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**"WHO KNEW ? CANCELLATION OF FIDELITY COVERAGE
UPON THE INSURED'S DISCOVERY OF DISHONESTY."**

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“WHO KNEW? CANCELLATION OF FIDELITY COVERAGE UPON THE INSURED’S DISCOVERY OF DISHONESTY”

The focus of this paper deals with one of the important conditions to Crime and Fidelity policies and examines the major decisions that have been interpreted in recent years.¹ The policy provision we deal with is the condition to fidelity coverage that terminates insurance as to any employee of the insured upon discovery that the employee has engaged in dishonest conduct. The purpose behind this provision is to terminate coverage as to any employee who has been demonstrably shown to be a dishonest person, and who, therefore, substantially increases the risk of additional loss to the insurer because of the possibility, if not likelihood, of later dishonest conduct.² In short, this condition stops the clock on coverage for further losses attributable to the employee.

A typical statement of this condition is:

E. Conditions.

1. Conditions applicable to all insuring agreements.

a. Cancellation as to any employee.

This policy is canceled as to any “employee”

(1) Immediately upon discovery by:

(a) You; or

(b) Any of your partners, “members”, “managers”, officers, directors, or trustees not in collusion with the “employee”;

of “theft” or any other dishonest act committed by the “employee” whether before or after becoming employed by YOU.³

¹ The underlying premise is that while “old” law may still be “good” law, “new” law is “better” law, since courts are generally more responsive to recent treatment of an issue if it is available.

² In re: Prime Corp. v. Lloyd’s, 187 B.R. 785 (N.D. Ga. 1995).

³ “Discovery” is generally defined to mean:

“Discovery of Loss occurs when you first become aware of facts which would cause a reasonable person to assume that a loss covered by this policy has been or will be incurred, even though the exact amount or details of loss may not then be known.”

While this provision seems relatively straightforward, needing little interpretation from courts, a clear statement of its meaning and boundaries has proven to be more elusive than the drafters would have reasonably expected. The courts have dealt with this condition in a variety of ways, and not always consistently.

1. Beginning Point.

As a beginning point, courts have traditionally upheld the validity of the conditions in fidelity bonds and crime policies which provide that coverage terminates for losses caused by a dishonest employee, effective upon the discovery of his dishonesty by the insured. See, e.g., Newhard Cook Co. v. Insurance Company of North America, 929 F. 2d 1355 (8th Cir. 1990); Central Progressive Bank v. Firemen's Fund Insurance Co., 658 F. 2d 377 (5th Cir. 1981); Ritchie Grocer Co. v. Aetna Casualty & Surety Co., 426 F. 2d 499 (8th Cir. 1970); St. Joe Paper Co. v. Hartford Accident & Indemnity Co., 376 F. 2d 33 (5th Cir. 1957); and Community Savings Bank v. Federal Ins. Co., 960 F. Supp. 16 (D. Conn. 1997).

2. Point of this Paper.

Many papers have been written that deal with various constituent parts of this condition, such as: (a) what is the "loss" that must be discovered in order to trigger the notice requirements; (b) what degree of knowledge is required to constitute discovery (e.g., are mere suspicions of wrongdoing sufficient?); and (c) whether the discovery standard to be applied is objective or subjective. ⁴

There are, however, other facts of this policy provision about which little has been written. This is the discreet issue with which this paper will deal.

"Discovery also occurs when you receive notice of an actual or potential claim against you alleging facts that if true would constitute a covered loss under this policy."

Also, "theft" is generally defined to mean:

⁴ "The unlawful taking of 'money', 'securities' or 'other property' to the deprivation of the Insured."

See, e.g., "Triggers pulled by discovery: duties of the insured and defenses of the surety", Craddock, presented at the 2001 Southern Surety and Fidelity Claims Conference.

3. The Cases.

Acadia Insurance Co. v. Keiser Industries, Inc., 793 A. 2d 495 (Me. 2002).

