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**SUBROGATION AND THE FIDELITY INSURER
“Understanding and Avoiding the
Superior Equities Defense”**

PRESENTED BY:

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1. Introduction

For the fidelity insurer, the issues of recovery and salvage are always significant aspects of the claims handling process. A major weapon in the fidelity insurer's recovery arsenal is a subrogation claim against those persons or entities that are ultimately responsible for the financial loss suffered by the insured. The fidelity insurer's subrogation targets may include the insured's employees, directors and officers. Depending on the facts of a particular claim, the fidelity insurer may also have a subrogation claim against third parties whom it believes are responsible for the insured's loss, including accountants and attorneys employed by the insured.

In subrogation, the insurer steps into the shoes of its insured, and typically can assert all claims which the insured had or has against the defendant. As such, the insurer's subrogation claim is subject to any defense which could have been asserted by the defendant against the insured. In the context of fidelity insurance and financial institution bonds, courts have developed a second hurdle which the subrogating insurer must overcome. This is the "superior equities" defense.

Simply put, the superior equities doctrine holds that a fidelity insurer pursuing subrogation must establish that its equities are greater than those of the person who is the subject of the subrogation action. At its core, the doctrine is premised on the equitable notion that a fidelity insurer should not be permitted to both collect a premium from its insured and then shift the risk of loss from itself to the insured's employees and agents. The doctrine –sometimes termed the "compensated surety" defense – has been successfully invoked against fidelity insurers in a number of varying contexts, including subrogation claims against the insurer's employees, directors and officers and agents.

2. Conventional v. Equitable Subrogation:

Courts recognize the existence of two types of subrogation: conventional subrogation and equitable subrogation. Conventional subrogation occurs where the insurer pursues its claim by virtue of an express agreement with its insured. Typically, this agreement will consist of a written assignment of claims executed by the insured in favor of the insurer. In contrast, equitable subrogation occurs by operation of law. An insurer's right of equitable subrogation arises upon payment of the insured's claim, and the right of subrogation arises without the need for any written agreement or assignment of claim. As the term suggests, the insured's claim of legal subrogation arises as a matter of equity, and is premised upon the fundamental notion that the law should place the risk of loss ultimately on the party responsible for the loss.

Courts generally recognize the validity of either conventional or equitable subrogation. However, the type of subrogation pursued by the insurer may have a significant impact on the defendant's ability to prevail on a superior equities defense. Some fidelity insurers have prevailed on the argument that the superior equities doctrine is as a matter of law not applicable to conventional subrogation claims. The most recent – and most significant – case so holding is *National Union Fire Insurance Company v. Riggs National Bank*, 646 A.2d 966 (D.C.App. 1994) ("*Riggs*"). In *Riggs*, the fidelity insurer paid approximately \$600,000 in settlement of a claim made by its insured, a property

management company. The property management company claimed that unknown individuals had cashed 14 fraudulent checks on the insured's account with Riggs National Bank. Riggs refused to recredit the insured's account for the amount of the fraudulent checks. The insurer paid the loss. In consideration for its payment in satisfaction of the claim, the insurer received a written assignment of its insured's claims against Riggs. The insurer thereafter commenced a subrogation action against Riggs in federal district court. The insurer argued that the bank was liable pursuant to the terms of the Uniform Commercial Code ("UCC").

Riggs argued *inter alia* that it was not liable to the insurer because the superior equities doctrine applied and barred the insurer's action. The district court agreed and the insurer appealed to the United States Court of Appeals for the District of Columbia Circuit. *National Union Fire Insurance Company v. Riggs National Bank*, 5 F.3d 554 (D.C. Cir. 1993). The federal appeals court certified the case to the District of Columbia Court of Appeals, which court held that the superior equities rule did not act to bar the insurer's subrogation action. In reaching its conclusion, the court first noted the difference between equitable subrogation and conventional subrogation. Conventional subrogation "arises from an express or implied agreement between the payor and the debtor or creditor, in contrast to 'equitable subrogation', which arises from the mere fact of payment by a third party." *Riggs*, 646 A.2d at 969 quoting 11 Appleman, Insurance Law and Practice § 6501. Equitable subrogation is – as the term suggests – an equitable remedy which arises as a matter of law upon payment by the insurer, and requires no written contract or assignment by the insured. In contrast, conventional subrogation requires a contract or agreement between the insurer and the insured, usually in the form of a written assignment of the claim at the time of payment. *Id.*

