

Maximizing Fidelity Loss Recoveries

By Edward J. Stein



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Just as a rising tide lifts all boats, receding prosperity reveals unsuspected threats. From corporate counsel's perspective, the risk is not just the phantoms of the deep — massive monsters like Madoff and the subprime meltdown — but also shallow scum like embezzling employees, computer hackers, forgers and other ordinary cheats.

The risk of loss from crimes like these should be addressed in every corporate insurance program through commercial crime or "fidelity" coverage. If a loss emerges, corporate counsel and risk managers should immediately focus on maximizing insurance recovery. This is easier said than done, since the discovery of betrayal by a trusted employee or business contact typically leads to disbelief, shock, anger and shame. Paralysis is understandable, but it only brings additional risk. Prompt analysis and action is necessary.

Responding To A Fidelity Loss

Upon learning of a loss due to theft or fraud, corporate counsel or risk managers should:

- Immediately send notice of the loss to all potentially responsible insurance companies, even if the full details remain to be determined. Many insurance policies state a specific period within which notice must be given. Failure to provide prompt notice may forfeit coverage.
- Conduct an immediate, discreet investigation focusing on the scope of the loss, the identity of participants, and the disposition of stolen assets.
- Implement immediate safeguards to prevent further losses.
- Gather information for a fraud audit and an asset seizure action.

- Attempt to interview, secure a statement, and secure restitution from any dishonest employees.
- Terminate dishonest employees.
- Prepare and submit a "proof of loss" regarding the insurance claim. Most insurance policies state a specific time period within which a sworn proof of loss must be submitted; policyholders should comply or obtain a written extension. *Failure to submit a timely sworn proof of loss may forfeit coverage.* The initial submission may be supplemented, if the full nature or extent of loss is not known by the applicable deadline.
- Identify and calendar the earliest possible date when the policyholder may have to file suit, and file a timely action if necessary. Many fidelity insurance policies state that an action against the insurance company must be commenced within two years of the discovery of a covered loss. Note that extending the deadline for a proof of loss, supplementing the proof, or ongoing "investigation" by the insurance company will not necessarily toll or extend the contractual suit limitation, which typically runs from discovery of the loss. *Failure to file a timely lawsuit may forfeit coverage.*

Throughout this investigation process, remember:

- do not make any promises to the dishonest employee that you will refrain from contacting the authorities;
- do not waive or release any claims against the dishonest employee or potentially secondarily responsible parties without complete restitution; and

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- do not settle with any party without first contacting the insurance company.

Sources of Fidelity Insurance And Typical Coverage Agreements

Potential sources of insurance coverage for theft and fraud losses include commercial crime policies; dishonesty, disappearance and destruction policies; "blanket" bonds; financial institution bonds (banker's bonds, brokerage bonds, etc.); all-risk policies covering loss of property; property policies with theft endorsements; comprehensive general liability policies with credit card and depositor's forgery endorsements; computer crime coverage; and even business interruption coverage, where theft of the policyholder's property renders it unable to operate.

Whatever the source, the coverage may include several different insuring agreements. Typical insuring agreement include: fidelity coverage (for losses arising from employee dishonesty); "On Premises" coverage (for loss of property while on the company's premises); "In Transit" coverage; "Forgery or alteration" coverage; "Securities" coverage (for losses arising from forged, altered, lost or stolen securities, titles, deeds, etc.); "Counterfeit" coverage; "Computer Systems Fraud" coverage (for fraudulent data entry or alteration causing the transfer of property or funds); and "Fraudulent Mortgage" coverage (for loan losses due to accepting mortgages, deeds or like instruments that are defective due to fraud or false pretenses).

Coverage Issues And Concepts

Insurance companies often deny or limit claims based on policy language or challenges to policy itself (i.e., rescission or reformation defenses). Each coverage defense must be assessed in light of the particular loss, policy language, and applicable law.

Typical insurance company arguments (and policyholder responses) include that a dishonest employee did not act with "manifest intent" to cause a loss or obtain an improper benefit (which may nevertheless be inferred from the circumstances); that there was no "dishonesty" (although the cases give dishonesty a broad definition); that the policyholder was negligent (although negligence is not a defense); that the stolen property did not belong to the policyholder (although coverage typically extends to assets for which the policyholder is

legally liable, or which it holds in any capacity); that coverage was terminated for a particular employee because the policyholder knew he was dishonest (although mere suspicion of dishonesty that falls short of criminal risk should not defeat coverage); that "trading loss" or "credit loss" is excluded (although not every trading or loan falls within the exclusions); and that the policyholder did not suffer a "direct" loss (although this remains a fact-specific problem with ambiguous policy language that should be construed in favor of coverage).

Maximizing Recoveries

Issues arising from policy limits can have an enormous impact on the scope of insurance recovery. Many claims exceed available limits; even the most prudent insurance purchasers can underestimate their fidelity risk.

Crime insurance policies often state limits on a "per occurrence" basis, with "occurrence" defined to mean "all loss caused by, or involving, one or more 'employees,' whether the result of a single act or series of acts." This seemingly infinite definition should not dissuade policyholders from seeking multiple "occurrence" limits on a single policy, under appropriate circumstances. Although the law on this issue is mixed, there is favorable authority for multiple occurrences where separate identifiable acts are involved.