In this case, a company that constructs modular homes hired an employee who was later promoted to be its president, and a director of the company. Following an independent audit of the company's books, it was discovered that the president had misused the company credit card for personal purchases, which was a direct violation of corporate policy. The company confronted the president, who promised that he would discontinue use of the card for personal purposes and pay back those charges within two weeks. The company did not take any further action against the president, nor did it follow up to verify that the president had paid back the money in question. As might be expected of dead-beats, the president did not repay the monies as promised, and continued to make personal charges on the company credit card. Approximately a year later when the president's personal purchases on the company credit card had ballooned substantially, he was again approached by the Board of Directors. Following several months of discussion, in which repayment was promised but not forthcoming, the president was terminated. A claim was then made against the employee dishonesty insuring agreement, and the insurer denied coverage, alleging that the dishonest acts had previously been discovered by the Board of Directors. The employer filed suit, and after a bench trial, the court determined that the policy was canceled upon the initial discovery of the president's improper use of the company credit card. This finding was upheld on appeal.

Adair State Bank v. American Casualty Co., 949 F. 2d 1067 (10th Cir. 1991).

In this case, the chairman and controlling shareholder of a bank engaged in a check kiting scheme. Since three separate bank officers were aware of the chairman's activities, the insurer declined coverage because the bond terminated as to the chairman upon the first discovery of his illegal activities. The issue on which this claim turned was whether or not the three bank officers were in "collusion" with the chairman. In this regard, none of them were involved in the scheme, and none of them profited from it. Their failure to report the chairman's dishonesty resulted from a combination of being intimidated by the chairman, as well as receiving an explanation that he was about to obtain a loan that would clear up any problems with the bank. As to one of the officers, she mentioned her knowledge of facts to the president of the bank, and did not believe that she needed to do anything further. Based upon these facts, the Tenth Circuit of Appeals upheld summary judgment which was entered in favor of the bank, finding that each of the three officers were in collusion with the chairman.

Banca Nazionale del Lavoro v. Underwriters of Lloyds, 458 S.E. 2d 142 (Ap Ct. Ga. 1995).

In this case, the Atlanta branch of an Italian bank suffered a loss because of the alleged dishonesty of ten of its employees. Fidelity coverage was provided by Lloyds, who denied coverage based upon the argument that the policy terminated upon discovery of the dishonest actions of one of the employees. In fact, ten of the former employees of the bank were the parties who were alleged to have participated in the dishonest actions which resulted in the bank's loss. Lloyds moved for summary judgment in the lower court based upon the termination provision, and it was granted. The appellate court, however, promptly reversed, finding that "if the termination was proper as to one of the employees, the question remains as to whether it continues to provide coverage in regard to other employees." The court proceeded to find that since there were ten employees of the branch that were alleged to have participated in the dishonest acts, then the insurer was obligated to show, with respect to each of the ten, knowledge of their dishonesty in order for the policy to terminate as to that employee. The court found that, at best, the evidence presented by the insurer demonstrated knowledge of dishonesty as to only a few of the employees, and "we find no connection between this evidence and most of the named employees." Thus, the court held "as the bank's claim is predicated on losses allegedly caused by the dishonesty of a large number of employees and the evidence does not establish that the policy was terminated as to each such employee, there remains the possibility of a recovery on the policy by the bank demonstrating a loss caused by an employee as to whom the policy was not terminated."

Century Business Services, Inc. v. Utica Mutual Ins. Co., 122 Fed. Appx. 196 (6th Cir. 2005).

In this case, the president of a wholly-owned subsidiary of the insured, which was engaged in the business of providing payroll related services to financial and other companies, began "borrowing" money from the client liability account. The president informed the subsidiary's controller that he had borrowed the money, and signed a promissory note at an interest rate of six percent (which the controller considered to be a competitive rate). The president's "borrowings" escalated from there, ultimately reaching over \$3.5 million, of which he only repaid about \$550,000. His employment was eventually terminated, and he was convicted of wire fraud. The insured then filed a claim against its fidelity insurer based upon the employee dishonesty insuring agreement, which claim was promptly denied. Suit was filed, and both parties filed motions for summary judgment. The trial court rejected the insurer's argument that the controller's discovery of the president's initial loan constituted discovery of dishonest acts by him, thereby canceling the policy. The court predicated this finding upon the fact that the controller was not a corporate officer. The case ultimately went to trial and a jury returned a verdict in favor of the insured in the amount of about \$3.5 million. On appeal to the Sixth Circuit Court of Appeals, the insurer argued that the automatic termination provision of the policy, upon discovery of

dishonesty, applied when the controller first learned of the “loans.” Since the controller was not an officer of the company, the insurer was required to establish that discovery by “You” should be read to include employees of the insured, not just officers. The court rejected this argument, finding that if “You” included all employees of the insured, the second clause in the provision which applied to partners, officers, directors, etc., would be rendered superfluous. Accordingly, the court, following Ohio state law precedent, found that the term “You” is ambiguous and therefore affirmed the judgment against the insurer.

