Inside the Mind of the Reasonable Person: Determining When Discovery of Loss Has Occurred under a Fidelity Bond in the Third Circuit

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INSIDE THE MIND OF THE REASONABLE PERSON: DETERMINING WHEN DISCOVERY OF LOSS HAS OCCURRED UNDER A FIDELITY BOND IN THE THIRD CIRCUIT

I. Introduction

Fraud is a continual problem for many businesses. It is a problem that can be devastating, as it represents a principal factor in the unexpected collapse of corporations and the failure of banks. Yet the primary actors in this fraud arena are not rogue outsiders; they are employees. According to the Association of Certified Fraud Examiners, the dishonest tactics of employees account for over $400 billion in annual losses to their employers. Despite the obvious problem employee infidelity presents, businesses are generally ill prepared to detect and defend against internal fraud. Indeed, many accept employee dishonesty as an inevitable cost of doing business.

1. See Daniel Hays, Loss Control Lags on Fraud Risk, NAT'L UNDERWRITER, Aug. 7, 2000, at 3 (stating that employee fraud and dishonesty is persistent threat for many employers); see also John C. Eichman, Submission of the Insured's Claim, in HANDLING FIDELITY BOND CLAIMS 55, 53 (Michael Keeley & Timothy M. Sukel eds., 1999) ("Nearly every type of organization in America—both profit and non-profit—finds itself victimized from time to time by the dishonesty of one of its employees.").

2. See Mark Ballamy, Risk Management of Management Risks, ACCOUNTANCY AGE, Feb. 24, 2000, at 28 (explaining that although unexpected corporate collapse has many causes, fraud is primary cause). Employee fraud affects not only corporations, but also financial institutions. See Allen N. David & Mauren Mulligan, Intent Is Key to Loan Recovery, Nat'l L.J., Dec. 7, 1992, at 22 (discussing employee fraud in financial institution setting). Although they are not covered by fidelity bonds, losses from loans are occurring at a high rate and have prompted many banks to investigate the conduct of bank officers that issue loans. See id. (stating "[l]oan losses are the single greatest cause of loss to banks and bank failures," and their increased frequency has caused banks to begin investigating the conduct of loan officers).

3. See Ballamy, supra note 2, at 28 (noting that survey shows directors and other senior managers are actively involved in most corporate fraud cases).


5. See Hays, supra note 1, at 3 (explaining that many businesses fail to adequately guard against risk of employee dishonesty).

6. See Arthur J. Bourque, III, Stop, Thief, NAT'L PUB. ACCOUNTANT, Sept. 1995, at 32 (stating that just as manufacturers accept some defects in their product lines, businesses often accept fraud as cost of operations); As Recent Cases Illustrate, Denial Doesn't Halt Fraud, PREVENTING BUS. FRAUD, Aug. 1999, at 2 ("Some [internal audii-
Though employers may be unable to prevent employee fraud completely, for many years they have been able to purchase insurance policies—called fidelity bonds—that cover losses caused by, among other things, dishonest or fraudulent acts of employees. A common condition for coverage on these agreements is that in order for a loss to fall under the bond, the insured must discover it during the bond period. Once the insured has discovered the loss or facts indicating the loss, the insured must give timely notice to the insurer. This timely notice satisfies a contractual condition leading to the insurer's duty to investigate the loss.

7. See Edward G. Gallagher et al., A Brief History of the Financial Institution Bond, in A.B.A. Financial Institution Bonds 3, 3 (Duncan L. Clore ed., 2d ed. 1998) (stating that roots of fidelity bonds date back to days of Babylonians). A bond is defined as "an insurance agreement pledging surety for financial loss caused to another by the act or default of a third person or by some contingency over which the third person may have no control." Merriam-Webster's Collegiate Dictionary (2001), available at http://www.m-w.com (last visited Apr. 17, 2001) (defining "bond"). A fidelity bond serves to protect the insured from financial loss caused by the failure of integrity, fidelity or honesty of the insured's employees or others owing a fiduciary duty to the insured. See 1 Eric Mills Holmes, Holmes' Appleman on Insurance § 1.32 (2d ed. 1999) (defining "fidelity bond").

The typical standard form fidelity bond is composed of several sections. See Andy Wilson, Recovering from Dishonesty, SEC. MGMT., Mar. 1, 1999, at 57 (discussing five components of typical fidelity bond). First, the "declarations" section provides information on the insured, the coverage period, the aggregate and limits of liability, and physical locations covered by the bond. See id. Second, the "insuring agreements" section defines the bond's indemnification coverage. See id. Third, the section entitled "general agreements" sets forth certain administrative understandings between the insurer and insured, such as what will happen to coverage in the event the insured is involved in a merger or a consolidation. See id. Fourth, the "conditions and limitations" section details which events or sequences must occur before coverage begins and also which events or sequences will terminate coverage. See id. This section also defines terms used throughout the bond, such as "employee" and "discovery." See id. Finally, the "riders and endorsements" section serves to cater the bond to a particular insured by adding or deleting certain coverage from the standard policy. See id.

8. See 1B John Alan Appleman & Jean Appleman, Appleman on Insurance Law & Practice § 6979 (1997) (explaining that to recover loss under fidelity bond, insured must show that it discovered loss during coverage period).


10. See Duncan L. Clore & Michael Keeley, Discovery of Loss: The Contractual Predicate to the Claim, in A.B.A. Financial Institution Bonds, supra note 7, at 149, 149 ("Compliance with the notice and proof of loss requirements . . . put[s] the claim process in motion, allowing the insurer the opportunity to begin its investigation, attempt to mitigate any loss, and if appropriate, establish reserves.").

Once the insured submits its notice of loss and supporting documents, the insurer will begin its investigation in order to discover facts that may be missing from the insured's report. See Duncan L. Clore & John Tomaine, Discovery of Loss, in Handling Fidelity Bond Claims, supra note 1, at 385, 402 (discussing purpose of insurer's investigation). The insurer will typically look at several sources from
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Though untimely loss is a viable affirmative defense to coverage as a breach of condition, many jurisdictions now require the insurer to show not only that notice was untimely, but also that it has caused the insurer to suffer prejudice. 11

Before the notice issue can be analyzed, the point at which the insured can be charged with discovery of loss must be determined—an issue that frequently sparks litigation between the insured and the insurer. 12

The test for discovery of loss in the standard form fidelity bond requires the insured to give notice to the insurer when the insured is aware of facts that would cause a reasonable person to conclude that a loss has occurred or will occur. 13 This test is primarily objective, and several United States Circuit Courts of Appeals and United States District Courts have dutifully applied its clear language in cases involving issues of loss discovery. 14

which to glean these facts: (1) interviews of the insured’s present and former employees and officers who either were involved in the transaction or took part in the insured’s investigation; (2) information from the meetings with the insured or its attorneys; (3) the insured’s financial records and books; and (4) information from external sources, such as the reports of auditors and regulatory agencies. See id.

11. See David T. DiBiase, Loss, Notice, Proof, in The COMMERCIAL BLANKET BOND ANNOTATED 105, 105 (William F. Haug ed., 1985) (discussing traditional and modern reading of notice requirement); Allen N. David & George C. Rockas, Late Notice of Losses Is Key Issue, Nat’l L.J., Nov. 19, 1990, at 17 (stating that insurer must demonstrate prejudice before denying coverage because of late notice). Traditionally, courts construed the notice requirement as a condition precedent to recovery under the bond and placed the initial burden of proof on the insured to prove notice was timely. See DiBiase, supra, at 105 (noting traditional construction of notice requirement).

12. See Clore & Tomaine, supra note 10, at 385 (“[T]he issue of when [a] loss was first ‘discovered’ is undoubtedly the most litigated, and debated, issue faced in fidelity claims.”); Paul R. Devin & Allen N. David, Discovery Under Fidelity Bonds: The Emerging Concept of the Insured’s Duty of Inquiry, 21 TORT & INS. L.J. 543, 544 (1986) (noting that issue of discovery is frequently litigated).

13. See FINANCIAL INSTITUTION BOND, STANDARD FORM NO. 24 (revised 1986), reprinted in A.B.A. FINANCIAL INSTITUTION BONDS, supra note 7, at 449, 453 (hereinafter “STANDARD FORM NO. 24”) (providing primarily objective standard for determining discovery of loss). Fidelity bonds are usually just one part of comprehensive insurance policies employers may purchase. See Horkovich et al., supra note 9, at 365 n.4. In addition to employee dishonesty, these policies typically cover losses resulting from on-premises burglary, forgery or alteration, false securities, counterfeit currency and computer crime. See id.


