

**FIFTEENTH ANNUAL
NORTHEAST SURETY AND FIDELITY
CLAIMS CONFERENCE**

SEPTEMBER 30 - OCTOBER 1, 2004

**PRACTICAL TIPS FOR HANDLING FIDELITY AND FINANCIAL
INSTITUTION BOND CLAIMS**

PRESENTED BY:

BERNARD A. REINERT, ESQ.

JENNIE I. BARTLETT, ESQ.

ISSA K. EMEISH, ESQ.

REINERT & ROURKE, P.C.

812 North Collins

Laclede's Landing

St. Louis, MO 63102-2174

314.621.5743

Practical Tips for Handling Fidelity and Financial Institution Bond Claims

Introduction

Fidelity bond claims and the investigation thereof present the claims representative or outside counsel the opportunity to delve into the often intriguing world of corporate corruption, embezzlement and employee dishonesty. Such forays into this world offer a welcome reprieve from the handling of more predictable and typically less scandalous surety bond claims. While many useful references exist to aid a bond claims representative or fidelity attorney in the handling of such claims, there are few which provide a concise overview of the fidelity bond claims process. This paper will attempt to fill that gap while adding some practical tips which may be useful to the fidelity bond practitioner along the way.

Discovery and Notice: Their Place in Fidelity and Financial Institution Bond Claims

I. Discovery

Discovery of employee dishonesty is the event that sets in motion the entire fidelity bond claims process. It is the starting point from which an insured's duty under the bond commences. Discovery, as defined in standard financial institution bonds, 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 [the] 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 may not then be known." Section 3—Discovery, Annotated Financial Institution Bond, Second Edition. This definition of discovery presents some pitfalls, both for the insured and the underwriter alike. Chief among these hazards is the failure of an insured to act in a reasonably timely manner following its receipt of information triggering its duty to notify the underwriter of the possibility of loss.

Financial institution bonds require the insured to have some awareness and appreciation of the types of acts and occurrences which might lead to a claim on the bond. The courts have arrived at varying definitions of what constitutes discovery. Some courts have held that an employer must have actual knowledge of the wrongful acts of its employees, while others have held that an insured can be charged with constructive knowledge of such acts. For example, some courts have held that the insured is charged with knowledge of those acts which would have been discovered had the employer/insured, on an ongoing basis, reviewed and made itself aware of what its own files and records show. Royal Trust Bank, N.A. v. National Union Fire Insurance Company of Pittsburgh, P.A., 788 F.2d 719 (11th Cir. 1986). The key to both proper submission of a bond claim and, alternatively, to a successful defense against a bond claim, is thorough investigation and analysis of when, precisely, the facts constituting dishonesty were, or should have been, discovered by the insured. Investigation into the timeliness of an insured's claim will be discussed more fully below.

II. Notice

Following an insured's determination that one of its employees may have engaged in dishonest conduct, it must provide timely notice to the underwriter. The standard clause in most bonds provides that notice must be given "at the earliest practicable moment, not to exceed 30 days, after discovery of loss..." Though this requirement leaves room for practical judgment as to what is the earliest date on which notice must be given, it does set a firm outside limit of not more than 30 days from the date of discovery, as defined above. This requirement allows the underwriter to commence its independent investigation into the claim reasonably soon after the alleged loss. This helps to ensure the preservation of pertinent evidence as well as affords the underwriter the opportunity to interview key witnesses, including the bond principal, perhaps prior to any criminal charges being filed.

Upon receipt of notice from an insured, either the underwriter's claims representative or its outside counsel should thoroughly analyze the underwriting file and the bond applications relative to the particular insured, including prior bonds and applications therefor. It is important to search for any possible inaccuracies or misrepresentations in the bond applications, as such misrepresentations could void coverage thereunder or create valid defenses to claims on the bond. For example, bond applications often contain questions regarding prior claims against any officer, director or employee of the insured. If an investigation turns up previously undisclosed actions or facts relating to a covered employee, this may be sufficient to justify denial of a claim under the bond. For example, pursuant to Section 12 of the Financial Institution Bond, the Bond coverage terminates as to a particular employee as soon as an officer of the insured learns of any dishonest or fraudulent employment or non-employment related dishonest act of that employee regardless of when the act was committed or whether or not it is of the type covered under Insuring Clause (A).

Section 12 "Termination or Cancellation" provides in part:

This Bond terminates as to any Employee or partner, officer, or employee of any Processor:

(a) as soon as the Insured, or any director or officer 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, whether or not of the type covered under Insuring Agreement (A), against the Insured or any other person or entity, without prejudice to the loss of any Property then in transit in the custody of such person . . .

Annotated Financial Institution Bond, Second Edition.

Also upon notice of a claim, the claims representative or outside counsel should carefully document the file including step by step recordation of actions taken to initiate and further the investigation of the claim. This should include documenting and calendaring each piece of information or documentation received, memorializing all telephone conversations regarding the claim and carefully creating a record of the investigation

through written correspondence with both the insured and the underwriter documenting the status of the investigation and anticipated next steps in the process. The calendar of events should include, for example, the date on which the insured states that it discovered any dishonest acts of its employee(s) and any evidence substantiating or contradicting what is reported, as financial institution bonds are discovery type bonds.

