

Application Of The Loss Under Prior Policy Provision

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I. Introduction

Courts have long recognized that fidelity bonds and policies may legitimately limit coverage to losses that the insured discovers within a particular time frame. This discovery requirement distinguishes fidelity bonds and policies from occurrence-based liability policies. It is placed in fidelity coverage as a “safeguard to the insurer,”¹ because it furthers the public policy of encouraging insureds to diligently monitor their employees and business practices.² Further, because investigations of employee dishonesty and other fidelity bond claims often are labor intensive, the discovery requirement protects the insurer from having to investigate claims that are many years old.³ The discovery requirement is certainly reasonable in this context given the fact that coverage is often dependent upon financial documents that are regularly destroyed pursuant to the insured’s document retention policies.

Some courts’ application of the Loss Under Prior Policy provision⁴ appears to fly in the face of the public policy basis for, and practical purposes of, such discovery limitations. These courts have expanded the coverage available to insureds for losses discovered after the discovery period (often within one year of the bond or policy’s expiration) through broad application of the provision. Thus, the message to the insureds is a mixed one. While the Loss Under Prior Policy provision certainly was intended to provide some relief to the rigid discovery requirement,⁵ the industry clearly did not intend the extent of relief that some courts have granted.

This article will address both the history of the Loss Under Prior Policy provision and its predecessor, the Superceded Suretyship Rider, and the five requirements under the

¹ See *Southeast Bakery Feeds, Inc. v. Ranger Ins. Co.*, 974 S.W.2d 635 (Mo. Ct. App. 1998).

² See *id.* (citing *Chicora Bank v. United States Fid. & Guar. Co.*, 159 S.E. 454, 455-56 (S.C. 1931); *Ballard County Bank S & E v. United States Fid. & Guar. Co.*, 150 S.W. 1, 2 (Ky. Ct. App. 1912)).

³ See *id.*

⁴ There are many versions of the bond clause that provides coverage for losses sustained during a prior policy period but not discovered until after that policy period expired. For ease of reference, with the exception of the Superceded Suretyship Rider, when speaking of the clause in general terms, throughout this paper the concept is referred to simply as the “Loss Under Prior Policy provision.”

⁵ See, e.g., *Commercial Crime Policy, Crime General Provisions, General Condition 15* (Insurance Services Office, Inc. 1994) [hereinafter *Commercial Crime Policy*], reprinted in *STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS’N OF AMERICA)* [hereinafter *STANDARD FORMS*]. General Condition 15 reads: “*Subject to the Loss Sustained During Prior Insurance condition*, we will pay only for loss the you sustained through acts committed or events occurring during the Policy Period.” (Emphasis added). In the newer *Commercial Crime Coverage Form*, similar language is found in the “Loss Sustained” condition.

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Loss Under Prior Policy provision that are essential to the recovery for losses sustained during an expired bond or policy period.⁶

II. Historical Perspectives and the Advent of the Loss Under Prior Policy Provision

As we all learned in History 101, in order to understand the future, we must understand the past. This concept has full force and effect when attempting to understand the Loss Under Prior Policy provision's scope in the fidelity coverage area: understanding its original purpose sheds light on its intended application today.

There are numerous well-written articles regarding the history of fidelity coverage, whether it be in the context of the current day Financial Institution Bond, the Commercial Crime Policy, or other employee dishonesty coverages.⁷ Each offers enlightening perspectives on the dawn of fidelity coverage.

The first corporate sureties organized for the purpose of writing fidelity coverage appeared in the United States toward the end of the nineteenth century.⁸ The original fidelity bonds were generally much more limited in coverage than today's modern bonds, usually covering only loss due to larceny or embezzlement.⁹ Further, contrary to the more generally accepted practice of today's policies, the original bonds were written on an individual basis.¹⁰ However, as business grew and more employers realized the benefit and need for such coverage, procuring an individual bond for each employee became too burdensome.¹¹

The industry responded by introducing the Schedule Bond. The bond was generally issued in one of two forms: the Name Schedule Bond or the Position Schedule

⁶ As with most legal writings, a prominent disclaimer is necessary. Around 1998 the Insurance Services Office began offering coverage under its Commercial Crime Program for losses on both a discovery and a loss-sustained basis. The standard applied in discovery policies is essentially equivalent to the standard applied in the modern-day Financial Institution Bond. That is, coverage is available for losses that are discovered during the policy period, regardless of whether they are sustained during that period. Of course, as coverage is provided for the entire loss through the policy during which the loss was discovered, there is no need for a Loss Under Prior Policy provision in the discovery policies. Hence, it is with a heavy heart that we advise the practitioner analyzing a claim falling under a discovery form to disregard the content of this paper.

⁷ See generally Robin V. Weldy, *History of the Bankers Blanket Bond and the Financial Institution Bond Standard Form No. 24 with Comments on the Drafting Process*, in ANNOTATED BANKERS BLANKET BOND 3 (Harvey C. Koch ed., 2d Supp. 1988); Robert A. Babcock, *History of Fidelity Coverage*, in THE COMMERCIAL BLANKET BOND ANNOTATED 1 (William F. Haug ed., 1985); Norbert Wegerzyn & John Morrissey, *Fidelity Insurance Policies: Yesterday, Today and Tomorrow*, in HANDLING FIDELITY BOND CLAIMS 1 (Michael Keeley & Timothy M. Sukel eds., 1999); David A. Lewis, *History of Fidelity Coverage; Types of Commercial Crime Policies*, in COMMERCIAL CRIME POLICY 1-5 (Gilbert J. Schroeder ed., 1997); James L. Knoll & Linda M. Bolduan, *A Brief History of the Financial Institution Bond*, in FINANCIAL INSTITUTION BONDS 1 (Duncan L. Clore ed., 1995); Edward G. Gallagher et al., *A Brief History of the Financial Institution Bond*, in FINANCIAL INSTITUTION BONDS 1 (Duncan L. Clore ed., 2d ed. 1998).

⁸ Babcock, *supra* note 7, at 3.

⁹ See *id.*

¹⁰ See *id.*

¹¹ See *id.*

Bond.¹² The Schedule Bonds were designed to provide coverage in situations where the insured desired coverage for multiple employees. The Name Schedule Bond, as its name indicates, provided coverage up to a specific amount for individual employees named or identified on the schedule. Consequently, numerous employees could be covered under the same bond, obviating the need for numerous individual bonds.

The disadvantage of the Name Schedule Bond was that the employer was required to notify the surety on every occasion in which an employee left, was terminated, or otherwise replaced. To alleviate this inconvenience, the industry developed the Position Schedule Bond. Rather than providing coverage for specifically-identified individuals, the Position Schedule Bond, as its name implies, provided coverage for the position, rather than the individual. The employer could simply identify the position, such as treasurer, and indicate the amount of coverage desired with respect to that position. Thus, as individuals in the treasurer's position came and went, there was no need to update or modify the bond.

Despite the improvements with the advent of the Schedule Bonds, the industry was still unable to satisfactorily compete with the London market. As such, the bonds continued to evolve and in 1915, the industry introduced the Bankers Blanket Bond.¹³ The Bankers Blanket Bond was significant because it offered coverage under several insuring agreements, rather than simply larceny or embezzlement coverage. But while banks enjoyed the benefits of the broader coverage, it was not until around 1926 that the concept of "blanket" coverage was made available to commercial entities other than financial institutions.¹⁴ These Commercial Blanket Bonds, like their counterparts for banks, were designed to cover all employees like a "blanket."¹⁵

A. THE SUPERCEDED SURETYSHIP RIDER

The Superceded Suretyship Rider arose as a result of the industry's response to the predicament insureds often faced each time their bond expired or the need to modify it arose. At the turn of the century, bonds were designed and intended to be continuous, often in effect for a number of years. There were many situations—especially where coverage was provided under a Name Schedule Bond—where a person named under the bond would leave, requiring the insured to request that the person be removed from coverage, and, perhaps, add a replacement. As such, it was necessary that a new bond be written.

Of course, there was no issue with respect to the departing employee or the new employee named under the bond—it was clear when coverage for the old employee terminated and when coverage for the new employee began. The problem involved the

¹² *See id.*

¹³ *See id.*

¹⁴ *See id.*

¹⁵ *See id.* Unfortunately, the concept of "blanket" coverage was misinterpreted nearly from the bond's inception. The intent of "blanket" coverage was to provide coverage for all *employees*, not coverage for all *losses*. By 1986, the industry had had enough and simply changed the name from "Bankers Blanket Bond" to "Financial Institution Bond."

other employees named in the previous bond for which the employer wanted coverage to continue during the subsequent bond. When the subsequent bond was written to provide coverage for the new employee, the continuity afforded under the previous bond was no longer available. As such, a mechanism was needed to provide coverage for those situations where a loss was sustained during the first bond period but not discovered until the second bond was in force.

The Superceded Suretyship Rider was the response. Its purpose was to provide continuation of coverage on a limited basis without creating cumulative coverage between the subsequent and prior bond.¹⁶ A typical Superceded Suretyship Rider, read, in part, as follows:

Whereas, said fidelity suretyship, as of the effective date of the attached bond, has been cancelled, or has been terminated by agreement, as is evidenced by the issuance and acceptance of the attached bond and this rider.

Now Therefore, it is hereby understood and agreed as follows:

First. That the attached bond shall be construed to cover, subject to its terms, conditions and limitation, any loss under said fidelity suretyship caused by any employee covered by the said fidelity suretyship, which shall be discovered after the expiration of the period allowed under said fidelity suretyship in which claim may be presented after cancellation or termination, or if no such period after the bar of the statute of limitations, and before the expiration of the time limited in the attached bond for the discovery of loss or making claim thereunder, and which would have been recoverable under said fidelity suretyship had it continued in force, and also under the attached bond had such loss occurred during the currency thereof.

Second. That nothing herein contained shall be construed to render the Surety liable under the attached bond for a larger amount on account of such loss or losses under said fidelity suretyship than would have been recoverable thereunder had it continued in force, or to increase the time for discovering loss under said fidelity suretyship beyond what would have been the time had it continued in force, and as to that part of the loss under the attached bond shall not exceed the amount applicable to the employee causing the loss under the attached bond, and as to the whole loss shall not exceed the amount applicable to the employee causing the loss under either the fidelity suretyship or the attached bond, whichever may be the larger.¹⁷

¹⁶ This intention was recognized and given effect in *Columbia Hosp. for Women v. United States Fid. & Guar. Co.*, 188 F.2d 654 (D.C. Cir. 1951).

¹⁷ *Hartford Accident & Indem. Co. v. Swedish Methodist Aid Ass'n*, 92 F.2d 649, 651 (7th Cir. 1937).

One court has summarized the Superseded Suretyship Rider's scope in the Bankers Blanket Bond "in the fewest possible words" as follows: "the prior bond is this day cancelled and this bond covers loss under the prior bond discovered more than one year from today."¹⁸ As such, the subsequent bond assumed all obligations of the prior bond.¹⁹

For the most part, courts addressing the Superseded Suretyship Rider seem to have applied the provision as intended. In *Exchange Building Association v. Indemnity Insurance Co.*,²⁰ the court found the language in the Superseded Suretyship Rider to be clear and unambiguous. The court held that recovery for a loss in excess of \$5,000 and occurring over two bond periods was limited to the \$2,000 limit on the subsequent bond, even though the prior bond had a limit of \$5,000.

The loss at issue in *Exchange Building* was not discovered until after the discovery tail on the prior bond expired. As such, the court looked to the Rider to determine whether additional coverage was available. Specifically, the court looked to paragraph 2 to determine whether coverage beyond the current bond's \$2,000 limit was available to the insured. Paragraph 2 of the Rider was slightly different than that reproduced above, and read as follows:

That nothing herein contained shall be construed to render the surety liable under the attached bond for a larger amount on account of such loss or losses under said prior bond than would have been recoverable thereunder had it continued in force, or for more than the amount recoverable under the attached bond on its effective date less all deductions on account of all payments made under the attached bond and the attached bond extended by this rider if the latter amount be the smaller.²¹

The court found the language of paragraph 2 "too clear to require argument" that the total recoverable amount available to the insured was \$2,000, the bond limit applicable during the current bond period.²²

In *Globe Indemnity Co. v. Wolcott & Lincoln, Inc.*,²³ the Loss Under Prior Policy issue arose under a depositor's forgery bond. Globe had issued two three-year bonds to the insured, each of which had a \$10,000 limit. The first bond had a twelve-month discovery tail and the subsequent bond had a Superseded Suretyship Rider attached.²⁴ During the second bond period, but within the first bond's twelve-month discovery tail, the insured discovered that it had sustained a loss during both bond periods. As such, the insured argued two \$10,000 limits applied.²⁵ The insurer, relying upon the Rider as a

¹⁸ *Fid. & Deposit Co. of Md. v. Lyon*, 124 S.W.2d 74 (Ky. Ct. App. 1938).