The court in *Riggs* held that, as a matter of District of Columbia law, the superior equities doctrine does not apply in cases where the insurer pursues conventional subrogation pursuant to an express agreement or assignment from the insured. The court reasoned that the equities need not be balanced in the first instance because the remedy sought by the insurer was not grounded in equity, but instead flowed from an express contract between the insured and the insurer. The court further reasoned that, because of the assignment, the insurer stands directly in the shoes of its insured for purposes of pursuing the bank. Thus, allowing subrogation would not saddle the bank with new or unexpected liability, since the bank would have been liable directly to the depositor had the depositor never pursued its insurance claim. *Riggs*, 646 A.2d at 969. The court also noted that District of Columbia law evinces a policy of free assignability of claims, and the UCC further evinces an intent to assign the ultimate liability in these cases to the bank. Both of these factors provided further support for the insurer's claim that subrogation was permitted under these circumstances.

Another case holding that the superior equities doctrine does not apply in circumstances where the insurer pursues conventional – as opposed to equitable – subrogation is *Liberty Mutual Insurance Company v. Thunderbird Bank*, 555 P.2d 333 (Ariz. 1976) (en banc) ("*Thunderbird Bank*"). In *Thunderbird Bank*, the insurer again paid its insured for losses arising out of a fraudulent check scheme. The insurer obtained an express assignment from its insured and pursued the bank for its losses under the UCC.

The bank argued that the superior equities doctrine applied. The Supreme Court of Arizona rejected the argument, reasoning that the doctrine did not apply where the insurer pursued subrogation via an express assignment or written agreement. The court reasoned that the insurer's rights of recovery would be "measured by the law of contract and not by the equitable doctrine of subrogation." *Thunderbird Bank*, 555 P.2d at 337. The court further noted that it would be illogical to rule that the bank should escape liability simply because its customer "took the precaution of insuring itself against the risk of loss." *Id.* The bank suffers no prejudice by allowance of the subrogation action, since the cause of action against the bank is simply contractually shifted from the customer-insured to its insurer.

Other courts have adopted the rule that the superior equities doctrine will not apply in instances where the insurer pursues conventional subrogation via a contract or express assignment. *American Surety Company v. Baker*, 172 F.2d 689, 692 (4th Cir. 1949) (North Carolina law); *National Surety Company v. Bankers' Trust Company*, 228 N.W. 635 (Iowa 1930); *Aetna Casualty & Surety Company v. Lindell Trust Company*, 348 S.W.2d 558 (Mo.Ct.App. 1961); *Grubnau v. Centennial National Bank*, 124 A. 142 (1924).

In contrast to the cases cited above, other courts have held that enforcement of subrogation rights will *always* require that the insurer prove superior equities, because the right of subrogation – whether by contract or by operation of law – remains at its essence an equitable claim. *Castleman Construction Company v. Pennington*, 432 S.W.2d 669, 676 (Tenn. 1968) (discussing subrogation in the context of a title insurance policy). The leading case espousing this view in the context of a fidelity bond is *Meyers v. Bank of America National Trust & Savings Association*, 77 P.2d 1084 (Cal. 1938) (per curiam) ("*Meyers*"). In *Meyers*, the insured's office manager fraudulently endorsed checks, which were negotiated and paid by the bank. The insured received payment for its loss from its insurer and gave an assignment of its claim against the bank to its insurer. The insurer commenced a subrogation action against the bank. The bank argued that the insurer was required to prove superior equities in order to pursue subrogation. The insurer argued that the superior equities doctrine was not applicable since it was pursuing conventional – and not equitable - subrogation. The Supreme Court of California agreed with the bank, and held that the insurer was required to prove superior equities notwithstanding the existence of an express assignment. The court reasoned:

[O]ne who asserts a right of subrogation, whether by virtue of an assignment or otherwise, must first show a right in equity to be entitled to such subrogation, or substitution, and that where such right is clearly shown by the application of equitable principles, an assignment adds nothing to his right thereto. Otherwise stated, where by the application of equitable principles, a surety has been found not to be entitled to subrogation, an assignment will not confer upon him the right to be so substituted in an action at law upon the assignment.

Meyers, 77 P.2d at 1086.

