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**“FIDELITY DEFENSES WHICH ARE OFTEN OVERLOOKED”**

**PRESENTED BY:**

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## INTRODUCTION

During the investigation of a fidelity policy or financial institution bond claim (collectively “policy” or “bond” and/or “bond claims”), there can be many different coverage issues which arise. The facts surrounding the claim and the actions of the insured are critical in making a determination as to whether all or a portion of the claim is covered under the bond. It is critical for the person investigating the claim to know the bond form and all the provisions in the bond form. Although most bond forms have similar provisions, the subtle differences between the various provisions can make a significant amount of difference in determining whether there is coverage and/or the extent of coverage. It is also critical to understand which jurisdiction’s case law is controlling. Set out in this paper are some of the often overlooked coverage defenses.

### I. NOTICE DEFENSES

Notice defenses can be very important. Determination should be made as to when the insured discovered the loss, or should have discovered the loss, and when the insured provided the bonding company with notice. I have seen numerous cases in which the insured discovered the loss long before it ever provided the insurance company with notice. Even if the loss is below the insured’s deductible, the insured is still required to give notice, and failure to do so can bar the insured’s recovery if the loss subsequently exceeds the deductible. The determination of the date of discovery is one of the first things that should be determined in any investigation. Since most policies are claims-made policies, discovery can also be extremely critical in the cases where the insured did not have coverage under a prior policy or in determining whether there is coverage under another insurance company’s policy.

Assuming the insured has failed to give timely notice as provided under the bond, is this a defense to coverage? The question then becomes which jurisdiction’s law is controlling and does the law in the controlling jurisdiction require a showing of prejudice to the bonding company? Tennessee law does not require a showing of any prejudice and, therefore, failure to give timely notice is a condition precedent to coverage and **the entire claim is barred for failure to give timely notice**. Other jurisdictions require a strict showing of prejudice before the bonding company can assert a notice defense and may limit the use of the defense only to the amount to which the bonding company has actually suffered damages.

In Tennessee, contractual provisions requiring timely notice in insurance policies and bonds must be obeyed by the insured as a condition precedent to coverage. Griffin Motors, Inc. v. Compass Ins. Co., 676 S.W.2d 555 (Tenn. App. 1983); Hartford Accident & Indemnity Co. v. Creasey, 530 S.W.2d 778 (Tenn. 1975). The Tennessee Supreme Court in Creasey reaffirmed the principle that “notice is a condition precedent to recovery under the policy and there need **not** be any showing of prejudice.” Id. at 779. See *also* North River Ins. Co., 757 S.W.2d 334 (Tenn. App. 1988). This defense and its requirements have also been recognized and approved by the 6<sup>th</sup> Circuit Court of Appeals in the case of Hospital Underwriting v. Summit Health Ltd., 63 F.3d 486 (6<sup>th</sup> Cir. 1995).

The notice requirement may be found in policy provisions such as the following:

#### **Conditions.**

### C. Notice/Proof - Legal Proceedings.

- (1) At the earliest practicable moment, not to exceed 30 days, after discovery of loss, the Insured shall give the Company notice thereof.

### B. Discovery

This bond applies to loss discovered by the Insured during the bond period. Discovery occurs when the Insured becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred, even though the exact amount of details or loss may not then be known.

Notice to the Insured of an actual or potential claim by a third party which alleges that the Insured is liable under circumstances which, if true, would create a loss under this bond constitutes such discovery.

#### 2. Duties in the Event of Occurrence, Claim or Suit.

- a. You must see to it that we are **notified promptly** of an **“occurrence”** which may result in a claim. Notice should include:

- (1) How, when and where the “occurrence” took place; and
- (2) The names and addresses of any injured persons and witnesses.

- b. If a claim is made or “suit” is brought against any insured, you must see to it that we receive **prompt written notice** of the **claim** or **“suit”**.

