

# THE NOTICE DEFENSE TO FINANCIAL INSTITUTION BOND CLAIMS DISSECTED: NO SHOWING OF PREJUDICE FROM LATE NOTICE SHOULD BE REQUIRED

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## I. INTRODUCTION

The Financial Institution Bond, Standard Form No. 24 (hereinafter referred to as “Financial Institution Bond” or “Bond”) is a specialized form of fidelity coverage provided to banks and other financial institutions which insures against losses resulting from certain dishonest conduct by employees of the insured.<sup>1</sup> Section 5(a) of the “CONDITIONS AND LIMITATIONS” section of the Bond provides as follows:

At the earliest practicable moment, not to exceed 30 days, after discovery of loss, the Insured shall give the Underwriter notice thereof.<sup>2</sup>

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1. Prior to 1986, the Financial Institution Bond - Standard Form No. 24 was entitled Bankers Blanket Bond - Standard Form No. 24. *See Standard Forms of the Surety Association of America*. (SURETY ASS'N OF AMERICA).

2. Prior to 1980, Standard Form No. 24, then referred to as the Bankers Blanket Bond, had the following notice provision: “At the earliest practicable moment after discovery of any loss hereunder the Insured shall give the Underwriter written notice thereof...” Thus, the notice provisions of both bond forms are functionally identical except that the pre-1980 bond form did not have a thirty day cutoff. While certain cases examined in this article were decided under the older form, the analysis is the same under either bond form for purposes of addressing whether the provision is a condition precedent to coverage. From a practical standpoint, the only difference is that the current form provides a time period beyond which notice automatically will be deemed untimely, such that there is no need to determine whether notice was given “at the earliest practicable moment.”

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A frequently litigated issue and the topic of this article is whether the foregoing notice provision should be strictly construed such that the insured's failure to comply therewith automatically results in a forfeiture of coverage, or whether the insurer must demonstrate that it was prejudiced from the late notice in order to avoid coverage. This article will examine the general views which jurisdictions have taken with respect to this issue and provide commentary and analysis supporting a view that this notice provision should be strictly enforced without requiring the insurer to demonstrate prejudice in order to deny coverage.

Obviously, a threshold issue in any given case is whether, indeed, notice was given late. Under the Bond, the event which gives rise to a claim and triggers the requirement to give notice to the insured is the discovery of any loss. Section 3 of the "CONDITIONS AND LIMITATIONS" section of the Bond provides as follows:

This bond applies to loss discovered by the Insured during the Bond Period. Discovery occurs when the Insured first becomes aware of facts which would cause a reasonable person to assume that a loss of the type covered by this bond has been or will be incurred, regardless of when the act or acts causing or contributing to such loss occurred, even though the exact amount or details of loss may not then be known.

Thus, a necessary consideration in determining whether notice was timely in a particular case is to ascertain when the discovery occurred. There has been much litigation and several articles published concerning what amount of knowledge constitutes "discovery" such that the notice requirement is triggered.<sup>3</sup> This issue, however, is beyond the scope of this article. Rather, this article will address whether, when notice is demonstrably untimely under the Bond, such late notice automatically results in a forfeiture of coverage or whether the insurer must further demonstrate prejudice resulting from the late notice in order to deny coverage.

## II. COURTS' VIEWS WITH RESPECT TO GENERAL COMMERCIAL LIABILITY INSURANCE POLICIES

For many years courts have addressed the issue of whether a commercial liability insurer is required to show prejudice in order to deny coverage based upon the insured's failure to comply with the policy's notice provision.<sup>4</sup> The traditional view was that compliance with a policy's notice

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3. See, e.g., Duncan L. Clore & Michael Keeley, *Discovery of Loss: The Contractual Predicate to the Claim*, FINANCIAL INSTITUTION BONDS, ch. 3 (D. Clore ed. 1995).

4. For a detailed and exhaustive survey of the views of all jurisdictions addressing this issue, see Annotation, *Modern Status of Rules Requiring Liability Insurer to Show Prejudice to Escape Liability Because of Insured's Failure or Delay in Giving Notice of Accident or Claim*, or in *Forwarding Suit Papers*, 32 A.L.R. 4th 141 (1984).

provision was a condition precedent to recovery such that the insurer need not show that it was prejudiced in order to escape liability.<sup>5</sup> These jurisdictions reasoned that failure to adhere to the policy's express provisions regarding notice constituted a breach of contract.<sup>6</sup> While some jurisdictions continue to adhere to the traditional rule, a substantial number of jurisdictions have adopted what has become the modern trend to require the insurer to show that it was prejudiced by the late notice in order to avoid liability.<sup>7</sup> The common reasoning of these courts is that the purpose of the notice requirement is to give the insurer an opportunity to investigate, so that the clause should not be enforced unless the insurer can show that it did not have such opportunity and was in some fashion prejudiced.<sup>8</sup> A few jurisdictions have taken the view that although prejudice to the insurer is not entirely immaterial, there is nevertheless a presumption of prejudice raised by late notice, and the insured may rebut such presumption by showing an absence of prejudice.<sup>9</sup> Finally, some jurisdictions have adopted the view that whether a showing of prejudice is required depends upon the type of insurance policy at issue. Thus, an increasing number of courts have held that prejudice resulting from late notice need not be shown with respect to "claims made" policies, as opposed to "occurrence" policies.<sup>10</sup>

### III. COURTS' VIEWS WITH RESPECT TO THE FINANCIAL INSTITUTION BOND AND OTHER TYPES OF FIDELITY POLICIES

While there is an abundance of case law concerning the issue of whether prejudice must be shown by the insurer under a general commercial liability insurance policy in order to deny coverage for the insured's untimely notice of claim, relatively few courts have examined the issue with respect to fidelity policies such as the Financial Institution Bond. For some time, the majority of courts that did address the issue ruled that the notice provision in the Financial Institution Bond is a condition precedent to recovery and, therefore, that the insurer need not demonstrate prejudice in order to deny coverage.

