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**FIDELITY BOND FORGERY COVERAGE -- IS THERE ANY  
SUCH THING IN THESE DAYS OF FED- EXES, FAXES,  
E-MAILS, AND WIRE TRANSFERS?**

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# **FIDELITY BOND FORGERY COVERAGE -- IS THERE ANY SUCH THING IN THESE DAYS OF FED EXES, FAXES, E-MAILS, AND WIRE TRANSFERS?**

## **I. Introduction**

In 1974, my wife and I had saved enough money to make a down payment for a house. After signing a purchase contract for the house, subject to financing, we went to a local bank in our local town in Michigan and met with a mortgage loan officer. We filled out a mortgage loan application, and finally our mortgage was approved.

The closing on the purchase of our home took place in a conference room at the local bank. The sellers were present at the closing and the loan officer from the bank was also there. Various checks, deeds, mortgages and other papers were shuttled around the conference room table and signed by the appropriate parties. After all the papers had been signed and an abstract of title and title opinion had been delivered to us, a cashiers check for the purchase price of the house was presented to the sellers.

The loan officer from the bank retained the original note, mortgage and deed so that the latter two items could be recorded. We were given copies of all the closing documents and the transaction was concluded.

In 1974, this was the typical way in which a loan closing for the purchase of a house was handled.

Now "fast-forward" to 2001. My wife and I are in the process of refinancing our home. The refinancing is being handled through a mortgage broker in upstate New York. I have only spoken to the representative of the mortgage broker by telephone, and have not, and never will, actually meet him in person.

The home that we are refinancing is in Tampa, Florida. The bank that is refinancing our mortgage is located in Wilmington, Delaware. I have never been in Wilmington, Delaware, in my life let alone in the particular bank that is making my loan for me.

The loan closing takes place in the waiting area of the airport in Grand Rapids, Michigan. We are met there by a notary public who tells us he represents the mortgage broker in upstate New York and the closing bank in Wilmington, Delaware, and has with him several sets of closing documents. We execute the documents in the airport and they are duly attested to by the notary. The notary retains two sets of originals and we retain one.

Several days later, we receive a copy of a title policy and a copy of the satisfaction of our previous mortgage. Three weeks after that, we receive a notice that our refinanced note and mortgage have been assigned to a bank in Texas.

## **II. Modern Day Residential Mortgage Transactions**

The refinancing of our home in 2001 was a typical transaction for these modern times. The refinancing was consummated through what is referred to as a "warehouse line" of credit between the mortgage broker in upstate New York and the closing bank, hereafter the

“warehouse line” bank, in Wilmington, Delaware.

Basically, a “warehouse line” works as follows: a mortgage broker establishes lines of credit, “the warehouse line”, with a bank, or in the case of large mortgage brokers, several banks. These banks can be located throughout the United States. The mortgage broker then solicits customers throughout the country either to finance or refinance their home mortgages. The mortgage broker handles all of the paperwork for the financing or refinancing to insure that the loan complies with Fannie Mae, Ginnie Mae or other similar institution underwriting standards. When the loan is ready to close, the mortgage broker then contacts the bank with whom it has the “warehouse line” and requests the bank to wire transfer funds to fund the loan, usually into the bank account of a title company with whom the mortgage broker has a relationship.

The loan documents are then executed by the appropriate parties (seller and buyer in the case of a home purchase and owner in the case of a refinance.). Sometimes the documents are executed at the title company where the funds have been wire transferred, but other times, as was the case with my wife and me, they can be executed nearly anywhere, including an airport lobby.

After the appropriate documents have been executed, the title company delivers them to the mortgage broker, which in turn forwards the original deed and mortgage for recording, and forwards the original note and an assignment of the deed and mortgage to the “warehouse line” bank.

After the closing, the mortgage broker accumulates a portfolio of similar mortgages, generally in the neighborhood of seventy to one hundred, and then packages this group of mortgages together and sells them to Fannie Mae, Ginnie Mae or some other such institution. Fannie Mae or Ginnie Mae then market these “bundles” of mortgages as mortgage-backed securities. The “warehouse line” bank is then paid back its loan, usually within two to three months of the time the loan was funded.

In these modern times, thousands and thousands of residential mortgage loans and refinancings are transacted using this “warehouse line” financing vehicle.

### **III. The 1974 Forgery Scenario**

Let us return for a moment to the 1974 closing at the local bank in Michigan. Suppose that two people, pretending to be my wife and I, attend the closing, sign my wife’s and my signatures on the various closing documents, and permit the cashiers check for the alleged purchase of the home to be given to the seller. Following the purported “closing,” the sellers and phony buyers split the proceeds of the cashiers check and disappear. For years, banks have had Financial Institution Bond or Commercial Crime Policy coverage for such occasions.

