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***THE SUBROGATION RIGHTS OF THE
FINANCIAL INSTITUTION BOND CARRIER
OR
WHO CAUSED THIS MESS, AND CAN WE SUE
THE OFFICERS AND DIRECTORS?***

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SUBROGATION RIGHTS OF THE FINANCIAL INSTITUTION BOND CARRIER

PROLOGUE

SCENE 1: [INTERIOR OF FEDERAL COURTROOM - DAY]

A sentencing hearing is about to commence. The defendant is SARI EMCOTT, formerly Executive Vice President and Chief Loan Officer of SOFT TOUCH SAVINGS & LOAN ASSOCIATION, who has pled guilty to a series of 42 embezzlements which occurred during the last ten years of his twelve year employment with Soft-Touch.

At the counsel table is ERNEST LEE, the lawyer representing Soft Touch who is attending the hearing for the sole purpose of requesting that the Judge impose the maximum possible sentence on Emcott, and also to request that a restitution order be entered in favor of Soft Touch.

[CAMERA PANS TO COUNSEL TABLE, WHERE ERNEST LEE IS PREPARING TO STAND]

ERNEST LEE: *First of all, I would like to say how much I appreciate the Court allowing us to be heard. Soft Touch is a small savings and loan. It was chartered for the benefit of the people of our county. Mr. Emcott was the Vice President of that institution for a number of years throughout the entire series of events which have occurred here. During that period of time he defrauded the institution, he lied to his fellow workers, lied to his employers, he stole money from the institution, and from the institutions depositors. A bonding company is going to have to pay out several hundred thousand dollars which will cause our premiums to go up. I really don't know what else to say Your Honor other than the fact that we wish the Court would go outside of the sentencing guidelines and place the appropriate sentence on this man and ask this man to pay restitution that is due ... and we ask that this Court impose the appropriate sentence to fit the crime this man has committed.*

[CAMERA BEGINS CUTTING BETWEEN JUDGE AT BENCH AND ERNEST LEE]

JUDGE: *Is there any explanation, Mr. Lee, as to how the Savings & Loan's internal security situation didn't pick this up? This was a ten year fraud, and I can understand how someone can rob Peter to pay Paul and pay back and roll over and ... well ... do that sort of conduct. But why didn't ya'll have internal checks that would pick up this scheme over such a period of time?*

LEE: *We appreciate your inquiry. I'm glad you brought that up, Your Honor. It was because this man was the number 2 man in the institution, a small institution to begin with, with not a lotta' folks at the top. That loan activity was his. Every time the President of the institution would establish a new guideline to defeat this type of activity, using his position and his status in the community and in the institution, Sari would go another scheme which had just not been caught yet. It was like chasing a bird with salt, Your Honor.*

JUDGE: *Well, that's disturbing, there's no question, and I'm very concerned about his conduct, but I'm also disturbed with what I see here as a lack of attention by the Savings & Loan there. You know, you can say it's small, but there is no Savings and Loan, no matter how small, that ought to be so structured for internal security that even the President could do this.*

LEE: *We agree. We agree, Your Honor.*

JUDGE: *Where did ya'll go wrong, and what have you done to correct that?*

LEE: *The way we went wrong was that we placed our trust in Sari Emcott, that's where we went wrong. That was the beginning of it.*

JUDGE: *But well run banks don't put their trust in one person.*

LEE: *They do if there is only two or three people who run the institution, Your Honor.*

JUDGE: *Then, they are not well run, Mr. Lee.*

[FADE TO SPEAKER AT PODIUM]

As at least one Federal Judge has noted, well run financial institutions rarely suffer significant losses from employee dishonesty where the dishonest conduct occurs over a significant period of time. This is because financial institutions typically employ a number of checks, balances, and controls designed to detect and prevent such fraud. Occasionally, of course, a determined and ingenious defalcator can escape detection long enough to create substantial problems for the financial institution bond carrier. Must the carrier bear the risk alone?

This paper will address the current status of the law concerning subrogation rights of the Financial Institution Bond carrier, with emphasis on rights of subrogation against officers and directors of financial institutions.

I. GENERAL CONSIDERATIONS - THE NATURE OF SUBROGATION

Subrogation is known best as an equitable doctrine pursuant to which an insurance carrier, upon payment of a claim, may acquire rights of its payee, including the right to pursue claims against third-

parties who may have caused or contributed to cause the underlying loss.¹ The equitable subrogation rights of the surety are, of course, near and dear to the hearts of those who labor in this area of the law. Often overlooked, however, is the distinction drawn between equitable subrogation and "conventional" subrogation. As noted by Professor Appleman, conventional subrogation arises from an express or implied agreement between the payor and the debtor or creditor, as opposed to "equitable subrogation," which arises from the mere fact of payment by a third party.²

Quite obviously, the fidelity carrier is ordinarily entitled to a matching judgment against the wrongdoer in the amount of its contractual liability to its insured. Wrongdoers, however, are rarely solvent, and any recoveries from the wrongdoers may be further limited if the insured institution has not been made "whole" by payment of the claim. Accordingly, Financial Institution Bond carriers will usually want to evaluate their rights and remedies against third parties, including the officers and directors of the insured institution, who typically owe a range of duties to the insured institution by virtue of their positions and who typically have access to liability insurance coverages.