¹⁹ *See id.*

²⁰ 12 A.2d 924 (Pa. 1940).

²¹ *Id.*

²² *See id.*

²³ 152 F.2d 545 (8th Cir. 1945).

²⁴ *Id.* at 546.

²⁵ *Id.*

limitation of the aggregate amount of its liabilities under both bonds, disagreed and argued that only one limit applied.²⁶

Focusing on the language of paragraph 1 in the Rider, the court noted that the Rider only applied when the loss sustained during the prior bond period is “discovered after the time limited therein for the making of claim or the discovery of loss thereunder.”²⁷ As the loss in *Globe* was discovered before the discovery tail in the first bond expired, an essential element of the Rider had not been met. As such, the Rider did not apply. While certainly there were limitations of coverage in the Rider and provisions specifically speaking to the non-cumulation of coverage,²⁸ the court found that these limitations only applied when the loss was not discovered until after the prior bond’s discovery tail expired and the Rider was, in fact, triggered. Absent a loss discovered after the prior bond’s discovery tail expired, the non-cumulation clause in paragraph 4 of the Rider was inapplicable. “The liability of the [insurer] under the first bond and its liability under the second bond were not cumulative liabilities, but were separate liabilities, for separate amounts, under separate contracts of insurance. Hence, an agreement that these distinct liabilities should not be cumulative in amounts would be meaningless.”²⁹

However, not all courts have demonstrated a clear understanding or appreciation of the provision’s scope. *Hartford Accident & Indemnity Co. v. Swedish Methodist Aid*

²⁶ *Id.*

²⁷ *Id.*

²⁸ The relevant limitations on coverage in the Rider provided:

2. That there shall be no liability under the attached bond as extended by this rider on account of any office covered under the prior bond unless such office be also covered under the attached bond at the time it becomes effective.
3. That liability under the attached bond as extended by this rider for loss or losses under the prior bond on account of any office shall not exceed the amount carried on such office under the attached bond at the time the attached bond becomes effective less all deductions on account of all payments made on account of such office under the attached bond and the attached bond as extended by this rider, and less all other deductions therefrom required to be made by the attached bond, or the amount which would have been recoverable under the prior bond on account of such loss or losses had the prior bond continued in force until the cancellation, termination or expiration of the attached bond, if the latter amount be smaller.
4. That liability under the prior bond in the attached bond on account of any office shall not be cumulative in amounts and to that end losses under the prior bond on account of such office shall be paid first, in any sum or sums which shall be paid under the attached bond on account of such office shall be deducted from any amount or amounts carried under the prior bond, and any sum or sums which shall be paid on account of such office under the prior bond and/or the attached bond as extended by this rider shall be deducted from any amount or amounts carried under the attached bond, such deduction, in either of the above cases, to be made in the same manner and subject to the same limitations and conditions as payments under the attached bond on account of any office are required to be deducted, but any sum or sums so deducted from any amount or amounts of the attached bond shall be restored thereto as provided in the attached bond and an additional pro rata premium shall be paid as provided therein.

Id. at 546-47.

²⁹ *Id.* at 548.

Ass'n involved the defalcations of a secretary over a period of time during which two Hartford bonds were effective.³⁰ The first bond was in effect from May 14, 1927, through October 8, 1931.³¹ The discovery period on the first bond ended August 10, 1932.³² The loss was not discovered until 1933.³³

Hartford argued that it had no obligation to indemnify the insured for losses that occurred during the term of the first bond unless those losses were discovered and reported within the discovery tail. The insured argued that this was the precise reason the second bond attached the Superseded Suretyship Rider (reproduced above). In addressing the Rider's language, the court's frustration with its wording was evident when it noted: "[j]ust why an instrument so confusing and contradictory in its terms should be employed, we do not know and do not care to hazard a guess."³⁴

The court held that the loss sustained during the first bond period (but not discovered until after the discovery tail on that bond expired) was covered under the Rider attached to the second bond.³⁵ This conclusion is sound, based upon the Rider's language. However, the court in *Swedish Methodist* also showed a willingness to expand the scope of coverage afforded under the second bond and the attached Rider.

Hartford argued that the act of misconduct causing the loss—raising checks—was not covered under the first bond because that bond only provided coverage for larceny or embezzlement.³⁶ The court expressed doubt as to whether raising checks would in fact fall outside the scope of coverage provided in the first bond. Regardless, it found that it was not necessary to decide this question because the *second* bond provided coverage for "fraud, dishonesty, forgery, theft, embezzlement, wrongful abstraction or willful misapplication."³⁷ The court found this language broad enough to cover the misconduct at issue.

The court's decision with respect to this issue disregarded the Rider's scope and the clear intent of its language, which provided coverage only for that "which would have been recoverable under said Fidelity Suretyship had it continued in force."³⁸ Rather than making a determination as to what would have been recoverable under the prior bond had it continued in effect until the time the loss was discovered, the court expanded the scope of coverage intended by the Rider simply because it found the loss was covered under the current policy. No deference was given to the fact that the loss occurred during two separate bond periods providing distinctive coverage.

³⁰ 92 F.2d 649 (7th Cir. 1937).

³¹ *Id.* at 650.

³² *Id.*

³³ *Id.*

³⁴ *Id.* at 651.

³⁵ *Id.* at 652.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* at 651. This is the second of the five requirements necessary to satisfy today's Loss Under Prior Policy provision.

B. LOSS UNDER PRIOR POLICY PROVISION

The modern-day Loss Under Prior Policy provision is the successor to the Superseded Suretyship Rider, which first appeared in Bankers Blanket Bonds. And while the Bankers Blanket Bond has been the role model for the commercial crime coverage, relevant to this article, the two coverages took a divergent path in the middle of the last century.³⁹ In 1954, Standard Form No. 24 was converted from a “loss sustained” form into a “loss discovery” form.⁴⁰ That is, after the 1954 revision, coverage under the Bankers Blanket Bond was available to the insured to the full extent of the loss discovered during the bond period, subject, of course, to the bond provisions. Thus, there was no need to identify the dates the specific loss occurred, and, hence, there was no longer any need for a Superseded Suretyship Rider or other equivalent provisions.

The commercial coverages did not follow suit with respect to the financial institution coverage’s transition from loss sustained to loss discovery. As such, the Loss Under Prior Policy provision remained essential in the commercial forms. However, standard forms providing coverage on a discovery basis have been available to commercial insureds for only the last five years. Nonetheless, coverage continues to be provided on a loss-sustained basis as well.

The modern-day Loss Under Prior Policy provision provides that, despite the policy’s admonition that coverage is only available for losses the insured sustains through acts committed during the policy period, coverage will be available for previous losses under the policy during which the insured discovers the loss if five conditions are met. First, the insured must have sustained a loss during the period of prior insurance. Second, the insured must have been able to recover under such prior insurance except that, third, the discovery period under the prior insurance had expired. Fourth, the current insurance must have become effective at the time that the prior insurance was cancelled. And, fifth, the loss sustained during the prior policy period would have been covered under the *current* policy had it been in effect at the earlier time.

The Loss Under Prior Policy provision in today’s loss-sustained policies generally takes one of two forms.⁴¹ For the most part, the same general characteristics are present in each provision. The provision appearing in the Commercial Crime Coverage Form reads as follows:

- (1) If you, or any predecessor in interest, sustained loss during a period of any prior insurance that you or the predecessor in interest could have recovered under that insurance except at the time

³⁹ The development of the Commercial Crime Policy owes its existence to the Bankers Blanket Bond. As there has not been overwhelming acceptance of any one policy in the commercial crime area, numerous products are currently available in the marketplace. See Wegerzyn & Morrissey, *supra* note 7, at 12. Adaptations of the Bankers Blanket Bond in the commercial insurance context include the Comprehensive Dishonesty, Disappearance and Destruction Policy (commonly referred to as the “3-D Policy”) as well as the Blanket Crime Policy and the modern-day Commercial Crime Policy. See *id.* at 11.

⁴⁰ Knoll & Bolduan, *supra* note 7, at 11.

⁴¹ It should go without saying that there are also many manuscripted policies in the commercial insurance area.

within which to discover loss had expired, we will pay for it under this insurance, provided:

- (a) This insurance became effective at the time of cancellation or termination of the prior insurance; and
 - (b) The loss would have been covered by this insurance had it been in effect when the acts or events causing the loss were committed or occurred.
- (2) The insurance under this Condition is part of, not in addition to, the Limits of Insurance applying to this insurance and is limited to the lesser of the amount recoverable under:
- (a) This insurance as of its effective date; or
 - (b) The prior insurance had it remained in effect.⁴²

The 3-D Policy, the Blanket Position Bond and the Blanket Crime Policy all include a similar Loss Under Prior Policy provision, which reads as follows:

C. If the coverage of this Policy is substituted for any prior bond or policy of insurance carried by the Insured or by any predecessor in interest of the insured, which prior bond or policy is terminated, canceled or allowed to expire as of the time of such substitution, the Company agrees that this Policy applies to loss which is discovered as provided in Section 1 of the conditions and limitations and which would have been recoverable by the Insured or such predecessor under such prior bond or policy except for the fact that the time within which to discover loss thereunder had expired, provided:

- (1) the insurance under this General Agreement C shall be a part of and not in addition to the amount of insurance afforded by this Policy;
- (2) such loss would have been covered under this Policy had this Policy with its agreements, conditions and limitations as of the time of such substitution been in force when the acts or events causing such loss were committed or occurred; and
- (3) recovery under this Policy on account of such loss shall in no event exceed the amount which would have been recoverable under the coverage of this Policy applicable to such loss in the amount for which it is written as of the time

⁴² Commercial Crime Coverage Form (Loss Sustained Form), Condition 1.m (ISO Properties, Inc., 2001) [hereinafter Commercial Crime Coverage (Loss Sustained) Form], *reprinted in* STANDARD FORMS.

of such substitution, had this Policy been in force when such acts or events were committed or occurred, or the amount which would have been recoverable under such prior bond or policy had such prior bond or policy continued in force until the discovery of such loss, if the latter amount be smaller.⁴³

The similarities between the original Superceded Suretyship Rider and today's Loss Under Prior Policy provision are uncanny considering the changes that other policies and provisions in the industry have undergone. In fact, the old adage "the more things change, the more they stay the same" is certainly on point when addressing the Loss Under Prior Policy provision. The same essential elements found in the modern-day provision were also part of the Superceded Suretyship Rider. That is, coverage under the Rider was available if: (1) the subsequent bond became effective at the prior bond's termination; (2) a loss was sustained during the prior bond period that was; (3) discovered after the discovery tail expired; (4) would have been recoverable under the prior bond; and (5) would have been recoverable under the current bond.

III. Requisites to Recovery Under the Loss Under Prior Policy Provision.

The modern-day Loss Under Prior Policy provision includes the five coverage requirements listed above. All five must be satisfied before the insured can recover for losses sustained during a prior policy, but not discovered until after the prior policy's discovery tail expired. Each requirement is addressed below.

A. LOSS SUSTAINED DURING PRIOR POLICY

The first requirement of the analysis requires that the insured sustain a loss during the prior policy period. The scope of this analysis is relatively straightforward. It requires the insured to identify the date that it sustained the loss. If the date of loss is during a prior policy, the first requirement is generally satisfied. However, an issue may arise regarding the scope of coverage under the provision, that is, how far back does the provision apply?

