

Don't Get Robbed of Your Fidelity Coverage

By Caroline R. Hurtado



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In hard economic times, employee theft and fraud generally spike upward. The recent Great Recession and ensuing weak recovery have been no exception. For companies victimized by dishonest employees — or in some cases, merely erring ones — fidelity insurance can provide substantial protection.

At the same time, it's important to recognize that any insurance purporting to provide coverage for crime or costly error is inherently problematic, insofar as claims of this kind provide the insurance company with multiple opportunities to allege that it was defrauded or that the company's loss is excluded for a variety of reasons. To obtain the coverage it pays for, a fidelity insurance policyholder must be vigilant at three points of vulnerability:

1. the application process,
2. the notification of loss, and
3. in response to common insurance company defenses against coverage.

Avoiding and Resisting Rescission

The application process is a critical component to obtaining effective fidelity insurance coverage. The insurance company often looks back to representations made in the application process as a basis for denying a claim — or even worse, for rescinding the entire policy. While a policyholder must always be careful about representations and warranties made in an application for a fidelity bond, there are limits to how far an insured can go in punishing a policyholder for what is stated in its application.

The policyholder must fully disclose material facts in response to questions on the application

form. To be the basis for rescission, the facts allegedly misstated by a policyholder in the application must have been material in the insurer's underwriting of the risk.

Fidelity coverage often applies to employee dishonesty, such as embezzlement and theft of property. In the application process, a fidelity insurer will thus seek information that evaluates the trustworthiness of a policyholder's employees. When an insurer attempts to rescind fidelity coverage, the policyholder's *knowledge* at the time the application was filled out takes center stage. As important as what the policyholder knew at the time of application, however, is a second question: was this knowledge material to the insurer in evaluating the risks?

A policyholder cannot apply for and accept fidelity coverage for employees known or believed to be untrustworthy. In most jurisdictions governed by principles of agency, the corporate policyholder

will be deemed responsible for the consequences of representations made by the officer applying for fidelity coverage. For this reason, it is critical that all decision makers communicate concerns about specific employees during the application process. In some jurisdictions, a false representation by the policyholder could void coverage even if made in good faith. But this is not as daunting as it may seem. Coverage can only be denied on grounds that the policyholder failed to reveal knowledge, not on grounds that the policyholder failed to gain knowledge.

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In sum, to rescind on the basis of a misrepresentation, the insurer must establish that:

1. the declaration by the policyholder was false
2. the false declaration was material to the risk insured, and
3. the policyholder knew the declaration to be false.

One representation common in applications for fidelity coverage is a statement that, to the best of the insured's knowledge, all of the insured's employees and officers have faithfully performed their duties. More specific representations include a statement that books and records have been examined and found correct, or statements as to the past fidelity of an employee. Again, to void coverage, the insurer must show that any alleged misrepresentation was material. Suppose, for example, that a policyholder erroneously represents that an employee's books and records were examined, or examined to a standard that they were not. Unless that misrepresentation bears on the risk and hazard assumed by the insurer, it is not in itself sufficient to void coverage.

Understanding the difference between representations and warranties is also important in the

application process. A statement that the employee's books and records have been examined and his or her accounts found correct is merely a representation that this has been done, and not a warranty that the accounts are correct. Therefore, later-discovered errors in accounts are not a basis for rescission, and may in fact be covered.

Send Notice Early and Often

After the application process, the next danger zone in obtaining coverage under fidelity insurance lies in the process of filing notice. Upon discovery of a theft or fraud, the policyholder should immediately send notice of the loss to its insurance broker. Speed is imperative, as policies typically specify that notice shall be given to the insurance company within 30 days of discovery of loss — and in some cases within as little as seven days. In some states, failure to comply with this timely notice provision can result in forfeiture, even if the insurance company cannot show that it was "prejudiced" by the delay. Even in less draconian jurisdictions, it is best to avoid the possibility of costly litigation over the notice issue.

In consultation with the broker, the policyholder must identify all policies that may cover all or part of the loss. That may include general liability policies with forgery endorsements, all-risk properties with loss of property coverage, or property policies with theft coverage as well as more tailored coverages such as financial institution bonds or commercial crime policies. The policyholder should make sure that the broker confirms that all potentially responsible insurance companies have been notified within the timely notice period.

As important as timely notice is in assembling the documents and proof necessary to establish the amount of the loss, here too, time is of the essence. Standard Form No. 24, the form governing most crime and theft policies, stipulates that proof of loss must be furnished within six months of discovery of the loss. Again, some policies provide an even shorter window.

Don't Take No for an Answer

Once notice has been given, the next stage in the gamut to full recovery entails forestalling or successfully resisting the insurance company's often overbroad assertion of coverage defenses.

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One common coverage trap is the so-called "inventory loss exclusion," which insurers invoke to contend that they have no obligation to pay for theft losses proven through inventory records. Needless to say, inventory records often loom large as a resource for calculating a loss. While inventory records cannot be the exclusive documentation of a loss, so long as there is independent proof of dishonesty, policyholders may in fact use their own inventory records to establish the value of stolen property. Properly construed, the inventory loss exclusion has a much narrower application than insurers habitually claim for it.

Fidelity insurers will also often attempt to deny coverage for acts that are not criminal in nature, refusing coverage for negligence, mistake or error in judgment if it is not criminal or "dishonest." In such cases, the insurance company is construing narrowly the promise to cover losses from an employee's failure to perform "a faithful discharge of duties." Under rules of interpretation, however, ambiguous policy language is construed against the insurer — and

this language has been construed as ambiguous by some courts. If the covered employee fails to use the diligence of an ordinary prudent person in protecting property entrusted to his or her care, there could be coverage even though the bond does not use the term "negligence."

For many businesses, protection from loss stemming from fraud or theft is a core insurance need. As with many lines of insurance, however, risk management on this front merely begins with the purchase of the appropriate type and amount of coverage. To obtain the coverage they paid for, policyholders must be vigilant in the application process (ensuring internal communication regarding employees), in the prompt and thorough filing of the claim, and in response to all-too-common insurance industry defenses.▲

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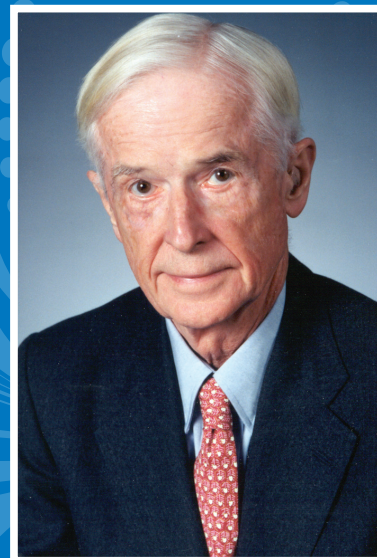
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In loving memory of our founding partner, mentor and friend

EUGENE R. ANDERSON

October 24, 1927 - July 30, 2010

Anderson Kill is deeply saddened by the loss of a mentor whose boundless energy, creativity, tenacity and zeal on behalf of policyholders has inspired those of us now working at Anderson Kill, as well as hundreds of attorneys in practice throughout the nation.



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