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LOAN LOSSES AND COLLUSION  
UNDER INSURING AGREEMENT A

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**I. INTRODUCTION**

Insuring Agreement A in the standard Form 24 Financial Institution Bond (the "Bond") insures banks against the dishonest or fraudulent acts of their employees. These bonds have existed for quite some time, but through the years there have been significant changes in the scope of fidelity bond coverage.

**II. COVERAGE PRIOR TO 1986**

In the 1960's and 1970's, various courts around the country broadly interpreted the words "dishonest" and "fraudulent" in fidelity bonds and readily held that coverage existed for acts that frequently are not covered under the language of today's bond. Federal Deposit Insurance Corporation v. Aetna Casualty & Surety Company, 426 F.2d 729 (5th Cir. 1970); Federal Deposit Insurance Corporation v. National Surety Corporation, 281 N.W. 2d 816 (Iowa 1979); Arlington Trust Company v. Hawkeye-Security Insurance Company, 301 F. Supp. 854 (E.D. Va. 1969); First National Bank of Sikeston v. TransAmerica Insurance Co., 514 F.2d 981 (8th Cir. 1975)<sup>1</sup>; Home Indemnity Company v. Reynolds, 38 Ill. App. 2d 358,

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<sup>1</sup> For example, the Sikeston court held that where an employee creates a conflict of interest or acts in disregard of his employer's interest, subjecting it to a likelihood of loss, such conduct is fraudulent and dishonest within the meaning of a fidelity bond.

187 N.E. 2d 274 (1962)<sup>2</sup>. It has been the intent of fidelity insurers to provide coverage only for intentionally dishonest acts and to exclude coverage for losses which a bank incurs due to negligent or reckless conduct. The above decisions forced insurers to pay for losses that they never intended to cover. Therefore, in 1976, the Surety Association of America published a rider to Insuring Agreement A which required that the employee act with the manifest intent to cause the bank a loss and with the manifest intent to obtain financial benefit. Mere dishonest or fraudulent acts no longer provided the basis for a claim. This change made it more difficult for banks to obtain coverage for their employees' conduct.

### III. 1986 AMENDMENT

Despite the 1976 amendment, many questioned whether it had gone far enough, particularly as it relates to defining the "financial benefit" the disloyal employee must intend to obtain in cases involving loan losses. In the 1980's, banks made many fidelity claims for losses resulting from loans that had gone bad. The insurers had no intent to cover recklessly or negligently made loans. Therefore, in 1986, the Surety Association supplemented the 1976 rider as follows:

However, if some or all of the insured's loss results directly or indirectly from Loans, that portion of the loss is not covered unless the employee was in collusion

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<sup>2</sup>Fraud or dishonesty includes conduct which is "manifestly unfair to the employer and probably subjects him to the likelihood of a loss" and acts which display "significant lack of probity, integrity, or trustworthiness".

with one or more parties to the transactions and has received, in connection therewith, a financial benefit with a value of at least \$2,500. (emphasis added).

With the adoption of this change, the industry intended to better protect itself against the rising number of claims from financial institutions for what the insurance industry has long considered to be non-covered bad loan losses. Insurers hope that claims for loan losses will only be recognized if the institution can show that the employee (a) was in collusion with the borrower and (b) received a "kickback" with a value of at least \$2,500. Coverage will no longer exist for situations where an employee merely makes a loan with the manifest intent to cause the bank a loss. Instead, the employee must have been in collusion with one or more parties to the loan and must have received the requisite benefit. This Amendment has added new hurdles to obtaining coverage for banks that incur loan losses.

Obviously, fidelity bonds are not intended to provide coverage for losses that result from honestly made loans. Additionally, they are not intended to cover loan losses which result from reckless or imprudent conduct. The new language should protect insurers from having to pay for such losses. It will now be more difficult for a bank to prove that its loan losses are covered based on circumstantial evidence. While an inference of collusion may be derived from a review of the circumstances, the bank can still not recover its loan losses unless a financial benefit exceeding \$2,500.00 has been received.

