

**ELEVENTH ANNUAL
NORTHEAST SURETY FIDELITY CLAIMS
CONFERENCE**

**WHO WANTS TO PAY A MILLION DOLLARS?
STRATEGIES FOR INVESTIGATING AND DEFENDING
FIDELITY CLAIMS BASED ON THE INSURED'S
DISCOVERY OF THE LOSS**

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Introduction

One of the threshold issues which the fidelity insurer must consider in addressing any claim is that of discovery, *i.e.*, when did the insured discover the conduct which forms the basis for the claim or loss. The date of the insured's discovery of the loss is a critical issue and represents a defining aspect of the claim. The date of discovery of the loss will typically establish applicable coverage period for the claim in question. The insured's discovery of the loss triggers the insured's obligations to provide notice of the loss to the insurer, file a proof of claim, and commence an action within a prescribed time period. See, e.g. Resolution Trust Company v. Fidelity & Deposit Co., 205 F.3d 615 (3d Cir. 2000) (discussing importance of discovery issue in the context of fidelity bond claims). The insured's failure to comply with these contractual conditions can, under the proper circumstances, present a complete defense to the claim. The insured's discovery of the loss will also terminate the bond's coverage as to the wrongdoing employee. And where a loss may implicate multiple bonds issued by different insurers, the date of discovery of the loss may establish which insurer is ultimately liable for the claim.

Since the issue of discovery is critical in any claim, the fidelity insurer's investigation should always include a thorough consideration and analysis of the circumstances surrounding the insured's discovery of the loss. Typically, defenses related to the discovery term of the bond will arise in one of the following contexts. First, the insurer may assert that the insured discovered the loss after the discovery period in the bond or policy had expired. In these cases, the insurer will seek to demonstrate that, during the bond's operative period, the insured had mere suspicions about the employee's actions, but these suspicions did not rise to the level of knowledge sufficient to establish discovery until after coverage under the bond had expired.

In other circumstances, the insurer will seek to argue that the insured discovered the loss before the insurer's bond or policy was issued. In these instances, the insurer will argue that – prior to the policy or bond period – the insured had sufficient knowledge of facts which would have led an objectively reasonable insured to conclude that a loss of the type covered by the bond had occurred or would occur. In these instances the insurer may also argue that the insured had a duty to make reasonable inquiry as to the actions of its employee, and it may also argue that the insured willfully ignored objective facts which, if investigated further, would have disclosed a fraud or other covered wrongdoing.

In summary, the issue of the insured's discovery of the loss invariably presents a challenging and often complex issue for the fidelity insurer. In evaluating this issue, the fidelity insurer should focus on the language of the bond or policy, the judicial interpretations given to these terms by courts in the controlling jurisdictions, and the practical steps which must be taken to proceed with an investigation of this issue and defense of the claim.¹

¹ The authors recommend the following recent articles and publications discussing the issue of discovery in the context of fidelity bonds and policies: Duncan L. Clore and John Tomaine, *Discovery of Loss*, in *Handling Fidelity Bond Claims*, (Michael Keeley & Timothy M. Sukel, eds., 1999); Duncan L. Clore and Michael Keeley, *Discovery of Loss: The Contractual Predicate to the Claim*, in *Financial Institution Bonds 4* (2d ed. Duncan L. Clore ed., 1998); Edward Etcheverry, *Discovery, Notice, Proof of Loss, and Suit Limitations*, in *Commercial Crime Policy 12* (Gilbert J. Schroeder ed., 1996).

1. The "Discovery" Term in Fidelity Bonds and Commercial Crime Policies

The fidelity insurer should first look to the language of its bond or policy to determine how – or if – it defines when the insured is deemed to have discovered the loss. With respect to a financial institution bond, the definition of discovery is typically set forth in Section 3 of the bond:

Discovery occurs when the Insured first becomes aware of facts which would cause a reasonable person to assume that a loss of a type covered by this bond has been or will be incurred, regardless of when the act or acts causing or contributing to such loss occurred, even though the exact amount or details of loss may not then be known.

