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**RES JUDICATA AND COLLATERAL ESTOPPEL IN
SURETY AND FIDELITY BOND CASES**

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I. Introduction

This paper deals with the preclusive effects of a judgment rendered in cases involving surety and fidelity bonds. Specifically, this paper will address the question of whether a prior lawsuit has any impact on a party that was not participating in that lawsuit, and if so, how far that impact goes. There is considerable confusion in this area of law as various courts have attempted to resolve the tension between the competing legal principles of judicial efficiency and homogeneity of legal decisions on the one hand and the fundamental right to be heard on the other hand in different ways.

The paper will examine the traditional judicial tools that are designed to balance the above-mentioned principles: *res judicata* and *collateral estoppel*.¹ In addition, the paper will analyze several rather specific rules developed by courts and adopted by secondary legal sources and thereby try to provide an overview of this legal issue as well as a practical guide for discerning the likely application of *res judicata* and *collateral estoppel*.

A. Res Judicata and Collateral Estoppel in Surety Cases

Litigation among the Obligee, Principal and Surety may arise upon default by the Principal of its obligations to the Obligee. In such litigation, the Obligee has several options. It can sue the both the Principal Obligor and the Surety², or only one of the two parties. If it chooses the latter option, then it needs to be determined what effect a judgment in that case (no matter in whose favor) has on the remaining party if another lawsuit ensues between the Obligee and the remaining party, or between the Principal and the Surety. The possible scenarios include the following:

- Obligee sues the Principal and obtains a default judgment
- Obligee sues the Principal and obtains a judgment on the merits
- Obligee sues the Principal and the Principal obtains a judgment in its favor
- Obligee sues the Surety and obtains a default (or other) judgment
- Obligee sues the Surety and obtains a judgment on the merits
- Obligee sues the Surety and the Surety obtains a judgment in its favor

¹ For a another good discussion of *res judicata* and *collateral estoppel* and their application to sureties, see James D. Ferrucci: Preclusive Effect Upon the Surety of Prior Judgment or Arbitration Award Against the Principal in: Kevin L. Lybeck and H. Bruce Shreves (editors): *The Law of Payment Bonds*, American Bar Association 1998.

² A Surety's obligation is coextensive with that of the Principal, see for example *Mayle v. Aetna Casualty & Surety Co.*, 166 S.E.2d 133, 136, and usually not conditioned on an attempt of the Obligee to compel performance from the principal obligor. Only default on the part of the principal obligor is required.

The questions that can arise from the above-mentioned scenarios, with regard to preclusion, include:

- What effect does a judgment in favor of Obligee in a lawsuit between Obligee and Principal have on a subsequent lawsuit between Obligee and Surety?
- What effect does a judgment in favor of the Principal in a lawsuit involving the Obligee versus the Principal have on a subsequent lawsuit between the Obligee and the Surety?
- What effect does a judgment in favor of the Obligee in a lawsuit involving the Obligee versus the Surety have on a subsequent lawsuit between the Surety (seeking subrogation) and the Principal?
- What effect does a judgment in favor of the Surety in a lawsuit involving the Obligee versus the Surety have on a subsequent lawsuit between the Obligee and the Principal?
- What effect does a judgment in favor of the Obligee in a lawsuit involving the Obligee versus the Surety have on a subsequent lawsuit between the Obligee and the Principal?

B. Res Judicata and Collateral Estoppel in Fidelity Cases

Res Judicata and Collateral Estoppel may be implicated in fidelity cases as well. Litigation pertaining to a fidelity bond or fidelity insurance may arise over coverage issues. In such litigation, the obligee or insured may sue the alleged defalcator as well as the fidelity bond surety or fidelity insurer, or only one of the two parties. If it chooses the latter option, then, as in surety cases, it needs to be determined what effect a judgment in that case has on the remaining party if another lawsuit ensues between the obligee or insured and the remaining party or between the alleged defalcator and the surety or insurer.

II. General Rules for Claim Preclusion and Issue

As a logical starting point, it makes sense to first look at the general rules with regard to the preclusive effect of earlier decisions on subsequent litigation.

Res Judicata is a legal doctrine that consists of two separate parts: true Res Judicata (claim preclusion) and Collateral Estoppel (issue preclusion). It is difficult and confusing to deal with court decisions applying these doctrines because courts tend to simply use the term “res judicata” no matter which one of the doctrines they are actually discussing. Also, courts often fail to state which one of the doctrines they discuss and why that particular doctrine is (or is not) applicable in a specific fact situation. Clearly, however, there are general requirements for both parts of the Doctrine of Res Judicata.

True Res Judicata (or claim preclusion) requires that a valid and final judgment on a claim preclude a second action on that claim or any part of it. In order to establish Res

Judicata, number of elements must be present:³

Identity of Claims

The first requirement for res judicata is that the claim(s) decided in the previous lawsuit must have been identical with the one(s) presented in the action in question.⁴

Final Judgment on the merits

The second requirement for res judicata is that there must have been a final⁵ judgment on the merits.⁶ One could argue that Res Judicata does not apply where a default judgment is entered, especially when imposed as a sanction for non-compliance with discovery orders, or if an action is dismissed with prejudice⁷ because the court in those situations never actually reaches the merits of the case. In many states, however, a default judgment is deemed to be a judgment on the merits⁸ for preclusion purposes. Therefore, like other judgments on the merits, the default judgment in such states has res judicata effect as to all issues that were or could have been raised⁹ in the prior proceeding.¹⁰ Dismissals without prejudice are somewhat problematic because there is the question of whether they constitute a final decision on the merits and therefore render Res Judicata principles inapplicable. While the federal rule governing the effect of involuntary dismissals seems to clearly award preclusive effect to all such dismissals except to those resulting from lack of jurisdiction, improper venue, and failure to join a party,¹¹ the United States Supreme Court has ruled that not all adjudications denominated to be “on the merits” are “entitled to...preclusive effect.”¹² The Court, finding that the term “judgment on the merits” had changed over time,¹³ cited decisions of different state courts that distinguished between dismissals that make a determination concerning a petition and those that actually make a determination with regard to a claim in support of its decision.¹⁴

³ The required elements are generally the same in most jurisdictions, having been established as part of the common law. In Missouri, the elements are often described as follows: 1. identity of the thing sued for, 2. identity of the cause of action, 3. identity of the persons or parties to the action, and 4. identity of the quality of the person for or against whom a claim is made, see *Prentzler v. Schneider*, 411 S.W.2d 135 (Mo.Banc 1966).

⁴ See, for example, *Marshall v. Inn on Madeleine Island*, 631 N.W.2d 113, 114 (Minn.App. 2001) citing *Leimert v. McCann*, 255 N.W.2d 526, 528, 529 (Wis. 1977).

⁵ See Restatement (Second) of Judgments, Section 13, comment b.

⁶ *Gall v. South Branch National Bank of South Dakota, of Sioux Falls, S.D.*, 783 F.2d 125, 127 (8th Cir. 1986).

⁷ See *Denny v. Mathieu*, 452 S.W.2d 114, 118-119 (Mo. Sup. Ct. 1970).