This paper discusses the 1986 Amendment concerning loan losses and the collusion that is required to obtain coverage.

IV. WHAT IS A "LOAN"?

The first step is to determine what constitutes a "loan." There is substantial case law discussing the definition of a "loan", and the courts have construed the term broadly, so that it includes situations far beyond the simple transaction in which a borrower signs a promissory note and obtains money from the bank. The Bond defines a "loan" as:

All extensions of credit by the Insured and all transactions creating a creditor relationship in favor of the Insured and all transactions by which the Insured assumes an existing creditor relationship.

The Annotated Bankers Blanket Bond (American Bar Association, 1983) confirms that the definition of a "loan" was intended to cover overdrafts and NSF checks. The second supplement to the annotations provides that:

Definition (m) loan is a new one and relates to exclusion (e). The critical language is that a loan includes 'all extensions of credit' and all transactions which create a debtor-creditor relationship. In other words, whenever one owes money to a financial institution whether the transaction was initiated or assumed, the transaction will be regarded as a loan. This would include such items as paying overdrafts in a checking account, advancing credit on a check which is returned non-sufficient funds and extension of credit in form of overdraft protection or on cash cards. Annotations 2d Sup. at 52.

Not only have courts held that loans include situations where a bank gives credit for overdrafts or NSF checks, but they have also

held that check kiting schemes may constitute a "loan."<sup>3</sup> For example, in First Texas Savings Association v. Reliance Insurance Company, 950 F.2d 1171 (5th Cir. 1992), a customer was allowed to draw on his account when the funds in the account were insufficient to cover the withdrawals. It was eventually discovered that the customer was involved in a check kiting scheme. Id. at 1173. The court noted that regardless of the form of the transaction, if one party transfers a sum of money to a party that agrees to repay the money, a loan exists. In First Texas, the bank relied on the customer's promise to repay the overdrafts when it granted him immediate access to the funds. Therefore, the bank made a loan as a matter of law. Id.

Likewise, in Affiliated Bank\Morton Grove v. Hartford Accident and Indemnity Company, 1992 W.L. 91761 (N.D. Ill.), a bank employee instructed a customer to write checks from its accounts in other banks to deposit into the employee's bank. The employee knew there were insufficient funds in the other bank accounts to cover the checks that were written. Since the employee knowingly extended credit to the customer, a debtor-creditor relationship was

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<sup>3</sup> A check kiting scheme is a process whereby a person with a checking account in two banks can create an illusion of money in his accounts. A check drawn on the first bank is deposited with the second bank. Before the check reaches the first bank for payment, a check drawn on the second bank is deposited in the first bank. If the bank is willing to give credit in the interim, and many banks are if the person is a regular customer, the person can use the bank's money without first providing collateral and without paying interest. The scheme can continue as long as the person deposits its checks in both banks and as long as the banks believe that there is money behind the checks. Calcasieu-Marine National Bank v. American Employers' Insurance Co., 533 F.2d 290, 294 n.3 (5th Cir. 1976).

established and a loan existed. Id. at 1. See also Calcasieu-Marine National Bank v. American Employer's Insurance Company, 533 F.2d 290 (5th Cir. 1976); Security National Bank of Kansas City, Kansas v. The Continental Insurance Company, 586 F. Supp. 139, 150 (Dist. Ct. Kan., 1982). But see National Bank of Paulding v. Fidelity and Casualty Company, 131 F. Supp. 121 (S.D. Ohio, 1954) (check kite did not constitute a loan because there was no intention to create a credit relationship between the bank and its customer).

To the advantage of insurers, the above cases allow for creativity in determining whether a particular transaction is a loan. Once a transaction is classified as a loan, the bank must then prove the existence of collusion and the requisite financial benefit.