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Other courts, however, have construed the standard as an exclusively subjective one, requiring that the insured realize that it has or will suffer a loss.\(^{15}\)

The United States Court of Appeals for the Third Circuit recently considered the issue of discovery of loss in Resolution Trust Corp. v. Fidelity & Deposit Co.,\(^{16}\) which is known in fidelity law as the City Savings case.\(^{17}\) In City Savings, the Third Circuit interpreted the discovery test of the standard form bond, concluding, after a survey of case law from the Third Circuit and other circuit case law, that a plain meaning application of the standard was appropriate.\(^{18}\) The Third Circuit’s reading of the standard was unlike that of several other circuits because it applied the full standard, not merely its subjective component.\(^{19}\) This reading puts insureds within the Third Circuit’s jurisdiction on notice that a court may find dis-


16. 205 F.3d 615 (3d Cir. 2000).

17. See generally id. at 615 (discussing discovery of loss under standard form financial institution bond). In the fidelity law practice area, this case is known as the City Savings case because, as will be further explained in Part III of this Casebrief, plaintiff Resolution Trust Corporation was appointed as receiver to and took legal action on behalf of City Federal Savings Bank (“City Savings”). See id. at 625. City Savings was the insured under the fidelity bond at issue when the bond was issued in 1987. See id. at 519.

18. See id. at 630-31 (discussing discovery standard).

19. Compare id. at 627 (applying primarily objective test to ascertain time of discovery under fidelity bond), with Fed. Deposit Ins. Corp., 45 F.3d at 974-75 (applying subjective standard to determine point of discovery under ambiguous discovery provision), Cal. Union, 949 F.2d at 563-65 (employing subjective standard to determine point of loss under fidelity bond with discovery provision featuring primarily objective standard), and Aetna, 903 F.2d at 1079 (applying subjective standard where bond provision expressly sets forth primarily objective standard).
covery has occurred even before the insureds have actual knowledge of a loss.  

This Casebrief explores the Third Circuit's approach in determining when an insured can be charged with discovery of loss under a fidelity bond, focusing on the Third Circuit's latest ruling on the issue. Part II examines the law governing fidelity bonds and discusses its application by the Third Circuit as well as other United States Courts of Appeals and United States District Courts. Part III sets forth the facts of City Savings, analyzes the Third Circuit's plain meaning approach to the application of the primarily objective discovery standard and discusses the practical implications of the court's decision. Part IV discusses the conclusions practitioners might draw from the Third Circuit's decision in City Savings.

II. BACKGROUND

In general, fidelity bonds come in two forms: (1) commercial crime policies for corporations and partnerships; and (2) financial institution bonds for banks, brokerage houses and other financial institutions.

20. See Jeffrey M. Winn & Susan E. Burke, Recent Developments in Fidelity Insurance, at http://www.sdma.com/images/recentdevfidinsurance.html (May, 2000) (concluding that "fidelity policies do not require discovery of all details of a fraud before the insured may be charged with 'discovery' of a loss").

21. For further discussion of the law governing fidelity bonds, see infra notes 24-79 and accompanying text.

22. For further discussion of the facts of and the Third Circuit's reasoning in City Savings, see infra notes 80-152 and accompanying text.

23. For further discussion of the conclusions drawn from City Savings, see infra notes 153-54 and accompanying text.

24. See Does Your Fidelity Insurance Cover All You Think It Does?, PREVENTING BUS. FRAUD, Feb. 1999, at 1 (comparing two types of fidelity bonds). Two commentators contend that history permits drawing several practical applications of fidelity bonds. See Norbert Wegerzyn & John Morrissey, Fidelity Insurance Policies: Yesterday, Today and Tomorrow, in HANDLING FIDELITY BOND CLAIMS, supra note 1, at 3, 5-11 (discussing practical applications of fidelity bonds one can draw from history).

First, these commentators note the fidelity bond is rooted in surety law. See id. at 5-8 (discussing cases in which courts have drawn similarities between surety and fidelity bonds). A traditional surety agreement involves three parties: (1) the principal, whose debt is the subject of the agreement; (2) the creditor, to whom the principal owes its debt or obligation; and (3) the surety, who agrees that the principal's debt or obligation will be paid or performed and who promises to perform if the principal does not. See Erik N. Videlock & Abbe F. Fletman, Financial Institution Bonds, in HANDLING FIDELITY, SURETY, AND FINANCIAL RISK CLAIMS 3, 5-6 (Robert F. Cushman et al. eds., 1990) (discussing traditional surety agreement). Under the traditional fidelity bond, the employees provided security to their employers through a bond underwritten by a surety. See id. at 6. In contrast, under the modern fidelity bond, only the surety and the financial institution are parties to the agreement. See id.

Second, the commentators state that the fidelity bond is an indemnity policy and not one for liability because courts will typically find that the fidelity bond does not cover third party creditor judgments against the insured. See Wegerzyn & Morrissey, supra, at 9 (noting that fidelity bond is not liability policy).
Though both types of bonds offer similar coverage in different contexts, this Casebrief focuses primarily on the financial institution bond.25

A. The Standard Form Financial Institution Bond in General

Most banks and other financial institutions are insured under standard form financial institution bonds drafted by the Surety Association of America ("SAA").26 One such commonly purchased bond is the Financial Institution Bond, Standard Form No. 24, which offers coverage for, among other things, losses caused by the infidelity of employees.27 This coverage

Finally, these commentators suggest that the fidelity bond is not a contract of adhesion because the American Bankers Association played a significant part in the bond’s drafting, and, therefore, courts should not apply the canon of contra proferentum when interpreting the bond’s language. See id. at 9-11 (discussing role of American Bankers Association in bond’s drafting process); Sharp v. Fed. Sav. & Loan Ins. Corp., 858 F.2d 1042, 1046 (5th Cir. 1988) (same). The contra proferentum theory of contract interpretation provides that where a term of an adhesion contract is ambiguous, the court shall construe the term in favor of the insured and against the insurer. See Wegerzyn & Morrissey, supra, at 16 (defining "contra proferentum").

25. For a discussion of commercial crime policies, see infra note 26. For a thorough discussion of many aspects of a claim under a commercial crime policy, see A.B.A. COMMERCIAL CRIME POLICY (Gilbert J. Schroeder ed., 1997).

26. See Andrew M. Reidy & Barbara M. Tapscott, The Pitfalls of Fidelity Insurance, Nat’l. L.J., Mar. 4, 1996, at B7 (stating that banks and financial institutions purchase policies based on Standard Form No. 24). Corporations and other business entities may also purchase similar bonds called commercial crime policies, which offer coverage of similar risks. See Dolores A. Parr & Gail K. Donovan, Back to the Future: Proposed Fidelity Coverage for Financial Institution Bonds and Commercial Crime Policies, 1 E-DICTA (2000), at http://www.abanet.org/tips/edicta/donovanparr.html. While the SAA has also written standard form commercial crime policies, they have not had as wide an acceptance as the financial institution standard form bonds. See id. (acknowledging that standard form commercial crime bonds have not been widely adopted). Therefore, most commercial crime policies are not standardized and vary by insurer. See id. (stating that most commercial crime bonds are not standard forms).

27. See STANDARD FORM NO. 24, supra note 13, at Insuring Agreement (A) (extending coverage to losses resulting from employee dishonesty). Section 1(g) of the Standard Form No. 24’s Conditions and Limitations defines “employee” as:

1. an officer or other employee of the Insured, while employed in, at, or by any of the Insured’s offices or premises covered hereunder, and a guest student pursuing studies or duties in any of said offices or premises;
2. an attorney retained by the Insured and an employee of such attorney while either is performing legal services for the Insured;
3. a person provided by an employment contractor to perform employee duties for the Insured under the Insured’s supervision at any of the Insured’s offices or premises covered hereunder;
4. an employee of an institution merged or consolidated with the Insured prior to the effective date of this bond; and
5. each natural person, partnership or corporation authorized by the Insured to perform services as data processor of checks or other accounting records of the Insured (not including preparation or modification of computer software or programs), herein called Processor.
extends to those losses only after the insured has proven four basic elements of a fidelity claim under the bond.28

First, the insured must demonstrate that it “discovered” the loss during the bond period.29 Second, the insured is required to show that it gave timely notice of the loss to the insurer.30 Third, the insured must prove that the bond did not “terminate” as to the dishonest employee before discovery.31 Finally, the insured must show that the dishonest em-

**Standard Form No. 24, supra note 13, at Conditions and Limitations § 1(g).** Essentially, determining whether an individual is an employee hinges on “whether, and to what extent, the employer maintains control over the individual.” Armen Shahinian & Scott D. Baron, *Who Is a Covered “Employee” Under the Financial Institution Bond?,* in A.B.A. *Financial Institution Bonds, supra note 7, at 113, 115* (discussing element of control when determining whether individual is “employee” under bond).

