UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 92-2923

FIDELITY & DEPOSIT COMPANY,

Plaintiff-Appellee,

versus

CYPRESS NATIONAL BANK,

Defendant-Appellant.

Appeal from the United States District Court for the Southern District of Texas
(CA H-91-0459)

(September 28, 1994)

Before GARWOOD and BARKSDALE, Circuit Judges, and SHAW,[*] District Judge.

GARWOOD, Circuit Judge:[**]

Plaintiff-appellee Fidelity and Deposit Company (F&D) brought this Texas law, diversity action for declaratory judgment against defendant-appellant Cypress National Bank (Cypress) to determine whether a loss suffered by Cypress was covered under the standard

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[*] Chief Judge of the Western District of Louisiana, sitting by designation.

[**] Local Rule 47.5 provides: "The publication of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens on the legal profession." Pursuant to that Rule, the Court has determined that this opinion should not be published.

financial institution bond (Bond) issued by F&D. Cypress filed a counterclaim alleging breach of contract for F&D's failure to pay on the Bond. The district court, following a bench trial on stipulated facts, issued a final judgment granting F&D's declaratory relief and denying Cypress's counterclaim. Cypress now appeals the judgment. We affirm.

Facts and Proceedings Below

Between March 1988 and September 1992, Judith Frye House (House) fraudulently obtained loans in excess of $3.2 million from several financial institutions in the Houston, Texas, area including Cypress by pledging fake stock certificates in various publicly traded companies as collateral. She has since pleaded guilty to several counts of fraud for using forged stock as collateral for loans from federally insured financial institutions. As part of this scheme, on August 17, 1990, House obtained a loan in the amount of $500,000 from Cypress (House loan) secured by what House represented to be a certificate for 34,000 shares of Keystone International, Inc. stock (Keystone) and a certificate for 5,000 shares of Apple Computer, Inc. stock (Apple). Although House actually only owned thirty-four shares of Keystone and ten shares of Apple, she created the phony certificates by color photocopying her original certificates after altering the number of shares to reflect a significantly greater amount of ownership.[1] After being

[1] While the fake certificates exhibited numerous facial inaccuracies, the district court determined that "except for the gross, substantial and material difference in the number of shares held, the other differences between theseSQthe fake certificate and the genuine certificateSQwould, in all likelihood not be sufficient to lead to the [finding that they were not

warned by an associate of House on September 21, 1990, Cypress contacted Keystone's transfer agent and learned that stock bearing the reported certificate number had been issued to House, but that the number of shares was incorrect. The loan, of course, was never repaid.

At the time this loss occurred, Cypress held fidelity insurance under a standard financial institution bond issued by F&D. On February 20, 1990, F&D filed the present action in the United States District Court for the Southern District of Texas under the Declaratory Judgment Act, 28 U.S.C. § 2201, seeking to have the district court declare that F&D was not liable under the Bond for the loss on the House loan because the bogus certificates were not "counterfeits."[2] Cypress filed a counterclaim for breach of contract for F&D's failure to indemnify Cypress under Agreement E. The parties waived a jury trial and proceeded with a bench trial on stipulated facts. On November 6, 1992, the district court issued a final Declaratory Judgment and Judgment Denying Counterclaim finding (a) in favor of F&D that it had no liability to Cypress under the Bond because the fake certificates did not fall under the Bond's definition of "counterfeit," (b) against F&D on its claim for attorneys' fees, and (c) against Cypress on its

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counterfeit]." *Fidelity & Deposit Company v. Cypress*, CA-H-91-0459 Ruling at 6 (S.D. Tex. Oct. 27, 1992).

[2] In the alternative, F&D also alleged that Agreement E did not cover the loss on the House loan because the loss did not "result directly from" Cypress's having loaned funds on the faith of counterfeit securities. Because we resolve the dispute without reaching this contention, we express no opinion as to its merit.

counterclaim. Cypress now appeals the district court's grant of declaratory judgment and denial of its counterclaim. We agree with the district court and affirm.

Discussion

The relevant portion of the Bond provides that F&D would indemnify Cypress for:

> "Loss resulting directly from the Insured [Cypress] having, in good faith, for its own account or for the account of others, . . . acquired, sold or delivered, or given value, extended credit, or assumed liability, on the faith of, . . . any . . .[Certified Security] which is a Counterfeit." Standard Financial Institution Bond, Insuring Agreement E (Agreement E) § 3.

Paragraph 1(e) of the Definitions section of the Bond defines the term "counterfeit" as "an imitation which is intended to deceive and to be taken as an original." Although the parties agree that the fake certificates were intended to deceive Cypress and to be taken as genuine certificates, they differ sharply as to whether the bogus certificates constituted "imitations" of originals.

