

STEALTH LOANS, ROGUE BANKING OFFICERS, AND
POOR BANKING PRACTICES UNDER INSURING
AGREEMENTS (A), (D), AND (E)

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I. INTRODUCTION

Poor banking practices and loan underwriting, often the root cause of a bank's loss, are not covered under the Financial Institution Bond, Standard Form No. 24.¹ To be covered by the Bond, the loss must fall within one of several Insuring Agreements. Losses from loans, in particular, are completely excluded from coverage under the Bond, unless covered under Insuring Agreements (A) (Fidelity), (D) (Forgery or Alteration), or (E) (Securities).² Accordingly, even if a loss arguably falls under Insuring Agreement B (On Premises), if the loss is the result of the non-payment of a loan, there is no coverage unless Insuring Agreements (A), (D), or (E) are applicable.³ The purpose of the loan loss exclusion is to balance the

¹ Hereinafter the Bond.

² Section 2(e) of the Bond provides as follows:

This bond does not cover:

(e) loss resulting directly or indirectly from the complete or partial nonpayment of, or default upon, any Loan 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 Evidences 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 Agreements (A), (D), or (E).

SURETY ASS'N OF AM., Standard Form No. 24 (rev'd Jan. 1986), in STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA.

³ See, e.g., *Liberty Savings Bank, F.S.B. v. American Casualty Co. of Reading, Pa.*, 754 F. Supp. 559 (S.D. Ohio 1990). In *Liberty*, a bank sought coverage under Insuring Agreement (B) following a loss after purchasing what it was led to believe were loans secured by first mortgages on property. As it turned out, the properties in question already were encumbered. The bank argued that its loss fell under Insuring Agreement (B)(1)(d) because it resulted from false pretenses committed by a person in an office on the bank's premises. The court granted the insurer's motion for summary judgment, concluding that the transaction involved an extension of credit for which there was no coverage absent the applicability of Insuring Agreements (A), (D), or (E). *Id.* at 561. The court noted that the loss in this case was no different from a loss arising from the exercise of poor judgment. Here, the bank could have protected itself against the loss by conducting title searches which would have revealed the existence of the prior liens. *Id.* at 562.

risk between the financial institution and the issuer of the Bond.⁴ Similarly, loss from forgery is excluded unless covered under Insuring Agreements (A), (D), (E) or (F) (Counterfeit Currency).⁵

The insurer should consider, in analyzing a claim for coverage, the actions of the bank in connection with the loss in question and decide whether the loss is due to a covered cause, or simply to the bank's negligence. The following cases are examples of unsuccessful attempts by banks to recover under the various Insuring Agreements in the face of the bank's negligence.

II. CLAIMS INVOLVING INSURING AGREEMENT (A)

Insuring Agreement (A) provides coverage for:

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.

However, 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 and has received, in connection therewith, a financial benefit with a value of at least \$2,500.

As used throughout this Insuring Agreement, financial benefit does not include any employee benefits earned in the

⁴ Karen Kohler Fitzgerald, *The Loan Exclusion: Allocating Business Risks to the Banker*, in *Financial Institution Bonds* at 293 (Duncan L. Clore ed. 1998).

⁵ Section 2(a) of the Bond provides as follows:

This bond does not cover:

- (a) loss resulting directly or indirectly from forgery or alteration, except when covered under Insuring Agreements (A), (D), (E) or (F).

normal course of employment, including: salaries, commissions, fees, bonuses, promotions, awards, profit sharing or pensions.⁶

Insuring Agreement (A) provides coverage for employee dishonesty. It is evident from the foregoing, however, that it does not cover all cases of dishonesty. It is limited to those acts which are committed by an employee with the manifest intent to cause loss to his employer and a financial benefit to himself or another person or entity. Much of the litigation involving Insuring Agreement A has focused on the employee's "manifest intent."

A. The Generous Loan Officer Is Alive and Well in Texas

*Progressive Casualty Insurance Company v. First Bank.*⁷ First Bank experienced \$2,000,000 in loan losses while Henry Massey was its president. According to First Bank, Massey made loans without documentation and without loan committee approval. He failed to follow internal procedures, and misrepresented the condition of borrowers and the value of their collateral. He also loaned money to friends on favorable terms, lowered the interest rates of borrowers who fell on hard times, and extended their loan maturity dates. He failed to take possession of stock pledged to the bank and for no apparent banking reason released collateral on outstanding loans.⁸

First Bank attempted to recover against Progressive under Insuring Agreement (A), but after twenty months of litigation the bank was unable to come up with any evidence of Massey's financial benefit, motive, or scheme. Rather, the bank argued that Massey would not have acted the way he did if he did not have a secret gain. The court disagreed emphasizing that "[t]he bond is not credit insurance to protect the lender against improvident or reckless extensions of credit."⁹ To fall within Insuring Agreement (A), the bank must show more than bad judgment on the part of its employee. As the court admonished, the bank's argument that it necessarily must have been cheated because it lost a lot of money "is unfortunately all too common in this era of freedom from accountability. The magnitude of Massey's errors equals the board's in hiring him."¹⁰

⁶ SURETY ASS'N OF AM., *supra* note 2.