⁸ See, for example, *Ha v. T.W. Smith Corp.*, 714 N.Y.S.2d 873, 896 (N.Y. 2000); *State ex rel. Agee v. Chapman*, 922 S.W.2d 516, 518 (Tenn. Ct. App. 1995); *Reyes v. Jackson*, 861 S.W.2d 554, 555 (Arkansas Ct. App. 1993); *Morgan Guar. Trust Co. of New York v. Staats*, 631 A.2d 631, 638 (Penn. S. Ct. 1993). Other jurisdictions are reluctant to give preclusive effect to default judgments, see for example *Wall v. Stinson*, 983 P.2d 736, 740 (Alaska 1999), or, at least with regard to issue preclusion, refuse to do so entirely, see for example *Blea v. Sandoval*, 761 P.2d 432, 436 (N.M. App., 1988).

⁹ *Defford v. Zurheide-Hermann, Inc.*, 536 S.W.2d 804, 809, 810 (Mo.App. 1976).

¹⁰ For the preclusive effect of other involuntary dismissals see general Collateral Estoppel discussion, infra.

¹¹ FRCP 41 (b): “[...] Unless the court in its order for dismissal otherwise specifies, a dismissal under this subdivision and any dismissal not provided for in this rule, other than a dismissal for lack of jurisdiction, for improper venue, or for failure to join a party under rule 19, operates as an **adjudication upon the merits.**”

¹² *Semtek International Inc. v. Lockheed Martin Corp.*, 121 S.Ct. 1021, 1025 (U.S. Sup.Ct. 2001).

¹³ *Id.*

¹⁴ See for example *Western Coal & Mining Co. v. Jones*, 167 P.2d 719, 724 (California 1946); *Allston v. Incorporated Village of Rockville Centre*, 267 N.Y.S.2d 564, 565-566 (N.Y. App.Div. 1966). An exhaustive article

Identity of Parties

A further precondition for the application of True Res Judicata is that the parties to both the former and the subsequent action must be the same.¹⁵

Collateral Estoppel (issue preclusion) is applicable where the cause of action (claim) in the second lawsuit is not identical to the claim in the prior proceeding. This doctrine, which is another subpart of the Res Judicata Doctrine, mandates that an issue on which a determination has been rendered in a final judgment on the merits is binding in subsequent litigation involving a different claim between the same parties or persons in privity to those parties.¹⁶ It also prohibits re-litigation of issues between a party to the original lawsuit and a stranger to that action.¹⁷ In order for the doctrine to bar re-litigation of an issue that was part of the previous lawsuit, those issues must actually have been litigated¹⁸ and determined. A further requirement is that resolution of the issue common to both lawsuits has actually been necessary in reaching a decision in the first case.¹⁹

Even if the above-mentioned preconditions have been met, the courts still have broad discretion²⁰ not to apply the Doctrine of Collateral Estoppel for reasons of fairness. In order to determine whether it would be unfair to impose Collateral Estoppel upon a party, courts look at whether such party has had a full and fair opportunity and incentive in the first action to litigate the issue in question.²¹ Courts have adopted a kind of totality of circumstances test to determine whether it is fair to apply the doctrine, considering, among others, the nature of the claim, the forum, competence and experience of the legal counsel, availability of evidence, and availability of discovery. Traditionally, Collateral Estoppel only had binding effect if the parties to the second action were identical to the parties involved in the previous litigation. Recently, however, many states have extended the applicability of the doctrine to cases involving parties different from the ones involved in the original lawsuit. This non-mutual form of Collateral Estoppel can be defensive in nature²² (defendant asserts that plaintiff is estopped from re-litigating an issue that has been resolved in defendant's favor in an earlier case involving a

concerning this topic for Missouri is found in: Dudley McCarter and Christopher L. Kanzler: Dismissal Without Prejudice: A Deadly Trap for the Unwary!, *Journal of the Missouri Bar*, Volume 56, No 4.

¹⁵ This does not mean that there may not be additional parties in the subsequent lawsuit so long as their presence is not required to decide the issue in question, see *Defford v. Zurheide*, p. 808, or that the parties have to be identical; mere privity is enough, see *Alaska Sport Fishing Ass'n v. Exxon Corp.*, 34 F.3d 769, 773 (C.A. 9, Alaska 1994).

¹⁶ *Shanan v. Shanan*, 988 S.W.2d 529, 532 (Mo 1999); *Hanna v. Read*, 102 Ill. 596 (Ill. 1882); *Tyndall v. Tyndall*, 238 A.2d 343, 346 (Del. Sup. Ct 1968); *People v. Gates*, 452 N.W.2d 627, 630 (Mich. 1990).

¹⁷ See p. 7 *infra*.

¹⁸ Which is why Collateral Estoppel is generally held inapplicable to default judgments, compare Sections 13 and 27 of the Restatement (Second) of Judgments.

¹⁹ For a description of the four classic elements see *Johnson v. Miera*, 926 F.2d 741 (8th Cir. 1991); *Tyndall v. Tyndall*, p. 346; *People v. Gates*, p. 630.

²⁰ *Parklane Hosiery Company, Inc. v. Shore*, 439 U.S. 322, 330-331 (U.S. Sup. Ct. 1979 [for offensive use of Coll. Estoppel]).

²¹ *Oates v. Safeco Insurance Co. of America*, 583 S.W.2d 713, 719 - 721 (Mo. 1979); *Commissioners of State Ins. Funds v. Low*, 148 N.E.2d 136, 138 (N.Y. 1958); *Industrial Comm. of State v. Moffat County School Dist.* RE No 1, 732 P.2d 616, 619-620 (Colo. 1987).

²² *Oates v. Safeco*, p. 719, *supra*.

different defendant), or offensive²³ (plaintiff in the later action estops defendant from re-litigating an issue resolved in plaintiff's favor in an earlier case involving a different plaintiff). Application of offensive Collateral Estoppel requires careful consideration of fairness²⁴ towards the person against whom the doctrine is asserted.

III. How Courts Apply the Doctrine in Suretyship Cases

Courts do not uniformly apply the general principles set forth above to suretyship situations. Many jurisdictions also apply other legal formulas to resolve the issue. Various different elements are taken into account by the courts, among them the question of whether or not there is privity²⁵ between the Principal and the Surety (and, as part of that, whether their interests are congruent), whether the Surety had a chance to litigate the important issues of the second proceeding in the course of the first lawsuit, and others. Therefore it is necessary to look at some of the various decisions in this field in order to illustrate the different ways in which courts approach preclusion. We will start with the preclusive effect of prior judgments against the Principal.

A. Obligee Institutes Action Against Principal and Prevails

The obligee sues the principal for default under the contract.

If the Obligee obtains a favorable judgment or award against the Principal before suing the Surety, the nature of the previous proceeding and the award have a substantial impact on what kind of preclusive effect (if any) the courts attribute to such a ruling.

1. Default Judgment

The principal fails to file an answer and the court enters a default judgment against it. Because the principal is insolvent, the obligee then brings an action against the surety.

In cases where the Obligee obtained a default judgment against the Principal and then sued the Surety (for example because the Principal is insolvent), court decisions have ranged between attributing full preclusive effect to the prior decision²⁶ and not attributing any such effect to the judgment in the prior proceeding.²⁷ Only a few decisions hold that a Surety is

²³ See *In re Caranchini*, 956 S.W.2d 910, 912 (Mo. 1997)

²⁴ See *Matter of Swate*, 99 F.3d 1282, 1290 (5th Circuit 1996) citing *Recover Edge L.P. v. Pentecost*, 44 F.3d 1284, 1290 (5th Circuit 1995), with further reference, for the fact that the fairness requirement for Collateral Estoppel in general originated as a limitation on offensive Collateral Estoppel.

