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THE BUBBLE BURST: THE FRAUDULENT MORTGAGE RIDER IN THE CURRENT MORTGAGE CRISIS

Jason Glasgow
Elizabeth F. Staruck

I. INTRODUCTION

Selling a home in one day—above the asking price.

Purchasing a first home with no down-payment and less than stellar credit.

Property values doubling in a year.

These notions, which were reality a few years ago, are now but a distant memory. The real estate bubble, unreal as it was, has burst. Almost three million homes faced foreclosure in 2009.[1] That was a 21% increase from 2008. The number is expected to increase to over three million in 2010. In other words, one in 45 homes in the United States were subject to at least one foreclosure in 2009. The numbers and statistics are astonishing and depressing. Many things went wrong in the real estate market. Lending institutions have collapsed at a rate not seen since the Great Depression. Fraud is a common theme in the mortgage crises. One losing party in these transactions, the lender, has and will continue to search for ways to recoup its losses.

[1] Reuters, *US 2009 Foreclosures Shatter Record Despite Aid*, http://www.reuters.com/article/idUSTRE60D0LZ20100114 (last visited June 4, 2010); *see also* Tom Ely, *Record US Foreclosures in 2009*, http://www.wsws.org/articles/2010/jan2010/home-j16.shtml (last visited Jan. 16, 2010).

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The Financial Institution Bond is not designed to cover losses for the collapse of the real estate market. However, with record foreclosures and banks across the country facing financial ruin, loan loss claims are clearly on the rise. Insureds may use various insuring clauses in the Financial Institution Bond in seeking coverage. Most notably, coverage is sought under Insuring Clause E and possibly A and D. Infrequently, claims are made under the Fraudulent Mortgage Rider.[2] The Fraudulent Mortgage Rider is a narrow insuring clause introduced to the Financial Institution Bond in 1956. It is intended to provide coverage for the limited circumstances of when the signatory on a mortgage or mortgage-like document was tricked into signing the mortgage such that the mortgage becomes "defective." From the time period of the Fraudulent Mortgage Rider's introduction to the Financial Institution Bond until the present, there have been a total of six reported cases. Of those cases, three were in the last four years. In many of the reported cases the insured's arguments stem from the fact that the loan was made as part of a fraudulent scheme, not that the signature was obtained by fraud. Banks are searching for ways to make up for the losses they have sustained on the rash of foreclosures. This article analyzes the Fraudulent Mortgage Rider and its specific, limited coverage.

II. HISTORY OF THE RIDER

The impetus that led to creation of the Fraudulent Mortgage Rider arose out of a single dispute that shed light on the extent of financial exposure lending institutions could face in real estate transactions. Ironically, the financial institution involved did not suffer loss, but the potential exposure led to industry-wide changes to the structure of insuring agreements. In *Osin v. Johnson*,[3] a vendor agreed to sell a parcel of land improved with real estate to a purchaser by way of a deed in exchange for a $30,000 promissory note. As security for the note, the purchaser fraudulently represented that he would prepare, execute and record a trust on the property. The vendor executed the deed conveying the property to the purchaser, and the purchaser executed the promissory note. The purchaser recorded the deed but never prepared,

[2] First introduced as a Rider, this insuring clause is now standard in many Bonds.

[3] 243 F.2d 653 (D.C. Cir. 1957).

executed, or recorded the deed of trust to secure the note. In fact, the purchaser never intended to record the trust instrument and promised the vendor he would do so only to obtain the property.

The purchaser then borrowed $11,000 from certain builders and a loan association that had no knowledge of the prior transaction. The purchaser then executed a deed of trust against the property. Later, creditors, including the loan association, obtained judgment liens against the property and commenced foreclosure proceedings based on the trust deeds executed by the purchaser. The vendor filed suit for equitable relief in the U.S. District Court for the District of Columbia to retrieve the property and joined the trust holders and judgment creditors as defendants. The vendor alleged that she did not knowingly execute and deliver the deed to the purchaser and that the purchaser fraudulently procured her signature on an instrument he represented to be a sales contract. The vendor attempted to demonstrate there was fraud in the execution of the deed of conveyance due to the following factors: there was a piece of paper held over and covering a part of the deed; the deed was folded in a peculiar manner; and the document was represented to her as being a sales contract and not a deed of conveyance.

The district court ruled and the U.S. Court of Appeals for the District of Columbia affirmed that the vendor's fraud in the execution argument was implausible based on facts developed at trial. The court held that the vendor knew and intended to execute a deed in reliance on the purchaser's promise to record a deed of trust to secure the note. The court concluded that the fraud perpetrated on the vendor was fraud in the inducement, and the case was remanded for a new trial to determine the equities between the judgment creditors and the vendor.[4]

The general rule applied in *Osin* is that a deed secured by fraud in the inducement results in a voidable deed, whereas a deed secured by fraud in the execution results in a deed that is void.[5] According to Black's Law Dictionary, "fraud in the inducement" occurs where

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[4] *Id.* at 654-58.

[5] For a more thorough analysis on the difference between "fraud in the inducement" and "fraud in the execution," see Harold Allen's Mobile Home Factory Outlet, Inc. v. Early, 776 So. 2d 777 (Ala. 2000) (discussing the two types of fraud in the context of a defective mobile home purchase).

misrepresentation leads a party to enter a transaction without truly appreciating the transaction and its risks, duties, or other obligations.[6] Alternatively, "fraud in the execution" (also known as "fraud in the factum") occurs where a party executes a document without knowledge of what the document actually is, such as signing a contract thought to be an entirely different instrument.[7] Where a deed is voidable, an innocent purchaser for value in the normal course, who does not have notice of the fraud, obtains free and clear title from the grantee. On the other hand, where a deed is absolutely void *ab initio*, the grantee cannot give clear title to even an innocent buyer; and the transaction is treated as not having taken place.