City Bank in Wellington v. U.S. Fidelity & Guaranty Co., 778 F. 2d 1103 (5th Cir. 1985).

In this case, the president of the small Texas bank engaged in fraudulent transactions with his bank in order to prop up a failing investment he had in another company who was a customer of the bank. Once that company failed, the bank sustained a sizeable loss and instituted suit against U.S.F. & G., who provided it with a Banker’s Blanket Bond. Following a trial, the district court entered judgment in favor of U.S.F. & G. Among the grounds supporting its decision was that coverage for acts by the president had terminated upon the vice president’s acquiring knowledge of his dishonest acts. While there was some dispute in the evidence as to whether the vice president had “actual” knowledge of the dishonesty, the district court stated that “if [the vice president] did not know, it is only because he deliberately closed his eyes, an act sufficient to charge him with knowledge.” The Fifth Circuit Court of Appeals found that the rule formulated by the trial court was correct, and further observed that there was abundant testimony in the record to find that the vice president did indeed have the requisite knowledge of dishonesty.

Community Savings Bank v. Federal Insurance Co., 960 F. Supp. 16 (D. Conn. 1997).

In this case, a bank sued Federal Insurance Company for losses sustained by an employee of the bank who was engaged in dishonest transactions. The employee in question was the president of the bank who made nine loans to borrowers with whom he had an undisclosed relationship. After the first of these loans was extended, the FDIC “adversely” classified the loan in question. Minutes from a special meeting of the Board of Directors of the Bank, revealed that the bank knew that the president had violated its banking policies in connection with the loan, and further that he was a partner in the borrower. One of the board members of the bank testified that they took no action with respect to this first loan, nor notified the carrier because the loan was performing. Unfortunately for the bank, in the subsequent loans the bank suffered significant losses. The district court entered summary judgment in favor of the insurer because the board learned of the president’s dishonesty on the very first loan, and thereafter took no action.

In Re: Conticommodity Services, Inc. Securities Litigation, 733 F. Supp. 1555 (N.D. Ill. 1990).

This case involved the trading activity at a commodities trading firm. A vice president of the commodities firm engaged in arbitrage trading for customers. Various customers complained about his trading activities, as being improper and fraudulent. In order to resolve these charges, the commodities firm was required to pay substantial sums of money. It then filed suit against Reliance Insurance Company to collect on the fidelity bond losses which it attributed to its dishonest employee. Reliance denied liability and defended on the basis that coverage had previously terminated as to the dishonest employee because of the insured's discovery of his dishonest conduct. On the strength of the testimony of the commodity broker's president, that he had formed an opinion about the dishonesty of the employee in question, Reliance moved for summary judgment. The court denied Reliance's motion for summary judgment, finding that based upon the wording of the policy, it required that the insured discover that the employee had engaged in dishonest conduct that would have been a covered loss under the policy. As the court stated: "This amendment makes clear that 'dishonest or fraudulent acts' as used in the cancellation clause means a dishonest or fraudulent act causing a covered loss, not just any dishonest act." Thus, the president's "belief" that the employee "was dishonest with him did not invoke the cancellation clause, only learning of a dishonest act causing a covered loss could do that."

Cooper Sportswear Manufacturing Co. v. Hartford Casualty Ins. Co., 818 F. Supp. 721 (D. N.J. 1993).

In this case, a company engaged in the manufacture and import of sportswear was victimized by a 40 year employee of the company. This individual stole cash and merchandise worth more than the \$500,000 policy limit of the employee dishonesty coverage. The claim was presented to Hartford, which denied coverage because it claimed that the employer had prior information about the employee's dishonesty. From the evidence presented to the district court, it was clear that the company's secretary-treasurer had received a good deal of information concerning theft by the employee. In fact, the secretary-treasurer retained a private investigation firm to put two plants in the building to keep a very close eye on the dishonest employee. The court found that this evidence, as a matter of law, constituted sufficient information to trigger the termination exclusion in the policy.

