

WHAT DID THEY KNOW AND WHEN DID THEY KNOW IT, WHO ARE “THEY” ANYWAY, AND WHAT DIFFERENCE DOES IT MAKE – IMPUTATION UNDER THE FINANCIAL INSTITUTION BOND AND ITS IMPLICATION FOR COVERAGE

Karen Wildau & Marlo Orlin Leach

I. INTRODUCTION

Perhaps one of the most often litigated fidelity bond issues is whether the insured “discovered” the loss within the terms of the bond, and thereafter complied with the notice provisions of the bond. This issue has been the subject of considerable litigation, as the insurer will frequently deny coverage on the grounds that the insured failed to discover the loss during the bond period, or that the insured failed to provide timely notice to the insurer. Resolution of these issues requires a factually intensive investigation into who knew what, when they knew it, and what that knowledge meant.

Section 3 of the standard form Financial Institution Bond¹ provides:

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 a 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 be known.

1. Financial Institution Bond, Standard Form No. 24 (revised Jan. 1986), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS’N OF AMERICA).

Karen Wildau is a partner and Marlo O. Leach is an associate with Powell Goldstein, Frazer & Murphy LLP, Atlanta, Georgia.

Many of the readers of this article have drafted, redrafted, interpreted, and litigated the meaning of “discover,” “aware,” “reasonable person,” “assume,” “loss,” and almost every other word in Section 3, but surprisingly, the question of who is the “insured” for purposes of discovery is one that has not been as widely examined as would be expected or hoped. At first blush, the obvious answer rests on the basic corporate principle that the corporate insured can act only through its agents, employees, officers or directors. Applying that standard to Section three, it is easily argued that the insured is deemed to have discovered a loss when any of its employees, officers, or directors become aware of facts sufficient to cause a reasonable person to assume a loss has been or will be incurred. This general formula oversimplifies the analysis, however, and ignores the complexities involved in determining whether the knowledge of a particular agent constitutes the knowledge of the insured. This article addresses the above complexities, catalogues and explores how the courts have treated them, and offers an approach that takes into account both the realities of corporate life and the basic principles of agency law.

II. POWER, AUTHORITY OR A PAYCHECK: THAT IS THE QUESTION

The case of *Fidelity and Deposit Co. of Maryland v. Courtney*² serves as a good starting point to analyze the evolution of discovery issues as they pertain to fidelity bonds. In *Courtney* the court interpreted a contractual provision regarding termination of coverage. According to the provision at issue, if the employer condoned an act or default of an “employee which would give the employer the right” to make a claim, subsequent losses caused by the employee would not be covered. The United States Supreme Court noted that a corporation acts only through its officers and agents, but nevertheless held that the “condoning” by the employer which would trigger the termination clause could only be done by the bank’s governing body,

[i]ts board of directors, or by a superior officer, such as the president of the bank, having a general power of supervision over the business of the corporation, and vested with the authority to condone the wrongdoing or to discharge a faithless employee. That is to say, the stipulation in all its aspects undoubtedly related to the bank, acting through its board of directors or through an official who, from the nature of his duties, was in effect the vice principal of the bank³

2. 186 U.S. 342 (1902).

3. *Id.* at 363.

Thus, the Court held that although the bank's vice president and director had actual knowledge of the dishonest acts of the bank's president, because a majority of the board of directors lacked such knowledge, their knowledge did not constitute the "employer's condoning the President's acts." The knowledge of the bank's vice president and director was insufficient to trigger the termination provision.⁴

The ruling in *Courtney* suggests a strict adherence to the corporate hierarchical structure so that, in the context of determining discovery, only the knowledge of those persons who "run" the corporation can be imputed to it. This ruling strongly favors insureds because discovery will not be found to have occurred unless the most powerful person in the company had knowledge of an employee's defalcation such as would vitiate coverage. Of course, rarely in modern times does one individual have exclusive control over, much less all encompassing knowledge of, the business of a corporation. Rather, it is common for numerous persons to have some degree of authority or supervisory control, making the ruling in *Courtney* at best outdated.

Taking into account modern corporate practice in the context of a determination of when a loss has been discovered, many courts began to focus on whether the scope of the agent's authority included the duty to investigate and disclose potentially fraudulent conduct, rather than simply on the position of the agent. That is not to say, however, that there are no vestiges of *Courtney* remaining. Many courts still require that the person whose knowledge is to be imputed to the bank maintain at least some position of authority or control.⁵

4. See also *American Bonding Co. of Baltimore v. Spokane Bld. and Loan Society*, 130 F. 737 (9th Cir. 1904).

5. See, e.g., *Mercedes-Benz of N. Am., Inc. v. Hartford Acc. & Indemn. Co.*, No 89-56011, 1992 U.S. App. LEXIS 19825 (9th Cir. Aug. 24, 1992) (knowledge of an employee's prior dishonesty possessed by manager of parts plan was sufficient to terminate coverage); *Calif. Un. Ins. Co. v. Am. Diversified Savings Bank*, 948 F.2d 556, 563 (9th Cir. 1991) (where bank receiver sought to recover for loss incurred due to defalcations of bank officers, discovery occurred when an "officer, director, general counsel or some other person in a position of responsibility became 'aware of facts which would cause a reasonable person to assume a loss'" occurred); *First Nat'l Bank of Sikeston v. Transamerica Ins. Co.*, 514 F.2d 981 (8th Cir. 1975) (in action by bank to recover under bankers bond for fraudulent conduct of bank president, knowledge of key employees and officers obtained in the course of their employment was imputable); *FDIC v. DeLoitte & Touche*, 834 F. Supp. 1129, 1138 (E.D. Ark. 1992) (in a professional malpractice case, the court held that "imputation may not be appropriate in cases where the relevant knowledge is held by an agent who does not exercise a sufficient degree of control over the corporation's affairs"); *Kinzer v. Fidelity and Deposit Co. of Md.*, 652 N.E.2d 20 (Ill. App.Ct. 1995) (although the general rule is that a principal is charged with notice of facts within the knowledge of agents, it is so charged only with the knowledge of key employees).

