INCOME EXCLUSION – IS THERE MORE TO IT?

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I. *Introduction*

A fundamental premise in every insurance contract is that it is intended to return or restore the insured to the position in which it would have been had the loss not occurred. Inherent within this premise is that the insured should not obtain a profit or gain as a result of a loss; the insured should not be in a better position after a loss than before.

Further underpinning this fundamental premise is the concept of a moral hazard. If an insured may gain from a loss, the insured may be tempted to incur the loss. Insurance is not intended to protect against a moral hazard.

In Financial Institution Bonds and Commercial Crime Policies, the so-called income exclusion is the means by which insurers seek to apply the fundamental premise that the coverage is intended to restore the insured to the position in which it would have been had the loss not occurred; that is, that the insured not obtain a gain of profit as the result of a covered loss.

The income exclusion is unique in that it excludes income, but income is not defined in the bond or policy. This article reviews the history of the income exclusion and discusses the differences in the language from the accounting perspective, in comparison to how the courts have viewed the income exclusion, and why the courts have often asked what the difference is between profit and income. The exclusion has not changed in form, but the interpretation of the exclusion has.

The first part of this article will look at income, potential and realized, both historically and from an international and United States accounting perspective. The article will touch on accrual and cash basis.

The income exclusion has been stated over history as follows:

COMMERCIAL FIDELITY	FINANCIAL INSTITUTION FIDELITY
A. GENERAL EXCLUSIONS We will not pay for loss as specified below:	FINANCIAL INSTITUTION BOND Standard Form No. 24, Revised to January, 1986
3. Indirect Loss: Loss that is an indirect result of any act of "occurrence" covered by this insurance including, but not limited to, loss resulting from:	(s) potential income, including but not limited to interest and dividends, not realized by the Insured:
a. Your ability to realize income that you would have realized had there been no loss of, or loss from damage to, Covered Property.	(v) indirect or consequential loss of any nature;
(CR1000 10 90)	

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CRIME PROTECTION POLICY Edition of March, 2000	COMMERCIAL CRIME POLICY	FINANCIAL INSTITUTION BOND Standard Form No. 24, Revised to April 1, 2004	FINANCIAL INSTITUTION CRIME POLICY FOR BANKS AND SAVINGS INSTITUTIONS (Non-Aggregate Form FI00 10 06 05)
D. EXCLUSIONS Applicable to All Insuring Agreements, Except as Indicated	C. Indirect Loss		D. Exclusions This policy does not cover:
We will not pay for loss as specified below:	1. This policy does not apply to:	(s) potential income, including but not limited to interest and dividends, not realized by the Insured;	4. Potential income, including but not limited to interest and dividends, not realized by you.
5. Indirect Loss Loss that is an indirect result of any act or occurrence covered by this insurance including, but not limited to, loss resulting from:	D. Indirect Loss Loss that is an indirect result of any act or "occurrence" covered by this policy including, but not limited to loss resulting from:	(v) indirect or consequential loss of any nature including, but not limited to, fines, penalties, multiple or punitive damages.	6. Indirect or consequential loss of any nature.
a. Your inability to realize income that you would have realized had there been no loss of, or loss from damage to, money, securities or other property.	(1) Your inability to realize income that you would have realized had there been no loss of, or loss, from damage to "money," "securities" or "other property."		
(SFAA)	(ISO CR 00 23 05 06)	(SFAA)	(ISO FI 00 10 06 05)

II. *What is Income?*

As illustrated above, the basic industry forms do not define the words *income*, *potential* or *realized*. As such, the insurance industry looks to CPAs, the accounting industry and legal precedents to assist with defining income, both potential and realized.

The first step is in understanding that there is no single definition of income according to an accountant's international accounting standards, or the United States Generally Accepted Accounting Principles. The concept of income reporting as a source for investor decision-making emerged over history in many forms:[1]

[1] Sidney S. Alexander, *Income Measurement in a Dynamic Economy*, *in* FIVE MONOGRAPHS ON BUSINESS INCOME 6 (Scholars Book Co. 1973).

1. Income is used as the basis of one of the principal forms of taxation.
2. Income is used in public reports as a measure of the success of a corporation's operations.
3. Income is used as a criterion for determining the availability of dividends.
4. Income is used by rate-regulating authorities for investigating whether those rates are fair and reasonable.
5. Income is used as a guide to trustees charged with distributing income to a life tenant while preserving the principle for a remainderman.
6. Income is used as a guide to management of an enterprise in the conduct of its affairs.

The aforementioned policies use the word income, yet the Financial Accounting Standards Board[2] does not consider income an element of financial statements. The financial statement elements, as defined by FASB, are:[3]

- Revenues
- Gains
- Expenses
- Losses
- Assets
- Liabilities
- Equity of Enterprises

Income is not an element of a financial statement, but rather it is derived from the combining of other elements. While income may seem to be an easy concept, it is a difficult and disputed concept, even within the FASB and the International Accounting Standards Board.[4] For instance, the FASB contradicts itself in its opinion as to whether income or cash flow is a better indicator of an entity's performance, value, and future earnings.[5]

There is a lack of consensus in the definition of income, especially between economists and accountants. The viewpoints revolve around the importance of the balance sheet versus the income statement.[6] Those who view the balance sheet as relevant look at the increase of assets over liabilities for the increase in net worth over the time period for the income generated. This is the economic approach. Alternatively, those who favor the income statement as relevant view income as a result of certain activities over a period of time. This is the transaction approach, whereby the revenue and costs are matched.