For example, in *State of Viroqua v. Capitol Indemnity Corp.*<sup>11</sup>, the Supreme Court of Wisconsin reviewed decisions from several jurisdictions

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5. *Id.* at 145.

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

10. See, e.g., *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Talcott*, 931 F.2d 166 (1st Cir. 1991); *Industrial Indem. v. Super. Ct.*, 275 Cal. Rptr. 218 (Cal. App. 1990); *Burns v. Int'l Ins. Co.*, 929 F.2d 1422 (9th Cir. 1991); *T.H.E. Ins. Co. v. P.T.P., Inc.*, 628 A.2d 223 (Md. 1993); *Continental Cas. Co. v. Maxwell*, 799 S.W.2d 882 (Mo. App. 1990); *Zuckerman v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 495 A.2d 395 (N.J. 1985).

11. 214 N.W.2d 42 (Wis. 1974).

regarding the effect of the insured's failure to comply with the provisions of the Bankers Blanket Bond concerning notice and proof of loss and ruled as follows:

We hold that where the giving of timely notice is required by the Bankers Blanket Bond prior to the maturity of the liability of the insurer, such requirement is a condition precedent in fact to liability whether or not its importance is emphasized by further language that noncompliance works a forfeiture or voids the policy.<sup>12</sup>

Similarly, in *First Security Savings v. Aetna Casualty & Surety Co.*,<sup>13</sup> the Supreme Court of Nebraska held that timely compliance with the notice provision of a Bankers Blanket Bond is a condition precedent to the liability of the insurer. Thus, the court ruled that:

In order for an insured to recover under a discovery bankers blanket bond, the insured must establish that it (1) discovered the loss within the period of the bond's existence, (2) furnished written notice to the underwriter at the earliest practicable moment after discovery, and (3) furnished the underwriter proof of loss with full particulars within the time specified by the bond.<sup>14</sup>

The same rule was followed under the law of Montana in *FSLIC v. Aetna Casualty & Surety Co.*<sup>15</sup>, where the court held that:

Montana has long recognized that timely notice of discovery is a condition precedent to recovery on a surety bond when the policy contains a notice clause. Aetna is not required to demonstrate that Montana Savings' failure to provide timely notice caused Aetna substantial prejudice. Montana Savings' failure to satisfy the conditions of the surety bond are dispositive in this case.<sup>16</sup>

In 1991, the Tenth Circuit Court of Appeals acknowledged that compliance with the terms of a fidelity bond governing notice is a condition precedent to coverage under the law of Oklahoma. In *Adair State Bank v. American Casualty Co.*,<sup>17</sup> the court stated:

The insured provided notice to the insurer on March 28, 1986. The insurer argues that the insured discovered the loss more than 30 days prior to that date. If, as the insurer alleges, the insured did discover its loss prior to that

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12. *Id.* at 46-47.

13. 445 N.W.2d 596 (Neb. 1989).

14. *Id.* at 596-97.

15. 785 F. Supp. 867 (D. Mont. 1991).

16. *Id.* at 871.

17. 949 F.2d 1067 (10th Cir. 1991).

time, then the insured failed to comply with a condition precedent for coverage, and liability under the fidelity bonds would not accrue.<sup>18</sup>

In addition to the foregoing decisions, there are other jurisdictions following the rule that adherence to the notice requirement in a fidelity policy is a condition precedent to coverage, such that no showing of prejudice is required to deny coverage.<sup>19</sup>

Some recent decisions, however, have gone the other way, holding that the fidelity insurer must demonstrate prejudice before denying a claim based upon untimely notice of loss.

For example, in *Federal Deposit Insurance Corp. v. Oldenburg*<sup>20</sup>, a case decided under Utah law, the FDIC sought recovery under two savings and loan blanket bonds which had notice provisions identical to that contained in the Financial Institution Bond. The Tenth Circuit Court of Appeals rejected the insurer's argument that timely notice of loss under the bonds was a condition precedent to coverage and therefore that coverage should be denied without a showing of prejudice. The court stated:

A review of the law of other jurisdictions reveals substantial support for the proposition that noncompliance with notice provisions of a fidelity policy will not defeat coverage absent a showing of substantial prejudice, unless the policy contains a forfeiture clause for noncompliance or express language making notice a condition precedent to recovery.<sup>21</sup>

Similarly, in *Federal Deposit Insurance Corp. v. Aetna Casualty & Surety Co.*<sup>22</sup>, decided under Louisiana law, the court held that proof of substantial prejudice must be shown in order to avoid coverage for failure to comply with the Financial Institution Bond's notice requirement, reasoning that:

The purposes of such time limits are to furnish the insurer with all relevant data necessary to determine the extent of his potential liability and to prevent the insured from committing fraud or ill practices and the

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18. *Id.* at 1073 (emphasis added).

19. See, e.g., *FDIC v. Ins. Co. of N. Am.*, 928 F.Supp 54, 59 (D. Mass. 1996); *J.I. Corp. v. Federal Ins. Co.* 920 F.2d 118, 120 (1st Cir. 1990); *Utica Mut. Ins. Co. v. Fireman's Fund Ins. Co.* 748 F.2d 118, 121 (2nd Cir. 1984) (applying New York law); *Boston Mut. Life Ins. Co. v. Fireman's Fund Ins. Co.*, 613 F.Supp. 1090 (D. Mass. 1985); *United States v. National Grange Mut. Ins. Co.*, 1994 WL 511563 (D. Mass. 1994); *Marez v. Dairyland Ins. Co.*, 638 P.2d 286, 290 (Colo. 1981); *Prime Comm. Corp. v. Underwriters at Lloyds*, 187 B.R. 785 (N.D. Ga. 1995); *Gov. Employees Ins. Co. v. Harvey*, 366 A.2d 13 (Md. 1976); *Terrell v. State Farm Ins. Co.*, 346 N.W.2d 149, 152 (Minn. 1984); *Reliance Ins. Co. of New York v. Garsart Building Corp.*, 517 N.Y.S.2d 189, 190 (N.Y. App. 1987); *Griffith Motors, Inc. v. Compass Ins. Co.*, 676 S.W.2d 555 (Tenn. App. 1984); *Podlewski v. Gov. Employees Ins. Co.*, 616 S.W.2d 298, 299 (Tex. Civ. App. 1981); 272 S.E.2d 196 (Va. 1980).