From the moment an underwriter receives notice of a claim and during the early stages of information gathering and investigation, it is important to make a record of documents and information received whether by the claims representative or outside counsel. This record should include memorialization of all telephone conversations because it is often the case that during this time (when the insured claims to have just discovered facts that are the basis of its claim) that an insured, its employees and/or agents are forthcoming in providing information as to when and what information was learned that lead to the making of a claim as well as the insured's procedures, if any, for preventing the actions for which the claim is made. In the case of an outside counsel performing the investigation on behalf of an underwriter, this includes keeping the client thoroughly informed in order that the claims representative responsible for the claim can readily report on the status of the investigation and make decisions with regard to furthering the investigation, denial or payment of the claim.

Additionally, upon notice of a claim, the claims representative and the outside counsel representing the underwriter should create and maintain a cooperative and respectful but businesslike relationship with the insured. The underwriter's claim representative and counsel need to exercise care, tact and skill in the management of the interpersonal relationships with the insured's representatives to avoid adversarial animosity arising in the relationships.

Particular to fidelity bond claims is the unique relationship of the insured and the underwriter. The insured is a valued customer of the underwriter and the underwriter has a vital interest in nurturing its relationship with its customers as a matter of good business relations. However, once an insured makes a claim on the bond, the relationship can easily become somewhat adversarial. Particularly if the insured is making a claim on its fidelity bond for the first time, it will assume that once it provides notice of its claim and a proof of loss, the underwriter will simply review the information provided by the insured and pay the claim. Such an insured may quickly become discouraged and frustrated as it learns that the underwriter must make a thorough investigation of its claim, which could ultimately result in its claim being denied. In this situation, the underwriter, its claim representative and outside counsel must educate the insured as to the investigation process while maintaining a cooperative relationship with the insured such that the insured will be inclined to provide the information requested by the underwriter in its investigation. If the underwriter can develop a good working relationship with the insured, the insured will be more likely to respond to an underwriter's request for documentation and information, its employees will be more likely to accommodate the underwriter in scheduling and providing sworn statements and, in general, in assisting the underwriter in its investigation. A more sophisticated insured, familiar with the fidelity bond claim process, will likely appreciate the new complexity of its relationship with the underwriter.

While the insured remains a customer of the underwriter, upon making a claim on the bond, the interests of the insured necessarily become at odds with the interests of the underwriter. Notwithstanding this fact, the insured has a contractual obligation to cooperate with the underwriter as set forth in Section 7 of the bond which reads in part:

Section 7.

- (d) Upon the Underwriter's request and at reasonable times and places designated by the Underwriter the Insured shall
 - (1) submit to examination by the Underwriter and subscribe to the same under oath; and
 - (2) produce for the Underwriter's examination all pertinent records; and
 - (3) cooperate with the Underwriter in all matters pertaining to the loss.

Annotated Financial Institution Bond, Second Edition.

In addition to the insured's contractual obligation to cooperate, the insured also has an interest in cooperating with the underwriter and in being forthcoming with information and documentation in order that the underwriter can quickly investigate its claim and determine coverage under the bond. However, upon notice of a claim, it is impossible to ignore the fact that, in asserting its claim on the bond, the insured is seeking payment from the underwriter. Meanwhile, the underwriter is seeking a determination based upon the facts as presented by the insured and as discovered through its investigation as to whether the insured's claim is covered under the bond and, if so, to what extent.

III. Knowing the Law of the Relevant Jurisdiction

It is critical that an attorney or claims representative faced with a claim on a financial institution bond know the applicable law of the jurisdiction in which the bond claim is made. As discussed above, the law varies from jurisdiction to jurisdiction in many critical areas including the definition of "discovery" and the effect of untimely notice on an insured's claim. For example, some jurisdictions apply a strict interpretation of the bond's six-month deadline for filing proofs of loss after an insured provides notice of potential loss to the underwriter (i.e. that timely filing is a condition precedent to bond coverage), while others follow the "no harm, no foul" rule, holding that untimely notice will not bar an insured's claim absent a showing of prejudice to the insured. Variations in the law among jurisdictions can mean the difference between paying a claim and having a valid and complete defense. Finally, keep in mind that as the facts of a particular case develop, it is important to update the legal research file to reflect these changes. Minor changes in the facts of a case can sometimes make a critical difference in the strength of a potential defense.

A good place to start an investigation into the law of a given jurisdiction is the Annotated Financial Institution Bond. Other good sources of information regarding the law governing fidelity and financial institution bonds include the Blanket Bond Manual and the Miscellaneous Bond Manual. These resources will provide a practitioner with numerous

citations to case law relative to the provision of a financial institution bond at issue.

