Adjusting to change:
Fidelity coverage situations on both sides of merger or acquisition transactions

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I. Introduction

The economic turmoil of the subprime meltdown and ensuing credit crisis five years ago served as a catalyst for several high-profile mergers, acquisitions, bankruptcies, and government takeovers in the financial sector. It is anticipated that merger and acquisition transactions and private equity buyouts across various sectors will increase in the next year. Such events often dramatically alter the insured risk underwritten by the fidelity insurers of the companies involved, and change the scope of coverage provided under their fidelity bonds.

To date, much of the case law and commentary addressing fidelity coverage issues in the context of takeovers focuses on actions by a receiver, liquidator, or state or federal official. With a focus on the financial sector, this article discusses key provisions in fidelity bonds pertinent to M&A transactions, including “change of control or ownership” and “termination” clauses, and how these provisions have been interpreted by the courts. In view of the increasing M&A activity and the impact of such transactions on the risks underwritten by fidelity insurers, this article will discuss coverage considerations raised under financial institution bonds when there is a change in control or ownership of an insured company or it is “taken over” by another corporation, private equity firm, or other business entity, and analyze case law addressing fidelity coverage issues in this context. In addition, this article identifies and discusses general underwriting issues that may arise in the context of M&A deals.


2 Hereinafter M&A.


Over the past three years, reported M&A activity involving North American firms has increased. Measured by transaction volume and deal value, U.S.-based companies reportedly were “the most important target” in 2012. Three of the top twenty deals by value in 2012 involved U.S. targets; two of the three companies were 100% acquired by U.S.-based firms while the third transaction involved acquisition of a twenty-three percent minority position. The volume of M&A deals targeting U.S. companies rose six percent, from 10,428 transactions in 2011 to 11,004 in 2012, although their value was nine percent lower in 2012 than in 2011. By volume and deal size, banks remain one of the most targeted sectors in the United States.

Further, global private equity activity remained robust, as volume and deal value increased for the third consecutive year. U.S. companies remained the top target for buyouts by private equity firms by volume and value, and both metrics increased nearly twenty-five percent from 2010 to 2012. In 2012, half of the top twenty private equity deals by value involved U.S.-based targets.

Commentators expect that M&A activity in North America will continue to grow in the short-term due to large cash reserves, favorable financing terms, improving debt and stock markets, and strengthened balance sheets across various sectors. Although North America is expected to remain the target region for M&A activity over the next year, corporations and private equity firms reportedly are looking at opportunities in Western Europe, China, and Brazil. It is anticipated that the largest increase in deal activity will be within the middle market (that is, deals valued at $250 million or less) in coming years.

In view of the increasing amount of M&A and buyout activity, fidelity insurers likely will see a growing number of claims by insureds involved in such transactions. Both underwriting and claims personnel will need to understand how such transactions impact the insured risk and the scope of coverage provided by fidelity bonds.
III. Bond provisions addressing M&A transactions

A. Change of Control or Change of Ownership – Notice

Fidelity bonds typically obligate the insured to notify the insurer of a change in control or ownership, and failure to do so may result in the loss of coverage that might otherwise have been available for losses involving a transferee of stock or other ownership interest. As discussed below, what constitutes a “change” in ownership or control sufficient to trigger the insured’s notice obligation varies depending on the circumstances and the bond’s particular wording.

While a planned “merger” of the insured into another entity likely would constitute a change of control or ownership, it is a closer question with respect to the acquisition of stock or other assets of the insured. Accordingly, even where the transaction does not rise to the level of “taking over” by another institution, an insured may be required to provide written notice of the transaction to its fidelity insurer in order to obtain coverage with respect to losses involving the transferee.

Failure to comply with the notice requirements of a change of control or ownership provision may result in termination of the bond with respect to loss involving a transferee. As discussed in Section IV below, insureds have been unsuccessful in arguing that the termination provision renders the “change of control” provision meaningless.

General Agreement C of the 1986 version of the standard form Financial Institution Bond (Form 24) provides:

**Change of Control – Notice**

When the Insured learns of a change in control, it shall give written notice to the Underwriter.

As used in this General Agreement, control means the power to determine the management or policy of a controlling holding company or the Insured by virtue of voting stock ownership. A change in ownership of voting stock which results in direct or indirect ownership by a stockholder or an affiliated group of stockholders of ten percent (10%) or more of such stock shall be presumed to result in a change of control for the purpose of the required notice.

Failure to give the required notice shall result in termination of coverage for any loss involving a transferee, to be effective upon the date of the stock transfer.

Pursuant to the “Change of Control” provision of the 1986 Financial Institution Bond, an insured is required to provide written notice to the insurer upon learning of a change in the power to determine management or policy of the insured or a controlling holding company, or by direct or indirect ownership by a stockholder or affiliated group of stockholders of ten percent or more of voting stock of the Insured. If the insured fails to provide the required notice, coverage will be terminated for any loss involving a transferee.

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17 See generally Am. Cas. Co. of Reading, Pa. v. Etowah Bank, 288 F.3d 1282, 1287-88 (11th Cir. 2002).

