or continuing employee fraud while excluding future known fraud. This would be similar to an insurer agreeing to insure losses associated with auto accidents, fires or other hazards that have already occurred but excluding similar hazards that might occur in the future. This outcome simply does not make sense when considering the purpose of insurance. As the insurer noted in *Waupaca Northwoods LLC v Travelers Casualty & Surety*, No. 10-C-459, 2011 BL 109466 (E.D. Wis. Apr. 25, 2011), "[t]he whole point of the termination provision is to prevent a company from obtaining insurance for losses that it has the ability to predict and/or prevent." *Id.* at 3.

Some types of insurance, most notably prescription drug coverage and some aspects of health insurance, sensibly provide coverage for known risks. Insuring against employee fraud when the employer has knowledge of an employee's prior fraudulent conduct, however, is not sensible. Moreover, insuring against employee fraud in this circumstance might violate public policy.

Finally, as a matter of strict contract interpretation, *Waupaca* misses the mark. The policy in *Waupaca* contained a provision that provided the policy terminated as to any employee "[a]s soon as . . . any Employee with managerial responsibility not in collusion with the Employee bec[ame] aware of any dishonest or fraudulent employment related act . . . ." *Id.* at 3. In order for termination to be effective, the insured in *Waupaca* asserted that knowledge of the dishonest conduct "must occur *while* the policy is in effect." *Id.* at 3. The insured assumed that *occur* means *first occur* and went on to argue that the policy could not terminate as to an employee where the company first acquired knowledge of dishonest conduct prior to the inception of the policy. The court agreed with this reasoning. The court's conclusion, however, does not logically follow from the definition of *occur*. *Occur* is defined by *Merriam-Webster* as: to appear, to happen, or to come to mind. The definition simply is not limited to when knowledge *first* appears, happens, or comes to mind. Therefore, knowledge of dishonest conduct may have first happened or occurred prior to the inception of the policy; nevertheless, if knowledge of the dishonest conduct "happens" or "comes to mind" after policy inception, then termination is still effective as to that employee.

For these reasons, with regard to commercial crime policies, *Capital Bank & Trust* presents the more sound holding.

Gordon S. Woodward, partner at Schnader Harrison Segal & Lewis LLP, concentrates his practice on litigation matters including construction, insurance, product liability, and general commercial disputes.

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Both the *Waupaca* case and the *Capital Bank & Trust Company* case are sound decisions. They highlight the importance of focusing on policy language when purchasing crime insurance. When analyzing policy language, courts will look to wording used by other insurers which, not surprisingly, can vary significantly. If a company has concerns concerning an employee's actions at a prior employer, care must be taken that the crime coverage language is clear and unambiguous.

The Travelers policy in the *Waupaca* case had relatively common wording:

> This Crime Policy terminates as to any Employee:
>
> a. As soon as your partner, any of your Management Staff Members or any Employee with managerial or supervisory responsibility not in collusion with the Employee becomes aware of any dishonest or fraudulent employment related act involving an amount in excess of one thousand dollars ($1,000);

Waupaca Northwoods, LLC v Travelers Cas. & Sur. Co. of Am., No. 10-C-459, 2011 BL 109466, at *2 (E.D. Wis. Apr. 25, 2011). This policy did not clearly address **where or when** the Employee was fraudulent or dishonest and was therefore considered ambiguous and the insured prevailed.

By contrast, the language in another crime policy quoted in *Waupaca* precluded "coverage after the insured or an officer of the insured . . . discovers or has knowledge or information that such Employee has committed any fraudulent or dishonest act in the service of the Insured or otherwise, *whether such act be committed before or after the date of the employment by the Insured*." *Id.* (quoting *St. Joe Paper Co. v Hartford Acc. & Indem. Co.*, 376 F.2d 33, 35 (5th Cir. 1967)); *see also Home Sav. Bank v. Colonial Am. Cas. & Sur. Co.*, 165 N.C. App. 189, 192 (2004) (fidelity bond provided that it terminated "as soon as any director, titled officer or risk manager of any Insured not in collusion with such person learns of any dishonest or fraudulent act committed by such person at any time, whether in the employment of the Insured or otherwise").