V. WHAT IS COLLUSION?

On its face, it is not clear what the collusion requirement will add in the context of loan losses. It seems that in most cases where an employee makes dishonest loans with the requisite manifest intent, he will be acting in collusion with the borrower or others to the transaction. It is difficult to imagine a transaction whereby an employee would make a dishonest loan and obtain a financial benefit exceeding \$2,500 without being in collusion with others involved in the transaction. If the kickback comes from the borrower, collusion can be more easily proved.

A primary issue, but one that has rarely been discussed by courts, is what constitutes collusion. BLACK'S LAW DICTIONARY (5th ed. 1983) defines collusion as follows:

An agreement between two or more persons to defraud a person of his rights by the forms of law, or to obtain an object forbidden by law....A secret combination, conspiracy or concert of action between two or more persons for fraudulent or deceitful purpose.

As with the manifest intent requirement of the bond, it may be rare to find a situation where the employee or customer admits to having agreed to collusively commit fraudulent acts. Therefore, it will likely be necessary to infer collusion from surrounding events. However, courts will not lightly infer the existence of collusion. For example, in Progressive Casualty Insurance Company v. First Bank, 828 F. Supp. 473 (S.D. Texas 1993), the bank's president made loans without documentation, failed to follow the bank's internal procedures, and misrepresented the financial condition of the borrowers and the value of their collateral. Id. at 474. After the bank incurred losses, it attempted to recover under its fidelity bond. However, the bank failed to produce any evidence of the president's financial benefit and instead relied on the argument that the president would have acted as he did only if he had a secret gain. Id. The bond requires more than that a borrower obtain some benefit. There must be collusion, at least inferable, from the banker's personal secret gain. Id. The bank's allegations did not implicate the borrower and the bank had no tangible evidence of collusion or gain (such as a "kickback" check

from the borrower to the banker). Therefore, no coverage existed. Id. at 475.

In Standard Chartered Bank v. Milus, 826 F. Supp. 310 (D. Ariz. 1990), the court granted the insurer's motion for summary judgment and held that the bond did not cover the losses caused by the bank officer's conduct. It is worth reviewing the Milus decision in detail because it is the only published opinion which thoroughly discusses the Bond's "collusion" requirement.

In Standard Chartered, Paul Milus was a vice president of the bank who allegedly gave millions in undercollateralized loans to two financially ill-liquid borrowers in order to keep loans to them from going into default and being written off the bank's books. Id. at 311. Milus stood to personally gain from a pending sale of the bank to another bank because Milus owned many shares of his bank's stock. However, if the borrower's loans were written off, the upcoming sale of the bank would be put in jeopardy and Milus might not gain from a sale. As a result of Milus' loans to these borrowers, the bank incurred losses and brought an action against its insurer, United States Fidelity and Guaranty Company. Id.

Since the losses involved loan transactions, no coverage would apply unless the borrowers were in collusion with Milus in connection with the loans. Although collusion was not defined in the contract, the parties agreed that it was synonymous with the term "conspiracy" as used in the criminal context. Id. at 312. However, there was no direct evidence of collusion. Therefore, the plaintiff relied on Direct Sales v. United States, 319 U.S. 703, 63

S. Ct. 1265, 87 L. Ed. 1674 (1943) to argue there was tacit collusion between Milus and the borrowers. In Direct Sales, the Supreme Court upheld a conviction of a pharmaceutical manufacturer for conspiracy with a doctor to distribute narcotics. The defendant contended that there was insufficient evidence of an agreement. The Supreme Court concluded that a jury could infer a conspiracy or concert of action between the doctor and pharmaceutical company, based on the company's clear knowledge that the doctor was putting drugs to an illegal use, plus the company's efforts to promote the doctor's activities by providing discounts. Id.

