FRAUD IN A MORTGAGE POOL: WHO PAYS FOR THE LOSS?

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What should a bank do when it discovers that it has purchased a pool of mortgages sprinkled with fraud? In this article, the authors explain how insurance coverage may protect the bank — and how to calculate the limits of that coverage.

Suppose that you are a sophisticated financial officer of a sophisticated financial institution that recently has purchased a mortgage pool. Suppose, moreover, that you have just found out — after the seller skipped off to a faroff Pacific island that has no extradition treaty — that the mortgage pool you purchased included $12,500,000 in forged loan notes and mortgages that now are worthless.

As a large financial institution that regularly purchases mortgage pools, do you have adequate insurance coverage to cover such risks?

MORTGAGE POOLING

Mortgage pooling or securitzation is the business of transferring a group of mortgages and "exchanging them for marketable interests in the transferred pool or in other mortgage loan pools."[1]

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The best place to find coverage for your institution's loss is its fidelity bond, which will provide coverage (often by endorsement) for mortgage securitization or mortgage pooling. Such an endorsement will typically provide coverage for:

I. Loss resulting from the Insured having in good faith and in the course of business in connection with any mortgage acquisition, mortgage financing or mortgage securitization, accepted, received, or acted upon the faith of a promissory note secured by a real property mortgage or deed of trust ("Note") or a facsimile thereof ("Facsimile" as to which:

   A. the facsimile was altered so that it is not identical to the Note of Mortgage/Deed of Trust.

   B. The signature of the payor on the Note or Mortgage/Deed of Trust was obtained through trick, artifact, fraud or false pretenses or the note or Mortgage/Deed of Trust is for any other reason illegal, invalid, nonbinding or not enforceable in accordance with its terms.

   C. The Note or Mortgage/Deed of Trust was materially altered or otherwise contains one or more material misrepresentations.

   D. The Note or Mortgage/Deed of Trust is conveyed to a party other than the Insured or otherwise exists in multiple forms.

Under such an endorsement, your financial institution is covered for the losses — right?

Don't be surprised if your trusty old insurance company tries to wiggle out of its obligations by artfully (and incorrectly) using the policy deductible in an attempt to pressure you out of pursuing your company's claim.

THE DEDUCTIBLE

Suppose the $12.5 million in collective losses involve forged notes of $300,000 or less *and* the fidelity policy has a $2.5 million deductible:

> The Limit of Liability applicable to this Insuring Agreement shall be TEN MILLION Dollars ($10,000,000)...subject to a single loss deductible of Two Million Five Hundred Thousand Dollars ($2,500,000).

Again, do not be surprised if your trusty old insurance company attempts to argue that since none of the forgeries exceeded the $2.5 million deductible, there is no coverage!

Do not be fooled. The issue is whether *all* the forgeries constituted a single loss (with one deductible) or multiple losses (with multiple deductibles). Review your policy again and focus on the definition of single loss. You will often find it defined as a series of related losses, thereby constituting one related act:

> Single Loss Defined
>
> Singe Loss means all covered loss...resulting from
>
> (a) any one act or *series or related acts* of burglary, robbery or attempt thereat, in which no Employee is implicated, or
>
> (b) any one act or *series of related unintentional or negligent acts or omissions* on the part of any person (whether an Employee or not) resulting in damage to or destruction or misplacement of Property;
>
> (c) *all acts or omissions* other than those specified in (a) and (b) preceding, caused by any person (whether an Employee or not) or in which such person is implicated, or
>
> (d) any one casualty or event not specified in (a), (b) or (c) preceding.

In other words, the forgeries were a series of interrelated wrongful acts and therefore a "single" $12,500,000 loss under the policy - entitling you to coverage up to your full $10,000,000 policy limits (minus the $2,500,000 deductible).