There are two possible avenues of coverage for the scenario set forth above:

The first avenue of possible coverage is Insuring Agreement E of the typical Financial Institution Bond which provides:

## SECURITIES

(E) Loss resulting directly from the Insured having, in good faith, for its own account or for the account of others,

(1) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any original

- (a) Certified Security,
- (b) Document of Title,
- (c) deed, mortgage or other instrument conveying title to, or creating or discharging a lien upon, real property,
- (d) Certificate of Origin or Title,
- (e) Evidence of Debt,
- (f) corporate, partnership or personal Guarantee,
- (g) Security Agreement,
- (h) Instruction to a Federal Reserve Bank of the United States, or
- (i) Statement of Uncertified Security of any Federal Reserve Bank of the United States

which

- (i) bears a signature of any maker, drawer, issuer, endorser, assignor, lessee, transfer agent, registrar, acceptor, surety, guarantor, or of any person signing in any other capacity which is a Forgery, or
- (ii) is altered, or
- (iii) is lost or stolen;

(2) guaranteed in writing or witnessed any signature upon any transfer, assignment, bill of sale, power of attorney, Guarantee, endorsement or any items listed in (a) through (h) above;

(3) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any item listed in (a) through (d) above which is a Counterfeit.

Actual physical possession of the items listed in (a) through (i) above by the Insured, its correspondent bank or other authorized representative, is a condition precedent to the Insured's having relied on the faith of such items.

A mechanically reproduced facsimile signature is treated the same as a handwritten signature.

The second possibility applicable provision of the typical Financial Institution Bond is Insuring Clause D, which provides:

## FORGERY OR ALTERATION

### (D) Loss resulting directly from

(1) Forgery or alteration of, on or in any Negotiable Instrument (except an Evidence of Debt) Acceptance, Withdrawal Order, receipt for the withdrawal of Property, Certificate of Deposit or Letter of Credit,

(2) transferring, paying or delivering any funds or Property or establishing any credit or giving any value on the faith of any written instructions or advices directed to the Insured and authorizing or acknowledging the transfer, payment, delivery or receipt of funds or Property, which instructions or advices purport to have been signed or endorsed by any customer of the Insured or by any banking institution but which instructions or advices either bear a signature which is a Forgery or have been altered without the knowledge and consent of such customer or banking institution. Telegraphic, cable or teletype instructions or advices, as aforesaid, exclusive of transmissions of electronic funds transfer systems, sent by a person other than the said customer or banking institution purporting to send such instructions or advices shall be deemed to bear a signature which is a Forgery.

A mechanically reproduced facsimile signature is treated the same as a handwritten signature.

Applying the 1974 forgery scenario to these two Insuring Agreements presents the threshold issue of whether or not the signatures on the closing documents are indeed “forgeries”. The term “forgery” is defined in the Financial Institution Bond as:

“(i) Forgery means the signing of the name of another person or organization with intent to deceive; it does not mean a signature which consists in whole or in part of one’s own name signed with or without authority, in any capacity, for any purpose.”

Applying this definition to the 1974 forgery scenario seems pretty clearly to indicate that the documents generated were forgeries under that scenario and within that definition.

If we walk the 1974 forgery closing scenario through the various elements of Insuring Agreement E, it appears that the losses incurred under that scenario would fall within the purview of Insuring Agreement E and, therefore, be covered by the Financial Institution Bond.

Similarly if we walk the 1974 forgery closing scenario through Insuring Agreement D, it appears there would also be coverage under that Insuring Agreement unless the note was considered an “Evidence of Debt”. However, if the note is considered an “Evidence of Debt”, then there is coverage under Insuring Agreement E.

#### **IV. The 2001 Forgery Scenario**

Let us now return to the 2001 “warehouse line” refinancing at the Grand Rapids airport.

Suppose that in fact no meeting took place at the Grand Rapids airport. No notary public was involved, and in fact neither my wife nor I were involved. Suppose instead that the mortgage broker in upstate New York somehow obtained copies of our actual existing note and mortgage for our home, prepared duplicate copies of that note and mortgage, except for the date and except for changing the mortgagee to the upstate New York mortgage broker. Suppose then that the mortgage broker forged my wife’s and my signatures to these bogus documents and used those documents as a basis to request a wire transfer of funds from the “warehouse line” bank into the account of a title company in fact controlled by the mortgage broker.

Suppose then that no closing actually took place but instead the mortgage broker pocketed the money that was wire transferred into the title company. Suppose then that the mortgage broker forwarded the forged note and mortgage documents to the “warehouse line” bank in the same manner and fashion as in a legitimate loan.

The above scenario is an actual case involving millions of dollars and several “warehouse line” banks located throughout the United States. The mortgage broker (which is now out of business and whose owners have fled to Costa Rica) obtained millions of dollars in wire transferred funds from these various “warehouse line” banks, which funds were supposed to be used to fund mortgages and refinances which were in fact bogus and forgeries.