⁷ 828 F. Supp. 473 (S.D. Tex. 1993).

⁸ *Id.* at 474.

⁹ *Id.* at 474.

¹⁰ *Id.* at 475.

B. Road Kill

*Susquehanna Bancshares, Inc. v. National Union Fire Insurance Co. of Pittsburgh.*¹¹ Citizens National Bank of Greencastle, a community bank, sustained losses in excess of \$1.4 million as a result of defaulted trailer truck loans made to seventeen truckers. Marvin Rice originated and oversaw many of those loans, sometimes exceeding his lending limit. As manager of the installment loan department, he had the authority to extend or refinance delinquent loans. Although there was no written policy, it was understood that a loan extension fee of one percent would be charged for refinancing such loans. Rice, however, frequently charged less than one percent, or charged no fee at all. He did this, he said, as an accommodation to the customer to get the loan paid. He also refinanced these loans to keep them off the delinquency list. The result of Rice's actions was the under-collateralization of these loans.¹²

Citizens National also had problems with its managerial structure. Rice's only superior was the bank's president, who exercised little or no supervision over his employees. Many loan applications were incomplete and the Office of the Comptroller of the Currency was very critical of Citizen National's lack of good management.

In determining whether Rice had the manifest intent to harm the bank, the Pennsylvania Superior Court followed a line of cases which hold that an employee's intent is to be determined from a review of all the evidence, not just the natural and probable consequences of the employee's acts.¹³ Only after all the evidence has been considered, including the employee's subjective intent, can the trial court determine whether it can infer that the employee knew that the losses were substantially certain to follow.¹⁴ The court criticized those cases which held that the fact finder could look only at the natural and probable consequences of an employee's acts, finding that such a standard would subject the insurer to liability for losses which resulted from poor business judgment and improvident decisions, which is not the intent of the bond.¹⁵

The trial court found that Rice's intent was to help his bank by trying to save troubled loans. That these loans were under-collateralized was simply the

¹¹ 659 A.2d 991 (Pa. Super 1995).

¹² *Id.* at 993.

¹³ *Id.* at 996.

¹⁴ *Id.*

¹⁵ *Id.*

result of poor business judgment. The trial court also concluded that Rice's actions were the result of a lending environment at Citizens National which had been plagued by years of mismanagement, lax supervision and widespread unsound banking practices. In rejecting the bank's argument that consideration of its poor management was the equivalent of considering contributory negligence, a consideration which the bank argued was inappropriate in a contract action, the court adopted the reasoning of the trial court:

[I]t was appropriate, indeed necessary, for the court to examine Rice's actions in the context of the bank's general operations and lending guidelines, or lack thereof. An employee's conduct cannot be judged as dishonest or fraudulent without a basis for comparison with conduct that is deemed proper and expected by the employer. The court cannot determine whether Rice's actions were dishonest or fraudulent within the terms of the fidelity bond without considering proper banking guidelines and procedures with which the Bank . . . claim[s] that Rice failed to comply.¹⁶

The foregoing cases illustrate that poor judgment is not equivalent to dishonesty under Insuring Agreement (A). Moreover, the actions of the employee must be considered in the context of the bank's general operations, guidelines and procedures in order to determine whether the employee acted dishonestly.

III. CLAIMS INVOLVING INSURING AGREEMENT (D)

Insuring Agreement (D) provides coverage for:

(D) 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

¹⁶ *Id.* at 998.

advices either bear a signature which is Forgery or have been altered without the knowledge or 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.¹⁷

Thus, Insuring Agreement (D) provides coverage for loss directly from forgery or alteration of negotiable instruments, most commonly checks, as well as a number of other listed instruments, such as CDs and letters of credit.

A. The Case of Daddy's Little Girl

*Empire Bank v. Fidelity & Deposit Co. of Maryland.*¹⁸ Campbell 66 Express was a large trucking company, founded by Frank Campbell, who turned over the business to his son-in-law, Randall Walker, upon his retirement. Randall and his wife, Frank's daughter, Trula, used several means to divert corporate funds from Campbell, eventually forcing it into bankruptcy. The bankruptcy trustee for Campbell brought an adversary proceeding against the bank in connection with the Walkers' defalcations. The bank paid \$208,735 to settle that suit, and then sued Fidelity & Deposit Company of Maryland to recover under its bond for false pretenses under Insuring Agreement (B) and forgery under Insuring Agreement (D).

During the time the bond was in effect, Trula used corporate funds to pay the salaries of her household employees. This she accomplished by directing the bookkeeper at Campbell to draw checks on corporate funds deposited in another bank in amounts payable to her household employees. Trula then picked up the checks, endorsed her employee's names on the back and presented them for payment at Empire, requesting either cash or traveler's checks. Trula's endorsement was never required when she cashed the checks, although this was against bank policy. In every instance, the teller was given permission to cash these checks in this manner, frequently by Floyd Tucker, vice-president of Empire. Trula

¹⁷ SURETY ASS'N OF AM., *supra* note 2.

