Declining Asset Values and Fidelity Insurance Coverage

by Robert M. Horkovich, Edward J. Stein and Peter A. Halprin

As lenders discover losses from employee dishonesty, forgery and other fidelity risks in the current economic downturn, insurance companies have attempted to avoid coverage by arguing that the losses are attributable to declining collateral values rather than the fraud that initially induced lending. Acceptance of that argument would erode the fundamental protection of the fidelity and commercial crime insurance commonly purchased by financial and commercial policyholders. Fortunately, however, courts recently have recognized that the decline in real estate and other asset values does not constitute a basis for denying coverage for employee dishonesty, forgery and other covered losses.

For example, in Beach Community Bank v. St. Paul Mercury Insurance Company, the policyholder bank approved a $10 million loan to finance a corporation's purchase of beachfront property. The loan was conditioned on personal guarantees of the corporation's sole shareholder, whose net worth was over $130 million, and his wife, whose guaranty was required as protection against a transfer of the shareholder's assets through joint ownership.

Several years later, the loan went into default, and the bank obtained a judgment for the unpaid principal and accumulated interest, which exceeded the original loan. That judgment went unsatisfied, because the personal guarantees proved worthless; the shareholder had died, leaving an estate with less than $100,000 in cash, and his wife had few personal assets. Moreover, in response to the bank's collection efforts, the wife denied she had signed the guaranty, and a handwriting expert confirmed that her signature had been forged.

The discovery of this forgery prompted a claim under the bank's financial institution bond, followed by coverage litigation to challenge the insurer's denial of the claim. The U.S. District Court for the Northern District of Florida ruled in favor of the insurer, finding that the loss did not result directly from the forgery. The district court reasoned "it was not the forged guarantee that precluded [the bank] from collecting on the loan, but rather [the guarantor's] diminished assets and the crashed real estate market that caused [the] loss," cautioning that a contrary holding would transform the financial institution bond into "credit insurance."

The U.S. Court of Appeals for the Eleventh Circuit reversed the decision, agreeing with the policyholder that it suffered a loss "resulting directly" from the forgery because the forged personal guaranty caused it to extend credit where it otherwise would not have. The appellate court measured the fidelity insurer's obligation by the amount of credit extended, not the amount that could be recovered in a hypothetical collection effort, holding that "the decline in [the guarantor's wealth] had nothing to do with the extension of credit ... and should not affect the coverage of the loss."

Notably, the Beach Community appellate court found support not only in the express language of the financial institution bond, but also in its basic purpose, reasoning that "insurance of guaranties would be illusory if a default by the borrower or decline in his wealth severed the direct causal relationship between reliance on a forged guaranty and a loss because a guaranty is enforced only when the borrower defaults and is unable to pay." As support, the court cited a 1992 Fifth Circuit decision in First Nat'l Bank of Louisville v. Lustig that explained "there will always be some intervening cause for the failure of [loans issued by an insured bank] to be repaid; otherwise the bank would suffer no loss."

Similarly, in Transwest Credit Union v. Cumis Ins. Society, a lender sustained losses on home loans made by two employees that violated several of its formal policies, including a specific prohibition on loans for "spec homes," i.e., properties built with the intention of listing for sale, rather than occupancy. After foreclosing, the policyholder claimed a loss of $1.5 million under its credit union bond due to the employees' "failure to faithfully perform [their] trust," a covered risk that was defined to include "acting in conscious disregard of ... established and enforced ... lending policies." The insurer denied coverage of the loss in market value of the spec homes that resulted from the decline in the real estate market after the initial extension of credit, relying on bond language that limited coverage to "loss resulting directly" from unfaithful employees and excluding "indirect or consequential loss, including ... diminution of value of property."

In the ensuing coverage litigation, the U.S. District Court for the District of Utah found for the policyholder, reasoning that "the impact of the real estate market is not a factor in determining the loss claim." The court held that the policyholder's loss "must be determined from the time the funds were wrongfully distributed," so that the claim amount must be determined when the money initially was loaned. The subsequent market decline was relevant only insofar as it affected the realization of offsetting value from the lender's collateral; the court concluded that the amount of the claim would be "the amount of the original loans minus any payments made or moneys recovered via foreclosure or other means."

In short, policyholders with fidelity losses should resist insurance company efforts to diminish or deny claims based on the effects of declining real estate or other assets pledged as collateral or held by guarantors. Declining asset values clearly can increase ultimate loan losses, but increasing a loss is different from causing it and does not defeat or reduce coverage. ■

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