

Warehouse Lending Losses Under the Financial Institution Bond

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I. Introduction

The average first-time homebuyer in the United States probably assumes that he or she will make their monthly mortgage payment to the same lender for the life of their loan. Twenty-five years ago, this might have been true. In today's market, this rarely is the case. As anyone who has received a notice letter directing them to start making their mortgage payments to a different company likely realizes, mortgage loans can be, and frequently are, bought and sold. This happens for a variety of reasons, one of which is the fact that many mortgage bankers simply do not have adequate capital to invest in and service the mortgage loans they make. Thus, many sell them to investors in the secondary investment market, often as part of a large pool of loans. These pools of loans are then divided into smaller investment units known as mortgage-backed securities.¹ The mortgage-backed securities are then sold to institutional or individual investors.² Thus, it is very likely that the first-time homebuyer's mortgage payment actually ends up in the pockets of institutional or individual investors far and wide.

¹ Mortgage-backed securities represent an investor's interest in the principal and/or interest payments due from their investment in a pool of mortgage loans. See U.S. Sec. & Exch. Comm'n, <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Aug. 19, 2006).

² *Id.*

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The typical mortgage banker's lack of capital also may give rise to the need for interim financing in order to fund and close the mortgage loans he or she originates. This is where warehouse lending often comes into play. Warehouse lenders provide mortgage bankers with short-term, revolving lines of credit that enable them to fund and inventory residential home mortgage loans until they are sold into the secondary market. The proceeds from the sale of the mortgage to the secondary market investor are then applied to pay off the corresponding warehouse loan.

The warehouse lending industry in the United States has experienced strong growth in recent years. Initially a niche market representing few lenders, the demand for warehouse lending has increased rapidly in recent years due to the continued growth in the mortgage lending industry and increased interest by investors in mortgage-backed securities.³ The number of warehouse lenders in the United States has doubled in the last decade.⁴ A recent survey conducted by the Reynolds Group, a mortgage banking consulting firm in Summit, New Jersey, estimates that total warehouse lender commitments and outstanding advances to mortgage bankers recently reached approximately \$270 billion and \$116 billion respectively.⁵

Due in part to the rapid growth in warehouse lending, the complexity of the warehouse lending process, and the increasing sophistication of criminals, fraud against warehouse lenders, commonly in the form of forged or altered loan documents, has grown significantly in recent years. In response, warehouse lenders increasingly are looking to fidelity insurers to absorb some or all of the resulting losses. However, as discussed at length in this article, fidelity policies rarely cover such losses.

This article begins with an overview of the basic mortgage lending process, including the structure, processes, and parties involved

³ Stanley Street, *Warehouse Lending Comes of Age: Automation is Bringing New Efficiencies and Transparency to the Business of Warehouse Lending*, in MORTGAGE BANKING 96 (Mar. 1, 2006).

⁴ *Id.*

⁵ Survey by the Reynolds Group, Summit, New Jersey (May 2006) (on file with the Reynolds Group).

in warehouse lending. It then explores the type of fraudulent losses most often experienced by warehouse lenders and provides analysis of many of the potential coverage issues raised by such claims under Insuring Agreements (D) and (E) of the 1986 and 2004 standard form Financial Institution Bonds⁶ and Insuring Agreement (G) of the 2004 Financial Institution Bond.⁷ This article concludes that, because the Financial Institution Bond generally excludes loan losses,⁸ and because of the structure and processes used by warehouse lenders in funding mortgage loans, warehouse loan losses from forged or fraudulent mortgage loan documents will rarely, if ever, be covered under the Financial Institution Bond.

II. Warehouse Lending and the Mortgage Banking Industry

A. THE MORTGAGE LENDING PROCESS

To understand the warehouse lending process, it is necessary to start with an understanding of its place in the mortgage lending industry. The mortgage lending process typically begins when a prospective buyer contacts a mortgage banker or broker⁹ seeking financing for the purchase

⁶ Financial Institution Bond, Standard Form No. 24 (revised Jan. 1986), reprinted in STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA) [hereinafter 1986 Financial Institution Bond]; Financial Institution Bond, Standard Form No. 24 (revised April 2004), reprinted in STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA) [hereinafter 2004 Financial Institution Bond].

⁷ The typical warehouse lending loss involves forgery or alteration of mortgage loan documents by a mortgage banker or his representative. Accordingly, Insuring Agreement (A) is less likely to be relevant than Insuring Agreement (D) or (E) in this context. However, it certainly is not inconceivable that an employee of a warehouse lender could participate in a mortgage banker's scheme to defraud the warehouse lender. Nonetheless, analysis of the potential coverage issues under Insuring Agreement (A) is beyond the scope of this article.

⁸ Financial Institution Bond, § 2(e).

⁹ In the traditional sense, the term "mortgage banker" is defined as a business enterprise that originates, underwrites, funds, and services residential mortgage loans. See generally Joe Garrett, *The Unbundling of an Industry*, in MORTGAGE BANKING 12 (May 1993). The term "mortgage broker" traditionally refers to a business enterprise that merely procures the original loan application

of a home. The prospective buyer will be asked to complete a loan application and provide it to the mortgage banker, along with various documents required for underwriting, such as bank statements, retirement account statements, W-2 earnings statements, and employment and income verification documents. Once this is done, the mortgage banker undertakes a several step underwriting process that includes review of the loan application and other documents provided by the buyer, receipt and review of an appraisal report on the house, and review of the borrower's credit report. During this period, the mortgage banker also is likely arranging for the loan to be sold into the secondary investment market.

After completing its underwriting, if the loan is approved, the mortgage banker then prepares the necessary loans documents¹⁰ and forwards them to the closing agent who actually transacts the loan closing for the mortgage banker. The closing process typically is carried out by an attorney or a title company agent chosen by the mortgage banker or the borrower. At closing, the borrower signs the promissory note, the mortgage or deed of trust, and any other necessary documents. The documents are then forwarded to the lender. The loan proceeds are then distributed to the seller through the closing agent and the loan is closed.¹¹ From the perspective of the home buyer and seller, this is the end of the process.

B. HOW WAREHOUSE LENDING FITS INTO THE PICTURE

Because many mortgage bankers do not have adequate capital to fund the mortgage loans they originate, many enter into revolving funding arrangements with large banks or other lenders—called warehouse lenders—to provide the necessary cash to close mortgage

and supporting documents and forwards them to a mortgage lender in exchange for a fee. *Id.* However, in today's mortgage lending industry, the roles of these entities often overlap. For simplicity's sake, this article uses the term "mortgage banker" generally to describe the entity that underwrites and funds residential mortgage loans through a warehouse lending arrangement.

¹⁰ Such documents typically include the promissory note, mortgage or deed of trust, and an assignment.

¹¹ Depending on the relevant state's law, mortgage loans can be funded either before or after the lender receives the signed, original loan documents.

loans. Warehouse lending is a form of asset-based financing (secured by the original promissory note) that provides mortgage bankers with a short-term source of funds to close and/or inventory mortgage loans until those loans are purchased by secondary market investors. The term “warehouse” reflects the short-term nature of the funding relationship on each loan or pool of loans between the mortgage banker and the warehouse lender. In most cases, the mortgage banker will borrow funds from a warehouse lender for a short period of time ranging between fifteen to sixty days, depending on how long it takes for the loan to be sold into the secondary market.

Many warehouse lenders will not agree to fund mortgage loans unless the mortgage banker has received a commitment from a secondary market investor to purchase the loan.¹² This requirement, which greatly reduces the risk to the warehouse lender, stems from the short-term nature of warehouse lending and the warehouse lender’s apparent concern that most mortgage bankers do not have the ability to timely repay their warehouse loans, absent the purchase commitment from the secondary market investor.¹³

Once the secondary market investor agrees to purchase the loan, the investor sends the purchase funds directly to the warehouse lender who then applies the proceeds to pay off the mortgage banker’s loan principal with the warehouse lender. The warehouse lender then nets out its fees and interest on the transaction and remits the remaining balance of the funds to the mortgage banker. This fund balance represents the mortgage banker’s revenue on the transaction. This cycle can repeat itself many times each month, depending on the volume of mortgage loans originated by the mortgage banker.

¹² See Thomas LaMalfa, *The Inside Line on Warehouse Lending*, in MORTGAGE BANKING 51 (Nov. 1990) (noting that most warehouse lenders require evidence of a purchase commitment from secondary market investors before funding a loan); Warehouseline, Ltd., <http://www.warehouseline.com/requirements.cfm> (last visited Aug. 15, 2006) (noting that a “purchase commitment from investor—investor lock” is required before the company will fund a loan).

¹³ *Id.*

C. THE FLOW OF FUNDS—“WET” FUNDING VS. “DRY” FUNDING

Warehouse loans typically fall into two categories: (1) “wet” funded loans; and (2) “dry” funded loans. “Wet” funding occurs when the warehouse lender funds a loan at or near the time of closing but before receiving the original loan documents signed by the borrower.¹⁴ “Dry” funding, on the other hand, occurs when the lender funds the loan only after it receives the signed, original loan documents.¹⁵

Understanding the distinction in timing between “wet” and “dry” funding is critical to analyzing any warehouse lending loss under the Financial Institution Bond. One of the important risk components for any warehouse lender is the level of control it has over the original executed promissory note because the promissory note represents the warehouse lender’s collateral. And, as could be expected, the risk of fraud is substantially greater with “wet” funded loans since the warehouse lender does not have possession of the original loan documents at the time it funds the loan.

III. Analysis of Coverage Issues Under the Financial Institution Bond

Although the warehouse lender faces many risks that could result in loss, the most common type of warehouse lending loss presented to fidelity insurers arises when a mortgage banker, acting in collusion with the closing agent, submits forged or fraudulent loan documents to the warehouse lender and diverts the loan proceeds to his or her own use before the fraud is discovered. In such a scenario, the ostensible borrower never receives the loan proceeds and likely never even knew that a loan had been applied for in his or her name. And, because warehouse lending is specifically designed to allow mortgage bankers to close more loans, more quickly than they would otherwise have the

¹⁴ *Id.* (noting that wet funding occurs “solely on receipt of copies of” the original loan documents).

¹⁵ The terms “wet” and “dry” refer to the ink used to sign the loan documents. The analogy is that “wet” loans are funded before the ink on the loan documents has had time to dry. Paul Muolo, *Wall Street Horns in on Mortgage Lending*, U.S. BANKER, Feb. 1994, at 36.

capital to handle, dishonest mortgage bankers can cause significant losses in a relatively short period of time.

This article focuses primarily on this type of forgery related loss. However, where appropriate, other potential types of fraud resulting in loss to the warehouse lender also are addressed.