- c. You and any other involved insured must:

- (1) **Immediately send us copies** of any **demands, notices, summonses** or **legal papers** received in connection with the claim or “suit;”
- (2) Authorize us to obtain records and other information;
- (3) Cooperate with us in the investigation, settlement or defense of the claim or “suit;” and
- (4) Assist us, upon our request, in the enforcement of any right against any person or organization which may be liable to the insured because of injury or damage to which this insurance may also apply.

Section 8. Upon knowledge or discovery of loss or of an occurrence which may give rise to a claim for loss, the Insured shall: (a) **give notice thereof as soon as practicable** to the Company or any of its authorized agents, and except under Insuring Agreements I and V, also to the policy if the loss is due to a violation of law;

(b) file detailed proof of loss, duly sworn to, with the Company **within four months after the discovery of loss.**

....

No action shall lie against the Company unless, as a condition precedent thereto, there shall have been full compliance with all the terms of this Policy, **nor until ninety days after the required proofs of loss have been filed with the Company, nor at all unless commenced within two years from the date when the Insured discovers the loss.** If any limitation of time for notice of loss or any legal proceeding herein contained is shorter than that permitted to be fixed by agreement under any statute controlling the construction of this Policy, the shortest permissible statutory limitation of time shall govern and shall supersede the time limitation herein stated.

Cases in Tennessee have construed the phrases “as soon as practicable” and “immediate notice” as requiring notice within a reasonable time under the circumstances of the case. Reliance Ins. Co. v. Athena Cablevision Corp., 560 S.W.2d 617, 618 (Tenn. 1977). The phrase “as soon as practicable” has been further defined as imposing a duty on the insured to give notice when he becomes aware, or should become aware of, facts which should suggest to a reasonably prudent person that the event for which coverage is sought might reasonably be expected to produce a claim against the insured. Lee v. Lee, 732 S.W.2d 275 (Tenn. 1987); Griffin Motors, Inc. v. Compass Ins. Co., 676 S.W.2d 555, 558 (Tenn. App. 1983). An objective standard applies to determine whether the insured has notified the insurer of an occurrence “as soon as practicable,” pursuant to a notice provision. Exchange Mut. Ins. Co. v. Sanders, 15 TAM 3-71, 12/8/89, W.S. at Knoxville.

In Lee, the court was interpreting a notice provision which stated:

DUTIES AFTER AN ACCIDENT OR LOSS. We must be notified promptly of how, when and where the accident or loss happened. Notice should also include the names and addresses of any injured persons and of any witnesses.

The court held that the phrase “notified promptly” is similar to “as soon as practicable” and therefore imposes the duty on the insured to give notice when he becomes, or should become aware of, facts which would suggest to a reasonably prudent person that the event for which coverage is sought might be reasonably be expected to produce a claim against the insurer. Id. at 276. The court in Transamerica Insurance Company v. Parrott 531 S.W.2d 306 (Tenn. App. 1975), noted that although the phrase “as soon as practicable” is ambiguous, notice is required within a reasonable time under the totality of the circumstances.

Tennessee cases have consistently upheld the insurer’s right to deny coverage where there has not been prompt notification. Allstate Ins. Co. v. Fitzgerald, 743 F. Supp. 539 (W.D. Tenn. 1990). See Barfield v. Insurance Company of North America, 59 Tenn. App. 631, 443 S.W.2d 42 (1969). In Melton v. Republic Vanguard Ins. Co., 548 S.W.2d 313 (Tenn. App. 1976), the court held that failure to give the insurer on a homeowners’ policy notice of a claimed accident until nearly seven months after the occurrence was a complete defense to an action against the insurer where the policy required complete and prompt reports of incidents from which claims might arise.

Similarly, in the case of FDIC v. Ins. Co. of North America, 928 F.Supp. 54 (D. Mass. 1996), a federal district court in Massachusetts granted a summary judgment motion filed by the insurance company on the ground that the insured bank did not provide timely notice of loss. Citing Massachusetts case law, the court stated:

Indeed, with respect to policies like the [financial institution] Bond in this case, timely notice of the loss is so important that [the insurance company] does not need to show actual prejudice resulting from the delay in giving notice. If notice to [the insurance company] was untimely, the Bank is precluded from recovery, regardless of whether [the insurance company] can prove any actual prejudice as a result of the delay.