The basis for the change begins with the application of the Restatement (Second) of Agency §272,⁶ which provides that “the liability of a principal is affected by the knowledge of an agent concerning a matter as to which he acts within his power to bind the principal or upon which it is his duty to give the principal information.”⁷ The Restatement, on its face, stands contrary to *Courtney* and many courts have relied, in part, on this section to determine whether the knowledge of an employee should be imputed to the company.

For example, in *Udolf, Inc. v. Aetna*⁸ a corporation that operated a men’s clothing store sued its insurer to recover for a loss it incurred as a result of the misconduct of one of its employees. Auer, the store manager, ran the store in Udolf’s absence. Auer’s job responsibilities included running the daily operations of the store and reporting relevant store activity to Udolf. From 1980 to 1981, one of the plaintiff’s employees misappropriated \$6,000 from the store. Her fraud was discovered by the store’s bookkeeper, who immediately reported her “discovery” to Auer. Rather than report the employee’s conduct to Udolf, they allowed her to repay the money and remain employed at the store. Although she ultimately repaid what she had stolen, from late 1981 to 1983 she again misappropriated funds from the store. Upon discovery of her conduct, she was immediately fired and the company’s two fidelity bond insurers, Aetna Casualty & Surety Company and Fire & Casualty Insurance Company, were promptly notified.

The insurers denied coverage on the grounds that their respective bonds did not apply to acts of a dishonest employee occurring after the insured had knowledge or information that the employee had committed any fraudulent or dishonest act. They argued successfully at trial that because the knowledge of the manager and bookkeeper of the employee’s fraud in 1981 was imputed to the company, the insured could not recover for the losses sustained as a result of her subsequent misconduct. The Connecticut Supreme Court affirmed, relying in part on §272 of the Restatement (Second) of Agency⁹, but the court limited its application only to those employees who possess a position of management or control:

We conclude that the knowledge of an employee may be imputed to an employer under an employee dishonesty insurance policy if the employee holds a position of management or control in the exercise of which a duty to report known dishonesty of a fellow employee can be found to exist either explicitly or by fair inference from a course of conduct. The knowledge of individual

6. RESTATEMENT (SECOND) OF AGENCY §272 (1984).

7. *Id.*

8. 573 A.2d 1211 (Conn. 1990)

9. RESTATEMENT, *supra* note 6.

officers and employees at a certain level of responsibility will be deemed the knowledge of the corporation; where the level of responsibility begins must be discerned from the circumstances of each case.¹⁰

The court in *Udolf* was careful to limit its holding so as only to impute the knowledge of those corporate employees who hold a position of management or control and who have a duty to report dishonesty, rather than applying the principle of imputation to each and every employee. Several courts have echoed this ruling.¹¹

A number of courts do not feel constrained to limit imputation only to those agents with some degree of management or control. Instead, they adhere to §272 of the Restatement and focus on whether it was within the scope of the agent's authority to discover, investigate, or report the fraud. In *Peoples State Bank v. American Casualty Co. of Reading, Pa.*,¹² for instance, the bank's vice president of installment loans defrauded the bank of over five million dollars through a scheme in which he filled out loan applications and signed them with the names of fictitious persons, signed notes with the false names, and signed fraudulent UCC-1 forms. He then either directed the loan proceeds to himself or to the accounts of "others," or he used the proceeds to make payments on fraudulent loans he previously created. To accomplish the latter, he issued cashier's checks and money orders payable to the bank or to the false borrower and presented them to bank tellers along with a payment coupon. In 1989 or 1990, one of the bank tellers noticed that the signatures on the checks presented to her by the vice president all looked the same. Shortly thereafter, she realized that the checks were in the handwriting of the vice president. The teller proceeded to make notations whenever the vice president presented checks to her, but it was not until 1991, when she ran a computer check of the vice president's transactions, that she learned that the borrowers' names on the loans did not match the payee names on the checks used to make payments on the loan.

The teller told a bank officer what she had discovered, and a month later the bank notified its insurer of its claim for the loss it sustained as a result of the vice president's fraud. American Casualty Insurance Company denied coverage and moved for summary judgment on the grounds that the bank

10. *Id.* at 1214 (quoting *Gordon Sel-Way, Inc. v. Spence Bros., Inc.*, 440 N.W.2d 907 (Mich. App. 1989)).

11. *See, e.g.*, *Mercedes-Benz of N. Am., Inc. v. Hartford Acc. & Indemn. Co.*, No 89-56011, 1992 U.S. App. LEXIS 19825; *Calif. Un. Ins. Co. v. Am. Diversified Savings Bank*, 948 F.2d at 563; *First Nat'l Bank of Sikeston v. Transamerica Ins. Co.*, 514 F.2d 981; *FDIC v. DeLoitte & Touche*, 834 F. Supp. at 1138; *Kinzer v. Fidelity and Deposit Co. of Md.*, 652 N.E.2d 20.

12. 818 F. Supp. 1073 (E.D. Mich. 1993).

discovered the vice president's fraud prior to the effective date of the bond or, alternatively, that the bank failed to notify it within thirty days of discovery. The court denied American Casualty's motion and held that it could not rule as a matter of law whether it was within the scope of the bank teller's employment to investigate the propriety of transactions presented to her by an officer of the bank. If it were within her authority, the court's ruling suggests that imputation would be proper. The court noted that although it was within the teller's authority to verify signatures and to refuse to cash forged checks, the teller claimed she was not responsible for determining the validity of transactions presented to her by a bank officer. Thus, although a bank teller is not in a position of upper management or even a "key" employee, so long as her job responsibilities included investigating transactions by a bank officer, imputation may be appropriate.