18 Id.; First Am. Nat’l Bank v. Fid. & Deposit Co. of Md., 5 F.3d 982, 985 (6th Cir. 1993) (“The purpose of the change of control section is to require notice to the insurer when ownership changes hands. The purpose of the termination clause, however, is to provide that coverage will automatically be terminated under certain circumstances, including takeovers. Each provision operates independently of the other even though a transaction may possibly constitute both a takeover and a change of control.”).

In 2004, Form 24 was amended to include a “Change of Ownership” provision in place of the “Change of Control” clause. The “Change of Ownership” provision in the current 2011 version of Form 24 provides:

**Change of Ownership – Notice**

When an Insured learns of a change in ownership by a single stockholder, partner or member, or by a group of affiliated stockholders, partners or members, of more than ten percent (10%) of its voting stock or total ownership interest, or of the voting stock or total ownership interest of a holding company or parent corporation which itself owns or controls the Insured, it shall give written notice to the Underwriter, as soon as practicable but not later than within thirty (30) days. Failure to give the required notice shall result in termination of coverage for any loss involving a transferee of such stock or ownership interest, effective upon the date of the stock transfer or transfer of ownership interest.

The “Change of Ownership” provision in the 2011 Financial Institution Bond includes several additional notification triggers, which provide possible grounds for termination of coverage with respect to the transferee if the insured does not comply. First, the amendment added single “partners or members” or a group of affiliated partners or members to single stockholders or an affiliated group of stockholders to the parties with ownership interest in voting stock. Second, the drafters slightly narrowed the change threshold from “ten percent (10%) or more” to “more than ten percent (10%)” ownership, but expanded the trigger for notice beyond changes in voting stock of the insured to include changes in “total ownership interest” of the insured, as well as “the voting stock or total ownership interest of a holding company or parent corporation which itself owns or controls the Insured.” Third, the revisions include an express time period within which to provide written notice of a change in ownership (within thirty days of learning of the change in ownership) or face termination of coverage with respect to loss involving the party taking a qualifying ownership interest.

Insureds and insurers have further amended the standard form “Change of Control” or “Change of Ownership” provisions in manuscript policies to include additional provisions requiring insureds, among other things, to identify: (i) the transferors and transferees; (ii) the amount of their ownership before and after the transfer; and (iii) the total amount of voting stock outstanding. Such information may provide insight into the motivations and intentions surrounding the transfer of stock, and possibly signal whether a “taking over”, hostile or otherwise, is on the horizon. Insurers also have agreed to increase the percentage of voting stock to twenty percent or more to trigger change of control or ownership provisions.

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B. Additional Offices or Employees – Consolidation, Merger or Purchase of Assets – Notice

Another important provision for insurers to consider with respect to M&A activity and similar transactions is the “Additional Offices or Employees – Consolidation, Merger or Purchase of Assets” clause. Such a clause addresses coverage for additional offices, branches, plans, or other assets purchased or formed by the insured or obtained by the insured by consolidation, merger, or purchase from another entity.

General Agreement B of the 1986 Financial Institution Bond provides:

Additional Offices or Employees – Consolidation Merger or Purchase of Assets – Notice

If the Insured shall, while this bond is in force, establish any additional offices, other than by consolidation or merger with, or purchase or acquisition of assets or liabilities of, another institution, such offices shall be automatically covered hereunder from the date of such establishment without the requirement of notice to the Underwriter or the payment of additional premium for the remainder of the premium period.

If the Insured shall, while this bond is in force, consolidate or merge with, or purchase or acquire assets or liabilities of, another institution, the Insured shall not have such coverage as is afforded under this bond for loss which:

a) has occurred or will occur in offices or premises, or
b) has been caused or will be caused by an employee or employees of such institution, or
c) has arisen or will arise out of the assets or liabilities acquired by the Insured as a result of such consolidation, merger or purchase or acquisition of assets or liabilities unless the Insured shall:

i. give the Underwriter written notice of the proposed consolidation, merger or purchase or acquisition of assets or liabilities prior to the proposed effective date of such action and

ii. obtain the written consent of the Underwriter to extend the coverage provided by this bond to such additional offices or premises, Employees and other exposures, and

iii. upon obtaining such consent, pay to the Underwriter an additional premium.

Pursuant to the “Additional Offices or Employees” provision, coverage automatically extends to new offices unless that office is established by the insured’s consolidation, merger, or acquisition, or the purchase of assets or liabilities of another institution. Where, however, an insured establishes an office by consolidation, merger, or acquisition, or the purchase of the assets or liabilities of another institution, coverage will be extended only to loss occurring in the new office or premises caused by an employee of the other institution, or arising out of the assets or liability acquired if the insured submits written notice to the insurer before the effective date of the transaction, obtains written consent from the insurer, and pays an additional premium. Such provisions also may be limited to transactions of a specified size or amount.

C. The Termination Provision

Termination provisions of fidelity bonds typically provide that coverage terminates upon the “taking over” of the insured and are therefore important provisions to consider when an insured is involved in an M&A transaction.

Standard form Financial Institution Bonds provide coverage for losses discovered during the bond period, irrespective of whether the loss was sustained prior to the bond period. Termination provisions, however,
eliminate the insurer’s liability for loss sustained by the insured that is discovered after the effective date of such termination. In addition to exhaustion of the limits and expiration of the bond period, events that may trigger termination of the bond include: (i) written notice by the insurer of its desire to cancel; (ii) written notice by the insured of its desire to cancel; (iii) takeover of the insured by a receiver or other liquidator; and (iv) takeover of the insured by another institution.