Id. at 59. For other cases following the rule that the notice requirement in a policy is a condition precedent to coverage, regardless of whether prejudice may be shown, see Adair State Bank v. American Cas. Co., 949 F.2d 1067 (10<sup>th</sup> Cir. 1991); FSLIC v. Aetna Cas. & Sur. Co., 785 F.Supp. 867 (D. Mont. 1991); Prime Comm. Corp. v. Underwriters at Lloyds, 187 B.R. 785 (N.D. Ga. 1995).

Other jurisdictions, however, have held that an insurer must demonstrate prejudice before it can deny a claim based upon untimely notice of loss. In the case of FDIC v. Oldenburg, 34 F.3d 1529 (10<sup>th</sup> Cir. 1994), the court rejected the argument that the notice provision was a condition precedent to coverage, and stated that coverage could not be defeated without a showing of substantial prejudice. The court also stated that the outcome would have been different if the policy had contained “express language making notice a condition precedent to recovery.” Id. at 1546. Proof of substantial prejudice was also required by the courts in FDIC v. Aetna Cas. & Sur. Co., 744 F.Supp. 729 (E.D. La. 1990) and Second National Bank of Kansas City v. Continental Ins. Co., 586 F.Supp. 139 (D. Kan. 1982). See also Resolution Trust Corp. v. Gaudet, 907 F.Supp. 212 (E.D. La. 1995); Downey Savings & Loan Assoc. v. Ohio Cas. Ins. Co., 234 Cal Rptr. 835 (Cal. App. 1987), cert. Denied, 486 U.S. 1036 (1988).

**A. FAILURE TO FILE PROOF OF LOSS TIMELY.**

Most bonds and policies require Proofs of Loss to be filed typically within four to six months of discovery. Once a bonding company receives notice of a loss, it should send an acknowledgment of the claim, request that a Proof of Loss be filed timely and as otherwise required under the terms of the bond. Additionally, there should be a full reservation of rights set out in the letter to the insured. If the insured does not file a timely Proof of Loss and there is no extension by the bonding company, then, depending on the jurisdiction, the bonding company may have grounds to deny coverage. Without the letter from the insured demanding that the Proof of Loss be filed timely, many courts will not enforce the provision requiring the Proof of Loss to be timely filed.

**B. FAILURE TO FILE SUIT WITHIN THE TIME PERIOD PROVIDED BY THE BOND.**

Most bonds require suit to be filed no later than two years after the date of discovery. In most jurisdictions, the limitations periods provided by the bond are enforceable even if a limitations period is shorter than what is required under the general contract law of that state. Again, it is important for the bonding company to fully reserve its rights during an investigation. If the bonding company is going to deny the claim, it is also critical that the letter denying the claim also state

that all rights are reserved, including the rights relating to the limitations provisions in the policy. Courts are much more likely to enforce a bond's limitations provisions if the insured has been reminded of the limitations period. The bonding company should also be careful not to take any action which the insured and/or the court could construe as an equitable waiver of the bond's limitations period.

In the case of Federal Deposit Ins. Corp. v. Hartford Accident & Indem. Co., 97 F.3d 1148 (8<sup>th</sup> Cir. 1996), the court considered the following timeline: (1) In October 1988, a bank discovered a potential loss. (2) In December 1988, the bank submitted a Proof of Loss. (3) In March 1990, after a thorough investigation of the claim, the surety denied coverage. (4) in November 1990, the bank filed suit against the surety. The bank's bond provided that any action on the bond must be brought within 24 months after discovery of the loss. Despite arguments that the 24 month period had been tolled during the surety's investigation, and that the surety had waived the limitations period, the court enforced the limitations period of the bond against the bank. Specifically, the court pointed to the clear language of the bond, and to the fact that the bank waited seven months to file suit after its claim had been denied by the surety.

