

1989

Home Savings and Loan, a Utah corporation v. The Aetna Casualty and Surety Company : Brief of Appellant

Utah Court of Appeals

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UTAH COURT OF APPEALS
BRIEF

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NO. **89-101 CA**

IN THE COURT OF APPEALS OF THE STATE OF UTAH

HOME SAVINGS AND LOAN, a Utah
corporation,

Plaintiff/Respondent
and Cross-Appellant,

vs.

THE AETNA CASUALTY AND SURETY
COMPANY,

Defendant/Appellant.

Docket No. 890101-CA

[Priority 14(b)]

APPELLANT'S BRIEF

Appeal From Rulings and a Final Judgment Entered
in the Third District Court
Salt Lake County, State of Utah
The Honorable Michael R. Murphy

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Barry T. ...
Clerk of the Court
Utah Court of Appeals

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JURISDICTION OF THE COURT OF APPEALS

This Court has jurisdiction over this appeal pursuant to the Utah Supreme Court's Order dated February 22, 1989, and Utah Code Ann. § 78-2a-3(2)(j) (1988).

NATURE OF PROCEEDINGS

This suit was brought by Home Savings to recover its losses on second mortgage loans which it made to AFCO investors from November 1981 to January 1982. Those loans involved Grant Affleck's infamous scheme to have people take out second mortgages on their homes and to sign over the proceeds to AFCO. Home Savings' management directly negotiated with Grant Affleck to participate as a lender in the AFCO scheme, and Home's management consciously changed lending practices and procedures to accommodate Affleck's operation. Nearly seven months after the last AFCO investor loan was made, and several months after the loans had all gone into default and the AFCO investors had sued Home Savings, Home Savings bought a Savings & Loan Blanket Bond, Standard Form 22, from The Aetna Casualty and Surety Company. Home Savings now claims in this action that its losses were caused by the dishonest acts of one minor employee, a loan solicitor named Larry Glad, and that the losses are covered by the fidelity bond issued by Aetna on July 14, 1982.

The trial court, the Honorable Michael R. Murphy presiding, made several dispositive rulings before trial which

reduced the number of issues to be considered by the jury. The remaining issues were then tried to a jury over a period of four and one-half weeks in the fall of 1987. Prior to submitting the case to the jury, the trial court made several additional legal rulings further limiting Aetna's defenses that the jury could consider. Ultimately, the jury completed a Special Verdict form making some findings in plaintiff's favor. It also answered Special Interrogatories in defendant's favor on several dispositive defenses. The court disregarded the Special Interrogatory findings, and entered Judgment for plaintiff.

Defendant Aetna Casualty and Surety Company appeals from the following rulings of the trial court: the final judgment entered on November 2, 1988, the Minute Entry dated May 29, 1987, the Order dated June 5, 1987, the Minute Order dated August 19, 1987, the Minute Order dated August 20, 1987, the Order and Minute Entry dated August 25, 1987, the Order dated September 21, 1987, the court's oral ruling on the record denying defendant's Rule 50(a) Motion dated November 10, 1987, the Order dated December 21, 1987 denying defendant's Rule 50(b) Motion, the Memorandum Decision dated March 4, 1988, and the Minute Entry dated May 10, 1988.

STATEMENT OF ISSUES PRESENTED ON APPEAL

A. Issues Requiring Reversal:

1. The jury found that Home Savings learned of its employee's (Larry Glad's) dishonesty in December 1981 during his employment, before many of the loans were closed, and seven months before the Bond was even issued. Does Section 11 of the Bond, which terminates coverage for an employee as soon as the Savings and Loan learns of such dishonesty, preclude coverage for loss from Larry Glad's conduct?

2. Home Savings was sued several times on the AFCO investor loans, and the loans were all in default, all several months before the Bond was even issued. Did the trial court err by concluding as a matter of law that Home Savings' discovery of loss occurred after Aetna issued the Bond?

3. The jury concluded on Special Interrogatories Nos. 2 and 4 that Home Savings made misrepresentations and nondisclosures in applying for the Aetna Bond. Did the trial court err in disregarding those findings and in entering judgment against Aetna notwithstanding the jury's responses?

B. Issues Requiring Remand for Further Proceedings:

4. In 1986, the Federal District Court for Utah found Home Savings liable for primary and secondary violations of state and federal securities laws in connection with its

loans to AFCO investors. Did this trial court err in failing to exclude the losses on the AFCO loans from bond coverage by virtue of the Bond's trading exclusion rider?

5. Two of Aetna's key trial defenses were that Home Savings exercised bad business judgment in entering into the arrangement with Grant Affleck and that Home Savings subsequently mismanaged the AFCO investor loans by failing to follow safe, sound lending procedures and its own policies. Did the trial court err by precluding the jury's consideration of these defenses as a cause of Home Savings' losses and by failing to allow the jury to make an allocation of causation between bad business judgment and mismanagement, on the one hand, and the conduct of Larry Glad, on the other?

6. Did the trial court err by failing to require plaintiff to join as an indispensable party its prior fidelity insurer, Fidelity and Deposit of Maryland, which covered Home Savings under an identical Savings & Loan Blanket Bond, Standard Form 22, which was in place during the relevant events in 1981 and up until June 21, 1982?

C. Issues Requiring Reduction of Damages:

7. Did the trial court err in ruling that the amount of Home Savings' losses should not be offset by the amount of money Home Savings recouped directly from the AFCO investor loan proceeds?

8. The Bond only indemnifies the insured for defense costs related to claims which, if proven, would

constitute covered losses. Did the trial court err in awarding as part of the damages in this case the plaintiffs' attorneys' fees in the suit filed by the AFCO investors against Home Savings and the full amount of attorney's fees and costs incurred by Home Savings in defending state and federal securities laws claims and the truth-in-lending claims in that lawsuit?

DETERMINATIVE STATUTORY PROVISIONS

Under Point III, the Appellate Court's application of U.C.A. § 31-19-8(1) (1974) pertaining to applications for insurance would be dispositive of the entire case if this Court upholds the jury's determination that Home Savings acquired the Aetna Bond through material misrepresentations or omissions, and that Aetna would not have issued the Bond if it had known of the misrepresented or omitted facts.

STATEMENT OF THE CASE

I. Nature of the Action.

The central dispute in this lawsuit involves a Savings and Loan Blanket Bond, Standard Form 22. The Bond provides coverage for losses resulting from employee dishonesty sustained at any time but "discovered" during the Bond period. The Aetna Casualty and Surety Company ("Aetna") issued the Bond to Home Savings and Loan Association ("Home Savings") effective beginning June 21, 1982. In 1986 in the case of Armitage v. Home Savings, a predecessor action, the Federal District Court for Utah entered judgment pursuant to jury verdicts against Home Savings for \$1.4 million as a result of Home Savings' state and federal securities law violations, common law fraud, and truth-in-lending violations, all of which Home committed from November 1981 to January 1982. Home Savings knew of the facts that ultimately gave rise to the loss from information it obtained from December 1981 to June 4, 1982. In addition, numerous lawsuits were filed against Home Savings by AFCO investors in March, April, and May 1982, before the Bond was issued. Nevertheless, Home Savings then filed this action to obtain indemnification from Aetna against the claims of those AFCO investors which were established in the Armitage judgment.

II. Course of Proceedings, and Trial Court Disposition.

Home Savings' Amended Complaint alleged that it suffered losses on second mortgage loans to AFCO investors because of the dishonesty of one of its employees, Larry Glad. Aetna answered that if Larry Glad's dishonesty were the effective cause of the Armitage verdict, then Home Savings had learned of the dishonesty and had discovered its loss prior to the period of Aetna's Bond. Section 11 of the Bond provides for termination of coverage as to any employee as soon as an employer learns of that employee's dishonesty. The Bond also provides that "discovery of loss" occurs when the insured actually learns of a loss or of facts that would cause a reasonable person to believe that a loss might result or when it is put on notice by a third party of a claim which would constitute a covered loss.

In the alternative, Aetna argued that Home's employee had not been "dishonest," as specifically defined by the Bond, because he lacked "manifest intent to cause [Home Savings] to sustain" a loss on the AFCO investor loans. In addition, Aetna argued both that the Bond specifically excluded coverage for losses from trading in the AFCO securities, and that the losses in Armitage were caused by the bad business judgment and mismanagement of Home Savings' officers and directors, rather than the conduct of one minor employee.

A series of pretrial, trial and post-trial motions were made by both parties. The trial court ruled against Aetna

on every significant issue. Most notably, before trial the court ruled as a matter of law that because Home Savings did not "sustain" a loss until February 1986 when the Armitage judgment was entered, that it could not have "discovered" its loss prior to that time, despite the Bond's reasonable person and per se standards of discovery, and in spite of considerable evidence that Home Savings actually learned of an impending loss before buying the Aetna Bond.

A four and one-half week jury trial of this case was conducted in October and November, 1987 before the Honorable Michael R. Murphy, Third Judicial District Court. Before submitting the case to the jury, the trial court determined that it would not allow Aetna to refuse coverage under Section 11 of the Bond even though Home Savings learned of Larry Glad's dishonesty many months before purchasing the Aetna Bond. In addition, and in spite of substantial evidence presented by Aetna, the court refused to allow the jury to consider Aetna's primary factual defense that Home Savings' loss was caused not by employee dishonesty, but by the mismanagement and the bad business judgment of its officers and directors. Finally, although the jury made dispositive findings in Aetna's favor in response to certain Special Interrogatories, the trial court entered judgment against Aetna on November 2, 1988 in the amount of \$1,977,505.73, plus court costs of \$3,751.75, and prejudgment interest in the amount of \$2,915.08.

STATEMENT OF FACTS

A. Home Savings' Loans Made to AFCO Investors.

1. From mid-November, 1981 through the first week of January, 1982, Home Savings made a total of 42 second mortgage loans to individuals ("AFCO investors") who invested the proceeds in several interrelated companies ("AFCO") owned and/or controlled by Grant C. Affleck. The loans were secured by second trust deeds on the investors' homes. (See Stipulated Pretrial Order, Uncontroverted Facts, R. at 727; and Jury Instruction No. 15, R. at 1313.) (Copies of the Stipulated Pretrial Order and of selected Jury Instructions are included at Document Addenda A and B, respectively, to Aetna's Appellant's Brief.)

B. Home Savings Learns of Employee Dishonesty and Discovers Losses on the AFCO Investor Loans.

2. Throughout the three months of AFCO investor lending activity in 1981, and during the first half of 1982, before Home Savings purchased the Bond from Aetna on July 14, 1982, Home Savings' officers and directors learned of a number of significant facts about the conduct of its employee, Larry Glad, about Grant Affleck and his AFCO businesses, and about irregularities and pending losses on the AFCO investor loans. Those facts and when Home Savings learned of them, are as follows:

a. Prior to granting a \$100,000 loan to AFCO Enterprises on November 10, 1981, Home Savings had in its possession a credit report on AFCO Enterprises which showed a foreclosure proceeding against AFCO by Deseret Federal Savings and Loan, an unsatisfactory record on AFCO's business checking account, slow payment by AFCO to its creditors, and unverifiable assets and income. (Tr. Ex. 13; F. Smolka testimony [test.] at 2919.19, .163-.167.)

b. Home Savings learned in approximately mid-December 1981 that Larry Glad had engaged in dishonest and fraudulent acts unrelated to the AFCO investor loans. (Jury Special Interrogatories Nos. 5 through 8, R. at 1353-54.) (Copies of the Jury Special Verdict and Jury Special Interrogatories are included as Document Addenda C and D, respectively, of Aetna's Appellant's Brief.)

c. On December 20, 1981, Home Savings learned that in November 1981 Larry Glad had received \$15,000 directly from AFCO for his handling of the investor loans. (Pretrial Order, Stipulated Facts, R. at 6; Jury Instruction No. 15, R. at 1313; W. Cox test., R. at 2905.83-.85.) As a result, Home Savings fired Larry Glad on December 29, 1981. (R. at 154.2; F. Smolka test. R. at 2919.37.)

d. On or about February 26, 1982, Fred Smolka received a letter from Grant Affleck advising Home

Savings of two major irregularities in the investor loans: (i) back-dating of documents affecting the borrower's right of rescission under federal truth-in-lending laws; and (ii) closing of loans outside of Home Savings' offices and without the required presence of Home Savings' representative. (Trial Exhibit [Tr. Ex.] 20; H. Bradshaw test., R. at 2907.110-.112; F. Smolka test., R. at 2919.50-.52.) (A copy of Affleck's letter is included at Tab 20 of Aetna's Exhibit Addendum.) Affleck's February 26, 1982 letter also came to the personal attention of Home Savings' President, Howard Bradshaw. (H. Bradshaw test., R. at 2907.110-.112.)

e. In January 1982, contrary to its policy only to accept payment on a loan from the individual borrower, Home Savings accepted a \$10,549.85 check from AFCO to be applied on the first monthly payment due on the investor loans. The check was not honored because of AFCO's insufficient funds. (Tr. Ex. 81; Fred Smolka test., R. at 2919.47-.49.) (A copy of the check is included at Tab 18 of Aetna's Exhibit Addendum.)

f. By February 28, 1982, the AFCO investor loans began showing delinquencies. (F. Smolka test., R. at 2919.55.)

g. On March 8, 1982, the AFCO companies filed Chapter 11 Bankruptcy Petitions in the United States

Bankruptcy Court for the Central District of Utah.
(See Pretrial Order, Uncontroverted Facts; R. at 724;
R. at 2962-2967.)

h. Between the AFCO bankruptcy filing and the date of the Bond (June 21, 1982), Salt Lake's two major newspapers reported on the AFCO bankruptcy and the financial collapse of Grant Affleck's real estate empire no fewer than 31 times. (R. at pp. 2969-95.) Fred Smolka, then Executive Vice President of Home Savings, was aware of and familiar with the local newspaper reports about AFCO's precarious financial circumstances. (F. Smolka test., R. at 2919.54, 2920.33.)

i. At Home Savings' March 17, 1982 Board of Directors Meeting, "Wallace Woodbury, Legal Counsel, reported the status of second mortgage loans referred by AFCO in light of AFCO's bankruptcy. Counsel report[ed] that Home's position should be sound based on documentation of the loans." (Tr. Ex. 111; a copy of Minutes of Home Savings' Board of Directors is included at Tab 111 of Exhibit Addendum.)

j. On April 7, 1982, Howard Bradshaw, then President of Home Savings, communicated with First Federal Savings & Loan in Great Falls, Montana (one of the purchasers of Home Savings' private placement of second mortgage AFCO investor loans), regarding AFCO's "extreme cash flow problem," AFCO's "obvious

inability to live up to [its] promise," and the impact which those difficulties were having upon Home Savings' collection of monthly payments from AFCO investors. (R. at 3005; Tr. Ex. 53, included at Tab 53 of Exhibit Addendum.) By April 1982, the AFCO investor loans were in default and Home Savings had sent demands or instituted foreclosure actions to enforce the loans against the investors. (H. Bradshaw test., R. at 2907.122-.123; 2907.138-.139.)

k. In March and April, 1982, still months before the purchase of the Aetna Bond, three separate lawsuits were filed by AFCO investors and served on Home Savings (Pretrial Order, Uncontested Facts, para. 11, R. at 725), alleging fraud, lending irregularities, and securities violations. (Tr. Exs. 356, 357, 358, 359, and 360.) After various pretrial maneuverings and proceedings, the largest of those cases became the Armitage v. Home Savings case in which judgment was entered against Home Savings.

