Squeezing The Turnip:

FIDELITY AND SURETY BOND SUBROGATION

[BY GARY L. WICKERT, MATTHIESEN, WICKERT & LEHRER, S.C., HARTFORD, WISCONSIN]

Every day, millions of dollars in claims are paid on surety and fidelity bond payments. Despite this, subrogation in this area remains mired in obscurity and confusion, and claims handlers rarely consider the positive effects that aggressive subrogation recognition and investigation can have on an insurer's bottom line. This article will serve as a tutorial on fidelity and surety bond subrogation and suggest ways to improve recoveries upon such payment of claims.

A fidelity bond is a debt obligation serving to protect an employer from loss in the event that an employee causes damages through dishonest or negligent actions. These bonds are traditionally issued by insurance companies, although the terms and conditions of claim payments under fidelity bonds can differ greatly from traditional insurance.

A surety bond is a bond issued by an entity on behalf of a second party, guaranteeing that the second party will fulfill an obligation or a series of obligations to a third party. In the event that the obligations are not met, the third party will recover its losses through a claim on the bond. Surety bonds are usually issued in construction settings or in situations in which payment of certain monies, such as taxes due to a governmental entity, are guaranteed by the entity issuing the bond.

In truth, bonds come in many shapes and sizes. The following are a number of different types of bonding instruments:

Advance Payment Bond: A bond that guarantees repayment by the principal of monies advanced in connection with a construction or supply bond or other type of contract.

Bid Bond: A bond given by a bidder on a contract that guarantees that the bidder, if selected, will enter into the contract and furnish the prescribed performance bond.

Blue Sky Bond: A bond required of securities dealers to prohibit the sale of worthless securities.

Concessionaire Bond: A bond required by principals operating a business venture on publicly owned or controlled property.

Court Bonds: All bonds and undertakings required of participants in a lawsuit permitting them to pursue certain remedies in the courts.

Depository Bond: A bond that guarantees that the principal (a bank) will be able to repay amounts deposited by the obligee.

Fidelity Bond: A form of "honesty insurance" which protects an employer from the dishonest acts of its bonded employees. Although called a "bond," a fidelity bond is really an insurance policy and not a three party agreement like a surety bond.

Game of Chance Bond: A bond required by New York and Florida which guarantees that an entity sponsoring a contest will award the related cash/prizes to the legitimate contest winner.

Indemnity Agreement: An agreement required by the surety stating that, should a loss occur under a bond, the principal will hold the surety harmless from any loss or expense it may sustain as a result of the loss.

Labor and Material Bond: A bond given by a contractor to guarantee payment for labor and material used in the work, which he or she is obligated to perform under the contract.

License and Permit Bond: A bond required to ensure the licensee will conform to the laws or ordinances related to the business in which they are engaged.

Lost Instrument Bond: A bond that guarantees against damages sustained by reissuing a lost instrument or security.

Maintenance Bond: A bond that guarantees against defective workmanship or materials.

Mechanics Lien - Bond to Discharge: A lien against real estate may be filed for an amount claimed to be due for labor or materials furnished for the construction of a building or other improvement upon property. Pending final determination of the owner's liability, the owner may discharge the lien by giving this bond conditioned for the payment of any amount that may be found due to the claimant with interest and costs. >>

Obligee: The obligee is the entity (person, firm, corporation, government) protected by the surety bond against loss. The surety bond "runs to" the obligee and the obligee has the ability to set the language of the surety bond.

Performance Bond: A three party agreement, which guarantees faithful performance of the terms of a written contract. (Performance bonds frequently incorporate Labor and Material and Maintenance liability.)

Public Official Bond: A bond that guarantees the faithful performance of a wide variety of public officials. (Notary bonds, for example.)

Principal: The principal is the entity obligated, with the surety, to the obligee.

Probate Bond: A bond that guarantees honest accounting and faithful performance of duties by administrators, trustees, guardians, executors and other fiduciaries.

Reclamation Bond: A bond that guarantees that the principal will reclaim land disturbed by mining operations.

Street Opening/Encroachment Bond: A bond required of a principal that has a permit to cut into a public sidewalk or road. The bond guarantees that the principal will comply with the conditions of the permit.

Subcontract Bond: A bond required by a general contractor of a subcontractor, guaranteeing that the subcontractor will faithfully perform the subcontract in accordance with its terms and will pay for labor and materials incurred in the prosecution of the subcontracted work.

Subdivision/Site Bond: Many municipalities require by ordinance that a developer who undertakes to develop a housing or industrial subdivision shall give a bond with surety to guarantee that, within a specified time, improvements on the property, such as streets, sidewalks, curbs, gutters and sewers will be constructed.

Supply Bond: A bond that guarantees faithful performance of a contract to furnish supplies or materials.

Surety: The surety is the entity obligated, with the principal, to the obligee. In the event of a default on the part of the principal, the surety is required to perform the terms of the contract between the principal and obligee.

Tax Bond: A bond that guarantees the principal will pay taxes (fuel, sales tax, etc.).

Utility Bond: A bond that guarantees the principal will pay utility bills as they come due. >>

A claim payment under any of these instruments carries with it the possibility that some third person might be responsible or liable for the resulting claim payment under the bond, presenting subrogation opportunities for the principal or insurance company underwriting the bond. There are three parties to any sort of a bond. The **principal** or **obligor** is the party that undertakes the obligation and who is primarily bound by the bond. The **surety** or insurance company guarantees that the obligation will be performed. The **obligee** is the party who receives the benefit of the bond and is protected from loss. Subrogating bonds require creative recognition of third parties and third party liability, and a commitment to cost-effectively, yet thoroughly, squeeze every recovery dollar out of those third parties. So let's look at how bond subrogation takes place.