The “Termination or Cancellation” provision of the 1986 Financial Institution Bond provides:

This bond terminates as an entirety upon occurrence of any of the following: (a) 60 days after the receipt by the Insured of a written notice from the Underwriters of its desire to cancel this bond, or (b) immediately upon the receipt by the Underwriter of a written notice from the Insured of its desire to cancel the bond, or (c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials, or (d) immediately upon the taking over of the Insured by another institution, or (e) immediately upon the exhaustion of the Aggregate Limit of Liability, or (f) immediately upon expiration of the Bond Period as set forth in Item 2 of the Declarations.

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.

Following the Eleventh Circuit’s 2002 decision in American Casualty Co. of Reading, Pennsylvania v. Etowah Bank, which is discussed below and which addressed the phrase “taking over” in the context of a stock acquisition, the “termination” provision of the standard Financial Institution Bond was amended to clarify what qualifies as “change in control” sufficient to terminate fidelity coverage in a non-regulatory takeover situation. Specifically, the “Termination or Cancellation” provision of the 2004 Financial Institution Bond provides as follows:

This bond terminates as an entirety upon occurrence of any of the following:

a) 60 days after the receipt by the Insured of a Written notice from the Underwriter of its desire to cancel this bond;

b) immediately upon the receipt by the Underwriter of a Written notice from the Insured of its desire to cancel this bond;

c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials;

d) immediately upon a Change in Control of the first named Insured;

e) immediately upon exhaustion of the Aggregate Limit of Liability; or

f) immediately upon expiration of the Bond Period as set forth in Item 2 of the Declarations.

If there is a Change in Control of an Insured other than the first named Insured, this bond immediately terminates as to that Insured only.

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

“Change in control” is defined in the 2004 Financial Institution Bond as “a change in ownership of more than fifty percent (50%) of the voting stock or ownership interest of the Insured, or of a parent corporation or holding company which controls the Insured.”

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24 See, e.g., id. § 12 (“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.”); 2004 Financial Institution Bond, section 14 (same).


27 288 F.3d 1282 (11th Cir. 2002).

IV. Case Law applying “Change of Control” and other “Termination” provisions to takeovers by other institutions

To date, few courts have directly addressed coverage issues under a fidelity bond arising from a “taking over” of the insured by another institution or business entity, although this may soon change in light of increasing M&A activity. Decisions considering a “taking over” of an insured by a corporation or private equity firm and analyzing changes made to the termination clause are discussed below.

With respect to changes in control and takeovers of an insured by a receiver, liquidator, or another institution, courts have recognized that such transactions may dramatically change the insured risk and other important considerations underlying and attendant to the need for automatic termination. These considerations also apply in the context of takeovers of an insured by another company. First, a takeover or receivership of an insured substantially alters the character of the risk covered by the fidelity bond. Second, while voluntary terminations by the insured or the insurers are within the control of the parties to the contract, termination by receivership or takeover occurs as a result of “a specified exogenous event that has nothing to do with the relationship between the insurer and the insured.” Third, in the case of a receivership or takeover, the insurer may never receive notice of the event and would not have reason to notify a regulator or acquiring party that it is terminating coverage. Therefore, the insurer “may inadvertently find itself insuring a risk substantially different from that originally contemplated.”

In the context of termination by virtue of a takeover, most commentators and cases have focused on situations where the insured entity is “taken over” by a receiver or liquidator. Cases addressing fidelity coverage following such takeovers, for the most part, have enforced the bond provisions and rejected attempts by receivers and liquidators to avoid automatic termination of a fidelity bond based on (i) ambiguity; (ii) public policy; (iii) the insurer’s failure to comply with notice provisions related to termination or cancelation; (iv) equitable tolling; and (v) lack of a “taking over” by the receiver or liquidator.

31 Id.
32 Id.
33 Id.
34 See generally the sources cited in note 3, supra.
36 See, e.g., Cal. Union, 948 F.2d at 562; Fed. Deposit Ins. Corp. v. Aetna Cas. & Sur. Co., 903 F.2d 1073, 1079 (6th Cir. 1990); Mut. Sec. Life Ins. Co. v. Fid. & Deposit Co. of Md., 659 N.E.2d 1096, 1099-1101 (Ind. Ct. App. 1995) (“If such provisions were deemed void, it would alter the risk analysis and the calculation of reserves. A judicial expansion of the scope of coverage would also deprive companies of the bargained-for allocation of risk as reflected in the premium.”).
39 See, e.g., U.S. Fire, 981 F.2d at 852; Cal. Union, 948 F.2d at 561.
Courts that have examined non-regulatory takeovers focus on the particular circumstances surrounding the transaction to determine whether the insured had been “taken over” by another firm, thereby terminating fidelity bond coverage. With one exception, courts have found the term “taking over” to be unambiguous. Courts have viewed the provision, however, as exclusionary and therefore placed the burden on the insurer to show that it applied.

As “taking over” is not defined in the standard form bond, courts have looked to the ordinary and usual meaning of the phrase. Common and legal definitions of “takeover” upon which courts have relied include “acquisition or gaining control of a company through the purchase or exchange of stock”, “the act of seizing, appropriating, and arrogating authority, control, management, etc., “to assume control or possession of”, or to “succeed to the management of”.

