CORPORATE counsel
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SPECIAL ADVERTISING SECTION

OUTSIDE PERSPECTIVES

INSURANCE

Maximizing Fidelity Loss Recoveries

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Just as a rising tide lifts all boats, receding prosperity reveals unsuspected threats. From corporate counsel's perspective, the risk is not just the phantoms of the deep — massive monsters like Madoff and the subprime meltdown — but also shallow scum like embezzling employees, computer hackers, forgers and other ordinary cheats.

The risk of loss from crimes like these should be addressed in every corporate insurance program through commercial crime or "fidelity" coverage. If a loss emerges, corporate counsel and risk managers should immediately focus on maximizing insurance recovery. This is easier said than done, since the discovery of betrayal by a trusted employee or business contact typically leads to disbelief, shock, anger and shame. Paralysis is understandable, but it only brings additional risk. Prompt analysis and action is necessary.

Responding To A Fidelity Loss

Upon learning of a loss due to theft or fraud, corporate counsel or risk managers should:

- Immediately send notice of the loss to all potentially responsible insurance companies, even if the full details remain to be determined. Many insurance policies state a specific period within which notice must be given. Failure to provide prompt notice may forfeit coverage.
- Conduct an immediate, discreet investigation focusing on the scope of the loss, the identity of participants, and the disposition of stolen assets.
- Implement immediate safeguards to prevent further losses.
- Gather information for a fraud audit and an asset seizure action.
- Attempt to interview, secure a statement, and secure restitution from any dishonest employees.
- Terminate dishonest employees.
- Prepare and submit a "proof of loss" regarding the insurance claim. Most insurance policies state a specific time period within which a sworn proof of loss must be submitted; policyholders should comply or obtain a written extension. Failure to submit a timely sworn proof of loss may forfeit coverage. The initial submission may be supplemented, if the full nature or extent of loss is not known by the applicable deadline.
- Identify and calendar the earliest possible date when the policyholder may have to file suit, and file a timely action if necessary. Many fidelity insurance policies state that an action against the insurance company must be commenced within two years of the discovery of a covered loss. Note that extending the deadline for a proof of loss, supplementing the proof, or ongoing "investigation" by the insurance company will not necessarily toll or extend the contractual suit limitation, which typically runs from discovery of the loss. Failure to file a timely lawsuit may forfeit coverage.

Throughout this investigation process, remember:

- Do not make any promises to the dishonest employee that you will refrain from contacting the authorities;
- Do not waive or release any claims against the dishonest employee or potentially secondarily responsible parties without complete restitution; and
- Do not settle with any party without first contacting the insurance company.

Sources of Fidelity Insurance And Typical Coverage Agreements

Potential sources of insurance coverage for theft and fraud losses include commercial crime policies; dishonesty, disappearance and destruction policies; "blanket" bonds; financial institution bonds (banker's bonds, brokerage bonds, etc.); all-risk policies covering loss of property; property policies with theft endorsements; comprehensive general liability policies with credit card and depositor's forgery endorsements; computer crime coverage; and even business interruption coverage, where theft of the policyholder's property renders it unable to operate.

Whatever the source, the coverage may include several different insuring agreements. Typical insuring agreement include: Fidelity coverage (for losses arising from employee dishonesty); "On Premises" coverage (for loss of property while on the company's premises); "In Transit" coverage; "Forgery or alteration" coverage; "Securities" coverage (for losses arising from forged, altered, lost or stolen securities, titles, deeds, etc.); "Counterfeit" coverage; "Computer Systems Fraud" coverage (for fraudulent data entry or alteration causing the transfer of property or funds); and "Fraudulent Mortgage" coverage (for loan losses due to accepting mortgages, deeds, or like instruments that are defective due to fraud or false pretenses).

Coverage Issues And Concepts

Insurance companies often deny or limit claims based on policy language or challenges to policy itself (i.e., rescission or reformation defenses). Each coverage defense must be assessed in light of the particular loss, policy language, and applicable law.

Typical insurance company arguments (and policyholder responses) include that a dishonest employee did not act with "manifest intent" to cause a loss or obtain an improper benefit (which may nevertheless be inferred from the circumstances); that there was no "dishonesty" (although the cases give dishonesty a broad definition); that the policyholder was negligent (although negligence is not a defense); that the stolen property did not belong to the policyholder (although coverage typically extends to assets for which the policyholder is legally liable, or which it holds in any capacity); that coverage was terminated for a particular employee because the policyholder knew he was dishonest (although mere suspicion of dishonesty that falls short of criminal risk should not defeat coverage); that "trading loss" or "credit loss" is excluded (although not every trading or loan falls within the exclusions); and that the policyholder did not suffer a "direct" loss (although this remains a fact-specific problem with ambiguous policy language that should be construed in favor of coverage).

Maximizing Recoveries

Issues arising from policy limits can have an enormous impact on the scope of insurance recovery. Many claims exceed available limits; even the most prudent insurance purchasers can underestimate their fidelity risk.

Crime insurance policies often state limits on a "per occurrence" basis, with "occurrence" defined to mean "all loss caused by, or involving, one or more 'employees,' whether the result of a single act or series of acts." This seemingly infinite definition should not dissuade policyholders from seeking multiple "occurrence" limits on a single policy, under appropriate circumstances. Although the law on this issue is mixed, there is favorable authority for multiple occurrences where separate identifiable acts are involved.

Multiple limits may also be available for losses which continue through successive crime insurance policy periods. Although insurers may deride this approach as "stacking," there is no prohibition of "stacking" in the policy language. Instead, the policies often provide coverage up to stated limits for each "occurrence," perhaps subject to "policy period," "non cumulation" and "extended discovery" provisions. In certain circumstances these provisions may allow multiple limits for employee dishonesty losses that continued undetected over several successive policy periods. Thus, while the policies currently in effect at the time of discovery are likely to cover concealed losses from prior policy periods (under "superseded suretyship" or "loss sustained during prior insurance" provisions), if the losses exceed current policy limits, a prior policy may provide additional coverage, subject to its own separate limit.

Conclusion

Insurance companies tend simply to assume the most restrictive policy interpretations on fidelity claims. Corporate counsel and their advocates should be alert to opportunities to challenge – and defeat – those assumptions, in order to secure the full protection they purchased and deserve to recover.

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