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## PROCRASTINATING PRINCIPALS: NECESSITY FOR PROVIDING TIMELY NOTICE OF CLAIM UNDER FIDELITY BONDS AND COMMERCIAL CRIME POLICIES.

**PRESENTED BY:**


**MARK A. CONNOLLY, ESQ.**
**SHUMAKER, LOOP & KENDRICK, LLP**
Bank of America Plaza
101 East Kennedy Boulevard
Tampa, Florida 33602
(813) 229-7600
(813) 229-1660

**Procrastinating Principals: Necessity for providing timely notice of claim under fidelity bonds and commercial crime policies.**

## I. INTRODUCTION

In today's society, it should be fairly easy to market fidelity insurance coverage. Remarkable tales of greed lie beneath employee theft losses. Employees are no longer satisfied with slipping pens and floppy discs into their pockets for their personal use-"better living through stolen office supplies." Rapidly changing information technology and a global economy have made it easier than ever for employees to line their pockets with substantial amounts of stolen company money. Losses include vendor kickbacks, inventory theft, fictitious purchases, and fraudulent loans, just to name a few.

According to the Association of Certified Fraud Examiners (ACFE), organizations lose 6% of their annual revenue to fraud and abuse, at a cost of more than $400 billion annually. The average organization loses more than $9 per day, per employee, to fraud and abuse. *See* Association of Certified Fraud Examiners 1996 Report to the Nation of Occupational Fraud and Abuse. The problem is widespread. Ernst & Young found that half of the companies it surveyed had been defrauded in the past twelve months and that 84% of the worst frauds were committed by employees, nearly half of whom had been employees for over five years. *See* Ernst & Young, Fraud Investigation Group, Fraud--The Unmanaged Risk: An International Survey of the Effect of Fraud on Business (1999).

Despite these alarming statistics, many companies simply fail to take advantage of fidelity coverage. According to Ernst & Young, only 13% of fraud losses were recovered by the companies surveyed for their 1999 report. This recovery rate would be even lower if courts required strict compliance with notice and proof of loss covenants in fidelity bonds and commercial crime policies.

Courts across the country have been unable to reach a consensus with regard to the issue of whether notice provisions set forth in fidelity bonds and commercial crime policies should be considered conditions precedent to coverage, thus requiring strict compliance by victimized companies seeking coverage.[1] In some instances, a jurisdiction's rules applicable to liability insurance coverage have been applied to fidelity coverage, with little analysis of the differences between liability and fidelity coverage.

In the early part of the 1900s, the majority rule in this country, with regard to both liability policies and fidelity bonds, required strict compliance with notice provisions in bonds and insurance policies. Under this "traditional" approach, unexcused untimely notice resulted in a forfeiture to the insured. This "traditional" approach was the majority position through at least 1952, when the American Law Reports published an annotation entitled "Effect of Failure to Give Notice, or Delay in Giving Notice or Filing of Proofs of Loss, Upon Fidelity Bond or Insurance" 23 A.L.R. 2d 1065 (1952). Section 3 of the ALR annotation lists numerous U.S. jurisdictions where failure to comply with notice provisions barred recovery against fidelity

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[1] Courts generally treat fidelity bonds as a contract of fidelity insurance. *See National Union Fire Ins. Co. v. FDIC*, 957 P.2d 357, 361 (Kan. 1998)*; Luso-American Credit Union v. Cumis Ins. Soc.*, 616 F. Supp. 846, 848 (D. Mass. 1985). Therefore, for the purposes of this paper, no distinction will be drawn between fidelity bonds and commercial crime insurance policies.

bonds, *even where* the fidelity bond did not specifically provide that satisfying the notice provision was a condition precedent to coverage.

Unfortunately, rulings with regard to enforceability of notice provisions set forth in fidelity bonds and commercial crime policies have been less than uniform since the publication of the ALR annotation referenced above. In the latter half of the last century, many jurisdictions adopted a friendlier approach towards insureds under liability policies, known as the "modern" approach, whereby insurance companies are required to show that they have been prejudiced in some manner by an insured's late notice before allowing a forfeiture. Some jurisdictions have simply followed the standard applied for liability insurance policies to find that an insurer must show prejudice in order to bar a claim based upon an insured's failure to timely provide notice. *See In Re Lloyd's Securities, Inc.*, 153 B.R. 677, 683 (E.D. Pa. 1993).

This paper is intended to assist the fidelity practitioner in determining when notice is required to be provided by the insured and whether late notice provides a viable coverage defense.

## II. DISCOVERY OF LOSS

Analysis of the enforceability of notice provisions begins with discovery, because notice requirements are triggered by the insured's "discovery" of a loss. *See FDIC v. Oldenburg, 34 F.3d 1529, 1548 (10th Cir. 1994).* Under most fidelity bonds and commercial crime policies, upon the insured's discovery of loss, the insured is required to: (a) give notice thereof "as soon as practicable" to the insurer, and (b) file detailed, sworn, proof of loss within a certain time period (commonly two to four months) after the discovery of loss. Discovery of loss clauses protect the insurer by imposing a duty on the insured to make reasonable efforts to monitor its employees' actions and faithfulness, and allow insurers to avoid investigating stale claims. *Southeast Bakery Feeds, Inc. v. Ranger Ins. Co.*, 974 S.W. 2d 635, 640 (E.D. Mo. 1998).