Discovery also occurs when the insured receives notice of an actual or potential claim in which it is alleged that the Insured is liable to a third party under circumstances which, if true, would constitute a loss under this bond.

Standard Forms of the Surety Association of America, Financial Institution Bond, Standard Form 24 (revised January, 1986).

The definition of the discovery term as contained in the current Form 24 bond is significant for several reasons. First, the inclusion of the reference to the “reasonable person” should leave no doubt but that an objective discovery standard – as compared to a subjective standard – should govern the claim. The authors will discuss the objective v. subjective debate in the next section of this paper. Second, the insured need not be aware of all of the specific details concerning the loss, nor will it need to know the full extent of the loss, in order for the insured to have discovered the loss as that term is defined in the bond. See Standard Form 24 Bond, § 3 (discovery may occur “even though the exact amount or details of loss may not then be known”). Therefore, to the extent that the bond at issue includes the discovery definition quoted above, the fidelity insurer will typically seek to rely on the specific language of the bond as a starting point for its analysis of the discovery issue.

In contrast to the terms of the standard financial institution bonds, current commercial crime policies do not specifically define the discovery term.² Under these circumstances the fidelity insurer may be faced with arguments from its insured that a subjective standard applies to the discovery issue, i.e. that discovery does not occur until the insured has an actual subjective belief that the employee engaged in wrongdoing which caused a covered loss.

2. Judicial Interpretations of the Discovery Term

In evaluating the discovery issue, the fidelity insurer or its counsel should always seek to ascertain the manner in which courts in the controlling jurisdiction have construed the discovery term in the bond. With respect to the Standard Form 24 Financial Institution Bond, courts generally have recognized that the bond language creates an objective analysis and requires the court to assess a reasonable person’s state of knowledge with respect to the loss.

² Duncan L. Clore and John Tomaine, Discovery of Loss, in *Handling Fidelity Bond Claims*, pp. 386-87 (Michael Keeley & Timothy M. Sukel, eds., 1999); Edward Etcheverry, Discovery, Notice, Proof of Loss, and Suit Limitations, in *Commercial Crime Policy* 12, p. 5 (Gilbert J. Schroeder ed., 1996).

FDIC v. Oldenburg, 34 F.3d 1529 (10th Cir. 1994); Resolution Trust Company v. Fidelity & Deposit Co., 205 F.3d 615 (3d Cir. 2000); Federal Savings & Loan v. Aetna Cas. & Surety, 785 F.Supp. 867 (D. Mont. 1990).

The most recent significant decision of which the insurer should be aware is Resolution Trust Company v. Fidelity & Deposit Co., 205 F.3d 615 (3d Cir. 2000) (hereinafter “RTC”). In RTC, Third Circuit Court of Appeals construed a savings and loan blanket fidelity bond issued to City Federal Savings Bank. The RTC, as City Federal’s successor, sought coverage under the bond for losses which City Federal incurred as a result of kiting scheme initiated by one of its customers. The customer had engaged in a scheme of wrongfully diverting collateral which had been used to secure loans made by City Federal to the customer. The evidence suggested that several employees of City Federal were aware of the fraudulent scheme but failed to report it to their superiors. The district court granted F & D’s motion for summary judgment, concluding that as a matter of law no reasonable jury could conclude that City Federal discovered the loss within the bond period. The RTC took an appeal, and the Third Circuit reversed the district court, finding that a reasonable jury could have concluded that City Federal had the requisite notice of the loss within the bond period. RTC, 205 F.3d at 635.

While the Court in RTC refused to find for the insurer on the notice issue as a matter of law, its analysis is instructive. The bond language at issue provided that “[d]iscovery occurs when the Insured becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred, even though the exact amount or details of loss may not then be known.” RTC, 205 F.3d at 627. The district court reasoned that City Federal had, during the operative bond period, only “concern and suspicion” that its employees had engaged in wrongdoing, but it did not have sufficient knowledge from which to conclude that a covered loss had in fact occurred.