Even states which require a strict showing of prejudice relating to notice defenses will often enforce the limitations provision of the bond.

## **II. MISREPRESENTATION**

Misrepresentation is one of the most often overlooked defenses. I believe it is important to review the underwriting file, particularly the applications and renewal applications for coverage. Intentional or negligent misrepresentations in the applications can result in barring coverage under certain circumstances.

The defense of misrepresentation can be enforced through statutory and/or common law, and may be reinforced by an insurer through the language of the policy application.

Section 56-7-103 of the Tennessee Code Annotated states as follows:

No written or oral misrepresentation or warranty therein made in the negotiations of a contract or policy of insurance, or in the application therefor, by the insured or in the insured's behalf, shall be deemed material or defeat or void the policy or prevent its attaching, unless such misrepresentation or warranty is made with actual intent to deceive, or unless the matter represented increases the risk of loss.

Tennessee courts have strictly applied this statute to prevent applicants for insurance from being able to withhold important information from the insurer and still remain covered under an insurance policy. The following case summaries demonstrate this consistent application:

"The rule as announced and followed by our courts is that a misrepresentation about any matter of sufficient importance, in the opinion of the court, to naturally and reasonably influence the judgment of the insurer in making the contract, is a misrepresentation that increases the risk of loss ... Such a false representation, relied upon by the company, renders the policy void in its inception." Milligan v. MFA Mutual Ins. Co., 497 S.W.2d 736, 739 (Tenn. App. 1973).

After court determined that applicant for credit life insurance had answered questions on application incorrectly, it held that "insurance policy ... was void and of no effect." Johnson v. State Farm Life Ins. Co., 633 S.W.2d 484 (Tenn. App. 1981).

"Our courts have also held in this jurisdiction that an insured's failure to disclose prior diseases or disabilities on an application for life insurance increases the risk of loss and renders the policy void." Cox v. Nationwide Mutual Fire Ins. Co., 1989 Tenn. App. LEXIS 526.

Court held that failure to disclose information that affected the evaluation of risk of loss allowed the insurer to "avoid the policy." First Tennessee Bank v. USF & G, 829 S.W.2d 144 (Tenn. App. 1991).

If a misrepresentation increases the risk of loss to the insurer or is made with the intent to deceive, it will void the policy. Spellmeyer v. TN Farmers Mut. Ins. Co., 879 S.W.2d 843 (Tenn. App. 1993).

Even if the misrepresentation is directly or indirectly caused by an agent of the insurance company, courts have held that the applicant has a duty to make certain that the application is correct, and the statute continues to apply:

"It is the general rule that one who enters into a written contract, negotiated by an agent, is presumed to know the contents of the writing and is bound thereby - although peculiar and exceptional circumstances may affect the application of this general rule." Cox v. Nationwide Mutual Fire Ins. Co., 1989 Tenn. App. LEXIS 526.

"An insured has the duty to read the application for insurance and to verify the accuracy of the information therein stated... It has been held that where the agent deliberately omits from the application the insured's correct medical history and that omission increases the risk of loss, there can be no recovery on the policy where the insured, failing to read the application, affirms the accuracy of the statements therein contained." Montgomery v. Reserve Life Ins., 585 S.W.2d 620, 622 (Tenn. App. 1979) (citations omitted).

In FDIC v. Aetna Cas. & Sur. Co., 947 F.2d 196 (6<sup>th</sup> Cir. 1991), the 6<sup>th</sup> Circuit Court of Appeals allowed Aetna to assert its misrepresentation defense against the FDIC, despite the federal regulatory statutes that grant broad power to the FDIC as the receiver for a failed bank. In this case, the bank did not disclose on its policy application to Aetna the fact that it was under investigation by state or federal authorities with regard to its banking practices. Even though the bankers blanket bond issued by Aetna to this bank did not contain a specific provision providing that coverage would be withdrawn in the event of any misrepresentation on the application, the Court of Appeals recognized that Aetna could assert the defense of misrepresentation pursuant to TCA §56-7-103. Id. at 207, footnote 14. The court stated:

To strip Aetna of the defense of material misrepresentation, a defense recognized under Tennessee law, would effectively deny Aetna of the benefit of its bargain.

