Blaneys Fidelity Year in Review 2015

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Introduction

In 2015, American and Canadian courts released a number of decisions of interest to fidelity claims professionals. Many of the decisions affirmed the coverage intent of fidelity insurers in the face of creative arguments from insureds. Courts released several notable coverage decisions concerning the direct loss requirement; the employee theft coverage; the computer fraud and funds transfer fraud coverages; and the securities coverage, as well as specialized coverages under financial institution bonds. Courts also released significant decisions concerning the inventory exclusion, the ownership condition and misrepresentation in the bond application, among other issues.

To mark the first year of Blaneys Fidelity Blog, we are pleased to present *Blaneys Fidelity Year in Review*, which provides summaries of the decisions that appeared on the Blaneys Fidelity Blog in 2015, along with one other decision that did not make the Blog.

For a more detailed summary of each decision, feel free to click on the hyperlink in each case summary to access the original summary as it appeared on the Blaneys Fidelity Blog.

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PART I: COVERAGES

Employee Theft, Direct Loss and Manifest Intent

“Direct Loss” of Client Funds: ***Taylor & Lieberman v. Federal Insurance Company***

In *Taylor & Lieberman v. Federal Insurance Company*, the U.S. District Court for the Central District of California applied the “direct means direct” approach to causation in finding that a business management firm did not have coverage in respect of client funds which it was fraudulently induced to wire overseas.

The insured, T&L, was an accounting firm that held client funds in separate accounts maintained with City National Bank. The clients granted powers of attorney over the accounts to a designated individual at T&L. A fraudster twice induced a T&L employee to fraudulently transfer funds from one of these accounts to accounts overseas.

T&L submitted a claim under its Forgery Coverage; its Computer Fraud Coverage; and its Funds Transfer Coverage, each of which required a “*direct loss sustained by an Insured*”. The Court found that no direct loss had been sustained by T&L. After reviewing the direct loss case law and observing that most courts have adopted the “direct means direct” approach, the Court held that the client’s loss was a third-party loss. Although T&L may have been liable to the client, T&L had not suffered a direct loss of its own funds. The Court rejected T&L’s assertion that its power of attorney made it tantamount to a trustee of the client funds, accepting Federal’s argument that T&L was not a trustee because the funds were not held in T&L’s account.

"Direct Means Direct": ***Hantz Financial Services, Inc. v. National Union Fire Insurance Company of Pittsburgh, PA.***

In *Hantz Financial Services, Inc. v. National Union Fire Insurance Company of Pittsburgh, PA.*, the U.S. District Court for the Eastern District of Michigan held that a fidelity bond did not provide coverage to a financial services firm in respect of frauds perpetrated by an employee against the firm's clients.

Hantz employed Laursen, who stole cheques from Hantz's clients. Laursen deposited the cheques into a bank account which he opened in a name similar to Hantz. Hantz reimbursed the clients and submitted a claim under its Financial Institution Bond, which covered loss resulting directly from dishonest or fraudulent acts committed by an Employee with the manifest intent to cause the insured to sustain a loss. The Bond excluded "*indirect or consequential loss of any nature*." National Union denied the claim, on the basis that Laursen's conduct did not result in a direct loss to Hantz; rather, Laursen caused a direct loss to each client. As Laursen had stolen from Hantz's clients and not Hantz directly, the Court concluded that, as a matter of law, Hantz's losses were indirect and therefore not covered by the Bond.

Alter Ego and the Employee Theft Coverage: ***Re Taylor, Bean & Whitaker Mortgage Corporation***

In *Re Taylor, Bean & Whitaker Mortgage Corporation*, the U.S. District Court for the Middle District of Florida dealt with a claim where the insured's *alter ego* allegedly colluded with subordinate employees who were not directing minds of the insured.

