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**WHO SHOULD PAY FOR THE BANK'S MISTAKES? A
DISCUSSION OF LOSS CAUSATION UNDER INSURING
AGREEMENT D AND INSURING AGREEMENT E OF THE
STANDARD FORM NO. 24 FINANCIAL INSTITUTION BOND**

PRESENTED BY:

**JEFFREY S. PRICE, ESQ.
JUSTIN D. WEAR, ESQ.
MANIER & HEROD
150 4th Avenue N. - Ste. 2200
Nashville, TN 37219
615-244-0030**

**ELIZABETH S. CARLEY
Superintendent of Bond Claims
CINCINNATI INSURANCE COMPANY**

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*Elizabeth S. Carley*¹
*Jeffrey S. Price*²
*Justin D. Wear*³

A. Introduction

The Standard Form Financial Institution Bond⁴ is generally not intended to cover losses resulting from loans. This intent is evidenced most notably by Exclusion E, which expressly excludes coverage for:

[L]oss resulting directly or indirectly from the complete or partial nonpayment of, or default upon, any Loan⁵ or transaction involving the Insured as a lender or borrower, or extension of credit, including the purchase, discounting or other acquisition of false or genuine accounts, invoices, notes, agreements or Evidence of Debt, whether such Loan, transaction, or extension was procured in good faith or through trick, artifice, fraud or false pretenses, except when covered under Insuring Agreement A, D, or E.

One court has noted that the "rationale underlying this exclusion is to deny coverage for poor loan underwriting."⁶ The FIB is not credit insurance intended to protect a lender from improvident or reckless extensions of credit.⁷ While the intent of Exclusion E, and the FIB itself, is to generally shift the risk of unpaid loans to the insured, there are

¹ Ms. Carley is Superintendent of Bond Claims with Cincinnati Insurance Company.

² Mr. Price is a principal at the law office of Manier & Herod. He received his undergraduate degree from Gardner-Webb University and his law degree from the University of Tennessee College of Law.

³ Mr. Wear is a senior associate at the law office of Manier & Herod. He received his undergraduate degree from the University of the South (Sewanee) and his law degree from the University of Tennessee College of Law.

⁴ The discussion in this paper will refer to the Financial Institution Bond, Standard Form No. 24 (revised Jan. 1986) as the "1986 Bond" and the Financial Institution Bond, Standard Form No. 24 (revised Apr. 2004) as the "2004 Bond." In discussions where differences in the two bond forms are not material, the 1986 Bond and the 2004 Bond will be referred to collectively as the "FIB" and will focus on the provisions of and case law addressing the 1986 Bond.

⁵ The 1986 Bond defines "Loan" as "all extension 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." 1986 Bond, Definition 1(m).

⁶ *First Union Corp. v. United States Fid. & Guar. Co.*, 730 A.2d 278, 281 (Md. Ct. App. 1999). See also ANNOTATED FINANCIAL INSTITUTION BOND 367 (Michael Keeley ed., 2d ed. 2004) ("The underlying rationale of this exclusion is that the making of loans is the business of the financial institution and, therefore, part of its 'business risk' which is not meant to be covered under the bond.").

⁷ *Progressive Cas. Ins. Co. v. First Bank*, 828 F. Supp. 473, 474 (S.D. Texas 1993). This intent is further evidenced by the language in Exclusion E excluding coverage even if the loan was procured through trick, artifice, fraud, or false pretenses.

certain express situations in which coverage is implicated for loan losses, i.e., when coverage is implicated under Insuring Agreement A, D, or E. This paper will focus solely on Insuring Agreements D and E,⁸ particularly those instances in which a document enumerated in those provisions (referred to as a "covered document") contains a defect enumerated in those provisions (referred to as a "covered defect"). In those situations, the determination of whether coverage is implicated frequently hinges on whether the covered document containing the covered defect *caused* the insured's loss. This element of coverage is particularly relevant in today's banking climate, as financial institutions are suffering the results of loosened underwriting practices – as evidenced by the subprime mortgage crisis⁹ – and issued loans without proper consideration of the credit risk. Many insureds are therefore attempting to transform a loss resulting directly from a poor lending decision into a loss resulting directly from a covered document containing a covered defect.

B. "Resulting Directly From"

Both Insuring Agreement D and Insuring Agreement E of the FIB require that an insured's loss must be "resulting directly from" the insured peril. This "requires the insured to prove a direct causal link between its claimed loss and the conduct specifically contemplated by the Bond's insuring agreements."¹⁰ The general purpose of this language is to limit the risks to the insurer and separate those risks from uninsured risks inherent to the business of operating a financial institution.¹¹ As noted above, it is well-established that the FIB is not credit insurance. "[T]he Bond is not a policy of credit insurance and does not protect the bank when it simply makes a bad business deal."¹² Obviously credit risks are inherent in banking and those risks are intended to remain with the insured.¹³ Legal scholars have noted that "Bond underwriters have always intended to limit coverage, and therefore recovery, to losses which result directly

⁸ Numerous articles have addressed coverage under Insuring Agreement A both in general and with regard to loan losses. See, e.g., FINANCIAL INSTITUTION BONDS (Duncan L. Clore ed., 2d ed. 1998); HANDLING FIDELITY BOND CLAIMS (Michael Keeley & Sean Duffy eds., 2d ed. 2005); THE MANIFEST INTENT HANDBOOK (Samuel J. Arena, Jr., Nicholas Deenis, Timothy P. Lennon & Andrew W. Boczkowski eds., 2002).

⁹ Subprime loans are frequently underwritten with limited or no verification of the applicant's income, unreliable confirmation of the assets securing the loan, and limited underwriting. See Chris Isidore, *'Liar loans': Mortgage Woes Beyond Subprime Loans Where Borrowers Gave Little Proof of Income Could be the Next Threat to the Troubled Real Estate Market - and the Economy*, http://money.cnn.com/2007/03/19/news/economy/next_subprime/index.htm (last visited March 12, 2009).

¹⁰ William T. Bogaert & Kerry Evensen, *Loss and Causation under the Financial Institution Bond*, in FINANCIAL INSTITUTION BONDS 577, 594 (Duncan L. Clore ed., 3d ed. 2008).

¹¹ *Id.* A minority of courts have even held that coverage is not implicated because the actual cause of the insured's loss was a failure to follow sound business practices or to follow its own procedures. See *Empire Bank v. Fid. & Deposit Co. of Md.*, 828 F. Supp. 675 (W.D. Mo. 1993); *Nat'l City Bank of Minneapolis v. St. Paul Fire & Marine Ins. Co.*, 447 N.W.2d 171 (Minn. 1989); *Pavex, Inc. v. York Fed. Sav. & Loan Ass'n*, 716 A.2d 640, 646 (Pa. Super. Ct. 1998); *Kraftsman Container Corp. v. United Counties Trust Co.*, 404 A.2d 1288 (N.J. Sup. Ct. 1979); *First Union Corp. v. U.S.F.&G.*, 730 A.2d 278 (Md. Ct. App. 1999). *But see* *Union Planters Bank, N.A. v. Cont'l Cas. Co.*, 478 F.3d 759 (6th Cir. 2007).

