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AUTHOR Kahn, Steven P.
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ABSTRACT

Fidelity bonds are important for an agency to hold to protect itself against any financial loss that can result from dishonest acts by its employees. Three types of fidelity bonds are available to an agency: (1) public official bonds; (2) dishonesty bonds; and (3) faithful performance bonds. Public official bonds are required by state law to be held by certain public officials, such as the city treasurer. Dishonesty bonds offer the public entity protection from loss in the case of any fraudulent or dishonest act by an employee. Faithful performance bonds ensure the agency against an employee's failure to faithfully perform his or her duties. Dishonesty and faithful performance bonds usually have four conditions attached to the policies: discovery period; duties in the event of a loss; subrogation; and cancellation. Historically public official bonds did not have any exclusions; however, recently public official bonds may contain two exclusions--bank failures, and loss resulting from failure to collect taxes. Dishonesty and faithful performance bonds contain numerous exclusions. One example of a dishonesty or faithful bond exclusion is loss caused by an employee whose coverage has been canceled. (KDP)

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by Steven P. Kahn, CPCU, ARM

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Public Risk Management Association (PRIMA)

Southern California
23701 Birtcher Drive
Lake Forest, CA 92630
(714)472-8324

Northern California
6939 Sunrise Boulevard
Suite 201
Citrus Heights, CA 95610
(916)726-8324

ARM TECH

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BASICS OF FIDELITY BONDS

by
Steven P. Kahn, CPCU, ARM
Principal, ARM Tech

The statutes of most, if not all, states require a "public officials" bond of certain elected and appointed officials. To protect themselves against financial loss, most public entities also purchase fidelity insurance on other employees.

Most governmental risk managers have long had responsibility for purchasing fidelity insurance on employees. While many risk managers have not been involved in determining when and to what limit surety bonds should be purchased, this is changing.

This article presents the basics of fidelity bonding. Key terms and coverages are discussed, as are the types of bonds that should be required and to what limits.

Types of Bonds

The major reason to buy fidelity bonds is to protect the agency against financial loss that can result from the dishonest acts of its employees. The three principal types of coverage and the protection provided by each are:

1. Public Official Bond

Public official bonds are the bonds certain officials (e.g., city treasurer and county tax collector) are required to purchase by state law. Because they are statutorily required, these are often referred to as *statutory bonds*.

The exact wording of a statutory bond is often contained in some statutes. Thus, it can vary by state.

The obligation for which the official is bonded usually reads: "to well, truthfully and faithfully perform all official duties required by law."

The bond limit may be established in the statutes. It is more likely that the statutes will state who is to establish the limit (e.g., a city council or school board).

Public official bonds usually run for the official's term of office. While some bonds may allow the insurer to cancel by providing a certain number of days' notice, most are non-cancelable.

2. Dishonesty Bond

Dishonesty bonds insure the public entity against:

> "Loss sustained by the insured through any fraudulent or dishonest act of the employees committed during the policy period."

Dishonesty bonds are organized in the same fashion as other insurance policies. As such:

a. They are usually written for a one- or three-year term.

b. They can be cancelled either by the insurer or by the insured.

c. The insured must select the limit of coverage it wishes to purchase.

While dishonesty bonds insure against dishonest acts of employees, for the insured to collect for a loss, the insured must show intent on the part of the employee to:

a. Cause financial loss to the insured (i.e., the public agency) and

b. Obtain financial benefit for the employee or any person or organization intended by the employee to receive that benefit.

3. Faithful Performance Bond

Faithful performance bonds insure against:

> "Loss sustained by the insured through failure of any employee to perform faithfully his duties or to account properly for all monies and property received by virtue of his position or employment during the policy period."

The insuring agreement of faithful performance bonds is broader than that of dishonesty bonds. This is because faithful performance bonds insure against failure to faithfully perform duties, not solely against dishonest acts. Also, faithful performance bonds do not contain the two caveats in dishonesty bonds regarding causing financial loss to the insured and obtaining financial benefit by the employee. It should be noted that faithful performance bonds usually cost 25% more than dishonesty bonds.

