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The Swan Song of a Dishonest Duck: A Prototype for Analyzing Coverage Under the Bankers Blanket Bond

Davis J. Howard*

I. INTRODUCTION

Financial institutions, like individuals and other companies, purchase insurance to avoid becoming economically crippled as a result of direct loss or liability to third parties. Whether a bank is large or small, it typically purchases several different types of insurance. Almost all banks and savings and loan associations will purchase a Bankers Blanket Bond to protect against a variety of direct losses caused by the torts or crimes of insiders or third par-


1. For a relatively small price, the insured transfers its risk to a professional risk-taker and thus receives a substantial benefit in the event that a covered loss is sustained. The spreading of risk also benefits the insurance company and its owners because only a small portion of insureds are likely to require the protection and reimbursement that their policies provide. Finally, the public-at-large benefits in a number of ways. First, businesses and their dependents are no longer rendered insolvent due to catastrophic losses. Second, because the ultimate risk is shifted to the majority of the insured public in the form of increased premiums, most individual premium increases are nominal. See generally R. Keeton & A. Widiss, INSURANCE LAW 1-3, 8-13 (West Practitioner's ed. 1988).

2. A bank will undoubtedly purchase a directors' and officers' liability insurance policy so that it will be entitled to reimbursement for indemnifying its directors and officers in the event they are liable to third parties. W. Knepper & D. Bailey, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 685-756 (4th ed. 1988). A bank will also purchase the policy to insure its directors and officers in the event that the bank is unable or unwilling to indemnify them. Id. Larger institutions purchase trust department errors and omissions insurance for liability arising from negligent acts or omissions in handling customers' trust accounts. Yeager, The Developing Law of Business Errors and Omissions Insurance, 89-92 (Practicing Law Institute 1983). Banks also purchase insurance typically issued to individuals, such as property, fire, automobile, and other general liability coverage. Paris & Eurich, The New Commercial General Liability Policy, in Insurance Coverage and Practice (May 12, 1988) (Defense Research Institute seminar material).

3. For a general analysis of a Bankers Blanket Bond, see infra notes 11-18 and accompanying text.

In 1980, the Insurance and Protection Division of the American Bankers Association reported that 89.4% of all banks had purchased some form of blanket bond insurance and that 50% of all insurance premiums paid by banks during 1980 were for the purchase of blanket bond insurance. Weldy, History and Development of the Bankers Blanket Bond, in Bank Insurance: The Revised Bankers Blanket Bond and Directors and Officers

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ties intent on swindling these institutions. After all, as Willy Sutton responded when asked why he robbed banks: "That's where they keep the money."

When a lawyer analyzes a Bankers Blanket Bond claim that arises from the acts or omissions of a servicing contractor, the lawyer will discover that neither case law nor commentary provides much assistance. Because the claim may implicate insuring agreements found in the bond's standard form, case law dealing with the subject may offer some general help. Such an analysis, however, will be incomplete because the factual configuration of a servicing contractor's claim is unique. In addition, financial institutions may purchase an optional insuring agreement known as a Servicing Contractors Endorsement. This insuring agreement is distinct from those found in the standard form of a pre-1986 blanket bond or a post-1986 financial institution bond.

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4. In this context, a servicing contractor is a person or company authorized to collect payments on real estate mortgages or home improvement loans on behalf of the financial institution that is, according to the mortgage or loan agreements, ultimately entitled to receive such payments. See CNA Insurance Companies, Servicing Contractors Coverage Discovery Form, No. G-11082-A, revised to October 1983 (unpublished Chicago, Ill.) [hereinafter CNA].

5. In 1986, the Surety Association of America changed the policy form's name from "blanket bond" to "financial institution bond" because the term "blanket" was thought to imply that the bond covered more losses than the draftsmen intended. See Fidelity Trust Co. v. American Sur. Co. of N.Y., 268 F.2d 805, 807 (3d Cir. 1959) ("[the] term 'Blanket Bond' indicates that its coverage is to be wide and it is not unfair to interpret the document in this fashion"); Century Bank v. St. Paul Fire & Marine Ins. Co., 4 Cal. 3d 319, 482 P.2d 193, 93 Cal. Rptr. 569 (1971) ("the very title of the policy... indicates that coverage is to be wide"). With respect to bankers blanket bonds generally, see 9A J. Appleman, Insurance Law and Practice §§ 5701-5723, at 375-486 (1981 & Supp. 1988). Standard Form No. 24 is the blanket bond form that has been used since 1941. It was revised in 1946, 1951, 1969, 1980, and 1986. Between each revision, new terms, conditions, definitions, agreements, and exclusions were often added by rider. Typically, a prior year's rider will become part of a subsequent year's standard form. Smirz, The New Definition of Employee Dishonesty, 55 Def. Couns. J. 432 (1988). For the text of the standard forms adopted in 1969, 1980, and 1986, see the specimen bonds contained in Financial Institution Bond Litigation: A Case Study for Bankers, Sureties, Insurers and Attorneys 1-25 (A.B.A. Tort & Ins. Prac. Sec. 1988) [hereinafter Bond Litigation]. For the text of a Servicing Contractors Endorsement, see CNA, supra note 4.

For an analysis of the historical evolution of blanket bonds, see generally Babcock, History of Fidelity Coverage, in The Commercial Blanket Bond Annotated 1-6 (A.B.A. 1985); Weldy, History of Financial Institution Bonds, in Bankers and Other Financial Institution Blanket Bonds 1-22 (A.B.A. 1979); Weldy, History of the Bankers Blanket Bond with Comments on the Drafting Process, in Annotated Bankers Blanket Bond 5-16 (A.B.A. Tort & Ins. Prac. Sec. 1980); Hinchey, Bankers and Savings and Loan Blanket Bonds, in Bank Insurance 1-3 (Nov. 18, 1985) (Executive Enter-
This Article creates a prototype for analyzing a complex claim under the Bankers Blanket Bond. Unless otherwise indicated, the Standard Form No. 24, revised in 1980, is the bond form that this Article analyzes. Although this is accomplished within the framework of loss relating to the acts and omissions of a servicing contractor, the same methodology applies to any loss that is arguably covered by any insuring clause in such a bond. Section II of this Article briefly analyzes the insuring provisions in the standard Bankers Blanket Bond. To avoid antiseptic treatment, Section III creates a hypothetical fact scenario that leads to a claim under the Bankers Blanket Bond with a Servicing Contractors Endorsement. The remainder of the Article analyzes coverage issues arising from the conjunction of the hypothetical facts and the bond's insuring clauses. Each insuring clause that arguably provides coverage is analyzed separately.

6. This Article also will discuss why strict construction of the coverage provisions and exclusions in the Bankers Blanket Bond is essential to deter financial institutions from engaging in easily avoided loss-producing conduct. Given that decisions construing blanket bond coverage disputes rarely address public policy, a description of the underlying functions served by the bond's various insuring agreements must, to some extent, be a product of educated speculation.

7. Although the standard form was revised again in 1986, the 1980 form retains its validity. Given that blanket bonds generally run continuously until cancelled by either party or pursuant to their own terms, coverage disputes under the 1980 standard form will be adjudicated for some time to come. Moreover, the marketing of a new form does not necessarily supersede older forms, even with respect to underwriting accomplished after the new form becomes available. Rather, the insurer may still issue, and the insured may still purchase, an earlier version of the blanket bond. Cases involving the earlier forms retain their validity to the extent that a provision remains unchanged or is revised only stylistically. Hinchey, supra note 5. To the extent that older cases rejected the insurer's position because of the absence of a provision in the policy, and such a provision is thereafter inserted, the insurer should rely on the older cases and the revised form in support of denying coverage. By the same token, if the coverage dispute arises under the older form, the insured may rely on older case law and changes in the 1986 form to support its coverage claim.

8. See infra notes 11-18 and accompanying text.

9. See infra notes 19-36 and accompanying text.

10. Section IV analyzes the on premises insuring agreement. See infra notes 37-101 and accompanying text. Section V analyzes the forgery or alteration insuring agreement. See infra notes 102-24 and accompanying text. Section VI analyzes the securities insuring agreement. See infra notes 125-44 and accompanying text. Section VII deals with the Servicing Contractors Endorsement. See infra notes 145-54 and accompanying text. Section VIII considers several subsidiary issues that affect coverage and the amount of reimbursement due from the bonding company if coverage is found to exist. See infra notes 155-69 and accompanying text. Section IX concludes this Article by considering the theme of the bond and its relationship to the bond's deterrent function. See infra
questions as answers, it will illuminate an area of insurance law that has, until now, remained largely in the shadows.

II. COVERAGE UNDER THE BOND: IN GENERAL

The Bankers Blanket Bond combines separate insurance contracts into one instrument. Originally, the coverage each insuring clause provided was found in a separate policy, and each policy was often issued by a different insurer. Combined coverage has advantages for both the insurer and the insured. From the insured's perspective, combination fosters administrative ease and a concomitant reduction in transaction costs because all standard protection may be purchased at one time from the same bonding company and through the same broker. From the insurer's perspective, a blanket bond assures that it will receive all underwriting premiums from a single financial institution, at least for the type of coverage the bond provides.

The Bankers Blanket Bond has six separate insuring agreements: fidelity; on premises; in transit; forgery or alteration; securities; and counterfeit currency. Additional insuring agreements, such as a Servicing Contractors Endorsement, may be purchased for an extra premium and added to the bond in the form of riders or endorsements.

The fidelity clause covers loss caused by the fraud or dishonesty of an insured's employees. The on premises clause covers loss to...
property of the insured caused by theft or false pretenses occurring on its premises. The in transit clause compensates an insured for loss of property sustained while the property is being transported to or from the insured by messenger. The insuring clauses relating to forgery, alteration, and securities cover loss caused by reliance on specified categories of documents that are forged, altered, lost, stolen, or counterfeit. The counterfeit currency clause covers loss caused by reliance on counterfeit United States or Canadian currency.

There is only one methodology for analyzing bond coverage: the facts underlying a financial institution’s loss must be juxtaposed against the provisions set forth in each insuring clause of the bond. This may seem simple and, if coverage is clearly absent, it is. If coverage is arguably present, however, the apparent simplicity frequently vanishes and is replaced by a coverage conundrum. When this occurs, an educated prediction, rather than a definitive conclusion, is often the most that may be achieved.

III. THE HYPOTHETICAL FACT SCENARIO

Happyvale National Bank ("Happyvale") is a small financial institution located in Wayne, New Jersey. Happyvale is run by President Paul Pokey and Executive Vice President Brett Markstone.

organization intended by the Employee to receive such benefit, other than salaries, commissions, fees, bonuses, promotions, awards, profit sharing, pensions or other employee benefits earned in the normal course of employment.

BOND LITIGATION, supra note 5, at 9.

15. For a detailed analysis of the on premises insuring clause, denominated Insuring Agreement (B), see infra notes 37-65 and accompanying text.

16. The in transit clause, denominated Insuring Agreement (C), covers:

Loss of Property resulting directly from robbery, common-law or statutory larceny, theft, misplacement, mysterious unexplainable disappearance, being lost or otherwise made away with, and damage thereto or destruction thereof, while the Property is in the custody of a person designated by the Insured to act as its messenger (or a person acting as messenger or custodian during an emergency arising from the incapacity of such designated messenger) and while the Property is in transit anywhere, such transit to begin immediately upon receipt of such Property by said messenger and to end immediately upon delivery to the designated recipient or its agent.

BOND LITIGATION, supra note 5, at 9.

17. For a detailed analysis of these insuring clauses, denominated Insuring Agreements (D) and (E), see infra notes 102-44 and accompanying text.

18. The counterfeit currency clause, denominated Insuring Agreement (F), covers "[l]oss resulting directly from the receipt by the Insured, in good faith, of any Counterfeit or altered Money of the United States of America or Canada." BOND LITIGATION, supra note 5, at 9.
Pokey, who is also Chairman of the Board of Directors, previously made all major decisions, while Markstone, who worked his way up from junior teller, merely carried them out. Some time ago, however, Markstone started to exercise substantial discretion, while Pokey began spending most of his time looking for the business instead of running it. Although Pokey’s ambitions always have exceeded his abilities, he firmly believes that a high ratio of ambition to ability is what made this country great. In any event, Pokey always thought that when he purchased insurance, he adequately protected the bank from loss caused by thieves and scoundrels whose base intent eluded even his remarkable abilities as a judge of human character.

Tony “The Duck” Valentino, whose real name was Bronislav Korcynsky, was a local “wheeler-dealer” who conducted most of his business through his wholly-owned corporation, the Star-Spangled Funding Corporation (“Star-Spangled Funding”). Given his preference for the histrionic, plus additional reasons that need not be referenced, Korcynsky changed his name some time ago:

He saw below his own image, but he was no longer a clumsy, dark, gray bird, ugly and ungainly. He was himself a swan! It does not matter in the least having been born in a duckyard, if only you come out of a swan’s egg.

When asked by Pokey and Markstone why he was known as “The Duck,” Valentino replied that it was because he was such a good swimmer:

There once was a fellow named Duck,
Who found himself plum out of luck.
He became quite mendacious,
His name was fallacious
‘Cause honest guys can’t make a buck.

In 1980 and 1981, Happyvale purchased home improvement

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19. Pokey may have mistaken a conditioned response for a causal connection. Simply because his own ambitions exceeded his abilities and he achieved a measure of success, he assumed that the former ratio caused the latter result. For a contrary view, see Soshyet, Falling Rats at Law Firms, Nat’l L.J., Oct. 24, 1988, at 13, col. 1. Issues of causation are integral to proper coverage analysis under the blanket bond. See infra notes 57-65 and accompanying text.


21. This limerick, written by Paul Pokey himself, and needlepointed by his wife in red, white, and blue, is now framed and hangs on his office wall. It was placed there to act as a constant reminder of what may happen when those whose ambitions exceed their abilities become wedged between the rock of a swindler and the hard place of an insurance company.
loans from Valentino. Happyvale serviced the loans itself for two reasons. First, Pokey was not then willing to rely on the representations or abilities of The Duck. Second, Happyvale had not at that time purchased a Servicing Contractors Endorsement from its bonding company. Pokey entered into these limited transactions, in which a total loss would be relatively inconsequential, because he hoped to determine The Duck's reliability and thereby decide whether to expand their relationship. The loans that Happyvale purchased were nearing maturity at the time of sale and each was subsequently paid in full over its remaining term or prepaid in full prior to expiration. As a result, Pokey became favorably impressed with The Duck and decided that an expanded relationship would indeed be propitious.

During the autumn of 1981, Pokey and The Duck held detailed discussions regarding the proposed expansion of their relationship. Valentino advised that he would soon obtain title to hundreds of home improvement promissory notes and would be willing to sell them to Happyvale. As negotiations continued, Pokey and The Duck agreed to several terms and conditions. Happyvale would have the option of purchasing an eighty percent participation interest in each home improvement loan. With respect to each loan Happyvale purchased, Valentino would assign to Happyvale the corresponding promissory note and mortgage. Valentino would repay to Happyvale, on a monthly basis and over the term of each underlying loan, the eighty percent purchase price, plus sixteen percent interest per annum. This obligation would endure regardless of whether the homeowners met their underlying obligations to

22. See generally Ryan, Interbank Problems: Buying Participations and Sharing Set-offs, in 4 ALI-ABA RESOURCE MATERIALS — BANKING AND COMMERCIAL LENDING LAW 355 (1983); P. Schmelzer & R. Chamness, A BANKER'S GUIDE TO LOAN PARTICIPATIONS (American Bankers Ass'n 1986); Hansford & Sowell, Loan Participations and the UCC, 106 BANKING L.J. 62 (1989); Hoberman & Schwartz, Loan Participations: Proceed With Caution, — NEW JERSEY LAWYER 18 (1988); Simpson, Loan Participations: Pitfalls for Participants, 31 BUS. LAW. 1977 (1976); Note, Security Interests in Notes and Mortgages: Determining the Applicable Law, 79 COLUM. L. REV. 1414 (1979). Although much of the legal literature dealing with loan participations involves huge transactions in which a "lead bank" sells participation interests to other banks, the principles referenced in this Article apply with full effect, and the author believes that a more personalized and less grandiose fact pattern will more effectively convey the essential messages.

23. Without a Servicing Contractors Endorsement, Pokey did not believe that Happyvale had coverage for losses that might occur if Valentino serviced the loans. For a detailed analysis of the Servicing Contractors Endorsement, see infra notes 145-54 and accompanying text.

24. In other words, the purchase price would be 80% of the amount of the underlying loan.
Star-Spangled Funding. Valentino would service all loans for Happyvale. In exchange for his services, The Duck would earn the difference between Happyvale's sixteen percent return and the interest rate that the homeowner-borrowers paid, which ranged from seventeen to twenty percent. Finally, in the event that a homeowner defaulted or Happyvale sent notice of termination, Valentino would repurchase all outstanding participation interests. The Duck made all of his representations verbally in Happyvale's offices and behind closed doors because he preferred not to communicate by telephone or to appear in public places. Neither Pokey nor Markstone asked him about his aversion to telephones or crowds.

The home improvement loans were made to homeowners of relatively modest means and were memorialized in a form of promissory note known as a "Home Improvement Loan Installment Contract." The term of each loan was often as long as five to ten years, with an annual interest rate of seventeen to twenty percent. Consequently, the total finance charge would often exceed the amount of the loan. Each homeowner was required to repay the same amount each month over the term of the loan.25 Each installment contract recited on its face the name and address of the homeowner, the amount and term of the loan, the annual interest rate, the dollar amount of the finance charge over the full term, the total sales price,26 and the amount that the borrower was obligated to repay per month.27 As collateral securing his promissory note, the homeowner would assign his mortgage to Star-Spangled Funding, with the face amount of the assignment being the same as the amount of the loan.

