

**TWENTY FIRST ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
CONFERENCE**

**Charleston, South Carolina
APRIL 15TH & 16TH, 2010**

**YOU ARE CORDIALLY INVITED...TO WISCONSIN:
LITIGATING THE MORTGAGE FRAUD FIDELITY CLAIM ON
FRIENDLY TURF**

PRESENTED BY:

**GREGORY P. BROWN
PAIGE A. GREENLEE
T. BENNETT ACUFF
HILL WARD HENDERSON**
101 E. Kennedy Boulevard, Suite 3700
Tampa, Florida 33602
(813) 221-3900

**You are Cordially Invited...to Wisconsin:
Litigating the Mortgage Fraud Fidelity Claim on Friendly Turf**

**Gregory P. Brown
Paige A. Greenlee
T. Bennett Acuff**

I. Sign of the Times

With Michael McGrath at the helm, CU National Mortgage (“CU National”) was not the company you would want to service your loans. In June 2009, McGrath, the former president and director of U.S. Mortgage and CU National Mortgage (a subsidiary and loan servicing company) admitted to federal prosecutors that from January 2004 through January 28, 2009, he conspired with others to fraudulently sell loans belonging to credit unions and used the proceeds to fund U.S. Mortgage’s operations and his personal investments. He now awaits sentencing.

When the market began to bottom out, McGrath sold hundreds of mortgage loans to Fannie Mae without the knowledge and consent of the credit unions that owned the loans. McGrath would sell the loans, keep the proceeds, and then make payments on the loans to the credit unions to make them believe CU National was still servicing the loans. To date, it appears that the scheme involved at least twenty-seven (27) credit unions, in excess of 200 loans, and more than \$130 million in mortgage value.

In January 2009, federal agencies began investigating U.S. Mortgage and CU National Mortgage and uncovered the frauds these companies were perpetrating on credit unions. The investigation became public on January 27, 2009, when dozens of federal law enforcement agents executed a search warrant at the headquarters of U.S. Mortgage and CU National Mortgage. Shortly thereafter, on February 23, 2009, U.S. Mortgage filed a Chapter 11 bankruptcy petition, which remains pending. McGrath pleaded guilty to mail and wire fraud and money laundering charges in June, 2009.

Although experiencing this type of greed and corruption in the past couple of years is not particularly novel, the issues that exist in the mortgage fraud cases discussed herein are. While victims of Bernie Madoff and his progeny were left to start over from scratch, the credit unions swindled by CU Mortgage were breathing a big sigh of relief - they had protected themselves from this very type of loss by obtaining fidelity bonds issued by CUMIS Insurance Society, Inc. (“Cumis”)...or had they?

This paper examines the on-going litigation commenced both by and against Cumis, in which the parties are seeking a determination regarding whether the losses sustained by the credit unions are covered by the fidelity bonds Cumis issued to them. While the various credit unions were beginning to learn of their losses and to proceed through the claims process by filing proofs of loss with Cumis, Cumis was busy filing a

declaratory action in its backyard, naming all of the credit unions who had filed proofs of loss, and seeking to establish that the fidelity bonds issued to the credit unions do not cover the losses caused by the fraud of CU National. Depending on which side you are on, you may characterize this as either a brilliant strategical move, or something a plaintiff's attorney could seize upon as dilatory claims handling. In any event, both sides are now mired in litigation related to the bond claims.

II. The Cumis Litigation

Cumis v. TCT Federal Credit Union et. al, United States District Court, W.D. Wisconsin

Cumis filed a declaratory action in Wisconsin state court on June 1, 2009, naming twenty-six (26) credit unions as defendants, and seeking a declaration that the bonds it issued did not cover any loss suffered due to the actions of CU National. Cumis subsequently dismissed the suit, and many of the defendants noted that Cumis never even served them with this suit. However, Cumis re-filed the suit on August 31, 2009, naming the same twenty-six (26) credit unions as defendants. On December 17, 2009, Educational Systems Federal Credit Union ("Educational Systems") removed the case to federal court.

A. Relief requested by Cumis

In its complaint, Cumis seeks a declaration that "Cumis has no duty under the Bonds to indemnify Defendants for any Losses allegedly resulting directly from acts committed by CU National, U.S. Mortgage and/or any partner, officer or employee of those entities." Cumis admits that it issued bonds to each of the twenty-six (26) credit unions and that each of them submitted a proof of loss to Cumis "with respect to Losses allegedly resulting from the acts of CU National, U.S. Mortgage and/or officers or employees of those entities." Cumis also acknowledges that CU National allegedly sold the loans owned by the various credit unions without their consent, but argues that the coverage under the fidelity bonds "does not extend to the claimed [l]osses." Cumis does not specifically state the basis for this argument but instead appears to take a "throw everything at the wall and see what sticks" approach by citing to numerous provisions of the policy.

