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COMPARING AND CONTRASTING INSURING AGREEMENTS (D) AND (E)

Timothy Markey
Scott Spearing
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I. INTRODUCTION

Insureds are frequently attempting to conflate Insuring Agreement D and Insuring Agreement E of the Financial Institution Bond despite the fact that each insuring agreement provides coverage for fundamentally different types of losses. Insuring Agreement D, on the one hand, provides a limited coverage for certain losses that a bank sustains as a direct result of forgery or alteration in its ordinary function of processing and paying checks and drafts as a financial institution. Insuring Agreement D is most often implicated in the context of check fraud losses. Insuring Agreement E, on the other hand, provides a limited coverage for certain losses that a bank sustains as a direct result of having, in good faith, extended credit or assumed liability on the faith of certain documents. Insuring Agreement E is most often implicated in the context of loan losses. Neither of these insuring agreements, however, provides credit insurance and, therefore, neither protects a financial institution against non-payment of a debt.[1]

[1] This fundamental principle that fidelity insurance is not credit insurance has been recognized by courts, including most recently by the Fifth Circuit in a decision handed down this year. *See, e.g.,* Renasant Bank v. St. Paul Mercury Ins. Co., 882 F.3d 203, 207 (5th Cir. 2018) (stating that fidelity bond's criteria for covering loan losses preserves "the distinction between fidelity insurers (who cover embezzlement and embezzlement-type acts) and credit

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Attempts to conflate Insuring Agreement D and Insuring Agreement E likely stem from a single common feature shared by the two insuring agreements, in that each provides some coverage for losses resulting directly from forgery or alteration of an enumerated covered document. However, the coverages provided by Insuring Agreement D and Insuring Agreement E, respectively, are mutually exclusive, as there is little to no overlap between the types of documents covered by these insuring agreements.

Insuring Agreement D and Insuring Agreement E also contain independent sets of conditions that must be satisfied before a loss is covered. Some of these conditions—for instance, the requirement that the loss "result directly from" the covered impairment or defect to a covered document—are shared by both insuring agreements. Other conditions—such as the requirements of "good faith" and "actual physical possession" of an "original"—were, at one time, unique to Insuring Agreement E. This is no longer the case, however, as revisions to the Financial Institution Bond made by the Surety Association of America (SAA) in 2004 added these same conditions to Insuring Agreement D.

This article will endeavor to acquaint the reader with the unique requirements for coverage under Insuring Agreement D and Insuring Agreement E and discuss how these requirements operate to render the coverage provided by the two insuring agreements mutually exclusive. This article also will explore the ways in which some financial institutions are attempting to use modern banking practices to expand the

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insurers"); *see also* Am. Cas. Co. of Reading, Pa. v. Etowah Bank, 288 F.3d 1282, 1284 (11th Cir. 2002) (applying Georgia law) ("A financial institution bond is a type of fidelity bond that is designed to insure financial institutions against fraudulent or unfaithful dealings by employees and certain outside parties which could damage the institution."); Fed. Deposit Ins. Corp. v. St. Paul Fire & Marine Ins. Co., 942 F.2d 1032, 1036-37 (6th Cir. 1991) (stating that bank's blanket bond "covers fraud, not bad business judgment, whether that be characterized as 'reckless and imprudent,' or just plain 'poor'") (internal citation omitted); Calcasieu-Marine Nat'l Bank of Lake Charles v. Am. Emp'rs' Ins. Co., 533 F.2d 290, 299 (5th Cir. 1976) (stating that bank's blanket bond "is not a policy of credit insurance and does not protect the bank when it simply makes a bad business deal").

coverage provided by these insuring agreements well beyond their intended applications.

II. THE COVERED DOCUMENT REQUIREMENT UNDER INSURING AGREEMENT (D) AND INSURING AGREEMENT (E)

The starting place for understanding the differences between the coverages provided by Insuring Agreement D and Insuring Agreement E is the list of documents covered by each insuring agreement. The document categories covered by each insuring agreement are mutually exclusive. This feature is representative of the fact that Insuring Agreements D and E cover distinct types of losses.

A. Types of Documents Covered by Insuring Agreement (D)

Insuring Agreement D of the Financial Institution Bond[2] provides:

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,

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[2] Unless otherwise indicated, the Financial Institution Bond (FIB) refers to Financial Institution Bond, Standard Form No. 24 (revised Apr. 2004) [hereinafter the 2004 Bond], *reprinted in* FINANCIAL INSTITUTION BONDS 1081-96 (Michael Keeley ed., 4th ed. 2016).

(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.[3]

By its plain terms, Insuring Agreement D limits coverage to losses resulting directly from forgery or alteration of an enumerated document. More specifically, it covers only those losses resulting directly from a forgery or alteration of: (1) a negotiable instrument (except an evidence of debt); (2) a certificate of deposit; (3) a letter of credit; (4) a withdrawal order; (5) a receipt for the withdrawal of property; or (6) an instruction or advice directed to the insured purportedly signed by a customer of the insured or by a banking institution. While most of the documents covered by Insuring Agreement D are defined in the Financial Institution Bond and have been the subject of limited dispute, there are exceptions discussed below.

1. Instruction or Advice

"Instruction or advice" is not defined in the Financial Institution Bond. This lack of a definition led to some dispute as to what types of documents qualify as an "instruction or advice" under the FIB. Many

[3] 2004 Bond, Insuring Agreement (D).

courts have held that the term refers principally to commercial paper, such as checks and drafts, and have rejected attempts by insureds to construe documents outside the realm of commercial paper as a covered "instruction or advice" under Insuring Agreement D.

For instance, in *Liberty National Bank & Trust Co. of Louisville v. National Surety Co.*,[4] the Sixth Circuit held that losses sustained by a bank when it purchased notes secured by forged automobile chattel mortgages and automobile leasing agreements were not covered by Insuring Agreement D. The bank argued that the automobile chattel mortgages and automobile leasing agreements constituted an "instruction" within the meaning of Insuring Agreement D. The Sixth Circuit rejected this argument, holding that Insuring Agreement D "deals principally with cases resulting from forgery of commercial paper of the nature of checks or drafts."[5] This principle has been frequently cited by insurers, and by courts, to avoid creative attempts by insureds to shoehorn losses involving documents outside the realm of commercial paper into the coverage provided by Insuring Agreement D.

That was the case in *KW Bancshares, Inc. v. Syndicates of Underwriters at Lloyds*.[6] There, the insured bank argued that a forged letter submitted by a customer of a bank seeking a personal loan constituted an "instruction" or "advice" under Insuring Agreement D. The letter indicated that the customer was to receive a substantial annual bonus, and was purportedly signed by an official of the customer's employer. The signature, however, was a forgery. When the customer defaulted on the loan, the bank learned of the forgery and sought coverage for the loss under Insuring Agreement D, arguing that the forged letter represents "instructions or advices" directed to the bank. The court disagreed. Relying on the dictionary definition of "instruction" as "orders or directions" and of "advice" as "information," the court reasoned that "[w]hile the letter does contain 'information,'" it "was not commercial paper, such as a check or draft."[7] The court, therefore, held

[4] 330 F.2d 697 (6th Cir. 1964).
[5] *Id.* at 699.
[6] 965 F. Supp. 1047 (W.D. Tenn. 1997).
[7] *Id.* at 1052.

that the letter clearly was not the type of document contemplated to be an "instruction or advice."[8]

Other courts also have rejected attempts by insureds to construe documents that clearly are not commercial paper as an "instruction" or "advice" within the meaning of Insuring Agreement D. In *First Union Corp. v. United States Fidelity and Guaranty Co.*,[9] for example, the Maryland appellate court concluded that a forged "incumbency certificate" submitted to a bank with an application for a commercial loan did not constitute an "instruction" within the meaning of the bond issued to the bank. The "incumbency certificate" was submitted by an individual purporting to act on behalf of the company and purported to represent his status as a high-ranking official with authority to act on the company's behalf. When the bank learned of the fraud, it sought to recover the funds advanced to the imposter under the bond, arguing that the forged "incumbency certificate" constitutes "written instructions" under Insuring Agreement D. The court disagreed, holding:

> Appellant next contends that the incumbency certificates are "written instructions" and, accordingly, qualify for coverage under Insuring Agreement (D)(2) of the bond. Cases addressing the subject, however, have held that "instructions and advices" refer principally to commercial paper, such as checks and drafts. The forged incumbency certificates in this case are clearly not commercial paper and, therefore, they do not constitute "instructions or advices."[10]

Similarly, in *Forcht Bank, N.A. v. Bancinsure, Inc.*,[11] a bank argued that its insurer was required to indemnify it for loans that it had made to a company that were secured by a life insurance policy issued to the company's principal. In the course of the loan application process, the principal provided to the bank a letter addressed to "Client" on what appeared to be Lincoln Financial Group letterhead, which stated that the accumulated cash value of the principal's life insurance policy was

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[8] *Id.*

[9] 730 A.2d 278 (Md. Ct. Spec. App. 1999).

