"Ninth Circuit Agrees that a Loan by Any Other Name is Still a Loan"

Committee:
IADC Fidelity & Surety Committee
October 2006 Newsletter

Authors:
Gary J. Valeriano & Mark J. Krone

Description of the Article:
The reports on the Ninth Circuit's affirmance of Judge Conti's decision analyzing the application of the financial institution bonds' "loan exclusion" in a bank loss resulting from the provision of cash to an ATM operator. Rather than rely on the bank's labels for its relationship with ATM operator, the court looked to the substance of the transactions and held that the bank's agreement with the ATM operator had the earmarks of a loan, and therefore the loan exclusion applied.

When does a bank's provision of cash to an ATM owner become an extension of credit or transaction in the nature of a loan under a financial institution bond? The United States Court of Appeals, Ninth Circuit, recently affirmed (at *Humboldt Bank v. Gulf Insurance Company*, 2006 WL 1933092) the answer provided by the decision in *Humboldt Bank v. Gulf Insurance Company*, 323 F.Supp.2d 1027 (N.D. Cal. 2004): The transaction is in the nature of a loan or an extension of credit when the bank permits the ATM owner to make productive use of the bank's money in exchange for a fixed rate of interest, allows the ATM owner a significant amount of physical control and possession over the money, and otherwise treats the transaction as it would treat a loan, regardless of the label the bank attaches to the transaction.

The Facts. The *Humboldt Bank* case concerns a common practice whereby banks allow owners of non-bank ATMs to use the bank's cash in the ATMs in exchange for interest and other fees on the money. In December of 2000, Tehama Bank (a northern California bank and predecessor in interest to plaintiff) entered into an ATM cash agreement with Direct Connect, a company that owned and leased ATMs on the East Coast. The sole principal and owner of Direct Connect was one Michael Schwartz. In the latter part of 2000, Schwartz applied to Tehama for an agreement to use the bank's cash in Direct Connect's ATMs (known as a "Cash Services Agreement"). Schwartz's application for the Cash Services Agreement included supplying Tehama with tax returns, financial statements, and submitting to on-site inspection of his business. The Cash Services Agreement provided that, upon Direct Connect's request, Tehama would supply cash to Direct Connect; Direct Connect would pay interest based on the amount of outstanding cash; and that the bank retained ownership of the cash in Direct Connect's ATMs until it was withdrawn by a customer. Additionally, the bank required Schwartz to provide the bank with collateral.

Normally, banks do not deliver cash directly to ATM owners. Generally, the cash is wire transferred to a correspondent bank, the money is then placed into cassettes and picked up by an armored carrier service. The armored carrier service then brings the cassette directly to the ATM, removes the old cassette from the ATM and inserts the new cassette. The armored carrier then returns the old cassette to the correspondent bank where the money is tabulated and wire transferred back to the originating bank. All of this is done without the ATM owner ever touching or having access to the funds. This is viewed as a normal check and balance to prevent theft or unauthorized use of funds by the ATM owners.

This, however, was not the normal case. In this case, Schwartz – with the bank's knowledge – was not only the sole owner of Direct Connect but also the sole owner of the armored carrier. Astonishingly, the address for both Direct Connect and the armored carrier was also Schwartz's home. Furthermore, the correspondent bank did not deliver funds to Schwartz in the pre-loaded cassettes, but in sacks, which Schwartz took home. Consequently, Schwartz had direct access to Tehama's cash that was destined for Direct Connect's ATMs.

Following Tehama's merger with Humboldt, Humboldt took over Tehama's ATM program. When Humboldt realized that Schwartz had direct access to Tehama's cash, it gave Schwartz 120 days to find a different armored carrier to service his ATMs or the Cash Services Agreement would terminate. In hindsight, giving Schwartz so much time to terminate the relationship was not a good idea, as Schwartz used the time to request and receive $5.25 million in small bills. Near the end of those 120 days, Humboldt stopped receiving reports from Schwartz/Direct Connect and the bank therefore called the authorities. After investigation, it was learned that Schwartz used Direct Connect and his armored car company to steal close to $5 million ($1.3 million after recoveries) of the bank's cash advances. The investigators later learned that Schwartz had loaded the sacks of cash in his van and then proceeded to drive to Florida where he rented a room and literally drank himself to death.

Humboldt made a claim on the Financial Institutions Bond issued by Gulf, which Gulf ultimately denied for a number of reasons. Prominently among those reasons was the fact that bank's loss fell within the scope of Exclusion (e), which provided: "This bond does not cover: (e) loss resulting directly or indirectly from the complete or partial nonpayment of or default upon … any loan, or any transaction in the nature of a loan, including repurchase agreements, or extensions of credit, whether or not involving the Insured as a lender or borrower … ."