The context in which the Loss Under Prior Policy developed suggests that the industry's initial intent was solely to insure losses sustained during the *immediately* preceding policy or bond. Certainly, at the time insurers were attaching Superceded Suretyship Riders, the consensus was that coverage was available to the insured during the entire bond period, with no reliance on annual renewals.⁴⁴ Insurers added the Riders when fidelity coverage was offered as a single, continuous bond, rather than multiple, separate contracts renewed on an annual basis. In this context, then, the stronger argument appears to be that coverage was intended to be available only for losses during

⁴³ Blanket Crime Policy (Revised to March, 1980), General Agreement C, *reprinted in* STANDARD FORMS.

⁴⁴ A consensus that most insurers continue to share today.

the prior policy, not policies.⁴⁵ However, several courts that have addressed this issue have held that the provision applies not only to the immediately preceding bond or policy, but to all preceding bonds or policies in effect during the life of the long-term loss, so long as the claim otherwise meets the Loss Under Prior Policy provision's five requirements.

Insureds often cite *Universal Underwriters Insurance Co. v. Buddy Jones Ford* in support of their argument that the Loss Under Prior Policy provision goes back indefinitely to provide coverage so long as the provision's requirements are satisfied.⁴⁶ In *Buddy Jones*, a bookkeeper misappropriated \$233,082.97 from the dealership on at least 175 separate occasions.⁴⁷ The defalcations took place over a four-year period, covering four separate Garage Liability policies that Universal issued to the insured.⁴⁸ Each policy included crime coverage that carried \$10,000 in Employee Dishonesty coverage with a \$250 deductible.⁴⁹

Universal took the position that the \$10,000 coverage limit was the total amount available to the insured for all loss caused by a dishonest employee. The insured, on the other hand, argued that the \$10,000 limit applied separately to each of the 175 acts of embezzlement. Unfortunately for Universal, its definition of "loss" failed to include "a series of related acts." Rather, the concept of loss due to employee dishonesty simply included "any fraudulent or dishonest act."⁵⁰ Keying on this language, the court found that the policy was ambiguous. It, therefore, interpreted the policy in the insured's favor and held that there was coverage up to \$10,000 for each individual act of embezzlement.⁵¹

No doubt adding salt to Universal's wounds, the court went on to hold that the Loss Under Prior Policy provision in Universal's crime coverage provided that coverage was available for all loss going back indefinitely throughout the time that Universal insured Buddy Jones. The lower court had held Universal would only be liable for loss "discovered not later than one year from the end of the coverage part period, which would be for all acts of embezzlement during the policy period from October 1, 1987, and from the policy period beginning October 1, 1987 [sic], to the alleged date of discovery of the loss on July 25, 1988."⁵² The lower court based its holding on the discovery provision in the policy that provided coverage only if the insured discovered the loss within one year from the end of the crime coverage period.⁵³

⁴⁵ However, it is worth noting that the prior policy itself may be in effect over several years, losses during which would be covered by the Loss Under Prior Policy provision.

⁴⁶ 734 So. 2d 173 (Miss. 1999).

⁴⁷ *Id.* at 174.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *See id.* at 178.

⁵² *Id.* The court most likely intended the second reference to October 1, 1987, to be 1988.

⁵³ The discovery clause provided that "LOSS is covered only if discovered not later than one year from the end of the Coverage Part period. Subject to [the Loss Under Prior Policy provision.]" *Id.* at 178.

On appeal, the Mississippi Supreme Court focused on the fact that the discovery clause was subject to the Loss Under Prior Policy provision, which read as follows:

3. LOSS UNDER PRIOR BOND OR POLICY—If EMPLOYEE DISHONESTY replaces a bond or policy carried by YOU (or YOUR predecessor in interest) that is no longer in effect, WE will pay for LOSS (subject to Condition 1) if LOSS would have been covered by the prior bond or policy except that the LOSS was not discovered in the Discovery Period of the prior bond or policy. Provided, however:

- (a) this extension is part of and not in addition to the limit stated in the declarations for EMPLOYEE DISHONESTY;
- (b) the LOSS would have been covered had this insurance been in effect when the act or event causing the LOSS took place;
- (c) LOSS recovery is limited to the least of the following:
 - (1) The amount recoverable at the time coverage was replaced by this insurance had it been in force at the time the act or event took place;
 - (2) The amount recoverable if the prior bond or policy had continued in force until the discovery of the LOSS.⁵⁴

Relying on *Cincinnati Insurance Co. v. Hopkins Sporting Goods, Inc.*,⁵⁵ the *Buddy Jones* court also found the limitation of the discovery clause and the application of the Loss Under Prior Policy provision created another ambiguity. Construing the ambiguity in the insured's favor, the court found that Universal's crime coverage was not limited to loss discovered within one year of the end of the crime coverage period. Rather, the court found that the Loss Under Prior Policy provision "continuously extends the discovery clause through each successive policy period, since Jones Ford continued to purchase coverage with Universal throughout the entire period the acts of embezzlement occurred."⁵⁶

In *Hopkins Sporting Goods*, the Iowa Supreme Court employed a very simple analysis in finding that the Loss Under Prior Policy provision trumped application of the discovery provision that also limited coverage to losses that were discovered within one year of the end of the effective period of the crime coverage. The *Hopkins Sporting Goods* court found that the Loss Under Prior Policy provision was "a clear incentive for insureds to continue to purchase coverage with [their current insurer, and could] be

⁵⁴ *Id.* at 178-79.

⁵⁵ 522 N.W.2d 837 (Iowa 1994).

⁵⁶ *Buddy Jones Ford*, 734 So. 2d at 179.

understood to extend the limitations period into the period of a new policy.”⁵⁷ The Iowa court relied upon *White Dairy Co. v. St. Paul Fire & Marine Insurance Co.*⁵⁸ in arriving at its decision, and although it recognized *White Dairy* was not necessarily a more “sound interpretation” of the policy than that suggested by the insurer in *Hopkins Sporting Goods*, the court found the former interpretation “plausible.”⁵⁹ Therefore, in light of the general rules of policy interpretation, it was obligated to follow the “plausible” interpretation.⁶⁰

The Tenth Circuit has also afforded the insured the opportunity to retreat indefinitely through the prior policies and access coverage throughout the time that it sustained the loss.⁶¹ In *Brigham Young University v. Lumbermens Mutual Casualty Co.*, the court afforded coverage under the then current policy’s Loss Under Prior Policy provision for losses sustained under three previous policies issued by three different insurers.⁶²

It is not alarming when coverage is found to be available for losses suffered during previous policies issued by the same insurer in jurisdictions that essentially view such coverage as a continuous bond.⁶³ What is disturbing, however, is situations similar to *Brigham Young*, where previous coverage is provided through numerous separate insurers. While certainly a loss may have been suffered during each of the prior policy periods—thus satisfying the first requirement—coverage should not be available because the fourth requirement of the Loss Under Prior Policy provision requires the current policy to replace the expiring one. In these situations, only loss suffered during the immediately preceding bond should be covered under the provision.

B. COVERAGE LIMITED TO WHAT “WOULD HAVE BEEN RECOVERABLE” UNDER PRIOR POLICY

Perhaps no other requirement of the Loss Under Prior Policy analysis is more significant than the second, which provides that coverage under the provision is available only to the extent the loss sustained under the prior bond would have been recovered.

1. Effect of Previous Losses

*Traders State Bank v. Continental Insurance Co.*⁶⁴ demonstrates the importance of obtaining the prior bond and reviewing its provisions as if a coverage determination under that bond were to be made as well. Such a coverage determination depends not only on the policy language, but also on an inquiry into the limits remaining on the prior bond. The *Traders State Bank* decision is also of interest because the prior bond, issued

⁵⁷ *Hopkins Sporting Goods, Inc.*, 522 N.W.2d at 839.

⁵⁸ 222 F. Supp. 1014 (N.D. Ala. 1963).

⁵⁹ *Hopkins Sporting Goods, Inc.*, 522 N.W.2d at 839.

⁶⁰ *Id.*

⁶¹ See *Brigham Young Univ. v. Lumbermens Mut. Cas. Co.*, 925 F.2d 830 (10th Cir. 1992).

⁶² *Id.* at 834. See *infra* Part III.B.2 for a more detailed discussion of *Brigham Young*.

⁶³ See *infra* Part III.B.3.

⁶⁴ 448 F.2d 280 (10th Cir. 1971).

by National Surety Corporation, was written on a discovery basis, while the subsequent bond, issued by Continental Insurance Company, was written on a loss-sustained basis.⁶⁵

In *Traders State Bank*, the insured bank suffered a \$191,000 loss from a check kiting scheme. At the time the loss was discovered, the bank was insured under the National Surety bond (the discovery bond). When National Surety denied coverage for the loss under its bond, it also gave notice of cancellation.⁶⁶ As a result, the bank then purchased the Continental bond (the loss-sustained bond), which included a Loss Under Prior Policy provision.⁶⁷ After the Continental bond came into effect, the bank settled with National Surety on the check-kiting loss for the bond limit of \$25,000.⁶⁸

Apparently the defalcator involved in the check-kiting scheme was more desperate and resourceful than originally believed. While the Continental bond was in effect, the insured discovered another loss of approximately \$181,000 resulting from the sale of forged notes to the bank by the same defalcator.⁶⁹ The insured determined that it suffered this loss during the National Surety bond period. Thus, it became necessary to address Continental's Loss Under Prior Policy provision.

Pursuant to the Loss Under Prior Policy provision's terms, Continental agreed to cover any losses sustained prior to the expiration of its bond if the losses "would have been recoverable under the coverage" of the prior bond. The court found that the provision "had the effect of making Continental's bond a loss discovered bond as to any loss sustained during the life of the National Surety bond but discovered during the Continental bond."⁷⁰ Specifically, the provision read as follows:

2. Loss sustained by the Insured at any time before the termination or cancellation of this bond as an entirety, which would have been recoverable under the coverage of any other insurance carried by the Insured or any predecessor in interest of the Insured and giving some or all of the coverage afforded under the Insuring Clause of this bond applicable to such losses, had such other insurance given all the coverage afforded under such Insuring Clause of this bond; PROVIDED, with respect to losses covered by this paragraph, that

(A) the applicable coverage of this bond is substituted, on or after noon of the date of this bond, for the coverage given by such other insurance and the Insured or such predecessor, as the case may be, carried such coverage continuously from the time such losses are sustained to the date and hour the coverage of this bond is substituted therefore, and

⁶⁵ *Id.* at 281.

⁶⁶ *Id.*

⁶⁷ The provision was labeled "Retroactive Extension of Coverage Clause."

⁶⁸ *Id.*

⁶⁹ *Id.* at 282.

⁷⁰ *Id.*

(B) such coverage in force at the time such losses are sustained gave some or all of the coverage afforded under the Insuring Clause of this bond applicable to such losses, and

(C) at the time of discovery of such losses, the period for discovery of loss under all bonds and policies of insurance which afford coverage applicable to such losses and for which the coverage of this bond is substituted, has expired, and

(D) if the applicable amount of this bond is larger than the amount of coverage under any other insurance carried by the Insured or such predecessor, as the case may be, and in force at the time such losses are sustained, and giving some or all of the coverage afforded under the Insuring Clause of this bond applicable to such losses, then liability hereunder for such losses shall not exceed the smaller amount.⁷¹

Paraphrasing the provision's language, the district court identified five conditions that had to be met in order to find coverage:

- (1) The bank must previously have carried other similar insurance;
- (2) The current bond must have superceded such other insurance;
- (3) The insurance coverage under the first bond when the loss was sustained must have afforded some or all of the coverage afforded under the second bond;
- (4) The period for discovery of loss must have expired under the first bond;
- (5) If the amount of the current bond is larger than the amount of the first bond, liability is limited to the smaller amount.⁷²

Finding that each of these conditions was satisfied, the district court held that coverage was available under the Continental bond.

Continental appealed and, upon review, the Tenth Circuit reversed the district court decision. The Tenth Circuit agreed that there was no dispute with respect to whether the five conditions were satisfied—Continental itself admitted as much. Continental argued, however, that the district court had overlooked the provision's limitation providing coverage only for losses that would have been recoverable under the prior bond.⁷³ Under the National Surety bond, the insurer's total liability for losses caused by the same person, whether related or separate, was limited to the bond's face

⁷¹ *Id.* at 281 n.1.