[10] *Id.* at 283 (internal citations omitted).

[11] 514 F. App'x 586 (6th Cir. 2013).

$1,766,361, with a death benefit of $2,441,361. The letter contained the forged signature of "Virginia Campbell." The court held that, although the company's principal fabricated the letter in order to acquire the loan, the letter did not constitute written instructions or advices because it was directed to "Client," who is the company's principal, not to the bank, and, therefore, was not directed to the insured.[12]

There are some outlier decisions, however, which have found documents other than commercial paper to be "instructions or advices". For instance, some courts have been more willing to find that documents which are not traditional commercial paper qualify as an "instruction or advice" where they relay direct instructions. That was the reasoning of one federal court in *Fidelity National Financial, Inc. v. National Union Fire Insurance Co. of Pittsburgh, PA*.[13] In *Fidelity National*, a title company sought coverage under a financial institution bond for a settlement into which the title company entered with the victims of a Ponzi scheme instigated by the principal of a financial planning business and in which the three employees of the title company were alleged to have actively participated. Applying the dictionary definitions of "instruction" and "advice," the court agreed with the title company's contention that the forged escrow instructions qualified as "written instructions and advices" for purposes of Insuring Agreement D, reasoning that "[t]he forged escrow instructions involved here plainly satisfy the common dictionary definition of either 'instructions' as an 'order or direction,' or 'advice' as 'a formal or official notice sent by one person or office to another concerning a business transaction.'"[14] Other courts, in determining whether particular documents qualify as a written instruction or advice within the scope of Insuring Agreement D, have employed differing reasoning to reach their holdings, but generally have confined their decisions to the specific facts involved.[15]

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[12] *Id.* at 591.

[13] No. 9-CV-140-GPC-KSC, 2014 WL 4909103 (S.D. Cal. Sept. 30, 2014).

[14] *Id.* at *15.

[15] *See, e.g.,* Missouri Bank and Trust Co. v. OneBeacon Ins. Co., 688 F.3d 943 (8th Cir. 2012) (fraudulent faxed wire transfer request bearing forged signature constituted "written instruction" because it was "retrievable in perceivable form" and thus was a writing, not an electronic record); Provident

2. Letters of Credit

"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."[16] The definition of "Letter of Credit" has resulted in little dispute between insurers and insureds, and as such, there are no reported cases interpreting the definition of "Letter of Credit" under the Financial Institution Bond.

3. Negotiable Instruments (Except an Evidence of Debt)

The Financial Institution Bond defines "Negotiable Instrument" as follows:

> Negotiable Instrument means any writing:
>
> (1) signed by the maker or drawer; and
> (2) 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;
> (3) is payable on demand or at a definite time; and
> (4) is payable to order or bearer.[17]

In contrast, the Uniform Commercial Code (UCC) contains a broader definition of "negotiable instrument" than that contained in the Financial Institution Bond. Section 3-104 of the UCC defines "negotiable instrument" as follows:

> "[N]egotiable instrument" means an unconditional promise or order to pay a fixed amount of money, with

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Trust Co. v. Nat'l Sur. Corp., 138 F.2d 252 (3d Cir. 1943) (fraudulent warehouse receipts securing insured's loan to customer constituted "written instructions or advices" because they notified the bank that the warehouse held the collateral identified in the receipts).

[16] 2004 Bond, Definitions, § 1(l).

[17] 2004 Bond, Definitions, § 1(p).

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.[18]

There are three key differences between the definitions of "Negotiable Instrument" under the Financial Institution Bond and the UCC. These differences sometimes result in a situation in which a document falls within the definition of "negotiable instrument" under the UCC but is not a "Negotiable Instrument" covered under Insuring Agreement D. First, the UCC 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," whereas the Financial Institution Bond requires only that the instrument be payable to order or bearer.[19] Second, the UCC requires that the instrument contain an "unconditional promise" to pay "a fixed amount of money," whereas the Financial Institution Bond requires that the instrument contain an "unconditional promise" to pay "a sum certain in Money."[20] Third, the Financial Institution Bond unequivocally requires that the instrument contain an "unconditional promise" and "no

[18] U.C.C. § 3-104(a) (1990).

[19] *Compare* U.C.C. § 3-104(a) (1990), *with* 2004 Bond, Definitions, § 1(p).

[20] *Id.*

other promise, order, obligation or power," whereas the UCC permits other promises in certain defined circumstances.[21]

These distinctions have led to disputes between insurers and insureds with respect to documents that may constitute a "negotiable instrument" under the UCC but do not constitute a "Negotiable Instrument" under the Financial Institution Bond. For instance, the Financial Institution Bond requires that the instrument contain an "unconditional promise" to pay "a sum certain in Money." It defines "Money" as "a medium of exchange in current use authorized or adopted by a domestic or foreign government as part of its currency." Court have interpreted the defined term "Money" to require a promise to pay in *cash*.[22]

In contrast, the UCC requires only that the instrument contain an "unconditional promise" to pay "a fixed amount of money," without providing an express definition of "money." Thus, instruments that require or permit payment in forms other than cash, such as by check or money order, constitute a "negotiable instrument" under the UCC. However, they do not constitute a "Negotiable Instrument" under the Financial Institution Bond because the requirement under the definition of "Negotiable Instrument" that the payment be "in Money" is not satisfied. As should be obvious, merely satisfying the UCC's definition of "negotiable instrument" does not establish coverage under Insuring Agreement D. Insurers and courts should be wary of self-serving attempts by insureds to rely upon the UCC to supplant the plain language of the definition of "Negotiable Instrument" contained in the Financial Institution Bond.

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[21] *Id.*

[22] *See, e.g.,* Midwest Fed. Sav. & Loan Ass'n of Minot v. Kouba, 335 N.W.2d. 780, 784 (N.D. 1983) (two-party check that debtors offered to bank to pay mortgage was not money because "[a] check is not included in the definition of money"); Fillion v. David Silvers Co., 708 S.W.2d 240, 247 (Tex. Ct. App. 1986) (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").

4. Receipts for the Withdrawal of Property

The term "receipt for the withdrawal of Property" is not defined in the Financial Institution Bond. The term "Property," however, is defined in the Financial Institution Bond to mean: "Money, Certificated 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 which are not hereinbefore enumerated."[23] Despite the broad definition of "Property" contained in the FIB, insureds do not frequently rely upon the term "receipts for the withdrawal of Property" in claiming coverage for a loss under Insuring Agreement D, and no reported case has addressed what documents constitute "receipts for the withdrawal of Property."

There have been occasions, however, where insureds have argued that because (1) insurers have chosen not to define "receipt for the withdrawal of Property" in the FIB and (2) there are no reported decisions in which a court has attempted to define the term, the phrase "receipt for the withdrawal of Property" must be given its plain and ordinary meaning and be construed liberally and in favor of the insured. In these claims, insureds have attempted to combine the definition of "Property" with the common dictionary definition of receipt—"a written acknowledgement of the receipt of money"[24]—to argue that many different types of documents are "receipts for the withdrawal of Property."

For example, on more than one occasion, a bank has claimed that a borrower's list of receivables submitted to the bank in support of a request for an advancement on the borrower's line of credit were "receipts for the withdrawal of Property" because the list of receivables was given to the bank for the purpose of withdrawing Property (*i.e.*, money) from the bank. Such an expansive interpretation of a "receipt for

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[23] 2004 Bond, Definitions, § 1(r).
[24] BLACK'S LAW DICTIONARY (10th ed. 2014).

the withdrawal of Property" is far too broad. In this scenario, the borrower's list of receivables is merely a recital (*i.e.*, it is drafted by the borrower) that purports to reflect what is owed to the borrower from one of its clients, as referenced by an invoice from the borrower to its client. A mere list of receivables does not acknowledge the receipt of any "Property" by anyone. Neither the list of receivables, nor the accompanying request for an advance on the borrower's line of credit, authorizes the bank to make a withdrawal from its customer's accounts. More importantly, the list of receivables and the request for an advance do not authorize or evidence any right on the part of the bank's customer to make a withdrawal from or receive "Property" from the bank.

