

## EMPLOYEE DISHONESTY - WHEN DOES YOUR BOND “AUTOMATICALLY TERMINATE”?

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### I. INTRODUCTION

Virtually every fidelity insurance policy provides that coverage for a particular employee ceases when the insured learns that the employee has committed a dishonest or fraudulent act — even if the act took place before, and does not provide the basis for, a claim against the policy. Insurers, courts and commentators universally call this “automatic termination” of coverage. As one author noted, “[ t] his contractual provision is deeply rooted both in common law and common sense, and is one of fundamental fairness. An employer who discovers an individual’s dishonesty should continue to employ that individual only at the employer’s own peril as to further losses, not at the peril of the insurer. This self-policing concept is at the heart of every fidelity bond.”<sup>2</sup> It also provides an absolute defense to any claim arising from the employee’s later dishonest acts.

Several issues commonly arise regarding automatic termination. First, whether the employee committed the type of act that meets the policy standards for termination. Second, when the insured “discovered” the act. “Discovery” in turn raises other issues, such as who at the insured knew of the facts and whether to impute that person’s knowledge to the insured. In addition, courts are sharply divided over whether to define discovery in objective terms (what a reasonable person knew or should have known) or subjective terms (what the insured actually knew and believed). A related issue involves whether the insured had a duty to inquire into suspicious circumstances. Finally, once “discovery” occurs, the courts must address exactly how the discovery impacts coverage.<sup>3</sup>

Any discussion of automatic termination, however, must begin with the particular bond language. Several courts have hesitated either to announce or rely on general rules, because the insured’s obligations and the insurer’s rights are

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<sup>1</sup> The authors gratefully acknowledge the assistance of Jana Maria Fried in the research and preparation of this paper.

<sup>2</sup> Michael B. McGeehon and Martin O’Leary, *Termination of Coverage, in Handling Fidelity Bond Claims*, 456 (ABA 1999).

<sup>3</sup> Although this article will address many issues in detail, it is not an exhaustive survey of every automatic termination case. Instead, the article will focus on cases that offer analysis or discussion useful in developing general standards for evaluating automatic termination, as opposed to cases that are purely fact-oriented.

contractual, not statutory or common-law matters.<sup>4</sup> As a result, holdings in particular cases might not extend to other cases involving different bond language.

## II. THE USUAL PROVISIONS

The FINANCIAL INSTITUTION BOND, Standard Form 24 (Rev. 1986), along with Form 14 for Stockbrokers (1987), Form 15 for Finance Companies (1990), and Form 25 for Insurance Companies (1987), all state that:

This bond terminates as to any Employee or partner, officer, or employee of any Processor: (a) as soon as the 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, whether in the employment of the Insured or otherwise, whether or not of the type covered under Insuring Agreement (A), against the insured or any other person or entity, without prejudice to the loss of any Property then in transit in the custody of such person . . . .

The 1980 COMMERCIAL BLANKET BOND and 1980 COMPREHENSIVE DISHONESTY, DISAPPEARANCE AND DESTRUCTION (“3-D”) POLICY state that:

Section 12. This Bond shall be deemed cancelled as to any Employee: (a) immediately upon discovery by the Insured, or by any partner or officer thereof not in collusion with such Employee, of any fraudulent or dishonest act on the part of such Employee. . . .

The CURRENT ISO COMMERCIAL CRIME POLICY, EMPLOYEE DISHONESTY COVERAGE FORM (COVERAGE FORM A—BLANKET) states that:

This insurance is cancelled as to any “employee:”  
a. Immediately upon discovery by:

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<sup>4</sup> In re Prime Commercial Corp., 187 B.R. 785 (N.D. Ga. 1995)(“[T]he duty to give notice under a fidelity policy is a contractual duty, not a duty that the law defines without reference to the policy at issue. . . . Rather than begin with general ‘rules’ concerning notice, it is appropriate to begin with the policy.”); Boston Mutual Life Ins. Co. v. Fireman’s Fund Ins. Co., 613 F.Supp. 1090 (D. Mass. 1985)(When evaluating state of mind necessary for discovery, “the answer cannot be found by comparing the number of decisions applying subjective standards with the number applying objective standards . . . the contract between the parties is to be construed and enforced in accordance with the manifested intent of the parties.”)

- (1) You; or
  - (2) Any of your partners, officers or directors not in collusion with the “employee”;
- of any dishonest act committed by that “employee” whether before or after becoming employed by you.

The upshot of these various iterations is that (1) the bond terminates as to an individual (2) as soon as the insured learns of any dishonest or fraudulent act committed by that individual.

As the case law shows, however, these form provisions are by no means the only ones out there. Regarding the state of mind necessary for termination, some policies require that the insured have “knowledge or information” regarding the fraudulent or dishonest act.<sup>5</sup> Regarding the type of act necessary for termination, some bonds require an “act . . . which is or could be the basis of a claim under this Bond.”<sup>6</sup> Still others require “dishonest or criminal” acts.<sup>7</sup>

Other bonds place specific limits on the types of dishonest acts that terminate coverage. The most typical limitation involves discovery of dishonest acts in prior employment, and requires the acts to reach a dollar threshold, often \$10,000.00, before coverage terminates.<sup>8</sup>

Despite the variations in policy language, the cases show fairly defined patterns of interpretation. Most automatic termination clauses contain similar operative language—the insured must “discover” “fraudulent or dishonest acts.” Even policies that tie termination to acts that are or might create a “claim” under the policy require a “fraudulent or dishonest” act, because the policies define “claim” in those terms.<sup>9</sup> In addition, one case explicitly, and other cases implicitly, recognize that “learn,” “discover,” and obtain “knowledge of” mean the same thing.<sup>10</sup>

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<sup>5</sup> *Cooper Sportswear Mfg. Co. v. Hartford Casualty Ins. Co.*, 818 F.Supp. 721 (D. N.J. 1993).

<sup>6</sup> *Boston Mutual Life Ins. Co. v. Fireman’s Fund Ins. Co.*, 613 F.Supp. 1090 (D. Mass. 1985).

<sup>7</sup> *U.S.F.&G. v. Constantin*, 157 So.2d 642 (Miss. 1963).

<sup>8</sup> *McGeehon and O’Leary, Termination of Coverage, supra. n. 1; In re Prime Commercial Corp.*, 187 B.R. 785 (N.D. Ga. 1995).

<sup>9</sup> See, policy language in *Boston Mutual Life Ins. Co. v. Fireman’s Fund Ins. Co.*, 613 F.Supp. 1090 (D. Mass. 1985).

<sup>10</sup> *First National Bank of Louisville v. Lustig*, 150 F.R.D. 548 (E.D. La. 1993).

The phrase “fraudulent or dishonest acts” also appears in the fidelity insuring agreements, and “discovery” also appears in the policy provisions regarding notice and proof of loss. As a result, the huge body of coverage law interpreting these terms also applies to automatic termination. This can be a boon to an adjuster or practitioner if the fact patterns, language, reasoning or dicta of the automatic termination cases do not fit the particular facts at hand.

### III. WHAT CONDUCT IS SUFFICIENT TO TRIGGER TERMINATION?

The acts must be “dishonest or fraudulent.” This is the same language in the policies’ insuring agreements, and the courts give it the same interpretation.

*In Ritchie Grocer Co. v. Aetna Casualty & Surety Co.*, 426 F.2d 499 (5<sup>th</sup> Cir. 1970), the insured, investigating the background of a job applicant, discovered that the applicant, six months earlier, had been caught breaking into a garage and removing tires. The applicant was a teenager. All concerned, including the sheriff, the prosecutor and the judge, viewed the offense as a youthful mistake and, after a stern lecture, dismissed the case. The insured, wanting to “give the boy a break,” hired him. He embezzled a substantial sum a year later. There was no question that the loss would be covered unless coverage terminated (or, never became effective) as to the employee.

