The Fidelity Law Journal

published by

The Fidelity Law Association

October 1999

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Cite as V FID. L.J. ___ (1999)

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The Fidelity Law Journal is published annually. Additional copies may be purchased by writing to: The Fidelity Law Association, 280 Corporate Center, 5 Becker Farm Road, Roseland, NJ 07068-1776.

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RECURRING QUESTIONS IN LOAN LOSS COVERAGE CASES

Toni Scott Reed

I. INTRODUCTION

Loan losses which arise as a result of alleged employee dishonesty present numerous recurring, but complicated, questions in the context of coverage analysis of the Financial Institution Bond (the "Bond"). First, a loan loss case is often not limited to one loan transaction but more likely involves a pattern of lending practices which have occurred over a long period of time and which have culminated in a series of extensive losses to an institution. Thus, the sheer magnitude of the loss and the complexity of the facts involved raise the stakes for both the insured attempting to establish the claim and the insurer trying to investigate the claim. Second, in the case of the extensive loan loss, the allegedly dishonest actor is often a person who occupies the position of president, chief executive officer, or controlling shareholder of the financial institution. In such cases, the pattern of making questionable loans often continues unchecked because such a controlling actor was involved in the transactions and could either direct the transactions or cause them to continue. Complicated factual issues regarding intent, financial benefit, collusion, and discovery are often involved in these types of cases.

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The presence of these numerous and complicated issues results in some amount of uncertainty regarding coverage questions which arise again and again. A careful study of the case law in this area reveals that, for many issues, there is no certain answer, but rather conflicting authority based upon quite specific case facts. Some of the cases, which involve federal regulators acting on behalf of failed institutions, reveal a results-oriented type of analysis, in which one could argue that the courts applied an "ends justify the means" approach. Careful study of the case law also reveals that many, if not all, of the recurring questions will likely involve questions of fact not amenable to summary disposition in any eventual legal proceedings.

Accordingly, it is important to be aware of the issues, the available theories, the possible defenses, and the amount of analysis which will be required in the case of the complex loan loss. This article is not meant to be an exhaustive review of all potentially applicable authority from every jurisdiction because such an undertaking would be even more voluminous than what follows, but it is meant to analyze some of the more interesting cases which will likely be instructive in the context of loan loss coverage analysis.

II. LOAN SCENARIOS

For purposes of analyzing various coverage issues which repeatedly arise, consider the following hypothetical facts:

1. A bank alleges that it has sustained losses in connection with loans which it says were "caused" to be made as a result of the dishonest conduct of one individual, its chairman of the board, CEO, and primary shareholder.
2. The bank alleges that the chairman and shareholder was a salaried employee of the bank but had no specific responsibilities or duties. Further evidence shows that the chairman and shareholder did not have any lending authority.
3. Some of the loans in question are alleged to have been creditworthy when made, and the bank claims a loss comprised of the entire outstanding balance on the loans, accrued interest on the loans, and loans made to cover up losses on prior loans.
4. The loan losses exceed the applicable Bond's limits, the bank has made some recoveries, and the bank has not credited any recoveries against the losses claimed.
5. The chairman and shareholder denies wrongdoing and denies that he or she intended to cause the bank to sustain any loss because, in fact, he or she owns the bank.
6. Lower-level loan officers or other employees were aware of the chairman and shareholder's pattern of conduct at the time the loans in question were

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made and/or were the actual officers who approved the loans because the chairman and shareholder did not have loan authority. None disclosed the activities to the other members on the board of directors.

7. Other employees in the bank were aware that the chairman and shareholder engaged in other questionable practices, such as an unrelated check kiting scheme, which ultimately stopped and did not result in any loss to the bank.

With these few facts, how many potential troublesome issues are immediately apparent? How many have easy answers? How many have no clear answers? In light of these hypothetical facts, consider the following coverage issues.

III. THE CHAIRMAN OF THE BOARD — CEO — CONTROLLING SHAREHOLDER PROBLEMS

A. *When, If Ever, Is a Controlling Actor of a Bank an Employee Under the Bond?*

One recurring fact pattern which appears to arise in the context of the large loan loss case is that the allegedly dishonest actor involved is the chairman of the board, chief executive officer, and/or primary shareholder of the bank itself or of the holding company which owns the bank. In such a large loan loss, the bank will often allege that the chairman, CEO, and shareholder "caused" the loans to be made, and that, but for the dishonesty of the chairman, CEO, and shareholder, the bank would not have made the loans and would not have sustained the losses. The investigation of such claims often reveals that the chairman, CEO, and shareholder was the dominant actor in the bank and that no other officer or director supervised his activities or decisions. In other cases, it becomes evident that the chairman, CEO, and shareholder did not have loan authority of his own; but the bank still alleges that he "caused" the loans to be made. Perhaps the chairman "caused" the loans to be made by an officer who had sufficient lending authority, and no other approval was required. If the loans were approved by a loan committee or a board of directors, the real facts associated with the loans were probably not disclosed.

A number of issues arise in the context of these allegations, including, in particular, the question of whether a chairman, CEO, and shareholder is an "Employee," within the meaning of the Bond. After all, the "Employee" requirement is one of the primary elements which the insured financial institution will have to establish in order to prove a dishonesty claim and establish a covered loss for a loan. Under what circumstances can a controlling actor be an "Employee," for purposes of coverage? Must a financial institution have the ability to direct and control the actor to be able to establish the

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"Employee" element? How does the alter ego doctrine affect the analysis? These and many other complex questions arise in the loan loss context.

1. The Traditional Tests

Insuring Agreement A of the Financial Institution Bond (Standard Form No. 24) provides that the Underwriter, in reliance upon all statements made and information furnished to the Underwriter by the Insured in applying for the Bond, agrees to indemnify the Insured for the following:

> (A) Loss resulting directly from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others.[1]

Employee dishonesty is usually the primary claim made in connection with loan losses, since, absent that type of claim or certain other facts, losses resulting from the mere nonpayment of a loan are clearly excluded from coverage by the Bond.[2]

Unlike some of the other key terms in Insuring Agreement (A), the term "Employee" happens to be a defined term in the Financial Institution Bond. With respect to the issue of loan losses, the portion of the definition of the term "Employee" which applies is found in the Definitions provision, Section 1(g), which states that the term "Employee" means "an officer or other employee of the Insured, while employed in, at, or by the Insured's offices or premises covered hereunder ...."[3]

In addition, the Exclusions provide one more limitation on the definition, where the Bond provides that it does not cover the following:

> loss resulting directly or indirectly from any acts of any director of the Insured other than one employed as a salaried, pensioned or elected official or an Employee of the Insured, except when performing acts coming within the scope of the usual duties of an Employee, or while acting as a

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[1] Financial Institution Bond (Standard Form No. 24, Revised January 1986), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (hereafter the "FIB"), Insuring Agreement (A).

[2] Exclusion (e) of the FIB provides that no coverage is afforded for loss "resulting directly or indirectly from the complete or partial nonpayment of, or default upon, any loan or transactions involving the Insured as a lender or borrower…, except when covered under Insuring Agreements (A), (D), or (E)." FIB, Exclusions, Section 2(e). The presence of Exclusion (e) has been the basis for the holding by many courts that an institution is precluded from treating the fidelity bond as credit insurance. *See, e.g.*, Third Fed. Sav. & Loan Ass'n of Cleveland v. Fireman's Fund Ins. Co., 548 F.2d 166, 172 (6th Cir. 1977). Thus, loan losses caused by defective documentation, poor underwriting, or poor credit decisions, for example, are not covered by the Bond, absent proof of employee dishonesty in connection with the loans.

[3] FIB, Definitions, Section 1(g).

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member of any committee duly elected or appointed by resolution of the board of directors of the Insured to perform specific, as distinguished from general, directorial acts on behalf of the Insured.[4]

Based upon these Bond terms and the common law applying to the employment relationship, the traditional test which has developed for determining whether a particular actor is an "Employee," for purposes of fidelity coverage, involves an examination of whether the insured has the right to direct and control the actor in question.[5] The courts which have considered the question of who is an "Employee" have noted that the "right to control is the hallmark of an employer-employee relationship" and that the "principal test of an employer and employee relationship is control."[6] Thus, in the specific case where a bank has been unable to establish that a bank officer or supervisory agent gave the actor in question instructions, directions, or supervision concerning the performance of his duties, or that the bank otherwise had a right to control the activities of the actor, one court has concluded that the actor could not be an "Employee" within the meaning of the bond.[7]

Within the context of the "right to direct and control" analysis, the courts have focused on the issue of controlling actors, who, because of their positions within an insured organization, may not be subject to the direction of any other person or group within the organization. Those courts have discussed the fact that a controlling shareholder who is also the chief executive officer or the principal director of an insured may not be an "Employee" for purposes of the Bond, in part, because the insured cannot and does not exercise the requisite control over such persons.[8] The majority view is that an actual, not a theoretical, right to govern and direct a dominant corporate actor is required in order to determine that an actor is an "Employee," as that term is used in the Bond.[9] These general concepts raise interesting questions when the dominant actor within a bank is alleged to be the dishonest employee who caused a loan loss.

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[4] FIB, Exclusions, Section 2(d).

[5] Bank of Cumberland v. Aetna Cas. & Sur. Co., 956 F.2d 595, 597 (6th Cir. 1992), *cert. denied*, 506 U.S. 871 (1992); *In re* Baker & Getty Finan. Services, Inc., 93 B.R. 559, 562 (Bankr. N.D. Ohio 1988).

[6] Third Fed. Sav. & Loan Ass'n v. Fireman's Fund Ins. Co., 548 F.2d 166, 171 (6th Cir. 1977); William H. Sill Mortgages v. Ohio Cas. Ins. Co., 412 F.2d 341, 344 (6th Cir. 1969).

[7] *Bank of Cumberland* 956 F.2d at 598.

[8] Bird v. Centennial Ins. Co., 11 F.3d 228, 232 (1st Cir. 1993); Matter of World Hospitality Ltd., 983 F.2d 650, 652 (5th Cir. 1993); California Union Ins. Co. v. American Diversified Sav. Bank, 948 F.2d 556, 566 (9th Cir. 1991); *In re* Prime Commercial Corp., 187 B.R. 785, 798 (Bankr. N.D. Ga. 1995).

[9] *Bird* v. 11 F.3d at 233; *Matter of World Hospitality* 983 F.2d at 651-52; Kerr v. Aetna Cas. & Sur. Co., 350 F.2d 146, 154-55 (4th Cir. 1965); Employer's Admin. Services, Inc. v. Hartford Acc. & Indem. Co., 709 P.2d 559, 562-63 (Ariz. Ct. App. 1985).

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2. The Control Issue in Banking and Financial Cases

In several banking or financial industry cases, the courts have focused on the control element in general as the primary factor for analyzing the term "Employee." In each of these cases, the courts have analyzed non-traditional positions of authority, where the actors were not necessarily a loan officer or other defined officer of an institution. Because the actors occupied such non-traditional positions, the courts were forced to rely on an analysis of the right to direct and control test to reach their conclusions.

For example, in *Third Federal Savings & Loan Ass'n of Cleveland v. Fireman's Fund Insurance Co.*,[10] the court found that the right to govern and control is the hallmark of an employer-employee relationship and that the Bond would not cover the acts of any person who performed services for the company but was not subject to the control of the employer.[11] In that case, the Sixth Circuit considered whether an independent real estate appraiser who was employed by a savings and loan to provide periodic progress inspections in connection with construction loans was an "Employee" within the meaning of the fidelity bond issued to the savings and loan. The real estate appraiser was never furnished with employees' withholding statements and was not listed as an employee for purposes of worker's compensation or unemployment compensation. He was not entitled to fringe benefits such as health and life insurance and participation in the pension plan. He paid all of his own expenses in connection with the inspections and performed inspections for other organizations as well. He had no set working hours and was paid an agreed-upon sum for each appraisal and inspection he made. Taking all of those factors into account, the court held that the facts indicated that the appraiser was an independent contractor, and not an "Employee."[12] However, the court also found that the factors were not sufficient by themselves to indicate that the appraiser was not an "Employee," as that term was defined, for purposes of the bond in question.

The court then discussed the issue that whether a person is an "Employee" is a question of fact and that the principal test of an employer/employee relationship is control. The court held that, if the employer retained control of, or the right to control, the mode and manner of doing the work contracted for, an employer/employee relationship would exist.[13] The court noted that there was no evidence that the savings and loan ever gave the appraiser any instructions or directions as to how the inspections should be performed.

[10] 548 F.2d 166 (6th Cir. 1977).

[11] *Id*. at 171.

[12] *Id*. at 169.

[13] Id. at 170.

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The court concluded that, because there was no evidence of the right to control the mode or manner of the work in question, the appraiser was not an "Employee" within the meaning of the bond at issue.[14]

The court in *William H. Sill Mortgages, Inc. v. Ohio Casualty Insurance Co.*[15] analyzed the very close supervision and control an insured corporation had over its independent mortgage broker whom it contracted to obtain and place mortgages for it in determining whether or not the broker was an "Employee" under the policy. The case involved a Lansing, Michigan, mortgage brokerage firm which was insured under a fidelity bond that provided coverage for the dishonesty of an "Employee," which term was defined as "one or more of the officers, clerks or other employees while employed in, at or by any of the insured's offices while covered under this bond."

William H. Sill, the stockholder, director, president, and general manager of the corporation, hired a gentlemen named Harold Stockford, who lived in Adrian, Michigan, to obtain and place mortgages through Sill's corporation. Stockford was a real estate broker who also ran his own mortgage, insurance, and construction business. William H. Sill Mortgages established a branch office for its operation in Stockford's offices in Adrian, Michigan. Stockford was placed in charge of the William H. Sill Mortgages operation in Adrian.

Two years after hiring Stockford to place mortgages, Sill suspected that there was something wrong with the finances of the Adrian branch operation. Sill investigated the financial records and discovered a loss of funds which Stockford had embezzled. Sill filed a claim under his bond for the losses his company sustained, which he alleged were the result of dishonesty by his "Employee" Stockford. The insurer disputed that Stockford was "employed" by the insured's offices.

The Sixth Circuit upheld the trial court's determination that Stockford was in fact an "Employee" within the meaning of the bond.[16] The evidence from the trial court revealed that Stockford received a salary and/or commissions based upon the loans he closed. Moreover, Stockford was an assistant vice president of the insured company and worked in a branch office of the company. Stockford had contact with Sill, his supervisor, almost daily. The supervision the broker received included instructions and advice with regard to his duties and the processing of mortgages. As a result of the level of direction, close supervision, and control which it found to exist, the court

[14] *Id*. at 171.

[15] 412 F.2d 341 (6th Cir. 1969).

[16] *Id*. at 344.

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concluded that the broker was in fact an "Employee," within the meaning of the policy in question in that case.[17]

In *Bank of Cumberland v. Aetna Casualty and Surety Co.*,[18] the court considered the question of whether Foster, a friend of the insured bank's president whom the president appointed to be his representative on the board of directors, was an "Employee" within the meaning of the fidelity bond insuring the bank. The bond language in question provided that an "Employee" of the bank was "an officer or other employee of the insured while employed in, at, or by any of the insured's offices or premises covered hereunder... ." The particular bond excluded from coverage any "loss resulting directly or indirectly from any acts of any director of the Insured other than one employed as a salaried, pensioned or elected official of an Employee of the insured."[19]

The bank president appointed Foster to serve on the board of directors and on the executive committee of the bank. At the same time, Foster was the president of a financial company called City and County Interstate Financial Corporation (CNCIFC), which contracted to make credit and management decisions for the bank and other related banks. As president of CNCIFC, Foster provided financial advice and information to the bank, including matching loan requests with participating banks based upon such factors as loan demands, risk, and the financial status of a particular bank. The insured bank routinely accepted Foster's recommendations for booking and renewing loans, including loans from out-of-territory borrowers, without reviewing the loan documents or files.

The insured bank and related banks later began to experience financial difficulty. The insured bank eventually became insolvent as a result of being forced to charge off losses from out-of-territory loans recommended by Foster. After investigation, the bank concluded that the losses it sustained were the result of Foster's dishonest and fraudulent acts. The bank filed an employee dishonesty claim, arguing that the losses were covered by the fidelity bond which insured the bank.

A jury which heard the case concluded that Foster was an "Employee" of the bank who was guilty of fraudulent and dishonest acts. The Sixth Circuit reversed that decision, concluding that Foster was not an "Employee" as that term was defined under the bond.[20]

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[17] *Id.*

[18] 956 F.2d 595 (6th Cir. 1992), *cert. denied*, 506 U.S. 871 (1992).

[19] *Id.* at 596.

[20] *Id.* at 598.

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The bank conceded on appeal that control was the necessary element to establish that Foster was an "Employee" under the bond. However, the court noted that the insured introduced no evidence that any officer or supervisory agent gave Foster instructions, directions, or supervision concerning the performance of his duties or that the bank otherwise had the right to control Foster's activities on behalf of the bank, or any evidence that inferentially established that the bank had the right to direct and control Foster.[21] The court noted that, while Foster may have been subject to the control of the bank president who appointed him to his position on the board, he was not subject to the control of the bank itself.[22] Thus, the court concluded that Foster acted as an independent contractor for the bank through the services of his own financial company, and not as an "Employee" of the bank, as required by the bond in question.[23]

These cases correctly focus on the right to direct and control element, which under common law is the hallmark of the employer/employee relation-ship.[24] This type of analysis appears to be the correct approach to determine whether a particular chairman, CEO, or primary shareholder can properly be described as an "Employee." In those cases where the evidence establishes that the chairman, CEO, or shareholder does not report to any other officer, or even a board of directors, and is not subject to the direction or control of any individual or group, he should not be classified as an "Employee" for purposes of Insuring Agreement (A) coverage.

The additional question which the right to direct and control analysis raises is whether an institution must actually exercise that right to direct and control an individual, or whether the general ability to do so is sufficient, even if the institution does not actually exercise its rights. In the context of other types of fidelity policies, the courts have concluded that the theoretical right to govern and direct a dominant corporate actor is not sufficient to render that actor an "Employee."[25] The First Circuit Court of Appeals has

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[21] *Id*.

[22] *Id*. at 597.

[23] *Id*. at 598.

[24] Further support for this general proposition appears in Black's Law Dictionary, which defines the term "Employee" as follows: "A person in the service of another under any contract of hire, express or implied, oral or written, where the employer has the power or right to direct the employee in the material details of how the work is to be performed . . . . Generally, when a person for whom services are performed has the right to control and direct the individual who performs services not only as to result to be accomplished by work but also as to details and means by which result is accomplished, individual subject to direction is an "employee …." BLACK'S LAW DICTIONARY 525 (6th ed. 1991) (citations omitted).

[25] *See, e.g.*, Bird v. Centennial Ins. Co., 11 F.3d 228, 232 (1st Cir. 1993) (holding that the owner, president, and director of the insured corporations was not subject to the control of the corporations).

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noted that the right to govern and direct "must be more than an ephemeral right inhering generally in the corporate form; rather, it must have some grounding in reality."[26] What this concept establishes is that, where a particular chairman, CEO, or other officer might theoretically be supervised by a board of directors or other authority, the lack of actual supervision should establish that the key element required for an individual to be an "Employee" is not present.[27]

These cases illustrate how a traditional loan officer, who is supervised by other officers, reports to a loan committee and is ultimately supervised by a bank president or board of directors, can fit within the "Employee" definition quite easily. In the case of a traditional type of loan officer, it is clear how a financial institution could establish the necessary control elements, and therefore the justification for a loan loss claim to be covered by Insuring Agreement (A). These cases also illustrate how a more non-traditional position, such as a consultant, broker, or other individual, can present a more challenging question for coverage. Finally, these cases illustrate how difficult a question is presented when a controlling actor is the alleged dishonest "Employee." If that controlling actor is an officer of the bank, but also is the primary or only shareholder and the primary or only director, then who supervises and controls that individual? What prevents the analogy that the controlling actor is the institution?

These questions lead to a discussion of the alter ego theory, which has also been applied in the context of financial institutions. Where the control element is entirely absent, such as in the case of certain chairmen or shareholders, the alter ego theory may likely apply and establish that the controlling actor cannot be an "Employee," for purposes of coverage.

3. The Alter Ego Doctrine and the Control Element

The alter ego defense can, in many ways, be considered a companion to the analysis of the control element involved in the "Employee" question. The alter ego defense is a defense which an insurer may raise in order to argue that an allegedly dishonest actor is not an "Employee" whose acts are covered by the Bond, but is instead the functional equivalent of the insured itself since no other person or group controls the actor. The fact that a particular individual may not fall within the definition of the term "Employee" does not automatically establish that he is the alter ego of the institution, but

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[26] *Id.*

[27] At least one case, however, has reached a contrary result. *In re* Baker & Getty Fin. Services, Inc., 93 B.R. 559, 563 (Bankr. N.D. Ohio 1988) (holding that "[t]he absence of actual control of [the employee] by [the insured], through its officers or Board of Directors, is irrelevant if the evidence demonstrates the existence of a *right* to control. The Court finds that [the insured] had a right to control [the employee].").

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in the case of a controlling shareholder, CEO, or chairman of the board, that overlap is more likely.