Peoples State Bank was not the first case to apply strict agency principles to determine whether imputation is proper irrespective of the level of the agent with the company. In *Columbia Union National Bank v. Hartford Accident & Indemnity Co.*¹³ the bank sought to recover under Insuring Clause B (loss of property through false pretenses) of a bankers blanket bond. It was alleged that certain defendants organized a company, High Point of the Midwest, in contemplation of the bankruptcy filing of two other companies. High Point was established to conceal and divert the assets of the other two companies. The bankruptcy trustee alleged that the bank continued to accept checks by mail made payable to the bankrupts, deposited them in the High Point account, and honored checks drawn on the account for several months after knowledge of the bankruptcy. The trustee sought to recover the funds it claimed were improperly deposited into the High Point account. Accordingly, the bank notified its insurer of its potential liability to the bankruptcy trustee.

One of the issues addressed by the court (although not addressed with respect to notice) was whether the knowledge of *any* bank employee, acting within the scope of his or her employment, that checks payable to the bankrupt company were being deposited into the High Point account, was imputable to the bank. The insurer contended that "knowledge to the bank can be established by a showing of knowledge of any employee acting in the scope of their employment. It is not necessary that the employee be an executive officer of the bank."¹⁴

13. 496 F. Supp. 1263 (W.D. Mo. 1980).

14. *Id.* at 1277.

The court held that the “knowledge of the mailroom clerks of the continuing deposits, gained while acting within the scope of their individual authority, is legally imputed to” the bank.¹⁵ The mailroom tellers’ job responsibilities included reviewing all mail deposits for proper endorsements and reporting improper endorsements. The court therefore disregarded the level of the employee and focused only on the authority of the clerks.¹⁶

Some courts, in applying strict agency principles, have imputed the knowledge of outside counsel to find notice or knowledge. In *First National Bank of Louisville v. Lustig*,¹⁷ for instance, the bank brought an action to recover under a banker’s bond for losses it incurred as a result of the fraudulent acts of the bank’s loan officer. The bank asked the court to reconsider its prior ruling that knowledge of outside counsel would be imputed to the bank. The court denied the motion and held that the bond expressly provided that the automatic termination clause was triggered upon the insured, or any director or officer, learning of an employee’s dishonesty. The court reasoned that the fact that the bond included the phrase “or any director or officer” did not restrict the definition of “insured” for purposes of imputation, only to directors or officers. Because a bank “can act only through its agents, an agent of the insured may learn of dishonest or fraudulent acts within the scope of his authority on behalf of the insured.”¹⁸

Similarly, in *Lafayette Bank and Trust Co. v. Aetna Casualty & Surety Co.*¹⁹ the bank brought suit under a blanket bond to recover loss arising out of a forged promissory note. The court held that a delay of twenty two weeks after notice of the forgery to outside counsel failed to constitute notice at the “earliest practicable moment.” The special role attorneys play probably accounts for the willingness of both courts to impute knowledge of a non employee to the corporation. Beyond perhaps outside auditors, however, there should be few cases where imputation should exceed the corporate boundaries.

Unlike the language of the discovery provision of Section three of the standard form Financial Institution Bond, which simply provides that discovery occurs “when the Insured” becomes aware that a loss has occurred or will occur, it has been argued that Section twelve creates an ambiguity as to the meaning of the term “Insured” as it is used in Section three. The ambi-

15. *Id.* at 1278.

16. *See also* *Globe Indemn. Co. v. First Nat’l Bank in St. Louis*, 133 S.W.2d 1066 (Mo. Ct. App. 1939) (knowledge of employee of minor rank is imputable to the corporation if obtainable within the scope of the employee’s authority).

17. 150 F.R.D. 548 (E.D. La. 1993).

18. *Id.* at 551.

19. 411 A.2d 937 (Conn. 1979).

guity arguably arises because Section twelve, the termination clause, provides that the bond is terminated “as soon as any Insured, or any director or officer not in collusion” with the dishonest employee, learns of the misconduct.²⁰

Some have argued that the omission of the phrase “any director or officer” in Section three suggests a reaffirmation of *Courtney* so that it is only the knowledge of the majority of the board of directors which can be imputed to the bank. This interpretation is incorrect, and is in fact contrary to the current trend in the case law. The language of Section twelve suggests that *Courtney* and its progeny do not set the appropriate standard to be applied to termination clauses. Instead, Section twelve reinforces the notion that the “insured” includes not only officers or directors, but other corporate agents as well. Although having a similar phrase in Section three would have avoided any confusion, its absence does not negate the persuasive argument that “Insured” in Section three includes corporate agents other than just the majority of the board or high ranking officers. The language in the *Lustig* bond is similar to Section twelve of the Financial Institution Bond, and yet the court had no problem imputing the knowledge of outside counsel.

Power or authority, but just not a paycheck: that is the answer. The cases suggest that while there has been a significant departure from strict adherence to corporate hierarchical structure, most courts still require that the employee whose knowledge is to be imputed to the corporation have at least some position of management or control. There are some cases, however, that properly recognize that power should not control the outcome. Those courts focus instead on authority. Refusing to impute the knowledge of an individual whose job responsibility includes discovering and reporting fraud merely because the individual is a lower level employee denies the realities of modern corporate organization and the well accepted and time tested principles of the Restatement of Agency.²¹

III. ALL FOR ONE AND ONE FOR ALL? THE COLLECTIVE KNOWLEDGE STANDARD

Most cases concerning imputation of knowledge for purposes of discovery under fidelity bonds involve a determination of whether a single

20. Accord Paul D. Schoonover, *Discovery, Notice and Automatic Cancellation Under Revised Form 24, XVI, THE FORUM* 962 (1981).

