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***THE INSURED'S NEGLIGENCE -
IS IT A VIABLE DEFENSE AGAINST FINANCIAL
INSTITUTION BOND CLAIMS***

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This paper analyzes the provisions of the Standard Form 24 Financial Institution Bond (the "Bond") and some of the insurer's potential defenses based on the negligence of the bank or its employees. The Bond is written with the intent that the insurer not be held responsible for losses resulting from negligent conduct. Although banks often make claims against the Bond for losses resulting from the conduct of their employees, fidelity insurers do not intend to cover the financial risks of an insured's transactions, such as bad loans by banks.

INTRODUCTION

When a bank incurs a loss and makes a claim under the Bond, the insurer often attempts to prove that the loss resulted from the negligent conduct of bank employees. For example, under Insuring Agreement (A), a bank may be covered for losses resulting from the dishonest or fraudulent acts of its employees. The intent has been to restrict the scope of a fidelity bond's coverage to true acts of employee dishonesty, such as embezzlement. However, such acts must be committed by the employee with the manifest intent to cause the bank to sustain a loss and with the manifest intent to obtain a financial benefit for himself or someone else. The intent of the bank employee is critical in determining whether coverage exists under Insuring Agreement (A).

Coverage should not exist if the employee merely intends to commit certain acts which in one way or another result in a loss to the insured. The employee must have knowingly intended to cause the loss. For example, in a check kiting case, the bank employee may provide funds to the customer when the account is overdrawn, or there are uncollected items of deposit. However, the employee could be acting with the intent and hope that the customer will eventually produce sufficient funds to cover the checks that are being written. Often the employee reasonably expects the check to be paid, even if there are no funds currently in the drawee bank to cover the check. This may occur if the customer is valued and has good credit status. If this is the employee's intent, then no coverage should exist under Insuring Agreement (A) because an employee's negligence or poor business judgment does not equate to a manifest intent to cause the bank a loss.¹

Many times a bank will incur a loss which might be covered under Insuring Agreements (A), (B) or (D), except that the loss is caused by the bank employee's negligent failure to follow industry standards, or violations of the bank's own policies and procedures. For example, an employee may fail to properly evaluate "kite suspect" reports on a particular account, thereby permitting the customer's kite to continue. Alternatively, the employee may issue unauthorized loans to a customer,

¹For example, in First Federal Savings and Loan v. TransAmerica Insurance Company, 935 F.2d 1164 (10th Cir. 1991), a loan officer approved several loans without the approval of the loan committee. This was against the bank's practice and amounted to poor business judgment. When losses resulted from the customer's failure to repay the loans, the bank sued its fidelity insurer. However, coverage was denied because there was no evidence of a manifest intent to obtain financial benefit or to cause the bank a loss. Id. at 1167.

or issue funds based on uncollected items of deposit. When an employee negligently causes or contributes to a loss, various provisions in the Bond may give the fidelity insurer a good defense to a claim on the Bond. A bank cannot simply ignore the conduct of its employees and customers, and then expect to recover the resulting losses, especially when the bank is aware of certain misconduct prior to the effective date of the Bond.

I. THE "DISCOVERY" CLAUSE

The Bond contains a Discovery clause which provides coverage only for losses discovered during the Bond period. Insurers often defend by claiming that the bank discovered the loss prior to the effective date of the Bond. For example, the bank may have ignored certain conduct of its employees or customers which are likely to result in a loss.

The Bond also requires the insured to provide notice to the insurer within thirty days of discovery of the loss, and to provide a proof of loss within six months after such discovery. A common defense for the insurer is to assert that discovery occurred at a time earlier than claimed by the insured and that the insured failed to give timely notice of the discovery.