The court adopted the Black’s Law Dictionary definition of “fraud,”<sup>11</sup> concluding that “innumerable” cases applied the same standard. Since the act in question, however, did not meet the definition of “fraud,” the court turned to the meaning of “dishonesty.” The court adopted Justice Cardozo’s view that for an act to be dishonest, “there must exist an element of moral turpitude or want of integrity. [Cardozo] declared: ‘Dishonesty, unlike embezzlement or larceny, is not a term of art. Even so, the measure of its meaning is not a standard of perfection, but an infirmity of purpose so opprobrious or furtive as to be fairly characterized as dishonest in the common speech of men.’” *Id.* at 503 (citing *Commercial Banking Corp v. Indemnity Ins. Co. of North America, et al.*, 1 F.R.D. 380 (N.Y. 1940)).

Applying this definition, the court held that it is “common knowledge” that breaking and entering and removing property without the owner’s consent is “contrary to law.” The court took judicial notice that the employee’s actions constituted “burglary and larceny subject to the penalty of law.” It did not matter that the courts and officers did not prosecute, because “this in no way affected the question of whether or not the act itself . . . was a fraudulent or dishonest act.” The

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<sup>11</sup> “An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right; a false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury.”

court held that the employee’s actions, regardless of their consequences (or forgiveness) were “dishonest” so as to trigger the termination clause. *Id.* at 504.

*Ritchie Grocer* shows that criminal acts, regardless of whether they were forgiven in order to “give a break” to the person, qualify the employee for termination of coverage. Insureds cannot use their own good intentions to shield themselves from the consequences of their knowledge.<sup>12</sup> The courts, when determining whether the insured would understand the acts to be dishonest, will apply “common knowledge,” and also take judicial notice of the criminal statutes. Nor do the crimes necessarily have to involve deception, lying or thievery. Any crime committed with “opprobrious purpose” may qualify.<sup>13</sup>

In *RTC v. Aetna Casualty and Surety Co.*, 873 F.Supp. 1386 (D. Ariz.. 1994), a bank officer intended to make a loan collateralized solely with the Bank’s stock. Other officers told him that such a loan was illegal, but he funded the loan anyway, intending to replace the prohibited collateral with legal collateral. While the court accepted the proposition that “an illegal act is not per se a dishonest or fraudulent act,” the court had no trouble finding that “a knowingly illegal act” was dishonest despite the official’s assertions that he was going to correct the violation.<sup>14</sup>

Finally, the cases make it clear that conduct need not be criminal to be “dishonest” so as to terminate coverage. *Fidelity and Casualty Co. of New York v. Central Bank of Houston*, 672 S.W.2d 641 (Tx.Ct.App.1984) contains one of the broadest statements of this principle:

The court in *First National Bank v. Insurance Co. of North America*, 606 F.2d 760, 768-69 (7th Cir.1979), set forth the following standard for defining dishonesty under a banker’s blanket bond. The words “dishonest” and “fraudulent” used with reference to conduct covered by a fidelity bond are to be given

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<sup>12</sup> See, *E. Udolf, Inc. v. Aetna Casualty and Surety Co.*, 573 A.2d 1211 (Conn. 1990). An employee embezzled \$6,000.00. The insured kept her employed and arranged for her to repay the debt, which she did in full. Her actions were “dishonest” and terminated coverage despite her repayment in full and the insured’s forgiveness of the theft.

<sup>13</sup> See, *Fidelity and Casualty Co. of New York v. Central Bank of Houston*, 672 S.W.2d 641 (Tx.App.1984). The insurer was permitted to plead as a defense that an employee’s indictment for rape and subsequent plea to assault was a “dishonest” act for purposes of coverage termination. The court decided the case on other grounds without further addressing the issue.

<sup>14</sup> See, *C. Douglas Wilson and Co. v. Insurance Company of North America*, 590 F.2d 1275 (4th Cir. 1991). The insured discovered that an employee had been falsifying reports to HUD in order to obtain premature advances on HUD-backed loans. The reporting form stated on its face that false statements thereon were subject to criminal sanction. The false statements on the reports were “dishonest” acts terminating coverage.

a broad meaning. Their connotation is broader and more comprehensive than the word “criminal”; and they include acts which show a want of integrity or breach of trust. Conduct may be fraudulent and dishonest within the meaning of a banker’s blanket bond even though it falls short of a criminal offense. Thus it has been held that where a bank employee creates a conflict of interest, looks after his own benefit, or acts in disregard of his employer’s interests, subjecting the employer to a likelihood of loss, he is acting fraudulently and dishonestly within the meaning of a fidelity bond. A bank’s assistant vice-president, in charge of an installment loan department, who approves a customer loan which exceeds authorized limits, and permits the customer to use names of other individuals as borrowers, commits a dishonest and fraudulent act within the meaning of the banker’s blanket bond. So it goes without saying that it is dishonest for the president of a bank to secretly obtain its funds putting forth others as being worthy of credit.

Id. at 645 (citations omitted). Under this standard, a director’s failure to disclose to the loan committee that he was business partners with the borrower created a “conflict of interest” which showed “want of integrity or breach of trust,” and was sufficiently “dishonest” to terminate coverage.<sup>15</sup>

An important aspect of automatic termination is that dishonest acts terminate coverage even if the employee intends to benefit the insured. In *Central Progressive Bank v. Fireman’s Fund Ins. Co.*, 658 F.2d 377 (5<sup>th</sup> Cir. 1981), the bank president made fictitious loans to allow use of bank money for political contributions. He intended to curry favor in order to obtain more business for the bank. The court found that the fake loans were fraudulent acts, regardless of the president’s beneficial motive. In *St. Joe Paper Co. v. Hartford Accident and Indemnity Co.*, 376 F.2d 33 (5<sup>th</sup> Cir. 1967), a salesman misappropriated company funds but used them to “wine and dine” a customer, as a result of which the company landed a large contract. The court found that the misappropriation was a dishonest act regardless of its beneficial impact. In *C. Douglas Wilson and Co. v. Insurance Company of North America*, 590 F.2d 1275 (4<sup>th</sup> Cir. 1991), an employee falsely stated, in reports to HUD, that loan advances were due from HUD before they actually were due. The employee claimed that false reporting was common practice, necessary to obtain funds timely because HUD’s bureaucratic

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<sup>15</sup> See also *RTC v. Aetna Casualty and Surety Co.*, 873 F.Supp. 1386 (D. Ariz. 1994). The court, in addition to evaluating what types of criminal acts qualified as “dishonest,” also held that “[t]he terms ‘dishonest’ and ‘fraudulent’ as used in fidelity bonds have a broad meaning. They include acts which show a ‘want of integrity’ or ‘breach of trust.’ They also include acts in disregard of an employer’s interest, which are likely to subject the employer to loss. The fact that one knowingly makes unauthorized loans in excess of authority has been called ‘such a breach of trust as will constitute fraud or dishonesty within the meaning of the law.’”

approval process took so long. The court found that the false statements were dishonest acts despite the fact that they did not expose the bank to risk of loss. These cases show that the road to termination can be paved with good intentions.

