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Insurance Coverage for Mortgage Fraud

by John Eichman*

Many banks have recently fallen victim to various types of fraud in mortgage loans or warehouse lending relationships. Common scenarios on both individual mortgage loans and warehouse loans have included forged signatures on promissory notes, deeds of trust, mortgages or powers of attorney, fictitious borrowers or nonexistent downpayments or collateral. Whatever fraudulent methodology was employed, the victimized bank must promptly consider whether it has insurance coverage for any resulting loss. The purpose of this article is to describe generally the parameters of coverage for such losses under a typical financial institution bond, which is the most likely source of coverage under the bank's own insurance policies.

If a bank employee was a party to the fraudulent mortgage scheme, the relevant part of the bond (referred to as an "insuring agreement") is the "Fidelity" insuring agreement. If a bank employee was not involved, the bank should consider the "Securities" insuring agreement and the "Forgery or Alteration" insuring agreement. In addition, some bonds now also contain an insuring agreement entitled "Fraudulent Mortgages" or "Fraudulently Obtained Signatures—Real Property Mortgages" that must also be considered. Although the language in all four of these insuring agreements has its genesis in standard form policies, carriers have varied the language in those agreements from time to time, so the bank should be sensitive to that possibility. Further, the language in these insuring agreements, and the carriers' application of the language, can be quite technical—some might say hyper-technical.

The Fidelity Insuring Agreement

If one or more of the bank's employees was a knowing participant in the fraudulent mortgage scheme, the typical financial institution bond will dictate that the "Fidelity" insuring agreement will be the only source of coverage provided by the bond. This insuring agreement will usually require that the bank's loss resulted directly from the employee's engaging in dishonest conduct, either alone or in collusion with one or more other actors, with the intent to cause the bank a loss or to obtain a benefit for a third party or himself. Because the conduct involved a loan, most bonds also require that the employee actually received a financial benefit, other than salary,

bonus or the like, in connection with the transactions. In a fraudulent mortgage scheme in which a bank employee is involved, most of the elements of this insuring agreement can be readily satisfied. The challenge for the bank usually will be in gathering sufficient evidence that its employee received the requisite financial benefit in connection with the transactions.

The "Securities" Insuring Agreement

This insuring agreement typically insures the bank from loss resulting directly from it extending credit, in good faith, based on an original "written instrument" that bears a signature that is a "forgery" or bears a "fraudulent alteration." The bank or its authorized representative must have actual physical possession of the written instrument. Questions that frequently arise under this insuring agreement include:

- Is the document a "written instrument?" "Written instruments" include evidence of debt, deeds of trust and mortgages, guarantees and security agreements, but not powers of attorney. An "evidence of debt," in turn, is an instrument executed by a customer of the bank and held by the bank, which in the regular course of business is treated as evidencing the customer's debt to the bank. A promissory note will typically fall within that definition if purportedly signed by a customer of the bank.
- Is the signature a "forgery?" "Forgery" is a technical, and frequently litigated, concept under the bond. It is typically defined to mean the signing of the name of another person or organization with intent to deceive. It does not mean a signature that consists in whole or in part of one's own name signed with or without authority for any purpose.
- Did the bank act in *good faith*, or was it on notice of the fraudulent activity?
- Did the loss *result directly* (some bonds say only "result") from the bank extending credit based on the instrument that contained a forged signature? This question has generated much litigation. For example, if a bank extends a mortgage loan and the promissory note and deed of trust or mortgage contain forged signatures and the property does not exist, the carrier will likely take the position that the loss resulted because the property did not exist rather than because the documents contained forgeries.
- Did the bank extend credit based on an *original* set of documents. If the bank disbursed funds based on faxed documents and received the original documents after funding, the carrier will take the position that there is no coverage.

The "Forgery or Alteration" Insuring Agreement

This insuring agreement is also sometimes called the "Unauthorized Signature or Alteration" insuring agreement. At first blush, this insuring agreement would seem to be a likely source of coverage for various types of mortgage fraud. To the contrary, though, this provision is actually quite narrow and will rarely provide coverage for mortgage fraud. The insuring agreement typically says that it covers loss resulting directly from "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." The provision therefore excludes coverage for loss resulting from a forged or altered promissory note. Even if a promissory note qualified under the bond's very narrow definition of "negotiable instrument" (and it probably does not), a forged promissory note is not covered because it falls within the typical definition of "evidence of debt." Similarly, loss resulting from a forged or altered deed of trust or mortgage would not be covered because neither is one of the documents listed in the insuring agreement.