21. See RESTATEMENT, *supra* note 6.

employee's knowledge is sufficient to justify imputation. There are instances, however, where several employees have obtained different knowledge, the sum total of which may be sufficient to constitute knowledge of a particular pattern of conduct. In those cases, the question arises as to whether the collective knowledge of the employees can be imputed to the corporation. The concept of collective knowledge has not yet been applied in the fidelity bond context, but it has been recognized in criminal and environmental cases. These cases could foreshadow a new dimension to the definition of discovery by the insured.

The notion of imputing the collective knowledge of corporate employees has been addressed in cases involving corporate liability for criminal violations of public safety regulations. For example, in *United States v. T.I.M.E.-D.C., Inc.*²² the government charged the defendant, an interstate motor carrier, with criminal violation of the Federal Highway Administration regulation, which forbids drivers from operating motor vehicles if their ability or alertness is impaired. The defendant had been experiencing problems with absenteeism, which caused major economic problems for the company. The company responded by altering its absentee policy so that when a driver called in sick and asked to be marked off from his shift, the absence was considered unexcused, but would be corrected if the driver provided a doctor's verification. The government claimed that the company did not inform the drivers that the unexcused absence would be removed upon presentment of proper medical verification, but instead told them only that their absence would be unexcused. Unaware of the true policy, the drivers chose to work rather than incur the penalty of an unexcused absence.

The company denied that it violated the law because it did not know that its employees were driving while impaired. The court, in finding against the company, noted the general rule that the knowledge of employees acquired within the scope of their employment is imputed to the corporation and further held that:

[A] corporation cannot plead innocence by asserting that the information obtained by several employees was not acquired by any one individual employee who then would have comprehended its full import. Rather, the corporation is considered to have acquired the collective knowledge of its employees and is held responsible for their failure to act accordingly.²³

22. *United States v. T.I.M.E. - D.C., Inc.*, 381 F. Supp. 730 (W.D. Va. 1974).

23. *Id.* at 738. *See also* *Inland Freight Lines v. United States*, 191 F.2d 313 (10th Cir. 1951) (collective knowledge of employees was sufficient to establish that company knowingly maintained false driver's logs).

The concept of collective knowledge has also been applied in environmental insurance coverage cases to determine a company's state of mind. In *Upjohn Co. v. New Hampshire Insurance Co.*,²⁴ for example, coverage depended upon whether the event that caused the loss was "expected." Upjohn pumped a chemical by-product into an underground storage tank and each day an Upjohn employee recorded the amount of the by-product in the tank. The employee then gave the record to his supervisor, who reviewed and compared it to prior records. On August 16, 1989, although Upjohn pumped 1700 gallons of the by-product into the tank, it measured only three inches or the equivalent of only eighty gallons. Upjohn pumped 1,700 gallons of the by-product into the tank daily for another two weeks, although measurements continued to show low tank levels inconsistent with the amount pumped into the tank. It was subsequently determined that approximately 15,000 gallons of the toxic by-product had leaked from the tank.

Upjohn sued its insurer, claiming that the clean up cost was covered under its comprehensive general liability policy. The insurer denied coverage on the ground that the policy only covered damage caused by a sudden or accidental discharge. The court ruled that such language meant an "unexpected" release so that if Upjohn expected the leak to occur, the loss was not covered.

The court held that the leak was "expected" by the company because each day the tank level measurements had been recorded by an Upjohn employee, turned over to that employee's supervisor, and reviewed and compared with prior records. Although Upjohn's records indicated that when 1,700 gallons of by-product were pumped into the tank, the tank levels measured only eighty gallons, Upjohn continued to add over 13,600 gallons of the by-product to the tank. The court reasoned that because on August 16 the tank level measured just eighty gallons, Upjohn must have "expected" a leak in the tank. The court noted that a corporation cannot "plead innocence" by asserting that the information obtained by several employees was not acquired by any one individual employee who would have comprehended its full import. "The corporation is considered to have acquired the collective knowledge of its employees and is held responsible for their failure to act accordingly."²⁵ Upjohn, through its employees and its records, had sufficient information available to it to expect a chemical release from the tank.²⁶

24. 476 N.W.2d 392 (Mich. 1991).

25. *Id.* at 400.

26. *Id.* at 401. *But see* *Arco Industries Corp. v. Am. Motorists Ins. Co.*, 531 N.W.2d 168 (Mich. 1995).

The *Upjohn* decision was not surprising because Michigan courts had previously refused to limit the collective knowledge doctrine only to corporate officers or supervisors.²⁷ There was a strong dissent in *Upjohn* in which it was argued that the use of the collective knowledge standard for imputation should be limited to only those “individual officers and employees at a certain level of responsibility to the corporation.”²⁸ At least one court has recognized the concerns raised by the *Upjohn* dissent by noting that to impute the collective knowledge of corporate employees, regardless of their status or position, “would likely paralyze a corporation as upper level management attempted to keep informed of all information known to all of its corporate employees.”²⁹

The court in *Texas Eastern Transmission Co., PCB Contamination Ins. Litigation*³⁰ had to determine whether a comprehensive general liability policy provided coverage for damage caused by the discharge of toxic chemicals from the insured’s compressor stations. The insured objected to being charged with the collective knowledge of its employees in order to determine the intent of the company. The court held that an agent’s knowledge is imputed to the company only if that knowledge was learned in the course of the employee’s employment related activities and the employee was “of a sufficient level of corporate responsibility to justify charging the corporation with that knowledge.”³¹ The court further held that the collective knowledge doctrine would be applied because the focus was not on the subjective intent of the insured, but rather the objective determination of what the corporation is likely to have known. Thus under these circumstances, the Texas Supreme Court would “require the corporation to be charged with the collective knowledge of its employees.”³²