In addition to the many cases explaining what acts trigger automatic termination, there is one case that explains what acts do not—*U.S.F. & G. v. Constantin*, 157 So.2d 642 (Miss. 1963). The insured, an oil company, hired an employee to run a service station. Every day, the employee had to report the number of gallons sold and submit a copy of a deposit slip showing that he had deposited sufficient funds to cover the cost of the oil products. After several months, the employee began falling behind in his reports. The insured’s investigation revealed that the employee, on his own responsibility, had advanced credit to customers who were slow in paying, and also increased his overhead, all of which left him with insufficient funds to pay for the oil products. The insured and the employee agreed on the amount due, and the employee executed a secured note, which he paid regularly.

Six months later, the insured received an anonymous tip regarding the employee. This time, the investigation revealed that the employee was submitting false reports. He reported selling smaller quantities than what he actually sold, and was keeping for himself the money he owed the insured. When the insured made a claim on its bond, the insurer argued that coverage terminated at the time the insured learned of the prior problems with late reporting. The insured contended that the prior problems were the result of “inefficient operation” and “poor judgment.” They showed only the employee’s failure to “conform to strict businesslike methods,” “slack operations” and “unintentional derelictions.” *Id.* at 643. By contrast, the employee’s later actions involved “deliberate” falsification of meter readings. “He had taken the company’s products and reported less than the value thereof.” He “retained the company’s money and was grossly dishonest in his conduct.” *Id.*

The appeals court affirmed the trial court’s judgment that the bond had not terminated with the prior late reporting problem. The court (relying on coverage cases) reasoned that “negligence or carelessness” or a “mistake of judgment” were not “dishonest” acts within the meaning of the bond. Nor were “carelessness or inattention to business,” “mistake, disobedience of orders, or bad judgment.” The court also looked to embezzlement cases where the insureds presented claims based on shortages of inventory or accounts. The court cited with approval the reasoning that “while every act of embezzlement involves a shortage, every shortage does not involve an act of embezzlement.” “Unexplained shortages” do not constitute dishonest acts.

Applying this reasoning to the facts, the court concluded that the problems related to the late filing of reports only demonstrated “mistake or inefficiency.” Indeed, at that point, the employee only exhibited tardiness, improvident credit extension, and excessive overhead. The falsification of the reports, by contrast,

were “furtive acts of the employee . . . manifestly taken in a deliberate and dishonest design to embezzle the money and property of the [insured] to his own use.” *Id.* at 645. As a result, the prior acts did not terminate coverage for the later acts.

Several general principles emerge from the cases. First and foremost, criminal activity will, almost always, be sufficient to trigger automatic termination. It is likely that the criminal activity does not have to involve actual fraud or deceit—any major crime seems to have sufficient “opprobrious purpose” to meet the broad standard for dishonesty. In addition, it probably does not matter if a crime was actually charged, if the charges were dismissed, or if the employee either served his time or was given “a break.” None of these events change the nature of the “act itself.” Insureds may argue that acts comprising technical crimes may not qualify. The cases indicate that such acts may terminate coverage if the employee committed them knowing they were illegal (i.e., advancing the loan after knowing it is illegal, falsifying the form when it says on its face that it is criminal to do so).

Dishonest acts terminate coverage even if the employee intended to benefit the insured. This is a crucial difference from the acts that create coverage. For purposes of termination, there is no need to inquire into “manifest intent to cause a loss,” unless the policy ties termination to acts that are or may form the basis for a “claim.”<sup>16</sup>

There is tension between the broad definition of “dishonesty” and the equally broad concept of not finding “dishonesty” in certain types of business derelictions, such as disobedience of orders or failure to follow business procedures. These types of derelictions, however, move beyond negligence and show at least an element of deliberateness or intent. This might be coupled with the concept that actions in “disregard of the employer’s interest” that are “likely to subject the employer to loss” may qualify as “dishonest.” Thus, where the violations of business procedures or disobedience of orders creates a likelihood of loss, insurers should carefully evaluate the circumstances for possible dishonesty.

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<sup>16</sup> *First National Bank of Louisville v. Lustig*, 961 F.2d 1162 (5<sup>th</sup> Cir. 1992)(“The only reasonable interpretation of the termination clause is that dishonest acts short of those triggering coverage under Insuring Agreement A may terminate coverage under the bond.”).

#### IV. WHEN DOES THE INSURED “DISCOVER” THE DISHONEST ACTS?

##### A. *Who Must Know the Facts?*

Coverage terminates when “the Insured” or “any” “officer,” “director,” or “partner” of the insured discovers the dishonest act. The latter three terms refer to specific individuals, who an insurer can identify by referring to the corporate or partnership minutes and records.

In *Foote, Cone and Belding Communications, Inc. v. Federal Ins. Co.*, 749 F.Supp. 892 (N.D. Ill. 1990), the court considered whether former officers and directors, who are still employees but no longer hold office, are included in the policy’s list. The policy in that case defined “knowledge” of the insured as “knowledge possessed by a partner, director or elected or appointed officer of the insured.” The court viewed the policy language, which was narrow in scope and phrased in the present tense, as including only directors and officers at the time the policy was obtained and thereafter. The court also held that an “officer” must be an “official” corporate officer and not a “de facto” officer.

*Foote*’s reasoning as to “former” versus “present” officers or directors should not apply generally. Most current bonds provide for termination upon discovery by *any* officer, director or partner. This more expansive phrasing should encompass (although, still, it does not specifically say) former as well as present officers or directors.

Perhaps due to current policy phrasing, most litigation does not challenge termination when “directors or officers” know of the dishonest acts. Instead, the disputes usually center on what it means for “the Insured” to discover the dishonest acts. The policy phrasing means that “the Insured” encompasses something beyond the individual officers, directors or partners also listed in the policy. *First National Bank of Louisville v. Lustig*, 150 F.R.D. 548 (E.D. La. 1993)(“The inclusion of the words ‘or any director or officer’ does not restrict the ‘insured’ to directors and officers.”). Since “the Insured,” as a business entity, can only “discover” something through the persons who work for it, the issue becomes: whose knowledge (other than an officer’s, director’s or partner’s) is sufficient to constitute “discovery” by the insured itself?

Courts resolve this issue by turning to traditional agency principles. In *City State Bank in Wellington v. U.S.F.&G.*, 778 F.2d 1103 (5<sup>th</sup> Cir. 1985), the policy provided for termination upon “the insured’s” discovery of dishonest acts, but did *not* list specific individuals or positions whose knowledge triggered termination. The insured argued that the knowledge of a vice president and director should not be imputed because he was basically inactive and “performed no substantial services in that office for [the insured].” *Id.* at 1104. The court rejected this argument:

Notice to an officer or agent is notice to the corporation in the circumstance where the officer or agent in the line of his duty “ought and could reasonably be expected, to act upon or communicate the knowledge to the corporation.” The office of a corporation director or officer is more than nominal, and those assuming the duties and responsibilities of such office are not justified in neglecting every precaution or investigation; it is their minimal duty and responsibility to protect the corporation against acts adverse to the interest of the corporation, whether perpetrated by fellow officers or directors or by strangers to the corporation. Similarly, Diamond’s duty to [the insured] as officer and director makes his knowledge imputable to the bank.

Id. at 1110. *City State Bank* establishes that directors’ and officers’ knowledge of dishonest acts is imputed to the insured as a matter of law. The court later indicated that whether to impute the knowledge of other individuals “must be discerned from the circumstances of each case.” Id.

