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***SUBROGATION RIGHTS AND THE FIDELITY INSURER:  
HOW TO PROTECT THEM, AND WHAT TO DO  
WHEN THEY HAVE BEEN PREJUDICED***

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# **SUBROGATION RIGHTS AND THE FIDELITY INSURER: HOW TO PROTECT THEM, AND WHAT TO DO WHEN THEY HAVE BEEN PREJUDICED**

## **1. Introduction**

Subrogation rights are an important – but sometimes overlooked – aspect of the fidelity insurer’s arsenal of weapons. Effective use of subrogation can often substantially reduce a fidelity insurer’s losses on an otherwise significant claim. At the same time, neglect of the insurer’s subrogation rights and options – especially at the inception of the handling of a claim – can lead to lost recovery opportunities and, in the final analysis, poor claims management.

Fidelity insurers are sometimes faced with claim scenarios in which their subrogation rights against third parties (1) have been destroyed, (2) may be substantially impaired, or (3) have been otherwise prejudiced by the conduct of the insured. In some cases, the fact pattern is simple: prior to making its bond claim, the insured has released and fully settled with the potential subrogation target without reserving the insurer’s rights. In other cases, the insured’s actions are not so obvious; where, for example, the insured allows a statute of limitation to lapse against a potential subrogation target while the claims adjustment process is ongoing.

The fidelity insurer must therefore be cognizant at all times of its subrogation options. This paper discusses the general rules developed by the courts with respect to situations in which the conduct of the insured impairs the insurer’s subrogation rights. Also discussed are cases analyzing this issue specifically with respect to fidelity insurers and the standard provisions of the Form 24 Financial Institution Bond. Based on the principles derived from these cases, this paper will discuss the practical issues faced by fidelity insurers relating to subrogation rights, and will offer suggestions for the most effective use and preservation of the rights of subrogation.

## **2. Subrogation Rights Generally**

Subrogation is the right of the insurer to be put in the position of the insured in order to pursue recovery from third parties legally responsible to the insured for a loss paid by the insurer. See, e.g. Couch on Insurance 2d (Rev. ed.) § 61:1; 44 Am. Jur. 2d, Insurance § 1794; Liberty Mutual Fire Ins. Co. v. Auto Spring Supply Co., 131 Cal. Rptr. 211, 59 Cal. App. 3d (2d Dist. 1976). There are two types of subrogation: legal and conventional. Legal subrogation arises by operation of law, i.e. by statute or common law, while conventional subrogation arises by virtue of contract or agreement, i.e. by the terms of the insurance policy or by a written assignment provided to the insurer by the insured. Couch on Insurance 2d (Rev. ed.) § 61:2; Travelers Indemnity Co. v. United States, 543 F.2d 71 (9<sup>th</sup> Cir. 1976).

While subrogation may exist pursuant to a written contract or a statute, most courts treat the right of subrogation as an equitable one. Couch on Insurance 2d (Rev. ed.) § 61:18. Subrogation thus seeks to work an equitable adjustment between the parties “by securing the ultimate discharge of a debt by the person who in equity and good conscience ought to pay it.” Id. Some courts will not enforce the right of subrogation of the insurer against “superior

equities” of another party. Id., § 61-21.

In general terms, subrogation confers no greater rights upon the insurer than the insured had against a third party tortfeasor. See, e.g. Brodsky v. Princemont Construction Company, 354 A.2d 440 (Md.App. 1976). Jaylynn, Inc. v. Star Supermarkets, Inc. 348 N.Y.S.2d 85, 75 Misc.2d 542 (1973). Stated otherwise, any defense available to the third party tortfeasor in an action by the insured will also be available to the tortfeasor in an action by the subrogated insurer. See Couch on Insurance 2d (Rev. ed.) § 61:224; Employers Insurance of Wausau v. Sheedy, 166 N.W.2d 220 (Wis. 1969). This would include, of course, any statute of limitations defense which would have otherwise applied to the insured’s claims and causes of action. See Couch on Insurance 2d (Rev. ed.) § 61:234.