A similar scenario was discussed in *Metro Credit Union v. Federal Insurance Co.*[25] in the context of what constitutes a "Withdrawal Order" under a FIB. In *Metro Credit Union*, the insured credit union argued that "if the [a]greements, [a]dvance requests, and invoices are considered together—they are a 'Withdrawal Order' because they collectively authorize the [credit union] to debit [its customer's] account."[26] The Court disagreed with this argument, holding such documents were "not withdrawal orders but applications for . . . financing."[27]

It is important to note that the phrase "receipt for the withdrawal of Property" appears in Insuring Agreement D as part of a list of similar type documents—instruments representing the signor's unilateral commitment to pay or surrender specified money or property. An invoice or list of receivables, such as those described above, are not documents that evidence a commitment to pay a specific sum of money nor do such documents acknowledge the receipt or payment of money or property. The FIB's reference to a "receipt for the withdrawal of Property" most likely refers to a written instrument that may be presented for the purpose of taking possession of property—*i.e.*, a warehouse receipt, a bill of landing, or even a pawn ticket, if used for the redemption of "Property". The phrase "receipt for the withdrawal of Property" is, therefore, much more limited than insureds contend.

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[25] 607 F. Supp. 2d 870 (N.D. Ill. 2009).
[26] *Id.* at 876.
[27] *Id.* at 876-77.

B. Types of Documents Covered by Insuring Agreement (E)

Insuring Agreement E of the Financial Institution Bond provides:

SECURITIES

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

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

(f) Evidence of Debt,

(g) Corporate, partnership or personal Guarantee, or

(h) Security Agreement,

which (i) bears a handwritten signature of any maker, drawer, issuer, endorser, assignor, lessee, transfer agent, registrar, acceptor, surety, guarantor, or of any other person whose signature is material to the validity or

> enforceability of the security, which is a Forgery, or (ii) is altered, or (iii) is lost or stolen.[28]

Insuring Agreement E covers an entirely separate and distinct group of document categories than Insuring Agreement D. With the exception of documents creating or discharging a lien upon real property, all of the documents covered under Insuring Agreement E are defined in the Financial Institution Bond. Despite this, disputes still have arisen regarding certain of the document categories—most commonly, with respect to the terms "Evidence of Debt" and "Security Agreement."

1. Evidence of Debt

The Financial Institution Bond defines "Evidence of Debt" as "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."[29] The typical "Evidence of Debt" is a promissory note given to the insured as the payee. While insureds have attempted to extend the definition of "Evidence of Debt" to encompass other documents containing a promise to pay money or take some other action, such attempts have met with only limited success.

For instance, in *Merchants National Bank of Winona v. Transamerica Insurance Co.*,[30] the insured bank loaned funds to a contractor and, in connection with the loan, obtained an assignment of the contractor's construction contracts, which bore forged signatures. The Minnesota Court of Appeals rejected the insured's argument that the construction contracts, which contained a promise to pay the contractor, constituted "Evidence of Debt" under Insuring Agreement E, reasoning that the insured was not owed anything under the construction contracts. The court summarized its reasoning as follows:

> "Evidence of debt" refers to primary indicia of debt, such as promissory notes or other instruments that reflect a customer's debt to the bank. Under this standard, the

[28] 2004 Bond, Insuring Agreement (E).
[29] 2004 Bond, Definitions, § 1(i).
[30] 408 N.W.2d 651 (Minn. Ct. App. 1987).

> construction contracts do not constitute evidence of [the contractor's] debt to [the insured].[31]

Other courts have applied the same reasoning to reject attempts by insureds to construe documents outside the realm of promissory notes as an "Evidence of Debt." For instance, in *Pine Bluff National Bank v. St. Paul Mercury Insurance Co.*,[32] the Eastern District of Arkansas held that falsified leases, by which the borrower secured a revolving line of credit from the bank, were not an "Evidence of Debt" under Insuring Agreement E. Similar to the *Merchants National* court, the *Pine Bluff* court reasoned that, "[t]o be an Evidence of Debt, the lease would have to evidence [the borrower's] debt to the Bank" and here, "[i]n fact, each lease is evidence, or purports to be evidence, of the lessee's debt to [the borrower], not [the borrower's] debt to the Bank." The court therefore held that, as a matter of law, the leases were not an "Evidence of Debt" within the meaning of the bond.[33]

A similarly-reasoned result was reached in *Metro Federal Credit Union v. Federal Insurance Co.*,[34] in which the Northern District of Illinois held that a borrower's requests for advances of funds, which attached invoices purportedly evidencing the borrower's accounts receivable, on which the credit union relied in extending funds to the borrower, were evidence of collateral, not an "Evidence of Debt" within the meaning of Insuring Agreement E. Other courts have reached similar conclusions with respect to other types of documents outside the realm of a promissory note.[35]

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[31] *Id.* at 653.

[32] 346 F. Supp. 2d 1020 (E.D. Ark. 2004).

[33] *Id.* at 1027.

[34] 607 F. Supp. 2d at 878-79.

[35] *See, e.g., First Union Corp.*, 730 A.2d at 282 (forged "incumbency certificate" submitted to bank with application for commercial loan did not constitute "evidence of debt" because it failed to evince debt to bank).

2. Deed, Mortgage, or Other Instrument Conveying Title To, or Creating or Discharging a Lien Upon, Real Property

The terms "deed, mortgage or other instrument conveying title to, or creating or discharging a lien upon, real property" are not defined in the Financial Institution Bond. However, there is little room for dispute regarding the application of these terms.

Black's Law Dictionary defines "deed" as "[a] written instrument by which land is conveyed."[36] It defines "mortgage" as "[a] conveyance of title to property that is given as security for the payment of a debt or the performance of a duty and that will become void upon payment or performance according to the stipulated terms."[37] A "lien" is defined as "[a] legal right or interest that a creditor has in another's property, lasting [usually] until a debt or duty that it secures is satisfied."[38] Taken together, a document qualifies as a deed or mortgage only if it conveys title to an interest in real property. Any other document qualifies for coverage under Insuring Agreement E only if it creates or discharges a lien upon real property.

While the legal definitions of the terms are not controversial, insureds occasionally have advanced creative arguments in an attempt to fit non-traditional documents within this category. In *First Federal Savings Bank of Newton, Kansas v. Continental Casualty Co.*,[39] the insured argued that allegedly counterfeit construction cost statements, subcontractor agreements, subcontractor invoices, and checks to subcontractors, which were all provided by a borrower to the bank, constituted "documents creating or discharging a lien upon real property." Relying on the Colorado mechanic's lien statute, the insured argued that a lien upon real property is created when the work is performed or the materials are supplied and, therefore, the documents showing that the work was performed or the materials were supplied create a lien upon the real property. The District of Kansas disagreed, reasoning that "[e]ven accepting plaintiff's argument that [*sic*] lien is

[36] BLACK'S LAW DICTIONARY (10th ed. 2014).
[37] *Id.*
[38] *Id.*
[39] 768 F. Supp. 1449 (D. Kan. 1991).

created by the performance of work or the furnishing of materials, it does not follow that any document evincing this work [such as, the construction cost statements, the subcontractor agreements, the subcontractor invoices, and the subcontractors checks, at issue] creates the lien."[40]

The *First Federal* court then addressed the insured's claim for coverage under Insuring Agreement E on the premise that the checks made out to the subcontractors, which contained forged lien waivers stamped on the back, were documents discharging rather than creating a lien upon real property. The insured argued that the checks were instruments discharging the subcontractors' liens because the checks purported to pay for work that the subcontractor had performed. The court assumed, without expressly deciding, that the checks and forged lien waivers could be documents discharging a lien upon real property. It held, however, that there was no coverage for the bank's loss because the other requirements for coverage were absent, including that the insured did not have actual physical possession of forged lien waivers before making payment and the checks did not meet the bond's definition of "counterfeit."[41]

3. Security Agreement

"Security Agreement" is defined in the Financial Institution Bond as "a Written agreement which creates an interest in personal property or fixtures and which secures payment or performance of an obligation."[42] A somewhat common area of dispute regarding the defined term "Security Agreement" is whether a lease agreement meets the definition.

For example, in *Pine Bluff National Bank*,[43] the Eastern District of Arkansas addressed whether falsified computer lease agreements that secured a revolving line of credit by the bank constituted "security agreements" within the meaning of Insuring Agreement E. The court agreed with the insured that the computer leases at issue met the

[40] *Id.* at 1455-56.
[41] *Id.* at 1456.
[42] 2004 Bond, Definitions, § 1(s).
[43] 346 F. Supp. 2d at 1027-28.

definition of "security agreement" under the bond because "[e]ach lease creates a leasehold interest in a copy machine, so each lease creates an interest in personal property" and "[e]ach lease secures payment of the lessee's obligation."[44] Pointing to provisions of the UCC adopted in Arkansas, the insurer argued that a lease may not be characterized as a security agreement unless there is no residual value to the lessor at the end of the lease term. The court found that the definition of "security agreement" in the bond was unambiguous and rejected the insurer's reliance on extrinsic material to determine the meaning of that definition.[45]

The Seventh Circuit, in *FDIC v. RLI Insurance Co.*,[46] stretched the definition of "security agreement" further in the context of documents related to a lease agreement. In this case, the FDIC, as receiver for a national bank, filed suit against the bank's insurer, claiming that the insurer breached the financial institution bond issued to the bank by failing to reimburse it for losses that the bank incurred from defaulted loans purportedly collateralized by forged equipment leases. The lessor's president forged the lessee's name to the lease schedules, which described equipment that never existed. The court held that the forged lease schedules qualified as "security agreements" under the definition contained in the bond. It reasoned that that "the bond does not specify what sort of 'interest' had to have been retained in the property in order for the lease to qualify as a security agreement," noting that "[t]he word 'interest' does not . . . describe only an ownership interest."[47] Because the court found that the lease schedules conveyed something less than full ownership—a possessory interest in the leased equipment—it held that the lease schedules anticipated the lessee taking possession of the listed equipment and, thus, the bank reasonably viewed them as creating an enforceable interest for the lessee in the listed equipment. In the court's view, that interest was sufficient to satisfy the bond's definition of "security agreement."[48]

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[44] *Id.* at 1027.
[45] *Id.* at 1028.
[46] 784 F.3d 1104 (7th Cir. 2015).
[47] *Id.* at 1108.
[48] *Id.* at 1108-09.