Though many people call Standard Form No. 24 a bond, it is technically an indemnity agreement through which the insurer reimburses the insured for loss the insured actually suffered under the contract provisions. See Videlock & Fletman, *supra* note 24, at 5 (explaining why Standard Form No. 24 is indemnity agreement and not bond). For background on the Financial Institution Bond, see generally James L. Knoll & Linda M. Bolduan, *A Brief History of the Financial Institution Bond, in A.B.A. Financial Institution Bonds 1* (Duncan L. Clore ed., 1995).

28. See Reidy & Tapscott, *supra* note 26, at B7 (stating that claim under standard form bond requires insured to prove four elements).

29. See *id.* (discussing discovery element). For the text of the discovery provision of Standard Form No. 24, see *infra* note 55 and accompanying text.

30. See Reidy & Tapscott, *supra* note 26, at B7 (discussing notice element). The notice provision of Standard Form No. 24 requires the insured to provide notice to the insurer “[a]t the earliest practicable moment, not to exceed 30 days, after discovery of loss . . . .” *Standard Form No. 24, supra note 13, at § 5(a).* For additional discussion of the notice element, see *supra* note 10 and accompanying text.

31. See Reidy & Tapscott, *supra* note 26, at B7 (discussing termination element). The termination section of Standard Form No. 24 states that the bond terminates:

[A]s 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.

Termination of the bond as to any Insured terminates liability for any loss sustained by such Insured which is discovered after the effective date of such termination.

**Standard Form No. 24, supra note 13, § 12.** The equitable rationale behind the termination provision is that it is unfair to impose on the insurer the risk of loss from an employee whom the insured knows or has reason to know is dishonest, yet continues to employ. See Reidy & Tapscott, *supra* note 26, at B7 (discussing reasoning behind termination clause). For a detailed discussion of cases involving the termination and cancellation clause of Standard Form No. 24, see David E. Bordon et al., *Conditions to Recovery: Termination and Cancellation, in A.B.A. Financial Institution Bonds, supra note 7, at 315, 316-29.*
ployee acted with the requisite mental state, or "manifest intent," to commit the fraudulent act.32 In addition to these basic elements, the insured will have the burden of proving that the dishonest acts of an employee directly caused the alleged loss.33

32. See Reidy & Tapscott, supra note 26, at B7 (discussing manifest intent element). The manifest intent provision of Standard Form No. 24 defines manifest intent as "dishonest or fraudulent acts committed by the employee" with the intent ")a) to cause the Insured to sustain such loss; and (b) to obtain financial benefit for the Employee or another person or entity." STANDARD FORM NO. 24, supra note 13, at Insuring Agreements § (A).

Commentators have fiercely debated the scope of the manifest intent clause. See Mark E. Wilson, How to Prepare and Present a Fidelity Claim: Advice for the Insured, 28 THE BRIEF 54, 59 n.33 (1999) (stating that definition of manifest intent is "[t]he single most controversial and dynamic area of law under fidelity bonds"). It is well settled, however, that the rationale behind the manifest intent requirement is to limit loan losses to claims in which the employee intended to defraud the employee, and not to include those in which the employee simply exercised poor business judgment. See Michael Keeley, Employee Dishonesty Claims: Discerning the Employee's Manifest Intent, 30 TORT & INS. L.J. 915, 919-20 (1995) (discussing purpose behind manifest intent element).

33. See Horkovich et al., supra note 9, at 372 (explaining additional elements insured must prove). To be clear, the standard to be used when determining whether a loss resulted directly from a dishonest or fraudulent act of an employee is a cause-in-fact standard, not a reasonable foreseeability/proximate cause standard. See STANDARD FORM NO. 24, supra note 13, at Insuring Agreements § (A) (stating that coverage extends only to losses caused directly by dishonest or fraudulent acts of employees); William T. Bogaert & Andrew F. Caplan, Computing the Amount of Compensable Loss Under the Financial Institution Bond, 33 TORT & INS. L.J. 807, 813-14 (1998) (discussing proof of actual causation under standard form financial institution bond). For a thorough discussion of the causation element of a claim under a fidelity bond, see Bradford R. Carver, Loss and Causation, in HANDLING FIDELITY BOND CLAIMS, supra note 1, at 333.

In contrast to Horkovich’s contentions, two commentators suggest that there are instead eight slightly different issues that the insured faces when attempting to recover for a loss under the bond’s fidelity insuring agreement. These issues are:

1. Was a loss incurred by the insured?
2. Did the loss result directly from certain acts by an Employee?
3. Were those acts committed by an Employee?
4. Were those acts dishonest or fraudulent?
5. Were the acts committed with the manifest intent to cause the insured to sustain a loss and to obtain a financial benefit for the Employee or another?
6. Was a financial benefit intended to be received by the Employee or another?
7. In connection with a loan loss claim, did the Employee act in collusion with one or more parties to the transactions? and
8. In connection with a loan loss claim, did the Employee receive a financial benefit with a value of at least $2,500 in connection with the transactions?

B. The Discovery of Loss Issue

1. United States Supreme Court Decisions Involving Pre-Standard Form Bonds

For nearly half a century before the SAA drafted Standard Form No. 24 in 1941, many courts grappled with the issue of when the insured could be charged with discovery of loss.\(^{34}\) The seminal case in this pre-Standard Form No. 24 era is the United States Supreme Court’s decision in American Surety Co. v. Pauly,\(^{35}\) which courts frequently cite when determining the point of discovery.\(^{36}\) In Pauly, the discovery provision of the bond at issue required the insured to give notice to the insurer “of any act on the part of the employé, which may involve a loss for which the company is responsible hereunder, as soon as practicable after the occurrence of such act shall have come to the knowledge of the employer.”\(^{37}\) In affirming the trial court’s jury instruction, the Court read the provision as employing a subjective standard: the insured could be charged with discovering a loss under the policy only once the insured had actual knowledge of some specific fraudulent act that resulted or would result in a loss.\(^{38}\) The Court also stated that the insured cannot be charged with discovery based merely on suspicions; instead, the insured must have knowledge of some specific

\(^{34}\) See Edward G. Gallagher et al., A Brief History of the Financial Institution Bond, in A.B.A. FINANCIAL INSTITUTION BONDS, supra note 7, at 1, 15 (noting that SAA drafted bankers blanket bond, Standard Form No. 24 in 1941). The 1941 Standard Form No. 24, then called a bankers blanket bond, offered coverage for loss of “property, broad forgery protection, and coverage for losses sustained by an insured bank through payment on stolen or lost unsold travelers checks containing forged signatures.” Id. at 16. The SAA renamed the bond to “financial institution bond” because of confusion over the term “blanket.” See Videlock & Fletman, supra note 24, at 5 (explaining reason for renaming of blanket bond). Some thought it referred to the uniform monetary amount of coverage the insurer applied to each insuring agreement unless the bond noted otherwise. See id. Others thought that it related to the fidelity provision of the bond, which covers nearly all of the insured’s employees. See id.

\(^{35}\) 170 U.S. 133 (1898).

\(^{36}\) See Clore & Keeley, supra note 10, at 151 (acknowledging that Pauly is starting place for discussions of loss discovery and is frequently cited opinion in such discussions).

\(^{37}\) Pauly, 170 U.S. at 136. The facts leading to the lawsuit in Pauly began in 1891, when an employee of the insured bank fraudulently credited $44,500 to the bank president’s account. See id. at 138. A few months later, the bank suffered serious financial setbacks, and Pauly was appointed its receiver. See id. An auditor noticed possible inconsistencies in the bank’s books, although Pauly was not aware of these irregularities until the auditor finished the examination. See id. at 138-39.

Pauly then filed a claim of loss with the insurer, which denied coverage, arguing that Pauly knew of the loss since his appointment and therefore had not given notice “as soon as practicable.” See id. at 144.

