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## Fidelity Bonds and the Restatement

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# FIDELITY BONDS AND THE *RESTATEMENT*

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## I. INTRODUCTION

The purpose of this Article is to analyze the portions of the current draft of the proposed *Restatement (Third) of Suretyship* that may relate to fidelity bonds.<sup>1</sup> A wide variety of fidelity bonds are issued by companies that routinely provide such contracts for a premium. In general, these contracts are designed to provide the obligee with some guaranty or protection against losses arising out of the dishonesty or lack of faithful performance of certain individuals or groups of individuals. They tend to fall into one of four categories: public official bonds, financial institution bonds, commercial fidelity coverages, and fiduciary bonds on court-supervised fiduciaries.<sup>2</sup> Tradition often shapes the reality of the practice of law. The field described as "fidelity and surety law" has developed many such traditions. For example, the relegation of bonds on court-supervised fiduciaries as "miscellaneous bonds" is part of that tradition.<sup>3</sup> It is reasonable to ask why the phrase "fidelity and surety," often spoken as if one word, was chosen to describe this specialty practice. The most probable reason is that the companies, hence the clients, that write surety bonds also generally write fidel-

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1. For the purposes of this paper, the terms "fidelity bonds," "fidelity coverages," "fidelity insurance," and "instruments of fidelity" refer to one or more of a variety of contracts issued by corporations in the business of issuing such contracts for premiums.

2. By agreement with another author in this Symposium, bonds on court-supervised fiduciaries will be discussed in another article. Traditionally such court bonds are considered "miscellaneous bonds." See James A. Black, Jr., *Miscellaneous Surety Bonds and the Restatement*, 34 WM. & MARY L. REV. 1195, 1198 (1993).

3. See *id.*

ity bonds. Furthermore, all such coverages involve at least one aspect of the law of suretyship: in each case the corporate surety or issuer of the fidelity bond is contractually obligated to respond should another default either in performance of a contract or in fulfilling obligations imposed by statute.<sup>4</sup>

The traditional view is that the "surety" of "fidelity and surety" refers to instruments in which the surety agrees to guarantee the performance of a written contract.<sup>5</sup> The overwhelming bulk of such bonds is issued in connection with construction contracts,<sup>6</sup> but there are many others. The common thread among "fidelity" bonds is that the issuer of the bond or coverage is required to respond should a loss result from a lack of fidelity on the part of the principal obligor.<sup>7</sup>

Many contracts with fidelity coverage are, in fact, insurance policies.<sup>8</sup> These policies provide a variety of coverages to the insured of which the fidelity coverage is only a part. Some, but not all, of such fidelity coverages are triggered by the dishonesty of the covered individual.<sup>9</sup> However, there are instruments, particularly public official bonds, in which the failure to perform faithfully the duties of an office will trigger the surety's obligation even though the motive was an honest one or the cause of the loss was merely negligence or oversight.<sup>10</sup>

Any reasonably thorough search for case citations and authorities in the field of fidelity and surety law will reveal thousands of cases on a variety of subjects. It is fair to say that an examination

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4. See, e.g., Patrick E. Hartigan & Julie F. Yanda, *Employee Dishonesty Claims*, in *HANDLING FIDELITY, SURETY, AND FINANCIAL RISK CLAIMS* § 3.1, § 3.1 (Robert F. Cushman et al. eds., 2d ed. 1990) [hereinafter *HANDLING FIDELITY CLAIMS*].

5. See, e.g., *Massachusetts Bonding & Ins. Co. v. Feutz*, 182 F.2d 752, 756 (8th Cir. 1950).

6. For a general discussion of bonds issued in connection with construction contracts, see T. Scott Leo, *The Construction Contract Surety and Some Suretyship Defenses*, 34 WM. & MARY L. REV. 1225 (1993).

7. Robert A. Babcock, *History of Fidelity Coverage: Types of Fidelity Bonds*, National Institute of the Section of Tort and Insurance Practice, Committee on Fidelity and Surety Law, American Bar Association 1, 4 (1991) (unpublished manuscript, on file with author).

8. See Erik N. Videlock & Abbe F. Fletman, *Financial Institution Bonds*, in *HANDLING FIDELITY CLAIMS*, *supra* note 4, § 1.1, § 1.1.

9. See *id.* § 1.2 (discussing employee dishonesty).

10. See Frank B. Keech et al., *Miscellaneous Bonds*, in *HANDLING FIDELITY CLAIMS*, *supra* note 4, § 10.1, § 10.9.

of any substantial number of those cases will reveal no citation to the current *Restatement of Security*.<sup>11</sup> In the experience of this practitioner, the 1941 *Restatement of Security* is completely neglected in the resolution of policy, philosophical, or practical issues in fidelity and surety coverages.

Yet, suretyship is a very significant field of law. It is a field that requires analysis based on an understanding of the goals it seeks to accomplish. It requires an organization and development of the subject matter to assist practitioners and courts in reaching correct and, often more important, predictable results. Thus, there is clearly a need for a new *Restatement of Suretyship*. This *Restatement* may cover a number of areas, but it must devote a principal area to fidelity and surety bonds as described in this Article. Some of the fidelity coverages offer interesting conceptual problems. The text of the current version of the proposed *Restatement (Third) of Suretyship* does assist in determining what doctrines of traditional suretyship law do and do not apply in such fidelity cases.

## II. PUBLIC OFFICIAL BONDS

Public official bonds are bonds that cover either a named public official or the office occupied by one or more public officials.<sup>12</sup> Some such bonds may be issued only for the benefit of the governmental unit in which the principal holds office.<sup>13</sup> However, often such bonds provide coverage to the general public.<sup>14</sup> Normally such a bond is required by statute and is often a prerequisite to the official's taking office.<sup>15</sup> In many instances, if such a bond is cancelled or terminated, or if it expires by its own terms without a replacement bond, the public official is removed from office.<sup>16</sup>

To the extent the bond is a statutory bond, it incorporates faithful performance of all statutory duties as obligations of the principal.<sup>17</sup> If the statute prescribes the text of the bond or indicates a

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11. RESTATEMENT OF SECURITY (1941).

12. Keech et al., *supra* note 10, §§ 10.1, 10.9.

13. See generally *id.* § 10.25; 63A AM. JUR. 2D *Public Officers and Employees* § 540 (1984) [hereinafter *Public Officers*].

14. See generally *Public Officers*, *supra* note 13, § 545.

15. See Keech et al., *supra* note 10, § 10.9.

16. See *id.* § 10.10.

17. *Id.* § 10.9.

more limited exposure for the bond, then the terms of the bond are governed by that text or that limited exposure. Comment d to section 11 of the *Restatement of Suretyship* discusses statutory bonds, stating that when the bond is required pursuant to a statute, "the terms of the statute *may be relevant* in determining the meaning of the secondary obligation."<sup>18</sup> In fact, in public official bonds, the rule is much stronger; to the extent the statute bears on the obligation undertaken in the bond, the statute controls.<sup>19</sup> Although the text of the bond may provide limitations on the coverages provided, such limitations are of no effect if they restrict the statutory requirements.<sup>20</sup>

The second type of bond that may be issued is a blanket public employee bond.<sup>21</sup> An example of such a bond would be one issued on all the employees of a county sheriff's department, or all the employees of the office of a state's secretary of state. Such bonds may be required by statute, but more often they are chosen to provide prudent protection to secure the governmental entity. To the extent such bonds may be required by statute, the statutory terms would be incorporated as part of the bond and could not be restricted by the text of the bond.<sup>22</sup>

#### A. *Do Public Official Bonds Have Suretyship Status?*

Section 1 of the *Restatement of Suretyship* describes the three-party surety relationship, discussing in turn the status of the "secondary obligor" or surety, the "principal obligor," and the "obligee."<sup>23</sup> For suretyship to exist, one person, the principal obligor, must owe performance of a duty, the underlying obligation, to another person, the obligee.<sup>24</sup> The suretyship arrangement is completed when a third person, the secondary obligor, is subject to a

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18. RESTATEMENT (THIRD) OF SURETYSHIP § 11 cmt. d (Tent. Draft No. 1, 1992) (emphasis added).

19. See, e.g., *State v. Lidster*, 467 N.E.2d 47, 49 (Ind. Ct. App. 1984).

20. See Keech et al., *supra* note 10, § 10.9.

21. See *id.* § 10.25.

22. See, e.g., *Lidster*, 467 N.E.2d at 49.

23. RESTATEMENT (THIRD) OF SURETYSHIP § 1(1) (Tent. Draft No. 1, 1992).

24. *Id.* § 1(1)(a).

“secondary obligation” to perform the underlying obligation pursuant to a contract.<sup>25</sup>

The following are also features of a surety relationship: the secondary obligor owes performance of the duty of the principal obligor to the obligee in the event the principal obligor fails to perform the underlying obligation;<sup>26</sup> if the underlying obligation is performed, the obligee is not entitled to performance of the secondary obligation;<sup>27</sup> and, as between the principal obligor and secondary obligor, the principal obligor has the duty to perform the underlying obligation or bear the cost of performance.<sup>28</sup>

The traditional public official bond is issued guaranteeing the performance of either a named individual, a person occupying a named office, a group of individuals stated by name, or a group of offices stated by name. It has the standard three-party relationship set forth in section 1 of the *Restatement*: the principal obligor is the holder of the public office who owes performance of the duties of that office (the underlying obligation) to the obligee, the government entity of which that person is an officer; the secondary obligor owes performance, in whole or in part, to cover losses caused by a breach of the duty of the public official to the governmental entity. These duties are set forth in the statutes and/or the text of the bond,<sup>29</sup> and normally this obligation of the public official is characterized as a “faithful performance” of the duties of the office.<sup>30</sup> Between the secondary obligor and the principal obligor, the primary obligation to perform the duty is on the principal obligor, the public official. The contract is usually formed by the execution of an instrument in which the signatures of both the primary obligor and the secondary obligor appear.<sup>31</sup> Thus, it is clear that public official bonds, which name as the principal obligor a public official or the office he holds, are traditional instruments of suretyship.

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25. *Id.* § 1(1)(b).

26. *Id.*

27. *Id.* § 1(1)(c).

28. *Id.*

29. Keech et al., *supra* note 10, § 10.10 (noting that a bond with terms broader than the statutory requirements may expand the obligation of the surety beyond statutory limits).

30. *Id.* § 10.9; see also Hugh E. Reynolds, *Some Problems Peculiar to Public Official Bonds*, 2 *FORUM* 292, 292 (1969).

31. See generally *Public Officers*, *supra* note 13, § 494.

Blanket public employee bonds, on the other hand, are normally issued covering a large number of governmental employees.<sup>32</sup> During the term of the bond, it would be expected that the make-up of that group of potential "principal obligors" would change. Usually the fidelity coverage in a public employee bond is triggered by dishonesty and does not include the broader "faithful performance" obligation.<sup>33</sup> Normally, the public employees covered by such a bond are not signatories to the bond and have no direct relationship with the issuer of the bond.<sup>34</sup> Thus, while a covered employee may be aware of the existence of such a bond, this would be a fortuity. The key to whether such a bond is an instrument of suretyship lies in whether the principal obligor has the primary duty of performance.