IV. Transmitting the Proof of Loss Form

When an underwriter receives notice of a potential loss from its insured, it should immediately acknowledge such receipt in a brief letter to the insured. Such letter should include the name and contact information of the underwriter's claims representative or outside counsel. In addition, the acknowledgement letter should confirm that the underwriter is taking steps to respond to the insured's claim. The acknowledgement letter should also ask the insured for certain vital information which will assist the underwriter in its investigation of the claim and its determination of coverage. This information includes the identification of the bond under which the claim is made, the date upon which the insured claims to have discovered the loss and the persons/employees who made such discovery. The acknowledgement letter should briefly describe some of the key elements of the investigative process including the fact that the underwriter will be seeking additional information from the insured at a later date. The acknowledgement letter should also make a record of the date upon which the underwriter received notice, by what means notice was received, and what information was received with the insured's notice. For example, if the initial notice was not received in writing, the acknowledgment letter will help create a written record of the date of the insured's notice. The date of notice can become critical if the insured fails to timely file its proof of loss (i.e. typically within 6 months of the date of notice). Finally, the acknowledgement letter should contain an explicit reservation of the underwriter's rights, defenses, claims and remedies. If properly drafted, the acknowledgement letter can be a good first step toward establishing a straightforward, businesslike working relationship between the underwriter and the insured. It can also help assure the insured that its claim is being handled in good faith.

Along with the acknowledgment letter, the underwriter should enclose a copy of a proof of loss form. Most underwriters have a standard proof of loss form that they transmit to their insureds following receipt of notice of a potential loss. However, in the letter transmitting the proof of loss form, the underwriter should state that the form is being sent simply to accommodate the insured. The insured should be notified that it can submit its proof of loss in any form, provided that such proof meets the bond requirements, i.e. it is in narrative form and contains an itemization of losses and credits.

Receipt of Proof of Loss

The insured's entitlement to payment under a financial institution bond is premised on its proper filing of a proof of loss. It has been held that compliance with the proof of loss provision is a condition precedent to recovery under the Bond. See *Abilene Sav. Ass'n v. Westchester Fire Ins. Co.*, 461 F.2d 557 (5th Cir. 1972); *World Secret Service Ass'n v. Travelers Indem. Co.*, 55 Tenn. App. 122, 396 S.W. 2d 848 (1965); *Ace Van & Storage Co. v. Liberty Mut. Ins. Co.*, 336 F.2d 925. Section 5 "Notice/Proof—Legal Proceedings Against Underwriter" provides in part:

Section 5.

(b) Within 6 months after such discovery, the Insured shall furnish

to the Underwriter proof of loss, duly sworn to, with full particulars.

Annotated Financial Institution Bond, Second Edition.

The proof of loss should give the underwriter and its claims representative or attorney a clear understanding of the facts and circumstances surrounding the dishonest acts.

Upon receipt of a proof of loss, the underwriter should carefully review both the proof of loss itself as well as the financial institution bond on which the claim is being made. A list of any and all documents referenced in the proof of loss should be created for use when drafting document requests. Particular attention must be given to the coverage exclusions contained in the bond. Such exclusions often preclude recovery for losses resulting from forgery, from non-payment or default on loans, from shortages in a bank teller's cash drawer, from erroneous credits to a depositor's account, etc. It is important to analyze all possible exclusions since the underwriter may be precluded from relying on such exclusions if it does not raise them in its initial letter notifying the insured of its denial of the claim. It is rarely the case that a claim can be denied as not covered or excluded from coverage upon the mere receipt of notice or even the notice together with the proof of loss and the review and analysis thereof without additional and usually substantial investigation and evaluation. If, based on the information contained in the proof of loss, a claim does not clearly appear not to be covered or to fall within one of the coverage exclusions, then the underwriter should commence with a full investigation of the claim.

If in the unusual case it clearly appears from the contents of the proof of loss that the insured's claim does not arise out of a covered loss, the underwriter should deny the claim. Letters of denial of a claim must be carefully worded so as to protect the underwriter's interests and rights, should the insured file a lawsuit. The denial of claim must state with particularity the basis for the underwriter's decision to deny. It should contain relevant citations to the facts contained in the insured's proof of loss or to any other facts the underwriter may have obtained.

Obviously, not every claim which could conceivably fall within a bond exclusion should be denied. The underwriter must also consider the amount of the insured's claim to determine, in its business and economic judgment, the likely costs associated with a defense against the claim in court. It may be that, despite a possible exclusion, the wiser business decision may be to compromise and pay some part, probably not all, of the claim. Some of the obvious considerations are the dollar amount of the claim, the defense costs, the customer relationship involved and the likelihood of defending successfully, should litigation become necessary. In making such practical judgment settlements, the underwriter's view with regard to the claim and the reason for the settlement and payment should be carefully articulated so that the insured does not get the idea that the claim is a covered claim and cite the disposition of it as precedential authority for payment of another claim later.

