

**"THE FINANCIAL INSTITUTION BOND:
WHO IS COVERED UNDER INSURING
AGREEMENT (A)"**

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**"THE FINANCIAL INSTITUTION BOND:
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Insuring Agreement (A) of the Financial Institution Bond-- Standard Form 24, Revised to January 1986 (hereinafter the "FIB"), provides coverage for employee dishonesty ("dishonest or fraudulent acts") under the policy. The focus of this paper is to determine who is considered to be an employee for the purposes of invoking coverage and under what circumstances are the acts of those considered to be employees covered under this agreement.'

DEFINITION OF "EMPLOYEE"

The definition of "employee" is set forth in Section 1 of the FIB's Conditions and Limitations. The definition is as follows:

SECTION 1

(g) Employee means

- (1) an officer or other employee of the Insured, while employed in, at or by any of the Insured's offices or premises covered hereunder, and a guest student pursuing studies or duties in any of said offices or premises;
- (2) an attorney retained by the Insured and an employee of such attorney while either is performing legal services for the Insured;
- (3) a person provided by an employment contractor to perform employee duties for the Insured under the Insured's supervision at any of the Insured's offices or premises covered hereunder;

- (4) an employee of an institution merged or consolidated with the Insured prior to the effective date of this bond; and
- (5) each natural person, partnership or corporation authorized by the Insured to perform services as data processor of checks or other accounting records of the Insured (not including preparation or modification of computer software or programs), herein called Processor (Each such Processor, and the partners, officers and employees of such Processor shall, collectively, be deemed to be one Employee for all the purposes of this bond, excepting, however, the second paragraph of Section 12. A Federal Reserve Bank or clearing house shall not be construed to be a processor.)

This definition is identical to the definition of "employee" contained in the 1980 Bond, except for some additional language in part (5), which is intended to exclude from the definition data processors authorized by the Insured to prepare or modify computer software or programs.

The FIB's definition also contains a Section (3), present in the 1980 Bond but absent from the 1969 Bond, which provides coverage for employees acquired through a temporary placement agency.

In most cases there is no issue as to whether or not the particular individual who is accused of dishonesty is an "employee"

within the definition of the FIB. However, there are cases in which this is an issue, and it is these cases which we examine and discuss in this paper.² Additionally, it will be instructive to look at those cases dealing with other types of fidelity bonds³ since the principles established in cases arising under various types of fidelity bonds are cited and used as guiding precedent by the courts.⁴

CONTROL

Courts look to several factors in determining whether or not an individual should be considered an employee for purposes of coverage under a fidelity bond, the most important factor being control.⁵ In William H. Sill Mortgages, Inc. v. Ohio Casualty Insurance Co.⁶, the insured (Sill), a mortgage broker business, arranged for Stockford, a real estate broker, to obtain and place mortgages through the company. Stockford was designated as an Assistant Vice-President of the company and was paid a percentage of the overage in discount of each loan he closed. The court held that Stockford was an employee within the meaning of the fidelity bond, stating:

Whether Stockford was an employee is a question of fact. The principal test of an employer and employee relationship is control. Under the finding of facts of the trial judge, which we find not to be clearly erroneous, Mr. Sill had a very close supervision and control over Stockford. Mr. Sill was in almost daily contact with Stockford instructing him and advising him

with reference to processing mortgages through the Sill company. The findings of fact of the trial judge with reference to the employer and employee relationship were not clearly erroneous and they support the legal conclusion that Stockford was an employee of the plaintiff company within the meaning of the bond.⁷

In Third Federal Savings and Loan Association of Cleveland v. Fireman's Fund Insurance Co.⁸ the Sixth Circuit Court of Appeals reversed the District Court and held that a real estate appraiser (Rogers) who was hired by a savings and loan association for a fee to provide periodic inspection reports in connection with construction loans, and who filed certain false inspection reports resulting in losses to the savings and loan association, was not an employee within the meaning of the fidelity bond. In coming to this conclusion, the court ran through a litany of items normally considered when examining whether or not an employer-employee relationship exists:

The appellants contend that the evidence does not support the District Court's finding that Rogers was an employee of the association. He was paid once or twice a month upon submission of statements to the association listing the appraisals and inspections he had made since the last statement. He was never furnished with an employee's withholding statement (W-2). The association did not withhold income tax or deduct social security employee contributions from his pay and made no social security

employer contributions on his behalf. Furthermore, Rogers was not listed as an employee for purposes of workmen's compensation or unemployment compensation. Rogers was not entitled to fringe benefits such as health and life insurance and participation in a pension program, but it was testified that there were other part-time employees that did not share in these benefits. Rogers paid all of his expenses in connection with inspections and appraisals for the association and did independent appraisals for other organizations. He had no set working hours. It is argued that all of these facts indicate that Rogers was an independent contractor rather than an employee of the association. These factors are indicative of some relationship other than that of employer-employee. However, they are not sufficient by themselves to require such a conclusion.⁹

The court examined its prior decision in the Sill case and in affirming its commitment to the principle of control in determining the employment relationship, stated:

Since the right to control is the hallmark of an employer-employee relationship, the exposure of Fireman's Fund may not be expanded by construing the bond to cover the acts of persons who perform services for the association but were not subject to such control. There is no ambiguity in the language of the bond as to require a construction in favor of the insured.¹⁰

Although control clearly remains the paramount factor in most cases in determining whether an individual is an "employee" under the bond, one recent case demonstrates that there are situations when control is not a factor at all in such determination. In Federal Deposit Insurance Corporation v. New Hampshire Insurance Co.¹¹, the FSLIC had brought suit as the Receiver of Ramona Savings and Loan Association to recover under a fidelity bond issued by New Hampshire Insurance Company for losses sustained by Ramona as a result of dishonest or fraudulent acts committed by Ramona's former president, director, and sole shareholder, John L. Molinaro. The district court had granted summary judgment in favor of New Hampshire, from which the FDIC (as successor to FSLIC) appealed. In reversing, the Ninth Circuit Court of Appeals held, inter alia, that Molinaro was an employee under the plain meaning of the definition of "employee" set out in the bond. In its discussion, the Court distinguished the Kerr v. Aetna Casualty & Surety Co.¹² and United States Fidelity & Guaranty Co. v. Three Garden Village Ltd. Partnership¹³ cases, which relied on the control test in their determination that sole stockholders were not "employees" under the bonds. The Court reasoned that in these cases, the bonds contained language limiting coverage to those employees "whom the Insured has the right to govern and direct at all times..." Such language necessitated application of the control test in those cases. However, the absence of such limiting language in New Hampshire's bond¹⁴ precluded application of the control test. As a result the Court held that Molinaro was an "employee" under the bond.

Another recent case, however, illustrates the point that while control is a necessary element in determining whether an individual is an "employee" so as to fall under the ambit of the bond, it is necessary that such control be exercised by the insured. In Bank of Cumberland v. Aetna Casualty and Surety Co.¹⁵, the Sixth Circuit Court of Appeals reversed the district court's denial of Aetna's motion for judgment notwithstanding the verdict and held that there was insufficient evidence to show that a representative of an owner of the insured bank was an employee of the bank. In its discussion, the court acknowledged that the principal test of the employer-employee relationship is control. The court went on to recite the evidence proffered at trial in support of the bank's contention that the dishonest individual (Foster) was an "employee" of the bank:

In order to satisfy its burden, BOC [the insured bank] introduced evidence that Butcher, who was a part owner of BOC, exerted control and/or influence over Foster. Butcher testified by deposition that he "hired" and "employed" Foster and that he voted Foster onto the Board of Directors of several of his banks, including BOC, to represent his interests.

The court discounted this evidence, however, and held that Foster was not an "employee" under the bond:

The fact that Foster was controlled by Butcher, however, does not necessarily establish that Foster was an employee of BOC, which was a separate legal entity from

Butcher.... Butcher's ownership of BOC is relevant only if Butcher acted as a manager or officer of BOC... or was somehow an "alter ego" of BOC....

It is undisputed in this record that Butcher was not an officer or manager of BOC. Further, there is no basis for finding, nor has BOC alleged, that Butcher was the alter ego of BOC. Thus, the relationship between Foster and Butcher is not determinative of the relationship between Foster and BOC.

