

**EIGHTH ANNUAL  
SOUTHERN SURETY AND FIDELITY CLAIMS  
CONFERENCE  
APRIL 3 - 4, 1997**

**“A REVIEW OF INSURING AGREEMENT "E" OF THE  
FINANCIAL INSTITUTION BOND”**

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## A REVIEW OF INSURING AGREEMENT "E" OF THE FINANCIAL INSTITUTION BOND

Insuring Agreement "E" of the Standard Form No. 24 Financial Institution Bond (the "FIB") has been a part of the FIB for many years. The specific focus of this paper will be on claims asserted by an insured because of loss sustained as the result of the acceptance by the insured of counterfeit securities. Until recently, it could be said that the jurisprudence interpreting Insuring Agreement "E" with respect to such claims was uniform. That is no longer the case.

Insuring Agreement (E) of the FIB provides coverage to insureds for:

Loss resulting directly from the insured having, in good faith, for its own account or for the account of others,

. . .

(3) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of, or otherwise acted upon [a security] which is a counterfeit.

The "Definitions" section of the FIB expressly defines the term "counterfeit" as:

[A]n imitation which is intended to deceive and to be taken as an original.

Under Insuring Agreement "E," the underwriters cover direct losses sustained by an insured who, in good faith, accepts "counterfeit" securities, i.e., securities which can be said to imitate originals. The references in the definition of "counterfeit" to "an imitation" and to "an original" clearly indicate that a document made out of whole cloth cannot be deemed a "counterfeit." To imitate, a document must reproduce or resemble a document that actually exists, an "original."

Absent ambiguity, it is hombook law that the definition of "counterfeit" should be applied as written and the courts, by and large, have done so. The "weight of authority requires that the claimed counterfeit document be **exactly** identical to another valid and fully enforceable document." Peter C. Haley, Insuring Agreement (E) in the 1990's, at 16-17 (1992). See also, Reliance Ins. Co. v. Capital Bancshares Inc./Capital Bank, 912 F.2d 756, 757 (5th Cir. 1990); Richardson Nat'l Bank v. Reliance Ins. Co., 491 F. Supp. 121, 123 (N.D. Tex. 1977), aff'd, 619 F.2d 557 (5th Cir. 1980); Bank of the Southwest v. National Sur. Co., 477 F.2d 73, 76 (5th Cir. 1973); French Am. Banking v. Flota Mercante Grancolombiana, S.A., 925 F.2d 603, 604 (2d Cir. 1991); Exchange Nat'l Bank of Olean v. Insurance Co. of North America, 341 F.2d 673 (2d Cir. 1965). Three cases are illustrative of the principle: one a recent case from the United States District Court for the Middle District of Louisiana, one from the United States Fifth Circuit Court of Appeals, arising out of the State of Texas, and one from the Supreme Court of Minnesota.

FDIC v. Fidelity & Deposit Co. of Md., 827 F. Supp. 385 (M.D. La. 1993) involved loans made by Capital Bank in reliance upon a certified copy of a public ordinance. Although an actual public ordinance with the same number existed, the written contents of the actual ordinance differed from the written contents of the purported certified copy presented to the bank. 827 F.Supp. at 394. The court concluded that the altered certified copy was "not an imitation of an authentic original document." Id. at 395.

In Bank of the Southwest v. National Sur. Co., 477 F.2d 73 (5th Cir. 1973), a bank had made a loan which was secured with the borrower's automobile Tax Collector's Receipt For Title Application (a "white slip") No. V-460376. Although a genuine white slip No. V-460376 existed, it had been issued with another owner's name and a different automobile identified. Id. at 76-77. Accordingly, the Court deemed that the white slip was not an imitation of an original. Id.

In National City Bank v. St. Paul Fire & Marine Ins. Co., 447 N.W.2d 171 (Minn. 1989), the Minnesota Supreme Court held that "fake" stock certificates pledged to a bank were not "counterfeit" even though certificates had in fact been issued by the corporation at issue with the same or similar shareholder name, serial number and appearance as those certificates presented to the bank. The Court noted that the pledged certificates were not "counterfeit" because they were not *exact* imitations of originals. The only change was that the *number of shares* appearing on the pledged certificates had been increased. Id. at 173, 177, 179.

In FDIC v. Fidelity & Deposit Co. of Md., supra; Bank of the Southwest v. National Sur. Co., supra; and, National City Bank v. St. Paul Fire & Marine Ins. Co., supra, each Court concluded that the documents upon which the financial institutions had relied were not "counterfeit" under the definition in the FIB, because the documents did not imitate original documents, as required by the FIB. See also Richardson Nat'l Bank v. Reliance Ins. Co., 491 F. Supp. 121 (N.D. Tex. 1977); Hinkson v. Fireman's Fund Ins. Co., 146 Cal. Rptr. 669 (Cal. App. 1978); Liberty Nat'l Bank v. Aetna Life & Cas. Co., 568 F. Supp. 860 (D.N.J. 1983); Gateway St. Bank v. North River Ins. Co., 387 N.W.2d 344 (Iowa 1986).