The "Fraudulent Mortgages" Insuring Agreement

Some bonds contain a provision insuring against loss resulting from the bank, in good faith and in the usual course of business, accepting a mortgage or deed of trust in connection with a loan when the mortgage or deed of trust is defective because it contains a signature obtained through trick, artifice, fraud or false pretenses. This provision also might cover losses when the signature on the deed conveying or releasing title to the property to the mortgagor under the mortgage or the grantor under a deed of trust was obtained by trick, artifice, fraud or false pretenses. This "fraudulently obtained signatures" insuring agreement consequently will cover some types of mortgage fraud. As a general rule, however, the provision will not cover schemes involving forged promissory notes, deeds of trust or mortgages or schemes involving fictitious borrowers or nonexistent collateral.

Conclusion

Lenders have confronted a myriad of fraudulent mortgage schemes. Unfortunately, not every such scheme falls within the parameters of the typical financial institution bond. Insurers will scrutinize the circumstances of the fraud to assess whether the loss resulted from conduct that falls within the rather technical language of one of these four insuring agreements. Litigation over the “Fidelity,” “Securities” and “Forgery” insuring agreements has been common, particularly where the losses have been substantial. Careful analysis of the facts of the loss and the language of the insuring agreements by the bank can be critical to its successful resolution of an insurance claim for mortgage fraud.

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ATM ALERT—MONITOR YOUR FEE DISCLOSURES

by Pam Gates O’Quinn

In this challenging economy, unfortunately some clever members of the plaintiff’s bar are seeking ways to “make a quick buck” at the expense of financial institutions that have neglected to maintain adequate ATM fee disclosures. Recently some financial institutions have become the target of class-action lawsuits for failure to provide proper ATM fee disclosures. We prepared this article in an effort to help others avoid a similar fate. By alerting you to certain ATM fee disclosure laws, we hope that you can use this knowledge to help minimize your bank’s litigation risk.

Under Regulation E (Electronic Fund Transfer Act [“EFTA”]), every ATM operator must provide certain specific disclosures at each ATM regarding fees for ATM transactions. If an ATM operator fails to provide the proper ATM notices, the ATM operator could be the subject of a class-action lawsuit. In such case, the ATM operator can be liable for damages of up to the lesser of $500,000 or 1 percent of the net worth of the institution.1 Therefore, it is imperative for ATM operators to regularly review their ATM fee disclosures for compliance with Regulation E.

Under Regulation E, the term “ATM operator” means “any person that operates an automated teller machine at which a consumer initiates an electronic funds transfer or a balance inquiry and that does not hold the account to or from which the transfer is made, or about which an inquiry is made.” The term includes virtually any financial institution that operates an ATM and that processes transactions for accounts not held at that institution.

For you to comply with Regulation E and reduce your liability with respect to ATM fee disclosures, we recommend that financial institutions adopt the following three rules. Keep in mind that these are not alternative disclosure methods: Regulation E requires compliance with each disclosure method described below.

1) Notice on the ATM machine. A notice must be posted on or at the ATM machine in a prominent and conspicuous location. This notice must state that “a fee will be imposed for providing electronic fund transfer services.” However, if there are certain circumstances in which a fee will not be imposed, such as a balance inquiry, the notice can state that a fee “may be imposed” rather than “will be imposed.”

2) Onscreen or on paper notice. A notice must be provided on the ATM screen or on paper prior to the consumer completing the ATM transaction. The notice must include the language in

[1] For individual actions, liability is the greater of actual damages or statutory damages up to $1,000. For class actions, damages are limited to the lesser of $500,000 or 1 percent of the net worth of the defendant. The EFTA also provides criminal liability if an ATM operator “knowingly and willfully … fails to comply with any provision” of the EFTA and “shall be fined not more than $5,000 or imprisoned not more than one year, or both.”

number one above, and it must state the actual fee that will be assessed if the transaction is completed. The onscreen notice must appear for a reasonable duration, and the consumer must have the ability to cancel the transaction and avoid the fee after reading this onscreen or paper notice (and before completing the transaction).