Finally, BOC has introduced no evidence that any BOC officer or supervisory agent gave Foster instructions, directions, or supervision concerning the performance of his duties; or that BOC otherwise had any right to control Foster's activities on behalf of the bank. Nor is there any evidence that inferentially establishes such a right to control. Therefore, a reasonable jury could only conclude that Foster acted as an independent contractor for BOC ... and not as an "employee" of BOC as required under the bonds.¹⁶

CAPACITY OF EMPLOYEE AT THE TIME OF CLAIMED LOSS

Another question that sometimes arises is whether or not an employee was acting as an employee **at the time** he caused the claimed loss.¹⁷ In First Hays Banshares, Inc. v. Kansas Banker's Surety Co.,¹⁸ the Kansas Supreme Court affirmed that part of the district court's holding which denied the surety's motion for summary judgment on the basis that a material question of fact

existed whether a director who defrauded the bank was an "employee" under a banker's blanket bond. The court cited the Third Federal Savings and Loan Association case¹⁹ and National Bank v. Fidelity and Casualty Co.,²⁰ for the proposition that whether a particular employee is listed in the application for a fidelity bond may be important evidence of whether the parties intended to include such employee within the scope of the bond's coverage. The court in framing the issue stated that whether Pratt (the director) was an employee would be determined by the intent of the parties. The court then discussed the relationship between coverage as an "employee" and the director exclusion:

KBS contends that Pratt is excluded from coverage of the bond because he is not an "employee" of First National, since it did not possess a right to control his activities as a director of the bank. However, the bond obviously contemplates a more generalized concept of the term "employee", since it explicitly includes the director exclusion contained in Section 2(d). If the bond only provided protection against the activities of those persons who are employees in the classic, common law sense, there would be no need for the Section 2(d) director exclusion.

A similar argument was advanced before the Washington Court of Appeals in Puget Sound Bank v. St. Paul Fire Ins.,²¹. The defendant insurer contended that its fidelity bond did not include the acts of Dreitzler, a director of the bank:

St. Paul first argues that Dreitzler was not an 'Employee' of the bank and his acts were therefore not covered by the bonds. We find it unnecessary to decide whether Dreitzler was an 'Employee', i.e., a common law employee of the bank, in order to determine whether his fraudulent acts were within the purview of the bonds. To limit coverage to loss caused by 'Employees' would ignore the director's exclusionary clause, which excludes coverage for any loss 'resulting from any act or acts of any director of the insured other than one employed as . . . an Employee of the Insured, *except when performing acts coming within the scope of the usual duties of an Employee*' (Italics ours.) If only 'Employees' as defined in the bond, were covered, then the latter part of the exclusion would be superfluous, since the clause already provides coverage for those directors who are 'Employees' and excludes those who are not. The latter part of the exclusionary clause, if it is to be given effect at all, must be read as providing coverage for non-'Employee' directors who perform acts ordinarily performed by 'Employees' resulting in loss to the bank . . .²²

In the case of Howard, Weil, Labouisse, Friedrichs, Inc. v.

Insurance Co. of North America,²³ the insured, a brokerage house, employed Latham as a commodity solicitor and registered representative. Latham also maintained a personal commodity account with the insured known as a "house account". While on the floor of the Chicago Board of Trade, he placed orders under his "house account" which over a four day period lost \$154,405.00. He gave the insured bad checks to cover the losses and eventually had to admit that he could not make them good. In considering whether Latham was an employee when he caused the loss the court stated:

INA's alternative argument (that Latham was not acting as an employee) is equally transparent. The bond covered "any loss through any dishonest or fraudulent act of any of the Employees, committed anywhere and whether committed directly or by collusion with others." This language would clearly embrace a collusive broker/customer arrangement to allow the customer to speculate at the expense of the broker's employer by meeting trading calls with bad checks. If the broker carried out such a scheme to the detriment of his employer, thus breaching a fiduciary obligation implicit in his employment, any loss incurred by his employer would unquestionably fall within the employee dishonesty coverage of the bond. The only difference between this example and the case before us is that here the broker and the customer are one and the same. We can see no legal distinction of the broker in the two situations.

Each constitutes employee fraud or dishonesty.²⁴

DUAL EMPLOYMENT

The question of the capacity in which the employee was acting also arises in dual employment cases.²⁵ In Wooddale, Inc. v. Fidelity and Deposit Co. of Maryland,²⁶ the alleged employee worked in a dual capacity as a subcontractor and corporate president of the alleged employer. The court concluded that there was nothing within the bond that prevented an employee from serving two masters in separate capacities, and after pointing out the activities performed by the president of the corporation, held that he met the requirements of an "employee" as defined under the terms of the policy.

The capacity in which the employee was serving at the time of the loss was also at issue in the case of Hudson City Savings Institution v. Hartford Accident and Indemnity Co.²⁷ In this case, insured had procured a Banker's Blanket Bond which provided coverage for employee dishonesty in the amount of \$500,000.00. The plaintiff had engaged a number of mortgage servicing companies to collect mortgage payments. It was the duty of these mortgage servicing companies to receive payments, to remit the principal and interest to plaintiff less a collection fee and to maintain tax escrow accounts in order to make real property tax payments to the appropriate taxing authorities. Plaintiff procured from Hartford a Servicing Contractor's Rider to its bond to protect plaintiff from any dishonesty of any mortgage servicing company. The Rider had a limit of \$50,000.00. When one of the mortgage servicing

companies failed to pay real estate taxes on the monies collected, plaintiff paid out over \$500,000.00 to rectify the situation. It rejected a payment from Hartford of \$50,000.00 under the Rider and sued for the full amount. The Court, after examining the various clauses in question, held that plaintiff's recovery was limited to that provided in the Rider, reasoning that had the mortgage service company been a covered employee under the original Bond, there would have been no reason for adding such coverage in the Rider.

Two cases present the unique situation of a raid on the corporate treasury by what are referred to as usurpers²⁸ and interlopers.²⁹ Both cases concerned a purchase of stock of a corporation, the election of the purchasers as officers and directors, and a quick withdrawal of funds to cover the purchase. In both cases, the Court denied recovery under the fidelity bonds holding that usurpers and interlopers were not "employees".

Banco De San German, Inc v. Maryland Casualty Co.³⁰ presents a situation where the court concluded that the insured suffered a loss and that the loss was caused by employee dishonesty, but where the court was unable to find that any specific employees were involved in the loss. Nevertheless, the court held that the loss was covered by the bond.

Kerr v. Aetna Casualty & Surety Co.³¹ sets out an unusual situation where two men, Cudd and Coan, controlled several companies, serving as officers and directors of them. After the corporations went into bankruptcy, the various receivers and trustees brought actions under the fidelity bonds. The principal

defense was that Cudd and Coan were not employees of the various corporations. In reversing a judgment in favor of the plaintiffs on this point, the Court of Appeals for the Fourth Circuit held as follows:

As shareholders of Underwriters, Cudd and Coan elected themselves its sole directors, and as directors they elected themselves its chief executive officers. Since the charter gave the directors the right to manage and control the corporation, Cudd and Coan as directors probably had the technical right to control Cudd and Coan as officers. But such a theoretical and unrealistic right of control did not make Cudd and Coan "Employees" of Underwriters covered by the bond. Such a bond is not intended to cover the fraud and dishonesty of men who are in effect the sole stockholders, as well as the only directors of a closely held corporation. As noted above, the bond is intended to protect the corporation from the fraud or dishonesty of its employees, not to protect its creditors from the fraud or dishonesty of its stockholders and directors. We cannot agree with the District Judge that the claimed loss as a result of the write-off of the debts resulted from the activities of Cudd and Coan as "Employees" of Underwriters."³²

Thereafter, the same court on two occasions held that the Kerr case facts were not present. In Phoenix Savings & Loan, Inc. v. Aetna Casualty & Surety Co.,³³ Coven and Marshall were President

and Secretary-Treasurer of plaintiff respectively, as well as directors and sole members of the plaintiff's Executive Committee. In reversing the summary judgment granted by the District Court³⁴, the Court of Appeals³⁵ went out of its way to touch an issue raised in Kerr but not relied on nor discussed by the court below.

