THE ABC’S OF INSURING AGREEMENT (D) 
UNDER THE FINANCIAL INSTITUTION BOND

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I. INTRODUCTION

This article is written to address the past, present and future of Insuring Agreement (D) of the Financial Institution Bond. It is a clause that changed over time as a consequence of numerous court rulings, in response to which the standard form bond was “tightened” by inclusion of a definition of the operative term—forgery. There is and has for some time been all but certain clarity on what is and is not a “forgery.”

More recently, the clause has been impacted by significant changes in commercial banking. The advent of “e-banking” has given rise to numerous opportunities for mischief, causing losses to banks that do not “fit” neatly into the clause. Paper checks have become the exception, and the challenge to financial institution bond insurers is to apply the current form to “e-losses” in a fashion consistent with the history and underwriting objectives of the clause.

It is probable that the wording of Insuring Agreement (D) will change as insurers continue their efforts to provide straightforward wordings to sophisticated insureds. For now, the clause is working relatively well in its present form, but it is likely to see revisions in the future.

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II.
HISTORY—
INSURANCE COVERAGE FOR “FORGERY” LOSSES

The law of forgery grows out of the English criminal common law. As society and commerce became more complex, the criminal law expanded beyond the nine common law felonies to a point where, by 1819, one commentator noted that in the City of London, 223 offenses were categorized as capital. According to the same commentator, during the same period, legislation relating to the crime of forgery accounted for one-third of the capital legislation passed during the period. By 1830, of the 120 statutes dealing with forgery, sixty-one inflicted the death penalty.

The earliest forgery statutes related to the forgery of documents, particularly documents relating to taxation that purported to be signed by or on behalf of the Crown. These taxation statutes arose out of the need to finance the military operations undertaken by the Crown in the late Seventeenth Century. Because of their direct connection with the State’s war-making power, and the fact that they purported to be on behalf of the Crown, forgery of such documents was equated with the counterfeiting of the coin of the Realm and a usurpation of the Crown’s authority. As noted by one court, “the common law rule of forgery began as a species of treason, including such acts as falsifying the King’s seal and counterfeiting money.” By 1696, these laws had been expanded to include bank notes drawn on the Bank of England and National Land Bank and other government obligations.

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3 Id. at 119.
4 Id. at 119-20.
5 Id. at 123-26.
7 Randall McGowen, supra note 2, at 126.
Parallel to this system of criminalization of forgeries related to governmental obligations and public activity was a criminal system relating to the forgery of private documents such as promissory notes, bills of exchange and bonds of private individuals or private banks. These private offenses continued to be prosecuted as misdemeanors (i.e., not capital offenses) under a statute enacted under the era of Queen Elizabeth. By 1729, however, Parliament had come to view forgery of private instruments to be as grave a threat to the Crown and public order as forgery of more public instrument. In 1729, the legislature passed many laws that made many forms of private forgery capital offenses. The increasing sophistication of the business community, and the increase in the use of paper instruments to pay for, memorialize and enforce such transactions, led to increasingly sophisticated criminal schemes and a need for more comprehensive laws to inhibit and criminalize the behaviors.

It cannot be doubted that forgery was taken quite seriously by our English forebears in the law. One commentator notes that one difficulty faced in the establishment of the civil law relating to forgery was that those convicted of forgery usually went to the gallows. In a landmark ruling from the King’s Bench in 1762, Lord Mansfield noted in passing that “both of these bills were forged by one Lee, who has been since hanged for forgery.” As another commentator noted, “forgery is to theft what poetry is to prose.” With the spread of the use of paper money and instruments and commercial transactions and development of modern banking, criminals diversified from strong-arm robbery to other forms of thievery, including forgery. One outgrowth of this trend was the development of surety and insurance products designed to provide indemnity to the bank for various risks relating to this new form of criminal activity. In New York, these various forms were combined with

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8 Id. at 130.
9 Id. at 131.

These forms are developed and influenced by a variety of factors, including competition among insurers, negotiations with banking and other trade associations, court decisions and technological change.\footnote{Id. at 6-7.} An example of the last element can be seen in endorsements available that provide certain indemnity for certain losses resulting directly from “desktop published” checks.\footnote{Id. at 7.} The modern version of Insuring Agreement (D) derives from the 1951 revision to what was then called the “Banker’s Blanket Bond.” Further amendments were made to that “standard form” in 1969, 1980, 1986, and 2004 in part, to account for technological developments, industry demands and case law.\footnote{Gilbert J. Schroeder, The Insuring Agreements, Section 4 Insuring Agreement (D)—Forgery or Alteration, in Annotated Financial Institution Bond (Keeley ed. 2004).} Of a particular interest from a historical perspective is the modern definition of “forgery,” which typically requires the signing of the name of another, but did not include the signing of one’s own name without authority.\footnote{Id.} This language hearkens back to the early criminal law discussed above, where forgery was viewed as the equivalent of the usurpation or falsification of the King’s seal.\footnote{Turner, supra note 12 at 942.}

Forgery was never a capital offense in the United States, so persons accused of forgery did not have to worry about the gallows. Instead, forgery, as a civil, commercial concept, developed with less regard to criminal forgery.\footnote{As discussed below, criminal law definitions of forgery, while never mentioned in the financial institution bond form, for many years played a material role in Insuring Agreement (D) precedents.} Its evolution, as a source of indemnity for financial mischief, more closely followed the evolution of the Uniform Commercial Code.
III.
OVERVIEW OF ISSUES UNDER THE UCC

A basic understanding of the law of negotiable instruments under the Uniform Commercial Code is helpful to understand the risks involved (and not involved) under Insuring Agreement (D). While UCC implications may arise under any insuring clause, this section will focus on the Forgery coverage in the Financial Institution Bond, Insuring Agreement (D).  

A. Financial Institution Bond

Insuring Agreement (D) of the Financial Institution Bond had, until 2004, provided coverage as follows:

(D) Loss resulting directly from

(1) Forgery or alteration of, on or in any Negotiable Instrument (except an Evidence of Debt), Acceptance, Withdrawal Order, receipt for the withdrawal of Property, Certificate of Deposit or Letter of Credit,

(2) Transferring, paying or delivering any funds or Property or establishing any credit or giving any value on the faith of any written instructions or advices directed to the insured and authorizing or acknowledging the transfer, payment, delivery or receipt of funds or Property, which instructions or advices purport to have been signed or endorsed by any customer of the insured or by any banking institution but which instructions or advices either bear a signature which is a Forgery or have been altered without the knowledge and consent of such customer or banking institution. Telegraphic, cable or teletype instructions or advices, as aforesaid, exclusive of transmissions of electronic funds transfer

20 A more comprehensive discussion of Articles 3, 4 and 4A of the U.C.C. appears at: Gary J. Valeriano, Handling Forgery Claims and Articles 3 and 4 of the Uniform Commercial Code, in HANDLING FIDELITY BOND CLAIMS 223 (Michael Keeley & Sean Duffy eds., 2d ed. 2005).
systems, sent by a person other than the said customer or banking institution purporting to send such instructions or advices shall be deemed to bear a signature which is a Forgery.

A mechanically reproduced facsimile signature is treated the same as a handwritten signature. 21

The 2004 coverage is as follows:

FORGERY OR ALTERATION

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

(1) Negotiable Instrument (except an Evidence of Debt),

(2) Certificate of Deposit,

(3) Letter of Credit,

(4) Withdrawal Order,

(5) Receipt for the withdrawal of Property, or

(6) Instruction or advice purportedly signed by a customer of the Insured or by a banking institution which (a) bears a handwritten signature of any maker, drawer or endorser which is a Forgery; or (b) is altered, but only to the extent the Forgery or alteration causes the loss.

Actual physical possession of the items listed in (1) through (6) above by the Insured is a condition precedent to the Insured’s having relied on the items.

A reproduction of a handwritten signature is treated the same as the handwritten signature. An electronic or digital signature is not treated as a reproduction of a handwritten signature.  

Coverage is provided for any loss resulting directly from a forgery or alteration on a number of enumerated documents, most significantly the “negotiable instrument,” which most often will be a check. It should be kept in mind that this clause is subject to a number of exclusions, and that most of the terms used in this coverage are defined. Therefore, a complete review of the policy for applicable limitations, conditions and exclusions is mandatory before any claim analysis. These are discussed at more length elsewhere in this paper.

For purposes of clarity, let us assume a standard hypothetical so that we can see how the various coverages set forth above might be invoked. Assume that a corporation has some of its checks stolen, and that the thief thereafter makes checks payable to a bank account specifically created for purposes of cashing the stolen checks. The checks are deposited at the thief’s bank, Bank A, and are then sent for collection to the corporation’s bank, Bank B. Bank B pays on the checks and debits the corporation’s account. The corporation’s controller, upon reviewing the bank statement, realizes that there has been a forgery and informs Bank B.

Based upon the foregoing, it is conceivable that the insurance policies of Bank A, Bank B and the corporation are all involved. If Bank A credits Bank B for the monies paid to the thief, Bank A will file a claim under Insuring Agreement (D) of its Financial Institution Bond. If Bank A refuses to re-credit Bank B with the money paid to the thief, and Bank B ends up crediting its customer, Bank B will have sustained a loss and will no doubt make claim under its Financial Institution Bond. If both banks fail to make good on the loss and the corporation ends up

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holding the bag, it will no doubt make claim on its Financial Institution Bond under the Forgery/Alteration coverage.

Under the foregoing hypothetical, Bank A, Bank B or the corporation might sustain the loss. This is a situation where the UCC comes into effect. If the claim is tendered to the insurer before any resolution of the loss, allocation provisions of the UCC would be helpful in determining who might, or should, ultimately bear the loss and, which bonding company (for the moment discounting other defenses, exclusions, and limitations), will be responsible for the loss.

When reviewing potential coverage under the Financial Institution Bond, the analysis should follow a checklist along the following lines:

1. **Has the Insured Sustained a “Loss” Under the Terms of the Policy?**

   Remember that the Financial Institution Bond is a contract of indemnity and that there is no obligation, excluding any defense provision, to reimburse the insured before the time the insured has actually sustained a loss. Though the policy only requires payment on actual losses, coverage is provided for those losses that are discovered during the applicable period as set forth in the Financial Institution Bond. Discovery, for purposes of triggering coverage, may occur in a situation where no loss has yet been sustained, but where the insured has been put on notice of a potential loss (such as by way of a lawsuit). Insofar as this is really a coverage question based upon the discovery of a loss, or potential loss, this aspect of the claim will not be discussed herein.

   Even though the Financial Institution Bond is an indemnity policy that does not require the insured to make good until some loss has been sustained, the insurer may nevertheless want to consider involving itself in the process early because the insurer ultimately may be liable for the loss, and the insured may not have the same incentive to defend the action. For example, cases have arisen whereby an insured bank may be sued by another bank or an aggrieved party claiming that the insured bank has accepted a forged instrument. If the insured bank knows that any loss sustained as a result of that claim will ultimately be covered by its bonding company, and if the insured bank has a modest deductible
and does not wish to incur further attorneys’ fees and court costs in defending that action, the insured bank may have little desire to put up a staunch defense. In that kind of situation, the insurer will want to be vigilant in making sure that the insured understands its duties and responsibilities, and that no prejudice accrues as a result of the insured’s handling of the underlying litigation.

2. Is There a Causal Connection Between the Forgery/Alteration and the Ultimate Loss Suffered by the Insured?

If the forgery that is the basis of the claim was on a document that was worthless in any event, there is no causal relationship between the loss and the forgery (remember the coverage speaks of a “direct” loss). A prime example of this would be a forged signature on a worthless title document. Even if the signature was valid, it would have made no difference since the document itself was a sham. Therefore, no loss has been sustained as a direct result of a forgery. There may, however, be other considerations under Insuring Agreement E, Securities.

Often a claim will be made under Insuring Agreement (D), simply because a document bears a forgery or an alteration. In some cases, even that threshold is not met. Many times, if a document contains a misrepresentation of fact, the claimant will assert that such misrepresentation constitutes a forgery or an alteration. That is, of course, not the case. Even if a document containing misrepresentations of fact, such as a report on current accounts receivable for purposes of a security agreement, bears a forgery, any loss sustained by the insured arguably would not be due to the forgery, but instead would be due to the inaccurate representations contained therein.23

In addition, if the document that bears the forgery seems to be an insignificant or trifling document when given the whole of the claim, statements should be taken from the various parties involved in the matter to determine if there was “reliance” placed upon that particular

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Though the answers to questions along these lines may sometimes be self-serving, it is important to get the insured’s position respecting the priority that was accorded to the document in question.  

The necessity of a causal connection between the loss and the alleged forgery is underscored by the recent modifications to Insuring Agreement (D). Under the newer version, “reliance” on the part of the insured is required. That is, the insured must actually alter its position based upon the import of the document that allegedly bears a forgery. In addition, the newer Insuring Agreement (D) adds the language “but only to the extent the Forgery or alteration causes the loss.” This belt-and-suspenders approach should insure that any losses to which a forgery or alteration may be “incidental”, are not covered under the bond.

3. Is There a Forgery?

After years of ever broadening definitions by the courts, underwriters finally decided to include a definition of what forgery is, and what it is not, within the policy itself. Forgery is defined as: “The signing of the name of another person or organization with intent to deceive; it does not mean a signature which consists in whole or in part of one’s own name signed with or without authority, in any capacity, for any purpose.”  

If a person signs a document under apparent authority from the corporation, and it later turns out that no authority exists, so long as that person signed his own name, the signature is not a forgery. Keep in mind, however, that the signing of the name of another organization would be a forgery and that, for purposes of the bond, a mechanically

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24 For there to be a covered loss under the policy, it is necessary that the loss actually be caused by the covered event. Therefore, if some other cause may have been, arguably, the effective cause of the loss, this may take the loss out of the realm of coverage. For a further explanation see infra § V, D, 1.
26 Financial Institution Bond (2004), Conditions And Limitations Section, 1(j).
reproduced facsimile signature is the same as a handwritten signature. Therefore, if someone without the authority of a corporation signs by use of the corporation’s name that could constitute a forgery under the definition within the bond.

As occasionally happens, an insured’s blank check may come into the hands of a thief who thereafter signs the check as maker and receives credit for the same. If the thief signed in the name of an authorized signer, then a forgery loss exists. If, however, the thief signed in his own name, then there is technically no “forgery” under the Financial Institution Bond. Because this is an unauthorized signature for purposes of releasing funds, that loss arguably would fall to the insured’s bank that released such funds without a proper signature.