Similarly, in the case of National Union Fire Ins. v. FDIC, 837 S.W. 2d 373 (Tenn. 1992), the Tennessee Supreme Court relied on FDIC v. Aetna to allow National Fire to pursue its misrepresentation defense against the FDIC, with regard to a director and officer liability policy issued to a bank in receivership under the FDIC. The court stated that:

By completing and submitting the application for insurance and accompanying documents required by the application, [the bank] made written representations which became part of the contract when the policy issued. ... To the extent of the written representations, National Union is entitled to defend against a claim under the policy by showing that [the bank] made misrepresentations in such a fashion to allow the policy to be voided pursuant to TCA §56-7-103.

Recently, a federal district court in New Jersey reached the same conclusion. In the case of FDIC v. Moskowitz, 946 F.Supp. 322 (D. N.J. 1996), a bank in receivership did not disclose criticism from bank regulator in response to a question on the fidelity bond application. The court held that this misrepresentation of material information on the bond application was a valid defense for the surety company, and would support rescission of the bond.

### **III. PREJUDICING SUBROGATION RIGHTS.**

Often, fidelity claims made by insureds involve third parties who are active participants in a dishonest scheme that has caused the insured to suffer loss. Through subrogation, a bonding company may often recoup its own payment to the insured by pursuing recovery rights against third parties who are at least partially liable for the loss. However, if the insured jeopardizes those recovery rights, the bonding company may have a defense against coverage under the policy.

One policy addresses this issue in the following provision:

In the event of any payment under this Endorsement, the Company shall be subrogated to all the Insured's rights of recovery against any person or organization, and the Insured shall execute and deliver instruments and papers and do whatever else is necessary to secure such rights. The Insured shall do nothing after loss to prejudice such rights.

The language of this subsection is not clear as to whether or not an insurer must provide payment under a policy before the insurer can assert a claim that the insured has prejudiced the "rights" of recovery. It is certainly arguable that although payment must occur before the insurer has any right of *subrogation*, the last sentence of the subsection obligates the Insured to protect "such rights" *prior* to any payment by the insurer, because "such rights" can only refer to "the insured's rights of recovery." Obviously, the insured can have and pursue rights of recovery against third parties before payment is even considered by the insurer; this subsection appears to require the insured to refrain from releasing or otherwise prejudicing those rights after loss has occurred.

Tennessee law is clear that a surety cannot receive subrogation rights from its insured until the claim of the insured has been paid in full, including but not limited to, payment from the surety. Wimberly v. Am. Cas. Co. of Reading, Pa., 584 S.W.2d 200 (Tenn. 1979) ("The insured must be made whole

before subrogation rights arise in favor of the insurers."). Thus, an insurer's subrogation rights cannot be impaired until they have arisen, which must be after payment on the bond by the insurer.

The issue of whether an insurer chooses to pay a claim under its bond could have a direct effect on the nature of this defense available under the bond. If the insurer has paid the amount of the loss, then the insurer can assert the defense that the insured impaired the subrogation rights of the insurer. This impairment defense is available to the insurer because of the language in the subsection mentioned above. On the other hand, if the insurer has *not* paid under the bond, the insurer has a possible defense that the insured has failed to mitigate its damages by not pursuing possible recovery rights against third parties. The mitigation defense does not necessarily depend on any language of the bond, but can arise merely as a general contract defense. However, the insured's failure to mitigate may not be a complete defense for the insurer; instead, it may only limit the amount of damages that the insured can claim under the Policy.

The impairment defense is contingent upon whether the insured's conduct toward the third parties can be construed as a waiver of any recovery rights that the insured has against them; if such a waiver has occurred then the bonding company's subrogation rights have certainly been impaired. If, however, the insured's conduct toward the third parties has not prejudiced the opportunity for recovery, an impairment defense will not be available to the bonding company because the company will be able to look to the third parties for reimbursement upon payment of the claim.

