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KNOWLEDGE OF PRIOR DISHONESTY—DOES IT REALLY TERMINATE COVERAGE?

Dolores A. Parr
Robert Briganti

I. INTRODUCTION

A basic principle of fidelity coverage is that coverage automatically terminates as to an employee if the insured learns of that employee’s dishonesty. Coverage terminates regardless of when the dishonesty occurred, whether the employee was in the insured’s employ, or whether the dishonesty occurred before or after the inception of the current policy. The reasoning behind this principle is to prevent shifting to the insurer the increased risk that insured employers incur when knowingly employing or retaining dishonest persons.\(^1\) The employer knows its employees better than its insurer and thus retains the risk inherent in employing someone who it knows has been dishonest in the past.

Whether an employer’s knowledge is sufficient to terminate coverage under a fidelity bond or crime policy is often litigated. The issue has become more prevalent in recent years due to the trend encouraging employers to employ persons who have criminal convictions, with the thought being that these persons have paid for their crimes and should be given the opportunity to obtain employment. “Ban the Box” regulations, which prohibit employers from asking about criminal convictions during the application process, are now fairly common. Most recently, New York adopted regulations that essentially

\(^{1}\) See Mark Gamell & Whitney Drasin, Cancellation and Termination of Coverage, in COMMERCIAL CRIME INSURANCE COVERAGE 511 (Randall Marmor & Susan Sullivan eds., 2014).
nullify the provisions in fidelity bonds and crime policies that automatically terminate coverage once an insured has knowledge of an employee’s dishonesty. This article provides an overview of the decisions involving an insured’s knowledge of its employee’s prior dishonesty and the impact of these decisions, the regulations on the principle, and how carriers are addressing these recent developments.

II. POLICY AND BOND PROVISIONS

Most, if not all, fidelity and employee theft policies contain a condition providing that coverage terminates automatically as to an employee upon the insured’s discovery of its employee’s dishonesty, even when the dishonesty did not result in a loss or did not occur while employed by the insured. This condition is not a recent addition. The condition appeared in the earliest iteration of the Standard Form Banker’s Blanket Bond, where Paragraph 11 provided, in part, that:

This bond shall terminate as to any Employee—(a) as soon as the Insured shall learn of any default hereunder committed by such Employee, or (b) fifteen days after receipt by the Insured of a written notice from the Underwriter of its desire to terminate the bond as to such Employee.²

This provision appears to have applied only to the type of loss for which the bond provided coverage, that is, loss “through any dishonest act of any of the Employees, wherever committed, and whether committed directly or in collusion with others.”³ It also arguably only terminated coverage for loss that the employee caused to the insured.

Later versions provide additional detail and expand the breadth of the automatic termination provision. These versions provide that coverage terminates for more than the type of dishonesty that is covered under the bond or policy, and that the dishonesty does not necessarily have to be committed while the employee is employed by the insured.

² Banker’s Blanket Bond, Standard Form No. 1, § 11 (SFAA 1923), reprinted in STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA.
³ Id.
For example, the 1986 version of the Standard Form 24 Financial Institution Bond provides that:

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 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.  

The 2011 version of the Standard Form 24 Financial Institution Bond contains similar language:

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.

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5 Financial Institution Bond, Standard Form No. 24, § 13 (May 2011), reprinted in Standard Forms of the Surety and Fidelity Association of America.
The drafters intended this provision to be comprehensive enough to bar recovery when the insured knew that an employee had acted dishonestly prior to the employee’s employment. As noted, however, courts did not always interpret this provision as broadly as the drafters intended. The 2011 version of the Standard Form 24 Financial Institution Bond, therefore, went even further and excluded coverage for dishonest employees:

Section 2. This bond does not cover:

. . . .

(bb) loss resulting directly or indirectly from the dishonest or fraudulent acts of an Employee if any Insured, or any director or officer of an Insured who is not in collusion with such Employee, knows, or knew at any time, of any dishonest or fraudulent act committed by such Employee 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 and without regard to whether knowledge was obtained before or after the commencement of this bond. Provided, however, that this exclusion does not apply to loss of any Property already in transit in the custody of such Employee at the time such knowledge was obtained or to loss resulting directly from dishonest or fraudulent acts occurring prior to the time such knowledge was obtained.\(^6\)

The exclusion emphasizes the fact that insurers who issue financial institution bonds do not intend to cover any loss after an insured learns that one of its employees has been dishonest, regardless of when the dishonesty occurred, and regardless of whether a loss occurred as the result of the dishonesty.

Financial institution bonds are not the only products with the automatic termination condition. Various forms of the crime policies

\(^6\) Id. at § 2(bb).
contain similar provisions and provide that there is no coverage for loss sustained after an insured becomes aware of any dishonesty on the part of its employee. For many years, the Comprehensive Dishonesty, Disappearance and Destruction Policy contained two conditions that addressed the situation where an insured knew of dishonesty on the part of an employee:

**Prior Fraud, Dishonesty or Cancelation**

Section 7. The coverage of Insuring Agreement I shall not apply to any Employee from and after the time that the Insured or any partner or officer thereof not in collusion with such Employee shall have knowledge or information that such Employee has committed any fraudulent or dishonest act in the service of the Insured or otherwise, whether such act be committed before or after the date of employment by the Insured.

If, prior to the issuance of this Policy, any fidelity insurance in favor of the Insured or any predecessor in interest of the Insured and covering one or more of the Insured’s Employees shall have been canceled as to any of such Employees by reason of the giving of written notice of cancelation by the insurer issuing such fidelity insurance, whether the Company or not, and if such Employees shall not have been reinstated under the coverage of said fidelity insurance or superseding fidelity insurance, the Company shall not be liable on account of such Employees unless the Company shall agree in writing to include such Employees within the coverage of Insuring Agreement I.7

This provision was in addition to the “Cancelation as to Any Employee” condition, which is similar to the condition found in financial institution bonds:

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Cancelation as to Any Employee

Section 15. Insuring Agreement I shall be deemed canceled as to any Employee: (a) immediately upon discovery by the Insured, or by any partner or officer thereof not in collusion with such Employee, of any fraudulent or dishonest act on the part of such Employee. . . .

The “Cancelation as to Any Employee” condition appeared to apply only to dishonesty that the insured discovered while the dishonest employee worked for the insured, whereas the “Prior Fraud, Dishonesty or Cancelation” condition applied to acts that occurred before the dishonest employee’s employment with the insured.