Prior to 1980, the Bond did not include a definition of when discovery of a loss occurred. Historically, a major issue in the discovery cases has been whether the court will apply an objective or subjective standard for discovery. That is, will discovery be deemed to occur when a bank should know of a loss, or will discovery only occur when a bank has actual knowledge of the loss? The courts typically held that discovery of a loss, and the need to give notice to the insurer, did not occur until the bank acquired actual knowledge of some specific fraudulent or dishonest act. Merchants and Farmers State Bank of Weatherford, Texas v. Fidelity and Casualty Company of New York, 791 F.2d 1141, 1151 (5th Cir. 1981). Notice would not be required when the bank merely suspected or had reason to suspect the wrongdoing. *Id.*

In 1980, the Bond finally included a definition of discovery. This definition was amended in 1986, and the provision now reads as follows:

DISCOVERY

Section 3. This bond applies to loss discovered by the insured during the bond period. Discovery occurs when the insured first becomes aware of facts which would cause a reasonable person to assume that a loss of a type covered by this bond has been or will be incurred, regardless of when the act or acts causing or contributing to such loss occurred, even though the exact amount or details of loss may not then be known.

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

By its clear terms, the Bond does not cover losses which are "discovered" prior to its effective date.

In contrast to the earlier case law, this Discovery clause clearly provides for an objective rather than a subjective test of discovery. FSLIC v. Aetna Casualty, 785 F. Supp. 867 (D. Mt. 1990). The test to be applied in determining when a discovery occurs is that of the objectively reasonable person. FDIC v. Oldenburg, 34 F.3d 1529, 1542 (10th Cir. 1994). Discovery occurs when the insured first becomes "aware of the facts," and does not require that the insured have actual knowledge of dishonest acts or that a loss has been incurred. It is similar to a "knew or should have known" standard. But see, Fontainebleau Community Bank of Slidell, La. v. Fidelity and Deposit Company of Maryland, 1994 WL 118334 (E.D. La. March 31, 1994), where the court focused on whether the insured actually had knowledge of the loss or dishonest acts during the policy period.²

A key issue in many of the discovery cases is whether the bank has a duty, upon becoming aware of certain facts, to investigate further and obtain as much knowledge as possible regarding the relevant events. Pursuant to the Discovery clause, insurers can defend a claim by arguing that the insured was aware of facts which would lead a reasonable person to believe that a loss occurred, or that the facts of which the insured was aware were sufficient to require the insured to look further into the wrongdoing. If the bank is aware of certain facts, but yet unreasonably believes that a loss has not or will not occur, the bank will be precluded from recovering under the Bond if these facts were known prior to the effective date of the bond. Below are some of the cases which discuss when discovery occurs.

In Guarantee Company of North America v. Mechanics' Savings Bank and Trust Company, 183 U.S. 402 (1902), the United States Supreme Court considered a provision similar to the language in Section 3 of the Bond. Specifically, the subject provision provided that "the employer shall at once notify the company on his becoming aware of his employee being engaged in speculation or gambling, or indulging in any disreputable or unlawful habits or pursuits." Id. When the bank made its claim, the insurer claimed that the bank was aware of

² Any argument that the discovery clause is ambiguous and should be construed against the insurer should fail. Most financial institution bonds are standard forms used by sureties which were formed by a collaborative effect through the American Bankers Association and the Surety Association of America. Since organizations of equal stature worked together to create the bonds/terms and conditions, it has been persuasively argued that these policies are not contracts of adhesion and that they should therefore not be construed against the insurers. Calcasieu-Marine National Bank v. American Employers Insurance Company, 533 F.2d 290 (5th Cir. 1976); Sharpe v. FSLIC, 858 F.2d 1042 (5th Cir. 1988); Shearson/American Express v. First Continental Bank, 579 F.Supp. 1305 (W.D.Mo. 1984); but see Transamerica Insurance Company v. Federal Deposit Insurance Corporation, 465 N.W.2d 713, 715 (Minn. Ct. of App. 1991). In any event, even under general insurance principles, bonds will not be construed against the insurer unless the policy is ambiguous. It has been held that the terms of the Bond are unambiguous and must be given effect as written. Mortell v. Insurance Company of North America, 458 N.E.2d 922, 929 (Ill. App. 1983); Benchmark Crafters, Inc. v. Northwestern National Insurance Company of Milwaukee, 363 N.W. 2d 89, 91 (Minn. Ct. of Appeals 1985). When a fidelity bond is unambiguous, its plain language is the only evidence of the parties' intent. United Bank and Trust Company of Norman, Oklahoma v. Kansas Bankers Surety Company, 901 F.2d 1520 (10th Cir. 1990).