The current draft of the *Restatement* indicates that, given the standard three-party relationship described above, the existence of suretyship status is not dependent on whether the principal obligor (the public employee) knows about the secondary obligation (the blanket bond).<sup>35</sup> Rather, the key question, which is determined by the text of the bond, is the nature of the coverage. More often than not, there is no statute prescribing or defining the obligation, thus the coverage afforded is determined entirely by the terms of the bond.<sup>36</sup> If coverage is triggered by the dishonesty of the employee of the public entity, it would seem that not only is the breach of duty that of the principal obligor, but that the secondary obligor has a right to recover its loss on its bond from the dishonest employee.<sup>37</sup>

However, if the bond includes "faithful performance" coverage, simple negligence may trigger coverage under the bond.<sup>38</sup> In such a

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32. See Keech et al., *supra* note 10, § 10.25.

33. See *id.* Some coverages may provide the broader "faithful performance" criteria but usually the bond only covers "dishonesty."

34. Fidelity coverage has increasingly been provided through two-party contracts between the "surety" and the "obligee." Babcock, *supra* note 7, at 2. As such, public official blanket bonds are usually written for the benefit of a public officer to cover employees. Keech et al., *supra* note 10, § 10.25. As a result, the individual employees are not parties to the bond.

35. RESTATEMENT (THIRD) OF SURETYSHIP § 1(2)(d)-(e) (Tent. Draft No. 1, 1992).

36. See generally *Public Officers*, *supra* note 13, § 505.

37. This will be discussed more fully under the section on financial institution bonds. See *infra* part III.

38. See *supra* text accompanying note 10.

case, is the covered employee actually an insured who has the right to look to the bond as though it were a liability insurance policy? If this were so, it would seem, philosophically, that the very linchpin of the surety relationship has fallen because the primary obligation in the event of loss to the obligee (or others protected under such bond) has been assumed by the carrier (secondary obligor). As a general principle of the law of suretyship, however, it would appear that whether such an instrument should be regarded as a surety instrument would depend on whether, with respect to the covered act, the primary obligation remains with the public employee or has been assumed, as a form of insurance, by the issuer of the bond.

The current *Restatement* clearly provides the key definitional guideline for this particular problem: "[A]s between the principal obligor and the secondary obligor, the principal obligor has a duty to perform the underlying obligation or bear the cost of performance."<sup>39</sup> It is possible to write an insurance policy against negligence under which the covered parties, including the public employee whose act or omission causes the actual loss, are fully indemnified by the insurance carrier. This is not the general purpose of public employee blanket bonds, though. To the extent that a public employee blanket bond contains such coverage, no surety relationship exists. If the agreement is truly in the form of a bond, the risk implicit in proper performance of the duties of the public employee (principal obligor) will not shift to the surety (secondary obligor). In fact, the surety will rarely know of the nonperformance of the duty until after the act or omission that gives rise to the claim.

Thus, the employee, whether dishonest or negligent, still has the primary obligation and, hence, the carrier is truly a secondary obligor as defined in the *Restatement*. The secondary obligation is assumed solely for purposes of indemnifying the obligee or third parties against damage. As noted, a claim based on dishonesty probably does not require any further analysis. Carriers, whether they are sureties or insurance carriers, do not insure individuals against those individuals' own dishonesty.

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39. RESTATEMENT (THIRD) OF SURETYSHIP § 1(1)(d) (Tent. Draft No. 1).



However, in the area of faithful performance where the act need not be dishonest to be covered, it may be helpful to look at the common law that would apply to the majority of such cases. Analysis is helped by examining the obligations and assuming that no such bond exists. If a member of the general public sues the government department that has caused damage, the department, under traditional laws of respondeat superior, can in turn recover against the employee whose negligent act caused the loss and, hence, the liability of the department. Thus, the public employee has an underlying obligation to the obligee whether the loss or damage is caused by dishonesty or by incompetence.<sup>40</sup>

This simple analysis would seem to resolve our problem. Absent express language in the bond indicating that it will provide insurance for the individual employee whose act or omission causes loss to the obligee, which loss is, in turn, recovered against the issuer of the bond, the requirements of section 1(2)(d) of the *Restatement* are met. The employee is the principal obligor and the carrier is the secondary obligor. Put another way, unless the statute or text of the bond makes the employee whose act causes the loss the functional equivalent of an "additional insured," this essential element of the surety relationship remains. More importantly, the surety that pays the loss has a right to recoup its payment from the employee whose act or omission causes the loss.<sup>41</sup>

It is important to remember that in many instances, the claims on both blanket public employee bonds and individual public official bonds are presented by members of the public. This does not change the appropriateness of the definition; this situation is no different from the very traditional and similar circumstances that govern payment bonds issued on construction contracts. The text of the instrument or statute widens the class of obligees from the employer of the public official (be it the public entity or the head of the department under which the covered employee works) so as to include members of the general public who are injured as a result of the lack of faithful performance.

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40. A further note is necessary lest the reader be led astray. Not every negligent act or omission of a covered employee constitutes a failure faithfully to perform that employee's duties. However, for purposes of the analysis of the suretyship implications, it is not necessary to enter the vast wasteland wherein such issues are located.

41. RESTATEMENT (THIRD) OF SURETYSHIP § 14(2)(b) (Tent. Draft No. 1).

An example of such a case could arise when a business entity files the appropriate forms for a search for UCC-1 financing statements with a secretary of state's office and a bribed state employee dishonestly fails to disclose the existence of a superior security interest in the property on which the requestor intends to rely for security for a loan. Assuming governmental immunity problems do not arise, the party who is injured, having made the loan, may have a cause of action against that department of the state government when it discovers that the report received from the secretary of state's office was erroneous. The bond would provide protection for the loss to the department, as a co-obligee with the damaged member of the general public. Theoretically, the secondary obligor would then have the same action against the employee (principal obligor) as would the public body.

As a practical matter and in the real world, such subrogation rights are rarely pursued. More often than not, such employees are practically (though perhaps not technically) judgmentproof.<sup>42</sup> One difference between an insurance policy and a surety bond is that the insurance coverage is triggered by a covered occurrence or accident whereas coverage under the bond for the obligee is triggered by dishonesty or lack of faithful performance (depending on the terms of the instrument) of the bonded employment contract or the duties of the office (or sometimes both) that causes a loss to the obligee.

#### *B. Specific Issues Arising in Claims on Public Official Bonds*

There are a number of unique perspectives as to the nature of the obligation and the types of claims that arise under public official bonds, blanket employee bonds, and the like. This Article is not designed to be a primer on public official bonds. Rather, it relates only to those aspects of such bonds that may be significant in testing the current text of the *Restatement of Suretyship*.

In the case of a true public official bond on either a named individual or a specific office, the public official knows of the existence

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42. George R. Veal, Subrogation—The Duties and Obligations of the Insured and Rights of the Insurer Revisited, Annual Meeting of the American Bar Association Section of Tort and Insurance Practice, Fidelity and Surety Law Committee 19 (Aug. 11, 1991) (unpublished manuscript, on file with author).

of the surety and often is a signatory on the bond.<sup>43</sup> However, in the case of some public official bonds that are broader in coverage or blanket public employee bonds, there may be individuals who have no relationship to and, indeed, no knowledge of the contract that created the obligation flowing from the secondary obligor to the obligee.<sup>44</sup> This issue also may arise in financial institution bonds and commercial fidelity coverages. The current *Restatement* draft clearly does not require the principal obligor's knowledge of the existence of the bond as a prerequisite to a surety relationship.<sup>45</sup>

The importance of conferring suretyship status on the issuer of the bond is that, if suretyship status exists, then the secondary obligor will have certain rights that might not otherwise be available. Subsection 1(1) of the *Restatement* points out that the rights of the secondary obligor against the principal include those that exist as a result of the written contract *plus* those that arise out of suretyship status.<sup>46</sup> The rights and duties inherent in suretyship status vis-à-vis the principal obligor include: 1) the right to require enforcement of the principal obligor's duty of performance (which is also termed "exoneration");<sup>47</sup> 2) the duty of the principal obligor to reimburse the secondary obligor for the costs of its performance ("reimbursement");<sup>48</sup> and 3) the right of the secondary obligor to be subrogated to the rights of the obligee.<sup>49</sup>

Claims on public official bonds may arise out of a variety of circumstances. However, the following six enumerated circumstances

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43. See *supra* text accompanying note 31.

44. See *supra* text accompanying note 34.

45. See RESTATEMENT (THIRD) OF SURETYSHIP § 1(2)(d) (Tent. Draft No. 1); *supra* note 39 and accompanying text; see also RESTATEMENT (THIRD) OF SURETYSHIP § 1 cmt. 1 (Tent. Draft No. 1) ("The secondary obligor may undertake its obligation as a result of direct dealings with the obligee *without the consent or knowledge of the principal obligor.*") (emphasis added); *id.* reporter's note, cmt. 1 (same).

46. See *id.* § 1(1).

47. *Id.* § 14(2)(a); see *id.* § 17. Note that although suretyship status is conferred when there is no knowledge on the part of the principal obligor, the normal suretyship right of exoneration does not exist in such a circumstance. See *id.* § 17(1) (requiring notice by the principal obligor of the secondary obligation).

48. *Id.* § 14(2)(b); see RESTATEMENT (THIRD) OF SURETYSHIP §§ 18-20 (Tent. Draft No. 2, 1993).

49. RESTATEMENT (THIRD) OF SURETYSHIP § 14(2)(c) (Tent. Draft No. 1); see RESTATEMENT (THIRD) OF SURETYSHIP §§ 23-24 (Tent. Draft No. 2).

would cover the vast majority of the cases: 1) embezzlement or misuse of funds by the public official or public employee;<sup>50</sup> 2) litigation commenced by either a governmental entity or the taxpayers against an official for failure to follow statutes, regulations, or the directions of superior officials in the disbursement or deposit of public funds;<sup>51</sup> 3) claims against peace officers for false arrest, false imprisonment, and the like, including claims for violations of civil rights in connection with the performance of a peace officer's duty;<sup>52</sup> 4) suits against sheriffs and other public-official process servers arising out of the failure to serve process properly;<sup>53</sup> 5) claims against notaries or comparable officers for negligence or dishonesty in the execution of the acknowledgment, or of other documents generated by such officials;<sup>54</sup> and 6) failure faithfully to perform a specified duty of the office which leads to damage either to the public entity or to a member of the general public who is protected under the specific terms of the statute requiring the bond or the terms of the bond.<sup>55</sup>

It is important to remember that the public official bond covers only acts the official performed while carrying out the duties of the office and those that he should have performed in carrying out the duties but failed to do.<sup>56</sup> Thus, in effect, the bond only applies when the public official, such as a sheriff, is acting as a sheriff and not to any act or omission committed by such individual as an individual. As might be expected, a number of cases have arisen out of disputes as to whether a given act was committed in the official capacity of the bonded public official.<sup>57</sup>

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50. See Keech et al., *supra* note 10, § 10.10.