Income may take various forms: physic, real and monetary. Physic is not measurable; it is based upon human wants. Real refers to increases in economic wealth. Money is easy to measure, but does not take into consideration the change in value of the monetary unit. Economists generally argue the objective of measuring income is to determine how much better

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[2] Hereinafter FASB.
[3] ACCOUNTING STANDARDS AS OF JUNE 1, 2002, FASB Concept Statements (Concept No. 1) Vol. 3, at 78-79, original pronouncements (Fin. Accounting Standards Bd. 2002).
[4] Hereinafter IASB.
[5] ACCOUNTING STANDARDS AS OF JUNE 1, 2002, FASB Concept Statements (Concept No. 1) Vol. 3, at 32-36, original pronouncements (Fin. Accounting Standards Bd. 2002).
[6] RICHARD G. SCHROEDER ET AL., FINANCIAL ACCOUNTING THEORY AND ANALYSIS 128 (8th ed. 2005).

off an entity has become during a time period.[7] Thus, economists and accountants have focused on real income.

There is a significant difference in viewpoints when measuring better off. There are two primary concepts: financial capital maintenance and physical capital maintenance. For example, if Company XYZ owns a piece of land that increases in value, there is a holding gain. Proponents of the physical capital maintenance concept consider holding gains as return in capital and do not include it as income, but rather a change to equity. However, the proponents of financial capital maintenance contend holding gains and losses are considered return on capital and are included in income. Many variables play into the measurement factors, thus continuing the question of the appropriate amount for valuing assets at Exit Price, Actual Cash Value, Fair Market Value, Replacement Cost, and so on. Here, the value of the asset will affect the value of the income.

In referring back to the concept of income, there are a number of definitions for income, of which only a small segment of viewpoints is explored within this paper. Besides defining income, it is necessary to look at the definitions of potential income and realized income. As mentioned earlier, there are two viewpoints in defining income: the physical capital maintenance concept versus the financial capital maintenance concept. The accounting profession has taken the position of measuring financial results based upon the transaction approach that income should be reported when there is evidence of an "arms-length transaction."[8]

According to the FSBA, income is treated as follows:[9]

+	Revenues	100	+	Earnings	15
–	Expenses	80	–	Cumulative accounting adjustments	2
+	Gains	3	+	Other non-owner changes in equity	1
–	Losses	8			
=	Earnings	15	=	Comprehensive income	14

Arguably, the word income, as stated in the policy, lies between earnings and comprehensive income, but income is not defined by the FASB or IASB.

We know the concept of income is derived from other financial statement elements. In the accounting transaction process, recognition is the formal process of recording a transaction or event. Realization is the process of converting non-cash assets to cash or cash equivalents. Transaction-based accounting recognizes (reports) revenues that are realized or realizable. Hence, accounting recognition relies upon the determination of when realization occurred. Critics of the accounting process favor the concept of real income, i.e., the physical capital maintenance approach.

[7] T. A. Lee, *A Note on the Nature and Determination of Income*, 1 J. BUS. FIN. & ACCOUNTING 145, 145-147 (1974).
[8] RICHARD G. SCHROEDER ET AL., FINANCIAL ACCOUNTING THEORY AND ANALYSIS 134 (8th ed. 2005).
[9] ACCOUNTING STANDARDS AS OF JUNE 1, 2002, FASB Concept Statements (Concept No. 5) Vol. 3, at 44, original pronouncements (Fin. Accounting Standards Bd. 2002).

The next step is to define realized income. To determine realized income, we look for realized revenues and gains. The concept of realization pivots upon the following criteria being applied:[10]

1. Revenue is capable of being measured.
2. The measurement is verified by a third-party source.
3. The crucial event has occurred (products or services have been exchanged).

There are four conditions for recognition. The accounting literature that has been developed since the conceptual framework guidance was introduced has attempted to provide additional conditions for determining when revenue has been earned and is realizable. As previously mentioned, some of that literature is transaction-specific, such as SOP 00-2 on the licensing of motion pictures, and some of it is issue-specific, such as FAS-49, *Accounting for Product Financing Arrangements*, on product financing arrangements. In contrast, SAB 101 is more general in nature.

Although different pieces of literature use different terms to get their ideas across, all of the literature generally indicates that revenue is both earned and realizable when each of the following four conditions is met:[11]

1. Persuasive evidence of an arrangement exists.
2. The arrangement fee is fixed or determinable.
3. Delivery or performance has occurred.
4. Collectibility is reasonably assured.

It is important to note that each of these conditions must be met by the end of the accounting period during which it is proposed that revenue be recognized. *Recognizing* is the recording of the event or measure.[12] Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors, (a) being realized or realizable, and (b) being earned, with sometimes one and sometimes the other being the more important consideration.[13]

In recognizing revenues and gains, the two conditions (being realized or realizable and being earned) are usually obtained by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at the time of sale (usually meaning delivery).[14]

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[10] RICHARD G. SCHROEDER ET AL., FINANCIAL ACCOUNTING THEORY AND ANALYSIS 137 (8th ed. 2005).
[11] *See* SAB 101, Topic 13A1; SOP 97-2, ¶ 8; SOP 00-2, ¶ 7.
[12] SCOTT A. TAUB & TERESA DIMATTIA, MILLER REVENUE RECOGNITION GUIDE 3.07 (2004).
[13] ACCOUNTING STANDARDS AS OF JUNE 1, 2002, FASB Concept Statements (Concept No. 5) Vol. 3, at 83, original pronouncements (Fin. Accounting Standards Bd. 2002).
[14] *Id*. at 84.

Examples of the crucial event, i.e., earned and realizable, are:

- A restaurant generally earns and realizes its revenue at the end of the meal, when the meal has been eaten and paid for by the patron.
- A retail store generally earns and realizes its revenue when the customer pays for the merchandise at the cash register.
- A manufacturer generally earns and realizes its revenue upon delivery for cash-on-delivery orders.
- Lawn care providers, home cleaning services and other service providers generally earn their revenue as they perform the related services. These providers get paid upon completion of those services.