¹⁸ 828 F. Supp. 675 (W.D. Mo. 1993), *affirmed*, 27 F.3d 333 (8th Cir. 1984).

was the only customer of the Bank allowed to cash third party checks without adding her endorsement.¹⁹

Randall Walker's scheme was to take checks made payable to Campbell by customers, endorse them as an officer of Campbell and cash them at Empire even though Campbell did not have a checking account or corporate payroll account at Empire. No Campbell corporate resolutions authorizing Randall to conduct any banking business other than in connection with certain certificates of deposit were on file at the bank. It was against bank policy to cash corporate checks without a corporate resolution on file. Moreover, during this period, Empire amended its policy to prohibit cashing any checks made payable to a corporation. Instead, all corporate checks were required to be deposited into a corporate checking account.²⁰

The court concluded that the forged endorsements by Trula were not the cause of Empire's loss. Although Tucker's instructions to the tellers to "do whatever Trula wants" relieved the tellers of any liability, it did not relieve Empire of the consequences of its failure to follow its own standard operating procedures and sound banking policies.²¹ As to Randall's endorsement of corporate checks, there was no forgery. Randall was authorized by Campbell to sign corporate checks. Further, Empire presented no proof that Randall made any representation to it, whether true or false, in an attempt to get the checks cashed. Randall and Tucker were close friends, and Tucker never questioned why Randall was cashing the checks.²² The court observed that a bonding company issues a banker's blanket bond under the assumption that the bonded bank will follow the procedures set forth in its own operations manual and operate in a commercially reasonable manner.²³ Empire's losses were all caused by the acts of one of its officers who had instructed bank employees to violate the bank's procedures and reasonable commercial banking practices. It was clear to the court that Tucker's motive was to lure Campbell's banking business away from the Commerce Bank of Springfield. In admonishing the bank the court stated, "[t]his type of irresponsible conduct is the

¹⁹ *Id.* at 676.

²⁰ *Id.* at 676-77.

²¹ *Id.* at 678.

²² *Id.* at 678.

²³ *Id.* at 678-79.

type which has contributed to the banking crisis and resulted in the failure of so many banking institutions in the last several years.”²⁴

B. Failure to Confirm Existence of Assets

*Georgia Bank & Trust v. The Cincinnati Insurance Co.*²⁵ In this case, the Georgia Bank & Trust sought recovery under its bond for losses it incurred following the default by C.A. and Tommie West on their obligations to the bank. The Wests had assigned their interests in a savings and loan account they maintained at the Bartow Employee’s Federal Credit Union as collateral for the renewal of their obligations with the bank. The bank obtained documents on two occasions which confirmed the amounts in the account. After the Wests defaulted on their obligations to the bank, it learned that the account confirmations supplied to it were false, that there was no money in the credit union account, and that the signature of the credit union representative on the confirmations was forged by Tommie West, the president of the credit union at the time of the forgery.

Insuring Agreements (D) and (E) of the bond were implicated by the facts. In ruling in favor of the insurer, the court explained that the bond insured that the documents submitted to the bank in connection with the loan are genuine and authentic. If they are not, the loss is borne by the insurer. On the other hand, the bonding company does not guarantee the truth of the documents. If the documents are not truthful, the loss is borne by the bank. The reason, explained the court, is that a bank cannot protect itself against counterfeit and forged documents. It can, however, protect itself from the contents of those documents by investigating the assertions made therein through credit checks, appraisals, title searches, financial statements, etc.²⁶ In this case, the bank’s loss was not caused by the lack of authenticity or genuineness of the documents, but, rather, by the fact that the statements made in the documents were not true. The assets did not exist. Even if the documents had been genuine, the loss still would have occurred. The bank’s responsibility to investigate the assets of its borrowers was never delegated to the insurer. Accordingly, the loss fell on the bank.²⁷

²⁴ *Id.* at 679. In affirming this decision, the appellate court explained that the district court also relied on the exclusion for losses caused by employees. 27 F.3d at 335. Exclusion 2 (h) precludes coverage for loss caused by an employee, except when covered under Insuring Agreement A.

²⁵ 2000 Ga. App. Lexis 1058 (Aug. 28, 2000). Note: At the time this opinion was reviewed, it was uncorrected and subject to revision by the court.

²⁶ *Id.* at ** 4-5 (citing *Liberty Nat’l Bank v. Aetna Life & Cas. Co.*, 568 F. Supp. 860 (D.N.J. 1983)).

²⁷ *Id.* at ** 5-7.

IV. CLAIMS INVOLVING INSURING AGREEMENT (E)

Insuring Agreement (E) 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) Certificated 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 any person signing in any other capacity which is a Forgery, or

(ii) is altered, or

(iii) is lost or stolen;

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

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

Actual physical possession of the items listed in (a) through (i) above by the Insured, its correspondent bank or other authorized representative, is a condition precedent to the Insured's having relied on the faith of such items.

