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TRIGGERS PULLED BY DISCOVERY: DUTIES OF THE INSURED AND DEFENSES OF THE SURETY

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> Discovery consists of seeing what everybody has seen and thinking what nobody has thought.
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> *The Scientist Speculates* [1962]
> -Albert Szent-Gy`rgyi von Nagyrapolt

INTRODUCTION

The date of discovery is a central question, which must be answered in every fidelity claim investigation. When a loss is "discovered" is a triggering event which determines the applicable period of coverage, the insured's obligation to provide timely notice to the insurer and the potential defenses available to the insurer. The insured's "discovery" also terminates coverage for the deceitful employee, which means that any additional loss caused by his subsequent dishonest acts will not be covered. The issue of when a loss was actually discovered is often hotly contested.

Discovery of a loss is a critical threshold issue in a wide variety of fidelity claims. Determining when the discovery of a loss actually occurred is a fact intensive process which often requires a claims representative to wade through reams of documents and interview numerous witnesses, whose testimony is sometimes conflicting, before it is possible for the insurer to arrive at an informed conclusion as to when discovery occurred. Employee thefts are typically concealed from those bearing the responsibility of notice. In other instances, the employer may prefer to withhold notice of a loss until the final results of an extensive and lengthy investigation into the theft has been concluded and the total amount of the theft has been calculated.

In addition, in this day and age of frequent bankruptcy filings, discovery triggers the date on which a claim arises under a policy or bond for purposes of determining whether a claim arose pre-petition or post-petition. Under the Bankruptcy Code, in order for a creditor to assert a right of set-off against a debtor, both the debt owed by the debtor to the creditor and the claim of the creditor against the debtor must have arisen pre-petition. 11 USC § 553. This would become important in the event that a surety had indemnity claims over against a principal, whom had claims against a fidelity policy issued by the surety for losses allegedly resulting from employee dishonesty.

INITIAL INQUIRY: LANGUAGE OF THE POLICY OR BOND

Any investigation of a fidelity loss must necessarily begin with the language of the policy or bond. It is that language which controls the duties of the insured as well as the liabilities of the insurer.

Under most standard commercial fidelity forms, discovery of a loss by the insured activates the insured's obligation to give notice to the insurer of the loss, to file a proof of loss

providing the details of the loss within a specified time after discovery and starts the clock ticking on the limitation period [usually 1 or 2 years] within which the insured must commence a lawsuit against the insurer.

The question that must be asked is "when is the loss considered 'discovered'"? The standard under the current Commercial Crime Policy form requires the insured to give notice to the insurer "[A]fter you discover a loss or situation that may result in a loss of, or loss from damage to, Covered Property." This wording makes it clear that the insured need not know each and every detail of the loss or dishonest scheme and need not, and cannot, wait until the loss has been fully quantified in order for "discovery" to have occurred.

NOTICE CONDITION PRECEDENTS UPHELD AND ENFORCED

"Discovery of loss" provisions in fidelity bonds and policies have long been recognized and enforced by courts around the United States. *Karen Kane, Inc. v. Reliance Ins. Co.,* 202 F.3d 1180 (9th Cir. 2000); *Hidden Splendor Mining Company v. General Insurance Company of America,* 370 F.2d 515 (10th Cir. 1966); *Federal Deposit Insurance Corporation (FDIC) v. Insurance Company of North America, et al.,* 105 F.3d 778 (5th Cir. 1997).

It is well settled that provisions in fidelity bonds and insurance policies which stipulate that coverage terminates or is canceled as to any employee upon discovery of dishonesty are valid and will be upheld. *Community Savings Bank v. Federal Ins. Co.*, 960 F. Supp. 16 (D. Conn. 1997); *J. S. Fraering v. Employer's Mutual Liability Co. of Wisconsin*, 242 F.2d 609 (5th Cir. 1957); *St. Joe Paper Co. v. Hartford Accident and Indemnity Co.*, 376 F.2d 33 (5th Cir. 1967); *Ritchie Grocer Co. v. Aetna Casualty & Surety Co.*, 426 F.2d 499 (8th Cir. 1970); *Central Progressive Bank v. Fireman's Fund Insurance Co.*, 658 F.2d 377 (5th Cir. 1981); *Newhard Cook Co. v. Insurance Co. of North America*, 929 F.2d 1355 (8th Cir. 1990).