²⁵ "Privity" is a somewhat troublesome legal construction in that the definitions for it vary widely and often are of little use for determining whether or not parties are privies. Privity is commonly defined as "*mutual successive relationships to the same rights of property*," *Shire Realty Corp. v. Schorr*, 390 N.Y.S.2d 622, 625 (N.Y. App.Div. 1977). Courts look at the specific facts of the case and tend to hold that parties are in privity to each other whenever it seems just to bind the non-party, see *Rhode Island Hosp. Trust National Bank v. Ohio Cas. Ins. Co.*, 789 F.2d 74, 82 (1st Circuit 1986) citing *Moore's Federal Practice*, para. 0.411 [1] at 392.

²⁶ See *First Mobile Home Corp. v. Little*, 298 So.2d 676, 682-683 (Miss. 1974); *Ward v. Federal Insurance Co.*, 106 S.E.2d 169, 170-171 (S.C. 1958).

²⁷ See for example *Leszauskis v. Downs*, 121 N.E. 590, 591 (Ill. 1918); *Monmouth Lumber Co. v. Indemnity Ins. Co. of North America*, 122 A.2d 604, 608 (N.J. 1956); *Shapiro v. Marstone Distributors, Inc.*, 328 N.Y.S.2d 592,

conclusively bound by a default judgment entered against the Principal. Under the Doctrine of Collateral Estoppel, such a decision cannot be reached due to the fact that the issue of the Principal's liability has neither been litigated nor decided.

A majority of courts hold that a default judgment against the Principal does not, in and of itself, preclude the Surety from re-litigating the issues that were part of the first lawsuit.²⁸ Some decisions suggest that the previous judgment should not be given full preclusive effect without requiring the presence of any additional circumstances,²⁹ which is in line with Section 139 (3) of the Restatement of Security³⁰ and Section 67 (3) of the Restatement, 3rd, of Suretyship and Guaranty.³¹ The reasoning behind not attributing any preclusive effect to a prior default judgment against the Principal is that the probative value of such a judgment is rather low. In addition, there is no necessity to bolster the efficiency of the judiciary by limiting trials on identical issues when the determination made in the first lawsuit does not rest on the consideration of evidence introduced by both parties to the prior lawsuit.³² Other courts hold that the prior default judgment against the Principal has preclusive effect on the Surety only if the latter one had notice or an opportunity to defend in the prior action.³³

A third group of cases holds that the prior judgment against the Principal is only prima facie evidence of the Surety's liability³⁴ or creates a rebuttable presumption of the Principal's liability³⁵ in the subsequent lawsuit against the Surety. These two approaches are not identical because the outcome of a trial may turn on whether there is evidence only of the Principal's liability, or of the liability of the Surety itself.

Other courts base their decisions as to the preclusive effect of a default judgment against the Principal on the Surety's conduct. These cases hold that the Surety is precluded from re-litigating issues of the previous lawsuit only if it ignored an opportunity to join in the lawsuit and defend itself.³⁶

594 (N.Y.A.D. 2 Dept. 1971); Treasurer and Receiver General v. Macdale Warehouse Co., 160 N.E. 434, 437 (Mass. 1928).

²⁸ See footnotes 31, 34, 35, and 36, *infra*, and accompanying text.

²⁹ United States v. Hayes, 369 F.2d 671, 675 (9th Circuit 1966).

³⁰ *"Where, in an action by a creditor against a principal, judgment is obtained by default or confession against the principal, and the creditor subsequently brings an action against the surety, proof of the judgment against the principal is evidence only of its rendition."*

³¹ *"When, in an action by the obligee against the principal obligor to enforce the underlying obligation, a judgment in favor of the obligee is obtained by default, confession, stipulation, or the like, the judgment against the principal obligor is evidence only of its rendition in a subsequent action of the obligee against the secondary obligor to enforce the secondary obligation."*

³² See comment e to § 139 (3) of the Restatement of Security and comment c to § 67 (3) of the Restatement, 3rd of Suretyship and Guaranty.

³³ Ohio Casualty Co. v. Kentucky Natural Resources and Environmental Protection Cabinet, 722 S.W.2d 290, 294-295 (Ky.App. 1986).

³⁴ See Heritage Insurance Co. of America v. Foster Electric Co., 393 So.2d 28, 29 (Fla.App. 3 Dist. 1981); Home Ins. Co. of New York v. Savage, 103 S.W.2d 900, 902 (Mo.App. 1937); Sette-Juliano Contracting, Inc. v. Aetna Cas. & Sur. Co., 674 N.Y.S2d 654, 658 (N.Y.A.D. 1 Dept. 1998).

³⁵ See Rouse Constr., Inc. v. Transamerica Ins. Co., 750 F.2d 1492, 1493-1494 (C.A.Ga 1985).

³⁶ See for example Kentucky Ins. Guar. Association v. Dooley Construction Co., 732 S.W.2d 887, 888 (Ky.Ct.App. 1987).

2. Judgments on the Merits Against the Principal

The principal defends and the court, after a full trial, enters judgment in favor of the obligee. Because the principal is insolvent, the obligee brings an action against the surety to recover from it.

In case the Obligee in the first lawsuit obtained a judgment on the merits against the Principal, court decisions come to varying and conflicting results concerning the preclusive effects of such judgment against the Surety in a subsequent proceeding. When the Surety's liability is based on a judgment bond, courts concur that the Surety, absent fraud or collusion, is always bound by the prior judgment against the Principal.³⁷ This makes sense and is fair because the Surety expressly agreed to be liable for any judgment against the Principal. If the Surety's liability is based on a general undertaking bond, i.e. a bond that covers general undertakings of the principal as opposed to covering any and all judgments rendered against the principal, full preclusive effect under any circumstances is usually only given with respect to awards resulting from arbitration where the bond incorporated the Principal's agreement to arbitrate. In the remaining cases involving general undertaking bonds, courts have held that a previous judgment against the principal has either no preclusive effect,³⁸ only limited preclusive effect, or full preclusive effect if some additional prerequisites have been met.

The few decisions suggesting that there is no preclusive effect resulting from the prior judgment against the principal seem to rely on the general principles of Res Judicata and Collateral Estoppel. If courts attribute full preclusive effect to a prior judgment on the merits against the principal, they usually do so only if certain additional circumstances are present, such as knowledge of the previous action and the opportunity to defend in that action.³⁹ This approach is related to the principle stated in the Restatement (Second) of Judgments,⁴⁰ which says that a nonparty to an action who participates substantially in that action, is bound by the determination of the issues decided in that case as if the nonparty had been a party to the lawsuit. Secondary obligors have been held to be bound by prior judgments against the principal obligor based on this legal principle.⁴¹

The Restatement of Security⁴² and the Restatement (Third) of Suretyship and Guaranty⁴³ takes an "intermediate" type approach with regard to the preclusive effect of a prior decision on the merits against the Principal. The Surety that has subsequently been sued is not barred from re-litigating issues resolved in the prior lawsuit but the judgment creates a

³⁷ See for example *United States Fidelity & Guaranty Co. v. Paulk*, 15 S.W.2d 100, 104 (Tex.Cir.App. 1929); *Howze v. Surety Corp. of America*, 584 S.W.2d 263. (Tex.Civ.App.-Austin 1978).