51. See *id.*

52. See *id.* §§ 10.10, 10.17.

53. See *id.* § 10.10.

54. See *id.* §§ 10.10, 10.17, 10.26.

55. See, e.g., *Valdez v. Gonzales*, 176 P.2d 173, 185-86 (N.M. 1946); *Fidelity & Deposit Co. v. Concerned Taxpayers of Lee County, Inc.*, 829 S.W.2d 923 (Tex. Ct. App. 1992).

56. See Keech et al., *supra* note 10, § 10.11.

57. See, e.g., *Taylor v. Shields*, 210 S.W. 168, 170 (Ky. Ct. App. 1919) (holding a surety not liable for the acts of a police officer who arrested the plaintiff without a warrant and assaulted him, because the police officer was not acting in his official capacity); *Town of Clayton v. Wall*, 8 S.E.2d 223, 224 (N.C. 1940) (holding that the unlawful arrest and imprisonment of an alleged tax delinquent by a tax collector did not constitute an act within scope of his authority).

The philosophical basis for the principle limiting liability to official acts or omissions clearly supports the view that the arrangement is a suretyship arrangement. The underlying premise of a suretyship arrangement is that the secondary obligor agrees to stand behind the performance of an underlying obligation which is a duty.<sup>58</sup> In the case of public official bonds, the duties are those imposed on the public official by virtue of the office, or in the case of a public employee bond, by virtue of holding public employment.

Furthermore, as the *Restatement* observes in subsection 13(2), although the duties between the secondary obligor and the obligee arise out of or exist "pursuant to the contract creating the secondary obligation," the duties and rights are also subject to defenses that arise out of suretyship status.<sup>59</sup> Thus, a secondary obligor on a fidelity instrument that is clothed with suretyship status is entitled to all of the usual defenses. As set forth in section 15, these defenses against the obligee may include: 1) discharge of the underlying obligation by the principal obligor's performance or other satisfaction;<sup>60</sup> 2) availability to the secondary obligor of defenses the principle obligor may possess against the underlying obligation;<sup>61</sup> 3) the obligee's unreasonable refusal of the principal obligor's tendered performance;<sup>62</sup> or 4) the secondary obligor's possession of a "suretyship defense."<sup>63</sup>

In general, suretyship defenses—impairment of recourse,<sup>64</sup> preservation of recourse,<sup>65</sup> release of underlying obligation,<sup>66</sup> and im-

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58. See RESTATEMENT (THIRD) OF SURETYSHIP § 1 cmt. 6 (Tent. Draft No. 1, 1992).

59. *Id.* § 13(2). Often when corporate sureties write bonds in a face-to-face relationship, a separate contract of indemnity is formed between the principal obligor and the secondary obligor. Scott Leo & George W. Thomas, *Surety's Right to Salvage*, in HANDLING FIDELITY CLAIMS, *supra* note 4, § 8.1, §§ 8.1-3; N. Rosie Rosenbaum, *Fidelity Guaranty Insurance*, in HANDLING FIDELITY CLAIMS, *supra* note 4, § 11.1, § 11.18. These contracts give the secondary obligor an arsenal of specific rights and impose significant duties on the principal obligor. Leo & Thomas, *supra*, §§ 8.1-3; Rosenbaum, *supra*, § 11.18. However, these documents are relatively unusual in the field of public official bonds except when a bond is issued on a particular individual who occupies a particular office.

60. RESTATEMENT (THIRD) OF SURETYSHIP § 15(a) (Tent. Draft No. 1).

61. *Id.* § 15(b).

62. *Id.* § 15(c).

63. *Id.* § 15(d).

64. RESTATEMENT (THIRD) OF SURETYSHIP § 33 (Tent. Draft No. 2, 1993).

65. *Id.* § 34.

pairment of collateral<sup>67</sup>—might arise occasionally in disputes on fidelity instruments. The other suretyship defenses enumerated in the *Restatement*<sup>68</sup> do not tend to arise in fidelity cases.

In certain states, the secondary obligor on a public official bond has the ability to seek to terminate the relationship before the expiration of the official's term of office.<sup>69</sup> These statutes allow a surety on a public official bond to file a petition with a court of competent jurisdiction and have the petition served on the institution.<sup>70</sup> The public official must appear before the court within the prescribed time and file a new bond.<sup>71</sup> In such a case, the previous bond will still cover acts for which the public official is liable up to the date of termination.<sup>72</sup> If the public official does not provide substitute coverage within the specific period of time, the public official forfeits the office.<sup>73</sup> Not surprisingly, the decision of a surety to exercise such a right can lead to some very nasty and complicated legal problems, particularly if the public official is unable to secure the substitute bond. This ability to terminate a suretyship relationship mid-stream and without cause is relatively unusual in suretyship contracts.

### III. FINANCIAL INSTITUTION BONDS

#### A. Background

Professional sureties have issued a number of types of financial institution bonds over the years. For many years, there were separate bonds, often containing very similar clauses, issued on banks, brokerage houses, savings and loan institutions, and the like. The

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66. *Id.* § 35.

67. *Id.* § 38.

68. *See id.* §§ 36-37, 39-41 (discussing the suretyship defenses of extension of time, modification of underlying obligation, other impairment of recourse, tender of performance, and obligee's nondisclosure of events giving secondary obligor power to terminate secondary obligation, respectively).

69. *See, e.g.,* IND. CODE ANN. § 5-4-4-8 (West 1989).

70. *See, e.g., id.*

71. *See, e.g., id.*

72. *See id.* § 5-4-4-13.

73. *Id.* § 5-4-4-10.

first so-called bankers blanket bond was issued in 1916.<sup>74</sup> Such bond forms were changed from time to time.<sup>75</sup> In the early 1980s, courts had a tendency to seize upon the term "blanket" in the bankers blanket bond to suggest broader coverage than the text of the bond purported to convey.<sup>76</sup> So the name was changed to "financial institution bond" with the revision of Form No. 24 in 1986.<sup>77</sup> With respect to issues in the *Restatement*, the suretyship principles applicable to the bonds issued to banks will not vary significantly from those principles applicable to other instruments on other financial institutions, such as brokerage houses.

The current Form No. 24 financial institution bond is clearly an insurance policy. The individual coverages are captioned "Insuring Agreements"<sup>78</sup> and consist of: "Fidelity" coverage (Insuring Agreement A), which is designed to cover dishonest acts of employees as defined in the coverage;<sup>79</sup> "On Premises" coverage (Insuring Agreement B), designed to cover loss of property under a variety of circumstances—including robbery, burglary, and false pretenses—which occur within the offices of the insured;<sup>80</sup> "In Transit" coverage (Insuring Agreement C), which insures against various forms of loss of property—robbery, larceny, theft, mysterious and unexplained disappearance, and the like—while it is in transfer or while in the custody of certain enumerated agencies or employees acting for the insured;<sup>81</sup> "Forgery or Alteration" coverage (Insuring Agreement D), which covers losses resulting from forgery or alteration as defined in the coverage;<sup>82</sup> "Securities" coverage (Insuring Agreement E), which covers losses resulting from acquiring or giv-

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74. See Robin V. Weldy, *History of the Bankers Blanket Bond with Comments on the Drafting Process*, in ANNOTATED BANKERS BLANKET BOND 5, 5 (Frank L. Skillern, Jr. ed., 1980).

75. See *id.* at 5-7.

76. See Robin V. Weldy, *History of the Bankers Blanket Bond and the Financial Institution Bond Standard Form No. 24 with Comments on the Drafting Process*, in ANNOTATED FINANCIAL INSTITUTION BOND (FORMERLY BANKERS BLANKET BOND) 3, 6 (Harvey C. Koch ed., 2d Supp. 1988) [hereinafter ANNOTATED FINANCIAL INSTITUTION BOND].

77. See *id.*

78. Financial Institution Bond, Standard Form No. 24 (1986), reprinted in ANNOTATED FINANCIAL INSTITUTION BOND, *supra* note 76, app. at 90, 91-92 [hereinafter Form No. 24].

79. See *id.* § A, at 91.

80. See *id.* § B, at 92.

81. See *id.* § C, at 92.

82. See *id.* § D, at 93.

ing value on original securities as defined in the coverage, under circumstances in which the bank had actual physical possession and relied upon the genuineness of the security;<sup>83</sup> and, last, "Counterfeit Currency" coverage (Insuring Agreement F), which covers losses sustained as a result of the receipt of counterfeit currency.<sup>84</sup>

As can be seen, in none of the coverages except Insuring Agreement A is a contract relationship between the bank (obligee) and the party causing the loss (principal obligor) an essential element to coverage.<sup>85</sup> Under the other coverages, the parties causing the loss to the bank need not have a contract with the bank as the basis for exposure. Coverage is triggered not because the carrier is agreeing to be responsible for the performance of a contract obligation of another, but because of an event causing loss to the bank that is otherwise insurable.

### *B. Insuring Agreement A—Employee Dishonesty*

Insuring Agreement A does postulate a situation involving a contract obligation. In addition to the usual duties inherent in the contract of employment, the agreement contains considerably greater duties because of banking regulations and a variety of statutes.<sup>86</sup> If the obligation not to be dishonest as defined in the bond is breached so as to cause a loss to the bank, the carrier (secondary obligor) agrees to cover.<sup>87</sup> In such a case, all of the normal indicia of a surety relationship as defined in the *Restatement of Suretyship* are present.<sup>88</sup>

We have already seen in the case of public employee blanket bonds that such bonds are defined as creating a surety relationship

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83. See *id.* § E, at 93-94.

84. See *id.* § F, at 94.

85. Compare *id.* § A, at 91-92 with *id.* §§ B-F, at 92-94.

86. Some of the statutes include: 18 U.S.C. § 215 (Supp. II 1990) (receipt of gifts or commissions for procuring loans); 18 U.S.C. § 371 (1988) (conspiracy to commit offense or to defraud the United States); 18 U.S.C. § 656 (Supp. II 1990) (theft, embezzlement, or misapplication by bank officer or employee); 18 U.S.C. § 1001 (1988) (statements or entries generally); 18 U.S.C. § 1005 (Supp. II 1990) (bank entries, reports, and transactions); 18 U.S.C. § 1014 (Supp. II 1990) (loan and credit applications generally, renewals and discounts, crop insurance); 18 U.S.C. § 1341 (Supp. II 1990) (frauds and swindles).

