

# The Question of Causation in Loan Loss Cases

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## ***I. Introduction***

There is a tension inherent in the Standard Form 24 Financial Institution Bond<sup>1</sup> between its overall exclusion for loan losses,<sup>2</sup> and the exception to that exclusion for loan losses covered under Insuring Agreements (A) (Employee Dishonesty), (D) (Forgery or Alteration) and (E) (Securities). This tension has been attributed to the drafters of the Bond, who endeavored to ensure that routine “business risks” remained with the insured financial institutions, while certain extraordinary risks, which could not be guarded against by prudent business practices, would be insured.<sup>3</sup> While this basic premise has not been the subject of much debate, in practice, courts have differed substantially as to which risks are allocable to the insured, and which risks instead give rise to coverage under the Bond. As a result, identical schemes resulting in loan losses might be covered in one jurisdiction, but not in another.

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<sup>1</sup> Financial Institution Bond, Standard Form No. 24 (revised Jan. 1986) [hereinafter Bond], *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (Surety Ass’n of Am.) [hereinafter STANDARD FORMS].

<sup>2</sup> The Bond specifically excludes coverage for: “(e) loss resulting directly or indirectly from the complete or partial non-payment 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).”

<sup>3</sup> Karen Kohler Fitzgerald, *The Loan Exclusion: Allocating Business Risks to the Banker*, in FINANCIAL INSTITUTION BONDS (Duncan L. Clore, ed. 1998).

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One reason for the conflicting rulings is the split of authority concerning the Bond's causation requirement. Insuring Agreements (A), (D) and (E) each require a "loss resulting directly from" the specific insured conduct.<sup>4</sup> Most courts have focused on the contract language, and determined that the Bond unambiguously requires the loss to be "direct" so that intervening and superceding acts will break the causal chain. Other courts have construed the "direct loss" requirement as equivalent to a "proximate cause" standard, even though that test is derived from tort law and appears to be inconsistent with the Bond language.<sup>5</sup> These decisions are not reconcilable.<sup>6</sup>

This article focuses on causation and related issues in loan loss claims. It examines recent decisions highlighting the divide between the "proximate cause" jurisdictions and the "direct means direct" jurisdictions. It also discusses the elements of "reliance" and "good faith" required in connection with a bank's extension of credit under Insuring Agreements (D) and (E). Finally, it discusses how these issues may be impacted by language contained in the newest Standard Form Financial Institution Bond,<sup>7</sup> as well as the recently revised Form 24 Bond, and the new ISO Financial Institution Crime Policy for Banks and Savings Institutions.

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<sup>4</sup> In addition, Exclusion (v) of the Bond excludes "indirect or consequential" losses of any nature."

<sup>5</sup> Bogda M.B. Clark, Patricia H. Thompson & Michael A. Shafir, "Loss Resulting Directly From . . .": Causation Under the Financial Institution Bond and Similar Insurance Forms, IX FID. L.J. 25 (Oct. 2003).

<sup>6</sup> In two decisions rendered within a few months of one another, the first court claimed that the "majority" of federal courts followed the "proximate cause" test, while the second court claimed that the "majority" of jurisdictions followed the "direct means direct" approach. Compare *Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.*, 854 A.2d 378 (N.J. 2004) (adopting proximate cause test) with *RBC Mortgage Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 812 N.E.2d 728 (Ill. Ct. App. 2004) (adopting "direct means direct" approach).

<sup>7</sup> Financial Institution Bond, Standard Form No. 24 (revised Apr. 2004) [hereinafter 2004 FIB], reprinted in STANDARD FORMS.

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## **II. The Causation Requirement In Loan Losses Resulting From Employee Dishonesty**

Loan losses generally are excluded from coverage under the Bond.<sup>8</sup> Coverage is implicated only if the loan losses are the direct result of: (1) employee dishonesty under Insuring Agreement A;<sup>9</sup> (2) forgery or alteration of certain documents under Insuring Agreement D; or (3) forgery or alteration or counterfeiting of “Securities” under Insuring Agreement E.<sup>10</sup>

Two recent decisions involving employee dishonesty claims exemplify the conflict between those courts construing the Bond’s causation requirement as “proximate cause” and those courts which apply the “direct” causation requirement. In *RBC Mortgage Co. v. National Union Fire Insurance Co. of Pittsburgh*,<sup>11</sup> the appellate court held the “direct loss” element requires that the loss directly follow from the alleged employee dishonesty. The *RBC* court rejected the proximate

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<sup>8</sup> See Bond, Exclusion (c).

<sup>9</sup> Insuring Agreement (A) of the Bond provides coverage for:

(A) Loss resulting directly from dishonest or fraudulent acts committed by any 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 Employer or another person or entity. . .

As used throughout this Insuring Agreement, financial benefit does not include any employee benefits earned in the normal course of employment, including: salaries, commissions, fees, bonuses, promotions, awards, profit sharing or pensions.

<sup>10</sup> To further underscore the limitation of coverage under those Insuring Agreements D and E, the Bond also excludes: “(a) loss resulting directly or indirectly from forgery or alteration except when covered under Insuring Agreements (A), (D), (E) or (F); and (p) loss resulting directly or indirectly from counterfeiting, except when covered under Insuring Agreements (A), (E), or (F).” Bond, Exclusions (a), (p).