The Appeals Court said:

The facts as presently developed upon the record fail to bring it within the ambit of [Kerr] * * * In [Kerr], at page 154, the definition of employee contained in the bond was different to that in the bond before us * * * In [Kerr] this court, in reversing the district court which had found that Cudd and Coan (the two wrongdoers) were "employees" of Underwriters in bringing about the claimed loss, concluded that the two were its sole directors, chief executive officers and owned individually seventy-five percent of its stock with the remainder being held by a private corporation which they owned. The testimony developed at the trial in the court below demonstrated clearly that Cudd and Coan had full and absolute control of Underwriters and all of its activities. We accordingly held that they were not "employees" within the meaning of the bond even though they were paid salaries by the corporation, and that the bond was not intended to cover the fraud and dishonesty of men who are "the sole stockholders, as well as the only directors of a closely held corporation". We found it unnecessary to

pass upon the other defenses of Aetna which were substantially the same as those asserted in this action and intimated no opinion thereabout.³⁶

On remand, evidence was submitted and at the conclusion of trial, the District Court granted the defendant's motion for a directed verdict.³⁷ In the course of its opinion, the District Court held that Coven and Marshall "never acted as employees". Once again the Court of Appeals reversed³⁸ and referred to its prior Kerr opinion. The Court stated:

The stipulated facts here are starkly different from the facts of those cases cited by Aetna which hold that no real employer-employee relationship exists where complete control of the corporation is lodged in the alleged employee. In Kerr v. Aetna Casualty and Sur. Co., 350 F.2d 146 (4th Cir. 1965), Cudd and Coan were the principal officers of the insured, the only directors of the insured and owned all of its stock either directly or indirectly.³⁹

Following the Kerr line of cases are Employer's Administrative Services, Inc. v. Hartford Accident & Indemnity Co.,⁴⁰ and United States Fidelity & Guaranty Co. v. Three Garden Village Limited Partnership⁴¹. In both of these cases, the courts held that sole stockholders and directors of the insured were not employees within the definition of the bond as the insured could not realistically exercise control over them.

As stated previously, in most cases the employment status of

the person against whom the claim is made is not at issue. However, this question must be answered affirmatively before moving on to other aspects of coverage. As the foregoing cases illustrate, this question is normally one of fact and is not necessarily to be determined or controlled by the title or office held by the person involved.

ATTORNEYS

The definition of "employee" also includes:

- (2) an attorney retained by the insured and an employee of such attorney while either is performing legal services for the insured.

Two reported decisions exhibit coverage problems which may arise under this section. In Pioneer National Title Insurance Co. v. American Casualty Co. of Reading, Pa.⁴² an approved attorney of the plaintiff title insurer was called upon to handle title closings for a client, Advance Mortgage Corporation, which was selling three pieces of property and taking back mortgages. Advance issued checks to the buyers in the amount loaned to each buyer to endorse and to be returned to Advance to pay the purchase price on the properties. The attorney handled the checks and was to secure title insurance from the plaintiff title insurer assuring that Advance's take-back mortgages were first liens on the properties. Plaintiff title insurer had given Advance a letter to induce use of its title insurer's services; the letter provided that the plaintiff title insurer would protect Advance if one of plaintiff title insurer's approved attorneys converted money

entrusted to him. When the approved attorney failed to remit the proper sums in the three transactions in issue, Advance brought suit against the title insurer, the defense of which was tendered to the title insurer's fidelity bond underwriter who refused to defend. Judgment was entered in this underlying suit against the title insurer who then sued the fidelity bond underwriter. The District Court entered summary judgment in favor of plaintiff title insurer, holding that the attorney was an "employee" within the definition of the bond and to that extent the Fifth Circuit Court of Appeals affirmed the District Court's holding. The case was remanded for further proceedings on other issues.

In Moultrie National Bank v. Traveler's Indemnity Co.⁴³ the plaintiff bank made a real estate loan to Gardner in reliance on a title opinion written by Craigmiles, an attorney, and furnished to the bank by Gardner, in which it was certified that Gardner had title to a piece of property when he did not. When a loss occurred, the bank first sued Craigmiles and when that proved unsuccessful, the bank brought suit against its Banker's Blanket Bond surety alleging dishonesty on the part of Craigmiles as an attorney "retained by it". The District Court held that Craigmiles had not been dishonest, but instead had been duped by Gardner, a person whom he trusted. The Court found it unnecessary to decide whether Craigmiles was an attorney retained by the insured bank, but on this issue went on to say rather curiously:

While lenders sometimes agree to accept a title opinion to be furnished by the borrower's attorney and under such

an arrangement there may exist a relationship of attorney and client between the lender and borrower's attorney if such was the mutual understanding * * *, this simply means that the lender may employ or retain the borrower's attorney to be also the lender's attorney, if such was the mutual understanding, and * * * the mere fact that the three party agreement is that the borrower will pay all the expenses of the loan including the attorney's fees does not preclude the claimed relationship of attorney and client between the lender and the attorney. It may be argued, however, that under such an arrangement the claimed relationship may exist without the lender having 'retained' such attorney. * * * It may be argued that this bond was intended to cover, as it says, 'attorneys retained by the Insured' and not a borrower's attorney never seen, never contacted, never retained by the bank, but whose opinion, for the convenience of the borrower, the bank agrees to rely upon, provided the borrower agrees to pay him. It may be, too, that by the language used in this bond the parties contemplated a less tenuous relationship than that shown to exist between the plaintiff bank and Judge Craigmiles.⁴⁴

The opinion of the United States District Court for the District of New Jersey in Midland Bank & Trust Co. v. Fidelity & Deposit Co. of Maryland,⁴⁵ raises a somewhat different question. Moraites, a member of the board of directors of plaintiff bank, was

a New York attorney who resided in New Jersey and was very active in maritime financing. He suggested that the bank engage in instant participation loans with some New York banks. Later he suggested that the bank make direct loans. It was the general understanding that he would be responsible for the necessary documentation of and would be counsel to the bank in connection with the ship loans. Loans were booked which did not satisfy the collateral requirements established by the bank's board. Other wrongful conduct took place with respect to these loans, all of which eventually led to losses for the bank. The Court in discussing Moraites and his relationship to the bank said:

Turning to the defendant's first argument, as noted above, F & D does not deny that Moraites served as Midland's counsel on the ship loans, rather they contend that neither Moraites nor his firm were ever "retained" to perform legal services within the meaning of the bonds. Defendant's argument focuses on the fact that the Bank never paid Moraites a retaining fee and, further, that he was not admitted to the practice of law in the State of New Jersey. Equating the word "retained" as used in the bond with the meaning of the word "retainer", defendant asserts that in the absence of being paid a fee, Moraites could not have been employed by the Bank to perform legal services. This Court feels, however, the construction of the clause urged by the defendant is too narrow. In addition to connoting the payment of fee,

"retain" means generally "to engage the services of an attorney or counselor to manage a cause." Black's Law Dictionary (Rev. 4th ed. 1968). It has been held on several occasions that payment of a fee is not necessary to give rise to the employment relationship of attorney-client. Shoup v. Dowsey, 134 N. J. Eq. 440, 475, 36 A.2d 66 (Ch. 1944); E. F. Hutton & Co. v. Brown, 305 F.Supp. 371, 388 (S.D. Tex. 1969). Whether an employment situation was intended to be created can be implied from the conduct of the parties. "While the relationship may be said to rest upon contract, formality is not an essential element of the employment." Shoup v. Dowsey, *Supra*, N.J.Eq. at 476, 36 A.2d at 85. Thus, the fact that Moraites was not hired, for example, by a formal resolution of the Board of Directors, would not preclude a finding that Moraites was retained by the Bank as their ship loan counsel. Nor does the fact that Moraites was licensed to practice law solely in the state of New York have any effect on whether an employment relationship existed. Although Moraites could not appear in New Jersey courts unless admitted pro hac vice, there was no bar against him acting as counsel for the Bank in preparing all necessary documentation.

This Court is therefore of the opinion that Moraites was in fact "retained by the Insured to perform legal

services," and, therefore, was an employee of the Bank within the meaning of the bonds.⁴⁶

The holdings of these cases illustrate that payment of fees is not necessary to an attorney-client relationship. This is a significant point since financial institutions do not generally pay the fees of their attorneys in loan transactions. This cost is normally borne by the borrower.

The practice in this regard has been changing in recent years. In the past, banks insisted that their attorneys would handle all of the details of a real estate closing. Borrowers were virtually unrepresented. The borrower paid the fees but the loyalty of the attorney was clearly to the bank even though he was virtually representing both sides. However, borrowers began to rebel and courts began declaring such situations to be unethical as involving conflicts of interest. Banks then began having borrowers sign a paper recognizing that the attorney required by the bank was representing the bank alone, with the borrowers free to engage, and of course pay the fees of other counsel of their choice. In more recent times, banks have permitted the borrowers' attorneys to close "the mortgage phase" as well as "the title phase" of real estate transactions recognizing that there were really two transactions and that the banks attorneys were mainly interested in the "mortgage" transaction. Another practice that has developed is to have a "reviewing attorney" review the papers to ensure their legal sufficiency. As before, this attorney's fee is paid by the borrower. Thus the borrower, who has to pay all of the fees

anyway, is at least paying the fees of one attorney of his choice. Nevertheless, the underlying dual representation has continued as the borrower's attorney continues to represent both the bank and the borrower. The bank entrusts the mortgage moneys to the attorney whether he or she is technically the bank's attorney or the borrower's attorney. Hence, any defalcation by either a misapplication of funds, a dishonest failure to clear liens from the title, or a failure to record and perfect the bank's first lien would appear to be within the coverage of the FIB regardless of which attorney is involved because, as noted, "payment of a fee" is not the determinative criterion. The question remains, regardless of who pays the attorneys' fees, was the attorney, or the attorneys engaged by the bank to perform services in the transactions and did the attorney(s) act dishonestly in performing that service.