Even though some courts have applied the definition of "security agreement" to lease agreements, courts generally have been reluctant to extend the definition further to encompass other types of documents. For instance, in *KW Bancshares, Inc.*,[49] the Western District of Tennessee refused to construe a forged letter submitted by a customer of a bank seeking a personal loan, which stated that he was to receive a substantial annual bonus, as a "security agreement" within the meaning of Insuring Agreement E. In connection with the loan, the customer signed a promissory note, promising to repay the loan on demand, and an assignment of bonus, assigning his annual bonus to the bank.[50] The court held that there was no reasonable basis upon which to construe the letter as a "security agreement," as "the letter did not have any real value to [the bank]", and that it was the assignment of the bonus payment, not the letter, that created an interest in favor of the bank in the customer's alleged bonus.[51] Insuring Agreement E therefore did not cover the bank's loss.[52]

Similarly, in *Merchants National Bank of Winona*,[53] the Minnesota Court of Appeals rejected a bank's attempt to construe forged construction contracts, which were assigned to the bank in connection the loan it made to a contractor, as a "security agreement" under the bank's bond. The court held that the construction contracts were not a "security agreement" because Insuring Agreement E "necessarily refers only to documents that have real value to the insured bank in the event of the borrower's default."[54] It held that the construction contracts could not be a "security interest" within the meaning of Insuring Agreement E because they did not create an interest in property and, absent the contractor's performance, were of no value.[55]

[49] 965 F. Supp. at 1055.
[50] *Id.* at 1049-50.
[51] *Id.* at 1055.
[52] *Id.*
[53] 408 N.W.2d at 654.
[54] *Id.*
[55] *Id.*

III.
COVERED IMPAIRMENTS UNDER INSURING AGREEMENT (D) AND INSURING AGREEMENT (E)

As noted previously, both Insuring Agreement D and Insuring Agreement E cover losses resulting directly from forged or altered enumerated documents. This common feature of the two insuring agreement has led some insureds to attempt to conflate the distinct coverage provided by each insuring agreement. Despite the fact that both Insuring Agreements D and E cover forged or altered documents, there should be no overlap in the coverage because of the distinct types of documents covered by each insuring agreement, as discussed in Part II, and because of the other requirements for coverage under each insuring agreement, as discussed in Part IV.

A. Impairments Covered Under Insuring Agreement (D)

1. Forgery

Forgery is defined in the Financial Institution Bond as follows:

> (1) affixing the handwritten signature, or a reproduction of the handwritten signature, of another natural person without authorization and with intent to deceive; or
> (2) affixing the name of an organization as an endorsement to a check without authority and with the intent to deceive.
>
> Provided, however, that a signature which consists in whole or in part of one's own name signed with our without authority, in any capacity, for any purpose is not a Forgery. An electronic or digital signature is not a reproduction of a handwritten signature or the name of an organization.[56]

This definition of "forgery" was added to the Financial Institution Bond by the SAA in 1980. It clarified that the signature of

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[56] 2004 Bond, Definitions, § 1(j).

one's own name does not constitute a "forgery" under the bond. Prior to this clarification, some courts had applied the term "forgery" to include any signature made without authority, even if the signature was of one's own name. For instance, in *Filor, Bullard & Smyth v. Insurance Co. of North America*,[57] the Second Circuit held that the signature of a dishonest bank president constituted a forgery under a brokers blanket bond, even though the president had signed his own name.[58] Similarly, in *Century Bank v. St. Paul Fire & Marine Insurance Co.*,[59] the California Supreme Court held that the signing of an individual's own name to an instrument, purportedly on behalf of a casualty insurer but without authority to so act, which purported to guarantee the casualty insurer's payment of a loan in the event of borrower default, constituted a forgery under the bond issued to the lending bank.[60]

The revised Financial Institution Bond promulgated by the SAA in 1980 responded to this case law by including a definition of "forgery" that did not include the signing of one's own name. The revised Financial Institution Bond takes a "belt and suspenders" approach to clarifying that the signing of one's own name does not constitute a "forgery." First, it specifies that "forgery" means "affixing the handwritten signature, or a reproduction of the handwritten signature, of *another* natural person."[61] Second, it also specifies that "a signature which consists in whole or in part of one's own name signed with our without authority, in any capacity, for any purpose is not a Forgery."[62]

Courts have responded to this revised definition of "forgery" by applying its plain terms to preclude coverage where one signs his or her own name, regardless of whether the signature is made with or without authority. In *French American Banking Corp. v. Flota Mercante Grancolombiana S.A.*,[63] the Southern District of New York rejected the insured's argument that an unauthorized signature constitutes a forgery

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[57] 605 F.2d 598 (2d Cir. 1978).
[58] *Id.* at 602.
[59] 482 P.2d 193 (Cal. 1971).
[60] *Id.* at 194-95.
[61] 2004 Bond, Definitions, § 1(j) (emphasis added).
[62] *Id.*
[63] 752 F. Supp. 83 (S.D.N.Y. 1990), *aff'd* 925 F.2d 603 (2d Cir. 1991).

under a banker's blanket bond.[64] Relying on the definition of "forgery" under the revised FIB, the court held that the signing of one's own name, even without authority, did not constitute a forgery.[65]

2. Alteration

The Financial Institution Bond does not contain a definition of "alteration." In the absence of an express definition, courts have looked to the UCC's definition of "alteration" to inform their application of the term under the Financial Institution Bond. The definition of "alteration" in the UCC was revised in 1990 and, therefore, decisions applying "alteration" can be divided into those decisions interpreting the term under the UCC in effect before 1990 and those decisions interpreting the term under the revised version of the UCC in effect in most jurisdictions after that date.[66]

Prior to 1990, the UCC defined "alteration" in terms of whether the change of the instrument was "material", stating that "any alteration of an instrument is material which changes the contract of any party thereto 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 authorized; or (c) the writing as signed, by addition to it or removing any part of it."[67] The requirement of "materiality" under the UCC led to a split among the jurisdictions regarding whether the application of "alteration" under the Financial Institution Bond required proof of materiality.[68] The revisions made to the UCC in 1990 revised the definition of "alteration" to state: "(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

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[64] *Id.* at 88-91.

[65] *Id.*

[66] *Compare* U.C.C. § 3-407 (1962), *with* U.C.C. § 3-407(a) (1990).

[67] U.C.C. § 3-407 (1962).

[68] *Compare* St. Paul Fire & Marine Ins. Co. v. State Bank of Salem, 412 N.E.2d 103 (Ind. Ct. App. 1980) (proof of materiality required to qualify as "alteration" within meaning of Insuring Agreement D), *with* Stix Friedman & Co. v. Fid. & Deposit Co. of Md., 563 S.W.2d 517 (Mo. Ct. App. 1978) (not requiring materiality as element of "alteration" for purposes of Insuring Agreement D).

changes to an incomplete instrument relating to the obligation of a party."[69]

Courts using the revised definition of "alteration" for purposes of Insuring Agreement D have applied the definition's plain language. For instance, courts have consistently held that the mere allegation or fact that a document was used in the commission of a fraud or that it contained a misrepresentation of fact does not qualify as an "alteration." In *Northside Bank v. American Casualty Co. of Reading*,[70] a bank opened an account with a company pursuant to a merchant services agreement. The company then accepted orders for merchandise and took payment by debit and credit cards. It electronically transmitted the debit and credit card authorizations to the bank and, upon receipt, the bank transferred money into the company's account. The bank later discovered that the company never delivered the purchased merchandise to its customers. The bank sought recovery under its bond for its loss, arguing that the company's submission of electronic instructions and subsequent failure to ship the merchandise should be viewed as an alteration of the electronic instruction. The court rejected this argument, finding that the mere fact that electronic instructions were used in the perpetration of a fraud does not constitute alteration. It reasoned:

> The simple truth is that the words "modified" and "altered" mean exactly what they say, and the electronic instructions submitted to Bank in this case were never modified or altered. These instructions directed that Bank pay a sum certain to [the company], and were unmodified and unaltered when they reached Bank; Bank read them, and, in fact, paid them in accordance with their unmodified and unaltered language.[71]

Similarly, in *Utica Mutual Insurance Co. v. Precedent Cos.*,[72] a mortgage company issued a check to a title company to fund a residential loan. The document accompanying the check included a statement

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[69] UCC § 3-407 (1990).