File Review

Financial institution bond claims, especially those dealing with employee dishonesty are, by their nature, extremely document intensive. Often, the only evidence of an employee's dishonesty is a lengthy inter-reticulated paper trail which requires considerable analysis to unravel. Therefore, it is crucial that the underwriter's request for and review of the relevant documents be undertaken in a diligent, organized and programmatic manner.

The claim investigation generally begins with an analysis of the bond, the proof of loss, the bond applications and the underwriter's entire existing account file, usually denominated as the underwriting and financial files. As previously mentioned, these files often contain information about the insured and its prior notice of potentially dishonest acts, which can be significant in the context of an employee dishonesty claim. For example, some financial institution bond applications require the insured to disclose whether any officer or director of the insured has been "alerted to any...extensions of credit which exceed the legal lending limit [or]...problems involving extensions of credit to directors, officers, employees [of the insured]." The answers provided by the insured on its application may dictate further research into the circumstances surrounding the prior conduct. Though taken individually, such acts may not amount to employee dishonesty sufficient to justify recovery under the bond. However, taken together, such conduct can form a pattern of dishonesty, the knowledge of which the insured would be charged with, under the subjective component of the discovery provision recognized in some jurisdictions.

Investigation into, and analysis of, the insured's financial file (typically maintained by the underwriter) is equally important. It goes without saying that an insured is covered under its bond only when it has made timely bond premium payments. Failure to do so can preclude an insured from recovering under the lapsed bond. The insured's financial file will contain the necessary information to determine if such bond premium payments have been received by the underwriter.

Financial institutions are required by federal law to file Suspicious Activity Reports ("SARs") with law enforcement agencies upon discovery of suspected criminal violations. These SARs contain valuable information regarding the insured's knowledge of potentially dishonest acts of its officer, directors and employees. As part of the initial document request to the insured, the underwriter should be sure to request copies of any and all SARs filed by the insured.

The underwriter and its claim representatives and attorneys must be sure to obtain and review all documents even potentially relevant to the insured's claim prior to making its decision as to whether or not to pay the bond claim. Only after such review will the underwriter be in a position to make an informed assessment of the claim and of any possible defenses or exclusions contained in its bond.

Informal Interviews

While some practitioners endorse informal interviews or questioning of witnesses, the authors prefer the more businesslike approach of obtaining sworn statements from

witnesses and employees of the insured, as fidelity bonds typically provide for. Informal interviews have limited value because the subject of the interview is not under oath and there is no formal record made of the interview. Moreover, any value to be gained is certainly outweighed by the fact that such interviews can serve to alert the witness and/or the insured to the weaknesses of the insured's claim as well as to the concerns and the strategy of the underwriter. For example, informal interview questioning that clearly bears upon the date of discovery of the loss raises a red flag to the insured and alerts it that the underwriter is not accepting the insured's purported date of discovery at face value. Such preliminary questioning eliminates the likelihood of candor and truthfulness the underwriter might have in taking formal sworn statements. As a practical point, if informal interviews are conducted, it is highly advisable to map out the questions to be asked and make a detailed record of any such interview and the answers given by sending a follow-up letter to the interviewee reciting the subject matter, content and the statements made during the interview. Such letter should request and instruct the interviewee to make corrections immediately to the memorandum or other document memorializing the interview in order to make the contents accurate and complete and return a signed copy of the same with any changes to the underwriter within a specified number of days, otherwise the underwriter will conclude that the memorialization is true, complete and correct.

Document Requests, Review and Organization

The underwriter should send a document request to the insured as soon as possible after its receipt of the proof of loss, and the initial document request should be as thorough as possible. The underwriter should request copies of the bond and of all other bonds under which the insured has not made its claim; for example, request copies of any errors and omissions policies and of the insured's prior fidelity bond coverage whether with the same underwriter or any other surety. These policies can become relevant depending upon what the investigation reveals particularly with respect to facts bearing upon when discovery occurred. In the case of an employee dishonesty claim, it is imperative to request the alleged dishonest employee's personnel file in its entirety, as well as all files related to the claim which he/she maintained and for which he/she bore any responsibility. Where the insured claims losses resulting from loan losses, the underwriter should request all of the loan files in which the losses were allegedly incurred as well as other files managed by the allegedly dishonest employee. The underwriter should request the insured's policy manuals with regard to the divisions/departments in which the loss occurred. The underwriter should also request any and all suspicious activity reports and documents specific to the insured's industry, such as bank examination reports if the insured is a bank.

Following is an example of a list of documents typically requested when a bank claims losses under a financial institution bond purportedly resulting from employee embezzlement carried out through fictitious loans.

