

Fraud in Your Mortgage Pools — Who Pays For Your Loss?

By R. Mark Keenan and James E. Franz

You are a sophisticated financial officer of a sophisticated financial institution. Your company has recently purchased a mortgage pool. However, you have just found out—after the seller skipped off to a far off pacific island that has no extradition treaty—the mortgage pool you purchased included \$12,500,000 in forged loan notes and mortgages are worthless.

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

Mortgage pooling or securitization 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.” *Securitization of Financial Assets*, 2d Ed. Volume 2 (2002) § 16.01.

The best place to find coverage for your company’s loss is the financial institution’s 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, non binding 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 forgery 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.

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Suppose the \$12.5 million in collective losses involve forged loan 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, you shouldn't be in shock if your friendly insurance company attempts to argue that since none of the forgeries exceeded the \$2.5 million deductible, there is no coverage!

Don't 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 that single loss is defined as a "series of related losses," thereby constituting one related act:

Single Loss Defined

Single 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). See *e.g. Business Interiors, Inc. v. Aetna Casualty & Surety Co.*, 751 F.2d 361 (10th Cir. 1984); *American Commerce Insurance Brokers, Inc. v. Minnesota Mutual Fire and Casualty Co.*, 551 N.W.2d 224 (Minn. 1996); *Christ Lutheran Church v. State Farm Fire & Cas. Co.*, 471 S.E.2d 124, 126 (N.C. Ct. App. 1996). ■

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The information appearing in this newsletter does not constitute legal advice or opinion. Such advice and opinion are provided by the Firm only upon engagement with respect to specific factual situations. For more information contact one of the attorneys listed.

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