<sup>11</sup> 812 N.E.2d 728.

cause standard, finding that “the proximate cause analysis simply is too broad to capture accurately the intent behind the phrase “loss resulting directly from.”<sup>12</sup> Six weeks after the *RBC* decision, the New Jersey Supreme Court issued its decision in *Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.*,<sup>13</sup> which adopted a “proximate cause” standard in construing a crime policy’s “direct loss” requirement, and in so doing reversed the widely cited appellate opinion, which had adopted the “direct means direct” analysis.<sup>14</sup>

**A. THE *AUTO LENDERS* DECISION: DIRECT MEANS  
PROXIMATELY CAUSED**

*Auto Lenders*<sup>15</sup> involved alleged losses on twenty-seven auto loans originated by a Gentilini Ford, Inc. employee named Randy Carpenter. During an eleven-month period in 1997, Carpenter apparently falsified or fabricated loan application documents, including drivers licenses and pay stubs, to secure loans for otherwise uncreditworthy purchasers. Gentilini had a contract with Auto Lenders by which Auto Lenders financed Gentilini’s higher credit risk customers. If Auto Lenders approved the credit application, it would advance the purchase price to Gentilini, and take back an assignment of all of Gentilini’s rights under the sales contract, including any security interest in the vehicle.

Auto Lenders discovered Carpenter’s fraud in early 1998. After some of the loans went into default, Auto Lenders filed suit against Gentilini for fraud and breach of contract. In particular, Auto Lenders alleged that under the contract, it was entitled to require Gentilini to repurchase all outstanding installment contracts that had not yet been paid in full—not only those allegedly involving fraud. Auto Lenders demanded judgment in the amount of \$831,932.90.

Gentilini filed a third-party complaint against its insurer, Ohio Casualty, after its request for a defense and indemnity in the Auto

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<sup>12</sup> *Id.* at 717.

<sup>13</sup> 854 A.2d 378.

<sup>14</sup> *See, e.g.*, Clark, et al., *supra* note 5.

<sup>15</sup> 854 A.2d 378.

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Lenders suit was denied. Thereafter, Gentilini entered into a settlement with Auto Lenders for \$215,000, and pursued its claim against Ohio Casualty.

Ohio Casualty issued a Commercial Package policy to Gentilini which included an endorsement providing coverage for “direct loss of or damage to Business Personal Property . . . resulting from dishonest acts committed by any of your employees . . . .”<sup>16</sup> The trial court granted summary judgment in favor of Gentilini, concluding that Carpenter had engaged in twenty-seven separate “occurrences” which had resulted in a “direct loss.”<sup>17</sup> The appellate court reversed, finding that: (1) no manifest intent to cause loss or damage to Gentilini had been established; and (2) there was no direct loss because Carpenter had defrauded a third party, not his employer.

The New Jersey Supreme Court reversed the appellate court’s ruling on the issue of “direct loss,” holding that New Jersey would follow the “proximate cause” analysis rather than requiring a direct loss. It also remanded the matter back to the trial court, finding an issue of fact on manifest intent.<sup>18</sup> The court also rejected Ohio Casualty’s argument that Carpenter’s conduct constituted a single occurrence, and instead ruled that each loan loss would constitute a separate occurrence under the policy, entitling the insured to a separate limit or liability for each occurrence.<sup>19</sup>

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<sup>16</sup> 854 A.2d at 383 (emphasis added) (although not identical to the Bond, the Ohio Casualty insurance policy provided substantially similar coverage).

<sup>17</sup> The Ohio Casualty policy contained a \$5,000 limit of liability per occurrence. Occurrence was defined as: “All loss or damage: (1) Caused by one or more persons; or (2) Involving a single act or series of related acts.”

<sup>18</sup> 854 A.2d at 395. The appellate court interpreted the phrase “manifest intent” to require a finding of specific intent on the part of the dishonest employee to cause loss to the employer. The high court acknowledged the logic of the appellate court’s analysis in requiring that the employee have a subjective intent to cause loss, but held that New Jersey would follow the less stringent “substantially certain” test, which permits a finding of “manifest intent” based upon either a subjective or an objective analysis.

<sup>19</sup> *Id.* at 397.

The *Auto Lenders* decision is troubling, in part, because the factual analysis by the court is wholly inconsistent with its legal analysis. And, the legal analysis is in turn inconsistent with the language of the insurance policy.

With regard to the direct loss analysis, the court implicitly acknowledged that Gentilini suffered no direct loss when Carpenter obtained financing for the twenty-seven auto loans because Gentilini was paid in full for the automobiles. The court also held that Gentilini's \$215,000 settlement with Auto Lenders did not necessarily represent the insured's direct loss, because the amount "constitute[d] Gentilini's liability as a result of Carpenter's fraud," but that amount did not necessarily reflect Gentilini's losses with regard to the twenty-seven fraudulently obtained loans.<sup>20</sup> In fact, the court acknowledged that it had no information before it from which it could determine the amount of Gentilini's "direct" loss.<sup>21</sup> For example, it did not know if any of the purchasers had continued to make payments on the autos, and it did not know whether Gentilini or Auto Lenders retained the rights under the sales contracts to pursue recovery against the purchasers and/or the collateral. Thus, the court held that a direct loss existed, but it was not the loss which the insured had sought to recover (the \$215,000 settlement payment it made to Auto Lenders).

Notwithstanding that there was no evidence before the court reflecting the amount of any direct loss to Gentilini, the court held that Gentilini had in fact sustained some manner of direct loss under the proximate cause analysis. The court advanced three reasons for following the proximate cause analysis.

First, the court cited to non-fidelity bond cases<sup>22</sup> in New Jersey that applied a proximate cause test to determine whether coverage for certain losses was subject to exclusions for losses arising from certain

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<sup>20</sup> *Id.* at 398.