**EMPLOYEES OF INSTITUTION MERGED OR
CONSOLIDATED WITH THE INSURED**

The definition of "employee" in the FIB includes coverage of "an employee of an institution merged or consolidated with the Insured prior to the effective date of this bond". This language, which was also present in the 1980 Bond, replaced the earlier language contained in the 1969 Bond, which referred to employees of "predecessor of the insured." The addition of such individuals as "employees" within coverage of the Bond stems from the nature of the FIB which is a "discovery" type of policy. Since coverage under the FIB depends on discovery made after the effective date of the Bond coverage, employees of institutions that have merged or

consolidated with the Insured present no special problems for the insurer. However, Section 12(d) of the FIB provides that the FIB terminates as an entirety "immediately upon the taking over of the Insured by another institution." Thus, under Section 12(d), if Bank A were to be merged or consolidated into Bank B, the bond of Bank A would terminate on the day of the merger or consolidation. The inclusion of "employee[s] of an institution merged or consolidated with the Insured prior to the effective date of this bond" is necessary so that there will be no gaps in coverage and so that the bond of Bank B will cover all employees of Bank A after the merger or consolidation. However, the inclusion of such employees under the definition of "employees" results in a number of coverage disputes, particularly regarding discovery of losses prior to the merger or consolidation.⁴⁷

In Wachovia Bank and Trust Company v. Manufacturers Cas. Ins. Co.⁴⁸ Wachovia was acquiring City Industrial and Savings Bank. On the day prior to the merger, Wachovia personnel were going over the books at City Industrial. They could not get certain records to balance, but no dishonesty was uncovered or suspected. One week after the merger a dishonesty loss was discovered which had actually occurred several months before the merger. Wachovia was insured by Hartford Accident and Indemnity Company while City Industrial was insured by Manufacturers. Wachovia chose to bring suit solely against Manufacturers.

The Court first pointed out that Manufacturers' bond terminated at the time of the merger. It then posed this problem:

The liability of the defendant for the loss in question depends on whether or not the loss was "discovered" prior to the termination of the defendant's bond at midnight on February 29, 1956. ⁴⁹

In its consideration of the problem of what constitutes "discovery" the Court continued:

In order to constitute a discovery in accordance with the terms of the policy under consideration, there must be facts known, at the time it is asserted that the discovery was made, which would lead a reasonable person to an assumption that a shortage existed. The facts must be viewed as they would have been by a reasonable person at the time discovery is asserted, and not as they later appeared in the light of subsequently acquired knowledge. While it is not necessary that the exact amount or details of the loss be known to constitute a discovery, the mere discovery of certain facts which later lead to other facts which reveal the existence of a shortage does not necessarily constitute a discovery. Knowledge available to the insured must rise above a mere suspicion of loss. The fact that an investigation after the termination of the policy leads to the disclosure of an actual defalcation does not raise a previous suspicion to the level of a discovery. Inefficient business procedures, or irregularities and discrepancies, in accounts, if as consistent with the integrity of

employees as their dishonesty, does not constitute a discovery, even though dishonest acts may later be found to exist. 50 Am. Jur., Suretyship 345-348, 45 C.J.S.. Insurance 804, 11 Appleman, Insurance Law and Practices 6979, Forest City Building & Loan Ass'n v. Davis, 1926, 192 N.C. 108, 133 S.E. 530; Massachusetts Bonding & Ins. Co. v. Norwich Pharmacal Co., 2 Cir., 1927, 18 F.2d 934.

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In another case⁵¹, Fidelity Savings and Loan Association merged with Trans-Bay Federal Savings and Loan Association. Fidelity was insured by Republic Insurance Company while Trans-Bay was insured by Fireman's Fund. Prior to the merger Trans-Bay had been named a defendant in several lawsuits that were based on allegedly fraudulent acts committed by Trans-Bay employees. After the merger, Fidelity defended the suits. After the suits were concluded, Fidelity brought suit against Republic, its insurer, and Fireman's Fund, the former insurer of Trans-Bay. Republic's motion to dismiss was granted, the District Court holding that Fidelity was limited to an action against Fireman's Fund. On appeal, the judgment in favor of Republic was affirmed.⁵² The Ninth Circuit Court of Appeals framed the issue as follows:

This appeal raises an interesting question of first impression: whether a standard banker's blanket bond issued to Company A covers litigation costs incurred by Company A after its merger with Company B for its defense of lawsuits filed against Company B before the merger.

In its consideration of the question, the Court reasoned as follows:

Fidelity * * * concedes that any loss to Trans-Bay was sustained prior to the merger. It argues, however, that Fidelity sustained a "loss" within the meaning of the bond, at the time of and by virtue of the merger. Fidelity's argument is based solely on the fact that at the moment of merger it became subject to all of Trans-Bay's liabilities. Thus, according to appellant, on March 1, 1966 - a date covered by the Republic bond - all of Trans-Bay's liabilities became Fidelity's liabilities and all of Trans-Bay's losses became Fidelity's losses.

The logic of appellant's position, however, does not withstand analysis. In the first place, Fidelity takes the inherently inconsistent position that one set of events giving rise to claims solely against Trans-Bay may result in a "loss" to Trans-Bay prior to the merger. But even apart from this inconsistent argument, we cannot accept appellant's view that Fidelity did in fact sustain a loss on the date of the merger. It is beyond dispute that Fidelity by virtue of the merger became subject to Trans-Bay's debts and liabilities; however, it is an unwarranted leap in logic to conclude that the acquisition of Trans-Bay's liabilities amounted to a new "loss" in the hands of Fidelity, the surviving

corporation. What appellant failed to recognize is that a merger does not create new liabilities or losses in the surviving corporation but merely allows pre-existing assets to survive the fusion of corporate bodies. ⁵³

DIRECTORS

Section 2(d) of the FIB, which is identical to Section 2(d) of the 1980 Bond, excludes from coverage "loss resulting directly or indirectly from any acts of any director of the Insured other than one employed as a salaried, pensioned, elected official or an Employee of the Insured, except when performing acts coming within the scope of the usual duties of an Employee, or while acting as a member of any committee duly elected or appointed by resolution of the board of directors of the Insured to perform specific, as distinguished from general, directorial acts on behalf of the Insured."

This exclusion, which excludes directors from coverage under the FIB unless they are acting as employees, and in some circumstances, on a committee, has given rise to a number of cases in which the surety company attempted to deny coverage based upon this exclusion.⁵⁴ In First Hays Banshares, Inc. v. Kansas Banker's Surety Co.⁵⁵ already discussed, the Kansas Supreme court reversed the lower court, which had granted summary judgment for the insured bank, holding that Pratt, who was a member of the Board of Directors, was a "director" within the Director's Exclusion of the bond. The Court then remanded the case for determination of the factual question of whether the loss occurred as a result of acts

committed by Pratt while acting as a member of either the discount or compliance committees, which would implicate coverage as one of the exceptions to the Director's Exclusion.

The exception to the Director's Exclusion concerning a director "performing acts coming within the scope of the usual duties as an "employee" was involved in FDIC v. Aetna Casualty and Surety Company.⁵⁶ In that case, Steiner, acting on behalf of Morris and Garrett, became a stockholder and director of First National Bank of Marlin. The Board of Directors of the Bank, at Steiner's suggestion, agreed to accept \$1,000,000.00 from two banks and in turn invest it in real estate notes purchased from a company controlled by Morriss and Garrett, which notes were to be approved by the Bank's attorneys. Steiner was aware of the bank's loan limit and that the notes could not have a maturity beyond 20 years. Relying upon misrepresentations by Steiner, the bank issued a check to pay for the notes. Many of the notes later proved to be improper. In a short time, when Steiner could not place the notes elsewhere, the bank became insolvent. The District Court found "that Steiner's acts in connection with the purchase of the notes were acts coming within the scope of the usual duties of an employee of the Bank," and entered judgment for plaintiff on the ground that the acts of Steiner were clearly encompassed by the exception to the Directors exclusion.