The above examples are all situations in which revenue is earned and realized at the same or almost the same time. However, there are many other common and simple transactions in which the two events occur at different times. Thus, in some cases, revenue is realized before it is earned. Examples are:

- Book, magazine and other subscriptions are frequently paid upon order or in advance. In this situation, the publisher realizes the revenue before any books or magazines are delivered, but cannot recognize the revenue until the revenue is earned when the books, magazines or other subscriptions are delivered.
- Airlines require payment immediately upon the purchase of a ticket and realize the revenue at that time. However, the revenue is not recognizable because it is not earned until transportation is provided.

In other cases, revenue is earned before it becomes realizable. Examples are:

- A manufacturer might sell products on a credit basis; thus, the revenue is earned when the products are delivered. An exception is that if the customer's ability to pay is in question, the revenue may not be immediately realizable.
- Retailers sometimes provide products on a trial basis, with the customer not having to pay for the goods unless the customer keeps the goods for a specified period of time. Although one can argue the earnings process is complete when the product is delivered, the revenue does not become realizable until the trial period elapses.[15]

[15] SCOTT A. TAUB & TERESA DIMATTIA, MILLER REVENUE RECOGNITION GUIDE 3.03 (2004).

An example of gains and losses that are recognized but not realized is as follows:

FACTS:

1. In 2007, an entity with a December 31st year-end purchase of an equity security with a determinable cost of $5,000.
2. At December 31, 2007, the fair market value of the security is $7,000.
3. During 2008, the security is sold for $11,000.

REPORTING GENERAL LEDGER:

2007 Recognize a $2,000 gain and adjust the carrying value.

2008 Recognize a $4,000 ($11,000 - $7,000) gain and adjust the carrying value to $0; or display a $6,000 realized gain ($11,000 - $5,000) less $2,000 recognized previously.

The most precise sense of realization means the process of converting non-cash resources and rights into money. Realization is most precisely used in accounting and financial reporting to refer to sales of assets for cash or claims to cash. The terms realized and unrealized are related to and, therefore, identify revenues or gains on assets sold and losses on assets unsold. In the process of formally recording or incorporating an item into the financial statements of an entity, those are the meanings of realization and related terms. Thus, an asset, liability, revenue, expense, gain or loss may be recognized (recorded) or unrecognized (unrecorded).

Once revenue is realizable, only then can comprehensive income be realized. Before we can determine the realized comprehensive income, we must match expenses to revenues. The process of identifying all expenses associated with producing recognized revenue is referred to as matching. Matching expenses to revenue is an easy concept in thought but can be very complex in application.[16] There are a number of matching concepts that do not correlate with the realized and potential concepts of income, thus they are left for another paper and another time.

Clearly, realization and recognition are not synonymous, although the courts use them as such.[17] There is a great deal of confusion over the precise meaning of recognition and realization. Recognition is the formal process of recording a transaction or event. Realization is the process of converting non-cash assets to cash or claims to cash. Transaction-based accounting recognizes and reports revenues that are realized or realizable and earned.[18]

The common loss situation for financial institutions is the creation of fictitious loans for which the insured has a loan that was created by an employee to conceal misappropriated monies, such as follows:

[16] RICHARD G. SCHROEDER ET AL., FINANCIAL ACCOUNTING THEORY AND ANALYSIS 143 (8th ed. 2005).
[17] ACCOUNTING STANDARDS AS OF JUNE 1, 2002, FASB Concept Statements (Concept No. 6) Vol. 3, at 143, original pronouncements (Fin. Accounting Standards Bd. 2002).
[18] SCOTT A. TAUB & TERESA DIMATTIA, MILLER REVENUE RECOGNITION GUIDE 3.03 (2004).

- On January 1, 2005, an employee creates a $10,000 fictitious loan and misappropriates the proceeds.
- On January 1, 2006, an employee creates a $12,000 loan to pay off the $10,000 original loan and the $2,000 interest charged on the $10,000 loan.
- On January 1, 2007, the financial institution discovers the $12,000 loan and the $3,000 interest due, for a total of $15,000 outstanding on the loan.

Many courts and carriers have addressed the $2,000 as realized and recognized and not excluded from coverage. As for the $3,000, many courts and carriers indicate it has not been recognized (recorded) or realized; and thus, it is excluded from coverage.

However, the accounting literature and standards contend that for the realizable concept to occur:[19]

1. Revenue must be capable of measurement.
2. Measurement must be verified by an external market transaction.[20]

Revenues and, subsequently, income cannot be realized until the necessary criteria are met. Creating fictitious loans does not add to the asset base or involve an external market transaction. Thus, in the perspective of Generally Accepted Accounting Principles ("GAAP"), for both the $2,000 interest charge and the $3,000 interest due above, there is <u>no</u> realized revenue, thus no realized income, and a restatement of the entity's financial statements should be made not to include the fictitious interest as revenue and, subsequently, income.

Some policies have been written to clarify their intent in the income exclusion, whether or not the interest is recognized:

1. If you incur a covered loss resulting from a "loan," we will reduce the amount of your covered loss by the amount of your realized earnings, including interest and fees, on that "loan."
2. If you incur a covered loss under Employee Or Director Dishonesty Coverage resulting from a "loan," we will reduce the amount of your covered loss by the amount of your realized earnings, including interest and fees:
   a. On that "loan;" and
   b. On any other dishonest "loans" originated or caused by the same dishonest "employee" or "director."[21]

Another approach to requiring the deduction of interest (income) has been to address it in the recovery provision of the policies:

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[19] RICHARD G. SCHROEDER ET AL., FINANCIAL ACCOUNTING THEORY AND ANALYSIS 137 (8th ed. 2005).
[20] ACCOUNTING STANDARDS AS OF JUNE 1, 2002, FASB Concept Statements (Concept No. 6) Vol. 3, at 143, original pronouncements (Fin. Accounting Standards Bd. 2002).
[21] *Application Of Realized Earnings In Loan Losses*, CUMIS Insurance Society, Inc. Bond 500 02/01, p. 47 (2001).