It is generally established that directors and officers owe the corporation a duty of care. Additional specific duties may be imposed by statute.³ However, a number of jurisdictions have enacted statutes which have limited the liability of directors and officers and therefore the law of the controlling jurisdiction should be closely researched in analyzing rights of the subrogated carrier. Under the most protective of such statutes, directors and officers are immunized from liability except for "willful or reckless" misconduct. Few, if any, jurisdictions restrict claims against officers and directors where it is apparent that the officer or director has received an improper personal benefit, or was actively

¹ Subrogation is defined as the substitution of one person in the place of another with reference to a lawful claim, demand, or right so that the substituted party succeeds to the rights of the other. (*Black's Law Dictionary* 1427 (6th Ed. 1990). Equitable subrogation was developed as a device "established as a matter of necessity for the purpose of administering essential justice. See APPLEMAN, Insurance Law and Practice Section 6502 (1981).

² See APPLEMAN, supra, Section 6501.

³ See Graham v. Alice-Chalmers Mfg. Co., 41 Del.Ch. 78, 188 A.2d 125 (1963). See, also, Bishop, Law of Corporate Officers and Directors, (1991) Section 2.01 et. seq.

involved in the dishonest scheme. Accordingly, the facts of each case must be examined to determine the level of culpability of the various officers and directors and the specific duties and responsibilities of each officer or director owed to the insured institution.⁴

II. THE SUPERIOR EQUITIES DOCTRINE

A threshold problem for the subrogated carrier is the applicability of the so-called "superior equities" defense, first advanced successfully by the defendants in First Nat'l Bank of Columbus v. Hansen⁵. In Hansen, the Bank claimed losses in excess of \$900,000.00 resulting from fraudulent acts committed over a four year period prior to the officer's termination. The Bank sued the carrier, and the carrier impleaded the officers and directors of the Bank, claiming "ordinary negligence" by the officers and directors in failing to exercise proper supervision over loan activities, delegation of exclusive authority and control to the wrongdoer, failure to form a committee to conduct an annual internal investigation and the failure to heed warnings by the governmental regulators concerning improper internal procedures. The trial court dismissed the third-party complaint and the carrier appealed.

In affirming, the Wisconsin Supreme Court observed that subrogation is an equitable remedy the exercise of which should not be permitted where the party seeking subrogation has no greater "equity" than the rights of the opposing party. The Wisconsin court also noted that the claim of the carrier did

⁴ Many states have adopted versions of the Model Business Corporation Act, which establishes specific standards of conduct for directors. For example, § 10-2B-8.30 of the Alabama Code requires directors to discharge his or her duties, including duties as committee members (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director believes to be in the best interest of the corporation. Notwithstanding these statutory guidelines, the Alabama Code imposes a stringent fiduciary obligation on corporate officers and directors:

§ 10-2B-8.31 Fiduciary Obligation Is Not Impaired

Neither an unqualified statement of rights or powers, nor an unqualified grant of authority in this Chapter, shall be taken or construed to abrogate, repeal, displace, modify or impair the fiduciary obligation of directors or other officers or employees of a corporation ... in order to forestall, prevent, correct, remedy or allow damages for fraud, oppression, imposition or other inequitable or remedial conduct in conformity with the applicable principals and practices of law.

⁵ 267 N.W.2d 367 (Wis. 1978).

not allege any personal benefit or gain by the officers or directors, but instead was limited to acts of "ordinary negligence." Observing that negligence of the bank would not be a defense to the employee dishonesty claim, the Wisconsin court held that "equity will not permit the fidelity insurer to avoid that result by suing the officers and directors individually." The Court summarized its holding as follows:

The bonding companies have assumed the risk of that negligence which is imputable to the Bank, and we conclude, therefore, that the bonding companies may not avoid that risk simply by paying on the bond and suing these officers and directors as individuals thereafter.