The financial institution bond "loan exclusion" applies to the bank's cash advances to the ATM operator. Humboldt argued to the District Court and the Ninth Circuit that, because the bank's internal accounting and financial reporting did not treat the cash advances to Direct Connect as "loans," Exclusion (e) did not apply to Schwartz's theft of ATM cash. Although the District Court afforded some weight to this argument, it noted that Exclusion (e) did not merely exclude "loans" as defined by banking industry standards. To the contrary, the court noted that Exclusion (e) is written broadly to include much more than just a "loan" as defined by banking industry standards. The exclusion also includes everything "in the nature of a loan" or an "extension of credit."

Finding that Exclusion (e) was not ambiguous, the court applied the exclusion according to its terms and held that a reasonable layperson would find that the Cash Services Agreement with Direct Connect was in the nature of a loan or an extension of credit. In doing so, the court's used the dictionary definitions of "loan" (the grant of temporary use by the lender) and "credit" (an amount or limit to the extent of which a person may receive goods or money for payment in the future) to guide its analysis. As a result of this line of reasoning, the court declined to accept the label the bank attached to the transaction in its ledgers, but rather looked to the economic substance of the transaction.

In determining that the Cash Services Agreement had the characteristics of a loan or an extension of credit, the court was persuaded by a number of factors: The bank let Schwartz make productive use of the bank's money in exchange for a fixed rate of interest on the money used – that is, Schwartz collected transaction fees from customers' withdrawals of the bank's money from Direct Connect's ATMs and the bank charged a fixed 11.5% on the outstanding funds. Schwartz provided the bank with much of the same material that the bank requested in its business loan applications. The Cash Services Agreement also provided for Schwartz's agreement to return the advanced cash or pay 18% interest on the funds, in other words, a "default" rate of interest. In the court's view, based on the above factors and the relationship as a whole, it was "commonsensical" that the bank's advances to Schwartz's company "was, at the very least, 'in the nature of a loan' or an 'extension of credit.'"

Though the Cash Services Agreement provided that the bank would retain ownership of the funds, this fact did not persuade the court that the transactions between Schwartz's companies and the bank were not "in the nature of a loan." Notwithstanding the fungible nature of cash (i.e., the physical currency in the bank's vault was not the physical currency that found its way into Schwartz's hands), the court found no authority for the proposition that a bank must relinquish possession or control over funds before Exclusion (e) can apply. Again eschewing the bank's label assigned to the transaction, the court found that Schwartz's actual possession and control of the funds undercut the bank's ownership argument.

Additionally, the court also examined the purpose and intent of Exclusion (e) with the insurance industry. That is, the purpose of the exclusion is to allocate the risk between the bank and the insurer, whereby the credit risk inherent in lending money stays with the bank. Using that line of analysis, the court reasoned that the bank's entrustment to a third party with the temporary use of its funds and its loss resulting when that person defaulted on the obligation to repay fell within the category of risk that Exclusion (e) meant to eliminate from coverage under the Financial Institutions Bond.

A word of caution. The District Court did not hold, and the Ninth Circuit did not affirm the broad proposition that a bank's provision of cash to a third-party ATM operator is, *a fortiori*, a loan, in the nature of a loan, or an extension of credit. Both courts, however, appear to have been persuaded that there was a loan in this case by the level of control ceded by the bank over its cash. Though the ATM company and the armored carrier were separate entities on paper, the bank knew that both entities were owned, operated and controlled by one person, who ran both businesses out of his house. Once the correspondent bank delivered the bags of cash to the armored carrier, Schwartz had unfettered discretion to determine when and how that money was used. Had the bank in fact retained the controls its Cash Services Agreement required, the analysis may have been different.

A note regarding who is an employee. The court also rejected Humboldt's argument that an exception to the exclusion was applicable. That is, Exclusion (e) did not apply to any dishonesty by an "employee" of the bank. Included in the bond's definition of "employee" was "any natural person and any organization authorized by the Insured to perform services for the Insured as electronic data processor of checks or negotiable orders of withdrawal or other accounting records of the insured … while performing such services." The bank argued that since Schwartz, as owner of the armored carrier, was required to submit the ATM machine tape and a report of ATM balances to the bank as part of the armored carrier service, Schwartz was an "electronic data processor" and therefore an "employee." The court did not read the definition quite so broadly. Although the bank's agreement with Schwartz's armored carrier company included the responsibility to provide the ATM transaction information to the bank, that function was, at best, subsidiary to the armored carrier's primary function to safely transport currency. Further, the court noted that the application of the bank's logic would transform any person supplying accounting information to the bank into "employees" – an illogical result.

Conclusion. In closing on this matter, the real lesson to be learned from the *Humboldt Bank* case deals not with the technicalities arising out of provision of bank cash or the intricacies of ATM transactions. Instead, the case stands for the proposition that if a bank extends credit to a third party, and that transaction has all the earmarks of a credit-based risk, then the so-called "loan exclusion," which is of course much broader, must apply. This is all part of the natural shifting of responsibilities and obligations between a bank and its insurer. The Financial Institution Bond is designed to protect the bank against those unforeseen and unfortunate incidences which cause loss, not losses based upon an improvident credit risk.