<sup>21</sup> *Id.* at 399.

<sup>22</sup> *Id.* at 385, (citing *City Search EDP, Inc. v. American Home Assurance Co.*, 632 A.2d 286 (N.J. Super. Ct. App. Div. 1993), *cert. denied*, 640 A.2d 848 (1994); *Franklin Packaging Co. v. Cal. Union Ins. Co.*, 408 A.2d 448 (N.J. Super. Ct. App. Div. 1979), *cert. denied*, 420 A.2d 340 (1980)).

causes.<sup>23</sup> It acknowledged that the cases arose out of different circumstances, but nevertheless utilized those cases as a basis for its determination.

Second, it asserted that a majority of federal courts had concluded that direct loss embodied a proximate cause standard. In particular, it cited to Second, Third, and Fifth Circuit opinions construing only New Jersey, Pennsylvania and Louisiana law.<sup>24</sup> It did not tally up the jurisdictions that had rejected the proximate cause test. Moreover, instead of examining the rationale for the adoption of the proximate cause test among some jurisdictions, but not others, the Court glossed over its decision, stating that there was “no sound reason why a proximate cause analysis should not be employed” and the test comported with the principle of broadly construing coverage provisions.<sup>25</sup>

Having rejected a direct loss requirement, the court went on to conclude that Gentilini had suffered a direct loss. However, the court’s attempted explanation as to what that direct loss consisted of is so obtuse, it contradicts facts in other portions of the opinion and, in fact, demonstrates that Gentilini suffered no direct loss. The court stated:

[W]e conclude that Gentilini sustained a direct loss of Business Personal Property as the result of Carpenter’s conduct when it was induced by his fraudulent acts to hand over automobiles in exchange for installment sales

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<sup>23</sup> *Id.* at 385-86, citing *Stone v. Royal Ins. Co.*, 511 A.2d 717 (N.J. Super. Ct. App. Div. 1981) (discussing cases arising out of errors and omissions policies and homeowner policies).

<sup>24</sup> *Id.* at 258-59, citing *Scirex Corp. v. Fed. Ins. Co.*, 313 F.3d 841, 850 (3d Cir. 2002) (under Pennsylvania law, company sustained “direct” loss when it was forced to redo clinical drug studies where nurses had falsified records); *FDIC v. Nat’l Union Fire Ins. Co. of Pittsburgh*, 205 F.3d 66, 76 (2d Cir. 2000) (decided under New Jersey law); *RTC v. Fid. and Deposit Co. of Md.*, 205 F.3d 615, 636 (3d Cir. 2000) (decided under New Jersey law); *Jefferson Bank v. Progressive Cas. Ins. Co.*, 965 F.2d 1274, 1281-1282 (3d Cir. 1992) (applying Pennsylvania law); *First Nat’l Bank of Louisville v. Lustig*, 961 F.2d 1162, 1667-68 (5th Cir. 1992) (applying Louisiana law).

<sup>25</sup> *Id.* at 387.

contracts signed by non-creditworthy customers. . . . By producing fictitious pay stubs and drivers' licenses for twenty-seven applicants, Carpenter skewed the indicators used by both Gentilini and Auto Lenders to determine an applicant's creditworthiness, thereby exposing Gentilini to a risk of default it would not have been willing to accept in the absence of fraud. Thus any loss to Gentilini resulting from the default of the purchasers on the sale of the automobiles was proximately, and therefore directly, the result of Carpenter's actions.<sup>26</sup>

First, Gentilini did not lose any money on the twenty-seven transactions. It was paid in full when it sold the autos—the downpayment was paid by the customer, and the balance was paid by Auto Lenders which then received an assignment of the sales contract and collateral. Once Auto Lenders paid Gentilini, Auto Lenders, not Gentilini, undertook any future risk of default.

Auto Lenders did not sue Gentilini to recover its net losses on any of the twenty-seven loans. It attempted to use Carpenter's conduct as a basis for invoking a provision in its contract with Gentilini, which would require Gentilini to buy back all of the installment contracts Auto Lenders had purchased. Thus, the claim against Gentilini involved: (1) a contract (the breach of which was not otherwise insured by Ohio Casualty); and (2) a claim for damages which far exceeded the scope of the alleged employee dishonesty.

While the court acknowledged that the settlement of the suit with Auto Lenders provided no indication of the amount of any direct loss to Gentilini, it nevertheless maintained that some sort of direct loss had occurred. Given the Court's own inability to identify any direct loss sustained by Gentilini as a result of Carpenter's conduct, its adoption of the proximate cause test without any substantive analysis is curious and unpersuasive.

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<sup>26</sup> *Id.*

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**B. THE *RBC MORTGAGE* DECISION: DIRECT MEANS DIRECT**

The decision in *RBC Mortgage Co. v. National Union Fire Insurance Co. of Pittsburgh*<sup>27</sup> was rendered six weeks before the *Auto Lenders* decision. The *RBC* decision contains no novel interpretation of the “directly resulting from” language of the Bond, but it does state in a logical and concise manner why the Bond requires a direct loss, not a proximately caused loss.

As in *Auto Lenders*, *RBC* involved an employee who falsified loan packages, which were then submitted to a third party who funded the loans. *RBC* and its subsidiary, First City Financial Corporation, engaged in mortgage banking. Brandon Earl was a loan officer with First City in 1999. Earl prepared a fraudulent loan package in the name of his spouse for \$450,000. In an apparent effort to conceal this personal loan, he prepared additional loan packages for other borrowers using borrowed or falsified documents.<sup>28</sup> He submitted these fraudulent loan packages to Evergreen Moneysource Mortgage Company,<sup>29</sup> which funded the loans and subsequently sold those loans to third party investors.

