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***SETTING THE RECORD STRAIGHT ON "RELIANCE",
"CAUSATION", AND "GOOD FAITH" UNDER INSURING
AGREEMENT (E)***

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I. INTRODUCTION

This paper focuses on Insuring Agreement (E) of the Financial Institution Bond and the interrelated principles of reliance, causation, and good faith, all of which are requirements for coverage under this provision. There are few cases interpreting this area of law and some of these cases erroneously interchange the three similar, but distinct, principles, creating some confusion. So let's set the record straight!

Before embarking on this endeavor, however, it is important to understand the basic tenets under Insuring Agreement (E), which states in its entirety:

- (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) Certificate 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

¹ The author wishes to thank Anne M. Sylvester, Esq., of Kimbrell & Hamann, P.A., Miami, Florida, for her assistance and contributions to this paper.

- (i) Statement of Uncertificated Security of any Federal Reserve Bank of the United States
 - (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 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.

This provision of the Financial Institution Bond provides coverage for losses resulting directly from certain defined documents listed in subparagraphs (a) through (h), which are forged, altered, lost, stolen or counterfeited. It is clear from Insuring Agreement (E) that the financial institution must, among other things, establish that it relied on the defective document, acted in good faith, and that the damage was caused by the forgery, alteration, loss, theft, or counterfeit nature of the document.

II. HYPOTHETICAL SCENARIO

To assist in our analysis, we offer the following hypothetical scenario to highlight the issues raised in this paper:

Jim E. Sleeze and his soon-to-be ex-wife, Sue Z. Sleeze, are long-time customers of Bumbling Fumbling Bank. The Sleezes' joint checking account is with Bumbling Fumbling Bank, and the bank has approved several loans in the past to the Sleezes.

Unbeknownst to his wife, Mr. Sleeze forms Fly By Night Builders, Inc., and slithers into Bumbling Fumbling Bank to acquire an operations loan for the new company. Bumbling Fumbling Bank requires Fly By Night and the Sleezes to submit corporate and personal financial statement to the bank; additionally, Bumbling Fumbling Bank requires Mr. & Mrs. Sleeze to post collateral in the amount of \$50,000 and to execute continuing and unconditional personal guarantees.

Mr. Sleeze provides Bumbling Fumbling Bank the corporate financial statements of the new company and the Sleeze's joint financial statement. He also tenders to the bank a collection of penny stock certificates held jointly which he claims is worth \$50,000. Mr. Sleeze is desperate for the loan and begs the bank officer, Isabelle M. Gullible, to submit the request to the loan committee. In the interim, Mr. Sleeze promises Ms. Gullible that he would obtain the signature of his bed-ridden wife on her personal guarantee.

Based upon the financial statements and the penny stock certificates, Bumbling Fumbling Bank approves the loan, subject to acquiring the personal guarantees of the Sleezes. Bumbling Fumbling Bank, however, authorizes an advance on the loan so that Mr. Sleeze can meet his first payroll. Ms. Gullible notifies Mr. Sleeze of the contingent loan approval. Mr. Sleeze immediately proceeds to forge his wife's signature while she is in Las Vegas obtaining a quickie divorce.

Subsequently, Fly-By-Night files for bankruptcy and defaults on the loan. Bumbling Fumbling Bank later discovers that the collateral is worthless and that Mrs. Sleeze's signature was forged on her personal guarantee. Thereafter, Bumbling Fumbling Bank makes a claim under Insuring Agreement (E) of Grade-A-Bonding Company's Financial Institution Bond.

We will address the issues raised in this quandary in our conclusion after analyzing the pertinent case law discussed below.