¹² James A. Knox & Karen Kohler Fitzgerald, *The Loan Exclusion: The Predominant Risk Allocator*, in FINANCIAL INSTITUTION BONDS 201 (Duncan L. Clore ed., 2d ed. 1998) (collecting cases).

¹³ Bogaert & Evensen, *supra* note 10, at 594.

from certain perils incidental to the central business functions of the insured."¹⁴ One essential way in which underwriters have attempted to limit coverage is by the stringent "direct loss" requirement.

Determining the proper causation standard is a critical part of the claims handling process. "[I]t is critical that the practitioner set the tone of the causation discussion so that the insured is properly focused on what causation does, and does not, mean in the Financial Institution Bond."¹⁵ If the insured or the court begins to "blur the distinction and control the causation dialogue, it will become exceedingly difficult to resolve the submitted claim."¹⁶ Not surprisingly, insureds routinely attempt to discount or downplay both the causation requirement in general and the "resulting directly from" language in particular.

1. "Resulting Directly From" is a Heightened Causation Standard

The "resulting directly from" language in the FIB is intended to convey a stricter standard of causation than mere "proximate cause."¹⁷ Several courts accurately enforced this phrase by first noting that "resulting directly from" is unambiguous.¹⁸ After a court holds that the phrase is unambiguous, it should have little choice but to enforce the oft-cited "direct means direct" language found in *Vons Cos., Inc. v. Federal Ins. Co.*¹⁹ The *Vons* court (interpreting a fidelity policy as opposed to the FIB) and numerous others have rejected insured's arguments that "resulting directly from" should be interpreted using a proximate cause analysis.²⁰ In *RBC Mortgage Co. v. Nat'l Union Fire Ins. Co.*,²¹ the Illinois Court of Appeals called the proximate cause application "too broad to capture accurately the intent behind the phrase 'loss resulting directly from.' A 'direct loss' must be afforded its plain and ordinary meaning: 'direct' means 'direct.'"

2. Courts Incorrectly Applying a "Proximate Cause" (or Lesser) Standard

Although it should be clear that "resulting directly from" requires more than the proximate cause analysis found in tort cases, a surprising number of courts have misinterpreted the FIB in the context of all insuring agreements. One of the cases most cited by insureds attempting to invoke a lessened causation standard is *Pine Bluff Nat'l Bank v. St. Paul Mercury Ins. Co.*²² In that case, the insurer denied coverage for loan losses suffered by the insured that involved forged leases. The court analyzed the

¹⁴ Bogaert & Evensen, *supra* note 10, at 594.

¹⁵ Bradford R. Carver, *Loss and Causation, in Handling Fidelity Bond Claims* (Michael Keeley & Sean Duffy, eds., (2d ed. 2005).

¹⁶ *Id.*

¹⁷ Bogaert & Evensen, *supra* note 10, at 596-97.

¹⁸ See, e.g., *Citizens Bank & Trust v. St. Paul Mercury Ins. Co.*, 2007 WL 4973847 (S.D. Ga. Sept. 14, 2007).

¹⁹ 212 F.3d 489 (9th Cir. 2000).

²⁰ See, e.g., *United Sec. Bank v. Fid. & Deposit Co. of Maryland*, 125 F.3d 860 (9th Cir. 1997) (direct loss is much narrower than proximately caused loss);

²¹ 812 N.E.2d 728, 736-37 (Ill. Ct. App. 2004) (internal citations omitted). See also *Merchants Bank & Trust Co.*, 2008 WL 728332 (S.D. Ohio Mar. 14, 2008).

²² 346 F. Supp. 2d 1020 (E.D. Ark. 2004).

phrase "loss resulting directly from" and held that the phrase was equivalent with the definition of proximate cause.²³ Therefore, the court held that coverage was implicated merely because the insured issued the loan "on the faith of" leases that happened to contain a forgery. Similarly, in *Jefferson Bank v. Progressive Cas. Ins. Co.*,²⁴ the Third Circuit recognized the correct meaning of the FIB's causation language yet failed to apply it. In that case, the insured suffered a loan loss when its mortgage document was forged and therefore rendered unenforceable. The court conceded that the "resulting directly from" language "suggests" a stricter standard than proximate cause.²⁵ The court nevertheless applied a standard proximate cause analysis and reversed the insurer's previous award of summary judgment.

One common theme in the cases incorrectly interpreting the "resulting directly from" requirement is that the courts have applied tort principles, and not contract interpretation principles, to determine the correct causation standard. "Instead of deriving their views from the language of the Bond, an increasing number of courts have imported the tort concepts of factual and proximate (also known as legal) causation into their interpretation of the Bond."²⁶ This is in direct contrast the instructions given by Judge Cardozo in *Bird v. St. Paul Fire & Marine Ins. Co.*,²⁷ in which he stated that "General definitions of proximate cause give little aid" when interpreting insurance contracts.

Rather than applying this tort analysis, the FIB should be enforced as written using the principles of contract interpretation. Therefore, a proximate cause analysis should not be applied unless the FIB requires that the loss be proximately caused by the insured peril. This is especially true since the FIB does not constitute a contract of adhesion, and was negotiated between the banking industry and the surety

²³ *Id.* at 1030. See also *Rothschild Investment Corp. v. Travelers Cas. & Sur. Co. of Am.*, 2006 WL 1236148 (N.D. Ill. May 4, 2006) (applying a proximate cause analysis); *Hanson, PLC v. Nat'l Union Fire Ins. Co.*, 794 P.2d 66 (Wash. Ct. App. 1990) (same); *Bidwell & Co. v. Nat'l Union Fire Ins. Co. of Pittsburg, Pa.*, 2001 WL 204843, *9 (D. Or. 2001) ("[t]he overwhelming, if not universal, authority from other jurisdictions is that the words represent a traditional proximate cause analysis."). In *Frontline Processing Corp. v. American Economy Ins. Co.*, 149 P.3d 906 (Mont. 2006), a particularly egregious case involving employee dishonesty, the insured's Chief Financial Officer allegedly engaged in dishonest acts such as forging checks, using the company credit card for personal expenses, and deliberately failing to file the company's payroll taxes and corporate income taxes. As a result of these actions, the insured hired forensic accountants, handwriting experts, and financial advisors to investigate. The insured sought coverage for the fees it incurred by retaining these personnel, as well as for costs, interest, and penalties assessed by the IRS for the CFO's failure to file tax documents. Although the insured filed suit in federal court, the following question was certified to the Montana Supreme Court: "Does the term 'direct loss' when used in the context of employee dishonesty coverage afforded under a business owner's liability policy, include consequential damages that were proximately caused by the alleged dishonesty, or is the construction of the term 'direct loss' limited to those damages that result directly from the alleged employee dishonesty?" The court answered that even *consequential* damages can be covered, holding that a loss is "direct" if it is proximately caused by the employee dishonesty. However, the court declined to determine whether all the expenses asserted by the insured were proximately caused by the CFO's dishonesty.