A. INSURING AGREEMENT (E)—SECURITIES

In the context of warehouse lending losses, Insuring Agreement (E) of the Financial Institution Bond generally provides two potentially applicable coverage provisions. The first, Insuring Agreement (E)(1), arises in cases where an insured claims that its loss was caused by forged or altered loan documents. The second, Insuring Agreement (E)(3), arises when the insured claims that its loss resulted from counterfeit loan documents. Analysis of the case law related to these provisions, of which there is almost none in the warehouse lending context, and the structure of most warehouse lending arrangements, strongly suggests that warehouse lending losses will rarely be covered by Insuring Agreement (E).

Insuring Agreement (E) of the 1986 version¹⁶ of the Financial Institution Bond provides, in relevant part, as follows:

- (E) Loss resulting directly from the Insured having, in good faith, for its own account or for the account of others,
 - (1) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of, any original
.....
 - (c) deed, mortgage or other instrument conveying title to, or

¹⁶ The 2004 version of the Financial Institution Bond is, for purposes of analysis of warehouse lending claims, identical to the 1986 version.

creating or discharging a lien upon, real property,

....

(e) Evidence of Debt,

which

(i) bears a signature of any maker, drawer, issuer, endorser, assignor, lessee, transfer agent, registrar, acceptor, surety, guarantor, or of any person signing in any other capacity which is a Forgery, or

(ii) is altered,

....

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

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.

In order to establish coverage under Insuring Agreement (E) for losses allegedly resulting from fraudulent loan documents, a warehouse lender insured must establish: (1) a loss; (2) resulting directly from the

insured having; (3) in good faith; (4) extended credit or otherwise acted in reliance upon; (5) any forged, altered, or counterfeit; (6) promissory note, mortgage, deed of trust or security assignment; and (7) the insured had actual physical possession of the subject document at the time the loan was funded.¹⁷

1. Typical Coverage Issues Under Insuring Agreement (E)

a. The “actual physical possession” requirement

Because many warehouse lenders actually fund mortgage loans at or very near the time of closing and before they receive the original loan documents signed by the borrower, Insuring Agreement (E)’s “actual physical possession” requirement frequently will be relevant to the insurer’s coverage analysis.¹⁸ Insuring Agreement (E) requires that the insured, its correspondent bank, or authorized representative have “actual physical possession” of the original of any of the enumerated documents upon which a claim is based as a “condition precedent” to the insureds having relied on the faith of such documents.¹⁹ Accordingly, in the context of a warehouse lending loss, an insurer must carefully analyze the flow of the loan documents and funds to determine whether the insured had “actual physical possession” of the loan documents at the time the loan was funded.

Courts that have considered this requirement uniformly have found that it is unambiguous and requires that the insured must establish

¹⁷ See *FDIC v. Fid. & Deposit Co. of Md.*, 827 F. Supp. 385, 391-92 (M.D. La. 1993), *aff’d*, 45 F.3d 969 (5th Cir. 1995); *First Fed. Sav. Bank v. Cont’l Cas. Co.*, 768 F. Supp. 1449, 1453 (D. Kan. 1991) (outlining elements (1), (2), (4), (5), (6) and (7)).

¹⁸ This requirement applies to both subsections (E)(1) and (E)(3) of the Financial Institution Bond.

¹⁹ A condition precedent is “any fact or event, subsequent to the making of a contract, which must exist or occur before a duty of immediate performance arises under the contract.” *Nat’l City Bank v. St. Paul Fire & Marine Ins. Co.*, 447 N.W.2d 171, 176 (Minn. 1989) (*citing* 5 SAMUEL WILLISTON, WILLISTON ON CONTRACTS § 666A (3d ed. 1961)). Where a condition precedent is not satisfied, no breach of contract can occur. *Quantum Mgmt. Group, Ltd. v. Univ. of Chicago Hosps.*, 283 F.3d 901, 905 (7th Cir. 2002).

that it, its correspondent bank, or its authorized representative actually had the signed, original loan documents in its possession at the time the loan was funded before coverage can exist.²⁰ For example, in *Republic National Bank v. Fidelity & Deposit Co. of Maryland*,²¹ the plaintiff bank claimed that it suffered losses covered under Insuring Agreement (E) as a result of its reliance on forged bills of lading pledged as security for a loan. The Eleventh Circuit disagreed, finding as a matter of law that the bank could not have acted in reliance on the forged bills of lading because it did not have them in its possession until *after* it had irrevocably committed to fund the subject loan. Similarly, in *Marsh Investment Corp. v. Langford*,²² the Fifth Circuit held that allegedly forged shareholder instruments could not form the basis for recovery under Insuring Agreement (E) “because the bank did not have actual physical possession of them at the [time it funded the loan].”²³

In the context of “dry” funded loans, the “actual physical possession” requirement typically will not be an issue because such loans

²⁰ *Republic Nat'l Bank v. Fid. & Deposit Co. of Md.*, 894 F.2d 1255, 1262 (11th Cir. 1990); *Marsh Inv. Corp. v. Langford*, 721 F.2d 1011, 1014 n.3 (5th Cir. 1983) (noting that “[t]he shareholder instruments could not form a basis of recovery because the bank did not have actual physical possession of them at the relevant time”); *Bancinsure, Inc. v. Marshall Bank, N.A.*, 400 F. Supp. 2d 1140, 1144 (D. Minn. 2005) (holding that, because the insured did not have actual physical possession of the original forged personal guarantees at the time it funded the loan, the insurer’s “contractual duty to indemnify never arose”); *First Fed. Sav. Bank*, 768 F. Supp. at 1456 n.1 (explaining in *dicta* that the plaintiff could not rely on copies of forged lien waivers as a basis for coverage under Insuring Agreement (E) because, *inter alia*, the plaintiff did not receive the copies until several weeks after it distributed the loan funds); *Nat'l City Bank*, 447 N.W.2d at 177-78 (holding that the insured was not entitled to indemnity under Insuring Agreement (E) because the insured did not have actual physical possession of the forged stock certificates offered as loan collateral before the insured funded the loan); *Hamilton Bank v. Ins. Co. of N. Am.*, 557 A.2d 747, 750 (Pa. Super. Ct. 1989) (holding that Insuring Agreement (E)’s requirement of actual physical possession was clear and unambiguous and required that the insured “physically possess the original [forged documents] at the time of extending credit before it may recover its losses”).

²¹ 894 F.2d at 1262.

²² *Id.* at 1263.

²³ 721 F.2d at 1014 n.3.

are funded only after the warehouse lender has received the signed, original loan documents. However, this issue must be closely reviewed in the context of “wet” funded loans because such loans are funded upon the warehouse lender’s receipt of “copies,” typically faxed, of the loan documents. Such transactions are more common than “dry” funding at least in part because of the perceived business advantages to a closing agent in being able to fund residential mortgages at closing rather than waiting until the warehouse lender receives the “originals” of the loan documents.²⁴ Such transactions must be carefully analyzed to determine whether the warehouse lender had possession of even “copies” of the loan documents prior to funding. If not, then the “actual physical possession” requirement of Insuring Agreement (E) will not have been met.

In response to this requirement, an insured may argue that the originating mortgage banker or closing agent,²⁵ one of whom likely had actual physical possession of the alleged forged documents at the time the loan was funded, was the insured’s “authorized representative,” thus satisfying the “actual physical possession” requirement. However, this argument should be unavailing as it would require a finding that the mortgage banker or closing agent was the agent of the warehouse lender.²⁶ Were a court to so hold, it would render meaningless the distinction between “wet” and “dry” funding in the warehouse lending context. Moreover, it would be extraordinary for a court to find that a

²⁴ LaMalfa, *supra* note 12, at 51.

²⁵ The “actual physical possession” requirement may also be satisfied if the insured’s “correspondent bank” had possession of the original loan documents at the time of funding. However, neither the mortgage banker nor the closing agent could be considered the warehouse lender’s correspondent bank. See American Banker Online, <http://www.americanbanker.com/glossary.html?alpha=C> (last visited Aug. 16, 2006) (defining a “correspondent bank” as “a bank that serves as a depository and provides banking services for another bank”); *Nat’l City Bank*, 447 N.W.2d at 175-76 (discussing proposed definitions of “correspondent bank” and impliedly approving a definition that would not encompass either a mortgage banker or a closing agent).

²⁶ See *Nat’l City Bank*, 447 N.W.2d at 176.

borrower was the agent of its lender, as the parties ostensibly are engaged in an arms-length transaction for each other's benefit.²⁷

b. The "original" document requirement under Insuring Agreement (E)(1)

Not surprisingly, as the market for warehouse lending has grown in recent years, so too has the demand for increased efficiencies in the funding process and data management in warehouse lending.²⁸ Warehouse lenders increasingly are embracing new technologies to reduce paper handling and increase capacity for warehouse lending relationships.²⁹ Against this backdrop, Insuring Agreement E(1) of the Financial Institution Bond requires that any of the enumerated documents upon which a claim is founded must have been an "original" document.³⁰ Thus, issues related to electronic, faxed, or photocopied versions of loan documents often arise in the warehouse lending context.

The word "original" is defined by Section 1(q) of the 2004 version of the Financial Institution Bond to mean "the first rendering or archetype and does not include photocopies or electronic transmissions even if received and printed." This definition has not been addressed in published case law to date. Nevertheless, the language of this provision is clear and unambiguous. Photocopies or electronic versions of loan documents do not constitute "originals" for purposes of Insuring Agreement (E)(1). Thus, a warehouse lender's argument to the contrary should be unavailing.

²⁷ See *RTC v. Aetna Cas. & Sur. Co.*, 831 F. Supp. 610, 618 (N.D. Ill. 1993).

²⁸ See Street, *supra* note 3, at 96.

²⁹ *Id.*

³⁰ The word "original" was not included as a defined term in the Financial Institution Bond until promulgation of the 2004 version. Section 1(q) of the 2004 Financial Institution Bond defines "Original" to mean "the first rendering or archetype and does not include photocopies or electronic transmissions even if received and printed." Because this definition has not been addressed in published case law to date, this section will analyze the courts' decisions regarding the original requirement under the 1986 Financial Institution Bond.

Unlike the 2004 version of the Financial Institution Bond, the 1986 version does not define the word “original.” Moreover, we have found no case addressing this undefined term in the context of electronic documents. Nonetheless, the existing case law addressing the “original” requirement under the 1986 Financial Institution Bond supports a reading in harmony with the new definition contained in the 2004 version of the Financial Institution Bond.

