DEFINING EMPLOYEE DISHONESTY WITHIN THE FRAMEWORK OF THE AUTOMATIC TERMINATION PROVISION AND THE FIDELITY INSURING AGREEMENT

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I. INTRODUCTION

Understanding the meaning of the term “employee dishonesty” is context specific, driven in large part by whether the term is analyzed within the framework of a fidelity bond’s automatic termination provision, or as part of the bond’s fidelity insuring agreement. Both the automatic termination provision and the insuring agreement refer to employee dishonesty with the same terms: dishonest or fraudulent acts committed by an employee. This overlap notwithstanding, employee dishonesty is not construed the same in both frameworks. Rather, employee dishonesty is construed broadly within the framework of the automatic termination provision, encompassing a broad spectrum of conduct, and it is construed relatively narrowly in connection with the fidelity insuring agreement, encompassing a relatively narrow spectrum of conduct. This article discusses the meaning of employee dishonesty in each context, with an emphasis on recent cases analyzing employee dishonesty under the automatic termination provision and the fidelity insuring agreement.

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II.
EMPLOYEE DISHonesty UNDER THE
AUTOMATIC TERMINATION PROVISION

A. The Automatic Termination Provision in Several Standard and Proprietary Bond Forms

Most fidelity bonds have a provision that automatically terminates coverage as to an employee or officer when the insured learns of a dishonest or fraudulent act committed by the employee or officer. Automatic termination provisions from the 2004 Surety Association of America Standard Form Financial Institution Bond Form 24, the Insurance Services Office, Inc., 2007 Financial Institution Crime Policy For Banks And Savings Institutions, the CUMIS Insurance Society, Inc. Credit Union Bond (a proprietary form) and the Surety Association of America 1986 Standard Form Financial Institution Bond are set forth below.

1. SAA 2004 Financial Institution Bond Form 24

TERMINATION OR CANCELATION

Section 14 . . . . This bond terminates as to any Employee, or any partner, officer or employee of any Electronic Data Processor, (a) as soon as any Insured, or any director or officer of an Insured who is not in collusion with such person, learns of any dishonest or fraudulent act committed by such person at any time, whether in the employment of the Insured or otherwise, whether or not of the type covered under insuring Agreement (A), against the Insured or any other person or entity, without prejudice to the loss of any Property then in transit in the custody of such person, or (b) 15 days after the receipt by the Insured of a Written notice from the Underwriter of its desire to cancel this bond as to such person.

Termination of this bond as to any Insured terminates liability for any loss sustained by such Insured which is discovered after the effective date of such termination.
Termination of this bond as to any Employee, or any partner, officer or employee of any Electronic Data Processor, terminates liability for any loss caused by a fraudulent or dishonesty act committed by such person after the date of such termination.¹

2. ISO 2007 Financial Institution Crime Policy For Banks And Savings Institutions

22. Policy Cancellation or Termination . . . . b. Policy Termination

(2) This policy terminates as to any “employee”, or any partner, member, manager, officer or employee of any “data processor”:

(A) as soon as a “designated person” or an “employee” in your Human Resources Department or its equivalent not in collusion with such person, learns of any dishonest or fraudulent act committed by such person at any time, whether in your employment or otherwise, whether or not the type covered under Insuring Agreement 1., against you or any other person or entity, without prejudice to the loss of any “property” then in transit in the custody of such person . . . .²


3. **CUMIS Credit Union Bond**

   9. Termination or Limitation Of Coverage for Employee or Director

   1. This Bond’s coverage for an “employee” or “director” terminates immediately when one of your “directors,” officers or supervisory staff not in collusion with such other persons learns of:

      a. Any dishonest or fraudulent act committed by such “employee” or “director” at any time, whether or not related to your activities or of the type covered under this Bond; or

      b. Any termination of bond coverage for such “employee” or “director” by any bonding company, which coverage was not reinstated.¹

4. **SAA 1986 Financial Institution Bond**

   This bond terminates as to any Employee or any partner, officer or employee of any Processor (a) as soon as any Insured, or any director or officer not in collusion with such person, learns of any dishonest or fraudulent act committed by such person at any time, whether in the employment of the Insured or otherwise, whether or not of the type covered under Insuring Agreement (A), against the Insured or any other person or entity, without

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prejudice to the loss of any Property then in transit in the
custody of such person . . . .

The common elements in each of these bond forms is the
automatic termination of coverage as to the employee upon a particular
person within the insured learning of any dishonest or fraudulent act
committed by the employee. Any dishonest or fraudulent act is
sufficient. For purposes of the automatic termination provision, the
dishonest or fraudulent act need not be employment related. Similarly,
the dishonest or fraudulent act need not be one committed during the
employee’s employment with the insured. None of these bonds forms
define “dishonest or fraudulent acts.”