The Third Circuit’s decision in RTC contains a lengthy analysis of the scope and meaning of the discovery term in the bond. The Court noted that the discovery standard is “comprised of a subjective and objective component: the trier of fact must identify what facts and information the insured actually knew during the relevant time period, and it must determine, based on those facts, the conclusion that a reasonable person could draw from them.” RTC, 205 F.3d at 630. The Court also accepted F & D’s argument that the discovery definition requires more than mere suspicions of employee dishonesty or fraud: “Courts have long recognized the principle that unsupported suspicions of employee misconduct do not constitute discovery in the fidelity bond context ... and we believe that the language of the bond incorporates that requirement by tying the concept of discovery to facts within the insured’s knowledge.” RTC, 205 F.3d at 630 citing National Newark & Essex Bank v. American Insurance Co., 385 A.2d 1216 (N.J. 1978).

The RTC Court then addressed the meaning of the objective standard set forth in the bond. The Court suggests that the insured must both discover facts showing employee dishonesty and appreciate the significance of these facts: “[w]e agree with those courts of appeals which have stated that ‘discovery’ of a loss under section 4 does not occur until the insured ‘discovers facts showing that dishonest acts occurred and appreciates the significance of those facts.’” RTC, 205 F.3d at 631 citing FDIC v. Fidelity & Deposit Co., 45 F.3d 969 (5th Cir. 1995); California Union Ins. Co. v. American Diversified Savings Bank, 948 F.2d 556 (9th

Cir. 1991); Royal Trust Bank, NA v. National Union Fire Ins., 788 F.2d 719 (11th Cir. 1986). The Court also observed that, in evaluating the objective component of the analysis, the trier of fact must “analyze the full range of information the insured knew so as to determine whether a reasonable person would assume, based on all the circumstances, that a covered loss had or would be incurred.” RTC, 205 F.3d at 631.³

Applying these standards, the Court held that a reasonable jury could have concluded that City Federal was aware, during the bond period, of facts which would cause a reasonable person to assume that a covered loss had or would occur. The Court relied upon the following key facts in support of its conclusion. First, the insured was aware during the bond period that one of its employees was himself aware of the customer’s kiting scheme, and – more significantly – was aware that the employee had committed a dishonest act by not disclosing his knowledge to City Federal’s in-house counsel during its internal investigation of the matter. The Court also noted that the factual context of the employee’s non-disclosure – i.e., that the customer’s loan account was specifically excluded from a sale of City Federal which had occurred contemporaneously with the customer’s admission of the kiting scheme – also could permit a reasonable person to conclude that a fraud had occurred. RTC, 205 F.3d at 632.

As an additional basis in support of its holding, the Court noted that City Federal’s in-house counsel had interviewed the dishonest employee as part of its internal investigation of the matter (which occurred during the bond period) and found that his demeanor was “elusive”. RTC, 205 F.3d at 632. The Court observed that this would not, standing alone, satisfy the requirements of discovery under the bond, but would nonetheless provide an additional basis for a jury to conclude that discovery had occurred during the bond period. Id.

The RTC court also considered and rejected the following arguments raised by F&D. First, F & D cited admissions which City Federal had made in a parallel civil action. In that action National Union Fire sought a declaratory judgment against City Federal that its bond – which was issued after the F & D bond – did not provide coverage for the loss because City Federal failed to disclose the existence of the loss in its bond application to National Union. F&D asserted that City Federal admitted in the National Union litigation that it was not aware of the loss during F & D’s bond period. The RTC Court reasoned that City Federal had merely admitted in the National Union action that it learned much of the information contained in its proof of loss after the bond period, but this admission would not preclude a finding that City Federal had learned of sufficient information during the bond period to trigger discovery. RTC, 205 F.3d at 633.