Most policies also require that the loss be sustained during the term of the insurance, with discovery occurring no later than a specified time period thereafter, usually one year from the policy's termination date. Aside from triggering requirements of notice and proof of loss, the insured's discovery of loss commonly also terminates coverage for the defalcating employee so that any additional loss caused by the employee's subsequent defalcation is not covered by the fidelity insurance.

When evidence supports a discovery defense, the insurer will claim that its insured did not discover the loss during the coverage period, but merely suspected a possible loss. In contrast, if the insurer does not raise a discovery defense, and instead argues that notice was untimely, then the insurer will attempt to locate evidence to indicate that its insured discovered the loss early, and that, despite having discovered the loss, the insured failed to timely notify the insurer.

Discovery of loss provisions limiting coverage to losses discovered within a certain covered period are uniformly held enforceable. *Karen Kane, Inc. v. Reliance Ins. Co.*, 202 F.3d 1180 (9th Cir. 2000); *Resolution Trust Corp. v. Fidelity and Deposit Co.*, 205 F.3d 615 (3d Cir. 2000); *Southeast Bakery Feeds, Inc. v. Ranger Ins. Co.*, 974 S.W. 2d 635 (E.D. Mo. 1998); *FDIC v. Ins. Co. North America*, 105 F.3d 778 (5th Cir. 1997); *Hidden Splendor Mining Co. v. General Ins. Co. of America*, 370 F.2d 515 (10th Cir. 1966).

## A. WHAT MUST THE INSURED DISCOVER?

"Discovery" is not defined uniformly in bonds and crime policies. Section 4 of the commercial crime policy form used by many insurers today requires the insured to notify the insurer after it "discover[s] a loss or a situation that may result in loss of, or loss from damage to, Covered Property." In comparison, the banker's blanket bond at issue in *FDIC. v. Underwriters of Lloyd's of London*, 3 F. Supp. 2d 120 (D. Mass. 1998) stated that discovery occurred on the date the policyholder first became "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." *Id*. at 145. A similar definition of discovery was used in the fidelity bond at issue in *Resolution Trust Corp. v. Moskowitz*, 1994 WL 475811 (D. N.J. 1994), which defined discovery as occurring "when the Insured first becomes aware of facts which would cause a reasonable person to assume that a loss of a type covered by the bond has occurred or will occur, regardless of when the act or acts causing or contributing to such loss occur, despite the fact that the amount of the loss or details thereof may not then be known." *Id*. at 4.

## B. THE DISCOVERY STANDARD.

There is no question that mere suspicion of employee dishonesty is insufficient to constitute discovery. *Resolution Trust Corp. v. Fidelity and Deposit Co. (RTC v. Fidelity),* 205 F.3d 615, 630 (3d Cir. 2000); *First Dakota National Bank v. St. Paul Fire & Marine Ins. Co.*, 2 F.3d 801 (8th Cir. 1993). Yet, under the definitions of discovery set forth above, it is also unnecessary for an insured to have actual knowledge of a loss for discovery to occur. In addressing this often litigated issue, the Third Circuit recently described a two-step inquiry comprised of both a subjective and objective component: "[T]he 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 conclusions that a reasonable person could draw from them." *RTC v. Fidelity*, 205 F.3d at 630. In *Alfalfa Electric Cooperative, Inc. v. Travelers Indem. Co.*, 376 F. Supp. 901 (W.D. Okla. 1973), the court attempted to clarify the distinction between suspicion and knowledge, explaining that discovery is synonymous with obtaining information, so that when an insured learns of facts which constitute potential employee dishonesty, its prior suspicions transform into knowledge which constitutes "discovery," which the insured cannot ignore. *Id*. at 906.

Thus, discovery requires actual subjective awareness by the insured of at least some facts suggesting that a loss has occurred as a result of employee dishonesty. In viewing this subjective component of discovery, the practitioner must determine if the jurisdiction imposes a duty of inquiry on the insured. Some courts have rejected arguments by insurers that discovery occurs when a vigilant insured might have realized an employee's dishonesty. *See Brad's Machine Products, Inc. v. Phoenix Assurance Co.*, 489 F.2d 622, 625 (5th Cir. 1974) (finding the bond imposed no duty of diligence on the insured to discover an employee's dishonesty). Other courts have imposed a duty of inquiry on insureds. *See In re Prime Commercial Corp.*, 187 B.R. 785, 803 (Bankr. N.D. Ga. 1995) (when an insured under a fidelity policy discovers employee dishonesty giving rise to a suspicion of fraud "a duty of inquiry arises" that cannot be satisfied by a mere assertion that no problem exists); *Utica Mutual Insurance Co. v. Fireman's Fund Ins. Co.*, 748 F.2d 118, 123 (2d Cir. 1984)(in rejecting Utica's

arguments concerning when a loss is discovered, the court explained that doing so would "eliminate the insured's duty to inquire into the facts.").