87. See Form No. 24, *supra* note 78, § A, at 91-92.

88. See RESTATEMENT (THIRD) OF SURETYSHIP §§ 1-2 (Tent. Draft No. 1, 1992); *supra* notes 23-28 and accompanying text.



under the draft *Restatement*.<sup>89</sup> However, because of the principal obligor's lack of notice of the secondary obligation, the usual rights and remedies of suretyship may be somewhat diminished, particularly in the area of exoneration, which requires notice by the principal obligor of the secondary obligation.<sup>90</sup> Exoneration as defined in section 17 of the *Restatement* creates two duties that the principal obligor owes to the secondary obligor. The first is to perform the underlying obligation.<sup>91</sup> The second is to refrain from conduct that impairs the reasonable expectation of the secondary obligor that the principal obligor will honor its duty of performance.<sup>92</sup> An advantage of the existence of the right of exoneration is its provision for full reimbursement for all damages sustained by the secondary obligor.<sup>93</sup> This includes recovery of some damages, such as attorneys' fees incurred by the secondary obligor in performing the secondary obligation, that usually are not recoverable by exercise of the right of reimbursement.<sup>94</sup>

Furthermore, the existence of the right of exoneration may give rise to the exercise of an action in *quia timet*.<sup>95</sup> *Quia timet* is an extraordinary remedy designed to allow prejudgment exercise of control or dominion over conduct, property, or assets of the principal obligor in order to protect the secondary obligor.<sup>96</sup> It may include a grant of injunctive relief.<sup>97</sup> The instruments of indemnity traditionally executed in favor of the secondary obligor by the principal obligor usually confer rights comparable to and more extensive than those provided through *quia timet*.

As a practical matter, the manner in which claims arise under Insuring Agreement A in financial institution bonds does not normally lend itself to an exercise of the rights of exoneration. It is a

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89. See *supra* notes 32-41 and accompanying text.

90. RESTATEMENT (THIRD) OF SURETYSHIP § 17(1) (Tent. Draft No. 1); see *supra* note 47.

91. See RESTATEMENT (THIRD) OF SURETYSHIP § 17(1)(a) (Tent. Draft No. 1).

92. See *id.* § 17(1)(b).

93. See RESTATEMENT (THIRD) OF SURETYSHIP § 19(1) (Tent. Draft No. 2, 1993).

94. See *id.* § 19 cmt. a. However, the secondary obligor may not recover attorneys' fees incurred while enforcing the principal obligor's duty of reimbursement. *Id.*

95. See RESTATEMENT (THIRD) OF SURETYSHIP § 17 cmt. j (Tent. Draft No. 1).

96. See *id.* cmt. j & reporter's note, cmt. j. (quoting *Borey v. Nat'l Union Fire Ins. Co.*, 934 F.2d 30, 32 (2d Cir. 1991)).

97. See *Borey*, 934 F.2d at 33 (holding that a preliminary injunction was warranted to maintain the status quo and prevent dissipation of the principal's funds).

rare case in which the damage is not already done by the time the secondary obligor is called upon to perform under its bond. Thus, conceptually, the financial institution bond is an insurance policy in which only one of the major coverages afforded to the insured is a contract of suretyship. There is nothing unique in this. Many credit-enhancement contracts contain extensive obligations, with only a small portion of the relationship possessing the criteria necessary to create a surety relationship.<sup>98</sup>

*C. Specific Issues Arising in Claims on Financial Institution Bonds*

Probably one of the most litigated issues under financial institution bonds and the previous bankers blanket bonds is what constitutes a "dishonest" act affording coverage to the obligee.<sup>99</sup> For many years, there was no definition or contractual distinction as to what was meant by the covered "dishonest or fraudulent act."<sup>100</sup> For example, the 1969 edition of Bankers Blanket Bond Standard Form No. 24 stated that it would cover

loss through any dishonest or fraudulent act of any of the Employees, committed anywhere and whether committed alone or in collusion with others, including loss, through any such act of any of the Employees, of Property held by the Insured for any purpose or in any capacity and whether so held gratuitously or not and whether or not the Insured is liable therefor.<sup>101</sup>

This language led to a series of adverse decisions for insurers in which what the insurer regarded as negligence, slightly tainted, be-

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98. For an example of a credit-enhancement contract, see RESTATEMENT (THIRD) OF SURETYSHIP § 1 illus. 15 (Tent. Draft No. 1).

99. See, e.g., *Eglin Nat'l Bank v. Home Indemnity Co.*, 583 F.2d 1281 (5th Cir. 1978) (noting that willfulness and intent to deceive are necessary elements for acts to be dishonest and fraudulent); *First Nat'l Bank v. Transamerica Ins. Co.*, 514 F.2d 981 (8th Cir. 1975) (defining action where an employee creates a conflict of interest and acts in his own interest or acts in disregard of his employer's interest as dishonest and fraudulent conduct).

100. Not until 1976 when the bonding industry issued a rider defining dishonesty, which was later incorporated into the body of the 1980 edition of Standard Form No. 24, did the Bankers Blanket Bond contain a definition of a "dishonest or fraudulent act." See ANNOTATED BANKERS BLANKET BOND, *supra* note 74, at 53-54.

101. Bankers Blanket Bond, Standard Form No. 24 § A (1969), reprinted in ANNOTATED BANKERS BLANKET BOND, *supra* note 74, app. at 211, 212.

came "dishonesty."<sup>102</sup> For example, some cases involved loans that violated certain lending policies but were not "dishonest," as that word is defined conventionally.<sup>103</sup> One case that particularly embittered the corporate sureties was *Mortgage Co. v. Aetna Casualty & Surety Co.*<sup>104</sup> In this case, an overworked employee of a bank was found to be "dishonest," thus bringing him within the bond's coverage even though the insurance carrier felt the circumstances involved only negligence, incompetence, or dereliction of duty.<sup>105</sup> A task of the employee was to inspect construction sites to determine whether the construction was far enough along to justify the percentage of construction draw upon which the bank was being asked to make loans secured by contract proceeds.<sup>106</sup> Because the inspector had more construction sites to visit than he had time to inspect, he did not visit a number of the sites; however he made out reports indicating that he had inspected the sites when he had not.<sup>107</sup>

What happened will certainly be of interest to lawyers. The surety companies began to incur losses from claims which were adversely decided involving situations similar to the *Mortgage Company* case.<sup>108</sup> Discussions were held between the Surety Association and the American Bankers Association.<sup>109</sup> After those discussions, what is generally described as the "manifest intent" definition of

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102. See, e.g., *Fidelity & Deposit Co. v. Bates*, 76 F.2d 160 (8th Cir. 1935) (ruling that a broad definition of dishonesty should be adopted, which could include dishonesty, negligence, or utter incompetence).

103. See, e.g., *Miami Nat'l Bank v. Pennsylvania Ins. Co.*, 314 F. Supp. 858 (S.D. Fla. 1970) (ruling that the insured's vice president's allowing a borrower to exceed authorized and statutory loan limits was fraudulent and dishonest).

104. 115 A.2d 43 (N.J. 1955).

105. *Id.*

106. *Id.* at 45.

107. *Id.*

108. Robin V. Weldy, *A Survey of Recent Changes in Financial Institution Bonds*, 12 FORUM 270 (1974).

109. The discussions between the American Bankers Association and the Surety Association of America and the role such discussions had in forming the language of financial institution bonds is discussed generally in Weldy, *supra* note 74, at 5; Weldy *supra* note 76, at 3-4. See also *Sharp v. Federal Sav. & Loan Ins. Corp.*, 858 F.2d 1042, 1046-47 (5th Cir. 1988); *Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co.*, 533 F.2d 290, 295 n.6 (5th Cir.), *cert. denied*, 429 U.S. 922 (1976); cf. Larry D. Dingus & Peter C. Haley, *The Doctrine of Contra Preferentem in Fidelity Coverage Cases*, 10 FORUM 75, 76-82 (1974).

dishonesty was developed.<sup>110</sup> This definition first appeared in endorsements to a variety of fidelity contracts.<sup>111</sup> It was then incorporated into the 1980 revision of Bankers Blanket Bond Standard Form No. 24. The key language under Insuring Agreement A was:

Dishonest or fraudulent acts as used in this Insuring Agreement shall mean only dishonest or fraudulent acts committed by such Employee with the manifest intent

- (a) to cause the Insured to sustain such a loss, and
- (b) to obtain financial benefit for the Employee or for any other person or organization intended by the Employee to receive such benefit, other than salaries, commissions, fees, bonuses, promotions, awards, profit sharing pensions or other employee benefits earned in the normal course of employment.<sup>112</sup>

This Article is not designed to provide a detailed examination or analysis of this very complex and interesting subject. There are many cases under the varied definitions of what is a covered "dishonest or fraudulent" act or omission.<sup>113</sup> But for purposes of analyzing the suretyship aspects of such bonds, the fact that the secondary obligor has carved out responsibilities for only a portion of the contractual obligations of the principal obligor is of considerable interest. This is probably quite different from most surety instruments in which the contract or duty owed from the principal obligor to the obligee (the underlying obligation) is covered, if not in full, in large measure, by the instrument of suretyship issued by the secondary obligor. From the first bankers blanket bond form, the obligation assumed by the secondary obligor was less than the totality of contractual duties owed by the bank employee to the bank.<sup>114</sup> These later changes emphasize that reality.

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110. "Manifest intent" refers to the first words of the new definition, and may be defined as an obvious or apparent intent to cause the insured to sustain the loss. Frank L. Skillern, Jr., *Fidelity Coverage—What Is Dishonesty?*, in *BANKERS AND OTHER FINANCIAL INSTITUTIONS BLANKET BONDS* 23, 40-41 (Frank L. Skillern, Jr. ed., 1979).

111. *Id.* at 39.

112. Bankers Blanket Bond, Standard Form No. 24 § A (1980), reprinted in *ANNOTATED BANKERS BLANKET BOND*, *supra* note 74, app. at 192, 193.

113. See, e.g., *Fidelity Sav. & Loan Ass'n v. Aetna Life & Casualty Co.*, 647 F.2d 933 (9th Cir. 1981); *World Exch. Bank v. Commercial Casualty Ins. Co.*, 173 N.E. 902 (N.Y. 1930).

114. Weldy, *supra* note 74, at 6.

Many of the problems that arose in cases between banks and bonding companies on these instruments were not completely solved by the 1980 amendment. In 1986, the financial institution bond was issued containing what might be described as "fine tuning" of these and other issues.<sup>115</sup> Ultimately, the surety companies tried to achieve an instrument that provided coverage for those acts that they felt they intended to cover. Certainly they intended to cover more than employee embezzlement. However, sureties felt that those kinds of bank problems involving deliberate breaches of banking regulations did not, in and of themselves, rise to the level of the type of act or omission the sureties believed should be insurable.<sup>116</sup> One of the purposes for departing from the long-used phrase "bankers blanket bond" was the fact that some courts, in the ever-expanding desire to find insurance coverage where none existed, seized on the word "blanket" to suggest that contract language should be expanded beyond its usual meaning.<sup>117</sup>

Most significant fidelity claims on financial institution bonds involve nonpayment of loans. One of the exclusions in such bonds is that the bank cannot recover for nonpayment of a loan except in the case of employee dishonesty (Insuring Agreement A)<sup>118</sup> or under the coverages afforded under Insuring Agreements D (forgery or alteration)<sup>119</sup> and E (securities).<sup>120</sup> Because the circumstances regarding the acts or omissions of the employees were often ambiguous, the following language was added in the 1986 revision of the Financial Institution Bond:

However, if some or all of the Insured's loss results directly or indirectly from Loans, that portion of the loss is not covered unless the Employee was in collusion with one or more parties to the transactions and as received, in connection therewith, a financial benefit with a value of at least \$2,500.<sup>121</sup>

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115. See Form No. 24, *supra* note 78, § A, at 91-92.