3) Fee disclosure on receipt. An ATM operator must disclose the fee on the receipt generated upon completion of the ATM transaction if the fee is included in the transaction amount. The terminal receipt itself is not an alternative to the onscreen or paper notice.

In addition to making these required disclosures, ATM operators should implement procedures to periodically monitor ATM disclosures, especially with respect to the notice that is posted on or at the ATM machine. We recommend that financial institutions contact third-party servicers to ensure that monitoring ATM fee disclosures is a part of ordinary ATM maintenance procedures. In addition, we recommend that financial institutions designate certain employees to regularly monitor disclosures at each ATM location. Further, in order to deter vandals from stealing or defacing notices at ATMs, ATM operators should consider placing ATM disclosures under glass or other clear cover.

Also, ATM operators should be aware of a little-known defense that can absolve them of liability in the event they are faced with a claim for violation of Regulation E. Is the ATM operator liable under Regulation E if the fee notice is removed from the ATM due to vandalism? No, so long as the notice was properly displayed prior to the vandalism and a third party was responsible for the vandalism. Under Section 705 of the Gramm-Leach-Bliley Act, ATM operators are not liable for failing to comply with the requirement to post a notice on or at the ATM if the notice is subsequently removed, damaged or altered by any person other than the ATM operator. Therefore, we recommend that ATM operators maintain a file with current pictures of all ATM fee disclosure notices to protect the institutions if vandals later damage or remove the notices. In order to be able to use this defense, the ATM operator must be able to demonstrate that the required notice had been posted.

In summary, ATM providers should implement and monitor three ATM fee disclosures under Regulation E: (1) notice on or at the ATM, (2) onscreen or paper notice prior to completing the ATM transaction and (3) disclosure of any fee on the post-transaction receipt. Considering the potential ramifications of violating Regulation E, including the cost of defending a class-action lawsuit, financial institutions should establish procedures to regularly monitor ATM notices. We recommend that ATM operators perform internal monitoring as well as external monitoring through third-party ATM servicers. We are happy to provide assistance to you with this process should you need it.

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Regulators Issue Interagency Guidance on Sound Incentive Compensation Policies

by Robert Flowers

On June 21, 2010, the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of Thrift Supervision ("OTS") and the Board of Governors of the Federal Reserve System ("Federal Reserve," and collectively referred to as the "Bank Regulators") jointly issued guidance concerning incentive compensation policies of each Bank Regulator's constituent financial institutions (the "Compensation Guidance"). The Compensation Guidance was a follow-up to, and result of, comments on the compensation guidance issued by the Federal Reserve in October 2009.

Background

Compensation arrangements are critical to successful management of financial institutions and serve several objectives, including attracting skilled employees, promoting employee retention and providing retirement security for employees. The Bank Regulators recognize this. The Bank Regulators also recognize, however, that certain compensation arrangements may lead employees to take aggressive or unnecessary risks that are inconsistent with sound banking practices, especially when the return for that risk-taking is in the form of higher potential compensation.

The Bank Regulators' view is that flawed incentive compensation practices were one of the many factors that led to the collapse of the financial system that began in 2007 and continues to some degree to this day. Accordingly, the Bank Regulators believe that financial institutions should reexamine compensation practices with an eye toward better alignment of the interests of employees with the soundness of the financial institution. The traditional approach taken by many financial institutions in first seeking to align the interests of employees and shareholders is perceived by Bank Regulators as not always sufficient to address the safety and soundness of the financial institution. This is primarily because the “safety net” provided by the Bank Regulators (through the examination process and resultant authority to impose administrative action) may lead shareholders to tolerate a greater degree of risk that is inconsistent with safety and soundness standards. Thus, the guidance seeks to separate shareholders’ view of compensation practices from the Bank Regulators’ view of compensation practices.

While the Compensation Guidance avoids mandates, structured standards and various threshold limits, it does provide a basic policy framework within which financial institutions would operate with respect to incentive compensation arrangements. This article will briefly discuss to whom the Compensation Guidance applies, to what types of compensation arrangements the Compensation Guidance applies, and the corporate governance and risk-management processes that the Compensation Guidance requires. This article concludes with some suggested “next steps” that financial institutions should take with respect to the Compensation Guidance.

To Whom Does the Compensation Guidance Apply?