\(^{38}\) See id. at 145 (“[I]t was plaintiff’s duty under the policy, when it came to his knowledge, when he was satisfied that the cashier had committed acts of dishonesty or fraud likely to involve loss to the defendant under the bond, as soon as was practicable thereafter to give written notice . . . .”).
fraudulent act.\textsuperscript{39} Courts have cited Pauly consistently for this proposition, including the Third Circuit in Fidelity \& Deposit Co. \textit{v. Hudson United Bank}\textsuperscript{40} and \textit{City Savings}, which are discussed below.\textsuperscript{41} Though many courts have cited Pauly when applying a strictly subjective test to determine the point of discovery, the Supreme Court may have also added an objective element to the standard.\textsuperscript{42} In the Pauly opinion, the Court explained that the insured could not be charged with discovery based on mere suspicions, but could be charged only when the insured had knowledge of facts "as would justify a careful and prudent [person] in charging another with fraud or dishonesty."\textsuperscript{43}

Further, in the subsequent case of Guarantee Co. of North America \textit{v. Mechanics' Savings Bank \& Trust Co.},\textsuperscript{44} the Court appeared to draw on an objective component—hinted at in Pauly.\textsuperscript{45} The bond at issue in Mechanics' Savings had two notice provisions which required the insured to notify the insurer either when the insured became aware of an employee engaged in "speculation or gambling" or when the insured gained knowledge of an act of an employee that might have involved a loss.\textsuperscript{46} The first provision, the Court noted, went to the insured's awareness of the act, which was not equivalent to its knowledge of the act.\textsuperscript{47} The Court stated that "to become aware of" was not the same in meaning as "to have knowledge of," but was better understood as "'to be informed of,' or, 'to be apprised of,' or, 'to be put on one's guard with respect to' . . . ."\textsuperscript{48}

\textsuperscript{39} See id. at 146 (stating that insured had no duty to notify insurer until insured had knowledge of some specific or fraudulent act).
\textsuperscript{40} 653 F.2d 766, 774 (3d Cir. 1981). For a discussion of Hudson United, see infra note 76 and accompanying text.
\textsuperscript{41} See City Savings, 205 F.3d 615, 629 n.7 (3d Cir. 2000) (citing Am. Sur. Co. \textit{v. Pauly}, 170 U.S. 133 (1898)). For a discussion of City Savings, see infra notes 80-152 and accompanying text.
\textsuperscript{42} See Clore \& Keeley, supra note 10, at 152 (noting that Court appeared to add reasonable person element to standard for ascertaining time of discovery of loss); Devin \& David, supra note 12, at 547 (explaining possible objective component to Pauly test for determining point of discovery of loss).
\textsuperscript{43} Pauly, 170 U.S. at 147.
\textsuperscript{44} 183 U.S. 492 (1902). In Mechanics' Savings, one of the insured's employees embezzled more than $100,000, which the insured reported after gaining knowledge of the fraud. See id. at 418. The insurer refused coverage, arguing that, based on the employee's testimony, the insured knew before the loss that the employee was a speculator. See id. The insured, citing Pauly, countered by arguing that it was not required to give notice until it had actual knowledge, not mere suspicion, sufficient to support a charge of fraud on the employee. See id.
\textsuperscript{45} See Clore \& Keeley, supra note 10, at 155 (stating that Court in Mechanics' Savings employed primarily objective standard to gauge point of discovery of loss); Devin \& David, supra note 12, at 547 (asserting that Mechanics' Savings supports use of primarily objective standard to determine time of discovery of loss).
\textsuperscript{46} See Mechs.' Sav., 183 U.S. at 405, 420 (setting notice provisions).
\textsuperscript{47} See id. ("To be aware is not the same as to have knowledge. The bond itself distinguishes between the two phrases and uses them as not synonymous with each other.").
\textsuperscript{48} Id.
According to two commentators, the bond's notice provisions in *Mechanics' Savings* seemed to require either notice or inquiry, or both, either when the insured gained knowledge of facts that might have led to a loss or when it learned of facts that would have led a "careful and prudent [person] to suspect dishonesty." Therefore, according to these commentators, the Court likened awareness to reasonable suspicion. Though some courts contend that Pauly provides a basis for an argument supporting an objective component in the discovery standard, these courts have typically produced opinions of questionable logic. Additionally, these courts have largely overlooked *Mechanics' Savings* in *City Savings*, the Third Circuit overlooked *Mechanics' Savings* when it interpreted the discovery standard of the standard form fidelity bond.

2. The Discovery Concept of the Standard Form Financial Institution Bond

For over half of a century after the Supreme Court decided *Pauly* and *Mechanics' Savings*, there was no consistent definition for discovery under fidelity bonds. In 1969, however, the SAA began to clear the air when it revised the SAA Standard Form No. 24 to include the first standard notice requirements; but the SAA did not include a discovery standard. Finally, in 1980, the SAA added a discovery definition to the bond, which in its modern form is embodied in the most recent revision of Standard Form No. 24:

Discovery occurs when the Insured first becomes aware of facts which would cause a reasonable person to assume that a loss of a type covered by this bond has been or will be incurred, regardless of when the act or acts causing or contributing to such loss oc-

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49. Clore & Keeley, *supra* note 10, at 155. Clore and Keeley base this conclusion on the Court's statement that, in reference to the facts of the case, it was difficult to see "how [a] careful and prudent [person] could have been justified in omitting independent inquiry" into the employee's activities. *Id.*

50. *See* Clore & Keeley, *supra* note 10, at 155 (concluding that Court associated awareness with reasonable suspicion).

51. *See* Devin & David, *supra* note 12, at 548 (noting illogical reliance on *Pauly* by courts applying primarily objective standard).

52. *See* Clore & Keeley, *supra* note 10, at 155 (stating that courts have essentially ignored *Mechanics' Savings*).

53. The Supreme Court decided *Pauly* in 1898 and *Mechanics' Savings* in 1902, but not until 1969 did the SAA began standardizing the discovery test. *See* Devin & David, *supra* note 12, at 544 n.7.

54. *See id.* (discussing first discovery standard). The 1969 bond simply required the insured to notify the insurer "[a]t the earliest practicable moment after discovery of any loss . . ." *Id.* The SAA also drafted several revisions between the periods of 1941-1951 and 1952-1969. *See* Knoll & Bolduan, *supra* note 27, at 11. Perhaps most significant of these revisions came in 1954, in which the SAA converted Standard Form No. 24 to a "Loss Discovery" form, which covered only those losses discovered before the termination or cancellation of the bond. *See id.*
Another standard form bond, Savings and Loan Blanket Bond, Standard Form No. 22, which was the focus of litigation in City Savings, features a discovery standard nearly identical to that of Standard Form No. 24. In addition, both bonds state that not only the insured's awareness of facts, but also the awareness of any director or officer of the insured who is not in collusion with the dishonest person can be considered when determining the point of discovery. In other words, courts will impute to the insured a director's or an officer's knowledge of facts that would cause a reasonable person to conclude that a loss has occurred or that a loss may occur.

55. Standard Form No. 24, supra note 13, § 3. Standard Form No. 24 also features a second discovery definition, which states, "Discovery also occurs when the Insured receives notice of an actual or potential claim in which it is alleged that the Insured is liable to a third party under circumstances which, if true, would constitute a loss under this bond." Id.

In comparison, the discovery standard set forth in the 1980 revision of the bond states, "Discovery occurs 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." Financial Institution Bond, Standard Form No. 24 (revised 1980) § 5, reprinted in A.B.A. Financial Institution Bonds, supra note 7, at 458. The SAA also revised the bond between the period of 1969-1979, which dealt with, among other things, the imprecise language of the fidelity insuring agreement and problems associated with consequential and indirect damages. See Knoll & Bolduan, supra note 27, at 14 (discussing revisions between years of 1969-79). As of 1995, there have been no plans to revise Standard Form No. 24 any further. See id. at 25-26 (noting that SAA has no plans to modify 1986 version of bond).

56. See Savings and Loan Blanket Bond, Standard Form No. 22 § 4 (revised 1982), reprinted in Financial Institution Bonds, supra note 7, at 475 [hereinafter "Standard Form No. 22"] (providing discovery standard). A difference between the Standard Form Nos. 22 and 24 is that the latter's discovery provision does not feature the second discovery standard featured in Standard Form No. 24. Compare id., with Standard Form No. 24, supra note 13, § 3. For the text of the second discovery definition of Standard Form No. 24, see supra note 55.

57. See Standard Form No. 24, supra note 13, § 12, (defining conditions that, when met, will terminate coverage as to dishonest employees); Standard Form No. 22, supra note 56, § 12 (same).

58. See Clore & Keeley, supra note 10, at 162 (explaining that knowledge will be imputed to insured). There is an exception to the general rule that knowledge of a loss or potential loss will be imputed to the insured. Under the "adverse domination" theory, knowledge may not be imputed to the corporate policyholder where corporate officers whose duty it is to report the loss are themselves the wrongdoers. See Horkovich et al., supra note 9, at 371 (discussing adverse domination exception to general imputation of knowledge rule). Several commentators note, however, that the adverse domination theory is rarely available as a valid affirmative defense to insureds because "[i]t is a rare business in which no one is in a position to discover and report dishonesty." David & Rockas, supra note 11, at 17; see also Wilson, supra note 32, at 57 (stating that insured can rely on doctrine of adverse domination theory "[i]n very limited situations" when submitting allegedly untimely loss).
3. *Decisions of Lower Federal Courts Involving the Discovery of Loss Issue*

The language of the 1986 bond's discovery standard is a primarily objective test and does not require that the insured appreciate the significance of any available facts before it can be charged with discovery of loss. 59 Indeed, as two commentators note, "the bond's discovery definition clearly is intended to counteract those decisions allowing insureds to delay providing their insurers notice due to their subjective doubts about an employee's dishonesty." 60 Nonetheless, several United States courts of appeals and United States district courts have disagreed over the issue of whether the definition requires that, in order to be charged with discovery, the insured itself must conclude that a loss has or will occur. 61

a. District Courts

Overwhelmingly, the United States district courts that have considered issues under the modern discovery provision have applied a primarily objective standard. 62 These courts have simply looked to the bond's plain language and concluded that the insured can be charged with discovery only when a reasonable person could conclude from the facts available to the insured that a loss had or would occur. 63 Interestingly, while there are

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59. See Clore & Keeley, supra note 10, at 158 (stating that discovery standard makes it clear that drafters intended reasonable person standard be applied).