20. 34 F.3d 1529 (10th Cir. 1994).

21. *Id.* at 1546.

22. 744 F. Supp. 729 (E.D. La. 1990).

insurer from being placed at a disadvantage in obtaining evidence. A purpose is not, however to provide Aetna with a technical escape-hatch [sic] by which to deny coverage.<sup>23</sup>

In *Resolution Trust Corp. v. Gaudet*,<sup>24</sup> an insurer under a financial institution bond filed a motion for summary judgment on the basis of the insured's failure to comply with the bond's notice provision. The court denied the insurer's motion, reasoning that since the financial institution bond did not make timely notice an explicit condition precedent to coverage, the insurer had to demonstrate prejudice resulting from the late notice in order to avoid coverage.

In *Downey Savings & Loan Association v. Ohio Casualty Insurance Co.*,<sup>25</sup> the court ruled that under a Bankers Blanket Bond, "[i]n the absence of prejudice an insurer may not rely on a breach of notice clause." A similar result was reached in *Second National Bank of Kansas City v. Continental Insurance Co.*,<sup>26</sup> where the court held that upon failure of the insured under a Bankers Blanket Bond to give timely notice, the insured is discharged from liability only upon a showing of substantial prejudice.

In addition to the foregoing decisions, courts have held that notice provisions in other types of fidelity policies are not condition precedents to coverage, and therefore a showing of prejudice is required for there to be a forfeiture of coverage.<sup>27</sup>

#### IV. THE NOTICE PROVISION IN THE FINANCIAL INSTITUTION BOND SHOULD BE STRICTLY ENFORCED

Although a fair number of recent cases have held that the insurer under the Financial Institution Bond must demonstrate prejudice in order to avoid coverage based upon late notice, the authors firmly believe that significant reasons exist both in law and public policy for the notice provision to be strictly enforced without the need for a demonstration of prejudice.

##### A. The Financial Institution Bond is Tantamount to a "Claims Made"

23. *Id.* at 734 (quoting *Miller v. Marcantel*, 221 So.2d 557, 559 (La. App. 1969)).

24. 907 F. Supp. 212 (E.D. La. 1995).

25. 234 Cal Rptr. 835 (Cal. App. 1987), cert. denied, 486 U.S. 1036 (1988).

26. 586 F. Supp. 139 (D. Kan. 1982).

27. See, e.g., *BAH Supply Co., Inc. v. Ins. Co. of N. Am.*, 311 S.E.2d 643 (N.C. App. Ct. 1984) (embezzlement insurance) (unexcused delay in notifying the insurer of a loss or claim does not relieve the company of its policy obligations if delay does not materially prejudice the insurer); *In re Mechem Financial, Inc.*, 167 B.R. 799 (Bankr. W.D. Pa. 1994) (fidelity bond) (in order to avoid liability, insurer must demonstrate prejudice from insured's failure to comply with bond's requirement that notice be given "as soon as practicable" after discovery of loss).

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## Insurance Policy

As noted above, several jurisdictions recognize a distinction between two types of insurance policies — “claims-made” policies and “occurrence” policies — with respect to enforcement of notice requirements contained therein.<sup>28</sup> For example, while New Jersey recognizes the rule that an insurer must demonstrate “appreciable prejudice” in order to avoid coverage for failure to adhere to the policy’s notice provision, it has carved out a significant exception for “claims made” or “discovery” policies and has eliminated the prejudice requirement with respect to such policies. *Zuckerman v. National Union Fire Insurance Co. of Pittsburgh, Pa.*<sup>29</sup> For jurisdictions like New Jersey which recognize the distinction between “claims made” and “occurrence” policies, the critical issue becomes whether the Financial Institution Bond constitutes or is otherwise akin to a “claims made” policy such that its notice provision should be strictly enforced without requiring a showing of prejudice. New Jersey has examined this issue and, as a result of a decision which appears inconsistent with *Zuckerman*, is at the forefront of this debate.<sup>30</sup> For this reason, the law in New Jersey with respect to this issue is significant and will be examined in some detail.

In *Zuckerman*, the plaintiff was insured under a legal malpractice insurance policy which provided that the insurer would:

pay on behalf of the insured all sums which the insured shall become legally obligated to pay as money damages because of any claim or claims first made against the insured and reported to the company during the policy period, arising out of an act or omission of the insured in rendering or failing to render professional services for others in the insured’s capacity as a lawyer.<sup>31</sup>

The policy also required that the insured give notice to the insurer “as soon as practicable” after “becoming aware of any act or omission which could reasonably be the basis of a [covered] claim or suit....”<sup>32</sup>

The insured learned of a lawsuit against him while his policy was in force. However, he did not notify the insurer until 10 months after his policy had terminated. The insurer denied coverage based upon the insured’s failure to give the company notice of the lawsuit during the policy period. The insured then filed a declaratory judgment action seeking a determination as to coverage under the policy. In ruling on cross-motions for summary judg-

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28. *See supra*, section II.

29. 495 A.2d 395 (N.J. 1985).

30. *See RTC v. Moskowitz*, 868 F. Supp. 634 (D.N.J. 1994).

31. *Id.* at 396-97.

32. *Id.* at 397.

ment, the trial court held that the insurer was required to demonstrate prejudice before it could rely upon the notice provision to deny coverage. The Appellate Division reversed, and the Supreme Court of New Jersey affirmed the reversal, holding that the insurer could properly deny coverage without showing that it was prejudiced.