A mechanically reproduced facsimile signature is treated the same as a handwritten signature.²⁸

Insuring Agreement (E) provides coverage for loss resulting directly from the bank's good faith reliance in certain transactions on documents which contain a forged signature or are counterfeited, altered, lost, or stolen. Actual, physical possession of the documents is necessary. The following cases focus on the good faith, reliance and possession requirements of Insuring Agreement (E).

A. *Drowning in a Sea of Red Flags*

Marsh Investment Corp. v. Langford.²⁹ In an attempt to restructure over a million dollars worth of loans to John Langford and his companies, as well as \$350,000 in loans to Langford's mother which were in default, officers of the Pontchartrain State Bank turned a blind eye to the transaction proposed by Langford. The bank agreed to dismiss its suit against Langford's mother and cancel her notes in exchange for a new note given by Langford for the combined indebtedness. The bank also agreed to give up a mortgage on an apartment complex securing the prior indebtedness. Instead, the new loan was to be secured by another existing mortgage as well as a collateral mortgage on property owned by the Marsh Investment Corporation. The bank agreed to the mortgage even though it knew that Langford was neither an officer, a director, or shareholder of Marsh. Marsh, as it turned out, was owned in large part by Carlos Marcello, an individual the court described as "a formidable local figure of some notoriety."³⁰ The bank, however, marched on. To validate the mortgage, the bank required that Langford provide a corporate resolution and the unanimous consent of all the Marsh shareholders establishing Langford's authority to encumber the property. Langford supplied his attorney with a purported corporate resolution authorizing the transaction and certified by one James Perez as corporate secretary. Langford also provided his attorney with a shareholder's list and the consent of each shareholder to the mortgage. The Bank was never given the corporate resolution or the shareholder consents. Rather, they were held by Langford's attorney in safekeeping in the event of litigation. Instead, the Bank was provided with a legal opinion which read as follows:

I have not received or even seen any charter, by-laws, stocks books or any other documents of this corporation, nor have I

²⁸ SURETY ASS'N OF AM., *supra* note 2.

²⁹ 721 F.2d 1011 (5th Cir. 1983).

³⁰ *Id.* at 1013. By that, the court apparently meant that he was a felon several times over, and litigious otherwise; the court cited to a case in which the government's long campaign to deport Marcello was explained in great detail. *United States ex rel. Marcello v. Dist. Dir. of the Immigration & Naturalization Serv.*, New Orleans, Louisiana, 634 F.2d 964 (5th Cir. 1981).

conducted any investigation of this corporation whatsoever, even as to its existence. I make no representation or warranty, or give any opinion, that these people are in fact shareholders of Marsh Investment Corporation, or, if they are that they are the same people who signed these consent forms.³¹

Despite the foregoing opinion, and although the bank was admittedly suspicious at the time, it closed the transaction without any further investigation, releasing its lien on the apartment complex, and canceling the note of Langford's mother. This, despite Marcello's dubious reputation and Langford's poor credit rating. And, to make matters worse, relying on another opinion from another attorney as to the validity of the mortgage, the bank advanced another \$200,000 to Langford a few months later.

Needless to say, all was bogus. No James Perez was ever a secretary of Marsh, the shareholder consents were false, and Langford had no authority to sign as an agent for Marsh. The bank then filed this action on its banker's blanket bond seeking coverage under Insuring Agreement (E) on the ground that Langford's signature on the mortgage was a forgery. The bank was not successful. The district court held, and the Fifth Circuit affirmed, that the bank was not in good faith when it restructured the loan. The Fifth Circuit dismissed the bank with the following rebuke:

Suffice it is to say that the bank, faced with an anomalous transaction that turned on the authority of one man -- a poor credit risk, as it admitted -- to mortgage the property of a corporation with which it knew he had little or no connection, and with the means of checking that authority lying as near as the closest telephone, failed in the face of what the trial court properly characterized as a veritable sea of red flags to lift a finger to verify that authority, choosing instead to proceed in ignorance and sole reliance on the debtor's critical representations about his own authority. If "selective ignorance" be the test, as it is for purposes of this appeal, it is amply demonstrated. Since it is, and since it is a sufficient basis for the trial court's judgment in favor of the bonding company, we need not explore the issue of forgery.³²

³¹ *Id.* at 1013.

³² *Id.* at 1014.