> Section 7. SUBROGATION – RECOVERY – COOPERATION – APPLICATION OF RECOVERIES
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> f. In determining the amount of any loss covered under this Bond, all Money received by the Insured from any source whatsoever in connection with any matter from which a loss has arisen, including payments and receipts of principal, interest, dividends, commission, and the like, received prior to a loss settlement under this Bond, shall be deducted from the amount actually paid out, advanced, withdrawn, taken or otherwise lost or stolen. The value of all property received by the Insured from any source whatsoever and whenever received, in connection with any matter from which a loss has arisen, shall be valued as of the date received and shall likewise be deducted from the claimed loss.[22]

"Potential" revenue is not considered or addressed in United States GAAP or International Accounting Standards[23] as realized or recognizable. Thus, potential income has been neither realized nor recognizable. However, as mentioned by these authors,[24] the courts do not determine whether the income is realizable (arms-length, outside, third-party transactions). The courts merely give the potential revenue difference (loss) to the insured.

As we can see from the accounting profession perspective, the concepts realization of income and recognition of income are different. Likewise, the concepts of accrual and cash basis are different.

The final concept we need to discuss is accrual, as it is another concept often misconstrued by the courts.

> ACCRUAL BASIS is an accounting method that "recognizes" revenue and expenses when earned or incurred rather than at the time of cash flow. The accrual basis is employed in the case of a manufacturer or dealer in inventory.[25]

But as discussed, to recognize means the criteria of realization and earned must occur.

> CASH BASIS is an acceptable accounting method that recognizes revenue and expenses at the time of cash receipt or payment. The cash basis may be used in the case where a company deals in inventory *only* if there is an uncertain realization of the sale. If inventory is not involved, such as a service-oriented business, the cash basis may be chosen. In the preparation of a tax return for an individual, the cash basis is typically used.[26]

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[22] Travelers Financial Institution Bond With Extended Coverage (Revised to June 2001).
[23] Hereinafter IAS.
[24] D. M. Studler & Joseph Werner, Address at the Annual Surety Claims Institute: Kickbacks—Kicked Through or Kicked Out (June 20-22, 2007).
[25] JAE K. SHIM & JOEL G. SIEGEL, ENCYCLOPEDIC DICTIONARY OF ACCOUNTING AND FINANCE 14 (1989).
[26] *Id*. at 87.

Cash basis for manufacturing entities and most entities with inventories do not comply with GAAP if revenues and expenses are recognized at the time cash is received.

Given the above background, it is appropriate to review the case law to determine how courts have dealt with the so-called income exclusion, given that the terms Income and Potential Income are not expressly defined in either the Financial Institution Bonds or the Commercial Crime Policies.

III. *Financial Institution Bond Case History and Interpretation*

The Financial Institution Bond excludes coverage for "potential income, including but not limited to interest and dividends, not realized by the Insured." This exclusion is typically considered when a claimed loan loss is comprised, in part, of interest. Simply put, we must consider whether the interest at issue is potential income and, therefore, excluded under the bond.

Although the term potential income is not defined in the bond, the courts have used the concepts of accrued versus unaccrued, and realized versus unrealized, to draw conclusions about what types of interest may be excluded from coverage. The use of these terms in case law is often not consistent with accounting terminology (see previous discussion of the terms realized and recognized.) Accrued is generally used by the courts to mean interest that is showing as due on the bank's books, while realized refers to the portion of a loan payment received by the bank that has been applied to interest. Using these definitions, courts generally find that accrued yet unrealized interest (interest showing on the bank's books as due, but not received by the bank) is excluded as potential income.

Although the treatment of interest in certain loan loss claims seems fairly straightforward, the courts have reached differing conclusions about the treatment of interest in fictitious loan scenarios. Further, the courts have allowed banks to apply recovered funds to the interest portion of loans. Finally, the courts have also considered the potential income exclusion when determining whether prejudgment interest is excluded from coverage.[27]

A fairly clear example of interest excluded as potential income is found in *First American State Bank v. The Continental Insurance Company.*[28] The case involved a bank suing its insurer under a bankers blanket fidelity bond after the insurer denied coverage for loan losses resulting from dishonest and fraudulent acts of the bank president. The bank president used the funds of two bank loan customers to operate fraudulent loan and commodity/cattle schemes. After discovery of the schemes, the bank settled with its customers, restructuring the debt of one customer. The bank claimed as part of its loss the interest income that it would have earned in the future had the bank not had to restructure the customer's debt. The court referred to this type of interest as "future interest," indicating "these payments were not yet due, not realized and therefore fell squarely within the potential income exclusion."[29] Notably, the court further supported its holding by indicating that the future interest payments did not represent a depletion

[27] Note that many of the cases discussed involve the interpretation of the potential income exclusion under a bankers' blanket bond.
[28] 897 F.2d. 319 (8th Cir. 1990).
[29] *Id*. at 329.

of funds—a direct loss resulting from a dishonest act—and therefore would not be covered under the bond.

The law is not quite as clear when considering the treatment of interest in fictitious loan losses. In these cases, the dishonest employee embezzles funds from the bank and conceals the loss by creating "fictitious loans" on the bank's books. Over time, the dishonest employee creates new such fictitious loans to create the appearance of payment of the previous loans. When such a loss is discovered, questions arise as to whether the portion of principal of the most recent fictitious loans used to repay interest on previous fictitious loans should be covered under the bond. Courts have reached differing conclusions on this issue.

This issue was considered in *Bank of Huntingdon v. Smothers.*[30] The case involved a dishonest bank employee embezzling funds over a sixteen-year period. The named principal, a bank officer, created fictitious notes and forged bank customers' signatures on those notes, then presented the notes to a teller and received the funds. When the notes became due, the principal created new fictitious notes to pay the interest due on previous notes, or to pay the principal and interest due, or to obtain additional funds. At the time of discovery of the loss, there were 190 forged fictitious notes with a face balance due of $468,495.75. The bank demanded the full amount from its fidelity blanket bond insurer.