Because the insurer’s subrogation rights are purely derivative in nature, certain actions by the insured may impair or destroy the insurer’s subrogation rights. See, e.g. 44 Am.Jur. 2d Insurance, § 1810; 6A Appleman, Insurance Law and Practice § 4091. Thus, a general release of claims given by an insured to a third party tortfeasor will, under most circumstances, operate to bar any subrogation action by the insurer against the tortfeasor. See 44 Am.Jur. 2d Insurance, § 1810; 6A Appleman, Insurance Law and Practice § 4092.

Courts have recognized an exception to the above-cited rule where the third party tortfeasor settles with the insured, and obtains a corresponding release, with knowledge of the presence of insurance, or with knowledge that the insured has received payment from the insurer. See Couch on Insurance 2d (Rev. ed.) § 61:195; 6A Appleman, Insurance Law and Practice, § 4092; Travelers Indemnity Company v. Chumbley, 394 S.W.2d 418 (Mo.App. 1965); Gibbs v. Hawaiian Eugenia Corp., 966 F.2d 101 (2d Cir. 1992). In these circumstances, the tortfeasor’s knowledge regarding his potential liability as a subrogation defendant renders the release ineffectual with respect to the rights of the insurer. Id.

The insured’s release of a third party, and the destruction of subrogation rights flowing therefrom, has been construed by some courts as a complete defense to liability in an action on the policy by the insurer against the insured. See 44 Am.Jur. Insurance, § 1813; Lady Corinne Trawlers v. Zurich Ins. Co., 507 So.2d 915 (Ala. 1987); Insurance Company of North America v. Abiouness, 313 S.E.2d 663 (Va. 1989). Some courts will require a showing of prejudice to the insurer before allowing the insurer to escape liability based upon the impairment of subrogation rights. Gibbs v. Hawaiian Eugenia Corp., 966 F.2d 101 (2d Cir. 1992); Weinberg v. Transamerica Insurance Company, 477 N.Y.S.2d 99, 465 N.E.2d 817 (1984). Other courts have held that the insurer’s liability on the policy is reduced pro tanto by the amount of the release given to the third party tortfeasor. See 6A Appleman, § 4093 and cases cited therein.

### **3. The Form 24 Provisions, And Cases in the Fidelity Bond Context**

Any analysis of the subrogation rights of the fidelity insurer must, of course, begin with the terms of the bond or contract at issue. Several provisions of the fidelity bond bear directly on this issue.

The standard Form 24 Financial Institution Bond (rev. 1986) codifies the duty of the

insured to refrain from prejudicing the subrogation rights of the insurer. Section 7(e) of the bond form thus provides:

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.

Section 7(b) of the current version of the Standard Form 24 Financial Institution Bond also provides the insurer with an express right of subrogation. This section thus provides:

In the event of payment under this bond, the Underwriter shall be subrogated to all of the Insured's rights of recovery thereto against any person or entity to the extent of such payment.

The current version of the Form 24 bond also includes a provision obligating the insured to provide, where requested, an assignment of its causes of action in connection with the claim. Section 7(a) provides:

In the event of payment under this bond, the Insured shall deliver, if so requested by the underwriter, an assignment of such of the Insured's rights, title and interest and causes of action as it has against any person or entity to the extent of the loss payment.

Based upon the above-cited provisions, the standard Form 24 bond appears to provide a significant degree of protection to the insurer seeking to enforce its subrogation rights. Indeed, Courts have construed these provisions – and other similar provisions – in the context of claims by fidelity insurers that the actions of the insured prejudiced the insurer's subrogation rights. A review of these cases suggests that, while in general terms an insured may not prejudice the rights of the insurer to pursue subrogation, courts are generally reluctant to accept impairment of subrogation rights as a complete defense to the claim unless the equities run strongly in favor of the insurer. This is especially so where the insurer seeks to invoke the impairment of subrogation defense for claims in which it originally denied coverage or disputed liability.

An example of the general unwillingness of courts to accord full weight to the impairment of subrogation defense can be found in Midland Bank & Trust v. Fidelity & Deposit Company of Maryland, 442 F.Supp. 960 (D.N.J. 1977) ("Midland"). In Midland, F&D claimed that it had no liability for a claim against its bond because the insured prejudiced its subrogation rights by settling with third party subrogation targets.