³⁸ See for example *United States v. Maryland Casualty Co.*, 204 F.2d 912 (5th Circuit 1953) and *Ward v. LaMonico*, 735 P.2d 92, 96 (Wash.Ct.App. 1987). In some states, this outcome is mandated by statutory law, see for example W.Va. Code § 45-1-3

³⁹ See for example *Von Engineering Co. v. R.W. Roberts Construction Co.*, 457 So.2d 1080, 1082 (Fla 1980).

⁴⁰ See Section 39.

⁴¹ See *E.B.R. Corp. v. PSL Air Lease Corp.*, 313 A.2d 893, 895 (Del. 1973).

⁴² See Section 139 (3), see *supra*.

⁴³ See Section 67 (2): "*When, in an action by the obligee against the principal obligor to enforce the underlying obligation, a judgment is given in favor of the obligee other than by default, confession, stipulation, or the like, the judgment creates a rebuttable presumption of the principal obligor's liability to the obligee in a subsequent action of the obligee against the secondary obligor to enforce the secondary obligation.*"

rebuttable presumption in favor of the Obligee.⁴⁴ The majority of courts seem to follow this rule. An example of this majority approach is in the case of *Ward v. LaMonico*⁴⁵ where the court held that the judgment against the Principal merely created a presumption concerning the Principal's liability in a subsequent lawsuit between the Obligee and the Surety.⁴⁶ The reason for this treatment of the issue is the attempt to balance the competing policies mentioned earlier in a just way. Courts that apply the intermediate approach (and thus follow the Restatements) do so because they find it unfair to have the Surety bound by a judgment he was not a party to. They also recognize the need to attribute some weight to the prior judgment in order to relieve the courts from multiple lawsuits on the same issues. By limiting the effect of the prior judgment to a presumption against the Surety, the Surety has the opportunity to convince the court it should have ruled differently in the first proceeding while having to overcome a presumption of correctness with respect to the prior judgment.⁴⁷ As already mentioned above with respect to default judgments, there is a similar approach that is based on the same kind of compromise, the "prima facie" approach. While the preclusive effect of the prima facie approach can be stronger as it may shift the burden of proof, most courts that apply it add some additional factors that are required to be present. As a result, this restricts the number of "eligible" cases beyond the Restatement approach where no further preconditions⁴⁸ need to be present.

B. Obligee sues Principal and Principal Prevails

The principal raises defenses, for example the defense that there was, in fact, no default. The court finds for the principal. The obligee then goes on to sue the surety.

Let us assume the Obligee sues the principal and the principal prevails. The general rules of Res Judicata and Collateral Estoppel seem to bar the Obligee as a party to the previous lawsuit from asserting the same claim against the Surety. Most courts do, in fact, reach this result even though they may not mention the classic doctrines of preclusion. Some decisions just observe that because the Surety's liability is based on the liability of the Principal, the Surety's liability cannot exceed that of the Principal.⁴⁹ Thus, if the Principal is not found to be liable at all, the Surety can usually not be held liable either.⁵⁰ Exceptions to this rule may exist where the Principal is not liable based on a personal defense or if the Surety made an unconditional promise to answer for a debt of the Principal. Both the Restatements are in line with the above-mentioned decisions. The Restatement of Security in Section 139 (1) makes a seemingly absolute statement to the effect that proof of a prior judgment in favor

⁴⁴ Id.

⁴⁵ 47 Wash.App. 373, 380.

⁴⁶ *Ford Motor Co. v. Transport Indemnity Co.*, 41 B.R. 433, 440 (D.C. Mich. 1984) and *Howze v. Surety Corp. of America*, p. 837 represent similar decisions holding that the prior judgment against Principal is prima facie evidence of Surety's liability.

⁴⁷ See comment b to Section 67 (2) of the Restatement (Third) of Suretyship and Guaranty.

⁴⁸ Such as a notice requirement, see for example *Von Engineering Co. v. R.W. Roberts Construction Co.* 1082.

⁴⁹ *J.R. Watkins Co. v. Lankford*, 256 S.W.2d 788, 793 (Mo. 1953); *Rhode Island Hospital Trust National Bank v. Ohio Casualty Insurance Company*, 789 F.2d 74, 79 (L.A. 1 (R.I.) 1986) citing *Stifel Estate Co. v. Cella*, 220 Mo.App. 657.

⁵⁰ The prior judgment on the merits in favor of Principal thus is conclusive as to the successful defenses that the Principal used in the prior lawsuit, see for example *New Paltz Central School District v. Reliance Insurance Co.*, 97 A.D.2d 566, 567 (N.Y.A.D. 1983).

of the principal is conclusive of the Principal's non-liability.⁵¹ The new Restatement (3rd) of Suretyship and Guaranty in Section 67 (1) restricts the preclusive effect of the prior judgment to defenses available to the secondary obligor while making clear that the Obligee is barred from suing the Surety to the same extent he would be barred from suing the principal a second time.

C. Obligee Sues Surety and Surety Prevails

Instead of going after the principal, the obligee sues the surety. The surety defends and prevails. The obligee then goes on to sue the principal.

The rule stated in Section 68 (1) of the Restatement (3rd) of Suretyship and Guaranty is a mirror image of Section 67 (1). This means that if the Surety prevails against the Obligee, the Obligee is precluded from asserting the same claim against the Principal to the same extent he would be precluded from re-asserting it against Surety unless the Surety prevailed in the first lawsuit because of a defense unavailable to the Principal. This rule actually relates to Section 51 (1) of the Restatement (2nd) of Judgments, which is applicable in situations involving judgments rendered against the Obligee where one of the obligors (the Surety) is vicariously liable for the other (the Principal). Section 51 (1) mandates that the Obligee cannot assert a claim against the obligor who was not a party to the first action where the Obligee is precluded from reasserting his claim against the defendant in the first action. The reason for this rule is that although the claim against the surety is not identical to the one against the principal,⁵² the claims are nevertheless closely related. While it seems just to afford the Obligee the opportunity to recover from someone other than the primary obligor, there is no reason to give the Obligee the chance to litigate the same issues twice with potentially contradictory outcomes.⁵³ Section 51 (1) is based on a long line of cases that established an exception to the general rule⁵⁴ that a person, in order to successfully assert Collateral Estoppel, would have had to be bound by the prior decision had the outcome been the other way. This Principle of Mutuality has since been abandoned in a majority of states.⁵⁵ But even in those states that still adhere to the Mutuality Rule, an exception has been carved out for cases

⁵¹ Comment a to Section 139 (1) actually makes clear that the proposed rule is not absolute but is rather identical to the one now found in Section 67 (1) of the Restatement (3rd) of Suretyship and Guaranty: *“When, in an action by the obligee against the principal obligor to enforce the underlying obligation, a judgment is given in favor of the principal obligor, the judgment bars the obligee from asserting a claim against the secondary obligor to enforce the secondary obligation to the same extent that the obligee is barred from reasserting its claim against the principal obligor, unless the obligee establishes that the judgment in favor of the principal obligor is based on a defense that is unavailable to the secondary obligor under § 34.*

⁵² With the result that Res Judicata would not apply.

⁵³ See comment b to Section 51 of the Restatement (2nd) of Judgments.

⁵⁴ See *Hanley v. Panhandle Eastern Pipeline Co.*, 138 F.Supp. 768, 770 (D.C. Mo. 1956) citing *Portland Gold Mining Co. v. Stratton's Independence, Limited et al.*, 158 F.63, 68, 69 (C.A. 8 1907). See also *Leary v. Virginia-Carolina Joint Stock Land Bank*, 2 S.E.2d 570, 574 (N.C. 1939) and *Williams v. Miller*, 272 P.2d 676, 679-680 (N.M. 1954).

