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Bankers Bond Insurance: Key Coverage Issues for Financial Institutions to Consider

By Geoffrey B. Fehling and Olivia G. Bushman*

In this article, the authors discuss a number of recurring claims-related issues under bankers bond insurance that can result in coverage disputes.

Bankers blanket bond insurance – also referred to as bankers bonds, fidelity bonds, or financial institution bonds – provides financial institutions with protection against direct financial loss sustained as a result of criminal activity. Bankers bonds often cover:

- Losses caused through dishonesty of employees;
- Losses arising out of counterfeit currency;
- Loss in transit, including theft or physical destruction of property during transportation;
- Losses caused by computer systems fraud;
- Losses caused by unauthorized signatures; and
- Losses caused by forged checks.

Bankers bonds have several unique features different from many other insurance types because they protect against losses incurred as a direct result of fraudulent or criminal activities from within the company. While most bankers bonds are already tailored to protect companies operating within the financial sector, they are a highly customizable risk management solution. Depending on the jurisdiction, financial institutions may be required to purchase a bankers bond to operate.

While coverage depends on the specific facts, policy language and circumstances giving rise to the loss, bankers bond claims present a number of recurring issues that can result in coverage disputes. Here are several key issues to consider.

DISCOVERY AND NOTICE

Unlike other coverages, which may turn on when an accident occurred or whether a claim was first made, bankers bonds typically apply based on whether the loss was first "discovered" during the policy period. Because discovery triggers coverage, the timing of when the company first becomes aware of a

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covered loss can become a contested issue if, for example, the insurer contends it occurred before the inception of the bond or if notice was not given in a timely manner.

The meaning of "discovery" is often defined in the bond, and small changes can impact whether or not a loss is covered. Whose knowledge is relevant for the purpose of discovery? What standard measures whether those individuals should assume a particular loss is covered? Does the bond distinguish between knowledge gained by facts versus receipt of actual or potential claims? The way bankers bonds address these and many other questions can often decide whether a loss is covered.

ENDORSEMENTS, RIDERS AND POLICY CUSTOMIZATION

Bankers bonds are as varied as the financial institutions that buy them. That means that bonds are not one-size-fits-all and can be heavily negotiated to provide greater and different coverages than what may be available "off the rack." These modifications are often accomplished through endorsements (or "riders") modifying or expanding coverage.

Banks can secure riders for a variety of different risks – reward payments, debit cards, safe deposit boxes, transit cash letters, unauthorized signatures, warranty statements, automated teller machines, audit and examination expenses, check kiting and email transfer fraud, just to name a few. Riders can even allow banks to recover "claim expenses," including legal fees, incurred in preparing and submitting covered claims for loss under the bond. Even the riders themselves are negotiable and can be modified.

CAUSATION

Many bankers bonds require that the policyholder show that a loss "resulted directly from" dishonest, criminal or malicious conduct. While this kind of causation language is common, disputes nevertheless arise over whether the offending conduct and loss are close enough in the timeline of events to fit within the bond's insuring agreement. For example, an insurer may contest whether a virus that infected the bank's computers is close enough in time or sequence to resulting loss to constitute covered computer systems fraud. In cases of employee dishonesty and fraud, financial institutions should be mindful of the bond's direct causation requirement.

EXCLUSIONS

Insuring agreements covering dishonest acts by employees often include significant carve outs that limit otherwise broad coverage for things like loans and trading losses. Those carve outs also can have important carve backs that preserve coverage if certain conditions are met. For example, most bonds will

exclude losses resulting from loans, unless the dishonest employee was in collusion with parties to the loan transaction and received some kind of improper financial benefit. But some bonds place monetary thresholds on the financial benefit required to preserve coverage or presume the requisite benefits were obtained under certain circumstances. Paying close attention to carve outs and exceptions and, if needed, negotiating broader coverage can strengthen critical protections against fidelity claims involving employees.

ACTUAL LOSS

An important threshold question in any bankers bond claim is whether a loss actually occurred. Despite the repeated use of "loss," many bankers bonds do not define the word, leaving it to courts to do so in the event of a dispute. One common theme in those disputes is whether the entity suffered an actual – rather than a theoretical – loss. In *Cincinnati Insurance Co. v. Star Financial Bank*, for example, the U.S. Court of Appeals for the Seventh Circuit defined "loss" as an "actual present loss, as distinguished from a theoretical or bookkeeping loss."[1] Policyholders should be prepared to show an identifiable "loss" was suffered.

CYBER-RELATED EVENTS

Given the proliferation of cybersecurity incidents and related exposures across all industries, including finance, bankers bonds have increasingly offered expanded coverage for cyber-related losses. In some instances, coverage between a cyber policy and a crime policy, like a bankers bond, may overlap.

But bankers bonds can provide critical coverage for a financial institution's direct financial loss arising from a host of cyber incidents. Bonds can extend coverage to include perils such as extortion (including cyber-related extortion and ransomware) and erroneous transfer, social engineering fraud, computer fraud and similar cyber risks. Financial institutions should coordinate coverage between all policies, including bankers bonds and cyber policies, to ensure adequate protection from cyber risks and avoid gaps in coverage.

CONCLUSION

This non-exhaustive list highlights several common issues of focus to negotiate robust coverage for a range of risks under bankers bonds. The best time to assess those risks is before discovery of a loss or receipt of a claim. Financial institutions should be proactive in their pursuit of insurance and mindful of these key coverage issues relating to bonds. Retaining experienced

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[1] Cincinnati Insurance Co. v. Star Financial Bank, 35 F.3d 1186, 1191 (7th Cir. 1994).

coverage counsel, insurance brokers and other risk professionals during bond placement (and renewal) and early in the claims process can help maximize recoveries.