The insurer paid over $250,000.00 as its estimated liability under the bond, but denied the remaining portion of the claim as falling within the potential income exclusion. The insurer maintained that the principal's scheme produced a "roll" or "pyramid" effect in which the principal embezzled funds, in part, to pay off previously created fictitious notes and interest on those notes. The insurer took the position that such payments were simply money transfers on the books of the bank and involved no actual loss to the bank. The insurer further maintained that any payment of interest was really payment of "potential income" to the bank and was, therefore, excluded from coverage.[31]

The court disagreed with the insurer, indicating that when a new fictitious note was created to pay off an old note, the general funds of the bank were then used to pay off the old note. It is at this point, according to the court, that the payment reentered the bank's general fund and lost any interest character it may have had at the time of payment; the payment of the previous note was "realized." The court opined it was clear that money advanced to the principal from the bank's general fund for any purpose cannot be considered as potential income; rather it is purely "actual outgo."[32] Therefore, the amounts of the notes that were credited to the bank's general fund are covered under the bond. It should be noted the court went on to say potential income is that which the bank hopes to receive in the future, and that the clause excludes "earned but unreceived" income. Therefore, any amount of earned interest that had not been paid by the principal, in the form of a fictitious loan or otherwise, would be excluded from coverage.

This issue was also considered in *St. Paul Fire and Marine Insurance Co. v. Branch Bank and Trust Co*.[33] The case involved a dishonest bank employee engaged in an embezzlement

[30] 626 S.W.2d 267 (Tenn. Ct. App. 1981).
[31] *Id*. at 268.
[32] *Id*.
[33] 834 F.2d 416 (4th Cir. 1987).

scheme. To conceal his embezzlement, the employee issued loans to fictitious persons and deposited the loan proceeds into checking accounts established under corresponding fictitious names. When the loans matured, the dishonest employee either renewed the loan or created another fictitious loan and applied part of the proceeds to pay principal and interest on the mature loan. Once the loss was discovered, the principal due on the twelve outstanding loans was $781,500.00. The bank's fidelity carrier concluded that $534,206.64 of this amount had been paid to the bank by subsequent loans as interest due on earlier loans and was, therefore, excluded as potential income. The bank brought suit against the carrier.

The carrier maintained these interest payments were "not realized" because they were derived from new loan proceeds and, therefore, cannot constitute a net gain for the bank. The court disagreed with the carrier, citing the holding and rationale of *Bank of Huntingdon v. Smothers*,[34] indicating "common sense" supports the conclusion that payments that have already been received by the bank have been "realized."[35] The court held the carrier was liable for the outstanding principal balance of the notes, less only the recovery of interest accrued but not yet paid.

In contrast, in *American Trust & Savings Bank v. USF&G*,[36] the court specifically rejected the holdings of the previously discussed cases when it held that an insurer was not liable for the portion of the face amount of outstanding fictitious notes created by a dishonest employee, which represented interest paid on prior fraudulent notes. In this case, the principal embezzled funds from the bank by forging notes purporting to be loan agreements of bank customers, then paid off the notes as they became due, in part with funds obtained from new forged notes. Over the course of the scheme, 496 fictitious notes were created. At the time of discovery of the loss, there were twelve remaining notes with face amounts totaling $4,305,500.00. Of this amount, $2,075,351.64 represented funds the principal used to make interest payments on the prior fraudulent notes; the total cash out of the bank resulting from the scheme was $2,230,148.36. The fidelity carrier paid this portion of the claim, the "total cash out," less the applicable deductible, and the bank brought suit for the remaining portion.

The court agreed with the insurer, reasoning that when the newly forged notes were used to pay interest, the bank suffered no loss because its assets were not diminished in fact, nor did the phony interest payments increase the bank's assets, although its books showed otherwise. The court further reasoned that if it were to allow recovery of the full face amount of the twelve outstanding notes, the bank would profit from the dishonest acts of its employee and such an interpretation of the bond would be unreasonable.[37]

A somewhat different scenario involves the determination of the proper application of recovered funds to loan interest. This issue was addressed in *First National Bank of Louisville v. Lustig.*[38] In that case, the bank recovered a portion of its loan loss through various collection efforts. At the time of the recoveries, the insurers had made no payment. The question arose as to whether the recoveries received by the bank must be applied first to principal on the underlying

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[34] 626 S.W.2d 267 (Tenn. Ct. App. 1981).
[35] *Branch Bank & Trust Co.*, 834 F.2d at 417.
[36] 418 N.W.2d 853 (Iowa 1988).
[37] *Id*. at 856.
[38] 847 F. Supp. 1322 (E.D. La. 1994).

loans to offset the insurers' liability under the bond, or whether the recoveries may be applied to interest not covered by the bond.

The court reconsidered its prior rulings about the potential income exclusion and held that the exclusion is not determinative of the manner in which recoveries should be applied. The court reasoned that the exclusion applies to interest "not realized," indicating the insurers were not bound to pay the bank for a loss of income that is earned but unreceived. However, in this case, the court indicated the bank's recoveries were both "accrued and received, or realized" and could therefore be applied first to offset an uncovered loss of accrued interest.[39]

Next, several courts have considered whether prejudgment interest is excluded under the bond as potential income. In *Oritani Savings & Loan Association v. Fidelity and Deposit Company of Maryland*,[40] the court held the savings and loan association was entitled to an award of prejudgment interest, notwithstanding the potential income exclusion. Specifically, the court agreed with the distinction made by the savings and loan between the interest that accrues, or could have been earned, between the time that a loss is suffered and a claim is paid, and the interest that accrued between the time a claim is wrongfully denied and recovery is had under the contract. The court reasoned that it was proper to interpret the purpose of the exclusion as limiting the bounds of insurance coverage, as opposed to limiting the insurer's liability in the event of a lawsuit. The court therefore affirmed the award of prejudgment interest.