At least one case has discussed this defense in the context of a bond. The court in First Nat. Bank of Louisville v. Lustig, 1990 U.S. Dist. LEXIS 7457 (Louisiana 1990), emphasized that the defense was not available to a surety unless the surety had paid the claim made on the bond, and stated that "under the plain language of the bond, the Sureties' subrogation rights do not arise until the bond has been paid. ... By denying coverage, the Sureties have implicitly waived the impairment of subrogation defense." However, the court also referred to the subrogation issue as the surety's concern that the insured "preserve all viable claims against [the third] parties connected to the tainted loan transactions."

#### **A. IMPAIRMENT OF COLLATERAL.**

Impairment of the rights of a surety is also discussed in the context of collateral given to a creditor as security for a loan. If a borrower defaults on a loan, and the surety pays the creditor, the surety obtains subrogation rights in the collateral held by the creditor as security. If the creditor does not protect its interest in the collateral, or allows the collateral to decrease in value, the collateral is considered to be "impaired," thus damaging the rights of the surety. In re Holland, 63 B.R. 675, 676 (Bkrtcy. W.D.Tenn. 1986). If the surety has not consented to the creditor's action, or inaction, with regard to the collateral and the surety's rights of subrogation are lost, "the surety may be discharged to the extent of the value of the impairment." Id. The case law from most jurisdictions discusses the impairment of a surety's rights of subrogation in the context of damage to security given to a creditor by a borrower for a loan, which is guaranteed by the surety. If the surety is called upon to pay the loan on behalf of the borrower, and the collateral is impaired by the creditor, the surety loses the opportunity to use the collateral as reimbursement for its payment. Therefore, the surety is allowed to be discharged from its obligations to the creditor to the extent that the collateral could have been used for reimbursement. The following cases are representative of this possible defense:

First Nat'l Consumer Discount Co. v. McCrossan, 486 A.2d 396 (Penn. 1984).

"The creditor in such a situation must not prejudice the right of the surety to resort to the security when the surety pays the debt and becomes entitled to subrogation. Impairment of the collateral discharges the surety to the extent that the unimpaired security would have paid the principal debt or to the extent of the surety's injury."

Katsoufris v. Adamo, 522 A.2d 1046 (N.J. App. 1987).

"We begin with the well-recognized principle that a release of collateral held by a creditor, or its impairment by improper action or inaction on his part, will extinguish the obligation of the surety, at least to the extent of the value of the security released or impaired. ... If the impairment of collateral can be measured in monetary terms, then the calculated amount of the impairment will ordinarily measure the extent of the surety's discharge. However, ... a surety may be able to establish that he has sustained prejudice, but be unable to measure its extent in terms of monetary loss. Where such a situation is presented the surety will normally be completely discharged."

Port Distributing Corp. v. Pflaumer, 880 F.Supp. 204 (S.D.N.Y. 1995).

"A creditor holding collateral security for an obligation that is guaranteed holds that collateral in trust for the guarantor, and must preserve it for the benefit of the guarantor. ... Since a surety has a right of substitution or subrogation in the event that he pays the debt, and can then compel the creditor to assign to him collateral security held for the debt for his indemnity, a creditor has no right to release or discharge such securities, and to throw upon the surety the burden of the debt which might otherwise have been paid in whole or in part out of the principal, or primary, obligor. ... A creditor who releases (rather than merely impairs) collateral without the consent of the guarantor discharges the guarantor from his or her obligations under the guarantee."

Bank of Idaho v. Nesselth, 664 P.2d 270 (Idaho 1983).

"The creditor ... is under a legal duty to take whatever action is necessary to maintain the value of security. Any diminution of value of the security caused by the creditor, whether by negligence or not, results in pro tanto discharge. The reason for the pro tanto discharge of the surety is the impairment of the surety's right of subrogation to enforce the security."

Fed. Home Loan Mortg. Corp. v. Estate of Santoro, 1995 Conn. Super. LEXIS 1253 (1995).