The critical factor in the Supreme Court's analysis was the recognition that the insurance policy at issue was "a 'claims made' or 'discovery' policy."<sup>33</sup> It distinguished such policies from "occurrence" policies in that:

In a discovery policy the coverage is effective if the negligent or omitted act is discovered and brought to the attention of the insurance company during the period of the policy, no matter when the act occurred. In an occurrence policy the coverage is effective if the negligent or omitted act occurred during the period of the policy, whatever the date of discovery.<sup>34</sup>

The Court also recognized that:

"Claims made" and "occurrence" policies may also be distinguished on the basis of the difference in the peril insured.... In the "occurrence" policy, the peril insured is the "occurrence" itself. Once the occurrence takes place, coverage attaches even though the claim may not be made for some time thereafter. While in the "claims made" policy, it is the making of the claim which is the event and peril being insured and, subject to policy language, regardless of when the occurrence took place.<sup>35</sup>

The Court, citing its prior decision in *Cooper v. Government Employees Insurance Co.*<sup>36</sup>, recognized that New Jersey previously had adopted the view that an insurer must demonstrate appreciable prejudice from late notice in order to deny coverage on that basis.<sup>37</sup> However, since the *Cooper* case involved an "occurrence" policy and because of the inherent differences between "occurrence" policies and "claims made" policies, the Court refused to require a showing of prejudice in order for the malpractice insurer to assert late notice as a defense to coverage. Therefore, the Court created an exception to the *Cooper* doctrine with respect to "claims made" or "discovery" policies, reasoning as follows:

[T]he requirement of notice in an occurrence policy is subsidiary to the event that invokes coverage, and the conditions related to giving notice should be liberally and practically construed.

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33. *Id.* at 398 (emphasis added).

34. *Id.* (quoting *Samuel N. Zarpas, Inc. v. Morrow*, 215 F. Supp. 887 (D.N.J. 1963)).

35. *Id.* at 398 (citation omitted).

36. 237 A.2d 870 (N.J. 1968).

37. See *Zuckerman*, 495 A.2d at 405.

....By contrast, the event that invokes coverage under a “claims made” policy is transmittal of notice of the claim to the insurance carrier. In exchange for limiting coverage only to claims made during the policy period, the carrier provides the insured with retroactive coverage for errors and omissions that took place prior to the policy period. Thus, an extension of the notice period in a “claims made” policy constitutes an unbargained for expansion of coverage, gratis, resulting in the insurance company’s exposure to a risk substantially broader than that expressly insured against in the policy. Obviously, such an expansion in the coverage provided by “claims made” policies would significantly affect both the actuarial basis upon which premiums have been calculated and, consequently, the cost of “claims made” insurance. So material a modification in the terms of this form of insurance widely used to provide professional liability coverage both in this State and throughout the country would be inequitable and unjustified.<sup>38</sup>

An examination of the terms of the Financial Institution Bond reveals that it is a “discovery” policy which is akin to a “claims made” policy, as opposed to an “occurrence” policy. Therefore, in New Jersey and other jurisdictions which recognize this distinction, the notice provision of the Financial Institution Bond should be strictly enforced without requiring a showing of prejudice.

As set forth in the section of the Financial Institution Bond entitled “CONDITIONS AND LIMITATIONS,” the Bond applies:

[T]o loss discovered by the Insured during the Bond Period. Discovery occurs when the Insured first becomes aware of facts which would cause a reasonable person to assume that a loss of the type covered by this bond has been or will be incurred, regardless of when the act or acts causing or contributing to such loss occurred, even though the exact amount or details of loss may not then be known.

Thus, the Bond covers a loss discovered during the policy period, regardless of when the loss occurred. As *Zuckerman* made clear, this is the exact feature which makes a “claims made” or “discovery” policy clearly distinguishable from an “occurrence” policy, which ties coverage to when the loss occurred.<sup>39</sup> The policy in *Zuckerman* also required notice of the discovery of a claim “as soon as practicable” after such discovery. Similarly, the Bond requires notice of the discovery of a claim “at the earliest practicable moment” (but within 30 days) after such discovery. In fact, this notice provision is placed squarely within the section of the Bond entitled “CONDITIONS AND LIMITATIONS”, which appears in boldface type and capital

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38. *Id.* at 406 (emphasis added).

39. See *Zuckerman*, 495 A. 2d at 406. See also *J.I. Corp. v. Federal Ins.*, 920 F.2d 118, 120 (1st Cir. 1990) (recognizing fidelity bond as “claims made” policy and enforcing notice provision as written).

letters.<sup>40</sup> Both policies, therefore, define coverage in terms of the discovery of a claim and intimately tie the notice requirement to such discovery.<sup>41</sup>

Thus, the terms of the policy in *Zuckerman* are essentially indistinguishable from the terms of the Financial Institution Bond. In *Zuckerman*, coverage was triggered when an actual claim was discovered by the insured, which in turn triggered the requirement to give notice “as soon as practicable” after such discovery.<sup>42</sup> In other words, the insured was required to give notice as soon as practicable after discovery of a potential loss, but in all cases before termination of the policy. This is precisely what the Financial Institution Bond requires, but with a 30-day “grace period” as to the transmittal of notice. As with the *Zuckerman* policy, the Financial Institution Bond ties coverage to the discovery of a loss (rather than to the occurrence of such loss) coupled with prompt notice thereof to the insurer. Thus, a “discovery” policy like the Financial Institution Bond is, in effect, a “claims made” policy with a 30-day grace period with respect to the notice deadline.

The fact that the Bond includes this grace period which potentially allows notice of a claim to be given 30 days after a policy has terminated in no way alters this analysis. The effect of this “grace period” is only to allow an additional window of time, not to exceed 30 days, to report a loss which is discovered within the last 30 days of the policy period. That is the only functional difference between the Financial Institution Bond and the policy at issue in *Zuckerman* insofar as the period of coverage and notice is concerned. The 30-day grace period does not change any other aspect of the analysis from *Zuckerman*. As with the policy in *Zuckerman*, the Financial Institution Bond contains a specific period within which losses must be discovered and reported to the insurer. This period provides a means for the insurer to calculate its risk and period of exposure under the Bond. As the *Zuckerman* Court reasoned, allowing losses to be reported outside the 30-day period after termination of the Bond would prevent the insurer from achieving any effective calculation of its loss exposure with respect to covered claims under the expired policy period and thus its required premiums. Therefore, in jurisdictions like New Jersey which recognize the distinction between “claims made” or “discovery” policies and “occurrence” policies, the notice provision of the Financial Institution Bond should be strictly enforced without requiring a showing of prejudice.

