Financial Institution Bonds

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Whether a Fidelity Bond is considered a Policy of Insurance varies by jurisdiction. 11 Couch on Ins. § 160:8 (2011). In California, Fidelity Bonds generally "resemble traditional contracts of insurance more than surety bonds involving a tripartite relationship between a surety, a principal and an obligee." *Cates Constr., Inc. v. Talbot Partners*, 980 P.2d 407, 417 (1999); *State Farm General Ins. Co. v. Wells Fargo Bank*, *N.A.*, 49 Cal.Rptr.3d 785, 791 n. 6. See also *Underwriting Members of Lloyd's in Lloyd's Policy No. 52342 v. California Fruit Growers Exchange*, 136 F.2d 560561 (9th Cir. 1943) (fidelity bonds "are essentially insurance contracts.")

As with all insurance contracts, evaluating coverage requires review of the terms of the policy. The key insuring coverages are set forth in the insuring agreement. Below is a portion of a form insuring agreement:

INSURING AGREEMENTS

FIDELITY

(A) loss resulting directly from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others.

- (1) Such dishonest or fraudulent acts must be committed by the Employee with the manifest intent:
  - (a) to cause the Insured to sustain such loss; and
  - (b) to obtain financial benefit for the Employee or another person or entity.

FORGERY OR ALTERATION

(D) Loss resulting directly from Forgery or alteration of, on, or in any

- (1) request made for change of beneficiary in any policy Issued by the Insured.
- (2) policy loan agreement made with the Insured.
- (3) assignment to the Insured of any of its policies.
- (4) Negotiable Instruments other than registered or bearer obligations, made or drawn by or drawn upon the Insured, or made or drawn by one acting as agent of the Insured, or purporting to have been made as herein before set forth

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

SECURITIES

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

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

(b) deed, mortgage or other instrument conveying title to, or creating or discharging lien upon, real property,

(c) Evidence of Debt,

(d) corporate, partnership or personal Guarantee,

(e) Security Agreement,

(f) Letter of Credit

(g) Instruction to a Federal Reserve Bank of the United States, or

(h) Statement of Uncertified Security of any Federal Reserve Bank of the United States which
(i) bears a signature of any maker, drawer, issuer, endorser, assignor, lessee, transfer agent, registrar acceptor, surety, guarantor, or of any person signing in any other capacity which is a Forgery, or
(ii) is altered, or
(iii) is lost or stolen;

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

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

Generally, Fidelity Bonds provide coverage for dishonest or fraudulent acts of an employee acting alone or in collusion with others. For coverage to apply, there must be a manifest intent to deprive the insured of money, or some other asset that has value, by the employee. This can be established by (a) a loss; and (b) financial benefit for the employee or another person. Typically, when some or all of the loss is directly from a loan, the employee must have acted in collusion with another party and received a financial benefit of $2500. In determining the meaning of manifest intent, the courts have adopted three different tests: (1) natural and probable consequences; (2) substantial certainty; and (3) specific intent.

The Ninth Circuit imposes proof of direct causation to establish coverage. Since Fidelity Bonds are not liability policies, when the loss is found to be caused by third parties, it is not covered. (See *Vons Companies v. Federal Insurance Company* 212 F.3d 49 (9th Cir. 2000.)

Insuring Agreement (D) and (E) provide coverage only when the insured relied on a defective document in good faith. Insuring clause (D) provides coverage for direct loss due to a forgery. Insuring clause (E) provides for coverage when the lender has acted in good faith in extending credit or selling or acquiring something that has a monetary value based on the faith of any originals. Fidelity Bond policies typically contain a list of defined documents covered under clauses (D) and (E) and require physical possession of the items. Most courts in evaluating what constitutes good faith have concluded that (1) mere negligence may be insufficient; (2) failure to notice “red flags" and do no further due diligence is not good faith conduct; and (3) unsound lending practices alone will not typically establish a lack of good faith. Since 2001, the predominant definition of good faith stated in the UCC and incorporated in the Fidelity Bond is a two-pronged test: (1) a subjective element ("honesty in fact"), and an objective test ("reasonable commercial standards of fair dealing"). Evaluating "good faith" is typically a fact-intensive investigation. The issue is not frequently litigated and is determined by a jury as an issue of fact based on the insured's conduct under the circumstances