In National Union Fire Insurance Co. of Pittsburgh, Pennsylvania v. Young, the Mississippi Supreme Court addressed the issue under a savings and loan blanket bond, which terminated by its terms “immediately upon the taking over of the Insured by another institution.” The court found that a corporate takeover of the insured bank had occurred where all of its assets were transferred to another corporation, and held that the transaction terminated coverage within the meaning of the bond.

More recent decisions from the Sixth and Eleventh Circuits have addressed the issue of termination in the context of stock transactions. In First American National Bank v. Fidelity & Deposit Co. of Maryland, the Sixth Circuit evaluated arguments that the “takeover” language in a termination clause nullified the change of control clause within the fidelity bond. The court considered whether coverage under a fidelity bond automatically terminated following the purchase of 80% of the insolvent insured’s voting stock at a public foreclosure sale. Following the purchase, the board of the insured bank approved an agreement to merge with the purchasing bank. Prior to the effective date of the merger, the insured bank discovered a loan loss and provided notice of the loss to its fidelity insurer. The insurer denied coverage, and litigation ensued.

The district court for the Western District of Tennessee ruled in favor of the insurer. On appeal, the successor of the insured bank argued that the district court’s interpretation of the termination provision would render the change in control provision in the same bond meaningless. In affirming the lower court’s judgment for the insurer, the appellate court concluded that the clauses are “distinguishable in purpose and applicability.” The Sixth Circuit further determined that the phrase “taking over” is unambiguous, and based on the plain and ordinary meaning of the


41 Etowah Bank, 288 F.3d at 1285-86; First Am. Nat'l Bank, 5 F.3d at 985, but see Kelly Assocs., 681 S.W.2d at 596.

42 First Am. Nat'l Bank, 5 F.3d at 984 (analyzing “whether the claim fell within the takeover exclusion described in the policies’ termination clauses” and noting that “[t]he burden of establishing that a loss results from a cause falling within a policy exclusion is on the insurer”), see also Kelly Assocs., 681 S.W.2d at 596.

43 See Etowah Bank, 288 F.3d at 1282; First Am. Nat'l Bank, 5 F.3d at 982; Kelly Assocs., 681 S.W.2d at 595.


45 199 So.2d 70 (Miss. 1967).

46 Id. at 71.

47 Id. at 73.

48 5 F.3d 982 (6th Cir. 1993) (applying Tennessee law).

49 Id. at 984-85.

50 Id. at 985.

51 Id.

52 Id.
phrase, "a takeover occurred when [the acquiring bank] assumed management control over the insured bank."\(^\text{53}\)

For purposes of coverage under the bond, a takeover occurred on the date the acquiring bank announced its management plans for the insured bank and the board of the insured bank approved the merger plan.\(^\text{54}\)

In *Etowah Bank*,\(^\text{55}\) the Eleventh Circuit examined what constitutes a "taking over of any Insured by another institution" in the context of a termination provision of a fidelity bond. Another entity acquired all of the insured’s outstanding stock, but the insured, among other things, continued to operate under the same bylaws, maintained separate financial records, and did not transfer significant assets.\(^\text{56}\) The insurer initiated a suit seeking a declaration that the bond terminated upon the stock purchase, and that, therefore, it had no obligation to cover loss discovered after the purchase.

Applying Georgia law, the Eleventh Circuit reversed the District Court for the Northern District of Georgia, holding that the lower court incorrectly concluded that the termination clause was limited to a takeover of a failing insured by another company at the direction of a regulator, or was sufficiently ambiguous to permit such an interpretation.\(^\text{57}\) The appellate court rejected the arguments made by the insured’s successor based on the "core function" line of cases in the Fifth Circuit and held that the doctrine was inapplicable to the circumstances at issue.\(^\text{58}\) The "core functions" test arises from and has been applied to situations involving takeovers of a failing institution by receivers, liquidators, or other agencies in order to determine what circumstances, other than acquisition of a controlling amount of the stock of an insured institution, constitute a takeover.\(^\text{59}\) The court described the "core functions" test as a way to "enable[] a court to determine whether in fact that kind of takeover has occurred by looking to changes in who is in control of the core functions of the insured."\(^\text{60}\)

Unlike regulatory takeovers of failed institutions, "when an institution acquires a controlling amount of stock in another, it obtains control of the other regardless of whether, how, or through whom it decides to exercise that control."\(^\text{61}\)

As an alternative argument, the insured’s successor asserted that the “change in control” provision would be rendered superfluous if “taking over” was not construed in conformance with the “core functions” line of cases. Relying on the rationale employed by the Sixth Circuit in *First American*, the Eleventh Circuit rejected this argument as well.\(^\text{62}\) The court characterized the “change in control” clause as a notice provision, reasoning that its purpose is to alert the insurer to changes in ownership of its insured.\(^\text{63}\)

The Eleventh Circuit succinctly summarized the difference and potential overlap between the "termination" and "change in control" provisions in fidelity bonds: "While every 'taking over' which terminates the bond will involve a change in control, not every change in control which requires that notice be given will involve a takeover."\(^\text{64}\)

In the one reported decision on this issue in favor of the insured, *Kelly Associates, Ltd. v. Aetna Cas. & Sur. Co.*,\(^\text{65}\) the Texas Supreme Court held that an insured partnership had not been taken over by another business entity where it “was not subject to the direction and control

\(^{53}\) Id. at 985-86.

