

Constructing a Problem

by **Mark Gamin** Sr. Claims Attorney

Several years ago, we published an article, "Constructing a Problem," on the perils that banks can face with residential construction loans, such as when the construction stops, the loan goes bad, or the borrower becomes unhappy for any reason.

The issues raised remain important today: banks continue to face the same exposures as described in that article, reprinted below.

Lender liability lawsuits can be based on the slimmest of reeds. Prudent bankers know that minimizing these claims requires diligence, such as making sure your paper record is complete, being wary of stringing along problem borrowers, and by taking other precautions.

One area that merits special attention and safeguards is if your bank makes residential construction loans. Know that all contractors are not created equal. When a contractor leaves an owner in the lurch—the dream house is partially built; the cost-to-complete is significantly more than the remaining loan funds; or

back cover >>

Excess Deposit Bond Now Available up to \$15 Million

In response to strong demand from bankers, Progressive has increased the available limit for its Excess Deposit Bond for community banks to \$15 million. Excess Deposit Bond provides a simple, cost-effective solution to protect customer deposits that exceed FDIC-insured levels. The coverage can be used to replace or complement other excess deposit products, and is available in most states.

For more information about Excess Deposit Bonds, call or have your agent call Progressive.

Cash Letter Imaging May Eliminate the Need for Transit Cash Letter Coverage

Technology that allows banks to image checks instead of sending traditional cash letters is prompting many bankers to ask if they still need to carry Transit Cash Letter coverage under their Financial Institution Bond.

Loss from theft or destruction of cash letters is generally covered under the Bond Insuring Agreement C - In Transit. The Transit Cash Letter Rider extends this coverage by eliminating the deductible, providing reimbursement for reproduction costs, and extending coverage beyond the final destination of the cash letter to the financial institution upon which an item was drawn.

Is this coverage necessary when the entire process is performed electronically? The answer depends on how your bank is sending imaged cash letters. If you are still microfilming or making copies of checks and sending to a data center where an imaged cash letter is created, then this coverage should be maintained. If your bank images at the point of receipt and is no longer transporting physical documents, the bank no longer needs the Transit Cash Letter Rider, as long as the bank saves the images.

Former ACB Members Eligible for Profit Distribution

Every year since 1991, ABPFIC (the mutual reinsurer of the ABA-sponsored insurance program) has distributed profits to banks that are both insured by Progressive and members of the ABA. Any Progressive insured can share in this year's profits simply by joining the ABA by January 15, 2008. **Former ACB members will be entitled to profit distributions upon renewing their membership to the newly merged association.** To ensure that your bank receives its share, call or have your agent call your Progressive underwriter.



Remote Deposit Capture: Who's Minding the Store?

see insert >>

We know community banks.



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Directors & Officers Liability Insurance: Getting Back to the Basics



by **Bill Shero** Complex Accounts Manager

Over the past few years, much has been written regarding D&O insurance and the hot-button issues and exposures that need to be addressed, including:

- › Side-A coverage
- › Order of payments language
- › Shareholder suits
- › Professional services—trust, brokerage/investment advisory and insurance
- › Privacy Liability

All of these important issues need to be evaluated when reviewing your liability insurance protection; however, do not lose sight of the most common exposures that your bank may face—Lender and Depositor Liability. **These seemingly mundane exposures account for over 70% of the D&O claims filed with Progressive over the past five years.**

Although community banks have introduced many new products and services over the past decade, the primary functions of a community bank have been—and continue to be—accepting deposits and making loans.

Let's look at these two primary exposures and review the questions you should be asking to ensure that your coverage is maximized.

Lender Liability

What lawsuits are covered?

Virtually all carriers that provide lender liability coverage will respond to claims brought by borrowers or guarantors. However, Progressive also includes coverage for lawsuits brought by other third parties such as contractors, spouses, or other financial institutions.

What types of loans are covered?

Most carriers will provide coverage for loans made directly by the bank. Progressive will also respond to claims involving loans originated by others (loan participations).

What lending-related services are covered?

Many carriers limit the types of lending-related services that are covered. However, Progressive includes coverage for first and third-party loan servicing, appraisal services and title services.