⁷² *Id.*

⁷³ *Id.*

amount.⁷⁴ Although it had initially denied coverage for the check kiting scheme, National Surety later settled that dispute with the bank for its bond limit of \$25,000. Consequently, the insured had exhausted the available coverage under the prior bond with respect to that specific defalcator. Thus, even though the loss was covered, it was not “recoverable.”⁷⁵

Focusing on the phrase “recoverable under the coverage,” the Tenth Circuit reinforced the Loss Under Prior Policy provision’s intent and application, holding that its purpose was to:

. . . provide the bank with coverage, which it would not otherwise have had, for losses discovered but not sustained during the life of a “loss sustained” bond. The effect of this construction is to limit Continental’s liability for losses sustained during the life of the antecedent bond, but discovered during the life of its bond to amounts that would have been recoverable under the antecedent bond if it had been in effect at the time the losses were discovered. This being so, the payment by National Surety of \$25,000, before Continental’s performance was due, exhausted its liability according to the terms of [the National Surety Bond]. National Surety’s liability being exhausted, there was no further recoverable loss under the coverage of the Continental Bond.⁷⁶

Because the second requirement was not met, there was no recovery under the Loss Under Prior Policy provision of Continental’s bond.

2. Effect of Deductibles

Loss that accumulates over multiple policy periods is often large enough to exhaust all coverage available under the policy in effect when the loss is ultimately discovered. Consequently, courts rarely address situations where multiple deductibles over the life of the loss will have an impact on the total recoverable loss. In most situations, the loss usually exceeds the current policy’s limit and the insured looks to the previous policies for additional coverage. Case law is abundant, and split, with respect to the cumulation of policy limits for losses that occur over several policy periods.⁷⁷ But because the policy limit during which the loss was discovered is generally exhausted in those cases, there is no issue with respect to the Loss Under Prior Policy provision because such coverage “is part of, not in addition to,” the current policy limits.

Thus, case law rarely addresses situations in which the policy limits under each policy period exceed the amount of loss sustained, not only per period, but also in sum total (for example, the Prior and Current Bonds each have coverage limits of \$1,000,000, and the insured suffers a loss of \$500,000). It is in these situations that the Loss Under

⁷⁴ *Id.* at 283.

⁷⁵ *Id.*

⁷⁶ *Id.* at 284.

⁷⁷ See, e.g., Susan Koehler Sullivan, *Two for the Price of One: The Impact of the Karen Kane Decision*, VI Fid. L.J. 25 (2000).

Prior Policy provision will not only apply to the previous policy but, as some courts have held, will go back indefinitely for every period in which the loss occurred until the policy limit is exhausted or the entire loss is covered.⁷⁸ It is also in these situations that multiple deductibles have an effect on the insured's recovery.

There are many situations, especially in general liability long-tail claims, where the insured seeks to obtain the benefit of multiple limits by invoking multiple policy periods but, at the same time, seeks to limit its own exposure by arguing that the court should only apply one deductible. This situation often arises in environmental claims, where multiple policies may be exposed in a jurisdiction that applies a "continuous" trigger. For the most part, courts have held in these situations that the insured cannot enjoy the benefit of multiple policy limits without the concomitant application of deductibles.⁷⁹ Bearing in mind the operative language of "what would have been recoverable," there should be an analogous rule in fidelity coverage.

The argument for the application of multiple deductibles is rather straightforward and is perhaps best explained by use of a hypothetical. Assume Prior Insurer issues a Commercial Crime Policy in effect during 2002, with a \$50,000 deductible and a \$1,000,000 policy limit. During 2003, Current Insurer issues an identical Commercial Crime Policy, with the same deductible and policy limit. Assume that the 2002 policy has a six-month discovery tail.

In the eighth month of the 2003 policy period, the insured discovers that it suffered a loss in the amount of \$250,000. After further investigation, the insured discovers that, during the 2003 policy period, the dishonest employee embezzled \$210,000 from the business. Further, the insured sustained losses in the amount of \$40,000 during the 2002 policy period.

Assuming that the conditions to coverage are met, the recoverable loss under the 2003 policy is fairly clear: \$160,000.⁸⁰ Faced with the 2002 loss, the insured will look to the Loss Under Prior Policy provision and argue that it is entitled to an additional \$40,000. However, the provision's plain language indicates that no such coverage would be available. Breaking the provision down into the five requirements identified above, it is clear that the second requirement—a loss for which the insured could have recovered—is not satisfied. Certainly, it cannot be disputed that the insured did in fact sustain a loss in the amount of \$40,000 during the 2002 policy. However, that loss would not have been recoverable under the 2002 policy because the loss did not exceed the applicable deductible of \$50,000. Consequently, the total recoverable under Current Insurer's policy as a result of the \$250,000 loss would be \$160,000.

⁷⁸ See *Brigham Young Univ. v. Lumbermens Mut. Cas. Co.*, 925 F.2d 830 (10th Cir. 1992); *White Dairy Co. v. St. Paul Fire & Marine Ins. Co.*, 222 F. Supp. 1014 (N.D. Ala. 1963); *Cincinnati Ins. Co. v. Hopkins Sporting Goods, Inc.*, 522 N.W.2d 837 (Iowa 1994); *Universal Underwriters Ins. Co. v. Buddy Jones Ford*, 734 So. 2d 173 (Miss. 1999).

⁷⁹ See Katherine E. Tammaro, *Giving Credit where Credit is Due: The Proper Application of Deductibles and SIRs in Multiple Consecutively-Triggered Policies*, 14 ENVTL. CLAIMS J. 157, 163 (2002).

⁸⁰ This amount represents the total loss sustained during the policy period (\$210,000), less the policy deductible (\$50,000).

The litmus test in this situation, as with any other situation involving a Loss Under Prior Policy provision, is applied by determining whether the outcome would be different when modifying one simple fact: suppose that the insured discovered the loss within the 2002 policy's six-month discovery tail. In that scenario, coverage is available from both the Prior and Current Insurers. Clearly, the outcome would be the same as that under the scenario where the insured first discovered the loss after the discovery tail expired. Prior Insurer will not provide any coverage to the insured for the \$40,000 loss incurred during the 2002 policy because the amount of loss does not exceed the policy deductible. Further, Current Insurer will indemnify the insured up to \$160,000: the total amount of the loss less the applicable policy deductible. The Loss Under Prior Policy provision will not apply because the loss was discovered within the 2002 policy's discovery tail (thus the third requirement in the analysis, discussed below, would not be met).

Now suppose that the same insured suffered the same amount of loss over the same period of time, except that our defalcator caused the insured \$125,000 in loss in each of the two policy periods. Again, there is no dispute with respect to the coverage conditions being satisfied, and the recoverable loss during the 2003 policy period is \$75,000.⁸¹ But the coverage analysis does not end there, and no doubt the insured, as well as the insurer, will look to the Loss Under Prior Policy provision to determine whether the remaining loss may be recovered.

In this situation, the second requirement is satisfied because there is an amount that would have been recoverable had the insured discovered the loss within the pertinent time frame. And, as noted above, we have assumed the other requirements are satisfied as well. Consequently, it appears that coverage is available up to the amount that the insured "could have recovered" under the prior insurance period.

The amount the insured could have recovered under the 2002 policy (had it been in effect) is \$75,000, not \$125,000. The insured would not have recovered the entire \$125,000 loss under the 2002 policy because coverage under that policy would only have been available for loss suffered over and above the applicable deductible. As noted in the first example, if the insured only suffered a \$40,000 loss during the 2002 policy, there would have been no coverage because the loss incurred during that policy period did not exceed the deductible. This line of reasoning should not be distorted solely because the loss during the 2002 policy period exceeds the deductible. That is, simply because the total loss incurred in a policy period exceeds the deductible does not mean that the deductible should be ignored. If the insured had suffered a \$49,000 loss in the 2002 policy period, there would have been no coverage because there was no "recoverable loss." And if the insured suffered a \$51,000 loss in the 2002 policy period, while there is a recoverable loss, such recovery should not be \$51,000, but rather, only \$1,000.

Again, we look to the litmus test. Had the insured discovered the loss within the 2002 policy's six-month discovery tail, coverage would have been available from Prior

⁸¹ This amount represents the total loss sustained during the policy period (\$125,000), less the policy deductible (\$50,000).

Insurer and Current Insurer. The situation in which Current Insurer finds itself with respect to coverage under its 2003 policy is unchanged—it is obligated to indemnify the insured for \$75,000. However, as the loss was discovered within its policy’s discovery tail, Prior Insurer also has an obligation to indemnify its insured. Finding that a loss of \$125,000 was sustained during its policy period, Prior Insurer would reimburse the insured for a total of \$75,000.⁸² Consequently, the total amount that the insured could have recovered in this situation would have been \$150,000, the same amount recoverable under the 2003 policy and its Loss Under Prior Policy provision when the insured failed to discover the loss within the discovery tail of the 2002 policy.

Of course, the counter-argument from the insured would be that coverage afforded by the Loss Under Prior Policy provision is “a part of, and not in addition to” that afforded by the entire policy. That is, the Loss Under Prior Policy provision is not in itself an additional insuring agreement. Therefore, the insured may argue that any coverage provided under the provision falls within that contemplated by the underwriters, who would have considered the application of but one deductible. Insurers must make a critical distinction responding to this argument: the current insurer does not apply multiple deductibles, but rather simply identifies “what would have been recoverable.” Some may argue that this is form over substance, but the plain language of the Loss Under Prior Policy provision only provides coverage for amounts that would have been recoverable under the prior insurance had it remained in effect. To hold otherwise actually affords the insured the opportunity to reap a benefit when changing insurers rather than simply placing it in the same position that it would have been in had it not changed.

Insurers should also emphasize the public policy issues that the insured’s interpretation would raise. If the insured were able to avoid the prior bond’s deductible, it would have an incentive to be complacent and non-diligent in investigating and employing checks and balances within its company. There would be nothing to gain by diligently investigating suspected losses before the prior bond’s discovery tail expired. By simply delaying investigation until after the discovery tail expires, the insured would be able to increase its recoverable loss. Given the relatively significant deductibles that are often present in fidelity coverage, the delay in investigation would likely be beneficial to the insured.

As mentioned briefly above, the *Brigham Young University* case represents a mixed bag with regard to the Loss Under Prior Policy provision.⁸³ While the Tenth Circuit did find coverage available through multiple prior policies issued by separate insurers, it reduced the recoverable loss by the deductibles under each prior policy.

The defalcator in the *Brigham Young University* case was a university professor who had stolen artwork from the school’s art collection over a period of ten to twelve years.⁸⁴ During this period of time, the professor’s fraudulent or dishonest acts resulted

⁸² Again, \$75,000 is the result of loss sustained (\$125,000), less the policy deductible (\$50,000).

⁸³ 925 F.2d 830 (10th Cir. 1992).

⁸⁴ *Id.* at 831.

in the loss of over 300 works of art.⁸⁵ The defalcations occurred during four separate policy periods, with each policy issued to the university by different companies as follows:

Insurance Company	Limit of Liability	Deductible	Coverage Period
Lumbermens Mutual	\$1,000,000	\$2,500	12/1/82 – Discovery
Federal Ins. Co.	\$1,000,000	\$2,500	12/1/78 – 12/1/82
Fidelity Deposit Co.	\$500,000	\$50,000	11/1/75 – 12/1/78
Western Cas. & Surety Co.	\$50,000	- 0 -	9/19/68 – 11/1/75 ⁸⁶

The stolen artwork was discovered during the Lumbermens policy period, and it was undisputed that the discovery periods for the prior policies had expired.⁸⁷ The value of all missing art was appraised at \$864,350. The value of the art known to be taken during the Lumbermens policy period was \$9,250. Based upon the value of art for which the insured could specifically identify the date of loss,⁸⁸ Lumbermens argued that the recoverable loss was as follows:

Insurance Co.	Limit of Liability	Deductible	Loss During Coverage Period	Amount Recoverable
Lumbermens	\$1,000,000	\$2,500	\$9,250	\$6,750
Federal Ins. Co.	\$1,000,000	\$2,500	\$17,200	\$14,700
Fidelity Dep. Co.	\$500,000	\$50,000	\$116,038	\$66,038
Western Cas. & Surety Co.	\$50,000	- 0 -	\$721,862	\$50,000

Consequently, of the \$864,350 appraised loss, Lumbermens argued that its coverage was limited to \$137,488.⁸⁹

On the other hand, the university took the rather simple approach and argued that Lumbermens was obligated to indemnify it up to the bond limit of \$1,000,000.⁹⁰ Resolution of the dispute boiled down to a determination of which bond provision applied to the matter at hand: the Loss Under Prior Policy provision in General

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ The insurer apparently was unable to identify the precise date on which each work of art was taken. As such, with respect to the pieces for which the date of theft was not known, Lumbermens, apparently without dispute from the University, placed the respective values into the Western policy period.