F & D also argued that City Federal’s letters providing first notice of the claim – which were sent at the end of F & D’s bond period – were “vague and conclusory”, and thus constituted evidence that City Federal lacked the requisite knowledge during the bond period. With little substantive analysis the Court rejects this argument, reasoning that a reasonable jury could nonetheless conclude that City Federal had sufficient knowledge despite the lack of detail included in their letters of notice to the insurer. F & D also pointed to the deposition testimony of City Federal’s in-house counsel, who repeatedly used the word “suspicious” to describe her assessment of the transaction at issue. The Court responded that the deposition

³ The RTC Court foreshadows its holding in favor of the insured in footnote 8 of its opinion. There the Court notes that the bond’s discovery term “places an insured in a difficult predicament” since, according to the Court, the operative date of discovery could generate a defense by the insurer that either the loss was discovered before the bond period had commenced or after the bond period expired. RTC, 205 F.3d at 631, n.8.

testimony, taken as a whole, demonstrated more than suspicions, and that the attorney's isolated use of the term would not, standing alone, support summary judgment in favor of the insurer. RTC, 205 F.3d at 634.

The Court concludes its analysis by noting that City Federal's in-house counsel had reached her own subjective conclusion during the bond period that employee dishonesty had taken place: "Thus, we are not faced with a situation where the evidence shows only that City Federal knew of the existence of the loss, but had not yet reached the subjective conclusion that employee dishonesty somehow was involved." RTC, 205 F.3d at 634-35 citing Block v. Granite State Ins. Co., 963 F.2d 1127, 1130 (8th Cir. 1992) (summary judgment for insurer where insured lacked contemporaneous subjective belief that employee dishonesty had occurred). The Court does not explain how the insured's subjective views would be relevant to the "reasonable person" standard imposed by the bond language.

The decision in RTC is heavily fact-based and the Court's legal analysis is, broadly speaking, consistent with the general principles applied by many courts addressing this issue. Nonetheless, as the most recent significant decision on the issue of notice, the fidelity insurer investigating and defending a complex claim should consider the following lessons from RTC: (1) some Courts will go to great lengths to allow an insured to prevail on the discovery issue, or to at least permit the issue to be presented to a jury; and (2) notwithstanding the bond language adopting an objective standard, the insured's subjective understanding may still be relevant to the issue. Indeed, much of the RTC Court's analysis focuses on the subjective state of mind of City Federal's in-house counsel. In this regard the analysis in RTC may present a problem for fidelity insurers in future litigation of the discovery issue.

Happily, other courts have been more willing to rule in favor of fidelity insurers on the discovery issue. See California Union Insurance Co v. American Diversified Savings Bank, 948 F.2d 556 (9th Cir. 1991) ("California Union") and FDIC v. Aetna Casualty & Surety, 903 F.2d 1073 (6th Cir. 1990) ("Aetna"). In California Union, the FSLIC sought recovery on standard form 22 bonds which provided that "[d]iscovery occurs when the Insured becomes aware of facts which would cause a reasonable person to assume a loss covered by the bond has been or will be incurred even though the exact amount or details of loss may not be known." California Union, 948 F.2d at 563. The district court granted summary judgment in favor of the insurer, finding that discovery had not, as a matter of law, occurred within the bond period. The Ninth Circuit Court of Appeals affirmed the granting of summary judgment in favor of the insurer. It reasoned that the record contained no evidence that the insured's non-wrongdoing employees had knowledge of facts which would support the conclusion that an actual loss occurred:

While arguably the evidence indicates the Insured was aware of infractions of banking regulations, and perhaps that internal banking procedures were not followed, there is no indication from the record that the non-wrongdoing employees were aware of facts which would cause a reasonable person to assume a loss covered by the bond [had] ... been incurred Also noticeably absent from the record is any testimony to indicate that a non-wrongdoing employee had knowledge of dishonest acts committed by [the dishonest employees]. FSLIC does not present any specific facts to indicate any knowledge beyond suspicion on the part of the Insured that covered losses occurred.

California Union, 948 F.2d at 564.