Obviously, the key question is whether or not the losses incurred by the various banks are covered under either Insuring Agreement E or D of the Financial Institution Bond cited above. As will be seen, there are significant issues as to whether or not there is coverage for the 2001 forgery scenario described above.

#### **V. Coverage for the 2001 Forgery Scenario**

##### **A. Forgery**

Once again, it appears clear under the 2001 forgery scenario set forth above that the loan documents are “forgeries” within the meaning of the definition of “forgery” contained in the Financial Institution Bond.

##### **B. Insuring Agreement E**

The 2001 forgery scenario complies with the elements for coverage under Insuring Agreement E down to that portion of Insuring Agreement E which requires:

“Actual physical possession. . . by the Insured, its correspondent bank or other authorized representative, is a condition precedent to the Insured’s having relied on the faith of such items.”

Under the 2001 forgery scenario, the “warehouse line” bank actually wire transferred the funds into the account of the title company designated by the mortgage broker prior to obtaining actual physical possession of the original note, deed and mortgage from the mortgage broker. This fact would appear to preclude coverage under Insuring Agreement E. However, there is one factor that might change the result and provide coverage:

Insuring Agreement E provides that the “actual physical possession” can be by the Insured, its correspondent bank or other “authorized representative”. The term “authorized representative” is not defined in the Financial Institution Bond. Unfortunately, the few cases dealing with the term “authorized representative” have not done so in circumstances resembling the 2001 forgery scenario.

### **1. Legal Discussion as to “Authorized Representative”**

The literal language of Insuring Agreement (E)’s “actual physical possession” requirement does not provide when an insured, or an insured’s authorized representative, must have “actual physical possession” of the covered documents. Rather, the bond’s language indicates only that “actual physical possession” is a *condition precedent* to having relied on the faith of a forged document.

Various courts, however, have read into that language a timing requirement. Specifically, courts have construed Insuring Agreement (E)’s “actual physical possession” language to mean that the insured must have “actual physical possession” of the documents *before* extending credit.<sup>1</sup> Indeed, not only must the insured have actual, physical possession of the covered documents before extending credit to obtain coverage under Insuring Agreement (E), but the insured must have “actual physical possession” of the *original* documents.<sup>2</sup> According to the court in *Hamilton Bank v. Insurance Co. of North America*, the “actual physical possession” requirement must be read in conjunction with paragraph (1) of Insuring Agreement (E), which requires the insured to have extended credit or assumed liability on the faith of an original document.<sup>3</sup>

The purpose of the “actual physical possession” requirement is to “allow an insured bank the opportunity to examine a document and to contact others to verify a document’s authenticity.”<sup>4</sup> This purpose is satisfied only where the insured has possession of the documents before extending credit.<sup>5</sup> At least one court has observed that the “failure to follow sound business practices and verify authenticity is a business risk taken by banks and not an insured risk covered by” the standard Financial Institution Bond.<sup>6</sup>

It appears that the drafters of the standard Financial Institution Bond attempted to alleviate some of the problems that the “actual physical possession” requirement may pose by allowing possession by an insured’s authorized representative or correspondent bank to satisfy the “actual

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<sup>1</sup> See *Hamilton Bank v. Insurance Co. of North Am.*, 557 A.2d 747, 750-51 (Pa. 1988); *National City Bank v. St. Paul Fire & Marine Ins. Co.*, 447 N.W.2d 171, 178 (Minn. 1989).

<sup>2</sup> See *Hamilton Bank*, 557 A.2d at 750-51.

<sup>3</sup> *Id.*

<sup>4</sup> *National City Bank*, 447 N.W. 2d at 177.

<sup>5</sup> See *National City Bank*, 447 N.W.2d at 178.

<sup>6</sup> *National City Bank*, 447 N.W.2d at 177.

physical possession” requirement. This “authorized representative” language, however, may raise problems of its own.

The court in *National City Bank v. St. Paul Fire & Marine Insurance Co.* has come the closest to providing a definition of “authorized representative”.<sup>7</sup> In that case, an individual borrowed money from First National Bank of Minneapolis (“First Bank”), pledging two fraudulent stock certificates representing 9,120 shares of common stock as collateral.<sup>8</sup> The individual then borrowed \$225,000 from National City Bank (the “Insured Bank”), pledging the same certificates (which were in First Bank’s possession) as collateral.<sup>9</sup> Later, the Insured Bank issued a money order made payable to First Bank, the proceeds of which were used to pay off the individual’s loan from First Bank.<sup>10</sup> Pursuant to an arrangement between Insured Bank and First Bank, the Insured Bank received the stock certificates upon payment of the money order.<sup>11</sup> The individual later defaulted on the loan, and the Insured Bank sought coverage under its Bankers Blanket Bond, which contained language essentially identical to that of Insuring Agreement (E) quoted above in this paper.<sup>12</sup>