III. RELIANCE

Although the term "on the faith of" is not defined in the text of Insuring Agreement (E), courts have had no difficulty in interpreting that term to require reliance upon the defective document in the

subject transaction. Courts have construed the term "on the faith of" under Insuring Agreement (E) to be akin to "reliance"² and, have even allowed the term "reliance" to be used in jury instructions.³

The issue of reliance under Insuring Agreement (E) often arises out of a financial institution's claim that a personal guarantee is forged. Financial institutions customarily require a borrower and its principals (including their spouses) to submit financial statements and to execute loan guarantees.⁴ In some situations, however, the financial institution will extend credit to a borrower prior to obtaining pertinent financial information or procuring the execution of a personal guarantee. In such situations, the insurer will be able to argue that the financial institution did not rely on the personal guarantee of the borrower, thereby barring coverage.

Such was the case in Continental Bank v. Phoenix Ins. Co.⁵ In that matter, the financial institution sought to recover a loss allegedly resulting from a forgery of a personal guarantee. The subject transaction in Continental Bank was a loan to a corporation in which the insured required the principals of the borrowing corporation to submit financial statements and to execute personal guarantees along with their wives. The loan was renewed although the bank was aware of the corporation's financial difficulties. Ultimately, the loan was declared in default, and the bank discovered that the signature on the guarantee of one of the wives, Mrs. Wilks, was forged.

In affirming the trial court's finding that the bank did not rely on the forged guarantee, the Continental Bank court concluded that there was no coverage under Insuring Agreement (E). The court

² Exeter Banking Co. v. N.H. Ins. Co., 438 A.2d 310, 315 (N.H. 1981) (finding that the term "on the faith of" signifies something done "in reliance upon"); Continental Bank v. Phoenix Ins. Co., 24 Cal. App. 3d 909, 913, 101 Cal. Rptr 392, 394 (1974) (holding that because the bank did not obtain financial information on one of the personal guarantors before extending credit, the bank did not rely upon the forged personal guarantee).

³ United States Nat'l Bank in Johnstown v. Reliance Ins. Co., 501 A.2d 283 (Pa. Super. 1985) (stating that using the terms "reliance" and "on the faith of" interchangeably is not improper).

⁴ Continental Bank v. Phoenix Ins. Co., 101 Cal. Rptr. 392 (1972).

⁵ Id.

found that the bank relied on the credit and guarantees of the others, to the exclusion of Mrs. Wilks, emphasizing that the bank had no financial information concerning the worth of Mrs. Wilks.

Another case addressing the issue of reliance in connection with a personal guarantee is United States National Bank in Johnstown v. Reliance Ins. Co.⁶ This case involves a line of credit given to a borrower in which the principals of the borrower, along with their wives, were required to sign certain unidentified documents. Financial statements were provided by both principals; one was submitted jointly (Mr. and Mrs. Walters), while the other was marked "personal" as to the husband, Mr. Jones. His wife, Mrs. Jones, did not submit a financial statement.

The signature of Mrs. Jones on the unidentified document was later determined to be forged. The bank verified the signatures of all individuals involved in the transaction, except for that of Mrs. Jones. The Johnstown court found that "the bank had no way to compare [Mrs. Jones'] signature, did not inquire into her credit, and had no contact with her regarding this or any other transaction."⁷

In denying coverage under Insuring Agreement (E), the Johnstown court concluded that the bank did not rely upon Mrs. Jones's signature. The court opined that "the bank was completely satisfied with Mr. Jones' word as to his wife's signature on the document", stating:

'Reliance' and even 'acting on the faith of' requires something more. While the signature was necessary for protection purposes, **it was not a determining factor in whether or not the loan should have been granted.**⁸

The court went on to say that the considerations acted upon by the loan committee were the financial statements of each partner, the financial statement and accounts receivable of the borrower, and the

⁶ 501 A.2d 283 (Pa. Super. 1985).

⁷ Id. at 284.

⁸ Id. at 285.

respective signatures of the husbands. Accordingly, the court deduced that Mrs. Jones' signature was not relied on in extending the loan and not given on the faith of her signature.⁹

The next line of "reliance" cases deals with security taken after money has been disbursed. It is difficult, at best, for a financial institution to claim that it relied on loan security taken after the loan money has been disbursed. Insuring Agreement (E) does not cover a loss resulting directly from a forged or counterfeit document if the money went to the borrower before the financial institution ever obtained documents.