"Negligence in action can be found to constitute impairment of collateral. To 'impair' collateral means to injure it or allow it to deteriorate in value. ... A surety ... is subrogated to the rights of the creditor against the collateral which secures that obligation. Thus, it is only fair that impairment of the collateral by the creditor operates to relieve the surety to the extent of the impairment."

## **B. MITIGATION OF DAMAGES.**

The duty to mitigate is a general duty that arises in both the tort and contract context. The following cases summarize the law regarding this duty:

"It is the duty of an injured party to exercise reasonable care and diligence to avoid loss or minimize damages. The applicable standard is one of reasonable care. The plaintiff is not required to mitigate his damages if such action is unduly burdensome or impossible." Haynes v. Cumberland Builders, Inc., 546 S.W.2d 228 (Tenn. App. 1976) (cites omitted).

"As a matter of general law, insureds must act reasonably to minimize their losses. The insurance policy echoes this proposition of law by denying liability for any loss resulting from the insured's failure to protect the car after an accident." Jones v. Allstate Insurance Company, 1991 Tenn. App. LEXIS 58 (February 6, 1991).

Other jurisdictions generally recognize that parties have an obligation to mitigate damages that have been incurred, for whatever reason. The following cases summarize this principle:

Pulaski Bank and Trust Co. v. Texas Amer. Bank, 759 S.W.2d 723 (Tex App. 1988).

"Texas law recognizes the doctrine of avoidable consequences, or the duty to mitigate damages. An injured person cannot recover damages that do not result proximately from the tortfeasor's breach of duty and thus damages that might be avoided or mitigated are not recoverable. ...public policy requires that persons should be discouraged from wasting their resources, both physical or economic. ... The doctrine of avoidable consequences requires an injured party to use reasonable efforts to avoid or prevent losses. ... The doctrine is applicable only if the victim of the wrongdoer's act has knowledge of the fact which makes avoidance of the consequences necessary, and if the damages can be avoided with only slight expense and reasonable effort." (cites omitted)

Home Life Ins. Co. v. Clay, 773 P.2d 666 (Kan. App. 1989).

"It is a general rule of law that one who is injured by the wrongful or negligent acts of another is bound to exercise reasonable care and diligence under the circumstances to avoid loss or to minimize the resulting damages, and to the extent that his damages are the result of the failure to exercise such care and diligence, he cannot recover."

Turner Const. v. First Indem. of America, 829 F.Supp. 752 (E.D.Pa. 1993).

"A party who suffers a loss due to a breach of contract has a duty to make reasonable efforts to mitigate his losses. Put another way, the amount recoverable by the damaged party must be reduced by the amount of losses which could have been avoided by that party's reasonable efforts to avoid them."

Fisher v. Fidelity & Deposit Co., 466 N.E.2d 332 (Ill. App. 1984).

"The rule in Illinois is that the plaintiff may not increase the measure of damages by his failure to mitigate the harm to his property."

Other jurisdictions have gone even farther and have recognized that failure to mitigate damages is available to sureties as a defense under their bonds. For example, in Texas Dept. of Transportation v. Shaw, 847 S.W.2d 618 (Tex. App. 1992), the court acknowledged that the State, as the insured under the public official fidelity bond, had a "duty to mitigate its potential damages by participating in the bankruptcy proceedings" of the third-party corporation who had received the embezzled funds. Similarly, the court in First Nat. Bank of Louisville v. Lustig, 150 F.R.D. 548 (E.D.La. 1993), briefly discussed a pre-trial motion that specifically recognized failure to mitigate as a defense to a fidelity bond claim.

### **1. Failure to Attach Available Assets and Offset Damages.**

In the case of Premier Elec. Const. Co. v. USF&G Co., 1987 U.S. Dist. LEXIS 5588 (Illinois 1987), a surety on a fidelity bond asserted a defense of failure to mitigate in response to a summary judgment motion. This particular defense involved the insured's failure to attach settlement proceeds received by the tortfeasor from an unrelated lawsuit. The court briefly discussed the fact that there could be some question as to whether the surety must provide notice to the insured regarding where and how any mitigation might be possible. The court also mentioned that the mitigation defense could only *reduce* the surety's liability under the bond, rather than release the surety completely. The court denied the insured's summary judgment motion and preserved the mitigation defense for trial.