The significance of the *Osin* decision is that the savings and loan institution that granted a loan to the purchaser and maintained valid deeds to the property was left in a position no better off than an unsecured creditor or purchaser due to the deed having been set aside in favor of the vendor. The institution did not sustain a loss, but both it and its insurer recognized that the result could have been different. The insurer also recognized that the language of the Standard Forms 22 or 24 would not have responded to such loss due to application of the loan loss exclusion and there being no forged or altered document for coverage under Insuring Clause E.

Lloyd's offered to rewrite the loan loss exclusion as a remedy to the apparent gap in coverage. The suggested language was as follows:

> (c) Any loss the result of the complete or partial non-payment of or default upon any loan made by or obtained from the Insured, unless such non-payment or default is due directly or indirectly to trick, artifice, fraud or dishonesty by any person or persons, whether employees of the Insured or not.

The insurer involved in the *Osin* matter brought the issue to the attention of The Surety Association of America[8] for consideration of a

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[6] BLACK'S LAW DICTIONARY 293 (2nd Pocket ed. 2001).

[7] *Id.*

[8] Now known as The Surety and Fidelity Association of America (hereinafter SFAA).

new insuring agreement using substantially similar language from the Lloyd's amended loan loss exclusion. The motion did not immediately pass, and the SFAA formed a team to explore the viability and exposure of such a new insuring clause. Later, in 1956, the SFAA presented to its members a Fraudulent Mortgage Rider that would be attached to the Standard Blanket Bonds 5, 22, and 24, which read as follows:

> Any loss through the Insured's having, in good faith, and in the course of business in connection with any loan, accepted or received, or acted upon the faith of, any real property mortgages, real property deeds of trust or like instruments pertaining to realty or assignments of such mortgages, deeds of trust or instruments which prove to have been defective by reason of
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> (a) the signature thereon of any person signing in any capacity, or
> (b) the signature on any recorded deed conveying such real property to the mortgagor or grantor of any such mortgage or deed of trust.

The Fraudulent Mortgage Rider also excepted this insuring clause from the loan exclusion and created a separate sub-limit for this clause.

The development of the Fraudulent Mortgage Rider was greatly influenced by the interpretation of Insuring Agreement E of the standard form Bond. As described in more detail later in this paper, Insuring Clause E generally provides coverage for losses directly caused by forged and altered documents of security, such as deeds, titles, and other documentary collateral for loan transactions. The Fraudulent Mortgage Rider is a much narrower insuring clause.

III.
THE INSURING CLAUSE

The Financial Institution Bond is a type of insuring agreement that financial institutions can purchase to insure themselves against

losses inherent in the lending and credit business.[9] In order to achieve balance in allocating risks of loss between insurers and their insureds, financial institution bonds contain loan exclusions. The Financial Institution Bond typically works by providing coverage for a loss caused by fraud unless it falls within a pre-defined loan exclusion. Such exclusions work to exclude all loan losses caused by a fraud unless the loss in turn falls within an exception to the loan exclusion. One exception to the loan loss exclusion under the Financial Institution Bond is the Fraudulent Mortgage Rider.

Currently, there are two forms of the Fraudulent Mortgage Rider. The first is used under either the Aggregate or Non-Aggregate Form of the Financial Institution Crime Policy published by ISO Properties, Inc.,[10] which provides as follows:

> We will pay for loss resulting directly from your having, in good faith, in connection with any "loan," accepted, received or acted upon the validity of any: **a.** Real property mortgage; **b.** Real property deed of trust or like instruments pertaining to realty; or **c.** Assignments of such mortgage, deed of trust or like instruments; which, with regard to Paragraphs 11.a., 11.b. and 11.c., prove to have been unenforceable by reason of: (1) The signature of any natural person on such document having been obtained through trick, artifice, fraud or false pretenses; or (2) The signature on the recorded deed conveying such real property to the mortgagor or grantor of such mortgage or deed of trust having been obtained by, or on

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[9] *See* Richard E. Elsea, Jeffrey S. Price & Justin D. Wear, *Specific Types of Claims (Accounts Receivable Financing, Loan Participation and Syndication, Subprime Lending, Floor Plan Financing, Equipment Lease Financing, Mortgage Warehouse Lending) and Riders (Fraudulent Mortgage Rider, and Servicing Contractor Rider)*, *in* LOAN LOSS COVERAGE UNDER FINANCIAL INSTITUTION BONDS 347 (Gilbert J. Schroeder & John J. Tomaine eds., 2007).

[10] Hereinafter ISO.

> behalf of, such mortgagor or grantor through trick, artifice, fraud or false pretenses.[11]

Slightly different, the 2004 Standard Form Financial Institution Bond published by the SFAA provides coverage for the following:

> Loss resulting directly from the Insured's having, in good faith and in the normal course of business in connection with any Loan, accepted or received or acted upon the faith of any Written, Original (1) real property mortgages, real property deeds of trust or like instruments pertaining to realty, or (2) assignments of such mortgages, deeds of trust or instruments, which prove to have been defective by reason of the signature thereon of any person having been obtained through trick, artifice, fraud or false pretenses or the signature on the recorded deed conveying such real property to the mortgagor or grantor of such mortgage or deed of trust having been obtained by or on behalf of such mortgagor or grantor through trick, artifice, fraud or false pretenses.[12]

The differences between the SFAA and the ISO fraudulent mortgage coverage provisions are few. The first difference relates to the timing of the loss: the SFAA policy requires the loss to occur in the "*normal course of business* in connection with any loan," while the ISO simply states that the loss need occur "in connection with any loan." The second difference is the manner in which the instrument at issue is obtained: the SFAA states that it should be "received or acted upon the *faith* of any Written, Original…[defined instruments]," while the ISO states that is should be "received or acted upon the *validity* of any [defined instruments]." The third difference relates to the definition of instruments covered: one of the limitations of coverage under the SFAA is for "assignments of such mortgages, deeds of trust or instruments,"

[11] Financial Institution Crime Policy For Banks and Savings Institutions (Non-Aggregate Form), ISO Properties, Inc. (2007); Financial Institution Crime Policy For Banks and Savings Institutions (Aggregate Form), ISO Properties, Inc. (2007).