²⁴ 965 F.2d 1274 (3rd Cir. 1992).

²⁵ *Id.* at 1281.

²⁶ Bogaert & Evensen, *supra* note 10, at 600.

²⁷ 120 N.E. 86 (N.Y. 1918).

association.²⁸ Numerous cases contain well-settled statements of law such as "In interpreting an insurance policy, the court must give the words of the policy their common and ordinary meaning."²⁹ However, too often courts do not then follow their own axiom. A small number of courts have even applied a "but for" or "causation-in-fact" to determine if coverage is implicated.³⁰

3. "Resulting Directly From" and FIB Exclusions

Although the phrase "resulting directly from" should clearly indicate that a covered loss must be more than proximately caused by the insured peril, interpreting the causation language in conjunction with various exclusions in the FIB emphasizes this point. For example, Exclusion V of the FIB expressly excludes coverage for "indirect or consequential loss of any nature."³¹ Exclusion T of the 1986 Bond excludes coverage for "damages of any type for which the Insured is legally liable, except compensatory damages, but not multiples thereof, arising directly from a loss covered under this bond." Under the principles of contract interpretation discussed above, the FIB should be construed as a whole and in light of the purpose of the entire contract.³² Therefore, courts should consider reading the insuring provision in conjunction with the exclusion to determine the appropriate interpretation of "resulting directly from."

When reading the insuring agreement in conjunction with Exclusion V and Exclusion T, it becomes clear that a loss can only be direct or indirect. A loss that is anything other than direct (including a proximately caused loss) falls to the classification of an indirect loss and is therefore not covered. Stated another way, the FIB only covers losses that are *not* indirect, which is merely another way of saying that it only covers losses that *are* direct. In *Direct Mortgage Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh*,³³ the District Court was faced with an issue of first impression in determining the proper interpretation of "resulting directly from" under Utah law. While acknowledging the aforementioned split of authority regarding the proper interpretation of "direct," the court applied the more stringent "direct means direct" standard based, in part, on its analysis of the exclusions similar to Exclusion T and V. "It appears, from the overall language of the Fidelity Bond, that the claimant must still demonstrate a direct loss before a finding of coverage is appropriate."³⁴ The *Direct Mortgage* case is a fine

²⁸ Other courts have strictly enforced the notice provisions of the FIB because, *inter alia*, it does not constitute a contract of adhesion. In both *Fed. Deposit Ins. Corp. v. Ins. Co. of N. Am.*, 105 F.3d 778 (1st Cir. 1997) and *Union Planters Bank, N.A. v. Continental Cas. Co.*, 478 F.3d 759 (6th Cir. 2007), the federal court of appeals disregarded the otherwise applicable "notice prejudice" rule in favor of a strict contract interpretation.

²⁹ See, e.g., *Continental Corp. v. Aetna Cas. & Sur. Co.*, 892 F.2d 540, 543 (7th Cir. 1989).

³⁰ See, e.g., *First Nat'l Bank v. Lustig*, 961 F.2d 1162 (5th Cir. 1992) ("A loss is directly caused by the dishonest and fraudulent act within the meaning of the bond where the bank can demonstrate that it would not have made the loan in the absence of the fraud.").

³¹ The 2004 Bond clarifies the exclusion by adding the phrase "including, but not limited to, fines, penalties, multiple or punitive damages."

³² See, e.g., *Patrick Schaumberg Automobiles, Inc. v. Hanover Ins. Co.*, 452 F. Supp. 2d 857, 868 (N.D. Ill. 2006).

³³ 2008 WL 3539804 (D. Utah Aug. 8, 2008).

³⁴ *Id.* at * 4.

example of a court looking past the competing case law and examining the FIB as a whole to accurately determine the meaning of "resulting directly from."³⁵

C. Insuring Agreement D

Insuring Agreement D of the 1986 Bond provides coverage for:

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 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.

Insuring Agreement D of the 2004 similarly provides coverage for:

Loss resulting directly from the Insured having, in good faith, paid or transferred any Property in reliance on any Written, Original:

³⁵ Of course, using the language of the exclusion to assist in interpreting the phrase "resulting directly from" is not without potential pitfalls. For example, Exclusion H generally excludes "loss *caused* by an Employee . . ." (emphasis added) without explanation as to whether such cause is direct or proximate. Numerous exclusions exclude losses resulting "directly or indirectly" from a certain peril, but the courts have not determined how that phrase is to be construed. See Bogaert & Evensen, *supra* note 10, at 606-610 ("One reasonable interpretation of 'directly or indirectly' is factual, or 'but for,' causation.").

- (1) Negotiable Instrument (except an Evidence of Debt),
- (2) Certificate of Deposit,
- (3) Letter of Credit,
- (4) Withdrawal Order,
- (5) receipt for the withdrawal of Property, or
- (6) instructions or advices purportedly signed by a customer of the Insured or by a banking institution

which (a) bears a handwritten signature of any maker, drawer, or endorser which is a Forgery; or (b) is altered, but only to the extent the Forgery or alteration caused the loss.

Actual physical possession of the items listed in (1) through (6) above by the Insured is a condition precedent to the Insured's having relied on the items.

A reproduction of a handwritten signature is treated the same as the handwritten signature. An electronic or digital signature is not treated as a reproduction of a handwritten signature.

One of the major additions of the 2004 Bond is to add the "actual physical possession" requirement that is found in Insuring Agreement E of the FIB.³⁶ The 2004 Bond also reiterates that the Forgery or alteration must actually cause the loss, as opposed to the insured suffering a loss caused by another factor under factual circumstances that tangentially involves a Forgery or alteration. However, by using the phrase "resulting directly from" in the preface of the insuring agreement and the phrase "caused" in the body of the insuring agreement, one wonders if insureds will attempt to claim that the potentially competing causation standards create an ambiguity, or evidence an intent to apply a proximate cause standard.

1. Primary Focus of Insuring Agreement D Investigation

The most common claim under Insuring Agreement D involves forged checks.³⁷ However, this provision is commonly relevant to loan loss cases, as Certificates of Deposit or Letters of Credit frequently serve to secure loans, and as the promissory note at issue may constitute a Negotiable Instrument.³⁸ Practitioners investigating

³⁶ The 2004 Bond defines "original" as the "first rendering or archetype and does not include photocopies or electronic transmissions even if received and printed."

³⁷ Gilbert J. Schroeder, *Insuring Agreement (D) – Forgery or Alteration*, in ANNOTATED FINANCIAL INSTITUTION BOND 218, 219 (Michael Keeley ed., 2d ed. 2004). See also Edward G. Gallagher & Robert J. Duke, *A Concise History of Fidelity Insurance*, in HANDLING FIDELITY BOND CLAIMS 1, 12 (Michael Keeley & Sean Duffy eds., 2d ed. 2005) ("Insuring Agreement D was never intended to cover fraudulent loans....").