Currently, the Insurance Services Office, Inc.™ Commercial Crime Policy addresses the issue through a condition and exclusion. Condition 2. provides:

2. Conditions Applicable to Insuring Agreement A.1.

a. Termination As To Any Employee
This Insuring Agreement terminates as to any “employee”:

(1) As soon as:
   (a) You; or
   (b) Any of your partners, “members,” “managers,” officers, directors or trustees not in collusion with the “employee”; learn of “theft” or any other dishonest act committed by the “employee” whether before or after becoming employed by you; or

(2) On the date specified in a notice mailed to the first Named Insured. That date

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8 Id. at § 15.
9 Hereinafter ISO.
Knowledge of Prior Dishonesty

will be at least 30 days after the date of mailing.
We will mail or deliver our notice to the first Named Insured’s last mailing address known to us. If notice is mailed, proof of mailing will be sufficient proof of notice.  

Further, Exclusion 1.b. in the 2015 edition of the ISO form excludes coverage for:

b. Acts Committed By Your Employees Learned Of By You Prior To the Policy Period

Loss caused by an “employee” if the “employee” had also committed “theft” or any other dishonest act prior to the effective date of this Policy and you or any of your partners, “members,” “managers,” officers, directors or trustees, not in collusion with the “employee,” learned of such “theft” or dishonest act prior to the Policy Period shown in the Declarations.  

The drafters intended, once again, to make it very clear that there is no coverage when an insured has any knowledge of any dishonesty.

Finally, the Surety & Fidelity Association of America’s Crime Protection Policy has the following automatic termination provision:

1. Insuring Agreement 1
   Cancellation as to Any Employee Coverage under this policy is canceled as to any employee:
   a. Immediately upon discovery by:
      (1) You; or

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10 Commercial Crime Policy (Discovery Form), Condition 2, ISO Form CR 00 22 11 15.
11 Id., Exclusion 1.b.
12 Hereinafter SFAA.
(2) Any of your partners, officers or directors not in collusion with the employee; or

(3) As to Employee Benefit plan(s), any trustee, fiduciary or plan administrator not in collusion with the employee; of any dishonest act committed by that employee whether before or after becoming employed by you. Whether such discovery occurs prior to or after commencement of this Policy, there is no coverage under Insuring Agreement 1. for loss or losses resulting from acts committed by that employee after the date of such discovery.

b. On the date specified in a notice mailed to you. That date will be at least 30 days after the date of mailing. The mailing of notice to you at the last mailing address known to us will be sufficient proof of notice. Delivery of notice is the same as mailing.\(^{13}\)

As the result of some decisions that construed the automatic termination provisions too narrowly, some later versions of this provision have been drafted to reiterate that the underwriting intent is to terminate coverage regardless of when the dishonesty occurred or when the insured learned of the dishonesty. It should be noted that the dishonest acts referenced in this condition, and other policy forms, is broader than the dishonesty or theft for which the policy or bond provides coverage.\(^{14}\)

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\(^{13}\) Crime Protection Policy, Standard Form No. SP 00 01 04 12, § E (Apr. 2012), *reprinted in* STANDARD FORMS OF THE SURETY AND FIDELITY ASSOCIATION OF AMERICA.

\(^{14}\) Although not discussed in this article, some proprietary versions limit the extent of the automatic termination provision by providing that coverage for dishonesty before employment applies only if the insured becomes aware of the
Although worded differently, each of these provisions clearly state that coverage for an employee terminates when the insured learns of the employee’s dishonesty. Insureds and courts, however, have not always considered the language to be clear and, in some instances, appear to have looked for reasons to find that coverage did not automatically terminate. The issues are many and courts have not been consistent in their interpretation of this provision. What is a very firm and basic provision of fidelity insurance has been the subject of much litigation, including:

- What type of dishonesty is sufficient to terminate coverage?
- Whose knowledge is sufficient to terminate coverage?
- If the policy provides that the insured (as opposed to specific personnel within the insured) must discover the dishonesty, who within the insured must have knowledge in order to terminate coverage as to an employee?
- Does coverage terminate if the insured had knowledge of the dishonesty before the effective date of coverage, such that the dishonesty was not discovered during the policy period?

Unfortunately, based on the many decisions interpreting the automatic termination language, there is no hard and fast rule regarding how to approach these issues. At times it seems that courts are more interested in the result than in the correct contract interpretation. Additionally, as discussed in this article, the automatic termination provision is now the subject of direct attack by regulators and legislators.

employee’s theft, fraud, or dishonest or criminal act committed before employment that involves money or property with a value of $25,000 or more. Interestingly, many of decisions concerning automatic termination with regard to an employee are unreported and therefore may be of limited precedential value. One could suggest, then, that these cases focused more on achieving a favorable result for the insured employer as opposed to a reasonable and correct interpretation of the contract language.
III. WHAT TYPE OF DISHONESTY IS SUFFICIENT TO TERMINATE COVERAGE?

As has been discussed, most, if not all, versions of fidelity coverage provide that coverage terminates automatically with regard to an employee once the insured learns of that employee’s dishonesty. The dishonesty does not have to be the type of dishonesty required to trigger coverage under the employee dishonesty or theft insuring agreement. The use in the termination provision of the term “dishonest,” with no definition of that term, implies that a broader definition applies for purposes of automatic termination of coverage.

There should be no doubt that coverage for an employee terminates automatically if the employee is caught embezzling from the insured employer. However, what type of other dishonesty is sufficient to terminate coverage? Does coverage terminate automatically if the employee has a reasonable explanation for what he or she is doing? If the insured did not sustain a loss as result of the employee’s dishonesty (for example, the employee repaid the loss), is coverage terminated for that employee? Much seems to depend on what an insured thinks about the employee’s activities and how egregious those activities were. In other words, did the insured think that the employee was dishonest?

At least some courts have held that whether a prior act was dishonest is a question for the jury. In St. Paul Mercury Insurance Co. v. Coconut Grove Bank, the insured bank claimed a loss from 571 used car loans, which its employee, Morales, allegedly made in exchange for bribes. In February 2002, a former employee of one of the used car dealerships called the bank and reported that the dealership was doing fake deals and provided basic information about Morales’s involvement. In the same month, the bank promoted Morales to vice president. In August 2002, the bank found some irregular transactions in an account that, although reserved for special situations, Morales had been using to deposit customer checks on a regular basis. The checks would be held for a few days, such that it would appear as though payments were made, but the checks did not actually clear for a few extra days. The insurer argued that the bond terminated because the bank knew of Morales’s activities

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vis-à-vis the dealership and that these activities constituted dishonesty. Rather than deciding the issue on its own, the court held that the jury was properly allowed to decide whether Morales’s prior acts were dishonest.