The courts have also recognized that fidelity policies and bonds may validly limit the liability of the insurer on such bonds or policies to losses discovered within a specified term. Such discovery of loss clauses are a safeguard to the insurer, imposing upon the insured a reasonable effort to monitor its employees' work and ensuring that the surety will not have to investigate stale claims. *Southeast Bakery Feeds, Inc. v. Ranger Ins. Co.*, 974 S.W.2d 635 (E.D. Mo. 1998)

The key issues to be addressed when determining when discovery of loss has occurred are:

1. What is the "loss" that must be discovered in order to trigger the notice requirements?;
2. What degree of knowledge is required to constitute discovery?; and
3. Is the discovery standard to be applied subjective or objective?

WHAT IS THE "LOSS" THAT MUST BE DISCOVERED IN ORDER TO TRIGGER THE NOTICE REQUIREMENTS?

Section 4 of the Commercial Crime Policy form provides that discovery occurs when the insured discovers "a loss or a situation that may result in loss of, or from damage to, Covered Property,…." This phrase clearly ties coverage to discovery of *possible loss*, and does not require actual loss, or knowledge of all of the particulars of a loss, in order for discovery to occur.

One of the earliest, and probably still most quoted, decision on this issue is *American Surety Company v. Pauly,* 170 U.S. 133, 18 S.Ct. 552, 42 L.Ed. 977 (1898). The policy at issue required the insured to notify the insurance company of a claim upon "discovery of a loss." The United States Supreme Court approved the following jury instruction in that situation:

"It is not sufficient to defeat the plaintiff's right of action upon the policy that it be shown that the plaintiff may have had suspicions of dishonest conduct[.] … He may have has suspicions of irregularities; he may have had suspicions of fraud, but he was not bound to act until he had acquired knowledge of some specific fraudulent or dishonest act[.]" Id., at p. 145, 18 S.Ct. 552

As noted in the case of *Nike, Inc. v. Northwestern Pacific Indemnity Company,* 166 Or. App. 312, 999 P.2d 1197 (2000), the following principles apply in determining whether there has been "discovery of the loss":

> "First, and logically, the loss must be a loss of a type that falls within the policy's coverage. [citation omitted] Second, 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. [citation omitted] Third, the standard is an objective one and turns on 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.' [citation omitted]" Id. at p. 321, 999 P.2d at 1203

One of the most frequently cited cases on this issue is the *Boomershine Pontiac-GMC Truck, Inc. v. Globe Ind. Co.*, 219 Ga. App. 842, 466 S.E.2d 915, 917 (1996) case. The Georgia Court of Appeals held that an insured "discovers" a loss under a fidelity policy when there are facts known that would lead a reasonable person to assume that a loss exists." The Court went on to state that the insured need not be in possession of knowledge as to the exact amount of the loss or the specific manner in which the scheme of loss occurred, but obviously the knowledge relied upon to constitute "discovery" must rise above a mere suspicion. *Boomershine*, 466 S.E.2d at 917.

In defining when "discovery" occurred, the Court in *Boomershine* turned to what are referred to as the guiding principals in the case of *Wachovia Bank and Trust Co. v. Manufacturers Cas. Ins. Co.*, 171 F. Supp. 369 (M.D. N.C. 1959). In *Wachovia*, the insured

was trying to prove that it had discovered a loss before a policy expired. If discovery had occurred, there was coverage, but if discovery had not occurred, there was no coverage. The *Wachovia Bank* stated that discovery occurs when there are facts known which would lead a reasonable person to assume that a shortage existed. 171 F. Supp. 369 at 375.