- 1) Alleged embezzler's (Mr. Smith's) personnel file;
- 2) All of the loan files originated and/or managed by Mr. Smith complete and including official documents, credit file, correspondence file and loan

- payment information;
- 3) Bank's loan making policy
 - 4) Any and all bulletins, e-mails, internal memoranda and correspondence defining or setting forth Bank's policy regarding loans and making of loans;
 - 5) Any and all bulletins, e-mails, internal memoranda and correspondence related in particular to Mr. Smith's loans
 - 6) Board meeting minutes making reference to any of Mr. Smith's loans discovered to be fraudulent transactions and board meeting minutes making reference to customers named on fraudulent loan documents
 - 7) Any FDIC, Office of Comptroller of Currency and State Division of Finance bank examination reports issued from January, _____ until the present date and any correspondence, internal memoranda and e-mails related to such bank examination reports;
 - 8) Any Suspicious Activity Reports filed by the Bank from January, _____ until the present date;
 - 9) Loan committee meeting minutes from January, _____ until the present date;
 - 10) Internal audit committee reports from January, _____ until the present date;
 - 11) External audit reports from January, _____ until the present date;
 - 12) Cumulative investigative materials and/or reports relevant to Mr. Smith's loans and fraudulent transactions;
 - 13) Bank's policy for requiring two authorized signatures on Cashier's checks;
 - 14) Bank's policy regarding issuance of Bank Cashier's checks in connection with loans;
 - 15) Original Cashier's checks used in connection with Mr. Smith's fraudulent transactions;
 - 16) Identification of the following Bank employees:
 - a) Direct supervisor of Mr. Smith during his employment as a loan officer;
 - b) Employee charged with monitoring and maintaining loan files including processing loan documents from January, _____ until the present date;
 - c) Employee charged with processing and/or monitoring loan payments from January, _____ until the present date;
 - d) Bank's Cashier and/or employee responsible for issuing and processing Bank Cashier's checks and validating cleared Bank Cashier's checks;
 - 17) Any and all correspondence pertaining to Mr. Smith's loans and/or fraudulent activities with persons and/or entities outside of the Bank; and
 - 18) Any and all internal memoranda, correspondence and e-mail pertaining to Mr. Smith's loans and/or fraudulent activities as a loan officer.

After reviewing the documents provided in response to the underwriter's initial document request, in almost all cases, an outside counsel or claims representative will need to make supplemental requests for documents. Obtaining the pertinent documents and investigation of the claim is an evolutionary process, and as it progresses, the existence of additional relevant documents will come to light. In particular, once the underwriter begins to take sworn statements, each successive statement can reveal the existence of additional relevant documents as well as facts bearing upon the institution's discovery of the claimed losses.

It is advisable to create and update a file with copies of each of the underwriter's document requests. This allows the underwriter to determine quickly and accurately if it has already requested a particular document several times which has not yet been provided by the insured. Also, upon receipt of documents provided by the insured and as the underwriter begins to organize documents received in response to its requests, the underwriter should create files for the documents that identify to which document request they are responsive and the date on which the documents were received by the underwriter.

Furthermore and particularly in the case of a large claim, as outside counsel or the claims representative for the underwriter begins to receive documents responsive to its requests, it must develop an organizational plan for managing the documents. For example, there should be a "coverage file" and in reviewing the documents, it is helpful to create a "chronological" file as well as an "important documents" file which would include copies of all documents that are critical to each transaction encompassed by the insured's claim. As the claim investigation progresses, the "important documents" file may be developed into topical files identified in relation to the issues presented in each transaction in the claim. As fidelity bonds are discovery bonds, it is often advisable to create a "discovery" file that would include copies of all documents evidencing what facts regarding a loss or likely loss were within the knowledge of the insured and when.

In the case of a large claim, it is advisable to inspect the insured's original files and documents pertaining to the claim. Making a visit to the office of the insured making the claim, meeting the employees with knowledge of the events, the proof of loss and the institution's internal investigation as well as combing through the insured's original files can be invaluable in gaining insights into the inner-workings of the institution and the varying degrees of knowledge of certain employees and supervisors. As mentioned above, although some practitioners recommend informal interviews of persons with knowledge of the claim, the authors advocate a very businesslike approach to handling fidelity bond claims. As such, an initial visit to the insured making the claim provides an opportunity to observe the employee relations, responsibilities and hierarchy, the opportunity to ask questions on the spot that arise during review of the original files and to obtain other documents that may not have been requested while the underwriter is on site. The initial visit also allows for the outside counsel or claims representative to make note of any conversations and voluntary statements made by the insured's employees, which provide helpful background information in preparing for the taking of sworn statements. However, this is not the time for specific questioning which could inform the insured as to the

underwriter's early impression of the claim (which may change) or its potential defenses (which may also change) such as failure to give prompt notice as required by Section 5 of the bond or the actual discovery date for purposes of Section 3 of the bond.

Other Document Request Considerations

I. Obtaining Bank Examination Reports

Because banks and other lending institutions are so heavily regulated as to their solvency and compliance with regulations and controls, various regulatory agencies are continually examining the bank's procedures and policies. (Obtaining Bank Examination and Suspicious Activity Reports, Tort Trial & Insurance Practice Law Journal, Spring 2004).

These examinations result in meticulous and comprehensive reports detailing all aspects of a bank's practices, management, business decisions, liquidity, assets, loans, and risk management. (Id.) The degree to which financial institutions' operations are scrutinized makes examination reports both highly desirable to underwriters and difficult for them to attain. (Id.)