Similarly, in *Cambridge Trust Co. v. Commercial Union Insurance Co.*,[41] the court was presented with the issue of whether the potential income exclusion barred recovery of prejudgment interest. The court upheld the prejudgment interest award citing the *Oritani* case, making a similar distinction between the interest that accrues between the time a loss is suffered and a claim is paid, and the interest that accrues between the time a claim is wrongfully denied and recovery is had under the contract. The court further opined "it is one thing for an insurer to define what losses it covers, quite another to attempt to neutralize what the State has declared a defendant is to pay by reason of its unlawful conduct."[42]

A claim for interest on the amount owed under a financial institution bond for the period between notice of loss and receipt of payment was properly excluded as potential income, according to the court in *Bank One, West Virginia v. USF&G.*[43] In this case, seventeen months elapsed between the Insured's filing of its proof of loss and payment of the claim by the insurer. The court held that the bank effectively discharged its claim against the insurer by accepting settlement of the principal amount of the loss. The court reasoned, in part, that the presence of the potential income exclusion indicated there could be no reasonable expectation that interest would be contemplated under the terms of the bond.

[39] *Id*. at 1324.
[40] 744 F. Supp. 1311 (D.N.J. 1990).
[41] 591 N.E.2d. 1117 (Mass. App. Ct.1992).
[42] *Id*. at 1121.
[43] 869 F. Supp. 426 (S.D. W. Va. 1994).

IV. *Commercial Crime Policy Case History and Interpretation*

One of the earlier cases interpreting the income exclusion is the case of *United States Gypsum Co. v. Insurance C. of North America.*[44] United States Gypsum was the only seller of a sealant called BISCO, which is used in nuclear power facilities. In addition, Gypsum developed a formula for a product that could be used in place of BISCO. Gypsum's employee, Mr. Banks, shared the formula with another company, violating his employment agreement to keep Gypsum's trade secrets confidential.

Gypsum filed a proof of loss with its insurer, Insurance Company of North America, seeking the gross revenues obtained by its new competitor from the sales of the alternative sealant. ICNA's Comprehensive Commercial Crime Policy provided coverage for "loss of Money, Securities and other property which the Insured shall sustain through any fraudulent or dishonest act or acts committed by any of the employees, acting alone or in collusion with others." ICNA denied coverage pursuant to the policy's potential income exclusion, which stated "the Company shall not be liable under any Insuring Agreement for (i) Potential income, including but not limited to interest and dividends, not realized by the Insured because of a loss covered under this Policy."[45]

Gypsum sought a declaratory judgment that ICNA's policy provided coverage for the claim for the income lost, plus interest, caused by the theft of its trade secret. The trial court granted summary judgment for ICNA. On appeal, Gypsum argued that if its employee had not stolen the trade secret, Gypsum would have earned the income from the alternative formula.

The Seventh Circuit discussed the rationale behind the policy's exclusion by analogizing the leak of the trade secret to the theft of a machine or device that produces the sealant. The court used the analogy to explain that the policy only provides coverage for the actual value of a particular asset and not the income an insured can derive from its use. Otherwise, there would be no incentive for an insured to act quickly to minimize its loss. The court wrote:

> It is not as though Gypsum had [an adhesive] making machine and Banks stole it; it is as though Banks used the machine . . . after work and sold the illicitly made BISCO. Gypsum still had the formula and the rights to it. Gypsum did not allege that the events caused Gypsum to lose the formula or the rights, through the formula becoming public, for example.
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> * * *
>
> Gypsum has the most control over how much it will suffer in the market as a result of the dishonesty of its employees. ICNA expressly declined to take on the risk of such losses, effectively forcing a strict duty of mitigation of such costs upon Gypsum. In the machine, analogy, Gypsum must act quickly to replace the machine or face the loss of sales. In a case like the present, Gypsum must move to stop the sales of the counterfeit BISCO.[46]

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[44] 813 F.2d 856 (7th Cir. 1987).
[45] *Id*. at 857.
[46] *Id*. at 858.

The court determined that the asset itself, the trade secret, remained unchanged and no less useful to Gypsum than it was before the secret was leaked. Thus, without any damage to or loss of the trade secret, coverage could not apply under the policy.

In *Diversified Group, Inc. v. Van Tassel*,[47] the court used the *Gypsum* case as precedence in its determination of a similar issue. In this case, the defendant, Mr. Van Tassel, was employed by DGI to submit proposals to the United States Military for furnishing berthing facilities for naval vessels. While employed with DGI, and using DGI resources, Mr. Van Tassel and a co-worker submitted competing bids against DGI for the same contracts. Mr. Van Tassel's individual bid was awarded the government contracts over DGI. DGI brought suit against Mr. Van Tassel and its own insurers, seeking to recover the loss of profits DGI would have received if it were awarded the contracts.

DGI was insured under St. Paul Insurance Company's Comprehensive Dishonesty, Disappearance and Destruction Policy, which provided the same essential coverage and exclusionary provisions as the policy referenced in *Gypsum*, above. The Fifth Circuit noted that it previously ruled that income losses resulting from the theft of corporate opportunity were covered by policies protecting against the dishonest acts of employees.[48] However, such rulings arose prior to use of the income exclusion at issue in this case. Without much explanation, the court ruled the exclusion was clear and unambiguous and "excludes coverage for loss of future profits, or future income flow, resulting from the fraudulent or dishonest acts of employees."[49] The court did note, however, that the DGI resources used by Mr. Van Tassel may be covered under the policy and remanded that portion of the case for determination.

Simon Marketing v. Gulf Insurance Co.[50] was just one of many cases that erupted throughout the nation when a promotional program offered by McDonald's went awry. Simon performed promotional and marketing services for McDonald's Corporation, which included "Who Wants to Be a Millionaire" and "Monopoly." Mr. Jerome Jacobson, director of security for Simon, was responsible for placing high-value winning game tickets in McDonald's locations throughout the country. Mr. Jacobson developed and implemented a scheme whereby he would funnel these tickets to specific individuals in exchange for kickbacks from the winners. The alleged value of the winning tickets was $21 million.