B. Scope of bond coverage

Cumis cites to the following provisions of the bonds in its complaint, without making any specific argument regarding which provisions it believes exclude the credit union claims:

Coverage A of the Bonds provides:

We will pay you for your loss resulting directly from dishonest acts committed by an "employee" or "director," acting alone or in collusion with others.

Such dishonest acts must be committed by the “employee” or “director” with the intent to:

- a. Cause you to sustain such loss; or
- b. Obtain an improper financial benefit for the “employee” or “director,” or any other person or entity.

However, if some or all of your loss resulted directly or indirectly from a “loan” or “trade,” that portion of the loss is not covered unless you establish that the portion of the loss involving a “loan” or “trade” resulted directly from dishonest acts committed by the “employee” or “director,” acting alone or in collusion with others, with the intent to:

- 1) Cause you to sustain such loss; and
- 2) Obtain an improper financial benefit for the “employee” or “director,” or a financial benefit for any other person or entity.

As used in this coverage, an improper financial benefit does not include any employment benefits received in the course of employment including salaries, commissions, fees, bonuses, promotions, awards, profit sharing, business entertainment or pensions.

“Employee” is defined under the Bond in pertinent part as follows:

- 1. “Employee” means persons who were, are, or may be in the future, acting under your immediate direction and control in the conduct of your business and while in the course or scope of performance of their assigned duties; and
 - a. Paid a regular wage or salary by you or by an employment service who provides such persons to you; or

* * *

- 3. For Employee Or Director Dishonesty Coverage only, “employee” also means:

* * *

- f. “Servicing Contractors.” All persons employed by any “servicing contractor,” including its partners, officers, and employees, will collectively be considered one “employee” for all purposes of this Bond, except for the Termination Or Limitation Of Coverage For Employee Or Director Condition.

- 4. Unless specifically listed in paragraphs 1., 2. or 3. above, “employee” does not mean:
 - a. Independent contractors; or
 - b. Agents, meaning persons authorized by you to act for you; or

- c. Brokers; or
- d. Persons employed by the Federal Reserve system; or
- e. Consultants; or
- f. Persons acting on behalf of a “service center,” including those who might otherwise be your “employee.”

Coverage S of the Bonds provides:

We will pay you for your loss resulting directly from the “forgery” or alteration of an “instrument.”

“Forgery” is defined under the Bonds as:

affixing the handwritten signature, or a reproduction of the handwritten signature, of another natural person without authorization or ratification, and with intent to deceive.

A signature written on an electronic pad, which captures the signature for purposes of creating an electronic digitized image of a handwritten signature, is treated the same as a handwritten signature. Any other form of electronic signature or “digital signature” is not treated as a handwritten signature, or a reproduction of a handwritten signature.

However, a signature that consists in whole or in part of one’s own name signed with or without authority, in any capacity for any purpose, is not a “forgery.”

“Instrument” is not defined under the Bond as:

An original: mortgage, “document of title,” deed, contract for deed, deed of trust, promissory note, “security agreement,” money order, certificate of deposit, “certificated securities,” bond coupon, interim receipt for a security, assignment of mortgage, check, draft, share draft, bill of exchange, “withdrawal order,” “letter of credit,” “acceptance,” passbook held as collateral, or “certificate of origin or title.”

“Instrument” also means a written instruction to the issuer of an “uncertificated security” requesting that the transfer, pledge, or release from pledge, of the “uncertificated security” specified, be registered.

C. *Nature of activity that resulted in losses*

In papers filed with the federal court in the Cumis case, one of the defendants provides a detailed description of how it alleges the fraud at issue was conducted. To conceal the fact that the mortgages had been sold, CU National and U.S. Mortgage continued to deliver periodic reports of all mortgages the credit union believed it owned and which it believed CU National was servicing. Of course, these reports indicated that the loans were still owned by the credit unions and that the credit unions were still receiving the monthly net payments from the mortgages.