60. Id. at 95.


63. See, e.g., *Fed. Deposit Ins. Corp.*, 1999 U.S. Dist. LEXIS 11029, at *10 ("As revealed by the express terms of the Bond, the definition and determination of
when discovery occurs is measured under an objective reasonable person standard.

b. Circuit Courts That Have Applied a Subjective Standard

Three United States circuit courts have applied subjective tests under the standard form bond, each beginning their analyses by acknowledging, but then promptly ignoring, the definition's primarily objective language. First, the United States Court of Appeals for the Fifth Circuit has merely offered lip service to the standard form definition. Then, after citing decisions of its sister circuits, the Fifth Circuit has held that an insured can be charged with discovery of loss only once the insured appreciates the significance of facts indicating that an employee has committed a dishonest act. Second, the United States Court of Appeals for the Sixth Circuit began its discovery analysis by quoting the discovery standard and proceeded to rely unconvincingly on the subjective analysis of a 1971 opinion from the United States Court of Appeals for the Eighth Circuit, when

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64. A thorough search of WESTLAW and LEXIS in April, 2001 for cases in which district courts have considered issues of discovery under Standard Form No. 24 and have applied a subjective test produced no results.

65. See, e.g., Fed. Deposit Ins. Corp., 45 F.3d at 974 (applying subjective standard to determine point of discovery under ambiguous discovery provision); Cal. Union, 948 F.2d at 564 (employing subjective standard to determine point of loss under a fidelity bond with discovery provision featuring primarily objective standard); Aetna, 903 F.2d at 1079 (applying subjective standard where bond provision expressly sets forth primarily objective standard).

66. See Fed. Deposit Ins. Corp., 45 F.3d at 974 (reading standard form bond discovery definition as requiring that insured have appreciation of facts indicating loss). In this case, the Fidelity & Deposit Company of Maryland ("F&D") sold a standard form financial institution bond to Capital Bank & Trust Co. ("Capital"). See id. at 971. In late 1986, Capital suspected that its chief lending officer, Allie Pogue, was issuing loans in exchange for bribes. See id. at 971-72. Capital investigated and discovered several undisclosed business relationships between Pogue and several loan customers. See id. at 972. Capital filed a notice of loss with F&D, which refused to cover the loss, alleging that the notice of loss did not properly indicate that certain loans were the claimed losses. See id. at 972, 974. Subsequently, Capital was placed in receivership as a result of these losses. See id. at 971.

67. See id. at 974 (applying discovery standard).
stating that the discovery provision requires the insured’s appreciation of facts.\textsuperscript{68} Finally, in stating that the discovery standard requires the insured to realize that a loss has occurred before being charged with discovery, the United States Court of Appeals for the Ninth Circuit has relied on the analysis of the Sixth Circuit, which, as explained, has looked to pre-standard form case law from the Eighth Circuit.\textsuperscript{69}

c. Circuit Courts That Have Applied the Primarily Objective Standard of the Bond

In contrast to the circuits that use a subjective discovery test, the circuits that implement a primarily objective standard simply apply the plain language of the bond’s discovery provision.\textsuperscript{70} For example, the Eighth Circuit has concluded, after consulting its previous decisions involving the issue, that discovery occurs when a reasonable person could conclude a

\textsuperscript{68} See Aetna, 903 F.2d at 1079 (applying subjective standard despite primarily objective definition in bond). In Aetna, the insured, United Southern Bank of Nashville ("USBN") entered insolvency and was loaned $25,000,000 by Federal Deposit Insurance Corporation ("FDIC"). See id. at 1074. FDIC conditioned the loan on USBN’s replacing its management, with which USBN complied. See id. Tom Mottern replaced C.H. Butcher, Jr., as USBN’s new president. See id. Shortly thereafter, however, USBN was placed in receivership and FDIC was appointed its receiver. See id. FDIC then learned of several USBN loans issued by Butcher in which Butcher received some benefit. See id. at 1076. FDIC next filed a notice of loss with Aetna, which refused coverage, arguing, among other things, that: (1) USBN failed to give timely notice of the Butcher losses; and (2) the bond terminated immediately upon the appointment of FDIC as receiver. See id. at 1076 (discussing arguments raised by FDIC when seeking coverage and Aetna when denying coverage).

\textsuperscript{69} See Cal. Union, 948 F.2d at 564 (applying subjective test to determine point of discovery under standard form bond). But see Fed. Deposit Ins. Corp. v. N.H. Ins. Co., 1992 U.S. App. LEXIS 2372, at *20 (9th Cir. Feb. 25, 1992) (agreeing with grand jury indictment that insured’s employees “were aware of facts during the term of the bond that would cause a reasonable person to assume that [insured’s employee] was committing dishonest acts”). In California Union, American Diversified Savings Bank ("ADSB") purchased fidelity coverage from National Union Fire Insurance Company ("National Union") and certain underwriters at Lloyd’s of London ("Lloyd’s"). See Cal. Union, 948 F.2d at 558. A year later in 1984, the Federal Home Loan Bank Board ("FHLB") investigated ADSB for possible fraudulent activity of ADSB employees. See id. In 1986, the Federal Savings and Loan Insurance Corporation ("FSLIC") was appointed conservator of ADSB. See id. FSLIC, claiming that a number of fraudulent activities took place during the FHLB investigation, notified National Union and Lloyd’s of these alleged losses. See id. National Union denied coverage, arguing that the bond had terminated once FSLIC became the conservator of ADSB. See id. at 559. Lloyd’s also denied coverage, arguing that the bond period had expired before ADSB had discovered the losses. See id. (stating that Lloyd’s argued that FSLIC had not demonstrated that ADSB discovered losses before expiration of policy).

\textsuperscript{70} See, e.g., City Savings, 205 F.3d 615, 631 (3d Cir. 2000) (applying primarily objective test to ascertain time of discovery under fidelity bond); Fed. Deposit Ins. Corp. v. Oldenberg, 94 F.3d 1529, 1542 (10th Cir. 1994) (stating that reasonable person’s standard is proper standard under which to determine point of discovery under fidelity bond); First Dakota Nat’l Bank v. St. Paul Fire & Marine Ins. Co., 2 F.3d 801, 807 (8th Cir. 1993) (same).
loss has or will occur. In taking a more straightforward approach, the United States Court of Appeals for the Tenth Circuit has simply quoted the discovery definition with no elaboration before applying it. These circuits have concluded that the discovery standard of the standard form bond is clear on its face and requires no manipulative interpretation.

d. The Third Circuit’s Decisions

The Third Circuit has issued three opinions based on loss discovery issues: one dealing with a pre-standard form bond, the second pertaining to the pre-1986 version of the discovery provision, and the last applying

71. See First Dakota, 2 F.3d at 807 ("Discovery of fraud or dishonesty is deemed to occur when the insured actually becomes aware of sufficient facts which would lead a reasonable person to believe that an insured loss has occurred."). In First Dakota, the president and CEO of American State Bank ("American Bank"), William Deam and several other bank officials became involved in a fraudulent scheme to divert company funds to Deam. See id. at 804. The scheme was complex and involved nearly twenty-eight different corporations and entities. See id. In 1986, nearly two years later, the FDIC began investigating American Bank. See id. Approximately one year later, the FDIC generally informed American Bank’s board of directors of Deam and the other executive’s fraudulent activities. See id. Shortly afterwards, Deam resigned and was replaced by John Lillibridge as interim president. See id. By 1987, Lillibridge learned the extent of Deam’s scheme, and under the terms of its fidelity bond, submitted proofs of loss to American Bank’s insured, St. Paul Fire & Marine Insurance Company ("St. Paul"). See id. Shortly afterwards, St. Paul informed American Bank that coverage under the two American Bank fidelity bonds would terminate in mid-1988. See id. One year later, First Dakota National Bank ("First Dakota"), merged with American Bank and sought coverage of the losses. See id. at 805. St. Paul denied coverage, arguing that American Bank had discovered the losses in 1986 and therefore had failed to notify St. Paul within twenty-four months after discovery. See id. at 806.