B. Purpose of the Automatic Termination Provision

Insulating an insured from the consequences of employing
someone known to have engaged in dishonest or fraudulent conduct
creates a moral hazard. Allowing an insured to obtain fidelity coverage
for losses caused by such an individual, reduces, if not eliminates
altogether, the incentive to screen prospective employees for potential
theft risks or to promptly terminate employees who engage in dishonest
or fraudulent conduct. The automatic termination provision mitigates

4 FINANCIAL INSTITUTION BOND, STANDARD FORM NO. 24 (1986),
Conditions and Limitations, 12, reprinted in FINANCIAL INSTITUTION BONDS
5 See 2004 FIB (“learns of any dishonest or fraudulent act”); 1986 FIB
(“learns of any dishonest or fraudulent act”); CUMIS Proprietary Bond (“learns of
. . . [a]ny dishonest or fraudulent act”); 2007 ISO FI Crime Policy (“learns of
any dishonest or fraudulent act”) (emphasis added).
6 See 2004 FIB, Section 14 (“learns of any dishonest or fraudulent act
committed by such person at any time, whether in the employment of the
Insured or otherwise”); 1986 FIB, Section 12 (“learns of any dishonest or
fraudulent act committed by such person at any time, whether in the
employment of the Insured or otherwise”); CUMIS Proprietary Bond (“learns of
. . . [a]ny dishonest or fraudulent act committed by such ‘employee’ or ‘director’
at any time, whether or not related to your activities”); 2007 ISO FI Crime
Policy, Section E.22.b.(2) (“learns of any dishonest or fraudulent act committed
by such person at any time, whether in your employment or otherwise”)
(emphasis added).
7 Id.
this moral hazard and furthers an important public policy interest. In
**Neward, Cook & Co. v. Insurance Co.**,⁸ the Eighth Circuit Court of
Appeals discussed this public policy interest:

Moreover, the immediate termination provision . . . of the bond rests upon the policy that the employer should responsibly supervise its employees, particularly since the insured is in a better position than the insurer to monitor the activities of its employees. By terminating indemnification for the further fraudulent conduct of an employee after the employer has learned that the employee defrauded clients, the termination clause encourages employers to supervise their employees. This incentive minimizes fraud, thus, benefiting both the investment industry and its customers. If the special rider is interpreted to eliminate immediate termination, these benefits diminish, and this certainly cannot be the intent of the special rider.⁹

Closely related to the public policy interests furthered by the automatic termination provision is the concept of known risk. When an insured has knowledge that one of its employee has engaged in dishonest or fraudulent conduct, that employee, and losses he or she may cause, is a known risk to the insured, and is not covered under the fidelity bond.¹⁰

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⁸ 929 F.2d 1355 (8th Cir. 1991).
⁹ Id. at 1358.
¹⁰ See In re Prime Commercial Corp., 187 B.R. 785, 804 (Bankr. N.D. Ga. 1995). (“[T]he Policy excludes coverage of an employee known to have been dishonest, whether before or after employment. The purpose of the . . . termination provision . . . is to limit the surety’s exposure to liability due to a known risk.”).
C. Employee Dishonesty Encompasses a Broad Spectrum of Conduct

The automatic termination provision\(^{11}\) requires knowledge of a “dishonest or fraudulent act.” Fraud and dishonesty\(^ {12}\) have distinct, albeit related, definitions. The concept of dishonesty tends to focus on the wrongful nature of the conduct. The concept of fraud tends to focus both on the wrongful nature of the conduct and the intent of the actor. While some courts and commentators have focused on the difference between fraud and dishonesty,\(^ {13}\) most courts analyzing these terms in the context of the automatic termination provision tend to treat them synonymously.\(^ {14}\) As one commentator has noted:

> Perhaps because of the similarity in the meanings of the terms, most courts have not bothered to dwell in detail on the implications or nuances of the two terms separately, as though they represented distinct, alternative forms of behavior. Apart from stating generally that the words “fraudulent” and “dishonest” should be interpreted according to their common and ordinary meanings, most courts have tended to view and

\(^{11}\) For an in depth discussion of the automatic termination provision, see Edward Etcheverry and Guy W. Harrison, Employee Dishonesty—When Does Your Bond ‘Automatically Terminate?, VI Fid. L.J. 71 (2000).

\(^{12}\) In Ritchie Grocer Co. v. Aetna Casualty & Surety Co., 426 F.2d 499 (5th Cir. 1970), the Fifth Circuit Court of Appeals held that dishonesty means “moral turpitude or want of integrity.” Black’s Law Dictionary defines fraud in terms of a knowing misrepresentation, or a tort arising therefrom. BLACK’S LAW DICTIONARY p. 731 (9th ed. 2009).

\(^{13}\) See 13 AM. JUR. 3d Proof of Facts § 559 (1991)(“It has been noted that the terms ‘fraud’ and ‘dishonesty’ are not strictly synonymous—that the term ‘dishonesty’ has a broader meaning that includes a variety of acts that are wrongful but fall short of fraud.”) citing Leuacadia, Inc. v. Reliance Ins. Co. 864 F.2d 964 (2d Cir. 1988), cert den 490 U.S. 1107 (1989).

\(^{14}\) Skirlick v. Fid. & Deposit Co. of Md., 852 F.2d 1376, 1377 (D.C. Cir. 1988)(“the ordinary meaning of the words ‘fraud’ and ‘dishonesty’ refers to acts which ‘show a breach of trust or of financial integrity, coupled with deceit and concealment exercised in a position of trust and confidence and causing financial loss.’”).
discuss "fraud or dishonesty," in the context of a fidelity bond, as a single, self-contained concept . . . .

