THE FINANCIAL INSTITUTION BOND:

ARE YOU COVERED WHEN AN EMPLOYEE BREAKS BAD?

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Seldom does a bank employee break bad and embezzle or commit similar fraud. But it happens, and the loss can be huge, especially when fraudulent lending is involved. That's why most bankers consider the Financial Institution Bond (FIB) or fidelity bond, formerly known as a bankers blanket bond, to be the single most important bank insurance policy. So do bank regulators.

Legal Requirements. Of course, since a bank must protect depositor funds, the law requires all banks to have appropriate insurance coverage for fidelity losses. Oklahoma banking law, 6 Okla. Stat. § 713(A), mandates that the directors of a bank or trust company

> *"… shall require good and sufficient fidelity bonds on all active officers and employees, … which bonds shall provide for indemnity to such bank or trust company on account of any losses sustained by it as the result of any dishonest, fraudulent or criminal conduct by them acting independently or in collusion or combination with any person or persons."*

A bank's board must annually determine the amount of a bank's fidelity bond coverage "after giving due and careful consideration to all known elements and factors constituting such risk or hazard," must record their action in the board minutes, and must promptly file with the Oklahoma Banking Department evidence that the bank has procured an appropriate fidelity bond. 6 Okla. Stat. § 713(B).

Bank Compliance. Compliance with Oklahoma law may seem like a straightforward and simple task, yet often it is not. FIBs are complex insurance policies. To the untrained eye the FIB may appear to provide much broader coverage than it actually does.

Many FIBs are written on a standard insurance industry form, the Standard Form 24 Financial Institution Bond. The Standard Form 24 FIB changes from time to time, usually in ways that attempt to narrow and restrict coverage for fidelity losses, most especially losses resulting directly or indirectly from fraudulent lending transactions. For example, many bankers are unaware that if a loss results from a fraudulent loan transaction — where fraud can take many different forms and may result in the complete loss of one or more large loans — the Standard Form 24 FIB imposes additional requirements for insurance coverage to apply. Specifically, in such cases the current Standard Form 24 FIB (revised to May, 2011) covers the loss only if the dishonest employee acted in "collusion" with a "one or more parties to the Loan transactions" and received "in connection therewith" an improper financial benefit (*e.g.*, a "kickback" of some sort, but excluding such things as the employee's salary, bonuses, or other normal employee benefits) of at least $2,500.

In addition, many insurers use their own proprietary versions of the Standard Form 24 FIB. These forms may include seemingly minor alterations in wording that, in practice, can significantly limit or eliminate coverage for potentially devastating employee dishonesty losses. For example, coverage may well turn on what the FIB provides regarding the employee's intent in relation to his or her dishonest or fraudulent act(s). Whether the FIB requires proof that the employee committed a dishonest or fraudulent act with an "intent" to cause loss to the bank, or with a "manifest intent" to cause loss, or with an "active and conscious purpose" to cause loss (which insurers usually equate

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to the most stringent standard of criminal intent, extremely difficult to prove in many instances involving fraudulent loan loss), can make all the difference as far as coverage is concerned. These are terms of art typically not defined in a FIB and normally left for a court to interpret and apply. And judicial interpretations are far from uniform, meaning that insurers often have room to dispute or deny a claim the bank believes is clearly covered, which may compel the bank to compromise its insurance recovery, litigate, or both.

Checklist for Annual FIB Review. A board's annual review of the bank's FIB should include more than a cursory review of stated limits of the FIB's coverage, and the premium. The least expensive FIB may leave the bank with a substantial coverage gap to be discovered only after a significant fidelity loss has occurred. Recommended steps in the annual review include:

- Evaluate changes in risk of employee dishonesty loss, such as growth in the bank's loan portfolio, growth in staff, staff turnover, changes in employee positions and duties, and any known internal control issues.
- Review the specific terms and conditions of the proposed FIB, as needed, to understand the risks of loss which are not or may not be covered.
- Seek advice from knowledgeable, independent professionals, as needed, to ensure that the coverage provided by the proposed FIB actually meets the bank's needs. In this regard, the bank should be sure it understands the role of any advising insurance agent or broker, including any limitations on the agent or broker's independence from the proposed FIB insurer(s).
- Request specific disclosures from the prospective insurer(s) regarding the intended meaning and impact of wording used in a proprietary form of FIB that differs from the Standard Form 24 FIB, and regarding any changes in terms and conditions of the bank's prior FIB.
- Request specific representations from the prospective insurer(s) as to whether the proposed FIB provides the breadth of fidelity coverage required by Oklahoma banking law.
- Consult with the Oklahoma Banking Department, if needed, to verify that the bank's FIB complies with banking law requirements, regardless of whether the Oklahoma Insurance Department has approved the prospective insurer's FIB form for use in Oklahoma.
- Carefully review the bank's FIB application to identify any unclear questions or answers, verify the accuracy of all answers, and verify that bank management has performed appropriate due diligence to support the bank's answers (e.g., has adequately determined that no director, officer or senior manager has become aware of any employee conduct that is or may be dishonest or fraudulent).
- Review and evaluate the bank's systems and methods for prompt detection of any dishonest or fraudulent conduct.
- If the board becomes aware of any employee conduct which is or may be dishonest or fraudulent, promptly consult an insurance professional about the possible need for investigation, corrective action, and/or reporting to the FIB insurer.

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Professional Resources. Some banks employ professionally-trained risk managers whose knowledge of FIBs and related law equips them to advise the bank's senior management and board regarding an annual review of FIB coverage. For banks without such a risk manager on staff, professional advice is readily available. For example, the bank may wish to consult with the OBA Insurance Agency, which represents several insurance carriers. In addition, GableGotwals offers its bank clients a complimentary annual review of FIB coverage. To arrange a GableGotwals review, contact your existing GableGotwals client partner, or David L. Bryant in our Tulsa office.


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GableGotwals is a full service law firm with offices in Oklahoma City and Tulsa. **David L. Bryant** is the senior shareholder leading the firm's professional liability insurance and related litigation practice. Mr. Bryant's experience includes numerous reviews, investigations, and litigation of FIB claims over more than 30 years. **Barbara M. Moschovidis** is the firm's senior associate in its professional liability insurance and related litigation practice.