72. See Oldenberg, 34 F.3d at 1542 (quoting and applying discovery definition from standard form financial institution bond). In Oldenberg, J. William Oldenberg, was owner, president, and chairman of the board of both Investment Mortgage International, Inc. ("IMI") and Empire State West ("Empire"). See id. at 1534. In 1983, Oldenberg became the owner of 9.99% of the stock in State Savings and Loan Association of Salt Lake City, Utah ("State Savings"). See id. at 1535. At that point, IMI was suffering serious financial difficulties and was near collapse. See id. Oldenberg sought a $10,000,000 loan from State Savings for IMI, only to discover he could not get the loan because he was the owner of State Savings. See id. To get the loan, Oldenberg devised a plan in which he would sell a piece of real estate to State Savings. See id. Before the State Savings board of directors approved the deal, however, Oldenberg arranged for a transfer from State Savings to IMI, which used the money to stay afloat. See id. The State Savings board approved the real estate purchase, which was discovered and investigated by the FDIC and Utah state regulators. See id. at 1536. In 1985, State Savings became insolvent and the FSLIC was appointed its receiver. See id. FDIC filed notice of loss for the real estate transaction with American Casualty ("American"), State Savings' insurer during most of 1984. See id. American denied coverage, asserting that FDIC had not discovered the losses during the bond period. See id. at 1542 (discussing American’s arguments made in its defense).

73. See Clore & Keeley, supra note 10, at 203 (stating that courts that have applied plain language of standard have applied it correctly).
the modern discovery provision. In the two cases decided before the SAA drafted the modern standard, *Hunt v. Fidelity & Deposit Co.* and *Fidelity & Deposit Co. v. Hudson United Bank*, the Third Circuit held that the insured had discovered a loss only once it had "sufficient knowledge of specific dishonest acts to justify a careful and prudent person in charging another with dishonesty or fraud." In *City Savings*, the Third Circuit decision involving issues under the modern standard, the court applied a primarily objective test after determining that the modern bond called for a plain meaning reading of the discovery standard. Therefore, the Third Circuit has consistently used a reasonable person analysis when de-

74. See *Hunt v. Fid. & Deposit Co.*, 92 F.2d 75, 77 (3d Cir. 1937), vacated, 95 F.2d 491 (3d Cir. 1938) (construing discovery standard of bankers blanket bond); *see also Fid. & Deposit Co. v. Hudson United Bank*, 653 F.2d 766, 774-76 (3d Cir. 1981) (applying discovery provision of pre-1986 revision of Standard Form No. 24); *City Savings*, 205 F.3d 615, 630-31 (3d Cir. 2000) (applying modern discovery standard).

75. 92 F.2d 75 (3d Cir. 1937). In *Hunt*, C.B. Love, president of the insured, Penn General Casualty Company, sold securities belonging to the insured and withdrew $17,500 from the insured's account without repaying the amount. *See id.* at 76. A short time before Love engaged in these dishonest acts, he had requested from J.V. Gosline, the insured's vice president, a $55,000 bond, which Love planned to use toward attachment proceedings on his yacht. *See id.* Gosline refused to issue the bond, and also advised E.J. Doyle, assistant treasurer of the insured, not to issue an $11,000 bond Love had requested. *See id.* During an audit, Gosline learned of Love's activities and reported the loss to the insurer, Fidelity & Deposit Company, which refused coverage, arguing it had not been notified during the coverage period. *See id.*

76. 653 F.2d 766 (3d Cir. 1981). In *Hudson United*, Hudson United Bank ("Hudson United") learned after an internal investigation that its vice president, Robert Lee Potter, was incompetent based on Potter's sloppy loan filings and his granting of loans to individuals of dubious backgrounds. *See id.* at 769. Hudson United learned that one of the candidates, Thomas Mullens, had been arrested for issuing bank checks and was being investigated for a $7,000,000 fraud scheme, among other things. *See id.* Upon realizing Potter's incompetence, Hudson United's president, Joseph L. Robertson, sent a letter to Fidelity & Deposit Insurance Corporation ("FDIC"), outlining the facts he knew about the Mullens loans. *See id.* at 770. Hudson United also informed its insurer, Employers Mutual Liability Insurance ("Employers"), of the Mullens loans. *See id.* Shortly afterwards, Hudson United learned of a series of loan scams involving Mullens and several other banks. *See id.* at 770. At that point, Employers decided not to renew its fidelity bond with Hudson United. *See id.* Fidelity & Deposit Co. thereafter issued a policy effective in March 1976. *See id.* In November 1976, Hudson United consequently filed proofs of loss with its insured, Fidelity & Deposit Company ("F&D"). *See id.* at 770-71. In January 1977, F&D notified Hudson United that it would be canceling the bond because Hudson United had notified Employers of a potential loss before coverage under the F&D bond had taken effect. *See id.* at 771. Hudson United then sued F&D when it denied coverage and offered to return Hudson United's premiums. *See id.*

77. *Hudson United*, 653 F.2d at 774; *see also Hunt*, 92 F.2d at 77 ("Reasonably prudent [people] might differ as to when [the insured's vice president] had sufficient facts to justify him in giving notice to the [insurer].").

78. *See City Savings*, 205 F.3d at 631 (applying reasonable person standard of modern bond's discovery provision).
ciding issues of discovery under fidelity bonds, the court’s most recent application of which is strongly supported by the modern bond.79

III. ANALYSIS OF THE THIRD CIRCUIT’S APPROACH TO DETERMINING THE POINT OF DISCOVERY OF LOSS UNDER THE STANDARD FORM FINANCIAL INSTITUTION BOND IN RESOLUTION TRUST CORP. v. FIDELITY & DEPOSIT CO.

A. Facts and Procedural Posture of City Savings

1. Facts

The City Savings case is, as the Third Circuit noted, “intensely fact-driven.”80 Therefore, to fully appreciate the court’s decision, a detailed review of the circumstances of the case is in order.

On March 22, 1987, City Federal Savings Bank (“City Savings”) purchased from Fidelity and Deposit Company of Maryland (“F&D”) the Savings and Loan Blanket Bond, Standard Form No. 22, whose bond period expired on March 22, 1989.81 F&D named as insureds City Savings and City Savings’ wholly owned subsidiary mortgage warehouse lending operation, City Collateral and Financial Services, Inc. (“City Collateral”).82

Three months later, City Savings agreed to extend a $30,000,000 warehouse credit line to Northwest Mortgage Company.83 During the effective period of the credit line, several City Collateral employees, including John Hurst and Gregory DeVany, noticed defects in Northwest’s collateral.84 Neither Hurst nor DeVany reported these problems to City Savings.85

In May of 1988, DeVany and several other City Collateral employees noticed other irregularities with the Northwest account, namely problems with the list of third parties who agreed to purchase notes and mortgages

79. For a discussion of the Third Circuit’s most recent decision involving the discovery standard, see infra notes 80-152 and accompanying text.
80. City Savings, 205 F.3d at 620.
81. See id. (stating that F&D issued standard form financial institution bond to City Savings). The bond stated that it would indemnify City Savings or its subsidiaries for up to $5,000,000 against losses resulting from employee dishonesty. See id.
82. See id. Typically, mortgage warehouse lenders advance money to a mortgage banker as collateral for mortgages on real property. See id. at 620 n.3. In consideration, the mortgage banker gives the mortgage notes to the lender, which acts as security for the loan. See id. Next, the mortgage banker sells the mortgage notes to an investor and tells the lender to send the mortgage notes to that investor. See id. Once the lender exchanges the mortgage notes for cash with the investor, the mortgage banker uses the proceeds of the sale to repay the lender. See id.
83. See id. at 621. Northwest was in the business of originating residential mortgage loans and selling them to investors, either individually or in groups. See id.
84. See id. at 621.
85. See id. Kevin Corcoran, a City Collateral loan officer, had told Hurst and DeVany of certain problems he experienced with Northwest’s collateral before leaving City Collateral’s employment. See id. (stating that before he left, Corcoran told Hurst and DeVany of Northwest credit line problems)
from Northwest. Again, DeVany chose not to report his findings to City Savings. In addition, Hurst recommended that the City Savings Loan Committee (the “Loan Committee”) extend the maturity date of Northwest’s credit line. In making his recommendation, Hurst did not disclose to the Loan Committee that the Northwest credit line was in technical default at the time.

Around the same time as the first extension of the maturity of Northwest’s credit line, Hurst and two other City Collateral Officers, Willem Ridder and Lyndon Merkle, learned that City Savings planned to sell City Collateral. Shortly afterwards, Hurst, Ridder and Merkle negotiated with City Collateral for final compensation plans. In June 1988, Hurst offered a “workout plan” to Northwest under which City Collateral would work to cure the technical default of Northwest’s credit line. A month later, City Collateral officially identified Northwest as a problem borrower, which DeVany, Hurst and the other employees did not mention to City Savings.