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40. On this basis alone, it would be a tenuous argument that compliance with the Bond’s notice requirement is not a condition precedent to recovery thereunder.

41. Hence, the *Zuckerman* Court’s reference to the policy as a “claims made” or “discovery” policy. *See Zuckerman*, 495 A.2d at 396, 398.

42. The notice requirement in the *Zuckerman* policy was triggered once “the insured be[came] aware of any act or omission which could reasonably be expected to be the basis of a [covered] claim or suit.” *Zuckerman*, 495 A.2d at 397.

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Notwithstanding the foregoing, in 1994 the court in *Resolution Trust Corporation v. Moskowitz*<sup>43</sup> held that, under New Jersey law, an insurer under a financial institution bond was required to show “appreciable prejudice” before denying a bond claim for failure to submit a proof of loss within the time specified in the bond. While *Moskowitz* involved an insured’s untimely filing of a proof of loss rather than an insured’s untimely notice of a claim, there is legitimate concern that its holding would be extended to a case involving untimely notice under the Financial Institution Bond. This is because the *Moskowitz* court classified the Financial Institution Bond as a “discovery” policy and erroneously distinguished it from a “claims made” policy. The *Moskowitz* court, in dicta, stated that:

[T]he long-standing New Jersey rule requiring an insurance company to prove ‘appreciable prejudice’ before denying a claim based on late notice should be applied to ‘discovery policies.’<sup>44</sup>

The *Moskowitz* court treated the Financial Institution Bond as if it were an “occurrence” type policy, despite recognizing that coverage under the Bond is clearly and expressly triggered not by the occurrence of the loss but by discovery of the loss!<sup>45</sup> As the *Zuckerman* Court made clear, a policy (such as the Financial Institution Bond) which ties coverage to the discovery of a loss coupled with prompt notice thereof to the insurer, is a “claims made” or “discovery” policy by definition, and is to be distinguished from an “occurrence” policy, which ties coverage to when the loss occurred, regardless of when it was discovered. The district court’s ruling in *Moskowitz*, therefore, is difficult to reconcile with *Zuckerman*. The *Moskowitz* court failed to explain how a policy which bases coverage upon when the loss was discovered rather than upon when the occurrence took place could be treated as an “occurrence” policy.

In addition, although the *Moskowitz* court apparently read *Zuckerman* as being limited to legal malpractice policies, there is no rational basis for such limitation and, in fact, other courts have applied *Zuckerman* outside the context of legal malpractice insurance. In *American Casualty Co. v. Continisio*,<sup>46</sup> the court enforced the requirement in a directors and officers liability policy that notice of a claim must have been given during the policy period. In doing so, the court relied expressly upon the distinctions, as ar-

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43. 868 F. Supp. 634 (D.N.J. 1994)

44. *Id.* at 639 (emphasis added).

45. *See Moskowitz*, 868 F. Supp. at 637.

46. 819 F. Supp. 385 (D.N.J. 1993), *aff’d*, 17 F.3d 62 (3d Cir. 1994).

ticulated in *Zuckerman*, between an “occurrence” policy and a “claims made” policy.<sup>47</sup>

In the authors’ opinion, the *Moskowitz* court misapplied *Zuckerman* by distinguishing “claims-made” and “discovery” policies as separate types of policies when *Zuckerman* demonstrated that they are the same type of policy and are to be distinguished from “occurrence” policies rather than from each other. In fact, in *Zuckerman*, the Court used the terms “claims made” and “discovery” interchangeably several times in its opinion.<sup>48</sup> This was no accident, since the policy in *Zuckerman* truly was a “claims-made/discovery” policy, the notice of claim being intimately tied to the discovery of such claim. Simply stated, “claims made” and “discovery” policies are functionally identical for purposes of enforcing the notice provision. Thus, the authors assert that the *Moskowitz* decision reflects a complete disregard for the principles carefully laid out in *Zuckerman* and, therefore, must be viewed as contrary to New Jersey law.

What is rather surprising and particularly bothersome in the authors’ opinion is that the *Moskowitz* court correctly pointed out that to determine whether the Financial Institution Bond is a claims made policy, “the Court must look to New Jersey law and attempt to predict how the *New Jersey Supreme Court* would answer [this question].”<sup>49</sup> However, the *Moskowitz* court failed to realize that the New Jersey Supreme Court, in effect, *already* had answered this question in *Zuckerman*. Similarly, the *Moskowitz* opinion correctly framed one of the issues as “Should the Appreciable Prejudice Rule Apply to ‘Discovery’ Policies?”<sup>50</sup> Again, the court failed to appreciate that this precise question was already answered “no” by *Zuckerman*. The *Moskowitz* court even acknowledged that “[i]n *Zuckerman*, the New Jersey Supreme Court refused to apply the appreciable prejudice rule to a ‘claims made’ insurance policy.”<sup>51</sup> The court then went on and held that the appreciable prejudice rule does apply to a discovery policy, drawing an artificial distinction between “claims made” and “discovery” policies when *Zuckerman* suggests that none exists. As *Zuckerman* clearly demonstrates, the distinction to be drawn is between the “claims made/discovery” policy and the “occurrence” policy, not between the “claims made” policy and the “discovery” policy.

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47. *Id.* at 398; *see also* *Insite-Properties, Inc. v. Phillips*, 638 A.2d 909 (N.J. App. 1994) (noting, under claims made policy covering professional services rendered by title abstractor, that, “[i]f a claim was actually received, there would be no coverage because notice was not timely forwarded to the carrier.”).