The Court rejected the defense out of hand, observing that it would be inequitable if F&D "were permitted to escape its liability under the bonds because [the insured] tried to mitigate its losses after [F&D] denied its liability." Midland, 442 F.Supp. at 973. The Court also reasoned that the F&D's rights of subrogation would not arise until after the insured had been reimbursed for the total amount of its loss. Id. Thus there could be no "impairment" of subrogation rights where, according to the Midland Court, the insurer's subrogation rights had not yet arisen. Id.

The Supreme Court of Kansas faced a similar issue in First Hays Banshares, Inc. v. Kansas Bankers Surety, 769 P.2d 1184 (Kan. 1989) (“First Hays Banshares”). In First Hays Banshares, the insured under a fidelity blanket bond entered into a settlement agreement with a third party wrongdoer without the approval of the insurer. Relying upon the language in Section 7(e) of the bond, the insurer argued that the insured’s actions extinguished its subrogation rights and thus discharged the insurer from any liability for the claim.

As in Midland, the insurer sought to invoke the defense after it had originally denied coverage for the claim. As with Midland, the Court in First Hays Banshares rejected the defense because of that original denial of coverage: “By denying coverage under the bonds, the defendant forfeited its rights to prior approval of any settlement agreement entered into by the insured.” First Hays Banshares, 769 P.2d at 1189.

Much of the court’s analysis is grounded in equity. The court reasoned that it would be unfair to punish the insured for mitigating its damages where the insurer has already communicated a denial of coverage of the claim. Id. The court further recognized the practical considerations at work:

[B]ecause of the financial condition of the third party or the size of other claims pending against it, it might be essential that redress against the third party be promptly pursued lest nothing remain to satisfy insured’s claim. On the other hand, the self-interest on the insured affords considerable protection to insurer under the present rule. Recognizing the possibility that his suit against the insurance company may fail, the insured will attempt to recoup as much of his losses as possible from the third party. If the insurer is ultimately held liable, the amount so recovered will inure to its benefit.

First Hays Banshares, 769 P.2d at 1189 quoting Bunge Corporation v. London and Overseas Insurance Co., 394 F.2d 496, 497 (2d Cir. 1968).

The Sixth Circuit Court of Appeals also held against a fidelity insurer alleging impairment of subrogation rights in Russell Gasket Co. v. Phoenix of Hartford Insurance Co., 512 F.2d 205 (6<sup>th</sup> Cir. 1976) (“Russell Gasket”). In Russell Gasket, the insurer claimed that the insured was precluded from recovery under the bond because it had settled with the third-party wrongdoer. Here again, the insurer sought to invoke the impairment defense where the equities were not in its favor: the insurer not only had denied coverage, but also took no action to preserve its rights when it became aware that the insured was pursuing the tortfeasor.

The insurer was thus estopped from asserting this defense because, according to the Sixth Circuit, it had not only denied coverage for the claim, but also “did nothing whatsoever to assist” the insured in pursuing the wrongdoer, and it “stood idly by” while the insured pursued the wrongdoer. Russell Gasket, 512 F.2d at 209. The Court concluded: “Right from the beginning, when [the insured] informed [the insurer] of its loss and claim, it is plain that under no circumstance would it help [the insured] and that it never intended to protect and assist its insured.” Id. (emphasis in original).

Notwithstanding the above-cited cases, some courts have upheld a fidelity insurer’s claim that it has no liability under its bond because the insured impaired its subrogation rights.

See, e.g. Security National Bank of Kansas City v. Continental Insurance Co., 586 F.Supp. 139 (D.Kan. 1982) (“Security National”). In Security National, the insured bank sustained a major loss resulting from a check-kiting scheme engineered by a series of companies. Those companies filed bankruptcy petitions, and the insured filed claims against the estates of those entities in the bankruptcy court. Security National, 586 F.Supp. at 145. The insured thereafter settled its claims with the bankruptcy trustee in exchange for a substantial payment from the estate. Id. As part of the settlement, the insured released those entities from any further claims, and with no reservation of the subrogation rights of the insurer. Id.

The Security National court held that the release of the companies in the bankruptcy court impaired the insurer’s subrogation rights, and thus precluded the insured from any recovery under the bond. The court rejected the insured’s argument that the insurer had failed to prove any “prejudice” resulting from the release of the wrongdoers. Id., 148. Indeed, the court placed the burden of proof on the issue of lack of prejudice on the insured. Id. The court observed in dicta that over \$800,000 remained in the bankrupts’ estates, and the insured failed to produce any evidence as to the disposition of the remaining assets. Id. In effect, the court presumed prejudice in the absence of any evidence to the contrary.