⁵⁵ See Howard M. Erichson: *Interjurisdictional Preclusion*, 96 Mich. L. Rev. 945, 966-967 (1988). On the federal level, the mutuality requirement was abolished in *Blonder Tongue Labs v. University of Illinois Found.*, 402 U.S. 313 (U.S. Sup.Ct. 1971).

involving a party that is vicariously liable for another party.⁵⁶ There seems to even be a tendency to preclude the Obligee from bringing suit against the Principal after losing the prior lawsuit against the Surety where the issues as to which the Obligee is supposed to be precluded have not been determined in the prior proceeding.⁵⁷ The degree of the preclusive effect attributed to such a prior decision, however, varies. Some courts hold that a prior judgment against the surety is only prima facie evidence against the Principal concerning the amount of money the Principal is liable to pay.⁵⁸ Other courts attribute conclusive effect to such prior decisions in all cases as long as the Principal at least had notice of the prior action.⁵⁹

An exception to the trend of applying Estoppel to the aforementioned type of cases is the case of *Porterfield v. Gilmer*.⁶⁰ In that case, a majority of judges held that a tortfeasor could not use a previous judgment in favor of his employer (who was vicariously liable for torts committed by tortfeasor) to estop Plaintiff from bringing an action against him where he was not bound⁶¹ by the prior judgment.⁶²

D. Obligee Sues Surety and Obligee Prevails

The obligee sues the surety, alleging that the principal defaulted. The surety either fails to file an answer (with the result that the court enters a default judgment) or, alternatively, defends unsuccessfully and suffers a judgment on the merits.

1. Preclusive Effect in Subsequent Lawsuit of Obligee Against Principal

Because the surety proves to be insolvent, the obligee, after having obtained a worthless judgment against the surety,, moves on to sue the principal.

This is a rather unusual situation because it arises only if the Surety is unable to pay out money according to the judgment it suffered and the Obligee then tries to obtain a judgment against the Principal. The situation is quite similar to the one discussed supra. Although there is practically no case law (and no Restatement provision) concerning this factual situation, it is fairly safe to predict that courts would decide such cases in a manner similar to how they resolve cases in which the (insolvent) Principal first suffered a judgment and the Obligee then sues the Surety in order to recover. This means that in cases where the prior judgment was obtained by default of the Surety, most courts would

⁵⁶ See for example *Hinton v. Iowa Mutual Insurance Co.*, 317 So.2d 832, 837 (Fla.App. 1975).

⁵⁷ *Mooney v. Central Motor Lines, Inc.*, 222 F.2d 572 (C.A. 6 1955). Although the prior lawsuit ended with a dismissal with prejudice, the court applied the general Estoppel principles and held that the "...dismissal...operates as an adjudication upon the merits."

⁵⁸ See *Lincoln County v. E.I. Du Pont De Nemours & Co.*, 32 S.W.2d 292, 294 (Mo.App. 1930), overruled as to other issues, with further reference.

⁵⁹ See *Kramer v. Morgan*, 85 F.2d 96 (N.Y.App. 1936), citing case law in support of the decision.

⁶⁰ 208 S.E.2d 295 (Georgia 1974), affirmed 212 S.E.2d 842.

⁶¹ Which was denied because the court held that master/servant relationships did not per se create privity, see *id.*, 296.

⁶² *Id.*, 297.

probably attribute limited preclusive effects to the prior judgment.⁶³

In cases where the prior judgment against the Surety was on the merits, because the Surety's liability is dependent on the liability of the Principal, the issue of the Principal's liability usually has to be determined in the prior lawsuit. Therefore, most courts would attribute at least limited preclusive effect to the prior decision. Courts may, however, be inclined to conclusively bind a Principal who had at least knowledge of the prior proceeding against the Surety.⁶⁴

2. Preclusive Effect in Subsequent Lawsuit of Surety against Principal

The surety, after making payments in accordance with the judgment that the obligee obtained against the surety, brings an action against the principal to recoup its payments.

Whenever the Obligee first sues the Surety and prevails, the most likely result is that the Surety, upon making payment in accordance with the bond, will bring suit against the Principal to recoup its loss. This situation is the subject of Section 68 (2) of the Restatement (3rd) of Suretyship and Guaranty. According to Section 68 (2a), the Principal is bound "as to any determination of fact common to both litigants if the principal obligor was a party to the action against the secondary obligor."⁶⁵ This makes sense because in such a situation the Principal would be precluded under the general Res Judicata Rules.⁶⁶

The rule stated in Section 68 (2b) of the Restatement (3rd) of Suretyship and Guaranty is somewhat more complex. According to that provision, the Principal is bound by a prior judgment rendered against the Surety if he (the Principal) was "vouched in" the prior action. Vouching in is a method to give conclusive effect to issues litigated in a prior action. It is also called "tendering the defense." To properly tender the defense, the Surety has to provide the Principal with notice of the action against him (the Surety), demand the Principal to take over his (the Surety's) defense, and advise the Principal that if he fails to so take over Surety's defense, the former will be bound by the determination of all issues common to the pending action in any subsequent lawsuits.⁶⁷ If these requirements have been met, the principal is bound by the prior decision as to the findings in that action.⁶⁸ The Restatement seems to depict the majority view on this issue. Some older cases were not in accordance as to the extent to which a Principal would be barred from re-litigating the issues determined in a prior judgment in favor of Obligee against the Surety.⁶⁹ Most courts, however, now follow the rule

⁶³ Note, however, that some courts may have a tendency to have the Principal estopped by any prior judgment against the Surety of which the Principal had notice if they apply the rationale set forth in *Kramer v. Morgan*, supra, that the Principal has a duty to indemnify and protect the Principal.

⁶⁴ See footnote 67.

⁶⁵ *Reed v. Humphrey*, 76 P.390, 392 (Kan. 1904); *Int. Fidelity Ins. Co. v. Goltra Corp.*, 374 A.2d 481, 482 (N.J. Super. A.D. 1977), addressing the effects of surety's failure to notify principal of prior action; *Maryland Cas. Co. v. Scheurman*, 165 N.W. 728, 729-730 (Mich. 1917); *Moxley v. Maupin*, 9 Ky. Op. 852 (Ky. 1878).

⁶⁶ Comment b to Section 68 (2a) states that in such cases the Principal had a prior chance to present all the defenses that might have negated his own or the Surety's liability. Therefore, he should not have the occasion to re-litigate those issues.

⁶⁷ Section 107 of the Restatement (1st) of Judgments; see *Litton Systems, Inc. v. Shaw's sales Service Ltd.*, 579 P.2d 48, 50-51 (Ariz.App. 1978).

⁶⁸ Comment c to Section 68 (2b) of the Restatement (3rd) of Suretyship and Guaranty.

⁶⁹ While, for example, in *Kramer v. Morgan*, 85 F.2d 96 (C.A. 2, 1936) it was said that "*it is indeed well settled that a judgment against the surety estops the principal, not only when he is vouched in, but also when he merely gets*

that the principal is bound with regard to issues determined in the prior lawsuit if he was either a party or was correctly vouched in with regard to the prior action.⁷⁰

E. Preclusion in an Arbitration Setting

The contract between the Obligee and the Principal or between the Principal and a third party involves an arbitration provision. Obligee and Principal resolve a dispute between them pursuant to that provision. Later, a lawsuit involving the Surety and either one of the parties to the arbitration proceeding ensues.