the employee's prior misconduct. Id. at 416. The court stated that the language "becoming aware" was different from having "knowledge". Id. at 419. The obvious meaning of "becoming aware" was "to be informed of," or, "to be apprised of," or, "to be put on one's guard in respect to." Id. at 420. The court also imposed a duty of inquiry or investigation on the insured, and found as follows:

To be aware is not the same as to have knowledge... We cannot regard the words becoming aware equivalent to "becoming satisfied," though perhaps they may be to "having reason to believe."

The facts known by the bank would have demanded investigation or notification, so the bank could not contend that it did not have reason to believe that the employee was speculating when it turned its back on any independent inquiry or investigation. Id. at 420.

A more recent court discussing the Bond has held that an insured has a duty to inquire when a reasonable person would do so once it had information which aroused suspicions. Royal Trust Bank, N.A. v. National Union Fire Insurance Company, 788 F.2d 719 (11th Cir. 1986). In Royal Trust, the bank incurred a loss of over \$300,000.00 as a result of a check kiting scheme perpetrated by one of its customers through an account that was managed by one of its employees. Id. at 720. The insurer contended that the loss was not covered by the bond because before the bond became effective, the bank had knowledge of facts that would lead a reasonable person to assume that a check kiting scheme was being perpetrated.

At trial, there was evidence that the bank could have discovered the check kiting scheme prior to the effective date of the bond if the bank had paid closer attention to its computer records and reports that were regularly reviewed. The issue was whether the bank's failure to investigate the irregularities revealed in the computer records and reports would preclude recovery under the bond. Id. at 720-721. The trial testimony revealed that the employee had frequently exceeded her authority in approving payments of checks on uncollected funds. Additionally, the subject account appeared almost daily on the bank's "kite suspect" report. The bank contended that negligence or inattention on the part of the bank could not preclude recovery, and cited Dixie National Bank of Dade County v. Employer's Commercial Union Insurance Company of America, 463 So. 2d 1147, 1152 (Fla. 1985), which provides that:

"In the area of fidelity insurance, the law is well settled that negligence or inattention, or anything short of actual discovery on the part of the insured employer will not defeat recovery under a fidelity bond covering the default of a dishonest employee, unless it is otherwise provided in the contract." Id. at 721.

The Royal Trust court declined to follow this precedent because the bond provided for a greater limitation on liability than provided for by Florida law. Under the terms of the bond in question (specifically, the Discovery clause), negligence or inattention on the part of the bank precluded recovery.

The Bond does not require that the bank have enough information to charge its employee with fraud or dishonesty. All that is required is that the bank have enough information to assume that the employee has so acted. Under these circumstances, a reasonable person would have assumed that the employee acted fraudulently, and the bank should have known of her behavior prior to the bond's effective date. Id. Therefore, the court properly admitted testimony regarding the bank's negligent acts. Id. at 722. The bond imposed a duty on the bank to make inquiries that a reasonable person would make under the circumstances, and the bank's negligence or inattention precluded recovery. Id. at 721.

In one of the few cases granting summary judgment as to the Discovery clause, the Eighth Circuit Court of Appeals affirmed a summary judgment in favor of the surety based on the court's finding that the bank had discovered its employee's dishonesty before the effective date of the bond. First Security Savings v. Kansas Bankers Surety Company, 849 F.2d 345 (8th Cir. 1988). In First Security, one of the bank's directors had an indication at a board meeting that the employee had committed dishonest acts. The director concluded that the violations discussed at the meeting related to certain loans, even though the FDIC had not specifically said so. Id. at 348. The court agreed with the bank that mere suspicions do not constitute "discovery," but held that an insured cannot disregard known facts. Id. at 350. In affirming the summary judgment, the court ruled that the bank had discovered the employee's dishonesty before the effective date of the bonds. Id. at 352.