[70] No. GD97-19482, 2001 WL 34090139 (Pa. Ct. Com. Pl. Jan. 10, 2001).

[71] *Id.* at 101.

[72] 782 N.E.2d 470 (Ind. Ct. App. 2003).

instructing the title company to invalidate the check and immediately return it to the mortgage company if circumstances prevent the scheduled closing from occurring. The residential loan did not close and was never funded. However, the title company deposited the check into its bank account and the check cleared within a few days. The mortgage company sought to recover under its financial institution bond, arguing that the title company altered the check within the meaning of Insuring Agreement D when, contrary to the attached instructions, it deposited the check despite the fact that the residential loan did not close. The court rejected the mortgage company's argument that, by depositing the check when the loan had not closed, the title company altered the parties' obligations. It reasoned that no alteration of the check occurred because the title company had not made any unauthorized change in or on the instrument, nor did it add words or numbers to the instrument.[73]

In *Bidwell & Co. v. National Union Fire Insurance Co. of Pittsburgh, PA*,[74] the plaintiff, a national discount securities brokerage firm, sued its insurer to recover under its bond for losses it sustained when its bank debited its account for the amount of checks that were allegedly forged or altered. Someone opened an account with the plaintiff under the name "Tauna J. Stewart." The plaintiff's loss resulted from two checks that had been deposited in the Tauna J. Stewart account. The first check was made payable to "Sony Pictures Studios, Inc." It was intercepted and the payee was altered to "Bidwell Investment Company, 317 North Broadway St., Chicago Illinois, 60657, Attn Tauna J. Stewart, Acct # 11767830." The back of the check was endorsed with the signature "Tauna J. Stewart." The court held that this check was altered because the payee line was changed and, therefore, the obligation of the drawer was altered. The second check was made payable to "Tenneco Packaging". The payee line of the check was not altered, but the back of the check was endorsed with the signature "Tauna J. Stewart" before being deposited. Applying the same reasoning as it applied to the first check, the court held that there was no alteration of the second check because there had not been a change made that modified the obligation of the drawer.[75]

[73] *Id.* at 477-78.
[74] No. CV-00-89-HU, 2001 WL 204843 (D. Or. Jan. 18, 2001).
[75] *Id.* at *4.

As the above cases demonstrate, "alteration" should be interpreted according to its commonsense meaning, requiring an actual physical change to the instrument, not merely the misrepresentation of fact in the instrument or the use of the instrument in the perpetration of a fraud.

B. Documentary Defects Covered Under Insuring Agreement (E)

1. Forged Signatures and Altered Documents

As explained above, two of the documentary defects covered by Insuring Agreement E—forgery and alteration—overlap with the impairments covered by Insuring Agreement D, but that overlap should not lead to an overlap in the coverage provided by Insuring Agreements D and E because the covered documents under the two insuring agreements are mutually exclusive. The same reasoning that informs the interpretation of the terms "forgery" and "alteration" under Insuring Agreement D generally should apply with equal force to the application of these terms under Insuring Agreement E.

2. Counterfeit

The Financial Institution Bond defines "counterfeit" as "a Written imitation of an actual, valid Original which is intended to deceive and to be taken as the Original."[76] A key requirement is that the counterfeit document must *imitate* an existing genuine original document. This requirement should not be controversial. One area where insurers and insureds have sparred, however, is the extent of imitation required to constitute a "counterfeit." Courts have delivered somewhat mixed results on this issue.

In *FDIC v. Fidelity and Deposit Co. of Maryland*,[77] a federal court in Louisiana held that a loan loss sustained by a bank as a result of a loan made to a borrower who submitted a fake city ordinance

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[76] 2004 Bond, Definitions, § 1(e). The Financial Institution Bond defines "Original" as "the first rendering or archetype and does not include photocopies or electronic transmissions even if received and printed." 2004 Bond, Definitions, § 1(q).

[77] 827 F. Supp. 385 (M.D. La. 1993), *aff'd* 45 F.3d 969 (5th Cir. 1995).

indicating that the borrower had obtained a cable television franchise was not covered under the bank's bond. The borrower submitted to the bank a document it represented to be Public Ordinance No. 1258 from the City of Gulfport, which purported to grant to the borrower a cable television franchise. On reliance upon that representation, the bank issued a loan to the borrower. The City of Gulfport never actually adopted an ordinance granting the borrower a cable television franchise and, in fact, the genuine Public Ordinance No. 1258 was adopted by the City of Gulfport to set the number of voting districts in the city. The court rejected the bank's argument that the document purporting to be Public Ordinance No. 1258 was a "counterfeit", finding that it was not an imitation of the genuine Public Ordinance No. 1258, which had nothing to do with cable television or the borrower and pertained instead to voting districts in the city. Because only the number and form of the genuine Public Ordinance No. 1258, and not the substance of it, was imitated, the court held that the document submitted to the bank was not a counterfeit.[78]

Two years later, in *One American Corp. v. Fidelity and Deposit Co. of Maryland*,[79] a state court in Louisiana interpreted "counterfeit" more broadly to include documents pledged to the bank, which purported to be stock and bond certificates owned by the borrowers, in connection with the acquisition of a loan. After the funds were advanced, the bank learned that the pledged certificates were not authentic. Although at first glance the pledged certificates appeared legitimate, trial evidence indicated that there were various differences between the real certificates and those presented to the bank, including the color and width of the borders, the printing style, the paper quality, and the exact location of the pictographs. The court rejected the insurer's argument that, for purposes of coverage under the bond, the certificates had to be a fastidious copy or duplication of the original. Comparing the pledged certificates to counterfeit dollar bills, the trial judge held that the pledged certificates were counterfeits, reasoning that counterfeit dollar bills are not flawless copies of real dollar bills. The appellate court affirmed the trial court, holding that, although not a fastidious copy of the original, the pledged

[78] *Id.* at 393-95.
[79] 658 So. 2d 23 (La. Ct. App. 1995).

certificates were imitations, were intended to deceive, and were meant to be accepted as originals, as required by the definition of "counterfeit."[80]

Other courts have emphasized the necessity of imitation for purposes of interpreting the term "counterfeit." For instance, it has been held that documents that contain a misrepresentation of fact or are procured under false pretenses are not counterfeit if the document is authentic.[81] It also has been held that documents that are complete fabrications and do not correspond to any actual original document do not qualify as counterfeits under a financial institution bond.[82] Although a fraudulent document, without an imitation of another preexisting document, is not sufficient to constitute a counterfeit, at least one court has held that a document is a counterfeit, even if it lacks a signature, if it looks like an original and is intended to deceive wary recipients. In *State Bank of the Lakes v. Kansas Bankers Surety Co.*,[83] the insured bank loaned money in reliance upon fake Manufacturer's Statements of Origin (MSOs) that were submitted to the bank, as well as to other multiple sources, to obtain loans against the same collateral. Some of the MSOs were unsigned. The fake MSOs were otherwise made to look like the real MSOs, including being produced of the same kind, size, texture, and color of paper as the originals and with identical inks, typefaces, and

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[80] *Id.* at 24-25.

[81] Bank of Brewton v. Travelers Cos., 777 F.3d 1339, 1342-43 (11th Cir. 2015) (stock certificate that was null and void when issued because it had been fraudulently procured was not "counterfeit" under financial institution bond).

[82] N. Shore Bank FSB v. Progressive Cas. Ins. Co., 674 F.3d 884, 887-89 (7th Cir. 2012) (certificate of origin for motor home that did not exist was not counterfeit because there never was "an actual, valid Original" certificate of origin for the non-existent motor home); Bank of Sw. v. Nat'l Sur. Co., 477 F.2d 73, 76-77 (5th Cir. 1973) ("white slip" was not counterfeit because it did not purport to be a direct imitation of an authentic original "white slip"); Dakota W. Credit Union v. Cumis Ins. Soc'y, Inc., 532 F. Supp. 2d 1110, 1115-17 (D.N.D. 2008) (faxed and unsigned "Buyer's Bill" submitted to credit union was not counterfeit where it was not an imitation of preexisting genuine "Buyer's Bill" issued by livestock seller that documented an actual purchase of steers on the specified date); Liberty Nat'l Bank v. Aetna Life & Cas. Co., 568 F. Supp. 860, 864 (D.N.J. 1983) (fake certificate of deposit was not counterfeit because it was not an imitation of a real certificate of deposit).