One issue on appeal was whether First Bank was the Insured Bank’s “authorized representative” for purposes of the “actual physical possession” requirement.<sup>13</sup> In examining the term “authorized representative,” the *National City Bank* Court indicated only that there must be some sort of agency relationship between the bank and its “authorized representative.”<sup>14</sup> The *National City Bank* Court then held that an “authorized representative” relationship did not exist in that case because it was a “mere coincidence” that First Bank was holding stock certificates for the Insured Bank.<sup>15</sup> The court went on to note that “there was no act making First Bank an ‘authorized representative’ of [the Insured Bank].”<sup>16</sup>

The court in *Resolution Trust Corp. v. Aetna Casualty & Surety Co.*,<sup>17</sup> also examined whether an “authorized representative” relationship existed. In that case the insured entered into a repurchase agreement (“repo”) with Bevill, Bresler & Schulman, Inc. (“BBS”), which was a securities broker-dealer.<sup>18</sup> Pursuant to that agreement, the insured transferred the mortgage loan certificates to BBS’s clearing agent.<sup>19</sup> Ultimately, the insured was forced to seek indemnification under its financial institution bond for losses arising out of the repo transaction, and one of the primary issues was whether BBS or its clearing agents were the insured’s “authorized representative” for the purposes of satisfying Insuring Agreement (E)’s “actual physical possession” requirement.

The *Resolution Trust Corp.* Court held that neither BBS nor its clearing agents were the

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<sup>7</sup> *Id.* at 176 (citing *Citizens Bank v. American Ins. Co.*, 289 F. Supp. 211, 213 (D. Or. 1968)).

<sup>8</sup> *See id.* at 173.

<sup>9</sup> *See id.*

<sup>10</sup> *See id.* at 174.

<sup>11</sup> *See id.*

<sup>12</sup> *See id.*

<sup>13</sup> *See id.* at 176-78.

<sup>14</sup> *Id.* at 176.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> 831 F. Supp. 610, 618 (N.D. Ill. 1993).

<sup>18</sup> *See id.* at 613.

<sup>19</sup> *See id.* at 614.

insured's "authorized representative."<sup>20</sup> In doing so, the court relied on the fact that there was "simply no evidence that BBS or its clearing agents . . . were acting as [the insured's] agent either before, during, or after" the parties repo transaction.<sup>21</sup> In particular, the court noted that the receipts confirming receipt of the insured's mortgage loan certificates by BBS contained language indicating that BBS was acting for its own benefit.<sup>22</sup> With respect to its holding that BBS's clearing agents were not the insured's "authorized representative," the court relied on the fact that neither of BBS's clearing agents "took directions from or had any direct communication with [the insured] concerning the underlying transactions and [the insured] never received any separate statements of account concerning these securities."<sup>23</sup>

An analysis of the preceding cases provides some factors courts may consider in determining whether an individual or entity is an "authorized representative." Based on *National City Bank*, courts should consider whether the insured has taken some action to make the individual or entity its agent, or whether it is a mere coincidence that the individual or entity came into possession of the documents. Other factors may include whether the individual or entity had ever acted on the insured's behalf previously, whether there is a written agreement detailing the parties' relationship, and whether the individual or entity took directions from the insured.

If agency law provides the answer, as the *National City Bank* Court suggests,<sup>24</sup> then *Citizens Bank v. American Insurance Company*<sup>25</sup> is also instructive. That case is instructive because it involves the existence of an agency relationship in a case determining coverage under a Financial Institution Bond, although it does not specifically address the "authorized representative" language contained in Insuring Agreement (E) or the "actual physical possession" requirement.

In *Citizens Bank v. American Insurance Company*, the court considered whether an intermediary bank was an agent of the insured (funding bank) for purposes of determining whether the intermediary's possession of stock certificates was sufficient to allow the insured to recover under a bankers blanket bond that was similar to the standard Financial Institution Bond.<sup>26</sup> In *Citizens Bank*, First State Bank requested that Citizens Bank loan \$75,000 to a third-party individual.<sup>27</sup> Citizens Bank and First State Bank agreed that First State would handle the

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<sup>20</sup> *Id.* at 618.

<sup>21</sup> *Id.*

<sup>22</sup> *See id.*

<sup>23</sup> *Id.*

<sup>24</sup> 447 N.W. 2d at 176. Other sources echo the *National City Bank* Court's agency requirement analysis. *Black's Law Dictionary* defines "representative" as:

a person or thing that represents, or stands for, a number or class of person or things, or that in some way corresponds to, stands for, replaces, or is equivalent to, another person or thing. One who represents others or another in a special capacity, as an agent, and term is interchangeable with "agent."

