

# **SETTLEMENT: TIMING AND CONSTITUENCIES ARE EVERYTHING**

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## ***I. INTRODUCTION***

Fidelity insurers invest significant time, effort and expense investigating complex fidelity claims, analyzing the compensability of claimed losses, and explaining their coverage analyses to the insured. While a reasonable settlement may not be possible in some claims, most fidelity claims are resolved amicably without litigation. Negotiating a favorable settlement in these claims is more art than science.

To devise a successful settlement strategy, an insurer must consider not only its maximum exposure, but other intangible factors, such as the timing of settlement negotiations and the nature of the insurer's relationship with its insured, as well because these considerations may dictate whether settlement negotiations will be successful. For example, in some cases, a premature settlement proposal may compromise the insurer's position because it may signal to an insured that the insurer is not confident in its coverage position and is unwilling to defend the claim through trial. In contrast, delaying settlement discussions until the insurer completes its investigation may impede a settlement because by then both parties may have expended significant fees and costs which might otherwise have been applied to a settlement.

While commentators have analyzed settlement negotiations from diverse perspectives over the past few years, those papers have focused on technical, legal issues. This article will focus on the practical and strategic considerations key to negotiating a favorable settlement of a fidelity claim. It reviews how to evaluate the merits of a claim and litigation risks (Section II), discusses how to build constituencies during negotiations (Section III), suggests ways to maintain open lines of communication with the insured (Section IV), and outlines alternative forums for negotiating a settlement.

## ***II. EVALUATING THE CLAIM***

### ***A. WHAT IS THE CLAIM WORTH?***

There are several factors which must be considered in determining the value of a claim. Obviously, the ideal is for the insurer to settle the claim for an amount equal to or less than it would likely be assessed if the matter proceeded through trial and the insurer were required to incur significant litigation costs. Predicting the outcome of the case, however, it is often extremely difficult. Two major issues in evaluating a fidelity claim are the judge or forum which will control the outcome of the case and the potential damage categories.

First, it is critical to understand the demeanor of the local judiciary before whom the case

will be tried. It is a common presumption that an insurer will receive more favorable treatment in federal court than in state court. While this is often an accurate assumption, more and more state court judges provide the expertise and fairness which can provide for a desirable forum for resolution of a fidelity claim. As many insurance disputes are resolved on summary judgment, knowing the biases and qualifications of the judge can be very important. It is necessary to understand whether the judge would be willing to rule in favor of an insurance company over a local bank or small business. Does the judge have the intellectual ability to understand the issues of the particular case? Is the judge more likely to enforce the strict terms of the bond or policy or attempt to construe the coverage to provide the maximum recovery to the insured? These are all important issues which should be addressed at the onset. These are also issues which should be considered once any lawsuit is filed in evaluating whether the case should be removed from state court to federal court, if possible.

While the best source of information on the local judiciary is normally local counsel because they can provide a frank and candid assessment of the local judiciary and an overview of local custom and procedure, there are also publications which rate and review judges. For federal judges, the best source of information on federal judges is the *Almanac of the Federal Judiciary* and the *Judicial Yellow Book*, which provides a background summary on every federal judge and a brief review by local attorneys.<sup>1</sup> For state court judges, local legal publications often publish short biographies on the local judiciary, which can often be a valuable source of information. In addition, *The American Bench* also provide a brief background summary on state court judges.<sup>2</sup>

In addition, an insurer should also research any local law addressing the disputed issues in the claim because recent coverage decisions can impact a fidelity carrier's choice of venue. If, for example, the local judiciary has recently published a string of decisions rejecting the insurer's position, the insurer might strongly consider selecting an alternative forum because, regardless of what law technically governs the dispute, a court may be more apt to apply its local law, as opposed to the law of another state, especially if the choice-of-law factors do not weigh strongly in favor of one state. Thereafter, after identifying the key issues in dispute, an insurer should research how the specific judges in the forum the insurer anticipates filing its suit have ruled on these issues to evaluate potential pitfalls before choosing a venue.

Second, it is important (although commonly overlooked during the investigation of a claim) to consider the division of potential damage categories. There are various categories of damages which the insured is claiming. For example, in a fictitious loan case, the insured may claim all or some of the following categories of damages:

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<sup>1</sup> Jamie Supek, *JUDICIAL YELLOW BOOK*, (Leadership Directories, Inc. 2002); Megan Chase, *ALMANAC OF THE FEDERAL JUDICIARY* (Aspen Law & Business 2002).

<sup>2</sup> Diana R. Irvine, *THE AMERICAN BENCH – JUDGES OF THE NATION* (Forster-Long, Inc. 2002).

- (1) the principal balance of the loan as of the date the loan was made;
- (2) accrued interest calculated in the current payoff of the loan;
- (3) penalties and fees which have been assessed pursuant to the loan's terms;
- (4) interest, fees, penalties, etc. which are now part of the principal balance of the loan due to a "rollover" of the prior loan;
- (5) accruing interest; and
- (6) attorneys' fees or expenses incurred by the insured in developing the claim.