Conditions

All insurance policies contain conditions. The conditions section of the policy imposes certain duties upon the insurer and the insured.

Public official bonds are actually a type of surety bond even though they protect the entity against the dishonest acts of employees, much the same as dishonesty bonds. Because

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public official bonds are not traditional insurance policies, they do not contain the conditions that are to be found in other types of insurance policies.

Dishonesty and faithful performance bonds are written on virtually identical policy forms and contain virtually the same conditions, key of which are:

1. Discovery Period

The insuring agreements of dishonesty and faithful performance bonds state that they cover losses committed during the policy period. The discovery period condition allows the insured up to one year from the end of the policy period to discover a loss and still make a claim under the policy.

2. Duties in the Event of a Loss

In the event of a loss, the insured must:

a. Notify the insurer of the loss.

b. Provide proof of the loss to the insurer.

c. Submit to examination by the insurer under oath.

d. Cooperate in the insurer's investigation of the employee(s) causing the loss.

3. Subrogation

The insurer requires that the insured give it the right to collect the loss from the dishonest employee. This is an important condition. If you submit a claim, you can expect the insurer to attempt to collect its payment from the employee.

4. Cancellation

The insurer is allowed to cancel coverage for a single employee or the entire bond. Coverage for individual employees is:

a. Automatically cancelled immediately upon discovery of a dishonest act committed by that employee. The discovery must be by "any official or employee authorized to manage, govern or control employees."

b. Cancelled upon 30 days' written notice by the insurer.

The insurer may cancel the entire bond (i.e., coverage for the whole organization) upon a certain number of days' written notice (typically 30 days).

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The provision stating that coverage is cancelled immediately upon discovery of a dishonest act by an employee is important. If one of your managers discovers a dishonest act by an employee, any subsequent losses caused by that employee are not covered. If you wish coverage to be continued on that employee, you must specifically arrange coverage with the insurer.

Exclusions

Historically, public official bonds contained no exclusions. Because of the losses some insurers have experienced, some public official bonds now exclude:

1. Bank failure, which is loss caused by the failure of any financial institution in which your organization has deposits.

2. Loss caused through failure to collect taxes.

Dishonesty and faithful performance bonds contain a number of exclusions. The most important are:

1. Loss caused by an employee for which similar coverage has been cancelled. If coverage for one of your employees has been cancelled (e.g., because of a prior dishonest act), you must notify the insurer and specifically arrange coverage.

2. Loss that must be proven by an inventory or profit and loss computation. To collect for loss, it is not sufficient that your books do not balance. You must be able to point to an employee whom you believe contributed to the loss.

3. Loss caused by an employee required to be bonded. Public officials required to purchase their own bond are excluded by the standard dishonesty and faithful performance bonds. Insurers reason that these individuals represent an extra hazard and are already bonded. However, it may be possible and desirable to cover these individuals under faithful performance and dishonesty bonds as discussed later.

4. Loss caused by a treasurer or tax collector, by whatever name known. Treasurers and tax collectors are usually required to purchase a public official bond. Hence, they would be excluded under number 3 above. Because treasurers and tax collectors represent a significant exposure to loss, they are excluded just in case they are not required to purchase a public official bond. Many insurers will delete this exclusion.

5. Loss resulting directly or indirectly from trading. Insurers will not pay losses you incur from swings in the stock market or from authorized or unauthorized trading.

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6. Loss resulting from failure of any entity (e.g., bank or savings and loan) acting as a depository. This is similar to the exclusion already described for public official bonds.

7. Indirect losses. The insurer will not pay:

   a. Loss of income, such as interest you did not earn because money was stolen.

   b. Payment of punitive or exemplary damages.

   c. Cost of proving the existence or amount of a loss.

Methods of Arranging Coverage

Two basic choices must be made in arranging coverage. The first is whether to purchase a blanket *position bond* or a *blanket bond*.

Blanket bonds apply the bond limit to the entire loss, regardless of the number or types of employees involved. If you have a blanket bond with a $100,000 limit and three employees contribute equally to a $250,000 loss, the insurer will only pay $100,000.