*Black's Law Dictionary* 1302 (6th ed. 1990) (citations omitted). Other courts have held that, when combined with "authorized," the term "representative" encompasses entities that have been given the authority to act on behalf of another. *See Stop & Shop Co. v. Federal Ins. Co.*, 136 F.3d 71, 74 (1<sup>st</sup> Cir. 1998); *Colson Servs. Corp. v. Insurance Co. of North Am.*, 874 F. Supp. 65, 68 (S.D.N.Y. 1994). Thus, an agency component is the common theme running through the cases discussing the term "authorized representative."

<sup>25</sup> 289 F. Supp. 211, 213 (D. Or. 1968).

<sup>26</sup> *Id.* at 213.

<sup>27</sup> *Id.* at 212.

mechanics of the loan.<sup>28</sup> The third-party individual executed a promissory note payable to First State, who then forwarded that note, along with other collateral, to Citizens Bank.<sup>29</sup> The next day, the third party delivered to First State a collateral agreement in which the third party pledged certain stock certificates as collateral.<sup>30</sup> First State forwarded receipts from the stock certificates to the plaintiff, but retained possession of the actual certificates.<sup>31</sup> In turn, Citizens Bank credited the account of First State in the amount of \$75,000, and First State subsequently issued the third party a check for the same amount.<sup>32</sup> It later turned out that the collateral that the defendant pledged was counterfeit.<sup>33</sup> On appeal, the court considered whether the bankers blanket bond “cover forged or counterfeit stock certificates not in the possession of, nor viewed by, the insured.”<sup>34</sup> In holding that there was coverage under the bond, the *Citizens Bank* Court held that First State was “obviously the agent of [Citizens Bank] and held possession of the [stock certificates] for the use and benefit of the [Citizens Bank].”<sup>35</sup>

## 2. “Authorized Representative” as applied to the 2001 Forgery Scenario

While the cases cited above provide a general framework as to who may or may not be an “authorized representative,” one are factually similar to the situation presented in the 2001 forgery scenario.

Applying this general framework to the 2001 forgery scenario, an argument can be made that the mortgage broker is the “warehouse line” bank’s “authorized representative” for purposes of obtaining the original note, deed, mortgage and other loan closing documents at closing and thereafter forwarding them to the “warehouse line” bank. All of the “warehouse line” agreements which this author has seen contain written undertakings by the mortgage broker to underwrite the loans to be financed in accordance with applicable Fannie Mae or Ginnie Mae standards; to obtain the appropriate original loan documents prior to releasing the funds to purchase the home or to pay off any prior mortgage; and to deliver the original documents to the “warehouse line” bank within a short time period, usually three days.

Arguably, these written undertakings by the mortgage broker on behalf of the “warehouse line” bank could be construed as making the mortgage broker the bank’s “authorized representative” for purposes of the “actual physical possession” requirement in Insuring Agreement E.

This issue and other issues related to the “actual physical possession” requirement of Insuring Agreement E are being litigated in a variety of cases which are ongoing and pending. It remains to be seen what the outcome of these cases will be with respect to these issues.

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<sup>28</sup> See *id.*

<sup>29</sup> See *id.*

<sup>30</sup> See *id.*

<sup>31</sup> See *id.*

<sup>32</sup> See *id.*

<sup>33</sup> See *id.* at 213.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

## C. Insuring Agreement D

With respect to Insuring Agreement D of the Financial Institution Bond, the 2001 forgery scenario appears to fit the elements of Insuring Agreement D except for the provision that the Negotiable Instrument being forged cannot be an “Evidence of Debt”. In other words, if the instrument containing the forgery is an “Evidence of Debt”, there is no coverage under Insuring Agreement D.

“Evidence of Debt” is defined in the Financial Institution Bond as:

“(h) Evidence of Debt means an instrument, including a Negotiable Instrument, executed by a customer of the Insured and held by the Insured which in the regular course of business is treated as evidencing the customer’s debt to the Insured.”

Since the forged note is clearly a Negotiable Instrument, the issue then becomes whether or not the note was executed by a “customer” of the “warehouse line” bank. If the persons whose signatures were forged on the note were “customers” of the “warehouse line” bank, then there is no coverage under Insuring Agreement D. Conversely, if the persons whose signatures were forged on the note were not “customers” of the “warehouse line” bank, then there is coverage under Insuring Agreement D.

### 1. Legal Discussion as to “Customer”

As was the case with the term “authorized representative,” the standard Financial Institution Bond does not define the term “customer.” Both insureds and insurers, then, must look beyond the Financial Institution Bond to determine the term’s meaning. Unfortunately, no cases construe the term “customer” in the context of Insuring Agreement (D).