Despite the Bond's language, many courts are reluctant to hold that a loss has been discovered unless the bank has actual knowledge of its employee's dishonest acts. These courts seem to follow a subjective standard in determining whether discovery of a loss has occurred, and focus on whether the bank has actual knowledge of the loss. In U.S. Fidelity and Guaranty Company v. Macon-Bibb County Economic Opportunity Council, Inc., 381 S.E. 2d 539 (Ga. App. 1989), USF&G defended on the basis of untimely notice of a loss resulting from misappropriation of funds by an officer of the bank. USF&G argued that the loss was discovered when a trial was held against the officer. However, the officer was acquitted in the trial, and the court held that the bank did not have knowledge of a loss until it performed its own audit after the trial, and that before that time the bank only had a mere suspicion of a loss and that this was insufficient to amount to discovery. Therefore, USF&G's motion for summary judgment on the notice issue was denied.

In Federal Deposit Insurance Corporation v. Reliance Insurance Corporation, 716 F. Supp. 1001 (E.D. Ky. 1989), the insurer claimed that the bank failed to comply with the notice provisions of the Bond. The court cited the discovery clause, which provides that discovery occurs when the insured becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred. . . . Id. at 1002. The court noted that case law generally defined discovery in terms of actual knowledge, rather than merely a suspicion. Id. The bond's own definition of discovery incorporates a reasonable person standard, anticipating a determination by a trier of fact. Id. The surety argued that the board should have known that the subject loans had reached an alarming level, and that the loans were well in excess of the employee's personal lending limits. Id. at 1003. The court noted that although a board may not hide from liability behind poor

management practices, case law requires actual knowledge of some specific fraudulent or dishonest act which might involve the insurer. Id. at 1004.

In Mid-America Bank of Chaska v. American Casualty Company of Reading, Pennsylvania, 745 F. Supp. 1480 (Dist. Minn. 1990), the court reversed a summary judgment entered in favor of the surety, and discussed the "discovery" clause. The court noted that the insured is not bound to give notice until he has acquired knowledge of some specific fraudulent or dishonest act. Id. at 1483. Mere suspicions on the part of the insured that a loss may have occurred is insufficient to trigger the notice requirement. Id. Although the bank admits that it knew of its employee's irregular practices, it denies that it knew these acts were fraudulent or dishonest. It simply attributed these practices to negligence or bad business judgment. The court cited the reasonableness standard set forth in the discovery clause, and held that the application of such a standard is a quintessential jury function. Id. at 1484.

II. THE "TERMINATION" CLAUSE

The cases involving the Discovery clause should be contrasted with those involving the Termination clause (Section 12 of the Bond). This clause provides that the Bond terminates as to any employee as soon as the insured "learns of" any dishonest or fraudulent act committed by such person at any time. The Bond does not terminate until the insured "learns of," or actually knows about prior dishonest acts. For example, in Federal Deposit Insurance Corporation v. CNA Casualty of Puerto Rico, 786 F. Supp. 1082 (Dist. P.R. 1991), the court noted that even the strongest suspicion does not amount to knowledge nor discovery of dishonesty, and that nothing short of actual discovery of dishonesty by the subject employee will terminate the bond. Id. at 1089.

In Federal Deposit Insurance Corporation v. St. Paul Fire & Marine Insurance Company, 738 F. Supp. 1146 (M.D. Tenn. 1990), modified at 942 F.2d 1032, the court discussed the Termination clause in Section 12 of the Bond, and held that discovery of dishonesty exists only when there is "knowledge which would justify a careful and prudent man in charging another with fraud or dishonesty." Id. at 1162. In Federal Deposit, the employee received "executive committee fees." These payments were known to two of the bank's officers at the time that they were made. Id. at 1150. In fact, one of these officers authorized and signed the payments without investigating their legitimacy. However, even though the officer thought these actions were unusual, she did not believe they were dishonest. Id. at 1150.