Taylor, Bean & Whitaker ("TBW"), a mortgage lending firm, collapsed following the discovery of a $87 million fraud perpetrated by its majority shareholder, Farkas. TBW alleged that its Treasurer and CFO assisted Farkas by effecting electronic transfers of funds and by setting up a "Due From" account to conceal the fraud. Its bankruptcy trustee submitted a proof of loss asserting acts of employee dishonesty. The Underwriters sought a declaration of no coverage on the basis that Farkas fell within an exception to the definition of "Employee" because he was TBW's majority shareholder. TBW conceded this point, but relied on a provision that excluded coverage for any loss involving an act of a Major Shareholder, except when the Major Shareholder is acting in the capacity of an Employee. TBW contended that a Majority Shareholder could still be considered an Employee for coverage purposes, so long as the individual was "*acting in the capacity of an Employee*" at the time that the dishonest act was committed.

The Court rejected this, finding that Farkas controlled the corporation to such an extent that it had no independent existence, and that he had become its *alter ego*. The Court held that Farkas was not a TBW employee, nor did he act in the capacity of an Employee when committing the fraud. TBW's "backup" argument was that its losses resulted from the Treasurer's and CFO's dishonest acts, and they were unquestionably Employees. The Court rejected this, reasoning that allowing for indemnity in these circumstances would effectively nullify the *alter ego* doctrine, and would also be contrary to public policy.

"Unlawful Taking" and "Forgery" in the Employee Theft Coverage: ***Tesoro Refining & Marketing v. National Union Fire Insurance Company of Pittsburgh, PA***

In *Tesoro Refining & Marketing Company LLC v. National Union Fire Insurance Company of Pittsburgh, Pennsylvania*, the U.S. District Court for the Western District of Texas considered the "unlawful taking" element of an Employee Theft coverage and also provided guidance with respect to an employee forgery provision included in that coverage.

The insured, Tesoro, sold fuel to Enmex on credit. Leavell managed Tesoro's Credit Department and the Enmex account. As Enmex's credit balance grew, Leavell represented to Tesoro that the account was secured by certain letters of credit. In fact, Leavell had created these letters of credit on his password-protected drive on Tesoro's server. Tesoro unwittingly presented one of these letters of credit to Bank of America, which confirmed its invalidity. Tesoro alleged that Leavell forged these letters and a security agreement.

No coverage was available under the policy's Forgery coverage, as loss resulting from forgery by employees was excluded unless the loss resulted from forgery of commercial paper "*made or drawn by or drawn upon*" Tesoro. Tesoro instead sought to fit the loss within the Employee Theft coverage, contending that Leavell's conduct was an "unlawful taking" of Tesoro's money or property and that the letters of credit were "forgeries" for the purpose of the Employee Theft coverage.

The Court found that there was no unlawful taking by Leavell; unlawful taking required that an employee seize or exercise control over an article without the owner's authorization. The Court held that the employee forgery provision was not stand-alone coverage, and that any loss had to meet the other requirements of the Employee Theft coverage. The Court clarified that the provision covered losses resulting from unlawful takings by employees by means of forgery, and not simply any loss resulting from an employee's forgery.

Manifest Intent: ***KeyBank National Association v. National Union Fire Insurance Company of Pittsburgh, PA***

The New York Supreme Court, Appellate Division's decision in *KeyBank National Association v. National Union Fire Insurance Company of Pittsburgh, PA.* highlights the difficulties inherent in assessing manifest intent in financial institution losses.

KeyBank had loaned $20 million to a condominium developer. The loans were secured by mortgage liens on the project's units. When the developer ran into financial difficulties, KeyBank's employee, Martin, permitted 20 liens to be released prematurely, allowing the developer to retain approximately $5 million that should have been paid to KeyBank.

After the losses came to light, KeyBank's internal investigation concluded that Martin had contravened its procedures and loan contracts, but revealed no evidence that he had secured a financial gain. The relevant policy provision indemnified KeyBank for losses resulting directly from dishonest or fraudulent acts committed by an employee with the manifest intent (a) to cause KeyBank to sustain the loss; or (b) to obtain a financial benefit for himself or another entity.