Applying similar standards, courts have little difficulty in imputing the knowledge of senior executives to the insured. *Boston Mutual Life Ins. Co. v. Fireman’s Fund Ins. Co.*, 613 F.Supp. 1090, 1094 (D. Mass. 1985) imputed the controller’s knowledge and that of “other executives” to the insured. “[T]he standard of being ‘aware’ applicable to [the insured] in this case is satisfied if it is proved that a person in authority for [the insured] (that is, a person having authority and acting within the scope of that authority) was ‘aware.’” The court in *R.T.C. v. Aetna Casualty and Surety Co.*, 873 F.Supp. 1386 (D. Ariz. 1994) imputed the knowledge of the bank’s Chief Financial Officer and Vice President for Lending to the insured.<sup>17</sup>

Courts also have not hesitated to impute the knowledge of employees farther “down the line,” under the right circumstances. In *E. Udolf, Inc. v. Aetna Casualty and Surety Co.*, 573 A.2d 1211 (Conn.Super.Ct. 1990), the sole officer, director and shareholder delegated operation of the store to a manager and recordkeeping to a bookkeeper. An employee embezzled some money, and the manager and bookkeeper found out. They decided not to fire the employee, but instead to have her repay the debt, which she did in full. They never told the owner. The insurer defended a later claim for embezzlement by arguing that coverage terminated for the employee when the manager and bookkeeper learned of the prior embezzlement. The court applied the following principles:

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<sup>17</sup> See also *First National Bank of Sikeston v. Transamerica Ins. Co.*, 514 F.2d 981 (8<sup>th</sup> Cir. 1975)(For purposes of termination, “the knowledge of key employees and officers obtained in the course of their employment is often imputed to the corporation . . . as is knowledge imparted to the Board of Directors.”).

[N]otice to, or knowledge of, an agent while acting within the scope of his authority and in reference to a matter over which his authority extends, is notice to, or knowledge of, the principal. . . . As stated in the Restatement (Second) of Agency § 272, “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.” . . . 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.

Id. at 1213, 1214 (citations omitted). The manager was “principally in charge of operations” at the store, and this included a duty to report to the owner. In addition, the duties of the bookkeeper included “a responsibility to report . . . any misappropriations.” Id. at 1214. Thus, the knowledge of each employee would be imputed to the insured.

In *Ritchie Grocer Co. v. Aetna Casualty and Surety Co.*, 426 F.2d 499 (8<sup>th</sup> Cir. 1970), a branch manager of a store took an employment application, performed a background check, and discovered prior burglary and larceny by the applicant. The court found that the branch manager had “full authority to act in carrying out the affairs of the business,” Id. at 502, and had “unfettered authority in the personnel management of [the insured’s] store.” Id. at 500. This being the case, the manager’s investigation of the employee, and the knowledge he gained of the prior thefts, was within the scope of his authority and imputed to the insured.<sup>18</sup>

The court in *First National Bank of Louisville v. Lustig*, 150 F.R.D. 548 (E.D. La. 1993) ruled that the bank *outside* counsel’s knowledge of fraudulent and dishonest acts was imputed to the bank. Noting that a corporation must act through agents, the court held that “an agent of the insured may learn of the dishonest or fraudulent acts within the scope of his authority on behalf of the insured in order to trigger section 12’s termination clause.” Id. at 551. *See also Lafayette Bank and Trust Co. v. Aetna Casualty and Surety Co.*, 411 A.2d. 937 (Conn. 1979)(same holding, an attorney’s knowledge is imputed to the client).

Courts, however, have drawn the line at imputing the dishonest employee’s own knowledge of dishonesty to the insured. This is based on the

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<sup>18</sup> See also *Mercedes-Benz of North America, Inc. v. Hartford Accident & Indemnity Co.*, 974 F.2d 1342 (9<sup>th</sup> Cir. 1992)(knowledge of manufacturing plant manager is imputed to insured for purposes of policy termination); *Alfalfa Electric Cooperative v. Traveler’s Indemnity Co.*, 376 F.Supp. 901, 907 (W.D. Okla. 1973)(knowledge of the following imputed to insured: assistant secretary, secretary, treasurer, superintendent, bookkeeper and acting cashier).

principle that an agent defrauding his principal is no longer acting on behalf of, but is acting adversely to, the interest of his principal.<sup>19</sup>

*In Adair State Bank v. American Casualty Co. of Reading, Pa.*, 949 F.2d 1067 (10<sup>th</sup> Cir. 1991), the bank's chairman commenced a check kiting scheme for his own benefit. He would write insufficient funds checks and instruct the bank to honor them and then hold them as "cash" items. Just before the end of each month, he would cover the bad checks with an insufficient funds check drawn on another bank. This would eliminate the large amount of cash items that would otherwise show up in month-end reports to the board of directors. After the month's end, he would cover the check from his other bank with another insufficient funds check from his own account, which his bank would honor and, again, hold as a cash item. He would repeat this cycle each month.

Three other bank officers discovered the scheme after it had commenced. They never participated in, benefited from or originated the scheme. Their actions were as follows:

*Hall, Vice President and Head Cashier.* She was the chairman's cousin. She discovered the correlation between his overdrafts and the cash items. She discussed the situation with the bank's president, who told her that the chairman said he would "take care of" the problem. Hall prepared the monthly reports to the directors in which it was her responsibility to inform the board of all overdrafts. In these reports, she concealed her knowledge of the large number of cash items and the chairman's overdrafts.

*Rice, Senior Vice President and Branch Manager.* She also was a cousin of the chairman. She discovered the problem with cash items and discussed it with the president. He told her the chairman was getting a loan to cover the overdrafts—itsself an illegal act. She also discussed the situation with the chairman himself, who assured her that he would take care of the problem and asked her not to "pull the plug." She did not take any further steps. She testified that she was concerned with family embarrassment if her cousin's actions were revealed. She also

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<sup>19</sup> See *Federal Deposit Inc. Corp. v. Lott*, 460 F.2d 82 (5<sup>th</sup> Cir. 1972)("[W]here, as here, Lott fraudulently dealt with the bank in his own interest, he is deemed to have an adverse interest and the knowledge possessed by him in the transaction is not imputable to the bank."); *Federal Deposit Insurance Corporation v. Aetna Casualty & Surety Co.*, 426 F.2d 729 (5<sup>th</sup> Cir. 1970)("the knowledge of Steiner and the directors associated with him cannot be imputed to the Bank since they were acting adversely to its interests"); *Phoenix Savings and Loan, Inc. v. Aetna Casualty and Surety Co.*, 427 F.2d 862 (4<sup>th</sup> Cir. 1970)("[T]he general rule is that the knowledge of an officer of the corporation obtained while acting outside the scope of his official duties, in relation to a matter in which he acted for himself and not for the corporation, is not, merely because of his office, to be imputed to the corporation.")

wanted to preserve the value of her bank stock, which she sold for a profit shortly before the scheme unraveled.

*Floyd, Bank President.* He was the chairman’s half-brother. He demonstrated extreme ambivalence about the scheme. He had told Rice and Hall not to take any further steps regarding the scheme. He would personally authorize the holding of the chairman’s bad checks as cash items, which was common practice as long as the balances were small. As the balances increased, he confronted the chairman, who threatened him with financial ruin if he disclosed the scheme. Floyd then took some indirect steps. He sent a summary of accounts to a director, but did not specifically indicate any problem with the cash items. He made an anonymous call to banking regulators saying that they should examine the bank but, again, not pointing to cash items specifically. The examination failed to uncover the scheme. He again confronted the chairman, who again threatened him. Finally, as the FDIC was about to investigate, he backed some of the chairman’s insufficient funds checks with his own money in order to make the checks appear good.

The trial court refused to impute the knowledge of these officers to the bank, and further held that they were in “collusion” with the chairman so as to preclude “discovery” through their knowledge of the chairman’s acts. The appeals court accepted the proposition that “the officers’ knowledge is imputed to the bank unless they participated in the wrongdoing that caused the loss.” The court then turned to “participation.”