The well-known history of the Financial Institution Bond further illustrates the intended meaning of the definition of "counterfeit." In Exchange Nat'l Bank of Olean v. Insurance Co. of North Am., supra, the leading case on this issue, the Second Circuit Court of Appeals held that, for purposes of coverage under a Banker's Blanket Bond (the predecessor to the FIB) a document is counterfeit only if it imitates an authentic original document. 341 F.2d at 676. At the time this case was decided, the "Banker's Blanket Bond" provided coverage for specific losses resulting from counterfeited signatures, but "counterfeit" was not a defined term. ABA, Section of Tort and Insurance Practice, Annotated Bankers Blanket Bond at 89-90 (Skillern, ed. 1980).

When the Banker's Blanket Bond (Standard Form 24) was modified in 1969, a definition of "counterfeit", similar to that used today, was included in the bonds. Id. The Banker's Blanket Bond was modified again in 1980 to include a definition of counterfeit within the separate definitions section, but the definition was essentially unchanged. Id. In January 1986, the standard form was revised into the FIB, but, again, the definition of "counterfeit" remained the same. Id.

The definition of "counterfeit," as well as Insuring Agreement (E) in the FIB, was formulated based upon the expectation that a bank will act reasonably and prudently to protect itself from loss. See Edgar L. Neel, Financial Institutions and Fidelity Coverage for Loan Losses, 21 Tort & Ins. L.J. 590, 611-614 (1986). As stated in National City Bank v. St. Paul Fire & Marine Ins. Co., 447 N.W.2d at 177, 179.

The [Financial Institution] Bond is designed "to protect [a bank] against risks of dishonesty, both external and internal, but does not insure good management nor against the risk of loss inherent in the banking

operations." 9A J. Appleman & J. Appleman, *Insurance Law and Practice*, § 5701, at 380 (1981) . . . .

. . .

An insured bank is not covered for mere loan losses resulting from a failure to follow sound business practices, since the bank can easily verify through minimal investigation if a fake document purports to be something that never was in existence.

Thus, it has often been said that financial institutions should bear the risk of loss for losses which they could have prevented through reasonable investigation or verification procedures. See Liberty Nat'l Bank v. Aetna Life & Cas. Co., 568 F. Supp. 860 (D.N.J. 1983). One commentator has observed:

Even if a customer presents a "good imitation" of a stock certificate, the **financial institution has the opportunity to verify whether the customer actually owns the shares of stock represented by that certificate**. There should be coverage under Insuring Agreement E only in those cases where the customer owns such shares, because it is only in those cases where the customer owns such shares, that the financial institution cannot prevent a loss through reasonable investigation and verification procedures.

Mark W. Bean, *Insurance Agreement E - An Analysis Of Recent Cases Interpreting What Is A Counterfeit Or Forgery*, 17 (1991) (emphasis added). And, in National City Bank v. St. Paul Fire & Marine Ins. Co., 447 N.W.2d at 179, the court explained:

The basic rationale behind the definition of "counterfeit" is to require that an insurance company cover only non-business losses or insured risks with a bank responsible for ordinary business losses.

. . .

If a bank . . . chooses not to follow sound business practices and fails to investigate, verify, examine, or even possess securities before remitting loan proceeds, it cannot successfully claim this is an insured risk, and not an ordinary business loss.

This argument implies the existence of a duty on the part of the insured, although neither the commentators nor the cases have articulated the source of that duty other than the underpinning rationale of the FIB. One source of that duty could be found in the requirement, under Insuring Agreement "E," that an insured have acted in good faith for a loss to be covered. Good faith is not, however, a defined term and the degree of diligence which good faith requires is arguable.

It is against this background that the matter of One American Corp. v. Fidelity & Deposit Co. of Maryland, 658 So.2d 23 (La. App. 5th Cir. 1995) writs denied, 662 So.2d 470 (La. 1995) arose.

In Louisiana state courts, the matter was res nova; however, there was a single decision out of the United States District Court for the Middle District of Louisiana which was favorable. Although there were two non-diverse defendants, the case was removed to federal court on the basis of fraudulent joinder. On motion of the plaintiffs, the case was remanded to state court. Following completion of discovery, cross motions for summary judgment were filed.