48. *See Zuckerman*, 495 A.2d at 396, 398.

49. *Moskowitz*, 868 F. Supp. at 637 (emphasis added).

50. *Id.* at 639.

51. *Id.*

The *Moskowitz* court also erred in analyzing the financial institution bond as a “blanket bond” which provides “broad” coverage, and, unlike a “claims made” policy, should be “construed...very liberally.”<sup>52</sup> This analysis hinges on a misunderstanding of the term “blanket bond.” Although the Financial Institution Bond was at one time referred to as the “Bankers Blanket Bonds,” it has been recognized that:

[T]he term “blanket” [is] something of [a] misnomer. The contract does not provide blanket coverage in the sense that it offers complete protection from every risk. The term “blanket” was borrowed from the name of the similar Lloyd’s product which had been marketed a few years earlier. The term means that a uniform dollar amount of coverage is applied to each Insuring Agreement unless designated otherwise.<sup>53</sup>

Finally, the *Moskowitz* court failed to consider New Jersey courts’ reluctance to expand coverage in other types of surety cases. For example, New Jersey courts generally enforce the provision in surety bonds that any lawsuit against the surety to recover under the bonds must be filed within one year, despite the fact that the applicable statute of limitations would allow a significantly longer period.<sup>54</sup> This approach is based upon the courts’ recognition that, in the absence of some ambiguity, “a surety is chargeable only according to the strict terms of its undertaking and its obligation cannot and should not be extended either by implication or construction beyond the confines of the contract.”<sup>55</sup>

#### B. There are Significant Public Policy Reasons for Enforcing Strictly the Notice Provision in the Financial Institution Bond

The *Zuckerman* Court recognized important reasons, as a matter of public policy, for enforcing strict time limits for providing notice of a claim in a “claims made/discovery” policy such as the Financial Institution Bond. Because “occurrence” policies focus the coverage question on when the act or loss occurred, an insurer can be forced to provide coverage for events which occurred long ago; this creates a long period (“tail”) of exposure for the insurer, with resulting inability of the insurer to calculate premiums

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52. *Id.* at 638.

53. “History of the Bankers Blanket Bond and the Financial Institution Bond Standard Form 24 with Comments on the Drafting Process,” Second Supplement to Annotated Financial Institution Bond (Formerly Bankers Blanket Bond) at p. 4; *see also* DIGEST OF BANK INSURANCE at 61 (5th ed.) (“The word ‘blanket’ refers to a single amount of coverage applying to the several perils covered by the bond and was never intended to imply that this is ‘all risk’ coverage.”)

54. *See, e.g., Eagle Fire Protection Corp. v. First Indem. of Am. Ins. Co.*, 655 A.2d 939 (N.J. App. 1995), *rev’d on other grounds*, 678 A.2d 699 (N.J. 1996); *Ribiera & Lourenco Concrete Const., Inc. v. Jackson Health Care Assocs.*, 554 A.2d 1350 (N.J. App.), *aff’d*, 571 A.2d 1311 (N.J. 1990); *V. Petrillo & Son, Inc. v. Am. Const. Co.*, 371 A.2d 799 (N.J. Ct. App. 1977).

55. *See Eagle Fire Protection Corp. v. First Indemnity of Am. Ins. Co.*, 678 A.2d 699 (N.J. 1996) (*quoting Monmouth Lumber Co. v. Indemn. Ins. Co.*, 122 A.2d 604 (N.J. 1956)).

accurately.<sup>56</sup> An additional disadvantage to such policies is that the “long tail exposure can lead to situations in which the policy underwriter is no longer in existence at the time a claim is finally made.”<sup>57</sup> In such cases, a party which thought itself insured will be personally exposed to all liability for an event insured under an “occurrence” policy.

By contrast, under a “claims made/discovery” policy, the insurer can calculate risks and premiums more precisely, since its exposure will end at a fixed period. As a consequence, the premium paid by the insured can be lower. “A corollary benefit to the insured is that since coverage is purchased on a contemporary basis, it can afford protection in current dollars for liability that may be based on [events] that occurred years earlier.”<sup>58</sup> Thus “claims made/discovery” policies address important insurance needs, particularly in complex business and professional operations where the loss may be discovered long after the acts causing the loss took place — for example, where embezzlement by a bank employee is discovered years after the employee’s activities at the bank had ceased.

“Claims made–discovery” policies can be underwritten cost-effectively (from the standpoint of both insurer and insured) only if the insurer can be certain of a final date after which claims under a policy cannot be made. Upon the 31<sup>st</sup> day after the expiration of the policy period in the Financial Institution Bond, the insurer should be able to “close its books” and be satisfied that there will be no further unasserted claims on the policy. Only then would it be able to effectively determine its risk and exposure and calculate its premiums accordingly. The *Moskowitz* court’s complete abrogation of the notice of loss requirement creates a situation where potential exposure (and thus premium charged) cannot be calculated. This extends coverage beyond the bargain made between the insurer and the insured and, therefore, results in precisely the problem the New Jersey Supreme Court was concerned about when it eliminated the appreciable prejudice rule for “claims made/discovery” policies.

*Zuckerman* is not the only court to recognize the critical differences between “occurrence” policies and “claims made–discovery” policies. Many other courts have applied a similar analysis and recognized the necessity of strictly enforcing the time limits provided in “claims made/discovery” policies. For example, in *National Union Fire Insurance Co. of Pittsburgh, Pa. v. Talcott*,<sup>59</sup> the court enforced the requirement that notice of a claim under

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56. See *Zuckerman*, 495 A.2d at 398-99.

57. *Id.* at 399.

58. *Id.* at 400.

59. 931 F.2d 166 (1st Cir. 1991).