[83] 328 F.3d 906 (7th Cir. 2003).

manufacturers' logos. The bank advanced funds against both signed and unsigned MSOs. When the borrower's scheme unraveled, the bank sought recovery under its bond on account of these loans with respect to which some other lender held the real MSO and thus obtained the value of the collateral.[84]

The insurer denied coverage, arguing that the unsigned MSOs cannot be "counterfeits." After a bench trial, the court disagreed. On appeal, the Seventh Circuit affirmed, holding that nothing in the definition of "counterfeit" requires a signature and that neither side had produced evidence regarding whether genuine MSOs are accepted in the trade even though unsigned. As such, the court concluded that the trier of fact was entitled to conclude that the unsigned MSOs were "counterfeits."[85]

The *State Bank of the Lakes* decision arguably stretches the definition of "counterfeit" beyond its plain terms, particularly where an imitation of a signed preexisting document, which itself does not contain a signature, cannot reasonably "be taken as the Original." Thus, it is likely of limited precedential value to cases in which it can be shown that a signature on the document in question is critical to its acceptance in the particular trade.

3. Lost Documents

Another type of documentary defect covered under Insuring Agreement E is a lost document. The term "lost" is not defined in the Financial Institution Bond. Courts interpreting the term have consistently concluded that, as a result of the requirement under Insuring Agreement E that the insured have "actual physical possession" of the document, the term "lost" necessarily refers to a document that has been lost by its rightful owner and then wrongfully used by the perpetrator to induce the insured to give value, extend credit, or assume liability.

The temporal element of "lost"—*i.e.*, that the document be lost at the point in time when the insured made a decision to give value, extend credit, or assume liability on the strength of the document—has

[84] *Id.* at 907-08.
[85] *Id.* at 908.

been emphasized by numerous courts. For instance, in *Ohio Savings Bank v. Progressive Casualty Insurance Co.*,[86] Ohio Savings Bank purchased eleven first-mortgage loans from an originator of home loan refinancing. The transactions were structured as "table funded" settlements, meaning that the funds were advanced by Ohio Savings Bank to an escrow account of the loan originator's closing agent, the loans closed with the originator as lender, and the originator subsequently assigned the loans to Ohio Savings Bank. The closing agent employed a Ponzi scheme to embezzle approximately $1 million from the escrow account after the borrowers' notes and mortgages were executed and assigned to Ohio Savings Bank. The borrowers refused to pay the mortgage loans assigned to Ohio Savings Bank. The original mortgage documents were lost during the investigation and unraveling of the perpetrator's crime.

Ohio Savings Bank argued that Insuring Agreement E covered its losses because the original mortgage documents were lost after the mortgages were assigned to Ohio Savings Bank, preventing it from recording the mortgages. The Eighth Circuit disagreed, holding that the loss of the original mortgage documents after Ohio Savings Bank made the decision to extend credit did not qualify the documents as "lost" within the meaning of Insuring Agreement E. The court reasoned:

> Here, the mortgages were not "lost or stolen" instruments when they were assigned to OSB. They were the borrowers' mortgages, and the original documents were not lost until after OSB relied on what was assigned in extending credit to the borrowers. Losing collateral documents after a loan has been made is precisely the sort of practice that is excluded from coverage by a bankers blanket bond. Thus, the district court correctly held that any financial loss to OSB caused by the post-acquisition loss of original mortgage documents signed by the borrowers was not covered by Insuring Agreement (E).[87]

[86] 521 F.3d 960 (8th Cir. 2008).
[87] *Id.* at 964-65.

The *Ohio Savings Bank* holding is consistent with those of other courts, which similarly have interpreted "lost" as referring to the status of a document at the point in time when the insured makes a decision to give value, extend credit, or assume liability based upon the document.[88]

4. Stolen Documents

Another type of documentary defect covered under Insuring Agreement E is a stolen document. The term "stolen" is not defined in the Financial Institution Bond and, as with lost documents, courts have looked to the status of the documents at the time that the insured agreed to give value, extend credit, or assume liability to determine whether the documents upon which the bank relied are "stolen" within the meaning of Insuring Agreement E.

That the documents must qualify as "stolen" at the time the insured acted upon them was addressed in *Exeter Banking Co. v. New Hampshire Insurance Co.*[89] In that case, the court held that, because the covered documents were not stolen when the insured decided to part with money in reliance upon them, there was no coverage for the loss under the insured's bond, regardless of whether the documents ultimately were stolen after the transaction took place. It reasoned:

> In order to obtain coverage under the first scenario, the insured's actions must concern instruments "which prove to have been . . . stolen." By using the past tense of the verb steal, the policy requires that the "stealing" occur prior to the insured's actions.[90]

A similar conclusion was reached by the Fifth Circuit in *Bank of Southwest v. National Surety Co.*,[91] where the court held that "[t]o recover for a loss on any documents which are 'stolen,' within the meaning of Coverage E of the Bond, the Bank must be in a situation

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[88] *See, e.g.,* RTC v. Aetna Cas. & Sur. Co. of Ill., 25 F.3d 570, 580 (7th Cir. 1994) ("this language, when read in its context, applies only to securities that have a defect in title at the time of acquisition" by the insured).

[89] 438 A.2d 310 (N.H. 1981).

[90] *Id.* at 314.

[91] 477 F.2d at 77.

where it could be required to give up the allegedly stolen document to the rightful owner."[92]

In *Brady National Bank v. Gulf Insurance Co.*,[93] however, the Fifth Circuit applied a more expansive interpretation of the term "stolen" to include a covered document that was acquired with stolen money. In that case, a borrower opened a checking account at the insured bank and deposited in that account funds he obtained from victims of an illegal investment scheme. He then purchased a certificate of deposit from the insured bank using the stolen investor funds in his checking account. The borrower pledged the certificate of deposit as collateral on a personal letter of credit and two personal credit card accounts. Soon after these initial transactions were completed, the borrower wired additional investor funds to his checking account, purchased a second certificate of deposit with these funds, and pledged that certificate of deposit as collateral on a personal line of credit. After the borrower was convicted of a slew of charges, the insured bank settled with the borrower's defrauded investors, resulting in a net loss to the insured bank under the certificates of deposit. The insured bank sought coverage for the loss under its bond, arguing that the certificates of deposit were "stolen" within the meaning of Insuring Agreement E because they were acquired with stolen money. The court agreed. Relying on the definition of "stolen" in Black's Law Dictionary, the court reasoned that the term "stolen" as used in the bond could be construed to include the certificates of deposit because they were "acquired, or possessed as a result of some dishonest act or taking."[94]

Fortunately, the *Brady* court's expansive application of the term "stolen" is likely of limited precedential value. It has not been adopted by any other court in a reported decision, likely for good reason. The plain language of Insuring Agreement E requires that the covered instrument on which the bank relies itself be stolen. In contrast to that requirement, the covered documents in *Brady*—*i.e.*, the certificates of deposit—were genuine. By finding coverage for the certificates of deposit, the *Brady* court found coverage for a loss that resulted directly from the theft of funds used to purchase *genuine* certificates of deposit,

[92] *Id.*
[93] 94 F. App'x 197 (5th Cir. 2004).
[94] *Id.* at 200-02.

thereby expanded Insuring Agreement E well beyond its intended application and its plain language.

5. The Bundling Theory

Occasionally, an insured will attempt to group together as one instrument an uncovered document, which contains a defect covered under Insuring Agreement D or E, with a document that is covered under Insuring Agreement D or E. In other words, the covered document, standing alone, is not entitled to coverage because it does not involve a covered impairment. Under the so-called "bundling theory," the covered document is considered together with an uncovered document which does bear a covered impairment. This argument defies basic principles of contract interpretation and has met with only limited success.

Perhaps the most often cited case by insureds with respect to bundling is *Community State Bank of Galva v. Hartford Insurance Co.*,[95] in which an Illinois appellate court held that, for purposes of establishing coverage under Insuring Agreement E, a forged power of attorney purportedly executed by a lawyer, as agent for a trustee, could be bundled together with a promissory note containing a genuine signature under which a bank extended credit to constitute a forged "evidence of debt." The court's holding, however, was limited to the facts before it and was based upon reasoning that both documents were necessary for the perpetrator to complete his scheme, both were delivered contemporaneously to the bank, and both were necessary for the bank to extend credit.