Another case in the fidelity context holding that the superior equities doctrine will apply in a conventional subrogation action is *Dixie National Bank of Dade County v.*

Employers Commercial Union Insurance Company of America, 463 So.2d 1147 (Fla. 1985).

3. Subrogation Against the Employees, Directors and Officers of the Insured

The fidelity insurer's prime subrogation targets typically include the employees, directors and officers of its insured. Often the fidelity insurer's investigation discloses that losses caused by a dishonest employee could have been prevented – or at least minimized – had other employees or agents of the insured been more diligent in supervising the dishonest employee. Subrogation claims by fidelity insurers based on claims of inadequate supervision and negligence are typically defended based on the superior equities doctrine. As the following discussion indicates, courts have generally barred the fidelity insurer from pursuing subrogation claims against officers, directors and employees where (1) the insurer's claim is one of simple negligence and inadequate supervision and (2) the subrogation target did not personally benefit from the dishonest employee's actions.

Perhaps the seminal case regarding the application of the superior equities doctrine to subrogation claims by a fidelity insurer against the bank's directors and officers is *National Bank of Columbus v. Hansen*, 267 N.W.2d 367 (Wis. 1978) ("*Hansen*"). In *Hansen*, the fidelity insurer commenced a subrogation action against the directors and officers of an insured bank, alleging that the directors and officers were negligent in failing to prevent losses caused by the bank's executive vice-president, and that such negligence caused the loss to the bank. The directors and officers argued that the superior equities doctrine barred the subrogation claim. The *Hansen* court agreed:

The bonding companies have not alleged that these directors participated in the concealment of [the vice-president's] dishonesty or that their neglect of their duties is tantamount to fraud or bad faith. If such culpability were proved or if the dishonesty of the defaulting employee conferred some benefit upon the directors as individuals, it is clear that the balance of equities would shift to the fidelity insurer and a right of subrogation against the directors would be proper. But lack of ordinary care by the directors and officers of the insured does not give the fidelity insurer, who is paid to assume this risk, an equitable position superior to that of the officers and directors of the bank.

Hansen, 267 N.W.2d at 372.

Hansen has been followed by a majority of courts in the United States. See, e.g. *Community Federal Savings & Loan v. Transamerica, Inc.*, 559 F.Supp. 536 (E.D.Mo. 1983). In this case, the insured bank made a claim against its insurer on a Savings & Loan Blanket Bond for losses sustained when it purchased security interests which it believed were first mortgages. In reality the bank had been defrauded in the transaction by a mortgage company. The insurer commenced a subrogation action against an officer of the bank, alleging that the officer's negligence in handling the transaction caused the loss. The officer moved to dismiss the complaint on the grounds that the subrogation claim was barred by the superior equities doctrine. The court denied the motion to dismiss because the factual record was not sufficient to support the remedy. However, the court suggested

that it would not permit the insurer to proceed against the officer based on a mere claim of negligence. The court reasoned that it would be inequitable to conclude that the fraud of the mortgage company “should be offset or cancelled by [the officer’s] negligence.” *Community Federal Savings & Loan v. Transamerica, Inc.*, 559 F.Supp. at 538.

Another case invoking the doctrine is *Home Indemnity Company v. Shaffer*, 860 F.2d 186 (6th Cir. 1988) (“*Home Indemnity*”). In *Home Indemnity*, the insured bank sustained a significant loss because of the conversion of funds by its former president, and also due to related loan losses. Home issued a Savings and Loan Blanket Bond to the bank, and made payment of \$579,000 in settlement of the bank’s claim. Home thereafter commenced a subrogation action against the directors and officers of the bank. Home alleged that the directors and officers had been negligent, grossly negligent and acted in breach of their fiduciary duties. *Home Indemnity*, 860 F.2d at 187.

The directors and officers moved for summary judgment, arguing that the superior equities doctrine precluded the bank’s subrogation action. The district court granted the motion, and the Sixth Circuit Court of Appeals affirmed. *Id.* Applying Ohio law, the court held that “a fidelity insurer in the absence of fraud, bad faith or evidence that the individual directors derived a benefit from the defaulting employer’s dishonesty, may not recover from the insured’s officers and directors.” *Home*, 860 F.2d at 188. As the insurer could not present evidence suggesting fraud, bad faith or personal benefit to the directors and officers, the court refused to permit the insurer to proceed.