B. *Blinded by the Smoke*

*First Union Corp. v. United States Fidelity and Guaranty Co.*³³ This suit resulted from an almost unbelievable scheme perpetrated by Ed Reiners, a former employee of Philip Morris. Reiners befriended Dick Nelson, a highly regarded customer of Signet Bank and a member of its advisory board. Nelson owned a computer leasing company and Reiners had leased equipment from Nelson for Philip Morris. Reiners confided to Nelson that Philip Morris was about to embark on a new and secret undertaking to develop a harmless tobacco. The project was to be conducted “off shore” and was confidential because Philip Morris would be experimenting with humans. Reiners explained that if the experiments were to take place in the United States, they would be too controversial and perhaps even illegal. At a minimum, they would involve the scrutiny of several federal agencies which Philip Morris wanted to avoid. Thus, Reiners insisted on strict confidentiality.³⁴

To carry out the venture, Reiners claimed he needed to lease \$25 million worth of computer equipment, and Nelson was happy to help. Reiners claimed that he also would need a loan from a bank. Nelson could help there as well. Nelson introduced Reiners to his good friend, Connie Mooney, a “relationship manager” at Signet, and to Mooney’s boss, and the chief credit officer at the bank. Over lunch Reiners explained the secret project to them dubbed “Project Star.” The bank quickly processed a credit application for a loan to World Wide Regional Export, the subsidiary Philip Morris had, supposedly, formed to carry out the project. The subsidiary was to be completely controlled by Reiners as its Chief Operating Officer. Over the following twenty-eight months, Reiners obtained more than \$300 million to carry out Project Star.³⁵

Signet referred to the loans as the “Stealth Loans.” Because they were so secret (Reiners required everyone in the know to sign a confidentiality agreement, expressly forbidding them from communicating directly with anyone at Philip Morris), and because they were not secured by the computers the money was loaned to purchase, Signet had trouble syndicating the loans to other banks. Attempts to market the stealth loans fell on deaf ears even though the loans were “above market.” One of the banks approached as a possible partner by Signet, Term Credit of Japan, simply ignored the confidentiality agreement and contacted Philip Morris to verify the existence of the project. An officer from Philip Morris faxed back

³³ 730 A.2d 278 (Md. Ct. Spec. App. 1999).

³⁴ *Id.* at 279.

³⁵ *Id.* at 279-80.

information which revealed that the entire Project Star was bogus, and Reiners was arrested by the FBI.³⁶

Signet was able to recover all but \$35 million of the money loaned and thereafter turned to its bonding company, United States Fidelity & Guaranty Company.³⁷ USF&G refused coverage for the loss under the financial institution bond it had issued to Signet and filed a declaratory judgment action. The district court granted USF&G's motion for summary judgment, holding that two forged incumbency certificates Reiners provided to the Bank to establish his authority to act for Philip Morris did not qualify for coverage as either "evidence of debt" under Insuring Agreement (E), or as "instructions or advices" under Insuring Agreement (D).

The appellate court affirmed. It began by explaining that Standard Form 24 has generally excluded losses caused by forgeries or loans made under false pretenses. Exclusion (a) excludes coverage for "loss resulting directly or indirectly from forgery or alteration, except when covered under Insuring Agreements (A), (D), (E) or (F)." The reason for the exclusion, the court stated, was to deny coverage for poor loan underwriting. Citing *National City Bank of Minneapolis v. St. Paul Fire & Marine Ins. Co.*,³⁸ the court agreed that "[t]he failure to follow sound business practices and verify authenticity is a business risk taken by banks and not an insured risk covered by the [b]ond."³⁹ Reflecting on the history of the bond, the court observed that the exceptions to exclusion (a) are to be construed narrowly. Before the 1980 amendments, Insuring Agreement (E) provided coverage for losses arising out of a bank's reliance on forged documents. Courts construed this language broadly, forcing the drafters of the 1980 amendments to limit coverage by listing and defining the documents that fall within Insuring Agreement (E). The drafters of the 1980 amendments also added a narrow definition of forgery, further supporting the fact that the bond does not provide broad coverage for losses from forgeries.⁴⁰

As to the case at bar, the court concluded that the forged incumbency certificates were not evidence of debt under Insuring Agreement (E)(1)(e). Rather, they simply represented that the imposter was an official at Philip Morris. The

³⁶ *Id.* at 280.

³⁷ Hereinafter USF&G.

³⁸ 447 N.W.2d 171, 177 (Minn. 1989).

³⁹ 730 A.2d. at 281.

⁴⁰ *Id.* at 281-82.

documents evidencing the debt in fact were signed by the imposter himself.⁴¹ Accordingly, there was no coverage under Insuring Agreement (E). Second, the court held that the incumbency certificates did not qualify as written instruments or advices such as checks or drafts: they did not authorize or acknowledge the payment or transfer of money.⁴² Consequently, the loss did not qualify for coverage under Insuring Agreement (D)(2) of the bond. Finally, as to both insuring agreements (D)(2) and (E)(1)(e), which require reliance on the forged instruments or advices as a condition of coverage, the bank loan committee approved the loan in question before receiving the incumbency certificates, thereby dispelling any notion that the bank had relied on them as a condition of approval.⁴³

C. *Caught Without Possession*

*National City Bank of Minneapolis v. St. Paul Fire & Marine Insurance Co.*⁴⁴ R.E. Clemens knowingly used two fake stock certificates purportedly issued by the Panhandle Eastern Pipe Line Corporation as security for a loan made to him by First National Bank of Minneapolis. While this loan was still outstanding, the National City Bank of Minneapolis extended credit to Clemens. National City determined that the stock of Panhandle listed by Clemens in his financial statement would be sufficient to secure National City's loan. First Bank remained in possession of the certificates as security for the outstanding balance of its loan to Clemens at the time National City loaned money to Clemens. National City, however, did call First Bank to verify its possession of the certificates. The proceeds of the loan by National City were used to pay off Clemens' outstanding loan to First Bank. Thereafter, National City obtained possession of the two fake certificates. The loan officer who received the certificates inspected them and then had them placed in the vault. The day after the certificates were obtained by National City, the FBI advised it that the certificates might not be genuine.

