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**NEW FIB, OLD CRIME: CONTRASTING FINANCIAL
INSTITUTION BOND REVISIONS WITH FORMERLY
PARALLEL CRIME POLICY PROVISIONS**

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INTRODUCTION

The Surety Association of America has been working for almost two years to revise Standard Form 24, the Financial Institution Bond. The last revision was in 1986, but the SAA board approved the current changes last September, and 30 states so far have approved the new form with an April 1, 2004 effective date. One of the two major purposes for the revisions is to limit the FIB's scope to paper banking transactions. The other major purpose is to clarify its terms and effectively overrule court decisions and insured's positions that "got it wrong" on various provisions.

Many of those provisions are similar or identical to those in the Commercial Crime Policy, developed by the SAA and the Insurance Services Office, Inc. in 1986. Because of its more recent development of the Crime Protection Policy as an alternative to the CCP, the SAA is unlikely to be involved in revising the CCP to keep it parallel to the new FIB. Consequently, we now live in a world where the FIB has been changed to clean up problem areas that still exist in the CCP. What are these areas, what are the differences, and will the FIB "cleanup" make results under the CCP messier?

INSURING AGREEMENT A—EMPLOYEE DISHONESTY

Since 1976, both the FIB and the crime-coverage predecessors leading up to the CCP have defined employee dishonesty essentially as "dishonest or fraudulent acts committed by the employee with the manifest intent to cause the insured to sustain a loss and to obtain financial benefit." Variations have been tried, including changing the requirement of loss and benefit to loss *or* benefit and inserting a definition of what the benefit may not be (i.e. salaries, bonuses, commissions, etc. earned in the normal course of employment).

This 28-year old definition brought results closer to the insurers' expectations concerning the scope of coverage, but not all courts ever have accepted the insurers' goal for "manifest intent." See Matt J. Farley, *What is Employee Dishonesty? "A Louisiana Perspective: 'Tell Them I Lied!'"* in COMMERCIAL CRIME Policy (Gilbert J. Schroeder ed., ABA 1996). Insurers simply required intent that is manifest, i.e. plain to see, and manifestly intended that requirement to restrict coverage.

Some courts instead have incorporated the tort concept of objectively deduced intent to reach the desired result of broader coverage. This is a result not of the definition itself but rather of some courts' rejection of that definition. See, e.g., *FDIC v. Oldenburg*, 34 F.3d 1529 (10th Cir. 1994) (reckless conduct supporting an inference of intent to cause a loss); *FDIC v. UPIC*, 29 F.3d 1070 (10th Cir. 1994) (natural and probable consequences

standard); *Affiliated Bank/Morton Grove v. Hartford Accident & Indemnity Co.*, 1992 WL 91761 (N.D. Ill 1992) (foreseeable consequences standard).

In its revision of the FIB, the SAA has stopped describing the evidence of intent required and has turned those courts' methodology around. Incorporating language from the model penal code instead of tort principles, the SAA has re-defined employee dishonesty to require "active and conscious purpose." "Intent" can skirt what the principal actually was thinking while committing the act, so that the reasonably foreseeable consequences lead to imputation of intent, but "conscious purpose" goes directly to the principal's thoughts. The term also carries with it the weight of criminal precedents addressing that high standard of intent.

The revised FIB also eliminates the two-pronged aspect of the definition by removing the requirement that the principal have intended to obtain a financial benefit, except in loan-loss and trading cases. If the employee has an active and conscious purpose to cause the insured a loss, but the insured simply cannot prove how the employee obtained or intentionally imparted to someone else a financial benefit, the loss now will fall within the definition of "employee dishonesty" under the FIB. Because this change opens the door to claims where the employee's purpose is sabotage, the revised FIB expressly excludes such losses under Exclusion (bb).