The Appellate Division held that there were material issues of fact both as to whether Martin had the manifest intent to cause KeyBank to sustain a loss, and as to whether Martin intended to obtain a financial benefit for the developer. With respect to Martin's intent to cause Keybank to sustain a loss, the Court adopted a "substantial certainty" threshold, which provides that "*[m]anifest intent to injure an employer exists as a matter of law where an employee acts with substantial certainty that his employer will ultimately bear the loss occasioned by his dishonesty and misconduct*."

With respect to Martin's intent to obtain a financial benefit for another entity, the Court held that there were material issues of fact (including conflicting expert evidence) as to whether the cash flow from the lien releases had, in fact, been used to pay construction costs, rather than simply being pocketed by the developer.

Computer Fraud and Funds Transfer Fraud Coverages

The Computer Fraud and Funds Transfer Fraud Coverages: ***Pestmaster Services, Inc. v. Travelers Casualty and Surety Company of America***

In *Pestmaster Services, Inc. v. Travelers Casualty and Surety Company of America*, the U.S. District Court for the Central District of California interpreted the Funds Transfer Fraud and Computer Fraud coverages provided by a Travelers Wrap+ policy.

The insured, Pestmaster, operated a pest control business. Pestmaster hired Priority to handle its payroll obligations, and authorized Priority to pay approved invoices and other obligations by initiating transfers from Pestmaster's account. Pestmaster later discovered that Priority had failed to remit payroll taxes and had diverted Pestmaster's funds.

Pestmaster sought indemnity under its Funds Transfer Fraud and Computer Fraud coverages. The Court held that there had been no Funds Transfer Fraud, because the transactions resulted from Priority's authorized access notwithstanding that they were associated with an underlying fraudulent scheme.

The Court also accepted Travelers' position that the Computer Fraud coverage was only engaged where a party obtained unauthorized access to, or hacked, a computer to cause an unauthorized transfer. The American jurisprudence on the Computer Fraud coverage generally holds that indemnity does not arise "*where an authorized user utilized the system as intended … but where the claims themselves were fraudulent*." Priority had been granted authorized access by Pestmaster, and was thus not a hacker or unauthorized user.

The Computer Fraud Coverage: *Universal American Corp. v. National Union Fire Insurance Company of Pittsburgh, PA* (not posted in Blog)

In *Universal American Corp. v. National Union Fire Insurance Company of Pittsburgh, PA*, the Court of Appeals of New York affirmed summary judgment for a fidelity insurer where the alleged losses resulted from the fraudulent acts of vendors with authorized access to the insured's computerized billing system.

The insured, Universal, a health insurer, had a computerized billing system that allowed health care providers to submit claims directly. Universal incurred $18 million in losses due to payments of fraudulent claims for services never actually performed under its plans.

Universal sought coverage under a Computer Systems Fraud rider which insured against the "fraudulent entry" of data. The Court rejected Universal's contention that "fraudulent entry" encompassed inputting fraudulent claims, and held that the rider unambiguously did not extend to fraudulent claims entered into Universal's system by authorized users. The coverage was intended to be restricted to unauthorized entry into the system by a hacker or virus.

The Securities Coverage

The Securities Coverage - what is a "Counterfeit" Document?: ***Bank of Brewton v. The Travelers Companies Inc.***

In *Bank of Brewton v. The Travelers Companies Inc.*, the Eleventh Circuit Court of Appeals reinforced the distinction between counterfeit documents and documents which, although fraudulently-procured and without intrinsic value, are nonetheless authentic.

The insured Bank granted a series of loans to its customer, Hines. Hines had assigned shares in a company, TSG, to the Bank as collateral for the loans and delivered a share certificate ("Certificate No. 2") representing these shares. Hines simultaneously assigned additional shares of TSG and delivered another stock certificate ("Certificate No. 7") to the Bank. A Bank employee later discovered that the supposed Certificate No. 2 the Bank had on hand was simply a colour copy of the original Certificate No. 2. Hines explained that he had inadvertently given the Bank a copy and had lost the original.