Simon sought coverage under two policies—one issued by Gulf and the other issued by Federal. The Gulf policy provided Employee Dishonesty coverage for Simon, but also contained standard income exclusionary language. The Federal policy provided Employee Theft coverage, with a similar income exclusion as that in the Gulf policy. Amongst other things, Simon asserted that it was entitled to recover its lost business resulting from Mr. Jacobson's criminal activity—an estimated $60 million.

The California Court of Appeal, Second District, upheld the trial court's decision, granting summary judgment for the insurers. The court noted that the Gulf and Federal policies excluded coverage for lost business opportunities. However, the court emphasized that Simon's

[47] 806 F.2d 1275 (5th Cir. 1987).
[48] *See* Eagle Indem. Co. v. Cherry, 182 F.2d 298 (5th Cir. 1950).
[49] *Van Tassel*, 806 F.2d at 1278.
[50] 149 Cal. App. 4th 616 (Cal. Ct. App. 2007).

claim did not constitute an actual loss of property covered under the policy. Pointing to provisions in *Couch on Insurance* and the *Gypsum* case, the court affirmed the basic tenets of property insurance: that there must be a loss of or damage to property for coverage to attach; and that "detrimental economic impact unaccompanied by a distinct, demonstrable, physical alteration of the property is not compensable under a contract of property insurance."[51]

Furthermore, the court in *Benchemark Printing, Inc. v. American Manufacturers Mutual Insurance Co.*[52] made a similar analysis when it determined that lost business contracts suffered by the insured were not covered property under the policy. Benchemark was a commercial printing company, whose crime policy also excluded from coverage "loss that is an indirect result of any act or 'occurrence' covered by this insurance including but not limited to, loss resulting from your inability to realize income that you would have realized had there been no loss of, or loss from damage to, 'Covered Property.'"

Benchemark's sales manager, Mr. Eugene Errico, was responsible for obtaining new clients as well as maintaining current clients. After Mr. Errico's resignation, Benchemark discovered Mr. Errico had represented to one of Benchemark's clients, the New York State United Teachers ("NYSUT"), that it was unable to perform their printing jobs and the jobs would be subcontracted to Dodge Graphics ("Dodge"), a Benchemark competitor, when, in fact, there was no subcontract agreement. Instead, Mr. Errico represented to Benchemark that it had lost the NYSUT account to competitors. Under this scheme, Mr. Errico requested that Dodge submit a quote for each job. Dodge sent an invoice to Mr. Errico, which he then marked up. Dodge invoiced the NYSUT according to the marked-up figures. NYSUT paid Dodge, who then paid Mr. Errico the difference between its quoted price and the mark-up. Mr. Errico also engaged in a similar scheme involving a separate printer and customer.

American Manufacturers Mutual Insurance Company denied coverage, and Benchemark brought suit, seeking the kickbacks the printers paid to Mr. Errico, as well as its lost profits, claiming these losses were covered property within the meaning of the insurance policy. The policy defined covered property as money, securities and other tangible property that has intrinsic value, which the insured owns, holds or is legally liable for. At issue in the case was whether the losses claimed were covered property under the policy.

The court found that Mr. Errico's conduct caused Benchemark lost business opportunities or profits. However, since Benchemark could not show it actually earned, owned, ever held or had any liability for these profits, the court found Benchemark's alleged losses were not covered property under the policy.

Since the court held the lost business profits were not property covered under the policy's insuring clause, the court did not truly address the applicability of the policy's income exclusion. However, in dictum, the court opined that in order for the income exclusion to apply, Benchemark would have to be seeking to recover the income it would have realized from the lost profits, such as interest.

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[51] *Id*. at *623 (citing 10A Lee R. Russ & Thomas F. Segalla, COUCH ON INSURANCE § 148:46 (2006)).
[52] No. 00-CV-0865, 2004 WL 66310 (N.D.N.Y. Jan. 26, 2001).

In *Koch Industries v. National Union Fire Insurance Co.*,[53] the court was faced with summary judgment motions from both the insurer and the insured as to the issue of coverage. The insured sought coverage for the loss it sustained when its employee engaged in a scheme accepting kickbacks from customers in exchange for allowing them to purchase oil from the insured at discounted prices.

In reviewing the motions before it, the court found that Koch's employee submitted special billing forms that enabled non-qualifying buyers to receive Koch's oil at a price lower than the market value. The court then concluded it was "evident that [the employee] defrauded Koch by means of a 'calculated scheme by which he used his extraordinary position of trust to enhance his personal financial gain at the expense of his employer,'"[54] thus committing a dishonest or fraudulent act within the meaning of the bond.

National Union argued, however, that it would not be obligated to pay for Koch's loss because it did not satisfy the policy's payroll language, above, or it was excluded under the policy as an indirect loss. The indirect loss exclusion provided the policy did not apply to "potential income, including but not limited to interest and dividends, not realized by the insured because of a loss covered under this Policy."[55]

Without explanation, the court found it did not have sufficient evidence to determine if the kickbacks received by Koch's employee were "benefits earned in the normal course of employment." However, the court found National Union's potential income exclusion was ambiguous and that the loss sustained by the insured should be measured by the fair market value of the goods lost. Thus, Koch would be entitled to receive the difference between the fair market value of the oil its employee sold to the non-qualifying buyers and the price Koch actually received.[56]

In *Patrick Schaumburg Automobiles, Inc. v. Hanover Insurance Co*.,[57] the court found a distinction between the policy at issue and the one at issue in *Koch*, above. In this case, the policy provided that indirect loss was "loss that is an indirect result of any act or occurrence . . . including, but not limited to, loss resulting from: [the insured's] inability to realize income that [the insured] would have realized had there been no loss of . . . Covered Property." The court found that this provision was *not* ambiguous, as it was not modified by a reference to interest and dividends, as in *Koch*. However, the result was essentially the same.