Pursuant to the agreement between First City and EMMC, once the loans were funded, they became the property of EMMC, which in turn paid a brokerage fee to First City. Under the agreement, First City warranted that the loan packages it submitted would not contain any untrue statements. In the event of a breach of warranty, First City was obligated to indemnify EMMC for resulting losses. After First City uncovered Earl’s fraud, it notified EMMC. EMMC filed suit against First City seeking damages resulting from its reliance on the fraudulent loan packages, and demanding that First City buy back the subject loans.

National Union issued a standard form fidelity bond to *RBC* and First City during the relevant period providing coverage under Insuring

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<sup>27</sup> 812 N.E.2d 728 (Ill. Ct. App. 2004).

<sup>28</sup> Unlike *Auto Lenders*, which appeared to involve actual auto sales transactions, in *RBC* the employee apparently fabricated the transactions giving rise to the mortgages.

<sup>29</sup> Hereinafter EMMC.

Agreement (A) for employee dishonesty. In April 2000, National Union was notified of the EMMC lawsuit, and declined to provide a defense. In October 2001, the EMMC suit was settled. RBC agreed to pay \$175,000 for losses incurred to date, and it agreed to indemnify EMMC, and one of EMMC's investors for future losses attributable to Earls' fraud. After National Union denied the claim on the basis that RBC's losses were not the "direct result" of the fraud, RBC and First City filed suit.

The trial court granted National Union's motion to dismiss the lawsuit, holding that on the face of the pleadings, RBC had not established a "direct loss" under Insuring Agreement (A) or (E).<sup>30</sup> On appeal, RBC argued that the term "direct loss" was ambiguous, and that the lower court should have adopted the proximate cause standard. RBC argued its losses were direct because they "emanate from the settlement agreement with EMMC, and manifest themselves in the form of a reduced market value of the fraudulent loans it re-purchased from EMMC, and the compensatory payments made to EMMC for losses already incurred."<sup>31</sup> In response, National Union asserted that RBC did not pay market value for the loans, and therefore did not suffer from any reduction in the market value of the loans. Rather, RBC received brokerage fees for each fraudulent loan. RBC's losses actually resulted from its contractual liability to EMMC.

The *RBC* court determined that the language requiring "losses directly resulting from" employee dishonesty in Insuring Agreement (A) required the insured to establish a direct loss or actual depletion of bank funds caused by the dishonest employee's acts.<sup>32</sup> It noted that the case law was resoundingly uniform on this issue.<sup>33</sup> Yet it did not simply rely

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<sup>30</sup> RBC did not appeal the question of coverage under Insuring Agreement (E). 812 N.E.2d at 731 n.2.

<sup>31</sup> *Id.* at 732.

<sup>32</sup> *Id.* at 733 (citing *FDIC v. United Pac. Ins. Co.*, 20 F.3d 1070, 1080 (10th Cir. 1994) and *Oriental Fin. Group v. Fed. Ins. Co.*, 309 F. Supp. 2d 216, 222 (D.P.R. 2004).

<sup>33</sup> While the *Auto Lenders* court relied upon federal court decisions construing New Jersey, Pennsylvania and Louisiana law, the *RBC* court cited to the following federal and state court opinions: *Vons Cos., Inc. v. Fed. Ins. Co.*,

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on these other decisions, it analyzed each issue and reached its own conclusions.

In particular, the RBC court analyzed another recent loan loss case, *Tri City National Bank v. Federal Insurance Co.*<sup>34</sup> *Tri City* also involved dishonest bank employees who, in collusion with others, defrauded two mortgage companies by assisting uncreditworthy borrowers to obtain loan funds. *Tri City* was sued by the mortgage companies and sought payment from its fidelity bond insurer. The insurer denied coverage on the ground that *Tri City* had not sustained a “direct loss” and subsequently obtained dismissal of *Tri City*’s coverage action on that basis.

The *Tri City* court rejected the insured’s contention that the “resulting directly from” language was ambiguous. In addition, it noted that even if the language were ambiguous, the language would not be construed strictly against the insurer because the language in the bond was jointly drafted by the banking and insurance industries.<sup>35</sup> The RBC court followed suit, finding the same language was “clear and unambiguous and must be afforded its plain and ordinary meaning.”<sup>36</sup> The court rejected RBC’s arguments that the phrase was ambiguous, stating:

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212 F.3d 489, 490-92 (9th Cir. 2000); *Lynch Properties Inc. v. Potomac Ins. Co. of Ill.*, 140 F.3d 622, 629 (5th Cir. 1998); *Foster v. Nat’l Union Fire Ins. Co.*, 902 F.2d 1316, 1318 (8th Cir. 1990); *City of Burlington v. W. Sur. Co.*, 599 N.W.2d 469, 472 (Iowa 1999); *Cent. Nat’l Ins. Co. v. Ins. Co. of N. Am.*, 522 N.W.2d 39, 42 (Iowa 1994); *Aetna Cas. & Sur. Co. v. Kidder Peabody & Co.*, 676 N.Y.S.2d 559 (App. Div. 1998); *Commercial Bank of Bluefield v. St. Paul Fire & Marine Ins. Co.*, 336 S.E.2d 552, 556 (W. Va. 1985); and *Tri City Nat’l Bank v. Fed. Ins. Co.*, 674 N.W.2d 617 (Wis. 2003). The court also cited to the appellate opinion in *Auto Lenders*, subsequently overruled by the New Jersey Supreme Court.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 795. See also Edward G. Gallagher, James L. Knoll & Linda M. Bolduan, *A Brief History of the Financial Institution Bond*, in FINANCIAL INSTITUTION BONDS 1 (Duncan L. Clore ed., 2d ed. 1998).