The Federal Deposit court noted that the two officers knew of the payments because they participated in their processing, but they did not investigate the validity of the fees. Id. at 1162. Their knowledge of the payments did not constitute knowledge of the employee's dishonest acts. If an officer senses that payments are unusual, or even has a suspicion that the payments are dishonest, this does not amount to discovery of dishonesty under a fidelity bond. Id. Without an investigation into the validity of the payments, the officers' did not have the requisite knowledge. Even proof of the officers' negligence would not bar recovery because "neither negligence nor inattention, nor any failure to discover what by diligence might have been discovered, nothing, in fact, short of actual discovery by the bank of dishonesty or a positive breach of an imperative condition, will defeat claims for loss caused by that dishonesty, unless it is otherwise provided in the contract". In this case, the surety did not claim that the contract provided otherwise. Therefore, the bank was not barred from recovery by Section 12 of the Bond. Id.

III. LOSS CAUSED BY AN EMPLOYEE

In many cases involving fidelity insurers, losses are caused, in whole or in part, by the negligence of the bank's employees. For example, the employees will often fail to follow industry standards and the bank's own internal policies and procedures, such as by making loans in excess of authority, providing funds to a customer based on uncollected items of deposit, and by failing to adequately review documents which reveal a potential loss, such as "kite suspect" reports. Exclusion (h) of the Bond provides an insurer with the means to avoid having to pay for such losses. The exclusion provides as follows:

EXCLUSIONS

Section 2. This Bond does not cover:

(h) loss caused by an Employee, except when covered under Insuring Agreement (A) or when covered under Insuring Agreement (B) or (C) and resulting directing from misplacement, mysterious unexplainable disappearance or destruction of or damage to property. For example, consider the scenario where a bank fails to revoke settlement on checks by the "midnight deadline," thereby becoming liable to the collecting bank for the amount of the checks. Any such loss would have been caused by the bank's own negligence, and would fall under exclusion (h).

By its terms, exclusion (h) will not apply if the employee who caused the loss acted with the requisite manifest intent under Insuring Agreement (A), or if the loss is covered under Insuring Agreement (B) or (C) and results from the misplacement or disappearance of property. However, under the right set of facts, this exclusion is powerful.

In Empire Bank v. Fidelity and Deposit Company of Maryland, 828 F. Supp. 675 (W.D. Miss. 1993), the district court held that a bank could not recover its losses which resulted when it allowed customers to cash checks without proper authorization and without proper endorsement. Id. at 679. The court held that a bonding company issuing a banker's blanket bond must assume that the bonded bank will follow the procedures set forth in its own operations manual and will conform its conduct to reasonable commercial banking practices. Id. at 678-679. This decision was affirmed by the Eighth Circuit Court of Appeals at 27 F.3d 333 (8th Cir. 1994).

In Empire, one of the bank's customers was Campbell's 66 Express, a trucking company. Randall Walker was president of the company and Trula Walker was his wife. Id. At Mrs. Walker's request, the company issued checks which were drawn on a Campbell's 66 account at another bank and made payable to Mrs. Walker's household employees. On one occasion, Mrs. Walker signed the name of her employee in the presence of the bank teller, and on other occasions she presented the checks already complete with forged endorsements. She refused to endorse the checks herself, despite the fact that the bank's official policy required endorsement by the presenter of third party checks. The bank's vice president waived this requirement for Mrs. Walker. Id. at 334.

Also, Mr. Walker took over \$300,000 worth of checks payable to Campbell's 66 and cashed them at the Bank. In exchange, he received either cash or cashier's checks payable to him or to his company. The Bank's internal policies required that before an individual can cash a corporate check, the bank must have a corporate resolution on file authorizing such transactions. However, Campbell's 66 had no such resolutions on file at the bank which would permit this. Furthermore, the bank had a policy which prohibited the cashing of checks payable to a corporation, but this policy was violated. Id.