116. See *First Fed. Sav. & Loan Ass'n v. Transamerica Ins. Co.*, 735 F.2d 1164 (10th Cir. 1991) (providing an example of a surety taking such a position).

117. Weldy, *supra* note 76, at 6.

118. See Form No. 24, *supra* note 78, § A, at 91-92.

119. See *id.* § D, at 93.

120. See *id.* § E, at 93-94.

121. *Id.* § A, at 91-92.

This is followed by language consistent with the earlier 1980 language: "As used throughout this Insuring Agreement, financial benefit does not include any employee benefits earned in the normal course of employment, including: salaries, commissions, fees, bonuses, promotions, awards, profit sharing or pensions."<sup>122</sup> Thus, there is an even narrower interpretation of the coverage to be afforded under this particular instrument of suretyship for nonpayment of loans. In general, those cases decided subsequent to the issuance of this bond form have largely enforced the language in accordance with the apparent general intention of the surety industry.<sup>123</sup> Again, the area of interest to those looking at the surety relationship as a concept is the fact that this particular surety relationship is carefully structured to carve out only a very small part of the duties owed to the obligee by the principal obligor, and to condition that liability in very specific terms. In this sense, this type of fiduciary coverage may be relatively unique in the realm of suretyship.

The financial pressures leading to the drafting of the "manifest intent" language was not confined to the American insurance market. About the time endorsements containing that language were being adopted in the United States, the 1977 Lloyds' Bankers Policy issued by Lloyds' of London provided an insuring clause for "infidelity of employees" as follows:

By reason of and solely and directly caused by one or more dishonest or fraudulent acts of any of the Employees of the Assured, which are committed with the manifest intent of making, and which result in, improper personal financial gain for themselves wherever committed and whether committed along or in collusion with others . . . .<sup>124</sup>

That language also excludes consideration of "[s]alary, fees" as a personal benefit.<sup>125</sup> This particular language is somewhat more restrictive than that in Financial Institution Bond Standard Form No. 24 because it requires benefit to the dishonest employee and is not satisfied by intent to provide a benefit to someone else.

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122. *Id.* at 92.

123. *See, e.g.*, *FDIC v. St. Paul Fire & Marine Ins. Co.*, 942 F.2d 1032 (6th Cir. 1991).

124. LLOYD'S OF LONDON, LLOYD'S BANKER'S POLICY, FORM LBP, Insuring Clause 1 (1977).

125. *Id.*

There is a theoretical question of whether the bond confers the right of exoneration. Under the current text of the *Restatement of Suretyship*, that right is conditioned on whether the principal obligor (bank employee) is charged with notice of the secondary obligation (the existence of the surety bond).<sup>126</sup> This author is unaware of any cases on this particular subject. In the practical world of fidelity and surety claims, it is not likely to arise because, as has been mentioned, normally all of the dust has settled, the loss has occurred, and the employee is usually gone (often under indictment) before the surety knows about it.<sup>127</sup> The right of exoneration is essentially legal preventive medicine. The right could be of some value if the surety sustains losses beyond those covered by the right of reimbursement and the principal obligor is financially responsible to cover reimbursement and these other damages as well.

One could argue that any bank employee could be charged with the knowledge that all banks are required by statute or regulation (or both) to have a financial institution bond or its functional equivalent. Once employees are charged with that knowledge, it would not require a leap of reason also to charge the employee with knowledge that among those coverages are coverages for employee dishonesty. If so, exoneration may be available.

The problem with this is that neither section 16 of the *Restatement* nor the comments thereto ever speaks in terms of "actual" notice. Rather, the section offers three criteria for a "charged" notice. The first is that the secondary obligation (bond) is entered into pursuant to the principal obligor's (employee's) assent, request, or agreement.<sup>128</sup> This is clearly not the case in a financial institution bond. The second criteria is that the principal obligor had notice before entering into the underlying obligation (the contract of employment) and that the existence of the secondary obligation was a condition of the obligee's decision to enter into the contract of employment.<sup>129</sup> The financial institution bond is usually in existence throughout. The employment of any particular individual automatically provides coverage absent a specific exclu-

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126. RESTATEMENT (THIRD) OF SURETYSHIP § 16 (Tent. Draft No. 1, 1992).

127. See *supra* note 42 and accompanying text.

128. RESTATEMENT (THIRD) OF SURETYSHIP § 16(a) (Tent. Draft No. 1).

129. *Id.* § 16(b).

sion or termination of coverage because of knowledge of prior dishonesty.<sup>130</sup> Therefore, it would seem the second criterion does not apply either. Finally, the third criterion is that the principal obligor assumed the duty of the secondary obligor.<sup>131</sup> This clearly does not apply to financial institution bonds. A question arises as to whether the current draft intends to operate only in those three circumstances.

Normally, chargeable knowledge is knowledge assumed from certain circumstances, whether or not actual knowledge is proven. It is not clear whether the current drafters of the *Restatement* have considered whether actual knowledge or implied-in-fact knowledge will meet the test to allow the right of exoneration.

Although not directly germane to the purpose of this Article, a few brief words on the contractual requirements and processing of fidelity claims under a financial institution bond may assist the reader in evaluating the relationship. There is a wealth of case authority concerning the rights, duties, and practices in these areas.<sup>132</sup> Such bonds generally are written for a term of one year.<sup>133</sup> Coverage under the bond is triggered by discovery of a "loss" within the year of coverage.<sup>134</sup> Such bonds may cover certain losses resulting from acts or omissions that occurred during the period of a prior bond, as long as the act or omission is discovered during the present bond's term; the bond usually covers these losses even if no coverage was afforded under the prior bond.<sup>135</sup>

The insured has a notice-of-loss requirement—normally, as soon as "practicable," but no later than thirty days from discovery.<sup>136</sup> Many claims involve litigation over whether those notice requirements have been met.<sup>137</sup> The obligation to notify arises after the

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130. See *infra* notes 217-19 and accompanying text.

131. RESTATEMENT (THIRD) OF SURETYSHIP § 16(c) (Tent. Draft No. 1).

132. See, e.g., *Perkins v. Clinton State Bank*, 593 F.2d 327 (8th Cir. 1979); *Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co.*, 533 F.2d 290 (5th Cir.), *cert. denied*, 429 U.S. 922 (1976).

133. Weldy, *supra* note 76, at 6.

134. See Videlock & Fletman, *supra* note 8, § 1.14.

135. See *id.*

136. Form No. 24, *supra* note 78, § 5(a), at 102.

137. See, e.g., *American Sur. Co. v. Pauly*, 170 U.S. 160, 163 (1898); *Lafayette Bank & Trust Co. v. Aetna Casualty & Sur. Co.*, 411 A.2d 937 (Conn. 1979).



insured has discovered a loss covered by the bond.<sup>138</sup> Such discovery occurs when either the insured knows of an act or omission of the type covered under the bond, which caused a loss, or the insured has knowledge that gives rise to a duty to investigate, and the investigation would have provided such a discovery.<sup>139</sup> The insured need not understand the full scope of the loss or have all of the details for "discovery" to occur.<sup>140</sup>

Most, but not all, states give the surety the benefit of a defense based on late notice only if prejudice has been shown.<sup>141</sup> In such states, often there is a period after which the failure to give notice is considered a violation of the contract as a matter of law.<sup>142</sup> In some instances, this becomes an absolute defense.<sup>143</sup> In other instances, it merely shifts the burden of proof on the issue of prejudice from the surety to the obligee.<sup>144</sup> The courts determine whether a notice defense does or does not require prejudice by determining whether the notice requirement is a condition precedent under the bond or a condition subsequent.<sup>145</sup> If it is a condition precedent, then generally (though not always), prejudice need not be shown. If it is a condition subsequent, prejudice does need to be shown. As a generality, sureties on financial institution bonds do not win late notice cases unless the circumstances are aggravated or the prejudice (where required) is clear.<sup>146</sup> However, even in con-

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138. See Videlock & Fletman, *supra* note 8, § 1.15.

139. See Form No. 24, *supra* note 78, § 3, at 101.

140. See *id.*

141. See, e.g., *Muncie Banking Co. v. American Sur. Co.*, 200 F.2d 115 (7th Cir. 1952) (applying Indiana law); *Downey Sav. & Loan Ass'n v. Ohio Casualty Ins. Co.*, 234 Cal. Rptr. 835 (1987), *cert. denied*, 486 U.S. 1036 (1988); *Aetna Casualty & Sur. Co. v. Murphy*, 538 A.2d 219 (Conn. 1988); *Home Life Ins. Co. v. Clay*, 719 P.2d 756 (Kan. Ct. App.), *review denied*, 239 Kan. 693 (1986); see also *Utica Mut. Ins. Co. v. Fireman's Fund Ins. Co.*, 748 F.2d 118, 121 (2d Cir. 1984) (holding that the surety need not show prejudice).

142. See generally Annotation, *Effect of Failure to Give Notice, or Delay in Giving Notice or Filing Proof of Loss, upon Fidelity Bond or Insurance*, 23 A.L.R.2d 1065 (1952).

143. *Id.*

144. *Id.*

145. Courts usually look to the terminology of the bond to determine whether compliance is a condition precedent to recovery. William H. Woods, *Conditions to Recovery: Notice, Proof of Loss and Timeliness of Filing Suit*, in *BANKERS AND OTHER FINANCIAL INSTITUTIONS BLANKET BONDS*, *supra* note 110, at 391, 409.

146. E.g., *United States v. United Bonding Co.*, 422 F.2d 277 (5th Cir. 1970) (applying Florida law); *Hartford Accident & Immunity Co. v. Hattiesburg Hardware Stores*, 49 So. 2d 813 (Miss. 1951).

dition precedent states where prejudice need not be shown, if provisions of the bond regarding the circumstances when notice must be given are ambiguous, the issue of fact is usually resolved against the insurer.<sup>147</sup> Looking at this matter from a result standpoint, the more likely result is that some effort may be made to provide some *pro tanto* reduction in the surety's liability by virtue of the circumstances which surround the late notice.

The bank then has an obligation to file a sworn proof of loss containing details of the claim.<sup>148</sup> It also may be obliged to provide one or more officers or employees for deposition by the surety upon request.<sup>149</sup> The surety has up to sixty days in which to investigate the loss before responding to the proof.<sup>150</sup> These time limits are often extended in practice by agreement because of the complex nature of many such claims.

There is express language in the bond that the bank may not recover the costs of processing the claim.<sup>151</sup> However, this costs bar can become occluded because some costs may be associated with restoring the records so the bank can continue operations in cases involving concealment, destruction, or alteration of records. Separating costs of restoring the records and costs of processing the claim can often be difficult.