[12] Financial Institution Bond, Standard Form No. 24, SFAA (2004).

while the ISO provides coverage for "assignments of such mortgage, deed of trust or *like* instruments." The final difference between the policies is what the insured must prove regarding the instrument: the SFAA requires the insured to prove the instrument "to have been *defective*," whereas the ISO requires the instrument "to have been *unenforceable*." In all other respects, the SFAA policy and the ISO policy are the same.

Perhaps the above differences are distinctions without significance. Presently, no court has interpreted the SFAA or ISO policies to come to different conclusions on the scope of coverage provided under each respective Fraudulent Mortgage Rider. This may be in part due to the fact that, although the Fraudulent Mortgage Rider has been in existence for some time, there are few reported cases discussing it. Most significant, is that in the last twenty years no reported case held in favor of the insured. The determinative issue common to many of these cases has been the failure of the insured to prove that a signature on the instrument, that is, a mortgage or deed of trust, was induced by fraud, as opposed to being part of a fraudulent scheme.[13] The following cases illustrate how the courts uniformly have found that coverage under the Fraudulent Mortgage Rider is available in only the most limited circumstances. For purposes of this article, wherever a policy or rider providing fraudulent mortgage coverage is discussed, it will be referred to as the "Fraudulent Mortgage Rider."

IV.
THE CASES ANALYZING THE FRAUDULENT MORTGAGE RIDER

A. Jefferson Bank v. Progressive Casualty Insurance Co.

The first decision discussing the Fraudulent Mortgage Rider came from the U.S. District Court for the Eastern District of Pennsylvania in *Jefferson Bank v. Progressive Casualty Insurance Company*.[14] In *Jefferson Bank*, a real estate attorney defrauded an

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[13] *Id.* at 349.

[14] No. 90-584, 1990 WL 180585, *1 (E.D. Pa. Nov. 19, 1990), *overruled on other grounds by*, Jefferson Bank v. Progressive Cas. Ins. Co., 965 F.2d 1272 (3d Cir. 1992).

insured bank out of more than $600,000 in connection with a loan the attorney received from the bank in exchange for a first mortgage on the attorney's primary residence. This was not the first business dealing between the parties. Previously, the attorney received a loan from the bank in connection with the purchase of a shopping center. The attorney also received a $275,000 unsecured line of credit from the insured.

To obtain the $600,000 loan, the attorney purportedly secured title insurance through a company named Sterling Abstract Corporation. Sterling Abstract Corporation was an authorized agent for Ticor Title Insurance Company, the underwriter of the policy. At the closing, a woman represented by the attorney to be both a notary and the Vice President of Sterling Abstract presented the insured with what she claimed was a current title commitment issued by Ticor for the property. The woman also notarized the mortgage. The insured witnessed the attorney's signature on the mortgage, and the parties agreed the attorney would record the mortgage.

The insured later discovered that "Sterling Abstract" was not the actual Sterling Abstract Corporation, but a dummy corporation created and incorporated by the attorney. Also, the woman who attended the closing was an imposter and not a notary or Vice President. The insured's mortgage was never recorded, and it was found that the attorney had defrauded six other banks in a similar manner.

The attorney accomplished the fraud through use of altered Ticor Title commitments he obtained through earlier, legitimate real estate transactions that he had participated. Criminal investigations further revealed the attorney did not own the shopping center involved in his prior transaction with the insured because the deed and agreement of sale he prepared for the transaction were false.

Complicating matters further, one of the six other banks defrauded by the attorney recorded its mortgage before the fraud was discovered and obtained priority over the insured's loan on the property.[15] The bank, unable to recover its losses from the attorney's primary residence or his other assets, filed a claim with its insurer under

[15] Jefferson Bank v. Progressive Cas. Ins. Co., 965 F.2d 1274, 1276 (3d Cir. 1992).

a financial institution bond.[16] The insurer denied the claim, and the insured filed suit in the district court.

The insured claimed that its losses fell within the Fraudulent Mortgage Rider. The primary issue before the district court was whether the language of the Fraudulent Mortgage Rider extended coverage to the insured for its losses in connection with the $600,000 loan, the shopping center loan, and the unsecured line of credit because of the attorney's fraud. The district court explained that the insured could only recover if it sustained "(1) a loss through (2) relying on a real property mortgage, real property deed of trust or like instrument pertaining to realty (3) which [was] defective (4) because the signature of any person was obtained by fraud."[17]

As to the $600,000 loan, the insured argued that coverage should be extended because it would not have entered the mortgage if it had known the attorney was a "swindler." The insured also asserted that the signature on the mortgage was obtained *through* fraud and thus its losses should be covered under the Fraudulent Mortgage Rider. The district court disagreed and found no coverage under the Fraudulent Mortgage Rider. The district court reasoned that, despite the fact the mortgage was arguably obtained through a fraudulent scheme, the signatures on the mortgage themselves did not render the mortgage "defective." The language of the Fraudulent Mortgage Rider required the mortgage to be "defective by reason of the signature thereon." In the instant case, the district court held that "the only thing that makes the mortgage defective is the fact that so much money was lent with this building for security."[18] The fact that the mortgage was "worthless" was not enough for coverage under the Fraudulent Mortgage Rider.

The district court also rejected the insured's argument that it should recover for its losses because the title insurance commitment had signatures obtained through "trick, artifice, fraud or false pretenses." The district court held that the Fraudulent Mortgage Rider did not cover these types of documents, reasoning the Fraudulent Mortgage Rider's coverage for "mortgages, deeds of trust or like instruments pertaining to

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[16] 1990 WL 180585 at *1.

[17] *Id.* at *5.