In *Hamilton Bank v. Insurance Co. of North America*,³¹ the insured sought coverage under Insuring Agreement (E)(1) for losses allegedly resulting from forged bills of lading that had been pledged as security for a series of loans. It was undisputed that the bank only had photocopies of the original bills of lading.³² The bank nonetheless argued that the photocopies qualified as “originals” because the term was subject to more than one reasonable meaning in the commercial setting. Finding that the loss was not covered, the court held that the term “original” was clear and free from ambiguity and that photocopies did not qualify as “original” documents. The court cited with approval the Black’s Law Dictionary definition of “original” which provides “[a]s applied to documents, the original is the first copy or archetype; that from which another instrument is transcribed, copied, or imitated.”³³ In dicta, the court noted that it found it “ludicrous” that the bank, “which certainly would not honor a photocopy of a check of nominal value, has the audacity to contend that it is reasonable to lend \$1.4 million based upon mere photocopies of duplicate bills of lading.”³⁴

In *Reliance Insurance Co. v. Capital Bancshares, Inc.*,³⁵ the Fifth Circuit held that bogus stock certificates did not constitute “original” documents within the meaning of Insuring Agreement E(1). The court held that the “original” requirement limits coverage to those documents, “which, apart from the forged signature or alteration (or loss

³¹ 557 A.2d 747 (Pa. Super. Ct. 1989).

³² *Id.* at 751.

³³ *Id.*

³⁴ *Id.*

³⁵ 912 F.2d 756, 758 (5th Cir. 1990).

or theft), are otherwise genuine, actual instruments of the kinds referenced which would have value as such.”³⁶

As this case and the new definition of the word “original” contained in the 2004 Financial Institution Bond make clear, only those loan documents containing the actual signature of the borrower (or the forger) qualify as “originals.” Photocopies, facsimiles, or electronic versions of such documents simply are not intended to be covered under Insuring Agreement (E)(1).

c. The “direct loss” requirement

Insuring Agreement (E) requires that the insured’s loss result “directly from” a covered cause of loss.³⁷ To establish that its loss was the direct result of forged loan documents, a warehouse lender must prove that, absent the forgery, the loan documents would have had real value.³⁸ Where the underlying documents would have been worthless even if the forged signature had been authentic, the loss cannot be said to have resulted “directly from” the forgery.³⁹

³⁶ *Id.* It should be noted that the court’s finding that the documents did not constitute originals because they were not otherwise genuine documents that would have had “value” otherwise, arguably could be characterized as simply a different name for the “resulting directly from” analysis employed by other courts.

³⁷ This requirement applies to both subsections (E)(1) and (E)(3) of the Financial Institution Bond. However, because no case law has addressed this issue in the context of alleged counterfeit loan documents, the analysis in this section focuses on forged loan documents.

³⁸ *KW Bancshares, Inc. v. Syndicates of Underwriters at Lloyds*, 965 F. Supp. 1047, 1053-54 (W.D. Tenn. 1997); *French Am. Banking Corp. v. Flota Mercante Grancolombiana*, 752 F. Supp. 83, 91 (S.D.N.Y. 1990); *Liberty Nat’l Bank v. Aetna Life & Cas. Co.*, 568 F. Supp. 860, 863 (D.N.J. 1983); *Ga. Bank & Trust v. Cincinnati Ins. Co.*, 538 S.E.2d 764, 765-66 (Ga. Ct. App. 2000).

³⁹ *Id.*; *but see Pine Bluff Nat’l Bank v. St. Paul Mercury Ins. Co.*, 346 F. Supp. 2d 1020, 1030 (E.D. Ark. 2004) (refusing to find that the “resulting directly from” language of Insuring Agreement (E) requires that the forgery be the sole cause of the loss and adopting, at least impliedly, a proximate cause standard).

The rationale for the strict causation requirement adopted by the majority of courts is clear. The Financial Institution Bond is not intended as a form of credit insurance—it does not insure against bad business decisions.⁴⁰ It allocates the risk that loan documents are forged to the insurer because a bank cannot reasonably take measures to protect itself from such risks.⁴¹ However, the risk that loan documents contain false information is allocated to the bank because banks are in the best position to investigate the assertions contained in loan documents through credit checks, appraisals, title searches, review of financial statements, and other similar efforts.⁴² Thus, if a bank fails to verify the existence or validity of collateral represented in forged loan documents and that collateral proves to be non-existent or of no value to the bank, the bank’s loss did not result “directly from” the forged loan documents but rather from the bank’s failure to conduct adequate due diligence—a risk the Financial Institution Bond clearly allocates to the bank.

This point is illustrated by several cases that have addressed the issue. For example, in *KW Bancshares, Inc. v. Syndicates of Underwriters at Lloyds*,⁴³ a customer sought a loan from the insured bank. In support of his loan application, the customer submitted a forged letter from his employer stating that the customer was entitled to a substantial bonus on a date certain in the future and that the employer would pay a specific portion of the bonus directly to the bank pursuant to an assignment by the customer.⁴⁴ Relying on this letter, the bank issued the loan. The customer ultimately defaulted on the loan, and the bank sought payment of the bonus from the customer’s employer. However, the customer was not actually entitled to a bonus, and the letter stating otherwise had been forged by the customer.⁴⁵

⁴⁰ *KW Bancshares, Inc.*, 965 F. Supp. at 1054-55 (citing *Republic Nat’l Bank v. Fid. & Deposit Co. of Md.*, 894 F.2d 1255, 1263 (11th Cir. 1990)); *Ga. Bank & Trust*, 538 S.E.2d at 766.

⁴¹ 965 F. Supp. at 1054-55.

⁴² *Id.*; see also *Nat’l City Bank v. St. Paul Fire & Marine Ins. Co.*, 447 N.W.2d 171, 177 (Minn. 1989).

⁴³ 965 F. Supp. at 1049-50.

⁴⁴ *Id.* at 1050.

⁴⁵ *Id.*

The bank filed a claim under its fidelity bond claiming that its reliance on the forged letter caused it to sustain a loss. Granting the insurer's motion for summary judgment, the court held that although the letter admittedly was forged, the bank's loss was not caused by the forgery.⁴⁶ The court explained as follows:

In this case, plaintiffs' loss did not result directly from having made [the loan] on the faith of the Crenshaw letter. Here, as in *Liberty National* and *French American Banking*, plaintiffs' loss was caused by the fact that the statements contained in the Crenshaw letter were not true—[the customer] was not entitled to an annual bonus Even if Crenshaw's signature . . . had been genuine, plaintiffs' loss would have occurred nonetheless because the alleged security, the Crenshaw letter, was worthless. It was worthless not because it was forged, but because [the customer] was not entitled to a bonus from [his employer]. Plaintiffs' loss, therefore, did not result directly from having made the [loan] on the faith of the Crenshaw letter.⁴⁷

Accordingly, where forged mortgage loan documents form the basis of a warehouse lender's claim, the insurer should consider whether the lender would have suffered the alleged losses even if the signatures on the loan documents had been authentic. If the losses would have been incurred irrespective of the forgery, there should be no coverage under Insuring Agreement (E).

⁴⁶ *Id.* at 1054; see also *Liberty Nat'l Bank*, 568 F. Supp. at 863 (holding that summary judgment for the insurer under Insuring Agreement E was appropriate because the assets represented by forged certificates of deposit allegedly relied upon by the plaintiff bank as collateral for the loan did not exist and that, therefore, the bank's loss was not "caused" by the forgery); *Ga. Bank & Trust v. Cincinnati Ins. Co.*, 538 S.E.2d 764, 766 (Ga. Ct. App. 2000) (holding that the bank's loss, allegedly caused by its reliance on forged letters of credit, was not covered by the Bond because the bank would have suffered the loss even had the letters of credit not been forged because the assets represented in the letters of credit did not exist).

⁴⁷ *KW Bancshares, Inc.*, 956 F. Supp. at 1054.

For example, if the house or other property represented in the allegedly forged loan documents never really existed, there should be no coverage. Similarly, if the ostensible borrower did not own the house represented in the loan documents, there should be no coverage. However, if the property represented in the loan documents did exist and was owned by the ostensible borrower, the insurer must consider whether, if the signatures on the loan documents had been authentic, the loan documents would have nonetheless been worthless.⁴⁸ The answer to this question may depend on the specific jurisdiction's interpretation and application of the federal Truth-in-Lending Act.⁴⁹

In the context of the typical warehouse lending loss, the ostensible borrower never receives the loan proceeds because they were embezzled by the mortgage banker or its representative. Accordingly, and depending on how the relevant jurisdiction interprets the TILA, even had the borrower's signature on the loan documents been authentic, the insured bank may not have been able to recover from the borrower if the loan documents would not have been enforceable against the borrower because the borrower never received the loan proceeds.

For example, in *Franck v. Bedenfield*,⁵⁰ the plaintiff, an assignee of a mortgage on the defendants' house, sought to foreclose on the mortgage for non-payment. In response, the defendant homeowners, who admittedly signed the mortgage documents, claimed rescission under the TILA. The borrowers claimed that the original mortgage transaction had never been "consummated," as that term is defined by the TILA, because the mortgage banker absconded with the loan proceeds before they were paid to the defendants.⁵¹ Finding for the defendants, the court held that "when the funds [from the loan] were never distributed to the consumer, he cannot be said to have been contractually obligated as a result of a credit transaction, and thus consummation

⁴⁸ This situation is most likely to occur in the context of a mortgage refinance, where the borrower already owns the house or property.

⁴⁹ Truth in Lending Act, 15 U.S.C. §§ 1601-1693r (2006) [hereinafter TILA].

⁵⁰ 494 N.W.2d 840 (Mich. Ct. App. 1992).

⁵¹ *Id.* at 841.

cannot be said to have occurred.”⁵² Accordingly, the defendants were permitted to rescind the loan transaction, and the plaintiff was required to discharge the mortgage.

Thus, in analyzing whether the underlying mortgage loan documents had value independent of the forgery, an insurer also should consider whether, if the signatures had been valid, the ostensible borrower would have nonetheless been able to rescind the promissory note and mortgage on the grounds that he or she never received the proceeds of the loan. If this is the case, an argument can be made that the loan documents would have been valueless to the warehouse lender irrespective of the forgery and that, therefore, the lender’s loss was not the “direct result” of the forgery as required by Insuring Agreement (E).

d. The “on the faith of” requirement

Both subsections (1) and (3) of Insuring Agreement (E) require that the insured act “on the faith of” the defective documents alleged to have caused the insured’s loss. Courts have interpreted this language to require that the insured establish that it “relied upon” the allegedly fraudulent documents in entering into the transaction that resulted in the insured’s loss.⁵³ Absent evidence of reliance, courts have declined to find coverage under Insuring Agreement (E).

⁵² *Id.* at 841; *but see* Gibson v. LTD Inc., 434 F.3d 275, 281-82 (4th Cir. 2006) (holding that a transaction is “consummated” for purposes of the TILA at the point the consumer signs a contract and after which he can no longer alter the terms, even where the other party to the contract retains the exclusive right to decide when and if it will execute the contract, because the focus is on the consumer’s obligation and not on the actual formation of a binding contract); Murphy v. Empire of Am., 746 F.2d 931, 934 (2d Cir. 1984) (holding that a transaction is “consummated” for purposes of the TILA “when the lender and borrower sign a contract obligating them, respectively, to lend and to borrow funds” because, after this point, either party can hold the other liable for damages for failure to comply with the contract’s terms).