In Aetna, the FDIC sought recovery under two financial institution bonds which defined discovery as when “the Insured becomes aware of facts which cause a reasonable person to assume that a loss covered by the bond has been or will be incurred, even though the exact amount or details of loss may not then be known.” Aetna, 903 F.2d at 1074. The bonds were issued in favor of USBN, a bank which was put into receivership and taken over by the FDIC. The evidence showed that, on the day that the bank was taken over by the FDIC, the bank sent a letter to the insurer advising it of two potential claims against the bank which could be covered losses under the bond. However, this letter failed to make any reference to the losses which were ultimately the subject of the FDIC’s bond claim. Instead, the FDIC’s bond claim was based on the dishonest actions of Butcher, the bank’s former chief executive officer. The bank’s president – who directed that the notice letter be sent to the insurer on the date that the bank closed – testified that at the time the bank was taken over he believed that Butcher had engaged in dishonest actions which would cause a loss to the bank, but he was not aware of any specific dishonest act or transaction of Butcher, and – at the time – his belief was based only on the precarious financial position of the bank. Aetna, 903 F.2d at 1076.

The Sixth Circuit Court of Appeals held, as a matter of law, that the bank did not discover the loss prior to the time that the FDIC commenced its takeover. The court’s conclusion was based on the following: (1) the bank’s president admitted that, on the day that the bank closed, he had only suspicions that Butcher had engaged in misconduct; (2) the FDIC produced no witnesses who had knowledge of Butcher’s dishonest conduct before the bank closed; and (3) the bank’s notice letter to the insurer, though referencing certain potential losses, did not make specific reference to any of the actions which were the subject of the FDIC’s claim on the bonds. Aetna, 903 F.2d at 1073.

Another decision favorable to an insurer on the discovery issue is Federal Saving & Loan v. Aetna Casualty & Surety, 785 F.Supp. 867 (D. Mont. 1990). Here the insurer sought summary judgment on the grounds that the insured bank discovered the loss well before it provided notice and a proof of loss, in contravention to the terms of the bond. The FSLIC argued that the bank had mere suspicions of a possible loss, but because the bank was dominated by the wrongdoers, it could not have discovered the loss at the time argued by the insurer. The district court granted summary judgment in favor of the insurer. The court noted that the bank’s proof of loss contained essentially the same information which was included a prior letter sent by the bank to the Federal Home Loan Bank Board (“FHLBB”). As such, the court agreed with the insurer’s argument that the bank’s discovery of the loss must have occurred no later than the date of the bank’s letter to the FHLBB. Based on that date of discovery, the bond claim was deemed untimely. Federal Saving & Loan v. Aetna Casualty & Surety, 785 F.Supp. at 870.

The contents of the insured’s proof of loss played a pivotal role in another favorable decisions for an insurer on the discovery issue. Block v. Granite State Insurance Company, 963 F.2d 1127 (8th Cir. 1992) (“Block”). In Block, the insured had obtained commercial crime coverage from the insurer, and sought coverage under the policy for the misappropriation of funds by the insured’s president. The proof of loss affidavit submitted by the insured asserted that the loss had been discovered in July, 1985. When the insured prepared the proof of loss it apparently overlooked the implications of the discovery and notice provisions of the bond,

since the parties later agreed that the loss must have been discovered by April, 1985 to be covered under the policy. Block, 963 F.2d at 1128.

While the trial court did not preclude the insured from taking a different position than was asserted in the proof of loss, it construed it as a “significant admission” which was not overcome by any other evidence submitted on this issue. Block, 963 F.2d at 1129. The Court of Appeals affirmed the entry of summary judgment in favor of the insurer. The Court noted that the insured had obtained a “management report” from an attorney and an accountant hired by the insured, which referred to the transaction at issue as an “ancillary problem” and noted that the insured’s president had offered explanations for the transaction which were consistent with innocence. The Court noted that these outside experts did not accuse the president of wrongdoing in their report. As such, the Court concluded that the insured had only a mere suspicion of wrongdoing, but was not aware of sufficient facts to establish that the loss had been discovered during the policy period. Block, 963 F.2d at 1130.