1. In March and April 1982, Home Savings received at least three letters from attorneys for AFCO investors. The letters notified Home Savings of numerous, serious irregularities in the processing and closing of the AFCO investor loans. (F. Smolka test., R. at 2920.39-.40; Tr. Exs. 113, 114, and 115.) Those letters set forth the exact

irregularities which later formed the basis of the judgment in Armitage. (Id.)

m. On June 4, 1982, approximately six weeks before Home Savings purchased the Bond from Aetna, the Federal Home Loan Bank Board ("FHLBB"), the federal agency which supervised Home Savings, completed its report of an annual examination of Home Savings and submitted a Report of Examination. (Tr. Ex. 196; a copy of the FHLBB Examination Report is included at Tab 196 of the Exhibit Addendum.) Home Savings had immediate access to that Report.

n. The FHLBB found multiple irregularities in Home Savings' lending practices, specifically citing the AFCO investor loans. The FHLBB also reported loan defaults, lawsuits and indications of lending irregularities from Home Savings' own files. The FHLBB concluded that Home Savings' management had subjected Home Savings to possible losses on the AFCO investor loans, noting that Home Savings had already scheduled \$888,998 on 41 investor loans as delinquent with risk of potential loss, and it had established a bad debt reserve on these loans. (Tr. Ex. 196; Elaine Weis test., R. at 2909.111-.114.)

C. Existing Bond During the Loan Closings and Discovery of Loss.

3. Throughout the period from November 1981 through June 21, 1982, Home Savings had \$900,000 of fidelity

bond coverage under a Standard Form 22 which was identical to Aetna's Bond, but which had been issued by Fidelity and Deposit Company of Maryland ("F&D"). (Depo. Ex. 116; D. Bradshaw test., R. at 2906.24-.26.) (A copy of F&D's bond is included at Tab 116 of Aetna's Exhibit Addendum.) Like Aetna's Bond, F&D's bond was a discovery-type policy which covered "loss sustained at any time but discovered during the Bond period.

D. Aetna's New Fidelity Bond.

4. In applying for the Aetna Bond, Home Savings did not disclose any of its knowledge or any information about suits alleging irregularities in and problems with the AFCO investor loans. (Tr. Ex. 122.)

5. On July 14, 1982, Aetna issued to Home Savings \$1,135,000 of coverage under a Savings and Loan Blanket Bond, Standard Form 22 (the "Bond"). (Exhibit A to Home Savings' Amended Complaint; Tr. Ex. 343 included at Tab 343 of Exhibit Addendum.) Aetna's Bond was made retroactively effective to June 21, 1982, the date F&D's prior coverage was due to expire.

E. Terms and Coverage Under the Bond.

6. The Bond contained basic employee fidelity coverage, which provided that Aetna would "indemnify and hold harmless" Home Savings for "loss resulting directly from one or more dishonest or fraudulent acts of an Employee,

committed anywhere and whether committed alone or in collusion with others" (Insuring Agreement (A), Tr. Ex. 343.)

7. The Bond did not cover losses resulting from the voluntary or intentional decisions or acts of Home Savings' officers and directors in the course of its business. Losses sustained as a result of mismanagement and bad business judgment were not covered.

8. As stated in the preamble to the Bond, it provided coverage only "with respect to loss sustained by the insured at any time but discovered during the Bond Period. . . ." (Tr. Ex. 343, p. 3) (emphasis added.)

9. In the "Conditions and Limitations" portion of the Bond, Section 11 specifically terminated coverage for an employee such as Larry Glad "as soon as the Insured shall learn of any dishonest or fraudulent act on the part of such Employee" (Tr. Ex. 343, p. 5.) This same limitation was contained in the F&D bond. (Depo. Ex. 116, p. 5.)

10. A Rider to the Bond on form SR 6091 provides that the insured's "discovery" of loss occurs objectively when the insured learned of "facts which would cause a reasonable person to assume a loss . . . has been or will be incurred." (Tr. Ex. 343, p. 25.) Rider 6091 also established per se discovery of loss when the insured received "notice . . . of an actual or potential claim by a third party . . . which, if true, would create a loss under the bond." Id.

11. Another Rider on form SR 6030a excludes from coverage any loss resulting directly or indirectly from trading in securities. (Tr. Ex. 343, p. 22.)

12. The General Agreements section of the Bond obligates Aetna to indemnify Home Savings only for Court Costs and Attorney's Fees "incurred and paid by the Insured in defending any suit or legal proceeding -- which, if established against the Insured, would constitute a valid and collectible loss . . . under the terms of this bond." (Tr. Ex. 343, p. 3.) Costs for defending any claim (i.e., securities law violations) outside the coverage of the Bond are not reimbursable.

F. Subsequent Developments After Aetna's Bond was Issued.

13. On December 9 and 21, 1982, Home Savings finally notified Aetna and F&D of the possibility of a loss covered by the Bond from the pending cases, including Armitage v. Home Savings. (Tr. Exs. 119 and 120; copies of notices to Aetna included at Tabs 119 and 120 of Exhibit Addendum.)

14. On September 30, 1983, Aetna elected not to assume defense of the Armitage litigation because the claim fell outside the coverage of the bond. (Tr. Ex. 140.) F&D also issued a denial of coverage for independent reasons.

15. On August 14, 1984, the Armitage jury rendered Special Verdicts against Home Savings, finding it liable in each of 36 AFCO investor loans for three primary violations of state and federal securities fraud provisions.

(A copy of the Armitage Special Verdict is included at Document Addendum E, R. at 210.70-.76.) In addition, the jury found Home Savings secondarily liable on the 36 AFCO investor loans both for controlling and for aiding and abetting violations by Grant Affleck and/or AFCO of § 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Id. The Armitage jury also found Home Savings liable for common law fraud, and for violations of federal Truth-in-Lending regulations. Id.

16. A Final Judgment in the Armitage case was entered on February 24, 1986. (Exhibit B to Home Savings' Amended Complaint; Tr. Ex. 330.) (A copy of the Armitage judgment is included at Tab 330 of Aetna's Exhibit Addendum.) The Armitage judgment rescinded the AFCO investor promissory notes and trust deeds resulting in a net principal loss to Home Savings of \$998,623 and included \$10,000 of punitive damages.

17. The Armitage court also entered a Judgment for Attorney's Fees against Home Savings on August 24, 1986, in the amount of \$381,294. The Judgment for Attorneys Fees was later negotiated down to \$190,647. (See Pretrial Order, Uncontroverted Facts, paras. 22-24; Document Addendum A; R. at 727-28.)

G. The Present Lawsuit.

18. Home Savings filed its Amended Complaint in the present action against Aetna on April 21, 1986. (R. at

13-24.) In filing the action, Home claimed that the losses it suffered in the Armitage case were wholly caused by the dishonest acts of its employee Larry Glad, and that those losses are covered by the employee fidelity bond issued by Aetna. Although Home Savings' key officers directly negotiated with Grant Affleck and entered into agreements with him regarding the AFCO investor loans; although Home Savings' Board of Directors specifically approved participation in the AFCO second mortgages; and although Home Savings' officers consciously approved, initiated, or allowed extraordinary lending procedures with regard to the AFCO investor loans: Home Savings alleged that its loan solicitor, Larry Glad, caused the Armitage verdict to be entered against it. (Amended Complaint, para. 15, R. at 20; Pretrial Order, Plaintiff's Claims, R. at 720-21.)

19. The alleged misconduct of Larry Glad falls into three distinct categories:

- a. The receipt by Larry Glad in November 1981 of a \$15,000 kickback from AFCO;
- b. The alleged withholding by Larry Glad of his personal knowledge about AFCO's precarious financial circumstances; and
- c. Larry Glad's participation in and purported control of irregularities in the processing and closing of loans made to AFCO investors.

(Amended Complaint, para. 9, R. at 16-19.)

20. As shown in paragraph 2, above, Home Savings clearly learned of Glad's kickback, of the financial instability of AFCO, and of egregious irregularities in the

AFCO investor loans many months before it applied for and was issued the Aetna Bond.

21. At trial, the jury found that Home Savings learned of Larry Glad's dishonesty or fraud fully seven months before the Aetna Bond was purchased. (Special Interrogatory No. 8, R. at 1354; copy at Document Addendum D.) Furthermore, Larry Glad was fired by Home Savings within approximately one week of such discovery. (F. Smolka test., R. at 2919.37.)

22. In addition, the jury found that Home Savings made misrepresentations and nondisclosures of material facts to Aetna, and also failed to volunteer material information, which if disclosed would have resulted in Aetna's refusing to issue the Bond or excluding that risk from coverage. (Special Interrogatories 2 and 4, R. at 1353-1353; see Aetna's Document Addendum D.)

Additional facts pertinent to the separate issues involved in this appeal, particularly details of Home Savings' bad business judgment and mismanagement, are contained below in the specific sections discussing each of those issues.

SUMMARY OF ARGUMENTS

Given the compelling facts of this case, it would be both inequitable and contrary to any reasonable interpretation of the Bond, to require Aetna to indemnify Home Savings for its loss. This appeal involves primarily issues of coverage definitions and matters relating to the timing in Home Savings' acquisition of the Bond.

POINT I. SECTION 11 OF THE BOND PRECLUDES COVERAGE FOR LOSS FROM LARRY GLAD'S CONDUCT BECAUSE HOME SAVINGS LEARNED OF HIS DISHONESTY DURING HIS EMPLOYMENT, BEFORE MANY OF THE LOANS CLOSED, AND SEVEN MONTHS BEFORE THE BOND WAS PURCHASED.

Section 11 of the bond provides for coverage to be automatically terminated as to any specific employee as soon as the insured learns of any dishonest or fraudulent act on his part. The trial court ruled as a matter of law that Section 11 could not apply because it would make coverage for loss from Glad's conduct void at the inception of the bond period. However, to preserve factual findings on this point for appeal, the jury answered special interrogatories, finding that Home Savings learned of dishonest or fraudulent acts on Larry Glad's part prior to his termination from employment at Home Savings; that the dishonesty did not relate directly to the AFCO investor loans; and that such knowledge was acquired in approximately mid-December, 1981, seven months before the Aetna Bond was issued. Based upon the jury's answers, Aetna prevailed on the Section 11 issue. The judgment should be reversed.

POINT II. HOME SAVINGS IS NOT COVERED UNDER AETNA'S FIDELITY BOND FOR ANY LOSS CAUSED BY LARRY GLAD BECAUSE PLAINTIFF DISCOVERED ITS LOSS PRIOR TO THE PERIOD OF THE BOND.

The Bond is a "discovery" type bond. A claim is covered only if, during the period of the bond, the insured employer learns of the likelihood of loss from an employee's infidelity. Discovery can occur objectively, when the insured itself learns of facts which would cause a reasonable person to assume a loss has or will occur; or discovery can be per se, when the employer receives notice from third parties of actual or potential claims which would be covered by the Bond. Under both the objective and per se standards of discovery, Home Savings "discovered" its loss between December 1981 and no later than the FHLBB Examination Report on June 4, 1982, before it purchased the Bond from Aetna.

The trial court's use of the date of the Armitage judgment as the date of Home Savings' "discovery of a loss sustained" as a matter of law, was an incorrect ruling. The date a monetary loss actually occurs is irrelevant to the coverage determination. Because Home Savings discovered its loss prior to the Bond's period, there is no coverage for loss from the AFCO investor loans, and the judgment should be reversed.

POINT III. THE TRIAL COURT ERRED IN DISREGARDING THE JURY'S RESPONSES ON SPECIAL INTERROGATORIES NOS. 2 AND 4 AND ENTERING A JUDGMENT NOTWITHSTANDING THE JURY'S RESPONSES.

In reaching its verdict, the jury found that Home Savings made "unintentional misrepresentations or nondisclosures of facts . . . which materially affected [Aetna's] risks under the Bond, and that [Aetna] would not have issued the bond or would have excluded the risk if it had known these facts." However, the trial court concluded that there was insufficient evidence to support those findings, and set the jury's decision aside. It was factual error to set aside the jury's finding after it had heard four and one-half weeks of evidence and specifically decided these issues in Aetna's favor. On the issue of disclosing information not requested on the application form, the trial court incorrectly held that there was a legal duty to volunteer information only if there was an intentional or fraudulent concealment of unrequested information. The Bond should be declared void, at least as to the AFCO investor loan losses which are directly related to those material misrepresentations and omissions.

POINT IV. THE TRIAL COURT ERRED WHEN IT ALLOWED HOME SAVINGS TO RECOVER UNDER AETNA'S BOND THOSE LOSSES FROM THE AFCO INVESTOR LOANS WHICH RESULTED FROM HOME'S VIOLATIONS OF STATE AND FEDERAL SECURITIES LAWS.

Rider 6030a of the Bond specifically excludes coverage for losses resulting from trading directly or indirectly in securities. In the Armitage case, Home Savings was held liable for three counts of its own primary violations

of state and federal securities laws, and for two counts of controlling and of aiding and abetting Grant Affleck in his violations of securities laws. The trial court construed Rider 6030a right out of the Bond by concluding that what was decided in Armitage did not constitute "trading" and so the exclusion didn't apply. This legal ruling should be reversed, and the case should be remanded for amendment of the judgment to exclude losses stemming from Home Savings' securities law violations.