The sooner an insurer understands the insured's claimed losses, the more likely the insurer may be able to resolve the claim. The insurer may be able to change the insured's perception from viewing the insurer's offer to settle as one for 60% of the total claim to a perception that the insurer is willing to pay 100% of the principal balance of the loans. The former is, often, far more acceptable to the insured and reaches the same result for the insurer.

In developing the issues of categories of damages, the fidelity insurer will often need to retain an accounting expert. A forensic accountant may be able to not only articulate the various categories of damages, but to reconstruct the underlying transactions to allow the fidelity insurer to more clearly understand the basis of the insured's claim and potential defenses.<sup>3</sup>

In evaluating defenses under the fidelity policy or bond, it is important to review any decisions by appellate courts in the relevant federal or state jurisdiction. The state law or law of the federal circuit can vary significantly depending on the particular issue. Two common issues which may be valued differently depending on the jurisdiction are the notice defense and the manifest intent requirement. A few states continue to enforce the notice provision in an insurance policy as a condition precedent to coverage. Many states enforce notice provisions only where the insurer can demonstrate prejudice. The manifest intent requirement under employee dishonesty insuring agreements has been interpreted differently by various jurisdictions. While most courts have now agreed on the proof necessary to demonstrate manifest intent, there remains a distinction regarding whether manifest intent requires subjective or objective intent by the dishonest employee.

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<sup>3</sup> For a discussion of retaining an accountant to assist in a fidelity investigation, see George Bleza and Christopher J. Franklin, *Use of Outside Professionals*, in *HANDLING FIDELITY BOND CLAIMS* (Michael Keeley & Timothy M. Sukel eds., 1999).

Also in considering the value of a claim, it is important to understand the worst case scenario. If the case goes to trial, the proof becomes overwhelming against the insurer, and the insurer's defenses deteriorate, what is the worst likely result? Can the insured recover attorneys' fees, interest and other damages which would not be considered part of the insured's basic claim? In some states, the insured's success at trial against an insurer can result in penalty damages, even if the denial is not in bad faith. An understanding of the bad faith statute and its applicability to fidelity policies in the particular jurisdiction can also be very important.<sup>4</sup> Once the parameters of the claim (best case v. worse case) are established, the insurer can more accurately evaluate the value of the claim.<sup>5</sup>

## B. EVALUATING THE COST OF LITIGATION

As with evaluating the value of the claim, knowing the forum in which the case will be tried is a key factor in evaluating the cost of potential litigation. If the case is in state court, there are typically very few deadlines and formal requirements imposed by the court. While this can provide for a less expensive case due to the failure to provide certain disclosures, attend certain hearings, and prepare certain documents, it often leads to more expensive litigation as cases can proceed for years with no limitation on discovery and no control over the conduct of a rogue plaintiff's attorney.

Many state court jurisdictions are beginning to follow federal court patterns setting scheduling conferences, scheduling orders, and attempting to more carefully control the litigation.

In federal court, the particular judge often makes a difference regarding the duration and nature of the litigation. While the federal court rules do, uniformly, provide for more standard case management procedures, many judges are even more strict and will carefully control the amount of discovery, number of depositions, and duration of the litigation. While fees and expenses relating to case management procedures may be more expensive in federal court, those expenses could be recouped in the savings which may be realized due to the federal judge's control over and limitation of the litigation process.

Another factor to consider in evaluating the cost of litigation is the number of potential witnesses and amount of documentation involved in the claim. The more issues on which the parties may stipulate, the lower the litigation costs will likely be. This is also a point in the litigation where the insurer can control litigation costs. If the claim involves allegations of employee dishonesty and

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<sup>4</sup> William H. Heywood, III, *Bad Faith Update* (an unpublished paper presented at the Southern Surety and Fidelity Claims Conference (1998)); Dirk E. Ehlers and Charles D. Thomas, *Bad Faith: Trends in Statutory and Common Law Framework and Review of Recent Cases*, IV Fid. L. J. 19 (1998).

<sup>5</sup> Andrew Caplan and William T. Bogaert, *Computing the Amount of Compensable Loss Under the Financial Institution Bond*, 33 TORT & INS. L.J. 807 (1998)

the alleged dishonest employee has already pled guilty to the criminal charges, it may benefit the insurer to stipulate regarding the issue of employee dishonesty and challenge only those additional conditions, exclusions, or limitations which may be applicable. This not only reduces the necessary discovery and litigation costs, it also may lend credibility to the insurer before the court and dispel the notion that the insurer is merely trying to make the insured's burden as difficult as possible. Cooperation with opposing counsel regarding potential stipulations can also foster a positive environment for future settlement discussions.