F&D issued a Financial Institution Bond to One American Corporation and its subsidiary, First American Bank & Trust Company ("First American"), which was effective from July 1, 1990 to July 1, 1991. On March 13, 1991, Robert O. Klein, on behalf of Prism Realty Investors, Inc., presented First American with several certificates, to be pledged as collateral for the promissory note which he executed in connection with a \$1 million line of credit. A vice president in lending at First American, together with the attorney representing First American at that meeting, rejected several of the certificates which were presented to them by Klein because the number of shares appearing on the certificates conflicted with the number of shares appearing elsewhere on the same certificates.

The next day, March 14, 1991, Klein returned to First American with new certificates, to be pledged in place of those which had been rejected. All together, Klein pledged fifteen stock certificates and one bond certificate, representing shares purportedly owned by Prism, to First American. Despite having rejected facially flawed shares the previous day, the vice president in lending did not attempt to confirm that Prism owned the shares evidenced by the certificates or that the sixteen certificates were otherwise genuine or valuable. The name of the issuer was misspelled on two of the certificates. Each of the certificates bore a serial number and indicated the numbers of shares and issue dates in either 1989 or 1990.

In the course of discovery, each of the six corporations (or their transfer agents) reviewed its corporate records of securities ownership, including records for the time period when each of the certificates was purportedly issued, and each corporation determined that neither Robert O. Klein nor Prism Realty Investors, Inc. had owned securities issued by the corporation.

In addition, no certificates issued by the six corporations in 1989 or 1990 bore the serial numbers found on the certificates.

Indeed, the serial numbers on each of the certificates contained an error which could have been immediately discovered. Most of the serial numbers had never been used or, if used, had been cancelled prior to the apparent issue date of the certificate tendered to First American.

Each corporation's representative or transfer agent has also compared the original certificate submitted to First American with an original specimen copy of a certificate actually issued by the corporation during the time period when the certificates were purportedly issued, and each corporation's representative testified that the certificates were dissimilar to certificates which were actually issued by the corporations. Based upon the deposition testimony of the representatives and transfer agents, a non-exhaustive list of the visual differences between the actual certificates issued by each of the corporations and the certificates was compiled and submitted in support of F&D's motion for summary judgment, together with the deposition transcripts of the representatives and transfer agents.

Among the obvious differences between the certificates and the corporations' specimen certificates, were the incorrect names and signatures of the signing corporate officers, the transfer agent, or both, differences in the type, color and width of borders, the printing styles, the wording

of the statement for shares, the type of numbers used for shareholder accounts, the style, color and/or location of pictographs, serial number boxes and share number boxes, the quality of the paper used, the sharpness and color of the inking, the letter prefixes in the serial numbers on the certificates, and/or the printing and indentation on the reverse of the certificates. Accordingly, upon simple comparison, each certificate was clearly distinguishable from the actual certificates issued by the corporations.

The reasons rendered by the trial court on the cross motions for summary judgment were illuminating:

The case is up before me on a Summary Judgment. It is clear that the loss which was injured has taken place, and it is now time to pay.

I adopt the petition advanced by the plaintiff in this matter.

The appellate court, without discussing a single case, affirmed the decision of the lower court. The court concluded that the "pledged Klein-Prism certificates were imitations, were intended to deceive and were meant to be accepted as originals, just as stated in the policy." 659 So.2d at 25. The court disregarded the issue of whether a bank has a duty to investigate under certain circumstances and whether First American had acted in good faith and exercised sound business practices, stating that the issues were not meaningfully before the court when the trial judge heard the motions. Those issues were before the trial court; however, the trial court declined to address them and, in any event, from the reasons given by the trial court, it would have been impossible for the appellate court to have determined what was addressed by the trial court.

## CONCLUSION

It would seem clear that the underwriters did not intend to cover the kind of loss at issue in One American Corporation v. Fidelity & Deposit Co. of Maryland, *supra*. To anyone outside the State of Louisiana, the decision in One American will likely appear aberrational because of its failure to address the uniform jurisprudence which reaches a contrary result. On the other hand, is the good faith requirement of Insuring Agreement "E" or the underlying rationale of the FIB, which anticipates sound practices of an insured financial institution, sufficient to impose a duty on an insured that is tantamount to a negligence standard? If so, what degree of negligence will preclude coverage of an otherwise covered loss? Viewed in a somewhat different vein, as the FIB is a policy intended by its drafters, the surety industry and the American Bankers Association, to establish a fair and reasonable apportionment of risk between two commercial enterprise -- the bank and the insurer -- should the bank be permitted, as a matter of policy, to recover notwithstanding its failure to conduct an inquiry which any reasonably prudent individual would have conducted under the circumstances? As of this writing, the First American case has yet to be cited by any court, wherever situated.