Federal Deposit Insurance Corp. v. Oldenburg, 34 F. 3d 1529 (10th Cir. 1994).

In this case, the owner of a real estate development firm, which was hemorrhaging money, purchased a 99.9% interest in a state savings bank. He asked the president of the bank to loan his company \$10 million, but this would have been a violation of Federal banking regulations. Accordingly, the parties decided that the

troubled real estate firm would be sold to the bank for \$50 million, without any appraisals of the real estate firm being undertaken. At the time of the sale, the real estate firm had a market value of about \$4 million. In undertaking these actions, it was clear that the bank's officers were aware of the need for Federal regulatory approval and purposely avoided it. Needless to say, a collapse of the real estate firm ensued, causing the bank enormous damages. Claims were made against the Banker's Blanket Bond, and after a bench trial, the Federal District Court ruled in favor of the insured and against the fidelity insurers. Among other findings made by the lower court was that the automatic termination provisions did not apply to terminate coverage under the bond. The issue addressed by the court was whether the bank officers that allegedly had knowledge of the dishonest conduct were "in collusion" with the perpetrators. Specifically, the insurer pointed to the fact that the tainted bank officers had engaged in fraudulent conduct in the past, which was known to the bank. The District Court found otherwise, stating that their acts may have amounted to negligence, "and constituted a departure from prudent lending practices." The court found that these earlier transactions, did not rise to the level of dishonesty or fraud. Giving deference to the lower court's findings of fact on this point, the Tenth Circuit Court of Appeals affirmed.

Federal Deposit Insurance Corp. v. St. Paul Fire & Marine Ins. Co.,
738 F. Supp. 1146 (M.D. Tenn. 1990).

In this action, the FDIC, in its role as receiver for a failed bank, purchased certain assets of the bank, including its rights under a Banker's Bond issued by St. Paul Fire & Marine Insurance Company. The FDIC then sued St. Paul for losses caused by dishonest conduct of the failed bank's president. Among other claims, the FDIC asserted that there was a covered claim by virtue of the bank's president having paid himself unauthorized executive committee fees. The directors of the bank were unaware of the payment of these fees, but two of the bank's vice presidents were directly involved in preparing and processing the payments. They did not, however, understand that the payment of these fees was illegal or dishonest. While the court concluded that the former bank president's actions "constituted pure embezzlement" the court refused to find that the termination exclusion applied because while the two vice presidents knew of the payments by virtue of their participation in their processing, neither knew that the president was acting dishonestly. There was apparently a great deal of evidence suggesting that the payments were "unusual", and a more attentive person would likely have investigated. Nonetheless, the court found that "neither negligence nor inattention" would constitute actual discovery of dishonesty.

First Dakota National Bank v. St. Paul Fire & Marine Ins. Co., 2 F.
2d 801 (8th Cir. 1993).

After First Dakota National Bank purchased a failed bank, it sued the provider of the Banker's Bond for the failed bank. The claim was that the dishonest former president of the failed bank, together with several other bank officers, engaged in

a fraudulent scheme involving 28 different corporations or entities. As this scheme was in progress, the FDIC investigated the bank that would later fail, and informed its directors that several bank officers were engaging in self-dealing conduct and that there were numerous apparent violations of Federal banking laws. Following a jury trial, in which the jury sided with First Dakota National Bank on most of the claims, the Federal District Court awarded judgment in favor of First Dakota for approximately \$4.4 million. St. Paul appealed and contended, among other things, that the lower court erred because it had established non-colluding officers and/or directors had learned about the scheme, thereby terminating coverage for the president and his cohorts. The Tenth Circuit affirmed the trial court's ruling on this issue, finding that there was not sufficient evidence to conclude that any non-colluding director or officer learned of the dishonest conduct while the scheme was in progress. While there was certainly evidence of knowledge of dishonest conduct, the court found that only knowledge of "a loss covered under the bond" would trigger a termination of coverage.