³⁸ Negotiable Instrument is defined under the Financial Institution Bond as follows (emphasis added):

Any writing:

- (1) signed by the maker or drawer;

Insuring Agreement D claims under the 1986 Bond typically focus on two (2) primary issues: does the claim involve a covered document, and does the claim involve a covered defect? The covered documents under Insuring Agreement D are:

- Negotiable Instrument (except an Evidence of Debt)
- Acceptance
- Withdrawal Order
- receipt for the withdrawal of Property
- Certificate of Deposit
- Letter of Credit
- Instruction or advice purportedly signed by a customer of the Insured or by a banking institution.

The covered defects are Forgery³⁹ and alteration.

The plain language of Insuring Agreements D (as well as Insuring Agreement E) provides that only certain documents implicate coverage. An insured's decision to extend credit in reliance on such defective documents routinely results in substantial loss. As noted by one commentator, "Borrowers who utilize forged security agreements to obtain loans rarely repay them; and foreclosing on a counterfeit deed of trust will never positively advance the collection efforts of the insured."⁴⁰ The increased

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- (2) containing any unconditional promise or order to pay a sum certain in Money and **no other promise**, order, obligation or power given by the maker or drawer; and
 - (3) is payable on demand or at a definite time; and
 - (4) is payable to order or bearer.

Promissory notes typically constitute the "quintessential form of negotiable instrument," but the promissory notes involved in mortgage loans may not always constitute "Negotiable Instruments" as defined by the FIB. See Charles L. Armstrong, Thomas H. McNeill, & James E. Reynolds, *Warehouse Lending Losses Under the Financial Institution Bond*, XII FID. L. J. 1, 29 (2006). The FIB definition clearly differs from the definition of "promissory note" provided by the Uniform Commercial Code, the primary resource utilized by insureds to support their claim that the real estate promissory note is a negotiable instrument. See UNIFORM COMMERCIAL CODE §§ 3-104 and 3-106. The UCC definition does not include language to the effect that "other promises" disqualify a writing evidencing a promise to pay from being a "negotiable instrument." Often, the promissory notes utilized in mortgage loan arrangements contain promises beyond the promise to pay. This is an issue that practitioners must analyze if the allegedly defective document is a promissory note.

³⁹ The 1986 Bond defines "Forgery" as 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." Prior to 1980, most bond forms did not define the term "forgery," leaving courts to use local criminal and civil law to determine if a forgery occurred. Scott L. Schmookler, *Insuring Agreement (D)*, in FINANCIAL INSTITUTION BONDS 313, 323 (Duncan L. Clore ed., 3d ed. 2008).

⁴⁰ Peter C. Haley & Sarah Mubashir, *How to Combine Fact Finding and Legal Research in the Investigation of Clause (E) Claims*, in HANDLING FIDELITY BOND CLAIMS 275, 277 (Michael Keeley & Sean Duffy eds., 2d ed. 2005).

sophistication of criminals, as well as their technologically-advanced means of forging or counterfeiting documents, has increased a financial institution's need for insurance against these risks.⁴¹

Many insureds mistakenly believe that if they suffer a loss that merely *involves* a covered document with a covered defect, coverage is implicated.⁴² Insureds routinely overlook the fact that its loss must result directly from the forgery or alteration. As discussed in more detail below, by adopting the "resulting directly from" standard, Insuring Agreement D distinguishes between the "risk of authentication" (against which the insured usually cannot reasonably protect itself), and credit risks associated with worthless collateral, market downturns, etc.⁴³

2. Did the Covered Defect on the Covered Document Cause the Loss?

The coverage element often overlooked by the insured (and sometimes by the insurer) in Insuring Agreement D cases is that the covered defect on the covered document must have actually and directly caused the claimed loss. To determine whether the forged or altered documents caused the loss, insurers must consider both (1) the issuance of the loans and (2) the loss resulting from the borrowers' default. One legal scholar has referred to this as "transaction causation" and "loss causation."⁴⁴ The bank must show both that the forgeries or alterations caused it to issue the loans and that the forgeries or alterations caused its loss.

i. Transaction Causation

Insureds must first demonstrate that the covered document caused it to issue the loan(s). Transaction causation is commonly referred to as the "reliance" requirement, and the 2004 Bond expressly requires that the insured transfer Property "in reliance on any Written, Original" covered document that contains a covered defect.⁴⁵ In response, the bank will almost certainly take the position that it never would have issued the loan if it was aware that a document was forged or altered. However, this statement is obviously self-serving and should not suffice to satisfy the "transaction causation" element of coverage. The insured must actually prove that the covered defect caused it to issue the loan. Determining transaction causation will typically require a fact-

⁴¹ *Id.*

⁴² In fact, insured sometime attempt to implicate coverage even if a covered document is not forged or altered, but a related document contains is forged or altered. These situations are routinely referred to as "bundling" cases. Robert Briganti, *Forgery or Alteration*, in FINANCIAL INSTITUTION BONDS 207, 219 (Duncan L. Clore ed., 2d ed. 1998). "The bundling scenario generally arises when whatever documents contain forgeries or other qualified impairments are not qualified documents under Insuring Agreement (D), while there are concurrently qualified documents under Insuring Agreement (D) which do not contain qualifying impairments, so the insured attempts to 'bundle' to two in order to achieve coverage." Briganti, *supra* note 109, at 219. "Bundling" cases addressing coverage include *Omnisource Corp. v. CNA/Transcon Ins. Co.*, 949 F. Supp. 681 (N.D. Ind. 1996) and *First Integrity Bank, N.A. v. Ohio Cas. Ins. Co.*, 2006 WL 1371674 (D. Minn. May 15, 2006).

⁴³ See *Liberty Nat'l Bank v. Aetna Life & Cas. Co.*, 568 F. Supp. 860 (D.N.J. 1983).

⁴⁴ Peter C. Haley, *Paradigms of Proximate Cause*, 36 TORT & INS. L.J. 147, 162-64 (2000).

⁴⁵ Other bond form may use the phrase "on the faith of" to satisfy the reliance requirement. See, e.g., *Republic Nat'l Bank of Miami v. Fidelity & Dep. Co. of Maryland*, 894 F.2d 1255, 1263 (11th Cir. 1990).

intensive investigation. The testimony of the loan officer, board of directors, and other bank officials should reveal whether the insured actually relied on the covered defect in the covered document when issuing the loan.

Because of the limited documents covered by Insuring Agreement D, it is usually easier to demonstrate reliance/transaction causation under Insuring Agreement D than Insuring Agreement E (discussed below). The documents covered under Insuring Agreement D typically have intrinsic value, and it is rarely difficult for an insured to demonstrate that, for example, it acted in reliance on a forged promissory note when issuing a loan. Therefore, the causation analysis under Insuring Agreement D will primarily focus on "loss causation."

ii. Loss Causation

In addition to affirmatively demonstrating transaction causation, an insured must also demonstrate that the covered defect in the covered document directly caused the claimed loss. To determine whether the loss causation element of coverage has been satisfied, insurers should consider whether the bank would have suffered an identical loss even if the documents at issue did not contain a forgery or alteration. The intent of Insuring Agreement D is to place the insured in the same position it would be in if the covered document did not contain a covered defect.