What if the thief signs the name of an imposter or an unknown third person? Under this set of facts, it is almost a certainty that the insured will argue for coverage, claiming that the party signing the instrument did so in the name of “another.” However, it seems apparent from the coverage that the term “other” contemplates an actual living person authorized to sign the instrument. Given the bond’s emphasis on reliance (i.e., the “on the faith” language of Insuring Agreement (D)(2)), it would be hard for an insured to argue that it relied upon or extended monies on the faith, of the signature of someone who does not even exist. In any event, it is a difficult circumstance, and one which must be approached carefully.

Similarly, if the signature is illegible, further problems can arise. Was the thief signing his own name (and therefore there is not a forgery), or was this an attempt to sign the name of an authorized signator (and therefore a forgery exists)? Unfortunately, there are no easy answers to these questions, and each situation must be approached upon its own unique circumstances and facts. The important thing is to be aware of the issue.

4. **Has There Been an Alteration?**

“Alteration” is not a defined term in the Financial Institution Bond. Under the UCC, an alteration is an unauthorized change in an instrument that purports to modify in any respect the obligation of a party or an unauthorized addition of words or numbers or other change to an
incomplete instrument relating to the obligation of a party. Remember, it is contemplated that the alteration is to an existing document, and not the complete fabrication of a document or instrument.

An alteration generally will be to an amount or a payee on a negotiable instrument. For example, “$100.00” will be changed to “$1,000.00,” or a payee by the name of “John Smith” will be changed to “John Smith & Company.”

In investigating these matters, it is important to determine who prepared the original document, and to take a statement as to the manner and form of the alteration. Keep in mind that under the UCC, an alteration is an “unauthorized change,” and that if the party making the change has the authority to do so, but did so inadvertently, there may be not be a covered loss.

5. Does the Forgery or Alteration Relate to a “Negotiable Instrument (Except an Evidence of Debt), an Acceptance, a Withdrawal Order, a Receipt for the Withdrawal of Property, a Certificate of Deposit or a Letter of Credit?”

The terms “negotiable instrument,” “evidence of debt,” “acceptance,” “withdrawal order,” “property,” “certificate of deposit” and a “letter of credit” are all defined terms in the Financial Institution Bond. An examination of those definitions must be conducted before any hard and fast conclusions are reached concerning whether or not you have a forgery or alteration on an appropriate instrument. Remember that while an evidence of debt is not covered under Insuring Agreement (D), it is one of the enumerated items in Insuring Agreement E.

30 For an interesting and extended discussion of the defined instruments susceptible to a forgery claim see First Union Corp. v. U.S. Fid. & Guar. Co., 730 A.2d 278 (Md. Ct. Spec. App. 1999), which found no coverage though the fraud and loss were exceptional.
Always keep in mind that the Financial Institution Bond excludes losses based upon an extension of credit unless those losses are directly related to employee dishonesty, forgery or fall within Insuring Agreement E, Securities. Oftentimes, an insured will sustain a large loss based upon a “premises” fraud whereby the borrower has made misrepresentations either orally, or in writing, however, unless the insured can show one of the specifically listed documents bears the signature of another, that loss is not covered and is specifically excluded under the “extension of credit” provision of the bond.

6. Does the Loss Involve a “Signature?”

The term “signature” is not defined within the bond. However, the term is explained under UCC section 3401. Under that section, a signature can be made by use of any name, including any trade or assumed name, upon an instrument or by any word, mark, or subject used in lieu of a written signature. Therefore, a “signature” is something that represents a person or entity in written form. It is not simply anything in writing. For example, if the thief who steals a check payable to another party deposits that check into his bank without endorsement, but only with an account number, that account number does not constitute a “signature,” and there can be no forgery. Similarly, if the thief were to stamp or write “for deposit only,” this again is not an endorsement and does not constitute a forgery or unauthorized signature of the name of another.

7. Has There, Under the Second Paragraph of Insuring Agreement (D), Been a Transfer, Payment, or Delivery of Funds or Property, Upon any Written Instruction or Advice to the Insured Bearing a Forgery?

This section specifically includes telegraphic, cable or teletype instructions or advices. If each of the foregoing factors has been

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established, then, subject to other policy defenses and exclusions, a covered loss, if in excess of any applicable deductible, may be established. It should again be noted that the bond in question is not a liability policy, but rather one of indemnity. Therefore, simply because an insured bank has been sued on a forged negotiable instrument, does not necessarily mean that it has, or will sustain, a loss. The financial institution that is the target of the lawsuit may have significant defenses available to it under the UCC, and any claim analysis on any settlement of a lawsuit that results in a loss to an insured financial institution, must take into consideration the available defenses that could have been asserted, but may not have been.

An insured bank that makes good on a series of forged checks bearing a forged maker signature may have a number of reasons for paying on that claim other than its potential liability. If, for example, the maker is a good customer of the bank, the bank, in an effort to preserve public relations, or the specific relationship, may decide for business reasons to credit the account. If the bank does so, it may then submit a claim under its bond. If, however, the bank failed to assert certain defenses it had under the UCC because of the relationship it had with its customer, and it failed to get the agreement of the insurer before reaching such a settlement, an argument can be made that the loss was not caused by the forgery or alteration, but instead by the insured volunteering to credit its customer's account when it had no obligation to do so. It also can be argued that the insured failed to mitigate its damages, or prejudiced the insurer. The various defenses available in such a circumstance, and the UCC allocation of loss rules, are explored later in this section.

B. Uniform Commercial Code Considerations

This section will deal with Articles 3 and 4 of the UCC, which were significantly revised in 1992. Before, however, a discussion of Articles 3 and 4 of the UCC, it is important to clarify some of the terms that will be used. Both in this discussion, and in the separate section following, the term “drawer” will denote the party who is actually making the check. Therefore, if an employer is issuing a check on its own bank account, the employer is, in the UCC scheme, considered the
“drawer” of the check. The bank at which the employer banks, would be known as the “drawee bank.” This is the bank primarily responsible for handling the employer’s account and would be charged, under normal circumstances, with the duty to review the employer’s checks as they come in for collection to ascertain the correctness of those checks for payment. This review should, but may not, include a visual review of the check and the drawer’s signature to make certain that it is a match with the signature of record. If there is any question as to the authenticity of the signature, it is perceived that the drawee bank would be in the best position to put a stop on the process.

The payee is the party to whom the check is made payable. The depositary bank indicates the institution at which the check is presented for deposit or negotiation.

In 1992, Articles 3 and 4 of the UCC were revised due to dissatisfaction with the way in which loss allocation had been dealt with in the past. Some commentators viewed the old rules as essentially a winner take all approach. That is, once it was determined which of the parties would ultimately bear responsibility, that party bore sole responsibility. There was no comparative negligence analysis and, even though a party may have been partially responsible for the ultimate loss, if that party managed to show the other party was more at fault, that party could escape without damage. The purpose behind the allocation system adopted in 1992 is to spread the blame in a more equitable fashion. If more than one party is responsible for the loss, then the new

34 Id. at § 4104(a)(8).
35 See Perini Corp. v. First Nat’l Bank, 553 F.2d 398, 405 (5th Cir. 1977).
38 See, e.g., id. at § 3405 cmt. 1.
provisions allow each of the parties to share in the loss to the extent of their comparable responsibility.

Some commentators have suggested that this approach was adopted so as to discourage litigation between financial institutions and customers/clients.\textsuperscript{40} It is believed that if the parties will ultimately share the responsibility for the loss, they may be more reasonable in approaching the litigation process and may be more inclined to settle. Under the old system, one of the parties was going to escape without any liability whatsoever; therefore, the parties might be more willing to take a chance on litigation. Since under the revisions the loss will be spread among the various parties, the parties may be less willing to fight since they know they cannot escape liability in total.

Another apparent reason for the revisions to Articles 3 and 4 was the belief that employers should bear more responsibility for the acts of their dishonest employees.\textsuperscript{41} Though the allocation of loss has been made comparative, rather than all or nothing, the code now specifically deals with situations where a dishonest employee manages to corrupt the system to achieve a personal benefit.\textsuperscript{42} Under the old system, it was possible to foist some of the responsibility for this loss (if not entire responsibility) on the banks involved. But under the current code, employers are taking on more responsibility, and therefore more liability, with respect to the dishonesty and fraud of their own employees.

For example, under the old code, a forged drawer signature was viewed to be the responsibility of the drawee bank since the drawee bank was in the best position to avoid the loss by simply checking the signature of its client before issuing credit. This was true even if the forged signature was the product of the drawer’s employee. Under the current code, the view is that the employer is in the best position to avoid this loss by adequately hiring, supervising and policing its own personnel and procedures. If nothing else, this new attitude certainly recognizes, and to some degree validates, the realities of modern day commercial

\textsuperscript{41} See, \textit{e.g.}, U.C.C. § 3405 cmt. 1 (1990).
\textsuperscript{42} \textit{Id.} at § 3405.
transactions. Financial institutions no longer undertake a sight examination of signatures, as to do so would simply be too time consuming and impractical. While this calls into question the sanctity of a correct signature, and indeed the necessity of a signature at all, it is a simple commercial reality.

C. Loss Allocation under the U.C.C

In this section, we will examine loss allocation and the payment of negotiable instruments. Some historical perspective will be discussed so as to view how things have changed and why.

1. Forged Drawer Signature
   
a. Historical Analysis

Assume that an XYZ Company blank check is stolen from its offices and its treasurer’s signature is forged. The check is filled in, taken by the thief to the thief’s bank and is cashed. XYZ Company’s bank gives credit for the check, which XYZ later determines is a forgery. Historically, this situation would have been controlled by the theory first enunciated in the 18th Century English case of Price v. Neal.\(^{43}\) That case held that the drawee bank was obligated to check the signature of its customer, the drawer, and not pay any instrument that was not properly signed. Therefore, the drawee bank, being in the best position to avoid this loss (by checking signatures), bore the responsibility.

That rationale had been adopted by the UCC, which allowed for a bank to charge against a client’s account any item “which is otherwise properly payable.”\(^{44}\) An item would not have been properly payable absent a “signature.”\(^{45}\) An unauthorized signature was “wholly inoperative,” for purposes of the bank’s obligations, and was the equivalent of no signature at all with respect to the bank’s client.\(^{46}\) The code specifically defined an “unauthorized signature” as “one made

\(^{43}\) (1762) 97 Eng. Rep. 871 (K.B.); 3 Burr. 1354.
\(^{44}\) U.C.C. § 4401(1), now § 4401(a) (1990).
\(^{45}\) Id. at § 3401. Current U.C.C. § 3401 still deals with “signatures.”
\(^{46}\) Id. at § 3404(1).
without actual, implied or apparent authority and includes a forgery."47 On this basis, under the old code, and consistent with the Price case, the drawee bank would be the party bearing the loss for this instrument. The bank would be obligated to recredit its customer’s account and to pursue its rights against either the depositary bank or the thief. As against the depositary bank, the drawee bank’s rights are nonexistent if the payee bank is a holder in due course.48 That is, absent good faith on the part of the depositary bank, a rare circumstance, the drawee bank is going to lose and will absorb the loss. Therefore, the drawee bank’s only recourse is against the thief, who is probably long gone.

Under the old code, however, the drawee bank had the right to assert what came to be known as a preclusion defense.49 Under section 3-406, a bank could preclude its customer from asserting the forgery if the customer, through negligence, substantially contributed to that forgery. Under the old law, banks scrambled frantically for ways in which to ascribe some negligence in the creation of the forgery. The question of how a drawer substantially contributes to the making of a forgery was a question that received much attention from the courts. Many courts equated the “substantial contribution” standard with the “substantial factor” test present in negligence common law.50 For example, a bank might argue that the checks were left unguarded or unprotected. If the checks had been lost, the bank could assert that as negligence on the part of the drawer. Generally, banks took the position that if a check somehow found its way into the hands of a thief, the drawer must have been negligent in some respect.

If the forgery was created by an employee of the drawer, this typically provided the banks in question with significant defenses. The banks would argue that the employer/drawer was in the best position to hire and supervise its employees, and that their failure to take reasonable steps to do so, led to the ultimate forgery. In that case, the employer/drawer would then be left trying to rationalize and explain its behavior and how nothing it could have done would have prevented this

47 Id. at § 1201(43).
48 Id. at § 3302.
49 Burke, supra note 39, at 338.
particular employee from creating this forgery. It was an imprecise science at best, and one that was hotly contested because the ultimate loser would bear full responsibility for the loss on the instrument. If the bank was successful in demonstrating that the drawer substantially contributed to the making of the forgery, the drawer would bear the full loss on that instrument. If the bank failed to do so, the bank would bear the full loss.

But it didn’t end there. Under section 3-406, even if the bank was successful in demonstrating that the drawer had substantially contributed to the forgery, the drawer could avoid liability if it could demonstrate that the bank failed to act “in good faith and in accordance with reasonable commercial standards.” This came to be known as the “last clear chance” doctrine, as the negligence of the drawer would be excused because of the negligence of the drawee bank.  

This also encouraged much finger-pointing and, in the case of litigation, extensive discovery. Generally, it was viewed by the drawers that if the bank had failed to compare, by sight, the signature of the drawer on the check, with the signature card on file at the drawee bank, the drawee bank had acted unreasonably, and had failed to abide by reasonable commercial standards. Of course, over time, drawee banks came to argue that reasonable commercial standards would not require a sight review of signatures on all checks. While this may have been true, many courts were reluctant to adopt this position. Therefore, generally, the loss fell to the banks. The only solace the bank could take in that instance would be an argument that the forgery was extremely “good,” and even a sight review would have failed to catch it. This encouraged much in the way of expert fees, as both sides scrambled to retain handwriting analysts.

b. The Uniform Code Today

The UCC now tempers this back and forth jostling. The drawee bank may charge against the account of the client any items that are properly payable. The current code states that “an item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank.”