By December 1981, President Pokey was ready to move ahead. First, he switched bonding companies, contracting with South Brook Casualty Company ("South Brook"). South Brook issued to Happyvale a Bankers Blanket Bond along with a Servicing Contractors Endorsement. This endorsement covered loss caused by the fraud or dishonesty of a servicing contractor and loss of funds

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25. Except for their longer terms and higher interest rates, the home improvement loans were similar to automobile financing contracts.
26. The total sales price is the sum of the amount of the loan and the finance charge.
27. To cite an example in which an amortization formula has not been applied, assume a homeowner borrowed $10,000 to build a duck pond and the interest rate on the loan was 20% per year over a five-year term. Since 20% of $10,000 x 5 = $10,000, the total finance charge would be $10,000 and the total sales price ($10,000 loan + $10,000 finance charge) would be $20,000. As the term of the loan was 60 months, the borrower would pay $333.33 each month for five years.
caused by a servicing contractor's failure to remit collected monies
to the insured, whether or not such failure involved fraud. The
bond became effective at 12:01 a.m., New Jersey time, on January
1, 1982.

President Pokey also instructed Happyvale's lawyer, Evan Sco-
ter, to draft a contract incorporating Pokey's recollection of the
terms and conditions previously discussed with The Duck. Scoter
also incorporated the following provisions into the contract: (i)
Happyvale would have the right to examine the originals of all
back-up documents before purchasing participation interests; (ii)
Happyvale would have the continuing right to examine all related
books, records, and documents in the custody or control of Star-
Spangled Funding; (iii) all promissory notes were owned by Star-
Spangled Funding free and clear of any encumbrances or liens;
and, (iv) no homeowners had been delinquent in repaying their
loans to The Duck.

Scoter made only one mistake and it was a big one. Instead of
providing that Happyvale would purchase eighty percent of the
amount loaned to each homeowner, the contract he drafted pro-
vided that Happyvale would purchase eighty percent of the "total
sales price" of each loan. Happyvale thus purchased a percent-
age of the entire amount loaned, plus the finance charge. This
oversight was not discovered prior to execution. The contract, de-
nominated a "Home Improvement Loan Participation Agree-
ment," was signed by Pokey and The Duck at Happyvale's
headquarters at 12:00 noon on January 1, 1982. Immediately after
execution, two things happened. First, Happyvale purchased its
first package of loans from Star-Spangled Funding, paying The
Duck eighty percent of the total sales price of each loan. Second,
The Duck made off with Pokey's fountain pen.

Earlier that morning, President Pokey had quickly examined all
back-up documents and concluded that they were in order. He did
not have his lawyer examine them and did not cause an investiga-
tion to be conducted into the creditworthiness of Valentino, Star-
Spangled Funding, or the homeowners. Thereafter, on the first
day of each month from February to October 1982, Happyvale

28. The Servicing Contractors Endorsement first came into use in 1956. Prior to that
time, such coverage was provided, if at all, under a separate policy. Hudson City Sav.
29. The back-up documents comprised the promissory notes and mortgage
assignments.
30. As a result of this situation, The Duck would necessarily owe more money to
Happyvale than he could possibly receive from the homeowner-borrowers.
purchased additional packages of loans from The Duck. At the time of each purchase, The Duck came to the bank and received a cashier's check from Pokey representing the purchase price of the package of loans.

Vice President Markstone, having been on extended leave, was not involved in the preparation or execution of the contract. When he returned to Happyvale in March 1982, Markstone was dismayed to learn that Pokey had entered into a long-term contract with The Duck. Markstone knew that Pokey had developed a reputation for paying less than scrupulous attention to detail. At Markstone's insistence, Pokey had promised to await the vice president's return before contracting with The Duck. But, when Valentino suggested that he might take his business elsewhere unless the deal closed by the first of the year, Pokey decided that he could not afford to look a gift duck in the bill. So, Pokey signed on the dotted line.

In Markstone's absence, Happyvale had purchased three packages of loans, at all times adhering to the formula set forth in the January 1, 1982 contract. Upon returning to Happyvale in mid-March and reviewing the relevant documents, Markstone at once realized that Happyvale had inadvertently purchased a percentage of the total sales price, rather than the amount of each loan. Because Valentino was supposedly receiving only seventeen to twenty percent interest from each homeowner on the amount of each loan, while at the same time remitting to Happyvale sixteen percent interest on the total sales price — which itself was often twice the amount of each loan — this necessarily meant that a substantial portion of the funds received by Happyvale came from a source other than the homeowners. Nonetheless, neither Pokey nor Markstone appeared suspicious and neither one inquired into the source of these phantom funds. They purported to be concerned only that Happyvale was under-collateralized because each mortgage assignment was in the face amount of each loan, rather than the total sales price of the loan.

Before Markstone would authorize Happyvale to purchase a fourth package of loans, he convened a meeting at the bank attended by Pokey, Valentino, and Scoter. He instructed Scoter to prepare a new contract providing for the purchase of eighty percent of the amount of each loan, advising The Duck in no uncertain terms that all subsequent loans would be purchased on the basis of this new calculation. The Duck agreed. The new contract was executed on the morning of April 1, 1982, and later that day,
Happyvale purchased its fourth package of loans from Star-Spangled Funding. President Pokey evidently believed that the first three packages of loans were reformed to become consistent with the originally intended formula expressed in the revised contract. This was not the case. In the first three transactions, Happyvale continued to receive sixteen percent interest on its eighty percent investment in the total sales price of each loan until October 1983, when disaster struck.

On October 30, 1983, Star-Spangled Funding failed to remit any money to Happyvale. After repeated efforts to telephone The Duck proved unsuccessful, Markstone went to Star-Spangled Funding's office, only to discover that it was a padlocked warehouse in a rather disreputable section of town. No one from the bank had previously visited the site or enforced the bank’s contractual right to examine the company’s records.

Happyvale immediately proceeded to superior court and sought to attach all assets of Valentino and Star-Spangled Funding. The bank also sought an order requiring that all homeowners tender their payments directly to Happyvale. This relief was granted on default and Happyvale promptly advised all homeowners to make payments directly to the bank. At the same time, it provided notice of claim to South Brook under its Bankers Blanket Bond.\textsuperscript{31}

After the court order was signed, Markstone gained admission

\begin{footnotes}
\textsuperscript{31} Section 5 of the Bankers Blanket Bond is entitled “NOTICE/PROOF-LEGAL PROCEEDINGS,” and is subsumed under the generic category of “CONDITIONS AND LIMITATIONS.” It provides:

(a) At the earliest practicable moment, not to exceed 30 days after discovery of loss, the Insured shall give the Underwriter notice thereof.

(b) Within 6 months after such discovery, the Insured shall furnish to the Underwriter proof of loss, duly sworn to, with full particulars.

(c) Lost Securities listed in a proof of loss shall be identified by certificate or bond numbers if the Securities were issued therewith.

(d) Legal proceedings for the recovery of any loss hereunder shall not be brought prior to the expiration of 60 days after the original proof of loss is filed with the Underwriter or after the expiration of 24 months from the discovery of such loss, except that any action or proceeding to recover hereunder on account of any judgment against the Insured . . . or to recover attorney’s fees paid in such suit, shall be brought within 24 months from the date upon which the judgment and such suit shall become final.

(e) If any limitation embodied in this bond is prohibited by any law controlling the construction hereof, such limitation shall be deemed to be amended so as to equal the minimum period of limitation provided by such law.

(f) This bond affords coverage only in favor of the Insured. No suit, action or legal proceedings shall be brought hereunder by anyone other than the named Insured.

\end{footnotes}
to The Duck's offices. Three things disturbed him: first, all the utilities had been shut off; second, the files were strewn all over the office; and third, a foul odor was coming from what turned out to be a dead fish wrapped in a newspaper:

There was a little man, and he had a little gun,
And his bullets were made of lead, lead, lead;
He went to the brook, and saw a little duck,
And shot it through the head, head, head.

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Given these circumstances, Happyvale required an extension of time in which to file its particularized proof of loss, and South Brook consented under a full reservation of rights.34

33. Blanket bonds typically require that the insured must provide notice of a claim to the insurer as soon as practicable after discovery, but in no event exceeding 30 days thereafter, and that a sworn proof of loss with full particulars must be submitted within six months after discovery of the loss. See supra note 31. Standard Form No. 24, as revised in 1980 and 1986, contains these requirements. The 1969 form, however, requires notice as soon as practicable, but does not require that such notice be provided within any specified number of days after the insured discovers the loss. BOND LITIGATION, supra note 5, at 4-5. The discovery clause in the 1980 version of Standard Form No. 24 provides:

This bond applies to loss discovered by the Insured during the bond period. Discovery occurs when the Insured becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred, even though the exact amount or details of loss may not then be known. Notice to the Insured of an actual or potential claim by a third party which alleges that the Insured is liable under circumstances which, if true, would create a loss under this bond constitutes such discovery.

Id. at 11.


34. If a surety reserves its rights when granting an extension of time to file a proof of loss, the surety thereby reserves the right to later deny coverage on the ground that the insured failed to provide notification of loss within 30 days of discovery. For a general analysis of the effects of an insurer's reservation of rights, see R. Keeton & A. Widiss, supra note 1, at 704-12; B. Ostrager & T. Newman, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 2.02, at 32-34 (1988); Herman, Guidelines for Reservation of Rights/Denial of Coverage, in INSURANCE COVERAGE AND PRACTICE m-l (D.R.I. 1988); Wall,
After organizing Valentino's files and conducting his own investigation, Markstone concluded that one-half of the loans purchased by Happyvale were uncollectible for several reasons. First, some were prepaid in full during the several months prior to The Duck's disappearance. Second, others were sold to two or more financial institutions and, to the extent that the underlying borrowers were not delinquent, they had been making payments directly to the other banks. Third, some homeowners had evidently signed the notes and mortgage assignments in blank and then decided not to borrow money, whereupon The Duck filled in the blanks without consent and sold the paper to Happyvale. Finally, many homeowners had been chronically delinquent in meeting their contractual obligations, some having never made any payments at all.

After reaching these conclusions, Happyvale submitted a proof of loss affidavit to South Brook seeking to recover $1,000,000 under the Servicing Contractors Endorsement to its Bankers Blanket Bond. This amount represented the remaining principal and interest due on these defective loans. As for The Duck, his whereabouts continued to remain a mystery:

Litigation and Prevention of Insurer Bad Faith § 3.04, at 26-28 (1985 & Supp. 1988). See also Metzner, Late Notice and Misrepresentation, in INSURANCE, EXCESS, AND REINSURANCE COVERAGE DISPUTES 371 (Practicing Law Institute 1989); Comment, Reservation of Rights Notices and Nonwaiver Agreements, 12 PAC. L.J. 763 (1981). South Brook should reserve its right to deny coverage on the ground that Happyvale discovered the loss in March 1982. Given that a reasonable person would expect to sustain loss upon learning that a substantial portion of the funds remitted by The Duck did not come from the homeowners, South Brook's argument should succeed. Happyvale was placed on constructive notice of this fact upon first receiving payments from Valentino because principal plus 16% interest on the total sales price could not have been derived from principal plus 17% to 20% interest on the amount financed. Happyvale had actual notice of potential loss in March 1982, when Markstone became aware of the discrepancy. Under traditional agency principles, his knowledge would be imputed to the bank. City State Bank in Wellington v. United States Fidelity & Guar. Co., 778 F.2d 1103 (5th Cir. 1985); Hartford Accident & Indem. Co. v. Hartley, 275 F. Supp. 610 (M.D. Ga. 1967), aff'd without op., 389 F.2d 91 (5th Cir. 1968); West Am. Fin. Co. v. Pacific Indem. Co., 17 Cal. App. 2d 225, 61 P.2d 963 (1936); Heake v. Atlantic Casualty Ins. Co., 415 N.J. 475, 482, 105 A.2d 526, 529-30 (1954). See Windt, INSURANCE CLAIMS AND DISPUTES § 1.02, at 4 n.11 (2d ed. 1988). But see Home Life Ins. Co. v. Clay, 11 Kan. App. 2d 280, 719 P.2d 756 (1986) (eighteen-month delay in notice after learning of check forgery did not entitle insurer to summary judgment because injured third party advised the bank that it would not sue to recover its loss). Clay adheres more to equity than to the terms of the bond's discovery clause.

35. Experience indicates that most insureds seek coverage under only one insuring agreement. Arguably, this is due in part to their overly simplistic understanding of the coverage afforded by the bond. For example, Happyvale sought coverage only under the Servicing Contractors Endorsement because it believed its loss was caused by Valentino, and Valentino was a servicing contractor. President Pokey failed to realize that Valentino was also a seller of promissory notes, an assignor of collateral, and perhaps a bor-
Always do that, wild ducks do. They shoot to the bottom, sir — and bite themselves fast in the tangle and seaweed — and all the devil's own mess that grows down there. And they never come up again.\footnote{36}

Ten months later, Valentino did come up again. His body washed up on the banks of the Raritan in New Brunswick. Upon reading the headline in the next day's newspaper — "Gangland Slaying Turns River into Duck Soup" — Pokey turned to Markstone and asked: "Do you think The Duck lied to us about being a good swimmer too?"

rower. Therefore, the loss Valentino caused might be covered under Insuring Agreements (B), (D), or (E).

Experience also reveals that insureds tend to focus on a single insuring agreement because of the way many carriers format their proofs of loss. With respect to the cause of loss, these forms often contain boxes that must be checked off. Each box corresponds to a separate insuring agreement. This appears to suggest to the insured that it may seek coverage only under one insuring agreement. The sophisticated insured will simply check off every box or describe the facts and refrain from characterizing the claim so that it would clearly fall within the scope of only one insuring clause. Alternatively, the insured may seek coverage under "each and every portion of the bond that provides coverage for the loss.” The insurer may object on the ground that the insured bears the burden of establishing its entitlement to coverage, notwithstanding the fact that the insurer unilaterally drafted the contract and should be more knowledgeable about its meaning. A. \textit{Windt, supra} note 11, § 6.27, at 277. See \textit{generally} Wright v. Newman, 598 F. Supp. 1178 (W.D. Mo. 1984), \textit{aff’d}, 767 F.2d 460 (8th Cir. 1985); Crawford v. Ranger Ins. Co., 653 F.2d 1248 (9th Cir. 1981); Hale v. Fawcett, 214 Va. 583, 586, 202 S.E.2d 923, 925 (1974); 13 J. \textit{Appleman, supra} note 5, § 7381 at 1-23; W. Knepper & D. Bailey, \textit{supra} note 2, § 20.16, at 642-43 (3d ed. 1978); Howard, \textit{Apportioning an Insurer's Liability Between Covered and Noncovered Parties and Claims}, 38 \textit{Fed’N Ins. & Corp. Couns. Q.} 319, 324 (1988). Although the policyholder bears the burden of establishing coverage, if a carrier is concerned about both its reputation among customers and how courts will perceive it in future coverage litigation, it should treat every claim as potentially arising under the entire bond and analyze coverage accordingly.

Even when the person responsible for a loss acts solely as a servicing contractor, the sophisticated insured will often attempt to place coverage under an insuring agreement in the standard form because the limit of liability under the Servicing Contractors Endorsement is typically lower than the limit for standard insuring agreements. \textit{See, e.g.}, Hudson City Sav. Inst. v. Hartford Accident & Indem. Co., 440 F. Supp. 41 (E.D.N.Y. 1977).

IV. COVERAGE UNDER INSURING AGREEMENT (B):  
"ON PREMISES"37

A. The "On Premises" Insuring Clause38

For purposes of analyzing Happyvale's claim, Insuring Clause (B) (the "on premises" clause) provides coverage for loss of property directly caused by a person's false pretenses while that person is on the insured's premises.39 The Bankers Blanket Bond defines property to include money.40 Although the term "directly" is not defined, its appearance in each of the standard form's insuring agreements, in conjunction with related exclusions,41 indicates that

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37. Insuring Agreement (A), the Fidelity Insuring Agreement, provides coverage for "[l]oss resulting directly from dishonest or fraudulent acts of an [e]mployee" of the insured. See supra note 14. Because neither Valentino nor Star-Spangled Funding was an employee of Happyvale, Insuring Agreement (A) is not implicated in this hypothetical. But see Employers Liab. Assurance Corp. v. Watson, 75 F.2d 749, 753 (8th Cir. 1935) (person hired by bank to perform discrete task deemed an "employee" for purpose of invoking coverage provisions of Insuring Clause (A)). This is not to say Insuring Clause (A) is irrelevant. It defines dishonesty and fraud in terms virtually identical to those used to define the same terms in the Servicing Contractors Endorsement. See supra note 14. See also infra note 145. Given the sparsity of case law interpreting the Servicing Contractors Endorsement, courts should look to cases decided under Insuring Clause (A) to interpret dishonesty and fraud as used in this rider.

38. Insuring Agreement (B) covers:
(1) Loss of Property resulting directly from
   (a) robbery, burglary, misplacement, mysterious unexplainable disappearance and damage thereto or destruction thereof, or
   (b) theft, false pretenses, common law or statutory larceny, committed by a person present in an office or on the premises of the Insured, while the Property is lodged or deposited within offices or premises located anywhere.
(2) Loss of or damage to
   (a) furnishings, fixtures, supplies or equipment within an office of the Insured covered under this bond resulting directly from larceny or theft in, or by burglary or robbery of, such office, or attempt thereat, or by vandalism or malicious mischief, or
   (b) such office resulting from larceny or theft in, or by burglary or robbery of such office or attempt there at, or to the interior of such office by vandalism or malicious mischief, provided that
      (i) the Insured is the owner of such furnishings, fixtures, supplies, equipment, or office or is liable for such loss or damage, and
      (ii) the loss is not caused by fire.