In preparing a portion of the offering memorandum that would be sent to City Collateral’s potential buyers, Hurst, Ridder and Merkle detailed problem credits and pending litigation, but did not mention that Northwest’s credit line was on a workout plan. After the memorandum was distributed to interested buyers, Hurst told City Savings that City Collateral would include the Northwest account in the sale while informing City Collateral employees that the credit line would not be included.

In the fall of 1988, the parent corporation of HonFed Bank (“HonFed”), a federally insured savings bank, expressed interest in buying City Collateral. During HonFed’s negotiations with City Savings, Hurst, Ridder and Merkle received a large portion of their compensation from their severance packages, all while holding separate negotiations for employment with HonFed. In December 1988, Northwest’s president, Harry Movroydis, met with DeVany to discuss the Northwest credit line and disclosed that he had been wrongly diverting the funds Northwest owed to City Collateral in order to cover market losses Northwest had suf-

86. See id. (explaining additional problems unearthed by DeVany while dealing with Northwest’s account).
87. See id.
88. See id.
89. See id.
90. See id.
91. See id. at 621-22 (discussing negotiations of City Collateral employees for final compensation plans).
92. See id. at 621 (discussing workout plan).
93. See id.
94. See id. at 622.
95. See id. (discussing differing reports given to City Savings and City Collateral employees).
96. See id.
97. See id.
ferred several months earlier.\textsuperscript{98} Again, DeVany did not report his findings to City Savings.\textsuperscript{99} In the same month, HonFed bought City Collateral and hired Hurst, Ridder and Merkle.\textsuperscript{100} HonFed also decided that it would not include the Northwest account in the deal.\textsuperscript{101}

In February 1989, City Savings learned of the serious problems involving the lending arrangement between City Collateral and Northwest.\textsuperscript{102} After some investigation, City Savings learned that Movroydis had misappropriated City Collateral funds when attempting to hide Northwest's marketing losses.\textsuperscript{103} In December 1989, due to numerous financial setbacks, City Savings became insolvent, and the Resolution Trust Corporation ("RTC") was appointed its receiver.\textsuperscript{104} The bond terminated once the bankruptcy court appointed RTC as receiver.\textsuperscript{105}

2. \textit{Procedural Posture}

Shortly after being appointed receiver of City Savings, RTC filed a "proof of loss" with F&D, upon which F&D denied coverage.\textsuperscript{106} Consequently, RTC initiated suit in the United States District Court for the District of New Jersey, naming F&D, Ridder, Hurst, Merkle and DeVany as defendants.\textsuperscript{107} RTC alleged that F&D breached its contract with RTC by refusing to indemnify RTC for the Northwest loss.\textsuperscript{108} In addition, RTC sought a declaratory judgment of coverage under the bond and further alleged that F&D violated the policy's implied covenant of good faith and fair dealing by denying coverage.\textsuperscript{109}

In response, F&D filed a motion for summary judgment, arguing, among other things, that under the bond's discovery provision, no reasonable jury could find that City Savings discovered the loss during the bond period, viewing the evidence in the light most favorable to RTC.\textsuperscript{110} The district court granted the summary judgment motion and dismissed RTC's claims against F&D with prejudice, whereupon RTC filed an appeal to the United States Court of Appeals for the Third Circuit.\textsuperscript{111}

\textsuperscript{98} See id. at 623.
\textsuperscript{99} See id.
\textsuperscript{100} See id. at 624.
\textsuperscript{101} See id.
\textsuperscript{102} See id. at 624-25.
\textsuperscript{103} See id. at 625.
\textsuperscript{104} See id. at 625.
\textsuperscript{105} See \textit{Standard Form No. 22, supra} note 56, § 12 ("This bond shall be deemed terminated or cancelled as an entirety ... (c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials ... ").
\textsuperscript{106} See City Savings, 205 F.3d at 625.
\textsuperscript{107} See id.
\textsuperscript{108} See id.
\textsuperscript{109} See id.
\textsuperscript{110} See id. at 625-26 (outlining F&D's arguments in its defense).
\textsuperscript{111} See id. at 626.
B. The Third Circuit’s Opinion in City Savings

In City Savings, the Third Circuit applied the plain language of the standard form financial institution bond’s discovery provision in determining that, contrary to the ruling of the district court, a reasonable jury could have concluded that City Savings “discovered” the Northwest loss before the bond had terminated. Before digressing into the discovery issue, the court noted that although it had addressed the general idea of discovery of loss under a fidelity bond in Hudson United, City Savings presented the first opportunity to examine the discovery definition of a standard form financial institution bond.

The court began its analysis of the discovery issue by quoting the discovery definition from section 4 of the bond. The court noted that the date of discovery is important because it not only determines whether the bond will cover the loss, but also activates the insured’s obligation to give notice of the potential loss to the insurer. The court then rejected the parties’ contention that the court’s discussion of discovery in Hudson United was controlling. Because the parties had contracted for a specific discovery provision, the court reasoned, the plain language of the bond would shape its discussion.

Next, the court stated that the discovery standard was comprised of both objective and subjective components. First, the factfinder must identify the facts and information known by the insured during the relevant period. Second, the factfinder must infer, from those facts, the conclusions that a reasonable person could draw from them.

Although appearing that the Third Circuit would proceed in its analysis by applying the controlling plain language of the bond, the court in...
stead stated that discovery under the standard form bond "does not occur until the insured 'discovers facts showing that dishonest acts occurred and appreciates the significance of those facts.'"121 The Third Circuit went on to state, however, that the determination of the point of discovery ultimately hinges on whether a reasonable person could assume, based on the facts available to the insured, that a loss had or would occur.122 Indeed, the court added that all the bond "requires is that the insured possess sufficient information to lead to a reasonable assumption of a covered loss; ... the insured need not know 'the exact amount or details' of the loss to be charged with discovery under [the bond's discovery provision]."123

Proceeding from its discussion of the relevant law and the facts before it, the Third Circuit concluded that the district court erred in ruling that no reasonable jury could conclude that City Savings had discovered the loss during the bond period.124 The court stated that before the bond period expired, City Savings was aware that DeVany knew about the Movroydis scheme and therefore dishonestly concealed the scheme from City Savings.125 In addition, the court noted that a reasonable jury could conclude that because HonFed specifically excluded the Northwest account from its purchase of the City Collateral assets, it too was aware of the Movroydis scheme.126 The court noted that HonFed's awareness of the Movroydis scheme was apparent because of its election to omit the Northwest account, a choice that would have been especially suspect to City Savings, considering that none of its management personnel were aware of any problems with the Northwest credit line.127 From this, the court stated, a reasonable jury could conclude that, based on the facts available to City Savings, a reasonable person could conclude that City Savings had incurred or would incur a covered loss.128

In further analysis of the district court's ruling, the Third Circuit criticized the trial judge's isolated examination of each piece of evidence instead of considering the probative value of the totality of the evidence.129 In addition, the court stated that in most circumstances, determining the point of discovery is a difficult task and is inherently fact-driven.130 Consequently, the court added, determining on summary judgment when the

121. Id. at 631 (citations omitted).
122. See id. (reaffirming role of objective component of discovery standard).
123. Id.
124. See id.
125. See id.
126. See id. at 632.
127. See id. (stating that HonFed's choice to omit Northwest account from its purchase was especially suspect).
128. See id. at 631 ("[A] reasonable jury could find that City [Savings] possessed sufficient knowledge of facts that would cause a reasonable person to assume that a covered loss had or would be incurred . . . .").
129. See id. at 632.
130. See id.
insured had discovered a loss could be equally as difficult for a trial court.131

C. Analysis and Practical Implications of the Third Circuit’s Approach to Discovery in City Savings

1. Analysis

The Third Circuit’s reading of the modern bond’s discovery provision was correct.132 The decision is a natural outgrowth of its pre-standard form financial institution bond opinions and follows the holdings of several other circuit courts and a great number of district courts.133 Perhaps more importantly, the court’s interpretation of the discovery standard as an objective test comports with the plain language of the bond’s discovery provision.134 Indeed, as one commentator notes, “The ‘subjective’ view is impossible to reconcile with the current language of the Standard Form 24 financial institution bond.”135 Unlike those circuits that have acknowledged, but ultimately ignored, the primarily objective language of the discovery standard, the Third Circuit and several other circuits have properly held that the standard does not require that the insured have enough in-

131. See id.

132. For a discussion of the Third Circuit’s interpretation of the discovery standard, see supra notes 114-23 and accompanying text.


134. For the text of the standard form financial institution bond’s discovery provision, see supra note 55 and accompanying text.