However, notwithstanding the information that appeared in these reports, partners, officers or employers of CU National and U.S. Mortgage had already

perpetuated the fraudulent scheme by preparing and executing two sets of allonges to promissory notes and assignments of mortgages held and owned by the credit unions. One set of allonges purportedly transferred the mortgages from the credit unions to U.S. Mortgage. The second set purportedly transferred the mortgages from U.S. Mortgage to Federal National Mortgage Association (“Fannie Mae”). In each of these cases, employees of CU National or U.S. Mortgage executed the allonges and assignments in the name of the respective credit union, under signatures fraudulently indicating that the employee was an “AVP” (probably “assistant vice president”) of the credit union.

According to allegations of the defendants, in certain circumstances, possibly because the original note was not available, employees of CU National or U.S. Mortgage created blank notes and forged the borrower’s signature prior to the execution of the allonges and assignments described above. CU National or U.S. Mortgage delivered these forged notes to Fannie Mae as part of the purported sale of the mortgages.

D. Legal issues presented

1) Coverage issues

Perhaps taking advantage of the imprecise nature of a declaratory action, Cumis’ complaint leaves everyone guessing as to how it will argue that the credit union claims are not covered under the bonds. As set forth above, the bonds provide coverage for all loss resulting “directly from dishonest acts committed by an ‘employee’...” and include “Servicing Contractors” within the definition of “employee.” The credit unions argue that the individuals who were engaged in the fraudulent behavior fall within the definition of “employee.” Presumably, Cumis will argue that CU National and U.S. Mortgage had a relationship with the credit unions that falls squarely within the exception to an “employee” under the policy.

Another issue likely to be litigated is the scope of services each credit union “duly authorized” the servicing contractors to perform. In addition, Cumis may argue that the losses did not occur “while [the servicing contractor] was performing such services.”

Without more facts, it is difficult to predict what argument Cumis intends to make with respect to the “forgery” language. However, it is clear it is contemplating making some argument, based upon the fact that it recites this section of the bond language in the complaint.

The bonds expressly exclude acts of dishonesty by employees of brokers or sales firms. CU National offers multiple sorts of services; thus the cases could turn not on the language of the bonds, but the individual relationships of each credit union and CU National. For this reason, among others, the defendants assert that the issues require a fact-specific inquiry into the nature of each individual credit union’s relationship with the servicing contractors at issue to determine how any losses occurred. Because of the nature of the analysis, defendants contend that there will not be any efficiency

gained by litigating the matter in one court – to resolve the issues, the court will have to look at each defendant’s relationship and loss individually. The fact that coverage may not exist for one of the credit unions does not necessarily mean that none of the defendants’ claims are covered by the bonds at issue.

2) Forum shopping

Cumis filed suit in Wisconsin because its principal place of business is in Madison, Wisconsin, which is a more convenient, and perhaps friendlier, venue for the plaintiff. In response, multiple defendants filed motions to dismiss the case for lack of personal jurisdiction, to abstain or to transfer venue. The motions accuse Cumis of forum shopping, as follows:

Cumis has engaged in classic-and disfavored-procedural fencing by racing to the courthouse to secretly file a declaratory judgment action on June 1, 2009, six weeks before there was a dispute between the parties, since Educational Systems had not even taken the first official step under the fidelity bond to report the details of its loss.

According to Educational Systems’ papers, Cumis also met with members of Educational Systems months after filing the declaratory action to investigate the loss, but made no mention of the fact that it had already filed suit. As discussed above, because Cumis did not have its complaint served, the credit unions were unaware that it had already won the race to the courthouse.

The motions to dismiss uniformly address the defendants’ lack of contact with Wisconsin, the fact that Cumis is a national insurance company with employees located across the country, that Cumis regularly litigates in forums other than Wisconsin, as well as the fact that the majority of the relevant documents and witnesses are located near the various credit union defendants, and outside the state of Wisconsin.

Cumis filed a motion to remand the case to Wisconsin state court, asserting that the requisite “complete diversity” between plaintiff and defendants is lacking, and therefore, the court lacks subject matter jurisdiction under 28 U.S.C. § 1332(a). One of the credit unions filed its own motion to remand, which it later supplemented to include a request that the case be dismissed.

On March 5, the court entered an order staying all motions to dismiss for lack of personal jurisdiction and agreed to allow discovery on personal jurisdiction issues. In this order, the court also denied motions several defendants had filed which asked the court to decide personal jurisdiction prior to subject matter jurisdiction. Presumably in response to this ruling, and perhaps concluding that there may be an issue with respect to subject matter jurisdictions, the defendants entered into a stipulation with Cumis that Cumis’ motion to remand should be granted. On March 22, 2010, the court entered an order granting the motion to remand and returning the case to the Circuit Court for Dane County, Wisconsin, where it remains pending.