For example, in Allen State Bank v. Travelers Indemnity Co.,¹⁰ the borrower was not required to give the bank any collateral when the loans were made. It was not until almost six months after the bank made the loans to the borrower that the borrower pledged promissory notes. The court held that since the borrower was not required to give the bank any collateral at the time of the extension of credit, Insuring Agreement (E) would not cover the loss.¹¹

The last issue which we will examine in connection with reliance is the condition precedent under Insuring Agreement (E) that the defective document be in the physical possession of the financial institution. Specifically, the Financial Institution Bond provides that "[a]ctual physical possession of the items listed in (a) through (i) above by the Insured . . . is a condition precedent to the Insured's having relied on the faith of such items."

As demonstrated by Republic Nat'l Bank of Miami v. Fidelity and Deposit Co. of Maryland,¹² such a condition precedent bars recovery of a loss arising out of a document which the financial

⁹ Id.

¹⁰ 270 So.2d. 270 (La. App. 1972).

¹¹ If, however, the loan security is taken as part of a loan work-out or renewal that amounts to a contractual novation, then the financial institution may be able to show that it relied on the defective document. French Am. Banking Corp. v. Flota Mercante Grancolombiana, S.A., 609 F.Supp. 1352 (S.D.N.Y. 1985).

¹² 894 F.2d 1255 (11th Cir. 1990).

institution does not have in its physical possession. In Republic, the beneficiary of a letter of credit presented the allegedly forged bills of lading after the bank had already irrevocably committed itself to extend credit to its customer and to honor the letter of credit presented by the beneficiary.

In holding that Insuring Agreement (E) does not provide coverage under the facts of Republic, the court resoundingly concluded that "the condition precedent contained in the banker's blanket bond will always preclude a bank from recovering for a loss arising out of its misplaced reliance on documents of title presented by the beneficiary of that letter of credit transaction."¹³ (Emphasis in original.) This is because the financial institution never receives the bill of lading until after it extends credit, in the form of letters of credit to a borrower.¹⁴

IV. CAUSATION

Insuring Agreement (E) only covers a loss "resulting directly from" the transaction at issue. Courts interpreting this phrase require that the loss be "proximately caused" by the defect in the document.¹⁵

The most recent case analyzing the causation element is Jefferson Bank v. Progressive Casualty Ins. Co.¹⁶ In that case, a borrower defaulted on his obligation to repay a mortgage. After discovering that the mortgage contained a forged signature, the bank claimed that its loss resulted directly from the forged signature. The insurer argued that "resulting directly from" means that the loss must be "directly caused" by the forged signature. In rejecting the insurer's position, the Jefferson court stated that

¹³ Id. at 1262-63.

¹⁴ Id.

¹⁵ See, St. Paul Fire & Marine Ins. Co. v. Bank of Stockton, 213 F.Supp. 716, 719 (N.D. Cal. 1963) (holding that bonding company could assert the security's lack of value as a defense); cf., Iselin-Jefferson Financial Co., Inc. v. United California Bank, 549 P.2d 142 (Cal. App. 1976) (rejecting bonding company's argument that guarantor's lack of assets obviated the finding of proximate cause because the guarantor may obtain assets in the future).