The Fifth Circuit, applying the alter ego theory to a case involving a majority owner, chief executive officer, and director of an insured, has best explained the public policy behind the alter ego theory as follows:

> A corporation can only act through its officers and directors. When one person owns a controlling interest in the corporation and dominates the corporation's actions, his acts are the corporation's acts. Allowing the corporation to recover for the owner's fraudulent or dishonest conduct would essentially allow the corporation to recover for its own fraudulent or dishonest acts. The [fidelity] bonds, however, were clearly designed to insure the corporations against their employee's dishonest acts and not their own dishonest acts.[28]

The public policy behind prohibiting an insured from insuring its own wrongful acts appears to be a very basic and well-accepted concept. However, the application of the concept to loan loss cases has resulted in various outcomes.

a. *Application of the Alter Ego Theory in Banking Cases*

The alter ego theory has been applied in various contexts, including specifically in banking cases and has resulted in the finding that a controlling actor in a bank cannot be an "Employee" for purposes of coverage under the Bond. For example, in *Farmers & Merchants State Bank of Verdon v. United States Fidelity & Guaranty Co.*,[29] the court held that a person who acquired a majority of the bank's stock and occupied a position of complete control over the bank lost his "Employee" status under a bankers' blanket bond, because he "practically [became] the master of the corporation, and ceas[ed] to be one of its servants."[30] The court noted that the other directors had a theoretical right to supervise the actor, as long as he allowed them to remain directors, but that, in reality, they held their positions at his direction, and the evidence established that they paid no personal attention to the management of the bank.

The court's language in support of its holding is now familiar in the context of the alter ego theory: "The object of the [bond] was to insure an employer against the fraudulent acts of an employee, not to insure an employer against

[28] Matter of World Hospitality Ltd., 983 F.2d 650, 652 (5th Cir. 1993).

[29] 133 N.W. 247 (S.D. 1911).

[30] *Id*. at 249.

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his own fraudulent acts."[31] Accordingly, the court held that, absent convincing evidence to the contrary, "it would be unreasonable to assume that the [insurer] would insure the conduct of any [person] thus situated. An undertaking insuring a person against his own dishonesty would be, to say the least, a novel and unusual contract."[32]

The Eighth Circuit applied a similar standard in a banking case in *Red Lake County State Bank v. Employer's Insurance of Wausau*,[33] where it concluded that a majority shareholder who was the president, chief operating officer, and director of the bank in question was not an "Employee" for purposes of the bank's fidelity bond. The court reached its conclusion based upon its reasoning that the dishonest acts by the individual were better characterized as being committed by the bank rather than its employees, and that to hold otherwise would be to permit the bank to insure itself against its own dishonesty.[34]

Establishing the domination of the bank by the alleged wrongdoer is critical, however, for the application of the alter ego theory. When courts have concluded that no such complete domination existed, they have refused to apply the alter ego doctrine. For example, in *United States Fidelity & Guaranty Co. v. State of Oklahoma*,[35] the Tenth Circuit rejected an alter ego theory advanced by the insurer on a bank employee dishonesty bond. The court held that the president of the insured bank was not the alter ego of the bank because the evidence established that the board of directors played a significant role in the management of the institution and because the insurer failed to establish that the president was the bank's sole representative.[36] The Iowa court in *FDIC v. National Surety Corp.*[37] reached the same conclusion in its decision not to apply the alter ego theory in a banking loan loss case, noting that there was no evidence that the board of directors of the bank "abdicated its responsibility to [the president] or that it was entirely subject to his control."[38]

[31] *Id*.

[32] *Id*.

[33] 874 F.2d 546 (8th Cir. 1989).

[34] *Id*. at 549.

[35] 383 F.2d 417 (10th Cir. 1967).

[36] *Id*. at 419.

[37] 281 N.W.2d 816, 821 (Iowa 1979).

[38] *Id*.

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The Minnesota Supreme Court also reached a similar result in *Transamerica Insurance Co. v. FDIC*,[39] where it concluded that the alter ego theory would not preclude coverage for the acts of the chief executive officer, president, majority owner, and chairman of the board since there was no evidence that the board of directors for the bank had abdicated their responsibilities.[40] The allegedly dishonest actor in the case owned the vast majority of the bank's stock, was the president and chief lending officer, served as a director and chairman of the board, elected all other directors who served at his pleasure, set his own salary and bonuses, and made all personnel decisions. In order to continue to maintain personal loans he had used to finance his purchase of the bank's stock, he sold certificates of deposit from the bank, but he did not record the liabilities and used the proceeds for various purposes which allowed him to maintain his own outstanding loans. When the FDIC discovered the misapplication of funds during an examination, the bank filed a claim under its bond.

The insurer denied coverage, arguing that the alter ego doctrine precluded coverage under the circumstances. As stated by the insurer, the alter ego doctrine stands for the proposition that "'[t]he owner of a controlling interest in an insured corporation is not included in the term employees covered by a fidelity bond.'"[41] The insurer argued that the primary question the court should consider in the context of the "Employee" question was whether the actor was under the direction and control of the bank or whether the actor himself controlled the bank. The FDIC countered that the bank existed as an independent, legal corporate entity which was controlled by a board of directors who had no knowledge of the president's actions.

The court concluded that the insurer had the burden to plead and prove not only that the president ran the bank and owned almost all of its stock, but also to show that the board abdicated its control of the corporation to such a degree that the president ceased to be an "Employee."[42] The court concluded that the bank had failed to do so because affidavits signed by the bank's board of directors alleged that the board functioned properly throughout the president's administration. In reaching its holding, the court distinguished the line of cases cited by the insurer on the grounds that in each the defalcating actor was a sole shareholder.[43]

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[39] 489 N.W.2d 224 (Minn. 1992).

[40] *Id*. at 229.

[41] *Id*. at 227.

[42] *Id*. at 228.

[43] *Id*. (citing United States Fid. & Guar. Co. v. Three Garden Village Ltd. Partnership, 551 A.2d 881 (1989); Kerr v. Aetna Cas. & Sur. Co., 350 F.2d 146 (4th Cir. 1965); McKee v. Great American Ins. Co., 316 F.2d 473 (5th Cir.), *cert. denied*, 375 U.S. 830 (1963)).

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Thus, all of the particular facts in a given case are important for the purpose of establishing the alter ego doctrine. The application of the doctrine may be a question of fact for the fact finder in many circumstances. Moreover, the insurer should be aware of the burden of proof placed upon it in the case law and be prepared to demonstrate the degree of control exercised by the dishonest actor, as well as the degree of control not exercised by any other person or group.

b. *The Alter Ego Theory in Other Transactions*

Other reported decisions relying on the alter ego theory appear to base their decisions upon the specific right to direct and govern language contained in various forms of the commercial crime policy. In *Kerr v. Aetna Casualty & Surety Co.*,[44] the Fourth Circuit concluded that two individuals who were the principal officers, directors, and owners of the insured could not be "Employees" within the meaning of the commercial crime policy in question.[45] The court also held that the two individuals' technical right to control themselves was merely theoretical and therefore could not render the two individuals "Employees."[46] The court concluded that a fidelity bond is not intended to cover the fraud and dishonesty of men who are, in effect, sole stockholders, as well as the only directors of a closely held corporation. Further, the court held that the bond was intended to protect the corporation from the fraud or dishonesty of its own servants, not to protect creditors from the fraud or dishonesty of stockholders or directors.[47]

In *First National Life Ins. Co. v. Fidelity & Deposit Co. of Maryland*,[48] the Fifth Circuit concluded that several individuals who purchased a controlling interest in the insured and made themselves officers and directors were not "Employees" within the meaning of the bond in question.[49] The court concluded that the individuals' "status as officials never placed them 'in the service' of [the insured], for they served only themselves."[50]

In both *Three Garden Village Ltd. Partnership v. United States Fidelity & Guaranty Co*.[51] and *Employer's Administrative Services, Inc. v. Hartford Accident & Indemnity Co.*,[52] the courts concluded that a sole officer, direc-

[44] 350 F.2d 146 (4th Cir. 1965).

[45] *Id*. at 154.

[46] *Id*.

[47] *Id*. at 155.

[48] 525 F.2d 966 (5th Cir. 1976).

[49] *Id*. at 970.

[50] *Id*.

[51] 567 A.2d 85, 90 (Md. 1989).

[52] 709 P.2d 559, 563 (Ariz. Ct. App. 1985).

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tor, and shareholder of the insured corporation who commits dishonest acts is not an "Employee" within the meaning of the commercial crime policy because the insured had no right to direct and control the individual and because allowing a recovery would permit the wrongdoers to insure their own dishonest acts. A New York decision, *In re Payroll Express Corp.*,[53] cited the foregoing cases with approval and concluded that a director who owned half of the stock of a corporation, who had check signing and signature authority for the insured, and who dominated and controlled the insured and misused corporate funds could not be an "Employee," for purposes of the employee dishonesty coverage provided by the corporation's particular bond.

Finally, the Georgia bankruptcy court in *In re Prime Commercial Corp.*[54] illustrated the application of the alter ego theory and granted summary judgment in favor of an insurer on the question of whether an individual was an "Employee" under a fidelity bond. The alleged dishonest actor, Patrick Wilson, owned eighty percent of the outstanding stock of the insured company and served as the president, chief executive officer, and a director of the insured. The insured had three other directors in addition to Wilson.

Wilson was accused of having committed fraudulent and dishonest acts by advancing funds or loans to four of the insured's customers. The insured alleged that the funds were advanced to customers to factor false accounts receivable and that Wilson received kickbacks from the customers in connection with some of the advances. The evidence in the case established that Wilson controlled the insured and that there was nothing to force Wilson to comply with the insured's rules which he could make or change himself. The other three directors testified that Wilson was a strong and domineering individual. One officer admitted that Wilson conducted the affairs of the insured in a unilateral manner and bypassed the loan committee in place at the insured.

In connection with the evidence presented, the court found that Wilson met all of the required criteria of an "Employee," with the exception that the insured did not have the right to direct Wilson's work.[55] The court concluded that the alter ego theory applied to the case, despite the fact that there was not a total identity among the shareholders, officers, and directors.[56] The court also adopted the Fifth Circuit's stated position that a public policy rationale for denying the corporation coverage under the bond in question is that, when one person owns a controlling interest in the insured and dominates the insured's actions, his acts are the insured's acts and allowing a company

[53] 216 B.R. 344, 361 (Bankr. S.D.N.Y. 1997).

[54] 187 B.R. 785 (Bankr. N.D. Ga. 1995).

[55] *Id.* at 798.

[56] *Id.*

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to recover for the owner's own fraudulent or dishonest conduct would allow the company to recover for its own wrongful conduct.[57] Finally, the court rejected the insured's argument that it should also consider the public policy of protecting the rights of creditors of the insured, opining that a fidelity bond is not about balancing such interests but instead is simply a question of the interpretation of a contract of insurance.[58]

These cases illustrate the correct application of the alter ego doctrine, based upon the specific public policy foundation of the defense. The common theme for these cases, regardless of the type of policy involved, is that an institution should not be able to insure its own wrongdoing. The reason that fidelity insurance exists is to bond the honest service of the servants of an institution, not to underwrite the institution's own bad acts.

4. Contradictory Public Policy Arguments and the Rejection of the Alter Ego Theory

Not all courts have agreed with the position taken by the court in *In re Prime Commercial Corp*. that the balancing of interests of the parties should not outweigh the clear contract language of the Bond. In at least two other decisions where the FDIC prosecuted a Bond claim on behalf of a failed financial institution, the courts have rejected the alter ego defense on the grounds that innocent shareholders and creditors should not have to bear a loss when the fraudulent majority shareholder would not benefit from his fraud.[59] In those particular cases, the federal regulators convinced the Fifth and Tenth Circuit Courts of Appeals that the regulators, not any wrongdoers, would benefit if coverage existed under the respective bonds.[60] Thus, both courts rejected the application of the alter ego doctrine, in favor of compensating the FDIC, which was prosecuting the claims as receiver for failed banks.

That balancing of interests argument appeared to be a predominant factor in the courts' rejection of the alter ego theory although the Fifth Circuit Court of Appeals did note that the insurer had failed to establish that the alleged wrongdoer was in sole control of the failed bank.[61] The Tenth Circuit Court of Appeals specifically inserted an element of injustice or inequity as a requirement for the application of the alter ego defense.[62] That is, the court

[57] *Id*. at 797-98 (citing Matter of World Hospitality Ltd., 983 F.2d 650, 652 (5th Cir. 1993)).

[58] *Id*. at 798.

[59] FDIC v. Oldenburg, 34 F.3d 1529, 1555 (10th Cir. 1994); FDIC v. Lott, 460 F.2d 82, 87 (5th Cir. 1972).

[60] *Id*.

[61] *Lott*, 460 F.2d at 87.

[62] *Oldenburg*, 34 F.3d at 1555.

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determined that the alter ego defense could not apply to bar the federal regulators' claims because no injustice or inequity would result if the regulators were allowed the recovery on the bond, as opposed to the wrongdoers themselves.[63]

The rationale used by these courts is incorrect and poses a great risk to the insurer that seeks to assert an alter ego defense. First, when a loan loss case involves very large or even catastrophic losses, it is highly unlikely that the alleged wrongdoer will be the bank officer in power at the institution which will be asserting the loan loss claim. Under those circumstances, it is much more likely that either the bank has failed and will be represented by a regulatory agency, or that the bank faced near failure and was taken over by a new institution. In either case, the party prosecuting the bond claim will not be an alleged wrongdoer but, in the words of the cases which have addressed the issue, an "innocent third party," for whom it would not be unjust for coverage to exist.

This argument overlooks the irreconcilable conflict with the public policy which underlies the alter ego doctrine in the first instance: an institution should not be permitted to insure itself for its own wrongful acts. The fact that a new owner will be the beneficiary of payments under the bond does not change that logical prohibition. Even though a new owner will physically receive any payments, the institution itself was still permitted to insure its own wrongdoing and, therefore, permitted to benefit from its dishonesty.

5. Rejection of the Control Test in the Banking Context on Other Grounds

Despite the well-founded decisions which discuss the right to direct and control as the predominant element of the "Employee" term and analysis, there is contrary authority which rejects that element altogether. While the majority of the courts which have analyzed the "Employee" term have focused on whether an insured had the right to direct and control the actor in question, the Bond's definition of "Employee" does not specifically include a reference to that control element. The Bond's definition might be described as being severely lacking in clear direction to the reader of the Bond because it defines the term "Employee" by referring to an "officer or other employee."[64] The Bond definition, in its omission of the control element, can be directly

[63] *Id*. This use of this particular rationale by the court illustrates the special powers which the regulators have had in the context of some bond claims. Although generally the receiver or other party who stands in the shoes of the insured would have no greater rights than the insured itself, the Tenth Circuit created special or additional rights for the FDIC because it found that the FDIC was not responsible for the wrongdoing at the bank. *Id*.

[64] FIB, Definitions, Section 1(g).

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contrasted with the definition of the term "Employee" found in the standard commercial crime policy and other similar policies.[65]

Within the financial institution context, some courts have incorrectly seized on the lack of inclusion of the "control" element in the definition of the term "Employee" in order to conclude that no such right to direct and control the actor in question is required under the Bond. The Ninth Circuit reached precisely that conclusion in *FDIC v. New Hampshire Insurance Co.*,[66] in which it analyzed the typical fidelity bond definition of the term "Employee" and focused on that specific absence of a control requirement in order to reach a conclusion that a particular actor was in fact an "Employee."

One primary question before the court in *FDIC v. New Hampshire Insurance Co.* was whether the alleged wrongdoer, who was the former president, director, and sole shareholder of a failed savings and loan, was an "Employee" under the bond in question. The bond contained the standard definition of "an officer or other employee of the insured, while employed in, at, or by any of the Insured's offices or premises covered hereunder ... ."[67] The insurer argued that the former president, shareholder, and director was not an "Employee" and cited a line of alter ego cases to support its position that the individual in question could not be an "Employee" of the insured because the individual controlled the insured, and not the other way around.[68]

The Ninth Circuit rejected the alter ego cases, concluding that they did not apply to the situation because the alter ego holdings in those decisions relied specifically upon a "right to govern and control" limitation in the definition of the term "Employee." Without engaging in any particular analysis, the court found that, because the alleged wrongdoer in question was an officer of the insured, he was also an "Employee" within the plain meaning of the Bond language.[69] The court did not comment upon the duties of the officer, the facts surrounding his involvement with the insured, or whether anyone else within the insured company had any right to direct him.

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[65] Under the General Definitions section of the Crime General Provisions Form of the standard policy, the term "Employee" is specifically defined, in relevant part, to mean "Any natural person: (1) While in your service (and for 30 days after termination of service); and (2) Whom you compensate directly by salary, wages or commissions; and (3) Whom you have the right to direct and control while performing services for you." Crime General Provisions, Section C (1).

[66] 953 F.2d 478 (9th Cir. 1991).

[67] *Id*. at 482.

[68] New Hampshire Insurance Co. cited both Kerr v. Aetna Cas. & Sur. Co., 350 F.2d 146 (4th Cir. 1965), and United Stated Fid. & Guar. Co. v. Three Garden Village Ltd. Partnership, 551 A.2d 881, *aff'd*, 567 A.2d 85 (Md. 1989), to support its alter ego argument. Both *Kerr* and *Three Garden Village* involved commercial crime policy definitions of the term "Employee."

[69] *New Hampshire*, 953 F.2d at 482.

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In reaching its decision, the court failed to focus on the policy which underlies the "alter ego" concept, such as not rewarding a wrongdoer for his own dishonest or fraudulent acts. The court did not address the factual implications of the alleged employee's status as the president, director, and sole shareholder. Finally, the court did not address the common-law implications of the employer-employee relationship, such as the fact that the right to direct and control is an implied and primary element of the employment relationship. Instead, the court focused on the inclusion of the term "officer" in the definition of "Employee" and ended its discussion and analysis there. The opinion may fairly be described as a results-driven decision, in which the federal regulators succeeded in reversing a summary judgment initially granted in favor of the insurer, thus allowing the regulators to continue to seek coverage on behalf of a failed savings and loan. Nevertheless, it stands as authority for the proposition that no right to direct and control may be required in the Ninth Circuit.

The court's failure to discuss the alter ego concept and to analyze the "Employee" concept is particularly interesting since, only two months before the *FDIC v. New Hampshire Insurance Co*. decision, the Ninth Circuit embraced the alter ego doctrine, including the public policy reasons behind it, in the context of a commercial crime policy.[70] In the *American Diversified Savings Bank* opinion, the Ninth Circuit concluded that two officers who were the only shareholders of the insured companies could not be employees, for purposes of the 3-D policies in effect, because the individuals controlled the insureds and because public policy did not permit a corporation to collect insurance for the defalcations of its alter ego.[71]

In *FDIC v. Kansas Banker's Surety Co*.,[72] an unreported opinion, the Tenth Circuit apparently engaged in a similar type of approach to the interpretation of the "Employee" term. Without any analysis or explanation, the court concluded that the former president of the bank in question was an "Employee" covered by the bond, based upon the unambiguous Bond language that "Employee" includes "an officer or other employee of the Insured."[73] The court dismissively stated that the alter ego doctrine did not apply to the case and that "[n]othing in the policy language requires the court to consider whether [the president] was under the control of any other person," as suggested by the insurer.[74] While the opinion lacks sufficient factual information to make an analysis of the conclusions which were reached by the court, the general approach taken by the court raises some concern.

[70] California Union Ins. Co. v. American Diversified Sav. Bank, 948 F.2d 556, 566 (9th Cir. 1991).

[71] *Id*.

[72] No. 93-1051, 1994 WL 55595 (10th Cir. Feb. 23, 1994).

[73] *Id*. at *1.

[74] *Id*.

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Insureds might use these particular opinions to challenge the application of many of the alter ego cases to a financial institution bond's definition of "Employee," which does not include the specific right to direct and govern language. However, the specific banking cases cited above provide support for the proposition that the better reasoned approach is that the right to direct and control should be implied within the employment context, regardless of the inclusion of that language in any particular definition. The starting point for any analysis of whether a particular actor is an "Employee" still should be the right to direct and control issue.

6. The Director Exclusion's Effect on the Analysis

The director exclusion discussed above provides one final nuance to consider in the context of the "Employee" analysis. Although a director generally exercises his office through the collective action of the board of which he is a member, and acts conducted in a directorial capacity are not covered under the "Employee" definition, there may be occasions where a director is specifically requested to perform duties which would be in the nature of those carried out by an officer or servant of the bank. When a director acts in the context of such a delegation of powers to him by the board, such actions may fall within the provisions of the director exclusion and, therefore, be afforded coverage under Insuring Agreement (A). In *FDIC v. Aetna Casualty & Surety Co.*,[75] the Fifth Circuit concluded that a director's purchase of certain notes in question was carried out as a result of a specific delegation of powers to that director by the board and that the acts committed in the officer-like capacity would be covered by the bond in question.[76]

Similarly, the court in *Puget Sound National Bank v. St. Paul Fire & Marine Insurance Co.*[77] concluded that a director who performed acts such as holding loan collateral and interacting directly with borrowers in matters relating to their loans were acts within the scope of duties of a traditional employee, and thus were covered under the fidelity bond in question.[78] The court reached its conclusion based upon expert testimony presented at the trial of the case, in which the expert opined that the usual duties of a bank employee would include holding loan collateral and interacting directly with bank borrowers with respect to their loans.

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[75] 426 F.2d 729 (5th Cir. 1970).

[76] *Id*. at 738.

[77] 645 P.2d 1122 (Wash. Ct. App. 1982).