National City recovered some of the loan proceeds from Clemens and then sought recovery of the balance under the banker's blanket bond issued to it by St. Paul Fire & Marine Insurance Company.⁴⁵ St. Paul denied coverage for two reasons. First, National City did not have actual physical possession of the stock certificates, a condition precedent to coverage. Second, the fake certificates did not meet the "counterfeited" definition of the bond.

⁴¹ *Id.* at 282.

⁴² *Id.* at 283.

⁴³ *Id.* at 284.

⁴⁴ 447 N.W.2d 171 (Minn. 1989).

⁴⁵ Hereinafter St. Paul.

As to the first issue, the question before the court was whether National City should be entitled to recover even though it did not have possession of the certificates when it loaned money to Clemens. The answer was “no.” The court reasoned as follows:

The primary rationales for the Bond’s physical possession condition are to allow an insured bank the opportunity to examine a document and to contact others to verify a document’s authenticity. Although such verification is not required by Clause (E) of the Bond, a loss that could easily have been avoided is a business loss if sound business practice would have required some investigation. Checking a CUSIP number or calling a corporate secretary can quickly verify authenticity in most cases. Reliance on another bank’s possession of stock certificates is not enough, since an insured bank has a duty to exercise some minimal level of care when making a loan. The failure to follow sound business practices and verify authenticity is a business risk taken by banks and not an insured risk covered by the Bond.⁴⁶

The lower courts in this case had not enforced the condition, citing *Marsh Investment Corp. v. Langford*.⁴⁷ They determined that National City had acted in good faith in relying on the fake stock certificates, as opposed to the Pontchartrain Bank in *Marsh* which the court there found had acted in bad faith. The Minnesota Supreme Court, however, held that the fact that the bank had acted in good faith was irrelevant to compliance with the requirement of possession.⁴⁸

The second issue involved whether the fake stock certificates were “counterfeited” securities. The Bond defines “counterfeited” to mean an imitation “which is *intended to deceive and to be taken for an original*.”⁴⁹ This definition was added to the bond in 1969 in response to inconsistent interpretations by the courts, and has been interpreted consistently since then to require the fake documents to be an imitation or duplicate of a preexisting genuine original

⁴⁶ *Id.* at 177.

⁴⁷ 721 F.2d 1011 (5th Cir. 1983).

⁴⁸ *Id.* at 177-78.

⁴⁹ *Id.* at 178 (emphasis original).

document.⁵⁰ In this case, the fake certificates were not imitations of original certificates. They were made on a standardized, generic stock certificate form, and were not imitations of genuine original Panhandle stock certificates.⁵¹ The rationale for the definition of “counterfeit” is to make it clear that an insurance company covers only non-business losses or insured risks, leaving the bank responsible for ordinary business losses.⁵² As the court explained:

An insured bank is not covered for mere loan losses resulting from a failure to follow sound business practices, since a bank can easily verify through minimal investigation if a fake document purports to be something that never was in existence. On the other hand, verifying the authenticity of a duplicate or imitation of a genuine document is unlikely to result in discovery of the fraud, a risk an insured bank cannot control. The Bond is not intended to cover this type of forgery loss. If a bank, such as respondent, 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.⁵³

D. The Coffee Caper

*Republic National Bank v. Fidelity and Deposit Company of Maryland.*⁵⁴ This case involved the issuance of a letter of credit by the Republic National Bank of Miami on behalf of the Colombian Coffee Corporation⁵⁵ and in favor of Luis A. Duque Pena e Hijos, Ltda.⁵⁶ to facilitate the alleged purchase and sale of coffee. In international transactions where the buyer and seller have never met, the seller does not wish to deliver its goods before receiving payment, and the buyer does not want to pay for goods before receiving them. To remedy the dilemma, the buyer can request that a bank issue an irrevocable letter of credit in favor of the seller. The

⁵⁰ *Id.* at 178-79.

⁵¹ *Id.* at 180.

⁵² *Id.* at 179.

⁵³ *Id.*

⁵⁴ 894 F.2d 1255 (11th Cir.), *cert. denied*, 498 U.S. 926 (1990).

⁵⁵ Hereinafter Colombian.