After determining the subjective knowledge of the insured, courts must then determine whether, viewed objectively, the information known to the insured is sufficient to constitute "discovery." Once an insured obtains facts which may constitute employee dishonesty, the insured is obligated to notify the insurer of loss if the facts would indicate employee dishonesty to a reasonable man. The seminal case imposing an objective discovery standard is *American Surety Co. v. Pauly*, 170 U.S. 133, 18 S.Ct. 552 (1898), which is still widely cited today. Analyzing the trial court's jury instruction, the Court explained that the insured was not required to provide notice unless the insured "had knowledge, not simply suspicion, of the existence of such facts as would justify a careful and prudent man in charging another with fraud or dishonesty." *Id.* at 147. Elaborating on its earlier ruling, in *American Surety Co. v. Pauly (No. 2)*, 170 U.S. 160, 18 S.Ct. 563 (1898), the Supreme Court explained:

> In our judgment … it was proper to instruct the jury that the receiver need not have given the required notice on mere suspicion as to acts by [the employee] involving fraud or dishonesty on his part as president of the bank, but was bound to do so only when satisfied that he had committed some specific act of dishonesty likely to involve loss to the company.

170 U.S. at 164. One of the most recent cases addressing the discovery of loss issue is *Nike, Inc. v. Northwestern Indem. Co.*, 999 P.2d 1197 (2000) where the court explained that "although knowledge of all of the details of the loss is not necessary, the insured must be aware of sufficient facts to lead a reasonable person to believe that the circumstances of the loss bring it within the policy's coverage." *Id.* at 1203. The *Nike* Court affirmed that the test to be applied remains

> an objective one in terms in what a reasonable person would or should conclude from the available information: Discovery takes place when the insured gains sufficient knowledge, greater than mere suspicion, which would justify a reasonable and prudent person to believe that an act of dishonesty and loss within the policy coverage had taken place.

*Id*. (citations and quotations omitted). Accordingly, an insured will be found to have discovered a loss even though the insured does not have all of the details of the loss and has not fully investigated or quantified the loss so long as a reasonable person having such information in his possession would believe that a loss has taken place. This discovery triggers the insured's obligation to provide notice to its insurer.

## III. THE NOTICE OF LOSS

### A. OVERVIEW.

The notice of loss is a brief statement to the insurance company informing the insurance company that the policyholder has discovered a loss covered by the bond or crime policy.[2]

[2] Typically, bonds and crime policies do not specify that any particular information must be included in the notice of loss, and, likewise, most do not specify the particular form of notice that must be provided to the insurer. However, if written notice is required, telephonic notice has been found insufficient. *Mutual Industrial Finance Corp. v. American Surety Co. of New York*, 175 A. 777 (Conn. App. 1934). Because the purpose behind providing notice of loss to the insurer is to alert the insurer to the occurrence of a loss, the notice is not

Virtually all fidelity bonds and commercial crime policies contain provisions requiring the insured to provide notice of loss to the insured "as soon as possible" after discovering the loss. Thereafter, insureds must submit a proof of loss to the insurer providing details with regard to the loss, which also must be provided within a specified time period of discovery. Although some policies additionally require that any legal action brought against the insurer must be commenced within two years from the date of discovery, many jurisdictions will not enforce a contractual shortening of the statute of limitations. For example, under Florida law, by statute, such contractual provisions are void. *See* §95.03, *Fla. Stat.*

The primary reason behind requiring prompt proof of loss is to allow prompt investigation of the loss by the insurer. The importance of prompt notice was explained by the court in *St. Paul Fire & Marine Ins. Co. v. Bank of Stockton*, 213 F. Supp. 716 (N.D. Calif. 1963) as affording the insurer the right to promptly investigate the loss and interview witnesses. There, the Court noted that the insured's five month delay left a "cold witness trial strewn with faulty memories, and, as in the case at bar, dead or missing witnesses." *Id.* at 722.

Although many fidelity bonds and commercial crime policies include verbiage making timely notice a condition precedent, the most recent crime policy form does not specify that the notice requirement is a condition precedent. The commercial crime form used today by many insurers contains the following notice requirements:

**CRIME GENERAL PROVISIONS**

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B. GENERAL CONDITIONS.

3. Discovery of Loss: We will pay only for covered loss discovered no later than one year from the end of the policy period.

4. Duties in the Event of Loss: After you discover a loss or a situation that may result in loss of, or loss from damage to, covered property you must:

    a. *notify us as soon as possible;*
    b. submit to examination under oath at our request and give us a signed statement of your answers;
    c. *give us a detailed, sworn proof of loss within 120 days*;
    d. cooperate with us in the investigation and settlement of any claim.

Fidelity bonds contain requirements that are similar to the crime policy form, and which may include explicit deadlines for providing notice. *See FDIC v. Ins. Co. of North America*, 105 F.3d 778, 782 (1st Cir. 1997) (requiring notice "at the earliest practicable moment, not to exceed 30 days"); *Security National Bank v. Continental Ins. Co.*, 586 F. Supp. 139, 148 (D. Kan. 1982) (requiring notice "at the earliest practicable moment after discovery," but with no 30 day limitation).

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required to include details that will often remain unknown to the insured at the time of discovery. See *National Newark & Essex Bank v. American Ins. Co.*, 385 A.2d 1216, 1225 (N.J. 1978) (purpose of a notice of loss is simply to acquaint the insurer as to the occurrence of a loss).