The court reasoned that the insurer’s acceptance of the bond premium from its insured evinces an acceptance by the insurer of the risk that the insured’s officers and directors may be negligent. Allowing Home to pursue these officers and directors would, the court reasoned, effectively permit the insurer to pursue subrogation against its own insured: “Although [the bank] is the named insured and its directors and officers are not named insureds, ... [the bank] nonetheless is an entity which can only act through its agents. The negligence of [the bank] is the negligence of its officers and directors who neglected their duties to supervise [the wrongdoer’s] activities and loans.” *Home*, 860 F.2d at 188.

The Supreme Court of Florida reached essentially the same conclusion in *Dixie National Bank of Dade County v. Employers Commercial Union Insurance Company of America*, 463 So.2d 1147 (Fla. 1985). Here the bank made claim against its insurer on a Bankers Blanket Bond for losses sustained as a result of embezzlement by a former cashier at the bank. The insurer settled the bond claim, took an assignment of the bank’s claims, and then commenced a subrogation against the directors of the bank. The insurer’s action against the directors sounded only in negligence. *Dixie National Bank of Dade County v. Employers Commercial Union Insurance Company of America*, 463 So.2d at 1149.

The directors asserted that the insurer’s claim was barred by the superior equities doctrine. The United States Court of Appeals for the Eleventh Circuit certified the issue to the Supreme Court of Florida. The Supreme Court of Florida agreed with the directors and held that a fidelity insurer seeking subrogation against an insured’s directors and officers must prove more than mere negligence in order to defeat the defense of the superior

equities doctrine. In so holding, the court first concluded that, under Florida law, the superior equities doctrine applies in cases where the insurer proceeds with either conventional or equitable subrogation. Thus the court rejected the insurer's argument that the assignment of claims which it obtained from the bank improved its position relative to the superior equities doctrine. *Dixie National Bank of Dade County v. Employers Commercial Union Insurance Company of America*, 463 So.2d at 1151.

The court next concluded that the "fidelity insurer's status as a paid insurer does establish superior equities in favor of the insured's directors and their insurer where the fidelity insurer merely asserted the directors' negligence as a basis for recovery." *Id.* at 1152. The court adopted the same rationale as set forth in *Home, supra*; i.e., the fidelity insurer assumes the risk of a loss caused by the directors and officers of its insured, and it would be inequitable to permit the fidelity insurer to pursue a subrogation action against its own insureds. *Id.* The court expressly adopted the reasoning set forth in *First National Bank of Columbus v. Hansen, supra*.

The United States District Court for the Central District of Illinois further limited the fidelity insurer's rights of subrogation against officers and directors of an insured financial institution in successive cases decided in 1987 and 1989. See *Employers Insurance of Wausau v. Doonan*, 664 F.Supp. 1220 (C.D.Ill. 1987) ("*Doonan I*") and 712 F.Supp. 1368 (C.D.Ill. 1989) ("*Doonan II*"). In *Doonan I*, the bank sustained a loss as a result of the fraudulent actions of its president and majority stockholder. The bank made claim on its banker's special bond, and the bank's insurer thereafter made payment to the bank in settlement of the claim. The insurer obtained an assignment of the bank's claims, and commenced a subrogation action against the bank's officers and directors. The insurer's claims against the directors sounded in negligence, gross negligence and recklessness.

The Court in *Doonan I* first outlined the three circumstances in which the fidelity insurer has been held to be subrogated to an insured's claims against employees or third persons. First, "upon payment of a loss caused by the wrongful acts of a bonded employee, a fidelity insurer becomes subrogated to any right of action the employer may have against the defaulting employee." *Doonan I*, 664 F.Supp. at 1223. Second, a fidelity insurer "is subrogated to the insured's claims against third persons, who have not acted in good faith with due care, or who are chargeable with notice of the wrongful acts of the bonded employee." *Id.* Third, the insurer may also be subrogated to "claims against third persons whose ordinary negligence contributed to the loss, particularly when the third person has benefited from the transaction." *Id.*

In *Doonan I*, the officers and directors argued that the insurer's claims of simple negligence were barred as a matter of law by the superior equities doctrine. The court agreed and adopted the reasoning set forth in *National Bank of Columbus v. Hansen*, 267 N.W.2d 367 (Wis. 1978) and *Dixie National Bank of Dade County v. Employers Commercial Union Insurance Company of America*, 463 So.2d 1147 (Fla. 1985). The court granted judgment on the pleadings as to the claims of subrogation based on negligence, and left open the question of whether the insurer could proceed with other claims against the directors and officers.

