

**AMERICAN CONFERENCE INSTITUTE
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LITIGATING CONTRACT SURETY BOND & FIDELITY CLAIMS

**Denae Budde
Alborg Veiluva & Martin LLP**

**Carleton R. Burch
Anderson, McPharlin & Conners LLP**

**Michael Keeley
Strasburger & Price, LLP**

**Susan Sullivan
Sedgwick LLP**

**Anthony Twardowski
Zarwin, Baum, DeVito, Kaplan,
Schaer,
Toddy, P.C.**

Fidelity Bonds in Banks – Fidelity Coverage

FINANCIAL INSTITUTION BOND (FIB)

Banks

Brokers and dealers

Thrift institutions

Insurance companies

COMMERCIAL CRIME POLICY

Commercial insureds other than financial institutions

PRINCIPAL INSURING AGREEMENTS

Clause (A) – Fidelity

Covers loss *resulting directly from* dishonest or fraudulent acts committed by officers and employees.

Clause (B) – On Premises

Covers loss of property within the insured's office *resulting directly from* robbery, misplacement or mysterious unexplainable disappearance.

Clause (C) – In Transit

Provides identical coverage as provided in Clause (B), except that the property is covered while in transit.

PRINCIPAL INSURING AGREEMENTS

Clause (D) – Forgery or Alteration

Covers loss *resulting directly from* forgery or alteration of checks, drafts, acceptances and other negotiable instruments.

Clause (E) – Securities

Covers loss *resulting directly from* the insured having, *in good faith*, for its own account or for the account of others, acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any forged, altered, lost or stolen original security, title document or agreement.

Clause (F) – Counterfeit Currency

Covers loss *resulting directly from* the receipt by the insured, *in good faith*, of any counterfeit or altered money of the United States or Canada or any foreign country in which the insured maintains a branch office.

STANDARD FORMS

Form 24

Introduced in 1941

American Bankers Association involvement

Benefits of using standard form

- rules of construction
- judicial guidance

1980 version most commonly used bond form today

- employee dishonesty most litigated
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The Critical Elements of Insuring Agreement (A)

INSURING AGREEMENT (A) - FIDELITY

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

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

INSURING AGREEMENT (A) - FIDELITY

However, if some or all of the Insured's loss results directly from Loans, that portion of the loss is not covered unless the Employee was in collusion with one or more parties to the transactions and has received, in connection therewith, a financial benefit with a value of at least \$2500.

INSURING AGREEMENT (A) - FIDELITY

Four Triggers to Coverage:

1. Dishonest or fraudulent act.
 2. Manifest intent to cause the insured a loss.
 3. Manifest intent to obtain a financial benefit and receipt of one in connection with a loan loss.
 4. Employee must have acted in collusion in connection with a loan loss.
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MEANING OF MANIFEST INTENT: THREE DIFFERENT TESTS ADOPTED BY COURTS



1. Natural and probable consequences (wholly objective)
2. Substantial certainty (objective or subjective, depending on case)
3. Specific intent (wholly subjective)

Manifest-Intent

COLLUSION



Under Insuring Agreement (A), if some or all of the Insured's loss results directly or indirectly from loans, that portion of the loss is not covered "unless the Employee was in *collusion* with one or more parties to the transactions. . . ."

FINANCIAL BENEFIT

Bond requires proof that *employee received financial benefit* with a value of at least \$2500 in connection with a loan loss.



Common Causation Issues Under Financial Institution Bonds



Employee Dishonesty

- First Party Losses
 - Contract causation – Direct means direct
 - Tort causation – proximate cause
 - Third Party Losses
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CONTRACT CAUSATION
– DIRECT MEANS DIRECT



Universal Mortgage Corp. v.
Wurttembergisch Versicherung AG



Direct Mortgage Corp. v. National Union
Fire Ins. Co. of Pittsburgh, PA

TORT CAUSATION

– PROXIMATE CAUSE

A minority of jurisdictions, including courts in the Third Circuit, have held that the requirement that a loss result “directly from” the covered peril equates to a “proximate cause” requirement.

Causation Issues Under Insuring Agreements D and E

- Nonexistent or worthless collateral;
 - Tort Causation – unenforceable guarantees.
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SECTION 4 – Insuring Agreement

(D) – Forgery or Alteration

- (D) Loss resulting directly from
 - 1) Forgery or alteration of, on or in any Negotiable Instrument (except as Evidence of Debt) Acceptance, Withdrawal, Order or receipt for the withdrawal of Property, Certificate of Deposit or Letter of Credit. ...
-

SECTION 5 – Insuring Agreement

(E) – 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 [(exclusive list of defined documents) which is defective as defined.]
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Valley Community. Bank v. Progressive Cas. Ins. Co.

Valley Cmty. Bank v. Progressive Cas. Ins. Co., 2012 U.S. Dist. LEXIS
22072 (N.D. Cal. February 22, 2012)



Forcht Bank N.A. v.

BancInsure, Inc.