One final factor in evaluating the cost of litigation is the opposing counsel. The plaintiff's attorney often drives the litigation and could cause the litigation costs to soar out of control. When the plaintiff's counsel is responsible and deals reasonably with the insurer, the parties are more likely to minimize litigation costs and streamline those issues relating to the claim. It is often also helpful to understand the fee arrangement of the plaintiff's counsel. Where the plaintiff's counsel has a financial interest in the litigation based upon a contingent fee arrangement, the plaintiff's counsel may be interested in doing the minimum amount of work in order to prepare the case for trial or settlement. In contrast, an attorney being paid on an hourly basis may create unnecessary litigation costs in an attempt to maximize his fees.<sup>6</sup>

### **C. EVALUATING PROSPECTS OF EARLY SETTLEMENT**

Ideally, the insurer will be able to resolve the claim based upon reasonable settlement terms at the onset of or before litigation. While this is sometimes not possible, the prospects of early settlement should be evaluated from the insurer's first receipt of the claim. In evaluating the possibility of early settlement, it is important to understand whether the insured has an unreasonable expectation regarding the settlement value. This determination should be made before any settlement offer is extended by the insurer. The presentation of the insured's claim, correspondence from the insured, and meetings with the insured and/or its counsel often can provide sufficient information to evaluate their settlement expectations. As will be discussed below, the initial handling of the claim is an appropriate opportunity to educate the insured regarding coverage and attempt to establish reasonable expectations regarding the value of its claim.

Either before any settlement offer is made or after the parties have engaged in settlement discussions, it is important to evaluate the likelihood that the matter would be litigated and the cost of potential litigation. In complex fidelity claims involving rooms full of documentation, the parties should be willing to factor in a percentage of the likely litigation costs in order to resolve a reasonable dispute over the value of the claim. Obviously, this will not close the gap between a claim where the insurer has disclaimed liability and the insured values its claim in excess of \$1 million. However, where the parties are merely disputing the amount of the claim, (i.e. ability to

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<sup>6</sup> For a discussion of retaining and managing outside counsel, see George R. Buleza, *Coordination and Working With Outside Counsel in Complex Fidelity Cases* (an unpublished paper presented at the annual meeting of the Surety Claims Institute, Lansdowne, Va., June 26, 1997); C. Randel Lewis, *How to Manage Outside Lawyers*, 38 N.J.L.J. 1061 (1994 Supp.).

recover interest, attorneys' fees, etc.) potential litigation costs can often be used to increase the insurer's offer and to decrease the insured's settlement demand ultimately saving both parties money.

### ***III. Building of Constituencies and Multiple Party Claims***

#### **A. GETTING TO KNOW THE INSURED**

Whether the fidelity claim involves a first party claim based upon loss resulting from employee dishonesty or from third party litigation against the insured, getting to know the parties can often assist the insurer in evaluating the claim and accomplishing a reasonable settlement. The first step in this process is getting to know the insured. An initial face-to-face meeting with the insured often becomes the basis from which the insurer establishes a working relationship with the insured. In first party claims by the insured, this meeting and relationship is of the greatest importance. As is a theme throughout this discussion, the education of the insured regarding coverage from the onset of the claim can set the tone for the claims handling process and, if necessary, the litigation.

It is important to quickly determine who, with the insured, controls the decision-making process. In some cases, a high level officer or owner of the insured will prepare the claim and will deal directly with the insurer from the initial notice of claim. However, the insured may retain counsel to prepare and submit its claim and expect communication to be conducted directly through its counsel. Finally, some insureds will designate a lower level employee to handle the claims administration process. The latter two scenarios present more difficulty as both counsel and the lower level employee will be required to obtain authority from some other person or to resolve a claim. This also presents the potential that the insurer's position may be misconstrued or not sufficiently presented to the decision-maker. In these cases, a direct face-to-face meeting with the insured becomes even more important. As soon as possible, and as often as possible, the insurer should attempt to deal directly with the insured's representatives who will ultimately control the decisions regarding settlement of the claim.

Evaluating the personalities involved on behalf of the insured is also very important. Dealing with the president of a rural bank is often different from dealing with the risk manager for a large international corporation. Knowing whether the individuals representing the insured have invested themselves personally in the claim or view the claim as a business deal is also very important. Negotiation style and the timing of settlement discussions should be determined, in part, by the person on the other side of the table.

Upon receipt of the Proof of Loss, the fidelity insurer should quickly evaluate whether the insured has spent the necessary time and resources to prepare a thorough properly documented claim. While an insured who has not spent the time to properly prepare his claim may omit some portion of the claim which would otherwise be compensable, most often it merely increases the time and expense which is necessary for the insurer to properly evaluate the claim. A claim involving loan losses may fail to provide credit for (1) performing loans, (2) liquidated collateral, (3) unliquidated collateral, or (4) loans which have been paid off by subsequent extensions of credit.

Where the fidelity insurer cannot be confident that the insured has properly documented and accurately reported its claim, the insurer not only has to spend more time in investigating the claim, but must be more careful when evaluating settlement potential. It is, unfortunately, very common for a Bank to list all bad loans made by a loan officer even if there is no employee dishonesty associated with a portion of the loans.

Although fidelity bonds are not liability policies and do not provide indemnity against an insured's vicarious liability to a third party,<sup>7</sup> insureds nonetheless commonly seek indemnity for such losses. In these types of claims, establishing a relationship with the insured can often be of greater importance. Ultimately, the insured and its counsel will either make a settlement demand or request for settlement authority. Being able to evaluate the credibility of the insured and determine whether there is legitimate exposure to liability or if the insured is merely attempting to extract a favorable settlement, will guide the insurer's ability to settle the claim.