<sup>36</sup> *RBC Mortgage Co.*, 812 N.E.2d at 734, citing *Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 607 N.E.2d 1204 (Ill. 1992).

Despite RBC's insistence that the "policy language may be construed in more than one way," an ambiguity is not created simply because the parties disagree about the meaning of the policy language. Courts will not strain to find ambiguity in a policy where none exists and, here, the language of the bond makes clear that indemnification is restricted to only those losses occurring as [a] "direct" result of the employee's fraudulent acts. Although RBC observes correctly that the phrase is not defined in the policy, as are other terms, the mere absence of a definition does not itself render a policy term ambiguous."<sup>37</sup>

The court also rejected RBC's argument that the phrase should be interpreted in accordance with RBC's "reasonable expectation of coverage for this type of loss," noting that the drafting history of the bond negated RBC's claimed "expectations." It also declined to interpret the policy in a way that would "render the clause or policy inconsistent or inherently contradictory."<sup>38</sup>

If an employee's dishonesty causes losses to a third party, which then leads to litigation concluding in a judgment or settlement, the insured has not incurred a "direct loss" under a fidelity bond; the insured's loss is "indirect" and the third party's loss is "direct." To find coverage in these circumstances would convert a direct loss policy into a third party indemnity policy or liability policy, under which the liability insurer indemnifies its insured for the insured's "indirect" loss, but payment, in practical effect, runs directly to the third-party claimant.

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<sup>37</sup> *Id.* (citations omitted).

<sup>38</sup> *Id.* In contrast, the *Auto Lenders* court showed no hesitation in "rewriting" the policy so as to render certain terms meaningless. Although it acknowledged that the policy "read literally" limited all losses for employee dishonesty by an employee to \$5,000, it concluded that it would "not adhere to the text's literal limitation." Instead, it construed the policy to provide a separate limit of liability for "each loss of property . . . regardless of the number of employees that may have caused the loss." 854 A.2d at 276.

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In the absence of a third-party-claims clause, an insured's fidelity bond, unlike a liability policy, does not provide indemnity for vicarious liability for losses suffered by others arising from its employee's tortious conduct.<sup>39</sup>

The *RBC* court considered, but rejected the insured's argument that the "proximate cause" test should be utilized. Examining the decisions of the Third Circuit adopting that approach (relied upon in *Auto Lenders*), the court noted that in *Jefferson Bank v. Progressive Casualty Insurance Co.*:<sup>40</sup>

[T]he court acknowledged that the phrase "resulting directly from" suggests a stricter standard of causation than mere proximate cause, and requires more than a substantial cause, since the words imply that the loss must flow "immediately," either in time or space from the fraud.<sup>41</sup>

The *Tri City* case further distinguished *Jefferson* and its progeny, noting that those cases involved situations where the insureds had arguably sustained a loss of their own property, or property for which they were legally liable "and the question to be resolved was whether some intervening event broke the causal connection between the dishonest conduct of an employee and the insured's loss."<sup>42</sup>

The *RBC* court concluded:

[T]he proximate cause analysis simply is too broad to capture accurately the intent behind the phrase "loss resulting directly from." A "direct loss" must be

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<sup>39</sup> *Id.* at 733 (citations omitted).

<sup>40</sup> 965 F.2d 1274, 1281 (3d Cir. 1992).

<sup>41</sup> *RBC Mortgage Co.*, 812 N.E.2d at 736.

<sup>42</sup> *Id.* (citing *Tri City*, 674 N.W.2d at 624-625); see also *RBC Dain Rauscher, Inc. v. Fed. Ins. Co.*, No. CIV 03-2609DSDSRN, 2005 WL 1211367 (D. Minn. May 10, 2005) (bank's wire transfer of funds held for the benefit of claimant constituted a "direct loss.").

afforded its plain and ordinary meaning; “direct means direct.” To equate “loss proximately caused by” requires a strained reading of “direct loss,” which is a much narrower concept than “proximately caused loss.”<sup>43</sup>

### ***III. Causation Under Insuring Agreements D And E***

Insuring Agreements (D) and (E) provide coverage in the event that the bank relies upon the authenticity of certain documents, which ultimately are determined to be forged, altered, counterfeit, lost or stolen. Because these Insuring Agreements are very specific in terms of the documents subject to coverage under each agreement, and the conduct which triggers coverage, the analysis of coverage under these insuring agreements implicates both causation and related reliance issues. In general, under these agreements one must determine: (1) whether the loss involves the type of documents subject to coverage under (D) or (E); (2) if so, whether those documents were forged or altered (under Insuring Agreement D), or forged, altered, counterfeited, lost or stolen (under Insuring Agreement E); (3) whether the bank relied or acted “on the faith” of the authenticity of the document in extending credit or otherwise advancing funds; and (4) whether the bank’s suffered a loss “resulting directly from” the fraudulent, lost or stolen documents.

In analyzing these reliance and causation elements in connection with loan loss claims, most courts have required that the insured demonstrate both “loss causation” and “transaction causation.”<sup>44</sup>

[T]he insured must show that (a) it would not have made the loan in question had it been aware that forged documents were being pledged as loan security, and (b) absent the forgery, the documents would have had real monetary value, thus causing an economic loss to the

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<sup>43</sup> *RBC Mortgage Co.*, 812 N.E.2d at 736-37.