⁵³ Republic Nat’l Bank v. Fid. & Deposit Co. of Md., 894 F.2d 1255, 1263 (11th Cir. 1990) (holding that insured must have *relied* on the forged bills of lading at issue); Exeter Banking Co. v. N.H. Ins. Co., 438 A.2d 310, 314 (N.H. 1981) (noting that “the phrase ‘on the faith of’ clearly signifies something

(i) Cases interpreting the “on the faith of” requirement

In *Continental Bank v. Phoenix Insurance Co.*,⁵⁴ the insured bank suffered losses when a corporate customer defaulted on a series of loans. Before making the loans, the bank required the corporation to provide personal loan guaranties from the corporation’s principals and the principals’ wives.⁵⁵ After the corporation defaulted on the loans, the bank discovered that the signature on a guaranty from the wife of one of the principals had been forged. The bank sought coverage under Insuring Agreement (E) arguing that its losses were caused by the forged loan guaranty.⁵⁶

At issue was whether the “on the faith of” language of Insuring Agreement (E) created a reliance requirement. Finding that it did, the court held that the “the phrase ‘on the faith of’ clearly signifies something done ‘in reliance upon.’”⁵⁷ The court then considered whether the bank had indeed relied on the forged loan guaranty in extending the credit. Adopting the trial court’s findings of fact, the court found that that the bank had not relied on the forged loan guaranty of the wife but rather had relied upon the creditworthiness and guaranties of the corporation’s principals.⁵⁸ Accordingly, the court held that the bank’s losses were not covered under Insuring Agreement (E).⁵⁹

In *Republic National Bank v. Fidelity & Deposit Co. of Maryland*,⁶⁰ the Eleventh Circuit took the “on the faith of” analysis a step further when it held that an insured bank’s loss was not covered under Insuring Agreement (E) when the bank’s reliance on forged documents was not commercially reasonable.⁶¹ In that case, the insured bank issued

done ‘in reliance upon.’”) (*citing* *Cont’l Bank v. Phoenix Ins. Co.*, 101 Cal. Rptr. 392 (Cal. Ct. App. 1972)).

⁵⁴ *Id.* at 911-12.

⁵⁵ *Id.*

⁵⁶ *Id.* at 912.

⁵⁷ *Id.* at 913.

⁵⁸ *Id.* at 914.

⁵⁹ *Id.*

⁶⁰ 894 F.2d 1255 (11th Cir. 1990).

⁶¹ *Id.* at 1263.

a letter of credit to a customer to facilitate the sale and purchase of six thousand bags of coffee. As security, the bank was provided with bills of lading for the coffee shipments.⁶² The customer ultimately defaulted on the loan issued. During its investigation of the loss, the bank determined that the bills of lading had been forged and that the coffee represented by the bills of lading did not exist.⁶³ The bank sought recovery for its losses under Insuring Agreement (E).

In considering the claim, the court found that the bank's losses were not covered because the bank had executed the letter of credit—thereby irrevocably committing itself to disburse the funds—*before* it had actual physical possession of the forged bills of lading.⁶⁴ However, the court went on to explain that the bank's claim was not covered for “another, more fundamental reason.”⁶⁵ “[A]ccepted standards of commercial reasonableness” precluded the bank from relying on the forged bills of lading.⁶⁶ The court explained that the bank could not “reasonably rely” on documents presented to secure the risk associated with financing a letter of credit, such reliance being “no more than a roll of the dice.”⁶⁷ Accordingly, the court found that the bank had not extended the credit in reliance upon the forged bills of lading but rather upon the customer's creditworthiness and guaranty.⁶⁸

The decisions in both *Continental Bank* and *Republic National Bank* establish that an insured must actually rely upon the defective documents in entering into the transaction alleged to have caused the insured's loss. Moreover, the *Republic National Bank* decision supports the argument that the insured's reliance must have been reasonable under the relevant circumstances. Thus, a warehouse lender seeking coverage under Insuring Agreement (E) should be required to establish not only

⁶² *Id.* at 1260.

⁶³ *Id.*

⁶⁴ *Id.* at 1262.

⁶⁵ *Id.* at 1263.

⁶⁶ *Id.*

⁶⁷ *Id.* (explaining that in the context of a letter of credit, banks typically are unable to verify the existence or value of the goods secured bills of lading because they are in transit—in this case, likely aboard ships at sea—and that the Financial Institution Bond does not insure against such risks).

⁶⁸ *Id.*

that it actually relied on the forged or counterfeit loan documents in making the loan to the mortgage banker, but also that its reliance in doing so was reasonable. However, the realities of warehouse lending suggest that warehouse lenders typically do not rely “on the faith of” the mortgage loan documents themselves.

(ii) Did the insured rely “on the faith of” the fraudulent loan documents?

In determining whether the warehouse lender relied “on the faith of” the alleged defective loan documents, the insurer first should determine whether the warehouse lender had “actual physical possession” of the loan documents before it funded the loan. Insuring Agreement (E) requires that the insured have “actual physical possession” of the enumerated documents as a “condition precedent to the Insured’s having relied on the faith of such items.” Because “wet” funded loans are, by definition, funded *before* the warehouse lender receives the original, signed loan documents, the warehouse lender should necessarily be precluded from establishing that it relied on the faith of the subject loan documents in this context.

In the context of “dry” funding, on the other hand, the warehouse lender has “actual physical possession” of the originals of the allegedly defective documents at the time the subject loan is funded. Thus, it is not automatically precluded from establishing that it relied on such documents in deciding to make the subject loan. Nonetheless, if the insurer’s investigation reveals that the bank did not actually rely on the allegedly defective documents or that the bank’s reliance was not reasonable under the circumstances, the loss should not be covered.

In considering whether the warehouse lender actually relied on the fraudulent loan documents, the insurer should thoroughly review and analyze both the subject documents and the processes and procedures used by the warehouse lender in deciding to make the loan at issue. The simple fact is that the structure and timing requirements of the typical warehouse lending arrangement dictate that most warehouse lenders do not actually rely, in any meaningful way—if at all—on the loan documents in deciding whether to fund a particular mortgage loan. In the authors’ experience, and due in large part to the timing constraints inherent to warehouse lending, warehouse lenders rarely, if ever, conduct

any due diligence on the creditworthiness of the underlying borrowers or the collateral represented by the loan documents, choosing instead to rely on the mortgage banker's underwriting of the mortgage loans.⁶⁹ Furthermore, many warehouse lenders base their decision to fund a given loan in large part on whether the mortgage banker has received a purchase commitment from a secondary market investor, thus insuring a quick payback on the loan.⁷⁰ Thus, in most cases the warehouse lender is not actually relying on the veracity of the loan documents themselves but on other external factors. While this may be standard practice in the warehouse lending industry, the Financial Institution Bond does not cover reliance on such external factors. Much like the letter of credit situation discussed by the Eleventh Circuit in the *Republic National Bank* case, such reliance amounts to "no more than a roll of the dice."⁷¹

In those cases where the evidence suggests that the warehouse lender did actually rely on the subject documents, if the evidence also suggests that its reliance was unreasonable under the circumstances, there should be no coverage. Evidence relevant to the reasonableness of a bank's reliance could include a forgery or an attempt to counterfeit another document that was so amateurish or sloppy that it would be unreasonable to rely upon the document without further inquiry. Obvious alterations to the document could also call into question the reasonableness of the insured's reliance. Similarly, knowledge by the insured of other facts that should have raised concerns about the transaction might also be relevant. For example, where the evidence suggests that the insured had concerns about the reliability or honesty of the mortgage banker or the veracity of the supporting loan documents but, whether based on negligence, prior dealing with the mortgage banker, or a corporate culture of tolerance for sloppy due diligence,

⁶⁹ Because warehouse lenders rely on the mortgage banker to insure that the underlying mortgage loan transaction is legitimate, most warehouse lenders conduct thorough underwriting and periodic review of the mortgage banker's creditworthiness, and its lending processes, procedures, and safeguards. See LaMalfa, *supra* note 12 (outlining the detailed underwriting procedures most warehouse lenders undertake before agreeing to extend a warehouse line of credit to a mortgage banker).

⁷⁰ *Id.* (noting that most warehouse lenders require a purchase commitment from a secondary market investor before agreeing to fund a loan).

⁷¹ *Republic Nat'l Bank*, 894 F.2d 1255, 1263 (11th Cir. 1990).

ignored such concerns, the reasonableness of the insured's reliance could be called into question.

e. The “Good Faith” requirement—Did the insured comply with reasonable banking standards?

In addition to the other requirements under Insuring Agreement (E), the insured's reliance on the enumerated documents must have been in “good faith.” The term “good faith” is not defined by either the 1986 or 2004 versions of the Financial Institution Bond. However, several courts have addressed this issue in the context of fidelity claims. And while the various courts' analysis of “good faith” is somewhat amorphous, the better definition of the term encompasses an objective analysis of whether the insured complied with reasonable banking standards in connection with the subject transaction.

In *Stix Friedman & Co. v. Fidelity & Deposit Co. of Maryland*,⁷² the court approved a jury instruction that defined “good faith” under a stock broker's blanket bond as “the exercise of reasonable discretion under the circumstances, and honest effort to ascertain the facts and to make a determination based on such ascertained facts.”⁷³ In *Marsh Investment Corp. v. Langford*,⁷⁴ the Fifth Circuit held that “mere ignorance is not bad faith, but that if one ‘chooses to remain ignorant . . . in fear of what a little knowledge will disclose . . .’ such ‘selective ignorance’ is bad faith.”⁷⁵ These courts' imposition of some duty of inquiry upon the insured comports with the Financial Institution Bond's general principle of allocating verifiable business risks to the insured.⁷⁶

⁷² 563 S.W.2d 517 (Mo. Ct. App. 1978).

⁷³ *Id.* at 521.

⁷⁴ 721 F.2d 1011 (5th Cir. 1983).

⁷⁵ *Id.* at 1014.

⁷⁶ See *Nat'l City Bank v. St. Paul Fire & Marine Ins. Co.*, 447 N.W.2d 171, 177 (Minn. 1989) (“[A] loss that could easily have been avoided is a business loss if sound business practice would have required some investigation.”); see also *Progressive Cas. Ins. Co. v. First Bank*, 828 F. Supp. 473, 474 (S.D. Tex. 1993) (“The bond is not credit insurance to protect the lender against improvident or reckless extensions of credit.”).