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a legal malpractice (claims made) policy be given during the policy period, relying upon

[T]he right of the insurer to set its future premiums and reserves with full knowledge of the outstanding claims it is obligated to meet, and this circumstance requires strict adherence to the notice requirement....<sup>60</sup>

Similarly, in *Esmailzadeh v. Johnson & Speakman*,<sup>61</sup> the court found the notice provision in a legal malpractice policy to be unambiguous and enforced the provision according to its terms, stating:

[T]he insurance company must keep the promise it made. But it was not paid to keep, nor should it be held to, a promise plainly not within the unambiguous language of the policy.... Under this kind of policy, the company clearly disclaims the risk of failure on the part of its insured to give it timely notice. Presumably the premium is therefore lower than it would otherwise have been.<sup>62</sup>

In *Burns v. International Insurance Co.*<sup>63</sup>, the court enforced the time limits for providing notice of a claim under a directors' and officers' liability policy and stated:

The social utility of claims made policies has been well documented.... The actuarial certainty of a claims made policy enables an insurer to attain a level of predictability unattainable under standard occurrence policies. This heightened predictability *translates* into significantly lower costs to consumers. An indispensable component of that predictability is the ability of the insurer to close its books on a policy. This enables an insurer to be more precise in calculating its necessary reserves and future premiums, among other things. The notice-prejudice rule is antithetical to this type of certainty and serves as a disincentive for insurers to offer this reduced-rate coverage.<sup>64</sup>

In affirming the district court's decision, the Ninth Circuit stated:

A claims-made policy reduces the potential exposure of the insurer and is therefore less expensive to the insured. To apply the notice-prejudice rule to a claims-made policy would be to rewrite the policy, extending the policy's coverage at no cost to the insured.<sup>65</sup>

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60. *Id.* at 168-69.

61. 869 F.2d 422 (8th Cir. 1989).

62. *Id.* at 425.

63. 709 F. Supp. 187 (N.D. Cal. 1989), *aff'd*, 929 F.2d 1422 (9th Cir. 1991).

64. *Id.* at 191 (citation omitted).

65. *Burns v. Int'l Ins. Co.*, 929 F.2d 1422, 1425 (9th Cir. 1991).

Other courts have noted the distinction between “claims made” and “occurrence” policies and recognized the importance of enforcing the notice provision in the “claims made” policy.<sup>66</sup>

Thus it is important to recognize and strictly enforce time limits for providing notice of loss in a “claims made/ discovery” policy such as the Financial Institution Bond, since it is on the basis of such time limits that the insurer can effectively calculate its risk. Any other construction would impair or prevent insurers from accurately calculating risks and establishing premiums, with the likely result that such insurance would become more expensive — and thus possibly unavailable — to insureds. The outside period (in the case of the Financial Institution Bond, 30 days) provided for reporting a loss after termination of a policy must be enforced if insurers are to calculate risks effectively and price policies accordingly.

### C. There are Public Policy Reasons Unique to the Financial Institution Bond Which Mandate Strict Enforcement of its Notice Provision

Additional reasons unique to the Financial Institution Bond justify strict enforcement of its notice provision without requiring a showing of prejudice in order to deny coverage.

#### *1. Strict enforcement of the bond’s notice provision is essential to the maintenance of the integrity of the policy.*

As discussed above, the notice requirement in the Financial Institution Bond is triggered by the discovery of a loss.<sup>67</sup> Courts have recognized that ascertaining this point of discovery may prove to be a difficult task indeed. As one court has recognized, “serious difficulties inhere in pinpointing the exact time of discovery of a loss under [a fidelity bond].”<sup>68</sup> Thus, unless the

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66. See, e.g., *FDIC v. Mijalis*, 15 F.3d 1314, 1330 (5th Cir. 1994) (“[N]otice provisions are integral parts of claims made policies.”); *J.I. Corp. v. Fed. Ins. Co.*, 920 F.2d 118, 120 (1st Cir. 1990) (recognizing fidelity bond as “claims made” policy and enforcing notice provision as written); *Nat’l Union Fire Ins. Co. of Pittsburgh, Pa. v. Bauman*, 1991 U.S. Dist. LEXIS 18668 at \*18 (N.D. Ill. Jan. 2, 1992), *aff’d sub nom.* (“Because the reporting requirement in a claims made policy helps define the scope of coverage under the policy, such reporting requirements are strictly construed.”); *Nat’l Union Fire Ins. Co. of Pittsburgh, Pa. v. Baker & McKenzie*, 997 F.2d 305 (7th Cir. 1993); *City of Harrisburg v. Int’l Surplus Lines Ins.*, 596 F. Supp. 954, 962 (M.D. Pa. 1984), *aff’d mem.* 770 F.2d 1067 (3d Cir. 1985) (“In a claims-made policy, the provision requiring notice...provides a certain date after which an insurer knows that it no longer is liable under the policy, and accordingly, allows the insurer to more accurately fix its reserves for future liabilities and compute premiums with greater certainty.”); *accord Thoracic Cardiovascular Assocs. v. St. Paul Fire & Marine Ins. Co.*, 1994 Ariz. App. LEXIS 201 (Sept. 13, 1994); *Pac. Employers Ins. v. Sup. Ct.*, 270 Cal. Rptr. 779 (Cal. App. 1990); *Gulf Ins. Co. v. Dolan, Fertig & Curtis*, 433 So. 2d 512 (Fla. 1983).

67. See *supra* sections I and IV.A.

68. *Nat’l Newark & Essex Bank v. Am. Ins. Co.*, 385 A.2d 1216 (N.J. 1978).