[18] *Id.*

realty" meant that it would cover "mortgage-like documents" rather than title insurance papers.[19] The district court denied the insured's claim for loss under the line of credit because it failed to produce any documentation indicating it relied on the earlier fraudulent transactions in granting or continuing the credit.[20]

The insured appealed to the U.S. Circuit Court of Appeals for the Third Circuit. In the appeal, the insured argued that the "legal effect of a mortgage is to protect against third-party claims to the same property."[21] Because an improperly notarized mortgage could not be recorded or used to gain priority over third-party loans under Pennsylvania law, the insured again argued that the imposter's fraudulent notary triggered coverage because it made the mortgage defective. The Third Circuit agreed that the mortgage was defective but stated that "[m]ere defect is not sufficient."[22] The Third Circuit reasoned that "the notary signature, the potential source of defect on the mortgage, or the various signatures on the title commitment would have to have been induced by fraud to allow [the insured] coverage under the Fraudulent Mortgage Rider."[23] In the instant case, the Third Circuit stated that the insured did not rely on a notary signature *induced* by fraud. Rather, the notary signature was a part of the fraud because the imposter "knew exactly what she was doing when she forged the signature" and thus was a participant to the fraudulent scheme.[24] In other words, the notary's signature needed to have been induced by fraud as it served as the potential source of defect on the mortgage.

For these same reasons, the Third Circuit affirmed the district court's denial of coverage in connection with the imposter's signature on the title commitment.[25] The court stated that the Fraudulent Mortgage Rider's phrase "mortgages, real property deeds of trust or like

[19] *Id.*
[20] *Id.* at *6.
[21] 965 F.2d at 1278.
[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] *Id.* at 1279.

instruments pertaining to realty" did not mean documents "as important as" a mortgage.[26] Rather, it meant "mortgage-like" instruments.[27]

Distinguishing coverage provided under other insuring agreements, the Third Circuit explained that the Fraudulent Mortgage Rider extended greater coverage for "loan losses caused by fraudulently induced—although not forged—signatures on mortgages."[28] In other words, "[t]he Rider thus would cover bank losses resulting when the seller of real property fraudulently induces the mortgagor to purchase the property and sign a mortgage by promising that the mortgage will never be enforced, by misrepresenting to the mortgagor that the mortgage covers a different piece of property, or by telling the mortgagor that the document being signed was a contract to purchase rather than a mortgage."[29] The insured was therefore barred from recovery under the Fraudulent Mortgage Rider.

B. North Jersey Savings and Loan Ass'n v. Fidelity and Deposit Co. of MD

Three years later, in *North Jersey Savings and Loan Ass'n v. Fidelity and Deposit Co. of Maryland*,[30] the court addressed a similar issue with regard to what constituted a fraudulently induced signature. As the insured in *Jefferson Bank*, the insured focused on the fraudulent scheme itself. In *North Jersey,* the insured savings and loan company decided to abandon its historically conservative lending philosophy to adopt a more aggressive investment strategy. The insured hired a contractor as its senior loan officer and made him responsible for developing a commercial real estate loan program.[31] Later, the insured received an opportunity to purchase a first and second mortgage in connection with a $10,000,000 loan. The loan officer reviewed the offer and issued a commitment letter for the mortgages.[32]

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[26] *Id*.
[27] *Id*.
[28] *Id*. at 1280.
[29] *Id*.
[30] 660 A.2d 1287 (N.J. Super. Ct. Law Div. 1993).
[31] *Id.* at 61.
[32] *Id.* at 62.

Prior to completing the purchase, however, one of the insured's private mortgage insurers notified it that the mortgages contained irregularities and that the mortgage insurer suspected the bank violated federal and state laws. The insured suspended the transaction temporarily but continued with the purchase of the mortgages after obtaining subsequent assurances that each of the loans in the transaction were fully covered by a different mortgage insurer and after obtaining advice from an insurance agent that the mortgage insurer for the loans had Best AA ratings.[33] The bank later defaulted on the mortgages and filed for bankruptcy.

The warnings were true. The bank had violated federal and state laws. In fact, several class action suits against the bank also exposed it to extensive civil and criminal liability that resulted in the imprisonment of bank officials and its attorney. The insured filed a claim under a Savings & Loan Blanket Bond in connection with alleged losses resulting from fraudulent mortgages. The insured filed suit in the New Jersey Superior Court when its claim was denied by the insurer.

The Fraudulent Mortgage Rider under the bond extended coverage to "loss through the receipt of any mortgages 'which prove to have been defective by reason of the signature thereon of any person having been obtained through trick, artifice, fraud or false pretenses. . . .'"[34] The insured argued that coverage existed under the Fraudulent Mortgage Rider because the mortgages were the product of violations of the Federal Truth In Lending statute and Regulation Z. The state court disagreed and drew a distinction "between a fraudulent scheme and a fraudulently induced signature."[35]

As the *Jefferson Bank* court, the court explained that the signatures on the mortgages were not alleged to be invalid, nor did the insured claim that any mortgagor of the bank failed to realize they were signing a mortgage. Instead, the insured sought coverage simply because the bank it conducted business with was found liable for failing to disclose terms and interest rates for its loans. The insured's losses were therefore not the result of defective mortgages but because the properties

[33] *Id.* at 63.
[34] *Id.* at 81.
[35] *Id.* at 82.

subject to the mortgages were over-valued. Without evidence that the mortgagors failed to know they were signing a mortgage or believed that the mortgage would not have the effect of encumbering the property, the court held that there is no coverage under the Fraudulent Mortgage Rider.

C. FDIC v. Firemen's Insurance Co. of Newark, New Jersey

In *FDIC v. Firemen's Insurance Co. of Newark, New Jersey*,[36] an insured savings association engaged in real estate transactions called "swaps," whereby the insured purchased pools of mortgage loans from two entities related to a single individual. Over an eight-month period, the swap value exceeded $40 million.[37] The insured and the individual also entered into Sales Agreements at the closing for each transaction wherein it was represented that the individual was selling "first mortgage loans on real estate." The individual personally guaranteed the loans and was also retained by the insured to service the loans.