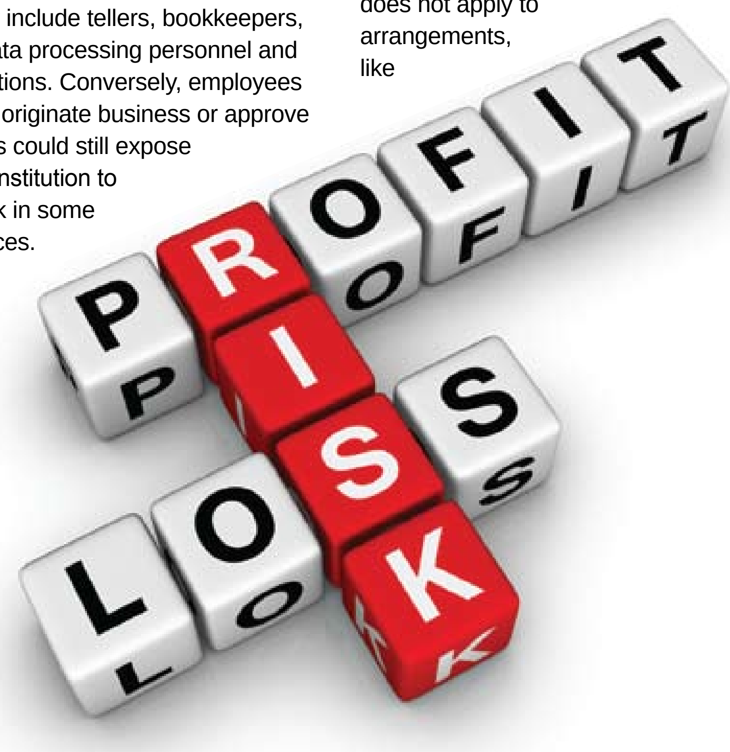
The Compensation Guidance applies to all banking organizations supervised by the Bank Regulators, including national banks, state member banks, state nonmember banks, savings associations, bank holding companies, thrift holding companies, and so on. The Compensation Guidance applies regardless of the size of the financial institution, although there are certain provisions and guidelines that apply only to “large complex banking organizations,” which are the largest and most complex financial institutions regulated by the Bank Regulators. More specific to this article, the Bank Regulators do recognize that the Compensation Guidance will generally have less impact on small financial institutions, such as the typical community bank, which are normally less complex and make less use of incentive compensation arrangements. Nevertheless, the Compensation Guidance does apply, and smaller financial institutions should take action to ensure compliance with its provisions and guidelines.

The Compensation Guidance applies to employees who, either individually or as part of a group, have the ability to expose the financial institution to material amounts of risk. The type of risks include credit, market, liquidity, operational, legal, compliance and reputational. Accordingly, the Compensation Guidance applies to employees other than senior executive officers. The employees subject to the Compensation Guidance are referred to as “covered employees.” Whether an employee or a group of employees has the ability to expose the financial institution to material amounts of risk is a “facts and circumstances” determination, but the Compensation Guidance does provide some direction by stating that such employees are those whose activities are material to the financial institution or are material to a business line or unit within the financial institution. Types of employees or categories of employees that might fall outside the scope of the Compensation Guidance would likely include tellers, bookkeepers, couriers, data processing personnel and similar positions. Conversely, employees who do not originate business or approve transactions could still expose a financial institution to material risk in some circumstances.

Consequently, the Compensation Guidance does not provide a blanket exception for any employee or group of employee, but instead suggests that a “facts and circumstances” determination should be applied to each employee within the financial institution to determine whether such employee is a “covered employee” under the Compensation Guidance. The Board Compensation Committee will need to determine the “covered employees” and document why any employee or category of employee was not designated.