A customer is not liable

51 Burke, supra note 39, at 341-42.
52 U.C.C. § 4401(a) (1990).
unless the customer has signed the instrument.\textsuperscript{53} Section 3401 does, however, provide that a party is liable if the instrument is signed “by an agent or representative.” An unauthorized signature is no longer “wholly inoperative,” but is instead “ineffective.”\textsuperscript{54} While the language is different, the intent seems to be the same. This is born out by the fact that the definition of “unauthorized signature” is virtually unchanged.\textsuperscript{55} Accordingly, the result under the code should be the same as it was historically. At this point, the bank, having taken an instrument that bears an unauthorized signature, would be responsible for the loss.

The bank may still avail itself of the defense under section 3406, though that has changed to some degree. The “substantially contributes” test of former section 3406 is continued; however, it is “loosened” from its former bindings:

The ‘substantially contributes’ test is meant to be less stringent than a ‘direct and proximate cause’ test. Under the less stringent test, the preclusion should be easier to establish. Conduct ‘substantially contributes’ to a material alteration or forged signature if it is a contributing cause of the alteration or signature and a substantial factor in bringing it about.\textsuperscript{56}

The example given in the UCC’s Comments is instructive. In that hypothetical, the employer is ultimately deemed responsible for the loss on the instrument because it had kept a rubber stamp of the employer’s signature, along with the employer’s personalized blank check forms, in an unlocked desk drawer.\textsuperscript{57} Therefore, the employer’s simple negligence “substantially contributes” to the making of the forged check, and the employer is deemed to be the loser. Therefore, under the code, it seems more likely that the bank can pass liability back to its customer. Instead, the code itself states that under the substantial contribution test, “the preclusion should be easier to establish.”

\textsuperscript{53} Id. at § 3401(a).
\textsuperscript{54} Id. at § 3403(a).
\textsuperscript{55} Id. at § 1201(43).
\textsuperscript{56} Id. at § 3406 cmt. 2.
\textsuperscript{57} Id. at § 3406 cmt. 3.
Again, however, the UCC allows the drawer/customer to assert the last clear chance doctrine in an attempt to push liability back to the drawee bank. However, there are two substantial differences on the implementation. First, the failure of the drawee bank to exercise ordinary care in the paying or taking of the instrument does not establish sole liability on the drawee bank. That liability is now proportional and the loss is “allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.”\textsuperscript{58} Therefore, if the drawer/customer is successful in demonstrating that the bank has failed to exercise ordinary care, that is not total absolution for the drawer/customer. Instead, the trier of fact must determine the percentages attributable to each party’s negligence.

Another code induced change to historical analysis is the definition of “ordinary care.”\textsuperscript{59} Ordinary care is defined as the “observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged.” However, the definition does not end there. In unmistakably clear language, the drafters of Articles 3 and 4, state as follows:

In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank’s prescribed procedures and the bank’s procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4. . . \textsuperscript{60}

If the bank has failed to sight review checks, and that failure neither violates the bank’s policies nor the standard practice of the banks in that area, the bank has acted with “ordinary care.” Therefore, section 3406(b) would not apply and the loss on the check would fail

\textsuperscript{58} Id. at § 3406(b).
\textsuperscript{59} Id. at § 3103(a)(9).
\textsuperscript{60} Id.
squarely on the side of the drawer/customer. As one commentator has noted:

Inasmuch as failure to examine items for forgery is virtually the only way in which a payor bank can be negligent in this context, the negligent customer will bear the loss much more frequently . . . under the code. As a result, it is more likely . . . that both negligent and non-negligent customers will choose to bear the loss rather than to litigate the question of negligence, even in the case of large items.\textsuperscript{61}

Under section 4406, a customer is barred from asserting forgery against a bank if multiple forgeries by the same party were not discovered within thirty days after the items and statements were made available to the customer. The customer is absolutely barred from raising the defense of an unauthorized signature if the customer fails to report such unauthorized signature within one year of the receipt of its monthly statement.

Again, the definition of “ordinary care” will have a substantial impact in this analysis.

Under the UCC, if the customer establishes a lack of ordinary care on the part of the bank, “the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent to which the failure of the customer . . . and the failure of the bank . . . contributed to the loss.”\textsuperscript{62} Therefore, comparative negligence is called into play, and the loss is allocated between the parties. However, it is important to keep in mind that, again, the definition of ordinary care seems to absolve the bank from the necessity of a sight review of checks. Accordingly, a lack of ordinary care has become harder to prove than in the past and, as a result, it is thought that customers have ended up bearing the loss in considerately more cases.\textsuperscript{63}

\textsuperscript{61} Ellis & Dow, \textit{supra} note 36, at 68.
\textsuperscript{62} U.C.C. § 4406(e) (1990).
2. **Forged Endorsements**

Historically, and under the old code, the depositary bank would typically bear the loss on the forged endorsement.\(^{64}\) This was logical because the depositary bank, being the party who actually dealt with the forger, was thought to be in the best position to avoid that loss by requiring sufficient proof of identification, or by not allowing the deposit of corporate checks into a personal account. The depositary bank was also deemed responsible for having adequate safeguards and restrictions on the opening of a corporate account. As in the case of a forged drawer’s signature, the endorsement in this situation was “wholly inoperative.”\(^{65}\) Because it was an unauthorized signature under section 1201(43), it meant that the signature requirement had not been fulfilled.\(^{66}\) Therefore, the instrument was not “properly payable,” and the depositary bank was stuck.\(^{67}\)

This was true even though the depositary bank had passed the check along to the drawee bank, who had paid on the instrument. The depositary bank remained liable because it had breached the “warranty of good title,” which, in essence, held that the depositary bank vouched for the authenticity of the signature of the endorser.\(^{68}\) Therefore, a drawer could request that the drawee bank recredit its account. The drawee bank would usually do so and assert liability on the part of the depositary bank for breach of warranty. In most cases involving a forged endorsement under the old code, the depositary bank would bear the loss.

Of course, both the depositary bank and the drawee bank had available to it the preclusion defense available under old section 3406. However, in the case of a forged endorsement, it was usually harder to establish that either the party who made the check, or the party to whom the check was payable, had been negligent in handling the instrument, unless an employee was involved. Generally, however, the depositary bank would bear the loss mainly because that bank had usually allowed a

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\(^{64}\) Unless the check was made to a fictitious payee or an imposter. U.C.C. § 3405 (1962).

\(^{65}\) *Id.* at § 3404.

\(^{66}\) *Id.* at § 3401.

\(^{67}\) *Id.* at § 4401.

\(^{68}\) *Id.* at § 4207.
third party to deposit a check made payable to another party, or because of its failure to abide by procedures regarding the opening of a corporate account (i.e., the failure to get corporate resolutions and/or articles of incorporation, a corporate stamped signature card, etc.). That being the case, the depositary bank usually had a difficult time proving that it had acted reasonably; therefore, if not under the initial analysis, at least under the last clear chance doctrine, the depositary bank would be the ultimate loser.

The current code does not seem to alter that situation very much in situations dealing with nonemployees. In most situations involving a forged endorsement, the depositary bank will still be liable. The biggest change under the code arises in cases where the endorsement is of a fictitious payee, or was done by an employee of the party asserting the forgery.

3. **Endorsement Where Thief is an Employee**

Historically, a forged endorsement by one who is an employee of the payor was usually treated no differently than a forged endorsement on a check stolen by a nonemployee.

The current code, however, has a section specifically dealing with this factual scenario:

For the purpose of determining the rights and liabilities of a person who, in good faith, pays an instrument or takes it for value or for collection, if an employer entrusted an employee with responsibility with respect to the instrument and the employee or person acting in concert with the employee makes a fraudulent endorsement of the instrument, the endorsement is effective as the endorsement of the person to whom the instrument is payable if it is made in the name of that person.\(^{69}\)

\(^{69}\) *Id.* at § 3405(b).
Therefore, under the UCC, if an employee with responsibility for checks forges the endorsement (or it is done by a co-conspirator), the endorsement is valid and the employer bears the loss.

Under the UCC, the term “responsibility” is defined as follows:

Responsibility with respect to instrument means authority (i) to sign or endorse instruments on behalf of the employer, (ii) to process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition, (iii) to prepare or process instruments for issue in the name of the employer, (iv) to supply information determining the names or addresses of payees of instruments to be issued in the name of the employer, (v) to control the disposition of instruments to be issued in the name of the employer, or (vi) to act otherwise with respect to instruments in a responsible capacity. ‘Responsibility’ does not include authority that merely allows an employee to have access to instruments or blank or incomplete instrument forms that are being stored or transported or are part of incoming or outgoing mail, or similar access.70

For example, if a janitor were to come upon a check made by his employer to a supplier, take that check and deposit it, the defense of section 3405 would not be triggered as the janitor was not a person who has been “entrusted” with responsibility with respect to the instrument. section 3406 may still come into play, but the stricter liability under section 3405 is not applicable.

Section 3405 does, however, contain an “out” if the employer can establish that the depositary bank failed to “exercise ordinary care in paying or taking the instrument and that failure contributes to loss

70 Id. at § 3405(a)(3).
resulting from the fraud . . .”71 In that case, the employer and the depositary bank share the loss on a comparative-negligence basis.72

D. Summary of Code Analysis

As a general rule, Articles 3 and 4 of the UCC have shifted the historical rights and responsibilities of the various parties in the check-cashing process. The emphasis seems to be on an even-distribution approach, substituting comparative negligence for what was before, an all-or-nothing analysis.

Employers, and the fidelity bonding companies of employers, should be very aware of this, as they substantially affect the right of the employer to make claims against either the drawee bank or the depositary bank on forged endorsements and drawers’ signatures. The UCC generally puts more responsibility on the employers. Though this is the case, the employers are still entitled to some recompense if the banks are at all negligent in their discharge of duties.

E. Defenses Related to The UCC and Checks

1. Midnight Deadline

As previously discussed, another defense that can be successfully asserted against an offending bank is the failure to honor the midnight deadline.73 Under the UCC, a bank has until midnight of the day following its receipt of an instrument to either credit or return that instrument. If the bank fails to do so, even if the instrument is forged or altered, the bank has assumed liability for it. Therefore, it is always important, as previously stated, to know the dates upon which the instrument was presented, the dates upon which the instrument was

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71 Id. at § 3405(b).
submitted to the clearing bank or federal reserve bank, and the date that the instrument was returned.

2. Third Party Claims

The courts have restricted the duty of banks respecting third parties who are not “customers” of that bank. For example, recent cases have held that a depositary bank that is defrauded into opening “dummy” accounts does not owe the actual person whose name is used for the “dummy” accounts a duty under law if that person is not a customer of the depositary bank. Therefore, if liability is alleged against a bank for failure to verify the bona fides on the opening of a dummy account, a very good defense to a negligence claim is presented.

This is also true in other cases involving actions by noncustomers. Suppose that an employee of a company fraudulently induces that company to issue checks payable in the name of its actual suppliers, gets genuine signatures on those checks and absconds with those checks, cashing them at a later time. At least one court has held that the depositary bank in that transaction did not have a general duty to noncustomers (i.e., the employees’ defrauded company) on negligence claims to verify the validity of the endorsement. It appears that the employer/company owner of the check is certainly in the best position to mitigate this fraud by properly auditing its books and segregating accounting duties. Therefore, liability properly rests with the employer company, and not with the depositary bank.

Claims personnel assessing the potential exposure of an insured bank to such claims should keep in mind these defenses when handling these claims. Likewise, when on the subrogation end, these considerations obviously have impact.

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3. Negligence

Though the UCC does deal with allocation of losses, certain situations arise that are handled strictly by the law of negligence. For example, a bank does not have a general duty to monitor a depositor’s account; therefore, it does not have a duty to notify one joint tenant of the account of “suspicious” withdrawals by another joint tenant of an account.76

While the UCC does set out an elaborate system for determining who should be responsible for ultimate losses, common sense must also come into play as stated previously, and there is a noticeable trend within the courts to move away from imposing “watchdog” status on financial institutions. Therefore, any claim arising under the UCC should be considered in the context of “who could have at best prevented this loss.” More often than not, that analysis will lead to the party who may be making the claim in the first place.

IV. INSURING AGREEMENT (D)77

A. What Is the Covered Peril?

1. Forgery

Once one determines that the instrument in question is one that falls within the defined classes of instruments listed in Insuring Agreement (D), one must then determine whether or not the instrument is defective in the manner prescribed in the Insuring Agreement, i.e., did the covered peril occur? In decisions reported before 1980, one can see the treatment of courts of language in Insuring Agreement (D) in Annotated Financial Institution Bond where the bond did not include a definition of

77 An extensive review of Insuring Agreement (D) appears at Scott L. Schmookler, Insuring Agreement (D) in Financial Institution Bond 313 (Duncan Clow ed., 3d ed. 2008) and in annotated form at Schroeder, Insuring Agreement (D)—Forgery or Alterations in Annotated Financial Institution Bond (Keeley ed. 2004), supra, note 13, at 218.
“forgery.” Some reported decisions limited the definition to situations where the perpetrator signed the name of another without authority.\textsuperscript{78} Other courts extended the definition to include situations in which the perpetrator signed his own name, without authority to do so in the particular instance in question.\textsuperscript{79}

The Second Circuit, in \textit{Filor, Bulard & Smyth v. Insurance Co. of North America},\textsuperscript{80} held that the signature by a dishonest bank president of his own name satisfied the bond requirements of a forgery (undefined in the bond in question), even though he signed his own name.\textsuperscript{81}

The California Supreme Court reached a similar conclusion in \textit{Century Bank v. St. Paul Fire & Marine Insurance Co.}\textsuperscript{82} In that case, the alleged principal signed his own name to the instrument in question, yet did so without authority. The court held that the defined term “forgery” was susceptible to a number of meanings and adopted the meaning contained in the California Penal Code. Under such analysis, the signature of one’s own name, without authority to sign on behalf of the entity in the particular instance, could be construed to be a “forgery” under the meaning of the Penal Code statute.\textsuperscript{83}

In response to this line of jurisprudence, the Surety Association of America (as it was known at the time), in discussions with the American Banking Association, promulgated a revised standard form financial institution bond in 1980, which included a definition of the term “forgery.” The definition provided that the signing of one’s own name does not constitute a “forgery” in two aspects. The definition defined forgery to include “signing of the name of another person or organization


\textsuperscript{80} Filor, Bulard & Smyth, 605 F.2d at 604.

\textsuperscript{81} Id. at 598, 601.

\textsuperscript{82} Century Bank, 482 P.2d at 194.