⁸⁹ *Id.* at 832.

⁹⁰ *See id.* Although the value of the missing art was appraised at \$864,350, the university argued it was also entitled to coverage for recovery costs of \$148,320.14. Hence, the claim exceeded the \$1 million limit under the Lumbermens bond. This paper is not concerned with the issues involving the recovery costs.

Agreement C, or the “Limit of Liability under this Bond and Prior Insurance” provision found in Section 10.⁹¹ The specific provisions on which the court relied read as follows:

C. Loss Under Prior Bond or Policy. If the coverage of this Bond is substituted for any prior bond or policy of insurance carried by the Insured or by any predecessor in interest of the Insured, which prior bond or policy is terminated, cancelled or allowed to expire as of the time of such substitution, the Underwriter agrees that this Bond applies to loss which is discovered as provided in Section 1 of the Conditions and Limitation and which would have been recoverable by the Insured or such predecessor under such prior bond or policy except for the fact that the time within which to discover loss thereunder had expired; provided:

(1) The indemnity afforded by this General Agreement C shall be a part of and not in addition to the amount of insurance afforded by this Bond;

(2) Such loss would have been covered under this Bond had this Bond with its agreements, limitations and conditions as of the time of such substitution been in force when the acts or defaults causing such loss were committed; and

(3) Recovery under this Bond on account of such loss shall in no event exceed the amount which would have been recoverable under this Bond in the amount for which it is written as of the time of such substitution, had this Bond been in force when such acts or defaults were committed, or the amount which would have been recoverable under such prior bond or policy had such prior bond or policy continued in force until the discovery of such loss, if the latter amount be smaller.

.....

Section 10. Limit of Liability under this Bond and Prior Insurance. With respect to loss caused by any Employee or in which such Employee is concerned or implicated or which is chargeable to any Employee as provided in Section IV and which occurs partly during the Bond Period and partly during the period of other bonds or policies issued by the Underwriters to the Insured or to any predecessor in interest of the Insured and terminated or cancelled or allowed to expire and in which the period for discovery has not expired at the time any such loss thereunder is discovered, the total liability of the Underwriter under this Bond and under such other bonds or policies shall not exceed, in the aggregate, the amount stated in Item 3 of the Declarations or the amount available to the Insured

⁹¹ The court does not identify the specific policy on which coverage was written. However, the language cited by the court in its opinion is nearly identical to that appearing in the Blanket Position Bond (Revised to March 1980), *reprinted in* STANDARD FORMS.

under such other bonds or policies, as limited by the terms and conditions thereof, for any such loss, if the latter amount be the larger.⁹²

The university argued that General Agreement C did not apply because that provision only applies in situations where the *entire* loss occurs during a prior bond period, not when the loss is spread over multiple periods.⁹³ The university argued that Section 10 applied not simply to situations where the current insurer issued the prior bond (in this case, Lumbermens), but rather, regardless of the previous carrier's identity.⁹⁴

Lumbermens responded that Section 10 could not apply because the time in which to discover the loss under the prior bond periods had expired. The university countered by arguing that the reference to the period for which "discovery has not expired" was to the Lumbermens' bond, not a prior bond.⁹⁵ After reviewing the bond, the Tenth Circuit recognized that General Agreement C was the relevant provision.⁹⁶

The *Brigham Young University* decision is not significant because the court applied the proper bond provision to the facts. Rather, the case is significant because the court focused on the language of General Agreement C to find that the amount of covered loss should be reduced by the deductible amount applicable to the prior bond. The court recognized that General Agreement C "limits Lumbermens' obligation under prior bonds to the 'amount which would have been recoverable under such prior bond or policy had such prior bond or policy continued in force until the discovery of such loss.'"⁹⁷ Based upon this clause, the amount "which would have been recoverable" was found to be that as computed by Lumbermens—loss minus deductible for each bond period.

Specific policy provisions dealing with the issue of deductibles are beginning to show up in the market. Many insurance companies, at least up until the market's recent turn, were incorporating provisions that specifically addressed multiple deductibles. One such clause reads as follows:

It is agreed that:

With respect to a loss for which coverage is provided by this policy and which is sustained partly during the period of other policies providing coverage for such loss issued to the insured or to any predecessor in interest of the insured and terminated or cancelled or allowed to expire as of the inception date of this policy, the amount of the deductible that is applicable to the portion of the loss sustained during the policy period shall be reduced, in whole or in part, by:

⁹² *Id.* at 833.

⁹³ *See id.* at 834.

⁹⁴ *See id.* at 833-34.

⁹⁵ *See id.* at 834.

⁹⁶ *See id.*

⁹⁷ *Id.*

- (1) The amount of the loss which is sustained by the Insured during the period of other policies if such loss is less than the amount of the deductible applicable to that loss under these other policies, or
- (2) The amount of the deductible applicable to the loss sustained by the Insured during the period of other policies if the applicable deductible is less than the amount of the loss sustained during that period.⁹⁸

This provision resolves the application of multiple deductibles for a long-term loss and potentially affords the insured the benefit of having only one deductible apply. Under this provision, revisiting the hypothetical set forth above yields a different outcome. Again, recall that Prior Insurer was on the risk in 2002, with a deductible of \$50,000. Current Insurer had the same deductible, and was on the risk in 2003. In the first scenario, the insured suffered a loss in the amount of \$210,000 during the 2003 policy period, and \$40,000 during the 2002 period. Because the amount of loss in the prior policy period did not exceed the deductible, sub-paragraph (1) of the Deductible Provision would reduce the deductible applied against the loss incurred during the 2003 policy period to \$10,000.⁹⁹ This \$10,000 deductible would then be applied against the \$210,000 loss sustained during the 2003 policy, providing total coverage to the insured in the amount of \$200,000.

In the second scenario set forth above, the insured sustained a loss of \$125,000 in each of the two policy periods. In that scenario, sub-paragraph (2) of the Deductible Provision above would apply. Because the deductible applicable to Prior Insurer's policy is less than the amount of loss sustained during the 2002 policy period, the entire deductible amount is applied against the \$50,000 deductible to Current Insurer's policy. Under this scenario, \$75,000 is recoverable under the Loss Under Prior Policy provision, and the full \$125,000 of loss sustained during the current bond is recoverable.¹⁰⁰ As such, the result is the same as the previous scenario: the insured recovers a total of \$200,000.

The recent Commercial Crime Coverage (Loss Sustained) Form incorporates a specific provision addressing the application of the deductible as well.¹⁰¹ However, the

⁹⁸ Wegerzyn & Morrissee, *supra* note 7, at 32.

⁹⁹ The current policy's deductible is reduced by the amount of loss the insured sustained during the prior policy period if that loss is less than the amount of the deductible applicable to that loss. Consequently, the \$50,000 deductible in Current Insurer's policy is reduced by the \$40,000 loss.

¹⁰⁰ The \$125,000 loss sustained during the 2002 policy is reduced by the applicable deductible of \$50,000. However, because the deductible applied to the prior loss reduced the deductible applicable to the 2003 policy to zero, the entire \$125,000 loss sustained during the 2003 policy period is recoverable.

¹⁰¹ Commercial Crime Coverage (Loss Sustained) Form, Section C. Deductible, provides:

We will not pay for loss in any one "occurrence" unless the amount of loss exceeds the Deductible Amount shown in the Declarations. We will then pay the amount of loss in excess of the Deductible Amount, up to the Limit of Insurance. In the event more than one Deductible Amount could apply to the same loss, only the highest Deductible Amount may be applied.

Loss Under Prior Policy provision in the new policy remains the same as that which has been provided over the last two decades. Consequently, it still provides coverage only for loss that the insured “could have recovered” under the prior insurance. It appears that the Deductible Provision simply applies to situations in which the loss may be covered by several Insuring Agreements under the same current policy, each of which has a separate deductible.

3. Continuous Versus Separate Policies

Another issue that the courts have rarely addressed involves the Loss Under Prior Policy provision’s scope in situations where: (1) the court considers the issuance of multiple consecutive annual policies by the same insurer to be in fact one continuous bond; and (2) the court considers the issuance of multiple consecutive annual policies to be separate, independent contracts. The scope of coverage available under the Loss Under Prior Policy provision can be much more extensive in situations where the court considers multiple consecutive annual policies to be one continuous bond.

Consider another hypothetical: the insured suffers a \$1,000,000 loss over a ten-year period, sustaining \$100,000 in loss per annual period. From 1994 through 1999, Prior Insurer provides coverage to the insured with a limit of \$500,000, and a \$25,000 deductible. From 2000 through 2003, Current Insurer provides coverage with a limit of \$1,000,000, and a \$50,000 deductible.

In jurisdictions in which courts consider the annual policies to be one continuous bond, the insured would appear to have \$850,000 in coverage. That is, Current Insurer would be obligated to provide \$350,000 in coverage under its policy.¹⁰² In addition to the coverage Current Insurer provided for loss sustained during its bond period, the Loss Under Prior Policy provision would also provide coverage for loss that the insured sustained during the prior bond period. Under this scenario, the insured sustained \$600,000 in losses during the time Prior Insurer was on the risk. However, as the limit of insurance during this time is \$500,000, this amount will represent the total available to the insured.¹⁰³ As such, Current Insurer would be obligated to reimburse the insured in the amount of \$850,000.

However, some courts have held that “[t]here is no question that the bond coverage which the parties maintained over the years occurred through a series of individual one-year contracts, rather than a single, continuous bond period Thus, by the express terms of the Declaration page, [the insured’s] acceptance of new one-year bond served as cancellation of the prior year’s bond period. Accordingly, only one bond remained in effect at any given time.”¹⁰⁴ In jurisdictions where the courts consider each policy to be a separate, independent contract, the outcome is quite different. In this situation, Current Insurer would be obligated to pay the amount of loss its insured

¹⁰² During the time Current Insurer was on the risk, \$400,000 in loss was sustained by the insured. Of course, the amount recoverable would be reduced due to the \$50,000 deductible.

¹⁰³ The \$25,000 deductible is inutile as the \$600,000 loss exceeds the limit of insurance by \$100,000.

¹⁰⁴ *Diamond Transp. Sys., Inc. v. Travelers Indem. Co.*, 817 F. Supp. 710, 711-12 (N.D. Ill. 1993).

suffered during the 2003 policy period (the current policy). This amount would be \$50,000.¹⁰⁵ From this point, two alternatives are then possible.

First, in those jurisdictions where the courts have narrowly applied the Loss Under Prior Policy provision and its plain meaning, the provision will only apply to the policy immediately preceding the 2003 policy. As such, only an additional \$50,000 would be available to the insured. Again, this amount would reflect the \$100,000 loss the insured sustained during the 2002 policy, less the applicable deductible of \$50,000. The policies before 2002 would not have been replaced by the 2003 policy, and consequently, the fourth requirement of the Loss Under Prior Policy provision, discussed below, would not be met. Thus, in this scenario, the insured would recover but \$100,000 of the \$1,000,000 loss.

The second alternative is derived from the holding in the *Brigham Young University* case. That is, although the court considers each policy to be an independent, separate contract, it will apply the prior policy's own Loss Under Prior Policy provision to determine what would have been "recoverable" under that policy. In essence, the provision continues to apply retroactively until there is either a gap in coverage, or no loss is sustained. In this situation, the amount recoverable would increase from the first alternative, but still not rise to the level of that provided under an interpretation of two continuous bonds. Specifically, the amount recoverable during the time Current Insurer's policies were in effect would be \$200,000.¹⁰⁶ In addition, the amount recoverable during the time that Prior Insurer's policies were in effect would be \$450,000.¹⁰⁷ In total then, the insured would have a recoverable loss of \$650,000.