\(^{54}\) Id. at 986.

\(^{55}\) 288 F.3d 1282.

\(^{56}\) Id.

\(^{57}\) Id. at 1286.

\(^{58}\) Id. at 1286-87 (citing U.S. Fire, 981 F.2d 850); Sharp, 858 F.2d 1042; First Nat’l Life Ins. Co. v. Fid. & Deposit Co. of Md., 525 F.2d 966 (5th Cir. 1976).

\(^{59}\) *Etowah Bank*, 288 F.3d at 1287.

\(^{60}\) Id.

\(^{61}\) Id.

\(^{62}\) Id. at 1287-88.

\(^{63}\) Id. at 1287.

\(^{64}\) Id. at 1287-88.

\(^{65}\) 681 S.W.2d 593 (Tex. 1984).
of [the acquiring firm] in all respects and, in particular, was not subject to [the acquiring firm’s] control as to the winding-up phase of its business.\(^6\)

In *Kelly Associates*, the insured partnership executed agreements during the bond period that transferred “a good part of the assets and business” of the insured to another firm but provided for the insured partnership to remain in existence to wind up certain obligations.\(^6\) After execution of the agreements but prior to termination of the partnership, the insured discovered that a former employee had misappropriated funds, and asserted a claim with its fidelity insurer.\(^6\) The insurer denied the claim based on the termination provision in the bond, which provided that the bond “shall be deemed terminated or cancelled as an entirety . . . immediately upon the taking over of the Insured by another business entity.”\(^6\)

The insured argued that, in the context of a partnership structure, a “takeover” does not occur until “the partnership is completely terminated, its partners disbanded, and its business wound up and transferred to another entity.”\(^6\) The insurer disputed this view and argued that the sale of the business was a “takeover” for coverage purposes.\(^6\) Finding the term susceptible to more than one reasonable construction, the court applied the insured’s construction.\(^6\)

In considering whether the insured had been taken over prior to the discovery of the misappropriation, the Texas Supreme Court analyzed the specific terms of the sale transaction.\(^7\) Ultimately, the court concluded that the bond “extend[ed] coverage through the winding-up phase of the limited partnership.”\(^7\) In reaching its decision, the court drew a distinction between takeovers of corporations and partnerships.\(^7\) Although the insured’s business effectively had been transferred to another entity, “the partnership continue[d] its existence for the purpose of winding up its affairs” and “[t]hese function remain[ed] under the sole management of the partners and ha[d] not been taken over by [the acquiring firm].”\(^7\)

Three dissenting judges in *Kelly*, however, determined that the termination provision “became effective upon the taking over of the insured, not upon its termination” and would have affirmed the lower court finding that “as a matter of law the sale . . . constituted a taking over.”\(^7\) The dissent found persuasive the fact that the direction and control of the insured’s business had been transferred pursuant to the sale transaction.\(^7\)

While there is limited authority addressing the “change of control” and “termination” provisions of fidelity bonds, most courts that have analyzed these provisions have found them to be unambiguous and enforced them pursuant to their clear terms. Whether the notice requirement of the “change of control” provision is triggered or coverage is terminated upon a change of control or takeover will depend on the particular facts of each case.

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66 Id. at 595.
67 Id. at 594-95.
68 Id. at 594.
69 Id.
70 Id. at 596.
71 Id.
72 Id.
73 Id. at 595.
74 Id. at 597.
75 Id. at 595-96 (“Since the right to participate in management is one of the property rights inherent in the general partners, a takeover in the corporate sense, by acquisition of a controlling number of voting shares, is not possible in a partnership.”).
76 Id. at 597.
77 Id. at 598.
78 Id. at 597-98 (stating that “[i]n this case, the entirety of the partnership’s business has been transferred to another business entity, in a transaction which simultaneously placed the managing partners under the control of that entity and prevented the original partnership from continuing existence for any other purpose than to wind up its affairs and terminate.”).
Another issue for fidelity insurers to consider with respect to M&A or other takeover transactions is the impact of statutory or regulatory notice requirements upon an insurer’s attempt to cancel or terminate a fidelity bond.

In some jurisdictions, termination of coverage may not be effective where the insured’s regulators were not notified of the cancellation or termination of the fidelity bond. Insureds have argued that state laws requiring that written notice be supplied to regulators before a termination becomes effective override and/or modify the bond language. At least one court has held that the burden to notify the appropriate party under the statute falls to the insurer where the insured fails to provide the required notice.

In Paradis v. Aetna Casualty & Surety Co., the insurer issued a cancellation notice to the insured loan and investment company pursuant to the terms of a “Small Loan Companies Blanket Bond”, which provided that the bond “shall be deemed canceled as an entirety . . . thirty days after the receipt by the Insured of a written notice from the Underwriter of its desire to cancel this bond.” A Rhode Island statute provided, in relevant part, that the insured shall maintain fidelity coverage and that “termination shall not become effective until thirty (30) days after the director of business regulation [i.e., the Rhode Island Department of Business Regulation] has received notice thereof.” It was undisputed that neither the insured nor the insurer advised the DBR of the cancellation.