135. Wilson, supra note 32, at 56 (“The issue is more open to argument under policies with no definition, such as standard commercial crime policies.”).
formation to charge an employee with dishonesty before it may be charged with discovery.\footnote{136}

The Third Circuit has found nothing unclear about the discovery standard’s language, nor has the court found it necessary to read words into a provision for which parties have specifically contracted.\footnote{137} Rather than ignoring the bond’s language and relying on pre-standard form bond opinions for the proposition that a subjective component is implied in the modern bond’s discovery standard as several circuits have done, the Third Circuit has agreed with several other circuits by constraining its analysis to the bond’s four corners.\footnote{138}

2. Practical Implications

The Third Circuit’s decision in City Savings produces two practical implications. First, although the bond’s discovery standard appears to be pro-insurer in the abstract, it will, in circumstances like those in City Savings, aid a receiver in recovering for losses sustained by the then-insured under the bond.\footnote{139} In City Savings, the bond terminated immediately when the receiver took over the insured, whereupon the insurer denied coverage for the loss, claiming the insured did not discover the loss before the takeover.\footnote{140} Under the Third Circuit’s approach and the bond’s plain language, however, a court will look to the circumstances before a takeover to determine if a reasonable person could conclude whether, based

\footnote{136} Compare City Savings, 205 F.3d 615, 630-31 (3d Cir. 2000) (applying primarily objective test to ascertain time of discovery under fidelity bond), Oldenberg, 34 F.3d at 1542 (stating that reasonable person standard is proper to determine point of discovery under fidelity bond), and First Dakota, 2 F.3d at 807 (using primarily objective standard to gauge time of discovery), with Fed. Deposit Ins. Corp. v. Fid. & Deposit Co., 45 F.3d 969, 974 (5th Cir. 1995) (applying subjective standard to determine point of discovery under ambiguous discovery provision), Cal. Union Ins. Co. v. Am. Diversified Sav. Bank, 948 F.2d 556, 564 (9th Cir. 1991) (employing subjective standard to determine point of loss under fidelity bond with discovery provision featuring primarily objective standard), and Fed. Deposit Ins. Corp. v. Aetna Cas. & Sur. Co., 905 F.2d 1073, 1079 (6th Cir. 1990) (applying subjective standard where bond provision expressly sets forth primarily objective standard).

\footnote{137} See John Dobbyn, Insurance Law in a Nutshell 348 (3d ed. 1996) ("[A] court reviewing a bond should look to the plain language of the bond instrument in an effort to effectuate the intent of the parties.").

\footnote{138} See E. Allan Farnsworth, Farnsworth on Contracts § 7.10(a) (2d ed. 1998) ("[E]ven though a court may look at all the circumstances in the process of interpreting contract language, the language itself imposes a limit on how far the court will go in that process.").

\footnote{139} See City Savings, 205 F.3d at 631 ("Put simply, we believe that there is more than one reasonable conclusion that could be reached based on the facts City [Savings] learned during the crucial days just prior to the bond’s expiration.").

\footnote{140} See id. at 626 (stating that F&D argued that because City Savings had not discovered loss during bond period, RTC could not recover for losses).
on the facts available to the insured, a loss had or would occur.\textsuperscript{141} If the court concludes that discovery did occur before the bond terminated and also determines that the insured provided notice within the thirty-day period prescribed by the bond, a receiver may be able to recover for the then-insured's losses under the terminated bond.\textsuperscript{142}

Second, where there is no issue of bond termination, an insured within the court's jurisdiction must pay close attention to the activities of its employees if the insured does not wish to jeopardize its recovery for loss based on its potential failure to give timely notice.\textsuperscript{143} Though most jurisdictions—including Pennsylvania—require an insurer to prove it has been prejudiced as a result of late notice, insureds will likely not want to risk coverage of a suffered loss and consequently must be prepared to investigate any suspected loss.\textsuperscript{144} This is because, under the bond's primarily objective standard, an insured may be charged with discovery based on the possible conclusions a reasonable person could draw, and therefore may jeopardize coverage based on its failure to give timely notice, even before there is enough evidence to formally charge an employee with fraud or dishonesty.\textsuperscript{145}

Where there is no issue of termination after takeover, however, some may argue that the Third Circuit's approach is pro-insurer and is too stringent and impractical.\textsuperscript{146} Indeed, as two commentators note, "[i]t is some-

\textsuperscript{141} See id. at 631-32 (looking to facts before takeover to determine which conclusions reasonable person could draw).

\textsuperscript{142} See id. at 630 (stating that time of discovery determines whether loss is covered by bond and triggers insured's obligation to give notice).

\textsuperscript{143} See David & Rockas, supra note 11, at 17 (discussing consequences of failure to give timely notice); Wilson, supra note 32, at 56 ("Failing to put the carrier on notice when required by the bond risks losing the benefit of the insurance coverage altogether, thus placing the value of the premiums already paid at substantial risk.").

\textsuperscript{144} See, e.g., Northwood Nursing & Convalescent Home, Inc. v. Continental Ins. Co., 902 F. Supp. 79, 84 (E.D. Pa. 1995) (applying Pennsylvania law and requiring proof of prejudice to insurer); In re Lloyd Sec., 153 B.R. 677, 683 (E.D. Pa. 1993) (applying Pennsylvania law and stating that "where the insured provided late notice of the potential claim, the insurance company will be relieved of its responsibilities under the policy only if it can prove actual prejudice resulting from the untimely notice"); Brakeman v. Potomac Ins. Co., 371 A.2d 193, 198 (Pa. 1977) (stating that insured must prove prejudice to succeed on defense of untimely notice).

\textsuperscript{145} See Standard Form Bond No. 24, supra note 15, § 3 (providing primarily objective standard for discovery of loss); Standard Form No. 22, supra note 56, § 4 (same).

\textsuperscript{146} See Wilson, supra note 32, at 56 (explaining how objective standard may be impractical). In regard to the rationales underlying the two contrasting readings of the discovery standard, one commentator has noted that:

The [insurer] would obviously prefer an "objective" standard, by which the knowledge of certain facts necessarily leads to "discovery" as that term is used in the bond. If a dispute over discovery arises, however, the insured will wish to argue that the bond has a merely "subjective" standard for discovery, by which the insured's own subjective conclusions as to the import of the known facts (regardless of the reasonableness of those con-
times difficult, at least initially, to distinguish negligence, inattention or incompetence from employee dishonesty."147 These commentators base this statement on the fact that discovery is often sudden and unplanned, and that dishonesty or fraud typically does not become apparent to the insured until individuals within an organization volunteer information—usually merely suspicions of wrongdoing—to their employer.148 Moreover, these commentators contend that an insured may not initially recognize the significance of this information, particularly "where no single individual has a complete picture of events or where knowledge of wrongdoing by subordinates has not been reported to senior management."149

Though these commentators may have raised viable concerns, the bond features a reasonableness test, meaning that insureds in the Third Circuit will be held to a standard no higher than that at which they should be monitoring employee activity.150 Thus, the objective standard will provide a measure of protection to insureds because their decisions will not be measured using some extraordinary yardstick.151 In addition, an objective standard serves as a stable guide at trial for determining the time of discovery because it focuses on the trial record and not the precise mental state of the insured at a point in the distant past.152

IV. Conclusion

The Court of Appeals for the Third Circuit has properly determined that the discovery standard of the standard form financial institution bond is primarily objective and does not require that the insured know a loss has or will occur before the insured can be charged with a discovery of loss.153 Though several circuits have ignored the standard’s primarily objective

147. Clore & Tomaine, supra note 10, at 399.
148. See id. at 398 (discussing practical considerations when determining point of discovery).
149. Id.
151. See Wegerzyn & Morrissey, supra note 24, at 9-11 (discussing role of American Bankers Association in bond’s drafting). Because the American Bankers Association played a key role in the SAA’s drafting of the primarily objective discovery standard, one cannot say courts’ use of a reasonable person test is in any way unfair to financial employers. See id.; Sharp v. Fed. Sav. & Loan Ins. Corp., 858 F.2d 1042, 1046 (5th Cir. 1988) (same).
152. See DiMatteo, supra note 150, at 300 (noting that use of reasonable person standard to address legal issues fulfills “[t]he need to maintain symmetry and generality of law . . .”).
153. See City Savings, 205 F.3d 615, 631 (3d Cir. 2000) (applying primarily objective test to ascertain time of discovery under fidelity bond).
language, the Third Circuit has honored the language of the provisions for which parties have contracted and has refused to read any unnecessary elements into the clearly written discovery standard.\textsuperscript{154}

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\footnote{154. See id. (stating that by examining facts available to insured through eyes of reasonable person, “we remain true to the plain language of the bond”).}