In *Doonan II* the Court concluded that the superior equities doctrine would also apply to bar an insurer's subrogation action against the insured's officers and directors, where the conduct of the officers and directors is alleged to be "greater than mere negligence but not rising to the level of fraud, bad faith, personal benefit or actual knowledge." *Doonan II*, 712 F.Supp. at 1369. The court reasoned that gross negligence on the part of the director or officer of the insured was still insufficient to overcome the presumption that the insurer had inferior equities: "The difference in degree between negligence and gross negligence or recklessness is simply not sufficient to shift the balance of equities in favor of the insurer.... The balance of equities approached equilibrium as the character of the conduct increases in egregiousness. However, absent evidence of some bad motive or actual discovery [of the wrongdoer's scheme], the balance does not shift and the insurer has no right of subrogation against agents of its insured." *Id.*

The United States District Court for the Eastern District of Tennessee provided a thorough discussion and summary of the caselaw regarding this issue in *Federal Savings & Loan Ins. Corp. v. Burdette*, 696 F.Supp. 1183 (E.D.Tenn. 1988) ("*Burdette*"). In this case the FSLIC as receiver for a bank sued the fidelity insurer for coverage under a savings and loan blanket bond for losses incurred by the bank as a result of the conduct of the former bank president and other officers and employees. The insurer commenced a third party action for indemnity based on subrogation principles against various officials of the bank. As it had no written assignment from the bank or the FSLIC, the insurer was proceeding under equitable subrogation principles.

The officials who had been sued by the insurer moved to dismiss the third party actions on the ground, *inter alia*, that the superior equities doctrine barred the action. Before analyzing the substance of the officials' claims, the court in *Burdette* first summarized the caselaw governing the superior equities doctrine. The court noted that the superior equities doctrine would not act as a bar to the insurer's subrogation claims where the insurer brings an action "against those 'active' wrongdoing employees causing the loss paid by the insurer." *Burdette*, 696 F.Supp. at 1193. The court offers no definition for the term 'active wrongdoer'.

One exception to this rule adheres where the "degree of wrongdoing alleged by the insurer is not sufficient to justify recovery under the terms of the bond." *Id.* Thus a fidelity insurer "may only sue active wrongdoing bank officials when the level of wrongdoing, be it negligence or fraud, is equal to or greater than the level of wrongdoing covered by the bond in question." *Id.* In short, if the bond covers only loss caused by the fraudulent and dishonest actions of an employee, and the insurer's subrogation claim against that employee alleges merely negligence, the subrogation claim cannot stand.

The *Burdette* court further noted that a second common type of subrogation claim occurs where the insurer pays a claim for losses caused by the conduct of certain employees of the financial institution, and the insurer thereafter commences an action against other employees alleging that they failed to discover and prevent the wrongdoing employees from causing the loss. In these instances, the *Burdette* court observed, the insurer's subrogation claim will not be permitted where the employees who failed to supervise are charged with "simple negligence." *Burdette*, 696 F.Supp. at 1193. An

exception to this rule exists, however, where the employee who failed to supervise obtained a personal benefit as a result of the misconduct of the employee whom they failed to properly supervise. Under these circumstances the superior equities doctrine will permit the insurer to proceed with its indemnity action.

The *Burdette* court held that the ambiguous nature of the fidelity insurer's allegations in its complaint made it difficult to ascertain whether its claims as pleaded could survive application of the superior equities doctrine. The court decided that the bank president was being sued as an "active wrongdoer", and the claims against him could therefore proceed. As to the rest of the defendants, the court noted that the complaint alleged both "active wrongdoing" and "inadequate supervision." Analyzing the terms of the bond, the court reasoned that the any claims based on simple or gross negligence would not be permitted because such claims were not covered under the bond. Conversely, any claims alleging dishonest or fraudulent actions with the manifest intent to cause a loss and sustain a benefit would be permitted because the bond provides coverage for such claims. *Burdette*, 696 F.Supp. at 1195. Finally, the court noted that all of the subrogation claims premised on inadequate supervision would be dismissed because such conduct is not the type covered by the bond itself. The court excepted from this ruling the inadequate supervision claims against officials who were alleged to have benefited from the improper conduct. *Id.*