As for loan losses, the FIB still requires the intent to obtain or confer an improper financial benefit, just as the CCP requires for any employee dishonesty. In fact, the new form changes the reference by adding "improper" to "financial benefit." The revised FIB goes on to counteract court decisions that have found such a benefit in the bonuses, commissions, or other forms of compensation incidentally generated as a by-product of dishonest schemes. The new language carves out from the concept of "improper financial benefit" any form of compensation paid intentionally to the dishonest employee, as contrasted with embezzled funds in the form of compensation. Instead of benefits "earned" in the normal course of employment, the benefits now simply must be "received" by the employee. The CCP, of course, has no language making any such distinctions and still will be subject to claims that the financial-benefit prong is satisfied by intentional and incidental compensation resulting from dishonest but real transactions.

On the other hand, the revised FIB has incorporated language from the CCP that now defines "employee" in the same terms. The new language expressly links employee status to the insured's right of direction and control, which has been the predominant standard under case law. Directors who perform an employee's role come within the revised definition, although the exception in Exclusion (d) of the FIB had this effect previously. The increased similarity in the definitions of "employee" stand in contrast to the very different definitions of "employee dishonesty" noted above.

INSURING AGREEMENT B—ON PREMISES

The crime policy, in Coverage Forms C and D, covers theft, disappearance, destruction, safe-burglary, and robbery if the property is on the insured's premises or any banking premises. The FIB's Insuring Agreement B has covered loss of property, while on

the insured's premises or anywhere, when caused by those perils as well as larceny and false pretenses. Courts have addressed the question of whether the wrongdoer must be on the premises when the insured actually loses control of the property. See *South National Bank of N.C. v. United Pacific Insurance Co.*, 864 F.2d 329 (4th Cir. 1989); *Bay Area Bank v. Fidelity & Deposit Company of Maryland*, 629 F. Supp. 693 (N.D. Calif. 1986). What if the wrongdoer visits the insured's premises to set up the fraud, e.g. by opening an account, filing documents, or otherwise laying the foundation for later execution of the scheme? Was the wrongdoer's presence, or constructive presence, enough to trigger on-premises coverage, and when did the loss occur—while the wrongdoer was present, or when the insured's money or property later left its control?

The revised FIB now requires that the wrongdoer be on the insured's premises when control of the insured's property is lost: "at the time the property is surrendered." Under the new language, the direct cause of loss will be the conduct at the point when the insured hands over its property, so that conduct merely setting up the scheme will not be covered as on-premises. False pretenses in setting up an account or making an order, even if implemented while the wrongdoer is on the insured's premises, will not be covered if the insured ships goods or issues funds later when the wrongdoer is gone. The distinction between "surrender" of the property and incurring the loss is designed to cover issuance of a cashier's check, where the insured loses control of its property upon issuance but does not incur the loss until the check is negotiated. The argument and dispute over this time-delay issue will continue under the CCP, which does not state specifically that the covered loss is surrender of property while the wrongdoer is on the insured's premises.

By changing Exclusion (n), the new FIB also departs from the CCP when a wrongdoer on the premises tricks the insured into parting with money or other covered property. If a wrongdoer fraudulently presents stolen gift certificates or otherwise commits "theft" on the premises, the CCP probably covers that loss (subject to the court's view of what constitutes "stealing"). Under the prior FIB, the insured's payment on a check or other instrument not finally collected or otherwise erroneously credited was covered only if the funds were paid over to the wrongdoer on the insured's premises. Apart from this exception, the general exclusion was based on the premise that bad banking practices are not covered, and the bank should collect the instrument before releasing the funds that it represented.

The SAA found no logic for the exception to the exclusion when the funds were paid on the premises and therefore has deleted that exception. Now, while the CCP will cover the insured's loss due to theft by deception on premises, the FIB will not cover funds paid on premises where the insured's loss results from "erroneous credits," unless covered under Insuring Agreement A. (See *Alpine State Bank v. Ohio Casualty Insurance Co.*, 941 F.2d 554 (7th Cir. 1991) (wrongdoer's theft of and forging of endorsements on checks occurred off premises, so no coverage for deposited checks under Insuring Agreement B of FIB; highlighting difference from new Exclusion (n), cash back from stolen checks, received on premises, was covered).