Black’s Law Dictionary’s definition of “fraudulent act” encompasses the terms “dishonest act” and “fraudulent or dishonest act.” Similarly, Couch defines “fraud” and “dishonesty” with reference to the same conduct.

The words ‘fraud’ and ‘dishonesty’ include any acts which show a want of integrity or a breach of trust. And, acts which show a breach of trust or of financial integrity, coupled with deceit and concealment exercised in a position of trust and confidence and causing financial loss, constitute both fraud and dishonesty.

The language used most frequently to describe employee dishonesty—dishonest or fraudulent conduct by an employee—is conduct involving either a want of integrity or breach of trust.

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15 See 13 AM. JUR. 3d Proof of Facts § 559.
16 “Fraudulent act” is “conduct involving bad faith, dishonesty, a lack of integrity, or moral turpitude. Also termed “dishonest act; fraudulent or dishonest act.” BLACK’S LAW DICTIONARY p. 733 (9th ed. 2009).
19 Id. (citing Exeter, 85 N.H. 458; Hanson, 58 Wash. App. 561).
1. The Dishonest or Fraudulent Act Need Not Rise to the Level of Conduct That Would Support a Claim Under the Fidelity Insuring Agreement

In the past, some fidelity bonds required a dishonest or fraudulent act “which is or could be the basis of a claim under [the] Bond” in order to invoke the automatic termination provision. The fidelity bond in Boston Mutual Life Insurance Co. v. Fireman’s Fund Insurance Co. contained an automatic termination provision which, provided in relevant part: “The coverage on any employee shall terminate when the employment terminates; . . . or the Insured becomes aware of any act of the employee which is or could be made the basis of a claim under this bond . . . .” Limiting the requisite dishonest or fraudulent act to the type “which . . . could be the basis of a claim under the Bond” could conceivably lead to a situation in which an insured discovered conduct that rises to the level of dishonesty or fraud but nevertheless did not rise to the level of conduct that could be the basis of a claim under the fidelity insuring agreement. All of the standard, and many of the proprietary, bond forms now in use foreclose this possibility by expressly stating that the dishonest or fraudulent act necessary to invoke the automatic termination provision is not limited to the type of conduct covered under the fidelity insuring agreement.

In First National Bank of Louisville v. Lustig, the Fifth Circuit held that a jury instruction based on the definition of dishonest or fraudulent act in the fidelity insuring agreement was erroneous when applied to the automatic termination provision. The fidelity insuring agreement limited dishonest or fraudulent acts to those committed by the employee with the manifest intent to cause the bank to sustain a loss and to obtain an improper financial benefit. An insured’s actions could be dishonest or fraudulent but still not satisfy these requirements.

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22 Id. at 1092.
23 Among other things, the fidelity insuring agreement requires a showing that the employee intended to cause the insured to sustain a loss and to obtain an improper financial benefit. An insured’s actions could be dishonest or fraudulent but still not satisfy these requirements.
24 See supra text accompany section II.A.
25 96 F.3d 1554 (5th Cir. 1996).
26 Id. at 1168.
automatic termination provision, in contrast, applied to the insured’s knowledge of any dishonest or fraudulent act committed by the employee. Requiring manifest intent to trigger the automatic termination provision ignores the plain and ordinary meaning of the terms in the automatic termination provision. “The only reasonable interpretation of the termination clause is that dishonest acts short of those triggering coverage under Insuring Agreement A may terminate coverage under the Bond.” The Fifth Circuit remanded the case to the trial court with instructions to instruct the jury “without the restrictive definition of dishonest or fraudulent conduct contained in” the fidelity insuring agreement.

2. **Conduct Can Rise to the Level of Fraud or Dishonesty Even Where the Employee Did not Intend to Cause a Loss**

A claim for employee dishonesty under the fidelity insuring agreement requires a showing of the employee’s intent to cause the employer a loss. In contrast, within the framework of the automatic termination provision, an employee’s intent to cause a loss is not required to establish an act as dishonest or fraudulent. Several courts, including the Fourth and Fifth Circuit Courts of Appeal, have held that the knowledge of a dishonest or fraudulent act by an employee, even where the employee did not intend to cause the employer a loss, is sufficient to trigger the automatic cancellation provision.

In *C. Douglas Wilson and Co. v. Insurance Co. of North America*, the insured mortgage broker made claims on multiple fidelity bonds for loan losses on certain HUD/FHA loans. The employee who underwrote the loans provided false information on HUD/FHA forms, which stated that criminal penalties attached for such false certifications. The employee admitted he falsely certified the dates and amounts of the advances under the loans on the HUD forms to make the

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27 Id.
28 Id.
30 590 F.2d 1275.
31 Id. at 1278.
forms HUD compliant. The employee claimed that these practice—falsifying the dates and amounts of draws—was standard, and that all lenders involved with FHA loans were doing likewise. Two insurers argued that coverage terminated as to the employee prior to the inception of the bonds. The trial court sustained the insurers’ arguments, granting the insurers’ post-trial motions on the ground that the insured’s vice-president discovered the employee’s dishonest conduct before the effective date of their bonds. The insured opposed the insurers’ motions, arguing that the employee’s conduct constituted poor judgment and bad business practice, but did not rise to the level of dishonesty or fraud. In support of this argument, the insured pointed to evidence showing that its losses were not caused by the advances the employee made. The trial court rejected this argument and, on appeal, so too did the Fourth Circuit. The Fourth Circuit held that dishonesty does not require the employee’s intent to profit or to cause the insured a loss.