[I]nformation known to corporate employees should not be blindly imputed to the corporation. An inquiry should be made as to whether the employee had a sufficient level of corporate responsibility to justify charging the corporation with that particular bit of knowledge. I do not understand this requirement to mean that an employee must have climbed to a particular rung on the corporate ladder, as [the corporate defendant argued], before an employee’s knowledge will be imputed. Rather, I believe this to mean that the

27. See *People v. Am. Med. Centers of Michigan*, 324 N.W.2ed 782 (Mich. Ct. App. 1982) (contrary to Michigan law to limit imputation of knowledge to only board members, officers or supervisors rather than combining the knowledge of employees).

28. *Id.* at 410.

29. *In re Tx. Eastern Transmission Co., PCB Contamination Ins. Litigation*, 870 F. Supp. 1293 (E.D. Pa. 1992).

30. *Id.*

31. *Id.* at 1307.

32. *Id.* at 1308.

knowledge must be substantially related to the task which the corporation has assigned the employee to perform. Therefore, information known to an employee which relates to the performance of the employee's job will be imputed [to the company].³³

The collective knowledge doctrine also has been applied in the banking context, but only in criminal matters. In *United States v. Bank of New England*³⁴ the bank was convicted of violating the Currency Transaction Reporting Act by failing to report currency transactions greater than \$10,000. The transactions at issue involved the withdrawal by a bank customer of more than \$410,000 through the use of multiple checks. The court rejected the bank's argument that the trial judge erred in charging the jury on the following:

In addition, however, we have to look at the bank as an institution. As such, its knowledge is the sum of the knowledge of all of the employees. That is, the bank's knowledge is a totality of what all of the employees know within the scope of their employment. So, if Employee A knows one facet of the currency reporting requirement, B knows another facet of it, and C a third facet of it, the bank knows them all The bank is also deemed to know [that CTR's had to be filed] if each of several employees knew a part of that requirement and the sum of what the separate employees knew amounted to knowledge that such a requirement existed.³⁵

The appellate court held that such an instruction "is entirely appropriate in the context of corporate criminal liability."³⁶ Because knowledge is compartmentalized in the corporate structure, so that certain duties and operations are subdivided into smaller components, the aggregate of those components is knowledge of the corporation concerning a particular operation.³⁷

The only case that even addresses the collective knowledge doctrine in a fidelity bond context is *People State Bank v. American Casualty Co. of Reading, Pa.*³⁸, discussed above. In that case, the court, in *dicta*, noted that under Michigan law, the "collective knowledge of employees may be imputed to a corporation."³⁹

33. *Id.*

34. 821 F.2d 844(1st Cir. 1987).

35. *Id.* at 855.

36. *Id.* at 856.

37. *Id.*

38. 818 F.Supp. 1073.

39. *Id.* at 1076.

When a person representing a corporation is doing a thing which is in connection with and pertinent to that part of the corporation's business in which he is employed, or authorized or selected to do, then that which is learned or done by that person pursuant thereto is in the knowledge of the corporation. The knowledge possessed by a corporation about a particular thing is the sum total of all knowledge which its officers and agents, who are authorized and charged with the doing of a particular thing acquired, while acting under and within the scope of their authority.⁴⁰

Some courts have refused to apply the collective knowledge doctrine to crimes requiring a showing of specific intent. In *First Equity Corp. of Florida v. Standard & Poor's Corp.*,⁴¹ the court held:

While it is not disputed that a corporation may be charged with the collective knowledge of its employees, it does not follow that the corporation may be deemed to have a culpable state of mind when that state of mind is possessed by no single employee. A corporation can be held to have a particular state of mind only when that state of mind is possessed by a single individual.⁴²

While the conclusion of the court in *First Equity Corp.* might not be directly applicable in the context of a fidelity bond claim, insureds can nevertheless be expected to make a similar argument against application of the doctrine. As with many issues, it may be that resolution of this legal issue will depend largely upon the facts of the case. If those possessing the collective knowledge of the insured are all persons in roles of significant responsibility, it is more likely a court will lean toward applying the doctrine. Ultimately, however, whether this doctrine will be applied in the context of fidelity bond claims remains to be seen.

IV. TO EVERY EXCEPTION, THERE IS AN EQUAL AND OPPOSITE EXCEPTION: THE ADVERSE INTEREST EXCEPTION TO IMPUTATION AND THE ALTER EGO DOCTRINE

When an agent acts adversely to his principal, the general rules concerning imputation will not apply. The Restatement (Second) of Agency §282 provides that where a corporate employee or agent "secretly is acting adversely to the principal and entirely for his own or another's purposes," the knowledge will not be imputed to the company. The financial institution bond also expressly recognizes one form of adverse interest by its reference

40. *Id.*

41. 690 F.Supp. 256 (S.D.N.Y. 1988), *affd.*, 869 F.2d 175 (2nd Cir. 1989).

42. *Id.* at 260 (citing *Kern Oil & Refining Co. v. Tenneco Oil Co.*, 792 F.2d 1380,1386-87 (9th Cir. 1986)).

to collusion. This concept is not foreign to fidelity bond jurisprudence and was recognized as far back as *American Surety Co. v. Pauly*.⁴³ What constitutes “acting adversely” is, however, often hotly debated.