The Eleventh Circuit has dealt with the issue of when facts are present which lead to discovery of a loss. In *Royal Trust Bank N.A. v. Nat'l Fire Ins. Co.*, 788 F.2d 719 (11th Cir. 1986), the language of what constitutes "discovery" was provided by the policy. While the policy definition tracked the language of the Georgia Court of Appeals in *Boomershine,* it went even further to elucidate the extent of the knowledge required: "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, even though the exact amount or details of loss may not then be known...." 788 F.2d at 720.

The Fifth Circuit Court of Appeals has adopted a somewhat more stringent standard for discovery, although that standard is based upon the precedent cited above and relied upon by others. In the case of *Federal Deposit Ins. Co. v. Fidelity & Deposit Co. of Maryland,* 1997 WL 560616 (N.D. Tex. 1997), the court stated that the rule of the Fifth Circuit is that "'discovery of loss does not occur until the insured discovers facts showing that dishonest acts occurred and appreciates the significance of those facts; suspicion of loss is not enough.' [citation omitted]" Id. at p. 3. This case is one of interest, however, in that the court did not believe that the employer's filing of a criminal referral alleging that former management had arranged an illegal stock purchase constituted sufficient "facts which would cause a reasonable person to assume that a loss will be incurred."

WHAT DEGREE OF KNOWLEDGE IS REQUIRED TO CONSTITUTE "DISCOVERY"?

It is well recognized in the Courts and in the fidelity industry that "mere suspicion" of a loss is insufficient to constitute discovery. The distinction between "mere suspicion" and "knowledge," however, is often difficult to ascertain. The courts seem to agree that once an employer learns of one or more dishonest acts committed by one or more of its employees, particularly when those acts are relied upon to establish a claimed loss, a loss has been "discovered."

According to Webster's Dictionary, to discover is "[to] obtain knowledge of through observation, search or study." There is a definite demarcation between the instant when one did not know something and the instant when that same person now knows something. As it has so eloquently been put:

> "The fact of discovery, which had to be known to plaintiff, had to occur in a given year. Discovery is not a gradual awakening of consciousness. It did or did not occur. It does not take years for the dawn to break. Before discovery there is, presumably, blissful ignorance, but once that ignorance, that lack of knowledge, is dispelled, then, like virginity, it is gone forever." *Drexel Burnham Lambert Group v. Vigilant Ins. Co.,* 595 N.Y.S.2d 999, 1006 (N.Y. Sup. Ct. 1993)

The language of the Commercial Crime Policy, which requires notice after discovery of a loss “or a situation that may result in a loss," makes it clear that the insured is not required to conclude or even believe that a covered loss has occurred so long as a reasonable person would have assumed that the potential for a loss exists. Once an employer/insured has uncovered irregularities that indicate that an employee has been dishonest and that a loss could possibly result, a loss has been discovered. The courts have held, however, that knowledge that an employee has violated company policy does not necessarily imply “discovery” of the fact that the employee has committed theft. The point at which the insured discovered the loss in that instance would turn on identifying when the insured had sufficient facts to conclude that the employee(s) acted with the necessary intent to cause the employer to suffer a loss. *Nike, Inc.*, supra. at pp. 322-323, 999 P.2d at pp.1203-1204 Should the insured delay in notifying the insurer of its discovery until the entire loss has been quantified or the full extent of the employee’s actions has been uncovered, it does so at its own peril.

An oft cited case dealing with the definition of discovery is *Alfalfa Electric Cooperative Inc. v. Travelers Ind. Co.*, 376 F. Supp. 901 (W.D. O.K. 1973). That case held, among other things, that "[knowledge] is what a reasonable person should have concluded from known facts." 376 F. Supp. 901 at 905.

The *Alfalfa* court went on to state, as have many others, that discovery is synonymous with acquiring the facts, not when the insured finally decides that the facts claimed to support the loss may be truthful. In support of its conclusions, the Court cited an old Fifth Circuit case, *J.S. Fraering, Inc. v. Employers Mutual Liability Ins. Co. of Wis.*, 242 F.2d 609 (5th Cir. 1957) which held that discovery occurs when an insured learns of the facts constituting dishonesty, even if the dishonesty results in very small losses for which no policy claim is made. 376 F. Supp. 901 at 906. Under the terms of the policy in the *Alfalfa* case, discovery started the time running on (a) notice, (b) proof of loss, (c) policy coverage termination and (d) time within which to file suit. 376 F. Supp 901 at 908. The court concluded that "discovery" means knowledge of the first dishonest act, not just the acts for which claim is made and not just each subsequent act as it occurs. 376 F. Supp. 901 at 908.