As to Floyd, the court noted that his actions were “essential for [the] scheme to work.” He actively participated by instructing bank employees to honor the bad checks and by attempting to conceal the checks from the FDIC. His half-hearted attempts to report the scheme were unpersuasive to the court, who viewed them as attempts to “escape blame for his actions when it was clear the overdrafts would be discovered.” As to Rice, the court noted that she, knowing of the illegal scheme, submitted reports to the board concealing the scheme. Rather than report the wrongdoing, she sold her bank stock for a profit. “She believed that it was in her best interest to conceal from her employer information which adversely affected its well-being.” Hall presented the most difficult problem, as she never colluded directly with the chairman and she had no fraudulent motive. The court, however, noted that she complied with directions to hold the bad checks as cash items, which she knew violated bank policy, and she also deliberately concealed the overdrafts from the board of directors in her monthly reports. The court found this sufficient for the trial court to conclude that she “participated” in the scheme.

The court then generalized the following standard from the specific facts:

In order for the scheme to succeed, it was necessary for each of the officers to perform certain actions and also remain silent in the face of their professional duty to report certain information to the board of directors. All three officers were repeatedly called upon to choose between the interests of the bank and the interests of Mr. Dunham. Each time, they chose to promote the welfare of Mr. Dunham to the detriment of their employer. The district court was not clearly erroneous when it concluded that officers Floyd, Hall, and Rice were participants in Mr. Dunham's check-kiting scheme.

Id. at 1074-1075. The employees' actions were not a mere "failure to report," but were positive, dishonest steps to conceal the dishonest scheme of which they knew.

This conclusion made it easy for the court also to conclude that the officers were in "collusion" with the wrongdoer, and so their knowledge did not constitute "discovery" under the bond. The court adopted the Black's Law Dictionary definition of "collusion:"

An agreement between two or more persons to defraud a person of his rights by the forms of law, or to obtain an object forbidden by law. It implies the existence of fraud of some kind, the employment of fraudulent means, or of lawful means for the accomplishment of an unlawful purpose. . . . A secret combination, conspiracy, or concert of action between two or more persons for fraudulent or deceitful purpose.

Id. at 1075. Applying this definition, the court reasoned that the actions of the officers in concealing the fraud from the board of directors, and of actually assisting in the processing of the bad checks, was sufficient to constitute "collusion." The insurer argued that, once they knew of the scheme but before they participated, the officers were not in "collusion" and so their knowledge was imputed. The court rejected this position, finding that the policy does not refer only to "pre-existing agreements to defraud," but to any act of collusion.

Several general principles can be drawn from the cases. Under most policies, knowledge of "official" officers, directors or partners always is sufficient to trigger termination, either under the specific language of most policies, or under the rationale of *Citizen's State Bank, supra*. Under the agency principles discussed in the cases, the knowledge of high-level executives should, almost without exception, be imputed the insured.

The cases also provide fairly clear guidelines for when to impute the knowledge of lower level executives or managers. When such persons have control

over the hiring and conduct of the employee, their knowledge of the employee’s activities should be imputed. This would include managers of discrete units of the insured, even if, technically, they are far down the management chain. The knowledge of other employees might be imputed if their scope of authority would include the reporting of wrongdoing regarding the dishonest employee. This category might be very broad and include persons associated with risk management, auditing, bookkeeping, or personnel. Imputing the knowledge of other employees becomes a purely fact-driven exercise.

The knowledge of employees cannot be imputed when they are participants in the scheme or are in collusion with the wrongdoer. “Participation” does not arise from mere silence, but must include some positive act to either further the scheme or to conceal it from the insured. The same is true of “collusion.” It makes no difference if the employee in collusion takes such action before or after learning of the scheme. An uninvolved employee’s silence without dishonest intent, however, is not sufficient to establish either participation or collusion. This includes silence in the face of threats or silence due to negligence or failure to appreciate known facts. These situations still call for imputation of knowledge to the insured if the other standards for imputation exist.

*B. What Degree of Knowledge Constitutes “Discovery”?*

By far, the courts are most confused, contradictory and confounded regarding how to determine when the insured “discovers” the dishonest act. Nonetheless, general principles are emerging in this area, largely due to the fact that courts often adopt the definition of “discovery” as developed in notice and proof of loss cases.<sup>20</sup> However, even where the courts say they are applying the same standard, a review of the cases shows that the decisions are, almost entirely, fact-dependent.

*The Subjective/Objective Standard.* Many courts are adopting a definition of “discovery” that is part subjective and part objective. The clearest explanation of the standard is in *First National Bank of Louisville v. Lustig*, 150 F.R.D. 548 (E.D. La. 1993). The court first observed that policy wording such as “discover,” “learn,” “know,” and “aware” all trigger essentially the same standard. Under this standard, automatic termination “applies when the insured has actual knowledge of facts which would cause a reasonable person in the insured’s position to infer that an employee has committed dishonest or fraudulent acts.” The court explained that “the standard lies between the purely objective standard of ‘should have known’ and the purely subjective standard of ‘actual knowledge’; it combines both subjective and objective elements—awareness of underlying facts from which the

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<sup>20</sup> *City State Bank in Wellington v. U.S.F.&G.*, 778 F.2d at 1103 (5th Cir. 1985); *First National Bank of Louisville v. Lustig*, 150 F.R.D. 548 (E.D. La. 1993).

insured as a reasonable person should make certain inferences about the fact in question.” Id. at 550.<sup>21</sup>

*In City State Bank in Wellington v. U.S.F.&G*, 778 F.2d at 1103 (5<sup>th</sup> Cir. 1985), the court was concerned that imposing an objective “reasonable man” standard might cause insureds to make accusations of fraud based on mere suspicion in order to preserve coverage. The court concluded that “the insured’s subjective knowledge should at least be considered.” The court approved a standard based on whether a reasonable person would infer dishonesty from the known facts. The insured learned that its president was giving immediate credit to a customer, in which the president had an interest, who presented drafts against an exhausted line of credit at another bank. An officer of the other bank told the insured he was concerned the president was engaged in “draft kiting.” This was sufficient to alert a reasonable bank to dishonesty on the part of the president.

In *In re Prime Commercial Corp.*, 187 B.R. 785, 804 (N.D. Ga. 1995), the court held that discovery depends on “knowledge of facts which, in the light of proven circumstances surrounding those facts and in the light of reasonable inferences which [may] be drawn from those facts, would inform the ordinary, reasonable and sensible employer that dishonesty has occurred.” The insured learned that its president had made large, irregular loans that were secured, in part, by fraudulent collateral. When questioned about the loans, the president promised to cease making advances, but then made several large advances, which the directors discovered. The suspicious nature of the loans, coupled with discovery of the president’s false statements regarding the loans, constituted “discovery” of the president’s dishonesty.<sup>22</sup>

*In Fidelity & Casualty Co. of N.Y. v. Central Bank of Houston*, 672 S.W.2d 641 (Tex.Ct. App. 1984), the bank’s board of directors learned that the bank’s president approved loans to a borrower with whom he had an undisclosed business interest. Applying a subjective/objective standard, the court found that knowledge of these facts revealed the president’s conflict of interest, which constituted “discovery” of the president’s dishonesty. In the same vein, *Community Savings Bank v. Federal Ins. Co.*, 960 F.Supp. 16 (D. Conn. 1997), held that “discovery” occurred when the bank’s directors discovered that the president submitted to the loan committee, and then voted to approve, a loan to a company in which he had an interest. This violation both of the bank’s “insider loan” and conflict of interest prohibitions gave the bank notice of dishonesty.