<sup>44</sup> Peter C. Haley, *Clause (E): The Continued Importance of Defined Terms and Causation Requirements in FINANCIAL INSTITUTION BONDS* 284 (Duncan L. Clore ed., 2d ed. 1998), cited in *Pine Bluff Nat’l Bank v. St. Paul Mercury Ins. Co.*, 346 F. Supp. 2d 1020, 1032 (E.D. Ark. 2004).

insured as a direct result of the forgery. This test insures that the loss will directly result only from an act of forgery rather than from a borrower's more generalized transactional fraud; transactional fraud is excluded from coverage, but discrete acts of forgery are not.<sup>45</sup>

In *Pine Bluff National Bank v. St. Paul Mercury Insurance Co.*,<sup>46</sup> the district court, applying Arkansas law, declined to impose a "transaction causation" requirement, concluding that it was not expressly required under Insuring Agreement E. There, the insured bank sustained a loss arising from a fraud perpetrated by its customer, Ralph Croy & Associates, Inc. The bank provided a line of credit to Croy, secured by assets and accounts receivables which, in this instance were copy machine leases. The bank's line of credit was calculated, in part, on a discounted value of the leases. After Croy defaulted on the loan, the bank discovered that the lease agreements provided to the bank had been altered to show a longer lease term, thereby inflating the borrowing base, and, in some instances, the leases contained forged signatures.

The bank's insurer moved for summary judgment under Insuring Agreements D and E. The district court granted summary adjudication as to Insuring Agreement D, concluding that the leases did not fall

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<sup>45</sup> *Id.*; see also *French Am. Banking Corp. v. Flota Mercante Grancolombiana, S.A.*, 752 F. Supp. 83 (S.D.N.Y. 1990), *aff'd*, 925 F.2d 603 (2d Cir. 1991) (where bills of lading on which credit was extended represented non-existent or previously completed transactions, bank would still have suffered losses even if signatures on bills of lading had been genuine, so no causal link between those documents and claimed losses from fraudulent scheme based on misrepresentations that goods were actually shipped); *Reliance Ins. Co. v. Capital Bancshares, Inc.*, 685 F. Supp. 148 (N.D. Tex. 1988) (where bank would have suffered same loss even if forged signature on bogus stock certificate had been genuine, loss not covered by banker's blanket bond); *Liberty Nat'l Bank v. Aetna Cas. & Sur. Co.*, 568 F. Supp. 860, 866-67 (D.N.J. 1983) (insured bank made loans secured by certificates of deposit purportedly issued to the borrowers by a company. While the signatures on the certificates may have been forged, the company had no assets and the court found no proximate causal connection between the forged signatures and the loss, as the loss was incurred because the assets represented by the forged document did not exist.).

<sup>46</sup> 346 F. Supp. 2d 1020 (E.D. Ark. 2004).

within any of the categories of documents enumerated under that provision. The court held that the leases fell within the definition of “Security Agreement” under Insuring Agreement E, but that there was no coverage based upon the bank’s alteration claim because the leases provided to the bank, although fraudulent, had not been altered. It denied summary judgment, however, on the bank’s forgery claim to the extent the leases bore forged signatures.<sup>47</sup> In particular, the court rejected St. Paul’s argument that the forged leases did not “cause” the loss because the bank would have suffered the same loss, even if the signatures been genuine.

The *Pine Bluff* court held that Insuring Agreement E does not expressly require that the forgery be the “sole” cause of the loss. The court reasoned that the phrase “loss resulting directly from” imposed only a “proximate cause” requirement on the insured, such that the bank’s loss could “have more than one proximate cause.”<sup>48</sup> In other words, the court held that the forged signatures need not “directly” cause the loss.

The court declined to follow the “direct” or “transactional loss” analysis adopted in *Liberty National Bank v. Aetna Life & Casualty Co.*<sup>49</sup> It concluded that the *Liberty National* court had improperly imposed an additional causation requirement, relying on the following passage from that case:

The Bond distinguishes 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. Thus, Insuring Agreements D and E protect against risks of authentication and genuineness. Section 2(e) *excludes* credit risks. . . . Given this division of risks within the Bond, the court concludes that the parties intended that

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<sup>47</sup> *Id.* at 1029 (court rejected the insured’s argument that the term forgery should be defined by reference to Arkansas criminal law, rather than pursuant to the Bond’s more limited definition of that term).

<sup>48</sup> *Id.* at 1030.

<sup>49</sup> 568 F. Supp. 860 (D.N.J. 1983).

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the Bank would assume the risk of the collateral being worthless.<sup>50</sup>

The *Pine Bluff* court construed the *Liberty National* opinion as utilizing the loan loss exclusion as a means to “narrow” the scope of the Insuring Agreement, which it concluded was contrary to Arkansas’ rules of contract interpretation and inconsistent with the language of the exclusion, which excepts losses otherwise covered under Insuring Agreements (A), (D) and (E).

However, *Liberty National* and its progeny are better understood to have interpreted the scope of Insuring Agreements (D) and (E) in conjunction with the language of the policy as a whole, including the exclusions, thereby giving effect to all provisions of the policy.

In *Liberty*, the insured bank sought to recover a loan loss on the basis that certificates of deposit provided as collateral were counterfeit and/or forged. The court granted a partial summary judgment to Aetna under Insuring Agreements (D) and (E) on its own motion, on the basis that even if the Bank were to establish forgery, it would still be unable to demonstrate that the forged documents directly caused the loss. The court explained its reasoning as follows:

The bond insures 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 guarantee[s] 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.