Examination reports are valuable to an underwriter in a number of ways. First, the reports may confirm when the financial institution first learned of conduct that is the subject of a pending bond claim or the scope of an accused employee's authority. Second, the reports may show that bank management permitted the proscribed conduct for a period of time without reporting it. Finally, examination reports may show when the bank actually discovered the loss.

Underwriters often have difficulty obtaining these reports, as the examining agencies will claim that the documents are privileged. However, federal banking agencies are often willing to permit underwriters to receive a copy of the bank examination report when the underwriter follows certain procedures. For example, while such reports are exempted from disclosure under the Freedom of Information Act, an underwriter may gain access by direct request, or even better, by letting the financial institution itself initiate the request for the documents.

II. Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act, also known as the Financial Modernization Act of 1999, governs the collection and disclosure of customers' personal financial information by financial institutions and other companies who receive such information. 15 U.S.C. §§ 6801-6809. The Act in effect prohibits financial institutions from directly or indirectly disclosing to a nonaffiliated third party any nonpublic personal information, unless such financial institution provides or has provided to the consumer a disclosure notice in advance and the consumer has been given an opportunity to direct that such information not be disclosed to the third party. 15 U.S.C. §6802.

Protecting customers' privacy is the Act's primary goal, but it does not preclude underwriters altogether from obtaining nonpublic personal information. The Act expressly states that a financial institution is not prevented from providing such information to a

nonaffiliated third party in order that the third party may perform services for or functions on behalf of the bank, so long as the financial institution fully discloses the providing of such information and enters into a contractual agreement with the third party that requires the third party to maintain the confidentiality of that information. 15 U.S.C. §§ 6802(a)-(b).

Another provision of the Act which seems to apply in the context of an investigation of an employee dishonesty claim made under a financial institution bond, is 15 U.S.C. § 6802(e)(3)(B) which provides that the previous sections relating to notice to the customer and the “opt out” provision do not prohibit disclosure of nonpublic personal information “to protect against or prevent actual or potential fraud, unauthorized transactions, claims or other liability.” Though no reported cases were found directly on point, it seems that the insured financial institution may, under this section of the Act, provide its underwriters with customer information (such as a customer’s loan files, etc.) in order to prevent fraud allegedly perpetrated by a bank employee. However, the unreported opinion of Union Planters Bank, N.A. v. Gavel, 2003 WL 1193671 (E.D.La. 2003), has held that the exception contained in § 6802(e)(3)(B) applies only when the customer himself is seeking to perpetuate fraud. This differs from the language used by the District Court for the District of Columbia in Individual Reference Services Group, Inc. v. F.T.C., 145 F.Supp. 2d 6 (D.D.C. 2001). In Individual Reference Services Group, the court described the purpose of exception contained in §6802(e)(3)-(4) as “protect[ion] of the integrity of the financial institution.” *Id.* at 35. This definition would seem to support a more broad reading of the Act, thereby encompassing disclosure of information when such disclosure may prevent any fraud (not just customer fraud) from being perpetrated (and, thus, compromising the “integrity of the financial institution.”

III. Sarbanes-Oxley Act of 2002

Congress enacted the Sarbanes-Oxley Act of 2002 for the express purpose of “protect[ing] investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.” Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of Titles 15, 29, 18, 11, and 28 of the United States Code). The practical implication of the Act is that companies, financial institutions, and executives who fail to provide accurate disclosures face new liabilities, including forfeiture of bonuses and profits and criminal prosecution. 1 DePaul Bus. & Com. L.J. 153, 156-157.

Sarbanes-Oxley also benefits underwriters because financial institutions already required to submit annual reports under the Securities Exchange Act of 1934 now must also include internal control reports for which management is liable, as well as a report card assessing the effectiveness of the most recent fiscal year’s methods of internal control structure and reporting procedures. Pub. L. No. 107-204, 116 Stat. 745, Section 404. In addition, the principal executive and financial officers must personally certify that they have reviewed the financial report and consider it complete, accurate, fairly representative, and truthful, and must personally vouch for the effectiveness of the institution’s internal controls. (Pub. L. No. 107-204, 116 Stat. 745, Section 302). Therefore, because Sarbanes-Oxley places corporate accountability on the shoulders of the chief executive and financial officers

of the company, executives have an incentive to be vigilant, and an investigating underwriter has added protection that the information provided in an insured's internal control reports is credible and complete. Such reports, as required, should provide information regarding internal controls and failures thereof, which can be significant with regard to the insured's discovery of the loss.

Sworn Statements

As referenced above, sworn statements are an effective tool in obtaining binding admissions from the insured as well as previously undiscovered information. Moreover, sworn statements are an essential aspect of the underwriter's investigation of the claim with specific provisions therefor contained in the bond itself. An outside counsel or claims representative of the insured needs to consider and reevaluate continually what sworn statements need to be taken and in what order. As the investigation progresses and new information is learned with regard to the claim, the underwriter's strategy for taking sworn statements may also change. With the first sworn statement and increasingly with each subsequent sworn statement, the insured learns more and more about the underwriter's views of the claim and its strategy in regard to the claim and is able to anticipate certain lines of questioning and prepare its witnesses' responses accordingly to support its claim under the bond. Moreover, with each successive sworn statement, the insured may become more cognizant of the underwriter's possible defenses and may begin to tailor its responses accordingly. Therefore, the underwriter must carefully evaluate the order in which it takes sworn statements, what questions to ask and to what degree it wants to maintain an element of surprise in its questioning.