In analyzing the “good faith” standard in the context of a warehouse lending loss, the insurer should conduct a thorough investigation of the warehouse lender’s practices in underwriting potential mortgage bankers, its processes for the handling and review of loan documents, and the subject transaction itself. Where the evidence suggests that the warehouse lender failed to conduct adequate due diligence prior to approving the warehousing agreement with the mortgage banker alleged to have caused the loss, questions about the insured’s good faith and compliance with reasonable banking standards could be raised.⁷⁷ Similarly, if it is determined that the warehouse lender had previous problems with the mortgage banker, yet continued to extend credit anyway, the warehouse lender’s good faith could be an issue. Where the insured had possession of the fraudulent mortgage documents before funding the subject loan but choose not to review them, when such a review would have identified obvious problems, the insured’s compliance with reasonable banking practices, and thus its good faith, could also be questioned.

As these examples illustrate, the potential factual issues related to the “good faith” requirement are myriad. Thus, the insured should conduct a thorough investigation before making its coverage determination.

2. Insuring Agreement E(3) - Are the loan documents “counterfeit”?

In addition to the issues related to Insuring Agreement (E)(3) discussed previously in this article, the first question that should be considered when a claim is brought under this insuring agreement is whether the fraudulent mortgage documents are, in fact, “counterfeit.” Insuring Agreement E(3) provides as follows:

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

⁷⁷ Review of both published and unpublished literature on warehouse lending practices suggests that the initial underwriting of the prospective mortgage banker is one of the most important factors in reducing risk to the warehouse lender. *E.g.*, LaMalfa, *supra* note 12.

....

(3) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of a [deed, mortgage or other instrument conveying title to real property] which is a Counterfeit.

The 1986 version of the Financial Institution Bond defines the term “Counterfeit” to mean “an imitation which is intended to deceive and to be taken as an original.”⁷⁸ Courts interpreting this term generally have found that a document must imitate an authentic document in order to fall within the definition of “counterfeit.”⁷⁹ The definition requires that there must now be, or there must once have been, an original document that the alleged counterfeit document attempts to imitate.⁸⁰

In *FDIC v. Fidelity & Deposit Co. of Maryland*,⁸¹ the court considered whether a falsified public ordinance related to the grant of a cable television franchise constituted a “counterfeit” document under the definition cited above. In weighing the issue, the court noted that the falsified document bore the number of a genuine public ordinance and that it attempted to duplicate the general form of an authentic public ordinance.⁸² However, the court also noted that the genuine public ordinance was related to the number and location of voting districts within the City of Gulfport, Mississippi, and not the grant of a cable television franchise.⁸³ Accordingly, the court held that the falsified public ordinance was not an imitation of an authentic original document and thus was not a “counterfeit” under Insuring Agreement E(3).⁸⁴

⁷⁸ 1986 Financial Institution Bond, § 1(e).

⁷⁹ *French Am. Banking Corp. v. Flota Mercantile Grancolombiana*, 752 F. Supp. 83, 92 (S.D.N.Y. 1990), *aff'd*, 925 F.2d 603 (2nd Cir. 1991); *Nat'l City Bank*, 447 N.W. 2d at 180.

⁸⁰ *FDIC v. Fid. & Deposit Co. of Md.*, 827 F. Supp. 385, 393 (M.D. La. 1993), *aff'd*, 45 F.3d 969 (5th Cir. 1995).

⁸¹ 827 F. Supp. at 385.

⁸² *Id.* at 394-95.

⁸³ *Id.*

⁸⁴ *Id.* at 395.

Similarly, in *French American Banking Corp. v. Flota Mercantile Grancolombiana*,⁸⁵ the court was asked to determine whether fake bills of lading constituted “counterfeit” documents under the 1986 Financial Institution Bond. The insured plaintiff argued that, because the bills of lading at issue were created on the actual forms of the plaintiff company, contained authentic stamps of the plaintiff company, and appeared in all other ways to be valid bills of lading, they constituted “counterfeits” under the Bond. The insurer, on the other hand, argued that the documents did not constitute “counterfeits” because they were original bills of lading that simply referenced non-existent shipments and were not imitations of original existing bills of lading.⁸⁶ The court agreed with the insurer and held that the documents were not “counterfeits” because none of the bills of lading attempted to simulate an existing original document. The court reasoned that there were never two identical sets of bills of lading, one genuine and one falsified.⁸⁷

Some courts, however, have been more liberal in construing the meaning of the term “counterfeit.” For example, in *One American Corp. v. Fidelity & Deposit Co. of Maryland*,⁸⁸ a Louisiana appeals court held that fake stock certificates were “counterfeit” notwithstanding the fact that they differed from authentic stock certificates in several ways, including the fact that the fake certificates utilized different colors, border widths, printing styles, paper quality, and the locations of pictographs.⁸⁹ The court noted that unless the policy clearly specifies otherwise, the false documents “need not be precise in every detail for coverage to apply . . . [i]t suffices if the false document reasonably resembles the original and is not so inaccurate as to arouse suspicion.⁹⁰” However, the court’s opinion failed to address whether the fake stock certificates represented false versions of actual, existing stock

⁸⁵ 752 F. Supp. 83.

⁸⁶ *Id.* at 91.

⁸⁷ *Id.* at 94; *see also* *Union Planters Bank, N.A. v. Cont’l Cas. Co.*, Cause No. 02-CV-2321-Ma, unpublished Order on cross-motions for summary judgment, dated Aug. 23, 2004 (noting that the relevant inquiry is whether the alleged counterfeit documents intended to be passed off “as substitutes for the valid original documents”).

⁸⁸ 658 So. 2d 23 (La. Ct. App. 1995).

⁸⁹ *Id.* at 24.

⁹⁰ *Id.*

certificates. Accordingly, this decision represents a minority position among the courts addressing the definition of “counterfeit.”

Perhaps in response to decisions like *One American Corp.*, the drafters of the 2004 version of the Financial Institution Bond revised the definition of “counterfeit” to mean “a Written imitation of an actual, valid Original which is intended to deceive and to be taken as the Original.”⁹¹ Whatever the drafters’ intent, the addition of the phrase “actual, valid Original” makes the current definition more closely track the findings of the majority of courts that addressed the prior definition.

In light of the current definition of the word “counterfeit,” and/or the reasoning of the majority of courts that addressed this issue under the prior definition, an insurer investigating allegedly “counterfeit” mortgage loan documents must consider whether such documents constitute close imitations of actual documents that either exist or once existed. Where loan documents are created from whole cloth and not in the form of authentic, existing loan documents, such documents clearly should not constitute “counterfeits.”

In cases where the alleged counterfeit document is simply a copy of an authentic promissory note or mortgage from a previously executed transaction with the same borrower, the insurer must look more closely to determine if the differences between the original and the alleged counterfeit are sufficient to take the document outside the definition of “counterfeit.” Some issues to consider on this point include whether the alleged counterfeit loan documents contain the same loan number, the same interest rate, the same repayment terms, and the same transaction date as the valid original loan documents. In the case of alleged counterfeit loan documents, there almost certainly will be differences between the alleged counterfeit documents and any original valid loan documents that should take the claim outside the provisions of Insuring Agreement E(3).

⁹¹ 2004 Financial Institution Bond, § 1(e).

**B. INSURING AGREEMENT (D)—FORGERY OR ALTERATION OF
PROMISSORY NOTES**

Claims for losses arising out of fraudulent mortgage loan documents most commonly are brought under Insuring Agreement (E). However, warehouse lenders often also seek coverage under Insuring Agreement (D)(1), notwithstanding the fact that loan losses resulting from fraudulent promissory notes are intended to be covered, if at all, only under Insuring Agreement (E).⁹²

Insuring Agreement (D)(1) of the 1986 Financial Institution Bond⁹³ provides, in relevant part, 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

⁹² See *Statement of Change, Bankers Blanket Bond, Standard Form No. 24 (Revised to July, 1980)*, in ANNOTATED FINANCIAL INSTITUTION BOND 636 (Michael Keeley ed., 2d ed. 2004) (noting that the term “evidence of debt” was specifically excepted from the definition of “negotiable instrument” in Insuring Agreement (D) because coverage for evidences of debt exists, if at all, under Insuring Agreement (E)).

⁹³ It should be noted that Insuring Agreement (D) of the 2004 version of the Financial Institution Bond contains additional requirements for coverage not contained in the 1986 version. The relevant changes include the addition of the “good faith,” “original document,” “actual physical possession,” and “direct loss/reliance” requirements contained in Insuring Agreement (E) and analyzed previously in this article. As might be expected, these new requirements have not yet been addressed by the courts in the context of Insuring Agreement (D). Nonetheless, the analysis of these requirements under new Insuring Agreement (D) should not differ substantively from the courts’ analysis of the same requirements under Insuring Agreement (E). Accordingly, and because the core coverage provided by Insuring Agreement (D) is not changed by the 2004 additions, this section will address only those issues unique to Insuring Agreement (D)(1), whether under the 2004 or 1986 version of the Financial Institution Bond.

withdrawal of Property, Certificate of Deposit or Letter of Credit,

....

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

Thus, in order to establish coverage under Insuring Agreement (D)(1) for a forged or altered promissory note, an insured warehouse lender should be required to establish the following elements: (1) a loss; (2) that resulted directly from a forgery or alteration of; (3) a “negotiable instrument;” and (4) that is not also an “evidence of debt.”⁹⁴

In the context of a warehouse lending claim, the relevant issues unique to Insuring Agreement (D)(1) relate to the Financial Institution Bond’s definitions of the terms “negotiable instrument” and “evidence of debt.” Accordingly, the analysis in this section is limited to a consideration of whether the typical mortgage promissory note meets Insuring Agreement (D)(1)’s initial requirement that it be a “negotiable instrument” and, if it does, whether it also constitutes an “evidence of debt,” thereby taking it out of coverage under Insuring Agreement (D)(1).

1. Do Promissory Notes Constitute “Negotiable Instruments”?

Promissory notes typically are considered the quintessential form of negotiable instrument.⁹⁵ The usual analysis of whether a document constitutes a negotiable instrument involves application of the definition of “negotiable instrument” under the Uniform Commercial Code.⁹⁶

⁹⁴ See *First Fed. Sav. Bank v. Cont’l Cas. Co.*, 768 F. Supp. 1499, 1453 (D. Kan. 1991) (outlining elements 1-3).

⁹⁵ See *FDIC v. Philadelphia Gear Corp.*, 476 U.S. 426, 442 (1986) (noting that “promissory notes typically are negotiable instruments.”); BLACK’S LAW DICTIONARY 1085 (7th ed. 1999) (defining “promissory note” as a “negotiable instrument”).

⁹⁶ Hereinafter UCC.

However, the Financial Institution Bond defines the term “negotiable instrument” more narrowly than the UCC. Thus, while cases addressing the definition of the term “negotiable instrument” under the UCC may be instructive for analysis of Insuring Agreement (D) claims, they will not be determinative.