\textsuperscript{83} Id. at 194-95.
with the intent to deceive,” and then continued to expressly provide that “a signature which consists in whole or in part of one’s own name signed with or without authority, in any capacity, for any purpose.”

At least one reported decision has analyzed the impact of this change in detail. In *French American Banking Corp. v. Flota Mercante Grancolombiana, S.A.*, the court rejected the arguments of the insured under the *Filor* case. The *Flota Mercante* court distinguished the *Filor* case on the ground that the bond before it contained an express definition of forgery, similar to that contained in the modern form 24 bond, and held that under that form, the signing of one’s own name, even without authority, did not constitute a forgery.

2. Alteration

The bond does not include an express definition of alteration. In the context of the instrument most likely to give rise to a claim of an “alteration,” at least potentially indemnifiable under Insuring Agreement (D)—the check)—the few reported decisions that have addressed the question of whether the check is altered within the intent of the drafters of the bond have looked to the provisions of the UCC in effect at the time for guidance.

Under the 1962 version of the UCC, an alteration was “material” where such alteration “changes the contract of any party thereto and in a material respect, including any such change in (a) the number or relations of the parties; or (b) an incomplete instrument, by completing it otherwise than as authorized; or (c) the writing as signed, by adding to it or removing any part of it.”

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84 Financial Institution Bond (1986).
Because the 1962 Code required that the alteration be “material,” a split arose in bond cases as whether the term “material” would be read into the insuring agreement. In reviewing these cases, one must do so with the mind that they rely upon the Code as it existed at the time, and are thus questionable authority in jurisdictions that have revised their Code as discussed below.\(^8\)

The widespread amendments to the Code, effective in most jurisdictions at the end of 1992, revised the definition of alteration to mean “(i) an unauthorized change in an instrument that purports to modify in any respect the obligation of a party, or (ii) an unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of a party.”\(^9\) Cases decided since the amendment to the UCC have largely construed the insuring agreement’s alteration coverage consistently with standard bank usage. For example, in Northside Bank v. American Casualty Co. of Redding,\(^9\) a customer of the bank opened an account as a merchant account for the clearing of payments under debit and credit cards. The customer transmitted the transactions to the bank electronically, and upon receipt, credited the customer’s account. The merchant began experiencing a large number of charge backs from its customers who claimed they failed to deliver merchandise resulting in a loss to the account, and thus to the bank that had previously given credit. The bank argued that it should be allowed to recover under its financial institution bond as the instruction in question contained a misrepresentation and thus was altered. The court rejected this argument, holding that the instruction was false, but had not been altered. It concluded that “the simple truth is that the [forms] ‘modify’ and ‘altered’ mean exactly what they say.”\(^9\)


\(^9\) Id. at *2.
In Bidwell & Co. v. National Union Fire Insurance Co. of Pittsburgh, PA, Bidwell negotiated three checks from clients, received payment for them from its bank and then suffered a loss when its bank debited its account for the amount of the checks because they had allegedly been forged or altered. Bidwell’s clients established user counts with Bidwell. Deposits to those accounts were maintained in the general account maintained by Bidwell with its bank. A Bidwell “customer” opened an account with Bidwell in the name of “Tauna J. Stewart.” A check was deposited to the Stewart account, endorsed with the name “Tauna J. Stewart,” though the payee was not altered from the original payee, “Tenneco Packaging.” Shortly thereafter, a check made payable to Sony Picture Studios was deposited to the account of Ms. Stewart. However, in this instance, the payee name was altered from “Sony Picture Studios, Inc.” to “Bidwell Investment Company, 317 North Broadway Street, Chicago, Illinois 60657, attention Tauna J. Stewart account 11767830.” The back of the check was endorsed with the signature “Tauna J. Stewart,” and deposited to the Stewart account with Bidwell. On these facts, the district court held that the Sony check was altered, but that the Tenneco check was not.

Finally, where an escrow agent deposits a check into its escrow account before the closing and funding of a loan, such deposit alone will not constitute an alteration. In reaching its decision, the Indiana Court of Appeals observed that the insured did not “allege, and the undisputed facts do not show, that the [escrow agent] added words or numbers to the instrument and the instrument was complete when [the escrow agent] received it.”

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93 Id. at *1-2.
94 Id. at *2-3.
95 The court reached a similar holding with respect to transactions on another account, but it is unclear whether the same perpetrator involved.
97 Id.
B. What Is “Loss”?  

Financial Institution Bonds are contracts of indemnity. Indemnity is available only for covered losses resulting directly from a covered peril. The insured bears the burden of establishing that it has sustained a loss covered under the Financial Institution Bond. 98 Loss is not defined in the Financial Institution Bond, and insureds have come up with creative ways to calculate loss supposedly sustained.

In order to adequately address claims that include questionable loss assumptions, one needs to look to the basic rule underlying indemnity insurance. Simply stated, to recover on a Financial Institution Bond an insured must sustain a direct actual pecuniary loss, i.e., an out-of-pocket loss. “Loss under a fidelity policy or bond refers to actual loss, as distinguished from a theoretical or bookkeeping loss.” 99 The insured must establish that it sustained a loss of money or property resulting directly from one of the specified perils. Courts interpreting the “resulting directly from” language have routinely held that the loss must be the direct result of the covered peril, e.g., forgery. 100 These decisions are further supported by the fact that the Financial Institution Bond specifically excludes coverage for indirect losses. 101

Insureds frequently submit claims under Financial Institution Bonds alleging loss sustained due to the insured’s liability to a third party. These claims for an insured’s liability to a third party are not covered under a Financial Institution Bond. In Lynch Properties v. Potomac Insurance Co., 102 the court recognized that Financial Institution Bonds are not liability policies, which “require[s] and insurer to discharge an obligation to a third party for some act of the insured or its employee.” In Lynch, the insured’s bookkeeper embezzled funds from

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99 See COUCH ON INSURANCE § 160:61; Cincinnati Ins. Co. v. Star Fin. Bank, 35 F.3d 1186, 1191 (7th Cir. 1994).
102 962 F. Supp. 956 (N.D. Tex. 1996), aff’d, 140 F.3d 622 (5th Cir. 1998).
an account that held funds of a customer for whom the insured provided accounting services. The funds embezzled were not the funds of the insured. In granting summary judgment in favor of the insurer, the court reasoned:

The “directly from” language, Potomac contends, allows coverage only for losses that are the immediate (i.e., not indirect) effect of employee dishonesty. Since the direct result of Bartlett’s embezzlement was a loss to Ms. Lynch’s personal funds, and the indirect result was Lynch’s replacement of those lost funds, Potomac concludes that Lynch cannot recover under the policy.\(^\text{103}\)

As an indemnity product, a Financial Institution Bond “[does] not provide coverage for third party claims.”\(^\text{104}\) In Vons, the insured was sued by investors that were bilked in connection with an dishonest employee’s Ponzi scheme. Vons paid $10 million to settle the lawsuits, and then sought to recover the $10 million under its crime coverage. The insured’s argument for coverage focused on the “legally liable” language of the “ownership” clause of the policy. The court rejected this argument, and focused on the insuring clause that provided coverage for “direct losses.” The court held that “direct means direct and that in absence of a third party claims clause, [the] policy did not provide indemnity for vicarious liability for tortious acts of employees.”\(^\text{105}\)

The “no loss, no coverage” principle was reaffirmed by the district court in Fireman’s Fund Ins. Co. v. Special Olympics International, Inc.,\(^\text{106}\) where the court confirmed that “bookkeeping or theoretical losses not accompanied by actual withdrawals of cash or other such pecuniary loss is not recoverable” under a fidelity bond.\(^\text{107}\) There,

\(^{103}\) Id. at 961.

\(^{104}\) Vons Co. Ins. v. Fed. Ins. Co., 212 F.3d 489, 492 (9th Cir. 2000); see also First Nat’l Bank v. Lustig, 975 F.2d 1165, 1168 (5th Cir. 1992) (dismissal of claim by third party upheld because bond did not provide liability insurance).

\(^{105}\) Vons Co. Ins., 212 F.3d at 491.

\(^{106}\) 249 F. Supp. 2d 19, 22 (D. Mass. 2003), aff’d on other grounds, 346 F.3d 259 (1st Cir. 2003).

\(^{107}\) Id. at 27.
an employee started an unauthorized fund raising campaign and deposited contributed funds to his own account. The court correctly ruled that the funds in question were not “owned” by the insured. In short, the court stated that “[i]n order to trigger coverage, the assets of the insured must be diminished as a result of the dishonest act of the insured’s employee.”

It is well recognized that coverage is not triggered under employee dishonesty policies unless there is a loss of, or damage to, property that the insured owns or holds. This was the issue in *Atlas Metal Products Co., Inc. v. Lumberman’s Mutual Casualty Co.*, where a dishonest employee, used her employer to get access to the assets of a separate business, from which she misappropriated funds. The insured made good on the loss to the third party and sought coverage on its fidelity bond. It argued that the policy’s “legally liable” language afforded it protection against damage claims for losses sustained by a third party. The court rejected that argument holding, as a matter of law, that the funds taken from the account of a third party did not fall within the property covered under the crime policy.

Although the cases holding that third-party losses are not covered, were primarily decided under employee dishonesty coverage, the rational can be applied to all insuring agreements in the Financial Institution Bond, including Insuring Agreement (D). In *California Korea Bank v. Virginia Surety Co.*, the insured sought coverage under its Financial Institution Bond for the amount it paid to settle a lawsuit brought by its customer relating to the bank’s handling of her certificates of deposit. The customer sued the bank for allowing her husband, who had altered the amount of a check, to wrongfully withdraw funds from her account. The insured sought coverage for the settlement it reached with its customer on the grounds that the settlement was a loss resulting from the forgery or alteration of the check. The court held that the bond did not provide coverage for the settlement, reasoning:

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108 *Id.*


110 No. CV 96 03891 DDP, 2000 U.S. App. LEXIS 12306 (9th Cir. June 1, 2000).
The judgment was in the amount of the funds due from the matured CDs, plus interest, less the amount Mrs. Yu had authorized to be expended, and less an offset for funds that she received. These are contract damages, not damages stemming from Mr. Yu’s fraud.\textsuperscript{111}

The \textit{California Korea Bank} decision demonstrates that losses sustained by an insured due to its contractual liability to a third party, even if based on the insured’s acceptance of altered checks, are not covered under a Financial Institution Bond.

The assessment of whether a purported loss falls within the scope of coverage afforded by a Financial Institution Bond requires an inquiry into whether the loss resulted directly from a covered peril. In \textit{Direct Mortgage Corp. v. National Union Fire Insurance Co. of Pittsburgh, PA},\textsuperscript{112} the court faced a situation where the insured’s employees falsified loan origination data and documentation on loans that were subsequently sold to investors. The insured was required to repurchase some of the loans when the investors discovered the fraudulent documentation. The insured settled with the investors, and then sought to recover under its fidelity bond. The court adopted the “direct means direct” approach when assessing coverage under the “loss resulting directly from” language of a fidelity bond. The court held that there was no coverage for the insured’s costs to settle its contractual liability to repurchase the mortgages because it was not a direct loss. The court reasoned that “adopting the proximate cause approach would effectively ignore the term ‘direct’ in the Fidelity Bond because a direct loss is narrower than a proximately caused loss.”\textsuperscript{113}

The fundamental question to be asked when an insured presents a claim for loss under Insuring Agreement (D) is whether the loss is an out-of-pocket loss. In most cases the answer to this question is straightforward. In those cases where it is not, the principles behind indemnity insurance and precedent should guide the way in determining

\textsuperscript{111} \textit{Id.} at *5.


\textsuperscript{113} \textit{Id.}
whether the insured has established a loss resulting directly from a covered peril.

C. **What Is “Resulting Directly From”?**

Among the elements that the insured must show in order to establish a covered cause of loss, is the requirement that the loss in question result “directly from” the covered peril. In claims under Insuring Agreement (D), insureds often argue that the causation requirement is satisfied if they show that the loss would not have occurred “but for” the covered peril having occurred on a given covered document. Such “but for” analysis is generally rejected by the courts.\(^{114}\) In some instances, an intervening action by the insured, or a third party, will be held sufficient to break the chain of causation.\(^{115}\) In *Empire Bank v. Fidelity & Deposit Co. of Maryland*,\(^ {116}\) Empire Bank’s employees allowed an employee of a customer to cash checks payable to a corporation. Such was a violation of the bank’s internal operating policies. Though the checks bore a forged endorsement, the court found that the bank’s loss sustained on its reimbursement of the payee was not covered. On appeal, the court affirmed the grant of summary judgment in favor of the insurer, holding that the bond included an exclusion for “loss caused by an employee,” and the employee’s decision to cash the corporate payee checks for the individual officer of the corporation, in violation of the bank’s policies and procedures, resulted in the exclusion of the loss under the referenced exclusion.\(^ {117}\) Significantly, the court noted that there was evidence to support the proposition that the departure was willful, though apparently not arising to the level of dishonesty.\(^ {118}\) The court went on to hold that under the exclusion before it, the bonding company need not show that the employee’s action was

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\(^{116}\) *Empire Bank*, 27 F.3d at 335.

\(^{117}\) *Id.*

\(^{118}\) *Id.*
the sole cause of the loss, but rather that it was a proximate cause.\textsuperscript{119} Other reported decisions have reached similar conclusions.\textsuperscript{120}

Yet another line of decisions has held that a loss will not be deemed to result directly from a forgery where the loss results from the extension of credit secured by collateral that is either fictitious or worth substantially less than believed at the inception of the transaction. The court in \textit{Liberty National} faced a fictitious collateral issue. There, the bank made loans secured in part by allegedly forged certificates of deposit. The loan went into default and the forgery was discovered. The court held that even if the requisite signatures on the documents were forged, such forgery did not cause the loss. Rather, the losses could have occurred even if the documents had been genuine in the execution, as the assets represented to be in the documents did not in fact exist.\textsuperscript{121}

The Court of Appeal for the Sixth Circuit faced a similar issue in \textit{Flagstar Bank, FSB v. Federal Insurance Co. and Continental Casualty Co.}.\textsuperscript{122} In that case, Flagstar entered into a mortgage warehouse lending agreement with a mortgage broker in Colorado. It opened a mortgage warehouse credit facility with a limit of $20 million. This was to be secured by original promissory notes executed by the borrower/customers of the mortgage broker. Flagstar submitted thirty-nine promissory notes that were later shown to be from “non existent mortgage transactions.” The broker had stolen the identities of natural persons and used such to fabricate the “loans” forging the signatures on the notes.\textsuperscript{123} Flagstar sought coverage under the bond’s Forgery provision, clause 4 of the bond in question.