[78] *Id*. at 1126.

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These cases illustrate that a finding that a particular director was a common law-employee of the bank in question is wholly unnecessary because the director exclusion sometimes expands the definition of the term "Employee" and the analysis of which persons might be covered under the Bond.[79] One court has also concluded that a bank need not introduce evidence that any specific employee of the bank had the same duties as the director in question.[80]

Two additional cases have focused on interesting aspects of the director exclusion, as well as the question of a director who occupies the position of both director and borrower at a bank. In *First Hays Bancshares, Inc. v. Kansas Bankers Surety Co.*,[81] the Kansas court examined the question of whether a director, who was a member of the directors' compliance committee and discount committee, was an "Employee" for purposes of the bond in question. The director had, in his capacity as a borrower of the bank, obtained loans secured by his interests in cattle. In fact, the cattle used as collateral for the loan did not exist, and the bank sustained large losses when the director was unable to repay his loans. The trial court entered a summary judgment on behalf of the bank, finding that the director's actions were covered by the bonds in question. The Kansas Supreme Court reversed, holding that a fact issue precluded summary judgment on the director exclusion.[82]

The insurer argued that because the director was not an "Employee" of the bank, as defined by the Bond, his actions could not be the subject of the Bond. The trial court had concluded that, by virtue of the director's status as a member on the two directors' committees, he became an "Employee," as a matter of law. The Kansas Supreme Court disagreed, finding that the trial court did not correctly apply all aspects of the director exclusion, which requires the director who is serving on a committee to be performing specific, not general, acts on behalf of the insured.[83] The court also focused on the language "while acting," which indicated that the dishonest acts had to be conducted in the context of the director's actions as a director.[84] By implication, at least, the court recognized that the "while acting" language was a limitation on the director exclusion (and therefore the "Employee" concept).

In *Interstate Production Credit Ass'n v. Fireman's Fund Insurance Co.*,[85] the Ninth Circuit was faced with the interpretation of a special farm credit

[79] *Id.* at 1125.

[80] *Id.* at 1126.

[81] 769 P.2d 1184 (Kan. 1989).

[82] *Id.* at 1191.

[83] *Id.*

[84] *Id.*

[85] 944 F.2d 536 (9th Cir. 1991).

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system blanket bond, which did not contain the FIB director exclusion, but did contain quite similar language. Interestingly, the director in that case also misrepresented the existence of cattle for security for a loan at the bank. The trial court in the case concluded that no coverage existed for the director's acts because the dishonesty committed was behavior that any borrowers could have committed and because coverage would only exist if the director were acting in his capacity as a director. The Ninth Circuit reversed, focusing on the director's fiduciary duty to disclose his own dishonest acts to the board of directors.[86] Because the court concluded that the director had a fiduciary obligation to inform the bank of any fraud that could adversely affect the bank's decisions, it concluded that the losses sustained would be covered by the bond in question.[87]

Thus, if a chairman, CEO, and controlling shareholder received some specific delegation of authority by the board of directors to undertake specific lending activities, there might be some argument that the actions could fall within the exception to the director exclusion.

7. What Impact Does a Lack of Loan Authority Have on the "Employee" Analysis?

All of the cases discussed above provide a general framework for the analysis of whether a particular actor can be an "Employee" under the Bond. Those cases illustrate that the right to direct and control should be the primary consideration for analyzing the "Employee" concept. When considering whether a chairman of the board, chief executive officer, and primary shareholder can qualify as an "Employee," it appears that the control element should be the first element to consider.

What, however, about the presence of or lack of loan authority? When the chairman of the board has specific loan authority, the causal relationship between the actor, certain loans, and loan losses may be direct, as it is required to be under the Bond. However, when the accused wrongdoer had absolutely no loan authority at the institution, what is the correct result? In such cases, banks and financial institutions nevertheless argue that the actor "caused" the loans to be made. If the actor lacked loan authority, how did he or she "cause" such loans to be approved and funded?

The fact situations where a controlling actor lacks lending authority appear to lead to various other considerations. First, what loan officers were

[86] *Id*. at 539.

[87] *Id*. at 541.

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involved in the transactions in order to actually approve the loans? What facts were known to those officers? Did those officers believe that the loans were good loans when they were made? Were the officers acting in collusion with the alleged wrongdoer? Were the loan officers themselves dishonest? Should coverage terminate for those officers as well?

It appears that an allegation of collusion would be necessary in order to tie the chairman of the board and the officer with actual loan authority to dishonest loans which resulted in losses. That issue of collusion between persons in the service of a bank is discussed in the Termination section below.

8. Does the Right to Govern and Control Trump All Other Considerations?

In light of all of the authority discussed above, it appears that the right to direct and control should be the predominant factor in the "Employee" analysis but that there are many other considerations as well. While the right to direct and control, and the related alter ego theory, have been widely accepted and applied in the banking context, there is contrary authority of which every practitioner should be aware. In certain circumstances, that authority involves the prosecution of bank claims by the FDIC and certain equitable arguments made by the regulators, but that involvement does not necessarily undermine the effect of those precedents. While such cases should be distinguished, they contain some holdings which are important to consider.

The better reasoned authority discussed above would conclude that a controlling actor, such as a chairman of the board, chief executive officer, and controlling shareholder, who truly did not report to any other person or entity and who dominated an insured institution, should not be considered an "Employee," as that term is used in the Bond. Public policy dictates that such an actor is the equivalent of the institution, and to insure his or her acts would be to insure the institution's own dishonesty.

B. *When Does an Owner or Controlling Shareholder Have the Manifest Intent to Cause His Own Business to Sustain a Loss?*

A related question which often arises in the context of a loan loss case involving a controlling shareholder is whether such a controlling shareholder could possibly have the required manifest intent of Insuring Agreement (A), in order to establish coverage for the losses sustained. In the massive loan loss case, it is often a controlling shareholder who is accused of directing the continuing loan schemes. Often, the schemes occur in difficult economic times, and the controlling shareholder claims that he was trying to help the borrowers and the institution together. Can those intentions qualify as a

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manifest intent to cause the actor's own bank to sustain a loss? Consider the following issues.

1. The Loan Loss Requirements, Including Manifest Intent

In connection with loan losses in particular, an insured must establish a number of elements in order to prove that coverage exists, including manifest intent to cause a loss, manifest intent to obtain and actual receipt of a financial benefit, and collusion, among others. Insuring Agreement (A) provides coverage for the following:

> (A) Loss resulting directly from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others. Such dishonest or fraudulent acts must be committed by the Employee with the manifest intent:
>
> (a) to cause the Insured to sustain such loss; and
>
> (b) to obtain financial benefit for the Employee or another person or entity.
>
> However, if some or all of the Insured's loss results directly or indirectly from Loans, that portion of the loss is not covered unless the Employee was in collusion with one or more parties to the transactions and has received, in connection therewith, a financial benefit with a value of at least $2,500.
>
> As used throughout this Insuring Agreement, financial benefit does not include any employee benefits earned in the normal course of employment, including: salaries, commissions, fees, bonuses, promotions, awards, profit sharing or pensions.[88]

When a controlling shareholder or owner is involved in the alleged loan losses, a very important question immediately arises: under what circumstances does a controlling shareholder or owner have the manifest intent to cause his own institution to sustain a loss and, therefore, to cause financial harm to himself? When a controlling shareholder or owner is involved in a loan loss, must other intentions, such as a risk-filled (and, ultimately, unwise) desire to benefit the institution be involved? How does, or should, that competing goal affect the manifest intent to cause a loss analysis?

2. The Substantial Certainty vs. Specific Intent Tests

Manifest intent has developed into one of the more complex issues in the context of analyzing the elements of a loan loss. The case law has appeared

[88] FIB, Insuring Agreement (A).

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to develop over time by moving away from an objective standard, which translated essentially into a recklessness standard,[89] toward a more subjective standard, which may be best described as a substantial certainty type of standard.[90] The objective test focused on the natural consequences of an actor's conduct, or a proximate cause standard, but did not necessarily focus on the actor's actual state of mind.[91] The middle ground, and perhaps the current prevailing standard, focuses in part upon the subjective state of mind of the actor to determine whether manifest intent was present in light of all surrounding circumstances and applies the substantial certainty test to draw a conclusion about the intentions of the actor.[92] The opposite extreme from the objective test appears to be the specific intent standard, by which the courts actually try to determine whether the actor in question specifically intended the resulting loss to the financial institution.[93]

Applying this spectrum of approaches to the manifest intent analysis results in a spectrum of results, even given the same set of loan loss facts. The result of the objective test, for example, is a presumption of manifest intent to cause a loss for every risky decision which actually results in a loan loss. The primary criticism of the objective test has been that it results in holding an insurer liable for losses caused by poor business judgment and improvident decisions, not necessarily just dishonest conduct, which is not the purpose of the Bond.[94] Undoubtedly, the objective standard is the weakest approach to determining manifest intent. To some degree, the substantial certainty test suffers from the same problems. Since it inserts the substantial certainty conclusion into the manifest intent equation, it too results in finding intent based upon reckless conduct which may be poor business judgment, but not dishonesty. Only the specific intent or subjective test focuses solely on the state of mind, by analyzing the surrounding circumstances and the testimony of the actor.

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[89] *See, e.g.*, Liberty Nat'l Bank v. Aetna Life Ins. Co., 568 F. Supp. 860, 868 (D.N.J. 1983); Transamerica Ins. Co. v. FDIC, 465 N.W.2d 713, 716 (Minn. Ct. App. 1991), *aff'd in part and rev'd in part on other grounds*, 489 N.W.2d 224 (Minn. 1992).

[90] *See, e.g.*, FDIC v. United Pacific Ins. Co., 20 F.3d 1070, 1077 (10th Cir. 1994); First Nat'l Bank of Louisville v. Lustig, 961 F.2d 1162, 1166 (5th Cir. 1992); Heller Int'l Corp. v. Sharp, 974 F.2d 850, 859 (7th Cir. 1992).

[91] United States Fid. & Guar. Co. v. Citizens Bank of Tazewell, 718 F. Supp. 471, 474 (W.D. Va. 1989); Nat'l Bank of Pakistan v. Basham, 531 N.Y.S.2d 250 (N.Y. App. Div. 1988), *aff'd*, 539 N.E.2d 101 (N.Y. 1989); *Transamerica Ins. Co*. 465 N.W. at 716.

[92] Peoples Bank & Trust Co. v. Aetna Cas. & Sur. Co., 113 F.3d 629, 635 (6th Cir. 1997); FDIC v. Oldenburg, 34 F.3d 1529, 1539 (10th Cir. 1994); First Dakota Nat'l Bank v. St. Paul Fire & Marine Ins. Co., 2 F.3d 801, 813 (8th Cir. 1992).

[93] General Analytics Corp. v. CNA Ins. Cos., 86 F.3d 51, 54 (4th Cir. 1996).

[94] *See, e.g.*, FDIC v. St. Paul Fire & Marine Ins. Co., 942 F.2d 1032, 1035 (6th Cir. 1991); Susquehanna Bancshares, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 659 A.2d 991, 996 (Penn. 1995).

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Whether a controlling shareholder or owner will be deemed to have the requisite manifest intent appears to depend in part upon whether the substantial certainty or the specific intent standard is applied. In the case of a substantial certainty test, it appears much more likely that a court could conclude that an owner had the manifest intent to cause the insured to sustain a loss will exist because an element of foreseeability will come into play and risky behavior may translate into manifest intent, even if no actual intent existed. On the other hand, if the specific intent standard applies, it may be less likely that a court would conclude that manifest intent to cause the insured to sustain a loss was present because direct evidence of such intent will not likely exist.

In *Progressive Casualty Insurance Co. v. First Bank*,[95] the United States District Court for the Southern District of Texas included a very thorough discussion which illustrates why a pure recklessness standard and even a substantial certainty standard are not the most appropriate approaches in the context of loan losses and a manifest intent analysis. In that case the bank president made a number of loans which were risky and lacked adequate documentation, and he misrepresented the financial condition of the borrowers and collateral and failed to comply with bank internal procedures. Certain loans were made to friends on favorable terms or without loan committee approval. The bank sustained a loss on various loans and filed a bond claim, alleging employee dishonesty. After almost two years of litigation, the bank had failed to produce any evidence of the president's manifest intent to cause a loss or to obtain a financial benefit for himself. Other employees described the president as a terrible banker who was careless, but not dishonest. Based upon the evidence, the court concluded as follows:

> The bank infers that [the employee] would have acted the way he did only if he had a secret gain. On the contrary, in every period of excess, like a boom, the hard lessons of experience and training, as well as common sense, are ignored. Sound practices give way to loose practices. The collapse of oil prices in 1986 produced a banking crisis. Many of the honest loans—loans made in what then passed for the normal course of business in Texas banks—were speculative to impossible credit risks.
>
> There is simply no evidence that [the president] received a financial benefit or that he intended for the bank to sustain a loss. The bond is not credit insurance to protect the lender against improvident or reckless extensions of credit.

[95] 828 F. Supp. 473 (S.D. Tex. 1993).

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> [The president] may have been imprudent in taking improper risks and in making loans to friends, and he was clearly wrong in not disclosing material facts to the board and in not recording all transactions in the proper records, but without more, only speculation can turn that conduct into dishonesty or malice.[96]

The court concluded its opinion simply: "Fidelity and competence are different. First Bank will take nothing from Progressive Insurance Company."[97] The decision reached by the court illustrates how a different conclusion could have resulted from the application of either an objective test or a substantial certainty test. Using either of those tests, it would have been possible, and even likely, that the court would have concluded that manifest intent was present, based upon the reckless acts of the bank president, even though it would have been against the owner's self interest to cause his own bank to sustain losses.

3. The Weight of the Actor's Own Testimony

Does it ever make intuitive sense that a business owner would intentionally cause his own business to sustain a loss? Or is it more likely that an owner sometimes takes risks which, in hindsight, were more dangerous than the actor believed and which may have resulted in an unintended loss? Can risky behavior, with the hope of large returns for an insured, fairly be characterized in hindsight as dishonest or fraudulent behavior?

How much weight should the testimony of the actor himself carry with respect to the manifest intent question, especially when the actor is a controlling shareholder for the institution? What better evidence exists of manifest intent than the testimony by the actor about his own motivations and goals at the time of his actions which are in question? While the actor may have every reason to testify that he did not intend harm to the financial institution in order to protect himself, it would still be up to the fact finder to weigh the credibility of the actor's testimony, just as the fact finder does in any other criminal or civil case involving an intent element. Can a fact finder determine manifest intent based upon the testimony of the actor alone?

The complexities of manifest intent have been explored extensively in the context of various loan loss cases, where the question of manifest intent has appeared to be quite challenging for the courts. In fact, it appears that the issue of manifest intent is explored in the context of loan losses more often

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[96] *Id*. at 474 (citations omitted).

[97] *Id*. at 475.

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than in any other type of losses. Accordingly, a wealth of case law exists in which loan losses and manifest intent can be analyzed. These various cases illustrate that the application of the specific intent standard, or a reasonable emphasis on specific intent, will result in more well-founded holdings in the case of a controlling shareholder or owner.

a. *Substantial Certainty Weighted by Specific Intent*

A number of cases involving loan losses have applied the prevailing substantial certainty test in the context of an analysis of the specific intent of the loan officer in question. These cases have tended to give much weight to the specific intent of the actor, including the direct testimony of the actor regarding intent. The conclusions in these cases illustrate how the amount of weight given to a controlling shareholder's testimony about intent can affect the manifest intent decision.

In *Susquehanna Bancshares, Inc. v. National Union Insurance Co.*,[98] the Pennsylvania court strongly considered the testimony of the allegedly dishonest actor and appeared to lean toward a specific intent standard to govern the manifest intent question.[99] The focus of the court's decision was that it was proper to consider the subjective intent of the allegedly dishonest actor in reaching a conclusion on manifest intent and that the subjective intent should be examined in the context of the circumstances prevailing in the case.

The insured's subsidiary, Citizens National Bank of Greencastle, suffered a loss in excess of $1.4 million on seventeen truck loans made through its installment loan department. The manager of the department had originated or overseen all of the loans. The insured alleged that the manager had changed and extended due dates for less than the standard one percent fee; fraudulently administered the loans; lied to the bank's loan committee and board of directors to conceal his activities; made new loans to refinance loans to existing customers with poor credit histories; mislead bank officers, auditors, and examiners about the status of certain accounts; and made under-collateralized loans. The manager admitted not collecting certain fees but claimed that his actions resulted in a better chance to have customers pay off their loans. After a more than two-week bench trial, the trial court concluded that no manifest intent by the manager existed but that his actions were the product of the lending environment at the bank, which had been marked by years of mismanagement, a lack of supervision, and the use of unsound banking practices.

[98] 659 A.2d 991 (Pa. Super. Ct. 1995).

[99] *Id*. at 996.

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The court discussed both the objective test (which it described as asking if the employee committed the acts and whether the natural and probable consequences of the acts was financial harm to the bank) and the subjective test (which it described as involving a review of a broad range of evidence including, but not limited to, the natural and probable consequences of the employee's acts).[100] The bank urged the application of the pure objective test and argued that the trial court should have considered the natural and probable consequences of the employee's acts and should have ignored the subjective intent of the employee. In rejecting both the purely objective and purely subjective approaches, the court cited the following with approval:

> "Looking backwards, all but freak results are the natural consequence of preceding acts. Many are foreseeable. Most employers' losses are the natural and foreseeable consequence of employee acts. But those acts may be negligent. They may be ill-advised or show bad judgment. They may even be reckless. The fact that an injury is the natural result of an act is a causation issue and does not answer the question of whether that injury was manifestly intended by the actor. The point of inquiry is misplaced. The question of manifest intent to cause the employer to suffer a loss must be answered by looking at the point in time when the acts were committed or were contemplated. Was the actor's purpose to cause the loss? Did the actor know that the loss was an inevitable result of his acts? These are the questions that should be asked."[101]

As a result of its analysis, the court concluded that the fact finder should consider the testimony of the actor himself, as to what he intended by his actions, what his purpose was in engaging in the acts, and whether he was substantially certain that a particular result would occur, as well as external indicia of the actor's subjective intent.[102] In addition, the court concluded that it was proper to look at all surrounding circumstances.[103] After examining all of the evidence presented, a court may infer manifest intent to cause a loss from actions which evidence knowledge that losses are substantially certain to result, but a court may also reject such an inference based upon the totality of the circumstances.[104]

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[100] *Id*. at 994-95.

[101] *Id*. at 997 (quoting Jane Landes Foster et al., "Does a Criminal Conviction Equal Dishonesty? Criminal Intent Versus Manifest Intent," 24 TORT & INS. L.J. 785, 800 (1989)).

[102] *Id*.

[103] *Id*. at 996.

[104] *Id*.

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The Fifth Circuit adopted a similar approach in *First National Bank v. Lustig*,[105] where it concluded that the jury should be instructed that it should consider "the range of evidentiary circumstances, including the relationship between the borrowers and the employee, the employee's knowledge of the likelihood that the loans would not be repaid, and all the other surrounding circumstances bearing on the employee's purpose."[106] The employee involved in the case was a young commercial real estate lending officer who admitted that he fabricated credit references on eight loans but claimed that he did so to make good loans and to get recognition in his bank, not to obtain personal gain from customers. The loan losses from the failure of eight loans totaled $20 million.

The court emphasized the importance of the employee's own purpose in its analysis but seemed to indicate that manifest intent will not necessarily be found when the employee hoped to benefit the bank, regardless of the certainty of a loss. The court recognized, for example, that an employee "may use fraudulent documents for loans, believing that they would be successfully paid, without manifest intent to cause the bank a loss."[107] The court also stated that a claim that no loss was intended would seldom be conclusive to determine intent and that the inquiry on that point would not be limited solely to the subjective purpose or motive of the employee. Instead, the court found that it would be proper to infer from reckless conduct and the surrounding circumstances that an employee intended to cause a loss.[108]

The Second Circuit has apparently considered the subjective intent of the employee as the predominant factor in two separate opinions. In *Leucadia, Inc. v. Reliance Insurance Co.*,[109] the Second Circuit analyzed a complicated loan loss case where the allegedly dishonest head of the loan department made speculative loans, extended loans, misrepresented the value of collateral, and committed other acts in connection with three separate lending relationships. The insured sustained losses of more than $15 million and claimed the losses under a bond issued by Reliance. The court reviewed numerous facts involving each separate series of transactions and concluded that the losses resulted from depressed market conditions, internal disorganization, and mismanagement of the loans by the insured. However, the court also determined that each decision to advance money could have been construed as reasonable under the circumstances, the acts were approved by other

[105] 961 F.2d 1162 (5th Cir. 1992).

[106] *Id*. at 1166-67.

[107] *Id*. at 1166.

[108] *Id*.

[109] 864 F.2d 964 (2d Cir. 1988), *cert. denied*, 490 U.S. 1107 (1989).