Under the agreement, the individual was required to make periodic guarantee payments to the insured regardless of whether the mortgagors made payments to the individual. Near the eighth month of the parties' engagements, the individual stopped making the required payments. Five months later, the insured discovered that it had been defrauded based on the fact that the majority of the mortgages it received through the swap had conflicting liens or were actually secured by subordinate liens rather than first liens as provided in the agreements. The insured was left with $17 million in loans secured by second or later-in-priority mortgages.

The insured held a $15 million blanket bond with a Fraudulent Mortgage Rider that provided indemnity coverage for losses in connection with real property mortgages that were defective by reason of fraud with respect to the signature thereon. After the insured's claim was denied, the Federal Deposit Insurance Company[38] as successor-in-interest to the insured filed a declaratory judgment action against the insurer.

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[36] 109 F.3d 1084 (5th Cir. 1997).
[37] *Id.* at 1086.
[38] Hereinafter FDIC.

The district court ruled in favor of the insurer, holding the Fraudulent Mortgage Rider did not provide coverage for the insured's losses.[39] The FDIC appealed to the U.S. Court of Appeals for the Eighth Circuit, asserting that the Fraudulent Mortgage Rider was ambiguous and should be interpreted in the insured's favor according to the applicable laws of Texas. Specifically, the FDIC argued that the Fraudulent Mortgage Rider covered "an insured's losses from a transaction related to the transfer of mortgages when any person is induced by fraud to sign any document related to the transfer."[40]

The FDIC based its reasoning on two points: first, it asserted that the swap transactions were akin to "assignments" of mortgages, which were covered under the Fraudulent Mortgage Rider; and, second, the swap assignments were defective because the insured was fraudulently induced to enter the mortgage transactions. The insured's signatures on the mortgages thereby provided coverage under the Fraudulent Mortgage Rider.

The Fifth Circuit disagreed and reasoned that "[t]he mortgages [the insured] obtained in the swap transactions may have been 'defective,' in the sense that they were worthless or had little value to [the insured]. However, this 'defect' was not caused by [the insured's] signature being obtained through fraud."[41] The Fifth Circuit continued, stating "[the insured's] signature, whether fraudulently obtained or not, had no effect on the value of the assignments or the underlying mortgages from [the insured's] perspective. [The insured], at its own option, could have enforced its rights against the fraudulent individual under the agreements or rescinded the transactions."[42]

The signature, obtained fraudulently, still did not *cause* any defect. The Fifth Circuit concluded that the Fraudulent Mortgage Rider would not provide coverage when the "defective" mortgage related to something other than a signature obtained through fraud. The insurer requested the court to further interpret the Fraudulent Mortgage Rider "to cover only instruments that are unenforceable and then only when the

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[39] *Id.* at 1087.
[40] *Id.* at 1088.
[41] *Id.*
[42] *Id.* at 1089.

instrument is unenforceable due to a signature being obtained by fraud in the factum rather than fraud in the inducement."[43] The Fifth Circuit declined to do so, finding that it was able to resolve the case without other grounds.

D. Ohio Savings Bank v. Duncanson

There are no reported decisions on the Fraudulent Mortgage Rider from 1997 until 2006; however, there have been three new decisions since 2006. For example, in *Ohio Savings Bank v. Duncanson*,[44] an insured savings bank originated, purchased, and sold residential mortgages. Some of the mortgages purchased by the insured came from a mortgage investment company that also originated and sold mortgages. When the investment company had a potential buyer, it solicited the insured to purchase the loan. If the insured expressed an interest, it sent funds for the loan to a third-party closing agent who simultaneously sold the loan from the investment company to the insured. In this fashion, the investment company never had to contribute funds to the loans.

On one occasion, a group of individuals sought to refinance their residential mortgages and thus executed notes and mortgages with the investment company. The investment company informed the insured of the opportunity to purchase the mortgages, and the insured agreed to provide funds for eleven of the residential mortgages. The insured used the closing agent to handle the transaction, which was worth approximately $1.3 million. After the insured disbursed funds to the closing agent, it discovered the closing agent stole $1.1 million of the monies intended to fund the purchases. The insured further discovered that the mortgages were never recorded, and several of the pre-existing notes and mortgages were also never paid or satisfied.

The insured filed a claim with its insurer for the loss under a Fraudulent Mortgages Insuring Agreement. The insurer denied the claim, and the insured filed suit against the insurer in the U.S. District Court for the District of Minnesota. The court held that the insured's

[43] *Id.*

[44] No. 05-45 (JNE/SRN), 2006 WL 2583413, *1 (D. Minn. Sept. 6, 2006).

loss was not covered. The court reasoned that the mortgagors knew they were refinancing and the investment company did not make any misrepresentation with intent to mislead the mortgagors in connection with the transactions. Thus, the loss was not caused by "signatures obtained through trick, artifice, fraud or false pretenses" so as to fall within the coverage of the Agreement. In other words, the insured's loss resulted from the closing agent's theft of the insured's funds rather than *signatures* on the mortgages having been fraudulently obtained.

E. TierOne Bank v. Hartford Fire Insurance Co.

In *TierOne Bank v. Hartford Insurance Co.,*[45] an insured extended a $10,000,000 line of credit to a company whose job was to locate potential residential real estate buyers and loan them funds to purchase such properties. The company then secured repayment of the loans by obtaining notes and mortgages or deeds of trust on the real estate purchased. The company also received advances from the insured in order to give funds to the buyers for purchasing. After closing, the company assigned the mortgage or deed of trust to the insured and sold the note and mortgage or deed of trust to an investor on a secondary market. The company then repaid the advance it obtained from the insured, plus any applicable interest.

In one purchase agreement, the insured funded two residential real estate loans for $747,500 and $812,500 from the company to a loan officer engaged in residential refinancing.[46] To secure the loans, the company obtained deeds of trust with regard to properties purportedly owned by the officer by way of a separate purchase agreement with a third party. The third party, however, misrepresented its ownership of the properties to the officer and thus did not convey good title. In turn, the officer misrepresented the amount of his assets when he applied for loans from the company. Thus, two misrepresentations occurred prior to the insured's involvement in the transaction.