Of what type of exclusions should we be aware?

All carriers, including Progressive, have a legal lending limit exclusion. Beyond this, exclusions can vary widely between carriers and should be reviewed closely. It is important to watch for the following exclusions:

- › **Lending Discrimination Exclusion:** Many carriers exclude claims alleging lending discrimination. Progressive's policy does not exclude lending discrimination, and defense costs are expressly covered, meaning the carrier will not attempt to recover defense costs

- › **Insider Loan Exclusion:** Many carriers exclude claims involving loans to insiders and their affiliates. Progressive does not have this type of exclusion.

- › **Violation of Law Exclusion (alleged truth-in-lending violation):** Some carriers specifically exclude violations of lending law (including TILA). Progressive's policy does not exclude unintentional lending law violations and expressly covers defense costs.

Depositor Liability

Is there coverage for depositor liability claims under my bank's D&O policy?

This is the key question. Most carriers provide little or no depositor liability coverage. Some carriers will state that the coverage is provided by their Bond. Any financial institution bond has a number of conditions that must be met before there is coverage. No bond provides the broad depositor liability coverage provided by a liability policy. Progressive's D&O/Broad Form Company Liability provides depositor liability coverage.

What are examples of depositor liability claims that are covered?

- › Loss due to a customer's dishonest employee.
- › Negligence in following wire transfer procedures.
- › Loss to investors from a crooked investment advisor who used your bank as his depository institution.

In addition to the questions above regarding Lender Liability and Depositor Liability, you should also ask yourself and your insurance carrier the following basic questions:

- › Does the bank have the proper limits in place?
- › Are we working with a carrier that is dedicated solely to working with community banks?
- › Does our carrier provide us with loss prevention services such as an EPL helpline and loss control newsletters?
- › Does our carrier employ tenured attorneys and claims professionals who are well-versed in handling community bank claims?
- › Does our carrier provide prompt and responsive customer service?

Community banks provide sophisticated financial services and are vital to the health of our communities. As we have seen, the world of community banking has become more complex. As it does, please remember to properly address the most basic exposures that your bank faces. Remember, community banking is still about accepting deposits and making loans.

From underwriter to Complex Account Manager, Bill has been a part of Progressive's underwriting team for over 14 years. He received his MBA from Kent State University and earned the accreditation of RPLU (Registered Professional Liability Underwriter).

Heighten Awareness of Potential Fraud after the Holiday Season

Community banks are increasingly reporting “crooked bookkeeper” claims: the bank’s commercial customer discovers that a trusted employee—often the bookkeeper—is embezzling funds through unauthorized payments, internet banking transactions, or check fraud. Despite being negligent by not personally reviewing monthly statements to detect suspicious activity, the customer typically tries to deflect responsibility for the loss to the bank. In the current economy, we anticipate a continued increase in this type of fraud, particularly during and immediately following the holiday season. Almost universally, the perpetrator does not plan to defraud the company, but intends to simply “borrow” the funds and repay them once a personal financial or health crisis has passed. The borrowings then escalate and become self-perpetuating, as the employee finds himself immersed in an even more severe predicament.

Protect your bank and your customers by heightening awareness of potential fraud this holiday season:

- › **Explain to your staff that fraud increases during and immediately following the holiday season as people become stretched financially.** Even the most trustworthy individual may unintentionally become a perpetrator by “borrowing” from an employer or family member.
- › **Reiterate to customers the need to oversee financial transactions and review monthly statements,** particularly if they entrust their bookkeeping to an employee.
- › **Review fraud detection policies and procedures with employees and reiterate the importance of following these procedures.** Retrain both front-line and back-office staff on signature verification procedures and how to detect a counterfeit or altered check.
- › **Impress upon employees the importance of reporting any suspicious behavior or unusual transactions, even those involving long-term customers.** Make sure that there is a “go to” person with whom employees can consult.
- › **Apply the same scrutiny to your employees, who may also be feeling financial pressures.** Ensure that segregation of duties is upheld throughout the bank, that all accounts are reconciled by an individual who does not have access to the accounts, and that employees are encouraged to report any suspicious transactions or behavior.