As noted above, both the CCP and the prior FIB covered destruction of property on the insured's premises. The CCP continues to do so, but the revised FIB no longer covers vandalism, malicious mischief, or damage to the interior or exterior of the insured's

premises. The reasoning is that the ISO property coverages already address such losses, so the FIB need not overlap. This straightforward reduction in coverage, though, does not raise the issues presented by changing definitions or the effect of previously parallel coverages still present in some form in both policies.

INSURING AGREEMENT D—FORGERY OR ALTERATION

Forgery or alteration of negotiable instruments certainly is a greater concern to the banks and other financial institutions buying FIB coverage than to the mercantile insureds under the CCP. In fact, only three decisions have addressed Coverage Form B under the CCP, which requires that the forgery or alteration involve a written instrument actually or purportedly made by or drawn on or by the insured. Those three deal with the meaning of “drawn” and include the incorrectly decided *Omnisource* and two contrary Fifth Circuit cases: *Omnisource Corp. v. CNA/Transcontinental Insurance Co.*, 949 F. Supp. 681 (N.D. Ind. 1996) (finding “drawn” ambiguous and choosing a dictionary meaning in favor of the insured over commercial or legal definitions); *Travelers Casualty & Surety Company of America v. Baptist Health System*, 313 F.3d 295 (5th Cir. 2002) (disagreeing with *Omnisource* and applying the common legal meaning of “drawn”); *Parkans International LLC v. Zurich Insurance Co.*, 299 F.3d 514 (5th Cir. 2002) (basis for *Baptist Health System*).

Neither the existing FIB nor the CCP required that the insured ever have possessed the original instrument. The revised FIB now requires that the insured have relied on an original, written instrument in its possession. Its new definition of “counterfeit” reinforces this condition that the insured rely on an original by requiring that a valid original document exist in order for a “counterfeit” to be possible. The CCP has no requirement for possession of any documents at any time, much less an original, and expressly permits proof of loss to be supported by an affidavit if the forged or altered instrument cannot be provided.

The *Omnisource* case also encouraged the argument that a forged document which is not covered under the FIB but is “bundled” with legitimate documents that are covered could result in coverage. The CCP likewise limits the documents that forgery can bring within the policy, so that the bundling argument can arise. The revised FIB adds new Section 9, “Anti-Bundling,” to eliminate this argument, but the CCP must continue to rely on the plain language of Coverage Form B listing only those documents the forgery of which may give rise to a covered loss.

The crime policy coverage form does not define “forgery” at all, while the FIB has revised its definition to limit forgery to signatures that are handwritten or reproductions and specifically includes unauthorized endorsement of checks in the name of an organization. The FIB already was narrower in its concept of “forgery” than is the CCP, which includes the concept of forged documents, not just forged signatures. To the extent that Coverage Form B was similar to Insuring Agreement D before, the FIB now has an even more restricted scope that will be harder to analogize.

INDIRECT LOSS—COMPENSATORY DAMAGES

Both the existing FIB and the CCP contain very similar exclusions for the insured's liability to third parties. The CCP includes its language in the "indirect loss" exclusion:

We will not pay for loss as specified below:

3. Indirect Loss: Loss that is an indirect result of any act or "occurrence" covered by this insurance, including, but not limited to, loss resulting from:

...

b. Payment of damages of any type for which you are legally liable. But, we will pay for compensatory damages arising directly from a loss covered under this insurance.

The FIB placed its provision in Exclusion (t):

This bond does not cover:

(t) damages of any type for which the Insured is legally liable, except compensatory damages, but not multiples thereof, arising directly from a loss covered under this bond.