Chapter Four of the Uniform Commercial Code, dealing with bank deposits and collections, defines “customer” as a “person having an account with a bank or for whom a bank has agreed to collect items, including a bank that maintains an account at another bank.”<sup>36</sup> An account means “any deposit or credit account with a bank, including a demand, time, savings, passbook, share draft, or like account, other than evidenced by a certificate of deposit.”<sup>37</sup> This definition provides a useful starting point and may help resolve the issue of who is a “customer” within the meaning of Insuring Agreement (D). Unfortunately, however, there are few cases construing the term “customer” even in the context of the UCC.<sup>38</sup>

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<sup>36</sup> UCC § 4-104(a)(5) (2002).

<sup>37</sup> UCC § 4-104(a)(1).

<sup>38</sup> While a recent Westlaw search revealed over 70 citations to UCC § 4-104(a)(5) (or its predecessor § 4-104(1)(e)), few of those cases provided significant discussion of the term “customer.” Much of the discussion that does exist concerns whether an individual is a “customer” under UCC § 4-104(a)(5) when that individual is an officer, director, or shareholder of a corporation that has an account at a financial institution in the name of the corporation. See generally, *Murdaugh Volkswagen, Inc. v. First Nat’l Bank*, 801 F.2d 719 (4<sup>th</sup> Cir. 1986); *G.P. Shoenfelder v. Arizona Bank*, 780 P.2d 434 (Ariz. Ct. App. 1989); *Agostino v. Moticello Greenhouses, Inc.*, 166 A.D.2d 471 (N.Y. App. Div. 1990). The author is not aware of any case holding that an individual or corporation was a “customer” under § 4-104-(a)(5) (or § 4-104(1)(e)) where the individual or corporation did not maintain an account at the financial institution.

## **2. “Customer” as applied to 2001 Forgery Scenario**

Based upon the foregoing analysis, whether or not the persons whose names are forged on the closing documents are “customers” of the “warehouse line” bank will depend upon whether or not those persons are considered as having “accounts” with that bank. In most legitimate “warehouse line” loan transactions, the persons executing the note and mortgage continue to make payments to the mortgage broker during the interim between the time that the loan is funded by the “warehouse line” bank and the time it is “bundled” and assigned to Fannie Mae or Ginnie Mae. The “warehouse line” bank receives an assignment of the mortgage on the property as security but never actually receives any payments from the makers of the note and mortgage, nor is it named as a payee under the note and mortgage.

Under these circumstances, it would seem difficult to argue that the makers of the note and mortgage were “customers” of the “warehouse line” bank since they have no “account” with the bank and do not owe any debt to the bank. It would therefore appear that the forged note is not a “Evidence of Debt” within the exclusionary language of Insuring Agreement D and, therefore, coverage would be afforded for the 2001 forgery scenario under Insuring Agreement D. Again, however, this matter has yet to be litigated in any court of which the author is aware.

## **VI. “Direct Loss”**

A final, and once again difficult, issue presented by the 2001 forgery scenario is the issue of causation. Both Insuring Agreements D and E require that the loss to the bank “result directly from” the forgery. Essentially, this means that if the document which was forged would have been worthless even if the signatures thereon were genuine, then there is no “direct loss” resulting from the forgery. On the other hand, if the document, had the signatures thereon been genuine, would have had value, then the loss does result directly from the forgery.

### **A. Legal Discussion as to “Direct Loss”**

As indicated above, the causation requirement arises from the “result directly from” language contained in Insuring Agreements D and E. According to one court, this “resulting directly from” language is analogous to the proximate cause standard found in tort law.<sup>39</sup> No court since then has held otherwise.<sup>40</sup> Thus, an insured seeking coverage under Insuring Agreement D or E must prove that the forgery was a substantial cause of the insured’s loss, not that the loss “flow[ed] ‘immediately,’ either in time or space, from the forged signature.”<sup>41</sup>

While the *Jefferson Bank v. Progressive Casualty Insurance. Co.* Court discussed the causation requirement in terms of proximate cause, the more precise analytical framework would be to analyze cases under the “but-for” test for causation. Several cases hold that a loss does not result directly from a forgery if the document at issue would have been worthless had it not been forged.<sup>42</sup> Thus, courts attempt to determine whether the loss would not have occurred but

<sup>39</sup> *Jefferson Bank v. Progressive Cas. Ins. Co.*, 965 F.2d 1274, 1280-81 (3<sup>rd</sup> Cir. 1992).

<sup>40</sup> See Peter C. Haley, *Clause (E): The Continued Importance of Defined Terms and Causation Requirements*, in *Financial Institution Bonds* 253, 282 (Duncan L. Clore ed. 1998).

<sup>41</sup> See *Jefferson Bank*, 965 F.2d at 1281.

<sup>42</sup> See *id.* at 1282-85; *Reliance Ins. Co. v. Capital Bancshares, Inc.*, 685 F. Supp. 148, 151-52 (N.D. Tex. 1988) (holding that bank would have suffered identical loss even if signatures on stock certificates were genuine); *Liberty Nat’l Bank v. Aetna Life & Cas. Co.*, 568 F. Supp. 860, 863 (D.N.J. 1983) (holding that coverage under a banker’s

for the forgery.