The Hansen decision has met with mixed reviews.⁶ Its rationale and holding was adopted and approved by the Supreme Court of Florida in response to certified questions received from the Eleventh Circuit in Dixie Nat'l Bank of Dade County v. Employers Commercial Union Ins. Co. of America.⁷ The law of Florida, at least according to the Eleventh Circuit, is now "clear"; claims for "ordinary negligence" against officers and directors may not be asserted by a subrogated fidelity insurance carrier. The law of New York, at least as perceived by another Federal Court, is different. An insurer who pays on a bond should "step into the shoes" of the corporation and should be able to assert claims of the corporation against third parties, including officers and directors.⁸

It is important to remember that the superior equities doctrine arose in the context of an equitable, as opposed to conventional, subrogation claim. Several courts have noted that where an insurer's subrogation rights are based upon contract or assignment, the superior equities doctrine has no application. For example, in National Union Fire Ins. Co. v. Riggs National Bank,⁹ The National Union policy contained standard language confirming that in the event of payment, it would be subrogated to the insureds rights of recovery against any third parties. Pursuant to the subrogation

⁶ See Appendix for a summary of the law in jurisdictions which have considered application of the superior equities doctrine.

⁷ 463 So.2d 1147 (Fla. 1985).

⁸ See FDIC v. National Surety Corporation, 434 F.Supp 61 (E.D.N.Y. 1977). Other jurisdictions have also reached different results.

⁹ The insurer paid the insured bank's loss resulting from cashing fraudulent checks.

provisions, the insured made a written assignment of all rights against the third parties, including Riggs National Bank, which defended the subsequent suit on the basis of the superior equities doctrine.

In rejecting application of the doctrine, the court reviewed the three basic approaches that courts have taken in analyzing the superior equities doctrine. First, a few jurisdictions have rejected application of the doctrine as to any form of subrogation (equitable or conventional) or assignment. A second approach is the exact opposite; some jurisdictions have applied and enforced the doctrine as to all forms of subrogation or assignment.¹⁰ The third approach - adopted by the National Union court - applies the doctrine in cases of equitable subrogation but denies its operation in cases of conventional subrogation or assignment.¹¹

If the superior equities doctrine has been decided adversely in your jurisdiction, all may not be lost. Substantial authority exists for the proposition that the doctrine has no application to cases involving conventional subrogation or assignments. Other distinctions may be relevant.

For example, the superior equities doctrine would presumably not apply if the conduct of the officers and directors is more than "ordinarily negligent." Arguably, a continuing failure to heed warnings from governmental or other external auditors or a persistent failure to implement reasonable internal controls, or a habitual pattern of absenteeism from committee meetings or other dereliction of corporate duties could support a claim of "gross negligence" or wantonness. No equities would favor immunization of the officers and directors in such cases. Such claims would presumably shift the balance of equities in favor of the surety.

If the "superior equities" doctrine has not been addressed in your jurisdiction, what arguments are available against it? If at all possible, the insured should obtain a written assignment of the insured's rights against third parties upon payment, and argue that the doctrine has no application.

¹⁰ See, e.g., Meyers v. Bank of America Nat. Trust and Svcs. Assoc., 77 P.2d 1084; see, also, Castleman Construction v. Pennington, 432 S.W.2d 669 (Tenn. 1968).

¹¹ 646 A.2d 966, 971.

More fundamentally, keep in mind that the doctrine is rooted in the basic principles that (1) subrogation is an equitable remedy, and (2) negligence of the bank is not a "defense" to a claim of employee dishonesty and therefore the fidelity insurer assumes a risk of "negligence." It is suggested that the carrier focus instead on the second supporting principal. It is simply wrong to argue that the fidelity insurer somehow "assumes a risk" of negligence on the part of the officers and directors. Such risks are more clearly assumed by the directors and officers liability insurance carrier, and can be easily shifted through such coverages. Employee dishonesty insurance premiums are predicated upon rights of subrogation being freely acquired and exercised; indeed, most, if not all, fidelity coverages include standard assignment and cooperation clauses, the purpose of which is to facilitate full recovery from third parties by the subrogated carrier. Further, permitting the "superior equities" defense to defeat claims of negligence by corporate officers imposes an artificial shield which will not encourage vigilance in the performance of corporate duties.

Thus, the "superior equities" doctrine is based upon an erroneous premise and is contrary to public policy. The law should promote corporate responsibility and should not excuse irresponsible conduct.

III. THE BUSINESS JUDGMENT RULE

Generally stated, the "business judgment rule" provides that directors and officers are not insurers and will not be held legally liable for mere mistakes or errors of judgment if they act in good faith and with due care.¹²

The case law establishes at least three general exceptions to the business judgment rule. Most obviously, the rule will not apply if the facts establish self-dealing, improper personal gain, or other conduct constituting "bad faith" by the officer or director.¹³ Unless the claim is based upon a business judgment, the rule could have no application.

Second, the rule applies only to "judgments" by an officer or director.¹⁴ If the focus of the third-party claim is on action or conduct not constituting a business or "judgment," then the rule does not apply.