Faced with the question of whether the bond validly terminated pursuant to its terms following the insurer’s cancellation, the court held that coverage remained in effect because the DBR had not received notice of the cancellation as required by the statute. In reaching its decision, the court rejected the insurer’s argument that the legislative intent was to place an obligation on the insured, but not the insurer, to keep the DBR apprised, and any failure by an insured to notify the DBR of termination of coverage should not be imputed to its insurer. The court found that “this is not a question of negligence but simply one of statutory interpretation.” The court held that the bond remained effective until the DBR was appointed receiver of the insured (more than two years after the cancellation notice was issued), citing the automatic termination provision of the bond canceling coverage “immediately upon the taking over of the Insured by a receiver.” Although not clear from the decision, it would appear that the insurer returned any unearned premium due to the insured, but would not have received additional premium following its notice of cancellation of the bond.

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79 See generally Newhard, Cook & Co. v. Ins. Co. of N. Am., 929 F.2d 1355, 1358-59 (8th Cir. 1991) (applying Missouri law) (holding that the special rider required by Missouri law did not require that the regulator be notified to effect termination of the bankers blanket bond as to an individual employee, but the notice obligation would apply to termination of the bond in its entirety); First Nat’l Bank in Manitowoc v. Cincinnati Ins. Co., 321 F. Supp. 2d 988, 991 (E.D. Wis. 2004); Paradis, 796 F. Supp. at 61.
81 Id. at 796 F. Supp. at 61-62.
82 Id.
83 Id. at 60.
84 Id. at 61 (quoting R.I. GEN. LAWS § 19-5-23 (repealed 1995)); hereinafter DBR.
85 Id. at 60.
86 Id. at 61-62.
87 Id. at 61.
88 Id. at 61-62.
89 Id. at 62.
Courts also have considered whether endorsements imposing similar notice obligations on an insurer may impact the effectiveness of termination. In \textit{First National Bank in Manitowoc v. Cincinnati Insurance Co.}, despite an endorsement to the fidelity bond issued to an insured bank requiring the insurer to provide notice to state banking commissioners in the event of termination or cancellation of coverage, the District Court for the Eastern District of Wisconsin held that the endorsement was inapplicable where the insured bank was federallychartered. In effect, the court determined that the endorsement to the bond was superfluous to coverage.

In \textit{First National Bank}, the insured sought to recover loss that it discovered shortly after it cancelled the financial institution bond. Not surprisingly, the insurer denied the claim on the ground that the loss was discovered after cancellation of the bond. Relying on an endorsement to the bond requiring that notice be given to the state bank regulators upon cancellation or termination of the bond, the insured argued that the bond was not effectively cancelled because the insurer failed to send notice of the cancellation to the state official within the time period specified.

The court rejected the insured’s argument and granted summary judgment in favor of the insurer, holding that neither the Wisconsin statutes nor the endorsement requiring notice to the state commissioners applied to the insured federal bank. In reaching this conclusion, the court noted that, as a federally chartered bank, the insured was subject to federal regulations regarding fidelity coverage for national banks. As a result, the insurer’s failure to notify state banking officials, as required by the endorsement, did not impact cancellation of coverage.

\begin{itemize}
  \item[90] Id. at 61; \textit{Newhard, Cook & Co.}, 929 F.2d at 1358 (8th Cir. 1991); \textit{First Nat’l Bank}, 321 F. Supp. 2d at 990.
  \item[91] 321 F. Supp. 2d 988 (E.D. Wis. 2004).
  \item[92] Id. at 991.
  \item[93] Id. at 989-90.
  \item[94] Id. at 990.
  \item[95] Id. at 991 (noting that the endorsement at issue appears to be an effort to comply with certain Wisconsin statutes (i.e., \textit{Wis. STAT. § 224.06, et. seq.}) regulating insurance for state chartered financial institutions.).
  \item[96] Id.
  \item[97] Id.
\end{itemize}
VI. The surviving entity

Once an acquired entity's bond terminates, the acquiring firm's fidelity insurer typically would be called upon to provide coverage for the new entity, assuming that the acquiring firm provided notice to its insurers as required by the “Change of Control or Ownership” and “Additional Offices or Employees” provisions of its bond. Alternatively, the acquirer may purchase new but separate coverage for the acquired firm. In either event, underwriters will need to carefully consider the impact of the transaction on the insured risk and take measures to protect against covering risks and losses prior to the transaction.

A. Underwriting the Extension of Coverage for the Surviving Entity

As discussed above, the taking over or change of control or ownership of an insured substantially alters the character of the risk covered by a fidelity bond. Courts have recognized that an entity winding-up its business remains “as susceptible to employee misappropriation as it was at any other time.” Accordingly, an underwriter considering whether to extend fidelity coverage to the acquired firm and, if so, what additional premium it should charge, must carefully consider the transaction and the new entity or the asset(s) being acquired or merged with the insured.

Among other things, an underwriter considering an extension of coverage or issuance of a new bond following a change of ownership or control or a takeover should carefully consider the impact on the insured’s business, including the following:

- The management team, business model, and structure of the acquired entity;
- The scope of the acquired firm’s business, including its activities in new and potentially higher risk markets, including emerging markets;
- Prior claims history of the acquired entity;
- Any evidence or knowledge of prior dishonesty by any employees of the acquired entity;
- State of internal controls and security procedures of the acquired entity, and their compatibility with the insured’s internal compliance and risk management systems; and
- Current or future regulatory considerations regarding the acquired entity.