Instead of a blanket bond, you may purchase a blanket position bond. Blanket position bonds apply the limit to each employee. In the example given, if a blanket position bond were in force, the insurer would pay up to $300,000 and the entire loss would be covered.

The second basic choice you must make is whether to purchase a blanket bond or a schedule bond. A blanket bond covers all employees (except those specifically excluded, such as treasurers and tax collectors). A schedule bond covers only the positions (e.g., school principal) or employees (i.e., individuals identified by name) listed in the bond.

Structuring Coverage

Exhibit 1 shows three alternatives for structuring coverage. Many additional structures could be used. The rationale for each structure in Exhibit 1 is:

1. Figure A. Many organizations want to purchase high limits of coverage on all employees. Their preferred form is a faithful performance blanket bond. However, it is sometimes difficult to obtain faithful performance coverage to the limits desired. In such situations, a faithful performance bond can be purchased to the limit available with excess coverage obtained under a dishonesty bond.

2. Figure B. You may decide that a faithful performance blanket bond to a certain limit provides sufficient protection for all but one or a few employees.

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In this situation, premiums can be saved by purchasing a schedule bond on the few individuals for which excess protection is desired rather than for all employees.

3. Figure C. The limit to which your public officials are required to purchase public official bonds may be low. With the insurer's approval, you may endorse your faithful performance (or dishonesty) blanket bond to apply in excess of the public official bonds.

There are many ways to arrange coverage. You must first, of course, decide which employees or officials are to be bonded, the form of coverage desired and the limit to be obtained. You can then obtain premium quotations for several alternatives and select the one that provides you the best combination of coverage and cost.

Limit

Selecting the correct bond limit is extremely difficult. It is impossible to predict the size of loss you might incur. Further, dishonesty losses occur infrequently. This makes it difficult to estimate what might happen to you based on which has happened to others.

The Surety Association of America published a chart to help select minimum bond limits. It is reproduced in Exhibit 2. While this was developed for corporations, it is worth using as a guide for public entities.

The table is used by first estimating an "exposure factor." The exposure factor is 20% of current assets plus 10% of annual revenue. The principal current asset of public entities is cash.

Once the exposure factor has been determined, the suggested minimum bond limit is obtained by reading across. If, for example, a public entity has $2 million cash in the bank and $25 million in annual revenue, the exposure factor would be:

.2 x $2 million + .10 x $25 million = $2.9 million

An exposure factor of $2.9 million results in a minimum bond limit in the $200,000 to $300,000 range.

Summary

This article has only touched the basics of fidelity bonding. To learn more, you should call your insurance advisor or your insurer. Fidelity bonds provide important protection to your entity. Properly arranging this coverage in advance will pay rich dividends in the event of a loss.