In the case of *Hidden Splendor Mining Company v. General Insurance Company of America,* 370 F.2d 515 (10th Cir. 1966), the fidelity bond delineated a specific condition precedent to recovery, that is, notice to the surety within four months of discovery of the fraudulent or dishonest acts of the insured’s employees. Hidden Splendor argued that the triggering event for notice to the surety was the day on which it learned that the employee was not going to reimburse Hidden Splendor for the loss suffered as a result of his dishonest acts, not the day it learned of the dishonest acts. The Court rejected that argument outright. It noted that Hidden Splendor had made a choice to seek restitution through negotiations and an agreement with its employee rather than to timely notify the surety and satisfy the condition precedent to recovery under the bond. As a result of that choice, Hidden Splendor had lost its right to recover under the bond. The District Court entered judgment for and discharged the surety and its ruling was affirmed by the Tenth Circuit Court of Appeals.

The Fifth Circuit Court of Appeals upheld a similar condition precedent and ruled that the surety was discharged by the principal’s untimely notice in the case of *Federal Deposit Insurance Corporation (FDIC) v. Insurance Company of North America, et al.,* 105 F.3d 778

(5th Cir. 1997). An officer of a bank and an attorney retained to represent the bank in mortgage closings conspired with a condominium development group to make hundreds of loans in violation of Bank regulations and the law. The bank had obtained a financial institution bond from Insurance Company of America. The bond issued by Insurance Company of North America ("INA") required that notice be given to the Underwriter within 30 days after discovery of the loss. INA denied the bank's claim for failure to satisfy the notice condition precedent. The bank was declared insolvent in 1992 and the FDIC was appointed receiver. The FDIC filed suit to recover under the bond. The trial court granted INA's motion for summary judgment and the FDIC appealed.

The *INA* court found that the bank had "discovered" the loss when it received lawsuits and counterclaims filed by at least two of the borrowers in which the borrowers alleged knowing acts of dishonesty or fraud by bank employees. The bank countered by arguing that the complaints were nothing more than litigation tactics of defaulting borrowers as opposed to allegations of deceit and misrepresentation on the part of bank employees. The Court ruled that in making that argument, the bank was missing the point. The bond required notice to the surety upon a claim of employee dishonesty and did not allow the bank to wait until the claim was proven. Id., at p. 783.

One final, and very important, point needs to be noted and that is that the discovery threshold is low. The court in the case of *Resolution Trust Corp. v. Fidelity and Deposit Co. of Maryland*, 205 F.3d 615 (3rd Cir. 2000) noted that while:

> "Inevitably a court must assess each case on its own facts, keeping in mind the general principle that the 'discovery threshold is low'.... All that [is] require[d] is that the insured possess sufficient information to lead to a reasonable assumption of a covered loss;...." 205 F.3d 615 at 631.

IS THE DISCOVERY STANDARD OBJECTIVE OR SUBJECTIVE?

The trend in most recent court decisions involving the Commercial Crime Policy is to apply an objective, reasonable man, standard for discovery of loss. Insureds, however, will continue to use the fact that the Commercial Crime Policy does not define "discovery of loss" as a basis for arguing that a subjective discovery standard should be applied.

The vast majority of jurisdictions hold that the standard for discovery is an objective standard taking into account what the facts were at a particular point in time, rather than viewing a loss subjectively, which would allow the insured to unilaterally define when the light came on and it discovered a loss. *Boomershine Pontiac-GMC Truck, Inc. v. Globe Ind. Co.*, 219 Ga. App. 842, 466 S.E.2d 915, 917 (1996); *Wachovia Bank and Trust Co. v. Manufacturers Cas. Ins. Co.*, 171 F. Supp. 369 (M.D. N.C. 1959). In *Boomershine*, the court stated that the facts must be viewed at the time discovery is asserted, and not in light of later knowledge.