Hines then caused TSG to issue a replacement share certificate ("Certificate No. 11") which was delivered to the Bank as a replacement for the colour copy of Certificate No. 2. The Bank proceeded to consolidate Hines' indebtedness and to hold Certificate Nos. 7 and 11 as security. However, TSG discovered that Hines had in fact assigned the real Certificate No. 2 to another creditor, and advised the Bank that Certificate No. 11 was void.

The Bank sought coverage under its Fidelity Bond's Securities coverage, which indemnified it for losses resulting directly from extending credit on the faith of a certificated security that is counterfeit. The Bank contended that the "Certificate No. 2" that had been in its possession had, in fact, been a phony, and thus came within the Bond's definition of "Counterfeit". In the Bank's view, Certificate No. 11 should also be considered to be a counterfeit, because (i) it was intended to replace Certificate No. 2, on which the Bank had relied in originally extending credit to Hines; and, (ii) Hines had fraudulently procured Certificate No. 11 from TSG by representing that it was needed to replace Certificate No. 2.

At first instance, the District Court rejected these contentions, and accepted Travelers' position that Certificate No. 11 was not actually a counterfeit, but was authentic and simply lacked value, due to TSG voiding it after Hines' fraud came to light. The Eleventh Circuit affirmed, holding that an attempt to deceive by means of a document that imitates the appearance of an authentic original is not the same as an attempt to deceive by means of false factual representations implicit in an authentic document. The Eleventh Circuit observed that the distinction between counterfeit documents and fraudulently-procured, but authentic, documents was an essential limiting principle in the Bond coverage.

The Securities Coverage - Direct Reliance on a Guarantee: ***BancInsure, Inc. v. Highland Bank***

In *BancInsure, Inc. v. Highland Bank*, the Eighth Circuit Court of Appeals considered what constitutes a "direct loss" under the Securities Coverage of a Financial Institution Bond and the reliance required for an insured to demonstrate that it has "extended credit on the faith of" a forged guarantee.

FPC, an equipment lease finance company, entered into a Master Lease Agreement and approximately 20 individual lease agreements with EAR, which was owned by Player and Malone. FPC leased EAR equipment, while Player and Malone provided FPC with personal guarantees. To finance its purchases of equipment, FPC typically entered into agreements with banks whereby it assigned EAR's payment streams.

The insured, Highland Bank, obtained assignments under three such agreements. Highland Bank reviewed the agreements and obtained a joint financial statement from Player and Malone, but did not inspect the equipment and had no direct contact with EAR, Player or Malone. EAR eventually filed for bankruptcy and it was revealed that EAR was a Ponzi scheme that was colluding with a distributor. Highland Bank learned that Malone's signature on the guarantee was likely forged.

Highland Bank advanced a claim under its Securities Coverage, and asserted that Malone's Guarantee Agreement was a "personal Guarantee" within the scope of coverage. The Eighth Circuit held that Highland Bank had failed to demonstrate a direct loss; it had never obtained a legal interest in Malone's guarantee, which was only in favour of FPC. Thus, there was no reliance on the guarantee in extending credit and, in any event, the guarantee was worthless at the time that Highland Bank had extended credit.

Outside Investment Advisor Rider and Securities Broker Exclusion

Outside Investment Advisor Rider and Securities Broker Exclusion: ***Jacobson Family Investments, Inc. v. National Union Fire Insurance Company of Pittsburgh, Pa***

In *Jacobson Family Investments, Inc. v. National Union Fire Insurance Company of Pittsburgh, PA*, the New York Supreme Court, Appellate Division considered a Financial Institution Bond's Outside Investment Advisor coverage rider and Securities Broker exclusion in the context of Bernie Madoff's Ponzi scheme.

The insured, JFI, managed MDG's assets. JFI submitted a claim for losses to MDG allegedly sustained as a result of the dishonest acts of Bernie Madoff; Madoff provided fraudulent investment advice and fraudulent brokerage account statements to MDG. The coverage dispute distilled to two issues: whether MDG's losses were covered under the Outside Investment Advisor rider and whether the Securities Broker exclusion applied. National Union took the position that MDG's loss was not caused by Madoff actingsolely in his duties as an Outside Investment Advisor, as required by the rider, but rather that Madoff had acted as both an investment advisor and as a securities broker, thus engaging the exclusion.