Despite unambiguous language in fidelity bonds and commercial crime policies which requires an insured to provide notice of claim as soon as possible after a loss has occurred, many courts have disregarded the contractual verbiage to simply require within a reasonable time under the circumstances. *See, e.g., Fidelity & Deposit Co. v. Courtney*, 186 U.S. 342, 22 S.Ct. 833 (1902) (bond requirement of immediate notice satisfied by notice provided within a reasonable time, taking into account all circumstances of the case); *Perpetual Building & Loan Ass'n. v. United States Fidelity & Guaranty Co.*, 92 N.W. 686 (1902) (requiring notice within a reasonable time and distinguishing accident insurance cases finding notice untimely on the basis that fidelity losses were more uncertain than personal injuries). Whether an insured timely complied with the notice requirements is commonly found to be a question for the trier of fact. *FDIC v. CNA Casualty of Puerto Rico*, 786 F. Supp. 1082 (D. P.R. 1991).

B. CONSEQUENCES OF UNTIMELY NOTICE.

The consequences of untimely notice vary greatly from state to state, ranging from no penalty to a forfeiture of all coverage. In years past, the majority of courts regarded timely compliance with a notice of loss provision as a condition precedent to recovery so that untimely notice often resulted in a forfeiture of insurance coverage regardless of any other excuse or circumstance. *See* 23 A.L.R. 2d 1065 (1952). As with the trend concerning liability insurance, the trend with commercial crime policies and fidelity bonds has been to disallow forfeiture unless the late notice has somehow prejudiced the insurance company. Accordingly, case law is currently split as to whether an insured's failure to provide notice as soon as possible provides a bar to recovery. In order to preserve the defense of untimely notice, the insurer must object promptly or a court may find that the insurer waived the defense. *See Standard Brass & Mfg. Co. v. Maryland Casualty Co.*, 153 So. 2d 475, 479 (La. Ct. App. 1963) (finding the insured's compliance with notice provision may be waived by the insurer, which may be implied from the insurer's conduct).

**The Traditional Rule**

Under the Traditional Rule, notice requirements are considered a condition precedent to recovery under fidelity bonds and commercial crime policies. *See* 23 A.L.R. 2d 1065, §§ 3-5 (1952 & Supp. March 2000). If a jurisdiction interprets the notice requirement as a condition precedent to recovery, failure to comply with such requirements within a reasonable time of discovery of loss relieves the carrier of liability.[3] The reasoning behind the Traditional Rule

[3] Some of the jurisdictions following the Traditional Rule on delayed notice include: *Federal Deposit Ins. Corp. v. Underwriters of Lloyd's of London*, 3 F. Supp. 2d 120, 146 *(D. Mass. 1998)* ("Notice provisions in fidelity bonds are valid and enforceable. To deny a claim because of untimely notice, an insurer need not demonstrate actual prejudice resulting from the delay."); *In re Prime Commercial Corp.*, 187 B.R. 785 (Bankr. N.D. GA 1995); *FDIC v. Kansas Bankers Surety Company*, 963 F.2d 289 (10th Cir 1992) (requiring the insured to strictly comply with the time requirement set forth in the bond); *FSLIC v. Aetna Casualty and Surety Co.*, 785 F. Supp. 867 (D. Mont. 1990); *State Farm Mutual Automobile Ins. Co. v. Burgess*, 474 So.2d 634 (Ala. 1985); *Utica Mutual Ins. Co. v. Fireman's Fund Ins. Co.*, 748 F.2d 118 (2d Cir. 1984); *Hidden Splendor Mining Co. v. General Ins. Co. of America*, 370 F.2d 515 (10th Cir. 1966) (strictly enforcing the requirement of timely notice and proofs of loss); *Alfalfa Electric Coop., Inc. v. Travelers Indem. Co.*, 376 F. Supp. 971 (W.D.Okla 1973) (finding timely notice to be a condition precedent to recovery under the bond); *City Loan and Savings Co. v. Employers Liability Assurance Corp.,* 249 F. Supp. 633 (N.D. Oh. 1964); *Marez v. Dairyland Ins. Co.*, 638 P.2d 286 (Colo 1981); *Government Employees Ins. Co. v. Harvey*, 366 A.2d 13 (Md. 1976); *Reliance Ins. Co. v. Gasart Building Corp.,* 517 N.Y.S. 2d 189 (N.Y.App. 1987); *Parlato v. Interport Trucking Co.,* 540 F. Supp. 1051, 1053-54 (E.D.N.Y. 1982) (insured's

was examined by the Supreme Court of Wisconsin in *State Bank of Viroqua v. Capitol Indem. Corp.*, 214 N.W. 2d 42 (Wis. 1974), where the Court questioned whether a contract means what it says, or must contain legal terms of art to render notice provisions enforceable. After reviewing decisions regarding the effect of failure of the insured to comply with notice provisions in fidelity bonds, the Court held that the giving of timely notice was "a condition precedent in fact to liability whether or not expressly so stated and is to be enforced as written whether or not its importance is emphasized by further language that noncompliance works a forfeiture or voids the policy." *Id*. at 46-47.

In *Federal Deposit Ins. Corp. v. The Kansas Bankers Surety Co.*, 963 F.2d 289 (10th Cir. 1992), the Court upheld the district court's ruling granting summary judgment to the insurer for the insureds' untimely notice. The Court held that by the terms of the fidelity bonds in question, pursuant to Oklahoma law, the parties had made time of the essence. *Id.* at 294. Therefore, because the insureds failed to timely provide notice under the bonds, the Court held that the insurer was not required to prove prejudice as a result of the late notice in order to defeat liability under the bonds. *Id*.