A recent case arising in the Bankruptcy Court of the Northern District of Georgia also applied the objective standard in analyzing coverage under a fidelity policy. In *In Re Prime Commercial Corporation: Ellenberg v. Those Certain Underwriters at Lloyd's*, 187 B.R. 785

(Bkrptcy. N.D. Ga. 1995), the Chapter 7 trustee filed suit on a fidelity policy. Among the rules stated by the Bankruptcy Court as applicable to a fidelity policy in Georgia is that discovery of a loss triggers the duty to notify, even if the insured believes it may ultimately avoid a loss by recovering the stolen property. The insured is damaged and suffers a "loss" for notice purposes the moment the dishonest employee (in that case a thief) unlawfully takes the property -- **not the moment the insured concludes it cannot recover the property.** 187 B.R. 785, 800.

The Georgia Court of Appeals, in the case of *Boomershine Pontiac-GMC Truck, Inc. v. Globe Indem. Co.*, 219 Ga. App. 842, 466 S.E.2d 915 (1996), summarized the objective standard as follows:

> "[To] constitute 'discovery,' facts must be known that would lead a reasonable person to assume that a loss exists. [citation omitted] Those facts must be viewed as they would have been at the time discovery is asserted and not in the light of knowledge that was subsequently acquired. The insured need not have been in possession of details such as the exact amount of the loss or the specific manner in which the scheme caused a loss, as required by the trial court here, but the knowledge relied on to constitute 'discovery' must rise above mere suspicion of loss. Simply being aware of facts that lead to other facts that ultimately reveal the existence of a shortage does not satisfy this test. The disclosure in an investigation after the expiration of the discovery period of an actual defalcation does not raise a previous suspicion to a level of discovery. Discovery of unusual or suspicious circumstances does not always constitute a 'discovery' of employee dishonesty even though the suspicion is confirmed when dishonest acts are later found to have occurred; if inefficient business procedures or discrepancies in accounts are as consistent with employees' integrity as with their dishonesty, such circumstances do not constitute a 'discovery' under the policy terms. (citation omitted.) Id. at p. 917.

An insured cannot ignore its initial suspicions as to an employee's wrongdoing and then hope to argue that its discovery of the loss did not occur until dishonest acts were actually discovered or a loss was fully quantified. The courts have recognized a duty to inquire once an employer uncovers facts, which would lead a reasonable person to believe that the employee was being dishonest. Judge Massey, in the *Ellenberg* decision, concluded that:

> "If an insured under a fidelity policy discovers an employee's dishonesty about business transactions that give rise to a suspicion of fraud, a duty of inquiry arises that cannot be satisfied by the undocumented assertion of the employee that no problem exists or if there is one, he will solve it. The failure of the insured to inquire promptly or the failure of the employee to respond promptly in a manner that would cause a reasonable and prudent person to put aside his suspicion or fraud triggers the duty to notify the surety under a policy requiring notice of discovery." 187 B.R. 785 at 803.

As previously stated, the vast majority of courts considering when discovery occurs have applied the objective standard. For example, in *Utica Mut. Ins. Co. v. Fireman's Fund*

Ins. Co., 748 F.2d 118 (2nd Cir. 1984), it was noted that: "[courts] have consistently held that a loss is discovered once an insured has obtained facts that would cause a reasonable person to recognize there has been a dishonesty or fraud resulting in loss. [Cits.]" 748 F.2d 118 at 121-122. The *Utica* court went on to note that while it is correct that mere suspicions do not trigger the notice requirement, an insured cannot disregard known facts. Thus, when the insured learns the facts constituting the alleged dishonesty, its prior suspicions are converted to knowledge which cannot be ignored and which constitutes "discovery." 748 F.2d 118 at 123. The court then affirmed the judgment in favor of the insurer.