The trial court rejected National Union's submission on the basis that it would render the rider's coverage meaningless. The trial court also held that the Securities Broker exclusion did not apply, as the evidence was not clear that Madoff had been acting as a securities broker. The Appellate Division reversed on all points, holding that the rider and exclusion were unambiguous and that, in view of the evidence at trial, there was "*simply no way to separate Madoff's activities as an investment advisor from his activities as a securities broker insofar as they produced the losses claimed*". The Appellate Division also held, as an alternate basis for denying coverage, that the

Securities Broker exclusion only required that the non-employee *be* a securities broker (which Madoff was) - not that he act in that capacity in causing the loss.

Outside Investment Advisor Rider and Securities Broker Exclusion**: *United States Fire Insurance Company v. Nine Thirty FEF Investments, LLC***

In *United States Fire Insurance Company v. Nine Thirty FEF Investments, LLC*, the New York Supreme Court, Appellate Division drew on *Jacobson Family Investments* in holding that the Securities Broker exclusion brought a loss outside the Outside Investment Advisor coverage, notwithstanding the insureds' argument that coverage and the exclusion could not both operate without creating an ambiguity.

The insureds, FEF and VC, opened accounts with Madoff pursuant to Customer Agreements that referred to Madoff as their "Broker". FEF and VC subsequently obtained Financial Institution Bonds from USFI. The bonds contained an Outside Investment Advisor rider whereby the insurer agreed to indemnify for any loss resulting directly from the dishonest acts of any Outside Investment Advisor solely for their duties as Outside Investment Advisor on behalf of the Insured. However, as in *Jacobson Family Investments*, the Securities Broker exclusion precluded coverage for any loss resulting from any dishonest or fraudulent act or acts committed by any non-employee who was a securities broker.

VC and FEF submitted claims under the Outside Investment Advisor rider, but USFI took the position that the Securities Broker exclusion applied. The motions court found that the rider "became" ambiguous when read together with the Securities Broker exclusion. The Appellate Division reversed and granted summary judgment in favour of USFI. Drawing on *Jacobson Family Investments*, the Appellate Division observed that the Securities Broker exclusion only required that the non-employee be a securities broker; the exclusion did not render the rider ambiguous, as the two could operate independently.

Telefacsimile and Voice Instruction Transactions

Telefacsimile and Voice Instruction Transactions - who is a "Customer"?: ***First National Bank of Northern California v. St. Paul Mercury Insurance Company***

In *First National Bank of Northern California v. St. Paul Mercury Insurance Company*, the Ninth Circuit Court of Appeals analyzed certain elements of a Telefacsimile and Voice Instruction Transactions coverage under a Financial Institution Bond.

The Bank's customers opened an account with the Bank and agreed to the terms of an account agreement that included a provision with respect to wire transfers. The customers also acknowledged receipt of a completed copy of the account agreement. However, the Bank did not provide the customers with a copy of its Security Procedures, nor of a wire transfer agreement. The Security Procedures permitted the Bank to rely on voice and facsimile instructions to make wire transfers if there was a wire transfer agreement on file, or if the customer's identity could be verified.

The Bank authorized two fraudulent wire transfers from the customers' account, both of which had been initiated via telephone. The customers later discovered these fraudulent transfers, and the Bank reimbursed them and then made a claim for coverage. The Bank's Telefacsimile and Voice Instruction Transactions applied only in respect of customers with whom the Bank had "*a written agreement … authorizing the Insured to rely on telephonic voice or Telefacsimile Device instructions to make transfers*".