Sometime after the funds transfer, the insured and the company became aware of the fraud between the officer and third party and filed a claim of loss with its insurer. The insurer denied the insured's claim and

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[45] No. 4:07cv3199, 2008 WL 5170579, *1 (D. Neb. Dec. 9, 2008).
[46] *Id.* at *2-3.

suit was filed in the U.S. District Court for Nebraska. A standard Fraudulent Mortgage Rider to the bond provided coverage for losses in connection with fraudulent mortgages where five factors existed:

> (1) the insured acted in good faith and in the course of business, (2) the insured suffered a loss, (3) the loss was caused by the insured's reliance on a mortgage or other instrument relating to mortgages, (4) the mortgage or instrument is defective, and (5) the defect was caused by a signature on that mortgage or instrument being obtained by fraud.[47]

The insured claimed that its losses were covered under the Fraudulent Mortgage Rider because the third party defrauded the officer into thinking he had obtained good title to the properties he later used as security for loans with the insured.[48]

In contrast, the insurer asserted that it rightfully denied coverage because the officer was himself a part of fraudulent activity that was connected with the insured's loss. The court agreed and explained further that "coverage does not automatically apply when a covered instrument, such as a deed of trust, contains a fraudulently induced signature. Rather, in order for coverage to exist, there must be some showing that the signature is invalid or defective because the signatory was tricked or defrauded as to the nature of the document signed."[49] Because there was no evidence that the officer's signatures on the deeds of trust was defective or that the officer did not know he was signing deeds of trust, coverage did not exist under the Fraudulent Mortgage Rider.[50]

The court's ruling in *TierOne Bank* is yet another decision to demonstrate that coverage under the Fraudulent Mortgage Rider is extremely narrow. The focus is on whether the person signing the note had no clue what she was doing or signing or that her signature would encumber her property. Clearly those circumstances are very limited.

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[47] *Id* at *5.
[48] *Id* at *6.
[49] *Id.*
[50] *Id* at *7.

F. Ohio Savings Bank v. Progressive Casualty Insurance Co.

In *Ohio Savings Bank v. Progressive Casualty Insurance Co.*,[51] an insured bank purchased eleven first mortgages from a home-loan refinancing company. The insured wired funds to an escrow account of the refinancing company's closing agent. The refinancing company then obtained notes and mortgages from borrowers and assigned the notes and mortgages to the insured. The closing agent then disbursed the loan proceeds from its escrow account most often to satisfy pre-existing first mortgages.

The closing agent, however, controlled a branch of the refinancing company and used his position to orchestrate an elaborate Ponzi scheme. The agent embezzled approximately $1 million from the escrow account after obtaining executed notes and mortgages from borrowers and assigning them to the insured. Loan proceeds were diverted for the agent's personal use or used to satisfy pre-existing liens on earlier mortgages to maintain the Ponzi scheme.

The agent's scheme defrauded the insured and eight other borrowers. When the borrower's prior mortgage loans were not paid, they refused to pay the mortgage loans assigned to the insured and losses resulted.[52] The insured filed a claim for fraudulent mortgage coverage under a Fraudulent Mortgage Rider to its Financial Institution Bond, Standard Form No. 24 policy. The Fraudulent Mortgage Rider was called a Fraudulent Mortgage Insuring Agreement.[53] After its claim was denied, the insured filed suit in the U.S. District Court for the District of Minnesota and appealed to the U.S. Court of Appeals for the Eighth Circuit after the district court ruled in favor of the insurer.

The insured argued that coverage under the FMIA should be extended for its losses because the borrowers were fraudulently induced to sign the notes and mortgages after the closing agent misrepresented to the borrowers that the loan proceeds would be used to pay their existing mortgage loans.[54] Accordingly, the insured asserted that because of the

[51] 521 F.3d 960, 961 (8th Cir. 2008).
[52] *Id* at 962.
[53] Hereinafter FMIA.
[54] 521 F.2d at 963.

false pretenses and the fraudulent scheme, those signatures were "obtained through trick, artifice, fraud or false pretenses" within the language of the FMIA.[55] The Eighth Circuit disagreed because the insured failed to focus on the word "defective" under the FMIA. The FMIA would cover loss "only if the [insured] relied on a mortgage that proves to be 'defective by reason of the signature thereon…having been obtained through trick, artifice, fraud, or false pretenses.'"[56]

The Eighth Circuit went further than the other decisions and explained that there is a distinction between common law fraud and fraud within the commercial context involving the nature and terms of an instrument being signed. The former is a defense against all persons, while the latter is a defense limited to particular persons such as holders in due course. Concluding that the FMIA is a narrow exception to the insured's overall loan coverage, the Eighth Circuit held that a "defective" mortgage is "one that fails to provide the promised security interest in real property because the mortgagor was tricked or defrauded as to the nature of the document being signed."[57] This type of defect would bar any holder in due course under commercial law and be the precise, "rare type of fraud" that the FMIA intended provide exception to the other exclusions under the policy.[58] The denial of coverage was therefore affirmed.

The scarcity of reported decisions is likely due to the fact that for many years this was optimal coverage. With the current mortgage crisis, it is likely more litigation will ensue.

V.
COVERAGE ISSUES TO CONSIDER

As demonstrated by the cases discussed above, an insured must establish that it sustained a direct loss by having (1) acted in good faith and in the course of business; (2) the loss was caused by the insured's reliance on a mortgage or other instrument relating to mortgages; (3) the mortgage or instrument is defective; and (4) the defect was caused by a

[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Id.*

signature on that mortgage or instrument being obtained by fraud, trick or artifice. As shown, the most litigated issue is whether the signature on the mortgage document was secured through fraud, trick, or artifice. The courts have uniformly held that a fraudulent scheme is not enough to establish coverage. Instead, one must be tricked into signing the mortgage or mortgage-like document. In other words, these scenarios are limited to situations where the signatory is completely unaware, through fraud, that he or she is signing a mortgage or a document that might encumber his or her property. There are other potential coverage issues that may arise under the Fraudulent Mortgage Rider. Some are frequently litigated issues with respect to other insuring clause. Others are unique to the Fraudulent Mortgage Rider.