POINT V. THE COURT ERRED IN REFUSING TO ALLOW THE JURY TO CONSIDER THE BAD BUSINESS JUDGMENT AND MISMANAGEMENT OF HOME SAVINGS' OFFICERS AND BOARD OF DIRECTORS AS THE CAUSE OF HOME SAVINGS' LOSS.

The trial court committed reversible error by: (1) refusing to read to the jury a number of key instructions setting forth Aetna's theory on causation, (2) giving the jury instructions that inadequately presented Aetna's defense, and (3) submitting a special verdict to the jury which wholly failed to mention Home Savings officers' and directors' actions as being the cause of Home Savings' loss.

The cumulative result of these errors was that the jury was never allowed to consider Aetna's chief factual defense of bad business judgment and mismanagement as a separate, distinct cause of Home Savings' loss. Although substantial testimony was introduced on this point, the court refused to instruct the jury that mismanagement and bad business judgment could be a cause of loss, distinct from employee dishonesty; and the jury wasn't allowed to apportion

the losses between Larry Glad's misconduct and the significant follies of Home Savings' management. The case should be remanded for an apportionment of cause between Larry Glad, on the one hand, and Home Savings' institutional mismanagement and bad business judgment, on the other hand.

POINT VI. THE TRIAL COURT COMMITTED LEGAL ERROR BY FAILING TO REQUIRE HOME SAVINGS TO JOIN ITS PRIOR FIDELITY BOND INSURER, F&D OF MARYLAND, AS AN INDISPENSABLE PARTY.

Aetna moved early in the case to have the issuer of Home Savings' prior fidelity bond, Fidelity & Deposit of Maryland, joined as an indispensable party under Rule 19, U.R.Civ.P. This was necessitated both by the interrelated terms of the two bonds, and by the timing of Home Savings' discovery of its loss during F&D's policy period. The trial court ruled as a matter of law that F&D was not a necessary party to a full and fair adjudication of the issues between Aetna and Home Savings, and denied Aetna's motion. That ruling was in error because the structure of the two discovery bonds is intentionally sequential so that fidelity coverage can continue from policy to policy and insurer to insurer without either overlap or gaps. Two of Aetna's key defenses involved the effect of Home Savings' discovery of its loss and its knowledge of its employee's dishonesty, both of which occurred during F&D's bond period.

POINT VII. PROPER CALCULATION OF HOME SAVINGS' LOSSES REQUIRES AN OFFSET FOR FUNDS WHICH HOME SAVINGS COLLECTED DIRECTLY FROM THE PROCEEDS OF THE AFCO INVESTOR LOANS.

As Home Savings made loans to the AFCO investors, some of those loan proceeds were endorsed back to Home Savings. Home Savings received \$237,760.77 in this manner. Those funds were used by Home Savings for its own benefit. Therefore, the principal of Home Savings' total damages should be reduced by \$237,760.77.

POINT VIII. HOME SAVINGS IS NOT ENTITLED TO INDEMNIFICATION FOR THE LEGAL FEES AWARDED TO THE ARMITAGE PLAINTIFFS NOR THE ENTIRE AMOUNT OF COURT COSTS AND ATTORNEYS' FEES INCURRED IN DEFENDING THE ARMITAGE LITIGATION.

Plaintiff's attorneys' fees in the Armitage lawsuit were awarded against Home Savings as part of the Armitage verdict, but were ultimately negotiated to \$190,647.31. The claims giving rise to the award of attorneys' fees were for violations in the sale or exchange of securities, a risk specifically excluded under the Trading Rider of the Bond. Because such losses are excluded from coverage, Aetna had no obligation to reimburse Home Savings for those fees. As to attorneys' fees incurred by Home Savings in defending the Armitage litigation (the stipulated amount of such fees being \$437,500.00), Aetna had no obligation to defend Home Savings in the Armitage litigation because Aetna owed no coverage to Home Savings for losses discovered outside the Bond's period or losses sustained as a result of trading in securities.

ARGUMENT

INTRODUCTION: APPLICABLE PRECEPTS OF INSURANCE LAW

A number of the issues in this case involve the interpretation and application of the Bond as a policy of insurance. An overview of the law in this area will be helpful at the outset.

A. A Bond is a Contract Subject to a Fixed Standard of Interpretation.

"[T]he bond cannot be extended by implication or enlarged by construction beyond the actual terms of the agreement entered into by the parties." Federal Deposit Ins. Corp. v. Aetna Casualty and Surety Co., 426 F.2d 729, 736 (5th Cir. 1970). "Ambiguity must appear upon the bond or policy and cannot be read into it by a strained interpretation in order to permit recovery." 35 Am. Jur. 2d Fidelity Bonds and Insurance § 3, p. 505 (1988). The consensus of case law also provides that "[a] fidelity bond may validly limit the liability of the insurer on such bond to losses discovered within a specified term." 13 Couch on Insurance 2d, § 46.191 (1982 Ed.).

A provision of a fidelity bond which clearly limits the liability of the insurer to losses discovered within a certain specified period must be enforced according to its terms, so that there can be no recovery on a fidelity bond if the loss is not discovered within the time specified therein.

Id.

B. Policy Riders are an Integral Part of the Contract of Insurance.

Aetna's Bond has several significant riders attached to it. Riders to insurance policies constitute an integral part of the contract of insurance. 1 Couch on Insurance 2d, § 4:27 p. 386 (1984). This is true even if the rider adds a new and different meaning to the original contract. Id. at 386-87.

Standard policy laws sometimes expressly authorize the attachment of slips or riders to contracts of insurance in a form provided thereby, so as to modify the provisions in the body of the policy; and where such a rider is properly attached, pursuant to such provision, it forms a part of the contract and supersedes the original provisions to which it applies.

1 Couch on Insurance 2d § 4:29, p. 391 (1984).

The Declarations page of Aetna's Bond at Item 4, specifically states that "the liability of the underwriter is subject to the terms" of various riders. Thus, the terms of its Riders form an integral part of the Bond. When rider terms are specific, as contrasted with general provisions of the policy, they govern the meaning of the bond. 1 Couch on Insurance 2d, § 4:28, p. 389-91 (1984).

C. The Trial Court's Legal Interpretation of an Insurance Policy is Subject to de Novo Review.

Bonds and insurance policies are contracts, and so "the trial court's interpretation [is entitled to] no

presumption of correctness." Valley Bank & Trust Co. v. U.S. Life Title Ins. Co. of Dallas, 776 P.2d 933, 935 (Utah Ct. App. 1989), citing Zions First Nat'l. Bank v. National Am. Title Ins. Co., 749 P.2d 651, 653 (Utah 1988). Therefore, the trial court's rulings as a matter of law on the meaning and application of the Aetna Bond are subject to de novo review by the appellate court. Allstate Enterprise, Inc. v. Heriford, 772 P.2d 466, 468 (Utah Ct. App. 1989); Scharf v. BMG Corp., 700 P.2d 1068, 1070 (Utah 1985).

POINT I

SECTION 11 OF THE BOND PRECLUDES COVERAGE
FOR LOSS FROM LARRY GLAD'S CONDUCT BECAUSE HOME SAVINGS
LEARNED OF HIS DISHONESTY DURING HIS EMPLOYMENT,
BEFORE MANY OF THE LOANS CLOSED, AND SEVEN
MONTHS BEFORE THE BOND WAS PURCHASED

A. The Language of Section 11 and its Proper Application.

Section 11 of the Aetna Bond prevented coverage from ever going into effect as to Larry Glad, because the Bond was written to reflect the bonding company's intent not to accept risk of loss related to any employee previously known to the Savings and Loan as dishonest. With regard to an employee already known to be dishonest, coverage is void from the inception of the policy, i.e., it is void ab initio. Section 11 of the Bond provides in part:

This bond shall be deemed terminated or cancelled as to any Employee - (a) as soon as the Insured shall learn of any dishonest or fraudulent act on the part of such Employee

(Tr. Ex. 343, copy included at Exhibit Addendum Tab 343.)

However, the trial court refused to enforce Section 11 of the Bond as a matter of law. (See R. at 2909.10; 2909.34-.35.) The trial court said Section 11 seems "baffling and inconsistent" and would permit the bonding company to "take premiums for not insuring people." (R. at 2906.27-.29.) Nevertheless, in response to Special Interrogatories Nos. 5, 6, 7, and 8, which were submitted to the jury solely to preserve its factual determination on this point, the jury in this case found: (5) Home Savings learned

of a dishonest or fraudulent act on the part of Larry Glad prior to December 29, 1981 (the date when he was terminated from employment at Home Savings and six and one-half months before the Bond was purchased); (6) the dishonest or fraudulent act occurred after Larry Glad became employed by Home Savings; (7) the dishonest or fraudulent act was not related to the AFCO investor loans; and (8) Home Savings first learned of such dishonest or fraudulent act about mid-December, 1981. (See Jury's Answers to Special Interrogatories 5-8, R. at 1351-1354; copy included at Document Addendum D.) The Bond, of course, was not even purchased until July 14, 1982, seven months later.

Section 11 of the Bond protects the bonding company from coverage exposure after the insured learns that an employee is dishonest. Once an employer is on notice of a dishonest employee, the insurance company cannot be required to indemnify losses resulting from similar subsequent conduct by that same employee. Likewise, an employer cannot lure a new bonding company not previously involved in insuring a known dishonest employee into writing a bond to cover that employee, especially if the Savings and Loan knows that employee to have been involved in possible losses and has not disclosed that information to the bonding company. Yet, that is exactly what the trial court sanctioned with its ruling on Section 11 of the Aetna Bond.

If there were any fidelity coverage for losses resulting from Larry Glad's conduct, then it should have been under F&D's bond (see Depo. Ex. 116 in Exhibit Addendum), which

was in place when Larry Glad's conduct occurred, when Home Savings learned of his conduct, and when Home Savings began experiencing actual losses and lawsuits regarding loans in which Larry Glad was involved. It is unconscionable to permit Home Savings to pass its losses on to Aetna, when it should have protected its position and preserved its rights under the F&D bond by simply giving notice to F&D when the dishonesty of Larry Glad was discovered, or at the very latest in March and April 1982, when the AFCO investors refused to make their payments and initiated litigation.

B. The Law of Section 11.

Aetna's position is nearly identical to the situation presented in Fidelity & Casualty Co. of New York v. Central Bank of Houston, 672 S.W. 2d 641 (Tex. App. 1984). In that case, a bank sought fidelity bond coverage for loan losses that resulted from the dishonest acts of its former president, Joseph P. DeLorenzo. That bond included a Section 11 identical to Section 11 of the Aetna Bond. The only factual difference between the two cases is that the bond under which Central Bank of Houston sought fidelity coverage was a renewal of a prior bond with that same insurer, F&C of New York. In contrast, the Aetna Bond was entirely new coverage which was issued to replace an F&D of Maryland Bond scheduled to expire on June 21, 1982, three weeks before Home Savings purchased coverage from Aetna.

Nevertheless, the jury in Central Bank found and the Court of Appeals affirmed that the directors of the bank had learned of other acts of dishonesty on the part of Central Bank's president prior to the effective date of the renewal bond. Based upon that finding, the Texas Court of Appeals held that "upon learning of those acts, coverage as to Defendant DeLorenzo immediately terminated." Id. at 646. That court held:

The jury's answer to special issue sixteen did not absolve appellant of liability for losses occurring after October, 1974 because the renewal bond which was issued December 11, 1974, was void from its inception. Rather, appellant is absolved of liability for these losses because a renewal policy does not reinstate coverage for an employee that had already been terminated by a known dishonest act; it simply continues whatever coverage existed at the time of renewal. To hold otherwise would be contrary to the principle that an insurer does not agree to insure a bank from losses caused by an officer known to be dishonest prior to the losses.

672 S.W. 2d at 647 (citation omitted, emphasis added.)

That holding is directly applicable to the present case. In both cases, the juries found that the lending institution learned of dishonest acts on the part of an employee prior to the purchase of a new bond. Section 11 of the bond is identical in both cases. The trial court was wrong in reinstating coverage for Larry Glad under the Aetna Bond where coverage had terminated as to Larry Glad under the prior F&D bond as of mid-December 1981. The trial court's legal conclusion is simply not defensible.

Similarly, in Ritchie Grocer Co. v. Aetna Casualty & Surety Co., 426 F.2d 499 (8th Cir. 1970), an insurance policy provided an exclusion from coverage for any employee who was known by the insured to have committed any fraudulent or dishonest act. The court found that it was undisputed that the insured knew of a dishonest act by the subject employee which occurred prior to his becoming employed by the insured. Therefore, the court held that coverage must be defeated ab initio. The court further ruled that such an exclusionary clause was reasonable and valid.

In this case, Aetna's counsel attempted by inference to explain the operation of Section 11 to the jury during opening statement (October 27, 1989, Tr. Trans., R. at 2921.80) and closing argument (November 24, 1989, Tr. Trans., R. at 2917.211-.215). But the trial court had previously articulated its position that Section 11 would not be allowed to defeat coverage (see, e.g., Transcript of October 20, 1987 hearing on Motion for Directed Verdict, R. at 2912.207-.210; see also R. at 2909/10, .34-.35; and 2906.27-.29), and it prevented complete explanation of this provision to the jury. (R. at 2917.59-.60; defendant's proposed Jury Instructions 8, 9 and 32, R. at 1233, 1234, and 1213.)

The result of the trial court's position on this issue is evident in the form and content of the jury instructions, special verdict and special interrogatories, as well as the court's judgment for Home Savings despite the jury's answers to Special Interrogatories 5-8. The trial court

refused, over Aetna's objection, to give proffered instructions 8, 9, and 32 (R. at 2917.59-60; R. at 1233, 1234, and 1213, copies included at Document Addendum F to Aetna's Appellant's Brief), so the jury had no instruction on whether it could consider the Section 11 issue and, if so, how it should go about deciding it, or what the effect of its findings would be. The trial court also refused to include a Section 11 issue identifiable to the jury in any portion of the Special Verdict. (A copy of the Special Verdict proposed by Aetna (R. at 1218-1223) is included at Document Addendum H to Aetna's Appellant's Brief.)