Multiple limits may also be available for losses

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which continue through successive crime insurance policy periods. Although insurers may deride this approach as “stacking,” there is no prohibition of “stacking” in the policy language. Instead, the policies often provide coverage up to stated limits for each “occurrence,” perhaps subject to “policy period,” “non cumulation” and “extended discovery” provisions. In certain circumstances these provisions may allow multiple limits for employee dishonesty losses that continued undetected over several successive policy periods. Thus, while the policies currently in effect at the time of discovery are likely to cover concealed losses from prior policy periods (under “superseded suretyship” or “loss sustained during prior insurance” provisions), if the losses exceed current policy limits, a prior policy may provide additional coverage, subject to its own separate limit.

Conclusion

Insurance companies tend simply to assume the most restrictive policy interpretations on fidelity claims. Corporate counsel and their advocates should be alert to opportunities to challenge — and defeat — those assumptions, in order to secure the full protection they purchased and deserve to recover.▲

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New Laws, New Liabilities, New Insurance Issues

By Mark Garbowski

The previous issue of the Policyholder Advisor addressed the increase in companies’ mass tort liability likely to result from the Obama administration’s ending of Federal preemption, as well as the insurance strategies that could help cover those risks. In this space, we want to briefly highlight two other legal changes that can increase your company’s liability risks — one already enacted and one under consideration by the current Administration and Congress.

The “Lily Ledbetter Fair Pay Act” and Its Insurance Implications

The Lily Ledbetter Fair Pay Act of 2009, signed by President Obama earlier this year, effectively overturns a Supreme Court decision and significantly extends the time by which employees can sue their employers for pay discrimination. The Supreme Court ruled in 2007 that the statute of limitations for asserting a wage difference discrimination claim began to run from the initial decision to pay a female worker less money than a male counterpart, even if the pay disparity continued for years. *Ledbetter v. Goodyear Tire & Rubber Co.*

The Ledbetter Act effectively restarts the applicable 180 (or 300) day statute of limitations clock each time a worker receives a paycheck which reflects a pay disparity. Thus, each paycheck could become the basis of a potential discriminatory violation of law, greatly extending the time in which a worker may bring a discriminatory pay claim against the employer. Moreover, although the Ledbetter case dealt only with sex-based pay disparity, the new law also includes claims based on protected characteristics such as race, age, religion and disability. Successful claimants can recover up to two years of back pay from the date the discrimination charge is filed.

Employers should consider whether their

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employment practices liability insurance (EPLI) policies adequately cover the new risks created by the Ledbetter Act (other liability policies are likely to exclude employment claims). Because EPLI policies are generally sold on a claims-made basis, you should review to determine if your retroactive date extends back far enough to cover claims based on events that occurred several years or even decades ago.

In addition, some EPLI policies exclude or limits coverage for lost wages and back pay, except under sometimes limited circumstances. Again, a review of your policy can put you in a position to purchase improved coverage in the future.

Negating "Stoneridge"

In late July, Senator Arlen Specter of Pennsylvania introduced the "Liability for Aiding and Abetting Securities Violations Act of 2009." The bill was co-sponsored by two other Democratic Senators, and is largely viewed as a legislative overturning of the 2007 Supreme Court decision *Stoneridge Investment Partners v. Scientific-Atlanta*.

Stoneridge involved a claim by shareholders of Charter Communications against companies that did business with Charter, alleging that certain transactions were structured to inflate Charter's cash flow in order to meet earnings expectations for a fiscal quarter.

The defendant counterparties, Scientific-Atlanta and Motorola, argued that they could not be held liable for aiding and abetting securities fraud under an earlier Supreme Court decision, *Central Bank of Denver*. The plaintiff shareholders attempted to evade the limitation on aiding and abetting liability by alleging that Scientific-Atlanta and Motorola were not merely aiding and abetting, but active participants in a securities fraud scheme. The Supreme Court

affirmed the dismissal of the claims against Scientific-Atlanta and Motorola but, in doing so, it arguably narrowed the protection offered to third-parties under *Central Bank*, and ruled in favor of the defendants because the plaintiffs could not claim reliance, a necessary element of their securities fraud claim.

Specter's bill would potentially overturn *Stoneridge* and even *Central Bank*, and significantly expand the number of entities that shareholders could target in securities fraud cases. It would place greater risk on all counterparties to transactions with companies that later suffer earnings shortfalls, as well as accounting, financial, and legal advisors to those same companies.

Many D&O and professional liability policies have special coverages and provisions applicable to claims involving securities issued by the policyholder. If Specter's bill passes, policyholders should consider whether their policies provide adequate protection for claims involving the securities of other entities. In addition, in the first few years after such a law is passed there is often a surge in expensive litigation that determines the scope of the law. Even if a claim against you is dismissed, such litigation could be costly. Policyholders should check whether their policies require defense costs to be advanced or reimbursed after the fact. Other provisions worth noting are exclusions for fraudulent and willful conduct, which should have clauses indicating they will only apply if the allegations are proven by judgment.

Prudent planning can help to manage the risks of increased liabilities under new laws. ▲

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