On appeal, the Court of Appeals for the Fifth Circuit first restated Aetna's position:

In its Conclusions of Law, the District Court held that "Loss from the dishonesty and fraudulent acts of a director, which acts come within the scope of the usual duties of an employee, are covered by the bonds issued by the defendants herein." On the other hand, the appellants argue that the proper construction of the provision would limit coverage to the acts of a director who was at the time an officer or employee of the Bank and, more precisely, to only those acts which "come within the scope of the usual duties of an Employee" and are authorized by the Board of Directors or by the proper officer. We cannot agree with the appellants' interpretation.⁵⁷

Thereafter, the Court ruled on Aetna's position in the following manner:

Likewise, the District Court was correct in holding that Steiner's acts in connection with the purchase of the notes were "acts coming within the scope of the usual duties of an Employee." While it is true that a director exercises his office only through the collective system of the Board of which he is a member and that a director has no individual power of action as does an officer who is usually elected or appointed to perform specific duties as agent of the corporation by the Board of Directors, Georgia Casualty and Surety Company v. Seaboard Surety Company, 210 F.Supp. 644, (N.D.Ga. 1962),

aff'd. without opinion, 327 F.2d 666 (5th Cir. 1964), there is nothing to prevent a board of directors from authorizing one of its members to act in an officer-like capacity for the corporation in a particular transaction. This is precisely what took place here.⁵⁸

THE ALTER EGO DEFENSE

The term **alter ego** (or **sole actor**) is usually applied to a person or to a group of persons who have such control of a corporation that the acts of that person or group of persons are deemed to be the acts of the corporation itself. This doctrine is frequently invoked in situations where one wishes to pierce the corporate veil. With respect to fidelity bond claims, the alter ego theory arises as a defense to a contention that an individual who is in control of the insured entity is covered under the bond. The reasoning behind the alter ego defense is perhaps best expressed in Kerr v. Aetna Casualty & Surety Co.,⁵⁹ where the Court said:

Such a bond is not intended to cover the fraud and dishonesty of men who are in effect the sole stockholders, as well as the only directors of a closely held corporation. As noted above, the bond was intended to protect the corporation from the fraud or dishonesty of its employees, not to protect its creditors from the fraud or dishonesty of its stockholders and directors.⁶⁰ In Hartford Accident and Indemnity Co. v. Hartley,⁶¹ the Court held that the knowledge of a partner who had sole

and complete control of the operations of an unincorporated Georgia bank as to misappropriation of bank funds was imputable both to the partnership and to the bank at the time the partner applied for a Banker's Blanket Bond, even though the bond application provided that the knowledge of any officer signing for the bank as to his own personal acts or conduct was not imputable to the bank. Accordingly, the bond was held void ab initio.

Likewise, in McKey v. American Casualty Co. ⁶² and McKey v. Great American Insurance Co., ⁶³ trustees in bankruptcy sought to recover on a Commercial Blanket Bond for losses resulting from the acts of the principal officer and sole shareholder of the corporation. The Fifth Circuit Court of Appeals held that the bonds did not cover the dishonesty of such officer and shareholder, stating that "the fact that (the principal officer and shareholder) took the corporation's money does not insulate it from the knowledge that he possessed since there was no adverse interests between (the principal officer and shareholder) and the corporation wholly owned by him."⁶⁴

A similar result was reached in United States Fidelity & Guaranty Co. v. Three Garden Village Limited Partnership, ⁶⁵ when the Court of Appeals of Maryland upheld the holding of the lower Court (Court of Special Appeals) which held as a matter of law that the sole shareholder and director of a management company was not an "employee" within the meaning of the fidelity bond. In that case, suit was brought by property owners whose monies had been

misappropriated by Stitt, the sole shareholder and director of the insured. The Court reasoned that Stitt was the alter ego of the insured and thus the insured did not have an actual right to control and direct Stitt. Accordingly, Stitt was held not to be an "employee" within the terms of the fidelity bond. Another interesting aspect of this case is that in dicta the Court noted that the suit was brought by the property owners who were third parties and not direct parties to the bond. Although the Court did not rule as to the property owners' standing to bring suit, it did express its opinion that fidelity bonds are a form of first party coverage and are not designed to indemnify third parties. ⁶⁶

Notwithstanding the foregoing cases, the alter ego defense should not be considered an absolute one, even in the "one-man" bank type of case. For example, in United States Fidelity & Guaranty Co v. State of Oklahoma, ⁶⁷ the alter ego defense was raised. In that case, the bank was essentially a "one-man" bank in which the Bank President, Lee, was the one misappropriating money. The Tenth Circuit Court of Appeals rejected the alter ego defense, citing the following facts:

The bank's Board of Directors met regularly, and Board Members took a fairly active part in bank affairs. The testimony given in the trial of this case indicates that board members examined the bank examiner's reports, checked on promissory notes and their security, and checked individual deposits in savings accounts. These examinations had failed to disclose Lee's fraud. The

board considered and approved the acquisition of the two fidelity bonds in question, and such approval was duly recorded in the minutes of the board. The bonding company has failed to establish that Lee was the bank's sole representative. ⁶⁸

Likewise, in General Finance Corporation v. Fidelity & Casualty Company of New York, ⁶⁹ although the District Court used the alter ego defense to bar suit against the fidelity bond insurer, on appeal, the Eighth Circuit Court of Appeals reversed. In its decision, the Court stated:

Nor do we believe that the fact that Leach and his wife owned a majority of the stock of GFC avoids liability. If majority stock ownership was thought to pose an unacceptable hazard, the insurer could have inserted a provision in the policy concerning stock ownership. Although the corporations were closely held, each was at all times a separate entity in the eyes of the law. Each of the corporations involved had separate boards of directors, of which Mr. Leach was not the sole member. This case is thus distinguishable from Kerr v. Aetna Casualty & Surety Company, 350 F.2d 146 (4th Cir. 1965). Although Mr. Leach and his wife owned a majority of the stock, the corporation was still subject to the control of the Directors who at all times had the right to govern and direct the exercise of all corporate powers, business and property. See Insurance Company of North America v.

Greenberg, ⁷⁰. Indeed the law places that duty on Directors generally. * * * The fact, if true, that the Directors were generally but a "rubber stamp" is not controlling here. The policy does not require that the board of the insured generally make independent decisions. The issue, under the terms of the policy, is did they have the "right to govern and direct" Leach, and the answer is in the affirmative. See Bank of Willow Lakes v. Syverson, 43 S.D. 295, 178 N.W. 999 (1920).⁷¹

Likewise, in Transamerica Insurance Company v. Federal Deposit Insurance Corp. as Receiver of Beaver Creek State Bank, ⁷² and in F.D.I.C. v. Lott, ⁷³ the Courts held that the fact that the allegedly dishonest employee was the President and controlling shareholder of the insured banks did not justify imputing his knowledge of his own fraudulent acts to the banks so as to terminate liability on the bond. In both cases the Courts ruled that the alter ego defense would not bar recovery under the bonds and that since the acts were contrary to the banks in interest and resulted in losses they were covered by the bonds.

Inherent in almost every alter ego case is the question of whether or not the knowledge of the dishonest acts by the wrongdoers is imputed to the insured in such a manner as to terminate coverage under Section 12 of the FIB. In addition such knowledge would, if imputed to the insured, trigger a defense of lack of proper notice under Section 5 of the FIB. Most of the cases that have dealt with the subject have refused to impute to

the bank the guilty knowledge of the culprit. The trend in this regard is perhaps best expressed in Maryland Casualty Company v. Tulsa Industrial Loan & Investment Company. ⁷⁴ In that case the Board of Directors of Tulsa on two occasions passed resolutions to secure fidelity bonds from Maryland Casualty Company. Each bond application had a rather standard provision that Tulsa knew of no dishonest employees and had no losses for the previous 5 years. Dunn, a director, secretary-treasurer and loan manager, signed the applications. Dunn also had been embezzling money for several years and continued to do so after issuance of the bonds. His embezzlements were later detected and notice was given to Maryland Casualty. The question presented to the court was posed and answered as follows:

Was his knowledge imputed to his principal? A corporation is charged with knowledge of all material facts of which its officer or agent receives or acquires knowledge while acting in the course of his employment, and within the scope of his authority, because it is presumed in law that such facts will be disclosed to the principal. That rule rests upon considerations of sound policy and imperative expediency; otherwise rights would frequently be impaled upon uncertainty and instability. The innumerable cases in which the doctrine has been reaffirmed and applied to varying facts need not be cited. But it bears a well-settled exception. It is that if in the course of his employment the agent acts

for his own benefit and to defraud his principal, the latter is not charged with constructive knowledge of the uncommunicated facts in the transaction since it is manifestly essential to the existence of such a fraud that the agent conceal the facts and consequently, the ordinary presumption that he will communicate to his principal all facts concerning the business, does not arise. The adverse character of his interest takes the case out of the general rule . . . There is another group of cases holding that the rational basis upon which the exception rests is that the agent acts outside of the scope of his agency and for that reason his knowledge cannot be imputed to the principal . . . Regardless of the divergence of reason underlying the exception, the courts in both groups agree that under such circumstances the knowledge of the agent is not imputed to the principal.⁷⁵