TOLLING OF THE LIMITATIONS PERIOD

The courts around the country are divided as to whether the limitations period within which an insured must file suit against an insurer or surety under a fidelity policy or bond is tolled during the initial non-suit period or the insurer's investigation. The majority of courts have refused to toll a limitation provision during the initial non-suit period or during the insurer's investigation. *Federal Deposit Ins. Co. v. Hartford Acc. & Indem. Co.,* 97 F.3d 1148 (8th Cir. 1996); *Ashland Fin. Co. v. Hartford Acc. & Indem. Co*., 474 S.W.2d 364, 366 (Ky. 1971); *Closser v. Penn. Mut. Fire Ins. Co.,* 457 A.2d 1081, 108-86 (Del. 1983) [refusing to toll a limitations provision where the insured were not prevented from complying with the provision]; *Suntrust Mtg., Inc. v. Georgia Farm Bureau Mut. Ins. Co.,* 203 Ga. App. 40, 416 S.E.2d 322, 323-24 (1992) [refusing to toll the limitations period during the 60-day non-suit period]; *Glass Elec. Co. v. Commercial Union Ins. Co.,* 711 F. Supp. 615, 616 (N.D. Ga. 1988); *Broadfoot v. Reliance Ins. Co.,* 601 F. Supp. 87, 89 (N.D. Ga. 1984); *Kelley v. Travelers Ins. Co*., 9 Ohio App.3d 58, 458 N.E.2d 151, 152 (Iowa 1983; rejecting the *Peloso* decision in the minority).

The courts adopting the minority view argue that such a tolling period is required by the incongruity stemming from the fact that the insurance policy requires suit to be commenced within one or two years, but does not account for the delays either required by the policy or inherent in the claims process. The minority courts reconcile the incongruity by allowing the period of limitation to run from the date of the discovery of loss but toll the period from the time the insured gives notice until the time the insurer denies the claim. *Peloso v. Hartford Fire Ins. Co.*, 56 N.J. 514, 267 A.2d 498, 501 (1970); *In re Certified Question: Ford Motor Co. v. Lumbermens Mut. Cas. Co.*, 413 Mich. 22, 319 N.W.2d 320, 323-25 (1982); *Prudential-LMI Comm. Ins. Co. v. Superior Court,* 51 Cal.3d 674, 274 Cal. Rptr. 387, 389, 798 P.2d 1230, 1232 (1990).

CONCLUSION

As has been made clear in the cases handed down on the discovery issue over the years, there is no hard and fast rule as to when a loss is deemed to have been "discovered." Any determination as to when discovery of a dishonesty loss occurred must be made on a case by case basis. The Proof of Loss will serve as the beginning point of any such investigation. The narrative provided in the Proof will provide the claims representative with a description of the loss and how the transactions leading to the loss occurred over time. The investigation cannot stop here. The claims representative must review all documentary evidence that the insured has reflecting or detailing the transactions. Then, the claims representative must interview as many people identified by the insured as possible to learn the

facts about the operation of the insured's business and about the transactions which make up the loss that are not and cannot be recorded in the documents.

In the event that criminal charges have been lodged against the employee(s) involved, the claims representative may not be able to interview the employee(s). The prosecuting attorney or his/her investigator may serve as a valuable source of information about the discovery of the theft or scheme. Be aware, however, that a prosecuting attorney is only interested in facts that can be proven beyond a reasonable doubt. The facts which constitute discovery of a loss for policy purposes may not rise to that level of certainty, however, and may "fly below" the prosecution's radar, so to speak. When speaking with the prosecution, make sure to review all documents in their file, not just those they believe to be relevant to the criminal prosecution, because something that may not be relevant to proof of a crime beyond a reasonable doubt may, in fact, constitute "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" and thus, constitute discovery of a loss for policy purposes.

Determining when a loss was discovered is a fact intensive endeavor. The claims representative will be inundated with documents detailing the transactions that make up or lead to the loss. In addition, the claims representative will be required to interview as many people as possible who might know or have known something about the employee's activities or the operation of the business and who might have seen something that would constitute discovery of the loss. It is the unique circumstances of each claim, however, that will govern just when discovery of the loss occurred and the clock started ticking under the policy.

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