The intent of these exclusions always has been to link the loss directly to the covered risk and avoid interposing a claim by a third party. As often stated, neither the CCP nor the FIB is a liability policy.

The choice of the phrase "compensatory damages," however, has created confusion. If the insured is required by law to compensate a third party because of acts within the coverage of the bond, such as employee dishonesty, then the insured will argue that the compensatory damages it must pay were caused by the dishonesty and should be covered. The courts generally have rejected this argument based on the requirement that the damages arise "directly" from a covered act. See *Patrick v. St. Paul Fire & Marine Insurance Co.*, 2001 WL 828251 ((D. Vt. 2001); *Lynch Properties, Inc. v. Potomac Insurance Co.*, 952 F. Supp. 956 (N.D. Tex. 1996); *Aetna Casualty & Surety Co. v. Kidder, Peabody & Co.*, 246 A.D. 2d 202 (N.Y. App. Div. 1998). The intervention of a third-party claim and the negotiation or adjudication of compensatory damages from the insured to that third party render any loss indirect and excluded.

The revised FIB exclusion now eliminates the exception for "compensatory damages," thereby removing the basis for arguing that it is the compensatory damages owed by the insured that are covered. The revised language goes on to state that, notwithstanding the indirect-loss exclusion, a loss otherwise covered will not be excluded simply because the insured also was required to pay compensatory damages to a third party. Regardless of such liability, the insured's own loss must be established and will be the only amount potentially covered by the bond.

The CCP continues to state that the insurer will pay for compensatory damages arising directly from a covered loss. Since loss of or damage to covered property is the starting point under the crime policy, the concept of compensatory damages should have no relevance except in distinction to other types of damages (e.g. multiple or punitive damages, which FIB Exclusion (v) now lists as examples of indirect or consequential loss). The FIB revision recognizes this by focusing on the insured's own loss instead of damages. Until the CCP follows suit and clears up its language, insured's will continue to argue for liability coverage.

CONDITIONS

Four other Conditions of the FIB have been changed in ways that may affect, or at least distinguish, how courts read the CCP.

(1) Neither policy ever has replenished the aggregate limit of coverage upon receipt of recoveries by the insurer. Section 4 of the FIB now does so, if that limit has not reduced to zero and if the recoveries precede termination of the bond. This change may favor insurers under the CCP by supporting the argument that recoveries do not restore the limits, absent language such as that in the new FIB.

(2) New Section 6 of the FIB now expressly provides that any value the insured receives, such as interest on fraudulent loans, credits, repayments, or other recoveries "however denominated," reduce the amount of the loss. The CCP has no comparable provision in General Condition 17 or otherwise. The FIB does not differentiate between recoveries before or after payment by the insurer, while the CCP speaks only to recoveries "made after settlement of loss covered by this insurance." The CCP is silent on what happens to funds received by the insured before the insurer pays.

Insureds have argued, and still argue, that funds obtained as part of the consequences of the covered loss may be applied or allocated without regard to the calculation of the net loss. For example, where an insured traces embezzled funds to property that can be captured and liquidated, the insured may argue that it can apply the recaptured value to expenses of proving the fact and amount of the loss, which are excluded expressly by the CCP. (Exclusion 3.c.) The insurer will respond that recapture of embezzled property, regardless of the timing or the form, reduces the insured's net loss.

The CCP does not speak to this argument, although cases have recognized that sums closely connected to the transactions giving rise to the covered loss should be netted against the gross loss. (See *First American State Bank v. Continental Insurance Co.*, 897 F.2d 319, 323 (8th Cir. 1990) (court's chart reduces loss by net gain from sale of property bought with fraudulent funds); *Kentuckiana Sales, Inc. v. Security Insurance Co.*, 394 S.W.2d 744 (Ky. Ct. App. 1965) (stamp books stolen by employee, loss reduced by books recovered); *City Trust & Savings Bank v. Underwriting Members of Lloyds*, 109 F.2d 110 (7th Cir. 1940) (loss reduced by amount dishonest employee returned); *James B. Lansing Sound, Inc. v. National Union Fire Insurance Co.*, 801 F.2d 1560 (9th Cir. 1986) (loss reduced by amount dishonest employee paid as part of scheme).) Regardless, the new FIB states in express terms the insurer's intent that it deal only with the net loss after crediting what the insured has recaptured.