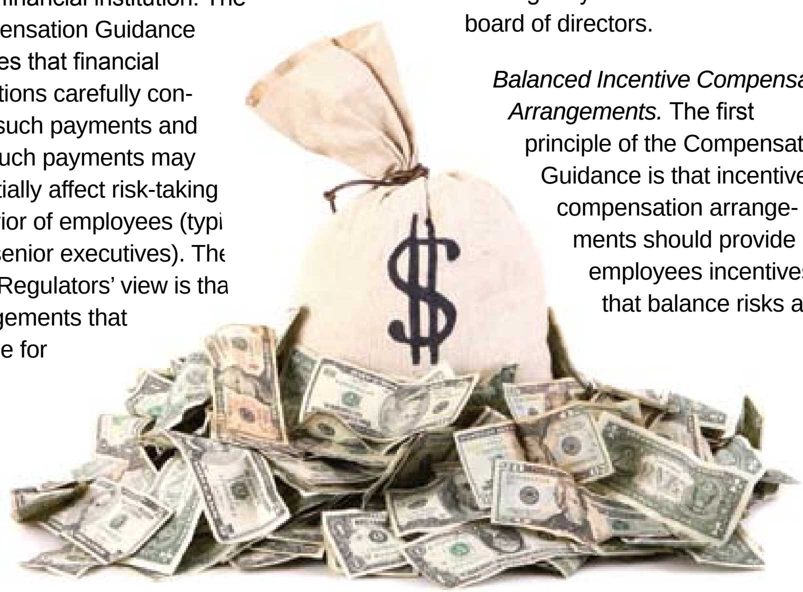
To What Types of Arrangements Does the Compensation Guidance Apply?

The Compensation Guidance is fairly (and intentionally) vague with respect to the types of incentive compensation arrangements to which the Compensation Guidance applies. The Compensation Guidance does not limit the forms of incentive compensation arrangements that may be entered into by financial institutions. It does not state what is and what is not an acceptable incentive compensation arrangement. It also clearly states that the Compensation Guidance does not apply to arrangements, like



401(k) retirement plans with employer contributions based upon salary levels, that are based solely upon the employees' level or compensation and that do not vary based upon employee performance or the financial institution's performance. Based upon this guideline, the Compensation Guidance would likely also not apply to profit-sharing plans, employee stock ownership plans or similar retirement arrangements. Whether the Compensation Guidance applies to salary continuation arrangements, supplemental executive retirement plans or similar nonqualified deferred compensation arrangements is unknown, but it likely does not, absent some incentive feature within the agreement. The Compensation Guidance also notes that incentive compensation arrangements that provide for awards based upon overall financial institution performance are unlikely to provide employees, other than senior executives and others who have the ability to materially affect overall financial institution performance, with risk-taking incentives.

The Compensation Guidance does, however, specifically address one type of compensation arrangement—the "golden parachute" payment. For this purpose, a "golden parachute" payment is any payment to an employee upon departure from the financial institution or in connection with a change in control of the financial institution. The Compensation Guidance requires that financial institutions carefully consider such payments and how such payments may potentially affect risk-taking behavior of employees (typically senior executives). The Bank Regulators' view is that arrangements that provide for guaranteed payments upon departure from or in connection with a sale of the financial institution, regardless of performance, may neutralize any balancing features that such arrangements may have to preclude risk-taking. While not expressly prohibited, it is clear that typical "golden parachute" payments tend to be viewed unfavorably by Bank Regulators.



What Does the Compensation Guidance Require?

After carefully reviewing comments received on the October 2009 compensation guidance issued by the Federal Reserve, the Bank Regulators adopted the final Compensation Guidance in June 2010, which is similar to the October 2009 guidance. There are three key principles in the Compensation Guidance concerning incentive compensation arrangements:

- such arrangements should provide employees incentives that balance risk and financial results in a manner that does not encourage employees to expose the financial institution to imprudent risks;
- such arrangements should be compatible with effective controls and risk management; and
- such arrangements should be supported by strong corporate governance with effective and active oversight by the financial institution's board of directors.

Balanced Incentive Compensation Arrangements. The first principle of the Compensation Guidance is that incentive compensation arrangements should provide employees incentives that balance risks and rewards in a manner designed to discourage imprudent or excessive risk-taking. Incentive compensation that may be available to employees should consider, and be adjusted for, the risks and losses—and gains—associated with applicable employees' activities. In other words, the greater the incentive to take risks, the greater the need for offsetting protections or disincentives. While the Compensation Guidance does not specifically set forth how this balancing technique should occur, it does suggest four methods that might make incentive compensation arrangements more sensitive to risk. Those methods are: (a) risk adjustment of awards (i.e., downward adjustment if risks are excessive), (b) deferral of payment, (c) longer performance periods and (d) reduced sensitivity to short-term performance. A typical disincentive would be a "claw-back" feature providing that incentive payments may be reduced if negative results are experienced. Financial institutions should note that these methods are not exclusive, and one may be combined with another to achieve the desired result. Further, methods used at one financial institution, or even for one employee within a single financial institution, may not be suitable for another. The financial institution should use a broad view when designing its incentive compensation arrangements, and should ensure that the arrangements are consistent with safety and soundness principles.