It may be necessary to take some sworn statements early on in the investigation. For instance, if the insured is providing little documentation or evasive answers to requests for information, taking sworn statements may be the only way to obtain information about the claim. Additionally, in some instances, particularly in the case of a dishonest employee, it may be necessary to take the dishonest employee's sworn statement at an early point in the investigation. This is the case when it appears likely that the employee will be prosecuted criminally. Once that process gets underway or once the employee engages criminal defense counsel, obtaining any information from the employee is likely to be seriously hindered, if not made impossible. The underwriter should carefully monitor any criminal proceedings brought against the allegedly dishonest employee, as resolution of the criminal proceedings may have implications for the insured's bond claim. Also, valuable information may be contained in the pleadings or hearing transcripts. However, it is unlikely that the bond principal's counsel will be willing to share any such information with the underwriter or its counsel. Finally, the underwriter may wish to inject its own arguments with regard to any restitution which may be imposed by the criminal court during sentencing. Underwriters and their counsel should be alert to the transferability of federal orders of restitution to state courts for execution thereon under 18 U.S.C. § 3664.

Determination of Payment or Denial of Claims

When faced with a claim which arguably could be valid, but which may also equally arguably not be covered, it may be possible to negotiate a favorable settlement with the

insured rather than simply paying the entire claim in full. Should the matter proceed to litigation, both the insured and the underwriter will be forced to expend a great deal of time and incur considerable expense. A reasonable insured will often agree to accept a reduced amount in settlement of its claim rather than expending significant attorney's fees filing and prosecuting a suit against the surety. A quick settlement of its claim may, for various reasons, be more beneficial to an insured than the prospect of protracted litigation. The underwriter and its attorneys will be in a better bargaining position if they have carefully documented the file, researched the relevant jurisdiction's case law, thoughtfully investigated the claim and analyzed the facts in light of the bond provisions and/or exclusions.

Of course, this is not to say that absolutely valid claims should be denied. That simply should not happen. It is important for the underwriter to maintain its reputation among potential customers. Settlement for less than the amount of the loss should be proposed only when the underwriter has a plausible defense to the insured's claim. Otherwise, the underwriter runs the risk of developing a reputation of being unwilling to live up to its obligations under the bonds it issues or facing a claim for bad faith denial of the insured's claim. If an insured is sufficiently agitated by the actions of the underwriter in denying or disputing the claim, it may seek to bring a claim for vexatious delay or vexatious refusal to pay against the underwriter. It is critical therefore that the underwriter be certain that it has a legitimate basis for denying the claim or proposing settlement.

The recurring theme throughout this paper is that thorough preparation, investigation and analysis of a claim is the key to its successful handling. An informed decision as to whether or not to pay a claim can only be made upon completion of the underwriter's investigation. Outside counsel for an underwriter should be sure to provide his/her client with a complete and thorough report and analysis of the claim in support of its recommendation relative to payment thereon or denial thereof. This report should clearly lay out the relevant facts and circumstances surrounding the claim, lay out the key parties involved and provide the underwriter with a detailed analysis of any applicable defenses or coverage exclusions and the legal bases therefor. When called upon to investigate a claim for an underwriter, outside counsel must ensure that the client has sufficient information, evaluation and analysis to assure it that it is making the appropriate decision regarding payment or denial of the claim.

The underwriter, its claim representative or its counsel should prepare a position letter to the insured setting forth the rationale and factual basis for the underwriter's decision regarding payment or denial of the insured's claim. While the position letter need not contain the same level of analysis and legal support as the investigation report created by the underwriter, its claim representative or its counsel, it should sufficiently convey to the insured the underwriter's position and the factual and legal basis for its decision. When denying a claim, it is important to quote any applicable coverage exclusions, setting out the relevant language thereof and applying it to the facts of the insured's claim.

Conclusion

Fidelity and financial institution bond claims can present the claims representative or outside counsel with many unique challenges. The key to effective claim handling is a regimented and thorough investigation of the facts and circumstances surrounding each claim. In addition, it is critical that the underwriter be aware of the variations among jurisdictions regarding the insured's submission of such claims and the underwriter's possible defenses thereto. Thoroughness in claim investigation will result in better outcomes for the underwriter, whether payment of any particular claim is ultimately made or denied.

BERNARD A. REINERT

Bernard A. Reinert is a principal shareholder, the Chairman and the President of the St. Louis law firm, Reinert & Rourke, Professional Corporation. The firm is engaged in the general practice of law. Its practice consists largely of construction contract litigation, but includes insurance litigation and all kinds of commercial and business litigation.