In 1994 the Tenth Circuit Court of Appeals addressed the discovery issue in two financial institution bonds in F.D.I.C. v. Oldenburg, 34 F.3d 1529 (“Oldenburg”). In Oldenburg, the bond claims concerned dishonest actions in connection with a sham transaction between a bank and its owner. The transaction was in violation of federal and state banking laws. The evidence showed that bank employees permitted the transaction to proceed with knowledge of its illegality. The Court found that, with respect to one of the bonds, the loss was discovered because the bank was the subject of a cease and desist order regarding the transaction at issue during the bond period. Oldenburg, 34 F.3d at 1542 citing Federal Savings & Loan v. Aetna Casualty & Surety, 785 F.Supp. 867 (D. Mont. 1990).

3. The Insured’s Duty to Inquire

In attempting to defeat a defense based on the date of discovery of the loss, an insured may argue that its level of knowledge amounted to only mere suspicions of fraud or dishonesty by the employee in question. The insured may have had some information available to it which - if scrutinized - would have led to discovery of the loss. The insured’s state of knowledge in these cases must be judged against the backdrop of transactions which first seem innocuous, then questionable or dubious, and – upon a more complete investigation and analysis – are finally confirmed as fraudulent or illegal. The fidelity insurer addressing such a claim may argue that the insured had a duty to inquire or investigate the transaction or employee at issue, and had the insured complied with this duty, it would have discovered the loss before the bond period commenced.

The current definition of discovery in the Standard Form 24 bond would, on its face, provide some support for the argument that a duty of reasonable inquiry exists and must be considered whenever the date of discovery presents a disputed issue. As discussed in Section 1 of this paper, the bond definition provides that discovery occurs when the insured “first becomes aware of facts which would cause a reasonable person to assume that a loss of a type covered by this bond has been or will be incurred[.]” The bond language clearly contemplates that the insured’s actions will be governed by the “reasonable person” standard. It is by no means a large leap to conclude that an objectively reasonable insured has some obligation to make a fair inquiry into transactions which present possible losses. The bond’s incorporation of the

reasonable person standard should be sufficient to establish a concomitant duty on the part of the insured to conduct reasonable inquiries where appropriate.

Some courts have been receptive to the argument that the insured under a fidelity bond or commercial crime policy has a duty to inquire. See, e.g. Royal Trust Bank v. National Union Fire Insurance Company, 788 F.2d 719 (11th Cir. 1986) (“Royal Trust”); Utica Mutual Insurance Company v. Fireman’s Fund Insurance Company, 748 F.2d 118 (2d Cir. 1984) (“Utica Mutual”); and In Re Prime Commercial Corp., 187 B.R. 785 (Bkrcty.N.D.Ga. 1995) (“Prime Commercial”).

In Royal Trust, the insured bank sought recovery for losses arising out of a check-kiting scheme perpetrated by one of its customers. The insurer argued, and the jury found, that the insured could have discovered the scheme before the inception of the bond period “if officers had paid closer attention to computer records and reports that were reviewed regularly.” Royal Trust, 788 F.2d at 720. The Eleventh Circuit upheld the judgment in favor of the insurer, and found that the trial court correctly rendered the following jury instructions with respect to the issue of the insured’s knowledge and duty to inquire:

The means of knowledge are ordinarily the equivalent in law to knowledge. So, if it appears from the evidence in the case that a person had information which would lead [a] reasonably prudent person to make inquiry through which he would surely learn certain facts, then this person may be found to have had actual knowledge of those facts, the same as if he had made such inquiry and had actually learned such facts.

That is to say, the law will charge a person with notice and knowledge of whatever he would learned, upon making such inquiry as it would have been reasonable to expect him to make under the circumstances.

Royal Trust, 788 F.2d at 721.

In finding for the insurer, the Court noted that the bank’s “kite suspect” computerized reports frequently identified the accounts in question before National Union’s bond period commenced. The bank asserted that it did not discover the loss as a result of these reports because of the negligence of its supervisory employees, but that such negligence could not, as a matter of law, provide the basis for a finding that the loss had been discovered under the bond. The Eleventh Circuit disagreed, holding that the jury instruction quoted above properly imposed a duty to inquire on the insured which, if fulfilled, would have resulted in discovery of the loss before the bond period. Id.