Most large fidelity claims arise out of the nonpayment of loans.<sup>152</sup> The majority of disputes involving nonpayment-of-loan claims center on the issue of whether the bank officer(s) involved in making the loans intended to cause a loss to the bank.<sup>153</sup> Prior to 1986, the resolution of those questions often centered on whether the bank officer had a personal interest in the loans.<sup>154</sup> Currently, the mere fact that one might expect or hope for bo-

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147. See John R. Hickisch, *Special Provisions of Brokers, Insurance Companies and Savings and Loan Blanket Bonds*, in *BANKERS AND OTHER FINANCIAL INSTITUTIONS BLANKET BONDS*, *supra* note 110, at 510, 513-18.

148. Form No. 24, *supra* note 78, § 5(b), at 102.

149. See *id.* § 7(d), at 104.

150. See Videlock & Fletman, *supra* note 8, § 1.17 (citing Form No. 24, *supra* note 78, § 5(d), at 102).

151. Form No. 24, *supra* note 78, § 2(u), at 100.

152. Kenneth E. Lewis, *Continuing to Make Questionable Loans to Same Customer as Constituting Dishonesty*, 10 *FORUM* 115, 117 (1974).

153. *Id.* at 125.

154. See, e.g., *Fidelity & Deposit Co. v. People's Bank*, 27 F.2d 932 (4th Cir. 1934).

nuses, promotion, or the like for making the loans that form the subject of the claim will not support a finding of the necessary personal benefit.<sup>155</sup> Rather, in fidelity claims *not* involving the nonpayment of loans, what must be shown is the "manifest intent" both to cause the bank such a loss and to confer a benefit on some specific person, not necessarily the employee.<sup>156</sup> In fidelity claims *involving* the nonpayment of loans, under the 1986 language, a benefit of at least \$2,500 to the alleged dishonest employee must be shown before coverage will be afforded.<sup>157</sup> The issues of what constitutes a benefit (i.e., whether the loan is dishonest) is often resolved by examining a complex set of facts and a comprehensive evaluation of circumstantial evidence surrounding the relationship between the alleged dishonest bank officer and the borrowers.

In the traditional suretyship claim situation (i.e., the nonpayment of a guaranteed note or the nonperformance of a breached construction contract), if the obligee releases the principal obligor from the obligation to pay the note or perform the contract, or releases it in part, that release operates to the benefit of the surety.<sup>158</sup> However, this circumstance is not unconditional. Under the current draft of the *Restatement*, subsection 35(a) indicates that when the principal obligor (bank employee) is charged with notice of the secondary obligation (the bond), the principal obligor is also released from the corresponding duties of performance and reimbursement owed to the secondary obligor, unless the release issued by the obligee (the bank) affects a preservation of the secondary obligor's recourse.<sup>159</sup>

Thus, as is pointed out in comment a, the bank employee, if aware of the existence of the bond, would expect that a release of obligation by the employer would release him of any obligation to indemnify the issuer of the surety bond.<sup>160</sup> As a practical matter, all such cases involve circumstances in which the consideration for the release is less than the amount of loss the obligee claims against the secondary obligor. This doctrine is somewhat problem-

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155. See Form No. 24, *supra* note 78, § A, at 91-92.

156. *Id.* at 91.

157. *Id.* at 91-92.

158. RESTATEMENT OF SECURITY § 122 (1941).

159. RESTATEMENT (THIRD) OF SURETYSHIP § 35(a) (Tent. Draft No. 2, 1993).

160. *Id.* § 35 cmt. a.

atic in the case of a financial institution bond. It is not clear from the case authority, nor would it be clear in every instance, that the employee entering into the release is aware of the existence of the surety bond.

More important to the bonding company is what happens with respect to its obligation if there is a release. The rule for discharge from unperformed duties is set forth in the *Restatement* as follows:

(c) if the secondary obligor is not discharged from its unperformed duties pursuant to the secondary obligation by operation of paragraph (b), the secondary obligor is discharged from those duties to the extent:

(i) of the value of the consideration for the release;

(ii) that the release of a duty to pay money pursuant to the underlying obligation would otherwise cause the secondary obligor a loss by increasing the difference between the cost to the secondary obligor of performing its duties pursuant to the secondary obligation and the amount recoverable by the secondary obligor from the principal obligor pursuant to its recourse incident to suretyship status (§§ 17-27) and

(iii) that the release discharges a duty of the principal obligor other than the payment of money, except to the extent that the obligee establishes that the discharge of that duty does not increase the difference between the cost to the secondary obligor of performing its duties pursuant to the secondary obligation and the amount recoverable by the secondary obligor pursuant to its recourse incident to suretyship status (§§ 17-27);

(d) the secondary obligor has a claim against the obligee to the extent provided in § 33(4).<sup>161</sup>

In fidelity bonds, it is fairly clear that the value of the consideration for the release will go to the surety's benefit, assuming that money is applied to the same loss. It is not so clear, though, that the surety is completely discharged merely by the release of the principal obligor. However, as stated in subparagraph (ii) of subsection 35(b), the secondary obligor is discharged if the terms of the release so state.<sup>162</sup>

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161. *Id.* § 35(c)-(d).

162. *Id.* § 35(b)(ii).

What usually happens in these cases is a *pro tanto* release or discharge measured by the release's adverse effect on the surety.<sup>163</sup> The litigation on such issues tends to revolve around whether the bank's actions were reasonable under the circumstances.<sup>164</sup> If the bank acted reasonably, the surety will not be released, although it may be relieved of a portion of its liability to the extent the obligee has been paid.<sup>165</sup>

The language of the bond relating to subrogation is instructive. In section 7 of the "conditions and limitations" portion of the financial institution bond, the bank is required, upon request, to give an assignment of its rights upon payment.<sup>166</sup> Second, the clause provides for contractual subrogation.<sup>167</sup> Next, a complicated clause allocates recoveries.<sup>168</sup> This clause allocates the net recovery first to the bank's losses that would have been covered under the bond but for the fact that they are in excess of the limits of the bond.<sup>169</sup> This section would benefit the insured for other losses recoverable against the uninsured individual or institution. If the insurer obtains its full recovery, the balance, if any, goes to reimburse the deductible.<sup>170</sup> The final language in this clause states, "The Insured shall execute all papers and render assistance to secure to the Underwriter the rights and causes of action provided for herein. The Insured shall do nothing after discovery of loss to prejudice such rights or causes of action."<sup>171</sup>

Because of the complex nature of the relationships in a case in which the surety has declined coverage (for whatever reason), a number of courts have allowed the bank to release its employee, as

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163. *Id.* § 35 cmt. c; see also *id.* illus. 4; *id.* reporter's note, cmt. e.

164. See, e.g., *Carney v. Central Nat'l Bank*, 450 N.E.2d 1034, 1037-38 (Ind. Ct. App. 1983).

165. *Id.* at 1036 (holding that when the creditor releases security given to the creditor by the principal, the surety is released to the extent of the value of the security so impaired); see also RESTATEMENT (THIRD) OF SURETYSHIP § 35 reporter's note, cmt. e (Tent. Draft No. 2).

166. Form No. 24, *supra* note 78, § 7(a), at 103.

167. *Id.* § 7(b), at 103 ("In the event of payment under this bond, the Underwriter shall be subrogated to all of the Insured's rights of recovery therefor against any person or entity to the extent of such payment.").

168. See *id.* § 7(c), at 103.

169. *Id.*

170. *Id.*

171. *Id.* § 7(e), at 104.

*long as it does so reasonably.*<sup>172</sup> The burden of proving that the release is unreasonable is generally on the bonding company.<sup>173</sup> One can see many practical commercial reasons, as well as reasons of fairness, why courts could reach this conclusion. Some courts, nonetheless, will reach the opposite conclusion and hold that the release of the alleged dishonest principal obligor releases the surety.<sup>174</sup>

We believe these cases are extremely fact sensitive. If the court decides that what the bank has done is fair or, conversely, that what the surety is doing is unfair, it will tend to deny the existence of a release, find that the release is not intended to operate to release the surety, or create some other legal reason for not giving the surety relief. This is not to say that the surety will not receive credit for the actual benefit incurred by reason of the arrangement. Thus, for example, if the claim is \$200,000 (which we will assume is within the limits), and the bank receives \$50,000 net of expenses as a result of its settlement with the dishonest employee, the claim is reduced to \$150,000.

Conversely, if a court decides that the bank has treated the surety unfavorably, particularly if there is some evidence that the surety has been greatly prejudiced, then there is greater likelihood that the court will find that the release of the principal obligor releases the secondary obligor. Often in such cases, the bank has let the dishonest employee "off the hook" and perhaps given up rights against financially responsible third parties without notice to the surety and before the surety has been called into the claim. In such a case, there is greater likelihood that a court may find a release of the surety. In most cases, if there is a settlement between the bank and the dishonest employee, the surety could not likely prove it could have gotten more had the settlement not been made. There also may be questions when the settlement is made not with

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172. See, e.g., *Midland Bank & Trust Co. v. Fidelity & Deposit Co.*, 442 F. Supp. 960 (D.N.J. 1977); *First Hays Banshares, Inc. v. Kansas Bankers Sur. Co.*, 769 P.2d 1184 (Kan. 1989).

173. See, e.g., *Bunge Corp. v. London & Overseas Ins. Co.*, 394 F.2d 496, 497-98 (2d. Cir. 1968).

174. See, e.g., *St. Louis Fed. Sav. & Loan Ass'n v. Fidelity & Deposit Co.*, 654 F. Supp. 314, 316 (E.D. Mo. 1987); *Security Nat'l Bank v. Continental Ins. Co.*, 586 F. Supp. 139, 146 (D. Kan. 1982).

the dishonest employee who is the principal obligor, but with some third party. In these cases, the language of the bond itself (as quoted above),<sup>175</sup> rather than principles of suretyship law, likely will be used to try to resolve these problems.

Measuring our experience against the current text of the *Restatement of Suretyship* and section 35 in particular, the general principles announced are reasonably consistent with what actually happens in practice. There could be a great deal of text and sub-text trying to delineate the various conceivable circumstances. This delineation is more likely to cause confusion because of omitted circumstances than the more general language currently employed in the *Restatement*.

This is probably not an issue that needs to be addressed further in the *Restatement*. The language in the current draft is adequate to cover bright-line cases, and in my experience, many cases indeed are bright line. Of course, many are not. The advantage of the current system is that the results tend, on the whole, to be fair. The disadvantage to the present system is the lack of predictability. Because, philosophically, the *Restatement* is supposed to be premised on the law that presently exists, the complexity and fact-sensitive nature of decisions in this area strongly suggest the more general language currently used is the better course.

#### IV. COMMERCIAL FIDELITY POLICIES

##### A. Background

The availability of blanket bonds to commercial (nonfinancial) institutions commenced in the mid-1920s.<sup>176</sup> A 1926 edition of a primary commercial blanket bond was supplemented by a blanket position bond in 1928.<sup>177</sup> In general, the early commercial blanket bonds were designed to cover all employees or all of a given class of employees.<sup>178</sup> The blanket position bond was more similar to a public official bond in that it was to cover only certain positions.<sup>179</sup>

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175. See *supra* notes 166-71 and accompanying text.