Travelers declined coverage on the basis that the Bank failed to establish that there was any written agreement with the customers that permitted reliance on phone calls or telefacsimile device instructions. The Ninth Circuit accepted Travelers' position. The Court also rejected the Bank's argument that the main account agreement obligated the customers to agree to enter into and comply with the wire transfer agreement and to comply with the Bank's Security Procedures. As neither the wire transfer agreement nor the Security Procedures were provided to the customers, they did not form part of the contractual arrangements, and the Court refused to incorporate the wire transfer

agreement and the Security Procedures by reference into the account agreement.

PART II: EXCLUSIONS

The Inventory Exclusion: ***W.L. Petrey Wholesale Co., Inc. v. Great American Insurance Company***

In *W.L. Petrey Wholesale Co., Inc. v. Great American Insurance Company*, the U.S. District Court for the Middle District of Alabama held that an Inventory Shortages exclusion applied to a loss, notwithstanding that the insured had been indemnified by the same insurer in respect of a prior, superficially-similar claim. The Eleventh Circuit Court of Appeals recently affirmed the decision, providing an illustration of the intended scope of the inventory exclusion.

Petrey was a wholesaler of 5-Hour Energy drinks, and employed and leased storage units to salespeople. Salespeople were to order and deliver the product, and Petrey would periodically inspect their trucks and storage units. Petrey incurred two losses that led to claims. In the first, a salesperson, McKean, abandoned his truck and job. Petrey conducted an inventory count which revealed a shortage. McKean was confronted, but denied any wrongdoing. However, he could not provide an alternate explanation for the shortage. The insurer accepted.

In the second claim, a salesperson, Bree, was dismissed and Petrey recovered Bree's truck. Petrey's inventory count revealed an apparent shortage. Bree could not be located. Great American denied Petrey's subsequent claim on the basis of the policy's Inventory Shortages exclusion, which excluded coverage for loss, the proof of which depends as to its existence or amount on an inventory computation.

The District Court dismissed Petrey's claim. On appeal to the Eleventh Circuit, Petrey advanced two arguments. Petrey first contended that its physical inventory count provided independent evidence of employee theft by demonstrating that Bree ordered the products, received them from Petrey, did not deliver them to his customers, and did not have them on hand in his storage locker. The Court rejected Petrey's contention as circular; the sole evidence consisted of order and sales records, which boiled down to inventory comparison computations.

Petrey's second argument was that it provided independent evidence of an employee dishonesty loss by showing that only Petrey employees had access to Bree's inventory (the "exclusive access" argument). The Eleventh Circuit also rejected this argument, relying on established authority that circumstantial evidence that, if a loss in fact was sustained, the insured's employees were the perpetrators, is not independent evidence of the existence of a loss.

PART III: CONDITIONS FOR COVERAGE

The Ownership Condition and Partnership Property: ***3M Company v. National Union Fire Insurance Company of Pittsburgh, PA***

In *3M Company v. National Union Fire Insurance Company of Pittsburgh, PA*, the U.S. District Court for the District of Minnesota applied a crime policy's Ownership Provision in a decision that illustrates the interaction between the Ownership Provision and statutory and jurisprudential concepts of "ownership" of partnership property.

3M invested its employee benefit plan assets in WG Trading, and structured that investment as a limited partnership interest in WG Trading. The principals of WG Trading also maintained another entity, WG Investors, which was a limited partner in WG Trading. WG Trading was a regulated and audited entity; WG Investors was not. In fact, the principals were running a Ponzi scheme.

3M claimed under its Blanket Crime Policy and to its excess crime insurers under follow-form excess policies. National Union denied coverage on the basis that the earnings did not satisfy the Ownership Condition. Even if 3M's investment in WG Trading generated legitimate earnings that could be quantified and attributed to 3M, those earnings

remained partnership property until distributed. The earnings were neither owned by 3M, nor held by 3M in any capacity, nor were they property for which 3M was legally liable.

The Court accepted National Union's position, finding that what 3M "owned" was a limited-partnership interest in WG Trading. Up to the point at which earnings were distributed to the partners, the earnings of WG Trading were owned by WG Trading, and not by 3M or any of the other limited partners. 3M's right to receive an eventual distribution of the partnership's assets did not change that.