Consider the hypothetical situation in which a borrower is issued a \$500,000 loan secured by real property worth \$500,000 when the loan was issued. Also consider that the promissory note at issue contains a valid signature and satisfies the definition of Negotiable Instrument, but has been altered by the borrower in some manner (unbeknownst to the bank). After the borrower defaults on the loan, the insured forecloses on the collateral. However, because of the troubled housing market the real property is now only worth \$400,000 and the bank asserts a covered loss of \$100,000. In that situation, it does not appear that the alteration directly caused the loss. The alteration on the Negotiable Instrument did not impair the bank's ability to collect on a valid debt, nor did the alteration prejudice the value of the Bank's collateral. All documents contractually binding the borrowers and the bank are valid and enforceable, as evidenced by the bank's foreclosure on the loans. It appears that this loss was caused by a decrease in the bank's collateral, and not by the alteration. Even if the Negotiable Instrument was not altered, the insured would have suffered the same loss.

Courts across the country have faced similar fact patterns. In *Liberty Nat'l Bank v. Aetna Life & Cas. Co.*,⁴⁶ the bank issued two (2) loans secured by CDs that contained forged signatures. When the loans were not repaid, the bank attempted to take control of the CDs and discovered that they were worthless. Although the bank presumably would not have extended the loan but for the forged signature on the CDs (therefore possibly satisfying the transaction causation element), the District Court held that the bank did not suffer a covered loss. Because the CDs were fabricated, the bank would have suffered the same loss even if the signature had been valid. Therefore, the loss causation element was not satisfied. According to the District Court, the bond:

⁴⁶ 568 F. Supp. 860 (D.N.J. 1983).

[I]nsures that the documents submitted to the bank in connection with a loan are genuine and authentic. If they are not, and a loss is caused thereby, the bonding company guarantees the loss. On the other hand, the bonding company does not guarantee the truth of said documents. If they are not truthful, and a loss results therefrom, it is not guaranteed.⁴⁷

The court distinguished "between the risk of authentication (forgery and counterfeiting) against which the [bank] could not reasonably protect itself and the credit risk posed by worthless collateral."⁴⁸

Another case in which an insured could not prove "loss causation" is *Flagstar Bank, FSB v. Federal Ins. Co.*⁴⁹ In that case, the insured was a commercial lender involved in "mortgage warehousing." In mortgage warehousing, a commercial lender advances funds to a mortgage banker on a short-term basis. The mortgage banker then uses the advanced funds to close and record mortgages in its name, pledging the secured mortgage notes as collateral to the commercial lender. The notes are then sold to a permanent lender, and the commercial lender's advances are repaid. As a result of 39 transactions in February and March of 2004, the insured advanced over \$19 million to Amerifunding/Amerimax Realty Group, Inc. ("Amerifunding"). However, the promissory notes submitted by Amerifunding to secure the insured's advances contained forged signatures. The insured therefore submitted a claim for coverage under a provision substantially identical to Insuring Agreement D. The insurer denied the claim, asserting that the forged signatures did not directly cause the insured's loss. The insurer argued that the loss instead was incurred because the collateral for the insured's advances to Amerifunding was worthless. Even if the signatures on the promissory notes were valid, the insured would have experienced the same loss because it had no collateral. The "borrowers" whose signatures were forged did not own or have interest in the property at issue. Predictably, the insured argued that the forgeries caused its loss because it would not have advanced any funds had it not received the forged promissory notes. Essentially, the insured asserted that satisfying the reliance or "transaction causation" requirement is sufficient to establish coverage.

The court carefully considered the *Liberty Nat'l* case discussed above as well as two (2) cases discussed below (in the section addressing Insuring Agreement E) before holding that coverage was not implicated. The court granted summary judgment in favor of the insured stating that, at most, the insured could demonstrate "transaction causation" but not "loss causation." "[J]ust as in *Liberty Nat'l*, *Georgia Bank*, and *KW Bancshares*, even though the [forged documents] may have induced Flagstar to advance funds, the real cause of its loss was the fact that the assertions made in the

⁴⁷ *Id.* at 863.

⁴⁸ *Id.* at 866.

⁴⁹ 2006 WL 3343765 (E.D. Mich. Nov. 17, 2006), *aff'd* 260 Fed. Appx. 820 (6th Cir. 2008). This case involved Insuring Agreement 4 of a non-standard form bond, but Insuring Agreement 4 is substantially identical to Insuring Agreement D of the 1986 Bond.

[forged documents] were not truthful."⁵⁰

The mere fact that an insured suffers a loan loss and that the loan file contains a covered document with a covered defect does not necessarily implicate coverage. Insurers must carefully review each element of coverage – particularly whether the covered document with the covered defect caused the bank to both issue the loan and caused the bank's loss – to determine if any amount are due and owing under the FIB.

D. Insuring Agreement E

Insuring Agreement E of the 1986 Bond provides coverage for:

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 Uncertificated 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,
 - (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

⁵⁰ 2006 WL 3343765 at * 12.

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.⁵¹

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 2004 Bond⁵² similarly provides coverage for:

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 Written,⁵³ 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) Certificate of Deposit,
 - (f) Evidence of Debt,
 - (g) Corporate, partnership or personal Guarantee, or
 - (h) Security Agreement, which

⁵¹ The 1986 Bond defines Counterfeit as "an imitation which is intended to deceive and be taken as an original." This definition is obviously less precise than the definition of Forgery, and therefore has spawned more litigation to determine if the relied-upon document was, in fact, a Counterfeit. For a discussion of this issue, see *FDIC v. Fid. & Deposit Co. of Md.*, 827 F. Supp. 385, 393 (M.D. La. 1993) (citing, *inter alia*, *Bank of the Southwest v. Nat'l Sur. Co.*, 477 F.2d 73, 76 (5th Cir. 1973)); *State Bank of the Lakes v. Kansas Bankers Sur. Co.*, 1999 WL 674739 (N.D. Ill. 1999).

⁵² Insuring Agreement E was first inserted into the Bankers Blanket Bond in 1951. The 2004 Bond marks the fourth time its language has been altered, following prior revisions in 1969, 1980, and 1986. See Peter C. Haley & Dolores Parr, *Coverage under Insuring Agreement (E) of the Financial Institution Bond*, in *FINANCIAL INSTITUTION BONDS* 385, 386 (Duncan L. Clore ed., 3d ed. 2008). The most notable of these amendments occurred in 1980, when Insuring Agreement E was revised to limit the number of covered documents. See Edgar L. Neel, *Financial Institutions and Fidelity Coverage for Loan Losses*, 21 *TORT & INS. L.J.* 590, 614 (1986). The 1969 Bond form broadly provided coverage for a forged "document."

⁵³ The 2004 Bond defines "Written" as "expressed through letters or marks placed upon paper and visible to the eye." This definition is not found in the 1986 Bond.