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executives, and the loan officer acted in order to salvage the loans. Based upon those facts, the court held that the loan officer did not have the manifest intent to cause the insured to sustain a loss and did not act dishonestly.[110]

In a subsequent trading loss case, the Second Circuit reached a similar conclusion. In *Glusband v. Fittin Cunningham & Lauzon, Inc*.,[111] the court concluded that the employee in question lacked any manifest intent to cause a loss because the evidence supporting a finding that the employee "intended to benefit [the employer], no matter how reckless and imprudent his conduct may have been."[112] In commenting upon the evidence in the *Leucadia* case, the Second Circuit stated that the loan officer in question "misguidedly hoped to benefit his employer and received no personal gain from the transactions."[113]

The best way to characterize this line of cases appears to be that they include a substantial certainty element, weighted heavily by an analysis of the subjective intent of the actor. They tend to focus more on the overall circumstances of the case and give great weight to the reasons for the actions of the allegedly dishonest employee. The result of this approach is that finding manifest intent by an owner is less likely.

b. *Substantial Certainty as the Prevailing Test*

Other cases which have discussed the substantial certainty test, however, have appeared to give less weight to the subjective intent of the actor. Under those circumstances, the conclusion about manifest intent appears to vary substantially. In *Peoples Bank & Trust Co. v. Aetna Casualty & Surety Co*.,[114] the Sixth Circuit made it clear that it would apply a substantial certainty test to determine manifest intent but would not apply the specific intent test. Two customers of the bank sued the bank and several officers and directors, alleging that the officers and directors engaged in a fraudulent scheme to sell the customers a restaurant and lounge owned by two directors and to earn a commission for the officers. The customers purchased the restaurant and lounge and immediately lost their money. On the bond claim for the losses which were sustained, the court found that no evidence in the record indicated that the employees had the manifest intent to cause the bank to sustain a loss and that the bank employees tried to protect the bank by obtaining a small business administration guarantee on the loan.

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[110] *Id*. at 973.

[111] 892 F.2d 208 (2d Cir. 1989).

[112] *Id*. at 210.

[113] *Id*. at 211.

[114] 113 F.3d 629 (6th Cir. 1997).

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The Sixth Circuit opined that manifest intent exists when a result is "substantially certain" to follow from certain conduct.[115] The court rejected the argument that manifest intent requires the employee to actively wish for the result, as well as the argument that only a mere probability that the result would occur must exist.[116] The court instead adopted the middle ground of "substantial certainty" and concluded that nothing in the case indicated that a loss to the bank was substantially certain to follow from actions toward the purchasers.

In the earlier decision of *FDIC v. St. Paul Fire & Marine Insurance Co*.,[117] the Sixth Circuit also applied the substantial certainty test. The court decided to do so in the context of its discussion that "intent" is a shorthand for a complicated series of inferences, all of which rely upon tangible manifestations of behavior.[118] The court found it unnecessary to concern itself with the actual existence of a mental state because external behavior is what we are forced to examine in order to determine what mental state exists.

The court in that case found that the bank president acted dishonestly and obtained benefits for himself but did not act with the manifest intent to cause the bank to sustain a loss.[119] The employee in question was the president and CEO of the bank, as well as a director and shareholder, who made various loans without following proper procedures. Ignoring bank policies dealing with conflicts of interest, the president entered into a number of transactions in which he had a personal financial stake. He approved a number of loans to friends without going through the proper procedures.

The loans were not repaid, and the bank sustained losses as a result. The bank failed, and the FDIC pursued bond claims based upon employee dishonesty. The court concluded that the president clearly lacked the manifest intent to cause the bank to suffer a loss because, as a party with a significant financial stake in the bank, the president would only cause financial ruin to himself by causing losses to the bank.[120] The court discussed the impact which significant losses to the bank would have to the president:

> [The president] could have only intended to cause the bank to sustain a loss on the loans if he also intended to wipe out a vast portion of his assets in the process, including his ownership interest in [the bank]. The evidence does not indicate that [the president] has such a financially suicidal intent.[121]

[115] *Id*. at 635.

[116] *Id*. at 635-36.

[117] 942 F.2d 1032 (6th Cir. 1991).

[118] *Id*. at 1035.

[119] *Id*. at 1034.

[120] *Id*. at 1036.

[121] *Id*. at 1034-35.

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The court concluded that the bond would cover dishonest acts but not bad business judgment, whether reckless and imprudent or just plain poor.[122] Based upon the president's own financial interest in the bank, the court concluded that he must have hoped that the enterprises would flourish and supply the income necessary to service the loans.[123] The results in this case, and the discussion of the court, appear to give greater weight to the intentions of the president than the Sixth Circuit might be willing to give in later cases. The language of the later *Peoples* case indicates that the Sixth Circuit will place a greater emphasis on the substantial certainty element in the future.

The Seventh Circuit adopted the Sixth Circuit's general "substantial certainty" approach in *Heller International Corp. v. Sharp*.[124] That case also involved a series of complicated loan losses. The question before the Seventh Circuit was whether the jury instructions used were proper on the issue of intent and manifest intent. The court cited a general insurance definition of "intent" which included elements that the actor "desires to cause the consequences of his act or believes that the consequences are substantially certain to result from it."[125] The court also cited with approval the approach taken by the court in the *FDIC v. St. Paul* decision, which emphasized the substantial certainty element, and the portion of the *Lustig* opinion which stated that the court would not inquire solely into the subjective motive or purpose of the actor. The court, therefore, refused to reject a definition of intent which leans more toward an objective approach than a subjective approach. The effect of the court's holding is that the Seventh Circuit will likely emphasize the "substantial certainty" portion of the manifest intent analysis, which will likely result in finding of manifest intent more often than not.

The Eighth Circuit also appeared to apply a loose "substantial certainty" approach in *First Dakota National Bank v. St. Paul Fire & Marine Insurance Co*.[126] In that case, the court upheld the use of a jury instruction which stated that the jury could draw an inference of intent from surrounding circumstances, which could indicate state of mind, but concluded that a person "is deemed to intend the natural consequences of his actions."[127] The court rejected St. Paul's argument that the instruction created a mandatory presumption of intent and held that the entire instruction permitted, but did not require, the jury to draw a particular conclusion.[128] Once again, the approach adopted by the court leans more toward the objective approach than

[122] *Id*. at 1036.

[123] *Id*. at 1037.

[124] 974 F.2d 850 (7th Cir. 1992).

[125] *Id*. at 858.

[126] 2 F.3d 801 (8th Cir. 1992).

[127] *Id*. at 813.

[128] *Id*. at 814.

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the subjective and, therefore, permits the finding of manifest intent in more circumstances than not.

c. *Examples of Both Approaches*

In three separate decisions, the Tenth Circuit has applied inconsistent standards in order to reach different conclusions about manifest intent. In the first opinion, the court tended to give great weight to the specific intent issue within the context of a substantial certainty case. In later opinions, however, the court appeared to abandon the examination of specific intent in favor of a much more objective type of approach.

First, in *First Federal Savings & Loan Ass'n v. Transamerica Insurance Co.*,[129] the Tenth Circuit concluded that no manifest intent to cause a loss to an insured existed because the loan officer in question attempted to arrange transactions that he hoped would be to the mutual benefit of both the bank and the borrowers. In that particular case, the loan officer allowed three customers whose applications had been rejected by the bank to assume loans the officer made to other borrowers. In each situation, the borrower either had insufficient income to service the debt or a poor credit history. The officer received an origination fee on one of the loans but later returned the fee to the bank. The borrowers defaulted on the loans, and the bank sued for its losses.

Without extensive discussion, the court upheld the trial court's decision to grant the motion for summary judgment filed by the insurer on the ground that no manifest intent to cause a loss existed on the part of the officer.[130] The court simply concluded that the bank failed to produce any evidence that the loan officer had any manifest intent to cause a loss and that the evidence indicated that the officer tried to arrange transactions which would mutually benefit the bank and the borrower. The court noted that the loan officer might have used poor business judgment in making the loans because they did not meet the bank's requirements but that no manifest intent to cause a loss was evident.[131]

In two subsequent decisions, the Tenth Circuit took quite a different approach. In *FDIC v. United Pacific Insurance Co.*,[132] the Tenth Circuit applied a subjective test which provided that manifest intent "does not require that the employee wish for or desire a particular result, but it does require that the results be substantially certain to happen."[133] The standard applied appears to be somewhat inconsistent with that from *First Federal* because it invokes

[129] 935 F.2d 1164 (10th Cir. 1991).

[130] *Id*. at 1167.

[131] *Id*.

[132] 20 F.3d 1070 (10th Cir. 1994).

[133] *Id*. at 1077.

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the "substantial certainty" element which did not appear to form the basis of the Tenth Circuit's prior opinion.

In *FDIC v. United Pacific*, the court applied a "substantial certainty" test in the context of losses which the bank alleged occurred as a result of loans made by the bank's president and major shareholder. The instructions used in the trial court and approved by the Tenth Circuit indicated that the jury could draw the inference that a person intends the natural consequences of his acts, that an intent to cause a loss can exist even if the loss was not the direct motive of the actor, and that wilful intent could be inferred from reckless indifference to the truth.[134] Each of these elements of the jury charge tend toward the objective approach, or the recklessness standard, rather than emphasizing any actual intent of the actor.

Finally, in *FDIC v. Oldenburg*,[135] the Tenth Circuit applied the substantial certainty standard, as well as the recklessness standard, and cited with approval certain language from the *FDIC v. United Pacific* opinion.[136] In particular, the court cited the following language in the context of its discussion regarding the "manifest intent" standard:

> "Manifest intent does not require that the employee actively wish for or desire a particular result; rather, *manifest intent exists when a particular result is substantially certain to follow from the employee's conduct. Manifest intent to cause a loss may be inferred from an employee's reckless conduct and other circumstantial evidence*. Direct evidence of the employee's intent is not required, and a claim by an employee that he intended no loss to the bank is not conclusive."[137]

The facts of the *Oldenburg* case involved an effort by senior officers and directors of a savings and loan to save a failing real estate company (which was owned by the bank's owner) by having the saving and loan purchase an asset from the real estate company. The senior officers and directors originally wanted to make a loan directly to the affiliated real estate company but used the asset purchase instead because of concerns about loan violations which could result from the direct loan. The court concluded that the officers and directors acted with the manifest intent to cause the savings and loan to sustain a loss.

The court focused on two particular actors in the case, the president of the bank and the general counsel for the bank. The court concluded that it

[134] *Id*.

[135] 34 F.3d 1529 (10th Cir. 1994).

[136] *Id*. at 1539.

[137] *Id*. (quoting FDIC v. United Pacific Ins. Co., 20 F.3d 1070, 1078 (10th Cir.1994)).

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was improper for the trial court to grant summary judgment on the manifest intent element with respect to the bank president.[138] The court found that relying strictly upon a criminal guilty plea on misapplying funds was improper because the criminal charge did not necessarily require the necessary element of intent to cause loss to the savings and loan. The court appeared to give considerable weight to the president's testimony that he believed that the transactions would benefit the savings and loan in reaching its conclusion that a court could not summarily find manifest intent in the face of that evidence.

On the other hand, the court upheld a finding of manifest intent on the part of the general counsel for the bank, based in large part on the evidence that the counsel had falsified documents for the transactions in an effort to make it look legitimate, and on the counsel's testimony that he took the actions despite the knowledge of possible negative consequences to the savings and loan.[139] The counsel testified that he had said that the savings and loan was going to run into problems with the transactions and that the end result would be the failure of the savings and loan and the real estate company. The court noted that the trial court had an opportunity to weigh the credibility of the witnesses with respect to the general counsel's conduct and that the evidence supported the district court's finding because, according to the court, "evidence of reckless conduct can support an inference of manifest intent."[140]

These decisions by the Tenth Circuit illustrate the differing conclusions about manifest intent which the courts can reach, depending on the theory which is applied by a particular court. The decisions also illustrate that the manifest intent inquiry will be fact intensive.

4. The Ultimate Weight: The Specific Intent Test

In *Affiliated Bank/Morton Grove v. Hartford Accident & Indemnity Co.*,[141] the arguments of the opposing parties perfectly contrast the difference that the application of the specific intent versus the substantial certainty tests will make. In this case, the bank's vice president devised a plan to conceal financial problems of a bank customer by having the customer participate in a check kiting scheme and by making transfers of funds between accounts in the bank to prevent the customer from appearing on overdraft reports. The insurer argued that the bank had failed to submit any evidence that the officer "had the specific intent that the bank actually suffer losses" and submitted evidence that the officer hoped for a happy ending, not for the bank to lose

[138] *Id*. at 1539.

[139] *Id*. at 1541.

[140] *Id*.

[141] No. 91-C-4446, 1992 WL 91761 (N.D. Ill. Apr. 23, 1992).

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money.[142] The result of the insurer's argument, and the application of the specific intent test, would have been a conclusion by the court that no manifest intent and, therefore, no coverage existed.

The court rejected the insurer's arguments, however, and instead applied a tort standard that the actor need only act with the same degree of intent as required under the law of intentional torts.[143] The court drew the distinction that courts which have considered the subjective intent of the allegedly dishonest employees "did not consider the ambiguous situation in which the bank employee prefers that no harm will come to the bank (perhaps even that the bank will benefit) yet acts with the knowledge that his action will create a substantial certainty that the bank will suffer a loss."[144] The court, therefore, adopted the "substantial certainty" test of the Sixth Circuit and focused on whether the actions by the loan officer were substantially certain to result in loss, regardless of the officer's good intentions.[145] The court concluded that a fact issue existed which would preclude summary judgment in the insurer's favor on the question of manifest intent and that a finding was required on the issue of whether the vice president acted knowing that there was a "substantial certainty" that losses to the bank would result from his actions.[146]

While the issue of manifest intent might have remained a fact issue regardless of the standard applied to it, the approach by the court illustrates how certain uses of the substantial certainty test can completely undermine the Bond's use of the term "manifest intent." According to the decision, manifest intent can be present, even when it is clear that the actor prefers that no loss result, because the degree of recklessness of the acts in question can override all other considerations. However, the use of the subjective approach would result in a different manifest intent conclusion.

In *General Analytics Corp. v. CNA Insurance Cos.*,[147] a case which did not involve a loan loss, the Fourth Circuit applied and adopted the specific intent standard in order to determine whether a particular employee had the manifest intent to cause the insured to sustain a loss. The employee in the case altered purchase orders to make it appear that the customer was ordering one brand of parts, when it actually ordered a different brand. The insured

[142] The various evidence, including testimony of the allegedly dishonest loan officer, included statements that the officer hoped that the customer he was helping would recover financially and all of the account holders would recover their money with interest, that everything that the officer did was to benefit the bank, and that the officer never meant to hurt the bank or its other customers. *Id*. at *3.

[143] *Id*. at *3.

[144] *Id*. at *4.

[145] *Id*.

[146] *Id*. at *5.

[147] 86 F.3d 51 (4th Cir. 1996).

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sustained a loss when the customer would not accept the delivery of the wrong brand of parts.

The Fourth Circuit adopted a very narrow interpretation of coverage under Insuring Agreement (A), holding that the bond was designed to "provide coverage for a specific type of loss characterized by embezzlement, which involves the direct theft of money."[148] Further, the court explained that Insuring Agreement (A) requires the existence of a specific intent, similar to that required by criminal law, in order to establish manifest intent:

> Thus, if a dishonest act has the *un*intended effect of causing a loss to the employer or providing a benefit to the employee, the act is not covered by the policy. Stated succinctly, employee dishonesty coverage insures against "loss caused by a thief," as opposed to a fool or saboteur, "who happens to be an employee of the insured."[149]

The court opined that a subjective test, involving an analysis of words and conduct of the actor, as well as the surrounding circumstances of the events, should be used to establish manifest intent because both words and conduct are probative of intent and because the circumstances illuminate the meaning of the words and conduct.[150] The court seemed convinced by the insurer's argument that the court's focus had to be the determination of the employee's true purpose, as determined from all of the relevant evidence, both subjective and objective.

The court illustrated its reluctance to adopt the "substantial certainty" kind of test used by other courts with its example of the use of a firearm:

> Thus, for example, the mere fact that a person discharges a firearm, killing a bystander, does not establish that the person holding the firearm shot the bystander *with the intent* to kill him. On the other hand, evidence that the person had just quarreled with the bystander (motive), that the person said, after shooting the bystander, "He deserved it" (subjective expression), and that the person was seen aiming the firearm at the bystander (conduct) tends to establish the person's intent to kill the bystander.[151]

This approach de-emphasizes the "substantially certain" element and focuses instead on the issue of true intent, regardless of the certainty of the result.

[148] *Id*. at 53.

[149] *Id*. at 54.

[150] *Id*.

[151] *Id*.

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5. Uncertainty and Confusion Resulting From the Approaches

The use of the "substantial certainty" portion of a manifest intent analysis will result in the insertion of an element of uncertainty for the person analyzing a Bond claim. The use of the "substantial certainty" element means that, regardless of the clearly expressed subjective intent of the actor, the fact that the conduct was extremely reckless can override the lack of intent to cause a loss. Is that really the intent of the Bond and its manifest intent language? Probably not, but it is nevertheless the approach which most courts have taken. While it may not be possible to convince the courts to utilize an entirely subjective approach, it appears that the better reasoned decisions analyze the substantial certainty test in the context of a careful analysis of the actor's subjective intent. By giving substantial weight to the subjective intent of the accused employee, the courts can at least guard against the application of what tends to amount to an objective standard of manifest intent.

The cases that have focused on the issue that the Bond is not intended to cover reckless conduct have used the correct approach. When a conclusion about manifest intent really arises based upon reckless conduct and what may be substantially certain to follow from reckless conduct, that conclusion seems to be at odds with the true purpose of the Bond. In fact, that approach would allow a court to conclude that a controlling actor could, in fact, have the manifest intent to cause loss to a financial institution, even though that loss will cause financial ruin to the actor personally, based upon his ownership interest in the bank. That type of result does not seem to be intuitively sound, but it appears possible in light of the court's approach to analyzing manifest intent.

The vast array of cases which analyze the manifest intent element in the context of loan losses provides a wealth of authority for both the insured and the insurer to use as weapons in support of or in defense of a claim. The better-reasoned cases support the argument that an owner or majority shareholder will not be likely to have the manifest intent to cause his or her own business to sustain massive losses. However, a conclusion of manifest intent is certainly possible, in light of many courts' application of a substantial certainty/recklessness standard.

C. *Additional Loan Loss Elements to Consider*

1. What Level of Agreement Supports a Finding of Collusion With the Borrower?

As noted above, collusion between the allegedly dishonest employee and another party to the loan transaction is an essential element for the insured to

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allege and prove in the context of a loan loss case.[152] The term "collusion" is not defined by the Bond, so the question of what degree of involvement constitutes collusion by another party to the loan immediately arises.

The Arizona court in *Standard Chartered Bank v. Milus*[153] adopted a rather strict test of collusion and refused to recognize the mere participation in negligent or reckless acts as collusive in effect.[154] The allegedly dishonest employee in the case was the former executive vice president and chief credit officer of the insured bank. That officer allegedly gave millions of dollars in under-collateralized loans to two separate borrowers in an attempt to keep their existing loans from going into default and being written off by the insured bank. The bank's theory in the case was that the officer undertook the scheme in order to ensure that a pending sale of the bank would not be adversely affected by the substandard loans. The alleged motivation for ensuring the sale was completed was that the officer stood to benefit financially from the sale since he owned a number of shares of the bank.

The insured bank and the insurer agreed that the term "collusion" should be analyzed in the same manner as the term "conspiracy," as it is used in the criminal context.[155] The insured bank argued that collusion or conspiracy should have been inferred from the tacit collusion between the officer and the borrowers because the borrowers should have been aware that the officer was approving the loans for his own unauthorized purposes and because the borrowers encouraged the unauthorized approvals by providing substantially overvalued or worthless collateral to the officer. The insurer argued that no conspiracy could be established because the bank did not have any evidence of an agreement between the officer and borrowers to exchange a benefit for the loans.

The court rejected the bank's collusion argument, finding the "mere act of procuring a loan, even one given negligently or recklessly by the loan officers, does not inherently place a borrower on notice of possible illegal activity on the part of the loan officer approving the loan transaction."[156] The court, therefore, concluded that the fact that the loans were allegedly supported by worthless collateral did not support an inference that the borrowers knew of or intended to promote an illegal scheme with the officer and that there was no evidence that the misrepresentations about the collateral

[152] FIB, Insuring Agreement (A).

[153] 826 F. Supp. 310 (D. Ariz. 1990).

[154] *Id*. at 313.

[155] *Id*. at 312.

[156] Id. at 313.

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were made at the officer's behest.[157] Even assuming that the borrowers were aware that the officer was lending money negligently, the court concluded that the borrowers' attempts to seek loans did not alone create an inference of conspiracy. Finally, absent some allegation that the borrowers knew about and supported the scheme, the court found that it would be a stretch of logic to infer intent to promote the scheme from the act of seeking a negligently made loan when it was equally likely that the officer's conduct could be attributed to a work-out strategy for the loans.[158]

Similarly, in *Progressive Casualty Insurance Co. v. First Bank*,[159] the court made it clear that collusion between a loan officer and a borrower should not be presumed. The court concluded that, even though the former president of the bank made loans to friends in violation of bank policy and made misrepresentations about the loans, his acts did not imply collusion by the borrowers themselves.[160] In other words, the court required at least some evidence of collusion, such as the banker's receipt of a secret gain, in order to implicate the borrowers in the banker's wrongdoing. The court held that violation of bank policy by the banker did not automatically establish collusion by the borrower since "being a bad credit risk is not dishonesty."[161]

These cases appear to adopt a reasonable approach to analyzing the involvement of borrowers in the loan process. Merely being involved in a risky loan should not, by itself, constitute evidence of collusion. At the other end of the spectrum, payment of kickbacks by a borrower in connection with a criticized loan will likely qualify as collusion. For all factual patterns in between, the collusion question is likely to be a question of fact for the jury or court analyzing the case. What these cases make clear is that collusion should never be presumed merely because dishonest conduct is alleged to have occurred. Evidence of active participation on the borrower's side of the loan is apparently required.