When the bank suffered losses in connection with these transactions, it brought a claim under the bond pursuant to the Forgery and On-Premises coverages. The district court found that Mrs. Walker's forgeries did not cause the bank's loss. Rather, "it was Empire's failure to follow their required procedures and good banking practice and insist upon Trula Walker's endorsements upon the checks. Id. The district court held that the losses were caused by the bank's own employees, based on the fact that the bank violated its own internal policies which required endorsement of the presenter in cashing a third party check and which required a corporate resolution authorizing an individual to cash a corporate check. Id. at 334-335.

In affirming the district court's decision, the Eighth Circuit concluded that the exclusion for "loss caused by an employee" applied. The bank argued that the district court had improperly read a negligence defense into the bond and that the exclusion for losses caused by an employee should be construed to mean losses caused solely by a bank employee. Id. at 335. The Eighth Circuit held that the bond excludes losses caused by a bank employee, whether negligent or not. Furthermore, there was no support in the bond language for the theory that the bank's act must be the only cause of the loss. Id. at 336. Therefore, the bond's exclusion applied and prevented the bank from recovering its losses. Id.

IV. FAILURE TO MITIGATE

When a bank makes a claim against its fidelity insurer to recover its losses, the insurer may be able to avoid liability, in whole or in part, by proving that the bank failed to mitigate its losses. This defense is related to exclusion (h), in that it allows the insurer to avoid paying for losses caused by a bank's employees. The mitigation defense arises out of contract law and has been applied to insurance cases. For example, Couch on Insurance states as follows:

It is the duty of the insured to do all that he reasonably can to minimize the loss, and failure to take reasonable care to avoid an increase of the loss may defeat a recovery, for the mere existence of an insurance policy does not justify carelessness and failing to protect the insured property after loss. § 74.

Section 7(e) of the Bond provides as follows:

The Insured shall execute all papers and render assistance to secure to the Underwriter the rights and causes of action provided for herein. The Insured shall do nothing after discovery of loss to prejudice such rights or causes of action.

This clause implies that the Insured bank has a duty to mitigate its losses, because it "shall do nothing after discovery of loss to prejudice" the insurer. The mitigation doctrine has been applied to cases involving bank liability. Although not involving a fidelity bond, these cases establish that the doctrine should be applied to this line of cases. In Pulaski Bank & Trust Company v. Texas American Bank/Ft. Worth, 759 S.W.2d 723 (Ct. App. 1988), there was a dispute between two banks. The bank learned that a check was returned to them because

it had not been paid. Id. at 736. The depository bank sued the collecting bank for damages resulting from the late return of the check. The court held that the plaintiff bank could have mitigated its damages with only minimal effort by freezing the subject bank account. Therefore, the bank could not recover the money which it lost as a result of its failure to mitigate. Id. The court stated that an injured person cannot recover damages that do not result from the tortfeasor's breach of duty and that damages that might be avoided or mitigated are not recoverable. Id. at 735. The doctrine requires the injured party to use reasonable efforts to avoid or prevent losses. Id.

In Premier Electric Construction Company v. United States Fidelity & Guaranty Company, 1987 U.S. District Lexis 5588 (N.D. Ill. June 22, 1987), the bank sought recovery under a fidelity bond for losses caused by the dishonest acts of one of its employees. After the loss, the employee received and spent a sum of money pursuant to a settlement in an unrelated lawsuit commenced by the employee. USF&G argued that the bank failed to mitigate its loss by failing to take control of the settlement funds. The bank argued that it had no duty to mitigate and moved for summary judgment on this issue. The court denied this motion for summary judgment, thereby preserving the mitigation defense. Id. at 24.

CONCLUSION

When a bank makes a claim under the Bond, the insurer must undertake to closely evaluate the conduct of the bank's employees. As the above cases illustrate, a bank may not be able to recover its losses where its employees have failed to follow standard industry practices or the bank's own policies and procedures. Likewise, the bank's management cannot ignore facts and circumstances which would put a reasonable person on notice that a loss has been or will be incurred. The insurer should always examine the facts known to the bank at the time it allegedly discovered the loss. Furthermore, the insurer must evaluate whether the bank's employees have caused or contributed to the loss, even though the employee's conduct is merely careless or negligent.

