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Fidelity Insurance

The Termination Provision in Fidelity Insurance Policies: Practitioners Discuss a Split in Authority

This month, Bloomberg Law Reports®–Commercial Insurance asked leading insurance coverage practitioners to weigh-in on the applicability of the termination provision in fidelity insurance policies.

Courts are split over the applicability of the termination provision in commercial crime policies. Some courts hold that the termination provision applies only if a manager becomes aware of an employee's dishonest conduct during the policy period. (See *Waupaca Northwoods, LLC v Travelers Cas. & Sur. Co. of Am.*, No. 10-C-459, 2011 BL 109466 (E.D. Wis. Apr. 25, 2011). Other courts, such as the Appellate Division of the Supreme Court of New York, Third Department, have held that a policy terminates upon inception as to the particular employee, if the manager knew of prior dishonest acts at the time the policy was issued. (See

***Capital Bank & Trust Co. v. Gulf Ins. Co.*, 2012 NY Slip Op 00451 (App. Div. Jan. 26, 2012). Which is the more sound holding?**



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General principles of insurance contract interpretation, such as enforcement of plain language, construing ambiguities against the drafter, and placing the burden on insurer's to establish the applicability of an exclusion, should be applied to interpret the similar termination provisions at issue in both *Waupaca Northwoods* and *Capital Bank*. In these cases, the termination provision was an exclusion on which the insurers relied to defeat the policyholder's claim of coverage. As such, it was the insurer's burden to establish the applicability of the exclusion. The exclusion should be interpreted according to the plain language if clear, and should be construed in favor of the policyholder if ambiguous.

While not identical policy language, the termination exclusion in *Capital Bank* is sufficient to illustrate the issue in both cases:

The coverage 'terminates as to any employee . . . as soon as [the policyholder], or any director or officer not in collusion with such employee, learns of any dishonest or fraudulent act committed by any such employee'

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In both cases, the issue involved knowledge of a prior alleged “dishonest” act that occurred prior to the policy period. Both cases purport to follow the plain language. In *Capital Bank*, the court focused on whether the prior act that was known by an officer was in fact considered “dishonest” even though the alleged prior forgeries did not cause any losses. The court held that a loan officer, approving transactions without authority in order to avoid detection, constitutes a dishonest act. In light of that holding, the exclusion was enforced and coverage was denied.

In *Waupaca Northwoods*, the court focused on the fact that the alleged dishonest act of which an officer had knowledge (using employees to build a fence at his residence), occurred well before the policy period. The court explained that because the exclusion “terminates” coverage “as soon as” the officer has knowledge of the dishonest act, the language at least implies that the knowledge must occur while the policy is in effect. In other words, this exclusion does not apply where the alleged dishonest act triggering the provision occurs prior to the policy period.

The reading of the language set forth in *Waupaca Northwoods*, which would have applied in equal force to *Capital Bank*, is the more sound holding because it adheres to the rules of policy interpretation. This exclusion is designed to terminate coverage for a theft by a particular employee “as soon as” certain information is learned; it cannot reasonably be read to provide that, from inception, this employee’s theft was never covered under the policy. Certainly, if that was what the insurer had intended, the insurer could have crafted clearer language. At most, the policy is ambiguous in this regard and should be interpreted in favor of the policyholder. This is particularly true here, where the insurer could have and should have asked questions on the policy application to learn about any prior dishonest acts of employees and exclude those employees from coverage if appropriate.

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