PART IV: OTHER ISSUES: MISREPRESENTATION AND SUBROGATION

What happens when the Defaulter makes Misrepresentations in the Application?: ***Scottsdale Indemnity Company v. Martinez, Inc.***

In *Scottsdale Indemnity Company v. Martinez, Inc.*, the Eleventh Circuit Court of Appeals considered a situation where the insured's application for fidelity coverage was completed by the very employee who was perpetrating a fraud against the insured.

MBS hired Walters as its accountant and, later, as its CEO and CFO. MBS' principal, Martinez, discovered that Walters had embezzled company funds. MBS held crime coverage with Scottsdale; however, Walters had made misrepresentations on the policy application. The Scottsdale policy contained a misrepresentation warranty, and also provided that the application was incorporated into the policy. Scottsdale relied on these provisions to deny MBS' claim. MBS relied on the "adverse interest" exception, arguing that Walters' misrepresentations should not be imputed to MBS, as she was acting against MBS' interests when she made the misrepresentations in the application.

At first instance, the District Court accepted Scottsdale's reliance on the misrepresentation warranty. The Court characterized MBS' attempt to take benefit from the policy to "attempt to take the benefit of the policy as an "*I want to have my cake and to eat it, too*" argument. Applying the plain language of the misrepresentation warranty, the Court concluded that Walters' misrepresentations were material to Scottsdale's acceptance of the risk. The District Court also rejected MBS's "adverse interest" argument, holding that where an agent is the sole representative of a principal in a transaction with a third party, her acts and knowledge are imputed to the principal therein, even if she is acting adversely to that principal.

The Eleventh Circuit affirmed the decision with respect to the misrepresentation warranty, and did not expressly address the applicability of the "adverse interest" principle or the "sole representative" exception.

Subrogation - the *Bills of Exchange Act* and Account Agreements: ***D2 Contracting Ltd. v. Bank of Nova Scotia***

The decision of the British Columbia Supreme Court in *D2 Contracting Ltd. v. Bank of Nova Scotia* provides useful guidance for fidelity claims and subrogation professionals that deal with cheque fraud losses arising from forged drawer signatures. The Court's decision demonstrates the necessity of ensuring that an insured's bank has been notified of irregularities immediately upon discovery.

D2 opened an account with BNS and agreed to an Operation of Account Agreement ("OAA"). The signature card required two of D2's principals, Copeman and Cooper, to sign any cheque drawn by D2. Copeman subsequently forged Cooper's signature on 594 cheques. Cooper became aware of the forgeries, but did not immediately alert BNS; instead, he simply reminded Copeman that both of them had to sign D2 cheques. Copeman continued to forge Cooper's signature, and when a subsequent cheque payable to Cooper was returned by BNS, Cooper alerted the bank.

D2 commenced an action against BNS for recovery under Canada's *Bills of Exchange Act*, which provides that a drawee bank will be liable, in certain circumstances, where it pays a cheque that contains a forgery of the customer's signature. However, this statutory liability can be avoided by contractual verification provisions, which the OAA

contained. The Court granted BNS's summary application, holding that the verification obligation, together with Cooper's failure to immediately advise of irregularities, provided BNS with a complete defence.

In any claim arising from allegedly-forged drawer signatures, the fidelity claims or subrogation professional should confirm that the insured has put its bank on notice, and should obtain and review a copy of the insured's OAA as soon as possible. Parties would also be wise to obtain guidance with respect to any causes of action or defences under the *Act*, and the effectiveness of any potential contractual defences in the OAA.

David S. Wilson and Chris McKibbin are partners, and Stuart Woody is an associate, with Blaney McMurtry LLP in Toronto. Their fidelity insurance practice encompasses all aspects of coverage analysis and litigation involving fidelity bonds, commercial crime policies and financial institution bonds, as well as fraud subrogation work against employees, co-conspirators, auditors and financial institutions. *The authors wish to thank student-at-law Zack Garcia for his assistance in the preparation of this review.*