One scenario that I have encountered involves severance packages provided by insureds to employees whose dishonesty resulted in a claim filed with the insured's bonding company. Generally, and especially in the case of employee dishonesty, such severance packages are not required to be paid by the insured, and in some cases, the amount of severance provided to the dishonest employee has exceeded the amount of the claimed loss. In such a case, the defense of failure to mitigate is certainly available to the bonding company, because the insured has failed to offset its damages.

Although employers cannot legally require that damages due to employee dishonesty be offset by distributions from pension plans, these distributions remain as possible recovery assets. Bonding companies should encourage insureds to discuss such distributions with the dishonest employees; often, employees will agree to waive their rights with regard to pension distributions in exchange for a complete or partial release.

### **2. Failure to File Bankruptcy Claims.**

As discussed above, in the case of Texas Dept. of Transportation v. Shaw, 847 S.W.2d 618 (Tex. App. 1992), the court acknowledged that the State, as the insured under a public official fidelity bond, had a "duty to mitigate its potential damages by participating in the bankruptcy proceedings" of the third-party corporation who had received the embezzled funds. Bonding companies often lose the possibility of partial recovery by the failure of an insured to file a proof of claim in the bankruptcy of a principal or an involved third party. Obviously, some consideration must be given to the assets of the particular bankruptcy estate, in order to make a determination regarding whether the possible recovery is worth the cost of filing the proof of claim. It is reasonable, however, to expect an insured to make such a consideration.

### **3. Allowing the Statute of Limitations to Run as to a Principal or Third Party.**

Another way that an insured can fail to mitigate its damages with regard to a claim is to allow the applicable statute of limitations to expire as to a possible legal action against a principal or an involved third party. As with a bankruptcy, as discussed above, some consideration must be given to the strength of such a legal action and to the possibility of eventual recovery. However, if a judgment would be relatively easy to obtain, it should be reasonable to expect insureds to assume that their bonding company would prefer to have a judgment against as many malefactors as possible. If the insured is represented by counsel, this is an especially reasonable expectation of the bonding company.

### **C. COOPERATION CLAUSE.**

Most bonds contain a cooperation clause which requires the insured to fully cooperate in the investigation and in pursuing salvage recoveries. This clause is not used so much as a defense but more as a means of persuading an uncooperative insured to provide documentation and otherwise cooperate with the bonding company's investigation and salvage efforts.

## **CONCLUSION**

Coverage defenses should be carefully evaluated and fully investigated. If a bonding company intends to assert a coverage defense, it is generally very prudent to obtain an opinion letter of counsel in the event the coverage defense is determined by a court not to be valid. An opinion letter of counsel, plus a thorough investigation of the claim, can strongly mitigate, or in some states even eliminate, the bonding company's exposure for a bad faith claim.

The notice defenses and the other defenses discussed above can inflame the insured because the claim is not being denied based upon the merits of the claim but rather because of what is viewed as a "technical" defense provided by the bond. Even if the bonding company believes that it has a notice defense, I generally recommend that the company complete a full investigation of the claim based upon the merits of the claim to determine whether there would otherwise be coverage. It is a lot more palatable to the insured to deny a claim based upon the merits of the claim rather than by using a notice defense. The handling of claims gets more complicated each day because of the underwriters' involvement, either directly or indirectly. The marketplace is extremely competitive, and underwriters can become concerned when the Claims Department, pursuant to the terms of the bond, properly denies a claim based on a notice defense, especially if the claim is small and the account is large. Some companies will not assert a notice defense except in conjunction with a defense relating to the merits of the claim.

It is very important to fully explain any coverage defense and its basis to the insured. This can reduce the chances of litigation with the insured and help to maintain the bonding company's relationship with its insured.