- (i) bears a handwritten signature of any maker, drawer, issuer, endorser, assignor, lessee, transfer agent, registrar, acceptor, surety, guarantor, or of any other person whose signature is material to the validity or enforceability of the security, 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; or
- (3) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any item listed in (a) through (e) above which is a Counterfeit.

Actual physical possession of the items listed in (a) through (h) 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 reproduction of a human signature is treated the same as the handwritten signature. An electronic or digital signature is not treated as a reproduction of a handwritten signature.

None of the cases discussed below involve the 2004 Bond. However, as banking practices evolve (particularly with technological advances), practitioners can anticipate additional revisions to Insuring Agreement E, particularly with regard to the "original" and "actual physical possession" requirements.⁵⁴

1. Primary Focus of Insuring Agreement E Investigation

The purpose of Insuring Agreement E has been described as "to provide protection against loss directly resulting from the Insured's good faith reliance, in making loans and in conducting other financial transactions, on specified documents which later

⁵⁴ Haley & Parr, *supra* note 52, at 389. For example, see *Citizens Bank of Or. v. Am. Ins. Co.*, 289 F. Supp. 211 (D. Or. 1968) (holding that coverage is implicated despite a lack of actual physical possession because the insured "constructively possessed" the covered documents).

are discovered to have been forged, counterfeit, altered, lost or stolen."⁵⁵ To implicate coverage under Insuring Agreement E, an insured must affirmatively demonstrate:

- a loss;
- involving an enumerated "covered document;"
- that is an original;⁵⁶
- that contains a "covered defect;"
- that the Insured, its authorized representative,⁵⁷ or a correspondent bank⁵⁸ had actual, physical possession⁵⁹ of the covered document containing a covered defect;
- that the Insured relied on the covered document containing the covered defect (i.e., transaction causation);
- that such reliance was in good faith;⁶⁰ and
- that the covered document containing the covered defect directly caused the loss (i.e., loss causation).

As with Insuring Agreement D claims, insureds commonly ignore the causation requirements and believe that coverage is implicated so long as the loss involves a covered document with a covered defect. Because a "high percentage of cases construing this insuring agreement are decided on summary judgment," insurers should conduct an investigation with the intention of establishing undisputed facts that clearly demonstrate whether coverage is or is not implicated.⁶¹

2. Did the Covered Defect on the Covered Document Cause the Loss?

⁵⁵ Haley & Parr, *supra* note 52, at 388.

⁵⁶ A discussion of what constitutes an "original" document is beyond the scope of this paper. For a thorough analysis of this issue, please refer to Haley & Parr, *supra* note 52. See also *BancInsure, Inc. v. Marshall Bank, N.A.*, 400 F. Supp. 2d 1140 (D. Minn. 2005).

⁵⁷ For a discussion of this issue, see *Stop & Shop, Inc. v. Fed. Ins. Co.*, 136 F.3d 71 (1st Cir. 1998).

⁵⁸ For a discussion of this issue, see *Nat'l City Bank v. St. Paul Fire & Marine Ins. Co.*, 447 N.W.2d 171 (Minn. 1989).

⁵⁹ For a discussion of what constitutes "actual, physical possession," please refer to Haley & Parr, *supra* note 52. See also *Republic Bank v. Fidelity & Deposit Co. of Maryland*, 894 F.2d 1255 (11th Cir. 1990).

⁶⁰ A discussion of what constitutes an "in good faith" is beyond the scope of this paper. However, it appears that a "majority rule" has developed requiring the bank to both act honestly and not recklessly ignore danger signs in the subject transaction. Haley & Parr, *supra* note 52, at 418. See also *Marsh Investment Co. v. Langford*, 721 F.2d 1011 (5th Cir. 1983). Courts have held that an insured's negligence, standing alone, is rarely a valid defense to coverage and does not eliminate the possibility that an insured acted "in good faith" under Insuring Agreement E. For a thorough analysis of this issue, please refer to Haley & Parr, *supra* note 52.

⁶¹ Haley & Parr, *supra* note 52, at 386.

In addition to the other coverage elements, insureds must affirmatively demonstrate both transaction causation and loss causation to implicate coverage under Insuring Agreement E. To determine whether the covered defect in the covered documents caused the loss, insurers must consider both (1) the issuance of the loans and (2) the loss resulting from the borrowers' default.

i. Transaction Causation

An essential element to coverage under Insuring Agreement E is that the insured acted "on the faith of" (i.e., relied) on the covered document containing the covered defect when issuing the loan or completing the subject transaction. The insuring provision provides that "actual physical possession" is a condition precedent to reliance, but actual physical possession does not necessarily satisfy the reliance requirement.

Many courts have properly examined the reliance element to determine that coverage is not implicated merely because the claim involves, for example, a forged guaranty. In *Continental Bank v. Phoenix Ins. Co.*,⁶² the insured sought coverage under a provision similar to Insuring Agreement E when a business failed to repay a loan. Before issuing the loan, the insured required that the company's three (3) principals – as well as their wives – each sign a personal guaranty. One of the wives' guaranty ultimately proved to contain a forgery. The court held that coverage was not implicated because the insured did not actually rely upon the forgery to issue the loan. Quoting with approval the opinion of the trial court, the appellate court stated:

The evidence clearly shows that the participation of Mr. and Mrs. Wilks in the credit negotiations and loan transactions . . . was so negligible as to be characterized *de minimis* and the evidence is further clear and convincing that plaintiff, Continental Bank, placed no reliance upon the Wilks or their credit. The evidence clearly manifests that the loans would have been made to [the borrower] whether the Wilks participated in the Continuing Guaranty or not, and that the forgery of Mrs. Wilks' signature was not a proximate cause of plaintiff, Continental Bank's loss.⁶³

The court further stated that the insured actually relied upon the credit and guaranties of the other parties to the loan "to the exclusion of Mr. and Mrs. Wilks."

While a bank officer testified that it was 'practice and principle' to obtain financial statements and guaranties of all principals and their wives, he also testified that 'the primary consideration of the net worth of the guarantors controls the loan,' adding that it is merely good banking practice to get the guaranties, on a theory that it doesn't cost any more and

⁶² 24 Cal. App. 3d 909 (Cal. Ct. App. 1972).

⁶³ *Id.* at 912.