176. Robert A. Babcock, *History of Fidelity Coverage*, in *THE COMMERCIAL BLANKET BOND ANNOTATED* 1, 4 (William F. Haug ed., 1985).

177. *Id.*

178. *Id.*

179. *Id.* at 4-5.

Furthermore, over time, coverage for "loss caused by unidentified employees" was incorporated into such bonds.<sup>180</sup> The commercial blanket bond was in use until 1986, when it was replaced by the so-called "crime policy"<sup>181</sup>—not surprisingly, coincidentally with the adoption of Financial Institution Bond Standard Form No. 24.

In general, blanket crime policies provided insuring agreements similar to, but not identical to, those provided by financial institution coverage. The 1980 Blanket Crime Policy form is typical. The coverages are: "Employee Dishonesty" (Insuring Agreement I);<sup>182</sup> "Loss Inside the Premises" coverage (Insuring Agreement II);<sup>183</sup> "Loss Outside the Premises" coverage (Insuring Agreement III);<sup>184</sup> "Money Orders and Counterfeit Paper Currency" coverage (Insuring Agreement IV);<sup>185</sup> and "Depositors Forgery" coverage (Insuring Agreement V).<sup>186</sup>

Here again, what is issued is an insurance policy. In such policies, the issuer is referred to as the "insurer" or "the company."<sup>187</sup> The business institution, which in a surety relationship would be the obligee, is referred to quite simply as the "insured."<sup>188</sup> Furthermore, as is true in the financial institution bond,<sup>189</sup> none of the coverages except employee dishonesty coverage contemplates, as a condition of the coverage, the existence of the contractual relationship between a principal obligor and obligee that is essential to suretyship.<sup>190</sup>

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180. *Id.* at 4.

181. Robert A. Babcock, *History of Fidelity Coverage*, in *THE COMMERCIAL BLANKET BOND ANNOTATED* 1, 1 (Carolyn P. Perry ed., 1st Supp. 1991). Prior to that time, there was another policy often referred to as the "3D Policy," officially encaptioned the "Dishonesty, Disappearance and Destruction Policy." Babcock, *supra* note 176, at 5. This policy first appeared in 1940. *Id.* Blanket crime policies were also in existence prior to 1986. Babcock, *supra*, at 1.

182. Blanket Crime Policy § I (1980), reprinted in *THE COMMERCIAL BLANKET BOND ANNOTATED*, *supra* note 176, app. B at 172, 173 [hereinafter *Crime Policy*].

183. *Id.* § II, at 173.

184. *Id.* § III, at 173.

185. *Id.* § IV, at 173.

186. *Id.* § V, at 173. Despite the differences in their names and the few differences in the policies, the basic coverages provided under the 3-D Policy were essentially the same as the Crime Policy. Babcock, *supra* note 176, at 5.

187. Crime Policy, *supra* note 182, at 172.

188. *Id.*

189. See *supra* note 85 and accompanying text.

190. Compare Crime Policy, *supra* note 182, § I, at 173 with *id.* §§ II-V, at 173.



Nonetheless, using the *Restatement* definitions of a suretyship relationship,<sup>191</sup> it is clear that a surety relationship does exist with respect to Insuring Agreement I. There is a contractual relationship between the employer (obligee) and the covered employee (principal obligor).<sup>192</sup> This employment relationship is the underlying obligation. The performance of that obligation remains primarily with the employee. The contract of employment is breached by the employee whose dishonesty is an essential predicate for coverage under the bond.<sup>193</sup> The surety is made to respond only when there has been a violation of that obligation by the requisite dishonesty as defined in the policy.<sup>194</sup>

The definition of dishonesty in current forms is the functional equivalent of and, for the most part, identical to the language used in financial institution bonds.<sup>195</sup> Dishonest and fraudulent acts must meet the "manifest intent" test, which requires intent to cause the insured to sustain such a loss, and intent to obtain financial benefit for the employee or any other person or organization (excluding salaries, commissions, and fees as financial benefit).<sup>196</sup>

*B. Specific Aspects of Commercial Fidelity Coverage  
Relevant to the Law of Suretyship*

Whatever may be the result under the financial institution bond, normal commercial fidelity coverages do not necessarily charge the covered employee with knowledge of the existence of the secondary obligor. Although this does not destroy the existence of a surety relationship, it does limit the rights available to the surety. From the standpoint of an employee, normally whether or not the employer has fidelity coverage is a fortuity. There is certainly no general usage in this respect. When the bond does include position coverage, the situation may be different. There could be commercial enterprises in which an employee must be bondable to obtain a

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191. See RESTATEMENT (THIRD) OF SURETYSHIP § 1 (Tent. Draft No. 1, 1992).

192. See Crime Policy, *supra* note 182, § I, at 173.

193. See *id.*

194. See *id.*

195. Compare *id.* (defining "dishonest or fraudulent acts" as requiring "manifest intent" to cause the loss and obtain a financial benefit) with Form No. 24, *supra* note 78, § A, at 91-92 (same).

196. Crime Policy, *supra* note 182, § I, at 173.

certain job and, if this is so, arguably the requisite charged knowledge exists.

Such policies generally provide that coverage which otherwise would exist (proof of a loss by employee dishonesty) still exists even though the insured is unable to identify the dishonest employee.<sup>197</sup> Thus, for example, section 4 of the conditions and limitations of a commercial blanket bond states:

If a loss is alleged to have been caused by the fraud or dishonesty of any one or more of the Employees and the Insured shall be unable to designate the specific Employee or Employees causing such loss, the Insured shall nevertheless have the benefit of this Bond, subject to the provisions of Section 2(b) of this Bond [i.e., the inventory exclusion], provided that the evidence submitted reasonably proves that the loss was in fact due to the fraud or dishonesty of one or more of the said Employees, and provided, further, that the aggregate liability of the Underwriter for any such losses shall not exceed the amount stated in Item 3 of the Declarations.<sup>198</sup>

This language is in a 1980 commercial blanket bond form. Comparable language in the 1990 commercial crime policy states: "Employee Dishonesty . . . means only dishonest acts committed by an 'employee' whether identified or not, acting alone or in collusion with other persons, except you or a partner . . . ."<sup>199</sup>

One can argue as a necessary corollary, harkening back to financial institution bonds, that because no such language appears in a financial institution bond, the obligee bank must be able to identify the particular dishonest bank employee who caused the loss. Coverage that is afforded even though the individual "principal obligor" cannot be identified is certainly a two-party surety relationship. Determining that a surety relationship exists at all in unidentified employee cases is, perhaps, pushing the envelope.

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197. Babcock, *supra* note 176, at 4.

198. Commercial Blanket Bond § 4 (1980), *reprinted in* THE COMMERCIAL BLANKET BOND ANNOTATED, *supra* note 176, app. A at 169, 170.

199. Employee Dishonesty Coverage Form A—Blanket § D(3)(a) (1990), *reprinted in* THE COMMERCIAL BLANKET BOND ANNOTATED, *supra* note 181, app. B at 96, 96 [hereinafter Employee Dishonesty Form A].

How can the suretyship defenses, such as release of the principal obligor,<sup>200</sup> operate when nobody knows who is the principal obligor? Against whom can the surety claim reimbursement or exoneration?<sup>201</sup> The right of subrogation arises by contract and probably arises by operation of law regardless of whether a surety relationship exists.<sup>202</sup> Thus, it is possible to argue philosophically that the employee dishonesty coverage in such policies as the crime policy is further subdivided in that the surety relationship exists only for the losses caused by an employee or employees who are identifiable.

Claims on employee dishonesty commercial coverages generally fall into one of four categories: 1) outright embezzlement or misuse of money;<sup>203</sup> 2) stealing or assisting in stealing the tangible personal property of the insured;<sup>204</sup> 3) enabling dishonest outsiders to secure credit to which they are not otherwise entitled;<sup>205</sup> or 4) selling products or services of or to the employer in which the amount is dishonestly deflated or inflated.<sup>206</sup>

In the four areas enumerated above, an issue leading to extensive litigation arises when the insured attempts to establish the existence or amount of its inventory losses by comparing its profit and loss information for a "normal period" against the period when the dishonest employee allegedly caused the loss.<sup>207</sup> A textbook example of such a case is when the owner of a liquor store catches an employee stealing \$100 worth of liquor. The owner then presents a claim on the fidelity bond for \$40,000 because inventory records purport to show that \$40,000 worth of liquor is missing.

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200. See RESTATEMENT (THIRD) OF SURETYSHIP § 35 (Tent. Draft No. 2, 1993).

201. See *id.* § 18; RESTATEMENT (THIRD) OF SURETYSHIP § 17 (Tent. Draft No. 1, 1992).

202. See RESTATEMENT (THIRD) OF SURETYSHIP § 18 (Tent. Draft No. 2).

203. See, e.g., *Chenoweth-Chapman Corp. v. American Ins. Co.*, 553 S.W.2d 872 (Mo. Ct. App. 1977).

204. See, e.g., *Jones v. Employers Mut. Casualty Co.*, 432 N.W.2d 535 (Neb. 1988); *Ace Wire & Cable Co. v. Aetna Casualty & Sur. Co.*, 454 N.Y.S.2d 897 (App. Div. 1982), *aff'd*, 457 N.E.2d 761 (N.Y. 1983).

205. See, e.g., *First Am. State Bank v. Continental Ins. Co.*, 897 F.2d 319 (8th Cir. 1990); *American Trust & Sav. Bank v. United States Fidelity Guar. Co.*, 418 N.W.2d 853 (Iowa 1988).

206. See, e.g., *James B. Lansing Sound, Inc. v. National Union Fire Ins. Co.*, 801 F.2d 1560 (9th Cir. 1986).

207. See, e.g., *Dunlop Tire & Rubber Corp. v. Fidelity & Deposit Co.*, 479 F.2d 1243, 1245 (2d Cir. 1973); *Gillette Co. v. Travelers Indem. Co.*, 365 F.2d 7 (7th Cir. 1966).

This is of interest because it is an area in which the secondary obligation is limited and not coextensive with the primary obligation. All such policies contain some version of what is described as the "Inventory and Profit and Loss" exclusion.<sup>208</sup> Such an exclusion might read:

We will not pay for loss as specified below:

b. Inventory Shortages: loss, or that part of any loss, the proof of which as to its existence or amount is dependent upon:

- (1) An inventory computation; or
- (2) A profit and loss computation.<sup>209</sup>

In earlier versions of this clause, courts found an ambiguity because of language stating, "However, this paragraph shall not apply to loss of . . . property which the insured can prove, through evidence wholly apart from such computations, is sustained by the insured . . . ." <sup>210</sup> Thus, in our textbook case, if the insured could prove a loss through dishonesty by means other than inventory computation (such as catching the employee red handed with \$100 worth of stolen liquor), the insured could then use an inventory shortage to attempt to prove the amount of the loss attributable to dishonesty.

After a long-delayed period of fighting such cases, the insurance industry removed the offending clause leaving the basic exclusion. The reasons for these exclusions should be fairly obvious. They relate to the determination by the sureties that they do not intend to cover inventory or operating statement losses simply because somebody has found a dishonest employee stealing from the company.