The Second Circuit Court of Appeals also imposed a duty of inquiry upon an insured in Utica Mutual. The transaction at issue in that case concerned the insured’s sale of tax-exempt bonds. The transactions were executed by the insured’s investment manager, Philip Turner. While the insurer intended that the change in its securities portfolio would yield a higher return, the transactions in fact did not generate any additional revenue. Instead, Turner engaged in a practice of “adjusted trading” or “overtrading”, pursuant to which the net value of the insured’s portfolio did not change, but the transactions at issue generated significant fees and commissions which were paid by the insured. Utica Mutual, 748 F.2d at 121.

The insured argued that it did not discover the loss for purposes of coverage under the bond until such time that it was informed by outside accountants and lawyers that it had suffered losses because of the commissions paid, and that the trades that generated these commissions were in fact illegal. In support of its position, the insured further argued that it maintained a good faith subjective belief that Turner did not engage in any wrongdoing until such time as it was informed by outside counsel that his actions were illegal. In response, the insurer argued that the discovery of the loss occurred much earlier than claimed by the insured, and the fact that the insured may not have appreciated the significance of the facts learned in its investigation did not alter the fact that the insured was previously aware of sufficient information which, upon further inquiry, would have confirmed the existence of illegal activity.

The Second Circuit agreed with the insurer and found that the claim was barred because the insured failed to provide timely notice. Applying New York substantive law, the Court held that the insured had a duty to inquire into the circumstances surrounding Turner's actions in connection with the stock trades. Thus it did not matter that the insured did not believe that Turner had acted illegally until it was so informed by outside counsel: "If Utica was uncertain of the legality of Turner's conduct, then Utica should have promptly obtained legal advice as part of its general inquiry into the transactions in question." Utica Mutual, 748 F.2d at 122. The holding in Utica Mutual may therefore be read for the proposition that the insured has a duty to inquire not only as to the facts surrounding a questionable transaction, but also must reasonably inquire about the legal significance of its employee's actions.

In Prime Commercial, the United States Bankruptcy Court for the Northern District of Georgia considered the duty to inquire in the context of a claim on an employee theft policy. The insurer argued that the claim was barred because notice was not provided within the period required by the policy. The bankruptcy trustee – who pursued the claim on behalf of a bankrupt insured – asserted that the claim was timely because the insured had only mere suspicions of theft by the employee in question. Applying Georgia law, the court declared the following with respect to the duty to inquire in the fidelity context:

If an insured under a fidelity policy discovers an employee's dishonesty about business transactions that give rise to a suspicion of fraud, a duty of inquiry arises that cannot be satisfied by the undocumented assertion of the employee that no problem exists or if there is one, he will solve it. The failure of the insured to inquire promptly or the failure of the employee to respond promptly in a manner that would cause a reasonable and prudent person to put aside his suspicion of fraud triggers the duty to notify the surety under a policy requiring notice of discovery of an 'occurrence which may become a loss' for theft or fraud.

Prime Commercial, 187 B.R. at 804. Based on this test, the Court granted the insurer's motion for summary judgment, finding that the insured's officers had sufficient information about the transactions at issue to trigger their duty of inquiry and, ultimately, the duty to give notice under the policy.

4. Investigating and Defending a Claim Based on Discovery

Defenses related to discovery do not prove themselves. The issue often arises in the context of complex financial transactions with multiple parties. Investigation and analysis of this issue is typically a lengthy and sometimes painstaking process. The fidelity insurer seeking to prevail on this issue must be prepared to spend a significant amount of time - and possibly money - pursuing the type of investigation which is invariably necessary to establish the defense. The authors offer the following suggestions and guidelines for the fidelity insurer.

The starting point should be the insured's first notice of claim and the proof of loss submitted by the insured. The insured's proof of loss should be scrutinized. Compare the proof of loss with prior correspondence from the insured or with other documents generated in connection with the insured's business. If the contents of the proof simply parrot the insured's prior communications regarding the loss, or are taken directly from prior reports regarding the loss, the insurer can successfully argue that the insured's discovery of the loss must have occurred no later than the date of the earlier reports or communications. Federal Saving & Loan v. Aetna Casualty & Surety, supra (insured's discovery of loss established by date of letter from insured to the FHLBB, where contents of letter were identical to the proof of loss allegations). The insured may also make statements in the proof of loss which can be used as admissions against its interest in any ensuing litigation. Block v. Granite State Insurance Company, supra (insured's proof of loss, which included assertion as to date of discovery which placed the loss outside the bond period, was deemed a "significant admission" in the litigation).