¹⁶ 965 F.2d 1274 (3d Cir. 1992)

"direct cause" was a nebulous and largely indeterminate concept and, therefore, adopted the proximate cause standard, lessening the burden of proof for causation.¹⁷

The typical situation in which an insurer could raise the issue of causation is where, irrespective of the forgery, the financial institution would be unable to recover its losses due to the worthless value of the collateral pledged or guarantee given. For example, in Liberty Nat'l Bank v. Aetna Life & Casualty Co.,¹⁸ a bank brought an action seeking to recover under its banker's blanket bond for losses from loans which were not repaid, and which were secured by worthless certificates of deposits issued by an entity which had no assets. Although the question of forgery presented a factual issue, the court in Liberty nevertheless granted summary judgment in favor of the bonding company on the basis of lack of proximate cause, stating:

[T]he loss sustained by the Bank was not caused by the lack of authenticity or genuineness of the documents. On the contrary, the loss was caused by the fact that the statements contained in the documents were not true. . . . If the documents were authentic and their signatures genuine and authorized, the loss nonetheless would have occurred.¹⁹

The court further emphasized that the loss was caused by the absence of any of assets purportedly represented by the documents, and not because of the forgery or counterfeit nature of the documents.²⁰

¹⁷ Id. at 1281.

¹⁸ 568 F.Supp. 860 (D.N.J. 1983).

¹⁹ Id. at 863.

²⁰ Id.; See also, Reliance Ins. Co. v. Capital Bancshares, Inc., et.al, 685 F.Supp. 148, 152 (N.D. Tex. 1988) (holding that bogus stock certificates were worthless and thus the bank would still have suffered losses even if the signatures had been genuine), aff'd on other grounds, 912 F.2d 756 (5th Cir. 1990) (declining to adopt the causation rationale of trial court); but see, Richardson Nat'l Bank v. Reliance, 491 F.Supp. 121, 124 (N.D. Tex. 1977) (refusing to grant summary judgment to bonding company on the basis of lack of causation because, but for the forgery, the insured may have had a cause of action against third parties to recover for the loss).

V. GOOD FAITH

Generally, a financial institution does not have a duty to inquire into the genuineness of a document upon which it relies in extending credit.²¹ However, a financial institution cannot choose to remain ignorant; the financial institution's reliance on a defective document must be in "good faith".

The leading case on the "good faith" requirement of Insuring Agreement (E) is Marsh Inv. Corp. v. Langford,²² in which a bank combined Langford's large debts in exchange for a note secured with a mortgage on property owned by Marsh Investment Corporation ("Marsh"). The bank, knowing that Langford was not an officer, director, or shareholder of Marsh, required the unanimous consent of all the Marsh shareholders and a corporate resolution to verify that Langford had the authority to encumber the Marsh property. Langford presented his own attorney, Stassi, with a corporate resolution authorizing the transaction and a list of the shareholders. The resolution was certified by the purported corporate secretary, and all shareholders had allegedly consented to the transaction.

However, the bank did not see the resolution or the list; by agreement, the resolution and the list were to be held in safekeeping by Stassi, who in turn prepared an opinion letter describing the shareholder documents. In part, Stassi's opinion stated "I make no representation or warranty, or give any opinion, that these people are in fact shareholders of Marsh . . . , or, if they are that they are the same people who signed these consent forms."²³

²¹ See, e.g., French Am. Banking Corp. v. Flota Mercante Grancolombiana, S.A., 609 F.Supp. 1352, 1359 (S.D.N.Y. 1985).

²² 721 F.2d 1011 (5th Cir. 1983). For a historical perspective of the good faith requirement, please compare Citizens Bank of Oregon v. Am. Ins. Co., 289 F.Supp. 211 (D. Ore. 1968) with Stix Friedman & Co. v. Fidelity & Deposit Co. of Maryland, 563 S.W.2d 517 (Mo. App. 1978).

²³ Id. at 1013.

Attorneys for the bank testified that this disclaimer "concerned them and made them suspicious."²⁴ Nonetheless, the bank did nothing to verify that Langford had authority to encumber Marsh's property. The resolution and the consent turned out to be bogus.