Section 11 was included subliminally in the Special Interrogatories as Nos. 5, 6, 7, and 8. The trial court only included those Special Interrogatories to avoid the necessity of retrial if it were reversed on appeal based on the jurors' legal interpretation of Section 11. (Transcript of October 20, 1987 hearing, R. at 2912.207-.210.) Nevertheless, the jury's answers on Special Interrogatory Nos. 5-8 reflect its common sense intention that Aetna should prevail on the public policy embodied in Section 11. By responding as they did, the jury concluded that Aetna would prevail because Home Savings knew of Larry Glad's dishonesty many months before Aetna wrote the Bond. (See also Juror Affidavits, R. at 2032-2053, and 2055-2057; copies are included at Document Addendum J.)

C. Summary.

The reasoning of the courts in Central Bank and Ritchie Grocer is sound and directly applicable to the case at bar. A savings and loan institution should not be able to obtain fidelity coverage for an employee who is known to have been dishonest and who was fired for that dishonesty seven months before the Bond was purchased. In this case, the jury concluded that preventing Home Savings from taking advantage of Aetna in this manner was the appropriate resolution, and it made specific findings consistent with that approach. The integrity of these jury findings should be upheld, and the validity of the Central Bank and Ritchie Grocer reasoning should be adopted by this court.

POINT II

HOME SAVINGS IS NOT COVERED UNDER AETNA'S FIDELITY
BOND FOR ANY LOSS CAUSED BY LARRY GLAD BECAUSE
PLAINTIFF DISCOVERED ITS LOSS PRIOR TO THE
PERIOD OF THE BOND

A. The Motion for Summary Judgment on Discovery of Loss.

On July 31, 1987, Aetna moved for summary judgment because Home Savings had discovered the likelihood of its impending loss prior to the period of coverage provided in the Bond. In addition, prior to its purchase of Aetna's Bond, Home Savings had received notice from third parties, through letters, lawsuits, and bank examinations, of claims involving fraud and dishonesty. After extensive briefs and oral argument, the trial court denied Aetna's motion on August 25, 1987. (R. at p. 344.) The court's ruling (a copy is included at Tab I of Document Addendum) states that although "the dishonesty of [its] employee, Larry Glad, was known before the policy period commenced," Home Savings did not discover a "loss sustained" until "the judgment in or settlement of the Armitage case" when Aetna's Bond was in effect. This is an erroneous legal conclusion which is entitled to de novo review on the merits.

B. Discovery-Type Coverage.

The proper interpretation of the Bond must start with its language. According to the preamble, there is coverage

"with respect to loss sustained by the insured at any time but discovered during the Bond Period" (Emphasis added.) An important Rider to the Bond on form SR 6091 provides for the insured's discovery to occur in either of two separate ways. Objectively:

Discovery occurs when the insured becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred even though the exact amount or details of loss may not be then known.

or, per se:

Notice to the insured of an actual or potential claim by a third party which alleges that the insured is liable under circumstances, which, if true, would create a loss under this bond constitutes such discovery.

(Emphasis added.)

The Bond on Standard Form 22 provides fidelity coverage which is common in the financial industry. (Banks are frequently covered by Bankers Blanket Bond, Standard Form No. 24.) The policy is called a "discovery bond," as distinguished from an "occurrences bond," which would cover any insured event that occurs within the period of the bond, no matter when the insured becomes aware of that event. See, e.g., USLIFE Savings & Loan Ass'n. v. National Sur. Corp., 115 Cal. App. 2d 336, 171 Cal. Rptr. 393 (1981).

Under a discovery bond, discovery of loss "means the date the fraud was discovered by the Bank - not the date the Bank was called upon to make good the loss." Federal Deposit Insurance Corp. v. Aetna Casualty & Sur. Co., 426 F.2d 729,

739 (5th Cir. 1970). Loss refers to the awareness of conditions out of which a claim may arise, not to the insured's adjudicated liability for that loss. 13A Couch on Insurance 2d § 49:216 (1982). Under the objective standard, discovery occurs when "a reasonable insured would understand the significance of [the facts] connoting the commission of a fraud." Perkins v. Clinton State Bank, supra, 593 F.2d 327, 334 (8th Cir. 1979).

"Despite the years of litigation, the definition set forth in American Sur. Co. of New York v. Pauly, 170 U.S. 133, 18 S.Ct. 552, 42 L.Ed. 977 (1898), continues to reappear as the basic yardstick" on the meaning of discovery of loss. Alfalfa Elec. Coop., Inc. v. Travelers Indemn. Co., 376 F.Supp. 901, 906 (W.D. Okla. 1973).

Paraphrased, 'discovery' means that time when the insured gains sufficient factual knowledge, not mere suspicion, which would justify a careful and prudent man [sic] in charging another with dishonesty.

Id. at 906. Accord: Continental Ins. Co. v. Morgan, Olmstead Etc., 83 Cal. App. 3d 593, 148 Cal. Rptr. 57 (1978); USLIFE Savings & Loan Ass'n. v. National Sur. Corp., 115 Cal. App. 2d 336, 171 Cal. Rptr. 393, 398 (1981); Perkins v. Clinton State Bank, 593 F.2d 327, 334 (8th Cir. 1979); First Nat'l. Bank of Fleming v. Maryland Casualty Co., 41 Colo. App. 195, 581 P.2d 744, 745 (Colo. Ct. App. 1978); United States Fidelity and Guar. Co. v. Empire State Bank, 448 F.2d 360, 364-65 (8th Cir. 1971); and National Newark & Essex Bank v. American Ins. Co., 76 N.J. 64, 385 A.2d 1216, 1224 (1978).

Under the Bond's per se standard of discovery, notice to the insured by third parties of actual or potential claims which, if true, would give rise to a loss covered by the bond, "constitutes such discovery." Rider 6091. By either the objective or per se definition, Home Savings definitely discovered the loss prior to June 21, 1982, the date the Bond became effective.

C. Home Savings' Knowledge of Larry Glad's Dishonesty and Discovery of its Loss.

In its Amended Complaint, Home Savings alleged that its employee, Larry Glad, committed certain dishonest or fraudulent acts. This conduct all occurred in October, November, and December 1981, consistent with the allegations contained in paragraph 9 of plaintiff's Amended Complaint. (R. at pp. 16-18.) Assuming the conduct constitutes "dishonesty" as defined by the Bond, both the conduct and the actual and reasonably anticipated loss from the AFCO investor loans, were extensively known by Home Savings long before it purchased the Bond. The facts which were submitted to the trial court in support of Aetna's Motion for Summary Judgment, and which were substantiated at trial, are itemized in paragraph 2 of the Statement of Facts, above.

The three lawsuits filed against Home Savings merit additional detail. On March 26, 1982, a complaint was filed by David and Patricia Bott against Home Savings in Box Elder County, Utah (Civil No. 17132). The Bott Complaint was answered by Home Savings on April 28, 1982. (Tr. Exs. 356 and

357.) Pages 3, 4 and 5 of the Bott Complaint contain a narrative recitation of the very irregularities in the AFCO investor second mortgage loans which later formed the basis of the judgment in Armitage.

On April 7, 1982, approximately three hundred (300) AFCO investors filed a complaint in the United States Bankruptcy Court against Home Savings and other financial institutions. (See Alcorn, et al. v. Grant C. Affleck, et al. Complaint, Adversary Proceeding No. 82-0333, Tr. Ex. 358.) The Alcorn Complaint was served on Home Savings' President, Howard Bradshaw, on April 13, 1982. (See Tr. Ex. 359.) Pages 20 through 26 of the Alcorn Complaint (see particularly para. 23 at p. 25) alleged Home Savings' improper association and involvement in the sale and distribution of the AFCO securities, as well as its commission of common law fraud and its departure from conventional and standard lending practices.

The Alcorn Complaint was dismissed on Home Savings' motion (R. at 3072-80) on July 21, 1982, for lack of Bankruptcy Court jurisdiction. (R. at 3070.) On July 22, 1982, it was refiled (with a few new plaintiff and defendant parties) in the Federal District Court for the District of Utah as Abbott, et al. v. Carvel Shaffer, et al., Civil No. C82-0628K. Abbott v. Shaffer was severed for trial against individual lender/defendants. That complaint was the basis of the Armitage v. Home Savings trial and judgment.

On April 29, 1982, a complaint was filed by Richard and Barbara Clifford against Home Savings in the District Court for Davis County, Utah. (Tr. Ex. 360.) A copy of that complaint, as well as an accompanying Restraining Order and Order to Show Cause, were served on Home Savings on April 30, 1982. (R. at 3087.) Pages 1 through 4 of the Clifford Complaint contain numerous specific allegations with regard to loan processing and closing irregularities by Home Savings as to the Clifford transaction and also as to forty (40) additional AFCO investor loan transactions with Home Savings & Loan.

Each of the facts recited in paragraph 2 of the Statement of Facts would alone constitute objective discovery of loss prior to the issuance of Aetna's Bond. The letters from third parties, the lawsuits, and the FHLBB Report of Examination each also constitute discovery of loss under the Bond's per se standard, which is satisfied by notice of "actual or potential claim by a third party which alleges . . . circumstances, which, if true, would create a loss under the bond." (Rider 6091.) The third-party allegations and notices were tried in the Armitage case, and the jury there found them to be true. There could be no clearer test of per se discovery.

Neither the Bond nor the law require that for discovery of loss to have occurred, the insured must be certain about the loss. The Bond's objective standard of discovery only requires that a reasonable person would have

cause to "assume" that a loss had been or would be incurred "even though the exact amount or details of loss may not then be known." Rider SR 6091. The case law is in accord. See, e.g., USLIFE v. National Sur. Corp., supra, 171 Cal. Rptr. at 398.

No objective or per se factors changed between the first half of 1982 and the month of December 1982 when Home Savings finally gave notice to both Aetna and F&D that lawsuits from the AFCO scheme were then pending against it. The December 1982 letters from Home Savings' counsel (Tr. Exs. 119 and 120, copies included at Tab 119 and 120 of Exhibit Addendum) notifying Aetna of pending claims do not contain one shred of information which was not actually known to Home Savings prior to June 21, 1982, when the Bond went into effect. Home Savings admitted in its report to the FHLBB of Violations of Criminal Statutes (Tr. Ex. 226A; copy included at Tab 226A of Exhibit Addendum) that it was put on notice on April 7, 1982, of all the significant irregularities in the AFCO investor loan program. This notice was imparted to Home Savings by the allegations in the massive Alcorn v. Affleck lawsuit.

D. Conclusion.

The trial court considered the evidence at summary judgment and ruled as a matter of law that before Home Savings purchased the Aetna Bond, it was aware of Larry Glad's conduct and the problems with the AFCO investor loans. But then the

trial court improperly ruled, also as a matter of law, that it was the timing of the "loss sustained" which triggered coverage under the Bond. After that misreading of the Bond, the trial court either did not perceive or else neglected to address the per se standard of discovery altogether. The Bond should be enforced as written, consistent with the interpretation of courts throughout the country.

In response to Special Interrogatory Nos. 2 and 4, the jury in this case found that Home Savings had omitted or misrepresented material information in applying for the Aetna Bond. (See Point III, below.) A primary explanation for this result is that the jury -- the final arbiter of the reasonable person -- had concluded that Home Savings had enough information before it purchased the Aetna Bond reasonably to assume that a covered loss had or would have occurred with the AFCO investor loans. The determination of the jury should be sustained. The decision of the trial court should be reversed with remand for entry of judgment in favor of Aetna.

POINT III

THE TRIAL COURT ERRED IN DISREGARDING THE JURY'S RESPONSES ON SPECIAL INTERROGATORIES NOS. 2 AND 4 AND ENTERING A JUDGMENT NOTWITHSTANDING THE JURY'S RESPONSES

The Utah insurance statute governing the Bond application process in this case, U.C.A. § 31-19-8(1) (1974 ed.), prevents recovery by an insured if the insured made misrepresentations or omissions in the application, provided such were either fraudulent or material or that the insurer would not have issued the coverage if it had known the facts. The jury below found two of those three elements - materiality and that Aetna would not have issued the coverage. The trial court mistakenly set aside those jury findings. In order to do so, the court erred by misinterpreting the statute to require both materiality and that the insurer would not have issued the coverage. The court agreed that there was an evidentiary basis for materiality, which taken alone required judgment for Aetna, but then erred again by requiring the third element as well as finding an insufficient basis for the jury's conclusion that Aetna would not have issued the coverage.

A. The Jury's Determination and the Supporting Evidence.

The jury answered Special Interrogatories 2 and 4 pertaining to Home Savings' misrepresentations in the Bond application process (see R. at 1352-1353, attached at Document Addendum D). The jury found that Home Savings made "unintentional" misrepresentations or omissions of facts were

known by Home Savings, which materially affected Aetna's risks under the Bond, and that Aetna would not have issued the Bond or would have excluded the risk disclosed if it had known those facts. (See Jury's Answer to Special Interrogatory No. 2, R. at 1352.) In addition, the jury found that Home Savings failed ("unintentionally") to disclose material facts known by Home Savings beyond those requested on the Application Questionnaire. (See Jury's Answer to Special Interrogatory No. 4, R. at 1352-1353.)

In the trial court's Memorandum Decision of March 4, 1988 at 9-14 (R. at 2066-2071), the court concluded that there was insufficient evidence to support those findings, and set the jury decision aside. Instead of following the statutory mandate requiring only one of the requisite elements and reviewing the entire body of evidence to determine whether there was an adequate basis for the jury's decision, the trial court ruled that the testimony of Don Bradshaw, an independent insurance agent, and David Robinson, Aetna's bond underwriter, was insufficient to support the jury's conclusion that the information was "material" to Aetna. (R. at 2068-2070.)

Setting aside the jury decision was improper. The jury determined unanimously that it had sufficient information to conclude that Home Savings had failed to provide information to Aetna, which it should have provided, and which would have resulted in Aetna's refusing to write the Bond coverage. (R. at 2917.248-.260; 1351-1353.) The jury heard evidence throughout the four and one-half week trial that long before

Home Savings purchased the Bond, its management was aware of Larry Glad's dishonesty, as well as the actual or potential losses on the AFCO investor loans. (See paragraph 2 of Statement of Facts, above.) Furthermore, Mr. Bradshaw and Mr. Robinson specifically testified about the issue of materiality.