In Central Progressive Bank v. Fireman’s Fund Insurance Co., the prior dishonest act of which the insured bank had knowledge was the employee making fictitious loans so as to allow the bank to use the loan proceeds to make political contributions. The purpose of the political contributions was to gain business for the bank, not to benefit the employee and not to cause the bank a loss. The Fifth Circuit affirmed the jury’s verdict that the bank prior knowledge of the fictitious loans operated to terminate coverage as to the employee prior to the losses at issue in the claim.

In Resolution Trust Corp. v. Aetna Casualty & Surety Co., the district court entered summary judgment in favor of Aetna on the ground that coverage as to the employee who caused the loss terminated upon the insured’s knowledge of the employee’s dishonest act. The bond at issue became effective on October 1, 1986. In April 1986, the employee, whose conduct would later become the subject of the claim at issue in the litigation, made an illegal loan. The employee, the former president of

32 Id. at 1277.
33 Id. at 1279.
34 658 F.2d 377.
35 Id. at 380.
36 Id. at 382.
the insured, authorized the funding of a loan to an official affiliated with a subsidiary of the insured, notwithstanding the fact that the employee had been informed that the loan was illegal because it was secured only by the insured’s stock. Three officers at the insured told the employee that the loan was illegal, but the employee nevertheless authorized the funding of the loan.\textsuperscript{38} In opposing Aetna’s motion for summary judgment, the insured argued that the employee’s conduct was not dishonest because he intended to later make the illegal loan legal by either collateralizing it with something other than the insured’s stock or by having the loan financed by another bank.\textsuperscript{39} The district court rejected the insured’s argument, reasoning that the illegal loan constituted dishonest conduct, regardless of whether the employee intended to later rectify his conduct.\textsuperscript{40}

3. **Criminal Conduct—Regardless of Whether the Crime is Charged or Results in a Conviction—Constitutes Dishonest or Fraudulent Conduct**

*Ritchie Grocer Co. v. Aetna Cas. & Surety Co.*,\textsuperscript{41} illustrates that criminal conduct, regardless of whether the crime is charged or results in a conviction, constitutes dishonest or fraudulent conduct under the automatic termination provision. Before hiring the employee whose embezzlement would later give rise to the claim at issue in this case, a manager of the insured investigated the employee’s background and learned that he had been caught breaking and entering into a garage to steal tires. The employee was not tried or convicted. The prosecution and court were persuaded that it was a case of a teenage boy who had made a mistake and, as such, the charges were dismissed. The insured hired the employee with knowledge of his arrest and the outcome of the criminal prosecution. The employee later embezzled from the insured, prompting the insured to submit a claim under the bond. The insurer denied the claim on the ground that the manager’s knowledge of the employee’s prior breaking and entering constituted knowledge of a dishonest act which terminated coverage. The district court entered judgment in favor of the insurer, finding that the automatic termination

\textsuperscript{38} *Id.* at 1388.
\textsuperscript{39} *Id.* at 1390.
\textsuperscript{40} *Id.*
\textsuperscript{41} 426 F.2d 499 (5th Cir. 1970).
provision precluded coverage for the embezzlement loss. The Eighth Circuit affirmed. It construed the term “dishonest act” to encompass conduct displaying “an element of moral turpitude or want of integrity.”\textsuperscript{42} Applying this definition, the court rejected the insured’s argument that breaking and entering and theft did not rise to the level of dishonest conduct. “It is common knowledge,” the Eighth Circuit reasoned, that such conduct “is contrary to law.”\textsuperscript{43} The Eighth Circuit reasoned that the unique outcome of the criminal proceedings, dismissed due in part to the employee’s age and the fact that he was “in need of a break,” should not in any way affect the analysis of whether the act itself was fraudulent or dishonest.\textsuperscript{44}

As discussed above, criminal conduct certainly rises to the level of fraud or dishonesty for purposes of the automatic termination provision. That said, conduct need not be criminal to constitute fraud or dishonesty. Numerous courts have held that conduct that falls short of constituting a crime can nevertheless be dishonest or fraudulent.\textsuperscript{45}

4. Negligence, Mistakes or Inadvertence Do Not Constitute Fraudulent or Dishonest Conduct

As discussed above, fraudulent or dishonest conduct encompasses a broad spectrum of conduct. Several courts have held that mere negligence, mistakes and inadvertence fall outside what it is considered fraudulent or dishonest for purposes of the automatic termination provision.\textsuperscript{46}