In *Schaumburg*, the insured Plaintiffs were automobile dealerships that claimed financial losses resulting from the dishonest activities of their former employee, Mr. David Hoffman. As part of their business, Plaintiffs purchased and sold used cars in the wholesale market. It was discovered that Mr. Hoffman received kickbacks from certain wholesalers as part of a scheme in which he sold Plaintiffs' cars to those wholesalers for an amount less than the cars' worth and purchased cars from these wholesalers for more than the cars' worth.

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[53] No. 89-1158-K, 1989 WL 158039 (D. Kan. Dec. 21, 1989).
[54] *Id*. at *16.
[55] *Id*. at *17.
[56] *Id*. at *19.
[57] 452 F. Supp. 2d 857 (N.D. Ill. 2006).

With respect to that portion of their claim relating to the overpayments to the wholesalers, the insured argued they were entitled to coverage under their crime policy with Hanover for the difference between the Black Book estimates of the value of the cars and the price at which they purchased the cars. Hanover argued the "direct loss" should be calculated based upon whether the Plaintiffs "recouped" the initial purchase price in later transactions in which Plaintiffs sold the cars. Thus, if Plaintiffs sold the cars for the same amount or more than the amount they paid, Hanover argued there was no loss. Alternatively, Hanover argued Plaintiffs' claim constituted a claim for lost profits, which were excluded from coverage.

The Illinois court rejected Hanover's recovery argument, stating Hanover's deduction of amounts received by Plaintiffs in subsequent transactions "was not correct." The court further held Plaintiffs' overpayment to the colluding wholesalers, resulting from Hoffman's dishonest activity, was a covered loss under the policy. Citing *RBC Mortgage Co. v. National Union Fire Insurance Co.*,[58] the court found the overpayment (compared to the Black Book value) was an actual depletion of bank funds caused by the employee's dishonest acts and, thus, was a loss resulting directly from dishonest activity and covered under the policy.[59]

With respect to the potential income exclusion, the court held that, to the extent Plaintiffs could prove they paid an amount greater than the amount they would have paid in an arm's-length transaction, that amount is a direct loss of covered property, not an inability to realize income.

V. *Conclusion*

From an accounting perspective, income is the result of two factors:

1. The sale of the entity's products or services (realized income); and
2. Increases and decreases in retained earnings, net assets, financial capital or physical capital.

Also from an accounting perspective, the timing of income reporting is constrained by the convention of realization. The realization convention requires the criteria of:

1. Revenue (income) is capable of being measured.
2. The measurement is verified by a third-party source.
3. Products or services have been exchanged in an arms-length transaction.

Realization requires that a transaction with an independent third party (arms-length) will take place before income is recognizable.

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[58] 812 N.E.2d 728 , 731, 733 (Ill. App. Ct. 2004).

[59] We note that in reaching its decision, the Illinois court relied upon one line from *FDIC v. United Pacific Ins. Co.,* 20 F.3d 1070 (10th Cir. 1994), wherein the court noted in the context of a loan loss that a direct loss occurs when the funds are improperly diverted. However, the Tenth Circuit also conceded that "if the collateral is finally determined in favor of the insured, under the terms of the bond, it becomes a 'recovery' applicable against the loss." The *Schaumburg* decision also appears to be inconsistent with a pronouncement in *Central National Chicago Corp. v. Lumbermens Mutual Casualty Co*., 359 N.E.2d 797 (Ill. App. Ct. 1977) that "there can be no recoverable loss where plaintiffs have been compensated for the injury suffered."

Thus, to realize revenue or income from fraudulent or dishonest acts of any employee, or from employee theft, is not possible under GAAP, FASB or IASB. Also, the concept of realized income is not possible when lost income is not measurable, as is the case in commercial claims.

From a legal perspective, unfortunately, because there is no single definition of income from an accounting perspective and because of the use of the words "not realized" in the exclusion, some courts have apparently chosen to apply a simplified approach that does not follow the accounting perspective and does not apply the fundamental concept in every insurance contract set forth at the beginning of this article. These courts conclude that income is "realized" (thus not "potential" and "not realized") simply because it is recorded on the books and records of the insured or because the insured had received money from a transaction even though the transaction is the result of employee dishonesty or employee theft.

Finally, it should be noted that to further support the fundamental premise that an insured should not realize a gain from a covered loss, an alternative approach, at least under the Financial Institution Bond by the Surety & Fidelity Association of America and the International Surety Organization, has been to include language requiring all money and property received by the insured (whether payment of principal, interest, dividends, commissions and the like), in connection with any matter from which a loss has arisen, be deducted from the amount paid out, advanced, withdrawn, taken or otherwise lost or stolen.

VALUATION

> Section 6.
>
> The value of any loss for purposes of coverage under this bond shall be the net loss to the Insured after crediting any receipts, payments or recoveries, however denominated, received by the Insured in connection with the transaction giving rise to the loss. If the loss involves a Loan, any interest or fees received by the Insured in connection with the Loan shall be such a credit.[60]
>
> 21. Valuation – Settlement
>
> The value of any loss for purposes of coverage under this policy shall be the net loss to you after crediting any receipts, payments or recoveries, however denominated, received by you in connection with the transaction giving rise to the loss. If the loss involves a "loan," any interest or fees received by you in connection with the "loan" shall be considered such a credit.[61]

Such language should be considered in addition to the income exclusion when dealing with a claim in which the insured seeks to recover income. However, what the future holds with respect to the differences between the accounting approach and the legal approach in defining income remains to be seen.

[60] SAA Standard Form 24 (April 1, 2004).
[61] FI 00 10 06 05, ISO Properties, Inc. 2004, p. 13.