David Robinson, Aetna's bond underwriting manager, testified that if Aetna had received accurate responses from Home Savings on the application regarding loan procedures in place at Home Savings, Aetna would have issued an interpretive letter limiting coverage (R. at 2916-11, .20-.23, .51-.52); if Home Savings had disclosed the firing of Larry Glad or the contents of Grant Affleck's letter (Trial Exhibit 20), Aetna would have re-examined writing the Bond at all (R. at 2916.23 -.24); and if Aetna had known of the AFCO bankruptcy, attorney letters and lawsuits, it would not have written the Bond (R. at 2916.24-.25). Mr. Robinson also explained that Aetna's risk was greatly increased by Home Savings' undisclosed problems with regulators, insider abuse, deviations from standard practices, and potential claims. (R. at 2916.25 -.26.) Don Bradshaw, the agent who wrote the Bond, but who also had close ties with Home Savings, testified that he would not have taken the application if he had known of any possible claims Home Savings might make (R. at 2916.67), or of claimed fraud and dishonesty with regard to the AFCO investor loans (id. at .56-.57, .60), or of Larry Glad's firing (id. at .65), or of Home Savings' reserve for uncollected interest on the loans

tied to possible dishonesty (id. at .60-.71). However, it was also apparent from the mass of other trial evidence that the misrepresented and undisclosed facts would be material to anyone issuing a bond that might cover that very subject matter about which Home Savings had so much information and notice.

Normally, a judge cannot intervene in the jury's factual decisions. A jury determination must be upheld if it is "supported by substantial competent evidence." Canyon Country Store v. Bracey, 112 Utah Adv. Rep. 19,21 (Utah 1989). The trial court did not meet the very high standard that is required before allowing such intervention.

B. The Statutory Standard.

The misrepresentation issue is governed by Utah's statute on insurance applications. The statute in effect during July of 1982, when Home Savings applied for the Bond, was Utah Code Ann. § 31-19-8(1)(1974). It provided as follows:

31-19-8. REPRESENTATIONS IN APPLICATIONS -
(1) All statements and descriptions in any application for an insurance policy or annuity contract, or for the reinstatement or renewal thereof, by or in behalf of the insured or annuitant, shall be deemed to be representations and not warranties. Misrepresentations, omissions, concealment of facts, and incorrect statements shall not prevent a recovery under the policy or contract unless:

- (a) fraudulent; or
- (b) material either to the acceptance of the risk, or to the hazard assumed by the insurer; or
- (c) The insurer in good faith either would not have issued the policy or

contract, or would not have issued, reinstated or renewed it at the same premium rate, or would not have issued , reinstated, or renewed a policy or contract in as large an amount, or would not have provided coverage with respect to the hazard resulting in the loss, if the true facts had been made known to the insurer as required either by the application for the policy or contract or otherwise.

In Jury Instruction No. 33, the Court instructed the jury with regard to this issue as follows:

Aetna also claims that there were unintentional misrepresentations or nondisclosure of facts known by Home Savings on the application questionnaire which facts materially affected its risks under the bond and that it would not have issued the bond or would have excluded the risk disclosed if it had known these facts. Aetna must establish each aspect of this claim by a preponderance of the evidence.

(R. at 1335.) In special Jury Interrogatory No. 2, the jury was asked to answer the following question:

In accordance with the standard of proof required in Numbered Paragraph 2 of Jury Instruction No. 33, did Aetna prove that there were unintentional misrepresentations or nondisclosure of facts known by Home Savings on the application questionnaire which facts materially affected its risks under the bond and that it would not have issued the bond or would have excluded the risk disclosed if it had known these facts?

(Emphasis added). The jury answered this Interrogatory, "Yes," finding both materiality and that Aetna would not have written this coverage if it had known the same facts as Home Savings.

In the trial court's post-trial Memorandum Decision of March 4, 1988, the court improperly ruled that the "statute

provides that factual omissions in an application for insurance shall not prevent recovery unless the facts are material and would have resulted in the insurer not issuing the policy or excluding the risk disclosed. . . ." (R. at 2067-2068)

(emphasis added.) The court went on to find that Mr. Bradshaw's testimony provided "an evidentiary basis for the materiality of the information known by Home" (R. at 2068), but that neither Mr. Bradshaw nor Mr. Robinson's testimony was sufficient to establish the third element. The trial court overlooked the fact that only one element need be established.

The Utah Supreme Court has decided a case virtually on all fours with the jury verdict herein, Berger v. Minnesota Mutual Life Insurance Co., 723 P.2d 388 (Utah 1986). In Berger, the plaintiff's deceased husband had obtained a credit life insurance policy from the defendant. The jury found that the decedent had made misrepresentations in the application which were "false but not fraudulently made." Id. at 389. The jury also found both materiality and that the insurer would not have issued the coverage if it had known the facts.

The Berger court held that just one of the statutory elements need be established in order to defeat coverage:

The statutory alternatives are stated in the disjunctive, not the conjunctive. In order to invalidate a policy because of a misrepresentation by the insured, an insurer need prove applicable only one of the above provisions.

Id. at 390 (citations omitted, emphasis added).

In the present case, as in Berger, the misrepresentations made by Home Savings were false but not fraudulently made. The jury did not find the first statutory element, fraud, but it found both of the other two elements.

The Berger holdings were subsequently followed in Hardy v. Prudential Insurance Co., 763 P.2d 761 (Utah 1988). In Hardy, the court again held that the statutory elements are stated in the disjunctive, so only one element need be proven for the insurer to prevail. Id. at 765-66.

As noted in Berger, five other states have statutes virtually identical to the Utah statute applicable to this case. A number of decisions interpreting those statutes have been issued in harmony with Berger. Coppin v. Shelter Mut. Ins. Co., 742 P.2d 594 (Okla. Ct. App., 1987); Matthews v. New York Life Ins. Co., 92 Idaho 372, 443 P.2d 456, 460 (1968) ("A contract of insurance, and the liability of an insurer, may be avoided by reason of . . . a misstatement of matters material to the risk."); Wardle v. Int'l. Health & Life Ins. Co., 97 Idaho 668, 551 P.2d 623 (1976); Kentner v. Gulf Ins. Co., 297 Or. 470, 686 P.2d 339, 343 (1984) (modified at 689 P.2d 955 (Or. 1984)); Hollinger v. Mutual Benefit Life Insurance Co., 192 Colo. 377, 560 P.2d 824, 827 (Colo. 1977).

In the present case, the jury went far beyond the statutory minimum elements by finding that the facts known by Home Savings were material, and that Aetna would not have issued the bond or would have restricted coverage if it had known those facts. Therefore, the additional reference in the

Special Interrogatory to the "unintentional" nature of the misrepresentations is superfluous.

C. The Common Law Standard.

Home Savings had a common law obligation to disclose all information to Aetna which was material to the risk undertaken by Aetna in issuing the fidelity bond to Home. Sumitomo Bank of Cal. v. Iwasaki, 73 Cal. Rptr. 564, 447 P.2d 956 (Cal. 1968); Phoenix Sav. and Loan, Inc. v. Aetna Casualty and Sur. Co., 266 F.Supp. 465 (D.C. Md. 1966); West Am. Fin. Co. v. Pacific Indemnity Co., 61 P.2d 963 (Cal. App. 1936). Under this common law duty, Home Savings had an obligation to divulge any and all material information, even if not specifically requested by Aetna, which directly affected Aetna's risk in issuing the Bond. A brief review of the three foregoing cases demonstrates that Home Savings breached its common law duty at the time it purchased the Bond by failing to disclose what it knew of Larry Glad's misconduct and of its actual and potential losses on the AFCO investor loans.

In West Am. Fin. Co. v. Pacific Indemnity Co., and Sumitomo Bank of Cal. v. Iwasaki, the California court carefully articulated the common law obligation imposed upon an insured when applying for a fidelity bond:

[I]t may be said to be a fundamental principle of the law of fidelity guaranty that if dishonesty of an agent, whose fidelity was guaranteed under a bond, exists before or at the time the surety on the bond becomes bound thereby, and the principal conceals it from the surety at the time of obtaining the fidelity bond,

the surety is not liable for the losses resulting therefrom . . . the mere nondisclosure of the circumstances affecting the situation of the parties which are material for the surety to be acquainted with and are within the knowledge of the person obtaining the surety bond, is undue concealment even though not willful or intentional or with a view to any advantage to himself.

61 P.2d 963, 968 (emphasis added); 447 P.2d 956, 960. In Sumitomo Bank, the California court stated that this "rule imposes an absolute duty upon the obligee to volunteer disclosure of all facts materially affecting the risk to the surety on a fidelity bond." Id. (emphasis added.) The court concluded that "[i]rrespective of motive or intent, mere non-disclosure of facts known by the obligee which materially affect the surety's risk, such as prior dishonesty of the principal on the fidelity bond, therefore discharges the surety." Id.

These same common law principles were applied by the Maryland Federal District Court in Phoenix Savings and Loan Inc. v. Aetna Casualty and Surety Co. In addition, the court in Phoenix Savings held that a fidelity bond identical to the one involved in the present case would be deemed null and void due to misrepresentations in the application procedure that were entirely innocent and unintentional. Specifically, the officer completing the questionnaire was charged with the knowledge of all officers and directors in providing complete and accurate information on the application. 266 F. Supp. at 470. (Compare Bond Rider SR 5538, Trial Exhibit 343, at

Tab 343 of the Exhibit Addendum, imputing knowledge of "any partner or officer" to the principal insured.)

Home breached its common law obligation to divulge all material information by failing to disclose the AFCO investor loans and the tremendous amount of activity pertaining to those loans at the time of and preceding the application process. Question 17 on the application form (Tr. Ex. 122) specifically requested information regarding losses, and since Home was already booking and experiencing losses related to these loans, it was obligated to disclose those to Aetna. This type of information is precisely what the California and Maryland courts held was vital and material to the surety's decision of whether or not to insure.

D. Summary.

The jury in this case made its determination of material misrepresentation and omission based on ample evidence. That determination should not have been overridden by the trial court. The Court of Appeals should reverse the trial court and remand with instructions to enter a judgment of "no cause of action" in favor of Aetna.

POINT IV

THE TRIAL COURT ERRED WHEN IT ALLOWED HOME SAVINGS
TO RECOVER UNDER AETNA'S BOND THOSE LOSSES FROM
THE AFCO INVESTOR LOANS WHICH RESULTED FROM HOME SAVINGS'
VIOLATIONS OF STATE AND FEDERAL SECURITIES LAWS.

A. Motion for Summary Judgment on the Bond's Trading
Exclusion Rider.

The Bond includes Rider SR 6030a, which excludes from coverage any loss resulting directly or indirectly from trading in securities. (See Tr. Ex. 343 p. 22.) On August 31, 1987, Aetna moved for summary judgment to exclude bond coverage for that portion of the Armitage judgment which arose from Home Savings' violations of state and federal security laws. Aetna's motion was supported by what the trial court called "the undisputed facts" (R. 331), including selected jury instructions and Special Verdict Form from the Armitage trial, as well as an affidavit from Francis X. LeMunyon, a Vice President of the Surety Association of America. (Copies of the Armitage jury instructions, Armitage Special Verdict Form, and the LeMunyon Affidavit are included as Document Addendums K, E, and L, respectively, to Aetna's Appellant's Brief.) (These Addendum documents are included in the Record at R. 210 through 210.87.)

By Minute Entry dated August 19, 1987 (a copy is included as Document Addendum M to Aetna's Appellant's Brief), the trial court denied Aetna's motion, in spite of its correct conclusion that "while no reference [in Rider SR 6030a] is made to trading in securities, . . no reasonable person could

believe that the Rider has reference to anything but securities." The trial court's ruling turned on a semantical declaration which was not supported by reasoned analysis or legal authority. It simply reads:

The nature of the evidence, jury instructions and verdict in Armitage necessarily requires the nomenclature 'involved in the sale or exchange of securities' to characterize Home's conduct and the jury's findings. Such 'involvement,' however does not necessarily equate to 'trading' in securities as that term is used in rider SR 6030a.

The trial court's decision overlooks the important language in Rider SR 6030a which excludes "loss resulting directly or indirectly in trading."

B. The Text and History of the Trading Exclusion.

Rider SR 6030a reads, in pertinent part, as follows:

The underwriter shall not be liable under the attached bond for any loss resulting directly or indirectly from trading, with or without the knowledge of the Insured, in the name of the Insured or otherwise, . . .

By its express terms, Rider SR 6030a is specifically "FOR USE WITH BLANKET BONDS, STANDARD FORMS NOS. 5, 22, 24, AND 28.

'DISCOVERY' FORMS TO DELETE TRADING LOSS COVERAGE."

Paragraph 2 of Rider 6030a says "[t]his rider applies to loss sustained at any time but discovered after 12:01 a.m. on June 21, 1982" when the Bond went into effect.

The Savings and Loan Blanket Bond, Standard Form No. 22, and its related riders were drafted by the Surety Association of America ("SAA"). The SAA is a non-profit

association of insurance companies which provide surety and indemnity coverage throughout the country. In preparing standard insurance policies, the SAA works with trade associations for those industries which are affected by the coverage contained in any given form, such as the American Bankers Association and the U.S. League of Savings and Loan Associations. (LeMunyon Affidavit at paragraphs 1 through 4, R. at 210.10-.12.) The trading exclusion rider was designed to cover activities involving the sale, purchase and trade of securities, and it pertains to losses resulting from either legal or illegal trading in securities. (LeMunyon Affidavit at paragraph 11.)

The trading exclusion rider functions as an affirmative limitation on policy coverage. An insured can override the trading exclusion by purchasing an exemption under another Bond Rider SR-6085 and paying appropriately higher premiums. (See July 27, 1987 letter from Francis X. LeMunyon, together with attached filing letter to Utah Insurance Department, all at Document Addendum N to Aetna's Appellant's Brief. R. 210.45-.47.) Home did not purchase extended coverage for losses resulting from trading in securities. (LeMunyon Affidavit at paragraphs 12 and 13.)