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<sup>21</sup> See also *Alfafa Electric Cooperative, Inc. v. Travelers Indemnity Co.*, 376 F. Supp. 901 (W.D. Okla. 1973)(“Discovery’ means that time when the insured gains sufficient factual knowledge . . . which would justify a careful and prudent man in charging another with dishonesty. . . . Knowledge is what a reasonable person should have concluded from known facts).

<sup>22</sup> See also *R.T.C. v. Aetna Casualty and Surety Co.*, 873 F.Supp. 1386 (D. Az. 1994)(Knowledge of irregular loan coupled with knowledge that officer lied about funding the loan constituted discovery.).

*First National Bank of Sikeston v. Transamerica Ins. Co.*, 514 F.2d 981 (8<sup>th</sup> Cir. 1975) is an excellent example of the subjective/objective standard. The court adopted the standard that “Knowledge is what a reasonable person should have concluded from known facts.” The bank had suffered losses when a check kiting scheme, engineered by its president, collapsed. Before the scheme began, the president authorized immediate credit for uncollected checks on behalf of a customer in which the president had an interest. The Comptroller of the Currency and the Regional Comptroller criticized this practice as extension of credit in excess of authorized limits and a conflict of interest. They recommended that the president resign. He did not resign until months later. After he resigned, he set up a complex three-way “float” to arrange credit for his business. Part of the “float” was First National issuing checks in excess of the customer’s balance, before funds came in to cover the amounts. The court concluded that knowledge of these facts was, as a matter of law, knowledge of a kiting scheme. Kiting, in turn, was, as a matter of law, well known to be a dishonest act. The court concluded that knowledge of the president’s crediting uncollected checks, which a reasonable bank would know was a conflict of interest, and knowledge of his participation in the float, which a reasonable bank would know to be a dishonest kiting scheme, terminated coverage.

The court in *North Jersey Savings and Loan Association*, 660 A.2d 1287 (N.J.App. 1993), adopted the standard of whether known facts would justify a “prudent person” in concluding fraud had been committed. The insured received a letter from its title insurer expressing concern that certain loans the insured had purchased involved violations of state and federal law on the part of the originating bank, including Truth in Lending, usury and similar defects. The insured put a hold on the loans, and submitted them to a different insurer, who reviewed and agreed to insure them. The unverified statements in the letter were insufficient to constitute “discovery” of dishonest acts by the officers involved with the loans. Applying a similar standard, the court in *In re J.T. Moran Financial Corp.*, 147 B.R. 335 (S.D. N.Y. 1992), considered the bank’s receipt of a national bank examiner’s report disapproving of certain practices, but not making any accusations of fraud. This report was not deemed sufficient to constitute “discovery” of the president’s fraudulent acts involving fictitious loans.<sup>23</sup>

The subjective/objective standard has mutual advantages for both the insured and the insurer. The subjective component benefits the insured by taking its actual state of knowledge into account and not holding it to some unknown, abstract standard of reasonableness. This relieves the insured of reporting even the

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<sup>23</sup> See also *FDIC v. National Surety Corp.*, 281 N.W.2d 816 (Iowa 1976). The directors received examiners’ reports pointing out irregularities such as holding excessive cash items and loans in excess of authorized limits. Subsequent reports indicated “improvements” and the bank overall received a high rating. No report suggested the possibility of fraud. The court found that the information in these reports was not sufficient to be deemed “discovery” of the bank of dishonest acts in connection with the “irregular” transactions.

most minor incidents out of fear it would lose coverage under a “higher” standard.<sup>24</sup> The objective component of the standard benefits the insurer by not allowing the insured to manipulate “discovery” by claiming it did not subjectively understand the significance of the known facts until a certain time.<sup>25</sup> This protects the insurer’s recognized interest in limiting liability for the acts of known dishonest employees.<sup>26</sup>

*The Subjective Standard.* Other courts have been more reluctant to make any “objective” element part of the standard for “dishonesty.” In *Boston Mutual Life Ins. Co. v. Fireman’s Fund Insurance Co.*, 613 F.Supp. 1090 (D.Mass. 1985), the bond provided for termination when the insured “becomes aware” of any act “which is or could be made the basis of a claim under this bond.” The court also equated “aware” for purposes of termination with “discovery” for purposes of notice and proof of loss. The court viewed this language as creating a pure “state of mind” standard. *Id.* at 1093. The court rejected any objective component to the standard, concluding that the insured must actually be “aware” that the act was fraudulent or could be made the basis for a claim. The court pointedly rejected authorities indicating that the subjective/objective standard should apply.

*Boston Mutual’s* reasoning, however, is seriously flawed. The court recognized that the plain language of controlling Massachusetts precedent, *Gilmour v. Standard Surety and Casualty Co.*, 197 N.E. 673 (Mass. 1935), expressly adopted the subjective/objective standard.<sup>27</sup> *The court, however, became confused because Gilmour* also recognized the entirely distinct concept that mere negligence of an employee does not amount to fraud. The court “transplanted” this concept into the

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<sup>24</sup> *In re Prime Commercial Corp.*, 187 B.R. 785, 803 (N.D. Ga. 1995).

<sup>25</sup> *Alfafa Electric Cooperative, Inc. v. Travelers Indemnity Co.*, 376 F. Supp. 901 (W.D. Okla. 1973). Once a reasonable person would appreciate the meaning of known facts, discovery “cannot be delayed by claiming knowledge of facts to be mere suspicions.” “Discovery is synonymous with the acquiring of facts, not when the insured finally decides that the facts . . . may be truthful.” The objective component prevents insureds from manipulating coverage dates by “contemplating whether or not it should believe the facts it had acquired.” *Id.* at 906. *See also, e.g.*, *USLIFE Savings and Loan Association v. National Surety Corp.*, 171 Cal. Rptr. 393 (Cal.Ct.App. 1981)(insured may not claim that discovery occurred only when it understood previously known facts; to do so would expose bonding companies to “virtually limitless liability”).

<sup>26</sup> *In re Prime Commercial Corp.*, 187 B.R. 785, 803 (N.D. Ga. 1995).

<sup>27</sup> *Gilmour* defined discovery in terms of “known facts or reasonable inferences of fact” “If facts known . . . and inferences which should reasonably be drawn therefrom would inform the ordinary man in his situation that there had been a loss, he has discovered the loss.” *Gilmour*, as do most “subjective/objective” cases, in turn cited to the seminal case of *American Surety Co. v. Pauly*, 170 U.S. 133, 18 S.Ct. 552, 42 L.Ed. 977 (1898) which first adopted the standard.

“discovery” arena and concluded that if “negligence” is not “dishonesty,” then “negligence” cannot equate to “discovery” of dishonesty.<sup>28</sup>

The court then addressed the very real possibility that an insured, under a “purely subjective” standard, may simply choose “not to know” what the facts would make obvious to a reasonable person. Turning to fraud cases, the court recognized that “reckless disregard” for facts can be equated with knowledge. Applying this concept to “discovery,” the court concluded that the “state of mind” test is satisfied by “awareness of uncertainty about whether a known act might be fraudulent and . . . dealing with [the employee and the insured] with the further state of mind of conscious disregard for ascertaining whether [the] act was fraudulent or not.” *Id.* at 1102.