While the *Community State Bank* court arguably reached the wrong result, other courts have relied upon *Community State Bank* or otherwise reasoned similarly in allowing an insured to bundle documents. For instance, in *Omnisource Corp. v. CNA/Transcontinental Insurance Co.*,[96] a federal court in Indiana applied similar reasoning to conclude that supporting documentation provided to a bank, which was not a covered instrument but was forged, could be construed together with a sight draft to determine whether there was a forgery of a covered instrument. Similar to the reasoning of *Community State Bank* court, the

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[95] 187 Ill. App. 3d 110 (Ill. App. Ct. 1989).
[96] 949 F. Supp. 681 (N.D. Ind. 1996).

court found that, pursuant to the letter of credit transaction under which the sight draft and supporting documents were provided to the bank, each supporting document was necessary to oblige the bank to honor the sight draft and the sight draft would have been useless without supporting documentation. Other courts have reached similar conclusions.[97]

Conversely, many courts, applying the plain language of the bond, have refused to allow insureds to sidestep the requirements for coverage under Insuring Agreements D and E by bundling documents. In *First Union Corp. v. United States Fidelity & Guaranty Co.*,[98] a Maryland appellate court rejected an insured's attempt to bundle forged "incumbency certificates" submitted in connection with a loan application with other documents in the loan transaction to constitute an "evidence of debt" under Insuring Agreement E. The court distinguished *Community State Bank* and enforced the plain language requirements of the bond, reasoning that "in determining whether a forged document qualifies for coverage under Insuring Agreement (E), the object of the court's inquiry should be the contents of the **forged** document; i.e., what is the relationship between the forged document and the instrument of debt."[99] Applying that principle, the court held that the documents evidencing the loan, *i.e.*, the primary indicia of debt, were not forged and, therefore, there was no coverage under Insuring Agreement E.[100]

Similar reasoning was applied by the Fifth Circuit in *Travelers Casualty & Surety Co. of America v. Baptist Health System.*[101] In that case, the court addressed whether a crime policy issued to plaintiff, a

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[97] *See, e.g.,* Success Healthcare, LLC v. Zurich Am. Ins. Co., No. 9:14-81423, 2015 WL 11439019 (S.D. Fla. Mar. 20, 2015) (for purpose of surviving motion to dismiss, fraudulently obtained electronic signature of insured's comptroller could be bundled with "reverse ACH" transactions"); Transp. Alliance Bank v. Bancinsure, Inc., No. 1:11cv148-DAK-EJF, 2014 WL 684691 (D. Utah Feb. 21, 2014) (fraudulent electronic account statements could be bundled with unaltered purchase and security agreement); Valley Cmty. Bank v. Progressive Cas. Ins. Co., 854 F. Supp. 2d 697 (N.D. Cal. 2012) (allowing bundling of account control agreement and loan agreements to constitute "security agreement").

[98] 730 A.2d at 282-83.

[99] *Id.* at 283 (emphasis in original).

[100] *Id.* at 282-83.

[101] 313 F.3d 295 (5th Cir. 2002).

medical facility system, covered a loss resulting from the plaintiff's payment of fraudulent invoices submitted by a vendor. The fraudulent invoices were created for work never performed and were not submitted to the plaintiff's financial services department for approval and signature. Instead, they were submitted directly to the plaintiff's accounts payable department with forged signatures of personnel in the financial services department. Believing that the signatures were genuine, the plaintiff's accounts payable department sent the vendor checks in the amounts indicated on the invoices. The plaintiff sued its insurer for coverage under its crime policy, contending that the checks and the forged invoices should be construed together as a "covered instrument." The court distinguished decisions that adopted a bundling argument in other contexts by noting that those cases were limited to situations in which the insured relied upon all involved documentation to extend credit or honor a draft. The court further reasoned that, even if it were to recognize bundling in other contexts, it would not apply to the checks issued upon the basis of the forged invoices:

> Even if we were to recognize the legitimacy of bundling in such contexts, we would distinguish the invoices forged by [the vendor]. To pay the checks drawn upon [the plaintiff], the bank did not have to receive the invoices; the bank demanded no supporting documents to honor the checks. We decline to treat the checks and forged invoices as one instrument. The invoices were only prerequisites insofar as [the plaintiff's] internal [] procedure made them such. They were not required by law or the bank.[102]

Despite its logical flaws, insureds are likely to continue to rely upon the bundling theory in the future in an attempt to expand the coverages of Insuring Agreements D and E well beyond their intended application. The 2004 Financial Institution Bond attempts to preclude the argument by including an express "anti-bundling" provision that prohibits the bundling of documents to create coverage:

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[102] *Id.* at 299.

ANTI-BUNDLING

> If any Insuring 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.[103]

The plain language of the anti-bundling provision is clear and, where used, should avoid fights with insureds over attempts to bundle documents not covered by the bond together with covered documents.

Curiously, however, one of the few cases to address this anti-bundling provision, *Valley Community Bank v. Progressive Casualty Insurance Co.*,[104] glossed over its import. In finding that an account control agreement could be read together with other documents relating to a loan to constitute a single covered "security agreement," the *Valley Community Bank* court stated that its holding did not implicate the bond's anti-bundling provision. The court's reasoning was less than clear. It stated simply that the anti-bundling provision was inconsequential to its holding because the provision "does not define what a security agreement is and whether that term encompasses the [account control agreement]."[105] This logic is deficient because it overlooks, without explanation, that the court's finding that the account control agreement constituted a "security agreement" depended upon the court allowing the insured to bundle together that agreement with other loan documents. Therefore, the court did precisely what the anti-bundling provision prohibits, *i.e.*, bundling together of non-covered and covered documents to constitute a single covered document with a covered impairment. While other courts should recognize the folly of this reasoning and enforce anti-bundling provisions in accordance with their plain terms, most bond forms in use today do not include an anti-bundling provision. Until an anti-bundling provision is incorporated into

[103] 2004 Bond, Anti-Bundling, § 9.
[104] 854 F. Supp. 2d at 703-05.
[105] *Id.* at 705.

most, if not all, bonds in use, insurers likely will continue to have to contend with bundling arguments.

IV.
OTHER REQUIREMENTS FOR COVERAGE

Merely establishing that a loss involves a covered defect or impairment of a covered instrument does not entitle the insured to coverage under Insuring Agreement D or E. The insured also must establish causation—*i.e.*, that the loss "resulted directly from" a covered defect or impairment of a covered instrument. Generally, courts have held that this qualifying language requires a higher standard of causation than "but for" or proximate cause, although a few outlier cases have allowed insureds to prevail on a more lax standard of causation. The latter decisions, while limited to the facts on which they were rendered, are arguably not based on a sound interpretation of the plain language of the bond, which requires that that loss "result *directly*" from a qualifying event.

A. Causation

1. Insuring Agreements (D) and (E)

Under Insuring Agreement D, an insured must establish that the loss "result[ed] directly from" a covered peril. Prior to 1980, the standard language of Insuring Agreement E of the Financial Institution Bond required only that the loss be sustained "through" a covered peril. In 1980, however, the Financial Institution Bond was revised to replace "through" with "resulting directly from."

Courts have held that the standard of causation required to satisfy the "resulting directly from" language is higher than "but for" or proximate causation.[106] This conclusion flows logically from the

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[106] *See, e.g.,* Cont'l Corp. v. Aetna Cas. & Sur. Co., 892 F.2d 540, 548-49 (7th Cir. 1989); Merchs. Bank and Trust Co. v. Cincinnati Ins. Co., No. 1:06cv561, 2008 WL 728332, at *3-4 (S.D. Ohio March 14, 2008); RBC Mortg. Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, 812 N.E.2d 728, 733-37 (Ill. App. Ct. 2004); Commerce Bank & Trust v. St. Paul Mercury Ins. Co., No. 04-1264B, 2005 WL 4881101 (Mass. Super. Ct. June 7, 2005).

requirement that the loss "result[] *directly* from" a covered peril. An Illinois appellate court described the reasoning succinctly:

> In the present case, adopting the reasoning from the majority of other jurisdictions, the proximate cause analysis simply is too broad to capture accurately the intent behind the phrase "loss resulting directly from." A "direct loss" must be afforded its plain and ordinary meaning; "direct" means "direct." 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 caused loss." This is because a proximate cause "need not be the sole cause nor the last or nearest cause. It is sufficient if it concurs with some other cause acting at the same time, which, in combination with it, causes the injury." Accordingly, the proximate cause analysis will not be applied to the case at bar.[107]

Applying this reasoning, courts have concluded that the requirement of a loss "resulting directly from" a covered peril had not been satisfied where an insured bank failed to follow reasonable commercial banking standards.[108] This reasoning makes sense, as Insuring Agreement D is not intended to protect against an insured bank's poor practices in processing and paying checks, and Insuring Agreement E is not intended to operate as credit insurance for loans issued by the insured bank.

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[107] *RBC Mortgage*, 812 N.E.2d at 736-37 (internal citations omitted).