2. The Financial Benefit Requirement

The language of Insuring Agreement (A) also requires an actual financial benefit of at least $2,500 to the allegedly dishonest employee but provides that the benefit does not include benefits earned in the normal course of employment.[162] The term "financial benefit" is not defined by the Bond, but

[157] *Id*.

[158] *Id*.

[159] 828 F. Supp. 473 (S.D. Tex. 1993).

[160] *Id*. at 476.

[161] *Id*. at 475.

[162] FIB, Insuring Agreement (A).

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the Bond does specifically exclude employment benefits and indicates that the financial benefit must be received in connection with the dishonest loan itself. The financial benefit requirement, therefore, raises various questions in the context of loan losses, such as whether commissions received in connection with fraudulent loans can constitute the financial benefit which is required by the Bond or whether other types of benefits are required and whether a financial benefit is required in connection with each and every dishonest transaction.

In *First Bank of Marietta v. Hartford Underwriters Mutual Insurance Co*.,[163] the court focused specifically on the issue of the employment benefit limitations imposed by the Bond. The insured's chief executive officer issued fraudulent loans to two fictitious entities and used the proceeds for his own benefit and improperly increased the credit line for an existing customer. The parties agreed that losses incurred by the bank for the fraudulent loans fulfilled the requirements of the bond in place, including manifest intent by the CEO to obtain a financial benefit for himself. However, the parties disagreed on coverage for the increased credit line since the chief executive officer received no kickback or other benefit from the borrower.

The court granted summary judgment in favor of the insurer, holding that the employee lacked the manifest intent to obtain a financial benefit outside his normal course of employment in connection with the increased credit line.[164] The court's decision relied upon the fact that the employee had no financial interest in the credit line, other than the commissions that he would have earned in the normal course of business when he increased a credit limit beyond his lending authority. The court also noted that no relationship existed between the officer and the borrower. That no kickbacks or other illegal benefits were involved and that the officer did not have any financial interest in the entity which received the credit increase were determinative of the financial benefit issue.[165] The case indicates that a separate financial benefit is required in connection with each separate dishonest act and, furthermore, that commissions will not satisfy the financial benefit requirement.

In the context of the financial benefit element, several cases have focused specifically on the bribe or kickback angle, and that type of benefit appears to be the universally accepted evidence of manifest intent to obtain a financial benefit, sufficient to trigger coverage of a loan loss under Insuring Agreement (A). For example, in *FDIC v. St. Paul Fire & Marine Insurance Co*.,[166] the court concluded that manifest intent to obtain a financial benefit

[163] 997 F. Supp. 934 (S.D. Ohio 1998).

[164] *Id*. at 938.

[165] *Id*.

[166] 738 F. Supp. 1146, 1157 (M.D. Tenn.), *aff'd in relevant part, vacated and remanded on other grounds*, 942 F.2d 1032 (6th Cir. 1991).

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existed where a bank executive covertly approved loans to entities in which he had a financial stake. In *Maryland Casualty Co. v. American Trust Co.*,[167] the court found manifest intent to obtain a financial benefit where a bank president improperly approved loans to joint ventures in which he participated with the loan recipients.

Finally, the insurer in *Standard Chartered Bank v. Milus*[168] attempted to rely upon the specific limitations of the "financial benefit" term as a defense to a bond claim. In that case, the loan officer in question made loans to insolvent customers in order to ensure that their existing loans would not go into default and would not be written off by the bank. The alleged motivation of and benefit to the loan officer was that the bank was in the process of being sold and the officer did not want that sale jeopardized since he owned stock in the bank and stood to gain financially in the sale. The insurer raised a credible defense that the term "in connection therewith" requires that any financial benefit derived by the officer must have come from the borrowers in the form of a bribe or kickback. Unfortunately, the court did not reach that issue and focused instead solely on the collusion element discussed above.

Based upon the case law addressing the issue of financial benefit, the better argument is that a financial benefit is required in connection with each dishonest act and that financial benefits other than loan commissions are required in order to fulfill the requirements of Insuring Agreement (A).

3. "Pattern of Dishonesty" Allegations and Their Effect on the Required Elements

While the language of Insuring Agreement (A) indicates that manifest intent to cause the insured to sustain a loss and to obtain a financial benefit is required for each separate loss in order to invoke coverage, some authority exists which may permit insureds to allege merely a pattern of bad conduct in connection with a group of transactions, rather than forcing the insured to establish each element of Insuring Agreement (A) for each transaction. An allegation of only a "pattern" of dishonesty appears to be a significant shortcut for the insured, as well as a way to undermine the requirement of the various elements set forth in Insuring Agreement (A).

The "pattern" issue is now an important one because the Fifth Circuit has created an unfortunate and confusing precedent in its *FDIC v. Fidelity & Deposit Co. of Maryland*[169] decision by concluding that "a general pattern of dishonesty, rather than a dishonest act for each loan, is sufficient" to meet

[167] 71 F.2d 137 (5th Cir. 1934), *cert. denied*, 293 U.S. 582 (1934).

[168] 826 F. Supp. at 312.

[169] 45 F.3d 969 (5th Cir. 1995).

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the insured's burden of proof of establishing loss due to dishonesty under the bond.[170] The Fifth Circuit's statement that "[t]here does not have to be a finding of fraud or dishonesty with respect to every disbursement" significantly undermines the clear language of the Bond that a loss must "result directly from" employee dishonesty, as well as the clear language in the manifest intent requirements. The decision of the Fifth Circuit in *FDIC v. F&D* permitted the insured in that case to claim losses for four separate groups of loans, even though dishonesty was not evident with respect to each and every transaction within each loan group. The court's language indicated that, in the court's mind, the tainted nature of the relationship from one transaction adversely affected all subsequent transactions in a loan group. However, a careful reading of the case also indicates that a transaction which precedes dishonest acts, and which has no indicia of dishonesty itself, cannot necessarily be thrown into the fray of a loan loss claim. Where no elements of dishonesty can be established for the early transaction, coverage cannot be invoked, even under the *FDIC v. F&D* formulation.[171]

Some insureds may also attempt to rely upon *Fidelity & Deposit Co. of Maryland v. USAFORM Hail Pool, Inc*.[172] and *Midland Bank & Trust Co. v. Fidelity & Deposit Co. of Maryland*,[173] two opinions which pre-date *FDIC v. Fidelity & Deposit Co. of Maryland* and contain similar statements regarding a pattern of dishonesty. For example, the *Midland Bank* case, citing *USAFORM Hail*, concluded that there is "no need to show the existence of a specific dishonest and fraudulent act with respect to every individual transaction where, as here, the dishonest conduct of the employees which caused the loss permeated the entire course of dealings."[174] Reliance upon these authorities would likely be misplaced, however, depending upon the particular form of language in question. Both the *USAFORM Hail* and *Midland Bank* cases analyzed bonds which provided coverage for losses sustained "through" dishonest acts, rather than the more specific "resulting directly from" language in later bond forms.

The Fifth Circuit and other courts' statements will be particularly dangerous in the context of massive loan losses alleged to be the result of dishonesty of a particular loan officer, especially when the officer is either the president of the bank or the key lending officer. In such a case, the insured will likely argue that every loan which was made by the officer and

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[170] *Id*. at 976.

[171] *Id*. at 975.

[172] 523 F.2d 744, 757 (5th Cir. 1975), *cert. denied*, 425 U.S. 950 (1976).

[173] 442 F. Supp. 960, 971 (D.N.J. 1977).

[174] *Id*.

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which resulted in a loss to the bank should be included in the loss computation, even when specific dishonest acts cannot be tied to the particular loan. The "pattern of dishonesty" concept could form the basis for the insured to argue that separate dishonesty, collusion, and financial benefit need not be shown for each and every loan comprising the claim and would substantially increase the level of investigation required for the claim.

The better approach or analysis in the case of a loan loss appears to be that which requires the insured to allege and prove each element of a loan loss for each separate loan transaction, particularly under the current Bond language. The Eighth Circuit noted such an approach in *United States Fidelity & Guaranty Co. v. Empire State Bank*,[175] where it concluded that a loss on one loan was not covered because no dishonesty from the principal could be imputed to that loan, even though a loss on another loan was covered since the insured did establish that it resulted from employee dishonesty.[176] Several other cases which have addressed this issue appear to require the proof of each element for each separate loan loss claimed.[177]

4. Proving All Loan Loss Elements

The cases discussing the additional elements of Insuring Agreement (A)'s provisions for loan losses illustrate that having a loan loss and a mere allegation of dishonesty is not sufficient to establish coverage for the loss. The additional elements of collusion and financial benefit are important parts of the analysis. In addition, the insured and insurer should focus on the insured's burden to prove each separate element of Insuring Agreement (A) within the context of each separate transaction or loss. The collusion and financial benefit elements often relate to one another since evidence of kickbacks or payments by the borrower to a loan officer appear to establish both the collusion and benefit requirements, without much additional discussion. Cases which involve conduct which falls short of actual kickbacks will likely raise additional fact issues to be debated by the insured and insurer.

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[175] 448 F.2d 360 (8th Cir. 1971).

[176] *Id*. at 367.

[177] Fidelity Sav. & Loan Ass'n v. Aetna Life & Cas. Corp., 440 F. Supp. 862, 874 (N.D. Cal. 1977), *aff'd*, 647 F.2d 933 (10th Cir. 1981); Sun Ins. Co. of New York v. Cullum's Men Shop, Inc., 331 F.2d 988, 990-91 (5th Cir. 1954); Danal Jewelry Co. v. Fireman's Fund Ins. Co., 264 A.2d 320, 325 (R.I. 1970).

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IV. PROPERLY DEFINING THE LOSS AND THE COMPUTATION OF THE LOSS

A. *Recurring Loan and Income Exclusion Issues*

Once the Employee, manifest intent, financial benefit, and collusion elements have been satisfied in the context of an alleged loan loss, the insured and insurer are still faced with an important question: what is the amount of the loan loss which was caused by employee dishonesty and which is covered by the Bond? One primary part of the Bond to analyze in this context is the income exclusion, which automatically calls into question an important part of the losses which have inevitably occurred.

1. What Portions of a Loan Loss Are Covered?

It is a generally accepted proposition that the Bond provides coverage for a loss which results from specific perils set forth in the Bond itself but does not provide general credit insurance.[178] The issues discussed above, and in particular the manifest intent discussion, make it clear that loss (although not defined) from loans must result from the type of fraudulent and dishonest conduct described in the Bond.

First, the Financial Institution Bond is a contract of indemnity, not liability insurance, and it covers only actual and direct losses, not theoretical losses.[179] In order to recover losses under the Bond, an insured must allege and prove that it sustained an out-of-pocket loss due to wrongful acts.[180] The mere shifting of assets or liabilities without any accompanying actual loss is not compensable.[181]

One important question to address when attempting to quantify an insured's loan loss is when the loss itself occurred. In a typical loan loss

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[178] *See, e.g.*, Third Fed. Sav. & Loan Ass'n of Cleveland v. Fireman's Fund Ins. Co., 548 F.2d 166, 172 (6th Cir. 1977).

[179] FDIC v. United Pacific Ins. Co., 20 F.3d 1070, 1080 (10th Cir. 1994) ("A fidelity insurance contract indemnifies against loss, and the insured under a fidelity Bond has the burden of proving that it suffered an actual loss by a preponderance of the evidence."); Cincinnati Ins. Co. v. Star Fin. Bank, 35 F.3d 1186, 1191 (7th Cir. 1994) (the Bond does not cover "bookkeeping or theoretical losses, not accompanied by actual withdrawals of cash or other such pecuniary loss"); Continental Corp. v. Aetna Cas. & Sur. Co., 892 F.2d 540, 543 (7th Cir. 1989) (Bond is an indemnity contract which guarantees reimbursement for losses sustained by the insured resulting from employee dishonesty).

[180] American Employers' Ins. Co. v. Roundup Coal Mining, Inc., 73 F.2d 592, 595 (8th Cir. 1934) ("Dishonesty in the abstract cannot be compensated in damages, and in a suit to recover on the Bond the dishonesty must have resulted in pecuniary loss.").

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case, where the insured claims that the loan in question was not creditworthy when made due to dishonesty, some authority exists for the proposition that the loss should be measured on the date of the extension of credit:

> [L]oss means the deprivation or disposition of money or property of the bank due to the dishonest, criminal, or fraudulent acts of its officers, regardless of the security the bank has for the loss, and that the "loss" occurred and was suffered by the plaintiff without regard to its possible remedies, when its funds were in fact diverted …. [182]

The loss itself may be measured, therefore, on the date of the loan with the understanding that various other factors, including but not limited to recoveries, may affect that calculation.[183] The outstanding principal balance of the loan may be the starting point for measuring the quantum of the loss, again taking into consideration the fact that other issues may affect the ultimate calculation.[184] The issues of both interest and recoveries from collateral present difficult questions for the further analysis of the loss.

2. The Income Exclusion

In the case of loan losses, one of the first questions which arises is whether principal, or interest, or fees, or any other elements of a loan are compensable. The income exclusion directly applies to these questions.

As a reinforcement of the out-of-pocket loss concept, the Bond contains a specific income exclusion which provides that "[t]his Bond does not cover potential income, including but not limited to interest and dividends, not realized by the Insured."[185] Since loans will, as a matter of course, involve interest for the insured, the income exclusion is an immediate issue in the computation of the loan loss. One recurring question appears to be that, if a dishonest employee causes losses through fictitious loans, is the interest paid or interest which was realized included in the loss computation?

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[181] Everhart v. Drake Management, Inc., 627 F.2d 686, 691 (5th Cir. 1980); Fidelity & Dep. Co. of Md. v. USAFORM Hail Pool, Inc., 463 F.2d 4, 6 (5th Cir. 1972); Transamerica Ins. Co. v. Federal Deposit Ins. Corp., 489 N.W.2d 224, 229-30 (Minn. 1992).

[182] Fitchburg Sav. Bank v. Massachusetts Bonding Ins. Co., 174 N.E. 324, 328 (Mass. 1931).

[183] FDIC v. United Pacific Ins. Co., 20 F.3d 1070, 1080 (10th Cir. 1994); Citizens of Oregon v. American Ins. Co., 289 F. Supp. 211, 216 (D. Or. 1968); *Fitchburg Sav. Bank*, 174 N.E. at 328.

[184] Puget Sound Nat'l Bank v. St. Paul Fire & Marine Ins. Co., 645 P.2d 1122, 1129 (Wash. Ct. App. 1992).

[185] FIB, Exclusions, Section 2(e).

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A split of authority on how to examine that question apparently exists; however, the better answer appears to be that such interest should not be included in the loss claimed. To allow the insured to claim the interest as a loss would be to allow the bank to earn income on the employee's fraud. The income exclusion makes it perfectly clear that the Bond is not an insurance policy intended to place the bank in the position it would have occupied if it had legitimately made loans to borrowers and had legitimately been repaid principal and interest on the loans. In the case of legitimate loans, the bank would reap not only the repayment of the loan principal but also would have made a profit on the transaction. The authorities cited above seem to indicate that what the Bond is intended to cover is the actual out-of-pocket funds which the bank lost as a result of dishonest conduct.[186] In the case of fraudulent loans, the out-of-pocket loss appears to be only the principal amount of the loan.

a. *The Improper Application of the Income Exclusion*

In *Bank of Huntingdon v. Smothers*,[187] the court incorrectly analyzed the income exclusion and permitted an insured bank to recover for interest payments made with its own funds. *Bank of Huntington* involved an officer of the bank who engaged in an embezzlement scheme through the use of loans over a period of sixteen years. His scheme involved the creation of a series of fictitious notes under the names of actual bank customers, which the officer would use to present to tellers to receive loan proceeds and to appropriate the funds for himself. When the notes were due, the officer would create additional fictitious notes to pay off prior notes, to pay interest due, and to obtain additional funds. The bank eventually discovered its employee's scheme and made a claim under its bond for the total outstanding face amount of the almost two hundred loans outstanding at that time, plus all earned interest accrued on those notes through the date of discovery.

The bank and its insurer agreed that the bank suffered a serious loss due to dishonesty but disagreed about the proper calculation of the loss. The insurer rejected the portion of the claim made for interest on the outstanding notes, arguing that coverage existed only for the portion of the funds which actually went into the pocket of the dishonest employee. The insurer argued that the employee's scheme actually created a pyramid effect where some later loans were actually used to repay earlier loans and interest on those loans. The insurer reasoned that such payments were simply money trans-

[186] *See, e.g.*, Everhart v. Drake Management, Inc., 627 F.2d 686, 691 (5th Cir. 1980); Fidelity & Deposit Co. of Md. v. USAFORM Hail Pool, Inc., 463 F.2d 4, 6 (5th Cir. 1972); Transamerica Ins. Co. v. Federal Deposit Ins. Corp., 489 N.W.2d 224, 229-30 (Minn. 1992).

[187] 626 S.W.2d 267 (Tenn. Ct. App. 1981).

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fers on the books of the bank but involved no actual loss to the bank and that portions of those payments represented potential income to the bank.

First, the court rejected the insurer's argument about the use of funds to repay prior notes, finding that the actual loss suffered by the bank was the principal balance due on the unpaid notes plus the accrued interest on those notes.[188] The court analyzed the situation as follows:

> If a new note is created to pay off an old note, such old note is paid off out of the general funds of the bank. When those funds reenter the bank as payment of an old note, even though such payment may represent an interest payment on the old note, it reenters the bank's general fund and loses any interest character it may have had at the time of payment. It matters not a whit whether this is accomplished by an account transfer by the bank or by actually handing out "greenbacks" by one hand and receiving them back with the other. The result is the same. The payment of the old note is realized.
>
> We bring this all out to show the bank's loss *and* to show that [the employee's] purpose in obtaining funds is completely immaterial as to that loss.[189]

With respect to the income exclusion, the court held that funds embezzled for the purpose of paying interest previously charged on the loans were not excluded by the policy.[190] The court limited the application of the potential income exclusion to the interest "which the bank hopes to receive from the *unrepaid* money loaned, taken, embezzled or stolen from its general fund."[191] The court, therefore, agreed that the potential income exclusion would exclude coverage for accrued but unpaid interest on the loans which were outstanding. In discussing the language of the exclusion, the court held that the insurer "meant to exclude unreceived income so that the bank would recover only that which it lost, not the income it hoped to receive from the lost amount."[192]

Despite the court's recognition of some limitations from the income exclusion, the effect of the court's holding in the case was still that the bank made money (or earned income) from the dishonesty of its employee. In other words, the bank for a sixteen-year period collected interest on loans which were not actually made and was allowed to keep that interest income and to claim it as a loss in its bond claim.

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[188] *Id*. at 270.

[189] *Id*.

[190] *Id*.

[191] *Id*.

[192] *Id*. at 271.

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In *Kinzer v. Fidelity & Deposit Co. of Maryland*,[193] an Illinois court considered the issue of a loss calculation in another context and made it clear that allowing an insured to profit from employee dishonesty, by allowing it to claim a loss, on top of a benefit it already gained, is not permitted.[194] Accordingly, that court held that the proper calculation of loss involved the total out-of-pocket loss to the insured, reduced by (not increased by) the amount of benefit it received from the scheme:

> Indeed, in the absence of such a calculus, the insured would be motivated to bury its head in the sand while illegal conduct on the part of its employees, which might prove profitable, is allowed to continue, thereby creating the possibility of not only reaping the benefits of that illegal conduct, but also recovering doubly against its surety. Equity should not, indeed, cannot countenance recovery where, as here, the "loss" is actually not as represented by [the insured].[195]

Despite this rationale that an insured should not be permitted to profit from its employee's dishonesty, other courts have followed the lead of the *Huntington* opinion. In *St. Paul Fire & Marine Insurance Co. v. Branch Bank & Trust*,[196] the Fourth Circuit Court of Appeals reached an identical conclusion about the income exclusion under an identical set of fraudulent loan facts. The officer in the case engaged in a twelve-year loan embezzlement scheme but was eventually caught with more than $780,000 in outstanding loans. Once again, the insurer refused coverage for amounts attributable to interest on earlier loans repaid by subsequent fraudulent notes. The Fourth Circuit relied upon the *Bank of Huntingdon* decision in determining that the interest previously paid on the retired loans was a covered loss.[197] The court rejected the insurer's argument that the bank was unfairly permitted to recover profits on fraudulent loans and required the insurer to pay the entire balance of the notes outstanding, excluding only the interest accrued but not yet paid.[198]

Finally, in *First National Bank of Dillonvale v. Progressive Casualty Insurance Co.*,[199] the Ohio court also followed the Huntington reasoning, concluding as follows:

> When fictitious loans are created and used to pay old interest on pre-existing loans, the face value of the fictitious loans, plus interest accrued on

[193] 652 N.E.2d 20 (Ill. Ct. App. 1995).

[194] *Id*. at 27.

[195] *Id*.

[196] 834 F.2d 416 (4th Cir. 1987).

[197] *Id*. at 418.

[198] *Id*.

[199] 640 N.E.2d 1147 (Ohio Ct. App. 1993).