Likewise, in Federal Deposit Insurance Corp. v. Denson, the insurer argued that the bank discovered the loss and the employee’s dishonesty when a supervisor made a surprise audit of the branch and found a $30,000 cash shortage. At the surprise audit, the dishonest employee showed the supervisor a cash-out ticket and represented that the money had been transferred to the teller cash dispenser. The supervisor did not count the cash in the teller cash dispenser or otherwise verify the truthfulness of the representation. The court held that there were genuine issues of fact as to whether this constituted the insured’s discovery of the loss or knowledge of prior dishonesty. The insurer argued that the insured’s imputed knowledge that a dual control policy was not being followed (which could have been ascertained from the bank’s records) combined with knowledge of the $30,000 shortage constituted discovery. The court rejected this argument, holding that the insured could not appreciate the significance of facts it did not actually know and “imputed knowledge will not suffice” for discovery under the facts of the case. Drawing on Federal Deposit Insurance Corp. v. Fidelity & Deposit Co. of Maryland, the court stated:

[T]he bond under consideration applied to loss discovered by the Insured during the bond period, and, like the Bond at issue here, defined discovery as occurring “when the Insured becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred, even though the exact amount or details of loss may not then be known. . . .” The Fifth Circuit, consistent with other courts, interpreted this clause to mean that “discovery of loss does not occur until the insured discovers facts showing that dishonest acts occurred and

18 Id. at 802.
19 45 F.3d 969 (5th Cir. 1995).
appreciates the significance of those facts; suspicion of loss is not enough.”

Automatic termination was not an issue in *S&K Motors, Inc. v. Harco National Insurance Co.*, 21 although the court did address it peripherally. This case involved a dispute between the insured and insurer as to how recoveries were to be applied. The employee had embezzled approximately $27,000 and agreed to repay the insured. While he was paying this amount back, however, he embezzled an additional $41,000. No one questioned the automatic termination of coverage.

Harco also argues that “the obvious intent of the termination provision in the Harco policy is to shift the risk of theft back to an insured employer when that employer elects to continue employing a worker whom they know is stealing.” We agree, and Pinnacle admits, that Harco bears none of the risk of paying for loss incurred after Pinnacle discovered Casino’s thefts. 22

*Newhard, Cook & Co. v. Insurance Co. of North America, n/k/a Cigna Property & Casualty Co.* 23 involved a stock broker, Phipps, that, on at least four occasions before the fraud giving rise to this case, clients had alleged engaged in fraud and misrepresentation with respect to their investments. Each of the allegations had been brought to the attention of the vice president, who described the employee’s conduct as “deceitful.” 24 The court held that the automatic termination provision had been triggered:

> When the insured’s own vice-president describes an employee’s conduct as deceitful, the insured has

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20 908 F. Supp. 2d at 802 (quoting FDIC v. Fid. & Deposit Co. of Md., 45 F.3d at 974).
21 213 P.3d 630 (Wash. 2009).
22  Id. at 635. The issue in this decision was how the recovery paid by the employee was to be applied. The court allowed the amounts repaid by the principal to be applied to the total loss, not just the prior loss. See id.
23 929 F.2d 1355 (8th Cir. 1991).
24  Id. at 1356.
knowledge of dishonesty and fraud on the part of the employee. Based on Reed’s admission that Phipps acted deceitfully and on the fact that Newhard knew of the conduct prompting this characterization prior to the time that Phipps defrauded Muncy, we hold that the termination clause had been triggered prior to the conduct which formed the basis of Muncy’s claim against Newhard.25

The court went on to explain the reasons for the automatic termination provision:

Moreover, the immediate termination provision of Section 9 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.26

An insured’s discovery of a small loss easily explained and repaid by the employee may not be sufficient to terminate coverage. Salley Grocer Co., Inc., v. Hartford Accident & Indemnity Co.27 involved a situation where the insured denied a claim because the employee had caused a similar loss several years before the defalcation which resulted in the claim. The previous incident was described as follows:

With respect to the incident of 1958, upon which defendant relies to establish its primary defense, Charles

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25 Id. at 1357.
26 Id. at 1358.
Fred Salley, Sr., plaintiff’s manager, testified Hearne reported to him that the accounts of some of his customers were out of balance and expressed a desire to get them “straightened out,” whereupon, without further inquiry, Hearne was referred to one of plaintiff’s bookkeepers for assistance in reconciling the accounts. This reconciliation disclosed to the bookkeeper that there was a deficit in Hearne’s remittances of $1,984.86. Thereupon Hearne delivered his personal check to the bookkeeper to cover this deficit. The funds thus received were credited to the appropriate accounts. The conclusion of the matter was not immediately made known to Salley, but the bookkeeper, several days later, reported to him that the matter had been taken care of.\(^\text{28}\)

The insured contended that the earlier incident was not truly an employee dishonesty loss, and the court agreed:

> In the instant case there is no showing in the record that Hearne had any criminal intent, by his acts of 1958, of defrauding plaintiff or of acting dishonestly, for, as stated, he voluntarily reported the discrepancies in his accounts, expressed a desire to straighten them out, and, moreover, gave his own check to make appropriate adjustments in the accounts. The words “fraudulent or dishonest act” imply positive acts of wrongdoing, the discovery of which releases the insurer of its obligation on the bond.

> Discovery is an important element, and one of the questions for determination in this case is: Did plaintiff acquire knowledge of any positive act of dishonesty committed by Hearne which would, under the provisions of the bond, immediately affect its termination? This question, we think, must be answered in the negative.