Exhibit 1

EXAMPLES OF COVERAGE STRUCTURES

Figure A

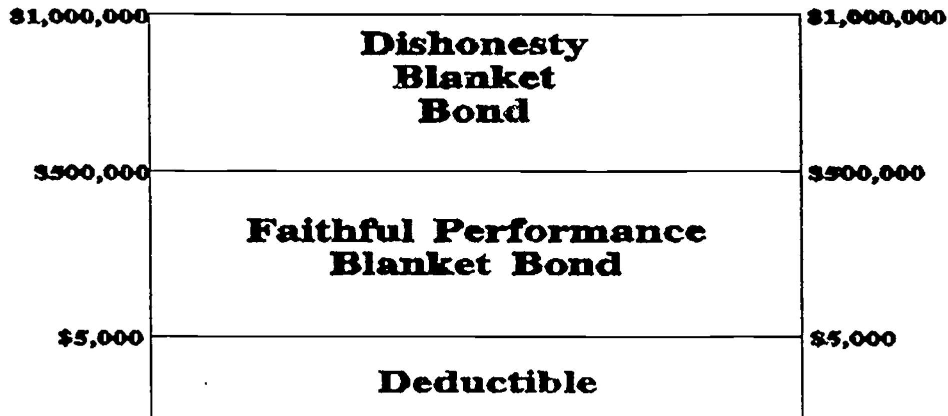

Figure B

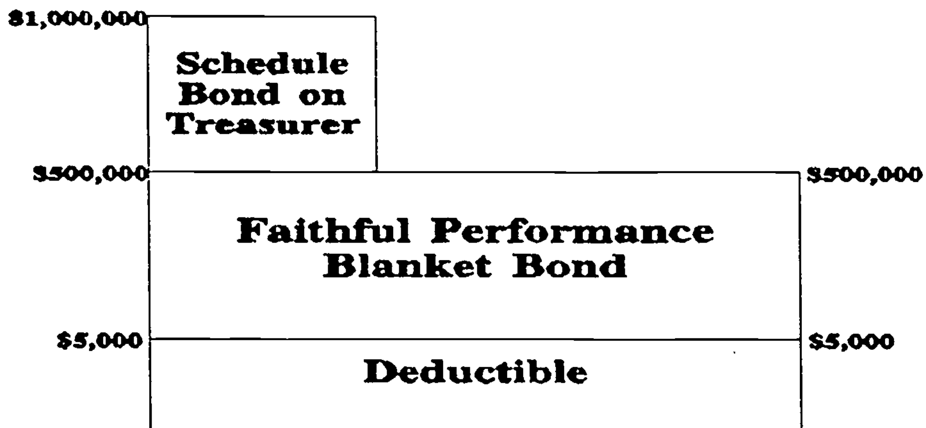

Figure C

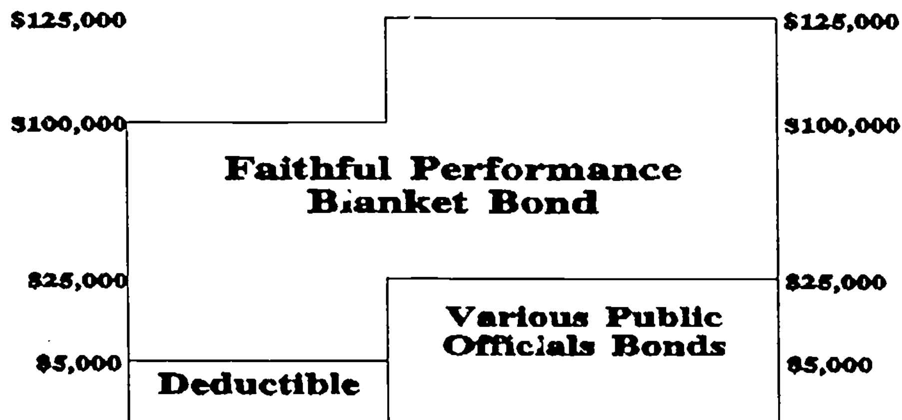

Exhibit 2

ESTIMATING COVERAGE LIMITS
ONE INSURER'S APPROACH

Exposure Factor = 20% of total current assets, plus 10% of annual revenue

Suggested Minimum Limits			
Exposure Factor		**Amount of Bond**	
Up to	$25,000	$2,500 to	$25,000
25,000 to	125,000	25,000 to	50,000
125,000 to	400,000	50,000 to	100,000
400,000 to	1,000,000	100,000 to	150,000
1,000,000 to	2,000,000	150,000 to	20,0000
2,000,000 to	4,000,000	200,000 to	300,000
4,000,000 to	6,000,000	300,000 to	400,000
6,000,000 to	10,000,000	400,000 to	600,000
10,000,000 to	15,000,000	600,000 to	800,000
15,000,000 to	25,000,000	800,000 to	1,000,000
25,000,000 to	75,000,000	1,000,000 to	1,500,000
75,000,000 to	175,000,000	1,500,000 to	2,000,000
175,000,000 to	500,000,000	2,000,000 to	3,000,000
500,000,000 to	1,000,000,000	3,000,000 to	4,000,000
1,000,000,000 to	1,500,000,000	4,000,000 to	5,000,000

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