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> them, is the amount of loss to the bank. The fact that interest payments on pre-existing loans were made with the funds does not render those interest payments potential income.[200]

b. The Proper Application of the Income Exclusion

Not every court, however, has missed the mark on the issue of the income exclusion. An Iowa court reached an opposite—but correct—conclusion in a case styled *American Trust & Savings Bank v. United States Fidelity & Deposit Co.*,[201] holding that the term "loss" does not include the portion of the outstanding notes which represent payments made to cover up prior embezzlements. Once again, the court analyzed the proper loss calculation in the context of a fraudulent loan scheme. The loan officer concealed his loan scheme for sixteen years by paying off prior loans and interest with new fraudulent loans. He was caught with more than $4.3 million in outstanding loans. The insurer paid approximately $2.2 million in losses, which represented the principal amount of the loans which had gone into the pocket of the officer, but rejected the remaining $2.1 million which was used to make interest payments to the bank on prior loans. The insurer's argument was that the loss was not determined from the face amount of the fictitious notes created by the officer but rather by the actual depletion of the bank's funds.

The court's analysis focused on the meaning of the term "loss," rather than on the specific income exclusion. Nevertheless, the reasoning is instructive and focuses on the proper intent of the Bond. The court held that "loss" refers to the actual depletion of bank funds caused from employee dishonesty but not to the eventual personal liability of the employee to the bank.[202] The court reached that conclusion because it reasoned that, if the interest were allowed as a covered loss, the bank would earn income from, and therefore benefit from, the dishonesty of its own employee. The court also opined that "loss" occurs and is fixed at the time of the original wrongdoing and therefore does not include the portion of outstanding notes which represents interest payments made to conceal prior embezzlement.[203] The court specifically rejected the result reached by the courts in the *Bank of Huntingdon* and the *Branch Bank & Trust* cases, finding that they did not present a proper resolution of the key issue.[204]

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[200] *Id*. at 1149-50.

[201] 418 N.W.2d 853 (Iowa 1988).

[202] *Id*. at 855.

[203] *Id*. at 856.

[204] *Id*.

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In *First American State Bank v. Continental Insurance Co.*,[205] the court also analyzed a fraudulent loan scheme and the income exclusion. The interest portion of the loss discussed in the court's decision was limited to future interest on still-outstanding loans. The court made it clear that future interest payments which would not be received, due to the fraudulent nature of the loans, were not covered under the bond, based upon the income exclusion.[206] The court reached its conclusion on two related grounds: first, such future and unpaid interest payments did not constitute an actual depletion of the insured's funds and, therefore, did not constitute a direct loss from employee dishonesty; and second, the interest in question fell squarely within the income exclusion.[207]

These cases indicate that both the insured and the insurer must carefully analyze the loss which the institution has sustained in connection with loans in order to determine what portion of the loss is based upon interest, either realized or unrealized. Both parties should refer to the income exclusion in order to determine how such interest should be treated.

3. Must the Loans be "Uncreditworthy" When Made?

The fact that a loan loss must result "directly" from dishonest or fraudulent conduct indicates that a loan must therefore not be creditworthy when made in order to qualify under the Bond. In two separate opinions, the Fifth Circuit has discussed the issue of loan losses and has concluded that a loan loss caused by dishonest or fraudulent conduct may be a covered loss when the bank can demonstrate that it would not have made the loan but for the fraud by the dishonest employee.[208] In one of the *Lustig* opinions, the Fifth Circuit Court of Appeals also indicated that it would not refuse to find coverage for loan losses merely because other factors, such as a declining real estate market, were present.[209] The court noted that a narrow reading of the causation requirement would all but eliminate coverage for loans made because of dishonest acts and that there would always be some intervening cause for the failure to repay the loans.[210] The court's conclusion was that a

[205] 897 F.2d 319 (8th Cir. 1990).

[206] *Id*. at 329.

[207] *Id*.

[208] FDIC v. Fidelity & Deposit Co. of Md., 45 F.3d 969, 976 (5th Cir. 1995); First Nat'l Bank of Louisville v. Lustig, 961 F.2d 1162, 1167 (5th Cir. 1992).

[209] *Lustig*, 961 F.2d at 1167.

[210] *Id*.

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bank would not have to rule out all reasons that the loan was not repaid before it could establish coverage for the losses.[211]

Additional factors contributing to the alleged loss on the back end of a loan transaction do not appear to be a basis upon which a court will decline to find coverage. However, a loan which appears strong on the front end and which fulfilled all of the loan guidelines for the particular institution should command additional review in the context of an employee dishonesty claim. If there were no real irregularities with the loan at the time it was made and if the loan was reviewed and approved by independent loan officers, how did employee dishonesty contribute to the loss? A creditworthy loan appears to directly contradict the "but for" theory applied in the case of employee dishonesty that, but for the fraudulent acts of the loan officer, the loan would never have been made. Accordingly, it appears unlikely that a creditworthy loan could fulfill the requirements for coverage under Insuring Agreement (A).

B. Recurring Computation of Loss Issues

Once a loss has been established and the quantum of the loss has been fixed, the issue of how to compute the loss and the amount which will be required to be paid under the Bond is still a complex issue. For example, an insured may make some recoveries in connection with the loans in question, including recoveries of payments on the outstanding principal, interest payments, or recoveries related to collateral. The difficult question which arises is how those recoveries should be treated for purposes of computing the compensable loss.

1. The Bond's Computation of Loss Provisions

Section 7 of the Bond contains various provisions which apply in the event that an insured or an insurer makes recoveries associated with loan losses. Section 7 provides, in relevant part, as follows:

> (a) In the event of payment under this bond, the Insured shall deliver, if so requested by the Underwriter, an assignment of such of the Insured's rights, title and interest and causes of action as it has against any person or entity to the extent of the loss payment.
>
> (b) In the event of payment under this bond, the Underwriter shall be subrogated to all of the Insured's rights of recovery therefor against any person or entity to the extent of such payment.

[211] The Bond considered by the Fifth Circuit contained the standard language requiring losses to result "directly" from dishonest or fraudulent conduct. If an insured instead has a Bond which includes some non-standard language which requires losses to result "solely" from dishonest or fraudulent conduct, for example, the analysis would clearly be different.

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> (c) Recoveries, whether effected by the Underwriter or by the Insured, shall be applied net of the expense of such recovery first to the satisfaction of the Insured's loss which would otherwise have been paid but for the fact that it is in excess of either the Single or Aggregate Limit of Liability, secondly, to the Underwriter as reimbursement of amounts paid in settlement of the Insured's claim, and thirdly, to the Insured in satisfaction of any Deductible Amount.
>
> ....
>
> (e) The Insured shall execute all papers and render assistance to secure to the Underwriter the rights and causes of action provided for herein. The Insured shall do nothing after discovery of loss to prejudice such rights or causes of action.[212]

In the case of loan losses and in the context of determining the proper method of computing loan losses, the provisions in Section 7 are very important, especially if the amount of loss claimed exceeds the limit of liability of the Bond. If an insured manages to secure any recoveries on the loans which are the subject of the loss, those recoveries could possibly reduce the amount of covered loss which exists. The purpose of Section 7 is to set out the respective rights of the insured and the insurer in the event of such recoveries and to specifically explain the order in which such recoveries should be credited.

In this context, Section 7(c) appears to be one of the most important provisions since it specifies who receives credit for a recovery and in what order. The section generally provides that recoveries apply in the following order: (1) to reimburse the party who incurred expenses to obtain the recovery; (2) to compensate the insured for any loss which would have been paid but for the fact that it exceeded the limit of the bond; (3) to reimburse the insurer for amounts paid in settlement of the claim; and (4) to reimburse the insured for any deductible paid. While these concepts seem straight forward in the context of Section 7, they have not been as easy for the courts to apply in the context of loan losses.

2. Proper Methods for Computing Loan Losses

The proper interpretation of the various parts of Section 7 has been the subject of some controversy in recent years. Despite what appears to be the plain language of Section 7(c), there is no clear consensus on the issue of how recoveries must be treated. Currently, there is a split of authority on the issue of how recoveries are properly applied, in light of the language of Section 7 in general and the language of Section 7(c) in particular. This split has

[212] FIB, Section 7.

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developed based upon the courts' various interpretations of the language of Section 7, as well as the courts' comparison of the various sub-parts of Section 7.

The insured and the insurer should be aware of these various authorities since loans which are made to third parties (as opposed to fraudulent loans made to the officer himself) are often the subject of these disputes. On such loans, a bank quite often can expect to receive some payments of principal or interest or some recoveries based upon collateral or other security. Based upon the current status of the case law, how those recoveries are treated may depend, at least in part, upon the jurisdiction in which the insured is located.

a. *The* Lustig *View*

The District Court for the Eastern District of Louisiana in *First Nat'l Bank of Louisville v. Lustig*[213] considered the question of whether payments received by an insured on loans claimed as losses should be allocated to unpaid interest on the underlying loan (which was not covered by the Bond) or to the unpaid principal claimed as a loss by the bank (which would reduce the liability of the insurer under the Bond in question). After considering the facts of the case and Section 7 of the Bond, the court incorrectly concluded that the insured's recoveries of principal and interest did not have to be applied to the loan principal to offset the insurers' liability under the Bond.[214] Instead, the court allowed the recoveries to be credited against accrued and unpaid interest not covered under the Bond. The court based its decision upon its reading of Section 7(c) and its conclusion that Section 7(c) does not apply to recoveries made by an insured before an insurer has paid the loss.[215]

In the alternative, the Louisiana court concluded that Section 7(c)'s provision for applying recoveries to the insured's "loss" in excess of the amount paid under the Bond did not require that the excess loss to which recoveries would apply be a covered loss under the Bond.[216] The court concluded that the potential income exclusion was not determinative of the way in which recoveries would be applied. The court limited the application of the potential income exclusion so that it governed only the amounts covered under the Bond but not the method by which an insured could apply additional recoveries. Therefore, the court held that funds actually collected by the insured could be applied first to offset an uncovered loss.[217]

[213] 847 F. Supp. 1322 (E.D. La. 1994).

[214] *Id*. at 1323-24.

[215] *Id*. at 1323.

[216] *Id*. at 1324.

[217] *Id*.

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On appeal in *First National Bank of Louisville v. Lustig*,[218] the Fifth Circuit affirmed the district court's decision that the insured could allocate the sales proceeds from loan collateral against unpaid interest on loans, rather than against the amount of loss claimed from its fidelity insurers, despite the fact that the Bond excludes coverage for potential income, such as unrealized interest income.[219] The Bond in question specifically provided that the allocation of recoveries was required first against the insured's loss in excess of the amount paid under the Bond. However, the court held that, because recoveries were made before the insurer's payment of the loss, the section was inapplicable and the insured was entitled to retain the proceeds of the sales and to allocate those recoveries to the interest due on the outstanding loss.[220] In addition, the court concluded that the section did not impose a responsibility upon the insured to refrain from prejudicing the insured before payment was made on the Bond.[221]

The conclusions reached by the court do not appear to be correct since Section 7(c), unlike Sections 7(a) and 7(b), does not contain the qualification that the section applies only after payment by the insurer has been made. Section 7(c) potentially applies even before payment has been made and can certainly constitute part of the dispute which might exist between an insured and an insurer about a compensable loss.

In addition, all of the language of the Bond makes it clear that the "loss" to which Section 7(c) refers should be construed to be the covered loss for which the insurer would indemnify the insured. Interpreting the term "loss" any other way frustrates the purpose of the Bond and the way in which the insuring agreements and exclusions work together in other contexts. At least some part of the court's reasoning in the *Lustig* case can be blamed on the fact that the court was interpreting the 1980 Financial Institution Bond, which contained slightly different language in Section 7(c). That language in the 1980 form bond provided that recoveries would be applied "first to the satisfaction of the Insured's loss in excess of the amount paid under this bond ... ."[222] The absence of the reference to the amount of loss "which would otherwise have been paid but for the fact that it is in excess of either the Single or Aggregate Limit of Liability" which appears in the 1986 Bond could arguably account for the conclusion that the court reached and could serve as the distinction upon which an insurer could now rely to argue that the result in *Lustig* should not be the one reached under a 1986 Bond.

[218] 96 F.3d 1554 (5th Cir. 1996).

[219] *Id*. at 1569.

[220] *Id*.

[221] *Id*.

[222] Financial Institution Bond (Standard Form No. 24, Revised July 1980), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA, Section 7(c).

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b. *The* FDIC v. Fidelity & Deposit Co. of Maryland *View*

In *FDIC v. Fidelity & Deposit Co. of Maryland*,[223] the District Court for the Middle District of Louisiana considered Section 7 and various computation of loss questions in the context of interest payments received by an insured after its discovery of a loan loss. The court reached the correct conclusion that the covered loss of the FDIC, as receiver of a failed bank, had to be reduced by loan payments received after the discovery of the loss.[224]

In the context of the coverage questions in the case, the FDIC and the insurer disagreed on the proper allocation of loan recoveries. The FDIC argued that the recoveries should be first applied to accrued and unpaid interest and then to principal. The insurer argued that the recoveries should be applied only to principal in order to reduce the out-of-pocket loss sustained by the insured bank.

The court analyzed the language of Section 7(c) in order to resolve the dispute between the parties and concluded that the recoveries had to be applied first to the insured's loss (which the court construed to mean the covered loss under the Bond) which was in excess of the amount paid under the Bond.[225] The court noted that the term "loss" was not defined in Section 7(c) and could therefore mean either a covered loss or the total loss to the insured. However, since the court found it clear that the parties intended the insured to be indemnified only for losses which fell within the scope of the insuring agreement, the court concluded that the "loss" referred to in Section 7 was only the covered loss.[226] In that context, the court noted that unpaid interest on loans is excluded from coverage by the Bond's income exclusion. Accordingly, the court concluded that recoveries could be applied only to principal and not to accrued interest.[227]

Another part of the court's analysis focused on how to allocate the value of collateral held by the FDIC. The insurer argued that the value of the collateral received and held by the insured bank as security for a loan must be applied to reduce the loss. The FDIC argued that the insurer did not have

[223] 827 F. Supp. 385 (M.D. La. 1993), *aff'd on other grounds*, 45 F.3d 969 (5th Cir. 1995).

[224] *Id*. at 390.

[225] *Id*.

[226] *Id*.

[227] Once again, the District Court for the Middle District of Louisiana was interpreting the language of the 1980 form Bond. Unlike the District Court for the Eastern District of Louisiana in the *Lustig* opinion, the District Court for the Middle District of Louisiana correctly interpreted the term "loss" in the context of the Bond. Once again, the changes made to the 1986 form Bond help to make this issue much more clear and should eliminate the debate over the meaning of the term "loss."

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any right to the collateral until the actual claim was paid. The court again turned to Section 7 of the Bond for guidance and held that no advance credit could be given to the insurer for the collateral.[228] Rather, the court concluded that the insurer would succeed to the rights to the collateral only after making the bond payment. The court relied on the first two portions of Section 7, which refer specifically to the assignment of rights after a payment by the insurer, in reaching its conclusion, rather than Section 7(c), which does not contain that limiting phrase.

While Section 7(c) refers to the amounts of the recoveries which should be offset against amounts paid in settlement by the insurer, that language should not be interpreted to mean that no offsets apply unless the payments have already been paid. In the context of an ongoing coverage dispute, all of those types of issues should be resolved simultaneously. To conclude a case, have the insurer make certain indemnity payments to the insured, and then still have outstanding recovery questions which have to be resolved appears to be a waste of time and judicial resources for all of the parties involved.

c. *The* FDIC v. United Pacific Insurance Co. *View*

In *FDIC v. United Pacific Insurance Co*.,[229] the Tenth Circuit also faced the question of the proper method of the computation of loss, based upon the receipt of various recoveries by the FDIC, as receiver for a failed institution. The FDIC sought to recover approximately $4.6 million in loan losses, reduced only by certain funds actually recovered prior to the date of the lawsuit by the FDIC in the amount of $1.25 million. The Bond at issue had an aggregate limit of $1.45 million.

When the loan officer originally made the $4.6 million loan in question, the bank received approximately $5.8 million in collateral, as well as a $92,000 origination fee from the borrower. When the FDIC took over the institution, it made a net recovery of approximately $1.25 million from certain collateral. The FDIC remained embroiled in litigation to recover the remaining collateral. At the same time, the FDIC also sued certain attorneys who had represented the bank and recovered approximately $1.9 million in that case, based upon a finding of a breach of various duties by the attorneys to the bank.

Despite the presence of certain additional collateral for the bank and the bank's recovery from the malpractice suit against its attorneys, the FDIC

[228] *Id*. at 389.

[229] 20 F.3d 1070, 1080-81 (10th Cir. 1994).

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argued that it was entitled to a claim on the Bond in the amount of the approximately $3.4 million loss net of prior recoveries of collateral only. On the other hand, the insurer argued that the bank did not sustain any actual loss at all, based upon the sum of all of the recoveries or potential recoveries made by the FDIC, including both collateral and legal claims. The insurer argued that the loss was, if anything, a bookkeeping loss which was not compensable under the Bond.

The court agreed that the language in the particular fidelity bond at issue which provided coverage for "losses directly resulting from . . ." certain covered activities indicated that a direct loss or the actual depletion of funds from an employee's dishonest acts was required in order to have a compensable loss in the first instance.[230] The court also held that, in the case of a loan loss, the bank suffers its loss at the time when the funds are disbursed as a result of an employee's wrongful conduct and that the correct measure of the actual loss from a loan is the outstanding balance due on the loan.[231]

Based upon those initial holdings, the court concluded that the bank did sustain an actual, as opposed to a bookkeeping, loss because it did disburse the $4.6 million loan to the borrower and because that amount would never be collected from that borrower. That figure was only the starting point for the determination of the amount of covered loss, however. The court held that the loss was incurred regardless of the value of the collateral which secured the loan.[232] The court also concluded that the value of the collateral which might finally be determined in favor of the insured would become a "recovery" which would be governed by Section 7 of the Bond rather than a factor which would determine the amount of the original loss. Thus, the court concluded that collateral which had already been determined as property of the insured had to be offset against the loan loss under Section 7 as a recovery.[233]

The court also determined that the collateral which remained the subject of separate litigation by the FDIC did not constitute any recovery and would not be treated as an offset until a final determination was made. Only at that point would the potential collateral be calculated as a "recovery" and treated under Section 7.[234] The court rejected the insurer's argument that the loss should be reduced, before the litigation over the collateral was concluded, by an estimated value of the collateral. The court correctly noted that, in the

[230] *Id*. at 1080.

[231] *Id*.

[232] *Id*.

[233] *Id*. at 1081.

[234] *Id*.

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event that the FDIC did make recoveries on the collateral, those recoveries would also be treated as offsets under Section 7. The court's holding on this point appears to focus not on the uncertainty of the value of the collateral but rather on the uncertainty of the FDIC's rights to the collateral which seems to be reasonable under Section 7.

The court only briefly discussed the issue of the origination fee paid to the insured in the context of the loan and incorrectly opined that it had been received by the bank in exchange for value received and therefore did not constitute a recovery.[235] The better view, in the context of a dishonesty claim on a loan, appears to be that such a profit to the bank should be used as an offset since it was a benefit which reduced the out-of-pocket loss. Because the bank must have been claiming that the loan would not have been made but for the employee dishonesty, the income would not have been realized by the bank but for the dishonesty.

Finally, the court determined that the amounts recovered by the insured in the legal malpractice suit would be treated as a recovery and used to offset the amount of loss claimed, also under Section 7.[236] That conclusion correctly treated the amounts received as a recovery which also reduced the out-of-pocket losses which the bank sustained.

In a later appeal of further proceedings in the case, the Tenth Circuit once again confirmed that the insurer was entitled to credits against the loss of the bank for any eventual recoveries related to collateral and to the legal malpractice claims.[237] The court found that to hold otherwise would permit the insured a double recovery: once for the collateral and legal malpractice judgment and a second time against the insurer.[238]

While not all of the Tenth Circuit's reasoning may be sound, the ultimate conclusions it reached regarding the order in which collateral recoveries and malpractice recoveries should be applied was correct. The case can be used as a general model for the fact that recoveries, from whatever source, should be credited against losses and that the losses which are referred to in Section 7(c) are covered losses.

[235] *Id*. at 1081 n.9.

[236] *Id*. at 1083.

[237] FDIC v. United Pacific Ins. Co., 152 F.3d 1266, 1274-75 (10th Cir. 1998).

[238] *Id*. at 1275.

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d. *An Alternative Approach*

The three cases discussed above illustrate the types of mistakes that courts can make in interpreting Section 7 when the sections are read separately or when the requirements of one section are engrafted upon a separate section which does not contain the limitation. Moreover, they illustrate the way in which the purpose of Section 7 can be overlooked when the parties do not carefully observe Section 7(e)'s requirement that an insured do nothing to prejudice the rights of the insurer after the discovery of loss. Since the authorities in the loan context fix the date of loss at the date of the extension of credit, freezing the rights of the parties as of the date of the discovery of loss makes sense. As soon as the insured discovers the loss, it cannot undertake any actions which will put the insurer in a more unfavorable position than it and the insured already occupy.

Section 7(e) should make it clear that the insured cannot use recoveries for its own benefit and in contravention of Section 7(c), regardless of whether the claim has been settled and paid or not. Instead, the rights of the parties should be fixed and determined at one time. The recovery of funds which are allowed to be applied to accrued but unpaid interest is one of the best examples of frustrating the purpose of the Bond and the agreement of the parties. By allowing recoveries in that fashion, the courts are permitting the bank to benefit from the dishonesty of its own employees by, in essence, earning income from the dishonesty or fraud. In actuality, the only equitable way to deal with such recoveries is to credit those funds against the out-of-pocket loss. The income exclusion discussed above illustrates this same concept.