\(^{28}\) *Id.* at 6.
Our conclusion is that defendant has not established that Hearne committed a fraudulent or dishonest act in 1958 or that plaintiff or any of its officers had knowledge of such an act, if committed, that would serve under the provisions of the bond, to which we have referred, to effect its cancellation as to the employee in 1958. 29

A fairly recent unpublished decision, on the other hand, found squarely that coverage terminated for the employee when the bank discovered that the employee had surreptitiously raised the limit on her bank-issued credit card. 30 The bank disciplined the employee, required her to pay off the credit card account, and gave the insurer notice of the incident. The insurer drafted a response that coverage for the employee was terminated, but the insurer’s response was never sent to the bank. Two years later, the employee stole $53,000 from customer accounts and the bank submitted a claim, which the insurer denied based on the automatic termination provision. Reversing judgment for the insured, the appellate court stated that the automatic termination provision was clear and unambiguous, regardless of whether the insurer failed to respond to the insured’s notice about the employee. “Under the law, [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 plaintiff suffered no economic loss and that [the employee] intended no financial loss to her employer does not make the conduct honest.” 31

IV. WHOSE KNOWLEDGE IS SUFFICIENT TO TERMINATE COVERAGE?

The standard coverage forms, in general, do not specify a person within the insured who must discover an employee’s dishonesty for purposes of terminating coverage for that employee. Many proprietary policies, however, provide that coverage terminates when a director,
titled officer, or risk manager learns of the dishonesty. The ISO financial institution forms provide that discovery is triggered when a “designated person,” that is, a risk manager, titled officer, director, trustee, or someone in human resources, learns of the dishonesty.\textsuperscript{32} Discovery by a designated person can also be added to the commercial crime policy by endorsement. Absent such language, however, whose knowledge of an employee’s dishonesty is sufficient to terminate coverage? As with the type of dishonesty that is sufficient to terminate coverage, there is no clear answer to this question. In general, the knowledge must at least be possessed by someone in a supervisory capacity. Knowledge by an officer or a director is usually sufficient.

In \textit{Aqua Group, LLC v. Federal Insurance Co.},\textsuperscript{33} the court found that the principal’s conviction for custodial kidnapping was not enough for the insurer to obtain summary judgment that coverage terminated. In this case, the insured alleged that an employee stole a van with valuable equipment inside. The employee claimed that he merely borrowed the van to move some personal property and that the van was stolen from him. Although the employee’s supervisor knew that the employee had been convicted of custodial kidnapping, the court found that the supervisor’s knowledge was not sufficient to terminate coverage.\textsuperscript{34}

In \textit{Century Business Services, Inc. v. Utica Mutual Insurance Co.},\textsuperscript{35} the president of the insured payroll processor, a subsidiary of a larger corporation, “borrowed” funds from client accounts and executed promissory notes for the “loans.” The insured’s controller was aware of the loans, and in September 1999, the General Manager of the insured learned about them. When the General Manager learned of the loans, the president had borrowed $499,750 and paid back $200,000.\textsuperscript{36} Subsequently, the president borrowed another $2,780,000 and repaid

\textsuperscript{32} See, e.g., Financial Institution Crime Policy for Banks and Savings Institutions (Nonaggregate Form), Condition 22.b.(2)(a), ISO Form FI 00 10 09 12.


\textsuperscript{34} \textit{Id.} at 835.

\textsuperscript{35} Nos. 03-3792; 03-3793; 03-3804, 2005 WL 96839 (6th Cir. Jan. 18, 2005).

\textsuperscript{36} \textit{Id.} at *4.
another $350,000. An officer of the parent corporation learned of the loans and terminated the president in May of 2000. The president was later convicted of wire fraud.

The policies provided for termination as to any employee upon discovery of dishonesty by “you” or by “any of your partners, officers or directors” not in collusion with the employee. At issue was whether the General Manager’s discovery terminated coverage. The Sixth Circuit, evidently thinking that “you” included all employees, held that “you” as applied to a corporation was ambiguous without discussing any definition of “you” in the policy. As such, it held that the general manager’s knowledge was not sufficient to terminate coverage.

In Akins Foods, Inc. v. American & Foreign Insurance Co., the employee disclosed a prior conviction for grand theft auto in his employment application. The store manager denied ever seeing the application, which was given to the store’s cashier/bookkeeper. The employee later participated in robbing the insured’s store. The court found that the insured had not discovered the prior act of dishonesty, holding that “discovery” required actual knowledge not constructive knowledge. The cashier/bookkeeper had actual knowledge, but the court found that “given the undeveloped factual record, the court refrains from imputing [the bookkeeper’s] actual knowledge to [the Insured].”

A somewhat older decision contains a very interesting discussion of who must know what, and when they should know it, in order to terminate coverage. Boston Mutual Life Insurance Co. v. Fireman’s Fund Insurance Co. involved a situation where the insured was aware—before the bond’s inception date—of what should be considered dishonesty on the part of a third party administrator who was covered under its bond. In that case, Thompson became a third party

37 Id.
38 Id. at *9.
39 Id.
41 Id. at *11.
42 Id.
administrator for the insured in October 1976. During 1977 and 1978, Boston Mutual discovered that Thompson had misappropriated some of its premiums from insurance policies. “Thompson agreed to return the money, and he signed a $120,000 note payable to Boston Mutual and eventually gave Boston Mutual a mortgage on his home. In light of Thompson’s agreement to return the money, Boston Mutual decided not to terminate his service as third-party administrator.” The court did not apply an objective standard to resolve the issue, as urged by the insurer, but rather a subjective standard. The court’s reasoning appears to be anything but clear and concise.

I conclude that a fair and reasonable construction of this language requires awareness by a person in authority for plaintiff not only of an “act” of Thompson, such as remittance to plaintiff of a premium payment at a time months after it was due, but also awareness by a person in authority for plaintiff that this act “is . . . the basis of a claim” of fraud by Thompson or awareness of the possibility that it “could be made the basis of a claim” of fraud. For example, suspicion that Thompson was delaying remittance to Boston Mutual after receiving the premium payment and was using the funds in the meantime for purposes not authorized by Boston Mutual would satisfy the awareness standard. The phrase “could be” sets a standard concerned with likelihood rather than certainty of claim, but construed in accordance with ordinary usage, it does not convert “awareness” from a state-of-mind standard to an objective standard. Thus, a common sense interpretation of the contract is that coverage does not terminate merely because some other person, more suspicious and discerning than any of the persons in authority for plaintiff, could or even would have thought a basis existed for a claim that Thompson was acting fraudulently. Subject to one more qualification noted in the paragraph next below, however, coverage does terminate when some person in

44 Id. at 1091.
45 Id.
46 Id. at 1092.
authority for plaintiff forms this state of mind of being “aware” of an act of Thompson and being “aware” that this act of Thompson “is . . . the basis of a claim” or of the possibility that it “could be made the basis of a claim” that Thompson was acting fraudulently. I reach this conclusion on the ground of fair and reasonable interpretation of the language, in the context of its use in this bond.47

Thus, in determining whether an insured’s knowledge of an employee’s actions terminates coverage, much depends on how the insured, or insured’s personnel, perceive the employee’s actions. If the insured does not perceive the actions as being dishonest because the employee provided a reasonable explanation for his actions or reimbursed any shortage, coverage most likely will not have terminated.