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Financial Institution Bond's requirement that notice be given within thirty days after discovery were strictly enforced, an insured would potentially be able to manipulate its coverage by effectively "backdating" the time of discovery. Take the following hypothetical: Suppose an insured is covered under a Financial Institution Bond which expires December 31, 1996. Suppose this insured discovers a loss on February 15, 1997 (after the expiration of the policy period). Such a loss obviously would not be covered under the Bond since the Bond only covers losses discovered during the policy period. At the end of business on January 31, 1997 (the last day that notice of loss could be given), the insurer under the policy would be entitled to "close its books" and calculate its risk and premiums on the basis that there will be no further claims under the Bond. However, if the notice provision were not strictly enforced, the insured would then be able to assert that it discovered the loss during the policy period (for example, in November of 1996). The insured might then be in a position to manipulate the facts concerning when the discovery was actually made, and thereby attempt to invoke coverage for an uncovered loss. Since, as courts have recognized, the exact time of discovery under a fidelity bond is often difficult to ascertain, the insurer may then have difficulty demonstrating that the discovery really took place after the expiration of the policy period. A proper mechanism to protect against this type of potential abuse and therefore maintain the integrity of the policy is to enforce strictly the notice provision as agreed upon by the parties.

In addition, Section 12 of the Financial Institution Bond provides that:

This bond terminates as to any Employee...as soon as any Insured, or any director or officer not in collusion with such person, learns of any dishonest or fraudulent act committed by such person at any time....

Termination of the bond as to any Insured terminates liability for any loss sustained by such Insured which is discovered after the effective date of such termination.

Thus, under the Bond, coverage terminates as to a particular employee upon the discovery of dishonest activity by that employee. Assuming such dishonest activity is of the type that gives rise to a claim under the Bond, failure to strictly enforce the notice provision may again result in the insured being in a position to manipulate its coverage. Consider the following hypothetical: Assume certain dishonest activity of employee A giving rise to a bond claim was discovered on September 1, 1996 and that the insured failed to give notice of its claim for several months. Suppose three months later on December 1, 1996, still before any notice is given, another loss is discovered resulting from the dishonest acts of employee A. However, suppose this loss is much greater than the first loss discovered three months earlier. Under Section 12, the Bond terminated as to employee A on September 1, 1996, such that the loss discovered on December 1, 1996 was not covered. However, if the notice provision were not strictly enforced, the

insured now has an incentive to assert that the second loss was really discovered back in August of 1996 (before discovery of the first loss on September 1, 1996) and thereby invoke coverage for the greater loss. Conversely, if the notice provision were strictly enforced, the insured would not be able to accomplish the foregoing scheme since the insurer would have an absolute defense of late notice. Again, strict enforcement of the notice provision is a proper mechanism to prevent this type of potential fraud and abuse.

*2. The financial institution bond is a product of equal bargaining between the insurance and banking industries and, therefore, its provisions should be enforced as written and not construed against the insurer.*

Many jurisdictions follow a rule that an insurance contract should be liberally construed in favor of the insured since the insurer drafted the document and the insured had little choice concerning its terms and conditions. This rule should not be applied with respect to the Financial Institution Bond because the banking industry collaborated with the insurance industry in determining the terms of the standard bond form and thus had input and bargaining power as to its terms and conditions. This fact was recognized by the Third Circuit in *Oritani Savings & Loan Assoc. v. Fidelity & Deposit Co.*<sup>69</sup>, where the court described the financial institution bond as “a particularized type of insurance policy which was partly drafted and widely discussed in the insured banking industry.”<sup>70</sup> The court further noted that “[t]he banking industry certainly had some bargaining power to effect changes in the language” of the bond.<sup>71</sup>

The Financial Institution Bond, therefore, is the result of the equal bargaining power of both the banking and insurance industries and is not a “take it or leave it” contract. Accordingly, no public policy mandate exists to ignore the unequivocal language of the Bond requiring as a condition to recovery thereunder, that notice be given within 30 days of discovery of loss. To hold otherwise would result in an “unbargained-for expansion of coverage, gratis, resulting in the insurance company’s exposure to a risk substantially broader than that expressly insured against in the policy.”<sup>72</sup> Similarly, because of the bargaining power of the banking industry in connection with the drafting of the standard Financial Institution Bond, courts also recognize that there is no basis for construing any ambiguous provision

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69. 989 F.2d 635 (3d Cir. 1993).

70. *Id.* at 642.

71. *Id.*; see also *United States Fire Ins. Co. v. FDIC*, 981 F.2d 850, 851 (5th Cir. 1988); *Sharp v. FSLIC*, 858 F.2d 1042, 1044 (5th Cir. 1988); *Calcasieu-Marine Nat’l Bank v. Am. Employers’ Ins. Co.*, 533 F.2d 290, 296 (5th Cir.), cert. denied, 429 U.S. 922 (1976); *Shearson/Am. Express, Inc. v. First Cont. Bank & Trust*, 579 F. Supp. 1305, 1311 (W.D. Wis. 1984).

72. See *Zuckerman*, 495 A.2d at 406.

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of the bond against the insurer.<sup>73</sup> Thus, even if the notice provision in the Financial Institution Bond could somehow be argued to be ambiguous, this would not be a basis for construing them against the insurer.

Furthermore, the Financial Institution Bond - Standard Form No. 24, is used throughout the banking insurance industry.<sup>74</sup> Refusing to enforce the notice provision in a policy which is standard in the banking insurance industry would be an “inequitable and unjustified” modification of the coverage expected and provided throughout the industry similar to that addressed by the New Jersey Supreme Court.<sup>75</sup>

There is simply no reason why, in a dispute between a bank and an insurance company with respect to a contract negotiated by their respective industries, a court should intervene and rewrite the terms of the parties’ contract.

## V. CONCLUSION

Courts have reached different results with respect to whether a notice provision in an insurance policy should be strictly enforced such that no prejudice need be shown from late notice in order to deny coverage. Sound reasons exist in both existing precedent and public policy to strictly enforce the condition and limitation of the Financial Institution Bond that notice of the discovery of a loss be given at the earliest practicable moment, not to exceed 30 days, after such discovery.

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73. See, e.g., *Oritani*, 989 F.2d at 642, note 3; *United States Fire*, 981 F.2d at 851; *Calcasieu-Marine*, 533 F.2d at 296 note 6; *Shearson/American Express*, 579 F. Supp. at 1311.

74. See DIGEST OF BANK INS., at 62-63 (5th ed.).

75. See *Zuckerman*, 495 A.2d at 406.