A. Did the Insured rely upon the document in "good faith"?

The Financial Institution Bond is not designed to provide coverage for bad banking practices. When a bank does not act in "good faith" coverage may be denied. What is "good faith"? If the bank is a participant in the fraudulent scheme or knowingly acquiesces to the scheme, a court may find a lack of good faith. The closer question is whether negligence or poor banking practices are sufficient for lack of good faith. Considering the massive amounts of loans issued in the last decade, the "good faith" issue is one to watch. There have been no reported decisions in the context of "good faith" and the Fraudulent Mortgage Rider; however, there have been numerous decisions on this issue in other contexts. Many extensive papers have been written that address the good faith issue and should be consulted.[59]

B. What documents must be relied upon?

As set forth in the first decision relating to the Fraudulent Mortgage Rider the document that must be relied upon has to be a "mortgage-like document."[60] Considering the fraudulent schemes that have made it to the front page of the papers lately, this is an important case. In a real estate transaction there are numerous documents outside

[59] *See, e.g.,* Maura Pelleteri, *Causation in Loan Loss Cases*, *in* LOAN LOSS COVERAGE UNDER FINANCIAL INSTITUTION BONDS 239 (Gilbert J. Schroeder & John J. Tomaine eds., 2007).

[60] *Jefferson Bank*, 965 F.2d at 1280.

the mortgage that could be deemed part of a fraudulent scheme. Those documents include, for example, a loan application, a title insurance policy, an appraisal, or other documents used in the underwriting of the loan. However, the Fraudulent Mortgage Rider only relates to signatures on documents that directly encumber the property. The policy language supports this. The *Jefferson Bank v. Progressive Casualty Insurance Co.* confirms this.

C. There's a covered loss … how much should we pay?

A claim for loss under a Financial Institution Bond does not consist merely of an insured submitting numeric figures it claims represent the monetary amount resulting from some fraudulent transaction to which it has fallen prey.[61] Rather, after a claim is made, a number of other factors come into play to determine an insured's "actual loss"—defined as "the actual pecuniary loss caused directly by a covered peril."[62] One of these factors is loan loss exclusions, such as the "potential income" exclusion, which will decrease the total amount an insured can claim under the Bond. The other factor to consider is the Bond's valuation clause. Both of these may have a dramatic impact on the amount owed.

1. Potential Income Exclusion

The potential income exclusion is now a standard exclusion under the 1986 Financial Institution Bond since its inception in the 1970s.[63] The language of the exclusion covers "potential income, including but not limited to interest and dividends, not realized by the Insured."[64] Insurers intended the exclusion to "place the risk of lost earnings potential on the insured" because the bond is "a contract of indemnity" that does not work to put the insured in the same financial position they would have been in had the loan connected with fraudulent

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[61] Samuel J. Arena, Jr. & Marianne Johnston, *Determining the Amount of Loan Loss and the Potential Income Exclusion*, *in* LOAN LOSS COVERAGE UNDER FINANCIAL INSTITUTION BONDS 153 (Gilbert J. Schroeder & John J. Tomaine eds., 2007).

[62] *Id.* at 154.

[63] *Id.* at 200.

[64] 1986 Financial Institution Bond, §2(s).

activity been legitimate.[65] Accordingly, courts interpreting the potential income exclusion have often denied an insured's attempt to receive coverage for interest on alleged loan losses caused by fraud.[66] In the fraudulent mortgage context, this would mean that an insured bank would not be able to recover for the lost interest it claims it would have received had a mortgage loan not involved fraud otherwise covered under the Fraudulent Mortgage Rider. Several other sources provide further discussion on the case law surrounding the potential income exclusion.[67]

2. The Valuation Clause

Relatedly, the amount of indemnity owed in a loan loss situation must be calculated pursuant to the Valuation Clause. The Standard Form 24 Financial Institution Bond provides the following:

Valuation

Section 6

> The value of any loss for purposes of coverage under this bond shall be the net loss to the Insured after crediting any receipts, payments or recoveries, however denominated, received by the Insured in connection with the transaction giving rise to the loss. If the loss involves a Loan, any interest or fees received by the Insured in connection with the Loan shall be such a credit.

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[65] Arena, *supra* note 62, at 200-01.

[66] *See, e.g.,* First Am. State Bank v. Cont'l Ins. Co., 897 F.2d 319 (8th Cir. 1990); Bank of Huntingdon v. Smothers, 626 S.W.2d 267 (Tenn. Ct. App. 1981).

[67] *See* Toni Scott Reed, *Recurring Questions in Loan Loss Coverage Cases*, V FID. L.J. 103, 150 (1999); Edgar L. Neel, *Loan Losses: Consideration with Respect to Claims Under Financial Institution and Fidelity Coverages*, *in* ABA Fidelity & Surety Law Comm. Annual Mid-Winter Meeting Publication 44 (1986).

The Valuation Clause's impact on the indemnity owed can be significant. Depending on the time period between the loan's origination and the default, the lender may have received substantial monies in the form of interest payments or penalties. Each of these payments reduces the amount of indemnity owed off the principal outstanding.

VI.
INTERPLAY BETWEEN FRAUDULENT MORTGAGE RIDER AND OTHER COVERAGE SECTIONS

A. Insuring Agreements A, D, and E in General

Insuring Agreements A, D, and E are by far the most litigated insuring agreements under the Financial Institution Bond. In their simplest form, Insuring Agreement A provides an insured coverage against fidelity losses and Insuring Agreement D provides coverage for fraud or alteration of instruments; while Insuring Agreement E provides coverage for losses dealing with securities.[68] Thus, Insuring Agreement (A) provides coverage for "loss resulting directly from dishonest or fraudulent acts caused by an 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."[69]

Insuring Agreement (D) states, in part, that an insured can receive coverage for loss resulting directly from the following:

> Forgery or alteration of, on or in any [specified document] . . . [or] "transferring, paying or delivering any funds or Property or establishing any credit or giving any value on the faith of any written instructions or advices directed to the Insured and authorizing or

[68] FINANCIAL INSTITUTION BOND, Standard Form No. 24 (revised Jan. 1986) [hereinafter 1986 Financial Institution Bond], *reprinted in* Standard Forms of the Surety & Fidelity Asso'n of America, at Insuring Agreements (A), (D), and (E): Financial Institution Bond, Standard Form No. 24 (revised Apr. 2004) [hereinafter 2004 Financial Institution Bond], *reprinted in* Standard Forms of the Surety & Fidelity Ass'n of America, at Insuring Agreements (A), (D), and (E).