C. LOSS MUST BE DISCOVERED AFTER DISCOVERY TAIL EXPIRES

The third requirement necessary to recover under the Loss Under Prior Policy provision requires that the loss sustained during the prior policy not be discovered until after the discovery tail on the prior policy expires. Generally, if the discovery tail has not yet expired, coverage under the prior bond remains available and there are no grounds to pursue recovery under the current bond. The insured's remedy is to pursue coverage

¹⁰⁵ The insured sustained \$100,000 in loss during each annual period. The policy in effect in 2003 had a \$50,000 deductible. As such, the insured would have recovered the loss sustained (\$100,000) less the deductible (\$50,000).

¹⁰⁶ Current Insurer was on the risk for four years, with the insured sustaining a loss of \$100,000 during each year. As we are considering this situation in the context of a court finding that each contract was a separate, independent contract, the amount recoverable under each policy would be reduced by the deductibles (unless, of course, the policies had a provision to the contrary). Consequently, the total loss of \$400,000 (\$100,000 times four policy periods) would be reduced by \$200,000 (\$50,000 deductible times four policy periods).

¹⁰⁷ Again, a total loss of \$100,000 per annual period is in effect. However, during this time, the applicable deductible is \$25,000. Applying the deductible against the loss for each annual period, a sum total of \$75,000 (\$100,000 minus \$25,000) in coverage is available. This amount, multiplied by the six annual periods, totals \$450,000.

from the prior insurer.¹⁰⁸ Although this requirement seems simple enough, it has been the source of some litigation.

In *London & Lancashire Indemnity Co. v. Peoples National Bank & Trust Co.*, the insured argued that, pursuant to the Superceded Suretyship Rider, the insurer broadly assumed “any loss occurring prior to the issuance of its bond” for which the prior insurer would have been liable.¹⁰⁹ The district court agreed. However, on appeal, the Seventh Circuit correctly noted that the Rider did not require the insurer to assume any and all liability under the prior bond. Rather, the subsequent bond only covered loss that would have been covered under the prior bond but for the fact it was not discovered within the prior bond’s discovery period. As the loss at issue was discovered within the prior bond’s discovery tail, the Rider did not provide any source of recovery to the holder.

The Eighth Circuit addressed the timing of discovery in *Winthrop & Weinstine v. Travelers Casualty & Sur. Co.*¹¹⁰ Over the period of time that the defalcator committed her acts of embezzlement, Winthrop & Weinstine had been insured by United States Fidelity & Guaranty Company (“USF&G”) for three annual policy periods and Aetna Casualty & Surety Company for one.¹¹¹ The last USF&G policy expired on February 1, 1994, and had a one-year discovery tail.

The insured discovered the defalcations in September of 1994. At that time Travelers¹¹² was on the risk, but the USF&G discovery tail was also in effect.¹¹³ The insured did not notify USF&G of the loss, but rather simply notified the current insurer, Travelers. During its investigation, the insured discovered additional losses.¹¹⁴ With each new discovery of loss, the insured notified Travelers but did not notify USF&G. No doubt frustrated by its continuing discoveries, the insured eventually hired an accounting firm to identify the full extent of the defalcations.¹¹⁵ After the accounting firm advised it of the total loss, the insured finally notified USF&G of a potential claim for the first time in October of 1995, well after the discovery tail had expired.

¹⁰⁸ Of course, if the same insurer issued the prior policy and the discovery tail was still open when a loss occurring during both policies was discovered, the relevant provision in the Commercial Crime Coverage (Loss Sustained) Form would be Condition 1.k, “Loss Covered Under This Insurance And Prior Insurance Issued By Us or Any Affiliate.” This condition was previously found in the Commercial Crime Policy, Crime General Provisions, General Condition 11, and Section 12 in the Blanket Crime Policy (Revised to March, 1980) and Comprehensive Dishonesty, Disappearance and Destruction Policy – Form A (Revised to March, 1980). In those provisions, coverage is limited to the larger of the amount recoverable under the current policy or the prior policy.

¹⁰⁹ 59 F.2d 149, 151 (7th Cir. 1932).

¹¹⁰ *Winthrop & Weinstine v. Travelers Cas. & Sur. Co.*, 187 F.3d 871 (8th Cir. 1999).

¹¹¹ *Id.* at 872.

¹¹² Aetna Casualty & Surety became known as Travelers Casualty & Surety Co. on July 1, 1997. For ease of reference, the Eighth Circuit refers to Aetna in its opinion as Travelers. To avoid confusion, this article does the same.

¹¹³ *See id.* at 873.

¹¹⁴ *See id.*

¹¹⁵ *See id.*

The insured argued that USF&G was responsible for all losses it sustained before February 1, 1994, the expiration of USF&G's last policy period.¹¹⁶ USF&G denied coverage on the basis that the insured did not timely notify it of the loss. Travelers also denied any obligation to indemnify the insured under its Loss Under Prior Policy provision for any loss prior to February 1, 1994. Travelers based its denial on the fact that the discovery tail on the USF&G policy had not yet expired when the insured discovered the dishonest conduct.¹¹⁷

The insured responded that the three USF&G policies were separate, independent policies, each with a one-year discovery window. Further, the insured argued that, because it had not discovered the loss until September 1994, the discovery windows for the first two policies had expired, therefore triggering the Loss Under Prior Policy provision in the Travelers policy.¹¹⁸ Considering the fact that Minnesota courts have recognized such bonds to be separate contracts, the argument for separate limits of liability, as well as separate discovery windows, was reasonable.¹¹⁹

Apparently reasoning that insurers always raise every legitimate defense available to them, the federal court explicitly rejected the insured's concept of multiple discovery windows because under the particular circumstances at hand, such an argument would have favored USF&G.¹²⁰ The court placed weight on the fact that USF&G could have raised (but did not) this interpretation of its policies as a defense to its own exposure. Rather, USF&G had simply relied on the late notice defense.

The court also addressed a more substantive alternative argument as to why Travelers' Loss Under Prior Policy provision did not apply to a situation involving multiple discovery windows. Focusing on the requirement that the Travelers' policy become "effective at the time of cancellation or termination of the prior insurance,"¹²¹ the court noted that the Travelers policy did not come into effect until the third USF&G policy period expired.¹²² The court held it could not interpret the Loss Under Prior Policy provision as the insured suggested because by doing so it would disregard a specific requirement of the provision—namely that the current insurance become effective at the time that the previous insurance is cancelled.

In response, the insured pointed to the policy language that stated that the provision would provide coverage for "loss during the period of *any* prior insurance."¹²³ The insured argued that an interpretation limiting coverage to loss occurring only during the "last" period was too restrictive. Regardless, the court relied upon the fact that the Travelers' policy came into effect only at the time the last USF&G policy was

¹¹⁶ See *id.* at 874.

¹¹⁷ See *id.*

¹¹⁸ See *id.* at 876.

¹¹⁹ See, e.g., *Columbia Heights Motors, Inc. v. Allstate Ins. Co.*, 275 N.W.2d 32 (Minn. 1979)

¹²⁰ *Winthrop & Weinstine*, 187 F.3d at 876.

¹²¹ This requirement is the fourth requirement in the Loss Under Prior Policy analysis.

¹²² *Id.*

¹²³ *Id.* (emphasis added).

terminated. Therefore, the Loss Under Prior Policy provision in the Traveler's policy could not be interpreted to skip prior policy periods.

While the insured correctly argued that the provision's purpose was to "avoid penalizing an insured when switching insurance companies," the court found that the insured's argument did not comport with this interpretation.¹²⁴ The court noted that under the insured's analysis, if USF&G had hypothetically issued a fourth policy, it would not have been liable for the losses sustained during the first and second policy periods because the separate discovery windows would have expired.¹²⁵ Nonetheless, although USF&G would not have been required to indemnify the insured, the insured was now arguing that Travelers should be required. The court correctly noted that, rather than avoiding a penalty as a result of switching insurance companies, the insured was in fact seeking to "reap a benefit for switching insurance companies."¹²⁶

D. CONTINUITY OF COVERAGE

1. No Gap in Coverage

The fourth requirement of the Loss Under Prior Policy provision requires the subsequent policy to become "effective at the time of cancellation or termination of the prior insurance." If there is any lapse in coverage, the Loss Under Prior Policy provision does not apply. As a gap in coverage is fatal to the insured's ability to recover under the provision, it is imperative that any analysis involving losses sustained over multiple policy periods begin with a determination of each policy's expiration and inception date. The new policy's inception date must correspond exactly to the cancellation date of the policy it replaces. Even a gap as little as one day will break the continuity requirement.

For the most part, courts have required compliance with the continuity requirement.¹²⁷ However, courts sometimes overlook it. For example in *Dilley, Dewey & Damon, P.C. v. St. Paul Fire & Marine Insurance Co.* the Ninth Circuit analyzed portions of the provision separately and found coverage under the Loss Under Prior Policy provision even when the policy during which the loss was suffered and the policy under which the provision applied were separated by two independent policies.¹²⁸

At issue in *Dilley, Dewey & Damon* were four one-year policies, each policy having a two-year discovery period.¹²⁹ The court correctly recognized that, as the loss was discovered during the fourth policy period, that policy covered the losses actually occurring during its policy period and the losses from prior years fell under its Loss Under Prior Policy provision.¹³⁰ However, noting that the discovery tail for the first

¹²⁴ *Id.*

¹²⁵ *See id.*

¹²⁶ *Id.*

¹²⁷ *See, e.g., Lincoln Technical Inst. v. Fed. Ins. Co.*, No. 94-16369, 1996 U.S. App. LEXIS 2155, at *8 n.3 (9th Cir., Jan. 31, 1996) (recognizing the insured had failed to establish there was no gap in coverage).

¹²⁸ No. G88-336, 1988 U.S. Dist. LEXIS 18070 (W.D. Mich. Dec. 6, 1988).

¹²⁹ *Id.* at *1.

¹³⁰ *See id.* at *8 n.2.

policy year would have expired by the time the loss was discovered during the fourth policy year, the court concluded that losses sustained during the first policy year were “clearly covered by the [first] paragraph of the Loss Under Prior Policy provision and are limited to the \$25,000 coverage limit of the current policy. The remaining losses are covered by the third paragraph of that clause.”¹³¹

This observation contradicted the court’s earlier reasoning. Throughout the opinion, the court analyzed the issue under the presumption that there were four independent policy periods. By stating that the losses sustained during the second and third policy periods fell within the provision’s third paragraph, but the first policy period fell within the scope of the provision’s first two paragraphs, the court ignored the language in the first paragraph that required that the previous bond terminate “at the time this agreement became effective.” There were two intervening bonds in effect between the first policy period and the fourth policy period. Under the court’s analysis of separate policies, the first two paragraphs of the provision should not have been triggered because the current policy did not replace any policy whose discovery period had ended.¹³² Thus, if the policies were all separate, then a gap existed and coverage for losses suffered during the first policy should not have been available.

It is important that the practitioner obtain the prior policy not only for specific reasons (i.e., determine dates, scope of coverage, identity of insured, availability of limits), but also to ensure the policy actually exists. There are often situations where, although the insured’s records indicate coverage was continually available, when one investigates further, certain policies are unable to be located. When neither the insured nor the insurer are able to locate the policy, lost policy issues arise.

¹³¹ *Id.* The provision read:

Continued Coverage. You may have been insured by a previous bond that covered the same losses this agreement covers and that ended at the time this agreement became effective. If you were, but can’t recover on a loss that was caused while the previous bond was in force because its discovery period has run out, we’ll cover your loss.

We won’t pay more than the limit of your coverage for the loss under the previous bond or under this agreement when it became effective, whichever coverage is less. And the amount we pay will be a part of your coverage under this agreement – not in addition to it.

We may have insured you under other bonds whose discovery period had not run out when you discovered a loss that occurred partly under those bonds and partly under this agreement. If this is the case, we’ll pay up to the limit of coverage under this agreement or under the previous bonds we issued, whichever coverage is greater. *Id.* at *3.