Supported by these facts, the Marsh court approved the trial court's finding in favor of the insurer based on the bank's failure to meet the good faith element of Insuring Agreement (E). The bank conceded that the trial court's definition of good faith/bad faith was correct:

mere ignorance is not bad faith, but... if one "chooses to remain ignorant... in fear of what a little knowledge will disclose..." such "selective ignorance" is bad faith.²⁵

It should be noted that, because the parties did not debate the definition of "good faith", the Marsh court left that issue open for another day, remarking that the concept of good faith is a "slippery one under Louisiana law."²⁶

The Fifth Circuit went on to say that the bank clearly demonstrated "selective ignorance":

[T]he bank, faced with an anomalous transaction that turned on the authority of one man - a poor credit risk, as it admitted - to mortgage the property of a corporation with which [the bank] knew that he had little or no connection, and with the means of checking that authority lying [sic] as near as the closest telephone, failed in the face of what the trial court properly characterized as a variable sea of red flags to lift a finger to verify that authority, choosing instead to proceed in ignorance and sole reliance on the debtor's critical representations about his own authority.²⁷

More recently, the Southern District of New York, in French American Banking Corp. v. Flota Mercante Grancolombiana, S.A.,²⁸ citing the Marsh decision, used the Uniform Commercial Code to define "good faith" under Insuring Agreement (E). In Flota, the bank brought an action to recover from

²⁴ Id.

²⁵ Id. at 1014 (quoting the trial court, 54 F.Supp. at 805).

²⁶ Id. at 1014.

²⁷ Id. at 1014.

²⁸ 609 F.Supp. 1352 (S.D.N.Y. 1985).

a bonding company under a banker's blanket bond for losses sustained when fictitious bills of lading were pledged to the bank in connection with several loans. The bonding company argued that the bank had a duty to inquire into the genuineness of the bills of lading. In rejecting the bonding company's argument, the court applied the subjective good faith test, stating that good faith means "honesty in fact in the conduct of transaction concerned."²⁹ Applying this standard, the court found that the bank acted in good faith as it did not have reason to be, and in fact was not, suspicious of the genuineness of the bills of lading. The Flota court remarked that the bank initiated an inquiry into the subject business and was reassured of its good reputation.

VI. CONCLUSION

Armed with the terms of the Financial Institution Bond and the cases interpreting it, we turn to the hypothetical scenario presented earlier in the paper to do battle with Bumbling Fumbling Bank and the mischievous, Mr. Jim E. Sleeze.

Grade-A-Bonding Company need not circle the wagons as it seems to be on high ground for this skirmish. Grade-A-Bonding Company should not be fooled by Bumbling Fumbling Bank's assertion that it relied on Mrs. Sleeze's assets reflected in the joint financial statement submitted by Mr. Sleeze. The joint financial statement is not the document which was forged. Clearly, Bumbling Fumbling Bank did not rely on the forged personal guaranty of Mrs. Sue Z. Sleeze. Not only was the bank not in physical possession of the guaranty at the time it extended credit to Fly-By-Night Builders, the guaranty was not a determining factor in whether or not the loan should have been granted as the loan committee reached its decision to advance funds to Fly-By-Night without the executed personal guarantees.

²⁹ Id. at 1359; U.C.C. §1-201(19).

Grade-A-Bonding Company can flank Bumbling Fumbling Bank from left and right on the issue of causation. As the certificates of penny stock held jointly by Mr. and Mrs. Sleeze are worthless, the loss cannot be said to have been proximately caused by the forged personal guaranty.

Finally, Bumbling Fumbling Bank surrenders, raising the white flag in defeat, as Grade-A-Bonding Company asserts the issue of bad faith in accepting the forged personal guaranty. As Mrs. Sleeze was a long-time customer, Bumbling Fumbling Bank had her signature on file. The bank had the duty to verify, although not to authenticate, her signature. The bank's breach of this duty constitutes bad faith, leaving the bank without any recourse against Grade-A-Bonding Company.

On a closing note, the Insuring Agreement (E) of the Financial Institution Bond has many twists and turns before an insured can establish a covered loss. The claims representative and the practitioner confronted with a claim under Insuring Agreement (E) should scrutinize the claim closely to ensure that the elements of "reliance", "causation" and "good faith" are established by the insured.