Take advantage of ABA Frontline Compliance Training at **NO COST** to ABA member banks

Compliance training for employees is expensive, and often the training is difficult to implement because of employee turnover and shifting regulations.

ABA Professional Development now offers unparalleled Frontline Compliance Training at no cost to ABA member banks, enabling your bank to stay in compliance and manage regulatory risk efforts. As part of ABA membership, banks will receive unlimited access to regulatory compliance eLearning courses on the ABA Knowledge Center. The ABA Knowledge Center allows you to register employees for courses, monitor their progress and print reports for internal management purposes or if regulators ask to see training records.

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Constructing a Problem *continued*

the contractor files Chapter 11, or is in Cancun, or both—the owner will look for funds from a deep pocket to finish construction.

A typical Construction Loan Agreement says that the bank has the right, but not the duty, to periodically inspect, and that such inspections are agreed to be for the benefit of the bank only, not the borrower. The onus of making sure that construction is satisfactory to the owner/borrower remains with the owner/borrower. In some instances, the contract documents make that explicit.

Similar to inspections are lien releases. The Construction Loan Agreement will require the builder, or the owner, to certify that lien waivers have been obtained, or to attach the lien waivers themselves to the draw requests. Again the bank has the right, but not the duty, to obtain releases. But through the magic of litigation, creative plaintiffs' lawyers, and compliant juries, that right can be transmuted into a duty, and thus make for significant headaches and in some cases large verdicts.

A lawsuit based on a plaintiff's home can be an emotional thing—one to which juries will likely respond sympathetically. And the law itself can be, in these circumstances, mobile.

Traditionally, a banker-borrower relationship is held at arm's length, with no special duties imposed on either party other than as contracted. But courts can and do find that the relationship is a fiduciary one—that is, one that imposes special duties—when the bank undertakes, or says it will undertake, to protect the borrowers' interest in extracontractual ways. One Florida court recently held that a bank can be found to owe a fiduciary duty to its borrowers when it “knew or had reason to know that they were placing their trust and confidence in the bank and were relying on the bank to counsel and inform them.”

Recently, we have seen a number of claims involving residential construction loans. The following example is an amalgam of the facts from several of these claims:

A New York surgeon took a loan to build a vacation home in the Rocky Mountains and hires an out-of-state builder. After construction started, he returned to his practice in New York. Eight months later, the builder walked off the job, having used the construction funds for other jobs. In the meantime, the bank had approved the payout of most of the loan funds without obtaining lien releases or verifying the progress of construction.

In the lawsuit, the owner alleged that the bank knew that he was leaving, and told him that it would “keep an eye

on the construction.” The bank employee testified that he made no such statement, but that he did know that the owner was leaving the area for an extended period.

To avoid the cost of litigation, and because the builder was judgment-proof, and because the bank had, indeed, made mistakes, the Bank paid a substantial settlement. (And there was another reason to settle: the subcontractors and materialmen were all local businesspeople for whom nonpayment on even one job would be devastating. They do other business with the bank—and they talk to their neighbors.)

The bank's mistakes were:

1. doing a very cursory check of the builder's references, not realizing, for example, that one of the three names given was his mother;
2. the loan officer driving by the property periodically—once getting out of his car to look at the swimming pool but never talking to the builder or his subs on site;
3. the original loan officer handing off the file to an inexperienced new employee who paid the builder any time and in whatever amount he requested; and
4. noticing two weeks after construction ceased that it had ceased—and another two weeks before informing the borrower.

In the above example, the bank had no duty to inspect, check references, or obtain lien releases. But no contract is ironclad in this environment, and no matter how strongly worded your loan agreement is, it can and will be attacked. There is no one answer to these kinds of problems in the construction loan area.

The answer, rather, is good, careful banking. “**Know your customer**” is an essential rule of banking. But in the construction context, you need to know your customer's builder, too. Performance bonds can be expensive on small jobs, but nevertheless, should be considered. And the owner should be encouraged to keep a close eye on construction—even while the bank, separately, keeps an eye on its collateral. In short, prudent banking helps keep the dream house from becoming a nightmare.