COURT DECISIONS

Numerous courts have agree with this reading of the definitions of "loss" or "occurrence" in a fidelity policy and have held that common acts committed by a single employee are a single loss or occurrence. For example, in *American Commerce Insurance Brokers, Inc. v. Minnesota Mutual Fire and Casualty Co.*,[2] the plaintiff insurance agency's employee embezzled cash and check payments made in person by the agency's customers. The fidelity policy had a per occurrence limit and stated that losses "involving a single act or series of related acts is considered one occurrence." The policyholder argued that the acts of embezzlement were separate occurrences, but the court concluded that the "series of related acts" language was unambiguous, and that "it is intended to encompass a continuous embezzlement scheme in which the dishonest employee converts funds from an employer by a common scheme on a constant basis."[3]

Even in the absence of a definition of "loss or "occurrence," courts have held a series of fraudulent acts to be a single occurrence because the intent of the employee or wrongdoer was to continue the dishonesty and not to begin a new scheme of dishonesty. In *Business Interiors, Inc. v. Aetna Casualty & Surety Co.*,[4] an employee was found to have embezzled by writing 40 checks, 31 one of which were forgeries and nine of which were material alterations of the original checks. Aetna argued that the policyholder's recovery was limited to $10,000, the per loss limit under the policy. The policyholder asserted its claim consisted of 40 separate losses, and that because each loss was under $10,000, it could recover its full loss. The court noted that the lower court's finding that the intent of the employee with regard to the last 39 checks "[was] essentially the intent to continue the dishonesty, not to commit an entirely new and different act of dishonesty." Thus, the court held, the 40 acts constituted one loss, for which coverage was limited to $10,000.

Similarly, in *Arlington Trust Co. v. Hawkeye-Security Insurance Co.*,[5] in the absence of a definition of "loss" or "occurrence" in the policy, the court held a scheme of fraudulent acts constituted a single loss. Arlington involved a bank employee who handled the bank's financing of government bills of lading, and who was found to have made loans beyond his authority, brought overdue loans up to date by renewal notes, and allowed borrowers to process

their own papers, among other acts. The insurance company claimed that it was entitled to apply a deductible to each note fraudulently financed, instead of a single deductible to the entire loss. The court rejected this argument, holding that "the losses resulted from a series of continuing dishonest and fraudulent acts on the part of the covered employee touching all phases of the Bill of Lading Loan Department."

As these cases establish, courts are generally inclined to find that a series of related dishonest acts, committed by an employee using a similar modus operandi, constitute a single "loss" or "occurrence." Although many of these cases are based on specific policy language, courts have found a series of acts to be a single occurrence in the absence of specific policy language.

Policyholders should not be fooled. If and when a fidelity loss is suffered, be sure to review your policy and its definition of "loss" or "occurrence. Don't take no for an answer.

NOTES

[1] *Securitization of Financial Assets*, 2d Ed. Volume 2 (2002) § 16.01.

[2] 551 N.W.2d 224 (Minn. 1996).

[3] *Id.* at 228. *See also Jefferson Parish Clerk of Court v. Fidelity & Dep. Co. of Maryland*, 673 So. 2d 1238, 1245 (La. Ct. App. 1996) (in interpreting a policy with "single act or series of related acts" language, finding that the loss suffered as a result of the clerk's failure to place funds withheld from employees for health insurance in the trust for such funds, was a single occurrence since "[the clerk's] acts were integral parts of a scheme to deprive the Trust Fund of current premiums" and that all of the employee's acts "were committed in the furtherance of the scheme"); *Christ Lutheran Church v. State Farm Fire & Cas. Co.*, 471 S.E.2d 124, 126 (N.C. Ct. App. 1996) (in interpreting a policy with "single act or series of related acts" language, holding that embezzlement by the church's treasurer on 24 occasions was "a continuum of wrongful actions" and thus one occurrence).

[4] 751 F.2d 361 (10th Cir. 1984).

[5] 301 F. Supp. 854 (E.D. Va. 1969).