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208. Hugh E. Reynolds, Jr. & Deanna L. Seward, *Inventory and Profit and Loss*, in *THE COMMERCIAL BLANKET BOND ANNOTATED*, *supra* note 176, at 45, 45.

209. *Id.*; see, e.g., Commercial Crime Coverage Form 0—Per Loss § D(1)(b) (1990), reprinted in *THE COMMERCIAL BLANKET BOND ANNOTATED*, *supra* note 181, app. D at 99, 99 (containing identical terms).

210. James E. Chelberg, *The Inventory Computation Exclusion—The Latest View*, 15 *FORUM* 930, 933 (1980).

V. *RESTATEMENT SECTIONS GENERALLY APPLICABLE TO  
FIDELITY COVERAGES*

Several sections of the *Restatement* should be examined in a more general fashion rather than by relating the section to a specific type of fidelity bond. These will be covered briefly to the extent they may be of interest.

A. *Voiding or Terminating the Secondary Obligation*

Section 9 of the *Restatement* instructs us regarding the circumstances making the secondary obligation voidable due to misrepresentation.<sup>211</sup> For fidelity coverages in general, a material misrepresentation by the principal obligor does not serve to void or make voidable the coverage.<sup>212</sup> If, however, that misrepresentation is known to the obligee, or if the obligee is chargeable with such knowledge, the suretyship contract may be voidable.<sup>213</sup> Normally, voidability will occur when the applications are issued and signed by the obligee in order to procure commercial fidelity policies, financial institution bonds, and, more rarely, types of public employee or public official coverages. In these cases, a material misrepresentation by the applicant-obligee can be a basis for revocation of the coverage.<sup>214</sup> The principles applicable to this circumstance are not materially different in fidelity coverage than in other types of surety relationships. The factual difference is that in most other surety relationships, the application is not made by the obligee. For example, in performance bonds, the application is usually made by the primary obligor rather than the obligee.<sup>215</sup>

Most of the cases involving this issue turn upon two separate fact situations—one renders the coverage voidable *ab initio*, and the other terminates coverage upon the existence of a fact that may or may not predate the coverage. The first of these circumstances arises when the obligee knows of prior dishonesty on the part of a covered employee or officer when making application, or

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211. *RESTATEMENT (THIRD) OF SURETYSHIP* § 9 (Tent. Draft No. 1, 1992).

212. *Id.* cmt. e.

213. *Id.* cmt. f.

214. *Id.* § 9(1).

215. See Carl R. Dickey et al., *Performance Bond Claims*, in *HANDLING FIDELITY CLAIMS*, *supra* note 4, § 6.1, 6.1.

when the obligee lies about some material relating to the operations of the bank or commercial institution.<sup>216</sup> Normally, the application will contain specific questions which, if properly answered, will reveal this information. Because the secondary obligor submits an application with questions, however, an argument exists that the provisions of subsection 9(3) of the *Restatement*, regarding the duty to disclose facts unknown to the secondary obligor,<sup>217</sup> may be merged in the legally justified assumption by the obligee that all relevant questions have been asked in the application.

A second very specific legal and factual question is common to financial institution bonds and most, but not all, commercial fidelity coverages. This is the so-called "termination of coverage" upon discovery of dishonesty. An example of such a provision follows:

This insurance is cancelled as to any "employee":

a. Immediately upon discovery by:

(1) You; or

(2) Any of your partners, officers or directors not in collusion with the "employee";

of any dishonest act committed by that "employee" whether before or after becoming employed by you.<sup>218</sup>

The current Financial Institution Bond Standard Form No. 24 contains comparable language in section 12 under "termination or cancellation":

This bond terminates as to any Employee or any partner, officer or employee of any Processor—(a) as soon as any Insured, or any director or officer not in collusion with such person, learns of any dishonest or fraudulent act committed by such person at any time, whether in the employment of the Insured or otherwise, whether or not of the type covered under Insuring Agreement (A), against the Insured or any other person or entity, without prejudice to the loss of any Property then in transit in the custody of such person . . . .<sup>219</sup>

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216. See, e.g., *St. Joe Paper Co. v. Hartford Accident & Indem. Co.*, 376 F.2d 33, 35 (5th Cir.), cert. denied, 389 U.S. 828 (1967).

217. RESTATEMENT (THIRD) OF SURETYSHIP § 9(3) (Tent. Draft No. 1, 1992).

218. Employee Dishonesty Form A, *supra* note 199, § D(2)(a), at 96.

219. Form No. 24, *supra* note 78, § 12, at 105.

The clause goes on to state, in pertinent part: "Termination of the bond as to any Insured terminates liability for any loss sustained by such Insured which is discovered after the effective date of such termination."<sup>220</sup>

As one can readily see, the broad scope of this particular termination clause goes far beyond the provisions of section 9 of the *Restatement*, which really apply to misrepresentations rather than knowledge of prior acts or omissions.

### B. *Assignment of Obligee's Rights*

Section 10 of the *Restatement* covers assignments.<sup>221</sup> Subsection 10(1) generally permits assignments of the secondary obligation absent three enumerated circumstances.<sup>222</sup> One of these enumerated circumstances is when the assignment is validly precluded by contract. Most fidelity policies preclude assignment without consent. Furthermore, many such policies terminate upon the insured's being taken over by a governmental agency such as the FDIC, going into bankruptcy, or the like.<sup>223</sup> Clauses generally in use would include general phrases such as, "Your rights and duties under this policy may not be transferred without our written consent except in the case of the death of an individual named insured."<sup>224</sup>

Under the standard rules of bankruptcy law, a general clause like that quoted above would not terminate the policy automatically upon bankruptcy.<sup>225</sup> Indeed such a result would be invalid under the bankruptcy laws, whatever the language of the change.<sup>226</sup> However, the existence of the bankruptcy should not affect the termination of coverage as to an individual employee upon discovery of dishonesty.

This issue arises more often with respect to financial institution bonds than commercial fidelity coverages. The relevant language in

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220. *Id.*

221. RESTATEMENT (THIRD) OF SURETYSHIP § 10 (Tent. Draft No. 1).

222. *Id.* § 10(1).

223. *See, e.g.*, Form No. 24, *supra* note 78, § 12, at 105.

224. INSURANCE SERVS. OFFICE, INC., COMMERCIAL LINES POLICY COMMON POLICY DECLARATIONS, condition F (CPP-6800-A) (Jan. 1987).

225. 11 U.S.C. § 541(c)(1)(B) (1988).

226. *See id.*

a financial institution bond that most often comes into play appears under section 12, "Termination or Cancellation": "This bond terminates as an entirety upon occurrence of any of the following: . . . (c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials, or (d) immediately upon the taking over of the Insured by another institution."<sup>227</sup> These issues have been fiercely litigated, particularly by federal regulators.<sup>228</sup> In general, this provision has been upheld<sup>229</sup> although judicial authorities probably will continue to challenge its applicability.<sup>230</sup> Note that this terminates coverage only as to the one employee.

### C. *Right of Set-Off*

Section 27 of the *Restatement* refers to the secondary obligor's right to return performance and the obligee's right of set-off.<sup>231</sup> This may be important in fidelity cases in which an obligation may be owing from the obligee (the bank) to the principal obligor (the dishonest employee). If we assume a surety relationship, subsection 27(2) would seem to disallow a set-off of other obligations against the right obtained through subrogation to return performance of a claim against the principal obligor when the claim against the principal obligor is "unrelated to the underlying obligation."<sup>232</sup> This language approaches, but does not precisely match, the portion of the financial institution bond subrogation section discussed heretofore.<sup>233</sup>

A question arises as to whether the specific language of the bond regarding allocation of recovery proceeds would control. The as-

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227. Form No. 24, *supra* note 78, § 12, at 105.

228. See, e.g., *Resolution Trust Corp. v. Fidelity & Deposit Co.*, 1992 U.S. App. LEXIS 1592 (9th Cir., Jan. 31, 1992); *California Union Ins. Co. v. American Diversified Sav. Bank*, 948 F.2d 556 (9th Cir. 1991).

229. See, e.g., *California Union*, 948 F.2d at 563; *FDIC v. Aetna Casualty & Sur. Co.*, 903 F.2d 1073, 1078 (6th Cir. 1990).

230. See, e.g., Eugene J. Comey, *Current Issues in FDIC/RTC Financial Institution Bond Litigation*, National Institute of the Section of Tort and Insurance Practice, Committee on Fidelity and Surety Law, American Bar Association (1992) (unpublished manuscript, on file with author).

231. RESTATEMENT (THIRD) OF SURETYSHIP § 27 (Tent. Draft No. 2, 1993).

232. *Id.* § 27(2).

233. See Form No. 24, *supra* note 78, § 7(b), at 103; *supra* note 165.



sumption is that it would. However, it is at least arguable under the language of the current *Restatement* that the the surety's rights to recoup could come ahead of the rights of the bank to recover the payment of a personal note of the dishonest employee owed to the bank from funds held by the bank.<sup>234</sup>

#### D. *Third-Party Beneficiaries*

I have already remarked that members of the general public often are third-party beneficiaries under public official bonds. However, the opposite is the case under most other instruments of fidelity coverage. Virtually all of the forms of financial institution bonds or commercial fidelity coverages state something like the following: "This bond shall apply to loss of Property (1) owned by the Insured, (2) held by the Insured in any capacity, or (3) for which the Insured is legally liable. This bond shall be for the sole use and benefit of the Insured named in the Declarations."<sup>235</sup>

Most often, this language becomes an issue when claimants, stockholders, or depositors (in the case of a financial institution) seek an action directly against the bond.<sup>236</sup> Absent proof of the requirements for a derivative action (which then makes the action that of the insured institution), such attempts to recover directly against the bond are uniformly unsuccessful.<sup>237</sup>

### VI. CONCLUSION

On balance, the *Restatement (Third) of Suretyship* accurately summarizes the experience of issuing various forms of fidelity coverages and the cases covering disputes arising out of such coverages. On some issues, the law is not clear and the *Restatement* now provides solid law on this point. There are some issues, however, that do arise but which are not covered by the *Restatement*. In some of these issues, it is probably just as well the *Restatement* does not cover the problem.

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234. RESTATEMENT (THIRD) OF SURETYSHIP § 27(3) (Tent. Draft No. 2).

235. *E.g.*, Form No. 24, *supra* note 78, § 10, at 104.

236. *See, e.g.*, *Fidelity & Deposit Co. v. Duke*, 293 F. 661 (9th Cir. 1923).

237. *Id.* at 664 (holding that depositors and creditors of a bank cannot maintain suit on a fidelity bond and that any benefit they may derive must be worked out through the bank).

By far, the most common area of concern is the reluctance of the courts to consider that the relationship created by employee dishonesty coverage in commercial fidelity policies or financial institution bonds is, essentially, a surety relationship. A majority of courts certainly accept that the surety relationship exists. The *Restatement* should assist in directing any court's attention to the existence of this relationship and a resolution of legal questions with that relationship and the contract provisions in mind.