In *Adair State Bank v. American Casualty Co. of Reading, Pennsylvania*⁴⁴ the bank sought to recover under a fidelity bond issued by the defendant, American Casualty, for losses the bank incurred as a result of a check kiting scheme conducted by the bank’s chairman of the board of directors, Harold Dunham. During the course of Dunham’s scheme, which began in May 1985, several other officers became aware of his conduct.

In the summer of 1985 Hall, a bank vice president, cashier, and cousin of Dunham, discovered a correlation between a list of overdrafts from Dunham’s account and a high balance in the bank’s cash items. Hall discussed her “discovery” with Floyd, the bank’s president. Floyd told her that he had spoken with Dunham about the overdrafts and had been assured that Dunham would remedy the problem. Hall did not mention her discovery to any other directors of the bank and continued to hold the checks in cash items, per Floyd’s instructions.

Rice, senior vice president of the bank, manager of a branch office, and Dunham’s cousin, was responsible for reviewing the bank’s reports on cash items and overdrafts. In the summer of 1985, she questioned Hall concerning a high balance in the bank’s cash items. Hall told her that the items were Dunham’s overdrafts and that he was getting a large loan to remove the items. Although the cash items for that month were removed, Rice noticed that they returned shortly thereafter in a large amount. Rice discussed it with Floyd, who assured her that Dunham was obtaining a loan to take care of the matter. Although Rice knew the practice was contrary to the law and the bank’s procedures, she agreed to Dunham’s request that she “not pull the plug.” The FDIC discovered the scheme in March of 1986, and the bank filed a claim under its bond. The insurer denied the claim, contending coverage terminated when the bank first discovered the fraud in 1985.

The court held that the officers’ knowledge could not be imputed to the bank because they were acting adversely to the bank and in collusion with Dunham. The court noted that Floyd’s “participation” was essential for Dunham’s scheme to succeed as Floyd honored Dunham’s checks knowing

43. 170 U.S. 133 (1898). *See also* *FDIC v. Aetna Cas. & Surety Co.*, 426 F.2d 729, 739 (5th Cir. 1970); *Mechanicsville Trust & Savings Bank v. Hawkeye-Security Ins. Co.*, 158 N.W. 2d 89 (Iowa 1968); *Puget Sound Nat’l Bank v. St. Paul Fire and Marine Ins. Co.*, 645 P.2d 1122 (Wash. Ct. App. 1982); *Maryland Cas. Co. v. Tulsa Indust. Loan & Inv.*, 83 F.2d 14,17 (10th Cir. 1936).

⁴⁴ 949 F.2d 1067 (10th Cir. 1991).

there were insufficient funds to cover them and agreed to place the overdrafts as bank cash items. Accordingly, Floyd's knowledge was held to be not imputable to the bank because he "clearly put the interest of his half brother above those of his employer."⁴⁵

The court also declined to impute Rice's knowledge to the bank since she too participated and contributed to the success of Dunham's scheme. Rice, as senior vice president, was responsible for overseeing the operation of the bank. She submitted reports to the board that she knew hid facts that would have led to the discovery of Dunham's fraudulent activities. When Rice realized the scheme would ultimately be discovered, rather than reporting Dunham's conduct, she sold her shares in the bank.

Similarly, the court held that without the assistance of Hall, the secretary and cashier to the bank, Dunham's scheme would have failed. Hall was responsible for preparing reports to the board of directors but never reported Dunham's conduct, and instead followed Floyd's instructions to hold Dunham's checks as cash items, knowing this procedure violated bank policy.

The *Adair* case is of particular interest because none of the bank officers stood to gain personally from the wrongdoer's behavior, which is the usual case when the adverse interest exception applies. Yet there is little doubt the officers' behavior was so adverse to the bank's interest that the court felt justified in labeling it collusion, despite the insurer's arguments regarding the absence of an express conspiracy to defraud. Indeed, there is often a fine line between an agent who is in collusion with another and an agent who has information of another employee's misconduct but for one reason or another fails to inform the insured.⁴⁶

*Federal Deposit Insurance Corp. v. Lott*⁴⁷ is also interesting because the court applied the adverse interest exception despite some significant knowledge by the board of Lott's activities. While the board could not be said to have participated or assisted Lott, a finding of imputation would not have been extraordinary under the circumstances. In *Lott*, the court held that knowledge of Lott, the bank's president, was not imputable to the bank

45. *Id.* at 1073.

46. *Compare* FDIC v. Aetna Cas. & Surety Co., 947 F.2d 196 (6th Cir. 1991), where the court upheld a jury charge that allowed silence by the bank officers with knowledge of employees' dishonesty to be considered evidence of collusion with City Bank in *Wellington v. United States Fidelity & Guaranty Co.*, 778 F.2d 1103 (5th Cir. 1985), where the court imputed the knowledge of a bank vice president and director who together with the bank's president had a financial interest in a borrower and knew the president was involved in a kiting scheme.

47. 460 F.2d 82 (5th Cir. 1972).

because he was acting alone and adversely to the bank. A state banking department examination criticized the bank for two lines of credit extended in excess of the bank's legal loan limit. Lott held an interest in one of the companies to which credit was extended. The examination revealed that both accounts had overdrafts that had been held as cash items for several weeks. A year later, it was again noted that the holding of the cash items resulted in an excessive and illegal loan. The examiner explained his report to Lott as well as to two other bank directors. Those directors discussed the situation with Lott, who assured them that he was correcting the problem. The examiner took no further action because he believed Lott would take the necessary remedial action.

A later examination revealed excessive loans made to the same two accounts. The examiner wrote to the board of directors criticizing the loans. Lott was also asked by the banking department to attend a personal conference with the department. Lott did not tell the board of the letter or his attendance at the meeting. When Lott received the department's reports, he read them to the board but excluded those portions critical of the two accounts. The directors knew only that there were some excessive loans on the accounts, but Lott had reassured them that he was taking care of the problem. In the past, Lott had properly corrected other excessive loans without board approval.