BOND LITIGATION, supra note 5, at 9.


40. BOND LITIGATION, supra note 5, at 10.

41. In the 1980 version of Standard Form No. 24, Exclusion (u) eliminates coverage for "damages of any type for which the insured is legally liable, except direct compensatory damages arising from a loss covered under this bond." Id. at 11. Exclusion (w) eliminates coverage for "indirect or consequential loss of any nature." Id. These exclusions have remained essentially the same in the 1986 financial institution bond, although they are re-lettered. Id. at 16.
the causal connection between a loss and the loss-producing act must be of a highly proximate nature for coverage to be present.42

As with the term "directly," the bond does not define "false pretenses," and courts that have construed the term do not always adopt a consistent approach. For example, in *Clarendon Bank and Trust v. Fidelity and Deposit Co.*,43 the court defined false pretenses to be identical to fraud. The court in *Merchants- Produce Bank v.*
United States Fidelity and Guaranty Co., however, purposely refrained from defining the term, reasoning that an individual's ability to devise novel and illicit schemes was so great that no single definition should limit it.45

Despite these different interpretations, it is evident that the term "false pretenses" was intended to connote some form of misrepresentation.46 Therefore, to obtain coverage under the on premises insuring clause, Happyvale must first establish that it lost money as a direct result of one or more misrepresentations made by The Duck while he was on the bank's premises.

B. Coverage Under the On Premises Insuring Clause

In the event that a Bankers Blanket Bond claim falls within an exclusion, the exclusion eliminates coverage that otherwise exists.47 An exclusion does not turn a covered claim into a non-covered claim. It is appropriate, therefore, to first consider coverage under the on premises insuring clause without taking the bond's exclusions into account. Only to the extent that coverage is arguably provided should the exclusions then be analyzed.

At the outset, it appears that Happyvale should be covered under the on premises clause. Valentino concealed the fact that he filled in blanks on promissory notes and mortgage assignments without authority. He also falsely represented that none of the homeowners were chronically delinquent in repaying their loans, and that Star-Spangled Funding owned the obligations when, in fact, they had already been assigned to other banks. But for these misrepresentations that Valentino made on the bank's premises, Happyvale would not have entered into the loss-producing transactions. Stated more simply: Had Pokey known The Duck was a

45. Id. at 966.
46. The words in an insurance policy are to be construed according to the way a reasonable lay person would interpret them. See Howard, D&O Insurance Through the Looking-Glass: An Attitudinal Primer, 38 FED'N INS. & CORP. COUNS. Q. 163, 172 n.28 (1988). For this reason, when a term is not defined in the insurance contract, a court will often consider its dictionary definition in the hope of thereby approximating its ordinary and common meaning. Silverman & Lane, Rules of Construction in Insurance Policies, in INSURANCE, EXCESS, AND REINSURANCE COVERAGE DISPUTES 9, 22 (Practicing Law Institute 1989). False pretenses are defined as "[c]alculated misrepresentation[s] of fact for purposes of fraud, as through forged documents." THE AMERICAN HERITAGE DICTIONARY 488 (2d college ed. 1985). A court, therefore, may conclude that "false pretenses," as used in the Bankers Blanket Bond, refers to misrepresentations.
swindler, he would have called off the deal. Although this analysis is appealing in its simplicity, a closer examination of each category of loss in conjunction with the concept of direct or proximate causation reveals that coverage may not exist under the on premises insuring agreement.

1. Loans Prepaid in Full

Coverage under the on premises clause is least likely for loss attributable to prepaid loans. Coverage is unlikely because Valentino made no misrepresentations concerning these loans at or prior to the time Happyvale purchased them.

Although Happyvale may claim that Valentino promised he would prepay the bank should a borrower prepay him and that, but for this misrepresentation Happyvale would not have purchased any loans, its claim would fail for several reasons. First, the entire notion of such a mirror-image prepayment obligation conflicts with the terms of the Home Improvement Loan Participation Agreements. As indicated, these agreements required only that Valentino pay Happyvale principal plus sixteen percent interest on a monthly basis, regardless of whether the homeowners paid Valentino anything. Assuming that the contract contained a merger or integration clause, the parol evidence rule would prevent Happyvale from admitting into evidence an oral understanding with Valentino that conflicted with the terms of their written agreement.

Even if Happyvale established that Valentino had a mirror-image prepayment obligation, coverage under the on premises clause still may not exist. The most that Happyvale could establish is that, but for Valentino's misrepresentations, the bank would not

48. Merger or integration clauses provide that the contract represents the entire agreement between the contracting parties and they prohibit alteration except by another written instrument that the same parties have executed. BLACK'S LAW DICTIONARY 726, 892 (5th ed. 1979); J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS § 41, at 80-81 (West 3d ed. 1970).


Happyvale might argue that the parol evidence rule is exclusively intended to protect the parties to the contract and, therefore, should not apply in a coverage action between the bank and its insurer. In effect, Happyvale would contend that this rule is inappropriate because it would protect South Brook, a non-party to the Home Improvement Loan Participation Agreements. See generally Annotation, Applicability of Parol Evidence Rule in Favor of or Against One not Party to Contract of Release, 13 A.L.R.3d 313 (1967).
have entered into the transactions and, therefore, would not have sustained any loss. But for cause or cause in fact, however, is not equivalent to proximate or direct cause. According to the on premises insuring agreement, the insured must sustain loss that is directly caused by false pretenses.\textsuperscript{50} South Brook may assert that Valentino's false pretenses did not directly cause the loss. Instead, it would argue that the loss was directly caused by Valentino's failure to remit collected funds to the bank or by his breach of the Home Improvement Loan Participation Agreements. In either event, the absence of proximate cause between Valentino's false pretenses and Happyvale's loss would eliminate coverage under the on premises clause for loss arising from loans prepaid in full.

2. Promissory Notes and Mortgage Assignments Signed in Blank

South Brook may incur exposure for the losses Happyvale sustained on the notes and mortgages the homeowners signed in blank. Valentino caused these losses when he falsely represented that the homeowners voluntarily entered into the home improvement loan installment contracts and that Star-Spangled Funding held unblemished title to the paper it sold to Happyvale. Once again, however, South Brook may argue that these misrepresentations did not directly cause Happyvale's loss.

South Brook's causation defense rests upon Article 3 of the Uniform Commercial Code ("UCC"). South Brook must assert that Happyvale was a holder in due course of the commercial paper signed in blank because a holder in due course may enforce such


Causation in contract law is a function of the parties' intent at the time the contract is executed. In contrast to tort law, causation in contract law is supposedly divorced from considerations such as blame, foreseeability, deterrence, and risk spreading. See, e.g., Barmat v. John and Jane Doe Partners, 155 Ariz. 519, 523-24, 747 P.2d 1218, 1220-21 (1987); McDowell, Foreseeability in Contract and Tort: The Problems of Responsibility and Remoteness, 36 Case W. Res. L. Rev. 286 (1985). In the context of financial institution bonds, this Article contends that the case law does not recognize this distinction.
obligations against both the endorsers and makers.\textsuperscript{51} Arguably, Happyvale’s loss was caused directly by its unwillingness or inability to enforce the notes or foreclose on the mortgages.\textsuperscript{52} Alternatively, South Brook may argue that Happyvale’s inability to enforce the terms of the Home Improvement Loan Participation Agreements against Star-Spangled Funding was the direct cause of the loss.\textsuperscript{53}

\begin{itemize}
\item \textsuperscript{51} 6 R. Anderson, Anderson on the Commercial Code § 3-407, at 210 (3d ed. 1984). Section 3-302 of the UCC provides in part:
\begin{itemize}
\item (1) A holder in due course is a holder who takes the instrument
\item (a) for value; and
\item (b) in good faith; and
\item (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person . . . .
\end{itemize}
\item \textsuperscript{52} 5 R. Anderson, Anderson on the Commercial Code § 3-302, at 484 (3d ed. 1984).
\end{itemize}


53. It is not absolutely certain that Happyvale would be deemed a holder in due course or a good faith purchaser for value. A holder in due course must purchase an
Happyvale could recover its loss under one set of circumstances. If Happyvale established that it spent good money to purchase worthless paper as a direct result of Valentino's false pretenses, then it could recover. But, Happyvale did not purchase worthless paper because it had, and still has, viable causes of action against Valentino, Star-Spangled Funding, and the homeowners, even if they all turn out to be judgment-proof. Happyvale purchased legally enforceable obligations and, thus, may not argue that it sustained a loss at the time it purchased participation interests in the home improvement loans. As such, it may not be said that loss sustained by Happyvale from instruments signed in blank directly caused its loss and the on premises insuring agreement should not,

instrument in good faith and without notice of any defenses. See 5 R. ANDERSON, ANDERSON ON THE COMMERCIAL CODE § 3-302, at 484 (3d ed. 1984). Given Happyvale's failure to conduct an investigation prior to executing the Home Improvement Loan Agreements and its failure to probe the source of the phantom funds that Valentino remitted, it may be argued that the bank was not a holder in due course because its conduct failed to satisfy the preconditions of good faith, and purchasing without notice of defenses that might be asserted by the borrowers. See Adams v. Madison Realty Dev. Inc., 853 F.2d 163 (3d Cir. 1988) (bank purchasing promissory notes not a holder in due course because the notes were endorsed on separate, unattached pages but the bank nonetheless failed to inquire regarding this anomaly). For an analysis of good faith reliance as a precondition to coverage under Insuring Agreement (E), see infra notes 130-40 and accompanying text. Even if Happyvale is not deemed a holder in due course because its behavior evidenced bad faith, it will not necessarily be covered for loss caused by instruments signed in blank because an insured may not be reimbursed, through insurance or otherwise, for the consequences of its intentional misconduct. Howard, supra note 46, at 179-80. Moreover, it is unclear whether any party to coverage litigation would willingly argue that Happyvale was not a holder in due course. South Brook will hesitate to make such an argument in order to preserve its proximate cause defense under the on premises insuring clause. Happyvale will also hesitate to make such an argument to maximize the likelihood of finding coverage under Insuring Agreement (E). See infra notes 130-40 and accompanying text. Therefore, unless the court were willing to rule sua sponte that Happyvale was not a holder in due course, which is unlikely, it is quite possible that the issue would never arise.

54. If Happyvale had purchased warehouse receipts purporting to represent non-existent stock, then it might validly be concluded that it paid good money for worthless paper. In this scenario, assuming the false representations regarding the contents of the warehouse were made on the bank's premises, coverage would arguably exist under the on premises clause. Similarly, coverage would exist if Valentino, rather than completing notes signed in blank without authority, had sold notes with signatures forged by a third party. In this situation, however, coverage for the loss should exist under Insuring Agreement (D) (forgery or alteration), rather than under the on premises clause. The bond sets forth several parallel exclusions that, when read together, provide that if the principal cause of a loss consists of a specific form of behavior, then the bank may seek coverage only under the insuring clause designed to afford reimbursement for loss caused primarily by such behavior. See infra note 57 and accompanying text. The apparent object of these provisions is to avoid overlapping coverage and the conundrum of concurrent causation issues.
therefore, provide coverage for such loss.\footnote{See supra notes 42, 52.}

3. Multiple Pledging

Whether there is coverage for loss caused by Valentino’s multiple sales of the same promissory notes and mortgage assignments depends on when the paper was sold to financial institutions other than Happyvale. Timing is also important because it determines whether The Duck’s false pretenses were the proximate cause of Happyvale’s loss.

If the other institutions purchased the paper before Happyvale did, then The Duck’s false representation to Pokey that he owned the notes and mortgages was arguably the direct cause of Happyvale’s loss. Under these circumstances, Valentino’s misrepresentations would appear to satisfy the dual requirements of cause in fact and proximate cause. Happyvale’s causation argument is more problematic if the loans were sold to other banks after it purchased them. In this event, The Duck’s representation at the time of purchase would not have been false and, therefore, would not have caused Happyvale to sustain loss. Rather, as was true for the notes and mortgages signed in blank, Happyvale would have received precisely what it bargained for at the time it parted with the purchase price.\footnote{See supra notes 52-55 and accompanying text.} Its subsequent loss would have been caused by three occurrences for which the on premises clause does not provide coverage: first, Valentino’s subsequent fraud; second, Happyvale’s inability or unwillingness to enforce the notes or foreclose on the mortgages; third, the bank’s inability to enforce the terms of the Home Improvement Loan Participation Agreements.

4. Loans Made to Delinquent Borrowers

As with those loans that were pledged severally, coverage for loans made to delinquent borrowers may depend on when each borrower became delinquent. If The Duck sold notes to Happyvale after the homeowners defaulted on their repayments, then the bank may argue that it would not have purchased the notes and, therefore, would not have sustained a loss but for his misrepresentations.

Even under this scenario, however, South Brook may have a good coverage defense if it argues that the loss was not caused directly by Valentino’s false pretenses, but rather by the homeown-
ers' failure to fulfill their obligations after his disappearance in October 1983. South Brook may also argue that Happyvale's loss was caused directly by its inability or unwillingness to enforce the notes or foreclose on the mortgages. Finally, the insurer may argue that the bank's loss was directly caused by its inability to recover from Star-Spangled Funding under the Home Improvement Loan Participation Agreements.

Assuming that the homeowners were making timely payments prior to Happyvale's purchase, South Brook would have a much stronger causation defense because The Duck would not have misrepresented the status of these loans at the time of purchase. To the contrary, he represented that he would sell participation interests in notes that were being timely repaid and he would have done just that.

C. Proximate Cause

The foregoing analysis of Happyvale's claim reveals that South Brook may legitimately argue that there is no coverage under the on-premises insuring clause because no loss was caused directly by The Duck's false pretenses made on the premises of the bank. This coverage defense, however, is not definitive. The concept of proximate cause under the Bankers Blanket Bond has not evolved enough to support unequivocally South Brook's causation defense.\[57\] Although it is clear that the bond provides coverage only

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57. Prior to 1976, the bond's insuring clauses provided coverage for losses sustained "through" the various hazards for which coverage was provided. See Hinchey, Causation and Loss, in Banking: The Revised Bankers Blanket Bond and D&O Liability Insurance Coverage (Nov. 4, 1982) (Banking Law Institute seminar materials). Even then, sureties contended that the bond was designed only to provide coverage for loss caused directly by the action or behavior referenced in the insuring clauses and some courts agreed. See, e.g., Miami Nat'l Bank v. Pennsylvania Ins. Co., 314 F. Supp. 858 (S.D. Fla. 1970); Dirk v. Amerco Mktg. Co., 88 Wash. 2d 607, 565 P.2d 90 (1977). Most courts held otherwise. See, e.g., Fidelity and Deposit Co. of Md. v. USAFORM Hall Pool, Inc., 573 F.2d 744, 75 (5th Cir. 1975), cert. denied, 442 U.S. 950 (1976); Maryland Casualty Co. v. American Trust Co., 71 F.2d 137 (5th Cir.), cert. denied, 293 U.S. 583 (1934). Probably in response, the Surety Association of America (the "Association") dispensed with the term "through." In 1976, it drafted a rider that replaced the term with the phrase "loss resulting directly from." In 1980, the Association placed the phrase in the Standard Form. See generally Bassett, Direct Loss Under the Fidelity Insuring Agreement of the Financial Institution Bond, 54 DEF. COUNS. J. 487 (1987); Causation and Loss, supra; Hinchey, supra note 5, at 9-9.

The issue of concurrent causation is another issue a lawyer should bear in mind. The bond's exclusions section attempts to diminish the problems associated with concurrent causation. The exclusions section provides that if a covered peril is primarily responsible for a loss, then the insured only may invoke the insuring agreement covering that peril. This restriction exists even if another clause might otherwise provide coverage for loss...
for “direct loss,” that term has never attained a precise meaning. Indeed, direct loss probably defies uniform definition because the very concept of proximate cause is one of the most chameleon-like in the law.

In insurance law, the meaning of proximate cause is highly fact sensitive. It changes as a function of different kinds of loss-producing events and different insuring clauses in a policy or bond. The

caused by a hazard that is secondarily present in the same situation leading to the loss. For example, Exclusion § 2(a) provides that the bond does not cover “loss resulting directly or indirectly from forgery or alteration, except when covered under Insuring Agreements (A), (D), (E), or (F).” BOND LITIGATION, supra note 5, at 10. Thus, if false pretenses are accomplished through forgery or alteration, then there can be no coverage under the on premises insuring agreement. Similarly, Exclusion § 2(h) eliminates coverage for “loss caused by an employee, except when covered under Insuring Agreement (A).” Id. Even if a dishonest or fraudulent employee causes loss through forgery, alteration, false pretenses, or counterfeit securities, coverage will exist only if his acts fall within the Fidelity Insuring Agreement. Id. Every insuring agreement in the bond has a corresponding exclusion functionally analogous to these examples. Id. at 8-11.

58. The term “direct loss” can be found at the beginning of each insuring clause in the standard form. See BOND LITIGATION, supra note 5, at 9. A carrier may draft its policy to avoid the inherent problems associated with determining coverage in concurrent cause situations. Such a policy was the subject of State Farm Fire & Casualty Co. v. Martin, 668 F. Supp. 1379 (C.D. Cal. 1987). In Martin, the insurer issued a homeowner’s policy that excluded coverage for loss caused by water damage and earth movement. Id. at 1382. The homeowner sought reimbursement for damage caused by a combination of covered and excluded causes. Id. at 1380. The policy provided that if concurrent causes were responsible for a loss, then there would be no coverage if excluded causes were as directly responsible for the loss as covered causes. Id. at 1382. The court upheld the policy language and granted summary judgment for the carrier. Id. at 1383.