In the *Capital Bank & Trust Company* case (where the court agreed with the insurer that there was no coverage), the bond contained an exclusion for "'loss arising out of or in connection with any circumstances or occurrences known to [plaintiff] prior to the inception [of the bond].'"

There was also a termination provision in the bond provided that coverage:

> terminates as to any [e]mployee . . . as soon as [plaintiff], or any director or officer not in collusion with such [employee], learns of any dishonest or fraudulent act committed [by] any such [employee] *while employed by* [plaintiff].'

Capital Bank & Trust Co. v. Gulf Ins. Co., 2012 NY Slip Op 00451, at *2 (App. Div. Jan. 26, 2012). (emphasis added)

Thus, we can see that insurance contracts provide the best clarity and therefore certainty when they specifically address the "where" and "when" of the prior dishonesty or fraud.

Elliott M. Kroll, a partner at Arent Fox LLP in New York, represents clients nationally and internationally in all major areas of the insurance industry.

Kenneth H. Frenchman
Kasowitz, Benson, Torres & Friedman LLP

General principles of insurance contract interpretation, such as enforcement of plain language, construing ambiguities against the drafter, and placing the burden on insurer's to establish the applicability of an exclusion, should be applied to interpret the similar termination provisions at issue in both *Waupaca Northwoods* and *Capital Bank*. In these cases, the termination provision was an exclusion on which the insurers relied to defeat the policyholder's claim of coverage. As such, it was the insurer's burden to establish the applicability of the exclusion. The exclusion should be interepreted according the plain language if clear, and should be construed in favor of the policyholder if ambiguous.

While not identical policy language, the termination exclusion in *Capital Bank* is sufficient to illustrate the issue in both cases:

The coverage 'terminates as to any employee . . . as soon as [the policyholder], or any director or officer not in collusion with such employee, learns of any dishonest or fraudulent act committed by any such employee . . . .'

In both cases, the issue involved knowledge of a prior alleged "dishonest" act that occurred prior to the policy period. Both cases purport to follow the plain language. In *Capital Bank*, the court focused on whether the prior act that was known by an officer was in fact considered "dishonest" even though the alleged prior forgeries did not cause any losses. The court held that a loan officer, approving transactions without authority in order to avoid detection, constitutes a dishonest act. In light of that holding, the exclusion was enforced and coverage was denied.

In *Waupaca Northwoods*, the court focused on the fact that the alleged dishonest act of which an officer had knowledge (using employees to build a fence at his residence), occurred well before the policy period. The court explained that because the exclusion "terminates" coverage "as soon as" the officer has knowledge of the dishonest act, the language at least implies that the knowledge must occur while the policy is in effect. In other words, this exclusion does not apply where the alleged dishonest act triggering the provision occurs prior to the policy period.

The reading of the language set forth in *Waupaca Northwoods*, which would have applied in equal force to *Capital Bank*, is the more sound holding because it adheres to the rules of policy interpretation. This exclusion is designed to terminate coverage for a theft by a particular employee "as soon as" certain information is learned; it cannot reasonably be read to provide that, from inception, this employee's theft was never covered under the policy. Certainly, if that was what the insurer had intended, the insurer could have crafted clearer language. At most, the policy is ambiguous in this regard and should be interpreted in favor of the policyholder. This is particularly true here, where the insurer could have and should have asked questions on the policy application to learn about any prior dishonest acts of employees and exclude those employees from coverage if appropriate.

Kenneth H. Frenchman is a partner with Kasowitz, Benson, Torres & Friedman LLP's insurance recovery practice in New York, with significant experience in insurance coverage litigation, counseling on insurance-related issues, and securing settlements with prominent American and European property and casualty insurers.