Mark earned his law degree from Case Western Reserve University and has published articles on various aspects of legal practice. He is the immediate past editor-in-chief of the American Bar Association's Tort & Insurance Law Journal and is active in the Fidelity Law Association.

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Remote Deposit Capture: Who's Minding the Store?

It has been over three years since The Check Clearing for the 21st Century Act, aka Check 21, was passed. Financial institutions can now attract commercial customers and streamline costs using technology that allows checks to be processed more efficiently. This service—Remote Deposit Capture or RDC—has been touted as a competitive advantage by financial institutions looking to differentiate themselves in the marketplace. Gone are the days when your local merchant had to leave his store to make the deposit deadline. Now, he can just scan paper checks and electronically send business deposits to his bank with the touch of a button, all without leaving his own place of business.

Perhaps your bank has been contemplating using RDC as a marketing strategy to attract and retain customers or maybe your bank has just started offering this service. As with any new service, there are risks and benefits which will ultimately affect a bank's business decision. The obvious benefits of RDC are more convenience for the merchant, along with reduced costs for both the merchant and the bank. However, this service creates its own set of risks, as RDC essentially causes the bank to place some of its check operations into its customers' hands. This increases the potential for electronic checks to be altered or counterfeited by criminals who may be more computer-savvy than the client. RDC also creates the possibility that the physical checks, which are now kept at the merchant's store, may be stolen, altered, and deposited at another branch or bank.

Here are issues that your bank should consider to minimize the risk associated with offering RDC:

Know your customer and be selective

It is prudent for any bank to know its customers before offering this service because the client is now acting as a check collector/processor, whereas prior to RDC, merchants solely acted in a client capacity. To conduct effective due diligence, understand the type of business in which your commercial customer is engaged. For example, it won't make sense to offer RDC to a business that has a high frequency of fraudulent activity among its employees. Assess the physical security of the merchant's place of business. Is it easy for customers to access the areas where the employees work? These types of questions must be asked before the bank agrees to offer RDC services to its customers. To address these issues, the bank should require a completed application from potential RDC customers to properly evaluate each customer on an individual basis. Remember, it is just as important to review and assess RDC clients as you would with an ACH or even a loan client. A good candidate for RDC would be a trusted, long-time customer, with a favorable account history, who has the capability and expertise to understand the technology and the risks associated with RDC.

Educate your customer and set clear guidelines

Since RDC involves check processing and technology, it is important to have a good understanding of these issues, from

both a bank and merchant/client perspective. While the banker may already understand how this technology works, it is unlikely that the merchant will have as good an understanding because he or she may not be used to the compliance issues that banks face, and therefore, may not understand the security risks associated with RDC. Customers should be informed about the importance of dual controls and segregation of duties, which are essential to limiting the potential for RDC fraud. Before signing up customers for RDC, draft specific agreements that contain clear and logical guidelines. The agreements should carefully spell out both parties' responsibilities and the bank's expectations of its customers, such as the agreed-upon check retention and destruction policies, safeguarding of checks, etc. If the bank does not provide the scanners, then the agreement should specify the type of scanner required. A high-quality scanner is critical to deter fraudulent check activity. Poorly scanned checks are an easy target for criminals. Additionally, to limit future disputes, the liability of both parties should be addressed in the agreement. Lastly, the agreement should allow your bank to periodically audit its customers to ensure that these clients are abiding by the terms of the agreement.

Carefully choose a vendor

It is smart to use a reputable vendor, perhaps one that your bank already knows and trusts. The most obvious area to review when choosing a vendor is security. It is absolutely critical that the vendor provide a secure mechanism that will protect the bank from fraudsters. Banks also need to carefully review contracts to make sure that the liability of both parties and "hold harmless" agreements are fair to the bank. Most, if not all, vendors provide added features such as duplicate check detection or other fraud detection software, so make sure that you are getting the most from your vendor; **make sure that this agreement is written into the contract to avoid potential problems if a loss occurs.** There have been cases in other operational areas, like credit card processing, where banks thought they had enhancements, but the contract stated otherwise. The bottom line is that the bank must be careful to assess each potential vendor in order to protect itself from losses.