V.
MUST THE DISHONESTY HAVE BEEN COMMITTED WHILE THE EMPLOYEE WAS EMPLOYED AT THE INSURED?

The Boston Mutual decision is also one of a line of cases where the court refused to apply the automatic termination condition to terminate coverage for an employee where the insured was aware of the employee’s dishonesty prior to the effective date of coverage. There have been several decisions in recent years where courts have found that the automatic termination provision was ambiguous and that a reasonable interpretation would be to apply it only to dishonesty discovered after the effective date of coverage. Although these cases appear to present a minority view on the interpretation of the automatic termination provision, when taken in conjunction with “Ban the Box” regulations and steps recently taken in New York, they appear to demonstrate a reluctance to deprive an insured of coverage when the insured has a dishonest employee. Under these decisions, the insured’s knowledge of the dishonesty prior to the inception of coverage does not terminate coverage for the dishonest employee.

47 Id. at 1094.
In *Home Savings Bank v. Colonial American Casualty & Surety Co.*,[48] the insured discovered in 1985 that its employee had been convicted of embezzling from a prior employer. The insured notified its then-current carrier of the employee’s prior record and the carrier agreed that the employee would continue to be covered as an employee under the bond.[49] In May 2001, after changing carriers, the insured discovered that the employee had embezzled over $1 million.[50] The insured had not notified the new insurer of the employee’s prior conviction or requested that this employee be covered. The insurer denied the claim, arguing that under the automatic termination provision, coverage never attached to this employee. The court agreed with the insured’s argument that coverage could not terminate before it goes into effect:

We agree with the trial court’s conclusion that the construction of the termination clause advanced by Home Savings—i.e., that coverage as to any employee under the bond only terminates where Home Savings initially discovers, *after the coverage period’s commencement*, the employee’s dishonest conduct—is a reasonable one. Significantly, the termination clause provides that the bond “*terminates . . . as soon as*” Home Savings “learns” of any dishonest conduct by an employee. Use of the present, rather than past, tense here suggests an intent by the parties that coverage under the bond must first commence *before* discovery of an employee’s dishonest conduct will operate to terminate it.[51]

A similar result was reached in *Waupaca Northwoods, LLC v. Travelers Casualty & Surety Co. of America.*[52] In that case, Travelers denied the insured’s claim because the insured knew that the employee committed dishonest acts in the past.

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49 Id. at 267.
50 Id.
51 Id. at 270 (emphasis in original).
Waupaca argues, however, that the termination clause does not apply because Shaffer’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. Shaffer learned about Neider’s conduct in 1998—ten years before the policy at issue here became effective—and thus the termination clause does not apply. Under Travelers’ interpretation, the policy was never actually in force as to Neider because Shaffer learned about Neider’s conduct in 1998. In Waupaca’s view, something that is never effective cannot later terminate.53

The court concluded that an insurer can exclude losses caused by an employee who has a prior record of dishonesty, including dishonesty that precedes the effective date of the policy, but that it must use language that makes its intent clear to the insured.54

On the other hand, there are courts who have taken a more reasonable approach to the automatic termination provision when dealing with the question of whether coverage terminated for an employee upon the employer’s knowledge that the employee had acted dishonestly. In *American Rice, Inc. v. National Union Fire Insurance Co. of Pittsburgh, Pa.*,55 the court affirmed summary judgment for the insurer on a crime policy because the insured knew, before it submitted the application, that its employee had been found civilly liable for fraud and had made money transfers which other officers questioned. Considering the fact that the insured’s officers were so concerned with the transactions that were the subject of this fraud that they demanded justification for them, the court stated that “[u]nder these circumstances, plaintiff cannot claim, as

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53 Id. at * 2 (emphasis in original).
54 Id.
represented in its application for the insurance, that it then had no reason to suspect this person’s honesty.”56

Following this reasoning, the court in *Capital Bank & Trust Co. v. Gulf Insurance Co.* 57 held that a loss was excluded because the insured was aware of an employee’s dishonesty prior to the effective date of the bond. The dishonest employee had forged the signatures of the insured’s presidents over a period of several years. One of the insured’s former presidents testified in a deposition that he discovered the employee’s forgery of his name to loan documents in 2001, prior to the effective date of coverage in 2002, confronted the employee, and instructed him to cease the practice.58 He also reported the incident to the chair of the insured’s board of directors, but no disciplinary action was taken against the employee. The insured argued that the 2001 incident was not prior knowledge of dishonesty because the insured incurred no loss. The court disagreed, and held that forging the president’s name was dishonest:

According to plaintiff, since Brunner’s signature was only forged on credit renewals and extensions, which did not advance new funds to customers but rather extended the time for repayment, no loss occurred and, therefore, use of the signature does not constitute a fraudulent or dishonest act triggering the termination provision. Even if no loss occurred as a result of the 2001 forgeries, the language of the bond contains no requirement that a loss occur in order for conduct to be considered dishonest or fraudulent. The express terms of the bond provide that

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56 Id. at 192; see also C. Douglas Wilson & Co. v. Ins. Co. of N. Am., 590 F.2d 1275 (4th Cir. 1979) (holding no coverage for an employee where the insured was aware of that employee’s dishonesty prior to the inception dated of coverage under a new bond); C.A. White, Inc. v. Travelers Cas. & Sur. Co. of Am., No. CV085023551S, 2009 WL 1218691, at *3 (Conn. Super. Ct. Apr. 9, 2009) (holding no coverage where the insured discovered an employee embezzlement but did not terminate the employee because she repaid the amount she had stolen, and discovered an additional embezzlement several years later, because “there was, and can be, no coverage under the contract of insurance for this dishonest employee subsequent to 1998.”).


58 Id. at 464.
dishonest or fraudulent acts plus loss presents the basis for a claim; hence, loss is not an element of a dishonest or fraudulent act. Thus, because the forgeries committed by White constitute dishonest acts and plaintiff was aware of this conduct in 2001, prior to the issuance of the bond, coverage as to White terminated immediately upon inception of the bond.\textsuperscript{59}

Likewise, in an unpublished opinion in \textit{Alcona County v. Michigan Municipal League Liability & Property Pool},\textsuperscript{60} the Michigan Court of Appeals upheld the automatic termination provision, holding that there was no coverage for an employee whose dishonesty was known to his employer prior to the effective date of coverage. Alcona County was insured under a series of annual bonds covering its Treasurer and another series of annual bonds covering its finance director. The elected County Treasurer, who was also an accountant, was arrested in 1998 on two counts of forgery and two counts of publishing a false, forged, altered or counterfeit document in connection with filings that he made with the state on a client’s behalf.\textsuperscript{61} He eventually pleaded guilty but complied with a diversion program and the conviction was expunged.\textsuperscript{62} He had been first elected Treasurer in 1993, however, and the criminal matter received substantial local publicity. He continued to be re-elected until the County discovered in 2006 that he had embezzled over $1.2 million.\textsuperscript{63}

The court granted summary judgment to the insurer based on the prior knowledge provision of the bonds. In doing so, the court held that the 1998 criminal activity was a fraudulent and dishonest act and rejected the County’s argument that, to be a dishonest act sufficient to terminate coverage, there had to be a loss to the County.