For instance, in *Liberty National Bank v. Aetna Life & Casualty Co.*, the insured bank made loans to an individual and the individual's mother totaling approximately \$225,000.<sup>43</sup> The bank's loans were secured by certificates of deposit ("CDs") purportedly issued by the National Bank of Commerce, Ltd. but which actually were forgeries.<sup>44</sup> Unbeknown to the insured bank, however, the assets represented by the forged CDs did not exist.<sup>45</sup> The borrowers defaulted on the loans, and the insured bank attempted to recover its losses under its Bankers Blanket Bond.<sup>46</sup>

The *Liberty National Bank* Court held that the bond did not cover the insured's losses because the losses did not result directly from forged certificates of deposits.<sup>47</sup> According to the court, "even if counterfeit *and* forged, the loss sustained by [the insured] was not caused by the lack of authenticity or genuineness of the documents."<sup>48</sup> The court reasoned that even if the signatures on the CDs were legitimate, the insured still would have suffered a loss because the CDs were not supported by any assets.<sup>49</sup> Thus, it was the lack of underlying assets, and not the authenticity of the documents, that caused the insured's losses.

The Court in *Jefferson Bank* engaged in a similar analysis in a more complicated case. In *Jefferson Bank* an individual requested a loan from the bank, offering a purported first mortgage on property that he owned as collateral.<sup>50</sup> At the closing, the borrower brought along a woman who claimed to be a notary.<sup>51</sup> The alleged notary notarized the borrower's signature on the mortgage.<sup>52</sup> It later turned out that the borrower had pledged the same property as security for six or seven other loans.<sup>53</sup> One of these loans (the "preexisting mortgage") had been taken out December 15, 1988, which was one day before the bank loaned the borrower money; but, the preexisting mortgage was not recorded until January 27, 1989.<sup>54</sup> Since the bank did not record its mortgage before the preexisting mortgage was recorded, the bank was not able to recover its losses when the borrower defaulted.<sup>55</sup>

The bank ultimately filed a claim under Insuring Agreement (E) of its Bankers Blanket Bond. The bank's argument essentially was that it could not properly record the mortgage because the notary's signature was a forgery. Consequently, the bank could not gain priority as

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blanket bond did not exist because the insured would have suffered a loss even if the signatures on the certificates of deposit that the borrower pledged as collateral were genuine and authorized); *K.W. Bancshares, Inc. v. Syndicates of Underwriters at Lloyds*, 965 F. Supp. 1047, 1054-55 (W.D. Tenn. 1997) (holding that the insured's loss was not a result of having extended credit on the faith of a forged letter, but rather because the letter contained untrue statements).

<sup>43</sup> 568 F. Supp. at 861

<sup>44</sup> *See id.*

<sup>45</sup> *See id.* at 863.

<sup>46</sup> *See id.* at 861.

<sup>47</sup> *Id.* at 863.

<sup>48</sup> *Id.*

<sup>49</sup> *See id.*

<sup>50</sup> 965 F.2d at 1275.

<sup>51</sup> *See id.*

<sup>52</sup> *See id.*

<sup>53</sup> *See id.* at 1276.

<sup>54</sup> *See id.*

<sup>55</sup> *See id.*

a first mortgage lienholder and, therefore, its loss resulted directly from the forgery.<sup>56</sup> The insurer argued in opposition that the forgery did not cause the bank's loss because the mortgage was worthless given the preexisting mortgage.<sup>57</sup>

The court struck a middle ground, holding that the mortgage had value for the brief period of time after the closing but before the preexisting mortgage was recorded.<sup>58</sup> The *Jefferson Bank* Court concluded that the mortgage had "theoretical"<sup>59</sup> value for two reasons.<sup>60</sup> First, the court concluded that, although the mortgage was not recordable because the notary's signature was fraudulent, the bank could have "theoretically" corrected that defect by either having the borrower acknowledge his signature before a legitimate notary or obtaining an equitable decree validating the notary's acknowledgment.<sup>61</sup> This would have allowed the bank to record its mortgage before the preexisting mortgage was recorded. Second, the bank could have obtained a judgment against the borrower because the borrower breached his covenant that the mortgage was unencumbered, thereby allowing the bank to foreclose almost immediately.<sup>62</sup> Such a judgment would have had priority over the preexisting mortgage if the preexisting mortgage had not been recorded.<sup>63</sup> Once the preexisting mortgage was recorded, however, the bank could not gain priority as lienholder even if the notary had not forged the signature. Therefore, the mortgage was worthless at that point.<sup>64</sup>

Once it determined that the mortgage had value for a brief period of time, the *Jefferson Bank* Court distinguished cases<sup>65</sup> holding that losses under financial institution bonds did not result directly from the forgeries, but rather from the fact that the security was worthless.<sup>66</sup> According to the *Jefferson Bank* Court, the case that it was presented with was "plainly distinguishable" from *Reliance Ins. Co. v. Capital Bancshares, Inc.* and *Liberty National Bank* because the securities in those cases never had value.<sup>67</sup> As indicated above, the court held that mortgages in *Jefferson Bank* had "theoretical" value for a brief period of time.