Ritchie Grocer Company v. Aetna Casualty & Surety Company⁷⁶

presents a different situation. In that case, the bond had a provision terminating coverage on knowledge of "any dishonest or fraudulent act." Kemp applied for employment. Polk, manager of the branch involved, inquired of the local sheriff concerning Kemp. The sheriff advised Polk that Kemp and some other boys had been arrested for tire theft but that the boys had admitted their mistake and that the case had been subsequently dismissed. Despite this knowledge, Polk employed Kemp, who thereafter took money from

the store. The District Court dismissed the suit against Aetna, holding that the insured had knowledge of the prior dishonesty of Kemp when they hired him. In affirming, the Court reasoned:

[K]nowledge possessed by Joe Polk, branch manager for one of the appellant's stores, that Wayne Kemp had previously committed tire theft is fully attributable to the "Insured" - appellant - within the meaning of Section 7. A corporation must necessarily act through agents, and the general rule is that knowledge of an agent acquired in the ordinary discharge of his duties for the corporation is ordinarily to be imputed to the principal.⁷⁷

However, in United States Fidelity & Guaranty v. State of Oklahoma,⁷⁸ the court, in its discussion of imputing an agent's guilty knowledge to the bank, said:

Of equal inapplicability is the bonding company's argument that the bank cannot seek to enforce a contract procured by the misrepresentations of its agent (sole or otherwise) without having imputed to it the agent's guilty knowledge, unless it has changed its position before learning of matters within the scope of his authority is knowledge of his principal, Knox v. First Security Bank of Utah, 206 F.2d 823 (10 Cir. 1953), for it is presumed that such knowledge will be disclosed to the principal. An exception exists when the transaction is one in which the agent is secretly acting adversely to

the principal. Great American Indemnity Co. v. First National Bank of Holdenville, Okl., 100 F.2d 763 (10th Cir. 1938); Restatement (Second), Agency 280, 282 (1958). If the agent is defrauding his principal, it is not realistic to presume that this very knowledge will be disclosed to the principal. ⁷⁹

Likewise, in FDIC v. Aetna Casualty & Surety Co. ⁸⁰ previously discussed, the Court said:

[T]he knowledge of Steiner and the directors associated with him cannot be imputed to the bank since they were acting adversely to its interests. ⁸¹

The same point made by the same Court is found in FDIC v. Lott ⁸² where the court said:

Generally, an officer's or director's knowledge acquired while acting within the scope of his duties will be imputed to the bank. 10 Am. Jur.2d, Banks 163 (1963). However, where, as here, Lott fraudulently dealt with the bank in his own interest, he is deemed to have an adverse interest and the knowledge possessed by him in the transaction is not imputed to the Bank ⁸³

KNOWLEDGE OF THE BANK AS A DEFENSE

The case of Farmer's and Merchant's State Bank of Pierz v. St. Paul Fire & Marine Ins. Co. ⁸⁴ presents a very interesting and unique situation. A school owned by a church was offered for sale at public auction. Two bank customers were interested in buying the school to renovate it into an apartment house. They went to

the bank and discussed a loan for this project with the Assistant Vice-President. The President, who was a 90% stockholder of the bank, learned of the customers' plan. The board of directors of the bank consisted of the President, his wife, the Cashier and the Assistant Vice-President. The church board, consisting of twenty-five members, including the three bank officers, met with the bank's customers, who offered to buy the school for \$3,000.00. The bank's officers became interested in buying the school for a new bank and although they knew the church board would sell it to the bank for \$3,000.00, offered to buy the school for \$10,000.00. The bank's officers knew they had a conflict of interest with their customers but did not tell them of the bank's desire to buy the property. The church board accepted the bank's offer and rejected the customers' offer. The customers brought suit against the bank and the three officers alleging a breach of fiduciary relationship and dishonesty. Defense of the suit was tendered to St. Paul which declined the tender. The bank defended itself, settled the suit and then brought suit against St. Paul for the costs of defense. The court, after stating the facts and some principles of law, said:

A banker's fidelity bond does not cover losses suffered by reason of fraud, dishonesty or breach of fiduciary duty when a bank through its board of directors, who had knowledge of acts complained of, appreciated their fraudulent nature, and condoned, acquiesced, or participated in them. Were it otherwise, the bank would

be insured against its own dishonesty. We are aware of no authority for construing a fidelity bond under such a manner. * * * Under the foregoing authority, the acts giving rise to the bank's alleged liability were acts of the directors, and thus acts of the bank. Since the policy was not intended to insure the bank against acts taken by its directors which they knew could create an allegation of liability for conflict of interest, there is no coverage for this liability under the bond.⁸⁵

Except for the alter ego cases, the other cases discussed in this paper have concerned particular employees engaged in dishonesty that was not known to most of the insured bank's officials. This case, however, involved all of the directors and a decision made by the board of directors itself. The policy reasons behind the decision in this case can be summarized by a quotation from the Kerr opinion:

[T]he bond is intended to protect the [insured] from the fraud or dishonesty of its employees, not to protect its creditors from the fraud or dishonesty of its stockholders and directors.⁸⁶

THE WINDFALL DOCTRINE CASES

Another group of cases that are important in this context are the windfall doctrine cases stemming from the United States Supreme Court Bangor Punta Operations case.⁸⁷ In that case, the Court held that for equitable reasons the present shareholder of substantially all of the stock, after sale and purchase of the stock, cannot

complain of the prior wrongdoing or mismanagement of the company by those from whom the stock was purchased. Among other reasons for this rule, it is presumed that the purchase price of the stock reflected its decreased value due to the mismanagement and wrongdoing. The purchaser therefore has received all that he has bargained for. A recovery awarded to him or the corporation in such circumstances would be a windfall and unjust enrichment.

This case was followed in Rock River Savings & Loan v. American States Insurance Co.⁸⁸, to defeat attempted subrogation recovery after settlement with the insured by an FIB surety which had sued the insured's former officers and accounting firm. One can speculate whether the result would have been different if the case had been tried as between the insured and the surety.

CONCLUSION

In sum, it is not often the case that the question is raised as to whether or not the person alleged to have been dishonest is an "employee" within the definition of the bond. However, the determination of that issue while sometimes problematic in the case of attorneys, employees of institutions that have merged with or been consolidated into the Insured, and directors, is basic to the determination of the question of whether coverage exists. More often than not the issue of control will be determinative as to the question of the definition of "employee". Once one determines that threshold question and decides that the individual is in fact an "employee" within the definition of the FIB, then the issue of coverage becomes a matter of deciding whether the individual

employee was acting as an "employee" at the time of doing the dishonest acts out of which the claimed loss is alleged to have arisen, or in some other capacity, or as an alter ego of the insured, in which cases coverage may not be implicated.

1986 BOND

Definitions

(g) **Employee means**

- (1) an officer or other employee of the Insured, while employed in, at or by any of the Insured's offices or premises covered hereunder, and a guest student pursuing studies or duties in any of the said offices or premises;
- (2) an attorney retained by the Insured and an employee of such attorney while either is performing legal services for the Insured;
- (3) a person provided by an employment contractor to perform employee duties for the Insured under the Insured's supervision at any of the Insured's offices or premises covered hereunder;
- (4) an employee of an institution merged or consolidated with the Insured prior to the effective date of this bond; and
- (5) each natural person, partnership or corporation authorized by the Insured to perform services as data processor of checks or other accounting records of the Insured (not including preparation or modification of computer software or programs), herein called Processor (Each such Processor and the partners, officers and employees of such Processor shall collectively be deemed to be one

Employee for all the purposes of this bond, excepting, however, the second paragraph of Section 12. A Federal Reserve Bank or clearing house shall not be construed to be a processor).

1980 BOND

Definitions

Section 1. As used in this bond,

(f) Employee means,

(1) An officer or other employee of the Insured, while employed in, at, or by any of the Insured's offices or premises covered hereunder, and a Guest Student pursuing studies or duties in any of said offices or premises;

(2) An attorney retained by the Insured and an employee of such attorney while either is performing legal services for the Insured;

(3) A person provided by an employment contractor to perform employee duties for the Insured under the Insured's supervision at any of the Insured's offices or premises covered hereunder;

(4) An Employee of an institution merged or consolidated with the Insured prior to the effective date of this bond; and

(5) Each natural person, partnership or corporation authorized by the Insured to perform services as data processor of checks or other accounting records of the Insured, herein called Processor. (Each such processor, and the partners, officers and employees of such processor shall, collectively, be deemed to be one employee for all purposes of this bond, excepting, however, the second paragraph of Section 12. A federal reserve bank or clearing house shall not be construed to be a processor.)