The allocation of such losses undoubtedly arises from the practicality of the situation. A bank cannot protect against counterfeit and forged documents. It can, on the other hand, investigate the assertions made therein through credit checks, appraisals, title searches, financial statements and the like.

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<sup>50</sup> *Id.* at 1031.

In this particular case the documents relied upon were not counterfeit but may have been forged. But even if counterfeit *and* forged, the loss sustained by the Bank was not caused by the lack of authenticity or genuineness of the documents. On the contrary, the loss was caused by the fact that the statements contained in the document were not true. The assets represented thereby did not exist. If the documents were authentic and their signatures genuine and authorized, the loss nonetheless would have occurred. The failure of the security was not because they were counterfeit or forged, but solely because the assets purportedly represented thereby were non-existent. This loss falls upon the Bank and not the bonding company by the terms and intent of the bond.<sup>51</sup>

Similarly, in *French American Banking Corp. v. Flota Mercante Grancolombiana, S.A.*,<sup>52</sup> the insured bank sustained a loss as a result of a loan made to a coffee company, secured by bills of lading for coffee shipments. The shipments were non-existent and the bank sued its insurer seeking to recover for the loss under Insuring Agreement (E), claiming the bills of lading were forged and/or counterfeit. The court held that the fraudulent bills of lading were not “counterfeit,” because they were not imitations of original documents. In addition, the court held that the bank failed to establish forgery, since it could not identify the signature on the bills of lading and therefore could not demonstrate that the signature was forged. As a separate basis for its decision, the court held that the loss was not covered under Insuring Agreement (E) “because the losses did not directly result from the purported forgery.”<sup>53</sup>

The court stated:

The language of the Bond is clear that in order for FABC to recover, the claimed loss must have resulted directly from FABC, in good faith, having given value

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<sup>51</sup> *Id.* at 863.

<sup>52</sup> 752 F. Supp. 83, 90-91 (S.D.N.Y. 1990).

<sup>53</sup> *Id.* at 90.

against bills of lading which “bears a signature which is a Forgery.” . . .

Here, FABC’s losses resulted not from the purported forgeries but from the Duque’s fraudulent scheme. FABC did not know who the authorized signatories of Flota were; FABC could not read the scribble on the bill of lading and had no idea whose name was purported to be represented thereby. 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. . . . Because the losses are not the direct result of FABC having “extended credit” or “otherwise acted” on the faith of the “signatures” on the bills of lading, those losses are not within the scope of Insuring Agreement (E) of the Bond.<sup>54</sup>

Like the *Auto Lenders* decision it follows, *Pine Bluff* is in the minority of jurisdictions that construe the “direct” loss requirement to mean “proximate cause,” thereby altering the intended risk allocation under the Bond.

#### ***IV. The Good Faith Requirement***

Insuring Agreement (E) provides coverage when an insured has sustained a “[l]oss resulting directly from the Insured having, in good faith . . . extended credit or assumed liability, on the faith of, any original” forged or counterfeit document which falls within the enumerated categories of (E). There is little case law construing this “good faith” requirement, even though it would appear to be another mechanism whereby the drafters of the Bond sought to ensure that banks would not obtain coverage for losses attributable to their own, commercially unreasonable conduct.<sup>55</sup> Although a bank’s mere

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<sup>54</sup> *Id.* at 90-91.

<sup>55</sup> *See, e.g.*, Uniform Commercial Code § 3-103(a)(6) (“‘Good faith’” means honesty in fact and the observance of reasonable commercial standards of fair dealing”).

negligence is insufficient to show that the bank failed to act in “good faith,” just what good faith means is less clear.<sup>56</sup>

In *Marsh Investment Corp. v. Langford*,<sup>57</sup> the Fifth Circuit, applying Louisiana law, upheld a judgment for the insured on the ground that the insured bank did not act in “good faith” in extending credit to John Langford and his mother, Eunice. Among other things, the bank restructured large debts owed by Langford in exchange for a new note and collateral, including a mortgage on a property owned by Marsh Investment Corporation. Langford was not an officer, director or shareholder of Marsh, so the bank requested a corporate resolution and a consent by the Marsh shareholders to the encumbrance of the property. The purported resolution was sent to the bank and consents were provided to the attorney for Langford. Langford’s attorney also prepared a letter to the bank in which he indicated he had not conducted an investigation of the corporation and he would “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.”<sup>58</sup>

The bank did no further investigation regarding Langford’s authority to encumber the Marsh property and proceeded with the restructure and subsequently advanced more funds to Langford. Subsequently, it was determined that Langford had no authority to encumber the property, the resolution and consents were false and Langford declared bankruptcy.

The trial court held that the bank had failed to act in good faith and the appellate court affirmed. On appeal, the parties did not dispute and the appellate court accepted the trial court’s definition of bad faith that: “mere ignorance is not bad faith, but that if one ‘chooses to remain

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<sup>56</sup> See, e.g. *First Nat’l Bank of Fort Walton Beach v. United States Fid. & Guar. Co.*, 416 F.2d 52 (5th Cir. 1969).

<sup>57</sup> 721 F.2d 1011 (5th Cir. 1983).