Other courts have likewise recognized impairment of subrogation rights defense in the context of a claim on a fidelity bond. See, e.g. Republic National Life Insurance Company v. United States Fire Insurance Company, 589 S.W.2d 737, 742 (Tex.Civ.App. 1979) rev’d on other grounds 602 S.W.2d 527 (1980) (there would be no recovery allowed under the bond if the insured failed to preserve the insurer’s subrogation rights by filing suit against the wrongdoer within the applicable statute of limitations period); Premier Elec. Constr. Co. v. United States Fidelity & Guar. Co., 1985 WL 2386 (N.D.Ill. 1985) (granting fidelity insurer summary judgment where insured impaired its subrogation rights against wrongdoer).

#### **4. Some Lessons From the Caselaw**

As the above-cited cases demonstrate, fidelity insurers must take great care to insure that their subrogation rights are protected. While the language of the standard fidelity bond clearly prohibits any action by the insured to impair subrogation rights, the practical reality is that many courts view the issue from a purely equitable perspective. Seasoned insurance (and surety) practitioners are no doubt aware that the balance of equities will rarely tip in favor of the insurer. Moreover, many courts are unwilling to grant the insurer a complete discharge of liability, especially where the insured’s conduct does not evince a total disregard for the rights of the insurer. Fidelity insurers and claims handlers should therefore be guided by the following practical suggestions:

##### **1. Identify Potential Targets and Statutes of Limitations Immediately**

Because subrogation rights will generally arise only after final payment is made on the claim, there may be a tendency to view subrogation options and strategy as an after-thought. This is a mistake. Analysis of potential subrogation rights and options should be one of the first steps undertaken by the insurer. A failure to do so may result in impairment in subrogation rights because of the tolling of a statute of limitation with respect to a potential target, the dissipation of assets by a potential target, a settlement by the insured with the tortfeasor, or

some other event which destroys any meaningful effort to obtain a recovery in the case.

As such, the initial review of the claim should include an analysis of potential subrogation targets. Potential targets in the context of fidelity bond claims may include employees of the insured, officers and directors of the insured, and third-party professionals such as accountants and attorneys. Determination of the applicable statutes of limitation will, of course, depend upon the particular laws of the jurisdiction which would control the claims in question. In performing this analysis, the insurer must always remember that its subrogation rights will be the substantive claims of its insured. Thus, for statute of limitations purposes, the insured must ascertain the causes of action – and the corresponding period of limitation -- applicable to the insured's claim against the target.

Once it has identified potential targets for subrogation efforts, another step which the insurer may wish to consider is to send written notice to the targets advising them of the insurer's interests and their possible liability in the matter. As discussed in Section 2 above, courts have held that an insurer's right of subrogation against a third party tortfeasor will not be extinguished by virtue of a release given to the third party by the insured where the tortfeasor is aware of the presence of insurance and/or the interests of the subrogating insurer. Thus, by giving written notice to the subrogation targets as soon as possible, the fidelity insurer increases the possibility that it will successfully avoid the defense that its subrogation rights have been extinguished.

In some cases, the insured will have already initiated proceedings against the target defendant at the time that the claim is made on the fidelity bond. Thus, the insurer's preliminary investigation of the claim should seek to identify all such proceedings. If the insurer is unable to obtain this information independently, it should ask the insured directly for it. In these circumstances the fidelity insurer should also advise the insured in writing that any settlement with, or release of, the tortfeasor without the express prior written approval of the insurer will be deemed a violation of the insured's obligations and a defense to any claim on the bond.

## **2. *Enlist the Resources of the Insured and Its Counsel***

Although the insurer has identified the potential subrogation targets and options at the outset of a claim, it may not be in a position to assert these rights immediately. In most instances, the insurer itself cannot commence a subrogation action until and unless it has made final payment and settlement of the insured's claim. In large and complex losses, the claims handling process can take months -- and perhaps years -- to conclude. In many cases the insurer will initially dispute liability for the claim, but will reach an agreed settlement of the claim at some point in the future.