First National Bank of Louisville v. Lustig, 961 F. 2d 1162 (5th Cir. 1992).

In this case, First National Bank of Louisville had an employee who was a member of its construction loan division. There, the employee prepared credit approval applications and administered the closing and payment of large, commercial real estate loans. The employee presented 8 large construction loans for approval, and in the process, misrepresented facts relating to the loans, often falsifying credit records of borrowers and guarantors, and sometimes misrepresenting the identity of permanent lenders, the number of pre-sold project condominiums, exaggerating the size of the borrower's contributions, and falsifying various loan related documents. The insurers that provided the Banker's Blanket Bond for the bank presented evidence that the bank learned that the employee had made misrepresentations and acted beyond the scope of his authority well before some of the failed loans were made. The total loss to the bank exceeded \$20 million from these loans. The employee's dishonesty was discovered and he later preliminarily plead guilty to violation of criminal statutes, although the plea was later withdrawn because the judge would not accept the lenient sentence suggested for him.

The case went to jury trial in the Federal district court and the jury rejected the sureties' defense of termination because of discovery of dishonesty. The jury had been instructed by the district court for purposes of the termination clause, dishonest or fraudulent acts are "any deceitful act committed by [the employee] with the manifest intent to cause the bank to sustain a loss and to obtain financial benefit for himself or for any other person or organization." The instruction incorporated the restrictive definition of dishonest or fraudulent acts from Insuring Agreement A into the termination clause. The court rejected this finding that the termination clause could be triggered when the insured learns that the employee has committed "any dishonest or fraudulent act" even if that conduct falls "short of those triggering coverage under Insuring Agreement A."

In Re: J.T. Moran Financial Corp., 147 B.R. 335 (S.D. N.Y. 1992).

This action involved the bankruptcy of a securities dealer. One of the securities dealer's stockbrokers had violated the dealer's policy which prohibited its stockbrokers from trading for their own account in options without having sufficient liquid assets in their accounts to cover potential losses. One such transaction had occurred, and which was discovered by the employer. On that occasion, the stockbroker was required to immediately cover "an open account" which he did immediately after attempting to explain that the violation of company policy resulted because a "sell" order had not been executed. On the next two days following this incident, the stockbroker again left open uncovered positions, which ultimately resulted in a loss to the brokerage firm of about \$400,000. The brokerage firm then made a claim against its fidelity insurer for this amount. After suit was filed, the insurer moved for summary judgment on the basis that the policy as to the dishonest broker had been terminated upon discovery of the first improper transaction. The court granted the insurer's motion for summary judgment, finding that the employer's knowledge of the first incident, even though no loss was experienced, was sufficient to terminate coverage as to the dishonest employee. The court found that while the employer may have condoned the improper conduct by the employee, "such condemnation did not bind National Union."

In Re: Meachem Financial, Inc., 167 B.R. 799 (W.D. Penn. 1994).

In this action, a company, who was in the business of investing money collected by funeral home directors for prepaid funerals, had its president and majority shareholder divert money for his own personal benefit. In denying coverage, the insurer claimed that the president's knowledge of his own wrongdoing should be imputed to the company, which would therefore trigger the automatic termination provision. The court rejected this argument, however, finding that the language in the insurance documents showed an intent that the knowledge of an individual who was involved in dishonesty would not be imputed to the insured.

E. Udolf, Inc. v. Aetna Casualty & Surety Co., 573 A. 2d 1211 (Conn. 1990).

In this action, a small company, operating a retail men's clothing store, experienced misappropriation of monies by an employee. The company's sole officer, director and shareholder was a gentleman who spent very little time at the store. In his absence, the store was run by the store manager. During the years 1980 and 1981, it was determined that one of the employees of the Plaintiff misappropriated \$6,000. The company's bookkeeper discovered the misappropriation and informed the store manager. The sole officer, director and shareholder was not informed. In his absence, they agreed to allow the employee to repay \$6,000 that was misappropriated, which she thereafter did. At a later point, she resumed her practice of misappropriations, and took another \$50,000 from the company. This was discovered and the owner of the