Third, it has been held that the rule does not apply where the officer or director fails to obtain adequate information upon which to base his judgment.¹⁵ In a case not involving allegations of personal gain, fraud, or bad faith, but involving an uninformed decision, the Delaware Supreme Court has held that the business judgment rule does not apply.¹⁶

The subrogated carrier's investigation should include a review of the duties imposed by statute on officers and directors. In jurisdictions which have adopted the Model Business Corporation Code or variations thereof, additional duties may be imposed which can be useful in formulating and enforcing rights of actions against officers and directors.

¹² See *Brodsky, Law of Corporate Officers and Directors*, § 2.07; see, also *Otis and Company v. Pennsylvania Railroad Co.*, 61 F.Supp. 905 (E.D.Pa. 1945).

¹³ See, e.g., *Casey v. Woodruff*, 49 N.Y.S.2d 625 (Sup.Ct. 1944).

¹⁴ See *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599 (Del.Ch. 1974).

¹⁵ See, e.g., *Seafirst Corporation v. Jenkins*, 644 F.Supp 1152 (W.D.Wash. 1986).

¹⁶ See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

IV. SUMMARY

A corporation can act only through its officers and directors. In the area of fidelity claims, losses can and will result from the failure of officers and directors to implement and enforce appropriate controls. Where appropriate, the subrogated fidelity carrier can and should pursue claims against the insureds officers and directors, recognizing, of course, that the law in this area is continuing to evolve.

APPENDIX

JURISDICTIONAL ANALYSIS OF THE SUPERIOR EQUITIES RULE

Alabama: No discussion of the superior equities rule in statute or case law.

Arizona: Superior Equities doctrine does not apply to conventional subrogation. See Liberty Mut'l Ins. Co. v. Thunderbird Bank, 555 P.2d 333, 334-5 (Ariz. 1976)

California: The rule applies to all claims. See Meyers v. Bank of Am. Nat'l Trust & Sav. Ass'n, 11 Cal.2d 92, 77 P.2d 1084, 1085-86 (1983).

District of Columbia: The doctrine applies only to equitable subrogation. See National Union Fire Ins. Co. of Pittsburgh v. Riggs Nat'l Bank of Washington, D.C., 646 A.2d 966 (D.C.App. 1994)

Florida: All subrogation is equitable, not conventional, so that superior equities must be established, regardless of written assignment. See Dixie Nat'l Bank of Dade County v. Employers Comm. Union Ins. Co. of America, 463 So.2d 1147 (Fla. 1985).

Georgia: Rule does not apply to conventional subrogation. See First Nat'l Bank v. American Sur. Co., 30 S.E.2d 402 (Ga. App. 1944).

Illinois: Superior Equities does not apply to conventional subrogation. See Spirek v. State Farm Mut. Auto. Ins. Co., 382 N.E.2d 111, 117 (Ill.App. 1978).

Iowa: Superior Equities doctrine does not apply to conventional subrogation. See National Sur. Co. v. Bankers' Trust Co., 228 N.W.2d 635, 637 (Iowa 1930).

Massachusetts: Superior Equities does not apply to conventional subrogation. See Comm'r of Ins. v. Conveyancers Title Ins. & Mortg. Co., 15 N.E.2d 820, 826 (1938).

Missouri: Superior Equities doctrine does not apply to conventional subrogation. See Aetna Cas. & Sur. Co. v. Lindell Trust Co., 348 S.W.2d 558, 570-71 (Mo.Ct.App. 1961).

New Jersey: Rejects Superior Equities doctrine. See Hartford Fire Ins. Co. v. Riefolo Constr. Co., 410 A.2d 658, 662 (N.J. 1980).

New York: Rejects Superior Equities doctrine. See FDIC v. Nat'l Surety Corp., 434 F.Supp. at 63.

North Carolina: Applies Superior Equities, but not to conventional subrogation. See American Sur. Co. v. Baker, 172 F.2d 689, 692 (4th Cir. 1949) [applying No. Carolina law].

Pennsylvania: Superior Equities Doctrine is not applicable to conventional subrogation. See Grubnau v. Centennial Nat'l Bank, 124 A. 142, 144 (Pa. 1944).

South Carolina: Rejects the superior equities doctrine. See South Carolina Nat'l Bank v. Lake City State Bank, 164 S.E.2d 103, 106 (S.C. 1968).

Tennessee: Follows Superior Equities doctrine. See Castleman Constr. Co. v. Pennington, 432 S.W.2d 669, 676 (Tenn. 1968).

Wisconsin: Subrogation is equitable, not conventional, so that Superior Equities must be established, regardless of written assignment. See First Nat'l Bank of Columbus v. Hansen, 267 N.W.2d 367 (Wisc. 1978).