\textsuperscript{42} Id. at 503.
\textsuperscript{43} Id.
\textsuperscript{44} Id. at 504.
\textsuperscript{45} See, e.g., Fid. & Cas. Co. of N.Y. v. Cent. Bank of Hous., 67 S.W.2d 641, 645 (Tex. Ct. App. 1934) (“Dishonest and fraudulent [are] broader and more comprehensive than the word criminal; and they include acts which show a want of integrity or breach of trust. Conduct may be fraudulent and dishonest within the meaning of [the bond] even though it falls short of a criminal offense.”).
\textsuperscript{46} See Midland Bank & Trust Co. v. Fid. & Deposit Co. of Md., 442 F. Supp. 960, 972 (D.N.J. 1977) (insured’s knowledge of significant volume of loans and shortcomings in loan documentation was not sufficient to establish the insured’s knowledge of fraudulent or dishonest conduct); Wachovia Bank &
D. Recent Cases Construing Employee Dishonesty Within the Context of the Automatic Termination Provision

1. Wuapaca Northwoods, LLC v. Travelers Casualty & Surety Co. of America

Wuapaca Northwoods, LLC v. Travelers Casualty & Surety Co. of America\(^47\) involved a claim arising out of employee theft of inventory under a commercial crime policy issued by Travelers. Travelers denied the claim on the ground that the insured had knowledge that the employee had committed dishonest acts at his prior employer, Pace. Pace fired the employee in 1998 for misappropriating company labor to make improvements on the employee’s home. The vice-president who terminated the employee from Pace later became a vice-president with the insured.\(^48\) Travelers moved for summary judgment, arguing that the termination provision precluded coverage. The insured argued that the termination provision did not apply because the vice-president acquired knowledge of the dishonest act in 1998, ten years before the crime policy became effective. According to the insured, knowledge of the dishonest act must be acquired while the policy is in effect for the termination provision to apply.

[The insured] argues, however, that the termination clause does not apply because [the vice-president’s] knowledge was obtained before the policy was even active. The key phrase in the termination clause provides that the crime policy terminates “as soon as” a manager learns of dishonest conduct, which implies that the dishonest conduct, or at least the knowledge of it, must occur while the policy is in effect. [The vice-president] learned about [the employee’s] conduct in 1998—ten years before the policy at issue here became effective—

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\(^{47}\) No. 10-C-459, 2011 WL 1563278 (E.D. Wis. Apr. 25, 2011).

\(^{48}\) Id. at *1.
and thus the termination clause does not apply. Under Travelers' interpretation, the policy was never actually in force as to [the employee] because [the vice-president] learned about [the employee's] conduct in 1998. In [the insured's] view, something that is never effective cannot later terminate.49

Travelers argued that accepting the insured’s argument would reward an insured who kept quiet about its employees’ prior dishonest acts and then obtained employee dishonesty coverage for those employees. Travelers emphasized the public policy considerations underlying the automatic termination provision. “The whole point of the termination provision is to prevent a company from obtaining insurance for losses that it has the ability to predict and / or prevent. If a company wants to hire an employee with a dishonest past, that is its prerogative, but then that company must not expect an insurer to assume the risk that attends that employee's relationship with the company.”50

The district court rejected Travelers’ argument. Focusing on the “as soon as” and “becomes aware” language in the automatic termination provision, the court concluded that the knowledge of the dishonest act must be first acquired after the policy becomes effective for the condition to apply. “[B]y stating that the coverage provided under the policy terminates ‘as soon as’ a manager ‘becomes aware of’ the employee’s dishonest conduct, the policy suggests that such ‘awareness’ must be in the present or future, not the past.”51 The district court reasoned that language, which employs the present tense, is “at least ambiguous.” A reasonable person, the court reasoned, would likely read the “as soon as” and “becomes aware” language as meaning that the automatic termination provision applies only to knowledge gained after the effective date of the policy, not before.52 The court declined to follow decisions by the District Court of New Jersey53 and the Fourth Circuit

49 Id. at *2.
50 Id.
51 Id. at *5.
52 Id.
Court of Appeals, both of which held that the automatic termination provision can apply to claims where the dishonest employee’s conduct was discovered prior to the inception of the policy. The court rejected these decisions in favor of the decision in *Home Savings Bank v. Colonial American*, a decision in which the North Carolina Court of Appeals also construed the terms “as soon as” in a crime policy’s automatic termination provision as requiring knowledge of the dishonest conduct while the policy is in effect, not before.

In *dicta*, the court attempted to explain how the result was not a “windfall for an insured who conceals material information from his insurer.” The court reasoned that the issue of an insured’s knowledge of prior dishonest conduct could be addressed in the application. The court noted that the application for the crime policy at issue in *Waupaca* “apparently [contained] no questions . . . relating to preexisting knowledge of dishonest conduct.” The court dismissed the legitimate public policy concern—an insured obtaining coverage for a known theft risk—by emphasizing the length of time between the employee’s prior dishonest act in 1998 and the crime policy’s inception in 2009. The court also appeared to question the seriousness of the prior dishonest act. “Finally, it is quite a jump from building a fence with company employees as a means of obtaining unauthorized compensation for unused vacation time to systematically embezzling the company’s own supplies and inventory.”