The court affirmed the grant of summary judgment in favor of the insurer holding that as the transactions in question were wholly fictitious, the losses in question were not a direct result of the forgeries

\textsuperscript{119} \textit{Id.} at 336.
\textsuperscript{121} \textit{See Liberty Nat’l Bank}, 568 F. Supp. at 866.
\textsuperscript{122} 260 F. App’x 820, 821 (6th Cir. 2008).
\textsuperscript{123} \textit{Id.} at 821.
on the promissory notes. In doing so, the Court of Appeals noted that its ruling was in harmony with a long line of authority holding that a forgery clause such as the one before it, would not provide indemnity for losses arising from extensions of loans based on fictitious collateral. In reaching this decision, the circuit court distinguished the case before it from cases where the notes in question were forged, but part of otherwise genuine transactions.

Accordingly, loss would not be held to result directly from a forgery where the collateral is not nonexistent, or where the loss would have occurred even if the document had not been forged or altered. The presence of an applicable exclusion may buttress this conclusion in a particular case.

D. Covered Instruments

1. Negotiable Instrument

Insuring Agreement (D) provides coverage for losses resulting directly from a covered peril on a negotiable instrument. “Negotiable Instrument” is defined in the Financial Institution Bond, Standard Form 24 (revised 2004) as:

Negotiable Instrument means any writing:

(a) signed by the maker or drawer; and

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124 Id.
(b) containing any unconditional promise or order to pay a sum certain in Money and no other promise, order, obligation or power given by the maker; and

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

(d) is payable to order or bearer.

One of the primary requirements of a “Negotiable Instrument” is that it contain an unconditional promise to pay a sum certain in “Money,” and contain no other promises. The writing must require that payment be made in the form of “Money.” “Money” is defined in the Financial Institution Bond as “a medium of exchange in current use authorized or adopted by a domestic or foreign government as a part of its currency.” In other words, a “Negotiable Instrument” must contain a promise to pay a certain sum in cash. A promise to pay by check, money order or credit card is not a promise to pay cash. 127

Several courts have interpreted the definition of “Money.” In Fillion v. David, 128 for example, the court held that a letter of credit did not “represent an unconditional offer by the debtors-appellees to pay appellants in cash money and therefore [was] not valid tender.” It follows that if a promissory note provides the option for a borrower to pay in either cash, check, money order or by credit card, it is not a “negotiable instrument” because money orders, checks and credit cards are not “Money” as defined in the Financial Institution Bond. Similarly, in Midwest Federal Savings & Loan Association of Minot v. Kouba, 129 the court held that the two-party check the debtors offered to the bank in payment of their mortgage was not money. The court relied on the UCC definition of “Money”, a similar, but not identical definition to the Financial Institution Bond’s definition of “Money”, and held that “[a] check is not included in [the] definition of “Money.”

The question of whether a document is a “Negotiable Instrument” typically arises when an insured, such as a warehouse

129 335 N.W.2d. at 780.
lender, seeks coverage under Insuring Agreement (D) for a forged promissory note under the assumption that promissory notes are considered negotiable instruments under the UCC. This assumption is in error since the UCC’s definition of a negotiable instrument is broader than the definition set forth in the Financial Institution Bond.

The UCC defines negotiable instrument as:

“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.\(^{130}\)

The differences between the UCC definition of negotiable instrument and the definition set forth in the Financial Institution Bond illustrate how an instrument may be a negotiable instrument under the UCC definition, but not under the bond’s definition. For example, the Financial Institution Bond definition provides that the instrument contain an unconditional promise to pay, and no other promise, order, obligation or power given by the maker, while the UCC definition allows for the instrument to grant certain other obligations or powers. Additionally, the UCC definition requires that the instrument be “payable to bearer or to order at the time it is issued or first comes into possession of a holder.”

\(^{130}\) U.C.C. § 3-104(a) (1990).
while the Financial Institution Bond requires only that it be “payable to
order or bearer.” Another difference is that the UCC requires that the
unconditional promise be “to pay a fixed amount of money” whereas the
Financial Institution Bond requires the unconditional promise be “to pay
a sum certain in money.” When an insured relies on the UCC definition
of negotiable instrument, an examination of the instrument with these
differences in mind is essential.

2. Exception—Evidence of Debt

Insuring Agreement (D) expressly provides that an Evidence of
Debt is not a covered document. Evidence of Debt is defined in the
Financial Institution Bond as:

Evidence of Debt means a Written instrument, including
a Negotiable Instrument, executed, or purportedly
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.\textsuperscript{131}

Decisions interpreting Evidence of Debt involve claims for
coverage under Insuring Agreement E.\textsuperscript{132} In Pine Bluff National Bank v.
St. Paul Mercury Insurance Co.,\textsuperscript{133} the court held that computer leases
were not an Evidence of Debt. In Merchants National Bank of
Winona v. Transamerica Insurance. Co.,\textsuperscript{134} the court found that
construction contracts were not an Evidence of Debt.

3. Acceptance, Withdrawal Order

An Acceptance is not identified as one of the enumerated
covered instruments under the 2004 form of Insuring Agreement (D).
But, Acceptance is defined in the 1986 form Financial Institution Bond

\textsuperscript{131} Financial Institution Bond (2004); Financial Institution Bond (1986).
\textsuperscript{133} Pine Bluff Nat’l Bank, 346 F. Supp. 2d at 1020.
\textsuperscript{134} Merchs. Nat’l Bank of Winona, 408 N.W.2d at 651.
as a “draft which the drawee has, by signature written thereon, engaged
to honor as presented.” There are no decisions that interpret the
Financial Institution Bond’s definition of Acceptance.

“Withdrawal Order” is defined in the 2004 form of the Financial
Institution Bond as a “[W]ritten, non-negotiable instrument, signed by a
customer of the Insured authorizing the Insured to debit the customer’s
account in the amount of funds stated therein.” The 1986 form defines
“Withdrawal Order” slightly differently: “a non-negotiable instrument,
other than an instruction, signed by a customer of the Insured authorizing
the Insured to debit the customer’s account in the amount of funds stated
therein.”

While the definition of “withdrawal order” is straightforward,
the court in Metro Federal Credit Union v. Federal Insurance Co.135
was tasked with determining whether advance requests on a line of credit that
were attached to fraudulent invoices fell within that definition. In Metro
Federal Credit Union, the insured loaned a percentage of the borrower’s
receivables based on the submission of advance requests. The advance
requests were attached to invoices from the borrower to the borrower’s
customers. The insured claimed that its loss was caused by the invoices
that fraudulently increased the amounts owed to the borrower. The court
found that no coverage was available under the bond’s equivalent of
Insuring Agreement (D). The advance requests were not a “withdrawal
order” because they did not empower the insured to withdraw money
from the customer’s account; rather, the advance requests were
applications for accounts-receivable financing.136 However, in denying
the motion to dismiss, the court found it was plausible that the claim
could be covered under the equivalent of Insuring Agreement E,
“Extended Forgery,” based on the insured’s extension of credit in
reliance or an altered security agreement.137

4. Receipt for Withdrawal of Property

Receipt for Withdrawal of Property is not defined in the
Financial Institution Bond. However, “Property” is defined as: “Money,

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135 607 F. Supp. 2d 870, 872 (N.D. Ill. 2009).
136 Id. at 876.
137 Id. at 879.
Certified Securities, Negotiable Instruments, Certificates of Deposit, Documents of Title, Evidences of Debt, Security Agreements, Withdrawal Orders, Certificates of Origin or Title, Letters of Credit, insurance policies, abstracts of title, deeds and mortgages on real estate, revenue and other stamps, tokens, unsold state lottery tickets, books of account and other records stored on tangible media, gems, jewelry, precious metals in bars or ingots (which are collectively the enumerated items of Property), and tangible items of personal property that are not hereinbefore enumerated.” The definition of “Property” includes the catch all phrase “and tangible items of personal property which are not hereinbefore enumerated.” There are no decisions on what documents constitute a Receipt for Withdrawal of Property for purposes of a Financial Institution Bond.

5. **Certificate of Deposit**

Certificate of Deposit is defined in the Financial Institution Bond as: “a Written acknowledgement by a financial institution of receipt of Money with an engagement to repay it.” This definition is nearly identical to the UCC’s definition, which defines it as “an instrument containing an acknowledgment by a bank that a sum of money has been received by the bank and a promise by the bank to repay the sum of money. A certificate of deposit is a note of the bank.”¹³⁸ There are no decisions that interpret this definition under Insuring Agreement (D) of the Financial Institution Bond.

6. **Letter of Credit**

A “Letter of Credit” is identified in Insuring Agreement (D) as one of the covered documents. “Letter of Credit” is defined in the Financial Institution Bond as: “a Written engagement by a bank or other person, made at the request of a customer, that the bank or other person will honor drafts or other demands for payment upon compliance with the conditions specified in the Letter of Credit.” The UCC¹³⁹ provides a similar definition of “letter of credit.” No cases specifically address the definition of “Letter of Credit,” or any coverage issues involving a “Letter of Credit.” It is not surprising that there is not any case law

¹³⁹ Id. at § 5-130(a).
interpreting the Financial Institution Bond’s definition of “Letter of Credit,” as letters of credit have commonly been used in the banking industry for well over a hundred years.

7. Written Instructions

Instructions or advice is not defined in the 2004 form of the Financial Institution Bond. Case law has held that “instructions and advices” in the context of Insuring Agreement (D)(2) “refer principally to commercial paper, such as checks or drafts.” In *KW Bancshares, Inc. v. Syndicates of Underwriters at Lloyd’s,* the court was presented with the question of interpreting the term “advice” in the context of Insuring Agreement (D). The bond in *KW Bancshares, Inc.* did not define the terms “instructions” or “advices.” In holding that letters purportedly signed by the president and controller of the borrower’s employer that explained that the borrower was a trusted leader of the company, and had earned a bonus equal to almost twice the amount of the loan, were not “advices,” the court noted that the dictionary defined “advice” as “opinion given as to what to do: counsel.” The court also noted that *Black’s Law Dictionary* defined “advice” as “[t]he instruction usually given by one merchant or banker to another by letter, informing him of shipments made to him, or of bills or drafts drawn upon him, with particulars of date, or sight, the sum, and the payee. Bills presented for acceptance or payment are frequently dishonored for want of advice.” In holding that the letters were not “instructions or advices,” the court in *KW Bancshares, Inc.* further reasoned that “the Crenshaw letter was not commercial paper, such as a check or draft. It is clear, therefore, that the Crenshaw letter is not the type of document contemplated to be an “instruction or advice.”

“Instruction” is defined in the 1986 form as “a written order to the issuer of an Uncertified Security requesting that the transfer, pledge, or release from pledge of the Uncertified Security specified be

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143 Id. at 1052 (emphasis added).
144 Id.
registered.” While the term “advice” is not defined in the Financial Institution Bond, or by the UCC, it is regularly used in connection with the UCC Section pertaining to Letters of Credit.

Insuring Agreement (D) requires that the instruction or advice: “bear a handwritten signature of any maker, drawer or endorser which is a Forgery; or (b) or have been altered without the knowledge and consent of such customer.” In First Thrift of Los Angeles v. Pacific Indemnity Co.\(^{145}\), the documents in question were actually prepared by the customer himself. In finding no coverage under a similar insuring agreement, the court in First Thrift of Los Angeles stated:

Appellant has alleged that the documents in question were actually prepared by the customer himself. Manifestly, they can not be said to bear the forged signature or endorsement or to have been altered without the knowledge or consent of such customer within the foregoing quoted language contained in the limited type of forgery covered by said second bond. (internal quotations omitted). (Emphasis in original).

A number of courts have addressed the issue of whether particular documents constitute a written instruction or advice:

(a.) Incumbency certificate: In First Union Corp. v. U.S.F. & G. Co.,\(^{146}\) the court held that an incumbency certificate that purported to verify an imposter’s authority to act on behalf of a Fortune 500 company did not constitute instructions or advices, reasoning that they were not commercial paper. The court also recognized that the terms of Insuring Agreement (D)(2) required that the instructions or advices authorize or acknowledge the transfer, payment, delivery or receipt of funds or Property, and that the incumbency certificates did not

\(^{145}\) 95 Cal. App. 2d 460, 462 (1949).

\(^{146}\) First Union Corp., 730 A.2d at 278, 283.
authorize or acknowledge the transfer of money or property.  

(b.) Faxed wire transfer request: In Missouri Bank & Trust Co. of Kansas City v. OneBeacon Insurance Co., the insured executed a faxed international wire transfer request that turned out to be forged. The insured refunded its customer’s account, but was unable to recover the funds from the receiving bank because they had already been released. The insurer maintained that the faxed wire transfer request was an electronic record and not a “writing” or something “written.” The court disagreed, holding that the faxed wire transfer request was written because it was “retrievable in perceivable form,” and intentionally reduced to tangible form. Thus, the loss fell within the scope of Insuring Agreement (D) of the Financial Institution Bond.

(c.) Purchase Agreement & Escrow Instructions: In Universal Bank v. Northland Insurance Co., the court held that “neither the purchase agreements nor escrow instructions met the bond definition of instruction.”

(d.) Chattel Mortgages & Leasing Agreements: In Liberty National Bank & Trust Co. of Louisville v. National Surety Corp., the insured sustained losses due to discounted notes it purchased, which were secured by forged automobile chattel mortgages and leasing agreements. The court held that the chattel mortgages and leasing agreements were not “advices and instructions” because they were not commercial paper.

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147 Id. at 509.
149 Id. at *11.
151 330 F.2d 697, 699 (6th Cir. 1964).
152 Id. at 699.
nor were they “directed to the bank” and authorizing the transfer, payment, delivery or receipt of funds or Property."

(e.) Warehouse receipts: In Provident Trust Co. v. National Surety Corp., the insured’s loan to a customer was secured by fraudulent warehouse receipts that the identified 632 barrels of liquor as collateral for the loan, when in fact there were only 141 barrels of liquor in existence at the time of the loan, and those barrels were encumbered by prior liens. The borrower defaulted on the loan and the insured sought coverage under a Bankers Blanket Bond. The court ruled in favor of the insured and found that the warehouse receipts were forged under Pennsylvania law, and that they constituted “written instructions or advices” because they notified the bank that the warehouse held the collateral identified in the receipts.