Although any insurer may draft its policy in this fashion, this approach is not necessarily desirable because it reduces coverage. This may tempt insureds to pay a reduced premium for less coverage, which is proper only if they understand the limitations inherent in the policy issued. On the other hand, when the insured’s house is destroyed by earthquake, flood, or fire, and coverage is unequivocally absent due to a non-covered concurrent cause, the public policy goals served by insurance will not have been accomplished. Each insurer must make its own cost/benefit analysis, balancing the marketability of its policy against liability for coverage that it may never have intended to provide. Notwithstanding the equitable predispositions of many courts resolving coverage disputes, insureds should also analyze the costs and benefits of purchasing greater or lesser amounts and types of coverage. For a more detailed analysis of these concerns, see Oettle & Howard, “Zuckerman and Sparks”: The Validity of “Claims Made” Insurance Policies as a Function of Retroactive Coverage, 21 TORT & INS. L.J. 659 (1986).


60. R. KEETON & A. WIDISS, supra note 1, § 5-5, at 545-63.
decision to deem a cause proximate is, to a large extent, an unarticulated, equity-based conclusion that one party, rather than another, should bear the loss. These equitable decisions are based on factors such as comparative blameworthiness, future deterrence of undesirable conduct, financial capacity to pay, sympathy for policyholders, or enmity toward insurance companies. For this reason, direct loss remains undefined in the new financial institution bond.

The insurance industry’s inability to create a generic definition for direct loss has two adverse consequences for bonding companies. First, notwithstanding the fact that adoption of the term direct loss was designed to limit coverage, the case law for the most part has remained unchanged since the incorporation of that term into the insuring clauses in the standard form. Second, and also in spite of the motivation behind the change in nomenclature, the revision may have actually expanded coverage. The terminology is now so amorphous that it tends to activate the doctrine of ambiguity. With respect to Happyvale’s bond, and assuming coverage

61. Id. See also R. Keeton, Basic Text on Insurance Law 306-20 (1971).
63. Bond Litigation, supra note 5, at 13-25.
64. See supra note 57.
65. The doctrine of ambiguity provides that if the wording of an insurance policy is subject to more than one reasonable interpretation, then the court should choose the interpretation that favors coverage. Silverman & Lane, supra note 46, at 11. This presumption is based largely on the assumptions that insurance policies are contracts of adhesion, that the insureds exercise no bargaining power in their formation, and that the insurer is far more sophisticated than the insured with respect to insurance law concepts. See B. Ostrager & T. Newman, supra note 11, at 1-29. For this reason, the courts will dispense with the doctrine of ambiguity when both parties to an insurance contract are insurance companies. Liberty Mut. Ins. Co. v. Gibbs, 773 F.2d 15, 17 (1st Cir. 1985); Great Am. Ins. Co. v. Fireman’s Fund Ins. Co., 481 F.2d 948, 954 (2d Cir. 1973); Fortress Reinsurance, Inc. v. Jefferson Ins. Co., 465 F. Supp. 333, 338 (E.D.N.Y.), aff’d, 629 F.2d 860 (4th Cir. 1980). Recently, many courts have dispensed with the doctrine when the insured, even though not an insurer, is highly sophisticated in matters relating to insurance. See MGIC Indem. Corp. v. Central Bank, 838 F.2d 1382, 1387 (5th Cir. 1988); First State Underwriters Agency v. Travelers Ins. Co., 803 F.2d 1308, 1314 n.5 (3d Cir. 1986). See also Werner Indus., Inc. v. First State Ins. Co., 112 N.J. 30, 38, 548 A.2d 188, 192 (1988). In Werner Industries, the court dispensed with contra-insurer presumptions with respect to commercial insurance purchased by a sophisticated corporation, but noted that it would be willing to apply such presumptions to personal insurance issued to unsophisticated individuals. Id. Although most commentators distinguish among the contra-insurer “doctrines” of ambiguity, reasonable expectations, public policy, and unconscionability, they are in fact separate points along a linear continuum that merge into one another at the interstices. See Howard, supra note 46, at 165-71.

Bonding companies have attempted to eliminate the impact of these contra-insurer doctrines. They have characterized the standard form as arising from a joint effort by the
litigation ensued between the bank and South Brook, a court could rely upon the doctrine of ambiguity to resolve each issue of proximate cause against the insurer and, thus, sustain the bank’s claim for reimbursement under the on premises clause.

D. The Function and Application of the Bond’s Loan Exclusion

South Brook should not conclude that the complexity of proximate cause and the doctrine of ambiguity preclude a definitive coverage defense under the on premises insuring clause because the foregoing coverage analysis was conducted without considering the bond’s exclusions. If South Brook invokes the bond’s loan exclusion, then it may eliminate or reduce any coverage that would otherwise be found under the bond’s on premises insuring clause. The loan exclusion eliminates coverage for loss caused directly or indirectly by default on a loan or any other transaction that is functionally equivalent to a loan.

The loan exclusion has strong public policy underpinnings. Banks are in the business of making loans and the blanket bond is not designed to serve as a safety net in the event the bank makes a loan. See Surety Association of America and the American Bankers Association. Therefore, they argue that the bond was bargained for by both parties to the contract, or at least by their representatives. For the most part, courts have rejected this argument. They require that the bargaining take place between the actual parties (surety and bank) to the particular bond at issue. See, e.g., First Nat’l Bank of Decatur v. Insurance Co. of N. Am., 424 F.2d 312 (7th Cir.), cert. denied, 398 U.S. 939 (1970); Clarendon Bank & Trust v. Fidelity & Deposit Co. of Md., 406 F. Supp. 1161, 1164 (E.D. Va. 1975); Shoals Nat’l Bank of Florence v. Home Indem. Co., 384 F. Supp. 49 (N.D. Ala. 1974), aff'd, 515 F.2d 1182 (5th Cir. 1975). But see Sharp v. FSLIC, 858 F.2d 1042 (5th Cir. 1988); National Bank of Commerce v. Fidelity Casualty Co. of N.Y., 312 F. Supp. 71 (E.D. La. 1970), aff’d, 437 F.2d 96 (5th Cir.), cert. denied, 403 U.S. 906 (1971). See also Dingus & Haley, The Doctrine of Contra Proferentum in Fidelity Coverage Cases, 10 FORUM 75 (1974); Kirwan, Bankers’ Blanket Bonds: Contracts of Adhesion? 43 INS. COUNS. J. 386 (1976); Meter, Contracts of Adhesion and the Doctrine of Fundamental Breach, 50 VA. L. REV. 1178 (1964).

The loan exclusion provides:

This bond does not cover . . . loss resulting directly or indirectly from the complete or partial non-payment of, or default upon, any loan or transaction in the nature of a loan or extension of credit, whether involving the Insured as a lender or as a borrower, including the purchase, discounting or other acquisition of false or genuine accounts, invoices, notes, agreements or Evidences of Debt, whether such loan or transaction was procured in good faith or through trick, artifice, fraud or false pretenses, except when covered under Insuring Agreements (A) [fidelity], (D) [forgery or alteration], or (E) [securities].

BOND LITIGATION, supra note 5, at 10 (emphasis added).

Given that insurance companies draft the policies, it should come as no surprise that while insuring clauses limit coverage to direct loss, the exclusions encompass loss caused “directly or indirectly” by the relevant act. Id.
bad loan based on a bad business decision. Financial bond coverage for bad business decisions would discourage banks from instituting adequate internal controls, such as checking the credit references of borrowers, which help prevent the loss at the outset.68

It is precisely because of this concern that the loan exclusion does not apply to coverage afforded under the fidelity, forgery, alteration, or securities insuring clauses.69 No matter how scrupulous bank officials are, beyond a certain point, there is little they can or should do to reduce the number of losses caused by an employee's dishonesty or by the institution's innocent reliance on forged, altered, or counterfeit documents. Under the Fidelity Insuring Agreement, it would seem that a bank could reduce losses by adopting more rigorous hiring and monitoring standards. Case law surveys, however, disclose that sophisticated, high-ranking personnel, who are long-time employees, are responsible for a disproportionate share of dishonesty-related losses.70 Even when financial transactions were less complex and less computerized, the real danger was never that tellers would steal money from the cash drawer or that customers would take pens, but rather that senior executives would embezzle substantial funds over long periods of time without being discovered. Increased scrutiny, undertaken when these executives commence employment, probably would not reduce the likelihood of future loss.

As for the forgery, alteration, and securities insuring clauses, a sophisticated financial institution presumably could discern many more forged, altered, or counterfeit documents before disbursing funds in reliance on such paper. However, banks process a high volume of these documents and the administrative cost of investigating the authenticity of each piece of paper, or the accuracy of its representations, arguably would be prohibitive. Hence, there is no strong policy argument against coverage for such losses.71

68. President Pokey's actions exemplify this concern. He believed that any Duck-related loss would be covered by South Brook. This mind-set evidently lulled him into a false sense of security that accentuated his carelessness.
69. See supra note 66.
70. See Skillern, Insuring Agreement (A) - Fidelity, in ANNOTATED BANKERS BLANKET BOND 53 (1980 & Supp. 1983); Seeman, Dishonest or Fraudulent Acts, in THE COMMERCIAL BLANKET BOND ANNOTATED 13-22 (A.B.A. 1985). Although Insuring Agreement (A) is limited by its terms to employees, it is fairly typical for a bank to purchase a rider that expands the definition of "employee" to include officers and directors.

There is a difference between extending credit on the basis of pledged counter-
E. Application of the Loan Exclusion

Even though the first clause in the loan exclusion, which excludes coverage for loss caused by default on a loan or any other transaction in the nature of a loan or extension of credit, is fairly unambiguous, the second clause is much less clear. The second clause excludes coverage for loss caused by the purchase, discounting, or other acquisition of accounts, invoices, notes, agreements, or evidences of debt. Case law has failed to interpret the second clause consistently. If the Happyvale-Valentino transaction is not considered a loan, then this judicial inconsistency has considerable implications for Happyvale's claim.

One line of cases holds that the second clause modifies the first
clause by expanding the definition of a loan. Alternatively, some courts hold that the second clause of the exclusion is, in effect, a separate exclusion for transactions that possess some indicia of a loan, but not enough to constitute a loan under the first clause. Under this formulation, the term loan exclusion is a misnomer when applied to the second clause. Given these different interpretations, the loan exclusion may be applied to Happyvale's loss in several different ways. Some applications eliminate coverage entirely, whereas others merely reduce it.

1. Viewing the Entire Transaction as a Loan from Happyvale to Valentino

South Brook should argue that the entire transaction between Happyvale and Valentino was, in substance, a loan or series of loans, rather than a sale or assignment of commercial paper. This argument avoids the confusion inherent in construing the loan exclusion's second clause. Of greater significance, because The Duck's failure to repay the loans would have directly or indirectly caused Happyvale's entire loss, there can be no coverage under the on premises insuring agreement.

To determine whether a transaction is a loan, courts look to substance, rather than form, and focus on written contracts in an effort to determine the intent of the parties. Intent, however, as reflected in the terms of a contract, is not conclusive because the parties may have intended to use their contract to disguise a loan as a sale of commercial paper.

76. There are a variety of reasons why a borrower and a lender might seek to disguise a loan. Some typical justifications include: avoidance of federal lending limit laws, known as "overline violations," 12 U.S.C. §§ 84, 93 (1982); avoidance of proscribed involvement by a bank in real estate investments, particularly when a loan is made to an affiliate of the financial institution, known as a "controlling person," 12 C.F.R. §§ 32.1 to 32.111 (1988), 18 U.S.C. § 1005 (1982); and avoidance of subsequent characterization of the loan as usurious under applicable state law. Usury and collection of unlawful debts are predicate acts under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18
Because the term "loan" is not defined in Happyvale's bond, a court will consult case law in search of an appropriate definition.\textsuperscript{77} New Jersey law will control the issue because the bond was issued in New Jersey, the loss occurred in New Jersey, and there was no alternative choice of law provision in the bond or the loan participation contract.\textsuperscript{78} The court will find that in New Jersey, as elsewhere, a loan has two primary elements: first, the lender advances money to another party, the borrower; and second, the borrower agrees to repay the money to the lender in the future, often with interest.\textsuperscript{79}


\textsuperscript{78} The 1986 version of Standard Form No. 24 provides that a loan encompasses "all extensions of credit by the Insured and all transactions creating a creditor relationship in favor of the Insured and all transactions by which the Insured assumes an existing creditor relationship." \textit{BOND LITIGATION}, \textit{supra} note 5, at 23. Under this definition, South Brook probably would have an easier time proving that the Happyvale-Valentino transaction was, in substance, a loan rather than a sale or assignment of commercial paper.

\textsuperscript{79} Conflict of Law issues are beyond the scope of this Article; therefore, the hypothetical does not raise conflict issues. New Jersey law would control substantive issues in either state or federal court. \textit{See generally} R. LEFLAR, \textit{AMERICAN CONFLICTS LAW} § 144, at 353-55 (2d ed. 1977); E. SCOLES & P. HAY, \textit{CONFLICTS OF LAWS} 675-76 (West 1982); R. WEINTRAUB, \textit{COMMENTARY ON CONFLICT OF LAWS} 348-97 (2d ed. 1980).

\textsuperscript{77} Freeman adsm. Brittin, 17 N.J.L. 191, 231 (Sup. Ct. 1839) ("The incidents appertaining to a contract for the loan of money are few and simple; an advancement of money, by the lender at the time of the contract, and a stipulation or agreement to repay it and generally with interest, at a future day, by the borrower or some other person in his behalf and on his account."). \textit{Accord} Calcasiere-Marine Nat'l Bank of St. Charles v. American Employers' Ins. Co., 533 F.2d 290, 296-97 (5th Cir.), \textit{cert. denied sub nom.}, Louisiana Bank & Trust Co. v. Employers Liab. Assurance Corp., 429 U.S. 922 (1976); Tierman v. Carasalja Pines, 51 N.J. Super. 393, 404-05, 143 A.2d 892, 898 (App. Div. 1958). Even though the court will look to New Jersey law to construe the policy, this definition of a loan is universally accepted. \textit{See BLACK'S LAW DICTIONARY} 844 (5th ed. 1979); \textit{THE AMERICAN HERITAGE DICTIONARY} 738 (2d College ed. 1985). As noted earlier, courts also are prone to consult dictionary definitions to ascertain the meaning that should be attributed to undefined terms in a standardized contract. \textit{See supra} note 46. Although the definition of a loan does not require that interest accompany repayment of principal, a court deciding a blanket bond coverage action will be more likely to find a loan if the payment of interest is, in fact, required. \textit{See} Hartford Accident & Indem. Co. v. FDIC, 204 F.2d 933, 936-37 (8th Cir. 1953).
Given these standards and the definition of a loan, the Happyvale court may reasonably conclude that Happyvale made a loan to Valentino. At the time each package of loans was purchased, Happyvale advanced a sum of money to Valentino. Valentino was in turn required to repay these sums to Happyvale in the future, along with sixteen percent interest per annum. Although in form the transactions between Happyvale and The Duck masqueraded as sales or assignments of commercial paper, in substance they memorialized loans.

No New Jersey court has addressed the loan issue in the blanket bond context. Several other jurisdictions, however, have determined in similar circumstances that a transaction was a "loan" for purposes of applying the blanket bond's loan exclusion. In these cases, the banks argued that the commercial paper had been sold or assigned to them. But, the courts looked beyond the form of the transactions as memorialized in the contracts and found, instead, that the banks had made loans that were collateralized by the commercial paper. The decision in In re Grand Union Co. is particularly persuasive in the Happyvale context. Even though the case did not involve coverage under a blanket bond, the court primarily addressed whether a transaction was either a loan collateralized by commercial paper or the sale of commercial paper and concluded that the transaction was a loan.

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80. Characterizing the transaction as a loan is further supported by the fact that Valentino repaid Happyvale until October 1983. These repayments were made notwithstanding the fact that many of the homeowners defaulted on their obligations to pay The Duck.


82. First Nat'l Bank & Trust Co., 510 F.2d at 11; Twin City Fed. Sav. & Loan Ass'n, 413 F.2d at 495; North Carolina Nat'l Bank, 335 F.2d at 487.

83. First Nat'l Bank & Trust Co., 510 F.2d at 11, 12; Twin City Fed. Sav. & Loan Ass'n, 413 F.2d at 499; North Carolina Nat'l Bank, 335 F.2d at 487.

84. 219 F. 353 (2d Cir. 1914), appeal dismissed, 238 U.S. 647 (1915).

85. Id. at 356-59. In Grand Union, the seller owned installment promissory notes that obligated underlying borrowers to repay the purchase price of pianos. Id. at 360. A corporation purchased a fixed percentage of the face amount of each note and the installment loan contracts then were assigned to the corporate purchaser. The seller, for additional consideration, was to collect all payments due under the notes and remit them to the corporation. In other words, the seller was to act in the separate capacity of servicing contractor. Id. If any underlying borrower defaulted, then the agreement provided that the seller would repurchase the notes. Id. at 361 Testimony adduced at trial established
In *Grand Union*, the written contract between the parties described their agreement as a sale of commercial paper with the seller acting as a servicing contractor. The court focused on the substance of the transaction, paying particular attention to three circumstances. First, the seller had continuing responsibility for collecting payments due on the notes. Second, the seller had continuing responsibility to repay the purchaser even if an underlying borrower defaulted. Third, the seller was obligated, at the request of the purchaser, to repurchase the notes in the event that an underlying borrower defaulted. The court reasoned that if there had been a true sale of commercial paper, then the seller would not have retained these post-sale obligations. Therefore, the court held that the transaction was in substance a loan and that the promissory notes merely collateralized that loan.

