

## FAQs on Crime Coverage

Successful companies have confidence in their employees. They also know the difference between trust and blind trust. Responsible risk managers – as they do for all perils – hope for the best and plan for the worst. In an effort to help you do just that, we offer answers to ten questions you may have on Crime coverage that we hope will be instructive and useful in planning your crime protection strategy.

**1. Question:** What is the difference between a Fidelity or Crime Bond and Fiduciary Liability insurance?

**Answer:** A Fidelity Bond protects the company against theft of its assets by its employees. A typical extension to the bond is the ERISA Rider (sometimes seen as a separate ERISA Fidelity Bond). This is mandatory under the Employee Retirement Income Security Act of 1974 (ERISA). Legally, anyone who handles plan assets must be covered by a Fidelity Bond providing coverage for theft of ERISA plan assets for a minimum amount of the lesser of 10 percent of plan assets or \$500,000.

A Fiduciary Liability policy, on the other hand, excludes theft and covers defense costs, settlements or court awards stemming from alleged breaches of fiduciary duty related to the company's pension and other employee benefit plans.

**2. Question:** Why do companies buy Crime coverage?

**Answer:** Crime policies protect balance sheets. Carrier loss experience shows that the severity of employee losses has increased significantly over the past five years. It is no longer unusual for carriers to pay seven-figure employee dishonesty claims. Even more unsettling is the fact that eight-figure theft losses, once considered a rarity, are now occurring with far greater frequency. The US Department of Commerce estimates that employee theft is responsible for nearly one-third of all business failures. Even for large companies, an

eight-figure loss would have a notable effect upon the corporation's income statement.

Many employee theft losses remain undetected for years. The Association of Fraud Examiners' 2004 Report to the Nation on Occupational Fraud and Abuse estimated that "the typical US organization loses up to six percent of its annual revenue to fraud. Applied to the US Gross Domestic Product for 2003, this translates to approximately \$660 billion annually." Losses that remain undetected for several years often translate into multimillion-dollar bond claims.

**3. Question:** What limits of coverage should we purchase?

**Answer:** In looking at exposure to theft, management tends to focus on inventory or petty cash exposures (hands-on exposures) and they may not fully appreciate their Fidelity exposure. Most large corporate thefts are much more sophisticated and result in millions of dollars of loss. Such losses are often caused by mid-level and senior-level employees and/or officers. Losses can include anything from the creation of bogus bank lines of credit to fraudulent fund transfers and vendor fraud schemes. When considering limits of liability associated with fraudulent behavior, all areas of an organization must be examined, from treasury to corporate banking to off-site field and plant locations. A peer group analysis or benchmarking study, while useful, does not account for an organization's unique exposures.

**4. Question:** Do all Crime Bonds have an aggregate limit of liability like D&O coverage?

**Answer:** For Commercial Crime policies, no. For Financial Institution Bonds, yes. Commercial Crime policies have an each-and-every-loss limit for each unrelated claim made under the policy.

**5. Question:** Do bonds automatically cover our subsidiaries? Globally?

**Answer:** No, the majority of bonds do not automatically cover an insured's subsidiaries and, with the exception of certain Financial Institution (FI) Bonds, they do not extend coverage globally. The omnibus, blanket wording commonly found in Directors & Officers (D&O), Fiduciary Liability and Employment Practices Liability insurance (EPLI) policies, even when purchased together, does not always apply to a bond. For organizations with foreign locations, territory provisions should be reviewed to assure they adequately cover all locations where the insured has a presence.

**6. Question:** Should we get a Fidelity Bond on our vendors?

**Answer:** Many companies will insist that vendors buy a Fidelity Bond and have the vendor name them as the loss payee. However, in cases where vendors are small companies or single individuals – for example, consultants or former employees – exclusions are likely to apply. Policies usually exclude crimes committed by the principles of the insured, which eliminates much of the coverage for small vendors. Another approach is to ask your own insurer to add coverage for the vendor. While there is no guarantee that underwriters will agree, given satisfactory internal controls, insurers may grant such an extension.

**7. Question:** What is the difference between a "loss-sustained" versus a "discovery" Crime policy?

**Answer:** For claims purposes, a loss-sustained policy applies the lesser of the terms and conditions of the current policy or the terms and conditions of the policy that was in effect when the actual loss occurred, or was sustained. As a result, if there was no coverage in force when the loss occurred, the current policy would not pay the claim. Similarly, if a prior policy provided less coverage than the current policy, the current carrier would only pay the lower amount.

On the other hand, a discovery-based contract applies the terms and conditions of the policy in effect when the loss is discovered, regardless of when the actual loss occurred and what coverage was in place at the time of loss. For organizations that have acquired smaller entities or that have recently increased limits, a discovery contract can be of significant benefit.

**8. Question:** Do we need to buy run-off (or an extended reporting period) on the bond for acquired entities?

**Answer:** No. Both FI Bonds and Commercial Crime policies provide "prior acts" coverage for acquisitions, so there is no need for a separate bond covering this time period. However, there are rare occasions when the acquiring company seeks to hold the seller responsible for pre-acquisition losses discovered post-acquisition. A seller can ask its current insurer to extend coverage for such Fidelity losses.

**9. Question:** Is identity theft or theft of confidential information generally covered by a Crime Bond?

**Answer:** No. The theft of confidential information, by itself, does not constitute a loss under a bond. If the stolen information is later used to perpetrate a fraud that causes loss, it is usually against a third party. In this case, insurers view this as an indirect or consequential loss which is excluded in Crime Bonds. To further reinforce this point, many insurers add a loss of trade secrets or confidential information exclusion.

**10. Question:** What are the most common Crime claims?

**Answer:** The variety of employee theft schemes reported by commercial organizations appears endless. Some of the more common scenarios include:

- a) Vendor Fraud – possibly the most widely used scheme. Employees submit invoices or vouchers for nonexistent goods or services.
- b) Inventory Theft – for warehoused high-end, readily marketable goods. Inventory losses are a frequent cause of loss.
- c) Fraudulent Credit Lines – where senior managers at the local plant level are given limited authority to open bank lines of credit. These can be used for fraudulent loans for the officers' personal gain.
- d) Ponzi Schemes – one of the most common fraud scenarios, often involving multiple thefts of client property. The scheme relies on a steady flow of cash that allows a dishonest employee to cover-up one theft by stealing another client's property. Robbing Peter to pay Paul can only last so long before the perpetrator is caught. As is the case with many crimes committed by employees against employers, however, discovery may occur after much damage has been done.

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