E. Mechanical Reproductions

Insuring Agreement (D) of the 1986 form Financial Institution Bond provides that “[a] mechanically reproduced facsimile signature is treated the same as a handwritten signature.” Insuring Agreement (D) of the 2004 bond form revised this clause providing that: “[a] reproduction of a handwritten signature is to be treated the same as the handwritten signature. An electronic or digital signature is not to be treated as a reproduction of a handwritten signature.”

In BancInsure, Inc. v. Marshall Bank, N.A., the court addressed the clause that “[a] mechanically reproduced facsimile signature is treated the same as a handwritten signature” under a claim involving Insuring Agreement E. The insured argued that the clause

\[153\text{ Id. at 700.}\]
\[154\text{ 138 F.2d 252, 253 (3d Cir. 1943).}\]
\[155\text{ Id. at 252-53.}\]
\[156\text{ Id. at 253.}\]
\[157\text{ 400 F. Supp. 2d 1140, 1142 (D. Minn. 2005), aff’d, 453 F.3d 1073 (8th Cir. 2006).}\]
meant that the signatures on the documents sent by facsimile transmission were the same as handwritten signatures and thus the documents were originals and, in any case, the facsimile copies would have been enforceable against the guarantors but for the forgery. The court disagreed and granted summary judgment in favor of the insurer because at the time the bank disbursed the loan proceeds, it had possession of only a facsimile transmission of the forged personal guarantees when Insuring Agreement E required possession of the originals. The Eighth Circuit noted in affirming the district court’s decision that the clause that provides that a mechanically reproduced facsimile signature is treated the same as a handwritten signature “speaks to what type of signature is acceptable.”

The revised language of the clause in the 2004 form Financial Institution Bond differs slightly from 1986 form and takes into account the advances in technology by providing that an electronic and digital signature is not to be treated as a reproduction of a handwritten signature. There are no decisions interpreting the 2004 form of the clause, but the court’s reasoning in BancInsure, Inc. v. Marshall Bank, N.A. that the clause speaks to what type of signature is acceptable still applies, especially given that the 2004 form of Insuring Agreement (D) requires possession of an original document.

F. Bundling Issues

Insuring Agreement (D), like Insuring agreement E, limits its scope of coverage to a very carefully defined set of documents. It is not uncommon to encounter an argument tacitly recognizing that the class of instruments specifically listed in the insuring agreement does not bear a forgery or alteration, but that a document should be somehow linked or bundled with the covered instrument to transmute the defect into a defect of a covered instrument. Such issues arise under both Financial Institution Bond forms and under commercial forms. Although the language of the particular form needs to be closely considered, we will examine both classes of policies in this article.

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159 Id.
An early discussion of the issue appears in the case of *Hobart Manufacturing Co. v. Fidelity & Deposit Co. of Maryland.*\(^{160}\) There, the “Depositor’s Forgery Bond” contained an insuring clause covering forgery or alteration. Hobart’s check process included a check attached by perforations to a voucher for that check. That voucher would contain the information relative to the issuance of the check, such as payee name, amount, purpose, and contained an approval box. The requesting party would bring the combined instrument to the supervisor with authority to approve the voucher, who would then sign the voucher. A second supervisor would be responsible for the preparation and signature of the check.

A Hobart employee, Tobias, altered check vouchers, fraudulently inducing the checks to be signed and issued to one of Tobias’ cohorts or a fictitious payee. The court found that Tobias’ scheme did not involve the forgery or alteration of the kind of instrument enumerated in the insuring clause:

> We do not construe forgery or alteration of a check to include to forgery or alteration of a voucher . . . the essence of this clever scheme was fraudulently obtaining firm funds for an unauthorized purpose, not in falsifying negotiable paper. We can only conclude that forgery or alteration of a voucher is beyond the risk intended to be covered by defendant’s bond, and consequently was not a forgery or alteration of a check.”\(^{161}\)

Similarly, *Pasadena Investment Co. v. Peerless Casualty Co.*\(^{162}\) involved a claim under a “forgery bond” providing coverage for forged “securities, obligations or other written instruments . . . .” Despite that significantly wider breadth of covered documents, the court found that the “invoices or receipts” there at issue were not covered.\(^{163}\)

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\(^{160}\) 360 F.2d 453, 454 (6th Cir. 1966).

\(^{161}\) *Id.* at 456 (emphasis added).


\(^{163}\) *Id.* at 330-31.
This analysis is consistent with the decision of *KW Bank Shares, Inc. v. Lloyd’s*\(^{164}\), where the Court granted the insurer summary judgment because the admittedly forged documents (employer memos and correspondence) were not “covered” documents. The court, obviously mindful of the depositor’s Forgery genre of documents listed in the insuring clause, noted that:

Insuring Agreement (D) deals ‘principally with cases resulting from forgery of commercial paper of the nature of checks or drafts . . . It is clear, therefore, that the Crenshaw letter is not the type of document contemplated to be an instruction or advice.\(^{165}\)

The court as well observed that the insured’s loss was not the result of “forged” documents, but rather “. . . the loss was caused by the fact that the statements contained in the documents were not true. . . .”\(^{166}\)

These decisions are in accord with more seasoned authority. For example, in *Greis v. Fidelity & Casualty Co. of New York*,\(^{167}\) Greis employees forged invoices that were paid by Greis. The court found that the invoices were not covered:

An invoice is merely another term for bill rendered, a list of goods sold and the prices charged for them; it is neither a bill of sale, nor evidence of sale, and standing alone, furnishes no proof of title . . . the approved invoice, standing alone, was not a written promise, order, or direction for the payment of money.\(^{168}\)

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\(^{165}\) *Id.* at 1052 (internal citations omitted).

\(^{166}\) *KW Bancshares*, 965 F. Supp. at 1054; see also *Hobart Mfg. Co.*, 360 F.2d at 453.


\(^{168}\) *Id.* at 481 (internal citations omitted).
In *First Union Corp. v. U.S. Fidelity & Guaranty Co.*, First Union was insured under a standard Form 24 (1986) bond. It suffered losses as there was also a fraudulent scheme by the name of “Project Star.” The scheme purportedly involved the research and development of “harmless” tobacco using human-subject experiments in laboratories overseas. The borrower asserted that the project needed to be handled in secret and insisted that the bank not investigate the project too closely or investigate the alleged parent company of the borrower, Phillip Morris. Ultimately, the borrower was a fraud, and not actually connected to Phillip Morris. The project itself was also a fraud.

By the time the scam unraveled, $300 million had been advanced by First Union, ostensibly for the use of leasing computer equipment. The insured argued that two “incumbency certificates” forged to establish the authority of the borrower to act on Phillip Morris’ behalf did not qualify as an “evidence of debt” or “instructions or advices.”

In reaching this decision, the court concluded that the forged incumbency certificates were not evidence of debt, but were a representation of the borrower’s purported authority to act on behalf of Phillip Morris. It also concluded that the certificates were not written instructions or advices and thus did not qualify for coverage.

The *First Union* opinion contains a helpful explanation of the history of the clause that was key to its conclusion. Its discussion is as follows:

Standard Form 24 has generally excluded losses caused by forgeries or loans made under false pretenses. Exclusion (a) provides that the bond does not cover loss resulting directly or indirectly from forgery or alteration, except when covered under insuring agreement (a), (d), (e) or (f). The rationale underlying this exclusion is to deny coverage for poor loan underwriting. Indeed, [t]he failure to follow sound business practices and verify authenticity is a business risk taken by banks and not an insured covered by the . . . under the 1969 bond, insuring

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170 Id. at 282-83.
agreement (e) provided coverage for losses arising out of a bank’s reliance on a forged document. Because courts constructed this language broadly, the drafters of the 1980 amendment sought to limit its coverage by enumerating and defining the specific documents that come within its purview . . . . Thus as the history of Standard Form 24 demonstrates, the bond does not provide broad coverage for losses resulting from forgery.\textsuperscript{171}

There is one reported decision that is contrary to the vast majority of cases discussed above. In \textit{Omnisource Corp. v. CNA,}\textsuperscript{172} the District Court reviewed a claim under a commercial form for the insured’s loss from payment of a sight draft whose supporting documents were forged. The key component of the court’s opinion was that a package of documents containing a forged original invoice, certificate of origin, packing list, bill of lading and other documents not expressly listed, which were attached to or “bundled” with the sight draft. The sight draft itself (which was a type of document covered under the form in question) was not forged or altered. On these facts, the court held that the forgeries on the documents bundled with the sight draft cased the loss on the sight draft to be covered.

A number of other decisions have allowed some degree of “bundling”. In response to these decisions, in 2003, the Surety Association of America (“SAA”) added an “anti-bundling” provision as Section 9 of the bond’s conditions. Although the SAA adopted Revised

\textsuperscript{171} First Union Corp., 730 A.2d at 282 (alteration in original) (internal quotations omitted), see Amy L. Cook & Michael J. Weber, “Have I Got a Document for You: Is Bundling of Transactional Documents a Means to Coverage Under a Financial Institution Bond?,” (unpublished paper presented at the Fidelity & Surety Law Committee of the Tort & Insurance Practice Section of the American Bar Association Fall Program in Baltimore, Maryland, Nov. 4, 2010) Profiles in Greed: A Study of Some Common Fidelity Loss Scenarios.

\textsuperscript{172} Omnisource Corp. v. CNA, 949 F. Supp. 681, 682 (N.D. Ind. 1996).

Form 24 on April 1, 2004, it is not commonly used, at least yet, in the industry.\textsuperscript{174} The provision provides

Section 9. If any insured agreement requires that an enumerated type of document be altered or counterfeit, or contain a signature which is a Forgery or obtained through trick, artifice, fraud or false pretenses, the alteration or counterfeit or signature must be on or of the enumerated document itself not on or of some other document submitted with, accompanying or incorporated by reference into the enumerated document.\textsuperscript{175}

In drafting the new section, the SAA provided the American Bankers Association with letters explaining the purpose of this revision and inviting input from the members. In its letter to the State Commissioner of Insurance, the SAA stated:

Section 9. The mistaken decision in \textit{Omnisource Corp. v. CNA Transcontinental Insurance Company}, 949 F. Supp. 681 (N.D. Ind. 1996) led a number of Insureds erroneously to believe that coverage can be claimed based on forgery to a document not covered by the bond if the forged document is ‘bundled’ with a covered document. A new condition 9 is added to correct this misconception.\textsuperscript{176}

It remains to be seen how this new language will fare when tested in court. However, for the claims handling professional, as is discussed in the SAA letter itself, which correctly describes the significance of the enumeration of covered documents, bundling is not permitted.

\textsuperscript{174} Financial Institution Bond (2004); Cook & Weber, \textit{supra} note 171, at 9.

\textsuperscript{175} Financial Institution Bond (2004).

\textsuperscript{176} Cook & Michael Weber, \textit{supra} note 171, at 10 (quoting Surety Association of American Form and filing letter (Dec. 2003)).
G. **Overlap of Claims Under Insuring Agreements D and E**

Like Insuring Agreement (D), Insuring Agreement E identifies specific documents for which coverage applies for a specific peril. Both insuring agreements include “Forgery” as a covered peril. For this reason, it is not uncommon for insureds to argue for coverage for the same loss under both Insuring Agreement (D) and Insuring Agreement E.\(^{177}\)

Insuring Agreement E of the Financial Institution Bond, Standard Form 24 (revised 1986) provides:

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

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

(a) Certificated Security,

(b) Document of Title,

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

(d) Certificate of Origin or Title,

(e) Evidence of Debt,

(f) corporate, partnership or personal Guarantee,

(g) Security Agreement,

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

(i) Statement of Uncertificated Security of any Federal Reserve Bank of the United States which

(ii) 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

(iii) is altered, or

(iv) is lost or stolen;

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

(3) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of 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.178

Subsection (2) of the 1986 Financial Institution Bond provides:

178 Financial Institution Bond (1986).
(2) Transferring, paying or delivering any funds or Property or establishing any credit or giving any value on the faith of any written instructions or advices directed to the insured and authorizing or acknowledging the transfer, payment, delivery or receipt of funds or Property, which instructions or advices purport to have been signed or endorsed by any customer of the insured or by any banking institution but which instructions or advices either bear a signature which is a Forgery or have been altered without the knowledge and consent of such customer or banking institution. Telegraphic, cable or teletype instructions or advices, as aforesaid, exclusive of transmissions of electronic funds transfer systems, sent by a person other than the said customer or banking institution purporting to send such instructions or advices shall be deemed to bear a signature which is a Forgery.\textsuperscript{179}

Theoretically, a loss resulting from a Forgery or alteration of one of the enumerated documents in Insuring Agreement E may also fall within the scope of subsection (2) of Insuring Agreement (D). Although both Insuring agreements include the covered perils of Forgery and altered documents, it is apparent that the two insuring agreements cover different types of documents. Insuring Agreement E is focused on Securities, while Insuring Agreement (D) focuses on negotiable instruments and the like.

The language of Insuring Agreement (D) that provides that a Negotiable Instrument does not include an Evidence of a Debt and the fact that an Evidence of a Debt is one of the covered documents under Insuring Agreement E demonstrates that the two insuring agreements are intended to cover different types of documents. This intent was recognized in \textit{First National Bank of Davis, Oklahoma v. Progressive Casualty Insurance Co.},\textsuperscript{180} where the court rejected the insured’s argument that Insuring Agreement E was ambiguous. The court reasoned that “the plain language of the bond is that Insuring Agreement

\textsuperscript{179} \textit{Id.}

(D) and Insuring Agreement (E) cover different types of forgeries and alterations.” The court also noted that “[t]he Exclusions section of the bond plainly indicates that forgeries and alterations may be “covered under Insuring Agreements (A), (D), (E) or (F).”

While it is possible that a claim involving a forgery or alteration of a document may overlap the coverages provided by Insuring Agreements D and E, the document at issue should fall under either those enumerated in Insuring Agreement (D), or those enumerated in Insuring Agreement E, but not both.