As to the surviving entity, the underwriter should seek insight into:

- Strategic plans for the surviving entity, including its entry into new types of business and new markets;
- Actual or potential integration issues (e.g., accounting, compliance, and risk management systems);
- Anticipated changes to regulatory oversight; and
- Changes in management structure.

B. Retroactive Date Riders

In addition to thorough underwriting, an insurer may further protect itself from unknown risks resulting from a merger, acquisition, or purchase of assets by including a retroactive date rider into the existing or new fidelity bond. Such provisions limit coverage prospectively to acts and events occurring at the acquired firm after the merger or acquisition date. Losses stemming from any dishonest or fraudulent activities prior to that date would be excluded.

99 Kelly Assocs., 681 S.W.2d at 596.
In *ABCO Premium Finance LLC v. American International Group, Inc.* the District Court for the Southern District of Florida analyzed a retroactive date rider in connection with a purchase agreement that transferred ownership of the insured to another institution.

The bond at issue included a retroactive date rider that read as follows:

This bond/policy applies only to a Single Loss, as defined in section 4, which was sustained in its entirety after the Retroactive Date set forth above. All acts or omissions causing or contributing to such Single Loss . . . must occur after the Retroactive Date for coverage under this bond/policy to apply. Such Single Loss must be discovered by the Insured during the Bond/Policy period.

“Single Loss” was defined as:

All covered loss, including court costs and attorneys’ fees . . . resulting from:

a) any one act or series of related acts of burglary, robbery or attempted threat, in which no Employee is implicated, or

b) any one act or series of related unintentional or negligent acts or omissions on the part of any person (whether an Employee or not) resulting in damage to or destruction or misplacement of Property, or

c) all acts or omissions other than those specified in (a) or (b) preceding, caused by any person (whether an Employee or not) or in which such person is implicated . . .

The retroactive date and inception date of the bond were both April 24, 2009. During the bond period, the insured discovered that it had been the victim of a fraudulent scheme perpetrated by one of its producing agents, which commenced more than two years prior to inception of the bond at issue. The insurer denied the claim based on the retroactive date rider.

Although the parties agreed that the retroactive date rider expressly precluded coverage for dishonest acts occurring prior to April 24, 2009, they disagreed on the appropriate construction of the term “Single Loss” used in the provision. The insurer argued that, as the fraudulent scheme was a “Single Loss” that began prior to the retroactive date, the loss was not sustained in its entirety after the retroactive date. The insured sought coverage only for that portion of the loss occurring after the retroactive date, and argued that the loss it sustained after the retroactive date constituted a “Single Loss” because the definition of the term includes “all covered loss.” The insured reasoned that if the fraud was considered a “covered loss,” then losses it incurred after the retroactive date would be covered.

The court in *ABCO Premium* agreed with the insurer and granted summary judgment in its favor, holding that the retroactive date rider was “clear and unambiguous that the bond only covered fraudulent schemes that began entirely after the retroactive date.” Applying the facts to the retroactive date provision, the court determined that coverage was precluded for all of the loss caused by the fraud scheme, which began prior to the retroactive date.

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101 2012 WL 3278628.

102 Id. at *11.

103 Id. On appeal, the insured argued that “no case exists that discusses or addresses a retroactive date rider that contains the term ‘Single Loss.’” Brief for Appellee at 14, *ABCO Premium Fin., LLC v. Am. Int’l Grp., Inc.*, 2013 WL 1442517 (11th Cir. Apr. 9, 2013).

104 *ABCO Premium*, 2012 WL 3278628, at *11.

105 Id (noting that the insured amended its claim for losses sustained both before and after the retroactive date to include only claims for losses incurred after the retroactive date).

106 Id. at *11.

107 Id. at *12.

108 Id.
In reaching this decision, the court looked to decisions addressing similar provisions in claims-made liability policies and recognized that "[t]he purpose of specifying a retroactive date in an insurance policy is to limit coverage to occurrences after a certain date."109 The court concluded that the insured’s interpretation of the provision failed to consider that the retroactive date rider precluded coverage for “Single Loss” that was not “sustained in its entirety after the retroactive date.”110 The insured’s argument was further undercut by the fact that it amended its claim seeking coverage for losses sustained both before and after the retroactive date to include only claims for losses incurred after the retroactive date.111

As to the insured’s claim for coverage of only those losses it sustained after the retroactive date, the court declined to “divide the fraud” in view of the language in the retroactive date rider that “[a]ll acts or omissions causing or contributing to such Single Loss . . . must occur after the Retroactive Date for coverage under this bond/policy to apply.”112 Relying on the perpetrator’s affidavit, which stated that he engaged in the same scheme prior to and after the retroactive date, the court concluded that “the fraud was indisputably one continuous act,” and that the claim for coverage was barred by the retroactive date rider.113

Insurers seeking to limit their exposure to unknown risks following a merger, acquisition, or the purchase of assets by the insured should consider including a retroactive date provision like that discussed above, stating that coverage is only available for a “Single Loss” sustained in its entirety after the retroactive date and that all acts or omissions causing or contributing to a “Single Loss” must occur after the retroactive date.