¹³² The Eighth Circuit addressed this same issue in *Winthrop & Weinstine*. There the court correctly held the same Loss Under Prior Policy provision could not skip policy periods.

2. Lost Policy Standard and Burdens of Proof

The threshold question in lost policy cases is whether the policy has been lost or destroyed in bad faith.¹³³ Absent bad faith, the party asserting the original policy's existence is not required to produce it. Obviously, a rule to the contrary would be of immense consequences to the insured, and, as a practical matter, would have little import in light of the insurer's ability to produce certified copies. Only in situations where, for one reason or another, the insurer is unable to compile a certified copy does the rule have potential import.¹³⁴

Whether a writing existed and whether a party has offered sufficient evidence to prove the contents of a lost writing are questions of fact for the jury.¹³⁵ In general, it is the insured's initial burden to prove the essential terms and conditions of coverage. When policies have been inadvertently lost or destroyed, the insured may satisfy its burden with circumstantial evidence, such as proof that the insurer issued a particular standard-form policy.¹³⁶ If the insured meets its burden of proof, the insurer may then respond with circumstantial evidence to establish the existence, terms, and conditions of any exclusions.¹³⁷

The primary issue is the standard of proof that the insured must overcome. In determining the applicable burden in lost policy cases, it is often helpful to refer to case law pertaining to lost instruments.¹³⁸ A survey of jurisdictions indicates that the courts apply two distinct standards: clear and convincing evidence and a preponderance of the evidence.¹³⁹ Traditionally, courts overwhelmingly favored the clear and convincing evidence standard. But there is a growing trend toward application of the less-demanding preponderance of the evidence standard. In fact, as a result of this trend, the general rule of thumb is that in today's disputes it is quite difficult—but certainly not impossible—for an insurer to prevail in lost-policy cases.

¹³³ See FED. R. EVID. 1004(1) (stating original document not required when all originals are lost or were destroyed, unless proponent lost or destroyed them in bad faith). If in a state court forum, for the most part, state rules of evidence generally closely follow the federal rules.

¹³⁴ One potential example arises in the environmental context: If the insurer issued a policy in the 1960s with an exclusion similar to today's standard "absolute" pollution exclusion but was unable to produce it, the insured's destruction of the policy with the intent to argue the "sudden and accidental" pollution exclusion was attached would be in bad faith and, although difficult to prove, would require the insured to produce the original.

¹³⁵ See FED. R. EVID. 1008 (stating when issue raised regarding whether asserted writing existed or whether other evidence of writing correctly reflects contents, issue is for the trier of fact).

¹³⁶ *Domtar, Inc. v. Niagara Fire Ins. Co.*, 563 N.W.2d 724, 736 (Minn. 1997); *but see* *SCA Disposal Servs. v. Cent. Nat'l Ins. Co.*, No. 90393C, 1994 Mass. Super. LEXIS 616 (April 12, 1994) (stating that "[b]ecause insurance policies are often customized or manuscripted, the use of a standard form in one policy is not by itself proof that it was included in a different policy"). This would appear to be most certainly relevant in commercial crime policies.

¹³⁷ See *Domtar, Inc.*, 563 N.W.2d at 736.

¹³⁸ See Ostrager & Newman, *Handbook on Insurance Coverage Disputes* § 17.02, p. 989 (11th ed. 2002).

¹³⁹ Compare *Boyce Thompson Inst. for Plant Research, Inc. v. Ins. Co. of N. Am.*, 751 F. Supp. 1137 (S.D.N.Y. 1990) (applying clear and convincing evidence standard), with *Remington Arms Co. v. Liberty Mut. Ins. Co.*, 810 F. Supp. 1420 (D. Del. 1992) (applying preponderance of the evidence standard).

Since the *Remington Arms Co. v. Liberty Mutual Insurance Co.* decision in 1992, the vast majority of jurisdictions have applied the preponderance of the evidence standard.¹⁴⁰ It appears that only Missouri has stated in a published decision that it continues to apply the clear and convincing evidence standard to lost insurance policies.¹⁴¹ While the clear and convincing standard has been applied in two other published decisions since *Remington Arms*, in neither case was the standard at issue; rather, it was simply applied without discussion.¹⁴² Because the overwhelming majority of jurisdictions conclude that an insured need only establish the existence and terms of an insurance policy under the preponderance of the evidence standard, it is likely that, absent clear precedent to the contrary, any court addressing the issue will follow the recent trend.

Although the existence and terms of a policy are ultimately questions of fact for the jury to decide, many courts have considered whether the insured has produced sufficient evidence to survive summary judgment. The level of sufficiency varies, but if the insured is able to produce some evidence of the policies' existence and terms, courts have generally refused to grant summary judgment to the insurer.¹⁴³ Nonetheless, requiring the insured to meet its burden of proof in establishing the existence of a prior policy is a necessity, not only because of the effect that the insured's failure to overcome the burden may have on coverage, but also because it is a powerful settlement tool.

E. SCOPE OF COVERAGE PROVIDED UNDER CURRENT POLICY

The final requirement of the Loss Under Prior Policy provision is that the current policy would have covered the loss if it had been in effect when the loss was sustained. There are many potential issues that could arise and have an affect on this requirement.

¹⁴⁰ See, e.g., *Cont'l Cas. Co. v. Hempel*, 246 F.3d 680 (10th Cir. 2001) (unpublished opinion); *Lincoln Elec. Co. v. St. Paul Fire & Marine Ins. Co.*, 210 F.3d 672 (6th Cir. 2000); *Burt Rigid Box Inc. v. Travelers Prop. Cas. Corp.*, No. 91-CV-303F, 2001 U.S. Dist. LEXIS 24493 (W.D.N.Y. Jan. 26, 2001); *Americhem Corp. v. St. Paul Fire & Marine Ins. Co.*, 942 F. Supp 1143 (W.D. Mich. 1995); *Servants of Paraclete, Inc. v. Great Am. Ins. Co.*, 857 F. Supp 822 (D.N.M. 1994). Numerous state jurisdictions have also applied the preponderance of the evidence standard since 1992.

¹⁴¹ See *Nichols v. Mama Stuffed*, 965 S.W.2d 171 (Mo. Ct. App. 1998).

¹⁴² See *UTI Corp. v. Fireman's Fund Ins. Co.*, 896 F. Supp. 362 (D.N.J. 1995); *Transamerica Ins. Co. v. Pa. Nat'l Ins. Cos.*, 908 S.W.2d 173 (Mo. Ct. App. 1995).

¹⁴³ See, e.g., *Americhem*, 942 F. Supp. at 1144 (concluding the insured demonstrated the existence of a genuine issue of material fact regarding the policies' terms when it introduced the policy declarations pages, which listed the policy numbers, dates of coverage, and premiums paid, as well as agent testimony and specimen forms); *Servants of Paraclete*, 857 F. Supp. at 827 (finding a reasonable fact-finder could conclude a policy existed when the insured introduced a letter from the insurer to the insured acknowledging it issued the policy, a business analyst with the insurer's claims department attesting the missing policy was an Owner's, Landlord's and Tenant's ("OL&T") liability policy, deposition testimony from the insurer's underwriter indicating during the period in question the insurer used three general liability coverage forms, one of which was an OL&T form, and its insurance agency's business records indicating policy number 589JA1915 was a three-year policy and stating the premium); *Am. States Ins. v. Mankato Iron & Metal, Inc.*, 848 F. Supp. 1436 (D. Minn. 1993) (concluding the insured's establishment of the missing policies' terms through circumstantial evidence not rebutted by the insurer was sufficient to survive summary judgment when the insured introduced evidence of policy numbers, effective dates, evidence that the insurer issued the policies, affidavits, and copies of the insuring clause providing bodily injury and property damage coverage in commercial general liability policies).

Generally, a thorough coverage analysis is all that is necessary to satisfy it. However, there are several issues that do tend to arise more often than others.

1. Differing Requirements of Manifest Intent

Especially with the variety of products currently available, significant time and attention must be given to discern the scope and application of the prior policies in claims involving losses occurring over several policy periods. With the soft market in the late 1990s, insurers were forced to revise or modify many of the products to attract business. No provision, whether it be in the Financial Institution Bond, the Commercial Crime Policy, or any other policy providing fidelity coverage, was immune. Even something that had established itself as a cornerstone of the fidelity bond for a number of decades—the manifest intent standard—has been modified.¹⁴⁴ With the advent of the new ISO program, many policies provide coverage for “employee theft” rather than the traditional “employee dishonesty” coverage available under the joint ISO-SAA program.¹⁴⁵ The practical effect of the “employee theft” coverage is that the requirement of “manifest intent” is no longer necessary for recovery.

Many other policies currently in the market were written to significantly restrict the standard’s application or even, in some cases, to remove it from the Employee Dishonesty coverage. In some policies, insurers have simply eliminated the word “manifest.”¹⁴⁶ Other modifications include changing the requirement that the defalcator cause the insured to sustain a loss and obtain a financial benefit from the conjunctive to the disjunctive.¹⁴⁷ In these policies, manifest intent can be demonstrated simply by proving the defalcator intended to cause the insured a loss or intended to gain a financial benefit for either himself or a third-party.

Given the variety of modifications to the manifest intent standard, it is quite likely that in today’s market, when a claim arises over a number of years, the standard applied during each policy or bond period will vary. Furthermore, given the nature of the recent market, as well as the commercial crime coverage line in general, many policies are manuscript, with deviations from the “standard language” spanning from subtle to blatant. It is in this situation that one must carefully examine the scope of each bond potentially at issue, bearing in mind the Loss Under Prior Policy provision’s parameters limiting coverage to that which the insured “could have recovered under” the prior bond

¹⁴⁴ Although it had appeared on occasion in earlier policies, the “manifest intent” concept became standard in commercial crime coverage in 1976, and in Bankers Blanket Bond, Standard Form No. 24, Insuring Agreement A (revised July 1980), reprinted in STANDARD FORMS. See Toni Scott Reed, *Employee Theft Versus Manifest Intent: The Changing Landscape of Commercial Crime Coverage*, 36 Tort & Ins. L.J. 43 (2000).

¹⁴⁵ See, e.g., Commercial Crime Coverage (Loss Sustained) Form, Insuring Agreement A.1, (providing that the insurer “will pay for loss of or damage to ‘money’, ‘securities’ and ‘other property’ resulting directly from ‘theft’ committed by an ‘employee’, whether identified or not, acting alone or in collusion with other persons.”).

¹⁴⁶ See Wegerzyn & Morrissee, *supra* note 7, at 32.

¹⁴⁷ See *id.* at 32-33. See also *id.* at 17-19 (providing five examples of the very broad discrepancy among the language in Insuring Agreement (A) of the Financial Institution Bond that is currently being written).

and which “would have been covered” under the current bond, had it been in effect. Given the softer language in the more recent policies, it is quite possible to have a situation where coverage is available under the current policy, but not under the prior policy or policies.

2. Addition or Deletion of Coverages

With “blanket” coverage offering numerous choices to the insured, it is certainly possible that the coverage available to the insured may undergo several revisions over the course of a long-term loss. Today’s Commercial Crime Policy provides coverage through Insuring Agreements for Employee Theft; Forgery Or Alteration; Inside the Premises – Theft of Money And Securities; Inside The Premises – Robbery Or Safe Burglary Of Other Property; Outside the Premises; Computer Fraud; Funds Transfer Fraud; Money Orders And Counterfeit Paper Currency. The insured may select any and all of these Insuring Agreements depending upon its needs.

It is at least conceivable that, with the concepts of “occurrence” or “loss” including “an act or series of related acts,” any one of the Insuring Agreements could be at issue in a loss sustained over multiple policy periods. Any time there is an addition or deletion of an Insuring Agreement that is the subject of coverage for the loss, the insurer must exercise extraordinary caution during the investigation.¹⁴⁸ Evidence of when each act occurred is essential in determining whether the loss may or may not be covered as a result of a modification to coverage.