Section 3-104 the UCC defines the term “negotiable instrument” as follows:

(a) Except as provided in subsections (c) and (d), “negotiable instrument” means an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:

(1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;

(2) is payable on demand or at a definite time; and

(3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise or order may contain

(i) an undertaking or power to give, maintain, or protect collateral to secure payment,

(ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or

(iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor.⁹⁷

Section 3-106 of the UCC also is relevant. It provides as follows:

(a) Except as provided in this section, for purposes of Section 3-104(a), a promise or order is unconditional unless it states (i) an express condition to payment, (ii) that the promise or order is subject to or governed by another record, or (iii) that rights or obligations with respect to the promise or order are stated in another record. A reference to another record does not of itself make the promise or order conditional.

(b) A promise or order is not made conditional (i) by reference to another record for a statement of rights with respect to collateral, prepayment, or acceleration, or (ii) because payment is limited to resort to a particular fund or source.⁹⁸

Taken together, these subsections specifically permit promissory notes under the UCC to refer to other extraneous documents containing additional promises for certain purposes. The Financial Institution Bond's definition of "negotiable instrument" arguably does not permit such references. The term "negotiable instrument" is defined by the Financial Institution Bond as follows:

- (o) Negotiable Instrument means any writing
- (1) signed by the maker or drawer; and
 - (2) containing an unconditional promise or order to pay a sum certain in Money **and no other promise**, order, obligation or power given by the maker or drawer; and

⁹⁷ UCC § 3-104 (2005).

⁹⁸ *Id.* at § 3-106.

(3) is payable on demand or at a definite time; and

(4) is payable to order or bearer.⁹⁹

Thus, under the Financial Institution Bond, unlike the UCC, in order to qualify as a “negotiable instrument” the subject instrument can not contain any “other promise” beyond the promise to pay.

In the context of a real estate promissory note, any number of items arguably could take the instrument out of the Financial Institution Bond’s definition of “negotiable instrument.” For instance, a promissory note might refer to or incorporate the mortgage or deed of trust. Such documents typically impose other duties on the borrower beyond the mere promise to pay money, and thus the note should not be considered negotiable under the Financial Institution Bond because it contains another promise, at least by reference.

The following provision is an example of language commonly included in real estate promissory notes:

If Borrower defaults in the payment of this note or in performance of any obligation in any instrument securing or collateral to this note, Lender may declare the unpaid principal balance and earned interest on this note immediately due.¹⁰⁰

While it is arguable that this provision does nothing more than refer to the corresponding mortgage or deed of trust for purposes of acceleration of the promissory note, the language clearly indicates that the borrower has additional “obligations” provided for in the other instruments.¹⁰¹

⁹⁹ 1986 Financial Institution Bond, Conditions & Limitations, § 1(o) (emphasis added). This definition is unchanged in the 2004 Financial Institution Bond. 2004 Financial Institution Bond, Conditions & Limitations, § 1(p).

¹⁰⁰ REAL ESTATE FORMS COMM., STATE BAR OF TEXAS, TEXAS REAL ESTATE FORMS MANUAL 14-1 (1999).

¹⁰¹ Such “obligations” might include the requirement that the borrower pay property taxes or maintain insurance on house—both obligations that might be construed as additional promises. *But see* *Burn v. RTC*, 880 S.W.2d 149, 150

Arguably then, reference to or incorporation of a mortgage or deed of trust gives rise to an additional promise beyond the borrower's "unconditional promise to pay," thus making the promissory note non-negotiable under the Financial Institution Bond.

a. Negotiable Instruments under the Uniform Commercial Code

Because no case law has addressed the Financial Institution Bond's definition of "negotiable instrument" in the context of a real estate promissory note, insureds might be expected to argue that courts should look to the UCC's definition of "negotiable instrument" when determining whether a promissory note is a "negotiable instrument" under Insuring Agreement (D)(1). However, because the Financial Institution Bond's definition of "negotiable instrument" is more narrow than the UCC's, cases interpreting the UCC's definition should not control the analysis.

Most real estate promissory notes include reference to a mortgage or other security agreement. As a result, the UCC developed in a way that allowed such provisions to exist without destroying the negotiability of an instrument. Under the UCC the mere reference in a promissory note to protection of the collateral (those normally found in the mortgage or deed of trust), will not destroy negotiability. However, if the note is "subject to or governed by" other promises, negotiability is destroyed. Of course, this distinction does not exist under the Financial Institution Bond, and so even a note's "reference" to other promises should destroy negotiability. Thus, cases addressing this issue under the UCC should not be persuasive in affirming negotiability under the Financial Institution Bond. On the other hand, cases finding that an instrument is non-negotiable *should* be persuasive because of the narrower definition under the Financial Institution Bond.

In *Resolution Trust Corp. v. 1601 Partners, Ltd.*,¹⁰² the RTC filed suit against a partnership on a promissory note. The partnership asserted that the note was not a negotiable instrument due to the

(Tex. Ct. App. 1994) (holding that an obligation to pay taxes on property a securing note was not an "additional promise" that would destroy negotiability).

¹⁰² 796 F. Supp. 238 (N.D. Tex. 1992).

incorporation of a deed of trust. The note in that case stated that “[t]he terms, agreements, and conditions of the [deed of trust] are by reference made a part of this instrument.”¹⁰³ In discussing whether the note was conditional, the court explained as follows:

Section 3.105(b) of the UCC provides that a promise is not unconditional if the instrument states that it is subject to or governed by any other agreement. Here, the note states that “the terms, agreements and conditions of [the deed of trust] are by reference made a part of this instrument.” Courts hold that when an instrument incorporates by reference the terms of another document, the instrument becomes “subject to or governed by” another agreement for purposes of section 3.105(b) and the promise contained within the instrument, therefore, is rendered conditional.

Mere reference to a note being secured by a mortgage, of course, is commercial practice, and does not affect the negotiability of the note (citation omitted). The language within the note executed by 1601 Partners, however, exceeds the outer bounds of “mere reference,” as it explicitly purports to incorporate the terms of the Deed of Trust. Accordingly, the note is not a negotiable instrument under Texas law.¹⁰⁴

Thus, if the language in a promissory note goes beyond “mere reference” to extraneous documents and actually incorporates such

¹⁰³ *Id.* at 240.

¹⁰⁴ *Id.* (citations omitted); *see also In re Apponline.com, Inc.*, 285 B.R. 805, 815-17 (Bankr. E.D.N.Y. 2002) (noting that simple references to collateral mortgages in the notes did not destroy negotiability because neither note contained language that the notes were “governed by” or “subject to” the relevant mortgages); *FFP Mktg. Co. v. Long Lane Master Trust IV*, 169 S.W.3d 402, 407-09 (Tex. Ct. App. 2005) (noting that the notes failed the “unconditional promise” requirement because each note incorporated by reference the terms of both the loan and indenture agreements executed in conjunction with the transaction as well as the waivers, consents, and acknowledgments of the maker found in other loan documents, requiring one to examine those documents to determine if they placed conditions on payment.).

documents by reference, such promissory note should be considered conditional even under the UCC's broader definition of "negotiable instrument."

It should be noted that some courts draw a distinction under the UCC between incorporation of documents generally and incorporation of documents only for the purposes of accelerating a note. For example, in *Marriott v. Diversified Mortgage Investors*,¹⁰⁵ the court concluded, without explanation, that a reference in a note to another document solely for the purposes of identifying acceleration rights and remedies did not destroy negotiability.¹⁰⁶ Similarly, in *First Western National Bank v. Corona*,¹⁰⁷ the court held that a promissory note was negotiable, despite noting that it was secured by a deed of trust that "described how and under what conditions I may be required to make immediate payment in full of all amounts that I owe under this note."¹⁰⁸ As such, under the UCC's definition, acceleration clauses such as the sample promissory note language quoted above, arguably would not destroy negotiability. Importantly though, the Financial Institution Bond's definition of "negotiable instrument" is more narrow than the UCC's definition. Thus, cases interpreting the UCC definition, while instructive on some points, are not on others.

b. Negotiable Instruments under the Uniform Negotiable Instruments Law

Prior to the adoption of Article 3 of the UCC, negotiable instruments were governed by the Uniform Negotiable Instruments Law.¹⁰⁹ The definition of "negotiable instrument" under the UNIL more closely tracks the definition in the Financial Institution Bond. The UNIL defined "negotiable instrument" as follows:

An instrument to be negotiable must conform to the following requirements:

¹⁰⁵ 368 S.E.2d 225 (Va. 1988).

¹⁰⁶ *Id.* at 238.

¹⁰⁷ 2002 Cal. App. Unpub. LEXIS 3563 (Cal Ct. App. Feb. 27, 2002).

¹⁰⁸ *Id.* at *3.

¹⁰⁹ Hereinafter UNIL. See *Schwegmann Bank & Trust Co. v. Simmons*, 880 F.2d 838, 842 (5th Cir. 1989).

1. It must be in writing signed by the maker or drawer;
2. Must contain an unconditional promise or order to pay a sum certain in money;
3. Must be payable on demand, or at a fixed or determinable future time;
4. Must be payable to order or to bearer; and,
5. Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty.¹¹⁰

Thus, cases interpreting the term “negotiable instrument” under the UNIL arguably are more persuasive than those under the UCC, although the UNIL does not specifically prohibit other promises; it simply does not specifically allow them.¹¹¹

Some courts interpreting the UNIL’s definition of “negotiable instrument” placed importance on whether other documents were executed concurrently with a promissory note. For example, a few cases held that a mortgage executed at the same time as a promissory note required that the documents be construed together, with the result being that if provisions in the mortgage would have destroyed negotiability had they been in the note itself, they also destroyed negotiability when the documents were construed together.¹¹² However, the current view of courts construing the UCC is, and the majority view under the UNIL was, that negotiability is determined solely from the face of the note itself, without regard to provisions in documents executed at the same time or as part of the same transaction.

¹¹⁰ UNIL § 1 (1961).

¹¹¹ Despite the arguably one-sided nature of the cases cited herein under the UNIL, it should be pointed out that the cases finding non-negotiability were largely the exceptions to the general rules of interpretation.

¹¹² See *Meyer v. Weber*, 65 P. 1110, 1112 (Cal. 1901); *Brooke v. Struthers*, 68 N.W. 272, 274 (Mich. 1896); *Allen v. Dunn*, 99 N.W. 680, 680-81 (Neb. 1904); *Garnett v. Meyers*, 91 N.W. 400, 401 (Neb. 1903).

It also is arguable that courts interpreting the UNIL more strictly construed requirements as to negotiability. This includes determination of whether the instrument identified a sum certain and payment at a definite time, as well as decisions addressing whether the instrument contained other promises which destroyed negotiability.