[108] *See, e.g.,* Empire Bank v. Fid. & Deposit Co. of Md., 27 F.3d 333 (8th Cir. 1994) (financial institution bond did not provide coverage for losses caused by bank due to cashing of unauthorized checks where bank employees failed to follow bank policy in cashing the checks); Republic Nat'l Bank of Miami v. Fid. & Deposit Co. of Md., 894 F.2d 1255, 1264 (11th Cir. 1990) (applying Florida law) (no coverage for loss resulting from letter of credit that bank issued without requiring certain documents of the letter's beneficiary); Mitsui Mfrs. Bank v. Fed. Ins. Co., 795 F.2d 827, 830-31 (9th Cir. 1986) (no coverage for claim by depository bank for loss resulting from payor bank's refusal to pay checks allegedly bearing forged endorsements because actions of depository bank in crediting checks and allowing subsequent withdrawal of funds caused loss).

Notwithstanding the majority approach, there are some outlier jurisdictions that apply a less stringent "proximate cause" analysis for a "loss resulting directly."[109] These decisions miss the mark because they do not give due weight to the "directly" requirement of the bond's plain language.

B. "In Good Faith" Requirement

Insuring Agreement E requires the insured to have acted "in good faith" in giving value, extending credit, or assuming liability. Prior to 2004, Insuring Agreement D did not contain an express "in good faith" requirement for coverage. However, revisions to the Financial Institution Bond in 2004 changed that, by adding the words "in good faith" to the requirements for coverage under Insuring Agreement D.

The requirement that the insured act "in good faith" operates as an additional reminder that the Financial Institution Bond is intended to operate neither as insurance against the insured's own recklessness nor as credit insurance. The seminal case interpreting the requirement of "good faith" is *Marsh Investment Co. v. Langford*,[110] in which the Court of Appeals for the Fifth Circuit, while declining to give a precise definition of "good faith," held that the facts before it clearly defeated a showing of good faith by the insured:

> Having summarized these already, we need not reiterate them at length. Suffice it to say that the bank, faced with an anomalous transaction that turned on the authority of one man—a poor credit risk, as it admitted—to mortgage the property of a corporation with which it knew he had little or no connection, and with the means of checking that authority lying as near as the closest telephone, failed in the face of what the trial court properly characterized as a veritable sea of red flags to lift a finger to verify that authority, choosing instead to

[109] *See, e.g.,* Resolution Trust Corp. v. Fid. and Deposit Co. of Md., 205 F.3d 615, 654-56 (3d Cir. 2000); Jefferson Bank v. Progressive Cas. Ins. Co., 965 F.2d 1274, 1280-82 (3d Cir. 1992); Graybar Elec. Co. v. Fed. Ins. Co., 567 F. Supp. 2d 1116, 1127 (E.D. Mo. 2008).

[110] 721 F.2d 1011 (5th Cir. 1983).

> proceed in ignorance and sole reliance on the debtor's critical representations about his own authority. If "selective ignorance" be the test, as it is for purposes of this appeal, it is amply demonstrated. Since it is, and since it is a sufficient basis for the trial court's judgment in favor of the bonding company, we need not explore the issue of forgery.[111]

This "selective ignorance" or "knowing indifference" standard has been applied by other courts in rejecting a claim of good faith where the insured ignores red flags that should have alerted it to the presence of an impairment or defect in the instrument relied upon.[112] The majority of courts, however, have been reluctant to conclude that an insured's mere negligence is sufficient to establish the absence of good faith and instead have required that the insured act dishonestly or recklessly to preclude a finding of good faith.[113]

C. "Actual Physical Possession" of an "Original"

Insuring Agreement E also requires that the insured have acted "on the faith of" an "[o]riginal" covered instrument. Related to this requirement is the condition precedent for coverage under Insuring Agreement E that the insured have "[a]ctual physical possession" of such "[o]riginal" covered instrument. The condition precedent of "[a]ctual physical possession" of an "[o]riginal" was added to Insuring Agreement D in 2004. Because of this, most of the cases interpreting the terms "original" and "actual physical possession" have concerned claims under Insuring Agreement E, although these decisions generally should apply with equal force to an analysis of Insuring Agreement D.

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[111] *Id.* at 1014.

[112] *Republic Nat'l Bank of Miami*, 894 F.2d at 1263-64 (insurer must show that insured acted fraudulently or with bad faith before it could properly deny coverage); FDIC v. Cincinnati Ins. Cos., 981 F. Supp. 2d 1324, 1335-39 (N.D. Ga. 2013) (by making loan despite numerous red flags, insured acted with gross negligence or knowing indifference amounting to bad faith);

[113] *See, e.g.,* Beach Cmty. Bank v. St. Paul Mercury Ins. Co., 635 F.3d 1190, 1200 (11th Cir. 2011) (applying Florida law); First Nat'l Bank of Fort Walton Beach v. U.S. Fid. & Guar. Co., 416 F.2d 52, 57 (5th Cir. 1969); Citizens Bank of Or. v. Am. Ins. Co., 289 F. Supp. 211, 214 (D. Or. 1986).

1. An "Original"

An "original" is defined under the Financial Institution Bond as "the first rendering or archetype and does not include photocopies or electronic transmissions even if received and printed."[114] Although it may appear obvious based upon the clear written definition of "original," if not its commonsense definition, faxes and photocopies do not constitute "originals."[115] The modern computer age has significantly increased the frequency with which documents are sent electronically. While at least one court has held that an electronic transmission can constitute an original, its holding was confined to a bond that did not contain a definition of "original."[116] Such a holding should not be relevant to cases involving bonds with the clear definition of "original" set forth above.

2. "Actual Physical Possession"

Not only must the document upon which the insured relies be an "original," the insured, as a condition precedent to coverage, must have "actual physical possession" of the "original." Although, since 2004, the Financial Institution Bond imposes "actual physical possession" as a condition precedent to coverage under both Insuring Agreements D and E, the requirement differs slightly under each insuring agreement. Insuring Agreement D states that "[a]ctual 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." The corresponding requirement under Insuring Agreement E states that "[a]ctual physical possession of the items listed in (a) through (h) 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." Thus, Insuring Agreement E allows actual physical

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[114] 2004 Bond, Definitions, § 1(q).

[115] BancInsure, Inc. v. Marshall Bank, N.A., 400 F. Supp. 2d 1140 (D. Minn. 2005), *aff'd*, 453 F.3d 1073 (8th Cir. 2006) (fax transmissions of personal guarantees did not constitute "originals"); Hamilton Bank v. Ins. Co. of N. Am., 557 A.2d 747, 750-51 (Pa. Super. 1989) (photocopies of covered documents do not qualify as "originals").

[116] *Transp. Alliance Bank,* 2014 WL 684691 at *6-8.

possession not only by the insured but also by "its correspondent bank or other authorized representative."

The "actual physical possession" requirement means that the insured must have the documents in its possession at the time that it acts in reliance upon them. For instance, in *Republic National Bank of Miami v. Fidelity and Deposit Co. of Maryland*,[117] the seminal case addressing the "actual physical possession" requirement, a bank brought suit against its insurer to recover for losses it sustained in a letter of credit transaction. The bank issued a letter of credit on behalf of a New York based coffee broker for the sale of coffee in favor of a third party. The letter of credit was requested on February 3. On February 16, the bank issued the letter of credit, and on that same date, the bank's irrevocable obligation to honor the letter of credit was established. The bills of lading referencing the coffee sale were forged. The bank did not, however, receive the forged bills of lading until February 17. The Eleventh Circuit held that this sequence of events precluded a finding that the insured had "actual physical possession" of the forged documents. It stated:

> Thus, by the time Republic received the forged bills, it already was irrevocably committed to the course of action that resulted in its loss. Republic, therefore, did not have the forged documents in its physical possession at the time it purportedly acted in reliance upon them.[118]

Who may qualify as an insured's "correspondent bank" or "other authorized representative" for purposes of the "actual physical possession" requirement under Insuring Agreement E generally has been resolved according to agency principles.[119]

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[117] 894 F.2d at 1262-63.

[118] *Id.* at 1262.

[119] *See, e.g., Beach Cmty. Bank*, 635 F.3d at 1199; Nat'l City Bank of Minn. v. St. Paul Fire & Marine Ins. Co., 447 N.W.2d 171, 176 (Minn. 1989).

V. CONCLUSION

Although Insuring Agreements D and E share certain common features, they do not provide overlapping coverage. Attempts to conflate the two insuring agreements most commonly arise in situations where an insured is attempting to shoehorn a document that does not fit within any of the document categories into coverage under at least one, if not both, of the insuring agreements. It is not uncommon in such situations to see an insured also invoke a so-called bundling theory in a creative attempt to obtain coverage for a loss that does not fit within the plain language of the bond. Both insurers and courts alike must be wary of such attempts to depart from the bond's plain language and the intended application of Insuring Agreements D and E and should methodically ensure that the specific, express requirements for coverage under the insuring agreements have been satisfied.