'you get as much as you can.'⁶⁴

Moreover, in *United States Nat'l Bank in Johnstown v. Reliance Ins. Co.*,⁶⁵ a Pennsylvania court relied upon *Continental Bank* to reach a similar result. In that case, the signature of one (1) of four (4) guarantors was forged (again, the signature of one of the principals' wife). The court held that coverage was not implicated under Insuring Agreement E because "While the signature was necessary for protection purposes, it was not a determining factor in whether or not the loan should have been granted."⁶⁶

The probing considerations acted on by the loan committee were the financial statements of each partner; the credit history of Mr. Walters; the financial statement of Summit Mines Company; the accounts receivable of the company; and the signatures of Walters and Jones. . . . Therefore, it seems clear that not only was Mrs. Jones' signature not 'relied on' in giving the loan but that the loan was not given 'on the faith of' her signature.⁶⁷

The reliance/transaction causation analysis extends beyond forged guaranties. In *KW Bancshares, Inc. v. Syndicates of Underwriters at Lloyd's*,⁶⁸ the insured bank loaned money based on a letter from the debtor's employer stating that the debtor was about to receive a large bonus. The letter was, in fact, a fabrication in that the debtor was never entitled to a bonus, and his employer's signature was forged. The district court held that the insured's loss:

[D]id not result directly from having made the Whitman loan on the faith of the Crenshaw letter. . . . [The] loss was caused by the fact that the statements contained in the Crenshaw letter were not true – Whitman was not entitled to an annual bonus of \$811,500 from NMC. Even if Crenshaw's signature on the February 21, 1992 letter had been genuine, plaintiffs' loss would have occurred nonetheless because the alleged security, the Crenshaw letter, was worthless.⁶⁹

In addition to being unable to satisfy the loss causation requirement (the loss would have been the same even if the forged signature was valid), the court also noted that the insured likely failed to satisfy the reliance requirement. Specifically, to the extent that the Bank actually relied upon the loan documents to issue the loans, it likely relied upon the *information* in the letter (i.e., that the debtor was to receive a large bonus) as

⁶⁴ *Id.* at 914.

⁶⁵ 501 A.2d 283 (Pa. Super. Ct. 1985)

⁶⁶ *Id.* at 285.

⁶⁷ *Id.*

⁶⁸ 965 F. Supp. 1047 (W.D. Tenn. 1997).

⁶⁹ *Id.* at 1054.

opposed to the *signature* on the letter. Had the contents of the letter been different, the insured was unlikely to issue the loan.

In most cases, it appears to be a fact-intensive endeavor to determine if an insured actually relied on the covered document to issue the loan. The insured will, of course, assert that it relies on each and every document in the loan file to issue the loan. However, as evidenced in the cases above, that is not always the case, and insurers should not concede this issue without first investigating the same.

Unfortunately, not all courts have enforced the plain language of the Bond to preclude coverage when the reliance requirement cannot be satisfied. The case of *Union Planters Bank, N.A. v. Continental Cas. Co.*⁷⁰ primarily involved whether the insured satisfied the "actual physical possession" requirement that is a condition precedent⁷¹ to proving reliance. In November of 1999, Union Planters extended a \$10 million warehouse line of credit to Greatstone, a mortgage-banking company.⁷² Each time Greatstone needed to finance a new mortgage, Union Planters advanced the necessary funds to Greatstone through a "wet" transaction. In "wet" transactions, the bank advances funds *before* it receives an original signed promissory note, mortgage, and assignment of mortgage. After Greatstone defaulted on its obligations to Union Planters, Union Planters discovered that Greatstone was involved in an elaborate scheme whereby Greatstone generated numerous legitimate mortgages to obtain information from individual applicants.⁷³ This information was then used to generate fraudulent mortgages by forging signatures on new loan requests. Therefore, the mortgage loans provided to the insured as collateral did not represent actual extensions of credit to the named borrowers. When Greatstone defaulted, the insured was left with worthless collateral (i.e., forged promissory notes and mortgages) for nearly \$25 million in advances.

After the insured filed suit, the District Court held that coverage was implicated under Insuring Agreement E and granted summary judgment for the insured.⁷⁴ The

⁷⁰ 478 F.3d 759 (6th Cir. 2007). Instead of the standard form FIB, this case involved a document entitled Financial Solutions Policy that was negotiated by the insured and the insurer.

⁷¹ A condition precedent is "any fact or event, subsequent to the making of a contract, which must exist or occur before a duty of immediate performance arises under the contract." *Nat'l City Bank of Minneapolis v. St. Paul Fire & Marine Ins. Co.*, 447 N.W.2d 171, 176 (Minn. 1989) (citing A. Corbin, *CORBIN ON CONTRACTS* § 628, at 16 (1960)). "If the fact or event required by the condition precedent does not occur, there can be no breach of contract." *Id.* (quoting *451 Corp. v. Pension Sys. for Policemen & Firemen*, 310 N.W.2d 922, 924 (Minn. 1981)).

⁷² For a more in-depth discussion of mortgage warehouse lending, see Scott L. Schmookler, *The Compensability of Warehouse Lending Losses*, in *LOAN LOSS COVERAGE UNDER FINANCIAL INSTITUTION BONDS*, 355 (Gilbert J. Schroeder & John T. Tomaine, eds., 2007). See also Richard E. Elsea, Jeffrey S. Price, & Justin D. Wear, *Specific Types of Claim (Accounts Receivable Financing, Loan Participation and Syndication, Subprime Lending, Floorplan Financing, Equipment Lease Financing, Mortgage Warehouse Lending) and Riders (Fraudulent Mortgage Rider and Servicing Contractor Rider)*, in *LOAN LOSS COVERAGE UNDER FINANCIAL INSTITUTION BONDS* 283, 335 (Gilbert J. Schroeder & John T. Tomaine, eds., 2007).

⁷³ *Union Planters*, 478 F.3d at 762.

⁷⁴ Among other issues, the insurer argued that Union Planters' losses did not result directly from the forgeries, but from its "commercially unreasonable" conduct. The insurers contended that Union Planters

insured successfully argued that the requirement was made so long as it possessed actual physical possession of loan documents from a previously funded mortgage loan which it relied upon as collateral for a subsequently funded mortgage loan. The Sixth Circuit acknowledged that the Union Planters had "no actual physical possession" of documents correlating to each new mortgage at the time it funded each new advance.⁷⁵ However, the Sixth Circuit also stated that the policy did not specifically exclude reliance on previous collateral and that there is no exclusion for the "wet" financing relationship engaged in by Union Planters and Greatstone.⁷⁶ Basically, the Sixth Circuit agreed with the District Court that a Warehouse Lender is entitled to rely upon the pool of collateral mortgage documents in making its determinations on whether to advance additional credit. Because the credit relationship is dictated by advancing funds based on a revolving pool of collateral and because the policy does not expressly exclude losses resulting from this kind of arrangement, the Sixth Circuit held that coverage applies.

On appeal, the insurer argued as a secondary issues that the forged signatures did not "directly cause" the insured's loss. The insurer argued that the loss instead was incurred because the collateral for the insured's advances to Greatstone was worthless (the best position Union Planters would have been in is a second position lien holder since each mortgage would have had a first mortgage ahead of it). The Sixth Circuit disagreed even though the insured undisputedly failed to satisfy the plain language of the bond at issue.⁷⁷ *Union Planters* is a prime example of how insurers must be "aware of how banking practices, especially lending practices, have evolved over time."⁷⁸ Specifically, "as lending practices have evolved, bond terms formerly believed to be unambiguous or relatively trivial have taken on enhanced importance."⁷⁹

It will often be a fact-intensive endeavor to determine if an insured actually relied upon the covered defect in the covered document to issue the loan. It is possible that the loan officer never looked at the covered document or was even aware that it was in the loan file. If the insured never physically received the covered document, it might have actually relied upon the promises of a closing agent or other third-party that the covered document was signed and was in transit. Finally, an insured may have actually relied upon the information contained in the defective document, as opposed to the defect itself (such as a forged signature). As noted above in the Insuring Agreement D

failed to verify the information on the loans, investigate the mortgage banking company's credit, inquire into the alleged property purchased, and follow the procedures in its agreement with the mortgage company. *Id.* at 764. the Court essentially stated that this is a veiled negligence argument, and held that the insured's negligence will not suffice to defeat coverage. *Id.* at 764-65.