⁵⁶ Hereinafter Limitada.

bank requires the buyer, the bank's customer, to secure the bank's liability to the seller by depositing sufficient funds or otherwise providing the bank with collateral. Once the letter of credit has been issued and delivered to the buyer/customer, the bank's obligation to the buyer becomes established and the letter of credit cannot be altered without the consent of the buyer. Once the buyer delivers the letter of credit to the seller/beneficiary, the bank's obligation to the seller is established and cannot be altered without the consent of the seller. Once the seller receives the letter of credit, he delivers his goods for shipment and receives from the shipper a bill of lading describing the goods delivered. The seller then presents the letter of credit and bill of lading to the issuing bank. If the description of the goods on the face of the bill of lading is exactly the same as the description recited on the face of the letter of credit, the bank must honor the letter by the third banking day following receipt of the documents. The bank, however, has no obligation to determine whether the documents presented to it are genuine. Once the issuing bank disburses the money to the beneficiary, it is entitled to immediate payment from its customer and may hold the bill of lading and other documents as a security interest. If the customer defaults, the bank can sell the goods represented by the documents. If, however, the documents are forged or counterfeit, the bank's security interest is worthless.⁵⁷

The bank in this case established a relationship with Alberto Duque on July 26, 1982, when Duque requested a short-term loan of \$1.8 million and provided the bank with a financial statement which indicated that his net worth was \$113,057,079. The statement showed that Duque had interests in Columbian, a New York based coffee broker, and the Duque Group, Columbia. The bank's investigation disclosed that the Duque Group was owned by Duque and other family members and that it controlled Limitada, the second largest exporter of coffee in Columbia. The bank also discovered that Duque owned most of the stock of the parent corporation of City National Bank of Miami.

The bank loan committee approved an unsecured loan in the amount of \$500,000 for the purchase of coffee. The loan closed on July 29, 1982 and Duque placed the funds in a checking account he opened at the bank. Duque also provided the bank with a power of attorney authorizing Camilo Bautista to act on his behalf. The loan was repaid on August 9. The following month the bank loaned Duque an additional unsecured loan of \$500,000 for a term of thirty days. In October, Bautista, Duque's agent, requested an extension of sixty days on the loan which the loan committee granted. This loan was repaid with interest on December 6. On

⁵⁷ *Id.* at 1257-58.

December 28, Bautista requested a third loan of \$500,000 for Duque which the loan committee approved.⁵⁸

While the third loan was outstanding, Bautista requested a letter of credit in the amount of \$1,239,000 to finance the exportation of 6000 bags of Columbian coffee. The letter was to be issued on behalf of Columbian for the benefit of Limitada. The loan committee approved the issuance of the letter of credit. An accompanying memorandum noted that Columbian had a net worth of \$4,449,300 in 1981 and \$4,474,500 in 1982. It also noted that Colombian's relationship to the bank was through Duque, who had agreed to guarantee Columbian's obligation to Republic. Thereafter, the bank was provided with an Application and Agreement for Commercial Letter of Credit signed by Bautista as vice president. The bank accepted this application without first obtaining a corporate resolution or any other information indicating that Bautista was an officer of Colombian. Thereafter, a letter of credit in the amount of \$1,239,000 in favor of Limitada was issued on February 14, 1983, secured only by Columbian's promise to repay the bank and Duque's guarantee. Columbian's obligation to repay was evidenced only through correspondence. No note or its equivalent had been issued.⁵⁹

The following day, Bautista sought to draw on the letter of credit, this time as vice president of Limitada. The bank balked because it had no verification of Bautista's authority to act for Limitada. The bank agreed, however, to let Bautista negotiate the letter of credit if he could get a bank to guarantee his endorsement. With a guarantee from City National Bank of Miami in hand, Bautista presented the bank with invoices and bills of lading in accordance with the letter of credit. The bills of lading identified 6000 sacks of coffee received on board from Limitada on February 2. The invoices were dated February 4 and noted that the coffee was to leave Columbia on February 9. They further stated that the terms of payment were "CASH AGAINST ORIGINAL DOCUMENTS . . . AS PER L/C 1-11366 of REPUBLIC NATL. BANK OR [*sic*] MIAMI DATED 2/14/83."⁶⁰ The court observed that in reviewing these documents the bank failed to inquire why Limitada would have delivered its coffee to a carrier twelve days before the bank had issued the letter of credit. The bank also failed to inquire why Limitada would allow the coffee to leave Columbia on February 9, five days before the issuance of the letter of credit. Further, the bank failed to consider how Limitada could have known when it issued the invoices on February 4 that the bank would issue its letter of credit on February 14, or how Limitada could have known on February 4 what number the bank's letter of credit would bear.

⁵⁸ *Id.* at 1258-59.

⁵⁹ *Id.* at 1259-60.

⁶⁰ *Id.* at 1260-61.

Heedless of all of the above, the bank issued a cashier's check in the amount of \$1,239,000 to the order of Limitada on February 17, even though the bank was not required to make payment until three days after demand. Later that day, Bautista presented the check for deposit with his signature guaranteed by City National. The bank made no attempt to verify the guarantee by City National, or to determine whether City National had a corporate resolution of Limitada in its files. After Columbian was advised by the bank that the letter of credit had been drawn, Columbian provided the bank with a note for \$1,239,000. The bank admitted that it did not know who had signed the note.