Arbitration has become quite a common tool in resolving disputes arising out of all sorts of commercial transactions. Naturally, the construction business is not an exception. It is not unusual for a contract between the owner of a project and the main contractor to contain an arbitration provision. The Federal Arbitration Act makes written arbitration agreements affecting interstate, foreign, or maritime commerce, with the exception of employment contracts, enforceable.⁷¹ Virtually all states have adopted provisions making arbitration awards enforceable within their boundaries when a commercial contract is based on intrastate commerce.⁷² Pursuant to Missouri's version of the Uniform Arbitration Act, for example, RSMo Section 435.350, written arbitration provisions are "*valid, enforceable and irrevocable...*" Statutes like this one, of course, do not address the question what kind of an impact an arbitration award resulting from a proceeding between the Obligee/subcontractor and the Principal has on any subsequent proceeding involving the Surety.⁷³ Section 84 of the Restatement (Second) of Judgments addresses this problem and states that, aside from narrowly drafted exceptions,⁷⁴ "*a valid and final*⁷⁵ *award by arbitration has the same effects under the rules of res judicata, subject to the same exceptions and qualifications, as a judgment of a court.*"⁷⁶ In essence, under the Restatement approach, prior arbitration awards

notice of the action," Lincoln County v. E.I. Du Pont De Nemours & Co., 32 S.W.2d 292, 294 (Mo.App. 1930) observed that "*it has been held repeatedly that a judgment against the Surety is prima facie evidence against the principal of the amount which the latter is to pay.*"

⁷⁰ See for example West Indian Co. v. S.S. Empress, 277 F.Supp. 1 (D.C.N.Y. 1967); U.S. Wire & Cable Corp. v. Ascher Corp., 34 N.J. 121, 126 (N.J. 1961).

⁷¹ 9 U.S.C. Sections 1, 2.

⁷² See G. Richard Shell: Res Judicata and Collateral Estoppel Effects of Commercial Arbitration in: UCLA Law Review, Volume 35, April 1998, p. 623, 635.

⁷³ This is the constellation to be dealt with here because it is the most likely one to arise. Another question arising in such situations is whether and to what extent the Surety is bound to participate in an arbitration proceeding because the contract between the Obligee and the Principal, which included an arbitration provision, was incorporated by reference into the bond.

⁷⁴ See Restatement (2nd) of Judgments, Section 84 (2) – (4).

⁷⁵ Courts usually do not require that an arbitration award be confirmed in a court of law but merely that the award be final under the arbitration rules under which the award was obtained, see for example Bailey v. Metropolitan Property & Liability Insurance Co., 505 N.E.2d 908, 911 (Mass.App.Ct. 1987); review denied, 508 N.E.2d 620 (Mass. 1987). A confirmed arbitration award is given the same effect as any other judgment.

⁷⁶ *Id.*, (1).

are generally given full effect⁷⁷ under True Res Judicata,⁷⁸ whereas the question of whether or not to attribute Collateral Estoppel effect to those awards is made dependant on the formality of the arbitration proceeding.⁷⁹ This is mainly because the informality of some arbitration proceedings may make it questionable whether the requirement of a full and fair opportunity to litigate the issue in question has been met. Courts have struck down this argument stating that the parties' consent to arbitrate included the consent to have the principles of preclusion applied to the resulting arbitration award, even where the arbitration proceeding had virtually none of the classic features of a lawsuit.⁸⁰

When looking at situations involving a prior arbitration award, it is important to distinguish between cases involving either performance bonds or payment bonds where the arbitration provision is found in the contract between the Obligee and the Principal and cases where the arbitration provision is found in an agreement between the Principal and a subcontractor and the Surety's liability is on a payment bond. This is because courts, in the former group of cases, tend to apply the so-called "Incorporation Doctrine," whereas in the latter group of cases, this is usually not done. Thus, the courts have to apply the general principles mentioned above.

1. Arbitration Provision is Found in Agreement Between Principal and Obligee and Surety is Liable on a Performance Bond or on a Construction Payment Bond

The Surety is responsible either on a Performance Bond (i.e. he has contracted to finish the project in case the Principal should default) or on a Payment Bond (i.e. he has contracted to make payments due for work and materials relating to the project in case the Obligee defaults). The Principal in fact defaults, and the Obligee, pursuant to a provision found in the contract between the Obligee and the Principal, brings an arbitration proceeding against him. The arbitrator issues a decision. After that the Surety is sued by either the Obligee/subcontractor or by the Principal.

Performance bonds provide security to the owner of a project by making sure that in case the Principal defaults, the project will be finished by the Surety. A payment bond provides security for those who provide labor and materials for the project. Because of the complex liabilities that arise for a Surety under either a payment or performance bond executed with the Obligee, it is necessary to clearly identify the duties of the Surety with respect to the project in question. In order to achieve this, the original contract between the owner and the construction company is usually incorporated by reference into these

⁷⁷ That means that an arbitration award entered by default due to the failure of one of the parties to arbitrate according to the underlying agreement, precludes that party from re-litigating issues that could have been litigated in the arbitration proceeding, see for example Rudell v. Comprehensive Accounting Corp., 802 F.2d 926, 932 (7th Circuit 1986), cert. Denied, 107 S.Ct. 1351 (1987).

⁷⁸ With the explanation that arbitration awards generally can be deemed the result of proceedings comparable to those in courts of law as long as they comply with the fundamental principles, see comment b to Section 84 of the Restatement (2nd) of Judgments.

⁷⁹ Id., comment c. The Restatement opts against the application of Collateral Estoppel to prior arbitration awards resulting from a very informal proceeding because the extent to which certain issues have actually been litigated and determined may not be comparable to the standard of court proceedings.

⁸⁰ See for example American Insurance Co. v. Aetna Casualty and Surety, 43 N.Y.2d 184, 189-190 (N.Y. 1977).

kinds of bonds.

If there has been an arbitration proceeding between the Obligee and the Principal, courts take two different avenues to get to a decision concerning the preclusive effect of the arbitration award against the Surety. Courts can either apply the same principles they would apply to prior judgments between the Obligee and the Principal,⁸¹ or they may invoke the Incorporation Doctrine.⁸² The difference in the outcome between the two approaches is that while courts applying general preclusion principles grant the same preclusive effect to prior arbitration awards as they do to prior judgments, courts applying the Incorporation Doctrine in fact tend to go beyond that.⁸³ The effect of such decisions is that a payment or performance bond incorporating the contract between the Obligee and the Principal containing an arbitration provision may be treated as if it were a judgment bond. Although it can certainly be said that any Surety impliedly agrees that disputes between the Obligee and the Principal arising from the underlying contract be resolved in the usual judicial proceedings, inferences comparable to those just mentioned in an arbitration setting⁸⁴ are not drawn in “conventional” cases.

2. Arbitration Provision is Found in Agreement Between Principal and a Subcontractor and Surety is Liable on a Payment Bond

Same Situation as in the previous fact scenario, with the exception that the arbitration provision is found in a contract between the Principal and the subcontractor. After obtaining an arbitration award against Principal, subcontractor discovers Principal's insolvency and brings suit against the Surety based on a payment bond.