The *Waupaca* decision and the *Home Savings Bank* decision it relies on are wrongly decided. The known risk doctrine furthers an important public policy, which the *Waupaca* decision largely ignores. Extending coverage to an employee known to be a theft risk eliminates the insured’s incentive to screen prospective employees for theft risk. Whether the insured first acquired knowledge of the employee’s prior dishonest act before or after the inception of the policy is immaterial.

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55 598 S.E.2d 265 (N.C. App. 2004).
56 *Id.* at 267.
58 *Id.* at *5.
59 See *supra*, notes 8 and 9.
from the standpoint of employing a known risk. Furthermore, the Wuapaca decision suggests, erroneously, that if the prior dishonest act occurred far enough in time before the insured acquired knowledge of the act (i.e., 11 years in the case of the insured in Wuapaca), the public policy concerns underlying the automatic termination provision are somehow lessened or mooted altogether. This is incorrect. The applicability of the automatic termination provision is not conditioned on the proximity in time between the prior dishonest act and the insured acquiring knowledge of the dishonest act.

2.  **Troy State Bank v. BancInsure, Inc.**

   *Troy State Bank v. BancInsure, Inc.* involved a claim under the 1986 Standard Form Financial Institution Bond. In August 1999, the bank discovered that its employee had secretly raised the credit limit on her bank issued VISA card from $5,000 to $15,000. Upon discovery, the bank cancelled the VISA card, put the employee on probation, required the employee to promptly repay the $15,000 balance on the VISA card, and undergo counseling and a psychological evaluation. The bank did not terminate the employee. In October 1999, the bank reported the incident to its insurer. In its letter, the bank characterized the employee’s conduct as a violation of the bank’s internal policy. The insurer drafted a response to the bank’s October 1999 letter explaining that coverage for the employee terminated, but did not send the letter until January 2002, after the bank made a claim under the bond. The bank’s claim was based upon the employee’s embezzlement of $53,532 from customer accounts during a three month period in 2001. The insurer denied coverage on the ground that coverage as to the employee terminated in 1999 as a result of the employee wrongfully raising her credit limit. The bank filed suit and, after a bench trial, the trial court found that the bank’s loss was covered. The appellate court reversed, holding that the loss was not covered because coverage for the employee terminated in 1999 pursuant to the bond’s automatic termination provision.

   On appeal, the bank argued that the employee’s conduct was nothing more than a violation of internal policy, and further argued that it had no knowledge that this conduct was dishonest. The appellate court rejected both arguments. It cited an earlier decision of the Supreme

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Court of Kansas holding that “the words ‘dishonest’ and ‘fraudulent’ are defined broadly to mean ‘a want of integrity or breach of trust.’” 61 The court rejected the bank’s argument that the words “dishonest” and “fraudulent” are ambiguous. 62 The court reasoned that the employee’s “surreptitious and unauthorized act of raising her personal credit limit constituted dishonest conduct within the meaning of Section 12 of the bond.” The fact that the bank suffered no economic loss and the employee intended no loss to the bank did not alter the appellate court’s conclusion that the employee’s conduct was dishonest. 63 The appellate court also rejected the bank’s argument that, if the employee’s conduct was dishonest, it had no actual knowledge of such dishonesty. The court reasoned that several facts were indicative of the bank’s knowledge of the employee’s dishonesty. The bank knew the employee’s conduct was done secretly and without authorization. The bank considered the matter sufficiently serious to put the employee on probation, require the employee to get counseling and a psychological evaluation and repay the entire amount outstanding within one month. In addition to all of this, the bank wrote to its insurer. These actions, the appellate court reasoned, “demonstrate knowledge that [the employee] had committed a dishonest act.

Finally, the appellate court analyzed the bank’s argument that the bank’s October 1999 letter to the insurer required the insurer to provide the bank with clarification as to how and whether coverage for the employee would be affected by the bank’s discovery. The trial court sided with the bank on this issue, concluding that because the bank sought clarification in its October 1999 letter, “it was incumbent on the Insurer to take reasonable steps to provide the answer in this case, which it did not.” The appellate court disagreed with this conclusion. “Under the explicit terms of the bond, the [insurer] was not obligated to inform the bank of the obvious—that [the employee’s] act of dishonesty


62 Id. at *4.

63 Id.
terminated her coverage under the bond.\textsuperscript{64} The appellate court also cited the text of the letter, which said nothing about requesting a response, and noted that the bank had not raised equitable estoppel or waiver in the trial court.

The \textit{Troy State Bank} decision illustrates several key points. First, the operative language “any dishonest or fraudulent act” is unambiguous and will be broadly construed to encompass a wide spectrum of conduct displaying a “want of integrity or breach of trust.” Second, a loss to the insured is not a prerequisite to a finding of dishonest or fraudulent conduct. Third, the employee’s intent to cause a loss is not a prerequisite to a finding of dishonesty or fraudulent conduct.