C. The Law of Trading Exclusions.

The trading exclusion under Rider 6030a was considered and interpreted in the case of Shearson/American

Express v. First Continental Bank and Trust Co., 579 F. Supp. 1305 (W.D. Mo. 1984) in the context of a Banker's Blanket Bond Form No. 24. As that case explains, the trading exclusion was adopted in the 1970's from the terms of insurance coverage then commonly issued only to stockbrokers. Shearson/American Express at 1310, citing Digest of Bank Insurance, 35 (3d ed. 1977.) (See also LeMunyon Affidavit, paragraph 9.) The trading exclusion was added to Blanket Bond Standard Forms 22 and 24 because of the increased involvement of financial institutions in the sale or exchange of securities. (LeMunyon Affidavit at paragraphs 10 and 11); Shearson/American Express at 310, citing Digest of Bank Insurance, 35 (3d ed. 1977).

The gradual deregulation of the financial industry which occurred in the 1970's resulted in increased activity by banks and by savings and loans in the sale, purchase and exchange of securities. The high risk of loss associated with this new activity was not originally taken into consideration by underwriters in calculating appropriate premiums. Therefore, both the American Surety Association, and the American Bankers Association and the U.S. League of Savings & Loan Associations, felt that those financial institutions which traded in securities, either directly or indirectly, should pay additional premiums for the attendant increased risk. Id. In like manner, the premiums of financial institutions which do not engage, either directly or indirectly in the purchase or sale of securities, reflect a lower level of risk assumption by the fidelity insurers. (LeMunyon Affidavit, paragraphs 10

through 13); Shearson/American Express at 1311, citing Digest of Bank Insurance, 1.3.33 (4th ed. 1981).

D. The Armitage Judgment -- The Cause of Home Savings' Loss.

Home Savings' loss resulted from the Armitage jury verdict which found Home Savings primarily and secondarily liable for fraud involved in the sale or exchange of securities. The Armitage jury could not have found Home liable on the counts of primary and secondary securities violations without finding for each count of the verdict that it traded either directly or indirectly in securities. The Armitage jury instructions (see Document Addendum K) are conclusive on this point. They are summarized as follows:

1. as a matter of law, the AFCO promissory notes given to the AFCO investors were securities. (Armitage instructions 5.03 and 6.03.)
2. with respect to liability under § 12(2) of the Securities Act of 1933, an essential element was the finding that Home Savings was a "seller" of the AFCO securities. (Armitage instruction 6.03.)
3. in order to find Home Savings liable for violations of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, the jury must find that Home Savings engaged in fraudulent conduct "in connection with the purchase or sale" of a security. (Armitage instructions 7.0 through 7.4.)
4. in order to find Home Savings liable under § 61-1-22(1)(a) of the Utah Uniform Securities Act, Home Savings must have offered or sold securities in violation of §§ 3, 10 or 17 of the Utah Uniform Securities Act. (Armitage instructions 8.01 through 8.08.)

5. in order to find Home Savings liable for secondary violations of the securities laws, Home Savings had to have either controlled or aided or abetted AFCO, its agents or Grant Affleck, in the primary violations by those parties of the state and federal securities laws. (Armitage instructions 12.01, .02, and .03.)

The Armitage judgment was based on Special Verdict Forms entered by the jury pursuant to the foregoing instructions. Through its Special Verdicts, the jury found Home liable on each of 36 separate AFCO investor loans for three primary violations of the state and federal securities fraud provisions. In addition, the jury found Home secondarily liable on the 36 AFCO investor loans both for controlling and for aiding and abetting Grant Affleck and AFCO in their violations of securities laws. The Armitage court entered judgment accordingly. (Tr. Ex. 330; a copy is included at Tab 330 of Exhibit Addendum.)

Although the Armitage special verdicts also found Home liable for committing common law fraud and for violating truth-in-lending provisions of federal and state law, Home's commission of these improprieties necessarily occurred in the context of its illegal trading in the AFCO securities. Furthermore, the fact that Home was found liable for common law fraud does not justify ignoring the operation of the trading exclusion in light of Home Savings' securities law violations. In Judge Learned Hand's now-famous dicta in Irving Nat'l. Bank v. Law, 10 F.2d 721 (2d Cir. 1926), "if the decision of a court on a point of law is based upon several grounds, each is

equally authoritative on all, and no one is obiter." Id. at 724.

E. Conclusion.

The judgment should be reversed and remanded for a determination of that portion of Home Savings' losses in the Armitage judgment which derived from trading directly or indirectly in securities. The damages in this case should be reduced proportionately.

POINT V

THE COURT ERRED IN REFUSING TO ALLOW THE JURY TO CONSIDER
THE BAD BUSINESS JUDGMENT AND MISMANAGEMENT
OF HOME SAVINGS' OFFICERS AND BOARD OF
DIRECTORS AS THE CAUSE OF ITS LOSS.

A. Evidence Establishing Home Savings' Bad Business Judgment
and Mismanagement.

The jury heard and saw a tremendous amount of evidence at trial suggesting that Home Savings incurred losses from the AFCO investor loans because of management's conscious decision to enter into the AFCO investor loans and its failure to follow federal and state lending guidelines, industry-recognized safe and sound lending practices, and its own internal procedures.

For example: Fred Smolka, then Director, Executive Vice President and Chief Operating Office of Home Savings, testified that Larry Glad was not present at the first three meetings between Grant Affleck and Home Savings' officers and directors regarding the AFCO loan (R. at 2919.137, .154-.155, .159); Larry Glad (through deposition testimony read to the jury) testified that Affleck and his staff "had literally taken over our office" to process the AFCO investor loans (R. at 2910.137); Home Savings' management was concerned about entering into these loans, but did so anyway because they thought the loans could be sold on the secondary market (Tr. Ex. 39; Fred Smolka test., R. at 2919.185; David Richards test., R. at 2907.179-.185; see also Larry Glad testimony, R. at 2910.131, .137). The loans were processed too quickly,

in one to three days, instead of the usual two weeks to one month (L. Glad test., R. at 2910.147); the loans were not closed by a Home Savings officer at Home Savings' office (F. Smolka test., R. at 2919.107-.111, 2920.13, .41-.42); and the Board of Directors disregarded red flags that had been raised about AFCO, Grant Affleck and the nature of the loans (D. Richards test., R. at 2907.179-.183; F. Smolka test., R. at 2921.138, .140-.141, .161, 2919.8, .19, .35-.36, .146-.148, .151-.153, .156-.157, .163-.165, .179-.182, 2920.5-.6, .13, .41-.42).

All of Home Savings' active involvement and its blatant mismanagement is corroborated and described in detail in the trial testimony of William Cox, Vice President in Charge of Mortgage Lending, and Elaine Reese, as assistant secretary of Home Savings and also the loan closing officer. The essence of their testimony is hard to improve upon by summary, so copies of selected portions are included at Document Addendum O (Cox) and P (Reese). Copies of agreements which Home Savings' management entered into with Grant Affleck through negotiations by its key officers (Tr. Exs. 8, 9, 10, and 11) are included at Exhibit Addendum Tabs 8, 9, 10, and 11. Copies of direct (mis)representations by Home Savings' management to the AFCO investors (Tr. Exs. 89 and 90) are included at Exhibit Addendum Tabs 89 and 90. In the entire trial, there was no evidence that Larry Glad ever had any communication with any of the AFCO investors, and none of the operative agreements between Home Savings and AFCO were negotiated or entered into by Larry Glad.

Aetna introduced testimony at trial from some of the most knowledgeable experts in the country to establish that Home Savings' own bad business decisions and mismanagement were the primary cause of Home Savings' loss. These witnesses also reviewed and interpreted the FHLBB's multiple negative reports on Home Savings' activities and on FHLBB action taken against Home Savings for those violations. Aetna's experts were: (1) James Croft, the former Director of the FHLBB's Office of Examinations and Supervision, author of books and articles in the subject area, officer of a large Maryland Savings and Loan, university professor and Savings and Loan consultant (R. at 2923.111-.114); (2) Elaine Weis, former Commissioner of the Utah Department of Financial Institutions, Savings and Loan consultant, and professor in the University of Utah Department of Finances (R. at 2909.64-.74); and (3) Douglas McEachern,, C.P.A., partner and National Director of Savings and Loan Practice in the national accounting firm of Touche Ross and Co., Chairman of the Committee for Savings and Loan Accounting and Reporting in the American Institute of CPAs, and representative for the accounting industry in several Savings and Loan organizations. (R. at 2922.4-.7.) All of these experts testified that Home Savings was badly managed, that management failed to follow both its own procedures and industry standards, that the AFCO investor loans were bad loans for Home Savings to make, and that management's decisions led to Home Savings' loss.

In the FHLBB's Report of Examination for Home Savings dated June 4, 1982 (Tr. Ex. 196), the FHLBB found that management had subjected Home Savings to possible losses and lawsuits on the AFCO investor loans (see Elaine Weis test., R. at 2909.107-.109), that management had demonstrated an "absence of sound procedures" and a "lack of supervision of loan department personnel" (id. at 2909.123), that Home Savings had demonstrated poor appraisal practices (id. at 2909.117), and that Home Savings had entered into the AFCO investor loans in a manner inconsistent with its own procedures, resulting in possible losses and lawsuits (id. at 2909.107-.109). Home Savings' management showed the same course of mismanagement for a period of years both before and after the AFCO loans. (Tr. Exs. 191, 200, 206, 210, 211; Elaine Weis testimony, R. at 2909.126-.131.)

In addition, Aetna's expert witnesses found a variety of serious problems with the AFCO loans, unrelated to Larry Glad's alleged dishonesty. Many of those problems were apparent on the face of the loan documents and should have raised red flags for management, loan officers or others reviewing the files. Loan documentation on the loans was received in many cases after the loan was made (E. Weis test., R. at 2909.91), AFCO was listed as the party ordering many appraisals instead of Home Savings (id. at 2909.96), some AFCO investors had apparently been turned down elsewhere on the same loans (id. at 2909.94-.95), and many AFCO investors

showed payment-to-income and total obligations-to-income ratios that were far too high (id. at 2909.92-.93).

As revealed in the FHLBB's 1981 and 1982 Exam Reports, Home Savings demonstrated a pattern on conduct of continued problems with meeting regulatory standards for loan documentation, failures to meet the FHLBB underwriting expectations, a high level of scheduled items (problem assets), poor appraisal practices, and a lack of attention to detail. (Testimony of James Croft, R. at 2923.120.) Given that the AFCO investor loans were more complicated and more difficult than most loans, and given Home Savings' level of lending experience, Home Savings should not have attempted this type of transaction; management's attempt to enter into these types of loans generated a high number of problem assets or scheduled items. (Id. at .121-.123.) Ultimately, because of the types of violations occurring in 1981 and 1982, the FHLBB took the extraordinary action of entering into a Consent Cease and Desist Order with Home Savings in 1986. (Id. at .130-.134; see Tr. Ex. 220.)

More specifically pertaining to the AFCO investor loans, it was bad practice for management to allow a loan solicitor (such as Larry Glad) to become involved in loan processing, underwriting, approval and closing. (Id. at .135-.138.) Mr. Croft also testified that because it was apparent that the \$100,000.00 loan to AFCO and the AFCO investor loans were interrelated, the primary source of repayment for the investor loans would be AFCO, and Home

Savings' management should have carefully looked at AFCO's ability to repay, including evaluating current audited financial statements and AFCO's history as a business. (Id. at .139-.142.) It was also unreasonable for Home Savings' management to allow AFCO to process the investor loans (id. at .145-.146); a one to three-day processing time was far too fast to insure accurate information (id. at .146); it was improper for Home Savings to allow AFCO to close loans outside of Home Savings' office (id. at .146-.147); and senior management of Home Savings should have become much more involved in administering these loans rather than allowing a loan solicitor with a vested interest in closing the loans to follow through on those loans (id. at .147).

The testimony of Mr. McEachern is best summarized in defendant's Trial Exhibit No. 378 (summary at Document Addendum G), which was prepared by Mr. McEachern and the accounting firm of Touche Ross. In the two pages constituting Section 1 of that exhibit (id.), Mr. McEachern summarized the 36 AFCO investor loans and whether or not the loan documentation in the Home Savings' file justified the making of those loans on the face of that documentation. He concluded that one of those loans was appropriate, six possibly were appropriate, but 29 should not have been made for one or more of the following reasons: the debt-service ratio was too high for the subject borrower, the borrower had no liquid net worth, and/or the payment on the new obligation resulted in too dramatic an increase in payments owed by that borrower

("payment shock"). (See, e.g., testimony of Douglas McEachern, R. at 2922.29-.31.) If management and the Home Savings' officer responsible for the loan approval process had properly evaluated nothing more than the loan documentation in their own files, they would not have made the vast majority of these loans and Home Savings' ultimate loss would have been avoided.

Home Savings' theory at trial was that Larry Glad's dishonesty was so egregious that it "pervaded" the entire series of AFCO investor loan transactions and made them unenforceable. If so, it argued it should not have to show that each individual loan was unenforceable because of some specific conduct of Larry Glad.

To the contrary, a case involving multiple transactions requires apportionment of loss among various causes. This approach is mandated by Fidelity Sav. & Loan Ass'n. v. Aetna Life & Casualty Co., 647 F.2d 933 (9th Cir. 1981). That case involved a series of poorly performing loans which, in conjunction with other factors, caused a bank to go out of business. The Ninth Circuit adopted the district court's "logical and equitable apportionment between dishonesty and other factors" which caused the bank to fail. (Citing Fidelity Sav. & Loan Ass'n. v. Aetna Life & Casualty Corp., 440 F.Supp. 862, 876 (N.D. Cal. 1977), aff'd. 647 F.2d 933.)

The trial court committed prejudicial error by allowing Home Savings to use the pervasive effect approach and by precluding the jury from deciding whether loan losses could

be allocated among the other possible causes, including Home's mismanagement and bad business judgment. This error occurred, over defense counsel's objections, by: (1) refusing to read the jury a number of key instructions setting forth Aetna's theory on causation (defendant's Requested Instructions 2 and 42, R. at 1227, 1996); (2) giving jury instructions that inaccurately presented Aetna's defense (Jury Instruction 26-30, R. at 1327-1331); (3) refusing to submit to the jury a Special Verdict question addressing this issue, as requested by defendant (defendant's requested Special Verdict, Question No. 6, R. at 1219); and (4) submitting a special verdict to the jury which wholly failed to mention Home Savings officers' and directors' actions as being a possible cause of Home Savings' loss. (Special Verdict, R. at 1347-1350.)