Predictably, Columbian defaulted on the note which occurred about the same time that the rest of the financial world realized that Duque had perpetrated a massive fraud in an attempt to keep his family's financial empire afloat. The fraud "involved falsely collateralized loans, prohibited insider bank transactions, and corporate legerdemain."⁶¹ The bank attempted to locate the coffee described in the bills of lading only to learn that the bills of lading were forged and the coffee did not in fact exist.

The bank's attempt to recover under Insuring Agreement (E) of Fidelity's bond was unsuccessful. The bank argued that it had relied on the forged bills of lading in honoring the letter of credit. The Bond, however, requires actual physical possession of a forged document as a condition precedent to reliance on the document. As the court explained, it was impossible for the bank to have physical possession of the bills of lading before it became irrevocably bound to honor the letter. The bank issued its letter of credit on February 16 at which time it became bound. The bank did not receive the bills of lading until February 17 when they were presented to it by Limitada. The bank, therefore, was irrevocably committed before it received the forged bills.⁶²

Further, the bank did not rely on the forged bills of lading and, indeed, the court held that "accepted standards of commercial reasonableness preclude such a determination as a matter of law."⁶³ The court reasoned that a bank has no guarantee that the documents which must be presented to it before it is obligated to honor the letter of credit will be genuine. Thus, it cannot rely on the presented documents to secure the risk that it takes in financing a letter of credit. Rather, the bank in this case relied on Columbian's credit and Duque's guarantee of that credit in issuing the letter of credit. The court emphasized this point by noting that if the

⁶¹ *Id.* at 1261.

⁶² *Id.* at 1262.

⁶³ *Id.* at 1263.

bank had truly relied on the bills of lading as collateral, any number of red lights should have gone off. These warnings were ignored by the bank because the bank was not relying on the Colombian/Limitada transaction, but on the credit of its customer and the customer's guarantor. In so holding, the court explained

that this court has long recognized that a banker's blanket bond "is not a policy of credit insurance and does not protect the bank when it simply makes a bad business deal." Were we to hold that [the bank] could recover on a banker's blanket bond in the instant transaction, we would in effect transform the blanket bond into such an insurance policy: our decision would allow banks to rely on documents presented by a beneficiary to a letter of credit transaction not because they are worthy of such reliance, but rather because the reliability of such documents is insured. At the least, such a holding would encourage sloppy banking practices such as those [the bank] employed in this case, for if a bank can rely on the documents of title presented by the beneficiary of a letter of credit, why should it bother to investigate thoroughly the credit worthiness of its customer? At the worst, of course, such a holding would promote outright fraud against the insurer. The result? Insurance companies would either raise their rate, rewrite their policies to exclude coverage under clause (E), or rescind clause (E) coverage altogether. Thus, we believe that no one ultimately would gain from a holding allowing coverage in this case.⁶⁴

⁶⁴ *Id.* at 1263-64. In another case arising out of the Duque/Columbian fraud, the bank did not fare much better in its suit for coverage. In *French American Banking Corporation v. Flota Mercante Grancolombian, S.A.*, 752 F. Supp. 83 (S.D.N.Y. 1985), *aff'd*, 925 F.2d 603 (2nd Cir. 1991), the court held that the bills of lading upon which the bank had relied in extending additional credit to Columbian were neither forged nor counterfeit. The court found that the signatures on the bills of lading did not appear to be that of any person authorized by Flota. Accordingly, the bank had not sustained its burden of proving a forgery. Moreover, the court held that the bank's losses, in any event, were not caused directly by the purported forgery. Rather, they were caused because of the Duque's fraud. Even if the bills of lading had been genuine, they represented non-existent or previously completed transactions and the bank would have suffered the same loss. *Id.* at 90-91. As to the argument that the bills of lading were counterfeits, the court concluded that they were not imitations of authentic instruments. Furthermore, the bank should have been more careful regarding the authenticity of the bills of lading given the fact that the bank was aware that Columbian had diverted \$1 million in funds owed to the bank prior to the bank's reliance on the fraudulent bills of lading. Columbian also had bounced checks and had cash flow difficulties. Although some of the bills of lading were outstanding months after the coffee should have arrived, the bank made no effort to determine the existence, condition, or value of the coffee. *Id.* at 91-94

V. CONCLUSION

The foregoing cases highlight the need to investigate all the facts and circumstances leading up to the claimed loss under a Financial Institution Bond. In particular, the bank's policies and procedures should be reviewed to determine whether they were followed, especially the bank's loan underwriting procedures. All documents involved in the loss should be examined. The dates on which events occurred or documents were issued should be analyzed. Involved bank employees should be interviewed and their motives considered. Any information which might reflect on the effectiveness or ineffectiveness of management should be reviewed. An investigation may reveal that the loss was caused by the bank's negligence, rather than a risk insured by the Bond.