[69] 1986 Financial Institution Bond (Insuring Agreement (A)).

> acknowledging the transfer, payment, delivery or receipt of funds or Property [when the] instructions or advices either bear a signature which is a Forgery or have been altered.[70]

There are two versions of Insuring Agreement (E). The 1986 version provides coverage for the following:

> Loss resulting directly from the Insured having, in good faith, for its own account or for the account of others, (1) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of, any original [specified document] which (i) bears a signature of any [specified person] which is a Forgery, or (ii) is altered, or (iii) is lost or stolen; (2) guaranteed in writing or witnessed any signature upon any [specified document]; [or] (3) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any [specified document] which is a Counterfeit.[71]

The 2004 Financial Institution Bond modified the language of the above coverage to no longer provide coverage for losses in connection with a "deed, mortgage or other instrument conveying title to, or creating or discharging a lien upon, real property."[72] Such losses are now covered under the fraudulent mortgage provisions of Insuring Agreement (G) within the 2004 Financial Institution Bond.[73]

B. The Fraudulent Mortgage Rider and Insuring Agreement E

Although case law suggests that insureds are seldom able to recover for losses under the Fraudulent Mortgage Rider, litigation involving the Fraudulent Mortgage Rider often also includes litigation under other Insuring Agreements to the Financial Institution Bond. For instance, in *Jefferson Bank v. Progressive Casualty Insurance Co.*, the Third Circuit conducted a lengthy discussion on what was meant by

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[70] 1986 Financial Institution Bond (Insuring Agreement (D)).
[71] 1986 Financial Institution Bond (Insuring Agreement (E)).
[72] 1986 Financial Institution Bond (Insuring Agreement (E)(1)(c)).
[73] 2004 Financial Institution Bond (Insuring Agreement (G)).

"proximate cause" and loss "resulting directly from" under Insuring Agreement (E) before it remanded the case to the district court for further analysis of these issues.[74] More fully discussed above, the Third Circuit denied the insured's claim for coverage under the Fraudulent Mortgage Rider earlier in its opinion.

As to Insuring Agreement (E), the insured argued that its losses were covered because it extended credit to the attorney in good faith reliance on a mortgage that bore a forged signature—that of the notary who was actually an imposter. The insurer, in contrast, argued that the insured's loss was not caused by the forged notary signature, but by the fact that the property secured by the mortgage was worthless due to the prior mortgage liens attached thereto.

The Third Circuit began its analysis by interpreting the phrase "resulting directly from" under Insuring Agreement (E) to mean "proximately caused by." The court then stated that both parties' explanation of what caused the loss was insufficient and drew its own conclusion that the loss at least theoretically occurred when the third-party bank recorded its mortgage on the same property the insured believed it held as security. At such point, the insured's security clearly lost all possible value, but this was only one factor to consider. The failure to record the mortgage was deemed a substantial factor causing the insured's loss, but the most potentially determinative issue was whether the forged notary's signature was a significant enough event to be considered the proximate cause of the loss. The Third Circuit concluded, however, that this was a genuine issue of fact and remanded the case to the district court for jury determination.

Similarly, the insured in *Ohio Savings Bank v. Progressive Casualty Insurance Co.* sought coverage under Insuring Agreement (E) as well the Fraudulent Mortgage Rider.[75] As discussed above, the Eighth Circuit denied the insured's claim for coverage under the Fraudulent Mortgage Rider. The insured also argued that its losses were covered under Insuring Agreement (E) because the original mortgage documents were lost after the mortgages were assigned to them, which then prevented them from being recorded.

[74] *Jefferson Bank*, 965 F.2d at 1280-82.
[75] 521 F.3d 960, 964 (8th Cir. 2008).

The Eighth Circuit rejected this argument, finding that Insuring Agreement (E) focuses on the point in time when a decision to extend credit occurs. At such time, "[a]ctual physical possession of the mortgage is a condition precedent" to coverage for a "mortgage [that] bears a forged signature, or is an altered instrument, or is 'lost or stolen.'"[76] Because the borrowers' mortgage instruments were not "lost or stolen" at the time they were assigned to the insured but after the loans were extended, no loss was covered under Insuring Agreement (E). The Eighth Circuit concluded that "the bankers blanket bond 'does not insure good management.'"[77]

Accordingly, denial of an insured's claim under the Fraudulent Mortgage Rider does not mean that its losses will be completely barred from coverage. Insureds can seek coverage under other Insuring Clauses such as (A), (D), and (E). Each of these Insuring Clauses will then present their own respective coverage issues.

VII.
CONCLUSION

No matter how grim things appear, the mortgage crisis will come to an end. The claims arising from the loan losses will likely outlast the crisis itself. While most loan losses are brought under other insuring agreements, claims arising under the Fraudulent Mortgage Rider are clearly on the rise. The scope of the coverage under that Fraudulent Mortgage Rider is extremely narrow and limited. To date, not one reported decision has found coverage under the Fraudulent Mortgage Rider. The uniformity of the decisions establish that the coverage is meant to be for the limited circumstance where the signatory had no clue he or she was encumbering the property. Obviously, those situations are few and far between.

[76] *Id.*

[77] *Id.* at 964 (quoting Nat'l City Bank of Minneapolis v. St. Paul Fire & Marine Ins. Co., 447 N.E.2d 171, 177 (Minn. 1989)).