### **B. KNOWING YOUR PRINCIPAL**

In a standard fidelity claim, some third party is alleged to have engaged in suspicious or wrongful conduct. If the third party admits responsibility or the evidence is overwhelming establishing the wrongful conduct, the involvement of the principal may be of less importance. However, where any aspect of the claim is disputed by the principal or if the insured's evidence is, primarily, circumstantial, the principal can play an important role in determining the outcome of the claim. Two important factors which will determine the effectiveness of the principal are: (1) the principal's credibility and (2) the principal's willingness to cooperate with the insurer.

Evaluating the credibility of the principal will likely require a face-to-face meeting or interview of the principal.<sup>8</sup> This is often difficult where the principal is represented by counsel and

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<sup>7</sup> E.g., *Lynch Prop., Inc. v. Potomac Ins. Co. of Ill.*, 140 F.3d 622, 629 (5th Cir. 1998); *Travelers Ins. Co. v. P.C. Quote, Inc.*, 570 N.E.2d 614, 621 (Ill. App. Ct. 1991); *Central Nat'l Ins. Co. of Omaha v. Ins. Co. of N.A.*, 522 N.W.2d 39, 43-4 (Iowa 1994); *Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co. Inc.*, 676 N.Y.S.2d 559, 566 (N.Y. App. Div. 1998).

<sup>8</sup> For an in-depth discussion of the legal, ethical and practical issues impacting a fidelity insurer's right and ability to interview witnesses, see Cole S. Kain and Cynthia A. Mellon, *Potential Conflicts Between Fidelity Insurers and Insureds: Parallel Proceedings, Interviewing Witnesses and Actions against*

criminal charges are either pending or may be brought by state or federal authorities. In those circumstances, it is sometimes possible to obtain a written response from the principal or his counsel to specific questions. Even under these circumstances, it may be beneficial to schedule a meeting with the principal and his counsel with the understanding that the principal will not be required to answer any specific questions. The discussion can be had between counsel regarding the claim. Being able to meet with the principal, though not resulting in additional information, will give the insurer a better opportunity to evaluate the credibility of the principal and the plausibility of his denial of misconduct.

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*Third Parties*, V Fid. L. J. 1, 21-31 (1999); see also Matthew M. Horowitz, *Ethical Considerations in Interviewing Third-Parties in the Course of a Surety Investigation* (unpublished paper presented at the annual meeting of the Surety Claims Institute, Lansdowne, Va., June 26, 1997).

Where the principal is cooperative, it is important to establish contact with the principal and his counsel, if applicable, and to avoid the appearance that the insurer has already sided with the insured. Specifically, the insurer should emphasize its interest in determining the accuracy of the fidelity claim and to understand any defenses which the principal may have and which may be available to the surety. If the issues on which the surety disputes coverage are dependent upon the principal for proof, the credibility of the principal is extremely important. Obviously, it will be difficult to challenge employee dishonesty and the manifest intent requirement under the financial institution bond if the principal has already been convicted of or pled guilty to the alleged conduct.<sup>9</sup> A videotaped deposition from a prison also does not bolster the credibility of the principal. On the other hand, where the principal is very credible, the insurer may have more confidence in the reliance upon his testimony. Knowing who will be your "star" witness prior to getting into settlement discussions can be very valuable.

As referenced above, cooperation from the principal is beneficial even where wrongful conduct by the principal is apparent. Establishing cooperation can be difficult. It is often an effective means of obtaining cooperation by scheduling a meeting with the principal in order to discuss the claim. Giving the principal (assuming he/she will meet with you) a copy of the Proof of Loss (after obtaining permission from the insured) and merely requesting the principal's response may result in valuable information about the claim. Even where a principal would normally be unlikely to cooperate, they may be unwilling to allow the insured's allegations to go unanswered. This is especially true where the principal is being forthcoming with the insurer. Establishing cooperation with the principal can also often reduce the insurer's liability. Where the principal is facing criminal prosecution, it is often effective to discuss with the principal and his counsel the benefit of making restitution prior to an indictment or sentencing. The sentencing guidelines are

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<sup>9</sup> E.g., *FDIC v. Oldenburg*, 34 F.3d 1529 (10th Cir. 1994); *In re Waddell Jenmar Sec., Inc.*, 991 F.2d 792 (4th Cir. 1993) (Table) (guilty plea considered along with other evidence); *First Nat'l Bank of Louisville v. Lustig*, 961 F.2d 1162 (5th Cir. 1992), *after remand*, 832 F. Supp. 1058 (E.D. La. 1993), *later case*, 96 F.3d 1954 (1996) (withdrawn plea of guilty not conclusive); *Fidelity Dep. Co. of Maryland v. Reliance Fed. Sav. & Loan Ass'n*, 795 F.2d 42 (7th Cir. 1986); *Lloyd v. American Export Lines, Inc.*, 580 F.2d 1179 (3d Cir.), *cert. denied sub nom. Alvarez v. American Export Lines, Inc.*, 439 U.S. 969 (1978); *Semler v. Psychiatric Inst. of Washington, D.C.*, 538 F.2d 121 (4th Cir.), *cert. denied sub nom. Folliard v. Semler*, 429 U.S. 827 (1976). Cf. *Transamerica Premier Ins. Co. v. Miller*, 41 F.3d 438 (9th Cir. 1994) (guilty plea fulfilled non-standard form bond's "conviction" requirement).

typically more lenient where attempts at restitution have been made. This can often result in a reduction of the total loss by the insured thereby benefiting the insurer, the insured, and even the principal.<sup>10</sup>

### **C. COOPERATION WITH INSURED'S COUNSEL IN DEFENSE OF THIRD PARTY CLAIM**

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<sup>10</sup> For a discussion of a fidelity rights and duties when interviewing the principal, see Toni Scott Reed, *Legal, Ethical, and Practical Considerations for an Insurer's Witness Interviews in the Context of a Fidelity Bond or Commercial Crime Policy Claim Investigation*, VII Fid. L. J. 1 (2001).