While the majority view is that a fidelity insurer must allege more than mere simple negligence to proceed against its officers and directors on a subrogation theory, two courts have reached the contrary result. *Federal Deposit Insurance Corporation v. National Surety Company*, 434 F.Supp. 61 (E.D. New York 1977) ("*National Surety Company*") and *Manufacturers Bank and Trust v. Transamerica Insurance Company*, 568 F.Supp. 790 (E.D. Mo. 1983) ("*Transamerica*"). In *National Surety Company*, the insurers under a series of bankers blanket bonds commended a third party subrogation action against the outside directors of a bank. The court permitted the insurer's subrogation claims to stand even though they alleged only that the outside directors caused or permitted the bank's employees to engage in fraudulent conduct which caused a loss to the bank. *National Surety Company*, 434 F.Supp. at 64.

In *Transamerica*, the bank sought coverage from its insurer for loan losses. The insurer commenced a third-party action for subrogation against two officers of the bank. The insurer alleged that the negligence of the officers in connection with the loan transactions caused the loss. The officers sought dismissal on the grounds, *inter alia*, that the superior equities doctrine precluded the claim. Citing *National Surety Company, supra*, the court in *Transamerica* permitted the subrogation action to proceed. *Transamerica*, 568 F.Supp. at 792. The court noted – and then refused to follow – the line of authority commencing with *National Bank of Columbus v. Hansen*, 267 N.W.2d 367 (Wis. 1978). The court's brief analysis on this issue is simply that application of the superior equities doctrine would unfairly deprive the insurer of the "rights of an ordinary subrogee". *Transamerica*, 568 F.Supp. at 792. The court further reasoned that subrogation should be

allowed because the insured under the bond is the bank and not the bank's officers and directors. *Id.*¹

4. Subrogation Against Third Parties

The fidelity insurer's investigation may disclose that third parties with business relationships with the insured were negligent or were somehow at fault in connection with the insured loss. The insured may have causes of action against these third parties. The fidelity insurer may seek to assert these claims in the context of a subrogation action against the third parties. Several courts have addressed the application of the superior equities doctrine under these circumstances, with varying results.

The New York Court of Appeals addressed the superior equities defense in the context of a fidelity insurer's subrogation claim against an accountant in *Federal Insurance Company v. Arthur Andersen & Co.*, 552 N.E.2d 870 (1990). In this case, an employee of the insured had embezzled approximately \$4,000,000 from the insured over an eight-year period. Arthur Andersen was the insured's auditor and accountant during that time period, and failed to uncover the embezzlement scheme. The insured discovered the loss and sought reimbursement from its fidelity insurer. The insurer paid part of the claim and the insured assigned its negligence claim against Arthur Andersen to the insurer. The insurer thereafter commenced a subrogation action against Arthur Andersen, alleging that Andersen was negligent in failing to discover the fraudulent scheme. *Federal Insurance Company v. Arthur Andersen & Co.*, 552 N.E.2d at 871.

Arthur Andersen argued at trial and on appeal that the superior equities doctrine applied and barred the insurer's subrogation action. The New York Court of Appeals rejected this argument. The court first observed that the subrogation is "designed to dispense equity and justice among the parties ... and should not be permitted where the result will not be achieved." *Federal Insurance Company v. Arthur Andersen & Co.*, 552 N.E.2d at 875. Permitting subrogation in this case would not result in injustice because Arthur Andersen could assert any defenses in the subrogation action which it could otherwise assert as against the insured. *Id.*

Andersen argued that the insurer's equities were inferior as a matter of law because it was a compensated insurer and assumed the risk that it would be required to pay out on its policy. Andersen also argued that the "doctrine of superior equities calls for a denial of subrogation by a fidelity insurer in a case of this kind because of the particular nature of the obligations of an accountant and auditor and the inherent limitations in detecting errors or irregularities through the auditing process." *Federal Insurance Company v. Arthur Andersen & Co.*, 552 N.E.2d at 876. The court rejected Andersen's efforts to create a flat rule prohibiting subrogation by fidelity insurers against accountants and auditors. The court reasoned that adoption of Andersen's position would allow Andersen to benefit from the