The new language of Section 7(c) contained in the 1986 Bond should help to alleviate the problem which the Louisiana courts created in their earlier decisions, which did not require the credit of recoveries against covered losses and instead permitted the insured to use the recoveries as a way to offset uncovered losses of accrued interest.

"Computation of Loss" or "Valuation" clauses may be the best way to minimize the confusion over the application of Section 7 recovery principles and related concepts. In *FDIC v. Certain Underwriters of Lloyds*,[239] an unpublished opinion, the United States District Court for the Western District of Texas illustrated how a certain version of the rider should apply. The court concluded that a recovery by an insured is valued as of the date of the

[239] No. A 93 CA 489, slip op. (W.D. Tex. Feb. 6, 1995).

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recovery, not at some future date when the collateral may eventually be liquidated.[240]

The court also concluded that the measure of the loss is calculated by first adding the amounts advanced on loans established to be dishonest and then deducting all recoveries of money and property received by the insured. Based upon the plain language of the rider, the recoveries would be valued on the date the insured received the property, not upon the date of disposition.

3. Addressing Computation Questions

The above authorities make it clear that addressing computation of loss questions may not be an easy task. The contradictory authority which exists should be carefully analyzed, especially in light of the revisions of the Bond language in Section 7(c). Moreover, all computation of loss questions and recovery issues should be analyzed in the context of Section 7(e)'s overriding governing concept: after discovery of loss, the insured cannot prejudice any rights of the insurer.

V. TERMINATION ISSUES BASED UPON THE DISCOVERY OF DISHONESTY

A. *Prior Dishonesty of the Alleged Employee*

In the complex loan loss case, it is very likely that the conduct in question continued for a long period of time and that others in the bank may have been aware of the conduct or some parts of it. Some officers may have discussed the problems with one another. Others may have been enlisted to help the accused employee in the scheme. What effect does the knowledge of others and the participation of others have? The knowledge and participation of others directly triggers Section 12 and directly affects when coverage exists and terminates for each actor.

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[240] The rider at issue provided as follows:

> In determining the amount collectable under this Policy for any loss, all money received by the Insured from any source whatsoever in connection with any matter from which a claimed loss has arisen, including payments and receipts of principal, interest, dividends, commissions and the like whenever received, shall be deducted from the amount actually paid out, advanced, withdrawn, taken or otherwise lost. The value of all property received by the Insured from any source whatsoever and whenever received in connection with any matter from which a claimed loss has arisen shall likewise be deducted from the Insured's claimed loss.

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1. The General Termination Provision

A recurring issue in loan loss cases is the issue of whether coverage for a particular accused employee terminated at some prior point in time, based upon the discovery of dishonest conduct by the insured. The Bond specifically provides that coverage will terminate for such an employee, upon that discovery.

Section 12 of the Bond provides as follows:

> This bond terminates as to any Employee … (a) as soon as any Insured, or any director or officer not in collusion with such person, learns of any dishonest or fraudulent act committed by such person at any time, whether in the employment of the Insured or otherwise, whether or not of the type covered under Insuring Agreement (A), against the Insured or any other person or entity .... [241]

This provision of the Bond establishes how termination of coverage for a particular individual can occur, based upon the prior discovery of dishonesty by the Insured itself or by any officer or director of the Insured who is not acting in collusion with the wrongdoer. The dishonest act need not fulfill all of the requirements of Insuring Agreement (A) in order to qualify as a terminating event and discovery, nor does the conduct have to be committed in the course of the individual's employment. The broad language of the provision appears to trigger termination based upon the discovery of any type of dishonest act, even if no loss occurs from the dishonesty.

A Georgia case has delved into the rationale for the inclusion of the termination provision in the Bond by exploring the balancing of risks undertaken by the parties to the Bond:

> These exclusion and termination provisions limit coverage because leaving a demonstrably dishonest person in a position to cause losses through dishonesty increases the risk beyond the point that the insurer believes it can make a profit on the premium charged. The outer limits of the type of dishonesty that will result in exclusion of coverage are not specifically defined …. Even if the Policy were not concerned with every deceitful, crooked, corrupt or mendacious act that an employee may have committed, it is plainly concerned with such acts that subject the insurer to substantially higher risk.[242]

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[241] FIB, Section 12.

[242] *In re* Prime Commercial Corp., 187 B.R. 785, 803 (Bankr. N.D. Ga. 1995).

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2. What Constitutes Discovery of Dishonesty?

In light of the Bond's language, what constitutes "learning" that dishonest or fraudulent conduct has occurred? What level of knowledge is required to qualify as "learning"? How much does an insured have to know?

A Connecticut court addressed the issue of discovery of dishonesty in connection with the actual loan in question in a loan loss case in *Community Savings Bank v. Federal Insurance Co*.[243] The former president and chief executive officer of the Community Savings Bank was accused of violating bank policy and making loans to borrowers in which the president had an undisclosed financial interest. The loan loss involved a series of nine loans, the first of which was made in 1988. The court concluded that the evidence showed that the bank, through members of the board of directors, actually discovered the dishonest acts of the president in connection with the loans in 1990 during a board meeting.[244] In particular, the board members learned that the president had a beneficial interest in a 1988 loan, but the bank did not take action since the loan was performing at that time. The bond in question did not take effect until 1992, and a claim was not made on the alleged losses until 1992. However, because discovery of dishonesty of the president occurred in 1990, the court concluded that coverage terminated for the president at that time and losses sustained in 1992 as a result of the president's dishonest conduct were therefore not covered.[245]

The *Community Savings Bank* case illustrates the clearest type of discovery: an actual, prior discovery of the facts which are later alleged to constitute the dishonesty which resulted in a loss to the bank. Clearly, for purposes of the termination provision, discovery of dishonesty occurred. The bank later claimed that the precise conduct which it had previously discovered was dishonest conduct which resulted in a loss. Accordingly, there was no dispute that the actions were fraudulent or dishonest. In addition, there was no quarrel over whether the types of acts which were known were sufficient to qualify as triggering events. The harder questions in the context of discovery involve what amount of information, short of prior and complete discovery of the dishonest acts in question, still fulfills the requirements of Section 12.

a. *The Standards Which Apply*

The courts have debated what type of knowledge is required and what constitutes knowledge of dishonesty in the context of Section 12. For ex-

[243] 960 F. Supp. 16 (D. Conn. 1997).

[244] *Id*. at 20.

[245] *Id*.

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ample, in *Kinzer v. Fidelity & Deposit Co. of Maryland*,[246] the court focused on the issue of termination of coverage for a particular employee. The court concluded that the automatic termination provision is "governed by an objective view of what the [insured] should have concluded from facts of which it was actually aware."[247] The court also focused on the issue of whose knowledge should be imputed to the insured for purposes of discovery and concluded as follows:

> "Generally speaking, a principal is chargeable with the notice of facts which are within the knowledge of his agent, acquired within the scope of the agent's authority. A well recognized exception to this rule is that, where an agent acquires information which it would be to his advantage to conceal from his principal, it is assumed that he did not impart such knowledge to his principal, and accordingly knowledge would not be imputed to the principal, and the general rule applies, and not the exception thereto."
>
> The exception, however, is qualified by the rule that, if the agent is the sole representative of the principal, or the only person or means by which the principal acts, then the knowledge of the agent will be imputed to the principal.[248]

The court further limited its remarks, however, by holding that only the knowledge of key employees may be imputed to the insured.[249]

A Louisiana court in one of the *Lustig* opinions rejected the pure objective or "should have known" approach, as well as the purely subjective standard of actual knowledge, in favor of the "reason to know" standard which combines both subjective and objective elements of an awareness of underlying facts from which the insured as a reasonable person should make certain inferences about the fact in question.[250] Thus, the court concluded that the termination clause of Section 12 applies when an insured has actual knowledge of facts which would cause a reasonable person in the insured's position to infer than an employee has committed dishonest or fraudulent acts.[251] The court found that mere suspicion of dishonesty without factual support from which a reasonable person would assume the existence of dishonest acts is insufficient to terminate coverage and that no duty to investigate a suspicion in order to develop facts on which an assumption can be predicated exists.[252]

Accordingly, a "reason to know" type of standard appears to apply to the requirement that an insured "learn" of a dishonest act in order to trigger coverage. A court will most likely analyze the specific facts which were

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[246] 652 N.E.2d 20 (Ill. Ct. App. 1995).

[247] *Id*. at 29.

[248] *Id*. (quoting Puget Sound Nat'l Bank v. St. Paul Fire & Marine Ins. Co., 645 P. 2d 1122 (1982)

[249] *Id*.

[250] First Nat'l Bank of Louisville v. Lustig, 150 F.R.D. 548, 550 (E.D. La. 1993).

[251] *Id*. at 550-51.

[252] *Id*. at 551.

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known to the insured, as well as what the insured should have concluded from the facts. Based upon this type of standard, it does not appear that an insured will have had to actually *know* about dishonesty at the time that the acts, if the insured *should have concluded* that the acts were dishonest, based upon all of the circumstances.

The types of prior acts which will qualify as dishonest or fraudulent are addressed in Section 12 itself. Section 12 provides that such acts can have occurred at any time, did not have to occur against the insured, and need not be covered by Insuring Agreement (A). However, those issues have been discussed by certain courts. In one of the reported parts of the *Lustig* case, the Fifth Circuit Court of Appeals clearly held that all of the elements of an Insuring Agreement (A) claim did not have to be present in order for termination to occur under Section 12 of the Bond.[253] The Fifth Circuit held that the trial court incorrectly instructed the jury that "any deceitful act committed by [the employee] with the manifest intent to cause the bank to sustain a loss and to obtain financial benefit for himself" would trigger Section 12.[254] The court found that the termination clause language was inconsistent with the restrictive definitions contained in Insuring Agreement (A), because Section 12 speaks of "any dishonest or fraudulent act … against the Insured or any other person or entity."[255]

b. *How Much Information Is Required to "Learn" about Dishonesty?*

Applying these general standards, several other cases have discussed the fact that an insured bank will "learn" of dishonesty when it has knowledge or information from which dishonesty can be inferred.[256] A Tennessee court implied a very lenient standard on the insured institution in *FDIC v. St. Paul Fire & Marine Insurance Co*.[257] when it held that knowledge by junior officers of payments to the president did not constitute discovery because the officers had to have "knowledge which would justify a careful and prudent

[253] First Nat'l Bank of Louisville v. Lustig, 961 F.2d 1162, 1168-69 (5th Cir. 1992).

[254] *Id*.

[255] *Id*.

[256] City Bank in Wellington v. United States Fid. & Guar. Co., 778 F.2d 1103, 1107-08 (5th Cir. 1985); Central Progressive Bank v. Fireman's Fund Ins. Co., 658 F.2d 377, 380 (5th Cir. 1981); FDIC v. St. Paul Fire & Marine Ins. Co., 738 F. Supp. 1146, 1161-62 (M.D. Tenn. 1990), *aff'd in part and vacated in part on other grounds*, 942 F.2d 1032 (6th Cir. 1991).

[257] 738 F. Supp. 1146 (M.D. Tenn. 1990), *aff'd in part, vacated in part*, 942 F.2d 1032 (6th Cir. 1991).

[258] *Id*.

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man in charging another with fraud or dishonesty."[258] In other words, the court did not find that the officers would have concluded that such payments were dishonest, based upon the information they had. However, many other courts have not been so lenient.

In *City State Bank in Wellington v. United States Fidelity & Guaranty Co.*,[259] the Fifth Circuit concluded that a bank vice president did have knowledge of the president's dishonest and fraudulent acts relating to the improper use of bank funds and, therefore, that coverage for the president terminated prior to the time the bank sustained the loss about which it complained in the case.[260] The improper use of funds related to the financing of a van manufacturing business, in which both the president and vice president were involved. The court focused on the vice president's knowledge of not only certain kiting activities by the president with respect to that business, but also the fact that the vice president had knowledge of the use of those funds since he continued to receive financial reports regarding the van company. The court concluded that the knowledge of the vice president, who was also a partial owner of the bank, would be imputed to the bank.[261]

In *RTC v. Aetna Casualty & Surety Co.*,[262] the court concluded that a bank's knowledge of prior loans made by the bank president in contravention of bank policy constituted discovery of dishonesty for purposes of termination of coverage for the president under Section 12. The Bond in question was effective from October 1, 1986, through October 1, 1987. The insurer in the case argued that bank officials were aware of three different dishonest or fraudulent acts which had been committed by the allegedly dishonest bank president prior to the effective date of the policy and, therefore, that coverage never existed for the president under the bond.

For purposes of the case, the insurer focused on one dishonest incident: the president's approval of a loan to an official of a bank subsidiary in April 1986. The loan was illegal and violated bank policies because it was secured only by bank stock. The insurer argued that bank officials knew about the loan, knew it was illegal, and allowed the loan to be funded anyway. The RTC countered that the officials did not necessarily view the conduct as dishonest or fraudulent.

The court's analysis focused on what the bank officials knew and when they knew it. The bank officials' testimony indicated that they were aware

[259] 778 F.2d 1103 (5th Cir. 1985).

[260] *Id*. at 1109.

[261] *Id*. at 1110.

[262] 873 F. Supp. 1386, 1391 (D. Ariz. 1994).

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of the loan and that the loan was illegal when made and remained that way. Apparently, there were ongoing discussions about the loan and whether it would be funded for a period of at least six months. The bank president claimed that he believed that the loan would be secured by additional property, but acknowledged that he had been told that the loan could not be made. The president ordered the loan to be funded anyway. The bank officials testified that they did not feel that they could believe what the president said about the loan by the time it was funded in the fall of 1986 and that they doubted that the president was ever telling the truth about the loan. Based upon the evidence presented, the court concluded that the bank officials knew that the president had knowingly authorized an illegal loan and that the president had not told the truth to them about how the loan would be handled and, therefore, that the termination provision was triggered.[263]

The Mississippi Supreme Court also found that termination occurred when other bank officers and the board of directors learned about unauthorized loans and permitted such loans to continue. In *Fidelity & Deposit Co. v. Merchants' & Marine Bank of Pascagoula*,[264] three separate loan officers made unauthorized loans to themselves. The insured argued that termination of coverage for the three officers occurred at the time of the loans, based upon the knowledge of others in the bank about the loans. The court agreed, holding that termination occurred either at the time of the loans, because other loan officers knew about the loans, or shortly thereafter when the board of directors learned about the loans but allowed the loans to continue.[265]

In *Fidelity & Casualty Co. of New York v. Central Bank of Houston*,[266] a Texas court concluded that a bank had learned of prior dishonesty by a bank employee when it learned that the former bank president had approved or allowed loans to be made to a business partner of his without disclosing his interest in the loans.[267] In that case, the bank president was involved in a partnership for trading securities with a bank customer. The bank president was a member of the executive loan committee when his business partner applied for additional loans at the bank. The president did not disclose his relationship to the borrower or the financial interest which he would have in the resulting loan to the board. Subsequently, the board of directors learned that the president did have a relationship with the borrower but that he did not disclose it to them. Based upon those facts, the court concluded that the

[263] *Id*. at 1391.

[264] 151 So. 372 (Miss. 1933).

[265] *Id*. at 375.

[266] 672 S.W.2d 641 (Tex. App.--Houston [14th Dist.] 1984, writ ref.d n.r.e.).

[267] *Id*. at 645.

[268] *Id*.

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bank, through its board of directors, did learn of dishonest acts by the president at the time the board learned of the prior non-disclosure.[268] The court concluded that the act of the bank president in failing to disclose the material information was a breach of his duties to the bank and raised questions about his true interests in the transaction.[269] Consequently, coverage for the president terminated when the board learned about his secret relationship with the borrower.

In *First Security Savings v. Kansas Bankers Surety Co.*,[270] the Eighth Circuit analyzed whether a bank's knowledge of the regulators' criticisms of loans meant that the bank had "learned" of dishonest conduct prior to the inception of a Bond. The loan officer in question, who was also the ninety percent owner of the bank, engaged in a number of loan transactions in which loans were made to straw men for the benefit of a relative of the officer. State regulators noted various violations on other loans made by the officer, including insufficiently documented loans. The board of directors for the institution was notified of the problems. Later, the state regulators noted additional violations and sent reports of apparent criminal irregularity to the U.S. Attorney's office. The reports criticized the irregularities in loan procedures and specifically criticized the disguised relative loans. In all cases, the same loan officer was noted as being responsible for the problems. The board even met to discuss the various problems noted by the regulators. Based upon that information, the court concluded that the institution had discovered fraudulent and dishonest conduct by the officer, even prior to the inception of coverage for him.[271]

Knowledge of even technical departures from loan requirements appears to qualify as fraudulent or dishonest conduct sufficient to terminate coverage for a particular employee. In *C. Douglas Wilson & Co. v. Insurance Co. of North America*,[272] the court concluded that termination of coverage for a loan officer occurred in the months before a claimed loss because a credit review officer had learned during that time of various lending practices which did not meet the insured's requirements. In the months before the loss, the credit review officer discovered that the officer advanced construction monies to contractors before obtaining approval from HUD, as required, and falsely certified the dates and amounts of advances on HUD forms. Only later did the credit review officer discover the employee's failure to obtain letters of credit as security, which failures resulted in losses to the insured.

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[269] *Id*.

[270] 849 F.2d 345 (8th Cir. 1988).

[271] *Id*. at 350.

[272] 590 F.2d 1275 (4th Cir. 1979), *cert. denied*, 444 U.S. 831 (1979).

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During the case, the credit review officer testified that, with the benefit of hindsight, the actions in connection with the HUD loans were dishonest, but that he viewed them as merely poor judgment and bad business practices at the time. The insured argued that the actions were "technical only." However, the trial court concluded that they were dishonest acts and subject to criminal penalties. Accordingly, the court held that termination of coverage for the employee occurred at the time of the earlier discoveries and that no coverage existed for the subsequent losses.[273]

Outside of the lending context, the Eighth Circuit has concluded that knowledge of prior allegations of dishonesty against an employee can terminate coverage for the employee.[274] In that case, the court concluded that fraud committed by the employee was not covered because coverage for him had terminated two years earlier when the vice president of the insured was advised of four separate complaints and claims of fraud or misconduct against the employee by other clients.[275] The court held that the insured's knowledge of those prior events, which were at the very least deceitful, according to the insured, caused termination of coverage.[276]

c. *Contrary Authorities*

To the contrary, in *FDIC v. Lott*,[277] the Fifth Circuit concluded that the bank officers did not learn of dishonest conduct, even though they knew about certain questionable activities. In that case, the bank president made excessive loans as a part of a scheme to defraud the bank. Officers of the bank were alerted to the loans in various bank examination reports. However, the president assured the officers that he was remedying the problems with the loans. Subsequent reports appeared to confirm the president's statements. Unknown to the other officers, the president continued to conceal detrimental information which would have exposed the level of the problems with the loans. The court analyzed whether the officers' knowledge of irregularities with respect to certain loans meant that they had learned about dishonest or fraudulent conduct and that termination of coverage for the president would result. The court concluded that they had not because the information provided to them showed that the irregularities were being corrected.[278]

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[273] *Id*. at 1278.

[274] Newhard, Cook & Co. v. Ins. Co. of North America, 929 F.2d 1355, 1357 (8th Cir. 1991).

[275] *Id*.

[276] *Id*.

[277] 460 F.2d 82 (5th Cir. 1972).

[278] *Id*. at 87.

[279] 281 N.W.2d 816 (Iowa 1979).

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The Iowa court in FDIC v National Surety Corp.[279] reached a similar conclusion based upon the fact that bank officials believed that prior problems had been addressed. The bank president in that case, who was also a substantial shareholder of the bank, exercised quite a bit of discretion in his lending practices and routinely extended credit beyond the bank's limit. These practices were criticized by bank examiners on several occasions, and the president apparently curtailed his activities. Shortly before the bank closed, the examiners had commended the bank on its improvement in lending practices. Unknown to the examiners at that time, the president had in fact continued his activities but concealed them by falsely reporting participations to other banks and making other false entries in the bank records.

The insurer in the case argued that coverage for the president terminated prior to the loss since the president's improper conduct was known to the bank. The insurer also argued that it was exposed to greater liability because the bank failed to alert it to the dangers associated with the president's behavior. The court disagreed, holding that, even though the earlier bank examination disclosed certain loans made in excess of lending authority, the board believed (as did the examiners) that the practices had stopped.[280] The court noted that the jury had found that most of the improper conduct by the president was concealed from the directors and the examiners and that the examiners had knowledge of only three of the original excessive loans. The court also noted the jury's findings that those three loans standing alone did not amount to dishonest or fraudulent conduct.

Finally, in *First National Bank of Cushing v. Security Mutual Casualty Co.*,[281] the court concluded that the insured bank did not have sufficient information to constitute knowledge of dishonest acts because it did not directly discover the dishonest conduct and did not have sufficient information from examination reports to discover the conduct.[282] The bank president in the case engaged in a pattern of permitting the payment of overdrafts on a commercial account by withholding certain checks written by the customer for extended periods of time and by granting fictitious loans. Those actions resulted in losses to the bank. According to the court, the activities were not disclosed in the regular examination reports for the bank, nor were they disclosed in the bank's own reviews. Although certain practices, such as holding items returned from bookkeeping, were criticizedin the examination reports, the court found that those acts were no more than fairly common poor banking practices. Accordingly, the court held that the board of directors had not

[280] *Id*. at 819.