Thus, the court, even though it adopted a purely subjective test, also lowered the bar for “discovery” to uncertainty about whether a known act is fraudulent, coupled with a failure to investigate. Or, as the court put it elsewhere, “suspicion . . . would satisfy the ‘awareness’ standard.” *Id.* at 1094. As a result, the court put insureds under an obligation to investigate “suspicion” of or “uncertainty” about wrongdoing, or risk loss of coverage.<sup>29</sup>

The facts of the case involved a group insurance administrator who misappropriated premiums for his own use. A year before, the administrator engaged in the same conduct, but the insured allowed him to remain employed once he repaid the funds. The administrator began the same pattern of delayed remittances that was the hallmark of his prior embezzlement. The insured’s executives had a meeting where they discussed the possibility that the administrator was able to deposit funds to his own account, and where they discussed a system for removing premium remittances from his control. Two years after that meeting, the insured submitted its claim. Applying a pure subjective standard, the court entered summary judgment for the insurer. The court found no other credible interpretation but that the insured was subjectively aware of dishonesty at the time of the meeting.

*In Cooper Sportswear Manufacturing Co., Inc. v. Hartford Casualty Ins. Co.*, 818 F. Supp. 721 (D. N.J. 1993), the insured’s Secretary-Treasurer heard the following statements from employees regarding the plant manager: one said “she knew he was stealing” but “did not know how,” another said “don’t ask me about it,” and a third said the employer “should be looking at the front of the building,”

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<sup>28</sup> The court stated that *Gilmour*’s clear enunciation of the subjective/objective standard was “contradicted by the implicit meaning noted above,” despite “the explicit declarations, of other passages in the same opinion.” Similarly, the court concluded that the “weight of authority” supported a subjective test even though the court’s own citations (and those quoted through *Gilmour*) showed that more cases favored an objective component to “discovery” than did not.

<sup>29</sup> As a result, the court ended up contradicting the traditional principal, discussed in its own opinion at 1097, that “mere suspicion” of loss does not equate to “discovery.”

a veiled reference to where the manager worked. Based on this, the insured hired a private investigation firm to place “undercover” employees in the building to “keep an eye” on the manager. The court, applying the policy standard of “information,” adopted a “pure” state-of-mind standard, and entered summary judgment in favor of the insurer. The evidence that the insured was taking its knowledge “seriously” was sufficient to constitute “information” of employee dishonesty. Ironically, the “information” the employer had was classic innuendo which, under an objective standard, created nothing more than “mere suspicion.” The subjective state-of-mind standard, however, elevated the insured’s suspicion to knowledge under the policy.

Other cases adopt a subjective standard without significant analysis. “We conclude that the [termination] provision requires actual knowledge and not mere suspicion of or a reason to know of the wrongdoing.” *First Hays Banshares, Inc. v. Kansas Bankers Surety Co.*, 769 P.2d 1184 (Kan. 1989). The court held that the insured’s knowledge of the employee’s depositing insufficient funds checks in his own account was not, without more, discovery of a dishonest act. In *Newhard, Cook & Co. v. INA*, 929 F.2d 1355 (8<sup>th</sup> Cir. 1991), the court ruled that “members of the board or employees of the insured must be ‘aware of the true nature of the events which have given rise to the allegation’ in order to trigger a termination clause in a fidelity bond.” The insured had been sued twice based on allegations of the employee’s fraudulent conduct. In one case, the insured stated that the employee’s actions had been “at best, deceitful.” This was sufficient “actual knowledge” to terminate coverage.

*The Objective Standard: Not Adopted, But Possible.* As of this date, no case has adopted a purely “objective” standard for automatic termination—that is, termination occurs when a reasonable person would or should have known of the dishonest acts, without regard to the insurer’s actual state of knowledge. The insurer argued for such a standard in *In re Prime Commercial Corp.*, 187 B.R. 785 (N.D. Ga. 1995). The insurer based its argument on *Royal Trust Bank v. National Union Fire Ins. Co.*, 788 F.2d 719 (11<sup>th</sup> Cir. 1986), where the court enforced a “purely objective” standard for discovery, under which the insured would be deemed to have discovered any facts that a reasonable investigation would disclose. In *Royal Trust*, however, the policy actually defined “discovery” as the insured becoming aware of facts “which would cause a reasonable person to assume” a loss occurred. *Royal Trust* was not an automatic termination case, and the *Prime* court refused to adopt its reasoning because the policy in *Prime* contained the traditional language regarding “discovery.” *Prime*’s reasoning, however, and the general principle that the applicable standard for “discovery” begins with the bond language,<sup>30</sup> leave open the possibility that, where the policy contains the “objective standard” language for “discovery,” the same standard will apply for termination of coverage.

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<sup>30</sup> See cases cited in footnote 3, *supra*.

“*Mere Suspicion.*” Regardless of what standard the courts apply, the courts routinely follow several rules regarding discovery. First, courts uniformly recognize that “mere suspicion” of wrongdoing is not sufficient to constitute discovery of a dishonest or fraudulent act. This language appears in virtually every case. This principle is extremely vague and cases have developed more specific approaches for separating “mere suspicion” from “discovery.”

*Presumption of Honesty.* Several courts have recognized that an employee is entitled to a “presumption of honesty” from the employer. *Maryland Casualty Co. v. Clements*, 487 P.2d 437 (Ariz.Ct.App. 1971). Under this presumption, business irregularities, “if as consistent with the integrity of employees as their dishonesty, do not constitute a discovery (of dishonesty) even though dishonest acts may later be found to exist.” *Wachovia Bank and Trust Co. v. Manufacturers Casualty Ins. Co.*, 171 F.Supp. 369 (M.D. N.C. 1959). As a result of the foregoing, cases also recognize that discovery of business irregularities such as “mistake or carelessness,” or a “shortage,” or “discrepancies in the employee’s accounts” does not constitute discovery of “dishonesty.” *Salley Grocer Co. v. Hartford Accident and Indemnity Co.*, 223 So.2d 5 (La.Ct.App. 1969).

These cases tie quite logically to *U.S.F.&G. v. Constantin*, 157 So.2d 642 (Miss. 1963), discussed in Part III, *supra*, which defines the types of business irregularities that do not, of themselves, constitute “dishonesty.” As a result, it is likely that knowledge of any of the acts specified in *Constantin* would not, without something more, constitute “discovery” of dishonest acts under the termination clause.

### *C. Does the Insured have a Duty of Inquiry?*

In the automatic termination context, the cases have rarely discussed whether the insured has a duty to investigate suspicious circumstances that, in themselves, fall short of “discovery” of dishonesty. One case held that:

[T]he following test applies. If an insured under a fidelity policy discovers an employee’s dishonesty about business transactions that give rise to a suspicion of fraud, a duty of inquiry arises that cannot be satisfied by the undocumented assertion of the employee that no problem exists or if there is one, he will solve it. The failure of the insured to inquire promptly or the failure of the employee to respond promptly in a manner that would cause a reasonable and prudent person to put aside his suspicion of fraud triggers the duty to notify the surety.

*In re Prime Commercial Corp.*, 187 B.R. 785, 804 (N.D. Ga. 1995). Under this standard, the duty of inquiry does not arise until there is *both* a transaction bearing indicia of fraud *and* employee dishonesty in connection with that transaction. This

combination of facts, however, would be sufficient to constitute “discovery” itself under any criteria. Indeed, the court had noted, on the previous page of its opinion, that it was the fraudulent transaction, by itself, that “shout[ed] for investigation,” and that employee dishonesty *in responding to the investigation* is the culminating “occurrence which would terminate coverage.” Id. at 803-804.<sup>31</sup>

The standards for “discovery” have not made a “duty of inquiry” necessary. Courts applying a pure “subjective” standard often find that mere suspicion or the hint of knowledge is sufficient to constitute discovery. Cases applying the subjective/objective standard rule that the insured cannot ignore the significance of known facts. Both of these current standards arguably are more favorable to insurers than creating a duty of inquiry, because neither requires a hypothetical inquiry into the results of a hypothetical investigation. Indeed, a duty of inquiry is consistent with the purely objective “reasonable man” standard, *see Royal Trust Bank v. National Union Fire Ins. Co.*, 788 F.2d 719 (11<sup>th</sup> Cir. 1986)(imputing to insured all facts that reasonable inquiry would reveal), which the courts have not yet adopted in the context of automatic termination.