The type of protection afforded an insured under a policy may be the key to resolving a notice dispute. In *Southeast Bakery Feeds, Inc. v. Ranger Ins. Co.*, 974 S.W.2d 635 (Mo. Ct. App. 1998), the insureds acknowledged providing late notice to Ranger, but argued that the late notice did not bar their claim absent prejudice to Ranger. On appeal, the Missouri appellate court reversed the trial court's grant of summary judgment in favor of the insureds. The court reasoned that the policy provided coverage on a "claims made" basis rather than an "occurrence" basis, so the issue of prejudice was not relevant. The court found that the "claims made" policy provided no coverage for late claims. [4]

In light of the trend in jurisdictions applying the notice-prejudice rule to liability policies, insureds must be able to distinguish fidelity coverage from liability coverage. In *FDIC v. Insurance Co. of North America ("FDIC v. ICNA*"), 105 F.3d 778 (1st Cir. 1997), the First Circuit provides a thorough analysis of how fidelity bonds and crime policies can be distinguished from liability policies in order to enforce the notice provision. As background, as a number of states have done, in 1977 the Massachusetts legislature enacted a statute which amended, Mass. Gen. Laws ch. 175, § 112, to provide that, for motor vehicle and certain other types of liability insurance, the courts of the State of Massachusetts could not deny coverage because of failure of the insured to provide timely notice unless the insurer was found to be prejudiced thereby. *See* Mass. Gen. Laws ch. 437. Under this new law, Massachusetts courts were required to apply a "notice prejudice" rule in most cases involving liability coverage. The new statutory rule departed from the State's traditional common law rule which had strictly enforced notice provisions in insurance policies to allow forfeiture of coverage where notice to an insurer of a claim was late.

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notice found untimely as a matter of law); *Podlewski v. Government Employees Ins. Co.*, 616 S.W.2d 298 (Tex. Civ. App. 1981); *State Farm Mutual Auto Ins. Co. v. Porter*, 272 S.E.2d 196 (Va. 1980).

[4] *But see Resolution Trust Corp. v. Moskowitz,* 868 F. Supp. 634, 637 (D.N.J. 1994), where the court noted the distinguishing features of "claims-made" and "discovery" policies and concluded that a "discovery" policy cannot be construed as a "claims-made" policy. *Id.* at 638. The Court explained that the history behind the banker's blanket bond at issue confirmed that it was a totally different form of insurance as compared to a "claims-made" policy. *Id.* at 638. The Court concluded that the notice-prejudice rule applied to the notice requirement in the "discovery" policy. *Id*. at 639.

In 1980, in *Johnson Controls, Inc. v. Bowes,* 381 Mass. 278, 409 N.E.2d 185 (Mass. 1980), the Supreme Court of Massachusetts extended the Notice-Prejudice Rule to "liability insurance policies" not specifically covered by statute. *Id*. at 188.[5] In *FDIC v. ICNA,* the court examined whether Massachusetts' Notice-Prejudice Rule, applicable to liability policies, extended to the Financial Institution Bond at issue, Standard Form No. 24, as revised in 1986 (at the time, the most recent form utilized by members of the Surety Association of America). The Court explained that such bonds are basically fidelity bonds, written specifically for financial institutions. *FDIC V. ICNA,* 105 F.3d at 785. Construing the Bond's definition of discovery, the district court found that, at the latest, the bank had discovered the loss by November 15, 1989. The district court thus determined that the bank was required to give notice to ICNA no later than December 15, 1989 and that notice provided on January 16, 1990 was, therefore, untimely. *Id*. at 782. The district court concluded that if notice to ICNA was untimely, the bank was barred from recovering under the bond, "regardless of whether [ICNA could] prove any actual prejudice as a result of the delay." *Id*. (citations omitted). The district court then granted INA's motion for summary judgment, which the FDIC appealed.

The First Circuit began its analysis by noting that Massachusetts Supreme Court had never applied the Notice-Prejudice Rule to a Financial Institution Bond, which the Court found to be different in kind from liability insurance policies. *Id.* at 783. The First Circuit explained that in creating a common law Notice-Prejudice Rule, the court in *Johnson Controls* did so in the context of liability policies, and that the usual application of the rule had been in liability policies. *Id*. at 784.

The Court then examined Massachusetts case law concerning fidelity policies, which, even though "not of recent vintage," supported the trial court's order granting summary judgment. *Id.* Citing to a Massachusetts Supreme Court decision from 1935, the Court explained that the common law of Massachusetts, which construed notice provisions "as written," had not been overruled by *Johnson Controls*. *Id.* The Court then noted that recent Massachusetts court decisions had declined to extend the Notice-Prejudice Rule of *Johnson Controls* to other forms of insurance coverage. In *Liberty Mutual Insurance Co. v. Gibbs,* 773 F.2d 15 (1st Cir. 1985), the Court held that, *Johnson Controls* notwithstanding, the notice-prejudice rule did not apply to a contract of reinsurance, which was to be enforced according to its terms, requiring notice "as soon as possible." *Gibbs*, 773 F.2d at 19.[6] In *Cheschi v. Boston Edison Co.,* 39 Mass. App. Ct. 133, 654 N.E.2d 48, 53 (Mass. App. Ct. 1995), the Court distinguished *Johnson Controls* and declined to extend the notice-prejudice rule to an indemnity contract.