A party to an action is entitled to have its theory of the case fully and fairly presented to the jury through appropriate jury instructions. Elkington v. Foust, 618 P.2d 37 (Utah 1980). An error in jury instructions requires reversal if it is determined to have been prejudicial, based on a review of the records as a whole. Cambelt Int'l. Corp. v. Dalton, 745 P.2d 1239 (Utah 1987); Durflinger v. Artiles, 727 F.2d 888, 895 (10th Cir. 1984). Error in jury instructions is determined "not [by] whether the charge was faultless in every particular, but whether the jury was misled in any way and whether it had understanding of the issues and its duties to determine those issues." Patty Precision Products Co. v.

Brown & Sharpe Mfg. Co., 846 F.2d 1247, 1252 (10th Cir. 1988).

B. Preclusion of Jury's Consideration of Aetna's Primary Factual Defense.

The trial court's preclusion of the bad business judgment/mismanagement defense is found in review of the jury instructions and special verdict form imposed by Judge Murphy. Over Aetna's objection, the trial court gave Jury Instruction No. 29, which precluded the jury from considering whether "better policies and procedures or adherence thereto would have checked the dishonesty, if any, of Larry Glad and prevented a loss that would have otherwise have occurred." The trial court refused to give Aetna's proffered Instruction No. 42, which proposed that there may be more than one "efficient cause of an event or loss" and that the jury could consider as a "contributing cause . . . the failure of the officers and directors of Home Savings to require compliance with appropriate lending practices and procedures" The trial court also refused to give Aetna's proffered Instruction No. 2, which proposed that if the losses occurred because of plaintiff's "own mismanagement, misfeasance or other negligence and/or failure to follow safe and sound lending practices, then you must find there was no coverage for Home under the bond."

In addition to omitting to mention the alternative cause of loss claimed by Aetna, the trial court in Instruction No. 26 stated that Aetna claims the plaintiff's loss "resulted not from the dishonesty of Larry Glad, but that it directly

resulted from a separate and independent cause"; however, "for Aetna to prevail on this defense [it] must prove the existence of an alternative cause [which is] separate and independent from Larry Glad's dishonesty, if any." (R. at 1327.) Instead of following up that instruction with clarification as to how the jury could consider other causes, the trial court gave Instruction Nos. 27, 28, 29, and 30. (R. at 1328-1331.) Those instructions stated that plaintiff's failure to supervise Larry Glad was not a defense, nor the negligent failure to discover Glad's dishonesty, nor Home's inadequate policies and procedures, nor the negligent failure to follow policies and procedures that it did have, nor the negligent hiring of Larry Glad. Therefore, taking the instructions on this point as a whole, the jury was forced to conclude that Home Savings' mismanagement and bad business practices could not be considered as a separate cause of the loss. (See also Juror Affidavits, R. at 2032-2053, 2055-2057, attached at Document Addendum J.)

This issue on appeal pertains to causation. The trial court instructed the jury to the effect that if Larry Glad's dishonesty was involved to any extent in causing the loss, full bond coverage would be allowed. On the other hand, under the instructions as given, if bad business judgment or mismanagement were not the exclusive, sole cause of a bad loan (thereby precluding even the nominal tainting effect of Larry Glad), it could not be considered to any extent in apportioning damages.

When it came time to draft the Special Verdict form, Aetna proposed the following question: "6. Did any loss sustained by Home Savings directly result from its mismanagement, misconduct, negligence, and/or failure to follow safe and sound lending practices?" (R. at 1219.) This, or a similar question, would have allowed the jury to indicate such causation and then to apportion cause between Larry Glad's dishonesty and Home's own mismanagement and bad business judgment. The trial court disallowed that language. Instead, the jury had to answer the following special verdict question: "2. Did the verdict against Home Savings in the lawsuit of Armitage, et al. v. Home Savings & Loan, in whole or in part, directly result from dishonest or fraudulent acts, if any, of Larry Glad?" (R. at 1347) (emphasis added.) Thus, the jury was left with an instruction which excluded the consideration of bad business judgment and mismanagement for any purpose, but which allowed recovery under the Bond if Glad's dishonesty was in any way involved ("in whole or in part") in the loss sustained by Home Savings.

C. Conclusion.

In spite of this combination of misleading instructions and the restrictive verdict form, one of the jurors (No. 10) still voted outright that Larry Glad's dishonesty had not "in whole or in part" caused home Savings' loss. (R. at 2917.258) A number of other jurors were confused by the combination of instructions and verdict form

and said so in the affidavits submitted to the Court in February 1988. (R. at 2032-2053, 2055-2057, attached at Document Addendum J.) The primary complaint of the jury was that the instructions and the verdict form took the case out of their hands and left them with only one result to reach on the thin thread of a finding that Larry Glad was "in part" involved in the AFCO investor lending activity.

The trial court's series of instructions and verdict forms nullified Aetna's strongest factual defense. A number of jurors claimed they were unfairly prevented from considering the alternative cause--that the court had "taken the case away from them." (Id.) The prejudice from instructional error is clear. This Court should rule in Aetna's favor on this issue and remand for a new trial on the basis of prejudicial errors in instructing the jury as to causation.

POINT VI

THE TRIAL COURT COMMITTED LEGAL ERROR BY FAILING
TO REQUIRE HOME SAVINGS TO JOIN ITS PRIOR FIDELITY
BOND INSURER, F&D OF MARYLAND, AS AN INDISPENSABLE PARTY.

A. Aetna's Motion to Join an Indispensable Party.

On April 15, 1987, Aetna moved for dismissal of Home Savings' Complaint for failure to join F&D as an indispensable party. (R. at 100-101A) The motion was brought to enforce Section 9 of the Bond which is entitled "Limit of Liability Under This Bond and Prior Insurance." Section 9 provides that coverage under Aetna's Bond shall be only excess to claims payable on prior insurance, to the extent that the loss was "discovered within the period permitted under such other bond or policy for the discovery of loss thereunder" (Emphasis added.)

The trial court ruled against Aetna on its motion. (See May 29, 1987, Minute Entry [R. at 143-45]; and June 12, 1987 Order [R. at 163-65].) This is in spite of the carefully drafted language of the F&D and the Aetna bonds, both Standard Form 22's, which is calculated to provide a steady line of coverage from bond to bond without either overlap or gaps. (Don Bradshaw test., R. at 2906.25; also Tr. Ex. 118.) On this issue, as on previous ones, the trial court strained the limits of both the Bond's language and the law to create coverage for Home Savings which it had lost due to its own inexplicable failure to pursue recovery on the F&D bond -- the bond which was in place at the time of Larry Glad's conduct, at the time

Home Savings had full knowledge of the nature of that conduct, and at the time which Home Savings was booking losses on and being sued over the AFCO investor loans which were then in total default.

B. The Law of Mandatory Joinder.

Rule 19, U.R.Civ.P., provides that a person shall be joined as a party if he is subject to process, if his presence will not deprive the Court of subject matter jurisdiction, and if "in his absence complete relief cannot be accorded among those already parties." This language affirms the traditional purpose of joinder, which is to assure a full and just adjudication between the existing parties. Stone v. Salt Lake City, 11 Utah 2d 196, 356 P.2d 631, 637 (1960), cert. denied, 365 U.S. 860 (1961). See also, Kemp v. Murray, 680 P.2d 758, 760 (Utah 1984).

In Continental Ins. Co. v. Morgan, Olmstead, etc., 83 Cal. App. 3d 543, 148 Cal. Rptr. 57 (1978), the court considered the dismissal of one insurance company when the issue of coverage between prior and subsequent policies was raised. Both bonds in that case were fidelity bonds with discovery clauses which limited coverage to losses sustained by the insured at any time but discovered within the period of the bond. Both bonds also had provisions which dealt with prior and subsequent coverage by other insurance policies.

The court in Continental Ins. v. Morgan held that where the coverage question was ambiguous because of the

"discovery" issue, it was inappropriate to dismiss either insurance company. Although the insured in Continental Ins. v. Morgan was eventually absolved of the alleged loss, the fidelity bonds in that case did require indemnification for costs associated with defending the action on the merits.

(Coverage of Home Savings' defense costs is also an issue in the present case. See discussion in Point VIII, below.) Under the circumstances, the court held "[w]here two insurers cover the same risk, defense costs must also be shared between them pro rata in proportion to the respective coverage afforded by them to the insured." 148 Cal. Rptr. at 66. Hence, where there is an issue as to which of two insurance policies provides coverage, both insuring companies are necessary parties to a full and proper adjudication.

C. The Facts of Two Separate Bonds.

Prior to June 21, 1982, plaintiff had \$900,000 of fidelity coverage from "F&D" on Standard Form No. 22, Bond No. 60 33 236. (See Exhibit Addendum, Tab 116.) Both the Aetna and the F&D bonds are modified by Riders SR 6041 which contain identical language defining the extent of coverage for loss through "dishonest or fraudulent acts of an Employee."

Both bonds contain language in Section 9 that coverage shall only be excess to claims payable on prior insurance. In addition, F&D's bond is modified by Rider No. 618, which limits F&D's exposure after termination of the bond to only those insurable events "discovered before the time

such termination . . . becomes effective." Home Savings let the F&D policy expire on June 21, 1982. It did not obtain the Aetna Bond until July 14, 1982, although coverage was made retroactive to June 21st in order to preserve continuity of coverage without overlap or gaps. (Don Bradshaw Test., R. at 2906.25; Tr. Ex. 118.)

On December 9, 1982, and December 21, 1982, plaintiff notified both F&D and Aetna of claims under their respective bonds through identical letters sent by David B. Boyce of the law firm Backman, Clark & Marsh and by Thomas A. Quinn of the law firm Ray, Quinney & Nebeker. (Tr. Exs. 119 and 120; copies included in Exhibit Addendum.) Both F&D and Aetna responded that the alleged conduct did not fall under the terms of coverage for employee dishonesty or fraud. (Tr. Ex. 140.) Both insurers also asserted that because of Section 9 of the bonds that Home Savings' claim, if valid, would be covered by the other company. Id. It was these contrary positions which required joinder of F&D as a party, as well as the fact that by the express terms of the bonds only one or the other but not both of the insurers could be liable for the losses.

D. Conclusion.

Because of the trial court's erroneous ruling on joinder, the case proceeded to trial without F&D, and with the trial court having determined as a matter of law that the Aetna Bond provided primary coverage because Home Savings discovered its "loss sustained" during the period of the Aetna

Bond. (See Point II, above). Aetna was thus denied even the possibility of apportionment of damages and defense costs. This is the incomplete resolution of issues with regard to existing parties which Rule 19(a)(1) is designed to avoid, and which requires joinder of the other insurer. See, South Kamas Irrigation Company v. Provo River Water Users' Association, 10 Utah 2d 225, 350 P.2d 851, 852 (1960). The Court of Appeals should reverse the judgment entered against Aetna because the trial court's failure to require the joinder of F&D severely prejudiced Aetna's defense at trial. See Seftel v. Capital City Bank, 767 P.2d 941 (Utah App. 1989).

POINT VII

PROPER CALCULATION OF HOME'S LOSSES REQUIRES AN OFFSET FOR FUNDS COLLECTED DIRECTLY THROUGH RESTRICTIVE ENDORSEMENTS AND OTHER FUNDS PAID FOR HOME SAVINGS' BENEFIT.

At trial, Home Savings proved the net amount of each of the 36 AFCO investor loans and it claimed and was awarded the aggregate as its principal damages. However, Home Savings also created Trial Exhibit 83 (copy included at Tab 83 of Exhibit Addendum), which shows that Home Savings recouped \$237,760.77 from those AFCO investor loans.

These funds were recovered by Home Savings through several unique arrangements. For instance, on four of the loans, Home Savings put restrictive endorsements ("Pay to the Order of Home Savings") on the back of the proceeds check prior to closing to insure that the funds would never leave its control. (E. Reese test., R. at 2903.114, and 2903.136-.138.) (See Tr. Exs. 163, 177, 172X, and 147W.) This was done with the knowledge and approval of Vice President, Bill Cox. (R. at 2903.114 and 2903.136-.138.) On other loans, the checks were endorsed by the borrower to AFCO, and then by Grant Affleck on behalf of AFCO back to Home Savings. (Tr. Exs. 174X and 168U; E. Reese test., R. at 2903.140.)

Late in December 1981, after Larry Glad had been fired and when AFCO's payments to Home Savings were all bouncing (E. Reese test., R. at 2803.143-.144), Bill Cox gave specific instructions to Home Savings' loan closing officer, Elaine Reese, to close certain loans and use the proceeds to

cover specific problems. (Tr. Ex. 67; a copy is included at Tab 67 of Exhibit Addendum.) Cox was directed to give that instruction by Executive Vice President Fred Smolka. (W. Cox test., R. at 2905.129-.130.) These circumstances, and Cox's note to Elaine Reese (Tr. Ex. 67), are some of the most blatant evidence of Home Savings' direct relationship with Grant Affleck and its accommodation of the unusual AFCO investor loan arrangements. This was all done because Home Savings had lost control of its loan process to Grant Affleck. (E. Reese test., R. at 2903.141-.142.) Larry Glad had no involvement, control, or input whatsoever in these arrangements.

As shown by Trial Exhibit 83 and the trial testimony of Bill Cox (R. at 2905.97-.99), Home Savings recovered \$237,760.77 from proceeds of the AFCO investor loans and disposed of those funds to its own benefit and at its sole discretion. Importantly, Larry Glad had nothing whatsoever to do with conceiving or executing this recoupment project. This insidious aspect of the AFCO investor loans is further evidence (see Point V, above) of Home Savings' management's direct involvement in and manipulation of the entire investment scheme.

The funds were first used to pay off principal and interest on the \$100,000 loan that Home Savings had made to AFCO on November 10, 1981. According to all the trial evidence, that was a bad loan because of President Howard Bradshaw's and Executive Vice President Fred Smolka's carelessness in negotiating and approving the loan on behalf of

Home Savings. (See discussion on Bad Business Judgment and Mismanagement at Point V, above.)

Home Savings next used the funds to rescind the Snitkoff and Sadler loans, which were not directly involved in the trial of this case. Snitkoff and Sadler were AFCO investors. The proceeds of their loans had been given to Grant Affleck through the special arrangements between Affleck and Home Savings' management, but the borrowers rescinded before Home Savings had recorded the trust deeds. (W. Cox test., R. at 2905.97-.98; E. Reese test.; R. at 2903.146-.147.) Thus, a \$65,823.33 loss was averted by Home Savings' recoupment of loan funds from other, less fortunate AFCO investors who later became parties in the Armitage lawsuit.