3. \textit{Akins Foods, Inc. v. American and Foreign Ins. Co.}

In \textit{Akins Foods, Inc. v. American and Foreign Insurance Co.},\textsuperscript{65} an employee robbed the insured, a supermarket. The insurer denied the supermarket’s claim under a commercial crime policy on the ground that coverage as to the employee was cancelled at the time he submitted an employment application in which he disclosed a conviction for grand theft auto. After the supermarket filed suit, the insurer moved for summary judgment, arguing that the crime policy’s automatic cancellation condition precluded coverage.

On the parties’ cross-motions for summary judgment, the supermarket argued that discovery requires actual knowledge of a dishonest act, while the insurer argued that it requires only constructive knowledge. The district court concluded that the dictionary definition of discovery, “the act, process, or an instance of gaining knowledge of or ascertaining the existence of something previously unknown or unrecognized,” “offers limited insight” on whether actual or constructive knowledge is required. The district court held that “discovery” is ambiguous. Resolving that ambiguity in the supermarket’s favor, the district court reasoned, required proof that one of the officials identified in the policy as having to have discovered the dishonesty in order for the bond to cancel must have had actual knowledge of the employee’s prior

\textsuperscript{64} \textit{Id.} at *6.

The district court concluded that none of the officials identified in the policy had actual knowledge of the employee’s theft conviction. The employee had given the application to a bookkeeper/cashier. The court noted that the “record is devoid of information relating to the [bookkeeper/cashier’s] responsibilities regarding the processing of employment applications, her actual knowledge of [the employee’s] prior conviction.” The employee’s supervisor testified that he never received or read the application. Under what it characterized as “the undeveloped factual record,” the district court would not impute the bookkeeper/cashier’s knowledge to the insured and denied the insurer’s motion for summary judgment on the automatic cancellation condition.

4. The Investment Center v. Great American Insurance

In The Investment Center v. Great American Insurance, a broker-dealer insured under a Financial Institution Bond was sued by several customers alleging that a former employee of the firm had defrauded it. The firm submitted a claim to its insurer, seeking indemnification for the costs of defending the lawsuits. The insurer denied the claim on the ground that the firm had knowledge of the employee’s fraudulent conduct before the inception of the bond. In March and April 1998, before the insurer had issued the bond, customers of the firm called the employee’s manager complaining about the employee. One customer complained about a loan he had made to the employee. Another customer complained about giving the employee money to open a brokerage account and not having received account statements. When the manager attempted to follow-up with the customers on these complaints they reported that the employee had resolved the issue to their satisfaction. In April 1998, the employee’s supervisor notified the firm’s compliance department that he would no longer supervise the employee. In May 1998, the manager obtained approval to fire the employee for non-compliance issues and low production. The employee voluntarily resigned in lieu of being fired. In August 1998, the NASD sent the firm a complaint it had received about the employee from a firm customer. In October 1998, the employee was

66 Id. at *4.
67 Id.
68 Id.
arrested on fourteen felony counts, including securities fraud, forgery, grand larceny and check fraud. The employee, it was alleged, had been taking money from prospective customers and not investing it.

In December 1998, the firm applied for a Financial Institution Bond for the period beginning January 1, 1999. In its application, the firm did not disclose any potential losses with respect to the employee’s conduct. The insurer issued the Financial Institution Bond. In September 1999, the firm notified the insurer of a potential loss regarding the employee’s conduct. The insurer denied the claim. In 2001, the insurer filed suit against the employee, his manager and the insurer.

The district court framed the firm’s knowledge as “the only issue for resolution of this case.” If the firm had knowledge of the employee’s conduct before 1999, the bond would not cover any resulting losses because the bond “only covered losses discovered between January 1, 1999, and January 1, 2000. The district court pointed to the bond’s automatic termination provision, which specified “that the bond terminates upon [the firm] learning of any “dishonest” activities upon the part of the employee.”

III.
EMPLOYEE DISHONESTY UNDER THE FIDELITY INSURING AGREEMENT

While the fidelity insuring agreement uses the same clause as the automatic termination provision—“dishonest or fraudulent act committed by an employee”—it also contains additional requirements which limit the scope of the coverage for employee dishonesty. Unlike the automatic termination provision, which broadly encompasses any dishonest or fraudulent act, the fidelity insuring agreement limits coverage to a dishonest or fraudulent act committed by an employee with the intent to cause the insured a loss and the intent to gain a financial benefit for the employee or some third party. Courts analyzing employee dishonesty within the context of the fidelity insuring agreement necessarily go beyond the question of whether the conduct displays a want of integrity

70 Id. at *3, n.2.
or breach of trust and also analyze the issues of intent and financial benefit.

A. The Fidelity Insuring Agreement in Several Standard Bond Forms

1. ISO 2007 FI Crime Policy

   a. We will pay for loss resulting directly from dishonest or fraudulent acts (except for that portion of any loss arising totally or partially from any “loans” or trading) committed by an “employee” acting alone or in collusion with others. Such dishonest or fraudulent acts must be committed by the “employee” with the specific intent to:

      (1) Cause you to sustain such loss; or

      (2) Obtain an improper financial benefit for the “employee” or another person or entity.⁽¹⁾

2. SAA 2004 Financial Institution Bond

   (A) Loss resulting directly from dishonest or fraudulent acts committed by an Employee, acting alone or in collusion with others, with the active and conscious purpose to cause the insured to sustain such loss. However, if some or all of the Insured’s loss results directly or indirectly from:

      (1) Loans, that portion of the loss is not covered unless the Employee also was in collusion with one or more parties to the Loan transactions and has received, in connection therewith, an improper financial benefit with a value of at least $2500; or

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Defining Employee Dishonesty

(2) trading, that portion of the loss is not covered unless the Employee also has received, in connection therewith, an improper financial benefit.\(^{72}\)

3. **SAA 1980 Bankers Blanket Bond**

(A) Loss resulting directly from dishonest or fraudulent acts of an Employee committed alone or in collusion with others.