Mr. Reinert was admitted to the Bar in Missouri in 1962 and in Illinois in 1963. He went to undergraduate school at St. Mary's Mission Seminary College at Techny, Illinois and at St. Louis University in St. Louis, Missouri and graduated with a Bachelor of Arts degree in 1958. He graduated from St. Louis University School of Law in 1962 with a Bachelor of Laws degree. He was a law clerk to United States District Judge Omer Poos in Springfield, IL in 1962-1963.

Mr. Reinert is a member of the American Bar Association, the Missouri Bar, the Illinois State Bar Association, and the Bar Association of Metropolitan St. Louis. He has been a member of the Torts and Insurance Practice Section and of the Fidelity and Surety Law Committee for approximately thirty years. He has served several terms as a Fidelity and Surety Law Committee Vice-Chairman. He has participated in many of the Committee's programs, chaired a program in San Francisco, and presented papers at more than a dozen industry programs. A notable paper which Mr. Reinert has authored is entitled "Duty of the Performing Surety to Bond Principal and Indemnitors: Good Faith". Another paper which he presented to the Committee dealt with the surety's rights in subrogation to bonded contract funds before and after the Federal Tax Lien Act of 1966. Mr. Reinert has participated in other activities of the Fidelity and Surety Law Committee including the Commercial Blanket Bond National Institute, and the Financial Institution Bond National Institute (London, 1992) and the Commercial Blanket Bond Annotation Project. He has participated in updating the Banker's Blanket Bond Annotation. He has participated in the publication of the Fidelity And Surety News (FSN) under the editorial sponsorship of St. Louis University School of Law. He has served as the FSN Subcommittee's liaison to the FSN Editor, St. Louis University Professors of Law, Donald King and Kathleen Kelley. Mr. Reinert continues to serve on the FSN Subcommittee. Mr. Reinert participated in the "Subrogation Project" culminating in the August, 1990 ABA Annual Meeting Program of the Fidelity and Surety Law Committee entitled "The Subrogation Rights of the Contract Bond Surety" presenting a paper entitled "Elements of Proof in the Contract Bond Surety's Subrogation Action to Recover the Bonded Contract Funds". In October 1996, Mr. Reinert prepared and presented a paper and participated as a discussion panel member in the "Construction Law Summit" program of the ABA Construction Industry Forum along with the ABA Public Contracts Law Section and the ABA/TIPS Fidelity and Surety Law Committee. In January, 1998 Mr. Reinert presented a paper as part of the ABA Joint Program of the Construction Industry Forum and the TIPS Fidelity & Surety Law Committee which was later published as the lead article in *The Construction Lawyer*, "Limitations on Recoverable Damages", Volume 18, No. 2, April 1998.

Mr. Reinert and his firm have participated in the Northeast Surety and Fidelity Claims Conference for the past thirteen years, contributing two papers annually including

this past year, 2003. Among the notable papers prepared for and presented to that Conference by Mr. Reinert was: "A Survey: State Prompt Payment Acts and the Surety."

Mr. Reinert lives in the St. Louis suburban community of Kirkwood and has been active in community affairs there, particularly as a member of the Kirkwood R7 School District Board for 15 years, 1976 to 1991. He presently serves as Chairman of the City of Kirkwood Civil Service Commission.

JENNIE I. BARTLETT

Jennie I. Bartlett is an associate at the St. Louis law firm of Reinert & Rourke, P.C. Ms. Bartlett is a graduate of Washington University School of Law in St. Louis, Missouri. She received her undergraduate education at The University of the South in Sewanee, Tennessee where she earned her Bachelor of Arts in 1994.

Ms. Bartlett is licensed to practice law in Missouri and Illinois as well as the United States District Court of the Eastern District of Missouri. She is a member of the Missouri Bar, the Illinois State Bar Association and the Bar Association of Metropolitan St. Louis. Ms. Bartlett practices primarily in the areas of surety and fidelity law as well as commercial and construction litigation.

ISSA K. EMEISH

Issa K. Emeish is an associate at the St. Louis law firm of Reinert & Rourke, P.C. Mr. Emeish is a graduate of Washington University School of Law in St. Louis, Missouri. He received his undergraduate education at Ball State University in Muncie, Indiana where he received his Bachelor of Science in 1993.

Mr. Emeish is licensed to practice law in Missouri and Illinois as well as in the United States District Courts for the Eastern District of Missouri and the Southern District of Illinois. He is a member of the American Bar Association, the Missouri Bar, the Illinois State Bar Association and the Bar Association of Metropolitan St. Louis. His practice emphasizes surety and fidelity law, commercial law and construction litigation. He was the co-author of the papers "Letters of Credit: What Are They and What Do I Do With One" and "Read the Darn Bond – Default, Declaration of Default, Cure Opportunity, Failure of Cure and Contract Termination as Preconditions to Performance Bond Liability" presented at the 2002 and 2003 Northeast Surety and Fidelity Claims Conferences, respectively.