The federal securities laws similarly support South Brook’s argument that the relationship between Happyvale and Valentino should be characterized as a loan. When parties to loan participation agreements are damaged and seek redress in federal court, they invoke jurisdiction under the federal securities laws by claiming that the loan participation was a security. Defendants have often moved to dismiss these actions on the ground that a loan participation is not a security. The majority of courts have agreed, noting that the purchase of a participation interest in a loan is itself a commercial loan transaction rather than a form of investment.

that the seller paid the corporate purchaser out of its general funds and that the purchaser looked only to the seller, rather than to the pianists, for a return on its investment. *Id.*

86. *Id.* at 354-55.
87. *Id.* at 356.
88. *Id.* at 361.
89. *Id.* at 361-62. With respect to servicing the loans, there is no reason why a seller of commercial paper should not also have the right to separately function as a servicing contractor, as would someone who acted exclusively in that capacity.
90. *Id.* at 359. See also Merchants’ Nat’l Bank v. First Nat’l Bank, 238 F. 502 (8th Cir. 1916). In *Merchants’ National Bank*, the court held that the purported sale of promissory notes by one bank to another was in fact a loan. *Id.* at 507. In reaching this conclusion, the court focused on the seller’s obligation to guarantee repayment and repurchase. The court thought that these conditions were consistent with collateralizing a loan but not with the true alienation of an asset. *Id.*
In sum, the substance of the Happyvale-Valentino transactions indicates that the Home Improvement Loan Participation Agreements memorialized loans. This conclusion is supported by the traditional definition of a loan, the cases construing similar transactions, and the *dicta* in the securities actions. Therefore, South Brook may successfully invoke the bond’s loan exclusion to exclude coverage for any loss caused directly by The Duck’s false pretenses.

2. Viewing the Transaction as a Purchase of Evidences of Debt

Should a court decline to treat the Happyvale-Valentino transaction as a loan and construe the second part of the loan exclusion as a narrower exclusion for transactions with only some indicia of a loan, South Brook may still argue that the exclusion is applicable. This argument succeeded in *United Virginia Factors v. Aetna Casualty and Surety Co.*93 In *United Virginia Factors*, the insured purchased eighty-five percent of the face amount of fictitious accounts receivable and then reported a loss under its blanket bond resulting from false pretenses.94 Although the court held that the transaction was not a loan and that the second clause of the loan exclusion was separate and narrower than the first, it nonetheless denied coverage.95 The *United Virginia Factors* court concluded that the nonpayment of notes, accounts, or other evidences of debt that were sold to the insured caused all the loss.96 The court held

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93. 624 F.2d 814 (4th Cir. 1980).
94. *Id.* at 815.
95. *Id.* at 816.
96. *Id.* at 818.
that this was precisely the type of loss for which coverage was excluded by the second clause of the bond's loan exclusion.\textsuperscript{97}

If Happyvale's claim is subjected to the same analysis adopted by the court in \textit{United Virginia Factors}, then coverage under the on premises insuring clause will be excluded by the second part of the loan exclusion. Coverage will be excluded even if a court finds that the Happyvale-Valentino transactions did not constitute a loan or series of loans. On the other hand, if the second part of the loan exclusion is applied more restrictively than in \textit{United Virginia Factors} (i.e., only in the event that a homeowner defaulted), then coverage will depend on the type of loans that caused each loss that the bank sustained.

\textit{a. Loans Prepaid in Full}

The exclusion will not eliminate coverage for losses attributable to loans prepaid in full because the homeowners did not default. Rather, they satisfied their obligations in full when they prepaid Valentino. This is not of great consequence because there will still be no coverage for this category of loss. The Duck did not misrepresent the status of these loans on the bank's premises at or prior to the time Happyvale purchased its participation interests in these loans.\textsuperscript{98}

\textit{b. Notes and Mortgage Assignments Signed in Blank}

The exclusion will not eliminate coverage if the court finds that the borrowers had no obligations with respect to documents fraudulently completed and sold by Valentino because, by definition, a borrower without an obligation to repay may not be deemed to have defaulted. Under section 3-407 of the UCC,\textsuperscript{99} however, he who signs an incomplete instrument is liable to a subsequent holder in due course even after the instrument is completed by a third party without consent.\textsuperscript{100} Thus, a court should rule that the borrowers were obligated to repay, that Happyvale's loss was thus caused directly or indirectly by their default, and that coverage is therefore excluded by the second portion of the loan exclusion.

\textsuperscript{97} \textit{Id.}

\textsuperscript{98} \textit{See supra} notes 48-50 and accompanying text.


even under its most pro-insured interpretation.101

c. **Multiple Pledging**

The exclusion will not eliminate coverage if the homeowners paid financial institutions other than Happyvale. In this event, Happyvale's loss would not have been caused directly or indirectly by their default because they did not default. Coverage would be excluded if the homeowners made no payments to any bank because, in that event, it would be proper to conclude that Happyvale's loss resulted directly or indirectly from their default.

d. **Loans Made to Delinquent Borrowers**

The exclusion will eliminate coverage for loss caused by loans made to delinquent borrowers because the loss resulted directly or indirectly from the homeowners' failure to make any payments. Such loss fits squarely within the exclusionary language of the second portion of the loan exclusion, no matter how it is construed.

F. **A Comment on Coverage Under the On Premises Clause**

By relying on the proximate cause requirement in Insuring Agreement (B) and on the second part of the bond's loan exclusion, South Brook may eliminate or substantially reduce any coverage that might otherwise exist under the on premises insuring clause. And, by relying on the first part of the loan exclusion, South Brook has the best chance of avoiding coverage for the entire claim. To succeed, South Brook must characterize the entire transaction between Happyvale and The Duck as a loan. Once this characterization is accepted, no court will hold that Valentino's default was neither directly nor indirectly related to Happyvale's loss.

Definitive predictions are nonetheless difficult because the requirement of direct loss in the on premises clause is difficult to define and the second part of the loan exclusion is subject to vary-

101. Experience indicates that many courts are loathe to undertake analysis as complex as this. Rather, they are more likely to throw up their hands at the complexities of the second clause of the loan exclusion and rule for the insured on the grounds of ambiguity, reasonable expectations, public policy, or unconscionability. For this very reason, when an insurer's only defense to coverage is found in the second clause of the loan exclusion, it should consider settlement rather than litigation. As a result, the insurer will avoid an unfavorable reported decision. To this end, insurers that lose at the trial level will often settle while the case is pending appeal, but only on the condition that the disposition below is vacated by the appellate court to wipe the slate clean. See 11 INSURANCE LITIGATION REPORTER 96-97 (1989).
ing interpretations. The best prediction is that the loan exclusion proper will eliminate any possibility of coverage under the on premises insuring clause because the Happyvale-Valentino transactions satisfy the accepted definition of a "loan." This result would be consistent with the public policy that underlies the exclusion, namely, to deter financial institutions from sustaining loss caused by bad business decisions. This policy is promoted by eliminating insurability for such loss, which in turn creates an incentive for an insured bank's managers to act more prudently. President Pokey, and others like him, evidently require just such an incentive.

V. COVERAGE UNDER INSURING AGREEMENT (D):
"FORGERY OR ALTERATION"102

Insuring Clause (D) provides coverage for loss resulting directly from the forgery or alteration of documents103 on which the banking industry frequently relies. To determine whether a particular loss is covered under this insuring clause, it is necessary to decide whether an act of forgery or alteration has occurred, the forged or altered document falls within the category of writings for which the clause provides coverage, and whether the causal connection between the forgery or alteration and the loss is sufficiently proximate to satisfy the insuring clause's requirement of "direct" loss.104

102. The forgery or alteration insuring agreement, denominated Insuring Agreement (D), covers:

Loss resulting directly from

(1) Forgery or alteration of, on or in any Negotiable Instrument (except an Evidence of Debt), Acceptance, withdrawal order, receipt for the withdrawal of Property, Certificate of Deposit or Letter of Credit.
(2) Transferring, paying or delivering any funds or Property or establishing any credit or giving any value on the faith of any written instructions or advices directed to the Insured and authorizing or acknowledging the transfer, payment, delivery or receipt of funds or Property, which instructions or advices purport to have been signed or endorsed by any customer of the Insured or by any banking institution but which instructions or advice either bear a signature which is a Forgery or have been altered without the knowledge or consent of such customer or banking institution. Telegraphic, cable or teletype instructions or advices, as aforesaid, exclusive of transmissions of electronic funds transfer systems, sent by a person other than the said customer or banking institution purporting to send such instructions or advices shall be deemed to bear a signature which is a forgery.
A mechanically reproduced facsimile signature is treated the same as a handwritten signature.

BOND LITIGATION, supra note 5, at 9.

103. The documents covered include negotiable instruments (except evidences of debt), acceptances, withdrawal orders, receipts for the withdrawal of property, certificates of deposit, and letters of credit. Id.

104. See generally Connally, Forgery or Alteration, in BANKERS AND OTHER FINAN-
The bond defines forgery as "the signing of the name of another with intent to deceive," and, even in the absence of such a definition, case law is generally in accord. Neither Valentino nor anyone else signed the name of another to any of the documents at issue. Therefore, South Brook will have no exposure under the forgery component of the forgery or alteration insuring agreement.

In contrast to forgery, the term "alteration" is not defined in the Bankers Blanket Bond. The only loss-producing act that arguably could constitute alteration would be Valentino's unauthorized completion of instruments signed in blank by the homeowners. Absent a definition of alteration, a court must look to case law. Case law, however, has not rendered a clearly accepted definition. Many decisions define alteration as a change in a document that is already legally complete. Under this line of authority, The Duck's unauthorized completion of promissory notes or mortgage assignments would not amount to alteration because the documents were not legally complete when he engaged in such conduct.

There is, however, other authority indicating that the unauthor-
ized completion of an incomplete instrument may indeed constitute alteration. Criminal and civil statutes in New Jersey plainly state that alteration encompasses the unauthorized completion of promissory notes and other evidences of debt. New Jersey's Commercial Code provides that alteration includes a change in "an incomplete instrument, by completing it otherwise than as authorized." Similarly, New Jersey's Criminal Code defines alteration as the completion of a writing "so that it purports to be the act of another who did not authorize that act." Given these provisions, a court applying New Jersey law is likely to conclude that the unauthorized completion of promissory notes or mortgage assignments constitutes alteration as the term is used in the forgery or alteration clause.

Assuming that a court finds that Valentino altered documents on which Happyvale detrimentally relied, South Brook could still avoid exposure because the forgery or alteration clause does not cover loss caused by reliance on "evidences of debt." The promissory notes and mortgage assignments are evidences of debt. In the hypothetical, these were the only instruments that Valentino arguably altered. Thus, it would appear that, even assuming that


111. N.J. STAT. ANN. § 12A:3-407(b) (West 1985). See also VA. CODE ANN. § 8.3-407 (1986) ("[a]ny alteration of an instrument is material which changes the contract of any party thereto in any respect, including any change in . . . an incomplete instrument, by completing it otherwise than as authorized"); Virginia Capital Bank v. Aetna Casualty & Sur. Co., 231 Va. 283, 284, 343 S.E.2d 81, 82 (1986).

112. N.J. STAT. ANN. § 2C:21-1 (West 1985). For two decisions that adopted an extremely broad definition of alteration, see Roodhouse National Bank v. Fidelity & Deposit Co. of Maryland, 426 F.2d 1347, 1349-50 (7th Cir. 1970); Stix Friedman & Co. v. Fidelity & Deposit Co. of Maryland, 563 S.W.2d 517, 521 (Mo. Ct. App. 1978).

113. Insuring Clause (D) covers loss resulting from "[f]orgery or alteration of, on or in any Negotiable Instrument (except an Evidence of Debt), Acceptance, withdrawal order, receipt for the withdrawal of Property, Certificate of Deposit or Letter of Credit." BOND LITIGATION, supra note 5, at 9. The 1980 bond defines a negotiable instrument as any writing signed by the maker or drawer, containing an unconditional promise or order to pay a sum certain in Money and no other promise, order, obligation or power given by the maker or drawer, payable on demand or at a definite time, and payable to order or bearer. Id. at 10.

114. The bond defines an "evidence of debt" as "an instrument, including a Negotiable Instrument, executed by a customer of the Insured and held by the Insured which in the regular course of business is treated as evidencing the customer's debt to the Insured." Id.
these documents were altered, the forgery or alteration clause could not cover the resulting loss. 115

Even if a court found that the instruments signed in blank were altered by Valentino and were not evidences of debt, South Brook could still avoid exposure under the forgery or alteration clause on causation grounds. South Brook may again argue that Happyvale's loss did not result directly from Valentino's alteration of the notes, but rather from Happyvale's inability or unwillingness to enforce the notes against their makers or endorsers. 116

The court in Virginia Capital Bank v. Aetna Casualty & Surety Co. 117 reached precisely this conclusion. In Virginia Capital Bank, the insured bank sought coverage for the amount of a loan that was secured by a fraudulently altered promissory note. The court ruled that pursuant to Virginia's Commercial Code, the bank was a holder in due course with "the right to enforce the note in its present form against the maker and the endorser for the full amount filled in." 118 Because the note was enforceable at the time the loan was made, the moment when a direct loss must occur to trigger coverage under the bond, 119 the alteration did not directly cause the bank's loss. Instead, the court held that the bank's inability to enforce the note was the proximate cause of its loss. Therefore, coverage was denied. 120

115. As a caveat, however, it should be noted that the bond defines an "evidence of debt" as "an instrument . . . executed by a customer of the Insured." See supra note 114 (emphasis added). No case law has considered whether debtors such as the homeowners are Happyvale's customers because the bank ultimately could enforce the promissory notes. Also, the fact that Happyvale may be a holder in due course of these instruments does not impact on the meaning of the term "customer" as used in the blanket bond. Assuming that the blanket bond was not intended to cover such loss under Insuring Clause (D), a court may justifiably overlook this technicality. See Community Nat'l Bank in Monmouth v. St. Paul Fire & Marine Ins. Co., 399 F. Supp. 873 (S.D. Ill. 1975) (rejecting an insured's coverage claim based on an extremely technical analysis of the bond's grammar, punctuation, and syntax). If, however, it found no coverage elsewhere in the bond and was intent on protecting Happyvale as a matter of equity, then a court may reason that the absence of an original customer relationship between Happyvale and the homeowners is a basis for finding coverage. See Jones v. Fireman's Fund Ins. Co., 270 Cal. App. 2d 779, 76 Cal. Rptr. 97 (1969). In Jones, the guarantor was not a customer at the time the bank extended credit on the basis of a forged instrument, but had become a customer by the time of the final advance of funds by the bank. The court found coverage on the ground that the bond's "customer" requirement was ambiguous and therefore must be construed in favor of coverage. Id. at 786, 76 Cal. Rptr. at 101.

116. See supra notes 51-56 and accompanying text.


118. Virginia Capital Bank, 231 Va. at 286, 343 S.E.2d at 83.

119. See supra note 52.

120. Virginia Capital Bank, 231 Va. at 288, 343 S.E.2d at 84. According to the court:
The *Virginia Capital Bank* holding should be persuasive in the Happyvale context. New Jersey has adopted the UCC provision on which the *Virginia Capital Bank* court relied. Therefore, it is quite likely that a New Jersey court would adopt the reasoning of that decision. As a result, South Brook should deny coverage under the forgery or alteration clause for loss sustained by Happyvale in connection with instruments signed in blank and fraudulently completed by The Duck.

As is true for the loan exclusion, the defense based on the right of a holder in due course to enforce an incomplete instrument against its maker or endorser has strong public policy underpinnings. Both coverage defenses illustrate that the bond is neither intended to serve as credit insurance nor to reimburse a bank for loss caused by an ordinary business risk, such as making a bad loan. These policy concerns are particularly salient when the bank could have avoided the loss through the exercise of reasonable diligence.

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Because the note is enforceable by the Bank, we do not agree with the Bank's contention that it suffered a 'loss' within the terms of the policy at the time it disbursed the loan proceeds in reliance on the altered note. No 'loss' is incurred by paying value for a valid and enforceable instrument . . . [E]ven if the Bank's efforts to enforce the note should prove unavailing, its loss would not be due to the alteration, but rather would be the product of the ordinary business risks to which all lenders are subject. Losses of the latter kind are outside the coverage of the 'banker's blanket bond' involved here.


121. N.J. STAT. ANN. § 12A:3-407(3) (West 1985) (“[a] subsequent holder in due course may in all cases enforce the instrument according to its original tenor, and when an incomplete instrument has been completed, he may enforce it as completed”).

122. *See supra* notes 68-71 and accompanying text.

123. *Id.*

124. In the case of a loan secured by inadequate collateral or a worthless personal guaranty, a bank can check on the collateral or the creditworthiness of the guarantor. In the case of notes signed in blank and thereafter fraudulently completed, the UCC affords the bank an opportunity to recover its loss from the maker or endorser of the incomplete instrument. To the extent that this protection is rendered meaningless because the putative defendants are judgment-proof or not subject to personal jurisdiction, the bank should absorb the loss. It could have consulted the note's signatory to corroborate his intent to borrow funds. The bank also could have provided the underlying borrower with notice of its intended purchase of the loan participation interest and thus afford him the opportunity to object to the validity of the underlying obligation. Arguably, these precautions are economically and administratively feasible.