As noted above, establishing cooperation with the insured's counsel is very important. Where the matter involves a potentially insured claim brought by a third party against the insured, this cooperation becomes extremely important.<sup>11</sup> In addition to reliance upon the insured's counsel for case evaluation and settlement recommendations, the insurer also relies upon the insured's counsel for status reports and a competent defense of the insured. If coverage for the third party claim is apparent under the bond or policy and the bond or policy allows for the insurer to designate counsel, this can often be used as a tool to avoid the use by the insured of an uncooperative or antagonistic attorney. In addition to meetings and conversation with the insured's counsel, some assistance by the insurer's counsel can help establish a cooperative relationship. Even if the insurer's counsel merely raises some issues or potential defenses to the insured and its counsel, this gesture of cooperation can often reap benefits far beyond the legal fees incurred by the insurer in researching and evaluating various legal issues. Most likely, this will not require the insurer to incur any additional expenses as its counsel will have already evaluated the insured's exposure.

#### **D. REDUCING THE PLAINTIFF'S EXPECTATIONS OF THE DEEP POCKET INSURER**

In more and more cases, the existence and terms of insurance coverage become available to third party claimants. While it is typically advantageous for the insurer to remain silent and exercise no presence as to the third party claimant, where the existence of insurance is established, it may be advantageous for the insurer, either directly or through its insured, to dispel the plaintiff's expectations of unlimited insurance coverage. If there are certain exclusions which may be implicated or if only a portion of the claim is covered, these limitations may be emphasized in order to reduce the plaintiff's expectations. Where the insured has made demands against the insurer for unreasonable settlement authority, it may even be advantageous for the insurer to participate directly in settlement discussions or mediation. This is an issue which must be carefully considered in light of the parties involved.

Just as important, the insurer should dispel the insured's expectations regarding the insurer's willingness to write a blank check. In the context of third party litigation, it is important to establish a relationship with the insured which will cause the insured to evaluate settlement as if it were contributing its own money toward settlement. With respect to first party claims against the insurer, it is important to establish the limitations, the coverage and the weaknesses in the insured's claim. Again, education of the insured is an important factor leading up to settlement.

#### ***IV. Assuring Lines of Communication Between Your Client and Plaintiff are Open***

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<sup>11</sup> As discussed above, fidelity bonds are not liability policies and only provide indemnity against third party losses in rare circumstances. For a detailed explanation of the compensability of third party losses under a fidelity bond, see Scott L. Schmookler, *The Compensability of Third-party Losses under Fidelity Bonds*, VII Fid. L. J. 115, 150-59 (2001).

### **A. MAINTAINING THE RELATIONSHIP BETWEEN THE INSURER AND THE INSURED**

A fidelity claim will typically arise by the provision of notice by the insured to the insurer or the insurer's agent. The initial contact is most often not by the insured's counsel and, therefore, an immediate relationship is established between the insurer and the insured. Even as counsel becomes involved on behalf of the various parties, it is often vital to keep the lines of communication open between the primary parties. While counsel is prohibited from communicating directly with a party who is represented by counsel, the individual parties are subject to no such prohibition. For this reason, the initial coverage decision and key communications should most often come from the insurer. While it is helpful to have counsel assist in the preparation of the correspondence, as the correspondence will ultimately become an exhibit in a lawsuit between the parties, maintaining the direct lines of communication can be very important.

Direct correspondence between the insured and the insurer can overcome a circumstance where the insured's counsel is either uncooperative or is not properly conveying the insurer's position to his client. It is also more effective for the purposes of settlement to have a degree of trust and familiarity between the primary parties.

If the insured is represented by counsel, it is equally important to establish and build a relationship with the insured's counsel. Where the insured's counsel becomes cooperative and helpful, this cooperation can often be used as a tool to settle a difficult claim. Also, if the relationship between the insured and the insurer is strained prior to the submission of the claim or becomes strained during the claims process, the intervention of counsel for both parties can smooth over many problems which may arise.

### **B. WHETHER TO MAINTAIN DIRECT CONTACT WITH THE PLAINTIFF IN A LIABILITY ACTION AGAINST THE INSURED**

A more difficult question arises where the insured is being sued by a third party and no direct relationship exists with the insurer. It is a delicate issue as to whether the insurer (or its counsel) should establish contact with the plaintiff's counsel. Obviously, any contact with plaintiff's counsel should be discussed with and cleared by the insured's counsel.