1969 BOND

Definition of Employees

Wherever used in this bond, Employee and Employees shall be deemed to mean, respectively, one or more of the Insured's officers, clerks and other employees while employed in, at or by any of the Insured's offices while covered under this bond, and attorneys retained by the Insured to perform legal services for the Insured and the employees of such attorneys while such attorneys or the employees of such attorneys in performing such services for the insured, and Guest Students pursuing their studies or duties in any of said offices.

1. This paper was originally written to update and edit the paper entitled "Fidelity Coverage: Who is Covered?" by James A. Black, Jr. which was presented as part of the 1989 National Institute on Financial Institution Bonds in Washington, D.C. on April 17, 1989 and in San Francisco, California on November 16, 1989. The author's original update of the Black paper became a part of the ABA/TIPS/FSLC National Institute Program on Financial Institution Bonds presented in London, England April 22-24, 1992 and has been published as part of the two volumes of papers emanating from that Program. The author also gratefully acknowledges the assistance of John W. Rourke, an associate in the law firm of Reinert, Duree & Crane, P.C., in the preparation of this paper which revises and updates the London paper.

2. First Nat'l Bank of Cushing v. Sec. Mut. Cas. Co., 431 F.2d 1025 (10th Cir. 1970), cert. denied, 401 U.S. 975 (1971) (President); First Nat'l Bank of Sikeston v. Transamerica Ins. Co., 377 F.Supp. 1041 (E.D.Mo. 1974) rev'd, 514 F.2d 981 (8th Cir. 1975) (Executive Vice President); Citizens State Bank v. Transamerica Ins. Co., 452 F.2d 199 (7th Cir. 1971) (Cashier-Vice President); Miami Nat'l Bank v. Pennsylvania Ins. Co., 314 F. Supp. 858 (S.D. Fla. 1970) (Vice President, Installment Loan Department); First Nat'l Bank of S. Md. v. United States Fid. & Guar. Co., 340 A.2d 275 (Md. App. 1970) (Assistant Vice President and General Manager); Arlington Trust Co., Inc. v. Hawkeye-Sec. Ins. Co., 301 F.Supp. 854 (E.D. Va. 1969) (Assistant Vice President, Bill of Lading Department); First Nat'l Bank of West Hamlin v. Maryland Cas. Co., 354 F. Supp. 189 (S.D. W.Va. 1973) (Assistant Cashier); National Newark & Essex Bank v. American Ins. Co., 76 N.J. 64, 385 A.2d 1216 (1978) (Vice-President and Branch Manager); United States Fid. & Guar. Co. v. Empire State Bank, 448 F.2d 360 (8th Cir. 1971).

3. See generally, W. Haug, The Commercial Blanket Bond Annotated, 1985 A.B.A. Tort and Ins. Prac. Sec. Pol. Annot. 32-40 (1985); Elliot, Who is an Employee under Fidelity Coverage, 14 Forum 620 (1979).

4. Transamerica Ins. Co. v. FDIC, 465 N.W.2d 713 (Minn. App. 1991); In re Leedy Mt. Co. v. Judge, 76 B.R. 440 (Bkrtcy. E.D. Pa. 1987); United States Fid. & Guar. v. Three Garden Village Ltd. Partnership, 77 Md. App. 640, 551 A.2d 881 (Md. App. 1989), aff'd 567 A.2d 85 (Md. 1989) (sole stockholder and director); Employer's Admin. Serv. v. Hartford Acc. & Indem., 709 P.2d 559 (Ariz. App. 1985) (sole stockholder and director); IBM Poughkeepsie Employees Fed. Credit Union v. Cumis Ins. Soc'y, Inc., 590 F.Supp. 769 (S.D.N.Y. 1984) (Bank Broker); Fidelity and Deposit Co. of Md. v. USAFORM Hail Pool, Inc., 318 F.Supp. 1301 (M.D. Fla., 1970) vacated,

463 F.2d 4 (5th Cir. 1972) (President); General Fin. Corp. v. Fidelity and Cas. Co. of New York, 311 F.Supp. 353 (D. S.D. 1970) rev'd, 439 F.2d 981 (8th Cir. 1971) (President); Insurance Co. of N. America v. Greenberg, 405 F.2d 330 (10th Cir. 1969) (President-General Manager); Wooddale, Inc. v. Fidelity and Deposit Co. of Md., 378 F.2d 627 (8th Cir. 1967) (President); Imperial Ins., Inc. v. Employer's Liab. Assur. Corp., 442 F.2d 1197 (D.C. Cir. 1970) (Vice President-General Manager); Boston Sec., Inc. v. United Bonding Ins. Co., 309 F.Supp. 1270 (E.D. Mo., 1970) aff'd 441 F.2d 1302 (8th Cir., 1971) (Office Manager); Mortgage Corp. of N. J. v. Aetna Cas. & Sur. Co., 19 N.J. 30 (S.Ct.N.J. 1955) (Inspector of Work); Home Indem. Co. v. Reynolds & Co., 38 Ill. App. 2d. 358, 187 N.E.2d 274 (Ill., App. 1963) (Salesman); Maryland Cas. Co. v. Tulsa Indus. Loan & Inv. Co., 83 F.2d 14 (10th Cir. 1936) (Agent); National Bank of Burlington v. Fidelity & Cas. Co. of N.Y., 125 F.2d 920 (4th Cir. 1942) (President).

5. William H. Sill Mortgages, Inc. v. Ohio Cas. Ins. Co., 412 F.2d 341 (6th Cir. 1969); FDIC v. New Hampshire Ins. Co., 953 F.2d 478 (1992); Charm Promotions, Ltd. v. Traveler's Indem. Co., 447 F.2d 607 (7th Cir. 1971); Third Fed. Sav. & Loan Ass'n of Cleveland v. Fireman's Fund Ins. Co., 548 F.2d 166 (6th Cir. 1977); Feller v. New Amsterdam Cas. Co., 363 Pa. 483, 70 A.2d 299 (1950); Stone v. Harris, 262 Mich. 195, 251 N.W. 322 (1933); Arkansas Fuel Oil Co. v. National Sur. Corp. 191 La. 115, 184 So. 560 (1938).
6. 412 F.2d 341 (6th Cir. 1969).
7. Id. at 344.
8. 548 F.2d 166 (6th Cir. 1977).
9. Id. at 169.
10. Id. at 171.
11. 953 F.2d 478 (9th Cir. 1992).
12. 350 F.2d 146 (4th Cir. 1965).
13. 77 Md.App. 640, 551 A.2d 881, aff'd, 318 Md. 98, 567 A.2d 85 (1989).
14. New Hampshire's bond defined employee as: "an officer or other employee of the insured, while employed in, at, or by any of the Insured's offices or premises covered hereunder..."
15. 956 F.2d 595 (6th Cir. 1992).

16. Id. at 597-598.
17. Interstate Prod. Credit Ass'n v. Fireman's Fund Ins. Co., 736 F.Supp. 225 (D. Or. 1990), rev'd 944 F.2d 536 (9th Cir. 1991); First Hays Banshares, Inc. v. Kansas Banker's Sur. Co., 769 P.2d 1184 (Ks. 1989); Howard, Weil, Labouisse, Friedrichs, Inc. v. Insurance Company of No. Am., 397 F.Supp. 1279 (E.D. La., 1975) aff'd, 557 F.2d 1055 (5th Cir. 1977); 378 F.2d 627 (8th Cir. 1967); 440 F.Supp. 41 (E.D. N.Y. 1977); First Nat'l Life Ins. Co. v. Fidelity and Deposit Co. of Md., 525 F.2d 966 (5th Cir. 1976); Georgia Cas. and Sur. Co. v. Seaboard Sur. Co., 210 F.Supp. 644 (N.D. Ga. 1962); 350 F.2d 146 (4th Cir. 1965).
18. 244 Kan. 576, 769 P.2d 1184 (1989).
19. 548 F.2d 166 (6th Cir. 1977).
20. 125 F.2d 920 (4th Cir. 1942).
21. 32 Wash. App. 32, 645 P.2d 1122 (1982).
22. Id. at 1191.
23. 397 F.Supp. 1279 (E.D.La. 1975), aff'd, 557 F.2d 1055 (5th Cir. 1977).
24. Id. at 1058.
25. Maryland Cas. Co. v. Queenan, 89 F.2d 155 (10th Cir. 1937); Fort Scott Bldg. and Loan Ass'n v. McAfee, 135 Kan. 355, 10 P.2d 851 (1932); Maryland Cas. Co. v. Crescent Valley Creamery, 103 S.W.2d 880 (Tex. App. 1937); Wooddale, Inc. v. Fidelity and Deposit of Md., 378 F.2d 627 (8th Cir. 1967); Sanders v. United States Fid. and Guar. Co., 108 Ga. App. 849, 134 S.E.2d 831 (1964).
26. 378 F.2d 627 (8th Cir. 1967).
27. 440 F.Supp. 41 (E.D.N.Y. 1977).
28. First Nat'l Life Ins. Co. v. Fidelity and Deposit Co. of M., 525 F.2d 966 (5th Cir. 1976).
29. Georgia Cas. and Sur. Co. v. Seaboard Sur. Co., 210 F.Supp. 644 (N.D.Ga. 1962).
30. 344 F.Supp. 496 (D.P.R. 1972).
31. 350 F.2d 146 (4th Cir. 1965).
32. Id. at 154.