Case law holds that a bank may not be deprived of coverage as a result of its negligence. *See First Nat'l Bank of Fort Walton Beach v. United States Fidelity & Guar. Co.*, 416 F.2d 52 (5th Cir.), *reh'g denied*, 417 F.2d 1339 (5th Cir. 1969). The terms and conditions on the face of the bankers blanket bond do not conflict with this conclusion. Nonetheless, when the terms, conditions, limitations, exclusions, and definitions in the contract are considered together, they penalize the financial institution that negligently
In sum, South Brook has several good reasons for declining coverage under the forgery or alteration insuring agreement. First, Happyvale’s loss was not caused by forgery and may not have been caused by alteration. Second, even assuming alteration, the forgery or alteration clause does not encompass loss caused by the alteration of evidences of debt. Third, if the first two coverage defenses are discounted, South Brook may still deny coverage because there was no direct causal connection between The Duck’s alteration and Happyvale’s loss.

VI. COVERAGE UNDER INSURING AGREEMENT (E):
“Securities”

Insuring Clause (E) provides coverage for loss caused directly by the insured’s good faith reliance on certain types of documents that are forged, altered, lost, stolen, or counterfeit. Unlike Insuring Clause (D), which expressly excludes evidences of debt, the Securities insuring agreement, denominated Insuring Agreement (E), covers:

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, or otherwise acted upon, any original

(a) Security
(b) Document of Title,
(c) deed, mortgage or other instrument conveying title to, or creating or discharging a lien upon, real property,
(d) Certificate of Origin or Title,
(e) Evidence of Debt,
(f) corporate, partnership or personal Guarantee, or
(g) Security Agreement which
(i) bears a signature of any maker, drawer, issuer, endorser, assignor, lessee, transfer agent, registrar, acceptor, surety, guarantor, or of any person signing in any other capacity which is a Forgery, or
(ii) is altered, or
(iii) is lost or stolen;

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

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

Actual physical possession of the items listed in (a) through (g) above by the Insured,
ties Insuring Agreement expressly encompasses such instruments under certain circumstances. In Happyvale’s case, the Securities Insuring Agreement arguably covers the bank’s loss because Pokey relied on promissory notes and mortgage assignments that Valentino presented for inspection before the bank purchased each package of home improvement loans. The existence of coverage will depend on whether these instruments were forged, altered, lost, stolen, or counterfeit and whether Happyvale relied on them in good faith.

A. Characteristics of the Instruments Relied On

Happyvale has not alleged that any promissory notes or mortgages on which it relied were lost or stolen. With respect to forgery and alteration, Valentino’s unauthorized completion is the only conduct that arguably could fall within these categories. In this regard, the analysis of the forgery or alteration clause applies with full force and effect. Assuming that the instruments were counterfeit, this would not necessarily trigger coverage for all of Happyvale’s losses. Under the Securities Insuring Agreement, coverage for loss caused by counterfeit documents does not extend to evidences of debt (i.e., the promissory notes). It is restricted to securities, documents of title, deeds, mortgages, other title-conveying instruments, and certificates of origin. There may be a question whether an assignment of mortgage used to collateralize a loan may be characterized as an evidence of debt or must be treated exclusively as a mortgage or other instrument creating a lien on property. Given the doctrine of ambiguity, such an assignment probably would be treated as a mortgage or other lien-creating document. The result is that any losses directly caused by Happyvale’s good faith reliance on counterfeit mortgage assignments would indeed be covered under the Securities Insuring Agreement.

Happyvale will argue, therefore, that the mortgage assignments signed in blank or sold to more than one financial institution were counterfeit. The bank’s argument should fail because the bond defines counterfeit as “an imitation which is intended to deceive and

its correspondent bank or other authorized representative, is a condition precedent to the Insured’s having relied on the faith of, or otherwise acted upon, such items.

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

BOND LITIGATION, supra note 5, at 9.

126. See supra notes 102-24 and accompanying text.

127. BOND LITIGATION, supra note 5, at 9. See supra note 125.
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to be taken as an original."128 Recent case law is, for the most part, consistent with this definition. The majority of jurisdictions hold that the presence of false or fraudulent information within an instrument or surrounding its sale or assignment does not render it counterfeit unless it imitates a genuine original instrument.129 Under this definition of counterfeit, none of the documents on which Happyvale relied would be deemed counterfeit because they were not imitations fraudulently passed off as genuine originals. If a court held otherwise, South Brook could still avoid exposure by establishing that Happyvale's reliance was not undertaken in "good faith."

B. Good Faith and the Doctrine of "Selective Ignorance"

Few cases have directly addressed the requirement of good faith reliance under the blanket bond's Securities Insuring Agreement. Initially, those courts that addressed the issue embraced a subjective standard that favored coverage. Recent decisions, however, are moving toward an objective standard that is more favorable to the insurer.

Prior to the late 1970s, the only certainty surrounding the good faith requirement was that an insurer could not defeat coverage

128. Bond Litigation, supra note 5, at 10.
129. See First Nat'l Bank & Trust Co. v. United States Fidelity & Guar. Co., 347 F.2d 945, 947 (10th Cir. 1965). According to the First National Bank court:

[T]he majority of courts which have encountered this problem have held [that] fictitious invoices and accounts receivable cannot be considered counterfeit within the meaning of Insuring Clause (E). These courts in general agree that the term 'counterfeit' means an imitation of an authentic document or writing or a resemblance intended to deceive and to be taken for the original.

merely by establishing that the insured's ordinary negligence caused or facilitated its loss. This rule derived from the common law doctrine that one should not benefit from or insure against the consequences of his own intentional misconduct. This is not the

130. In First National Bank of Fort Walton Beach v. United States Fidelity & Guaranty Co., 416 F.2d 52 (5th Cir.), reh'g denied, 417 F.2d 1339 (5th Cir. 1969), for example, a blanket bond carrier unsuccessfully defended a coverage action by asserting that the insured failed to investigate the authenticity of securities collateralizing a series of loans. The court stressed that negligence alone could not overcome the requirement of good faith reliance demanded by Insuring Clause (E):

Ordinary negligence, without more, does not convert good faith into bad. Had negligence been intended as a good defense to payment for injuries covered by [Insuring Clause] (E), it should have been set out in the agreement.

Id. at 57 (citations omitted). The court in Citizens Bank of Oregon v. American Insurance Co., 289 F. Supp. 211 (D. Ore. 1968), went further. In Citizens Bank of Oregon, the insured bank made loans that were collateralized by forged stock certificates, and the court held that ordinary negligence was no defense to coverage under the securities insuring agreement. Id. at 214. Although the court explored the meaning of "good faith," its comments were cryptic. The court stated:

'Honesty' is good faith. 'Dishonesty' is bad faith . . . . Of course, want of due care has nothing to do with honesty or dishonesty . . . . A Bankers Blanket Bond, such as the one before me, was involved in First National Bank of Crandon v. United States F. & G. Co. of Baltimore, 150 Wis. 601, 137 N.W. 742, in which the Court held that mere negligence on the part of the insured which resulted in loss is not a defense to an action on the bond, unless such negligence amounts to fraud or bad faith.

Id. at 214.

The court's statement that simple negligence was insufficient to overcome a finding of 'good faith' reliance was unobjectionable. Its suggestion, however, that fraud, dishonesty or bad faith is required was entirely without support. The court relied on Crandon, which was decided under a fidelity insuring clause rather than on the securities insuring agreement. First Nat'l Bank of Crandon v. United States Fidelity & Guar. Co., 150 Wis. 601, 137 N.W. 742 (1912). In Crandon, the record established that the bank's loss was caused by the fraud and dishonesty of an employee and was therefore covered under the terms of the bond's fidelity insuring clause. Id. at 603, 137 N.W. at 743. The court rejected the insurer's defense that the bank was negligent in failing to discover and abort its employee's participation in a check kiting operation, noting that "mere negligence" is one of the risks covered by such insurance, and that only fraud, subjective bad faith, or dishonesty on the part of the insured could be a valid defense to coverage under the fidelity clause. Id. at 610, 137 N.W. at 745.

same doctrine reflected in the requirement of good faith reliance in Insuring Clause (E). Simply put, the courts improperly equated Insuring Agreement (E)'s affirmative requirement of good faith with the common law rule that the insured's bad faith defeats coverage. The common law doctrine that an insured may not benefit from the consequences of its wrongdoing applies to all contracts of insurance, whereas Insuring Agreement (E)'s requirement of good faith reliance is created exclusively by the express terms of that clause. Thus, if good faith means nothing more than the absence of bad faith, then its inclusion in Insuring Clause (E) would be superfluous.

*First National Bank of Decatur v. Insurance Co. of North America* was one of the earliest blanket bond decisions to recognize that good faith means more than the absence of subjective bad faith. Even though the court determined that the insured acted in good faith, it reformulated the test by treating good faith as commercial reasonableness. The *Decatur* court considered whether the insured reasonably should have known of the existence of the false pretenses that caused the loss. The *Decatur* decision was, thus, a harbinger of more recent decisions that have addressed the requirement of good faith reliance.

Recent cases construing the Securities Insuring Agreement have expanded the objective standard to include the doctrine of selective ignorance. For example, in *Marsh Investment Corp. v. Langford*,

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133. Id.
134. 424 F.2d 312 (7th Cir.), cert. denied, 398 U.S. 939 (1970) [hereinafter *Decatur*]. Although the case did not implicate an insuring agreement whose coverage was conditioned on the insured's exercise of good faith reliance, the carrier nonetheless raised the insured's lack of good faith (but not the presence of bad faith) as a defense to coverage. *Id.* at 316.
135. *Id.* The court stated:

> [W]e are not persuaded that the [insured] knew or reasonably should have known that such difficulties had pressed an apparently respected corporation into activities that amounted to a violation of the criminal law of Illinois. As soon as it learned facts which gave a hint of such activity, it froze Community's account. Accordingly, we hold that [the insured] is not precluded from a recovery on the instant bond on the ground that it failed to exercise commercial 'good faith.'

*Id.* (emphasis added). Although the *Decatur* court correctly advanced the definition of "good faith" as a precondition to coverage under certain insuring clauses in a blanket bond, the court mistakenly applied the "good faith" requirement to the facts of the case. The court was mistaken because the policy being construed contained no provision requiring "good faith" as a precondition to coverage. *Id.* at 315.
136. 554 F. Supp. 800 (E.D. La. 1982), aff'd in part and vacated in part, 721 F.2d
the insured bank cancelled a substantial indebtedness in exchange for a mortgage on a corporation's property. The instrument that memorialized the substituted obligation was executed by an individual whom the bank knew was not an officer, director, or a shareholder of the corporation. The bank possessed this knowledge because the individual's own attorney had refused to represent him as such at the bank's request. The bank, which sustained a loss because the individual was judgment-proof and the corporation not bound by his signature, sought reimbursement under the Securities Insuring Clause of its Bankers Blanket Bond. The insurer denied coverage on the ground that the bank had not met the precondition of good faith reliance, and in subsequent coverage litigation, the district court agreed.

In reaching its decision, the *Marsh Investment Corp.* court noted that actions taken out of ignorance or negligence may have been taken in good faith. But when a person chooses to remain ignorant and disregards suspicious circumstances, a court may not deem his subsequent conduct as the product of good faith. "Selective ignorance," the court held, should not "satisfy the good faith requirement for coverage." The court proceeded to chronicle each

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1011 (5th Cir. 1983). Although the Fifth Circuit affirmed the trial court's finding that there was no good faith reliance under the doctrine of selective ignorance, the appellate court did not expressly approve the doctrine. In the district court, the bank conceded that the doctrine of selective ignorance should be applied to determine whether the precondition of good faith reliance was satisfied. The Fifth Circuit accepted this concession and left "for another day any definitive pronouncement on this vexed question of state law." *Id.* at 1014. See also *Stix Friedman & Co. v. Fidelity & Deposit Co. of Md.*, 563 S.W.2d 517 (Mo. Ct. App. 1978). In *Stix Friedman*, the court affirmed the following jury instruction:

The Court instructs the jury that 'good faith' means freedom from knowledge of circumstances which ought to put a person upon inquiry. This includes the exercise of reasonable discretion under the circumstances, and an honest effort to ascertain the facts and to make a determination based on such ascertained facts. *Id.* at 521. See also *General Inv. Corp. v. Angelini*, 58 N.J. 396, 405, 278 A.2d 193, 197 (1971) ("Absence of inquiry under the circumstances amounts to an intentional closing of the eyes and mind to any defects in or defenses to the transaction").


138. *Id.* at 805-06. The *Marsh Investment Corp.* court applied a standard of commercial reasonableness similar to the one used to define "good faith" in the Uniform Commercial Code. See Jordan, *Holder in Due Course*, in BASIC UCC SKILLS 1987: ARTICLE 3 AND ARTICLE 4, 45, 52-60 (Practicing Law Institute 1987); J. WHITE AND R. SUMMERS, supra note 51, § 14-6, at 562-68; Rohner, *Holder in Due Course in Consumer Transaction: Requiem, Revival, or Reformation?*, 60 CORNELL L. REV. 503 (1975); Annotation, *What Constitutes Taking Instrument in Good Faith, and Without Notice of Infirmities or Defenses, to Support Holder-In-Due Course Status, Under UCC § 3-302, 36 A.L.R. 4TH 212 (1985).

139. *Marsh Inv. Corp.*, 544 F. Supp. at 805. The doctrine of selective ignorance has a
suspicious incident in the loan restructuring that should have put the insured bank on inquiry notice as to the likelihood of future loss, concluding: "this course of deliberate inaction, of concerted ignorance, in the face of so many circumstances which fairly cried out for further investigation and scrutiny, leads me to the inescapable conclusion that the Bank did not act in 'good faith'."

life beyond the Marsh Investment Corp. case. In French American Banking Corp. v. Flota Mercante Grancolombiana, 609 F. Supp. 1352 (S.D.N.Y. 1985), a bank sustained loss when it extended a loan collateralized with forged bills of lading. When it sought reimbursement under its blanket bond, the carrier moved for summary judgment on the ground that the insured did not proceed in good faith, as required by Insuring Clause (E), because it failed to investigate adequately the genuineness of the collateral. Id. at 1358. The court denied the motion for summary judgment because the question of good faith required further factual development. Id. at 1359. What is significant is that, relying principally on Marsh Investment Corp., it accepted the doctrine of selective ignorance as the proper test for determining good faith reliance under the bond's Securities Insuring Agreement. Id. at 1358-59.

40. Marsh Inv. Corp., 554 F. Supp. at 806. The court went on to cite non-insurance cases decided under the UCC's standard of commercial reasonableness in which the dispositive question was whether a bank had proceeded in "good faith" in order to prevail as a holder in due course or a bona fide purchaser for value. Id. (citing Hollywood Nat'l Bank v. I.B.M., 38 Cal. App. 3d 607, 113 Cal. Rptr. 494 (1974) (bank's refusal to inquire as to how loan recipient with poor credit rating obtained $70,000 stock certificate to secure loan supported finding that bank did not act in good faith); Seinfeld v. Commercial Bank & Trust Co., 405 So. 2d 1039, 1042 (Fla. Dist. Ct. App. 1981) (bank's immediate clearance of checks from unknown customer without adequate investigation raised issue of good faith on part of bank); Community Bank v. Ell, 278 Or. 417, 428, 564 P.2d 685, 691, reh'g denied, 279 Or. 245, 566 P.2d 903 (1977) ("[I]f a party fails to make an inquiry for the purpose of remaining ignorant of acts which he believes or fears would disclose a defect in the transaction, he may be found to have acted in bad faith"). Outside of the insurance setting, the doctrine of selective ignorance was expressed in 1971 by the New Jersey Supreme Court in General Investment Corp. v. Angelini, 58 N.J. 396, 278 A.2d 193 (1971). In Angelini, the issue had to be explored in order to determine whether the plaintiff was a holder in due course:

The test is neither freedom from negligence in entering into the transaction nor awareness of circumstances calculated to arouse suspicions either as to whether the instrument is subject to some defense not appearing on its face or whether the promise to pay is not as unconditional as it appears therein. However, evidence of circumstances surrounding the negotiation of the note which excite questions as to whether the obligation it represents is really dependent upon performance of some duty by the payee is of probative value if it provides some support for a finding of a bad faith taking by the holder .... Ordinarily, where the note appears to be negotiable in form and regular on its face, the holder is under no duty to inquire as to possible defenses such as failure of consideration, unless the circumstances of which he has knowledge rise to the level that the failure to inquire reveals a deliberate desire on his part to evade knowledge because of a belief or fear that investigation would disclose a defense arising from the transaction. And, in this connection, once it appears that a defense exists against the payee, the person claiming the rights of a holder in due course has the burden of establishing that he is in all respects such a holder .... Absence of inquiry under the circumstances amounts to an intentional closing of the eyes and mind to any defects in or defenses to the transaction.
On the basis of the cases surveyed, several conclusions can be reached safely. Whenever an insuring agreement requires good faith reliance as a precondition to coverage, both the insurer and the court should look beyond the insured’s protestations of ignorance or mere negligence. They should review the facts critically. If the facts indicate that sufficient warnings existed to cause a reasonable person to inquire further, a failure to inquire may constitute selective ignorance. Selective ignorance should defeat coverage when good faith reliance is a *sine qua non* to coverage. As with the loan exclusion under the on premises insuring clause and the requirement of direct causation under all the insuring agreements in the bond, the threshold of good faith reliance in the Securities Insuring Clause is evidently designed to serve public policy by withholding reimbursement from banks sustaining loss that could have and should have been avoided in the first place.