The County cites the definition of “dishonest or fraudulent acts” contained in Coverage Agreement I as indicating that the prior fraud or dishonesty exclusion set

\textsuperscript{59} Id. at 465-66.
\textsuperscript{61} Id. at *2.
\textsuperscript{62} Id.
\textsuperscript{63} Id.
forth in Section 7 of the Conditions and Limitations is only applicable to prior dishonest or fraudulent acts resulting in loss to the Member. The County thus argues that, because Katona’s prior fraudulent or dishonest act did not cause any loss to the County, the prior fraud or dishonesty exclusion was not triggered by that prior conduct. The County’s argument is without merit. . . . Once the County had knowledge or information that Katona had committed dishonest acts, such as those underlying the 1998 proceedings against him, the position bonds issued by the Pool no longer indemnified the County against losses resulting from any subsequent fraudulent or dishonest conduct by Katona.64

Another recent decision of note is National Credit Union Administration Board v. CUMIS Insurance Society.65 There, the dishonest employee was the manager of the insured credit union from 1995 until 2010.66 From at least 2000, the employee was accepting bribes and making fraudulent loans. However, since 2002, the employee reported to the Board of Directors, the federal regulators, and the insured’s external auditor, that there were zero delinquent loans. At least two Board members were aware that a small percentage of loans had consistently been delinquent. The Board questioned the employee on this, but never received a straight, satisfactory answer. The court found that the employee’s lies to the insured’s Board were dishonest for purposes of the bond’s automatic termination provision and that at least one director was aware of the dishonest statements.67 The bond, therefore, did not cover the claimed loss because coverage for the dishonest employee terminated before the bond’s effective date.

Here, however, the relevant provision (the 2010 Bond’s Termination provision) does not hinge on knowledge of dishonest or fraudulent acts that trigger coverage. Rather, as the Court has already noted, the Termination

64 Id. at 6.
66 Id. at *7.
67 Id.
Knowledge of Prior Dishonesty

provision expressly provides that coverage for an employee terminates immediately when a director or officer (not in collusion with such employee) learns of “any dishonest or fraudulent act committed by such ‘employee’ . . . at any time, whether or not related to your activities or of the type covered under this Bond.” Thus, the Court reads this provision as simply requiring that Calevich know that Raguz committed a dishonest act; i.e., any act that shows a want of integrity or breach of trust. The Court does not construe this provision as further requiring that Calevich appreciate that Raguz’s dishonest act triggered coverage under the Bond. In other words, for purposes of the Termination provision, the Court does not believe that Defendant must show Calevich made the connection between Raguz’s falsely reporting a zero delinquency rate and Raguz’s overall fraudulent scheme.68

As can be seen, the assertion that an insured’s knowledge that an employee acted dishonestly does not always operate to terminate coverage under a fidelity bond or crime policy for loss that employee caused. Even knowledge of a criminal conviction may not terminate the coverage. Rather, some courts have interpreted the automatic termination provision by tying it into an insured’s knowledge of its employee’s dishonesty and how the insured perceived the employee’s actions. Further, not all criminal activity is necessarily dishonest. For instance, a person who has killed someone may have committed an act of moral turpitude, but causing a person’s death is not necessarily dishonest. Likewise, a conviction for drug possession does not indicate that the person convicted has a propensity to steal. A juvenile offense also may not automatically terminate coverage, especially when the documents for the prosecution of the offense are sealed. On the other hand, if an insured employer knows that someone embezzled from a prior employer, coverage may terminate regardless of whether the employee had been criminally charged or convicted of the embezzlement.

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68 Id. at *47-48 (emphasis in original).
VI. “BAN THE BOX” AND NEW YORK INSURANCE REGULATION 209

Opposing the principle that an employer’s knowledge of an employee’s dishonesty automatically terminates fidelity coverage for that employee is a desire on the part of governmental entities to afford persons with criminal records the ability to find employment after serving sentences for their crimes. The “Ban the Box” movement promotes the employment of persons with prior criminal convictions, such that potential employers cannot ask about a potential employee’s prior criminal convictions during the application process. New York has even gone so far as to encourage employers, under certain circumstances, to hire qualified persons with criminal records and negate the automatic termination provision of fidelity bonds and crime policies.

A. The “Ban the Box” Movement

What started as a case involving a claimed violation of Title VII of the Civil Rights Act has, through numerous iterations over the past four decades, been transformed into an insurance regulation that directly restricts the application of the prior acts termination provision of crime insurance. “Ban the Box” is the name associated with a campaign by civil rights groups and fair chance advocates to remove the checkbox asking about an applicant’s criminal history from the employment application. The goal of the BTB regulations is to promote the hiring of persons with criminal convictions so that these persons can obtain employment and become useful citizens.

The initial judicial support for the movement can be found in Green v. Missouri Pacific Railroad Co., a 1975 case involving Buck Green, a black applicant who was denied employment with Missouri Pacific Railroad Company because of his prior conviction for refusing military induction. MoPac had an absolute policy of refusing to consider

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69 Hereinafter BTB.
71 523 F.2d 1290 (8th Cir. 1975).
72 Hereinafter MoPac.
for employment any person convicted of a crime, other than a minor traffic offense. Green claimed discrimination, and the Eighth Circuit agreed, holding that the employment practice was not justified by business necessity:

There is no doubt that the State could logically prohibit and refuse employment in certain positions where the felony conviction would directly reflect on the felon’s qualifications for the job (e. g., conviction of embezzlement and a job requiring the handling of large sums of money).

. . . .