## **B. "Direct Loss" as applied to 1974 and 2001 Forgery Scenarios**

Once again, whether or not the loss was a direct result of the forgery will depend upon the facts and circumstances of each particular case. Under either the 1974 or 2001 forgery scenarios set forth above, the critical question will be whether or not the notes and mortgages in those scenarios, had they not been forged, would have had value. Under both of the above scenarios, the notes were purportedly executed by legitimate borrowers who had undergone credit investigation and who had passed underwriting standards of the particular financial

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<sup>56</sup> See *id.* at 1282.

<sup>57</sup> See *id.*

<sup>58</sup> See *id.* at 1282-83.

<sup>59</sup> The *Jefferson Bank* Court observed that any value the mortgage had was theoretical because the bank did not have any notice that the notary's signature was fraudulent; therefore, the bank would not have availed itself of the two avenues it could have pursued to give the mortgage value. *Id.* at 1283.

<sup>60</sup> See *id.* at 1283.

<sup>61</sup> See *id.*

<sup>62</sup> See *id.*

<sup>63</sup> See *id.*

<sup>64</sup> See *id.*

<sup>65</sup> These cases included *Reliance Ins. Co. v. Capital Bancshares, Inc.*, 685 F. Supp. 148 (N.D. Tex. 1988) and *Liberty Nat'l Bank v. Aetna Life & Cas. Co.*, 568 F. Supp. 860 (D.N.J. 1983).

<sup>66</sup> See *id.* at 1283 n.16.

<sup>67</sup> See *id.*

institutions involved with respect to their ability to pay the note and mortgage. Furthermore, the real property subject to the forged mortgage actually existed and actual appraisals confirming the value of such property were in the otherwise bogus loan files. In addition, the mortgages purportedly executed by the borrowers in each scenario stated on their face that they were first mortgages on otherwise unencumbered property which actually had value.

Under these circumstances, it would seem that both the notes and mortgages in each scenario, had they not been forged, would have had value and, therefore, the requirement of a "Direct Loss" under both Insuring Agreements D and E would be met. Again, however, these issues are being litigated at the present and remain unresolved.

## **VII. The "Big Picture" Issue**

As pointed out above, all of the legal issues discussed above are in the process of being litigated in several forums across the country. The outcomes of these legal disputes will hopefully be able to be presented at a future date at this seminar or elsewhere.

Regardless of the outcome of the pending litigations however, larger issues are presented as a result of this entire "warehouse line" scenario. It is undisputed that a large percentage of home mortgages and home mortgage refinancings these days are handled through mortgage brokers which have "warehouse line" as described at the beginning of this paper. Closings on these transactions no longer take place with all the involved parties sitting in the same room executing original documents and exchanging them all at the same time and place. Financial institutions certainly will wish to have fidelity bond coverage for losses due to forgeries which occur in these "warehouse line" loan closings which now comprise such a large portion of their mortgage business.

If, in fact, the current Financial Institution Bond form, in particular Insuring Agreements D and E, does not provide coverage for losses caused by forgeries which may take place as part of these "warehouse line" closings, then the financial institutions will either stop purchasing fidelity bond coverage or, more likely, will bring pressure to bear to change the language of Insuring Agreements D and E so as to provide coverage for losses due to forgeries in "warehouse line" transactions.

The fidelity bond industry may wish to "get out in front" of this issue and modify its Financial Institution Bond form so as to afford such coverage in the future.

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Lecturer, 1995 Southern Surety & Fidelity Claims Association Conference, Atlanta, Georgia, "Retention Limits in Fidelity Bonds and D&O Policies: One Loss or Multiple Losses? The Wrong Answer Can Cost You Big Bucks!"

Lecturer, 1996 Southern Surety & Fidelity Claims Association Conference, Atlanta, Georgia, and 1996 Northeast Surety & Fidelity Claims Conference, Iselin, New Jersey, "The IRS is at it Again! Personal liability of the Surety and Surety's Counsel for Unpaid Withholding on Principal's Payroll!"

Author and instructor, "Surety Case Study"  
1997 Northeast Surety & Fidelity Claims Conference, Iselin, New Jersey

Lecturer, 1999 Southern Surety & Fidelity Claims Association Conference, New Orleans, Louisiana, and 1999 Northeast Surety & Fidelity Claims Conference, Iselin, New Jersey, "Watch Out! The Gator Will Bite You! – Idiosyncrasies of Florida Law that All Claims Persons Should Know."

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