The very nature of fidelity coverage dictates that modifications to existing coverage are provided on a prospective basis only.¹⁴⁹ An interpretation to the contrary would undermine the coverage’s backbone by discouraging prompt inquiry and discovery of wrongful conduct. Such an interpretation would also empower the insured with the discretion to simply determine when it would trigger coverage;¹⁵⁰ the timing of such dictated no doubt by when coverage is either made available or at its highest limit. Absent an ill-advised representation by the underwriter or specific endorsement language providing coverage retroactively, analysis involving a determination of whether a certain act is covered should simply involve lining up the date of the acts or loss against the date the coverage became effective. Losses occurring before the Insuring Agreement’s effective date, or after its termination, are unrecoverable.

3. Modification to Policy Limits.

It is expected that any time differing policy limits are potentially available, the insured will argue that the larger amount is the relevant limit. On the other hand, the

¹⁴⁸ Obviously, such is true not only in the context of the Loss Under Prior Policy provision, but perhaps even more so, in the context of discovery issues.

¹⁴⁹ See *Lincoln Technical Inst. v. Fed. Ins. Co.*, (No. 94-16369), 1996 U.S. App. LEXIS 2155, at *8 (9th Cir. Jan. 31, 1996).

¹⁵⁰ See *id.* (citing *Leucadia, Inc. v. Reliance Ins. Co.*, 864 F.2d 964, 971 (2d Cir. 1988); *United Bank & Trust Co. v. Kan. Bankers Sur. Co.*, 901 F.2d 1520, 1522 (10th Cir. 1990)).

insured would likely contend that the inverse is true. Fortunately, this potential dispute is addressed in the Loss Under Prior Policy provision.

When the limits available to the insured under the prior and subsequent bonds differ, the Loss Under Prior Policy provision clearly indicates that, regardless of which bond had the higher limit, the smaller limit applies to coverage for loss sustained during the prior bond period. The relevant language in the Commercial Crime Policy provides as follows:

The insurance under [the Loss Sustained During Prior Insurance] Condition is part of, not in addition to, the Limits of Insurance applying to this insurance and is limited to the lesser of the amount recoverable under:

- (a) This insurance as of its effective date; or
- (b) The prior insurance had it remained in effect.¹⁵¹

This concept has been incorporated into the Loss Under Prior Policy provision since its inception and appeared in the Superceded Suretyship Riders as well, although not always with the same result and provision of coverage.¹⁵²

Analyzing modifications to the limits between separate policies is the easier issue. More difficult issues arise when the modification to the limit is made during the same policy period. It is imperative that a well-worded endorsement accompany the increase or decrease in policy limits. Although certainly not guaranteed, such an endorsement will often preclude significant discussion on the issue.

In *Lincoln Technical Institute v. Federal Insurance Co.*, the insurer issued fidelity coverage effective April 1, 1989, through April 1, 1992.¹⁵³ Initially, the policy limit was \$100,000, with a \$1,000 deductible.¹⁵⁴ On November 14, 1991, however, the policy limit was increased to \$1,200,000, with a \$25,000 deductible.¹⁵⁵

After the policy was terminated, but within the discovery tail, Lincoln discovered an employee had embezzled money over a period of time that encompassed the effective dates of the policy. The discovered loss was broken down as follows:

¹⁵¹ Commercial Crime Coverage (Loss Sustained) Form, Condition E.1.m(2).

¹⁵² For example, compare Commercial Crime Coverage (Loss Sustained) Form, Condition E.1.m(2), Commercial Crime Policy, Crime General Provisions, General Condition 8 (Insurance Services Office, Inc. 1984), reprinted in STANDARD FORMS, and the Superceded Suretyship Rider at issue in *Globe Indem. Co. v. Wolcott & Lincoln, Inc.*, 152 F.2d 545, 546 (8th Cir. 1945), each limiting coverage to the *smaller* of the limits in the prior and subsequent bond, with the Superceded Suretyship Rider at issue in *Hartford Accident & Indem. Co. v. Swedish Methodist Aid Ass'n*, 92 F.2d 649, 651 (7th Cir. 1937), which limited the total loss recoverable under the prior and subsequent bonds to the *larger* of the limits.

¹⁵³ *Lincoln Technical Inst. v. Fed. Ins. Co.*, No. 94-16369, 1996 U.S. App. LEXIS 2155, at *2 (9th Cir. Jan. 31, 1996).

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

Prior to April 1, 1989	\$ 8,550.00
April 1, 1989, to November 13, 1991	\$ 310,666.72
November 14, 1991, to April 1, 1992	\$ 20,678.00
After April 1, 1992	\$ 7,513.26 ¹⁵⁶

In response to the insured's notification of the loss, Federal indemnified the insured for \$99,000 of the \$347,407.98 loss.¹⁵⁷ The amount Federal paid was solely for the amount of loss that the insured sustained during the period of April 1, 1989, to November 13, 1991.¹⁵⁸

The insured argued coverage was available for losses sustained before the effective date of its policy. The provision at issue was a modified Loss Under Prior Policy provision that provided coverage as follows:

3.6 The liability of the Company for loss sustained prior to (1) the effective date of this policy or (2) the effective date additional insureds or coverages are subsequently added, is subject to the following:

(A) the Insured or some predecessor in interest of the Insured carried some other bond or policy . . . which, at the time such loss was sustained, afforded on or at the Premises at which the loss was sustained or on the person or persons . . . causing the loss, some or all of the coverage of the Insuring Clause of the policy applicable to the loss; and

(B) such prior coverage and the right of claim for loss thereunder continued under the same or some superseding bond or policy without interruption from the time the loss was sustained until the date specified in (1) or (2) above; and

(C) the loss shall have been discovered after the expiration of the time for discovery of such loss under the last such bond or policy.

The liability of the Company, with respect to such loss shall not exceed the amount which would have been recoverable under the coverage in force at the time the loss was sustained, or the amount recoverable under the Insuring Clause of this policy applicable to the loss, whichever is smaller.¹⁵⁹

With minimal analysis, the court found there was no coverage available under Federal's policy with respect to the loss that the insured allegedly sustained before the policy's effective date (April 1, 1989). Lincoln had failed to establish that it was covered under a different policy at the time it sustained the prior loss. It also failed to establish

¹⁵⁶ *Id.* at *2-3.

¹⁵⁷ *Id.*

¹⁵⁸ Federal paid the policy limit (\$100,000), effective April 1, 1989 through November 13, 1991, less the applicable policy deductible at the time (\$1,000).

¹⁵⁹ *Lincoln Technical*, U.S. App. LEXIS 2155, at *5.

that there was no gap in coverage when Federal's policy came into effect.¹⁶⁰ Further, finding the concept of "loss sustained" to be unambiguous,¹⁶¹ the court held that Federal's interpretation of the policy was correct and it was only required to indemnify the insured in the amount of \$99,000.¹⁶²

The court also affirmed the lower court's holding that coverage was unavailable for losses sustained after the increase in policy limits on November 14, 1991. The court's approach essentially addressed the insured's loss as if it occurred during two Federal policy periods. Certainly, this was due to the clear language provided with the endorsement increasing the policy limits.¹⁶³ Applying the new limits as of the date they went into effect against the losses sustained during that time, the court held there was no coverage available after November 14, 1991, because the insured's loss (\$20,678) did not exceed the applicable deductible in place at that time—\$25,000. As the loss did not exceed the deductible, the \$1,200,000 policy limit was not available.

4. Non-Cumulation of Limit of Insurance

The scope of coverage provided by the Loss Under Prior Policy provision is in fact limited. It is "a part of and not in addition" to the coverage afforded under the policy's applicable Insuring Agreement.¹⁶⁴ That is, the insured cannot look to the provision to provide coverage beyond the policy limits for losses sustained during the prior policy period. If the policy carries a \$100,000 limit and the insured sustains a loss in excess of \$100,000 during the current policy period, there is no coverage for any loss sustained during a prior policy period under any circumstances. If the insured sustains a loss of \$80,000 during the current policy period, the maximum amount of recovery under any circumstances for loss sustained during a prior policy period is \$20,000.

In *Dilley, Dewey & Damon, P.C. v. St. Paul Fire & Marine Insurance Co.*, the court focused on whether the insured was able to cumulate the policy limits under the crime coverage when it sustained a loss over a four-year period.¹⁶⁵ St. Paul issued a business package policy that provided coverage on an annual basis for a period of four years.¹⁶⁶ Within the business package policy, there was \$25,000 available for losses

¹⁶⁰ See *id.* at *8 n.3.

¹⁶¹ The court held that the insured sustained a loss each time money was embezzled; thus, a loss was sustained before, during, and after the policy's effective period.

¹⁶² *Lincoln Technical*, U.S. App. LEXIS 2155, at *8.

¹⁶³ The endorsement increasing the policy limits stated that "such increased amount(s) shall apply only to losses sustained on or after the effective date of said increase(s)." *Id.* at *4.

¹⁶⁴ See, e.g., *Davenport Peters Co. v. Royal Globe Ins. Co.*, 490 F. Supp. 286 (D. Mass. 1980) (finding that the interplay of General Agreement C, Section 11, and Section 12 in Crime coverage is unambiguous and that the loss under prior policy provision in General Agreement C is not in itself an Insuring Agreement and does not provide an additional limit of insurance to the insured). Commercial Crime Coverage (Loss Sustained) Form, Condition E.1.m(2) provides:

The insurance under this Condition is part of, not in addition to, the Limits of Insurance applying to this insurance and is limited to the lesser of the amount recoverable under:

(a) This insurance as of its effective date; or
(b) The prior insurance had it remained in effect.

¹⁶⁵ No. G88-336, 1988 U.S. Dist. LEXIS 18070 (W.D. Mich. Dec. 6, 1988).

¹⁶⁶ *Id.* at *1.

caused by employee fraud or dishonesty.¹⁶⁷ Over the four years the policies were in effect, the insured sustained a \$53,212.97 loss as a result of an employee's misconduct.¹⁶⁸ Relying on the Loss Under Prior Policy provision, the court held the insured could not cumulate coverage and its recovery was therefore limited to \$25,000.¹⁶⁹

The relevant language at issue in *Dilley, Dewey & Damon* read as follows:

Continued Coverage. You may have been insured by a previous bond that covered the same losses this agreement covers and that ended at the time this agreement became effective. If you were, but can't recover on a loss that was caused while the previous bond was in force because its discovery period has run out, we'll cover your loss.

We won't pay more than the limit of your coverage for the loss under the previous bond or under this agreement when it became effective, whichever coverage is less. And the amount we pay will be a part of your coverage under this agreement—not in addition to it.¹⁷⁰

Recognizing the provision's intended scope and application, the court found that the coverage available to the insured was clearly limited to \$25,000, even if the loss occurred over several prior policy periods.¹⁷¹

IV. Conclusion

Fidelity coverage has always evolved and will continue to do so, ebbing and flowing with market fluctuations. As a result of this evolving nature, any analysis of losses spanning multiple policy periods must be approached with deliberate and thorough caution. Numerous conditions could impose a significant reduction in the amount of recoverable loss under the Loss Under Prior Policy provision. Although the provision's scope is relatively straightforward, its application has not always been so. The important point to bear in mind whenever the provision comes into play is that the coverage available is limited. The provision does not provide any additional coverage and is not intended to create a windfall for the insured in the event that it is not diligent in discovering losses that were sustained over a number of policy periods. Rather, the provision is simply written to avoid penalizing insureds when they switch insurance companies. When these principles are applied, the goal of the provision is achieved, and the insured will generally find itself in the same position that it would have been in had it

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* Specifically, the court broke down the losses as follows: \$10,578.69 during the first policy year; \$14,807.57 during the second policy year; \$12,602.01 during the third policy year; and \$15,224.70 during the fourth policy year. *Id.* at *1 n.1.

¹⁶⁹ *Id.* at *8. However, while the court correctly found that the insured was limited to a \$25,000 recovery under the facts and policy language at issue in the case, at least with respect to one of its observations, the court's analysis may have been flawed. *See supra* Part III.D.1.

¹⁷⁰ *Id.* at *4.

¹⁷¹ *Id.* at *7; *see also* Exch. Bldg. Ass'n v. Indem. Ins. Co., 12 A.2d 924 (Pa. 1940).

continued to obtain its fidelity coverage from the same insurer over the life of a loss spanning multiple policy periods.