There are certain circumstances where it is not proper for the insurer to become visible in the lawsuit. Where the existence of insurance is not discoverable or is unknown, the insurer may actually increase the settlement expectations of the plaintiff by becoming involved. Where there is no dispute regarding coverage and it is clear that the insurer is responsible for any damages assessed, it may not be effective for the insurer to maintain direct contact with the plaintiff's counsel. Finally, where the insured objects to the insurer's involvement, it may be advisable to avoid contact with the plaintiff.

Under very limited circumstances, it can be beneficial for the insurer to become visibly active in a lawsuit. First, where there are coverage disputes and potential exclusions for coverage, it may be important for the insurer to articulate those provisions to the plaintiff to reduce the plaintiff's settlement expectations. Often, the insured's counsel is not in a position to advocate the

absence of coverage to the plaintiff and both parties may benefit by the insurer's explanation of coverage. The involvement in the lawsuit by the insurer can also give the insurer a certain degree of control over the litigation (which is often not advisable). If it is appropriate, however, the insurer may help broker a resolution of the case, limit expenses, or otherwise assist in bringing the parties to a reasonable resolution of the claim. No discussion with Plaintiff's counsel by the insurer should be initiated without the full support of the insured and its counsel. Based on experience, it is the insured and/or its counsel that requests the insurer's involvement, especially in mediation between the Plaintiff and the insured.

## ***V. Settling the Claim***

### **A. DIRECT SETTLEMENT DISCUSSIONS BETWEEN THE PARTIES**

As has been discussed above, establishing the most direct and effective line of communication between the insurer and the insured is very important. When engaging in settlement discussions, utilizing the proper line of communication may help broker a more reasonable settlement. If the insurer is concerned that the proper presentation regarding the coverage issues has not been made by the insured's counsel to the insured, direct correspondence from the insurer to the insured may be an appropriate manner in which to discuss settlement. Where the attorney for the insured may be helpful in explaining the legal issues to the insured and assisting in the education of the insured, communication between the insurer's counsel and the insured's counsel may be the most effective line of communication. It will often become apparent early in the claims process as to what line of communication will be most effective.

In conjunction with any settlement offer and, preferably, prior to any settlement offer, the insurer should take all possible steps in educating the insured regarding coverage. Where there is no significant dispute of fact, the most common hurdle in resolving a fidelity claim is the insured's failure to understand the scope and limitations of coverage. Explaining the scope and limitations of coverage before a dispute arises between the insurer and the insured can often pay enormous dividends. Where the insured does not expect to receive accrued and unpaid interest on a fraudulent loan, settlement of the claim may be more effective. For the same reason, it is often very effective to tie a settlement offer to certain items of loss. In other words, it may be more effective to offer \$85,000 in settlement of a claim, tying the \$85,000 to particular loans, instead of making a flat offer of \$100,000 without attributing the settlement to any particular items in the insured's loss. Again, this is another opportunity to explain the distinctions between various items of the loss and the parameters of coverage.

Where settlement discussions begin with communications between the parties and not through a formal mediation, a tactical consideration regarding who makes the first offer may or may not be important. As alluded to above, if a portion of the items claimed by the insured do appear to be covered, an initial offer from the insurer to settle the claim through payment of those covered items often establishes credibility of the insurer, lets the insured know that the insurer is not merely denying the claim without due consideration, and establishes a point from which the parties may

then negotiate a settlement. In contrast, where no portion of the claim is covered and the insurer is reasonably confident that it will succeed if the matter proceeds to litigation, it may be more effective to await an initial settlement offer from the insured, thereby reducing the insured's expectation that the insurer merely wants to negotiate a settlement of the claim. It is also important to consider whether the insurer should make a nominal settlement offer, sending a potential message to the insured regarding the insurer's evaluation of the claim or make a reasonable settlement offer in an amount which the insurer considers to be at or close to the actual value of the claim. Most often, a reasonably fair settlement offer from the insurer is more effective as it does not offend the insured or create an immediate adversarial atmosphere where settlement becomes less likely.

## **B. MEDIATION/ALTERNATIVE DISPUTE RESOLUTION**

### **1. Mediation**

Mediation is a voluntary procedure where the parties meet with a mediator in an attempt to foster voluntary settlement between the parties. The mediator, usually an attorney or a retired judge, will schedule a mediation in his or her office. Mediators have different requirements regarding pre-mediation submissions. Some mediators will request the opportunity to review relevant motions which have been filed in the case, while other mediators will merely request a position statement from both the parties. Mediators will often request that the parties submit a statement regarding the strength and weaknesses of the case agreeing to keep the mediation statements confidential.

Once the parties have submitted the relevant pre-mediation papers, they will meet in the mediator's office. Initially, the mediator may request all the parties to come together and allow the parties to give a short statement of their case. Then, the parties are separated and the mediator shuttles between the parties conveying settlement offers, positions, and, under certain circumstances, the mediator's opinion. If the mediation fosters settlement, it will result in the negotiation of a formal agreement between the parties. If the parties do not settle, they are under no obligation to do so and can terminate the mediation at any time. With the exception of the cost of mediation, mediation is a relatively risk free option.