**C. Application of the Doctrine of Selective Ignorance To the Happyvale-Star-Spangled Funding Transactions**

South Brook may raise the selective ignorance defense in two ways. First, as to losses arising from the first three packages of loans, South Brook may argue that Pokey was selectively ignorant when he executed the first Home Improvement Loan Participation Agreement. Pokey negligently failed to realize that, contrary to his understanding with The Duck, the contract provided that Happyvale would purchase a percentage of the total sales price of each loan, rather than a percentage of the amount financed. Pokey’s

Id. at 403-05, 278 A.2d at 196-97. In corporate law, it is also well established that a director or officer may not avoid liability for injuries caused by corporate misconduct by asserting that he was unaware of the improprieties. See, e.g., Francis v. United Jersey Bank, 87 N.J. 15, 31, 432 A.2d 814, 822 (1981) (corporate managers may not “shut their eyes to corporate misconduct, and then claim that because they did not see the misconduct they did not have a duty to look”); Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968). According to Bishop:

The evil of the decoy duck director, whose main function is to give to actual and potential public investors a false feeling of security, has long been recognized as real and serious. . . . Outside directors who do not supervise may be dangerous in much the same way that a quack cancer cure is dangerous; reliance upon them inhibits resort to other and more effective remedies. . . . So far as I know, it is not a crime to be a director who does not direct; at least I am not aware that any director has ever been sent to jail for aggravated abdication of his responsibilities. The only legal deterrent to such conduct, and perhaps the only substantial deterrent of any sort, is the fear of civil liability.

Id. at 1092-93. Professor Bishop also might have noted that the fear of no coverage under an insurance policy also may serve as a deterrent to the type of behavior he criticized.
negligence was compounded when The Duck’s payments were received on the first three packages. At that time, Pokey failed or refused to recognize that a substantial portion of the cash flow could not have been generated by payments from the homeowners.

Although Pokey’s eyes were undoubtedly closed to these suspicious circumstances, South Brook’s argument is, nonetheless, weak because Scoter drafted the contract and the discrepancy was corrected as soon as Markstone discovered it. Thus, it appears that Happyvale may have negligently entered into the first three loan packages, rather than purposely looked the other way. As noted, negligence in and of itself is an insufficient foundation for a selective ignorance defense.¹⁴¹

South Brook’s stronger argument is based on Happyvale’s failure to investigate after Markstone returned and realized that the first three loan packages were purchased pursuant to an incorrect formula. Because The Duck was not in default, Pokey and Markstone certainly knew by then that approximately one half of the payments thus far received consisted of funds that could not possibly have been generated by the homeowners. This information placed them on notice of a highly suspicious set of circumstances. They should have conducted an investigation and demanded satisfactory answers about the true source of these funds. Absent satisfactory answers, they should not have entered into the remaining transactions. They also should have exercised the bank’s right to cancel the first three transactions and demanded that The Duck repurchase the loan participations previously sold.¹⁴²

¹⁴¹. See supra note 130 and accompanying text.

¹⁴². It is also possible that the bond may be canceled — at least as to the last seven loan packages — pursuant to a provision in the Servicing Contractors Endorsement that provides that “[t]he attached bond shall be deemed canceled as to any Servicing Contractor immediately upon discovery by the Insured of any dishonest or fraudulent act on the part of such Servicing Contractor.” CNA Insurance Companies’ Servicing Contractors Discovery Form No. G-11082-A, revised October, 1983. The standard form provides that “[d]iscovery occurs when the Insured becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred, even though the exact amount or details of loss may not then be known.” BOND LITIGATION, supra note 5, at 11 (emphasis added).

South Brook should argue that discovery occurred when Markstone realized the discrepancy in the first three loan packages, because such a realization would have caused a reasonable person to assume that a covered loss would be incurred. The bond, therefore, should be deemed canceled prior to the purchase of package four, with the result that loss caused by the last seven loan packages would be excluded from coverage. This application of the Servicing Contractors Endorsement’s cancellation clause, in conjunction with the bond’s definition of discovery, functions essentially the same as the defense of selective ignorance under the securities insuring clause. See City State Bank in Wellington v. United States Fidelity & Guar. Co., 778 F.2d 1103 (5th Cir. 1985); Borden, Termination
In fact, neither Pokey nor Markstone raised any of these issues with The Duck. The logical implication is that they chose to look the other way because the arrangement was, at that time, profitable and Pokey evidently believed that if anything went wrong, a deep-pocketed South Brook would cover any loss. South Brook, therefore, should deny coverage under the securities insuring agreement on the basis of selective ignorance. Simultaneously or immediately thereafter, South Brook should commence a declaratory judgment action against the insured. Although South Brook will not get summary judgment in the absence of discovery, the facts suggest a strong likelihood that the defense of selective ignorance ultimately may prevail.

VII. COVERAGE UNDER THE SERVICING CONTRACTORS ENDORSEMENT

In exchange for an additional premium, a financial institution may purchase additional insuring agreements in the form of riders attached to the policy jacket. One such rider, often purchased by banks, is known as the Servicing Contractors Endorsement.


144. That Valentino was known as “The Duck,” eschewed the use of telephones, and refused to appear in public places should further aid South Brook's selective ignorance defense. Although these facts are insufficient, in and of themselves, as grounds for denying coverage, they will combine with the discrepancy in the first three packages of loans to support the conclusion that Pokey and Markstone closed their eyes in the face of circumstances that demanded further investigation and scrutiny. They chose to believe that the duck was a swan.

145. The insuring portion of the Servicing Contractors Endorsement provides:

It is agreed that:

1. The attached bond is hereby amended by adding an additional Insuring Agreement as follows:

"Servicing Contractors"

A. Loss through any dishonest or fraudulent act committed by any Servicing Contractor, as hereinafter defined, acting alone or in collusion with others.

Dishonest or fraudulent acts as used in this Insuring Agreement shall mean any dishonest or fraudulent acts committed by such Servicing Contractor with the manifest intent:

(a) to cause the Insured to sustain such loss; and

(b) to obtain financial benefit for the Servicing Contractor or for any other person or
This endorsement provides coverage for loss caused by a servicing contractor's fraud or dishonesty or his failure to remit money collected for the insured's account. The endorsement defines a "servicing contractor" as a person or entity, other than an officer or employee of the insured, that is authorized to collect and record home improvement loans on behalf of the insured.

Coverage provided by the Servicing Contractors Endorsement may be analyzed in two ways. First, the standard form's loan exclusion, or the virtually identical loan exclusion in the endorsement itself, may preclude or reduce coverage for the same reasons coverage would be eliminated or reduced by application of the loan exclusion to the on premises insuring agreement. Alternatively, a strict construction of the term "servicing contractor" may preclude coverage to the extent that Happyvale's losses are not attributable to The Duck's acts or omissions in his capacity as a servicing contractor.

A. Application of the Loan Exclusion

The loan exclusion in the standard form applies with full force to the Servicing Contractors Endorsement. Moreover, the endorsement contains its own loan exclusion which is virtually identical to the first clause of the loan exclusion in the policy jacket.

organization intended by the Servicing Contractor to receive such benefit, other than salaries, commissions, fees, bonuses, promotions, awards, profit sharing, pensions or other employee benefits earned in the normal course of employment or performance of the servicing contract.

B. Loss of money (including obligations of the United States of America) collected or received for the Insured by any such Servicing Contractor through the failure of such Servicing Contractor to pay to the Insured the money so collected or received as is discovered to be due and payable while this Insuring Agreement is in force, except, however, money disbursed by such Servicing Contractor in accordance with instructions from the Insured.

The term Servicing Contractor, as used in this bond shall mean a natural person, partnership or corporation, other than an officer or employee of the Insured, duly authorized by the Insured to perform any or all of the following:

(a) collect and record payments on real estate mortgage or home improvement loans made, held or assigned to the insured, and establish tax and insurance escrow accounts,
(b) manage real property owned by or under the supervision or control of the Insured,
(c) perform other acts directly related to the above,
but only while such natural person, partnership or corporation is actually performing such services within the United States of America, the Virgin Islands, Puerto Rico or Canada.

CNA, supra note 4.

146. Id.
147. See BOND LITIGATION, supra note 5, at 10.
148. The exclusions section of the Servicing Contractors Endorsement provides:
Therefore, regardless of which exclusion is applied, the result will be the same. Because the two loan exclusions are so similar, the foregoing coverage analysis of the standard form's loan exclusion will be dispositive.\textsuperscript{149} If South Brook can convince a court that Happyvale's loss was caused directly or indirectly by Valentino's failure to repay loans from the bank, then coverage will be denied.\textsuperscript{150}

**B. Definition of Servicing Contractor**

Under the Home Improvement Loan Participation Agreements, Valentino undoubtedly was a servicing contractor because he was paid to collect and record the homeowners' payments and remit a portion of these funds to Happyvale. Although it is evident that The Duck was a servicing contractor, it is equally evident that he acted distinctly as a seller or assignor of promissory notes and mortgage assignments, or as a borrower of funds.\textsuperscript{151} These addi-
tional capacities have significant coverage implications.

When the same person or entity wears two or more hats, the coverage analysis should be no different than if a different person or entity wore each hat. This is because the endorsement defines a servicing contractor in functional, rather than nominal terms. In effect, the Home Improvement Loan Participation Agreements were two separate contracts. Under one contract, Valentino either sold or assigned notes to Happyvale or he borrowed money from Happyvale. Under the other contract, Happyvale retained Valentino solely to service the home improvement loans (i.e. to collect, record and remit payments). Although South Brook is arguably responsible for loss caused by The Duck's acts or omissions as a servicing contractor, losses arising from his acts or omissions undertaken in another capacity should not trigger coverage under the rider. As a result, it is critical to determine in what capacity The Duck acted with respect to each category of loss.

Loss caused by loans prepaid in full would trigger coverage only if Valentino was obligated to prepay Happyvale in the event a homeowner prepaid him. If such an obligation existed, then the loss arguably would be covered under both parts of the endorsement, because it would have been caused by The Duck's fraud as a servicing contractor, as well as by his failure as a servicing contractor, to remit collected funds to Happyvale. Such loss would not trigger coverage if Valentino had no mirror-image prepayment obligation. In that event, the loss would have resulted from the breach of his obligation to repay Happyvale, on a monthly basis, principal, plus sixteen percent interest. The loss, therefore,

152. This concept was emphasized recently in the context of insurance company liquidation proceedings. When an insurer is adjudicated insolvent and placed in liquidation, the state's Insurance Commissioner is appointed by the court to serve as the statutory receiver of the defunct corporation. Notwithstanding the fact that the same person will occupy both roles, the positions themselves must be treated as legally distinct. Hence, if the liquidator commences an action against the insurer's former directors and officers, he may not interpose the affirmative defense of contributory or comparative negligence by asserting that the Insurance Commissioner earlier failed to discover that the company was in a hazardous financial condition. Such a defense may be raised only against the plaintiff and the plaintiff is the liquidator, rather than the Commissioner, even though the same person occupies both roles. In re Liquidation of Ideal Mut. Ins. Co., 140 App. Div. 2d 62, 532 N.Y.S.2d 371 (1988); Corcoran v. National Union Fire Ins. Co., 143 A.D. 2d 309, 532 N.Y.S.2d 376 (N.Y. App. Div. 1988). With regard to the relationship between commissioners and liquidators in general, see Howard, How to Fail at Liquidating an Insurance Company without Really Trying: Appoint a Policyholders' Committee, 39 FED'N INS. & CORP. COUS. Q. 31, 33-39 (1988); Howard, Uncle Sam Versus the Insurance Commissioners: A Multi-Level Approach to Defining the "Business of Insurance" under the McCarran-Ferguson Act, 25 WILLAMETTE L. REV. 1, 7-14 (1989).

153. Assuming that Valentino had no obligation to pay Happyvale with funds re-
would be attributable to Valentino's breach of his obligations to Happyvale in his capacity as seller or assignor of commercial paper or as a borrower of funds.

In fact, the Home Improvement Loan Agreements did not impose any mirror-image prepayment obligations. Loss related to loans prepaid in full was unrelated to Valentino's function as a servicing contractor and therefore falls outside the coverage provisions of the Servicing Contractors Endorsement.

Similarly, South Brook should not cover loss caused by The Duck's fraudulent completion of instruments signed in blank or his multiple pledging of the same promissory notes and mortgage assignments. South Brook should not cover these losses because they were caused by Valentino's fraudulent acts as a seller or assignor of commercial paper, rather than as a servicing contractor.

For similar reasons, South Brook should not cover the portion of Happyvale's loss that the delinquent homeowners caused. If Happyvale's loss resulted from Valentino's false representation that no homeowners were chronically delinquent in repaying their debts, then he caused the loss in his capacity as seller or assignor of commercial paper, rather than as a servicing contractor. If the loss resulted from Happyvale's inability or unwillingness to enforce the notes or foreclose on the mortgages, then the loss was again unrelated to The Duck's role as a servicing contractor. Finally, if the loss resulted from the borrowers' continued default after Valentino's disappearance in October 1983, then the loss also was unrelated to his acts or omissions as a servicing contractor because he ceased to service anything after October 1983, except perhaps the fishes.\(^{154}\)

In sum, Happyvale's claim is not covered by the Servicing Contractors Endorsement. To the extent that the bank's loss resulted from Valentino's default on a loan from Happyvale, the loan excluded from the homeowners, coverage for loss based on unremitting collections might also be excluded under the endorsement's third exclusion. The third exclusion bars coverage for loss of money collected by the contractor when he is not legally liable to the insured as a result of the loss of such money. See supra note 148.

\(^{154}\) Any loss arguably caused by The Duck's failure to service the loans actually was caused by mere breach of contract. Valentino breached his contractual obligation to collect funds from the homeowners and failed to pay the principal plus 16% interest to Happyvale on a monthly basis. Breach of contract does not constitute fraud by a servicing contractor. Similarly, it does not constitute failure to remit collected funds because the funds never were collected in the first place. See supra notes 145, 148. Consequently, no matter what category of loss is subjected to analysis, the conclusion should be that such loss was not caused by the acts or omissions of a servicing contractor and, therefore, is not covered by the rider.
sion in the bond or endorsement eliminates coverage. Moreover, Valentino did not cause Happyvale's loss in his capacity as a servicing contractor by engaging in fraud or failing to remit money collected for Happyvale. Absent this indispensable causal link, the endorsement is of no use to the bank under these circumstances.

VIII. ADDITIONAL PRACTICAL CONSIDERATIONS

A. Multiple Applications of the Bonds's Deductible

Every blanket bond contains a deductible or self-insured retention. Assuming that the deductible is applied once for each separate loss, there is authority to support the assertion that each loan gives rise to a separate loss and that the insurer may, therefore, apply the deductible once for each loan-related loss.\(^{155}\) Depending on the amount of each loan, the amount of the deductible, and the amount of each loan-related loss, the multiple deductible argument could either eliminate or reduce coverage.

There are several drawbacks to employing the multiple deductible argument. Most notably, the blanket bond does not clearly state that the deductible applies once for each loss.\(^ {156}\) The bond also fails to state clearly what conduct constitutes a single loss for purposes of applying the deductible.\(^ {157}\) Therefore, a court may employ the doctrine of ambiguity to reject multiple deductibles and maximize coverage.\(^ {158}\)

Equitable considerations increase the likelihood that a court

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155. See North River Ins. Co. v. Huff, 628 F. Supp. 1129, 1133 (D. Kan. 1985) (three transactions that comprised one “loan swap” were all separate occurrences); General Casualty of Am. v. Gunion, 99 A.2d 643 (D.C. 1953) (each of five fraudulent loans made by same person gives rise to a separate loss); Slater v. United States Fidelity & Guar. Co., 7 Mass. App. 281, 400 N.E.2d 1256 (1980) (each defalcation by same employee over a 15 month period is a separate occurrence); Burlington County Abstract Co. v. QMA Assocs., Inc., 167 N.J. Super. 398, 400 A.2d 1211 (App. Div.), cert. denied, 81 N.J. 280, 405 A.2d 824 (1979) (deductible should be applied to each of 84 occurrences that took place over a two-year period); Humboldt Trust & Sav. Bank v. Fidelity & Casualty Co. of N.Y., 255 Iowa 524, 122 N.W.2d 358 (1963) (eight forgeries over two years were separate occurrences). But see Business Interiors, Inc. v. Aetna Casualty Co., 751 F.2d 361 (10th Cir. 1984) (thirty-nine acts of forgery by one employee over seven-month period constitutes a single occurrence under blanket bond).

156. BOND LITIGATION, supra note 5, at 10-11.

157. Id.

158. The Declarations Page of the 1980 bond references a “deductible,” with a blank space beneath that word to be filled in with the appropriate dollar amount for each insuring agreement. Any ambiguity has been removed in the 1986 revision, whose Declarations Page substitutes the term “Single Loss Deductible.” Id. at 8, 20. Notwithstanding this revision, the 1986 bond’s definition of a single loss, much like the 1980 bond’s definition of deductible amount, is sufficiently ambiguous that it provides little guidance for
would find the deductible provisions ambiguous and, thus, reject the multiple deductible argument. Most courts that embrace the idea that each loan results in a separate loss do so to multiply the limit of liability and thereby increase coverage. In contrast, South Brook would invoke this concept to substantially reduce or eliminate coverage. The final drawback to the multiple deductible argument is that it may detract from the credibility of stronger arguments.