The First Circuit recognized that fidelity bonds act as "honesty insurance," insuring against employee dishonesty. It described the party who ensures the fidelity of another's

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[5] In *Goodman v. American Casualty Co*., 419 Mass. 138, 643 N.E.2d 432, 434 (Mass. 1994), the Massachusetts Supreme Court extended the Notice-Prejudice Rule, then applicable only to liability insurance, to uninsured motorist coverage, as the Court found no meaningful distinction between the two types of coverage.

[6] In *Gibbs*, the Court found it significant that the parties involved were experienced businesses rather than lay policyholders, who may require protection. The *Gibbs* Court also noted that the Massachusetts insurance statute distinguished between the contracts of reinsurance and liability policies. *Gibbs*, 773 F.2d at 18. Applying the reasoning of *Gibbs* to the case before it, the First Circuit, in *FDIC v. ICNA,* cited to Mass. Gen. Laws ch. 175, § 107 as distinguishing between surety bonds and insurance contracts. The Court found Massachusetts law, therefore, distinguished between fidelity coverage and liability coverage. *Id*.

employee as part insurer and part surety, with liability in either capacity being primary and direct. *FDIC v. ICNA,* 105 F.3d at 785. Citing to Couch on Insurance, the Court further recognized that for most purposes fidelity bonds are considered to be a form of insurance, subject to the rules applicable to insurance contracts generally. *Id.* However, the Court then explained that a fidelity bond is not insurance, but rather a contract of indemnity with characteristics of surety arrangements, and that surety bonds are treated by the Massachusetts' courts and legislature differently than insurance contracts. *Id.* at 785-786.

Citing substantial distinctions between liability insurance and fidelity bonds, the First Circuit declined to extend the notice-prejudice rule to the Financial Institution Bond at issue. *Id.* at 786. The Court reasoned that, unlike liability insurance, the parties to a fidelity bond typically involve sophisticated businesses. Accordingly, the Court found no reason to depart from the common law rule which held the parties to their bargain. *Id.* at 786. [7]

**The Notice-Prejudice Rule**

Over the past thirty years, many courts have moved away from allowing total forfeiture of coverage under the traditional rule for the purported purpose of providing a balance between the insurer's need for prompt notice of loss and the public's interest in having insured claims paid. Under this trend, courts will look to determine whether the insurance company actually has been prejudiced by the untimely notice. In these cases, the insurance company usually bears the burden of establishing that the insured's delay in providing notice prejudiced or "substantially" prejudiced its position.[8] In *National Union Fire Ins. Co. v. FDIC*, 957 P.2d 357 (Kan. 1998), the Court reviewed the positions taken by various jurisdictions regarding which party should bear the burden of providing prejudice before holding that, under Kansas law, the insurer should prove prejudice resulting from the insured's late notice. *Id.* at 368. Some jurisdictions presume prejudice as a result of late notice, which can be rebutted by the insured. *See Miami National Bank v. Pennsylvania Ins. Co*., 240 So. 2d 832 (Fla.3d DCA 1970) (requiring insured to prove lack of prejudice to the insurance company).

Insurers have been able to successfully defend claims on the basis of late notice even when required to show prejudice. One of the more recent cases applying the Notice-Prejudice Rule is *Winthrop and Weinstine, P.A. v. Travelers Casualty and Surety Co.*, 187 F.3d 871 (8th

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[7] The Court also rejected the bank's reliance on *FDIC v. Oldenburg,* 34 F.3d 1529 (10th Cir. 1994), *cert. denied*, 116 S. Ct. 171, 133 L. Ed. 2d 112 (1995) and district court decisions from other jurisdictions. As discussed in detail herein, the court in *Oldenburg* predicted that Utah law would require a Financial Institution Bond company to show prejudice in order to avoid coverage where the bank gave late notice. *Oldenburg,* 34 F.3d. at 1546.

[8] Some of the jurisdictions applying the Notice-Prejudice Rule include: *First Nat'l Bank of Louisville v. Lustig*, 961 F.2d 1162 (5th Cir. 1992) (requiring insurer to bear the burden of showing "probable prejudice" caused by the policyholder's delay); *Northwood Nursing & Convalescent Home, Inc. v. Continental Ins. Co.*, 902 F. Supp. 79, 84 (E.D. Pa. 1995) (holding that the insurer was required to prove that notice was untimely and that it was prejudiced); *Resolution Trust Corp. v. Moskowitz,* 868 F. Supp. 634, 641 (D.N.J. 1994) (requiring insurer to prove prejudice before denying a claim based on late notice); *In re Lloyd's Securities, Inc.*, 153 B.R. 677 (Bankr. E.D. Pa. 1993) (requiring insurer to prove "actual prejudice"); *Oritani Sav. & Loan Ass'n v. Fidelity & Deposit Co.*, 744 F. Supp. 1311, 1317 (D.N.J. 1990) (requiring insurer to prove late notice caused prejudice), *rev'd on other grounds*, 989 F.2d 635 (3d Cir. 1993); *Security Nat'l Bank v. Continental Ins. Co.*, 586 F. Supp. 139 (D. Kan. 1982) (insurer allowed to rebut presumption of no prejudice); *National Union Fire Ins. Co. v. FDIC*, 957 P.2d 357 (Kan. 1998); *Downey Sav. & Loan Ass'n v. Ohio Cas. Ins. Co.*, 234 Cal. Rptr. 835 (Cal. Ct. App. 1987).