Large and commercially sophisticated insureds may pursue extensive internal investigations of potential losses before the fidelity insurer is even notified of the claim. Such investigations may include the use of in-house counsel, outside counsel and outside accountants. The work product of these professionals may include relevant evidence on the issue of discovery. The fidelity insurer should request and analyze attorney opinion letters, accountant reports, and other similar documents generated by the insured's internal review and investigation. These documents often contain significant allegations of wrongdoing which may establish discovery of the loss.

Claim notices received at the end of a bond or policy period should raise a red flag for the fidelity insurer. Such notices may be sent based only on suspicion of dishonest conduct, but not actual discovery. While the insured may in good faith believe that it is sending such notice to preserve its rights under the bond, the fact remains that there is no coverage absent a discovery during the bond period. In these cases the fidelity insurer should examine the letters of first notice of claim to the insurer, and compare those to the claims as asserted in the final proof of loss and the claims as asserted in the litigation. If the allegations in the notice letters bear little or no relation to the conduct or transactions which are the subject of the claim, the fidelity insurer may have a compelling argument that discovery did not occur during the bond period.

Ultimately, whether the insurer will prevail on the discovery issue will invariably depend upon the content of the insured's internal documents, and the inferences which can be drawn from them about the insured's knowledge regarding the transactions at issue. Thus the fidelity

insurer should make written comprehensive requests for pertinent documents. The documents which the insurer should request will, of course, be a function of the specific facts of each claim. Documents which the insurer should generally request include bank loan policies, director's reports, board of director's reports and meeting minutes, internal audits and reviews, personnel files for the employees in question, loan committee reports, communications to and from regulatory agencies, and reports generated from internal investigations performed by the insured.

The insured's internal reports may disclose irregularities or failures to comply with company procedures. Where those reports were in fact reviewed and considered by supervisors and managers, the dates of their review may establish the date of discovery of the loss. Even where these reports are ignored or not reviewed, the insurer may argue that the insured had a duty to inquire further. Royal Trust Bank v. National Union Fire Insurance Company, supra (computer documents and reports, if reviewed by the insured, would have led to discovery of check kiting scheme). Reports of regulatory agencies and minutes from board of directors meeting may also included important evidence. First Security Savings v. Kansas Bankers Surety, 849 F.2d 345 (8th Cir. 1988).

The fidelity insurer should identify all key individuals connected with the claim, and seek interviews of them. These individuals may include co-workers of the wrongdoing-employees, managers and supervisors, members of the board of directors and loan committees, in-house counsel and the insured's risk manager and personnel director. If the claim proceeds to litigation, the insurer's counsel should pursue the depositions of these individuals.

The fidelity insurer should also examine the underwriting files with respect to the insured, and also closely scrutinize the insured's application for insurance coverage. The application may provide evidence of the insured's prior knowledge of wrongful conduct. This evidence may allow the insurer to establish that the insured discovered the loss before the operative date of its bond. Alternatively, the fidelity insurer may use the insured's prior knowledge as a basis to seek rescission of the bond or policy because of misrepresentations in the application process. Fidelity & Deposit of Maryland v. Hudson United Bank, 493 F.Supp. 434 (D.N.J. 1980)

5. Conclusion

The fidelity insurer faces an uphill - but not impossible - task when seeking to avoid liability based on the date of the insured's discovery of the loss. Proving the defense requires an extensive review and analysis of numerous documents generated by the insured. The Third Circuit Court of Appeal's recent decision in RTC evidences a judicial reluctance to find against the insured on this issue. Nonetheless, the cases discussed above demonstrate that, in the proper case, the fidelity insurer can successfully defeat a claim based on the timing of the insured's discovery of the loss.

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