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Don't Get Robbed of Your Fidelity Coverage

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In hard economic times, employee theft and fraud generally spike upward. The recent Great Recession and ensuing weak recovery have been no exception. For companies victimized by dishonest employees — or in some cases, merely erring ones — fidelity insurance can provide a lot of welcome protection.

But, while fidelity insurers market their products with fanfare suggesting broad coverage, the reality is that most crime carriers and bonding companies read their policies narrowly — often far more narrowly than these policies warrant. To obtain the coverage it pays for, a fidelity insurance policyholder must be vigilant at three points of vulnerability: (1) the application process, (2) the notification of loss, and (3) common insurance company defenses to coverage.

Avoiding Rescission

The application process is a critical component in obtaining effective fidelity insurance. The insurance company often looks back to representations made in the application process seeking a basis for denying a claim — or even worse, rescission. While a policyholder must always be careful about representations and warranties made in an application for a fidelity bond, there are limits to how far an insurer can go in punishing a policyholder for what may be an innocent error in its application.

An insurer relies on facts stated in an application to evaluate the risks being insured. The policyholder must fully disclose all facts that will be material in the underwriting process. To be the basis for rescission, the facts allegedly misstated by a policyholder in the application must have been material to the insurer's underwriting of the risk.

The great majority of fidelity bonds and commercial crime policies cover one common risk: losses caused by employee dishonesty. Often they also cover fraud losses caused by others in a variety of loss scenarios tailored to specific industries. The application is the first place an insurance company goes when assessing just how likely these kinds of losses will be, so it can price the policy correctly.
In the application process, a fidelity insurer may ask about the trustworthiness of the policyholder's employees (for example, does the company do pre-employment background

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checks?), and the internal controls in place to prevent employee and third party fraud (is the company's alarm system regularly checked to ensure it is operational? Do employees take consecutive two-week vacations every year?).

These areas of inquiry give the underwriter a checklist that, depending on the answers, lets him or her know whether the prospective insured meets the criteria set out by the carrier for accepting the risk.

But when the application contains misstatements of fact, it becomes a potential time bomb. In some states, unintentional but material mistakes in the application do not give the insurance company a defense to coverage. In these jurisdictions, the insured can avoid coverage only if a material misstatement was made intentionally, to mislead the underwriter. In many other states, however, material errors in the application on which the underwriter relied give the insurer a complete defense to coverage, even if the mistakes were unintentional or even avoidable. These "no fault" states allow the carrier to rescind coverage — giving back the premium and calling off the contract as if it had never been made — based solely on the insurance company's proof that the misstatement was material and that the underwriter relied upon it.

Many applications ask the insured to submit its latest audited financial statements with the application. If the financial statements later have to be restated to correct some mistake material enough to require amendment, the insured may be vulnerable to a claim involving the original mistaken representations. In this circumstance, if the insurer wants to get off the risk, it will give back the premium and rescind, cutting off coverage for all claims arising under the policy. If it wants to keep the premium, it will simply deny the claim at hand. Either way, the policyholder faces loss of coverage in the face of a claim.

When an insurer gives notice of rescission based on misstated fact in the application, this usually means that the carrier-policyholder relationship has broken down irretrievably. Avoiding this result means taking the application process very seriously, taking all possible precautions to ensure accuracy in the facts reported to the underwriter.

Send Notice and Information Early and Often

After the application process, the next danger zone in obtaining coverage under fidelity insurance lies in the process of submitting notice of claim. Upon discovery of a theft or fraud, the policyholder should immediately send notice of the loss to its insurance broker and its insurer. Speed is imperative, as policies often specify that notice shall be given to the insurance company within thirty days of discovery of loss — and in some cases within as little as seven days. In some states, failure to comply with this notice provision can result in forfeiture, even if the insurance company is not prejudiced by the delay. Even in less Draconian jurisdictions, it is best to avoid the possibility of costly litigation over notice by giving notice as promptly as possible.

In consultation with the broker, the policyholder must systematically identify all policies that may cover all or part of the loss. That may include general liability policies with forgery endorsements (if the loss creates an actual or potential third party exposure), all-risk properties with loss of property coverage, or property policies with theft coverage. Often the applicable policy will be the more tailored coverages, such as a financial institution bond. The policyholder should make sure the broker confirms that all potentially responsible insurance companies have been notified within the notice period, and back up the broker with direct notices of claim.

As important as timely notice is assembling the documents and proof necessary to establish the amount of the loss, here too, time is of the essence. The Standard Form No. 24 Financial Institution Bond (the form specifically designed for banks) states that proof of loss must be furnished within six months of discovery of the loss.

Don't Take No For An Answer

Once notice has been given, the next stage in the road to full recovery entails successfully resisting the insurance company's often overbroad assertion of coverage defenses. One common coverage trap under commercial fidelity policies is the so-called "inventory loss exclusion," which insurers invoke to contend that they have no obligation to pay for theft losses proven through inventory records. In the insurer's view, the policyholder's own inventory is an unreliable source of information for calculating an employee dishonesty loss. But often there is other evidence (surveillance videotape, for instance) of the nature and amount of the loss that, standing by itself, might be a less effective source of proof than inventory.

While inventory records cannot be the exclusive documentation of a loss, so long as there is independent proof of dishonesty, policyholders may still use their own inventory records to establish the value of stolen property. Properly construed, the inventory loss exclusion has a much narrower application than insurers claim for it.

For many businesses, protection from loss stemming from fraud or theft is a core insurance need. As with many lines of insurance, however, risk management on this front merely begins with the purchase of the appropriate type and amount of coverage. To obtain the coverage they paid for, policyholders must be vigilant in the application process, in the prompt and thorough submission of the claim, and in response to all-too-common insurance industry defenses.

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