C. Coverage Under the Surviving Institution’s Bond

Where Company A is merged into or acquired by Company B, the fidelity bond of Company B generally will respond to any loss sustained at Company A prior to the merger or acquisition provided that the loss was first discovered after the merger or acquisition.

In Fidelity Savings and Loan Association v. Republic Insurance Co.,114 the surviving savings and loan association filed a coverage action against its insurer and the insurer of another savings and loan association with which it merged. The surviving entity sought coverage under standard form savings and loan blanket bonds for loss incurred subsequent to the merger resulting from fraudulent acts committed by employees of the merged entity prior to the merger.

At the time of the merger, litigation involving the fraudulent conduct of the employees had been pending. As a result of the merger, the surviving association acquired the liability associated with the litigation and assumed the defense of the litigation.115 In the coverage action, the surviving entity sought coverage for the costs it incurred in the underlying litigation.

The District Court for the Northern District of California dismissed the claims against the surviving entity’s insurer, and the insured appealed. The Ninth Circuit considered whether the defense costs incurred in the lawsuit filed against the acquired entity prior to the merger could constitute a covered loss under a bond issued to the surviving entity.116 In affirming the lower court’s decision, the Ninth Circuit adopted the insurer’s position that coverage was not available because the underlying “losses” were incurred by the non-insured merged association prior to the merger.117 The court held that “the ‘loss’ occurred at the time of

109 Id.
110 Id. at *11 (emphasis added).
111 Id.
112 Id. at *12.
113 Id.
114 513 F.2d 954 (9th Cir. 1975).
115 Id. at 954.
116 Id. at 955-56. The appeal does not involve the merged entity’s insurer at the time of the events giving rise to the underlying litigation.
117 Id. at 956.
the activity giving rise to the claim against the insured and not at the time of trial proceedings or entrance of judgment.”

The Ninth Circuit expressly rejected the insured’s position that it sustained a “loss” by virtue of its assumption of the liabilities of the merged entity at the time of the merger, including the underlying litigation. In this regard, the court found inconsistent the insured’s argument that acts leading to claims solely against the merged entity could give rise to a covered loss to the merged entity prior to the merger and to the surviving entity upon effectiveness of the merger. Further, the court concluded that it is “an unwarranted leap of logic to conclude that the acquisition of . . . abilities amounted to a new ‘loss’ in the hands of [the surviving entity].”

In Bei Sensors & Systems Co. v. Great American Insurance Co., the District Court for the Northern District of California again considered whether losses sustained before the acquired entity became a subsidiary of the named insured would fall within the surviving entity’s fidelity coverage. Unlike Republic Insurance, however, the loss was not discovered until after completion of the acquisition.

Following the acquisition, it was discovered that certain employees of the acquired entity had engaged in theft of gold prior to and subsequent to the acquisition. At the time of discovery, the acquired entity was an insured under the bond of the acquiring firm, and made a claim under that bond for the entire loss it sustained as a result of the theft. The insurer moved for summary judgment as to its obligation to cover losses sustained before the acquired entity became a subsidiary of the named insured. In support of this position, the insurer argued that the acquired entity was not an insured under the bond prior to the acquisition and, thus, could not have sustained a covered loss as a result of the theft.

The court rejected the insurer’s construction of the policy, finding that it was “inconsistent with the plain and unambiguous language of the Policy”, which provided coverage for losses resulting directly from acts or events occurring “at any time and discovered . . . during the Policy Period.” Further, the bond did “not require that [the insured] incurred the losses while it [was] a named insured; rather it only require[d] that the losses be discovered while it [was] a named insured.”

Unlike the situation in Republic Insurance, the named insured had acquired the subsidiary impacted by the theft several years prior to both discovery of the loss and issuance of the policy. The court noted that:

[e]xtending coverage in [Republic Insurance] would have held [the insurer] liable for losses of an entity that was not part of the insured at the time the policy was issued. It would also have extended coverage for a loss that the insured was aware of before it acquired the other company.

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117 Id. at 956.
118 Id.
119 Id.
120 Id.
121 Id.
123 Id. at *7.
124 Id. at *8.
125 Id. (emphasis in original).
126 Id. at *9.
VII. Conclusion

Following the extraordinary economic events of the last five years, which resulted in widespread consolidation, bankruptcies, and government takeovers in the financial sector, observers predict that M&A activity within the sector will continue to increase. As private equity and other financial institutions are expected to seek opportunities to merge or acquire assets within this segment of the market, fidelity insurers should remain vigilant about the character of the risk insured following such deals. In particular, insurers must understand the impact of the transaction, particularly whether it has sufficiently altered the control, management, and business of the insured firm.

As discussed above, the various revisions of the standard form Financial Institution Bond contain several mechanisms to limit or terminate coverage in the event of a change of control or ownership or a takeover. Fidelity insurers should remain mindful, however, that statutes or regulations governing their insureds may require prior notice to certain regulators before termination of coverage becomes effective. In addition to standard form provisions, fidelity underwriters should consider inclusion of a retroactive date rider precluding coverage for losses stemming from any dishonest or fraudulent activities prior to the retroactive date.

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