In Standard Chartered, the bank asserted that Milus approved the loans under such egregious circumstances that the borrowers must have known that Milus was approving the loans for his own unauthorized purposes, and also that the borrowers encouraged the unauthorized loans by providing Milus with substantially overvalued or worthless collateral. Id. The plaintiff believed this was enough to show tacit collusion. While the Standard Chartered court did not necessarily agree that the Direct Sales analysis would apply, it held that even assuming the Direct Sales analysis applied, the facts of the case did not create a sufficient inference of tacit collusion. Id. at 313.

The court noted that the mere act of procuring a loan, even one given negligently or recklessly, does not inherently place a borrower on notice of possible illegal activity on the part of the loan officer. Furthermore, just because the loans were supported

by worthless collateral does not support an inference that the borrowers knew of or intended to promote Milus' scheme. There were no allegations that the borrowers engaged in activity knowingly designed to encourage the unauthorized lending of funds. Id. Even assuming the borrowers knew that Milus was negligently or recklessly lending money, their continued efforts to seek loans alone do not create an inference of conspiracy. There was no clear and unequivocal evidence that the borrowers knew of Milus' alleged scheme to protect the value of his stock, nor was there any evidence that the borrowers knew of the upcoming sale. The court cited Direct Sales' analysis that knowledge cannot support an inference of intent to promote an illegal act unless evidence of the knowledge is clear and unequivocal. Absent such allegations, it was a stretch of logic to infer intent to promote Milus' scheme from the mere act of seeking negligently or recklessly made loans. Id.

The bank appealed the decision and argued that the court had improperly applied a criminal conspiracy standard. In approving the decision, the Ninth Circuit assumed that a civil conspiracy standard applied and held that although there may have been evidence of improper motives of Milus and the borrowers, there was no evidence of explicit or tacit agreement or joinder of purpose. 1993 U.S. App. LEXIS 3654 (Feb. 23, 1993).

There are not too many cases involving collusion where the parties to the transaction admit that they acted in concert. There may be numerous cases where there is direct evidence of collusion,

such as where documentation exists showing that the parties acted in concert. For example, if a borrower has written a check to the loan officer at or about the time of the dishonest loan, and there is no valid explanation for the check, then collusion may be easily proved. However, difficulty will arise in situations such as Standard Chartered where there is no direct evidence of collusion. Banks will have to rely on circumstances surrounding the transaction. Coverage should not be denied simply because an employee testifies that he did not act in collusion with another party to the transaction. The Standard Chartered case indicates that courts may apply an objective standard of collusion and evaluate all the circumstances surrounding the loan to determine whether an inference of collusion is warranted.

Of course, even if collusion exists, the bank must prove that the loan officer received, in connection with the collusive transaction, a financial benefit exceeding \$2,500. Even if a borrower colludes with a loan officer, no coverage will exist under the bond if the loan officer has not received the requisite benefit. That issue, however, could be the subject of another paper.

For example, in Standard Chartered, even had collusion been proven, the loan officer arguably did not obtain a financial benefit because his alleged attempt to obtain an increased value of the stock that he owned could be classified as an employee benefit earned in the normal course of employment and therefore would not

fall within the definition of financial benefit. This issue, however, is too detailed to be addressed in this paper.

Banks will often allege that an employee has received the requisite financial benefit, yet no proof will exist that such a benefit was received. If no evidence or documentation exists to prove the financial benefit, the insurer should move for summary judgment. The bank bears the burden of proving that the employee received the requisite financial benefit. Therefore, when moving for summary judgment, the insurer need not produce evidence in negation of the financial benefit element. Instead, the insurer may discharge its burden simply by demonstrating the absence of supporting evidence in the record. Celotex Corporation v. Catrett, 477 U.S. 317, 106 S.Ct. 2548 (1986).

#### VI. CONCLUSION

Unfortunately, due to the lack of precedent, neither insurers nor banks have been provided with clear guidelines for what constitutes collusion within the meaning of loan losses. Therefore, there is room for creativity on the part of counsel. Nonetheless, even if the bank can prove the collusion requirement, the bank must still prove that the employee received a financial benefit exceeding \$2,500.00.

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