33. 381 F.2d 245 (4th Cir. 1967).
34. 266 F.Supp.465 (D.Md. 1966).
35. 381 F.2d 245, 251.
36. Id.
37. 302 F.Supp. 832 (D.Md., 1969).
38. 427 F.2d 862 (4th Cir. 1970).
39. Id at 872.
40. 147 Ariz. 202, 709 P.2d 559 (Ariz.App. 1985).
41. 77 Md. App. 640, 551 A.2d 881 (Md.App. 1989), aff'd, 567 A.2d 85 (Md. 1989).
42. 459 F.2d 963 (5th Cir. 1972).
43. 181 F.Supp. 447 (M.D.Ga. 1959) aff'd, 275 F.2d 903 (5th Cir. 1960).
44. Id. at 447.
45. 442 F.Supp. 960 (D. N. J. 1977).
46. Id. at 970.
47. First Hays Banshares, Inc. v. Kansas Bankers Sur. Co., 244 Kan. 576, 769 P.2d 1184 (Ks. 1989); Oklahoma Morris Plan Co. v. Security Mut. Cas. Co., 455 F.2d 1209 (8th Cir. 1972); First Sec. Sav. v. Kansas Bankers Sur. Co., 849 F.2d 345 (8th Cir., 1988); Fidelity Sav. and Loan Ass'n v. Republic Ins. Co., 513 F.2d 954 (9th Cir., 1975); Wachovia Bank and Trust Co. v. Manufacturers Cas. Ins. Co., 171 F.Supp. 369 (M.D.N.C. 1959); C. Douglas Wilson & Co. v. Insurance Co. of N. America, 464 F.Supp. 1 (D.S.C. 1977).
48. 171 F. Supp. 369 (M.D.N.C. 1959).
49. Id. at 375.
50. Id. at 375-6.
51. Fidelity Sav. and Loan Ass'n v. Republic Ins. Co., 513 F.2d 954 (9th Cir. 1975)
52. Fidelity Sav. and Loan Ass'n v. Republic Ins. Co., 513 F.2d 954 (9th Cir. 1975).

53. *Id.* at 955.
54. Home Indem. Co. v. Reynolds & Co., 38 Ill. App. 2d 358, 187 N.E.2d 274 (Ill. App. 1962); Georgia Cas. and Sur. Co. v. Seaboard Sur. Co., 210 F.Supp. 644 (N.D. Ga., 1962); Phoenix Sav. & Loan, Inc. v. Aetna Cas. & Sur. Co., 266 F.Supp. 465 (D.Md. 1966) rev'd, 381 F.2d 245 (4th Cir. 1967) remanded, 302 F.Supp. 832 (D. Md. 1969) rev'd. 427 F.2d 862 (4th Cir., 1970); Insurance Co. of N. America v. Greenberg, 405 F.2d 330 (10th Cir. 1969); General Fin. Corp. v. Fidelity and Cas. Co. of N.Y., 311 F.Supp. 353 (D. S.D. 1970) rev'd, 439 F.2d 981 (8th Cir. 1971); FDIC v. Lott, 460 F.2d 82 (5th Cir. 1972); Fidelity and Deposit Co. of Md. v. USAFORM Hail Pool, Inc., 318 F.Supp. 1301 (M.D. Fla., 1970) vacated, 463 F.2d 4(5th Cir. 1972), 523 F.2d 744 (5th Cir. 1975) cert. denied, 425 U.S. 950 (1976); First Nat'l Bank of Sikeston v. Transamerica Ins. Co., 377 F.Supp. 1041 (E.D.Mo. 1974) rev'd on other grounds, 514 F.2d 981 (8th Cir. 1975). Also see, Interstate Prod. Credit Ass'n v. Fireman's Fund Ins. Co., 736 F.Supp. 225 (D.Or. 1990).
55. 244 Kan. 576, 769 P.2d 1184 (Ks. 1989)
56. 426 F.2d 729 (5th Cir. 1970).
57. *Id.* at 736.
58. *Id.* at 738
59. 350 F.2d 146 (4th Cir. 1965).
60. *Id.* at 154.
61. 275 F.Supp. 610 (M.D.Ga. 1967) aff'd, 339 F.2d 91 (5th Cir. 1968).
62. 316 F.2d 428 (5th Cir. 1963).
63. 316 F.2d 473 (5th Cir. 1963).
64. 316 F.2d 430.
65. 77 Md.App. 640, 551 A.2d 881 (Md.App. 1989) aff'd, 567 A.2d 85 (Md. 1989).
66. See, 567 A.2d 85, 93-94 where the Court cites: Everhart v. Drake Management, Inc., 627 F.2d 686 (5th Cir. 1980); American Empire Ins. Co. v. Fidelity & Deposit Co., 408 F.2d 72 (5th Cir.), cert. denied, 396 U.S. 818, 90 S.Ct. 55, 24 L.Ed. 2d 69 (1969); Western Nat. Bank v. Hawkeve Sec. Ins. Co., 380 F.Supp. 508 (D.Wyo. 1974); Employer's Adm. Services, Inc. v. Hartford Accident and Idemn. Co., *Supra*;

Ronnau v. Caravan Int'l Corp., 205 Ks. 154, 468 P.2d 118 (1970); Foxley Cattle Co. v. Bank of Mead, 196 Neb. 587, 244 N.W.2d 205 (1976); Commercial Bank v. St. Paul Fire & Marine Ins. Co., 336 S.E.2d 552 (W.Va. 1985); Anderson v. Employer's Ins. of Waussau, 826 F.2d 777 (8th Cir. 1987); One Seventy Five E. 74th Corp. v. Hartford Accident and Indem. Co., 435 N.Y.S.2d 584, 51 N.Y.2d 585, 416 N.E.2d 584 (1980).

67. 383 F.2d 417 (10th Cir. 1967).
68. Id. at 419.
69. 311 F.Supp. 353 (D.S.D. 1970) rev'd, 439 F.2d 981 (8th Cir. 1971).
70. 405 F.2d 330 (10th Cir. 1969).
71. 439 F.2d 981 at 984.
72. 465 N.W.2d 713 (Minn.App. 1991).
73. 460 F.2d 82 (5th Cir. 1972).
74. 83 F.2d 14 (10 Cir. 1936); there are a number of excellent articles treating this subject matter, among them, McCormick, Frauds of the Insured, Imputation of Knowledge and Implementing the Employee in Fidelity Cases, 4 Forum 204 (1969); Skillern, When Dishonesty by Officers of Insured Becomes Dishonesty of Insured to Preclude Recovery Under Fidelity Bond, 5 Forum 235 (1970); Baudler and Klafter, Fraud and Dishonesty Under the Blanket Bond, 9 Forum 229, 256 (1973); Balkin, Fraud and Dishonesty Under the Blanket Bond, 9 Forum 229, 291 (1973); Reinert, Court's Failure to Terminate Coverage Where Owner Knows of Dishonesty, 9 Forum 1014 (1976); Montgomery, The Alter Ego Type Defenses Reconsidered, 13 Forum (1978).
75. 83 F.2d, 14, 16.
76. 426 F.2d 499 (8th Cir. 1970).
77. Id. at 500.
78. 383 F.2d 417 (10th Cir. 1967).
79. Id. at 419.
80. 426 F.2d 729 (5th Cir. 1970).
81. Id. at 739.

82. 460 F.2d 82 (5th Cir. 1972).
83. Id. at 869.
84. 242 N.W.2d 840 (S.Ct. Minn. 1976).
85. Id. at 843.
86. 350 F.2d 146 (4th Cir. 1965).
87. Bangor Punta Operations v. Bangor & A. R. Co., 417 U.S. 703, 41 L.Ed.2d 418, 94 S.Ct. 2578 (1974).
88. 594 F.2d 633 (7th Cir. 1979).