(3) Both the FIB and the CCP contain a duty to cooperate. The CCP puts the duty under “Duties in the Event of Loss” and ties it to “the investigation and settlement of any claim.” The duty does not apply expressly to recoveries or subrogation, as to which the insured merely must do nothing to cause the insurer to lose its rights. Under the FIB, the duty to cooperate appeared under prior Section 7: “Assignment—Subrogation—Recovery—Cooperation.” Subsection (d) stated:

Upon the Underwriter’s request and at reasonable times and places designated by the Underwriter the Insured shall . . .

. . .

(3) cooperate with the Underwriter in all matters pertaining to the loss.

The FIB therefore arguably did not tie the duty to cooperate to recoveries or subrogation, other than by lumping the provision into the same section. The alternative would be to say that putting the provision in that section meant the insured had no duty to cooperate in any respect other than regarding recoveries. The revised FIB corrects this by dividing the duty to cooperate, leaving a requirement in Section 7 to “render assistance” concerning subrogation and recoveries but also creating new Section 8, “Cooperation,” concerning claim or loss. The CCP’s express duty to cooperate, though, remains limited to “investigation and settlement of the claim.”

(4) Former Section 10 of the FIB and Section 14 of the CCP both included within coverage property “for which the insured is legally liable.” That clause has compounded the arguments relating to the “compensatory damages” language of the indirect-loss exclusion and led insureds to seek liability coverage. In neither form does the clause state at what point the insured must have legal liability, and the very term “liability” is a problem. The language was intended to cover situations in which the insured has responsibility for property regardless of any occurrence giving rise to a loss; bailment is the classic example. Nothing in the condition was intended to cover liability that the insured might suffer in favor of third parties solely because of the facts leading to a covered loss.

The case of *Lynch Properties, Inc. v. Potomac Insurance Co.*, 140 F.3d 622 (5th Cir. 1998), properly addressed this distinction. Although the insured held blank checks on the customer’s personal account, and the insured’s employee used those checks to embezzle from that account, the insured did not manage the account or otherwise have pre-existing responsibility (“legal liability”) for the funds in the account. Therefore, the policy did not cover the loss of the customer’s funds.

In contrast, the 10th Circuit held that employee embezzlement from real estate escrow accounts would be covered even though the bankrupt insured had not paid anything back to those whose escrowed funds were embezzled. *Nelson v. ITT Hartford Fire Insurance Co.*, No. 99-6275, 2000 WL 763772 (10th Cir. 2000) (unpublished). In that case, the circuit court of appeals cited specifically the indirect-loss exclusion’s reference to “compensatory damages arising directly from a loss” and the “property for which you are legally liable” language of the condition. Although the result arguably was correct, in that

the insured already was responsible for the escrowed funds in its control, the court cited the quoted policy language to hold that the policy afforded "indemnity from liability." This is the concept that *Lynch* rejected.

To avoid such an improper reading of the ownership condition in the FIB, the revised language clarifies that the insured must own or hold the property, or else the insured must be responsible for the property before the occurrence of the loss. The phrase "legally liable" has been deleted altogether. The CCP, with the language of the prior FIB, therefore will retain the same vulnerability to the argument lost in *Nelson* and overcome only at the circuit court of appeals level in *Lynch*.