Exhibit 83 also shows that Home Savings made three payments directly to AFCO from the investor funds that it had recouped. This \$38,235.86 represents a gratuitous transfer from Home Savings of funds which it had in its possession.

Finally, although in its calculation of damages the trial court deducted the 3 percent origination fee paid to Home Savings by the AFCO investors on the loans which were rescinded in the Armitage judgment, it failed to deduct the 2.5 percent commitment fee paid to Home Savings by AFCO for those loans. (Cf., Tr. Ex. 83 with Tr. Exs. 11 and 8.) So proper calculation of Home Savings' true loss would require reduction of the \$31,875.00 commitment fee as well.

The funds which Home Savings recouped from the disbursement of the AFCO investor loans represents losses which

Home Savings did not sustain. If Home Savings had properly used those funds to reduce the principal on the 36 AFCO investor loans which were not being paid by Grant Affleck as agreed (see, e.g., Tr. Ex. 81) and which were all in default, there would have been a direct reduction in the losses Home Savings experienced in the Armitage judgment. Accordingly, the trial court should have reduced the losses on the principal of the AFCO investor loans by \$237,760.77 in calculating its judgment.

POINT VIII

HOME SAVINGS IS NOT ENTITLED TO INDEMNIFICATION
FOR THE LEGAL FEES AWARDED TO THE ARMITAGE PLAINTIFFS
NOR THE ENTIRE AMOUNT OF COURT COSTS AND
ATTORNEYS' FEES INCURRED IN DEFENDING
THE ARMITAGE LITIGATION

A. The Legal Fees Awarded to the Armitage Plaintiffs.

In order for the attorney's fees of a third-party (i.e., the Armitage plaintiffs) to be recoverable by an insured in an action to enforce a fidelity bond, the third-party's causes of action must fall within the terms of the insured's policy coverage. Continental Bank & Trust Co. v. St. Paul Fire & Marine Ins. Co., 550 P.2d 222, 223 (Utah 1976); 15A Couch on Insurance 2d § 57:47 at 136-38 (1983). The Federal District Court in the Armitage case expressly awarded the Armitage plaintiffs their attorney's fees on the basis of "the federal and state truth in lending statutes and the Utah securities statute" (See Order Awarding Attorney's Fees, p. 2, R. at 2243-2244.) This Order was made in accordance with the rule that attorney's fees are awardable only if provided by statute or a contract, since attorney's fees were not recoverable at common law. Golden Key Realty, Inc. v. Mantas, 699 P.2d 730 (Utah 1985); C.G. Horman Co. v. Lloyd, 28 Utah 2d 112, 499 P.2d 124 (1972).

Plaintiff cannot recover the amount it paid for the Armitage plaintiffs' legal fees (\$190,647.31), because those fees derive from a claim which is expressly excluded from bond coverage by the securities trading rider of the Bond. (See

Point IV, above). The Bond excludes coverage for losses which are "directly or indirectly" connected with the trading of securities. Id. In the case of Hepler v. Fireman's Fund Ins. Co., 239 S.2d 669 (La. Ct. App. 1970), the court interpreted the trading exclusion rider in a bond identical in all material respects to the Aetna Bond. The court held that the insured could not recover expenses and attorney fees it incurred in defense of an action based on an employee's wrongful trading activities. Id. at 677. Therefore, the award against Home Savings of the Armitage plaintiffs' attorneys' fees under the Utah securities law, U.C.A. § 61-1-22(1)(b), cannot be recovered under the Bond.

The other basis for awarding the Armitage plaintiffs' legal fees was Home Savings' violation of the statutory truth-in-lending laws. (R. at 2243-2244.) See 15 U.S.C. § 1640(a)(3); and U.C.A. § 70B-5-203(1)(c). But under Insuring Agreement A, and Rider SR 6041, Aetna's bond covers only losses due to "dishonest or fraudulent acts," i.e., the type of wrong which is malum in se.

Under the common law, a crime consisted of two elements, an evil intention and an unlawful act (malum in se). Malum in se crimes usually fall into two classifications: (1) those such as theft and fraud, which require a specific intent to commit, and (2) offenses such as rape, which require no specific intent to commit the offense.

State v. Jones, 242 Kan. 385, 748 P.2d 839, 844 (1988).

In contrast, truth-in-lending laws cover conduct which is malum prohibitum, that is wrong because it is

prohibited, not because it is inherently immoral or improper. State v. Jones, 17 Utah 2d 190, 407 P.2d 571, 574 (1965) ("[failure to file a tax return] is an offense malum prohibitum, a wrong because it is made so by statute, and thus of a character not generally considered to be inherently evil, as in the case of offenses which are malum in se.")

The technical and statutory aspect of truth-in-lending violations is reflected in Jury Instruction No. 13.01 which was given in the Armitage case. (Document Addendum K.) As a statutory or malum prohibitum type of infraction, any liability imposed on plaintiff as a result of its violations of truth-in-lending law is not the type of loss contemplated by the parties in entering into the fidelity bond, and it is therefore not covered.

Furthermore, the evidence presented in this case demonstrates that the truth-in-lending violation was caused by Home Savings' loan officer, Elaine Reese. It was she who was in charge of preparing closing documents and arranging for closings. (E. Reese test.; R. at 2903.121.) It was she who back-dated the loan documents in order to expedite AFCO's receipt of its investors' funds. (E. Reese test.; R. at 2903.150.) Thus, any violation of the truth-in-lending statute was not a loss caused by the conduct of Larry Glad.

Prior to the trial, Home Savings had made general allegations of employee dishonesty which were not restricted to Larry Glad. In the Pretrial Order, Home Savings restricted itself to losses covered only by Larry Glad. (R. at 721.) In

addition, during the conferences with the Court to draft Jury Instructions and prepare Special Verdict forms and Special Interrogatories, plaintiff's counsel limited its claims expressly to the conduct of Larry Glad and rejected any inclusion of Elaine Reese as a source of dishonest or fraudulent conduct which caused its loss. Therefore, the fees awarded against plaintiff under the truth-in-lending laws do not constitute a covered loss. The judgment should be reduced by \$190,647.31.

B. Home Savings' Costs and Fees in Defending the Armitage Litigation.

Home Savings and Aetna have stipulated that \$437,500.00 was Home Savings' reasonable cost of defending the Armitage lawsuit and initiating an appeal from the adverse judgment. (See Stipulation of November 2, 1988; R. at 3850-3853.) However, defendant Aetna reserved the issue of whether Home Savings is entitled to those fees at all in defending a liability which falls outside the terms and period of the Aetna Bond. Id.

General Agreement C of the Bond states that the insured is indemnified for "court costs and reasonable attorneys' fees incurred . . . on account of any loss, claim or damage which, if established against the Insured, would constitute a valid and collectible loss sustained by the Insured under the terms of this bond." Because of the trading exclusion (Rider SR 6030a; see Point IV, above) and the fact that the loss was discovered long before the Bond went into

effect (Preamble, and Rider 6091; see Point II, above), the Armitage defense could not "constitute a valid and collectible loss sustained by the Insured under this bond." Therefore, the attorneys' fees and costs of defense should not be allowed.

An indemnitee under a bond is bound by the determinations of a former adverse judgment, as it reflects on the issue of coverage, particularly where the indemnitee puts the former judgment into evidence in an action against its indemnitor. 11 Couch on Insurance 2d § 44:9 pp. 196-97 (1982). Home Savings put the Armitage judgment into evidence both as Exhibit "B" to its Amended Complaint, and as Trial Exhibit 343. That judgment was for multiple securities claims. The only one of seven causes of action in Armitage falling within the terms of the Bond's coverage was common law fraud. Accordingly, Home Savings is entitled to recover only those court costs and reasonable attorneys' fees incurred in defending against that claim. See, i.e., Waite v. Aetna Casualty and Sur. Co., 77 Wash. 2d 850, 467 P.2d 847 (1970) (damages and attorney's fees apportioned between claims covered and not covered by insurance policy).

In Fidelity Sav. & Loan Ass'n. v. Aetna Life & Casualty Co., 647 F.2d 933 (9th Cir. 1981) the court dealt with an apportionment problem similar to the one faced in the present case. That case involved a bank's failure, in part, because a number of the bank's borrowers were unable to repay their loans. Many of the bad loans had been granted only after

the bank's president and chairman of the board personally received "loan fees" or other benefits in exchange for approving the loans. Id. at 935. The bank's depositors lost money and sought recourse through recovery on the bank's fidelity bond. The Ninth Circuit held that "only that proportion of loss arising from the nonpayment of dishonest loans should be attributed to dishonesty and thus [be] recoverable under the [bank's fidelity] bond." Id. at 936. In so holding, that court adopted the district court's "logical and equitable apportionment between dishonesty and other factors" which caused the bank to fail. See Fidelity Savings & Loan Ass'n. v. Aetna Life & Casualty Corp., 440 F.Supp. 862, 876 (N.D. Cal. 1977), aff'd 647 F.2d 933. Similarly, in Biundo v. Old Equity Life Ins. Co., 662 F.2d 1297 (9th Cir. 1981), the Ninth Circuit held that recovery of attorney's fees may not exceed the amount attributable to the attorney's efforts to obtain payment due under an insurance contract, and that an insured may not collect attorney's fees incurred in pursuit of a claim for damages not covered by the policy.

Under this state of the law, and in light of the language of Aetna's Bond, plaintiff's \$437,500.00 of defense costs should be denied. If allowed at all, they should only be in an amount equivalent to the expense of defending the common law fraud claim in the Armitage case. At most, Home Savings should recover only one seventh (\$62,500.00) of its defense costs under General Agreement C of the Bond.

CONCLUSION

Home Savings was not entitled to coverage under the Aetna Bond for sound and equitable reasons, which are reinforced by applicable case law. The timing of Home Savings' purchase of the Aetna Bond on July 14, 1982, in relation to the occurrence of events from November 1981 to January 1982, giving rise to Home Savings' ultimate loss, together with Home Savings' "discovery" of those facts during a period through June 4, 1982, is the primary thrust of Aetna's defenses. Aetna made every reasonable effort to present those defenses to the jury, but the trial court refused to allow the jury to decide most of those issues. The jury's findings in Aetna's favor on the Bond application process and on Home Savings' learning of Larry Glad's dishonesty seven months before Home Savings' purchase of the Aetna Bond, were disregarded by the trial court in entering its judgment.

Given the facts of this case, the Bond should be rescinded because Home Savings made misrepresentations and nondisclosures of material facts to Aetna in the Bond application process. If the Bond is given effect, then it was void ab initio as to Larry Glad because of Home Savings' prior knowledge of Larry Glad's dishonesty, and it was void ab initio as to losses on the AFCO investor loans because Home Savings' "discovery" of loss on those loans occurred prior to the Bond period. These results are equitable in particular because Home Savings had an identical Bond in place through

Fidelity & Deposit up through the time that the Aetna Bond took effect.

The trial court further erred by failing to present to the jury Aetna's primary factual defense of mismanagement and bad business judgment as an alternative cause for Home Savings' loss. In addition, the Bond's trading exclusion Rider excludes coverage for losses from trading insecurities because Aetna did not contemplate and Home Savings did not purchase coverage for this type of special risk. The award of attorney fees as an element of damages should be adjusted accordingly. Finally, and in the alternative, any award of damages to Home Savings should be reduced to the extent of Home Savings' benefit from proceeds it received directly from the AFCO investor loans.

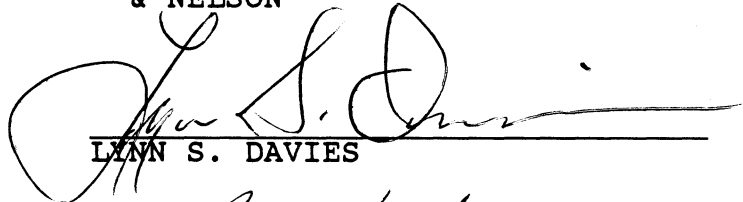
Aetna does not challenge the jury's very limited factual finding in Home Savings' favor on the Special Verdict. However, Aetna does challenge the trial court's disregarding of the jury's findings in Aetna's favor in the Special Interrogatories. Aetna also challenges the trial court's ruling on many important issues as a matter of law and its refusal to present those potentially dispositive issues to the jury. Ultimately, the jury intended Aetna to prevail, and it attempted to find accordingly; but it believed that after four and one-half weeks of trial, the case had been taken away from it by the trial court. That perception is accurate.

Aetna requests the following relief: (1) if this Court finds in Aetna's favor on Points I, II or III, this Court

should direct entry of judgment in Aetna's favor, no cause of action; (2) if this Court finds in Aetna's favor on Points IV, V, or VI, this case should be remanded to the trial court for further proceedings and retrial; and (3) if the Court finds in Aetna's favor on Points VII or VIII, the trial court should be directed to reduce the amount of judgment.

DATED this 28th day of December, 1989.

RICHARDS, BRANDT, MILLER
& NELSON



LYNN S. DAVIES



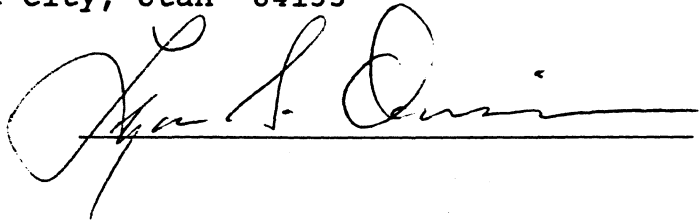
RUSSELL C. FERICKS

Attorneys for Appellant
The Aetna Casualty and Surety Co.

CERTIFICATE OF HAND DELIVERY

I HEREBY CERTIFY that four true and correct copies of the foregoing instrument were HAND DELIVERED on this 28th day of December, 1989, to the following counsel of record:

Gary R. Howe
Bryan P. Fishburn
CALLISTER, DUNCAN & NEBEKER
10 East South Temple
Salt Lake City, Utah 84133

A handwritten signature in cursive script, appearing to read "Gary R. Howe", is written over a horizontal line.

HOME/JULEE
6724-596