The underlying point of this first principle is that incentive compensation arrangements should be balanced, in that the arrangements contain not only incentives for performance but also "negative" incentives for taking excessive and imprudent risks.

Compatibility With Effective Controls and Risk Management. The second tenet in the Compensation Guidance is that a financial institution's risk-management processes and internal control procedures should reinforce and support the development and maintenance of balanced incentive compensation arrangements. In other words, financial institutions should:

- have appropriate controls to ensure that processes for achieving balance are followed;
- ensure that appropriate personnel, such as risk-management personnel, have input on the design and assessment of incentive compensation arrangements; and
- monitor incentive compensation awards, risk taken and actual risk outcomes to determine whether the incentive compensation arrangements and awards are properly balanced vis-à-vis risk exposure.

With respect to internal controls and risk management, the Compensation Guidance recognizes that monitoring methods and processes used by a financial institution should be commensurate with its size and complexity, the understanding being that smaller financial institutions may be able to satisfy this principle through normal management processes.

The underlying point of this second principle is to monitor and review the results of incentive compensation arrangements to make sure that the first principle of balance is attained and maintained.

Strong Corporate Governance. The final principle in the Compensation Guidance is that incentive compensation arrangements should be supported by strong corporate governance, including active and effective oversight by the financial institution's board of directors. It is the ultimate responsibility of the financial institution's board of directors that incentive compensation arrangements are appropriately balanced, effectively monitored and reviewed, and are within the principles of safety and soundness. In that regard, the Compensation Guidance notes that boards of directors should receive data and analysis from management and other sources (compensation consultants, accountants, attorneys, etc.) to sufficiently enable the board of directors to review and assess the overall design and actual performance of the incentive compensation arrangement in light of safety and soundness principles. Further, boards of directors should have sufficient expertise and knowledge on compensation and risk-management issues, whether through directors on the board or through access to appropriate consultants outside of the board.

In addition to corporate governance at the board level, the Compensation Guidance mandates that a financial institution's disclosure practices should support safe and sound incentive compensation arrangements. The institution should disclose to its shareholders sufficient information concerning its incentive compensation arrangements and related risk-management, control and corporate governance processes to enable shareholders to monitor and, where appropriate, take action to restrain the potential for such arrangements causing employees to take excessive or imprudent risks. The challenge in this regard is that the Compensation Guidance does not impose specific disclosure requirements on financial institutions. Rather, the scope and level of disclosure should be tailored to the nature and complexity of the organization and its incentive compensation arrangements. Some hint is provided, however, in that financial institutions should attempt to comply with the incentive compensation disclosure requirements under federal securities laws.

What Should You Do Right Now?

Make no mistake, the Bank Regulators are serious about the Compensation Guidance. To that point, one of the most important concepts to take from the Compensation Guidance is that examinations performed by Bank Regulators will incorporate the Compensation Guidance, and financial institutions' compliance with the Compensation Guidance, into future safety and soundness examinations.

In fact, this process has already begun. The Compensation Guidance has been mentioned in a few recent examination exit interviews. Accordingly, boards of directors and management of financial institutions should act quickly to inventory any type of compensation arrangement that may fall within the parameters of the Compensation Guidance. Financial institutions should then work closely with their compensation consultants, accountants and attorneys, preferably those with knowledge of tax law, corporate governance law, employment law and benefits law, as well as the requirements of the Compensation Guidance, to (a) review the arrangements and, where necessary, amend them to incorporate certain of the concepts within the Compensation Guidance, (b) review the financial institution's internal risk-management and control processes with respect to compensation matters and (c) ensure that the financial institution has proper corporate governance processes to meet the requirements of the Compensation Guidance. Further, this entire process should be well documented for regulatory review during the examination process. In fact, it may be advisable to conduct certain of these processes at least twice per year. This process will undoubtedly involve a multidisciplinary approach, and financial institutions should be prepared, at least initially, for increased regulatory costs in that regard.

The Compensation Guidance is intentionally vague, and contains no specific "recipe" as to how a financial institution should comply with it. There are numerous ingredients. Our team of financial institution and benefits lawyers are more than happy to work with bankers to audit existing plans and agreements and to help devise a program to ensure compliance with the Compensation Guidance.

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