company then ordered that she immediately be fired. A claim was made under the employee dishonesty insuring agreement, and was denied based upon the provision that insurance would immediately terminate as to any employee immediately upon discovery that the employee had been engaged in dishonest conduct. Under the policy provision, discovery had to be made by a partner or officer of the insured. Since those that discovered the employee's initial dishonesty met neither of those qualifications, it was argued that the policy's coverage did not terminate. The trial court rejected this, finding that the knowledge of the store manager or bookkeeper was imputed to the company. It was further found that the store manager and bookkeeper made a poor decision, but that their act was not in collusion with the dishonest employee. On appeal, the court affirmed the findings of the lower court with respect to the imputation of knowledge because the positions held by the store manager and bookkeeper "gave rise to a duty to report misappropriations" to the owner.

4. What Does It All Mean?

We can safely say that the cases reach a diversity of results – hardly an unexpected phenomenon. But what sense can we make of them? Cases can be broken down into a relatively few areas for purpose of analysis, although there is no grand unifying principle that can be used to explain all of the results, with the possible exception that courts find a way to reach the result they want.

(a) The Expected.

A significant group of the recent cases have reached an "expected" result based upon the policy language. These are:

- (1) Acadia Insurance Company, where prior knowledge of dishonesty was clearly shown.
- (2) City Bank in Wellington, where the vice president was found to not be able to deliberately close his eyes to the dishonest acts of the president.
- (3) Community Savings Bank, where the court found that even where a loan is performing, and therefore no loss is currently sustained, knowledge of dishonest conduct still cancels the policy as to the dishonest employee.
- (4) Cooper Sportswear Manufacturing Co., where clear prior knowledge of dishonesty was shown.
- (5) In Re T. H. Moran Financial Corp., where clear knowledge of prior dishonesty was shown.

- (6) In Re Meachem Financial, Inc., where the court found that no imputation of knowledge to the corporation could be made because of the wrongdoer's knowledge of his own dishonest conduct.
- (7) E. Udolf, Inc., there, in contra-distinction to the case above, found that the conduct of non-colluding, non-officers was imputed to the insured, even though the policy provided for discovery by officers or directors.

(b) **Must Dishonesty be of a "Covered Loss?"**

An area of conflict among the cases is whether knowledge of "any" fraud or dishonesty by an employee is sufficient to terminate coverage, or whether it must constitute a "covered loss" to trigger termination. Cases that have considered this issue are the following:

- (1) It must be a covered loss.

In Re: Conticommodity Services, Inc. Securities Litigation

First Dakota National Bank

- (2) The opposing view:

First National Bank of Louisville.

(c) **Where Multiple Employees of the Insured are Involved in Dishonesty.**

In cases where multiple employees of the insured are involved in the dishonest conduct, the one case that squarely addresses this is: Banca Nazionale del Lavoro holding that discovery of dishonesty as to each of the employees involved must be made in order to terminate coverage as to that particular employee.

(d) **Stupidity Is Not Enough.**

There is a fine line between intentionally closing one's eyes to another employee's dishonesty, which was found to be a sufficient basis to terminate coverage, and bone-headed stupidity. The FDIC has perfected this counter to the insurer's argument, and prevailed in both the FDIC v. Oldenburg and FDIC v. St. Paul cases. A lot of the difference in these types of cases is in the eyes of the beholder, and the result can go either way.

(e) **“In Collusion” Used Offensively.**

In one case, Adair State Bank, the court found that the other officers of the insured, who discovered the fraud, and who did not participate in or profit from the fraud, but who did not report it for various reasons were “in collusion” with the dishonest employee. Many other courts would have ruled these employees to have discovered the dishonesty, and based upon that, found that coverage terminated. When a court wants to find coverage, however, the Adair State Bank court has given them a basis for doing so – by condoning and not reporting the dishonest employee, the court found that these employees were “in collusion” thereby thwarting the termination of coverage.

(f) **Ambiguity.**

A final defense to the insurer’s attempt to terminate coverage is presented in the very recent decision of the Sixth Circuit Court of Appeals in Century Business Services. There, the court focused on the policy language of “You” when applied to the discovery of dishonesty by a non-officer employee of the insured. The court concluded that “You” is an ambiguous term, ambiguities are construed against the insurer, and accordingly, the policy did not terminate.

5. Conclusion.

Stay tuned.