⁷⁵ *Id.* at 763.

⁷⁶ *Id.* at 764.

⁷⁷ The unambiguous "actual physical possession" requirement of the bond was ignored even though the Sixth Circuit held, in relation to a notice provision, that the bond is not a contract of adhesion and therefore should not be construed in favor of coverage. CITE. See also *F.D.I.C. v. Ins. Co. of N. Am.*, 105 F.3d 778 (1st Cir. 1997); *State Bank of Viroqua v. Capitol Indem. Corp.*, 214 N.W.2d 42 (Wis. 1974).

⁷⁸ Haley & Parr, *supra* note 52, at 389.

⁷⁹ *Id.* at 389-90. By analyzing the plain language of Insuring Agreement E of the 1986 Bond, some commentators had previously predicted that "warehouse lending losses will rarely be covered by Insuring Agreement E." Charles L. Armstrong, Thomas H. McNeill, & James E. Reynolds, *Warehouse Lending Losses Under the Financial Institution Bond*, XII FID. L. J. 1, 7 (2006).

discussion, the bank will almost certainly take the position that it never would have issued the loan if it was aware that a covered document contained a covered defect. Insurers should be wary to allow this self-serving statement to cause them to concede the reliance element of coverage.

ii. Loss Causation

Even if an insured can successfully prove that it relied upon the covered defect in the covered document to issue the loans, coverage is not necessarily implicated. The insured must still affirmatively prove that the covered defect in the covered document caused the loss. In *Georgia Bank & Trust v. Cincinnati Ins. Co.*,⁸⁰ the bank sought coverage under Insuring Agreement E of Cincinnati's bond for losses stemming from a transaction in which it loaned money against a savings account that never contained funds. As collateral for the loan, the bank received an assignment of the savings account. On two occasions the bank received documents from a local credit union confirming the account balance in the savings account. However, the account balance on these documents had been altered and the credit union representative's signature had been forged. In reality, the savings account had a negative balance. Despite the foregoing, the Georgia Court of Appeals held that the forged signature did not cause the bank's loss because the bank would have suffered the same loss even if the signature was valid.⁸¹ The covered loss is the intrinsic "value" of the defective document, which in *Georgia Bank* was nothing.

Furthermore, in *Reliance Ins. Co. v. Capital Bancshares, Inc./Capital Bank*,⁸² the insured advanced funds in reliance stock certificates containing a forgery. Although the insured could likely prove transaction causation/reliance, it could not prove loss causation. As noted by the District Court:

In this case the losses suffered by Capital and Sunbelt resulted directly from Coats' fraudulent scheme, but not from the forged signatures. Even if the signatures had been genuine, the bogus stock certificates would not have been and the banks would still have suffered losses identical to those they now face. Thus, the losses are not the direct result of the banks having extended credit on the faith of securities that bore forged signatures.⁸³

Unfortunately, as with the issue of transaction causation/reliance, some courts have incorrectly ruled that the entire loss is covered even if the loss causation element is not satisfied. In *St. Paul Fire & Marine Ins. Co. v. Bank of Stockton*,⁸⁴ the insured

⁸⁰ 538 S.E.2d 764 (Ga. Ct. App. 2000).

⁸¹ *Id.* at 766.

⁸² 685 F. Supp. 148 (N.D. Tex. 1988).

⁸³ *Id.* at 151-52. See also *French Am. Banking Corp. v. Flota Mercante Grancolombiana*, 752 F. Supp. 83, 91 (S.D.N.Y. 1990) (holding that the insured could prove neither transaction causation nor loss causation because (1) the insured "could not read the scribble on the bill of lading and had no idea whose name was purported to be represented thereby," and (2) "Even if the signatures had been identifiable and genuine, the bills still represented non-existent or previously completed transactions and FABC would have still suffered losses identical to those they now face.").

⁸⁴ 213 F. Supp. 716 (N.D. Cal. 1963).

bank loaned money to a third person based on a guarantee signed by a husband as guarantor. Because California is a community property state, the wife's signature was also required to make the guarantee effective. The bank permitted the husband to take the guarantee form home to procure his wife's signature, but the husband instead forged his wife's signature. When the debtor defaulted on the loan, the bank attempted to collect on the guarantee but discovered that it was unenforceable due to the forgery. The insured argued that the proper measure of the bank's loss is the amount that the bank could have recovered from the guarantors if the signature had not been forged. The court disagreed, stating that:

[N]either the parties to this action nor the Court should be required or permitted to speculate concerning how much could have been recovered from the [guarantors] or what would have been the value of a judgment against the [guarantors] if the forgery had not intervened. Innumerable factors could make a good judgment worthless or a valueless judgment collectible the day after either was obtained. There is nothing in the record to compel the Court to find other than that on the day the Guarantee was returned to the Bank it would have had a value of \$50,000.00 except for the forgery. The Court will not go beyond the question of the originally assumed and accepted value of the Guarantee and I, therefore, find that Bank has sustained its burden of showing that because of the forgery it sustained a loss of \$50,000.00.⁸⁵

In *St. Paul*, the court only analyzed coverage under the transaction causation/reliance requirement, stating that the bank would have never issued the loan but for the forged signature. The court unfortunately ignored the issue of what the bank could have recovered from the guarantors had the guaranty not contained a covered defect.

E. Conclusion

The discussion in this chapter is not intended to be an exhaustive discussion of investigating and resolving claims under Insuring Agreement D and Insuring Agreement E. Numerous well-reasoned and well-written articles and publications have more exhaustively addressed each of the specific requirements for coverage under Insuring Agreements D and E. The issue of causation remains one of the coverage elements most-overlooked by insureds and, unfortunately, insurers. A claim is not covered merely because a loan has been issued, the insured has suffered a loss, and the loan file contains a forged or altered document. Although it may seem a harsh result to deny coverage when the insured is the victim of a fraudulent scheme involving forged documents, the FIB remains a document that balances specific risk between the parties. The fact that no insurance coverage would otherwise exist does not justify expanding a narrow coverage document into broad, general fraud coverage. The specific coverage

⁸⁵ *Id.* at 718.

provisions of Insuring Agreement D and E⁸⁶, when read in conjunction with Exclusion E, indicates that coverage should rarely be implemented when an insured suffers loan losses.

⁸⁶ Non-Standard Form policies may provide broader coverage, especially where the "covered documents" are not specifically delineated.