¹ Some courts have rejected the superior equities doctrine in its entirety. See, e.g. *Hartford Fire Insurance Company v. Riefolo Construction Company*, 410 A.2d 658, 662 (N.J. 1980) (subrogee "need not show 'superior equities', but the conduct of the insurer must not be such as would make the granting of the relief unconscionable"). Cf. *South Carolina National Bank of Charleston v. Lake City State Bank*, 164 S.E.2d 103, 106 (S.C. 1968) (questioning applicability of superior equities defense given "modern banking practices.")

existence of the insured's fidelity policy: "In effect, defendant seeks to avail itself of [the insured's] fidelity insurance as its own liability policy without paying for it." *Id.*

The California Court of Appeals took a markedly different approach to the superior equities defense with respect to a fidelity insurer's subrogation claim against a third-party brokerage firm in *Continental Insurance Company v. Morgan, Olmstead, Kennedy & Gardner*, 148 Cal.Rptr. 57 (1978) ("*Continental*"). In *Continental*, Manufacturer's Bank held a significant amount of United States treasury bills, which it allowed to be stolen from one of its offices. The person who stole the bills thereafter liquidated them through Morgan, a brokerage firm. Manufacturer's Bank recovered the amount of its losses from its fidelity insurer. The insurer thereafter commenced a subrogation action against Morgan. The insurer claimed that Morgan failed to exercise due diligence in determining that the treasury bills had been stolen and improperly obtained from Manufacturer's. Morgan argued that subrogation should not be permitted because the insurer lacked superior equities. *Continental*, 148 Cal.Rptr. at 62.

The California Court of Appeals held that the insurer's subrogation claim was barred by the superior equities doctrine. In reaching this conclusion, the court noted that the surety – in order to avoid the application of the superior equities doctrine in a subrogation claim against a third party – must establish that the third party "is in a better position to avoid the loss than is the insured or the surety." *Continental*, 148 Cal.Rptr. at 63. Thus, the "fault of the third person which creates the superior equity in the surety suing in subrogation must be related to the 'primary cause' of the loss." *Id.*

Applying this rule to the case at hand, the court had no difficulty in concluding that the insurer's equities were inferior to Morgan's. The court reasoned that the 'primary cause' of the loss was the negligence of Manufacturer's Bank in failing to take minimal measures to protect the treasury bills which were stolen and converted. (The evidence showed that Manufacturer's left large piles of the bills unattended and in plain view of workmen and employees, who had unfettered access to the bills for significant periods of time). The court also noted that, while Morgan may have been negligent in failing to ascertain whether the Bills were stolen, such negligence was secondary to the Manufacturer's malfeasance. In short, Morgan was in no better position to avoid this loss than Manufacturer's. *Continental*, 148 Cal.Rptr. at 64.

The insurer also argued that the superior equities doctrine should not apply because Morgan itself had insurance to cover the subrogation claim. The court easily rejected this argument, concluding that the existence *vel non* of indemnity insurance in favor of the defendant in a subrogation action does not improve the equity position of the subrogating insurer. *Id.* In dicta, the *Continental* court suggested that subrogation claims against banks based upon the bank's honoring of checks forged by an employee of the insured would not be permitted "absent some negligent conduct [by the bank] of a character which promotes or encourages the employee's fraud, [since] the bank is not in a better position to avoid the loss than is the insured's employer." *Continental*, 148 Cal.Rptr. at 63. In contrast, the court observed that a subrogation action against a bank could be maintained "in the case of a bank grossly departing from its own and generally accepted practices, [because] the trier of

fact could find that the departure was the primary cause and the departure such that the bank failed to avoid the loss where it was in the best position to do so.” *Id.*

Other courts have permitted insurers and sureties to pursue subrogation claims against accountants and auditors notwithstanding the existence of the superior equities defense. *Western Surety Company v. Loy*, 594 P.2d 257 (Kan.App. 1979) (surety on fidelity treasurer’s bond permitted to pursue subrogation action in negligence against accountant; the surety would be required to prove superior equities to maintain the action, and the court notes that from the record there appeared to be no doubt but that the surety could in fact establish superior equities); *Maryland Casualty Co. v. Cook*, 35 F.Supp. 160 (E.D.Mich. 1940) (permitting fidelity insurer to pursue subrogation action against accountant); *National Surety Company v. Lybrand*, 256 App.Div. 226, 9 N.Y.S.2d 554 (1939).