We cannot conceive of any business necessity that would automatically place every individual convicted of any offense, except a minor traffic offense, in the permanent ranks of the unemployed.73

The Equal Employment Opportunity Commission74 effectively adopted this principle in its enforcement guidance, interpreting Green as setting forth three factors which employers must examine: (1) the nature and gravity of the offense or conduct; (2) the time that has passed since the offense, conduct, and/or completion of the sentence; and (3) the nature of the job held or sought.75 In addition, the EEOC guidance sets forth recommendations for employers, which include eliminating “policies or practices that exclude people from employment based on any criminal record” and creating a “narrowly tailored” policy for evaluating applicants for past criminal conduct.76

BTB proponents hope that by eliminating the conviction question on an employment application and an immediate rejection if the

73 Id. at 1297-98.
74 Hereinafter EEOC.
76 Id.
“box” is checked, a candidate could secure further consideration based on their qualifications (for example, through an interview) and have a better opportunity of securing employment. Statistics demonstrate, however, that the implementation of BTB regulations may not provide a benefit for the intended group of applicants.

We find that BTB policies decrease the probability of being employed by 3.4 percentage points (5.1%) for young, low-skilled black men, and by 2.3 percentage points (2.9%) for young, low-skilled Hispanic men. These findings support the hypothesis that when an applicant’s criminal history is unavailable, employers statistically discriminate against demographic groups that are likely to have a criminal record.

In addition to the EEOC, many states and local jurisdictions have enacted BTB-type legislation and regulations. Twenty-six states, starting with Hawaii in 1998, have adopted policies concerning applicants who have prior convictions, ten of which apply the policies to private employers. Many cities and counties have also adopted similar rules even in states that have not adopted a statewide regulation. Unfortunately, there is no uniformity in the wording of the statutes or ordinances. For example, some jurisdictions restrict timing of


79 California, Colorado, Connecticut, Delaware, Georgia, Hawaii, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, New Jersey, New Mexico, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Utah, Vermont, Virginia, and Wisconsin.


81 See, e.g., NATIVIDAD RODRIGUEZ & AVERY, supra note 77, at 3-5.
background checks to after an interview, while others restrict such until after a conditional offer of employment.\textsuperscript{82}

\textbf{B. Significance of BTB Regulations to Crime Insurance}

It should be noted that there is no requirement in the policy or bond that an employer screen applicants for prior criminal history in order to obtain fidelity insurance. An underwriter, however, would typically expect an insured to screen applicants for prior criminal convictions. As part of an investigation, a claim representative will typically request the personnel file of an accused employee and should expect to find the information concerning prior convictions and background checks in it. If no background check was performed, however, and if the insured has no knowledge of a prior criminal background, an insurer would be unable to invoke the termination clause.

Due to the BTB regulations an insured may be limited in time or scope from asking the applicant for prior conviction information or performing a background check. As such, an insured may have modified its hiring practices in response to BTB laws or other considerations and consequently hired individuals with prior criminal convictions.\textsuperscript{83} In the event of a claim, the prior conviction may be the subject of the termination provisions of the fidelity insurance if the insured had knowledge of the prior conviction. How the prior conviction and its application to a claim may be treated will vary depending on the facts of the claim and whether the location is subject to BTB laws or ordinances.

\textbf{C. New York’s Insurance Regulation 209}

One state has gone beyond BTB and mandated that, under certain specified circumstances, a prior criminal conviction cannot be used to deny an otherwise valid fidelity claim. New York’s BTB regulation is contained in Article 23-A, \textit{Licensure and Employment of}

\textsuperscript{82}See, e.g., \textit{id.} at 1, 20, 22, 74.

\textsuperscript{83}“Major employers such as Starbucks, Facebook, Koch Industries, Target and Walmart removed the ‘box’ because it made sense.” MICHELLE NATIVIDAD RODRIGUEZ, NAT’L EMP’T LAW PROJECT, “BAN THE BOX” IS A FAIR CHANCE FOR WORKERS WITH RECORDS I (2017), \textit{available at www.nelp.org/content/uploads/Ban-the-Box-Fair-Chance-Fact-Sheet.pdf}. 
Persons Previously Convicted of One or More Criminal Offenses. The significance of New York’s implementation, however, is that the Insurance Department has gone beyond the statute and adopted a rule restricting a crime insurer from excluding loss based on a prior conviction if the insured hired or retained the individual in accordance with Correction Law article 23-A. Specifically, Insurance Regulation 209 provides that:

No policy issued, renewed or delivered in this state that provides commercial crime coverage may exclude or limit coverage for loss or damage caused by an employee on the basis that the employee was convicted of one or more criminal offenses in this state or any other jurisdiction prior to being employed by the employer, if, after learning about an employee’s past criminal conviction or convictions, the employer made a determination to hire or retain the employee utilizing the factors set out in Correction Law article 23-A.

Section 753 of Correction Law article 23-A sets forth factors that an employer should consider when hiring someone with a previous criminal conviction:

(a) The public policy of this state, as expressed in this act, to encourage the licensure and employment of persons previously convicted of one or more criminal offenses.

(b) The specific duties and responsibilities necessarily related to the license or employment sought or held by the person.

(c) The bearing, if any, the criminal offense or offenses for which the person was previously convicted will have on his fitness or ability to perform one or more such duties or responsibilities.

84 N.Y. CORRECT. LAW § 753 (McKinney 2017).
(d) The time which has elapsed since the occurrence of the criminal offense or offenses.

(e) The age of the person at the time of occurrence of the criminal offense or offenses.

(f) The seriousness of the offense or offenses.

(g) Any information produced by the person, or produced on his behalf, in regard to his rehabilitation and good conduct.

(h) The legitimate interest of the public agency or private employer in protecting property, and the safety and welfare of specific individuals or the general public.\(^{86}\)

The purpose of Insurance Regulation 209 is stated in its “Preamble and purpose”:

(a) Correction Law section 753 states that the public policy of New York, as expressed in Correction Law article 23-A, is to encourage the licensure and employment of persons previously convicted of one or more criminal offenses. Correction Law section 752 forbids discrimination based upon a conviction for a previous criminal offense unless there is a direct relationship between one or more of the previous offenses and the specific employment sought or held by the individual; or the granting or continuation of employment would involve an unreasonable risk to property or to the safety or welfare of specific individuals or the general public. Correction Law section 753 specifies eight factors, including the public policy of the state, to be considered in making a determination pursuant to section 752.