The insurer denied coverage on the grounds that the notice was too late because Lott's knowledge of his wrongful conduct was imputed to the bank. Because the directors had been assured by Lott that the problems noted by the examination would be remedied, the first bank examination report had noted that the illegal loan excesses had been corrected, an FDIC examination reported that prior violations in one of the accounts had been rectified, and Lott had concealed material information from the directors, the court held that it was reasonable for the jury to have concluded that the directors thought the irregularities were being corrected and were not the result of fraudulent or dishonest criminal acts by Lott. Their knowledge, therefore, was not imputed to the bank for notice purposes.⁴⁸ The court held that because Lott "fraudulently dealt with the bank in his own interest, he is deemed to have an adverse interest in the knowledge possessed by him and the transaction is not imputable to the bank."⁴⁹

Determining whether an agent is adverse *enough* is not always straightforward. Several cases outside the fidelity bond context provide examples of

48. *Id.* at 87.

49. *Id.* at 88.

how an agent might be acting in his own interest, while also benefiting the principal. For example, in *LanChile Airlines v. Connecticut General Life Insurance Co. of North America*,⁵⁰ the plaintiff airline company, after learning that the insurance premiums it paid on its employees' health insurance policy would increase by forty-six percent, directed its agent, Rodriguez, to obtain group health insurance at a lower cost. Rodriguez, unbeknownst to LanChile, was a partner in S&M Insurance Consultants. Rodriguez and his partner Melena, an agent of CIGNA, which did not know of his involvement in S&M, sold an insurance contract to LanChile that provided a five percent decrease in the overall cost of LanChile's premiums. LanChile paid its premium directly to S&M rather than to CIGNA for four years until it discovered that its premium included certain administrative/consulting fees for S&M.

The issue before the court was whether Rodriguez's knowledge of his interest in S&M was imputable to LanChile. The court noted that "the mere fact that the agent's primary interests are not coincident with those of the principal does not prevent the latter from being affected by the knowledge of the agent if the agent is acting for the principal's interests."⁵¹ The court ruled that it would not decide as a matter of law whether Rodriguez's action in charging LanChile for insurance in an amount in excess of the actual cost was adverse to LanChile. While Rodriguez retained a portion of the premiums paid by LanChile as an undisclosed fee, he did arrange for the necessary insurance at a rate lower than what LanChile had previously paid.

The court's ruling suggests that because Rodriguez assisted LanChile in reducing its insurance costs, as he was requested to do, the company was not harmed by its agent's conduct, and even benefited from it. That LanChile benefited from Rodriguez's conduct does not eliminate the impropriety of Rodriguez's conduct, but there is merit to a ruling that suggests that where there is "no harm no foul," the adverse interest exception might not be appropriate.⁵²

Acting adversely was an equally slippery concept in two important and often cited accounting malpractice cases. In *Schact v. Brown*⁵³ the court refused to impute the knowledge of corporate directors' fraud because the corporation was harmed by permitting it to be fraudulently continued past the point of insolvency, benefiting only corporate managers and not the

50. 759 F. Supp. 811 (S.D. Fla. 1991).

51. *Id.* at 814.

52. *Id.* (quoting *Comeau v. Rupp*, 810 F. Supp 1127 (D.Kan. 1992)).

53. 711 F.2d. 1343 (7th Cir. 1983).

corporation. In *Cenco, Inc. v. Seidman & Seidman*⁵⁴ accountants successfully defended a malpractice claim by urging imputation of top management's fraud. The court held that because the fraud primarily affected outsiders and was perpetrated by corrupt managers, it was assumed that management was acting for the benefit of the company even though after the fraud was unmasked, the corporation could be liable for damages.⁵⁵

No matter how detrimental an agent's actions, the adverse interest exception does not apply if the agent acting adversely is the "sole representative" or alter ego of the corporation.

The 'sole representative' or 'sole actor' doctrine is an exception to the adverse interest exception. In cases where the business or transaction in question is entrusted to an officer or agent of the corporation as its sole representative, the adverse interest exception does not apply and the knowledge of the officer or agent is imputable to the corporation. The reason for the rule is that, where the officer in question is the sole representative of that corporation, there is no one to whom to impart his knowledge and no one from whom he may conceal it.⁵⁶

The "alter ego" defense has often been raised successfully in fidelity bond cases. For example, in *Federal Deposit Insurance Corp. v. American Surety Co. of New York*,⁵⁷ the court applied the alter ego or sole actor doctrine to impute the knowledge of the bank president to the bank. The FDIC, as the bank's receiver, filed an action against American Surety for losses the bank sustained as a result of the fraud of the bank president. Morten, the president, director and majority shareholder of the bank was appointed "Committee of John Catron," Mr. Catron having been declared to be of unsound mind. Morten was also a "dominating officer" in the bank who transacted most of the bank's important business affairs. Morten fraudulently converted the assets of the Catron estate to his own use. The court, in determining whether the bank had knowledge of Morten's conduct, held that while there was no doubt that Morten had acted adversely to the bank, Morten was the sole representative of the bank in the transaction and the alter ego of the bank. Virtually all bank stock was owned by either Morten or his family, which made him the "dominating personage in the bank. It was a typical

54. 686 F.2d 449 (7th Cir. 1982).

55. See also *In re Phar-Mor, Inc. Securities Litigation v. Coopers & Lybrand*, 900 F. Supp. 784 (W.D. Pa. 1995) (whether an agent's actions are truly adverse to the corporation depends "on whether the misdeeds of the corporate employee worked to the benefit or detriment of the corporation.")