V. KEY EXCLUSIONS

A. Uncollected Funds Exclusion

One of the more significant exclusions impacting the claims for losses under Insuring Agreement (D) of the Financial Institution Bond is the uncollected funds exclusion. As stated in the Standard Form No. 24 1986 version, the exclusion excludes “(o) loss resulting directly or indirectly from payments made or withdrawals from a depositor’s account involving items of deposit which are not finally paid for any reason, including but not limited to forgery or any other fraud, except when covered under Insuring Agreement (a).”

This exclusion had its origins in Exclusion (e) of the 1968 version of the Banker’s Blanket Bond. Through at least one amendment, it evolved into the 1986 form as shown above. As one commentator stated:

The current exclusion . . . applies equally to claims arising from items which are not finally paid, even if the depositor receives payment or withdraws the deposited funds while on the premises of the bank.

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181 Id. at *6.
182 Id.
183 Exclusion (o), Financial Institution Bond (1986).
The provision is commonly referred to as the “uncollected funds exclusion” or the “check-kiting exclusion”. While the exclusion intended to preclude coverage for loss resulting from a check-kiting scheme, the plain language is broader in its application. Until an item of deposit is “finally paid,” any loss resulting from payments or withdrawals from the account on which an item of deposit is not finally paid is excluded from coverage . . . 184

As another commentator has explained:

[T]he rationale for the uncollected funds exclusion is that the insured bank is in the best position to prevent forgery or other fraud when accepting checks for deposit. If the bank inspects a check tendered for deposit and has doubts about or cannot verify an endorsement, the bank can place an extended hold on the check, extend overdraft privileges to a creditworthy customer to create a source of recourse in the event the check is returned unpaid, require collateral from the customer as a condition to paying on the check, or simply decline to accept the check on any terms . . . 185

In First Texas Savings Association v. Reliance Insurance Co., 186 the savings and loan in question suffered a loss on a customer’s check-kiting scheme. The trial court granted summary judgment in favor of the savings and loan. On appeal, the Fifth Circuit reversed the trial court’s summary judgment. In so doing, it found that the loan exclusion applied in light of the fact that the savings and loan had allowed repeated overdrafts that ultimately resulted in a loss, and had done so on the strength the representations made by the bank. It concluded that in light of these advances made upon the strength of the customer’s

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184 Sam Poteet and Jeff Price, Exclusions, Section 2 Exclusion (o), in Annotated Financial Institution Bond (Keeley ed. 2004).
186 950 F.2d 1171, 1172 (5th Cir. 1992).
representations, the loss was more in the nature of a loan loss than that of the uncollected funds exclusion. The court explained:

Our determination that the loan exclusion clause excludes coverage of First Texas’ loss in this case does not render the uncollected funds exclusion meaningless. This is so because as we have explained, First Texas allowed Rosenstein to withdraw these funds because of its faith in Rosenstein, not in his deposits. In the typical check-kiting case, where the bank advances funds in reliance on the validity of the deposited items, the uncollected funds clause may apply. But in this case, where the bank advanced funds in reliance on the customer’s ability and willingness to repay overdrafts, the Loan Exclusion clause, rather than the Uncollected Funds Exclusion clause, applies.

Thus, care must be made to determine the exact circumstance under which the loss arose and to evaluate the possible applicability of other pertinent exclusions, such as the loan exclusion.

In a case arising in Mississippi, the Fifth Circuit addressed a loss that ultimately resulted in a finding that certain items were covered and certain items were excluded by the uncollected funds exclusion. As described by the court, William C. Maloney, Jr. stole trust account checks from a law firm. The firm maintained its account at Planters Bank. Maloney forged deposits and negotiated forged trust account checks carrying out a check-kiting scheme between the trust account and accounts he maintained for himself at two other banks. Planters is reported to have immediately given account credit to the items deposited into the trust account. He would then deposit items to be issued on the trust account by way of the stolen check stock, forging the signature of the true signatory, and depositing those items to his accounts at other banks. The court concluded that, to the extent that Planters’ loss resulted from items of deposit on which credit was given before final payment,

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187 Id. at 1178 n.6.
188 Id. (emphasis added).
the uncollected funds exclusion barred recovery for such losses.  However, it held that certain items drawn on the trust account for cash or cashier’s checks while Maloney was on the bank premises were covered under the on premises clause, and not excluded under the uncollected funds exclusion. In so doing, it held that, “Exclusion (o) is dependent upon the account being improperly credited with deposits that have not been collected from the payor bank.” Here, however, the trust account had sufficient funds on the deposit when Maloney cashed the forged checks. Therefore, Exclusion (o) did not apply. Furthermore, the checks were forgeries negotiated on the premises of Planters, falling within the plain language of the bond. Thus, it appears that the portion of loss paid under the on premises coverage related to depletion of otherwise genuine funds that were on deposit in the trust account at the time of the withdrawal. Bradley Bank v. Hartford Accident & Indemnity Co. applied the on premises carve-out of the former exclusion consistently with United States Fidelity & Guaranty Co. v. Planters Bank & Trust.

The provisions of the uncollected funds exclusion have been applied in contexts other than checks. For example, in Bay Area Bank v. Fidelity & Deposit Co. of Maryland, the district court reviewed a claim in which Bay Area Bank suffered a loss on its bank card merchant credit account with Kevin Flynn. Under this account agreement, Flynn was authorized to honor certain credit cards and would then in turn transmit the sales drafts to the bank for collection. As stated in the opinion:

The bank agreed to post the drafts to Flynn’s account immediately upon receipt, without awaiting collection. Flynn could draw checks against the amount so credited but the bank retained the right at any time to charge Flynn’s account without notice or any sales drafts alleged by the cardholder to have been drawn without authority.”

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190 Id. at 867.  
191 Id.  
192 737 F.2d 657, 661 (7th Cir. 1984).  
194 Id. at 694.
Flynn then used the account to clear payments for magazine subscriptions. A number of customers were dissatisfied and caused charge-backs to be made on their charges which ultimately resulted in a loss on the account. The bank brought suit to recover for its alleged loss. In granting summary judgment in favor of USF&G, the court noted that the bond in question had added, by endorsement, an uncollected funds exclusion, which read:

The underwriter shall not be liable under the attached bond for:

Loss resulting from payments made or withdrawals from any depositor’s account which are uncollected for any reason, including forgery, unless such payments are made to or withdrawn by such depositor or representative of such depositor who is within the office of the Insured at the time of such payment or withdrawal, or unless such loss is covered under insuring agreement/clause (A) [the employee dishonesty coverage which was not applicable].

The court noted that the provision “excludes from coverage losses resulting from the extension of credit on uncollected items of deposit.” The court concluded the exclusion contained a limited carve-out for losses on payments or withdrawals while the depositor was physically present on the bank premises.

The parties agreed that credit card sales drafts could be “uncollected items of deposit.” The litigation thus focused on whether or not the exclusion was strictly limited to situations involving check-kites. The court rejected this limited reading of the exclusion holding that:

By its plain terms, the exclusion applies to losses resulting from items of deposit which are uncollected for any reason, and is not limited to losses incurred through

\begin{footnotes}
195 \textit{Id.} at 695.
196 \textit{Id.}
197 \textit{Id.} at 695.
198 In this regard, the exclusion differs from that of the 1986 edition of the Bond quoted above.
\end{footnotes}
check-kiting. Plaintiff’s loss clearly results from the payment of items of deposit which were uncollected by reason of a fraud perpetrated on the Bank. Therefore, the uncollected funds exclusion applies and the bank’s loss is excluded from coverage unless the Bank can invoke the on premises exception [in the endorsement in question].

Interestingly, the court did not address the question of whether or not any of the charge-back period for the subject charge slips had expired. Such analysis might impact the question of whether or not the item had been “finally paid”.

The question of whether or not the charge slips such as those at issue in the Bay Area Bank case constituted “items of deposit” was decided by the district court in Broadway National Bank v. Progressive Casualty Insurance Co. In that case, Broadway National Bank cleared credit card deposit slips for merchant customers. The bank began to experience charge-backs for various reasons relating to these charge slips, resulting in a loss to the bank. The court held that because of the charge-backs, the items were not finally paid. The court stated that:

The sole dispute regarding this clause [the Uncollected Funds Exclusion] is whether the items of deposit includes credit card sales slips. The clause admits of no other interpretation than that advocated by Progressive; Broadway’s argument that ‘items of deposit’ does not cover credit card slips is meritless . . . . [Although no court has yet construed items of deposit like the other terms used in the clause, its meaning is plain. The ordinary and obvious meaning of the words items of deposit is any financial instruments accepted by a bank for deposit.

The court noted that the New York Uniform Commercial Code, and the leading treatise on bank deposits, supported this construction of the term

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199 Bay Area Bank, 629 F. Supp. at 695 (internal quotations omitted).
201 Id. at 128 (emphasis added).
“items of deposit”. Thus, courts have tended to construe the exclusion to other instruments other than checks.

The Ninth Circuit opinion in Mitsui Manufacturers Bank v. Federal Insurance Co.\(^{202}\) provides further guidance. The insured bank suffered a loss when items taken for deposit, credited to the account of Mitsui’s depositor, were returned for various reasons, including forged endorsements.\(^{203}\) The deposits in question were made on November 20 and November 21 of 1980. The returns were made over a period of time stretching from November 1980 through March 1981. Mitsui had credited the accounts of the depositor on the day of deposit, and allowed her to draw against the checks before they cleared. Mitsui thus suffered a loss on the checks.

Mitsui filed a claim on its bond with Federal Insurance Company. The bond in question included a clause similar to Exclusion (o) in the 1986 bond. Federal’s bond provided, in pertinent part, that “[T]his bond does not cover: loss resulting from payments made or withdrawals from any depositor’s account by reason of uncollected items of deposit having been credited by the Assured to such account, whether or not such items are forged or altered in any respect . . . .”\(^{204}\)

The Ninth Circuit affirmed the trial court’s summary judgment in favor of Federal Insurance Company. In so doing, it stated that:

The plain language of the provision itself is unambiguous. It excludes from coverage a loss resulting from payments made or withdrawals from any depositor’s account by reason of uncollected items of deposit having been credited by the Assured to such account, whether or not such items are forged or altered in any respect . . . . The deposits in question were uncollected because the endorsements were forged. The

\(^{202}\) 795 F.2d 827, 830 (9th Cir. 1986).  
\(^{203}\) Id. at 828.  
\(^{204}\) Id. at 829.
The plain language of the exclusion is clearly applicable to this loss . . .

The court also concluded that the exclusion in question was unambiguous.

The question of whether or not a given item has been finally paid is a recurring issue in litigation under the uncollected funds exclusion. In *Pacific Business Bank v. St. Paul Mercury Insurance Co.*, the California Court of Appeal addressed an item that was negotiated at the insured bank then transferred to an intermediary collecting bank that was able to process the foreign currency item (the check was in British pounds). The intermediary then wired the funds to the insured bank, Pacific Business Bank, which in turn deposited the funds to the account of Mr. Au Yang, the customer. The item turned out to be a counterfeit. The purported payor bank detected this before honoring the item, returning it through the overseas collection process. Shortly after the hold was released at Pacific Business Bank, and the funds withdrawn by Pacific Business Bank’s customer, the returned item reached the intermediary collecting bank, which in turn demanded payment by Pacific Business Bank. Pacific Business Bank declined. The intermediary collecting bank, East West Bank, set off against Federal Funds on deposit with East West Bank.

Pacific Business Bank sued East West Bank and Pacific Business Bank’s bonding company, St. Paul Mercury Insurance. Pacific Business Bank argued that East West Bank had finally settled the check by way of a payment of “good funds” through the fed wire system. The court rejected this argument as well as that the item had not been deposited at Pacific Business Bank.

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205 *Id.* at 839 (internal quotations omitted).
206 An extensive discussion of these issues appears at Wood, *supra* note 185.
On appeal, the plaintiff abandoned the argument that the item had not been finally paid. Instead, it focused on its argument as to whether or not the item had been deposited to Ms. Yang’s account at Pacific Business Bank. The court held that the deposit of funds by Pacific Business Bank received by wire by it from East West Bank as a part of the negotiation of the check was sufficient to create a “deposit” such as would cause the item to be excluded by the uncollected funds exclusion.\(^{209}\)

It remains unsettled as to whether or not the rules of the UCC or other pertinent regulations (such as Treasury regulations in the case of a Treasury check) controls any question of whether or not an item is “finally paid” for purposes of the exclusion, or whether a lack of final payment under any standard should apply. At least one decision (albeit an unpublished decision), has held that the Code’s rules control. In Bidwell & Co. v. National Union Fire Insurance Co. of Pittsburgh, Pennsylvania,\(^{210}\) the court held that the UCC’s rules should apply. If the UCC rules are applied, an item could be “finally paid” under UCC § 4215 but it is still subject to recoupment by a payor bank under a warranty claim, or a conversion claim by the genuine payee where an endorsement has been forged. If the UCC rules apply, the applicability of the uncollected funds exclusion becomes questionable.

However, if the court were to apply the contractual language as drafted, which excludes losses “which are not finally paid for any reason” items of deposit to the customer’s account would rarely be covered because of the operation of the exclusion.\(^{211}\) Some might argue that such a construction would render coverage under Insuring Agreement (D) illusory. It would not. Indemnity would still remain for items drawn on the customer’s account bearing alterations or forged signatures, at a minimum. It would, however, dramatically reduce the scope of indemnity available for items deposited to the customer’s account. This makes sense in today’s automated, and semi-automated banking collections, where large volumes of checks can be deposited to a customer’s account without any form of visual inspection. If a bank


\(^{211}\) See Wood, supra note 185, at 127.
chooses to offer such services, it may do so. However, the bonding company may, by drafting an exclusion, elect not to insure such risks. Conceivably, a market might exist for an endorsement relating to such items.

The uncollected funds exclusion remains one of the more significant exclusions in the bond, particularly as relates to risks potentially insured under Insuring Agreement (D).

**B. Potential Income Exclusion**

The potential income exclusion, first incorporated in the 1980 Bankers Blanket Bond, provides that the Financial Institution Bond does not cover “potential income, including but not limited to interest and dividends, not realized by the insured.” This exclusion, like the indirect loss exclusion, emphasizes that financial institution bonds only provide coverage for out-of-pocket loss.