E-COMMERCE CHANGES IN THE FIB

Neither the FIB nor the CCP was drafted with electronic transactions, the Internet, on-line banking, or any other kind of e-commerce in mind. The policies are not crafted for those issues and do not address them well. Riders, endorsements, and other coverages are being developed in a patchwork to address insured's desire for coverage in a fast-changing electronic world. The basic language of the policies, though, has remained pretty much unaffected.

When and how is an electronic record on the insured's premises? Is it there when residing in a web-hosting computer in the insured's offices but available to outsiders who have a password? What if the record actually resides on a web-server hosted by a third party under contract with the insured, although the world never knows who hosts the insured's website? If a copy of a transferable record mysteriously disappears from the insured's web-server and is negotiated at the insured's expense, was covered property ever on the insured's premises? Federal and uniform laws purport to give such electronic property essentially the same legal effect as paper instruments, but an insurer can determine whether paper was or was not located on the insured's premises more easily than it can find bits and bytes.

By analogy, insureds have argued that the wrongdoer is on the insured's premises via telephone. Two cases have ruled that sending electronic signals through a telephone wire terminating at telephones on the insured's premises nevertheless did not make the wrongdoer "constructively present" for purposes of fidelity coverage. *Oritani Savings & Loan Association v. Fidelity & Deposit Company of Maryland*, 989 F.2d 635 (3d Cir. 1993); *Southern National Bank v. United Pacific Insurance Co.*, 864 F.2d 329 (4th Cir. 1989). We nevertheless can expect the argument that the wrongdoer is on the premises when communicating with the insured's server via the Internet.

Similarly, is an Internet Service Provider or web host either a "messenger" (under both types of policy) or a "transportation company" (under the FIB) for purposes of electronic records? An ISP or host conveys those records just as surely as other entities convey paper, and the policies insure against loss while the property is in the custody of a messenger or transportation company. The more commonplace such transactions become, and the more frequently we see them leading to losses and litigation, the more

tempted the courts will be to squeeze and stretch the FIB and CCP to fit the facts that, we will be told, everyone surely contemplated when the coverage was bought.

Such questions and concerns have led the SAA to revise the FIB by inserting the new term "Written" throughout the bond and thereby attempt to head off claims based on electronic transactions. "Written" requires "letters or marks placed upon paper and visible to the eye." (Definition (v).) "Forgery" now expressly does not include electronic/digital signatures. (Definition (j).) An "Original" does not include "electronic transmissions even if received and printed." (Definition (q).) Riders will be offered to cover some e-commerce losses, essentially where some human interaction provides a safeguard. The changes and new provisions show a clear intent to limit coverage to paper transactions.

The CCP's protections against claims arising from electronic transactions are two-fold: (1) "covered property" generally will not include information, access to databases, and other intangibles that have value but are not within the policy's scope, and (2) the recent laws concerning electronic transactions require consent by the participants, and the CCP insurer has not consented to cover such transactions. Of course, the insured and its customers or clients do agree every day to deal digitally, and the courts eventually will insist that the CCP insurer must have contemplated such agreements and their likely consequences. The absence of the limiting and clarifying language of the FIB revisions could lead to courts analogizing electronic transactions to paper transactions under the CCP for purposes of finding coverage.

CONCLUSION

The Financial Institution Bond and the Commercial Crime Policy have many provisions that share common origins and intent. Courts and commentators have relied on precedents under one policy in understanding and construing the other. With the current revision to the FIB, the two policies part company in significant ways that will make comparison more complicated. Moreover, CCP insurers can expect insureds to argue that the very need for changes in the FIB demonstrates that the CCP is ambiguous or, worse, does not mean what the insurer intends. Until the crime-policy underwriters follow the FIB's lead, we all need to keep one eye on the new differences and their potential for unintended mischief.

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A more complete list and discussion of the new FIB provisions is available in the Winter, 2004 ABA FSLC Newsletter, the lead article being submitted by Edward G. Gallagher, Esq., General Counsel for the Surety Association of America. The author appreciates the SAA's providing a copy of the new form for review prior to its effective date.