*General Principles Regarding “Discovery.”* Given the divergence of opinions and the numerous issues that the courts have addressed, it is difficult to articulate a comprehensive “black letter” structure for evaluating “discovery” of dishonesty. The cases, however, do suggest a certain framework.

First and foremost, facts, far more than legal abstractions, govern the courts’ decisions. The cases show that no standard, be it “subjective/objective” or purely “subjective,” is more or less favorable to insurers. In fact, insurers routinely obtain summary judgments in their favor under either standard. As a result, insurers should examine the facts at hand and compare them to precedent before deciding which “standard” to argue for. In so doing, some common-sense notions drawn from the cases may be helpful.

Discovery of business irregularities such as shortages, discrepancies in accounts, failure to follow instructions or normal procedures, or instances of poor judgment, standing alone, will not constitute “discovery” of dishonest acts so as to terminate coverage. The insured is entitled to presume its employees are honest unless positive evidence creates a contrary inference. Rumor, gossip, innuendo and hearsay are not enough, unless the insured demonstrates that it takes the information seriously (i.e. conducting an investigation). Otherwise, the insured reaches “discovery” in several ways. The insured, of course, can learn of actual crimes, lies, stealing, embezzlement, or self-dealing by the employee. This easily qualifies as “discovery” and cases involving these facts often do not even bother to

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<sup>31</sup> *See also R.T.C. v. Aetna Casualty and Surety Co.*, 873 F.Supp. 1386 (D. Az. 1994)(discovery of loans supported by fraudulent documentation and employee’s lies in connection with those loans constitutes “discovery” of dishonesty).

articulate whether they apply the “subjective/objective” or purely “subjective” standards, as such discussion is unnecessary.

Next, the insured may learn of irregular transactions coupled with facts showing that the employee’s involvement with the irregular transaction demonstrates dishonesty, in its broad sense. Thus, if the employee’s conduct qualifies as criminal, or a deliberate, knowing violation of regulations, or demonstrates concealment, falsification, deceit, misrepresentation, conflict of interest, breach of trust, or conscious disregard of the employer’s interest creating a substantial likelihood of loss, “discovery” occurs.

Finally, the insured may learn of transactions that show positive indicia of dishonesty, such as false paperwork or concealment of required information, but the indicia of dishonesty do not point to any particular employee. If, during an inquiry into the transactions, an employee engages in acts of dishonesty such as lying or concealing material information or disregarding instructions, then “discovery” occurs unless the insured takes immediate and thorough steps that would satisfy a reasonable person to put aside its suspicions of fraud.

#### V. WHAT ARE THE CONSEQUENCES OF DISCOVERY?

It may seem surprising that there is uncertainty regarding the consequences of “discovery,” but this has been the subject of significant litigation. In *C. Douglas Wilson Co. v. INA*, 590 F.2d 1275 (4<sup>th</sup> Cir. 1979), the court considered the contention that, after discovery, coverage terminated for all acts of the employee. The court disagreed, holding that coverage terminated for all dishonest acts committed after discovery, but remained in place for acts committed prior to discovery of dishonesty but uncovered later. This rationale makes sense. The insured’s obligation is to remove dishonest employees immediately upon discovery of their dishonesty. Thus, if the employee commits further dishonest acts, the insured must bear the loss.<sup>32</sup> The insurer’s obligation is to cover losses caused by acts of the employee taking place before discovery of dishonesty. It makes sense that, if an insured discovers dishonesty, it will investigate the employee. It may well discover loss from previously undetected dishonest acts. The insurer should not escape its obligation by claiming that the insured only gets “one chance” to discover all dishonest acts simultaneously.

Cases also recognize that discovery of dishonesty not only terminates coverage, it keeps coverage from ever coming into effect, if the discovery took place before commencement of the policy. *R.T.C. v. Aetna Casualty and Surety Co.*, 873 F.Supp. 1386 (D. Ariz. 1994). Although the policy is phrased in terms of “termination,” courts recognize that it would be “unreasonable and unnatural” to make a distinction between commencement and termination of coverage.

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<sup>32</sup> In re J.T. Moran, 147 B.R. 335 (S.D. N.Y. 1992). The insured allowed the employee to continue with transactions, but “such condonation does not bind National Union.” The bond is “not as tolerant” of dishonest acts.

Otherwise, an insured “could hire a veritable Rogue’s Gallery” and obtain full coverage just because it discovered their dishonesty before obtaining the policy. *William C. Roney & Co. v. Federal Ins. Co.*, 674 F.2d 587 (6<sup>th</sup> Cir. 1982).

The one unsettled area is the realm of replacement insurance. It seems well settled that renewals cover newly-discovered dishonest acts of employees that took place before the discovery of the initial act that terminated coverage. Replacement insurance, however, is a different matter. Although the replacement insurer may be offering (from the insured’s point of view) the same coverage, it is undertaking (from its point of view) a new risk. As a result, some courts have held that a replacement policy should be treated as a new policy so that prior knowledge of dishonesty keeps coverage for the involved employee from ever taking effect.

This was the case in *C. Douglas Wilson Co. v. INA*, 590 F.2d 1275 (4<sup>th</sup> Cir. 1979). The insured discovered and made claim for dishonesty losses under the prior coverage. After obtaining a replacement policy when the prior coverage expired, the insured discovered previously unknown acts of dishonesty by the same employee. The court ruled that the replacement policy did not provide coverage for the dishonest employee. The court noted that it was bad “luck” for the insured to change carriers in the midst of its investigation, but that that could not change the plain language of the policy. The court in *Drexel Burnham Lambert Group v. Vigilant Ins. Co.*, 595 N.Y.S.2d 999 (N.Y.Ct.App. 1993), reached the same conclusion, reasoning that “it would be inconceivable for any rational insurer to assume coverage from a predecessor insurer for dishonesty previously discovered but not yet delineated.”

One case, however, has left the replacement insurer on the hook. *Home Savings and Loan v. Aetna Casualty and Surety Co.*, 817 P.2d 341 (Ut.Ct.App. 1991), ruled that the purpose of replacement coverage is to continue the previous coverage in full force and effect, and that the replacement insurer simply continues in the role of the previous insurer. The court refused to allow “bad luck” to deprive the insured of coverage simply because of a change in carriers. *Home Savings* pointedly rejected *Wilson*. This split of authority remains unresolved.

## VI. CONCLUSION

The right of automatic termination is one of the most important that an insurer bargains for when issuing a fidelity policy. Although the cases in this area show a substantial degree of complexity and conflict, they are uniformly respectful of the insurers’ rights even where they find that termination does not take place.<sup>33</sup>

Whether termination takes place in any particular circumstance primarily depends on the facts involved. This article has set forth general guidelines from the

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<sup>33</sup> A review of many of the authorities cited herein shows that even when the courts did not find termination, they almost always rejected the insured’s attempts to sue for bad faith or punitive damages.

cases to assist in evaluating the issue. Any final decision to deny coverage, however, should consider factually related precedent, as the facts are by far the most important aspect of a successful termination defense.