In *Bank of the Southwest v. National Surety Company*, 477 F.2d 73 (5th Cir. 1973), also a diversity case arising in Texas, we ruled that for a bogus document to be considered a counterfeit for purposes of Agreement E, "there must be or must have been [an] original instrument that the alleged counterfeit document attempts to imitate." *Id*. at 76.[3] Essential to a determination that the

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[3] Because our jurisdiction is based solely on diversity of citizenship, we must look to the substantive law of Texas to construe the term "counterfeit" as it pertains to Agreement E. We attempted to certify this question to the Texas Supreme Court in July 1989. *See Reliance Insurance Company v. Capital Bancshares/Capital Bank*, CA-3-86-1930-H (5th Cir. July 20, 1989) (published as appendix, 912 F.2d 756, 765 (5th Cir. 1990)). In August 1990, however, the court declined our request, apparently

bogus document is a "counterfeit" is whether the "authentic original document" describes the same collateral as the bogus document. *Id*. at 77. In *Bank of the Southwest*, a Texas bank made a $7,000 loan to Lou Levine secured by a 1970 Cadillac, evidenced by the surrender of a Tax Collector's Receipt for Title Application No. V-460376 (white slip). *Id*. A genuine white slip bearing this number existed, but had been issued to a different person, and described a 1969 Mercury rather than a 1970 Cadillac. *Id*. Apparently the phony white slip resembled an authentic white slip, except that it had been altered to identify a different owner and to describe different collateral. The Court found that since no genuine document existed evincing Levine's ownership of the actual collateral he purported to pledge, the white slip "was not an imitation of an authentic original document" and, thus, not a counterfeit within the coverage of Agreement E. *Id. See also Federal Deposit Insurance Corporation v. Fidelity and Deposit Company of Maryland*, 827 F.Supp. 385, 394-95 (M.D. La. 1993).

We first applied the *Bank of the Southwest* holding to a situation involving phony stock certificates in *Reliance Insurance Company v. Capital Bancshares/Capital Bank*, 912 F.2d 756 (5th Cir. 1990), another Texas law diversity case. The bank in *Reliance* sought indemnification under an identical bond for a $900,000 loss it had suffered as a result of loans secured only by bogus stock certificates for 30,000 shares of AIG stock. *Reliance Insurance*

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concluding that our decision in *Bank of the Southwest* "ha[d] already properly resolved the legal issue." *See Amberboy v. Societe de Banque Privee*, 831 S.W.2d 793, 800 & n.9 (Tex. 1992) (Doggett, J., concurring in part and dissenting in part).

Company v. Capital Bancshares Inc./Capital Bank, 685 F.Supp. 148, 149 (N.D. Tex. 1989), *aff'd* 921 F.2d 756 (5th Cir. 1990). The certificates given as collateral were phony certificates printed on generic, blank stock forms. *Reliance*, 921 F.2d at 760 (App.). The Court found that the bogus certificates were fabrications, rather than imitations, "because there never existed any one or more particular genuine AIG stock certificates which the bogus certificates could be said to purport to be or represent or imitate." *Id*. at 757.[4] We agreed with the lower court's conclusion that a document could not constitute a counterfeit merely by imitating a particular type of collateral; rather, "the imitation must essentially duplicate" a particular preexisting genuine original document. *Reliance*, 685 F.Supp. at 151.[5]

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[4] *See also Richardson National Bank v. Reliance Insurance Company*, 491 F.Supp. 121, 123 (N.D. Tex. 1977) *aff'd on basis of district court's opinion* 619 F.2d 557 (5th Cir. 1980) (per curium) ("There were no original instruments and accordingly the MSO's did not imitate but created.").

[5] We recognize that the judicial gloss on Agreement E leads to a seemingly incongruous distinction concerning the coverage of "counterfeit" securities and "altered" securities. Had House actually owned 34,000 shares of Keystone and simply made copies of the genuine certificate, then submitted those copies to several banks as collateral, the resulting phony stock certificates would undoubtedly be "counterfeit" within the Bond's definition. *See Reliance*, 685 F. Supp. at 151 (proposing this exact hypothetical situation); *see also American National Bank & Trust Co. v. Fidelity & Casualty Company*, 431 F.2d 920 (5th Cir. 1970). Likewise, the bank's loss would have also been covered had House merely altered her original certificate for thirty-four shares to reflect 34,000 shares and then used that altered original as collateral. *See* Agreement E § 1(a)(ii) (coverage for loss from extension of credit on the faith of altered original security). The bogus certificates created by House, however, were neither imitations or duplicates of originals, nor were they altered originals. Essentially, they were duplicates of altered originals. The exclusion of these securities is reasonable in light of the policy concerns underlying the Bond. *See National*

In the instant case, actual stock certificates for Keystone and Apple *did* exist, but represented substantially less ownership than the bogus certificates. There never had been issued to House and there never existed in House's name any genuine Keystone stock certificate other than the one certificate for 34 shares; similarly, there never had been issued to House and there never existed in House's name any genuine Apple stock certificate other than the one certificate for 10 shares. The district court held that the difference between House's purported ownership and her actual ownership was "a fatal disparity." *Fidelity & Deposit Company v. Cypress*, CA-H-91-0459 Ruling at 6-7. We agree. Thus, because there never existed any one or more particular genuine stock certificates for such substantial holdings by House in either Keystone or Apple, we hold that the bogus certificates were not counterfeit within the meaning of Agreement E of the Bond.

The district court reached the only decision it could consistent with our Texas law holdings in *Reliance Insurance Company; Richardson National Bank; and Bank of the Southwest.*

Conclusion

The judgment of the district court is accordingly

AFFIRMED.

City Bank of Minneapolis v. St. Paul Fire and Marine Insurance Company, 447 N.W.2d 171 (Minn. 1989). Regarding counterfeits of originals, banks are unable to protect themselves by verifying the securities because the respective corporation's books would not disclose the fraud. Where altered original securities are used as collateral, the Bond condones the bank's failure to verify the securities, at least in part, because the insurer's exposure is limited to a single transaction rather than the potentially limitless exposure created by an operation such as House's scheme.