Cir. 1999). Applying Minnesota law, the court noted that the insured's late notice would bar coverage only if the insurer could show prejudice or if the policy specifically made timely notice a condition precedent to coverage, which it did not do. There, the insured's bookkeeper embezzled money by altering the name of the payee on checks. *Id*. at 873. The Court held that the late notice prejudiced the insurer's subrogation rights against the banks that paid the altered checks because the insurer was unable to give timely notice to the banks within the one-year limitation period imposed by the Uniform Commercial Code. *Id*. at 874-75. *See also Northwood Nursing and Convalescent Home, Inc. v. Continental Insurance Co.*, 902 F. Supp. 79, 84 (E.D. Penn. 1995) (prejudice to insurer shown because insurer, if held responsible for payment, would have to "pay more than it could have were the theft nipped in the bud."); *Columbia Union Nat'l Bank v. Hartford Accident & Indem. Co.,* 496 F. Supp. 1263, 1275-76 (W.D. Mo. 1980) (holding that the insurance company was prejudiced where the insured's untimely notice prevented the insured from filing an interpleader action to reduce its liability exposure), aff'd, 669 F.2d 1210 (8th Cir. 1982).

One of the more well known cases cited in support of a trend applying a notice-prejudice rule to fidelity bonds and crime policies is *FDIC v. Oldenburg,* 34 F.3d 1529 (10th Cir. 1994). Language in the case regarding the "modern trend" supports such a citation. Yet, as with many other cases applying the notice-prejudice rule, it is apparent that the court's ruling would likely have been different had the bond in question included forfeiture language or other language expressly making compliance with the notice provision a condition precedent.

In *Oldenburg,* the FDIC sued former officers of a savings & loan and also sued to recover under two blanket bonds issued to the savings & loan. At a bench trial, the district court held that an insurer must show that it was materially prejudiced by an insured's untimely notice to avoid coverage, *Id*. at 1545, and entered judgment for the FDIC on the fidelity bonds.

On appeal, the Tenth Circuit noted that the bonds at issue did not state that compliance with the notice provision was a condition precedent to recovery or that forfeiture would result as a result of untimely notice. *Id.* The Court noted that in *Anderson v. Beneficial Fire & Cas. Co.*, 442 P.2d 933 (Utah 1968), the theft policy at issue included an explicit forfeiture clause. There, the Utah Supreme Court held that the insured's failure to file suit within the time frame specified by the policy defeated coverage. In comparison, since the bonds at issue did not contain forfeiture verbiage, the Tenth Circuit sought to determine if late notice of loss "automatically relieved [the insurer] of liability absent any showing of prejudice." *Oldenburg,* 34 F.3d at 1545. Because Utah courts had not decided the issue, the Tenth Circuit looked to other jurisdictions for guidance.

Reviewing other jurisdictions, the Tenth Circuit found substantial support for the proposition that an insured's failure to comply with notice provisions in a fidelity policy will not defeat coverage absent a showing of substantial prejudice, *unless* the policy contains a forfeiture clause or language making compliance with notice a condition precedent to recovery. *Id*. at 1546 (citations omitted). The Court noted the existence of opposing case law, as found in 23 A.L.R.2d 1065 (1952 & 1994 Supp.). Despite the A.L.R. annotation, the Court declared that "the modern trend is to require insurers to show prejudice in order to avoid policy coverage for noncompliance with certain notice provisions." *Oldenburg,* 34 F.3d at 1546.

Convinced that Utah courts would require a fidelity insurer to show prejudice to avoid a claim on the basis of late notice if the policy included no forfeiture or condition precedent

verbiage, the Tenth Circuit upheld the trial court's ruling requiring prejudice. In so ruling, the Tenth Circuit was careful to distinguish cases involving fidelity policies which included such forfeiture verbiage which held that late notice automatically relieved the insurer of liability. *Id.* Indeed, the Tenth Circuit noted the "critical distinction" between policies which explicitly make timely notice a condition precedent to recovery and those that omit such express provisions. *Id.*

## IV. THE PROOF OF LOSS

After providing notice of a loss, the insured must investigate the loss and provide the insurer with a "proof of loss," explaining what the insured knows about the loss and why the loss is covered under the bond or crime policy. The proof of loss should also substantiate the amount of the loss in reasonable detail. *See Fitchburg Sav. Bank v. Massachusetts Bonding & Ins. Co.,* 174 N.E. 324, 329 (Mass. 1931) (declaring the loss not indemnified because the policyholder failed to provide a proof of loss with full particulars). The purpose behind requiring a timely proof of loss was described by the court in *Sutton v. Fire Ins. Exch.*, 509 P.2d 418 (Or. 1973), as providing the insurer an opportunity to conduct an informed analysis of its rights and liabilities by furnishing the insurer with the particulars of the loss and information necessary to determine its liability and the amount thereof. *Id.* at 419.