The fidelity insurer may thus often face the inherent difficulty of seeking to preserve its subrogation rights while, at the same time, maintaining a defense of the insured's underlying claim. There are, however, some basic steps available to the insurer to protect its subrogation interests. In these circumstances, one such option is to utilize the insured and the insured's counsel to take actions which will preserve the insurer's subrogation rights. Thus, in every case the insurer should put the insured on written notice of its duty to refrain from prejudicing

the insurer's subrogation rights. In this letter the insurer should also advise the insured of its general duty to mitigate its damages in connection with the claimed loss. The insurer should send this letter even where the insurer has made a preliminary denial of liability for the claim.

The insurer's written notice to the insured should be as detailed and specific as possible. Thus, the insurer should identify by name the potential third party target(s), the potential causes of action against that person, and – where there is a statute of limitations running – the date of the tolling of the statute of limitations for that target defendant. This notice will serve to place the burden upon the insured and the insured's counsel to take action to fulfill its obligation to mitigate damages, and to preserve potential subrogation options which may come to fruition once the claims adjustment process has been completed and the claim fully settled.

Ideally, the insured and its counsel will then take steps to pursue the subrogation target. As the Court observed in First Hays Banshares, *supra*, any recovery obtained by the insured may ultimately inure to the benefit of the insurer, since it will serve to reduce the amount of the loss sustained by the insured and, in turn, reduce the exposure of the insurer on the bond claim. In short, while the insured's counsel may for some purposes be an adversary to the insurer, he may also be an ally, especially where he is made fully aware of the risks involved in not pursuing potential avenues of recovery.

The extent of cooperation obtained from the insured and its counsel will, of course, depend upon the particular circumstances and the parties involved. In some cases, counsel for the insured have been known to take the position that, while they have a duty to refrain from prejudicing the insurer's subrogation rights, they have no duty to take any affirmative steps to secure recovery from the third party. Any insured (or counsel for the insured) taking this position is risking a defense by the insurer that the subrogation rights of the insurer have been impaired, as well as the defense that the insured failed to comply with its common law duty to mitigate damages. The fidelity insurer and its counsel should so advise any insured of this risk in writing at the outset of the claim, so that a record is made which will support the insurer's position.

### ***3. Invoke the Impairment Defense In The Right Case***

The cases discussed in Section 3 above demonstrate that courts will not look kindly upon the impairment of subrogation rights defense where the insurer has disputed liability for the claim throughout the entire case. In simplest terms, the impairment of subrogation rights will probably fail if it is being raised by the fidelity insurer in the same action in which the insurer is disputing liability in general.

In these scenarios the courts will almost always find that the equities run in favor of the insured, and will thus reject the defense. The rationale for this view is simple: having denied liability on the claim, the insurer cannot thereafter escape liability because the insured exercised its right to settle claims against a third party. Insurers must therefore be sure to invoke the impairment of subrogation rights defense only in cases where, from both a legal and equitable standpoint, the defense is justified. As such, the insurer should invoke the defense judiciously and only in cases where the equities are in its favor.

The fidelity insurer should also be cognizant of the possibility that it may be required to establish prejudice in connection with any claim that it should be discharged from liability based on the impairment of its subrogation rights. See discussion in Section 2 above. If applicable law imposes such a requirement, the insurer must consider whether it can establish the defense in the absence of proof that the claim against the third party tortfeasor had merit, or – perhaps most importantly – whether the tortfeasor possessed the resources to compensate the insurer had it pursued a subrogation action and prevailed against the tortfeasor.

## **5. Conclusion**

On their face, the provisions in the Standard Form 24 bond provide the fidelity insurer with substantial rights and protections relative to subrogation. In reality, however, many courts have been unwilling to give full effect to these contractual provisions. Courts have instead analyzed subrogation issues from a purely equitable standpoint, and have more often than not found against the insurer.

As such, fidelity insurers and their counsel must take great care to take steps from the outset of the claim to insure that subrogation rights are fully protected. This requires immediate identification of possible claims and subrogation targets. To the extent possible, the fidelity insurer should seek to place the burden on the insured and the insured's counsel to take all necessary steps to pursue potential wrongdoers.

When subrogation rights have been impaired, the insurer should evaluate the merits of any such defense with an eye toward its own conduct. If the record demonstrates that the insurer denied coverage from the outset, there will probably be no basis for the defense that subrogation rights have been impaired.

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