More and more courts are requiring pre-trial mediation in an attempt to foster settlement of the lawsuit. Voluntary mediation, in contrast, can be agreed to by the parties before litigation, during litigation, or even after a case has been tried and is on appeal. Voluntary mediation is often most effective as the parties have voluntarily made the decision to engage in the mediation. Court-ordered mediation is effective where the parties have not engaged in settlement discussions and one or more party is unwilling to submit to voluntary mediation. While with voluntary mediation the parties' commitment to and expectation of settlement is heightened, any mediation requires the parties to carefully consider their case and its weaknesses and attempt to resolve the claim.

While a single mediator is the most common form of mediation, it may be possible for the parties to agree on two or more mediators. This may be most effective where the parties cannot agree on a single mediator and both parties desire to name a separate mediator. As a general rule, multiple mediators merely increase the cost of mediation and reduce the effect of the mediator's

role. With a single mediator, the mediator is often viewed as a de facto judge which can provide unbiased analysis and criticism of the parties' positions.

The most important step is identifying the proper mediator. While parties attempt to obtain mediators who may have a bias toward the insurer or the insured, this is often a minor consideration in selecting a mediator. More importantly, the parties should consider the legal background of the mediator, the technical background of the mediator, and the mediator's style. While legal background in the specific field at issue may not be as important, it is important to obtain an attorney who has sufficient commercial experience and legal background to understand the issues and speak authoritatively thereon. Technical background of the mediator is often unimportant in the fidelity context. However, where there are specific unique issues on which specific technical expertise may be helpful, the technical background of the mediator may be important. In cases such as construction litigation, a mediator with a background in construction law and an understanding of construction terminology can be extremely beneficial. Finally, the style of the mediator can often determine the effectiveness of the mediation. Note also that different styles can be effective in different circumstances. Some mediators merely convey offers of settlement and attempt to find creative ways to resolve the claims. Some mediators attempt to evaluate the parties' respective positions and work the parties toward a business resolution. Finally, some mediators will evaluate the claim and attack the parties' respective positions in order to foster settlement. Depending upon the parties' understanding of their respective cases, any one of these styles may be most beneficial. In cases which may be more difficult to settle, a more authoritative mediator should be considered.

Regardless of the particular procedures, the mediator, or the circumstances surrounding the necessity of the mediation (voluntary v. court ordered), mediation is a risk free opportunity for the parties to sit down to mediate the case. One great benefit of mediation is that settlement is expected and the parties have devoted a significant amount of time for the purpose of considering settlement. If the case does not appear to be conducive to voluntary settlement between the parties, mediation is an excellent alternative.

## **2. Arbitration**

Arbitration is more formal than mediation and is binding on the parties. It is also different from mediation in that it does not involve settlement discussions between the parties. The parties choose an arbitrator or panel of arbitrators to hear the case and the case is litigated before the arbitrators just as it would be before a court. Arbitration is often preferred because it is viewed to be less expensive and a quicker process. Under certain circumstances, arbitration can be more expensive and can be just as lengthy as a court trial. Arbitration must either be agreed upon by the parties or be part of an enforceable written contract. Some insurance policies do contain an arbitration provision. Arbitration provisions are typically enforced by the courts and a party may obtain dismissal of a lawsuit based upon the objection of the opposing party seeking to enforce an

arbitration provision. Absent an enforceable arbitration provision, the insurer cannot force the insured to arbitrate a case.<sup>12</sup>

The advantage of arbitration usually comes in the ability to choose an arbitrator or panel of arbitrators who are more knowledgeable on specific issues in the case. A typical judge will hear hundreds of cases in a year ranging from divorce and criminal prosecutions to civil contract disputes. Of those cases, the judge may hear one or two cases similar to a fidelity claim. Therefore, the judge is at a disadvantage in not having the expertise on the particular legal issues. It may be possible to choose an arbitrator who is more familiar with the particular legal and technical issues presented in the case. One other advantage in arbitration is that the case is heard by the arbitrator and there is no opportunity for a jury trial. This reduces the chance for an arbitrary judgment against the insurer based solely upon sympathy or bias toward the local insured.<sup>13</sup>

The cost of arbitration is often viewed as one of its benefits.<sup>14</sup> This can be true if the parties are able to streamline the litigation process through arbitration. The ability to shorten the time from filing through trial in an arbitration proceeding definitely reduces the regular ongoing expenses being incurred by the insurer. However, the same discovery is normally necessary, the same length of trial is typically required, and the arbitrator's fees greatly exceed the costs assessed by the court.

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<sup>12</sup> For a general discussion of alternative dispute resolution, see William R. Brick, Jr., *An Idea Whose Time Has Come* (unpublished paper presented at the annual meeting of the American Bar Association, New York, New York, 1992); Bruce E. Larson and Susan B. Hansen, *Alternative Dispute Resolution and Bad Faith Claims*, (unpublished paper presented at the annual meeting of the American Bar Association, New York, New York, 1992).

<sup>13</sup> For a discussion of the enforceability and appealability of arbitration decisions, see Keith Witten, *Settlement*, in *HANDLING FIDELITY BOND CLAIMS* (Michael Keeley & Timothy M. Sukel eds., 1999).