An insured need only show substantial compliance with the proof of loss requirements set forth in a bond or crime policy, even when the insured is required to provide itemization of claims with full particulars. *Fidelity & Deposit Co. v. People's Bank of Sanford*, 72 F.2d 932, 939 (4th Cir. 1934). In *Irvin Jacobs & Co. v. Fidelity & Deposit Co.,* 202 F.2d 794 (7th Cir. 1953), the Court found the insured's offer to allow its books to be inspected by the insurer along with the following information provided within the proof of loss satisfied the bond's requirement:

> The proof of loss contained schedules of claimed losses, specified the name of the employee whose acts caused the losses, listed the type of acts committed by [the employee] in the handling of his duties which led to the losses, and specified the manner in which the losses arose.

*Id*. at 799.

As with notice provisions, courts have construed proof of loss provisions generally to require that the proof of loss be provided within a reasonable time. *See* annotation 23 A.L.R. 2d 1065, section 8. For example, in *Fidelity & Deposit Co. v. Courtney*, 186 U.S. 342, 22 S.Ct. 833 (1902), the Court found that a bond provision requiring the insured to provide proof of loss "as soon as practicable" was satisfied where the insured provided the proof of loss four and one-half months after notice had been given. A more extreme holding was provided in *United States v. Indiana Bonding & Surety Co.*, 625 F.2d 26 (5th Cir. 1980), *criticized on other grounds by Expertise, Inc. v. Aetna Finance Co.*, 810 F.2d 968 (10th Cir. 1987), where a two year delay in providing proof of loss was found to satisfy the bond requirement of providing proof of loss "as soon as practicable." There, the district court found evidence suggested that administrative action could not take place until criminal matters were resolved the Justice Department, and that a two year delay was not unusual under the circumstances. On appeal, the 10th Circuit ruled that the district court's finding was not clearly erroneous. *Id.* at 30.

Historically, courts regarded proof of loss requirements in the same manner as notice requirements and frequently held that untimely submission of a proof of loss resulted in forfeiture of coverage regardless of whether the insurance company was prejudiced. *See Alianza Hispano-Americana v. Hartford Accident & Indem. Co.,* 209 F.2d 578 (9th Cir. 1954) (holding that the providing of notice of loss and proof of loss were conditions precedent to recovery); *Alfalfa Electric Cooperative, Inc.,* 376 F. Supp. at 909-11 (timely filing of proof of loss, like timely notice, is a condition precedent to liability).

Like untimely notices of loss, courts have increasingly applied a prejudice standard before allowing forfeiture. For example, in *Resolution Trust Corp. v. Moskowitz*, 868 F. Supp. 634 (D.N.J. 1994), the court rejected the insurer's argument that the insured's failure to timely submit a proof of loss precluded the receiver of a bank from recovering under a fidelity bond and instead, required the insurer to prove prejudice before denying coverage as a result of the insured's late filing of a proof of loss. *Id.* at 642. The *Moscowitz* court explained:

> Since the purpose of the proof of loss provision, like the notice provision, is to enable the insurance company to investigate and pay the claim without prejudice, it only makes sense to require the insurance company to prove prejudice before denying coverage based of sic the late filing of a proof of loss.

*Id*. at 641. In *National Union Fire Ins. Co. v. FDIC*, 957 P.2d 357 (Kan. 1998), the court determined whether, under Kansas law, late submission of a proof of loss provided a basis for denying coverage. After reviewing numerous cases, the court found the better-reasoned position required a showing of prejudice. The court reasoned that, with regard to both notice of loss and proof of loss, since insurance contracts are not "negotiated agreements," there was no compelling reason for allowing the insurer to avoid making payment unless the insured's delay caused loss to the insurer. *Id.* at 368.

## V. CONCLUSION

When an insurer receives notice of loss from its insured and acknowledges receipt of same, it should state explicitly state that it is not waiving any defenses provided to it under the bond or policy and request that the insured provide details concerning discovery of the loss in the proof of loss. Until the insurer receives details regarding how and when its insured discovered the loss, it cannot determine whether a notice defense or a discovery defense is potentially applicable.

If the facts support a discovery defense, the insurer has available a substantial body of case law supporting the enforceability of discovery provisions. However, if the facts support a notice defense, the insurer must look carefully to the statutes and common law of the jurisdiction whose laws govern the case to determine the viability of the defense. Statutes regarding notice provisions will typically apply to liability insurance, but may be viewed by the courts as establishing a public policy protecting insureds. Practitioners must educate courts as to the differences between liability policies and commercial crime policies, and the relative sophistication of the parties to a crime policy, thus obviating the need for special protection afforded John Q. Public under a liability policy.

In Traditional Rule jurisdictions, the insurer will not be required to show prejudice resulting from untimely notice in order to enforce the notice provision. However, in jurisdictions applying the Notice Prejudice Rule, the insurer has a much more difficult burden in enforcing a notice provision. The insurer will typically be required to show prejudice to avoid liability under the policy, although some jurisdictions will allow enforcement of notice provisions with no showing of prejudice if the policy specifically states that an insured's failure to satisfy the notice provision will result in a forfeiture of coverage. Therefore, insurers desiring to preserve the enforceability of notice provisions should ensure that their bonds and crime policies contain a clear and concise statement warning insureds that they must fully comply with the notice provision as a condition precedent to coverage and that failure to comply therewith will void the policy.