**Civil Action No. 10-259-JBC, 2011 WL
4834133 (East. Dist. Of KY 2011)**



Beach Community Bank v.
St. Paul Mercury Insurance
635 F.3d 1190 (11th Cir. 2011)



The Good Faith Defense

Introduction

- Insuring clauses (d) and (e) provide coverage only when the insured financial institution relied upon the defective documents in “good faith.”
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Insuring Clause D - Forgery

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

1. Negotiable Instrument (except as evidence of debt),
2. Certificate of Deposit,
3. Letter of Credit,
4. Withdrawal Order,
5. Receipt for the withdrawal of Property, or
6. Instruction or advice . . .

Which (a) bears a handwritten signature of any maker, drawer or endorser which is a Forgery; or (b) is altered . . .

Insuring Clause E - Securities

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, Original,

- (a) Certificated Security,
- (b) Document of Title,
- (c) Deed, mortgage or other instrument conveying title . . .
- (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 (i) bears handwritten signature . . . which is a Forgery, or is (ii) altered, or (iii) is lost or stolen;”

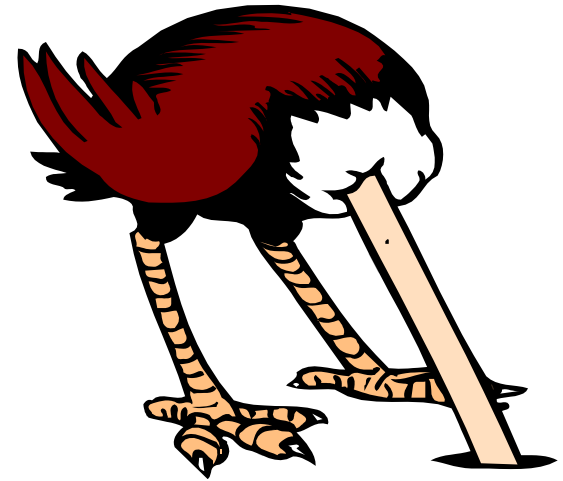
Subjective Good Faith and the Blind Eye Test

With some exceptions, most courts analyzing “good faith” have concluded that:

- 1) “mere negligence” is insufficient to establish a lack of good faith,
 - 2) a lender lacks good faith if it had sufficient notice of red flags regarding the borrower to warrant further due diligence before extending credit; and
 - 3) unsound lending practices alone are unlikely to establish a lack of good faith.
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Marsh v. Langford – The Archetypical Good Faith Case

- Marsh Investment Corp. v. Langford, 721 F.2d 1011 (5th Cir. 1983) is oft-cited as one of the leading opinions on “good faith.”
- “[M]ere ignorance is not bad faith . . . if one ‘chooses to remain ignorant . . . in fear of what a little knowledge will disclose. . .’ such ‘selective ignorance’ is bad faith.”



The Mixed, Subjective and Objective Good Faith Test

- The predominant definition of good faith both in the UCC and as incorporated into the Bond since at least 2001 is a two-pronged test. It involves a
 - subjective (“honesty in fact”) component and
 - an objective (“reasonable commercial standards of fair dealing”) component.



The Mixed, Subjective and Objective Good Faith Test

- Court applying the mixed test typically look at the following whether a party was on “inquiry notice” of red flags.
 - While sloppy business practices alone may not signal a lack of good faith, objectively unsound business practices may themselves constitute “red flags” relevant to the good faith analysis.
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Objective Good Faith Summary

- “Blind eye” test rejects the notion that a bank can ignore red flags in extending credit.
 - Courts look to the facts known to the bank and generally refuse to find good faith when a question is presented as to whether the bank’s role in the transaction was reasonable under the circumstances.
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Conclusions

- The issue of good faith is fact intensive and will typically require an in-depth exploration of the transactions at issue.
 - While “good faith” is not litigated often in the bond context, it remains a key pre-condition to coverage and one which is essential to maintaining the division of risk as between the fidelity insurer and its insured.
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The Forgery Exclusion to Coverage

Sample Exclusion Language:

"Section 1. This Bond Does Not Cover:

Any loss effected directly or indirectly by means of forgery. . ."

The Forgery Exclusion to Coverage

- What types of documents typically are excluded from coverage based on the forgery exclusion in a bankers blanket bond or fidelity bond?
- Does a counterfeit document qualify as a forgery and so excluded from coverage under a bankers blanket bond or fidelity bond?
- Can an unauthorized use of a stamped signature qualify as a forgery for the purpose of being excluded from coverage under the forgery exclusion in a bankers blanket bond or fidelity bond?

The Forgery Exclusion to Coverage

- Sample Exclusion Language:
- "Section 1. This Bond Does Not Cover:
- Any loss effected directly or indirectly by means of forgery..."

The Uncollected Funds Exclusion to Coverage

- Sample Exclusion Language:
- “This bond does not cover:
- loss resulting from payments made or withdrawals from any depositor's account by reason of uncollected items of deposit having been credited by the Assured to such account, whether or not such items are forged or altered in any respect, notwithstanding the provisions of Insuring Clause 4 or sub-section (e) of Section 1.”
- Some forms contain an “on premises” exception.

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