<sup>58</sup> *Id.* at 1013.

ignorant . . . in fear of what a little knowledge will disclose . . .’ such ‘selective ignorance’ is bad faith.”<sup>59</sup> The appellate court concluded:

Suffice it 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.<sup>60</sup>

In *First National Bank v. Hartford Accident & Indemnity Co.*,<sup>61</sup> the court appeared to combine an analysis of “good faith” and “reliance,” and found that the insured did not extend credit “on the faith of” a settlement agreement which the bank had been provided by its customer — even though the bank asserted it had “relied” on the agreement. The court concluded there were too many facts in the bank’s possession which demonstrated that the altered settlement agreement provided by the customer was bogus, such that the bank could not have reasonably relied on the agreement. Among other things, the settlement agreement, which was supposed to evidence forthcoming payments to the bank customer, instead provided by its own terms that the customer had already been fully paid and no further payments would be made. In addition, the bank discovered that a photocopy of a settlement check provided by the customer for \$54,822.40 was in fact only for \$4,822.40. The trial court wrote:

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<sup>59</sup> *Id.* at 1014.

<sup>60</sup> *Id.*

<sup>61</sup> 295 N.W.2d 425 (Iowa 1980).

This court declines to believe that any reasonable person, much less a banker of Mr. Stinson's stature and experience, could possibly have given any credence to the altered figures in the termination agreement, given the irreconcilable conflicts and contradictions in the information he had available to him after learning what he learned from the IRS and the Omaha bank.<sup>62</sup>

The appellate court agreed with the trial court's determination that the bank could not have "relied" on the information provided to it by the customer under that circumstance.

In *Stix Friedman & Co. v. Fidelity & Deposit Co. of Maryland*,<sup>63</sup> the insured had accepted stock certificates from another broker which the insured thought were for one company, but were actually for a similarly named company whose certificates had a much lower value, causing loss to the insured. An issue at trial was whether the insured had acted in good faith in accepting the lower valued stock certificates. The jury instructions on good faith utilized during trial provided:

The Court instructs the jury that "good faith" means freedom from knowledge of circumstances which ought to put a person upon inquiry. This includes the exercise of reasonable discretion under the circumstances, and an honest effort to ascertain the facts and to make a determination based upon such ascertained facts.<sup>64</sup>

The court acknowledged that this good faith standard included both subjective and objective components as follows:

The definition of good faith agreed to by the parties and appearing in the jury instruction goes beyond a requirement of a mere subjective, innocent and honest belief in the lawfulness and correctness of some action. . . . In addition to this basic requirement, the

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<sup>62</sup> *Id.* at 428-29.

<sup>63</sup> 563 S.W.2d 517 (Mo. Ct. App. 1978).

<sup>64</sup> *Id.* at 521.

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parties' definition and jury instruction require that [the insured's] acceptance of the certificates be reasonable under the circumstances. In terms of the U.C.C. this means that the action be 'commercially reasonable.' [citations omitted.]<sup>65</sup>

Thus, while some courts have construed the "good faith" requirement as only requiring honesty in fact,<sup>66</sup> other courts have also imposed an objective or commercially reasonable requirement, which would appear to be more consistent with business practices, the Uniform Commercial Code, and the intended scope of coverage under the Bond.

### V. New Forms

The 2004 edition of Standard Form 24 does not revise the "arising directly from" causation requirement of the earlier bond form. As a result, cases construing the earlier form will remain relevant. However, the 2004 Bond alters the scope of the loan loss exclusion. In particular, the loan loss exclusion no longer includes an exception for losses otherwise covered under Insuring Agreement (D). The 2004 Bond contains a new Insuring Agreement for fraudulent mortgages, and the loan loss exclusion contains an additional exception for loan losses under Insuring Agreement (G).

Exclusion (t) of the 2004 Bond now precludes coverage for:

Damages of any type for which the Insured is legally liable, unless the Insured establishes that the act or acts which gave rise to the damages involved conduct which would have caused a covered loss to the Insured in a similar amount in the absence of such damages.<sup>67</sup>

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<sup>65</sup> *Id.* at 521-22.

<sup>66</sup> *See, e.g.,* Citizens Bank of Oregon v. Am. Ins. Co., 289 F. Supp. 211, 214 (D. Or. 1968) (no more than honesty on the part of the insured is required to act in "good faith").

<sup>67</sup> 2004 Bond, Exclusion (A).

This language would appear to further bolster the bond's "direct loss" requirement by requiring "transaction causation" in addition to "loss causation." For example, there would be no coverage in the *Auto Lenders* case because, absent the third party lawsuit, the auto dealer had not sustained damages resulting from its employee's misconduct.

The new Insurance Services Office Financial Institution Crime Policy for Banks and Savings Institutions<sup>68</sup> contains a separate insuring agreement for loan losses, which requires that the "loss [be] caused directly by such dishonest or fraudulent acts committed by the employee, and further that the employee must have "specific intent" to cause the insured to sustain loss and to obtain an improper financial benefit. While this language also imposes a direct causation requirement, it remains to be seen whether those jurisdictions applying a proximate cause test will conclude that direct means direct.

### ***VI. Conclusion***

Despite the fact that the Bond has been in existence nearly twenty years, the dispute over the causation standard continues. As a result, a loan loss may be covered in one jurisdiction but not in another. Because the applicable causation standard may prove determinative in whether coverage is found to exist for loan losses, this issue should be thoroughly analyzed in connection with the initial claim investigation. In addition, in those jurisdictions which have not ruled upon the proper causation standard, particular care should be taken to provide the courts with the relevant history of the Bond and case law to highlight the correlation between the language and the intended risk allocation.

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<sup>68</sup> Crime Protection Policy (Discovery Form), CR 00 22 07 02 (March 2002), *reprinted in* HANDLING FIDELITY BOND CLAIMS (Michael Keeley & Sean Duffy eds., 2d ed. 2005).