The United States District Court for the Eastern District of Pennsylvania discussed the superior equities doctrine in the context of a subrogation claim by a fidelity insurer against a bank in *General Accident Insurance Company v. Fidelity & Deposit Co. of Maryland*, 598 F.Supp. 1223 (E.D.Penn. 1984). Here the insured – General Accident – sought recovery against its insurer under a blanket bond for \$2,000,000 in losses sustained as a result of a check forging scheme perpetrated by some of its employees. The insurer commenced third party subrogation actions against several banks involved in the collection process. The banks moved to dismiss the actions on the grounds, *inter alia*, of the superior equities doctrine.

The court denied the motions to dismiss, principally on the grounds that the issue was too fact specific to be decided in the context of a motion to dismiss. The court noted in dicta that as the insurer had alleged that at least one bank had been involved as a party to the conspiracy, and that such involvement would support a “substantial argument” that the equities doctrine would not bar the action. The court further noted that previous decisions addressing the superior equities doctrine in the context of claims against banks may no longer be valid due to the existence of Uniform Commercial Code § 3-405. This provision addresses fraudulent endorsements made by an employee with respect to instruments with respect to which the employer has entrusted responsibility to the employee. Section 3-405(b) provides that where a bank fails to exercise ordinary care in the collection process with regard to a fraudulent check and that failure substantially contributes to the loss, the employer who sustained a loss as a result of the fraud may shift that loss to the bank to the extent that the failure to exercise ordinary care contributed to the loss. The court in *General Accident Insurance Company v. Fidelity & Deposit Co. of Maryland* suggests – but does not expressly hold – that § 3-405 may displace the superior equities doctrine, and would thus permit the fidelity insurer to pursue the banks in subrogation.

Other courts have refused to permit either conventional or equitable subrogation against banks based on the novel theory that the insured’s acceptance of payment from its insurer destroyed any claim which the insured could have maintained against the bank or wrongdoing party. *Bank of Fort Mill v. Lawyers Title Insurance Corporation*, 268 F.2d 313, 316 (4th Cir. 1959) and *American Surety Company v. Bank of California*, 133 F.2d 160, 164 (9th Cir. 1943). In both of these cases the insurer paid its insured for the loss and took

written assignments from the insureds. The insurers thereafter commenced conventional subrogation actions against banks to recover their losses. In both cases the courts refused to permit the subrogation actions. The courts reasoned that upon payment by the insurers of the insured's claim, the insured's right of action against the banks was destroyed because the law could not permit "dual recovery" by the insured (*i.e.*, recovery for the same losses from both the insurer and the bank). In essence, the payment by the insurer extinguished the debt, and the insurer could not obtain the benefit of the assignment of a claim which no longer existed. *American Surety Company v. Bank of California*, 133 F.2d at 164. *Bank of Fort Mill v. Lawyers Title Insurance Corporation*, 268 F.2d at 316.

5. Conclusion

The superior equities doctrine can present a formidable obstacle to the fidelity insurer pursuing subrogation. To the extent possible the insurer should obtain a written assignment of claims for its insured, and should pursue both conventional and equitable subrogation. The insurer must always consider raising the argument that the superior equities doctrine does not as a matter of law apply to claims of conventional subrogation.

With respect to the officers and directors of the insured, in most jurisdictions the fidelity insurer's subrogation claim will fail as a matter of law where the allegations and evidence establish mere negligence on the part of the defendant, or where the defendant did not obtain a benefit from the loss at issue. Thus the fidelity insurer and its counsel must carefully evaluate its evidence against the subrogation target and make a realistic judgment as to whether it can pass muster under this standard.

As to subrogation claims against third parties such as banks, accountants, attorneys and brokerage firms, the law appears to be much less settled. The opinion of the New York Court of Appeals in *Federal Insurance Company v. Arthur Andersen & Co.*, suggests that the superior equities doctrine will have limited applicability in these cases. In contrast, *Continental Insurance Company v. Morgan, Olmstead, Kennedy & Gardner* suggests that the fidelity insurer must meet the high burden of showing that the third party was in a better position to avoid the loss than the insured.

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