Educational System Federal Credit Union v. Cumis, United States District Court, D. Maryland

On December 2, 2009, while defending the above-referenced litigation, Educational Systems filed a complaint against Cumis in the United States District Court of Maryland seeking a declaratory judgment regarding the bond coverage and alleging breach of contract. In its complaint, Educational Systems alleges that CU National sold thirty-six (36) Educational Systems loans to Fannie Mae without Educational Systems' knowledge or consent. Educational Systems seeks a declaration that the bond Cumis issued covers the loss CU National caused and that Cumis has breached the material terms of the bond by refusing to pay Educational Systems for that loss.

As described above, Educational Systems filed this suit almost six months after Cumis filed the declaratory action in Wisconsin. In its complaint, Educational Systems alleges that it only discovered the existence of the declaratory action on October 27, 2009, after specifically asking Cumis representatives, in a face-to-face meeting, whether Cumis had filed any suit involving Educational Systems.

On January 14, 2010, Cumis moved to dismiss or stay the Educational Systems Complaint on abstention grounds based upon the "first-to-file" rule, referring to the complaint in this case as a "duplicative complaint," and asserting that the two actions concern substantially identical questions of law and fact. On February 1, 2010, Educational Systems responded and argued that the "first-to-file" rule does not apply when used as a forum-shopping tool. Citing *Neuralstem, Inc. v. Stemcells, Inc.*, 573 F. Supp. 2d 888, 901 (D. Md. 2008), Educational Systems argued that "bad faith, anticipatory action and forum shopping are factors that can lead a court to depart from the first-to-file rule." As of March 25, this issue remains unresolved and there has not been any other record activity in the case.

Suffolk Federal Credit Union v. Cumis, United States District Court, E.D. NY, Case No. 10-001

Suffolk Federal Credit Union ("Suffolk"), which is also a defendant in the Wisconsin action, filed a complaint against Cumis on January 4, 2010 seeking declaratory relief and alleging a breach of contract. In its complaint, Suffolk alleges that McGrath sold one hundred and eighty-nine (189) Suffolk loans to Fannie Mae without authorization. Similar to Educational Systems, Suffolk alleges that Cumis breached the material terms of the bond by refusing to pay Suffolk for the loss.

On February 8, 2010, Cumis moved to dismiss or stay the action on abstention grounds based upon the "first-to-file" rule, referring to the complaint as a "duplicative complaint." On February 25, 2010, Suffolk responded with a lengthy memorandum arguing that the Wisconsin action was void as applied to Suffolk because Cumis did not serve Suffolk within ninety (90) days, and the "first-to-file" rule should not be used as a

tool for forum shopping. Apparently, Cumis took a similar tact with Suffolk as it did with Educational Systems. In its papers, Suffolk notes that “[i]n fact, as late as November 11, 2009, the parties were still talking and Cumis was still representing to Suffolk that it had not made a final determination regarding coverage, even though it had secretly filed a declaratory judgment action against Suffolk months before.” Suffolk also notes that Cumis did not mention that it moved to remand the Wisconsin action to state court, where the “first-to-file” rule would not apply. On March 8, 2010, Cumis filed a Reply in Support of its Motion to Dismiss or Stay on Abstention Grounds that is nearly identical to reply it filed in the Education Systems case. As of March 12, 2010, the matter remains unresolved.

III. TO BE CONTINUED...

Obviously, these cases are in their infancy, and where they will go is anyone’s guess at this point. We hope the courts will begin addressing some of the substantive issues in advance of the conference. We will provide case updates at the conference and look forward to an interactive presentation, including the following discussion points:

- What are the arguments regarding whether coverage exists under the bond language?
- If Cumis intended to exclude these types of claims from the scope of coverage, how could it make the bond language clearer?
- Is this something the courts can decide without engaging in a case by case, fact intense analysis that focuses on the relationship that existed between each of the credit unions and CU National/U.S. Mortgage?
- How does U.S. Mortgage’s bankruptcy impact these cases – i.e., would the credit unions be fighting so hard for bond coverage if U.S. Mortgage was a viable source of recovery?
- Is there any problem with the way Cumis handled this – i.e., engaging in discussions regarding tolling agreements/coverage analysis without disclosing the fact that it had filed a declaratory judgment action?
- Should the courts require credit unions with very little, if any, contact with Wisconsin to litigate claims there?