For example, an instrument was held non-negotiable where it required the bearer to pay the principal sum of \$1,000 on a date certain, but interest only out of net profits, because the sum certain was conditional upon the existence of net profits.¹¹³ Likewise, a stipulation in a note requiring the obligor “to pay all costs, charges and expenses, including reasonable attorneys’ fees incurred by the payee in any foreclosure or other legal proceeding for the collection of debt and in any other litigation or controversy arising from or connected with this note” rendered the instrument non-negotiable because it did not identify a sum certain.¹¹⁴ Regarding other promises, several UNIL cases found notes non-negotiable because there was a promise in the note in addition to the payment of money.¹¹⁵

Some courts also found that acceleration clauses destroyed negotiability. For example, in *Iowa National Bank v. Carter*,¹¹⁶ the court held that an acceleration clause in a mortgage which was imported into the note by reference destroyed negotiability because it required written consent of the payee prior to the disposition of collateral. Similarly, in *Lynch v. Schemmel*,¹¹⁷ a promissory note was held non-negotiable where

¹¹³ See *Edwards v. Bay St. Cas. Co.*, 91 F. 946, 948 (Del. Cir. 1898).

¹¹⁴ See *Nussenfeld v. Smith*, 148 A. 388, 390 (Conn. 1930).

¹¹⁵ See, e.g., *First Nat’l Bank of Dothan v. Elba Hardware & Furniture Co.*, 137 So. 173 (Ala. 1931) (promise to give ten days notice for the appointment of auditors to examine accounts); *Midwest Collection Bureau v. Greenwald*, 214 Ill. App. 468 (1919) (specific course of instruction); *Citizens State Bank v. Pauly*, 102 P.2d 966 (Kan. 1940) (promise to assign any payments received pursuant to crop insurance policy); *Holliday St. Bank v. Hoffman*, 116 P. 239 (Kan. 1911) (allowing holder to demand more security if the collateral depreciated in value); *Nussear v. Hazard*, 129 A. 506 (Md. 1925) (promise to execute and deliver a mortgage); *First State Sav. Bank v. Russell*, 221 N.W. 142 (Mich. 1928) (promise to insure certain property); *Albany State Bank v. Anthony*, 254 P. 806 (Ore. 1927).

¹¹⁶ 123 N.W. 237, 240 (Iowa 1909).

¹¹⁷ 155 N.W. 1019, 1022 (Iowa 1916).

it became due at the option of the holder if the holder left the county where the property was located. Another line of cases found notes that allowed the holder to accelerate maturity when the holder felt unsafe or insecure about payment or collateral securing the note to be non-negotiable.¹¹⁸ However, these cases are in the minority. Both under the UNIL and the prior common law, the majority of courts held that acceleration clauses incorporating promises from a mortgage did not destroy negotiability.¹¹⁹

In analyzing whether a subject promissory note meets the Financial Institution Bond's definition of "negotiable instrument," the insurer should carefully review the language of the promissory note and any additional documents referenced therein. If the promissory note contains any promise in addition to the promise to pay, or makes the promise to pay conditional, the instrument clearly should not be considered a "negotiable instrument." Moreover, if the promissory note references or otherwise purports to be "subject to" or "governed by" the terms of another document, the promissory note likewise should not come within the Financial Institution Bond's definition of "negotiable instrument. And, if the promissory note does not constitute a "negotiable instrument," it can not be covered under Insuring Agreement (D)(1).

2. Do Promissory Notes Constitute an "Evidence of Debt"?

Even if the insured can establish that a forged or altered promissory note constitutes a "negotiable instrument" under the Financial Institution Bond's definition, if the insurer establishes that it also constitutes an "evidence of debt," there should be no coverage under Insuring Agreement (D)(1). Section 1(h) of the 1986 version of the

¹¹⁸ See *Murrell v. Exch. Bank*, 271 S.W. 21 (Ark. 1925); *Kimpton v. Studebaker Bros. Co.*, 94 P. 1039 (Idaho 1922); *Guio v. Lutes*, 184 N.E. 416 (Ind. Ct. App. 1933); *First Nat'l Bank v. McCartan*, 220 N.W. 364 (Iowa 1928); *Harrison v. Fugatt*, 65 P.2d 1200 (Okla. 1937); *Reynolds v. Vint*, 144 P. 526 (Ore. 1914); *Carroll County Sav. Bank v. Strother*, 6 S.E. 313 (S.C. 1887); *Birken v. Hickey*, 176 N.W. 137 (S.D. 1920); *Puget Sound St. Bank v. Wash. Paving Co.*, 162 P. 870 (Wash. 1917).

¹¹⁹ See generally WILLIAM BRITTON, *BILLS AND NOTES* § 28 (2d ed. 1961).

Financial Institution Bond defines the term “Evidence of Debt” as follows:

- (h) Evidence of Debt means an instrument, including a Negotiable Instrument, executed by a customer of the Insured and held by the Insured which in the regular course of business is treated as evidencing the customer’s debt to the Insured.¹²⁰

In *Merchants National Bank of Winona v. TransAmerican Insurance Co.*,¹²¹ the only case the authors found that directly addresses this definition, the court noted that the term “evidence of debt” refers to “primary indicia of debt, such as promissory notes or other instruments that reflect a customer’s debt to the bank.”¹²² This interpretation comports with other courts’ recognition, although outside the context of the Financial Institution Bond’s definition, that a promissory note generally is considered an “evidence of debt.”¹²³ For example, the Eight Circuit has held that “[t]he phrase ‘evidence of debt’ . . . refers to debtor-creditor relationships, such as those in bonds, mortgages, and promissory notes, not to every contract where one party is obligated to pay money to the other.”¹²⁴

Clearly then, a typical promissory note executed by a borrower in favor an insured lender would fall within the Financial Institution Bond’s definition of “evidence of debt,” and thus would not be covered under Insuring Agreement (D)(1). However, in the context of warehouse

¹²⁰ The definition of “evidence of debt” in the 2004 Financial Institution Bond is slightly revised from the 1986 version. However, the difference does not appear to affect the substantive coverage analysis in this context.

¹²¹ 408 N.W.2d 651 (Minn. Ct. App. 1987).

¹²² *Id.* at 653-54.

¹²³ *First Union Corp. v. U.S.F.& G.*, 730 A.2d 278, 282 (Md. Ct. Spec. App. 1999) (noting the “the bond’s own definition of ‘evidence of debt’ is entirely consistent with the interpretation that various courts have given it”).

¹²⁴ *Orion Fin. Corp. v. Am. Foods Group, Inc.*, 281 F.3d 733, 745 (8th Cir. 2002).

lending, the Financial Institution Bond's definition of "evidence of debt" may give rise to additional issues that warrant consideration.

(i) Was the promissory note "executed by a customer" of the insured?

In order to constitute an "evidence of debt," the allegedly forged or altered document must have been "executed by a customer" of the insured.¹²⁵ Thus, the question becomes: was the maker of the allegedly fraudulent promissory note a customer of the warehouse lender? Warehouse lenders might argue that, while the mortgage banker may have been its customer, the underlying borrower was not and that, therefore, the fraudulent promissory note was not executed by a customer of the warehouse lender. This argument should be unavailing.

The term "customer" is not defined by either the 1986 or 2004 Financial Institution Bond. However, basic rules of contract construction require that it must be interpreted in accordance with its commonly used meaning.¹²⁶ In general usage, the term "customer" refers to "one who has business dealings with another."¹²⁷ Under the UCC, the term "customer" similarly is defined broadly.¹²⁸ In *American Nat'l Bank v. Stanfill*,¹²⁹ the court specifically held that the maker of a promissory note was a "customer" of the lender for purposes of the UCC.¹³⁰

Thus, a mortgage banker¹³¹ almost certainly constitutes a customer of the warehouse lender. Moreover, under the Uniform

¹²⁵ 1986 Financial Institution Bond, Section 1(i).

¹²⁶ *E.g.*, *State Farm Fire & Cas. Co. v. Wilson*, 153 Fed. Appx. 952, 956 (6th Cir. 2005).

¹²⁷ *Swordloff v. Miami Nat'l Bank*, 584 F.2d 54, 58-59 (5th Cir. 1978).

¹²⁸ *See Williams v. Cullin Center Bank & Trust*, 685 S.W.2d 311, 314 (Tex. 1985) (noting that under the UCC, the term "customer" includes "any person having an account with a bank or for whom a bank has agreed to collect items and includes a bank carrying an account with another bank").

¹²⁹ 252 Cal. Rptr. 861 (Cal. Ct. App. 1988).

¹³⁰ *Id.* at 866.

¹³¹ Where the name of the account holder is a legal entity, courts consider a number of factors to determine whether individual employees constitute customers, including the authorized signatories, the circumstances surrounding the account opening, what persons control the account, and the

Commercial Code,¹³² a forged signature is treated as the signature of the person who actually signed the instrument, not the person whose name appears on the instrument. The pertinent language of the UCC provides:

- (a) Unless otherwise provided in this Article or Article 4, an unauthorized signature is ineffective except as the signature of the unauthorized signer in favor of a person who in good faith pays the instrument or takes it for value. An unauthorized signature may be ratified for all purposes of this Article.¹³³

The Official Comments to this section include the following explanation:

"Unauthorized" signature is defined in Section 1-201(43) as one that includes a forgery as well as a signature made by one exceeding actual or apparent authority.

....

The except clause of the first sentence of subsection (a) [quoted above] states the generally accepted rule that the unauthorized signature, while it is wholly inoperative as that of the person whose name is signed, is effective to impose liability upon the signer or to transfer any rights that the signer may have in the instrument. The signer's liability is not in damages for breach of warranty of authority, but is full liability on the instrument in the capacity in which the signer signed. It is, however,

beneficial interest of persons associated with the account. *See* Lietzmann v. Ruidoso State Bank, 827 P.2d 1294, 1299 (N.M. 1992); *see also* Schoenfelder v. Ariz. Bank, 796 P.2d 881, 889 (Ariz. 1990) (addressing whether officer was customer via corporate account); Kendall Yacht Corp. v. United Cal. Bank, 123 Cal. Rptr. 848, 853 (Ct. App. 1975) (disregarding corporate entity); Parrett v. Platte Valley St. Bank & Trust Co., 459 N.W.2d 371, 378 (Neb. 1990) (same); *but see* Koger v. East First Nat'l Bank, 443 So. 2d 141, 142-43 (Fla. Dist. Ct. App. 1983) (refusing to find individual partner liability because partnership was the customer).

¹³² UCC § 3-403 (2005).

¹³³ *Id.*

limited to parties who take or pay the instrument in good faith; and one who knows that the signature is unauthorized cannot recover from the signer on the instrument.¹³⁴

Thus, the UCC supports the argument that, when a mortgage banker forges the borrower's signature on a promissory note, the forged signature should be treated as the signature of the mortgage banker, thereby satisfying the requirement that the forged document be "executed" by a customer of the warehouse lender. Furthermore, because the mortgage banker clearly is a customer of the warehouse lender in the mortgage lending context, the "customer" requirement should be satisfied as well.