\(^{86}\) N.Y. CORRECT. LAW § 753.
(b) However, commercial crime insurance policies often have provisions that will exclude coverage for loss or damage caused by an employee who has been convicted of a criminal offense, where the employer knew about the conviction prior to the loss or damage. This puts employers in the untenable position of either not being able to obtain insurance or violating the Correction Law by not hiring the individual, even though a review of the Correction Law factors would weigh in favor of employment. Given the strong public policy of the State, the Superintendent has determined that it would be an unfair method of competition or an unfair or deceptive act and practice in the conduct of the business of insurance in this state for an insurer that writes commercial crime insurance policies in this state to exclude coverage where the employer has weighed the factors set out in Correction Law article 23-A and made a determination favorable to the employee.87

Insurance Regulation 209 applies to policies issued, renewed or delivered in New York that provide commercial crime coverage “under a policy of commercial risk insurance that provides burglary and theft insurance or fidelity insurance” on or after July 1, 2017.88 Failing to comply with the regulation is “deemed to be an unfair method of competition or an unfair or deceptive act and practice in the conduct of the business of insurance.”89 Note that the conviction may have been in New York or any other jurisdiction and may have occurred at any time prior to employment.90 Interestingly, it should be noted that the

87 N.Y. COMP. CODES R. & REGS. tit. 11, § 76.0 (2017).
88 Id. § 76.1. New York Insurance Law §107(a)(47) effectively defines “Commercial risk insurance” as insurance for “(A) loss of or damage to real property; (B) loss of or damage to personal property; (C) losses or liabilities arising out of the ownership, operation or use of a motor vehicle; (D) liabilities of persons acting as officers or directors; or (E) other liabilities, including product liability, for loss of, damage to, or injury to persons or property.” N.Y. INS. LAW § 107(a)(47) (McKinney 2017).
89 N.Y. COMP. CODES R. & REGS. tit. 11, § 76.3 (2017).
90 Id. § 76.2.
regulation does not apply if the insured has knowledge of the employee’s dishonesty if there has been no criminal conviction.

ISO and SFAA have drafted endorsements to comply with Insurance Regulation 209. The ISO endorsement modifies its New York Changes Endorsement, which is attached to crime polices that are subject to the Regulation, and provides:

A. The following is added to Exclusion D.1.b. Acts Committed By Your Employees Learned Of By You Prior To The Policy Period:

However, this Paragraph D.1.b. does not apply to an “employee” who was convicted of one or more criminal offenses in this state or any other jurisdiction prior to becoming employed by you if, after learning about the “employee’s” past criminal conviction or convictions, you made a determination to hire or retain the “employee” utilizing the factors set out in New York Correction Law Article 23-A.

B. Under Section E. Conditions:

2. Paragraph (1) of the Termination As To Any Employee Condition is replaced by the following and supersedes any provision in this condition to the contrary:

This insurance terminates as to any “employee”:

(1) As soon as:

(a) You; or

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(b) Any of your partners, “members,” “managers,” officers, directors or trustees not in collusion with the “employee”; learn of “theft” or any other dishonest act committed by the “employee” whether before or after becoming employed by you. However, this Paragraph (1) does not apply to an “employee” whose “theft” or other dishonest act was committed prior to becoming employed by you and which resulted in the “employee” being convicted of one or more criminal offenses in this state or any other jurisdiction, if, after learning about the “employee’s” past criminal conviction or convictions, you made a determination to hire or retain the “employee” utilizing the factors set out in New York Correction Law Article 23-A.\(^{92}\)

ISO has issued similar endorsements to its financial institution forms with slightly different wording due to additional prohibitions, such as section 19 of the Federal Deposit Insurance Act, that might apply to an insured and restrict hiring any applicant with a prior criminal conviction.

The SFAA has issued similar endorsements to its Crime Protection Policy and its financial institution forms. For example, the following provision, added to the Financial Institution Bond Standard Form 14 by endorsement, provides that Exclusion (cc) does not apply:

\(^{92}\) Id.
(2) to loss caused by an Employee of an Insured that is located in New York who was convicted of a fraudulent or dishonest act prior to becoming employed by the Insured and the Insured made a determination to hire or retain such Employee utilizing the factors set out in Correction Law Article 23-A.93

D. Legislative Intent and effect on Underwriting and Claims Resolution

A review of the Rule Making Activities as reported in the New York Register concerning the Notice of Adoption of Regulation 20994 is useful to determine its application and guidance in dealing with situations that might arise in underwriting and claim handling. This guidance is significant since there is no historical perspective to use as guidance to an administrative removal of this provision in a fidelity policy.

The stated motivation in creating the Rule is to protect the employer who complies with Article 23-A and hires an individual with a prior criminal conviction so that it does not lose fidelity coverage as a result of such compliance.

One alternative would be to continue to allow insurers to exclude the coverage. However, it is unacceptable not to protect employers against losses when they are complying with the strong public policy of the State in hiring individuals who have been convicted of criminal offenses.95

While the limitation of coverage for employees with a prior criminal conviction has always been part of the fidelity policy, the Department of Insurance noted that was no data that indicate an

93 New York Statutory Rider, Form SR 6332 (July 2017), reprinted in STANDARD FORMS OF THE SURETY AND FIDELITY ASSOCIATION OF AMERICA.
95 Id. at 15.
increased risk to insurers by eliminating the limitation if the employer follows Article 23-A:

Because the employer would have to make a determination utilizing the statutory factors, the risk to insurers should be mitigated. The Department is not aware of any data that would indicate that an employee with a criminal history who has undergone a background check consistent with Article 23-A is any more of an insurance risk than an employee without such a criminal history.

Another alternative would be simply to prohibit insurers from excluding coverage, regardless of whether the employer considered the Article 23-A factors. However, that would impose a greater risk on insurers than would be necessary to implement the State’s public policy mandate.  

While Regulation 209 is new and the consequences of its adoption cannot be predicted, it is only applicable to limited circumstances that combine the requirements specified in Article 23-A (most notably a conviction) and follow the requirements set forth in the state endorsements drafted by ISO and SFAA. As stated in Green, however, there is still no prohibition against considering the conviction on the qualifications of the job, for example, embezzlement and a job requiring handling large sums of money.

VII.
CONCLUSION

Fidelity bonds and commercial crime policies terminate automatically as to an employee when an insured discovers that such employee acted dishonestly. In theory at least, the dishonesty may occur prior to employment and not necessarily involve criminal charges. When

96 Id.
97 Green, 523 F.2d at 1297.
dealing with a claim where an insured’s prior notice of dishonesty is an issue, however, the insurer must closely review the alleged dishonest activity and identify exactly what knowledge the insured had of the activity.

The insurer also must be aware of any BTB regulations and how that may affect an insured’s hiring process. The “don’t-ask-don’t-tell” way of handling a situation may have moved into the employment process in general. The BTB trend is of some concern to the claims professional who handles fidelity and crime claims. In the long run, however, given the current state of the law, this trend may have little or no impact on the handling of fidelity and employee theft claims.