Because Payment bonds usually do not incorporate contracts between the Principal and a subcontractor,⁸⁵ the Incorporation Doctrine rarely can be applied in those situations to bind a Surety with concern to a prior arbitration award. Courts usually hold that the Surety can neither invoke an arbitration provision resulting from the contract between a

⁸¹ This is the Restatement approach, at least with regard to claim preclusion, see *supra*.

⁸² And hold that the Surety is precluded from re-litigating the issues resolved in the prior arbitration proceeding due to the fact that he impliedly agreed to be bound by the arbitration award by incorporating the contract between the Obligee and the Principal containing the arbitration provision, see for example *Fidelity and Deposit Co. of Md. v. Parsons & Whittemore Contractors Corp.*, 397 N.E.2d 380, 382 (N.Y. 1979).

⁸³ See for example *Kearsarge Metallurgical Corp. v. Peerless Insurance Co.*, 418 N.E.2d 580, 583 (Mass. 1981). In that decision the court held that the Surety was bound by the prior arbitration because he was the guarantor of the underlying contract with respect to which the contractual parties had agreed to resolve their disputes by way of arbitration. Although the Surety in this case had at least notice of the prior arbitration proceeding, the court seemed to base its decision on the fact that the case involved an arbitration provision. If the courts do apply general estoppel rules, however, the preclusive effect of a prior decision may be more restricted than in cases involving a prior judgment. This is the case when arbitrators, in making their decision, abstain from making findings of fact and from giving reasons for their decision. A court in a subsequent action may hold that it is not possible to determine whether there is an identity of issues and thus decline to attribute any preclusive effect to the prior award. See for example *Ufheil Construction Co. v. Town of New Windsor*, 478 F.Supp. 766, 768-769 (D.C.N.Y. 1979), affirmed 636 F.2d 1204 (2nd Cir. N.Y. 1980).

⁸⁴ I.e. that the Surety is bound to have agreed to satisfy any and all judgments against the Principal, no matter whether the Principal was justified in defaulting or not.

⁸⁵ The reason is probably that the bond relates rather to the project secured than to the people secured by the bond.

third party⁸⁶ and the Principal nor be bound by a decision resulting from such a proceeding⁸⁷ because he was not a party to that contract.⁸⁸ In such cases the courts apply the general principles set forth supra.

III. Fidelity Cases

Res Judicata and Collateral Estoppel issues may arise in situations when the obligee under a fidelity bond or insured under a fidelity policy is involved in separate litigation arising out of the actions of an alleged defalcator, typically an alleged defalcating employee. In such cases, it may need to be determined what effect a judgment in a prior case (no matter in whose favor) has on the remaining party if another lawsuit ensues, typically over coverage.

The prior judgment can have preclusive effect, notwithstanding the fact that it might have arisen under a variety of proceedings, including:

- A criminal conviction under state law or under federal criminal law, including a conviction for the underlying offense or a conviction for tax evasion⁸⁹;
- An adjudication as to the dischargeability of a debt under Section 523 of the Bankruptcy Code (particularly Sections 523(a)(2), (4), (6), (11), (12) and (13));
- A civil case in state or federal court which results in a judgment; or
- An administrative order in some situations.

Section 85 of the Restatement of Judgments (Second) governs the effect of a criminal judgment in a subsequent civil action. That Section provides:

“With respect to issues determined in a criminal prosecution:

(1) A judgment in favor of the prosecuting authority is preclusive in favor of the government:

(a) In a subsequent civil action between the government and the defendant in the criminal prosecution, as stated in section 27 with the exceptions stated in section 28;

(b) In a subsequent civil action between the government and another person whose claim is derivative from the defendant as specified in sections 46, 48, 56(1), and 59-61, or analogous rules.

(2) A judgment in favor of the prosecuting authority is preclusive in favor of a third person in a civil action:

⁸⁶ See for example *Cost Brothers, Inc. v. Travelers Indemnity Co.*, 760 F.2d 58, 60 (C.A. 3 [Pa] 1985).

⁸⁷ This follows from the court’s reasoning in *United States ex rel. Capital Electronic Construction Co. v. Pool and Canfield, Inc.*, 778 F.Supp. 1088, 1090 (W.D. Mo. 1991), where the court stated that the Surety could not be forced to arbitrate just because there was an arbitration provision in the contract between the claimant and the Principal.

⁸⁸ *Id.* at 1088.

⁸⁹ An unsuccessful prosecution of a criminal offense—as opposed to conviction—has no preclusive effect due to the higher burden of proof required (beyond a reasonable doubt versus preponderance of the evidence) in a criminal proceeding.

- (a) Against the defendant in the criminal prosecution as stated in section 29; and
- (b) Against a person having a relationship with the defendant as specified in sections 46, 48, 56(1), and 59-61, or analogous rules.
- (3) A judgment against the prosecuting authority is preclusive against the government only under conditions stated in sections 27-29.”

Apart from a criminal proceeding involving the defalcating employee, the most common situations that might or might not implicate res judicata or collateral estoppel involve civil suits. In such civil suits, possible scenarios include the following:

- Employer sues defalcating employee and obtains a default judgment⁹⁰
- Employer sues the defalcating employee and obtains a judgment on the merits
- Employer sues the defalcating employee and the employee obtains a judgment in his or her favor
- Employer sues the Surety and obtains a default (or other) judgment
- Employer sues the Surety and obtains a judgment on the merits
- Employer sues the Surety and the Surety obtains a judgment in its favor

The questions that can arise from the above-mentioned scenarios, with regard to preclusion, include:

- What effect does a judgment in favor of the Employer in a lawsuit between the Employer and the alleged defalcating employee have on a subsequent lawsuit between the Employer and the Surety?
- What effect does a judgment in favor of the alleged defalcating employee in a lawsuit involving the Employer versus the defalcating employee have on a subsequent lawsuit between the Employer and the Surety?
- What effect does a judgment in favor of the Employer in a lawsuit involving the Employer versus the Surety have on a subsequent lawsuit between the Surety (seeking subrogation) and the defalcating employee?
- What effect does a judgment in favor of the Surety in a lawsuit involving the Employer versus the Surety have on a subsequent lawsuit between the Employer and the alleged defalcating employee?
- What effect does a judgment in favor of the Employer in a lawsuit involving the

⁹⁰ For ease of explanation, the insured will be referred to as the “employer”; the alleged defalcator will be referred to as the “defalcating employee”; and the fidelity bond surety or fidelity insurer will be referred to as “the surety”. This obviously does not adequately address all of the possible combinations of coverages and players in a fidelity claim situation but does have the virtue of brevity.

Employer versus the Surety have on a subsequent lawsuit between the Employer and the alleged defalcating employee?

In the foregoing cases, courts will attempt to apply the general principles of res judicata and collateral estoppel. The results are analogous to the results in other surety bond cases as far as issue preclusion is concerned; however, the distinction in fidelity cases is that notwithstanding the fact that the dishonesty of an employee may or may not have been established, there are frequently more complicated determinations of coverage that need to be made than in the typical surety case.

For example, most fidelity policies contain coverage for “employee dishonesty”, typically defined as follows:

- a. “Employee Dishonesty”⁹¹ in paragraph A.2. 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, with the manifest intent to:
 - (1) Cause you to sustain loss; and also
 - (2) Obtain financial benefit (other than salaries, commissions, fees, bonuses, promotions, awards, profit sharing, pensions or other employee benefits earned in the normal course of employment) for:
 - (a) The “employee”; or
 - (b) Any person or organization intended by the “employee” to receive that benefit.