In the case where a promissory note is only alleged to have been altered (that is, the loan amount was inflated without the borrower's knowledge) but otherwise contains the underlying borrower's true signature, a good argument still can be made that the "customer" requirement is satisfied. For example, in many cases the warehouse lender receives an assignment of the mortgage and promissory note at closing. Thus, it could be argued that the underlying borrower was a "customer" of the warehouse lender in as much as the warehouse lender could foreclose the loan in the event the borrower defaulted on the loan. Similarly, the fact that warehouse lenders typically directly fund the underlying borrower's mortgage loan also supports the argument that the underlying borrower was a customer of the warehouse lender. Depending on how the particular transaction was structured, it is conceivable that other facts also could support this argument. Thus, the insurer should conduct a thorough investigation of the actual flow of documents and money in any given transaction to determine whether the "customer" requirement has been met.

(ii) Were the promissory notes "held" by the insured?

In addition to the "executed by a customer" requirement, the definition of "evidence of debt" also requires that the alleged forged or

¹³⁴ *Id.* Official Comments (1), (2).

altered document be “held by the Insured.”¹³⁵ There appears to be no case law interpreting this phrase in the context of the Financial Institution Bond’s definition of “Evidence of Debt” or under Insuring Agreement (D). However, section 10 of the Conditions and Limitations section of the Financial Institution Bond pertaining to “Ownership” of “Property” provides as follows:

This bond shall apply to loss of Property (1) owned by the Insured (2) held by the Insured in any capacity, or (3) for which the Insured is legally liable. This bond shall be for the sole use and benefit of the Insured named in the Declarations.

The term “held” under this section seems to be interpreted broadly, in that the Property must be “held” by the Insured in *any* capacity. Accordingly, under this interpretation, even if the warehouse lender does not have possession of the promissory note,¹³⁶ if the notes are eventually forwarded to the warehouse lender, which is the standard practice, the notes should be found to have been “held by the Insured.”

(iii) Did the insured, in the regular course of business, treat the notes as evidencing the customer’s debt?

The final element of the Financial Institution Bond’s definition of “evidence of debt” requires that “in the regular course of business [the promissory note] is treated as evidencing the customer’s debt to the Insured.”¹³⁷ Not surprisingly, there is no case law interpreting this requirement in the context of warehouse lending. However, at least one court that has addressed the “evidence of debt” definition in another context found that promissory notes, or other “primary indicia” of debt do constitute “Evidences of Debt” under the Bond.¹³⁸ In the context of

¹³⁵ 1986 Financial Institution Bond, § 1(i).

¹³⁶ Because Insuring Agreement (D) of the 2004 Financial Institution Bond contains the “actual physical possession” requirement found in Insuring Agreement (E), the “held by the Insured” requirement should not be an issue in claims under the 2004 Financial Institution Bond.

¹³⁷ 1986 Financial Institution Bond, § 1(i).

¹³⁸ *Merchants Nat’l Bank*, 408 N.W.2d at 652.

warehouse lending, the lender almost certainly treats promissory notes as evidencing the mortgage banker's debt to the warehouse lender. Accordingly, and assuming the "customer" requirement is satisfied, forged promissory notes should be found to be "evidences of debt," and thus outside the coverages of Insuring Agreement (D).

C. INSURING AGREEMENT G—FRAUDULENT MORTGAGE COVERAGE

The 2004 revisions to the standard form Financial Institution Bond incorporated the prior Fraudulent Mortgage Rider as Insuring Agreement (G).¹³⁹ Insuring Agreement (G) provides as follows:

FRAUDULENT MORTGAGES

Loss resulting directly from the Insured's having, in good faith and in the normal course of business in connection with any Loan, accepted or received or acted upon the faith of any Written, Original

(1) real property mortgages, real property deeds of trust or like instruments pertaining to realty, or

(2) assignments of such mortgages, deeds of trust or instruments

which prove to have been defective by reason of the signature thereon of any person having been obtained through trick, artifice, fraud or false pretenses or the signature on the recorded deed conveying such real property to the mortgage or deed of trust having been obtained by or on behalf of such mortgagor or grantor through trick, artifice, fraud or false pretenses.

¹³⁹ Edward G. Gallagher & Robert J. Duke, *A Concise History of Fidelity Insurance*, in *HANDLING FIDELITY BOND CLAIMS* 1, 12 (Michael Keeley & Sean Duffy eds., 2005).

Thus, Insuring Agreement (G) arguably applies to loan losses where a signature on a mortgage, deed of trust or similar document, or an assignment of such documents, was obtained through “trick, artifice, fraud or false pretenses,” thereby rendering the relevant document defective.¹⁴⁰ Insuring Agreement (G) clearly does not provide coverage for forged documents.¹⁴¹ Thus, because most losses in the warehouse lending context involve forgery of loan documents by the mortgage banker or its representative, Insuring Agreement (G) likely will not be applicable in the warehouse lending context.

Insuring Agreement (G) could be relevant where, for example, a dishonest mortgage banker secures a borrower’s signature on a mortgage or deed of trust in connection with a home loan, and later, without the borrower’s consent, increases the loan amount or otherwise alters the document. Losses arising in this context arguably might be covered by Insuring Agreement (G), assuming all other requirements for coverage also were met.

The authors also are aware of a fraudulent mortgage claim where a dishonest mortgage banker secured a borrower’s signature on legitimate loan documents and later forwarded such documents to several different warehouse lenders in order to obtain the funds for the original loan multiple times. In that claim, the defrauded warehouse lender argued that the borrower’s signature was obtained by fraud and thus was covered under the Financial Institution Bond. However, because the borrower signed the loan documents as part of an otherwise legitimate transaction, such documents could not have been said to have been obtained through trick, artifice, fraud or false pretenses. Instead, the borrower signed the loan documents and the loan proceeds went to the seller to pay for the home being purchased. The warehouse lender who received the original loan documents was not defrauded and indeed was able to pool the loan in a legitimate transaction. However, the dishonest mortgage banker defrauded multiple other warehouse lenders who wired

¹⁴⁰ This section will address only those issues unique to Insuring Agreement (G).

¹⁴¹ *Jefferson Bank v. Progressive Cas. Ins. Co.*, 965 F.2d 1274, 1280 (3d Cir. 1992) (noting that the Fraudulent Mortgage coverage is only applicable where loan losses were caused by “fraudulently induced—although not forged—signatures on mortgages”).

funds as a result of its “wet funding” relationship with the mortgage banker and simply never noticed that they did not ever receive originals of the loan documents.

An instructive case is *North Jersey Savings & Loan Assoc. v. Fidelity & Deposit Co. of Maryland*.¹⁴² In this case the plaintiff sought recovery for losses stemming from mortgages it purchased from another lender. The mortgages proved to be unenforceable and worthless when the underlying borrowers established that the original lender had violated various state and federal statutes in making the original loans. The plaintiff sought coverage under the Fraudulent Mortgage Rider in its Savings and Loan Blanket Bond.

Finding that the plaintiff’s losses were not covered, the court held that there was “no evidence that the mortgages were defective by reason of the mortgagor’s signature having been obtained through trick, artifice, fraud or false pretenses.”¹⁴³ Rather, the mortgages were invalid due to the fact that the original lender’s scheme violated various statutes. The court explained that for purposes of the Fraudulent Mortgage Rider, there is a difference between a “fraudulent scheme and a fraudulently induced signature.”¹⁴⁴ This is precisely the case in the example above. The warehouse lenders who received only copies of the loan documents incurred the losses, not due to fraudulently induced signatures, but instead, due to the mortgage banker’s fraudulent scheme.

Thus where the evidence establishes that the underlying borrower’s signature on a mortgage or deed of trust was procured as part of an otherwise legitimate loan transaction, and that the document was later used by the mortgage banker to defraud other lenders, there should be no coverage under Insuring Agreement (G).

Another potential issue under Insuring Agreement (G) is whether the documents at issue are of the type covered by Insuring Agreement (G). Where the document is not a mortgage or deed of trust, or an assignment of such documents, the question becomes whether the document nonetheless constitute a “like instrument.”

¹⁴² 660 A.2d 1287 (N.J. Super. Ct. Law Div. 1993).

¹⁴³ *Id.* at 1300.

¹⁴⁴ *Id.*

In *Jefferson Bank v. Progressive Casualty Insurance Co.*,¹⁴⁵ the court considered whether the phrase “like instruments”¹⁴⁶ extended coverage to include a title commitment that contained a fraudulently obtained signature. Analyzing the phrase’s placement in the insuring provision, the court explained that “the term ‘like instrument’ necessarily refers back to its immediate antecedents, ‘mortgages’ and ‘deeds of trust.’”¹⁴⁷ Thus, the court held that the term “like instrument” means “mortgage-like” instruments.¹⁴⁸ Because the title commitments could not be considered “mortgage-like” instruments, the court held that they could not form the basis of a claim under the Fraudulent Mortgage Rider.

When presented with a claim for warehouse lending loan losses under Insuring Agreement (G), the insurer should thoroughly review the allegedly defective documents and the collateral represented by them, as well as the facts surrounding the underlying transaction. If the evidence establishes that the signature alleged to have been fraudulently obtained, actually was procured as part of an otherwise legitimate transaction, the loss should not be covered. Similarly, if the instrument alleged to contain the fraudulently induced signature is not a mortgage, deed of trust, or other “mortgage-like” instrument, the loss should not be covered under Insuring Agreement (G).

IV. Conclusion

The strong growth in the residential real estate market in recent years has given rise to correspondingly strong growth in the warehouse lending industry. Warehouse lending no longer is a niche market serving only a few mortgage lenders, it is an integral part of today’s mortgage lending business. And, because it is one of the more complex aspects of the mortgage business, it comes with the potential for myriad forms of fraud.

The insurer faced with a warehouse lending claim must take the time to gain a thorough understanding of the documents, parties, and

¹⁴⁵ 965 F.2d 1274 (3d Cir. 1992).

¹⁴⁶ The “like instruments” language is contained in subsection (1) of Insuring Agreement (G) of the 2004 Financial Institution Bond.

¹⁴⁷ 965 F.2d at 1279.

¹⁴⁸ *Id.*

complex processes involved in a warehouse lending arrangement, as well as the applicable provision of the policy at issue.

Because the typical warehouse lending arrangement is structured to facilitate the rapid processing and funding of residential real estate loans, warehouse lenders rarely, if ever, have possession of, or the time to analyze, the original loan documents before funding a given loan. While insurers are willing to assume the risk of certain specific losses under Insuring Agreements (D), (E), and (G), this is clearly not one of them. As such, and for the other reasons discussed in detail in this article, loan losses in the warehouse lending context will rarely, if ever, be covered by the Financial Institution Bond.