Despite these caveats, an insurer should set forth the multiple deductible argument in a reservation of rights letter, in a denial of coverage, and as an affirmative defense to a coverage action commenced by the insured. Whether a bonding company should use it in a declaratory judgment action commenced against the insured is determining whether a servicing contractor has caused one large loss or a series of smaller losses.

The standard form is far more specific with respect to the definition of a single loss for purposes of applying the limit of liability. Section 3 of the “Conditions and Limitations” portion of the bond provides in pertinent part that with respect to acts other than burglary, robbery, and misplacement of, or damage or destruction to property, all related acts committed by the same person shall constitute a single loss. Id. at 11. Thus, for purposes of applying the limit of liability, the loss Happylake sustained due to Valentino’s acts would be deemed a single loss. In the liability insurance context, courts have applied this same definition of a single loss applicable to defining the limit of liability to determine the number of losses for purposes of applying a per loss deductible. Liability insurance policies provide that a series of interrelated acts (or of continuous or repeated exposure to the same general conditions) shall be deemed a single loss or occurrence for the purpose of limiting the insurer’s liability to a single limit of liability as set forth in the declarations. Most courts also use this provision to determine the number of losses or occurrences for purposes of applying the deductible, notwithstanding the fact that the provision, by its own terms, is limited to reducing the insurer’s liability. See Hobel, *Current Insurance Litigation, Techniques of Self-Insurance 1987: Corporate Survival in a World with Inadequate Commercial Insurance* 301, 331-34 (Practicing Law Institute 1987); Howard, *Apportioning an Insurer’s Liability Between Covered and Noncovered Parties And Claims*, 38 Fed’N Ins. & Corp. Couns. Q. 319, 349 (1988); Liederman, *Application of Occurrence/Accident to an Insurer’s Limit of Liability and Deductible*, in *The Comprehensive General Liability Policy: A Critique of Selected Provisions* 113 (A.B.A. Tort & Ins. Prac. Sec. 1985). Courts have co-opted this definition of a “single loss” to provide added protection to the insured. They apply this definition because it almost always leads to a single loss and, thus, only one application of the deductible. One court has refused to apply the definition for purposes of determining the number of deductibles, on the ground that it was limited in application to the limit of liability. *Cf. Burlington County Abstract Co.*, 167 N.J. Super. at 398, 400 A.2d at 824; Wurth v. Ideal Mut. Ins. Co., 34 Ohio App. 3d 325, 330, 518 N.E.2d 607, 612 (1987) (“[a]n insurer is entitled to have the titles provided to the various sections of its policy recognized by a court in interpreting those sections”).

a matter for individual judgment based on the facts of the case, the applicable law, and the track record of the court in which the action has been brought.

B. Offsets

To the extent that Happyvale's loss is covered in whole or in part (or the carrier, notwithstanding a firm conviction that there is no coverage, makes a business decision to settle rather than litigate), South Brook should deduct from Happyvale's claim certain funds that Happyvale received as a result of its transactions with Valentino. These offsets would include, among other things: the value of any property the bank received from executing on Valentino's or Star-Spangled Funding's assets; the servicing contractor's fees on all loans, whether or not they formed the basis for Happyvale's claim under its Bankers Blanket Bond; and, any payments received by the bank from homeowners after October 1983.

Happyvale, in all likelihood, will object to this offsetting concept. It probably will assert that it is entitled to retain the servicing contractor's fee because, by virtue of The Duck's breach of contract, Happyvale was forced to service the loans itself. Happyvale may even seek to increase its claim by adding any fees and disbursements of counsel retained to assist in its collection efforts against delinquent borrowers.160

Although South Brook may sympathize with the bank's plight, it must assert that, pursuant to the provisions of the insurance contract, such expenses are not entitled to consideration in determining the amount of Happyvale's claim.161 Such conflicts between policyholders and insurance companies may serve a useful function in settlement negotiations. Although counsel for the bank and the bonding company will both realize that the issue is relatively in-

160. The bond might proscribe Happyvale's collection actions because if Happyvale settled with a third party debtor (e.g., a homeowner) for less than the full amount due, then such a settlement would invalidate the bonding company's subrogation rights against the debtor. In theory, the insurer, after paying a claim, could exact the full amount of the debt owed by the third party. See BOND LITIGATION, supra note 5, at 11; Comment, The Nature and Extent of Subrogation Rights of Fidelity Insurers Against Officers and Directors of Financial Institutions, 47 U. Pitt. L. Rev. 727 (1986). In practice, however, large insurers are probably not interested in hiring counsel to recover a substantial number of small debts originally owed by many debtors to the insured, because the cost of prosecuting collection actions is frequently not worth the amounts that may be collected. The benefit to the surety is further reduced because collection lawyers generally charge on a contingency basis, retaining a substantial percentage of any debt collected from each separate piece of litigation.

161. BOND LITIGATION, supra note 5, at 11.
consequential, a bargaining victory on this point may persuade a reluctant client to settle, rather than litigate, based on the illusion that he has received something to which he was not strictly entitled as a matter of law.

C. Impleading Pokey and Markstone

If South Brook denies coverage and Happyvale brings suit against South Brook, then the bonding company should consider joining Pokey and Markstone as third-party defendants. South Brook can argue that their negligence caused, facilitated, or contributed to the bank's loss. Although they may have been far less culpable than The Duck, they were more culpable than South Brook. It is, therefore, equitable for them to assume or at least share in any loss sustained by South Brook.

Jurisdictions are split on whether a bonding company may engage in such third-party practice. Many courts are reluctant to allow impleader because it shifts all or part of the bonding company's exposure to the bank's managers and, through them, to its Directors and Officers ("D & O") liability insurer. Because it is well-settled that the bonding company may not assert a claim against its insured on the basis of the bank's mere negligence, cases proscribing such third-party practice tend to equate the D & O's with the bank they serve. These decisions stress that a bank may

162. A D & O policy provides coverage for loss caused by the negligence of the financial institution's officers and directors. See generally W. KNEPPER & D. BAILEY, supra note 2, § 21.18, at 685-741; Howard, supra note 46, at 163; Ichel & Thompson, supra note 76, at 220; Miller & Johnston, An Analysis of Key Provisions of Directors and Officers Liability Insurance Policies, in THE CRISIS IN DIRECTORS' AND OFFICERS' LIABILITY INSURANCE 37 (1986); Oettle & Howard, supra note 58, at 337; Sullivan & Barry, The Directors and Officers Liability Policy: An Overview, 55 DEF. COUNS. J. 248 (1988); Note, The D & O Insurance Crisis: Darkness at the End of the Tunnel, 39 S.C.L. REV. 653 (1988); Note, Disbursement of Insurance Money Covering an Insured's Legal Expenses as Incurred, 16 FORDHAM URB. L.J. 467 (1988). If the same insurer issued a blanket bond and a D & O policy to the same insured, which is not unlikely, then such third-party practice realistically would not occur because the same insurer would for all intents and purposes be suing itself. In theory, however, this might not result in a wash if the type and quantum of reinsurance on each policy was significantly different. The directors and officers of a financial institution should, therefore, make a concerted effort to purchase a D & O liability policy and a financial institution bond from the same insurance company. Although this will generally result in lower aggregate premiums, the directors and officers should proceed in the same fashion even if the result is a slight increase in aggregate premiums. Nevertheless, if the difference in premiums is substantial, then the directors and officers risk being accused of breaching their fiduciary duties to the institution. See W. KNEPPER & D. BAILEY, supra note 2, at §§ 1.04-1.06, 12.01-12.18.

With respect to the relationship between D & O and bond coverage, see Eglin National Bank v. Home Indemnity Co., 583 F.2d 1281 (5th Cir. 1978).
act only through its D & Os, whose conduct will be imputed to the institution. Courts that allow impleader distinguish the directors and officers from the institution. They stress that under principles of equitable and contractual subrogation, the carrier may proceed against any responsible party whom the bank could sue and that a bank may sue its own directors and officers for loss caused by their negligence. The ability of the bank itself to recover from its D & O insurer is considerably reduced because of the presence of "insured versus insured" exclusions in most recently-issued D & O policies. The "insured versus insured" exclusion eliminates D & O coverage for loss resulting from litigation in which a corporation or financial institution sues its own directors or officers.

The likelihood that South Brook's third-party action against

163. For cases holding that such third-party practice will not be permitted, see Dixie National Bank of Dade County v. Employers Commercial Union Insurance Co. of America, 759 F.2d 826 (11th Cir. 1985) (same for gross negligence); Federal Savings & Loan Insurance Co. v. Fidelity & Deposit Co. of Maryland, No. 840067-G(M) (S.D. Cal. June 11, 1985); Plaza Del Sol National Bank v. Fireman's Insurance Co., No. 78-073-B (D.N.M. Apr. 20, 1979); Dixie National Bank of Dade County v. Carney, 463 So. 2d 1147 (Fla. 1985); First National Bank of Columbus v. Hansen, 84 Wis. 2d 422, 267 N.W.2d 367 (1978). See also Federal Sav. & Loan Ins. Co. v. Aetna Casualty & Sur. Co., 696 F. Supp. 1190 (E.D. Tenn. 1988) (allowing impleader only if directors or officers personally profited as a result of their negligence); Rizk, Bank Directors' Liability to Fidelity Insurers: How "Bad" is Bad Faith? 19 FORUM 481 (1984)(takes position that Ds & Os should be liable only for fraud or bad faith, but that gross negligence, recklessness, or selective ignorance may, under some circumstances, constitute "bad faith"); Comment, The Nature and Extent of Subrogation Rights of Fidelity Insurers Against Officers and Directors of Financial Institutions, 47 U. PITT. L. REV. 727 (1986) (surveys case law and takes position that surety should not have subrogation rights against negligent directors and officers).


165. See Howard, supra note 46, at 170 n.26. Although it is well-established that a subrogated surety may not exercise any rights greater than those possessed by the bank to whose claims it has become subrogated, it is an open question as to whether the surety's rights are also limited by contractual limitations imposed on the bank pursuant to the terms of its D & O liability policy. See American Casualty Co. v. FDIC, 677 F. Supp. 600, 604-07 (N.D. Iowa 1987); FDIC v. National Union Fire Insurance Co., 630 F. Supp. 1149, 1156-57 (W.D. La. 1986), both treating a D & O insurer's right to assert the policy's "insured v. insured" exclusion against the FDIC as successor to a failed bank.

Pokey and Markstone will succeed on the merits, or even survive a motion to dismiss, will thus depend on the jurisdiction in which the coverage action is commenced. Regardless of the jurisdiction, South Brook should implead these officers. It need not worry about Rule 11 sanctions in federal court or equivalent state sanctions. Even in a jurisdiction that has rejected such third-party practice, the bonding company may proffer an equitable argument for change in the law. Moreover, the notion of spreading loss between two insurance companies is not likely to offend the equitable sense of any court.

D. Exclusion for Lost Interest and Profits

Happyvale submitted a proof of loss affidavit seeking to recover the principal and interest it would have received in the event the transactions with The Duck proceeded as expected. South Brook should unquestionably deny coverage for that portion of the claim representing lost interest. This is because the bond expressly excludes coverage for "potential income, including but not limited to interest and dividends, not realized by the Insured."\(^\text{167}\)

In other words, a loss is what the bank gives up, rather than what it expects to get back but fails to receive in the future.\(^\text{168}\) Regardless of the cause of a loss, anticipated profits are consequential, rather than direct losses. In addition, the potential income exclusion has been construed consistently to eliminate coverage for unrealized interest.\(^\text{169}\) Therefore, assuming coverage existed for all loss sustained by Happyvale, the bank would at most be entitled to the purchase price of the loans, less the amount of return realized through October 1983.

IX. CONCLUSION

A. The Theme of the Bond

The blanket bond requires good faith reliance as a precondition

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167. Bond Litigation, supra note 5, at 11.
168. See supra note 52.
to coverage under Insuring Clause (E). The bond’s loan exclusion precludes coverage for loss caused by false pretenses if the loss was also caused by a bad business decision. Under Insuring Clause (D), a surety may deny coverage based on insufficient proximate cause if the bank could have recovered its loss by proceeding directly against the maker or endorser of an instrument signed in blank. Finally, the common law holds that one may not benefit from the consequences of his own wrongdoing.

In combination, these rules are strikingly similar to those that govern everyday human interaction. People offend one another and this threatens to disrupt important collective activities. The stability and duration of a relationship is determined by whether the offended party accepts the excuses proffered by the offending party. Ignorance, a lay concept equivalent to negligence, is the most typical excuse offered. Most people give one another the benefit of the doubt. Therefore, if the excuse of ignorance is perceived as genuine, most people will accept it and relationships will endure. The result may be otherwise if the surrounding circumstances suggest that the offender “purposely” offended, should not have offended, could have easily avoided the offense by searching more diligently for the truth, or chose to “look the other way.”

Similar dynamics apply to coverage under the Bankers Blanket Bond. If surrounding circumstances disclose that offensive behavior by the insured — its failure to take action that avoids loss — resulted from unavoidable negligence or excusable ignorance, then both the insurer and the court are likely to give the insured the benefit of the doubt and afford it that most sublime form of protection, known as coverage. Should it become evident, however, that the insured chose to be ignorant by looking the other way in the face of suspicious circumstances, or made a bad business decision by failing to take inexpensive precautions that could have avoided all loss in the first place, its excuses may fall on deaf ears. Coverage, accordingly, may be denied. Insurance was not created entirely in the image of Man’s compassion. Nonetheless, insurance tends toward compassion — to the extent that this may be accomplished without eliminating important deterrents to loss-producing conduct.

Insurance relationships are like human relationships. Just as a policyholder gains peace of mind by purchasing protection in the form of a contract that provides coverage for certain types of loss, a man obtains peace of mind by insulating himself with the protection of others. Should either abuse these relationships, he may
parchently discover that the protection, usually taken for granted, suddenly has ceased.

B. Happyvale’s Future

Whether South Brook seeks to avoid all exposure or uses its coverage defenses as leverage in settling the claim,¹⁷⁰ it should pay the full claim only if a final adjudication so requires.¹⁷¹ Although South Brook’s ability to deny or reduce coverage for Happyvale’s loss must necessarily result from a seemingly hyper-technical construction of the terms, conditions, agreements, definitions, and exclusions set forth in the blanket bond, such a result is also equitable

¹⁷⁰ Regardless of its ultimate action, South Brook should set forth its defenses in writing as early as possible because a subsequent bad faith claim by the insured may be defeated by proof of genuine or debatable reasons for denying coverage. Insurance Co. of N. Am. v. Citizensbank of Thomasville, 491 So. 2d 880, 884 (Ala. 1986). See also W. SHERNOFF, S. GAGE & H. LEVINE, INSURANCE BAD FAITH LITIGATION §§ 5.01-5.44 (1987); Goldberg, Standards of Liability for Bad Faith Refusal to Pay Benefits in First Party Insurance, 29 Ariz. L. Rev. 115 (1987).

¹⁷¹ Such an adjudication is a distinct possibility, notwithstanding the defenses to coverage set forth in the text. Many judges allow their equitable concerns for the insured to supersede an objective analysis of the insurance contract, with the result that decisions tend to be outcome-oriented. Outcome oriented decisions diminish the predictability of coverage determinations and thereby decrease the likelihood of extra-judicial settlements. They encourage the insured to litigate coverage even when it appears that coverage is not provided by the terms of the insurance policy. The consequential increase in the administrative costs of claims adjusting, settlements and judgments causes insurers to increase premiums and/or further diminish policy coverage, both of which harm policyholders at large. Thus, the cumulative impact of individual pro-insured decisions is a negative impact on insureds as a class. See Howard, “Continuous Trigger” Liability: Application To Toxic Waste Cases And Impact On The Number Of “Occurrences”, 22 Tort & Ins. L.J. 624 (1987); Howard, D & O Insurance Through The Looking-Glass: An Attitudinal Primer, 38 Fed’n Ins. & Corp. Couns. Q. 163 (1988); Oettle & Howard, D & O Insurance: Judicially Transforming A ‘Duty To Pay’ Policy Into A ‘Duty To Defend’ Policy, 22 Tort & Ins. L.J. 337 (1987); Oettle & Howard, Zuckerman And Sparks: The Validity of ‘Claims Made’ Insurance Policies as a Function Of Retroactive Coverage, 21 Tort & Ins. L.J. 659 (1986). As for the general principle that good defensive arguments may have absolutely no impact on a dispute’s outcome, Aesop said it better than any insurance lawyer could:

A Wolf, meeting with a Lamb astray from the fold, resolved not to lay violent hands on him, but to find some plea to justify to the lamb the Wolf’s right to eat him. He thus addressed him: ‘Sirrah, last year you grossly insulted me.’ ‘Indeed,’ bleated the Lamb in a mournful tone of voice, ‘I was not then born.’ Then said the Wolf, ‘You feed in my pasture.’ ‘No, good sir,’ replied the Lamb, ‘I have not yet tasted grass.’ Again said the Wolf, ‘You drink of my well.’ ‘No,’ exclaimed the Lamb, ‘I never yet drank water, for as yet my mother’s milk is both food and drink to me.’ Upon which the Wolf seized him and ate him up, saying, ‘Well! I won’t remain supperless, even though you refute every one of my imputations.’

and accomplishes important public policy goals. For if Happyvale must absorb all or a substantial portion of its loss, then Pokey and Markstone will undoubtedly put their ducks in order before the next Bronislav Korcynsky comes knocking at their door, with a new first and last name, with the nickname "Fingers" — because he was a classical pianist — and most importantly of all, with promises of easy money!