[281] 431 F.2d 1025 (10th Cir. 1970), *cert. denied*, 401 U.S. 975 (1971).

[282] *Id*. at 1028.

[283] *Id*.

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directly learned of any dishonest acts and that the board was not negligent in failing to discover those acts.[283]

These cases tend to impose a lower level of diligence and a higher level of awareness for discovery on other bank officers. They illustrate how a court might refuse to conclude that an insured had certain knowledge when the insured's officers believed that a situation would be addressed and corrected. That approach, however, does not appear to be the best one, in light of the specific language of Section 12. Section 12 is triggered as soon as an Insured, or any officer or director not in collusion with the wrongdoer, learns about dishonest conduct. Subsequent measures to correct the conduct should not undermine the original knowledge or the application of the termination provision.

3. Who Must Discover the Acts?

In order to constitute a discovery which terminates coverage, who must make the discovery? Must it be the board of directors, or a senior level officer, or will a loan secretary suffice? The language of the Bond refers to the "Insured" and to any officer or director not in collusion with the wrongdoer. The reference to any officer or director is basically clear, but the question remains regarding who qualifies as the "Insured."

In two separate opinions, the Fifth Circuit Court of Appeals, not surprisingly, has found that actual discovery by the bank's board of directors of dishonest acts of a loan officer or bank president fulfilled the requirements of Section 12 and terminated coverage for the wrongdoer.[284] There can be no question that discovery by the board itself must be discovery by the "Insured," as well as discovery by one or more directors.

In another Fifth Circuit opinion, the court concluded that a vice president and owner's discovery of dishonesty by a bank president constitute discovery sufficient to terminate coverage for the president.[285] The status of the vice president as an officer of the insured bank clearly fulfilled the requirements of the language of Section 12 for termination.

Discovery by supervisors of dishonest loan officers also appears to be sufficient. For example, in *City Loan & Savings Co. v. Employers' Liability Assurance Corp., Ltd.*,[286] the court concluded that discovery of irregularities by a loan officer's supervisor was sufficient to terminate coverage for that

[284] First Nat'l Bank of Louisville v. Lustig, 961 F.2d 1162, 1168 (5th Cir. 1992); Central Progressive Bank v. Fireman's Fund Ins. Co., 658 F.2d 377, 381 (5th Cir. 1981).

[285] City State Bank in Wellington v. United States Fid. & Guar. Co., 778 F.2d 1103 (5th Cir. 1985).

[286] 249 F. Supp. 633 (N.D. Ohio 1964).

[287] *Id*. at 655.

[288] 590 F.2d 1275 (4th Cir. 1979).

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officer.[287] Similarly, in C. Douglas Wilson & Co. v. Insurance Co. of North America,[288] the court concluded that a credit review officer's knowledge of irregularities by a lower level loan officer with respect to earlier loans constituted knowledge by the insured sufficient to terminate coverage under Section 12.[289] In both cases, the loan supervisors reported the conduct to the president of the insured or other high level officials.

Knowledge of dishonest or fraudulent acts by a controlling shareholder or officer is not imputed to an insured bank, however, when there is no evidence that no board members or other officers ever discovered the dishonesty of the controlling actor.[290] In addition, knowledge of dishonest acts by other officers who are in collusion with the wrongdoer or who later decide to collude with the wrongdoer apparently cannot fulfill the knowledge requirement of Section 12.[291]

Arguably, then, discovery by any employee of the insured who is not in collusion with the wrongdoer could constitute knowledge by the insured. At least one case has indicated, however, that the knowledge must be that of a higher level employee.[292] Therefore, the knowledge of a loan secretary may be insufficient unless that employee reports the discovery to other officers in the bank.

4. What Acts Constitute Collusion with the Dishonest Employee?

The fact that knowledge by an officer or director who is in collusion with the wrongdoer will not be imputed to the insured for purposes of triggering Section 12 begs the question of what constitutes "collusion." That term is not defined by the Bond and has been the subject of various discussion by courts considering the application of Section 12.

In *Adair State Bank v. American Casualty Co. of Reading, Pennsylvania*,[293] the Tenth Circuit concluded that no termination occurred at the time of an initial discovery of dishonest conduct by bank officers because the officers were deemed to be in collusion with the wrongdoer and because the court concluded that permitting termination would be contrary to the public policy which required the bank to maintain fidelity coverage in the first instance.[294] The chairman of the board and majority owner of Adair State Bank engaged in a check kiting scheme for a number of years, which ultimately

[289] *Id*. at 1278.

[290] FDIC v. Lott, 460 F.2d 82, 88 (5th Cir. 1972).

[291] *See, e.g.*, Adair State Bank v. American Cas. Co. of Reading, Pa. 949 F.2d 1067, 1076 (10th Cir. 1991).

[292] Kinzer v. Fidelity & Deposit Co. of Md. 652 N.E.2d 20, 29 (Ill. Ct. App. 1995).

[293] 949 F.2d 1067 (10th Cir. 1991).

[294] *Id*. at 1075-76.

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led to losses to the bank. The chairman began his scheme by writing a check on his Adair account when there were insufficient funds to cover it and then instructing a bank employee to hold the check and show it as a cash item on the bank's books. The bank honored the check rather than returning it, and the chairman's account was not shown as overdrawn. The chairman later deposited funds to cover the check. The chairman continued his scheme for more than a year. The way in which the scheme was conducted assured that the checks would not show up on month-end reports which went to the board of directors.

At least three separate bank officers knew about the scheme or assisted the chairman in it. A vice president and cashier at the bank, who was also a relative of the chairman, discovered the scheme in the summer of 1995 when she reviewed various bank records. The cashier discussed the practices with the bank president, who admitted that he had spoken to the chairman about the problems, and with her director supervisor. The cashier did not discuss the issue with any other directors, even though she was the secretary to the board of directors. The cashier testified that she did not intend to defraud the bank by not reporting the conduct, but rather that she felt she had adequately addressed it by speaking to her two supervisors.

Another senior vice president, who was a branch manager and also a relative of the chairman, also knew about the scheme. She discovered it in the summer of 1985 during her review of the various overdraft reports. She questioned the other vice president about the pattern of conduct and eventually confronted the president of the bank about the problem. The bank president assured her that the chairman was taking care of the matter. She did not report the issue to the board because she said that she was wary of the relationships between the chairman and various board members.

Finally, the bank president, who was also related to the chairman, discovered the scheme no later than September 1985. He spoke with both vice presidents about the issues and addressed the problem directly with the chairman. The chairman threatened the bank president with financial ruin if he did not keep quiet about the kiting.

The scheme finally ended in the spring of 1986 when the FDIC performed an examination of another bank and discovered the check kiting patterns. The bank made a claim on its Bond for the losses sustained in the scheme. The insurer defended on various grounds, including a defense that termination for the chairman occurred in 1985, based upon the discovery of the dishonest conduct by various bank officers. The court analyzed the actions of each of the three bank officers who knew about the scheme and concluded that it was necessary for each of the officers to perform certain acts and to remain silent in order for the scheme to succeed. The court discussed the

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fact that all three of the officers were "repeatedly called upon to choose between the interests of the bank and the interests of [the chairman]," but that each time they chose to promote the welfare of the chairman to the detriment of the bank.[295] Based upon those facts, the Tenth Circuit concluded that the trial court had not erred in concluding that the three officers were participants in the scheme and that their discovery could not be imputed to the bank.[296]

The court also determined that the actions of the three officers constituted "collusion" for purposes of Section 12 and that no discovery by the insured had occurred.[297] The court analyzed the term "collusion," since it was not defined by the Bond, and applied a plain and ordinary meaning to it. The court concluded that "collusion" would mean an agreement between two or more persons to defraud another of his rights through a secret combination or conspiracy.[298] The insurer objected to the application of that decision to the first vice president who discovered the actions and argued that she did not have a secret agreement to further the scheme and never spoke to the chairman about the scheme. The insurer argued that she was not a co-conspirator but that she felt that she had addressed the issue with her superiors in an appropriate manner. The court disagreed, focusing in part on certain reports that the vice president submitted to the board each month, which allowed the actions to be concealed. The court concluded that evidence of her silence was sufficient to uphold the court's finding that she was in collusion with the chairman.[299]

Finally, the court rejected that insurer's argument that, at the precise time the officers discovered the dishonest acts, they were not yet in collusion with the chairman and their knowledge should be imputed to the bank. The court held that such an interpretation of the termination provision would undermine the intent of the state statute which required fidelity insurance.[300] The court found that the intent of the termination provision is to encourage insureds to release dishonest employees and that, in the case of the chairman, the insured never had the knowledge or the opportunity to do so.

The decision in *Adair State Bank* illustrates an extreme in the interpretation of the term "collusion." It may provide authority for the argument that an employee who reports dishonest conduct to her supervisors but not to a board of directors does not adequately address the problem and therefore decides to collude with the wrongdoer. That conclusion seems quite extreme under the circumstances because the person who discovered the acts

[295] *Id*. at 1075.

[296] *Id*.

[297] *Id*.

[298] *Id*.

[299] *Id*. at 1076.

[300] *Id*.

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was clearly an officer and therefore a person who fits within the requirements of Section 12.

Not all of the authorities, however, have taken such an extreme view. In *RTC v. Aetna Casualty & Surety Co.*,[301] the court concluded that bank officials who were aware of the president's illegal loans and who were ordered to fund those loans and put together various loan documentation did not act in collusion with the bank president. Accordingly, their knowledge of prior dishonesty was attributed to the insured bank and was sufficient to trigger the termination of coverage for the president. The RTC argued that the failure of those officers to report the president's conduct was a violation of their duty to the bank and that the officers should be found to be in collusion. The court rejected that argument, holding that the fact that the officers followed their boss' orders to fund and document the loan in question was not sufficient to constitute collusion by them with the wrongdoer.[302]

In *FDIC v. Oldenburg*,[303] the court declined to decide whether the types of conduct which trigger the automatic termination provision must fulfill all of the same requirements of the type of conduct which invokes coverage under the Bond. In that case, the insurer argued that the savings and loan president and general counsel, who were accused of engaging in a dishonest transaction on behalf of the savings and loan with a separate company owned by the savings and loans' owner, had engaged in a pattern of prior fraudulent loans with that company. The insurer argued that savings and loan employees' knowledge of those prior loans constituted discovery of prior dishonest acts which would trigger termination of coverage for those two actors. The court noted that the trial court found the prior loans to be negligently underwritten and inconsistent with prudent lending practices but apparently did not find direct fraud or dishonesty. In that context, the court declined to say whether the type of conduct in question rose to the level of that which could terminate coverage. Instead, the court focused on that fact that the insurer failed to establish that those persons who knew about the prior transactions were not in collusion with the president and general counsel. Because the insurer admitted that the employees who were alleged to have made the discovery worked on the loans with the dishonest employees, the court concluded that such facts supported the finding of collusion made by the trial court.[304]

Accordingly, the issue of how certain conduct will be viewed is not entirely clear. Failing to take all of the actions possible to bring dishonest

[301] 873 F. Supp. at 1393.

[302] *Id.*

[303] 34 F.3d 1529, 1549 (10th Cir. 1994).

[304] *Id.*

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conduct to the attention of the board itself may mean that an employee will be accused of participating in the scheme. However, the better view appears to be that such conduct is not collusion.

5. For Whom is Coverage Terminated?

The termination provision of Section 12 appears to apply with respect to individual employees who are discovered to have committed dishonest acts. Termination of coverage for the one employee who acted dishonestly does not, however, terminate coverage for all employees simultaneously. The cases which have analyzed Section 12 support such an interpretation.

In *Banca Nazionale Del Lavoro v. Underwriters of Lloyds*,[305] the court considered the issue of whether triggering a termination clause for a group of employees can render a Bond void ab initio. The insured in the case was an Italian bank which alleged that ten former employees from its Atlanta branch committed fraudulent and dishonest acts, including making unauthorized loans which exceeded their lending authority. The insurer invoked the termination clause and argued that the fidelity portions of the bond were void ab initio because officers and employees of the bank outside of the Atlanta branch knew or should have known about the dishonest activities of the Atlanta branch employees before the particular bond was issued.

The court held that the termination provision of the Bond did not relate to employees collectively, but rather as individuals since termination as to one employee does not render the Bond itself void.[306] The court noted that not all of the Atlanta branch employees were identified as being associated with the transactions causing losses to the bank and that not all of the branch employees were accused of dishonesty. The court concluded that, because the evidence did not establish that the policy was terminated as to each and every accused employee, there remained a possibility of a recovery on the policy by the bank if it could demonstrate a loss caused by an employee for whom termination had not occurred.[307]

Once termination occurs for a dishonest employee, however, a subsequent renewal of the same policy does not reinstate coverage for the employee.[308] Rather, the coverage which otherwise existed continues after the renewal. Coverage cannot be re-created by the simple renewal of an

[305] 458 S.E.2d 142 (Ga. Ct. App. 1995).

[306] *Id*. at 143.

[307] Id. at 144.

[308] *See, e.g.*, Fid. & Cas. Co. of New York v. Central Bank of Houston, 672 S.W.2d 641, 647 (Tex. App.--Houston [14th Dist.] 1984, writ denied, n.r.e.).

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existing policy. Termination of coverage for any particular employee under a policy with respect to an insurer remains in effect during all subsequent renewals of the same policy with the same insurer. One court has held that to conclude otherwise would be contrary to the principle that an insurer does not agree to insure a bank from losses caused by any officer who is known to the insured to be dishonest.[309]

6. Must the Insured Sustain a Loss in Connection With the Prior Acts?

The plain language of the Bond now indicates that the elements of Insuring Agreement (A), including the manifest intent to cause the insured to sustain a loss, do not apply in connection with Section 12. Certain courts have emphasized that point as well. For example, the Fifth Circuit in one of the *Lustig* opinions concluded that it was error to instruct a jury that, in order to trigger the automatic termination clause, the bank must have been aware of "deceitful acts committed [by the employee] with the manifest intent to cause the bank to sustain a loss and to obtain a financial benefit for himself or for any other person or organization."[310] The court concluded that it was not proper to incorporate the restrictive terms of Insuring Agreement (A) into the automatic termination clause and that the only reasonable interpretation of the clause is that knowledge of dishonest acts which fall short of the requirements of Insuring Agreement (A) can terminate coverage under the Bond.[311] Accordingly, no manifest intent to cause the insured to sustain a loss is required, and no loss in connection with the prior acts should be a requirement for the application of Section 12.

A Louisiana court correctly applied this theory in *Employers' Liability Assurance Corp. v. Southern Produce Co*.[312] In that case, a bookkeeper embezzled funds, and the employer claimed a loss under its particular fidelity bond. After paying the claim, the insurer discovered that the employee in question had been caught embezzling funds three years earlier. At the request of the employee's priest, the employee had not been fired in connection with the first theft. In addition, the employee repaid all of the stolen funds. Nevertheless, the court concluded that termination of coverage occurred for the employee when the insured discovered the first theft, even if no loss was

[309] *Id*.

[310] First Nat'l Bank of Louisville v. Lustig, 961 F.2d 1162 (5th Cir. 1992).

[311] *Id*. at 1168-69.

[312] 129 So. 2d 247 (La. Ct. App. 1961)

[313] Id. at 249.

[314] 514 F.2d 981 (8th Cir. 1975).

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ultimately sustained by the insured.[313] No coverage existed for the second theft, and the insured was required to repay the funds to the insurer.

The Eighth Circuit considered an interesting fact pattern in *First National Bank of Sikeston v. Transamerica Insurance Co*.[314] In that case, the court found as follows: officers of the insured bank discovered that the bank's president was a partial owner of a livestock company, the president had previously used his position as a bank officer to give the livestock company immediate credit on checks deposited but not yet collected, the scheme had been criticized by the comptroller of currency, and the president made arrangements with another bank to cover checks drawn on the livestock company's account on the day they arrived at the bank. The Eighth Circuit concluded that knowledge of these events by other bank officers constituted knowledge of dishonest and fraudulent acts by the president sufficient to trigger termination of coverage for the president under the Bond.[315] As with many funds transfer schemes, the earlier transfers did not result in a loss to the bank although the later transfers did. Despite the fact that the earlier transactions did not cause a loss, the court concluded that the acts were dishonest and would terminate coverage for the president, such that the later transactions which did result in losses would not be covered.[316]

In *Central Progressive Bank v. Fireman's Fund Insurance Co*.,[317] another loan loss case, the Fifth Circuit concluded that an insured bank's knowledge of prior loans used to make political contributions terminated coverage for the bank president in question.[318] In that case, the bank claimed a loss resulting from the fraudulent acts of its president in permitting borrowers to take assets pledged as collateral for outstanding loans. The insurer defended on several grounds, one of which was that termination of coverage for the president occurred several years earlier when the board discovered prior fraud by the president. The insurer established at the trial of the matter that the bank, through its board of directors, knew several years before the losses at issue occurred that the president had made fictitious loans to allow use of bank funds for political contributions which would gain business for the bank. The jury had found that the board of directors had knowledge of and, in addition, approved the loans for political contributions. Based upon that knowledge, the Fifth Circuit agreed that termination of coverage occurred at the time of the political contribution loans and, therefore, no coverage existed for the later acts of the president.[319] The prior acts were not alleged to have resulted in any loss to the bank and were in fact characterized as a way

[315] *Id*. at 987.

[316] *Id*.

[317] 658 F.2d 377 (5th Cir. 1981).

[318] *Id*. at 380.

[319] *Id*.

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to obtain additional business. Nevertheless, those fraudulent loans were dishonest acts sufficient to terminate coverage.

These cases emphasize the point that no loss need result from the prior dishonest or fraudulent conduct, so long as it is determined to be dishonest or fraudulent. The conduct itself, and the knowledge of it by the insured, will terminate coverage.

7. What Conduct Triggers Termination After All?

The cases which are discussed above illustrate that any kind of prior dishonest acts by an employee, regardless of whether they were committed during the employment with the insured and regardless of whether they caused any loss to the insured, can termination coverage for the employee under Section 12. The standards which have been applied to Section 12 for determining when an insured has "learned" of dishonest conduct may, however, create certain fact issues in the context of loan losses. The various cases discussed illustrate the broad spectrum of results which have been reached by some courts. Some courts have applied a more lenient standard in determining that, while an insured knew of specific conduct, it did not know enough to conclude that the conduct was dishonest, or it believed that the conduct had stopped. Those standards do not appear to meet the requirements of Section 12, which indicates that "learning" of dishonest conduct requires only a low threshold of knowledge. The better-reasoned cases conclude that an insured has "learned" of dishonesty when it knows about specific facts and a reasonable insured would have concluded that dishonesty was involved, regardless of whether any loss occurred or whether the conduct later ceased.

B. *The Relationship Between Termination Due to Prior Discovery of Dishonesty and the Fraud in the Application Defense*

In general, the termination provision will determine at what point in time during a policy period that coverage may end for a particular employee, based upon the discovery of dishonest acts about the employee by the insured. However, if the discovery of dishonest conduct occurs before the application for coverage, it is possible that the insurer will have the factual basis, fraud in the application, to argue that a bond should be rescinded.

In *Federal Deposit Insurance Corp. v. Underwriters of Lloyd's of London*,[320] the court concluded that the insurer was entitled to rescind the Bond in question because the insured, Heritage Bank, had made material misrepre-

[320] 3 F. Supp. 2d 120 (D. Mass. 1998).

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sentations in the Bond applications. According to the court's opinion, it was apparent to a number of senior members of the bank that other high-ranking officials were engaged in dubious conduct. The responses made by the bank in its Bond application did not disclose the knowledge of these material risks. The court held that it is "one thing for an insurer to take on the risk that a competently operated banking institution will be overwhelmed by adverse economic conditions. It is quite another for the officials to conceal their colleagues' misconduct."[321]

The court in *FDIC v. Moskowitz*[322] reached a similar conclusion, based upon its determination that an insured made material misrepresentations to its insurer regarding criticism of operations by regulators. The court recognized that rescission is a drastic remedy but found that the remedy was justified because the insured concealed information which would have materially affected the insurer's decision to issue any Bond.[323]

In the case of a rescission argument, whether a Bond will be held to be void due to material misrepresentations in the application will depend upon state law and applicable statutes. The state law of many jurisdictions appears to focus on the issue of the intent of the insured in its application. Because of the very specific nature of rescission requirements, the insured and insurer should carefully review the applicable state law to determine how, if ever, the right to rescind based upon prior discovery of dishonesty might apply.

VI. CONCLUSION

Loan loss cases can potentially present extremely complex and challenging coverage issues for both the insured and the insurer. Any set of loan loss facts can trigger a number of these complex issues and make the investigation of the claim and the coverage analysis quite involved. It is important for the insured, the insurer, and their respective counsel to be aware of these various issues and to focus on the effect of the legal issues early in the investigation. Many issues will not have any easy answer, and many will be subsumed by complex factual determinations and ultimately fact issues. Most importantly, resolution of these issues may not be easy, based upon the numerous conflicting legal authorities which exist on each point.

[321] *Id*. at 148.

[322] 946 F. Supp. 322 (D.N.J. 1996).

[323] *Id*. at 332.

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