Notwithstanding the fact that an employee may have been found liable for fraud or conversion—or even, in some scenarios, convicted of defrauding his employer—it is possible that these are insufficient to establish “employee dishonesty” within the terms of the coverage. Moreover, even if this issue were to be established, it would still be necessary to satisfy other coverage conditions. In sum, even if there is some preclusion of issues due to prior adjudications, there is typically some disconnect between the issues previously adjudicated and the fact and amount of fidelity coverage.

A. Employer Sues Alleged Defalcating Employee and Prevails

If the employer obtains a favorable judgment against the alleged defalcating employee, issues in this proceeding can be held to have been conclusively established for purposes of later proceedings. In such cases, the results in section IIIA, supra., are generally applicable as to issue preclusion. Thus, for example, if an employer sues an alleged defalcating employee for fraud and conversion and obtains a judgment against that employee on those legal theories, whether or not the employee’s fraud and conversion has been conclusively established (thereby precluding those issues from being re-litigated) in a subsequent action against the surety on its fidelity bond is dependent upon the nature of the previous proceeding and award. As is discussed in section IIIA, supra., a judgment on the merits after a trial of the

⁹¹ Commercial Crime Coverage Form A—Blanket.

case will frequently, dependent upon the jurisdiction, be given more of a preclusive effect than a default judgment.

B. Employer Sues Alleged Defalcating Employee but Employee Prevails

If the employer sues the alleged defalcating employee but the employee prevails, the employer would, as is discussed in section IIIB, supra., generally be barred from asserting the same claim against the surety.

C. Employer Sues Surety and Surety Prevails

If the employer sues the surety but the surety prevails, the employer would be precluded, under Sections 67(1) and 68(1) of the Restatement (3rd) of Suretyship and Guaranty, from asserting the same claim against the employee in a later action to the same extent it would be precluded from re-asserting it against the surety unless the surety prevailed in the first lawsuit because of a defense unavailable to the employee. As a practical matter, the effect of this is that the employer would be precluded from re-litigating the underlying actions of the employee if the judgment in favor of the surety was based on a defense arising out of the underlying actions or facts. On the other hand, if the judgment was based upon a defense unavailable to the employee—such as technical surety or policy defense—the employer would be re-assert the same claim against the employee. With the foregoing in mind, analysis of this factual situation is in accordance with the analysis in section IIIC, supra..

D. Employer Sues Surety and Employer Prevails

If the employer sues the surety and the employer prevails, the first lawsuit could have preclusive effects in a subsequent lawsuit by the employer against the employee as well as a subsequent lawsuit by the surety against the employee. The former situation would be highly unusual because it would presumably arise only if the surety was unable to pay the judgment against it. In any case, although the analysis of this situation would follow the analysis in section IIID(1), supra., it would be unlikely that a court would give much more than limited preclusive effect to the prior judgment unless the employee actively participated in the defense of the prior case or at least had knowledge thereof. Even in that case, it is quite likely that a court would, at most, give limited preclusive effects to the prior judgment.

In a subsequent lawsuit by the surety against the employee, the employee would the analysis would follow the analysis in section IIID(2), supra.. In such a case, the employee would generally be bound in regard to the issues determined in the prior lawsuit if the employee was either a party to that lawsuit or was correctly “vouched in” with regard to the prior lawsuit.

V. Conclusion

Although in many of the situations that have been examined throughout this paper there is no definitive answer as to how a specific court would decide, general statements can be made with regard to the probable outcome of such litigation. Knowledge of the most common court approaches and of the factors that courts consider in reaching their decisions can help

practitioners to take the necessary steps in order to avoid unpleasant surprises for their clients. The following “capsule summary” relates to the fact scenarios outlined in this paper⁹²:

If the Obligee/Employer sues the Principal/Employee and obtains a default judgment, the Surety is conclusively bound if it is liable on a judgment bond. If the Surety is liable on a general undertaking bond, such as fidelity bond or some other surety bond, courts usually attribute limited preclusive effect to the prior default judgment and often require that the Surety had at least notice of the prior lawsuit. In cases in which the Obligee/Employer obtained a judgment on the merits, the Surety is usually held to be conclusively bound if it is liable on a judgment bond or if the prior decision was an arbitration award and the contract containing the arbitration agreement was incorporated into the bond. Some courts hold that the Surety is conclusively bound by a prior judgment on the merits if it had knowledge of the prior action and the opportunity to defend. Other courts attribute no preclusive effect to a prior judgment on the merits in favor of the Obligee because state law mandates that outcome or because they find that the general prerequisites of Res Judicata are not met. The majority of decisions involving general undertaking bonds attribute limited preclusive effect to a prior judgment in favor of the Obligee. This means that the prior decision creates either a rebuttable presumption of the Principal’s liability or is prima facie evidence of Surety’s liability in a subsequent lawsuit between Obligee and Surety.

If the Obligee/Employer sues the Principal/Employee and the latter one prevails, the Obligee/Employer is held to be conclusively bound by the prior decision and cannot bring a second action against the Surety unless the Surety’s promise to pay is unconditional or the Principal/Employee in the prior lawsuit prevailed on a personal defense.

In cases in which the Obligee/Employer sues the Surety and the Surety prevails, the vast majority of courts hold that the Obligee/Employer is precluded from bringing the same claim against the Principal/Employee, unless the Surety prevailed by virtue of a defense unavailable to the Principal/Employee.

When the Obligee/Employer sues the Surety and prevails, the preclusive effect of the prior judgment in a subsequent action between the Obligee/Employer and the Principal/Employee is probably limited if the judgment was obtained by default. If the prior judgment is on the merits, courts would probably attribute at least some preclusive effect to it if the Principal/Employee had notice of the prior action, and at least limited preclusive effect in all other cases.

If the Obligee/Employer sues the Surety and prevails, the effect of the prior judgment in a subsequent action between the Surety and the Principal/Employee is conclusive in case the Principal/Employee was either a party to the previous lawsuit or was properly vouched in.

In cases in which the prior decision was an arbitration award, courts tend to apply general Res Judicata and Collateral Estoppel principles. Courts commonly use the Incorporation Doctrine to attribute conclusive effect to a prior arbitration award where the contract containing the arbitration agreement was incorporated into the bond on which the Surety is liable.

⁹² For purposes of the capsule summary, the fidelity and surety analyses are generalized together.

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Biographical Sketch

John W. Rourke is a shareholder in the St. Louis law firm of Reinert & Duree, P.C.. His practice emphasizes fidelity and surety bond claims and litigation, construction litigation, and commercial law. He is a graduate of the University of Virginia and the University of Missouri School of Law.

Mr. Rourke is licensed to practice law in Missouri, Illinois, and a number of federal courts. He is a member of the American Bar Association, the Missouri Bar, the Illinois State Bar Association, the Chicago Bar Association, and the Bar Association of Metropolitan St. Louis. He has been a contributor to or co-author of a number of papers and publications pertaining to fidelity law, surety law construction law and real estate law.

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Boris A. Kaupp is an associate in the St. Louis law firm of Reinert & Rourke, P.C. He practices fidelity and surety law, commercial law and construction law. Being a German, he studied law in Germany and graduated from Eberhard –Karls University in Tuebingen, Germany in 1995. After working for several years in Germany, he completed an LL.M. degree in American Law at Saint Louis University. He is a member of the New York Bar, the Missouri Bar, the Bar Association of Metropolitan St. Louis, and the American Bar Association.