A number of courts have acknowledged that potential income not realized by an insured is not a covered loss. In *U.S. Gypsum Co. v. Insurance Co. of North America*, the dishonest employee shared with a competitor the insured’s formula used to manufacture a sealant used in nuclear power facilities. The formula provided U.S. Gypsum with a complete monopoly on this type of product until the formula was leaked by the dishonest employee. The evidence showed that the competitor made approximately $139,000 in sales from its unauthorized use of the formula. The insured submitted a claim under its employee dishonesty coverage for the $139,000 in lost sales it claimed it would have made but for the trade secret theft.

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212 Financial Institution Bond (1986) § 2(s); Financial Institution Bond, Standard Form 24 (2004) § 2(s).


214 *U.S. Gypsum Co.*, 813 F.2d at 858-59.
The court rejected the insured’s claim for coverage. The court’s analysis was that the employee’s dishonesty did not cause the insured to lose the trade secret, or the rights to the trade secret. U.S. Gypsum still had the formula and all rights to it. The court appropriately recognized that the detriment to U.S. Gypsum caused by the leak of the trade secret was that it had been deprived of sales that it should have made though its monopolistic use of the formula. In other words, the insured was seeking the recovery of the income it lost that was quantified by the amount of sales its competitors derived from the use of the trade secret. The court found that this “loss of potential” income was expressly excluded under the “potential income . . . not realized by the Insured” exclusion of the policy. The “potential income” exclusion precluded the insured’s recovery of a loss measured by its competitor’s sales. The court aptly noted that if an employee steals a machine from the insured, the cost of the machine may be covered, but the loss of sales that the insured was unable to make due to the loss of the machine would not be covered. The holding of U.S. Gypsum confirms the principle that while a fidelity bond may cover income producing property that is stolen, it does not cover the potential income that the property may have generated.

In Diversified Group, Inc. v. Van Tassel, employees of the insured secretly submitted a competing bid, through a corporation owned by the dishonest employees, for a government contract for an amount less than they had bid through their employer, the insured. When the government contract was awarded to the dishonest employees’ corporation, the insured sought recovery under its employee dishonesty coverage for the loss of profits it claimed it would have received had it been awarded the government contract. The court concluded that the “potential income” exclusion of the policy excluded “coverage for the loss of future profits, or future income flow, resulting from the fraudulent or dishonest conduct.” However, the insured also sought recovery for its employees’ misuse of company assets and diversion of company recourses they used in making the competing bid. These included the salaries the employees received for personally diverted time, travel expenses, telephone services, corporate facilities and overhead, secretarial services and other office supplies attributable to the employees’ efforts in making the competing bid. Although the court did

215 Diversified Group, Inc., 806 F.2d at 1276.
216 Id. at 1278.
not preclude recovery of these type of losses, it did note that the insured may be unable to carry its burden of proof on these items of loss.

In *Flagstar Bank, FSB v. Federal Insurance. Co.*,\(^{217}\) the insured sought recovery from the excess layer insurer for its loss, which it calculated as including, among other items, interest and fees. The insured argued that it should not have to credit various interest and fees payments received in the fraudulent transactions, and should be able to claim interest on the loss. The court disagreed, noting that the terms of the bond were clear and unambiguous and the potential income exclusion barred post loss interest.\(^{218}\)

In *Citizens Bank & Trust Co. v. St. Paul Mercury Insurance Co.*,\(^{219}\) the insured’s employee embezzled funds by issuing a series of fraudulent loans. A portion of the loan proceeds were used to repay prior fraudulent loans and accrued interest. At the time the fraudulent scheme was discovered, the outstanding principal balance on the loans was $1,452,010.92, with $46,606.57 of accrued interest. Although there was a dispute over the amount of the loss recoverable under the bond, the insured agreed that the potential income exclusion excluded the $46,606.57 of accrued interest. As for the dispute over the amount of recoverable loss, the court agreed with the insurer finding that the “loss resulting directly from” language was not ambiguous, and required an actual depletion of bank’s assets, not just a theoretical or bookkeeping loss. The court found that the proceeds of fraudulent loans used to pay interest on earlier loans never left the bank. Thus, there was no depletion of the bank’s assets. Therefore, those amounts were not a direct loss.

In *First Defiance Financial Corp. v. Progressive Casualty Insurance Co.*,\(^{220}\) the insured sought recovery for the amount it spent to reimburse its customers for monies stolen from their accounts, plus $66,679.99 in interest that the customers would have earned on the


\(^{218}\) Id.


\(^{220}\) No. 3:08CV2429, 2010 U.S. Dist. LEXIS 64963, at *2-3 (N.D. Ohio June 30, 2010).
funds. The insurer argued that the $66,679.99 was excluded from coverage by operation of the potential income exclusion. The court disagreed, reasoning that the potential income at issue was not income to the insured, but rather was income to the customers. The court found that the exclusion was straightforward in that it applies to income lost by the insured, not lost income of the insured’s customers.221

As the court in First Defiance Financial Corp. recognized, the potential income exclusions by its own terms, applies to potential income not realized by the insured.222 Thus, any part of loss alleged by an insured that amounts to potential income, or interest that the insured failed to realize due to the loss, falls within the scope of the potential income exclusion.

C. Causation

Insuring Agreement (D) provides, in pertinent part, that an insurer will pay for “Loss resulting directly from” a covered peril. If an insured establishes that a loss resulted in connection with a covered document, and a covered peril, the insured must still establish that the loss “resulted directly from” the covered peril. As a part of the insured’s burden of making a prima facie claim, the insured must prove that its loss of covered property was a direct result of the covered peril. The coverage language itself has a built in limitation on the scope of damages that may be recoverable under the bond.

Numerous decisions address the causation issue, with the majority of jurisdictions rejecting a proximate cause standard view of “direct loss.” In Commerce Bank & Trust v. St. Paul Mercury Insurance Co.,223 the court recognized, and followed, the majority of jurisdictions that “have held that the ‘resulting directly from’ language in the employee dishonesty clauses of fidelity bonds includes only those losses that immediately follow the covered event.”224 In Commerce Bank & Trust, a bookkeeper for Vulcan Industries used a signature stamp to

221 Id. at *5.
222 Id.
224 Id. at *14.
negotiate checks at various branches of the insured. She deposited the checks to credit her home equity loan account she held at Commerce Bank. Her employer, Vulcan Industries, was not a customer of the insured. When the fraud was discovered by her employer, it filed suit against the insured. The insured in turn filed suit against its Financial Institution Bond insurer for a declaratory judgment that the Bond covered any amount that it may be found to owe the employer. Summary judgment was entered in favor of the insurer on the grounds that there was no “direct loss.” The court reasoned that the “resulting directly” language, coupled with the exclusionary clauses that exclude coverage for indirect or consequential loss, demonstrated a crystal clear intent not to cover indirect losses.225

The requirement of a “direct loss” in Insuring Agreement (D), and the other insuring agreement of the Financial Institution Bond, requires something more than a basic “but for” analysis. In RBC Mortgage Co. v. National Union Fire Insurance Co. of Pittsburgh, PA,226 the court stated:

A ‘direct loss’ must be afforded its plain and ordinary meaning. To equate ‘loss resulting directly from’ with ‘loss proximately caused by’ requires a strained reading of ‘direct loss’, which is a much narrower concept than ‘proximately cause loss.’227

The application of a tort concept of “proximate causation” in interpreting the contractual term of “direct loss” is not appropriate. The court in Vons Companies Inc.228 recognized this, and held that ‘direct’ means ‘direct.’229

In the case of Flagstar Bank, FSB v. Federal Insurance Co. and Continental Casualty Co.,230 the court was presented with a forgery claim

225 Id. at *12.
227 Id. at 736-37.
228 Vons Co. v. Fed. Ins. Co., 212 F.3d 489, 490 (9th Cir. 2000).
229 Id. at 492.
230 260 F. App’x 820, 821 (6th Cir. 2008).
based upon loan funds advanced on nonexistent collateral. In granting summary judgment in favor of the insurer, the court followed the logic of cases finding that fidelity or crime policies, “which cover loss resulting either directly or indirectly from forgery, do not cover loss arising from the extension of loans based on fictitious collateral.”

The court held that the promissory notes received by the insured, though forged, were valueless due to the failure of collateral and thus the “loss did not directly result from forgery.”

In Stop & Shop Cos. v. Federal Insurance Co., the court held that “direct loss” means immediate damage resulting from covered cause and that “directly” means “immediately.” Thus, the longer the delay between the covered peril and the monetary loss, the more likely the loss is not the direct result of the covered peril.

A few jurisdictions, however, apply a proximate cause analysis for “direct loss.” In Owens, Schine & Nicola, P.C. v. Travelers Casualty & Surety Co. of America, the insured law firm was retained to collect an alleged debt owed to a Chinese company. The alleged debtor sent the firm an “official check” purportedly from Wachovia Bank, and the law firm wired the amount of the check, less a small fee, to an account in South Korea designated by the purported client. The “official check” was a fraud, and the law firm was out the money it wired. The law firm claimed a loss under the Computer Crime coverage of its policy, on the theory that its communications with the scammer were via e-mail and the fraudulent check was most likely created by use of a computer. The insurer denied the claim. In denying the insurer’s motion for summary judgment in the subsequent lawsuit, the court noted

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231 Id. at 823.
233 Id. at 106.
that “[t]he direct causation requirement in a crime policy in Connecticut is synonymous with proximate cause,” and in doing so rejected the insurer’s argument that the cause of the loss was the insured’s wiring money out of its account. 236

In the decisions where the courts apply a “proximate cause” standard, the insured did in fact part with money at or about the time of the making of the loan as a direct result of the dishonest conduct of the principal. The loan was the “quid” for the “quo” of the bribe. The courts in these cases generally did not allow the insurer to point to another factor as the cause where the dishonest conduct was also a direct cause of the loss. While one may quarrel with the reasoning of the courts in these opinions, finding coverage under the facts of their cases, it is important to recognize that their application should be limited to the factual context in which they were rendered, and in light of their view that the “quid” of the loan was the “quo” for the bribe, thus constituting a direct relationship between the detriment and the benefit to the dishonest employee.

In any case, whether in a majority jurisdiction where “direct means direct,” or in a minority jurisdiction applying a more flexible approach to the “resulting directly from” requirement, a temporal analysis of the acts related to the covered peril to when the money left the insured’s pocket should be scrutinized.

D. Failure of Financial Institution

Exclusion (x) was first introduced in the 1986 form of the Financial Institution Bond. The exclusion excludes:

[L]oss resulting directly or indirectly from the failure of a financial or depository institution, or its receiver or liquidator, to pay or deliver, on demand of the Insured, funds or Property of the Insured held by it in any

236 Id. at 22.
capacity, except when covered under Insuring Agreements (A) or (B)(1)(a).”

The exclusion provides that no loss, whether direct or indirect, caused by the failure of a financial institution or depository institution to return funds or property to the insured, is covered unless the loss of funds or property is directly caused by employee dishonesty or one of the enumerated causes of loss under Insuring Agreement B(1)(a), such as robbery, burglary, misplacement, mysterious unexplainable disappearance and damage or destruction thereof. The fundamental purpose of the exclusion appears to exclude losses caused by the failure of another financial institution to pay or deliver over funds or property of the insured that were lost due to one reason or another, including theft, fire or liquidation of the other financial institution. However, no decisions have addressed this exclusion.

VI. CURRENT TRENDS AND ISSUES

Insureds continue to be creative in their attempts obtain indemnity from the insurer for losses having little, if anything, to do with a “Forgery.” Frequently, insureds who sustain a loss that involves irregular documentation will seek coverage under both Insuring Agreements D and E, contending one or the other must apply. The courts continue to properly recognize that coverage, if available, falls under either D or E but not both. The courts also recognize that not all bank losses that involve irregular documentation are necessarily covered at all.

The expansion of e-commerce, and losses associated with it involving fraudulent transactions, has presented unique claims for coverage under the Financial Institution Bond. A number of insured have sought coverage for losses associated with wire transfers. The typical example is where an insured accepts a check for deposit, and then, at the request of its depositor, wires funds to an account outside the United States. Korea and China have become a popular destination for such wire transfer schemes. The insured then discerns, too late in the

process, that the check was defective for one reason or another, usually because it was a fake. Sometimes it is not the check that is fake, but the wire transfer request that is forged or otherwise fraudulent. For example, as previously discussed in the section above on Written Instructions, in Missouri Bank and Trust Co. of Kansas City v. OneBeacon Insurance Co. the insured sought coverage under Insuring Agreement (D) for loss associated in honoring a faxed wire transfer request from an imposter, and the funds were transferred to a Korean bank. The court found that the faxed wire transfer request fell within the scope of Insuring Agreement (D) because it was a written instruction.

In any event, when evaluating coverage under Insuring Agreement (D), it is important to examine the specific document at issue to determine if it falls with the scope of the enumerated documents in the insuring agreement.

VII. THE FUTURE OF INSURING AGREEMENT (D)

The financial services industry continues to develop transaction structures outside the traditional paper-based formats. Internet banking, mobile banking and e-mail were all unheard of at the time Insuring Agreement (D) was developed. From a practical point of view, Insuring Agreement (D) does not fully address certain e-commerce risks of loss that now exist in the market place. While the paper-based market risks still exist, new insuring products have been developed, and will continue to be developed, to help provide the market with a means of financing e-commerce risks. Examples of these new coverages include computer systems fraud coverage, electronic funds transfer coverage and manuscript forms designed for the e-commerce type of risks. With the introduction of these specialized products, the industry will likely see fewer claims attempting to find coverage for these more exotic, nonpaper-based risks under Insuring Agreement (D). Rather, the market and the industry will have access to specialized products designed to address the new types of risks associated with e-commerce. Before these products, insureds commonly tried to obtain coverage for losses involving new e-commerce type under the coverages afforded by

\[238\text{ 2010 U.S. Dist. LEXIS 114748, at *4.}\]
Insuring Agreements D or E. Now insureds can look to other products for specially tailored to finance these new risks.

Despite the new e-commerce type risks, such as those presented by automatic bill pay and online transfers, which are becoming more and more popular by the day, paper-based risks still exist. Paper checks are widely used, and criminals continue to forge and alter checks on a regular basis. Insuring Agreement (D) is still needed to address these and the other specific perils that fall within the scope of Insuring Agreement (D).

Insuring Agreement (D) provides an important purpose for specified paper-based risks. Coverage disputes under that Insuring Agreement will probably decrease as banks begin to look for, and the insurance market provides, insurance for risks of loss arising from e-commerce fraud.