<sup>14</sup> For a discussion of the costs and benefits of alternative dispute resolution, see Dolores A. Parr, *ADR and The Litigation Crisis Within The Insurance Industry, A Cost/Benefit Analysis* (unpublished paper presented at the annual meeting of the American Bar Association, New York, New York, 1992); Thomas R. McCoy, *The Sophisticated Consumer's Guide to Alternative Dispute Resolution Techniques: What You Should Expect (or Demand) from ADR Services*, (unpublished paper presented at the annual meeting of the American Bar Association, New York, New York, 1992).

Normally, the arbitrator charges on an hourly basis and charges a premium rate. Therefore, while the cost of arbitration should be considered, it may not always be a significant factor or may even become a factor against arbitration.

### **C. EVALUATING THE TIMING OF SETTLEMENT DISCUSSIONS**

As discussed above, the timing of settlement discussions can be very important. We have discussed the issue of whether the insurer should attempt to make the first offer. The insurer may also decide to solicit the first offer, but require the insurer to make a settlement demand. In addition to the timing of settlement discussions, the amount of the settlement offer is very important. Under most circumstances, the insurer should make a reasonable settlement offer which allows the insured to know both that the insurer properly appreciates the insured's claim and it is sincere about reaching a reasonable resolution of the claim. Settlement offers which are aimed at obtaining a resolution of the case at an extreme discount often backfire and result in an impasse between the parties.

While making a reasonable settlement offer is important, it is also important not to box the insurer into a settlement corner. If the insurer has evaluated the claim and determined that the maximum amount which it is willing to pay in resolution of the claim is \$100,000, an initial settlement offer of \$90,000 would not be effective. In spite of purported "final offers" or other lines drawn in the sand, parties to litigation continue to perceive settlement discussions as a chess game where both parties consider the strategy in each offer.

Some cases are clearly not ripe for settlement at the onset of litigation and an early settlement offer would likely be fruitless. In these circumstances, it may be more effective to allow important discovery to take place and await the filing of dispositive motions. A summary judgment motion can often force a plaintiff to carefully evaluate its claim and provide an opportunity to push a reasonable settlement. Strategic consideration should be made as to whether the parties wait for the motion to be filed or even heard. Obviously, once a summary judgment motion is decided, the defendant has less leverage in negotiating a settlement unless the defendant has succeeded on summary judgment. Most often, the plaintiff is willing to consider settlement just before a final decision on a summary judgment motion.<sup>15</sup>

The final, and least desirable, opportunity for settlement before trial is "on the courthouse steps." By the time the case reaches trial, the parties should have had ample time to consider all of the evidence and legal issues. In addition, the parties have incurred significant legal fees which would, if anything, drive the respective settlement positions further apart. Therefore, settlement should occur on the courthouse steps only where (1) the trial has begun and the case is not going as

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<sup>15</sup> For an in-depth discussion of an insurer's duties during settlement discussions, see Jacqueline Lewis, *Good Faith is Good Business: Denying a Fidelity Claim While Avoiding Bad Faith Liability and Keeping the Customer Satisfied (Discussion of How Safeguards Against Bad Faith Can Engender a Positive Impact on Business)* (unpublished paper presented at the annual meeting of the American Bar Association, New York, New York, 1998).

well as expected or (2) where the plaintiff finally concedes to a reasonable settlement amount. With settlement discussions, it does take two parties to cooperate. Therefore, in spite of the insurer's best efforts, an insured may push the case to trial before it is willing to engage in meaningful settlement discussions. The insurer and its counsel should, from the onset of the case, evaluate settlement and attempt to avoid incurring significant fees and expenses only to settle a case for the same amount which it could have settled prior to the filing of the lawsuit. However, the insurer should not abandon its legitimate coverage position if the insured is not willing to reach an equitable compromise.

## ***VI. Conclusion***

The above factors are merely considerations which the insurer and its counsel should take into account when evaluating the claim. The most important principle that the insurer should consider is that all aspects of the claim (litigation, settlement, and claims evaluation) should be considered together and throughout the litigation. From the very first coverage decision to the insured through trial, the insurer should consider the effect of each action on potential settlement negotiations and on the case if it proceeds to trial. A candid, upfront consideration or evaluation of the case can make all of the difference in avoiding significant legal fees and expenses only to find the insurer at a disadvantage at trial.

While settlement is clearly important in resolving fidelity claims, the fidelity insurer should also understand that certain issues are subject to reasonable dispute and may require litigation. Every case cannot settle and the insurer must be willing to litigate certain claims if it is not willing to compromise on its position. However, considering well over 90% of all litigation settles prior to trial, the insurer should devote as much attention and effort in preparing for settlement as it does in preparing for trial. Fortunately, with the proper strategy, these two considerations will overlap and compliment one another.

While the insurer is stuck with the facts as it gets them, it can drastically impact the value of a claim based upon its proper considerations, its timing, and the relationships that it builds with the insured and other parties involved in the claim. Having an experienced claims department actively participate in the claims process can be critical to being able to successfully settle a claim. Counsel for the insurer should keep the claims officer fully informed in the evaluation process and developing strategy and timing of settlement overtures.