56. *In re Plaza Mortgage and Finance Corp.*, 187 B.R. 37, 45 n.6 (N.D. Ga. 1995).

57. 39 F. Supp. 551 (W.D. Ky. 1941).

one-man bank.”⁵⁸ Thus, the court applied the sole actor doctrine and imputed the knowledge of the president’s fraudulent conduct to the bank.

Similarly, in *Bosworth v. Maryland Casualty Co.*⁵⁹ a bank president and trustee of a trust used trust funds to pay his personal debt to the bank. Knowledge of his fraud was imputed to the bank because the president directed the business of the bank, was superior to all others, and he “was the bank.”⁶⁰

The sole actor doctrine is not necessarily applied only where the wrongdoer alone controls the corporation. In *First National Bank of Cicero v. Lewco Securities Corp.*,⁶¹ the court noted that there is little authority regarding

how participation in a transaction may render an agent a sole actor. Courts have found an agent to be a sole actor for his principal when the whole procedure ... was entrusted by [the principal] to the initiation and execution of the agent” Alternatively, agents have also been held to be sole actors when they were in “complete control of [the principal’s] affairs,” ... or when “there is not the slightest indication that any officer or employee of the bank except [the agent] exercises any independent choice or judgment.”

The sole actor exception has not been applied where there is evidence that the directors or officers exercise some supervisory role or are in some capacity involved in the transactions at issue. In *Puget Sound National Bank v. St. Paul Fire & Marine Insurance Co.*,⁶² imputation was rejected even though the dishonest employee was both a bank director and president of an insurance brokerage company that steered business to the bank. The bank sought to recover on a loss resulting from its director’s fraudulent insurance premium financing scheme. The bank board approved the director’s proposal to implement an insurance premium financing program managed by the director, whereby the bank loaned money to the director’s clients to fund their insurance premiums. As security for the loans, the insureds assigned the bank their rights to cancel the insurance policies and receive the unearned premiums. If an insured defaulted on a loan, the bank could cancel the policy and recoup its loss from the unearned premiums.

The director had arranged matters so that all contacts between the bank and the loan customers were channeled through him. The bank suffered a

58. *Id.* at 556.

59. 74 F.2d 519 (7th Cir. 1935).

60. *See also* *McKee v. Great Am. Ins. Co.*, 316 F.2d 473 (5th Cir. 1963); *McKee v. Aetna Cas. & Surety Co.*, 316 F.2d 428 (5th Cir. 1963); *Jacobson v. FDIC.*, 407 F. Supp. 821 (S.D. Iowa 1976) (citations omitted).

61. 860 F.2d 1407, 1418 (7th Cir. 1988) (citations omitted).

62. 645 P.2d 1122 (Wash. App. 1982).

loss when it was unable to collect on fraudulent loans arranged by the director. The insurer denied coverage claiming that the director's knowledge of his wrongdoing was imputed to the bank. Although the director acted solely for his own interest and adversely to the bank, the insurer argued that because he was the sole representative of the bank with regard to the premium financing program, the adverse interest exception was inapplicable, and imputation was appropriate. The court refused to apply the sole actor doctrine and impute the director's knowledge to the bank because the premium financing program was subject to review by the board, which had revised the program, a bank loan officer booked the loans, and bank employees prepared the audit notices.⁶³

Despite the *Lewis* court's observation regarding the lack of guidance as to the extent of corporate participation which will preclude the application of the sole actor doctrine, courts are generally loathe to apply the doctrine unless the agent acting adversely to his principal dominates a transaction to the virtual exclusion of the other corporate directors or officers. Financial institution bond cases fairly consistently hold that where the board or other executive officers remain active in bank affairs, or perform at least some of their responsibilities, the sole actor defense will fail.

V. CONCLUSION

The simple answer to the question of who is the insured is a rhetorical response: "Who is the judge?" The answer will often depend on a particular employee's duties and responsibilities, both expressed and implied. And, the same set of facts may lend themselves to several different conclusions. Many courts are still inclined to focus on levels of authority and official control rather than applying a more reasonable and realistic analysis which focuses on the scope of an employee's responsibilities and the relationship between those responsibilities and the conduct of corporate business. The better reasoned analyses properly rely on agency principles which require an inquiry into the authority and duty of the particular agent to "discover"

63. See also *FDIC v. Lott*, 460 F.2d 82 (5th Cir. 1972) (bank director, controlling shareholder and officer was not the sole actor as the other bank directors had not abdicated their directorial responsibilities); *United States Fidelity and Guaranty Co. v. State of Oklahoma*, 383 F.2d 417 (10th Cir. 1967) (sole actor doctrine inapplicable because the bank board met regularly, was active in the bank's affairs, examined the bank examiner's reports and reviewed promissory notes and attendant collateral); *Maryland Cas. Co. v. Tulsa Indus. Loan & Investment Co.*, 83 F.2d 14 (10th Cir. 1936) (bank director was not the sole actor because the bank's board occasionally acted in connection with the transactions at issue); *Aetna Cas. & Surety Co. v. Local Bld. & Loan Assoc.*, 19 P.2d 612 (Ok. 1933) (sole actor doctrine not applicable because embezzler/agent not only agent acting for bank in the transaction).

and to communicate that discovery. If such a duty exists, then whether the discovering employee is an officer or director should make no difference. The decision should turn on the duties of the employee as understood both by the employee and the employer. That “understanding” is frequently the subject of much discovery and intense scrutiny. Such an analysis takes into account both the realities of modern corporate life and the fact that a corporation can only act through its agents and arrive at a reasonable compromise that addresses the fair expectations of both the insured and the insurer.