Dishonest or fraudulent acts as used in this Insuring Agreement shall mean only dishonest or fraudulent acts committed by such Employee with the manifest intent

(a) to cause the insured to sustain such loss, and

(b) to obtain financial benefit for the Employee or for any other person or organization intended by the Employee to receive such benefit, other than salaries, commissions, fees, bonuses, promotions, awards, profit sharing, pensions or other employee benefits earned in the normal course of employment.\(^{73}\)

B. **The Intent to Cause the Insured a Loss Requirement Limits Employee Dishonesty Under the Fidelity Insuring Agreement**

The manifest intent requirement was added “to the standard form Bankers Blanket Bond in 1980, requiring proof that the employee acted with the manifest intent to cause the insured to sustain a loss.”\(^{74}\) The

\(^{72}\) 2004 FIB, Insuring Agreement (A).


manifest intent requirement was the industry’s response to a series of decisions applying the fidelity insuring agreement beyond its intended scope.\textsuperscript{75}

Insuring Agreement (A) was revised to clarify the Surety Association’s long standing intent, . . . to limit loan losses to claims in which the culpable employee acted with the intent or purpose to gain a benefit at the expense of his employer—in other words, when the employee intended to defraud the insured bank of money.\textsuperscript{76}

The manifest intent requirement has since been replaced in the SAA 2004 FIB with the active and conscious purpose requirement. In the ISO 2007 FI Crime Policy, specific intent is used. The intent requirement, whether it be manifest intent, specific intent or active and conscious purpose, limits the scope of covered employee dishonesty under the fidelity insuring agreement.\textsuperscript{77} It is not enough for the employee’s conduct to display a want of integrity or a breach of trust; the conduct must meet at least this threshold, plus have been undertaken with the intent to cause the insured a loss and to obtain a gain for the employee or someone else. The effect of the intent requirement is to limit the fidelity insuring agreement to embezzlement or embezzlement-like acts.\textsuperscript{78}

\textsuperscript{75} Id.; Frank Skillern, Jr., \textit{The New Definition of Dishonesty in Financial Institution Bonds}, 14 FORUM 339, 340 (1978).


C. The Intent to Obtain a Financial Benefit Requirement Limits Employee Dishonesty Under the Fidelity Insuring Agreement

An important purpose of the financial benefit requirement\(^79\) is to “protect the insurer from claims where the employee’s motivation is undeterminable or intangible.”\(^80\) Coverage for dishonesty under the insuring agreement requires more than a showing of dishonest conduct. The conduct must be combined with the employee’s intent to harm the employer, as discussed above, and also to gain for himself or for some third party.\(^81\) “It is this additional financial motivation which implicates coverage under the employee dishonesty insuring agreement.”\(^82\)

In *St. Paul Mercury Insurance Co. v. FDIC*,\(^83\) an employee of the insured caused the bank to purchase certain loans as investments. When the value of those loans dropped, the bank resold the loans to third parties. The sales of the loans were fraudulent and the employee was ultimately convicted of various fraud and obstruction of justice charges. The FDIC closed the bank and submitted an employee dishonesty claim under the bond for losses arising out of the employee’s purchase and sale of the loans. The insurer moved for summary judgment on the ground that the FDIC could not prove that the employee received the requisite financial benefit.\(^84\) There was no evidence that the employee received any money as a result of the purchase or sale of the loans. The district

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\(^81\) Id. at 369.

\(^82\) Id.

\(^83\) No. 08-21192-CIV, 2010 WL 1332434 (March 30, 2010).

\(^84\) Id. at *5.
court sustained this argument and entered summary judgment in favor of the insurer.\textsuperscript{85}

This case illustrates how the financial benefit requirement restricts what constitutes employee dishonesty. If the facts of this case were analyzed under the automatic termination provision, there is little doubt that the employee’s conduct displays a want of integrity or breach of trust. The sales he orchestrated were illegal and led to his conviction on numerous fraud and obstruction of justice charges. Under several cases discussed in section II, this conduct would qualify as dishonest and/or fraudulent.\textsuperscript{86} Under the fidelity insuring agreement, however, where evidence of the employee’s intent to obtain a financial benefit is a prerequisite, the employee’s conduct in St. Paul falls outside the scope of covered employee dishonesty if there is no intent to benefit. Numerous other courts have applied the financial benefit requirement to reach similar results.\textsuperscript{87}

IV.

CONCLUSION

employee dishonesty encompasses a relatively narrow spectrum of conduct where the employee intended to cause a loss and gain a financial benefit for himself.