The subrogation rights of a surety can arise from pure common law – equitable subrogation – without any specific bond language or assignments. More commonly, however, the bond itself contains language granting subrogation rights, such as:

> *In the event of any payment under this endorsement the Company shall be subrogated to all the Insured's rights of recovery therefore against any person or organization and the Insured shall execute and deliver instruments and papers and do whatsoever else is necessary to secure such rights. The Insured shall do nothing after loss to prejudice such rights.*

Such contractual subrogation rights such as these may or may not trump equitable defense to subrogation such as the made whole doctrine, which requires that the insured be made whole for all damages before the surety can subrogate, or the common fund doctrine, which requires that any attorney who creates a fund from which a subrogation recovery is obtained, is entitled to receive a reasonable fee from that recovery.

It is well-established that any surety who discharges a principal's obligation is subrogated to the rights of the obligee against the principal. *United States v. Munsey Trust Co.*, 332 U.S. 234 (1947). A tax bond issued to benefit an obligee, such as the State of Texas for payment of sales taxes by a principal, is a typical bond you might see. Some years ago, Gary Wickert represented Hartford Casualty Insurance Company as surety on a tax bond issued to the State of Texas insuring the payment of sales taxes by Herbert W. Fields, the owner of a Texas business. After filing suit against Fields for recovery of a bond payment made when Fields failed to make his required sales tax payments to the State, Fields filed for bankruptcy, and tried to discharge the tax debt. Hartford argued that the tax debt couldn't be discharged in bankruptcy while Fields argued that Hartford had no standing to claim an exemption from discharge–only the State could. The United States Bankruptcy Court held for Hartford, the matter was appealed to the United States District Court for the Southern District of Texas and later appealed to the Fifth Circuit Court of Appeals. Ultimately, the court confirmed that Hartford stepped into the shoes of the State of Texas and assumed whatever rights and remedies they had–even the right to claim an exception to discharge of the debt in bankruptcy. *Hartford Casualty Ins. Co. v. Fields*, 926 F.2d 501 (5th Cir. 1991). The United States Supreme Court even asked for briefs on the subject and ultimately denied writ, confirming the power of a subrogating bond issuer.

With fidelity bonds, a surety pays a claim when the dishonesty or theft of an employee costs the obligee company, for whom the bond is issued, money. Where an employee embezzles money from an obligee company (employer), the surety clearly has a subrogation action it can pursue against the dishonest employee. The problem here is that the employee rarely has any assets to satisfy a subrogation judgment against him or her, and

It is well-established that any surety who discharges a principal's obligation is subrogated to the rights of the obligee against the principal.

is most often judgment proof. Rather than throwing good money after bad by pursuing a paper judgment against the employee, a prudent claims handler will conduct a detailed investigation into the loss which covers such things as:

- all accounting and banking records of the insured;
- a detailed synopsis of how the thefts took place;
- recorded statements of fellow employees and principals of the insured;
- copies of bank statements and cancelled checks;
- procedures for fraud prevention and audits of the insured; and
- copies of internal accounting procedures and protocols.

In nearly two-thirds of fidelity bond subrogation cases, the insured's bank account or checks were instrumental in facilitating the thefts. The dishonest employee will issue checks to himself and forge the maker's signature, issue checks to fictitious vendors, endorse the fictitious vendor's name on the checks and then deposit them in his or her own bank account, or some derivation thereof. The Uniform Commercial Code provides a number of protections to an account holder, including holding drawing and collecting banks liable for instruments, including checks, paid on forged makers' signatures or forged endorsements. Banking rules and regulations require an insured to review its monthly bank statement thoroughly and note any discrepancies. The problem is that, quite often, the dishonest employee is the one who receives and reviews the statements. All of this is governed by the Uniform Commercial Code (U.C.C.), a uniform law governing commercial transactions. Uniform Commercial Code § 1-101, *et seq.* The U.C.C. has been adopted by all states except Louisiana.

Although the law is complicated in this area, banks assume certain liabilities simply by being in the banking business, and banking customers assume certain responsibilities. Under the U.C.C. and subject to certain responsibilities of the bank customer to review its statement and discover and report unauthorized signatures, banks warrant that checks will not >>

be paid on forged endorsements or forged makers' signatures. The type of warranty given depends on what role the bank plays–drawer bank, collecting bank, etc. The important thing for subrogation professionals to keep in mind is that the liability of a bank can be sharply limited or eliminated altogether based on the time that passes between the date the bank customer (insured) gets its bank statement, and the date that it discovers the theft or embezzlement. Accordingly, the following should be done in addition to a zealous subrogation investigation:

- Notify the bank or banks involved immediately of the problem, specifying in detail the checks involved, the suspected forgeries and all relevant information; and

- Get subrogation counsel involved as soon as possible. Not only are there strict statutes of limitation with regard to filing suit against banks under the U.C.C., but there may be additional third parties out there to be pursued.

Subrogation claims against banks may provide the only avenue of recovery when dishonest employees embezzle funds with the use of checking accounts. Time is of the essence, so don't wait for a significant dollar employee dishonesty fidelity bond claim to resolve itself before engaging subrogation counsel or referring it to your subrogation department. Due to the way that the U.C.C. operates, with each day that passes, more and more checks become "stale" for purposes of subrogation. Squeezing blood from a turnip can be lucrative, provided everyone in the claim chain understands that time is of the essence.