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JOINT CONTROL, NO CONTROL, OUT OF CONTROL

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(THE SURETY'S PERSPECTIVE OF JOINT CONTROL ACCOUNTS)

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I. INTRODUCTION.

The “joint control account” is one of the basic tools that claims representatives (and, more increasingly, underwriters) have developed to manage bond losses, inhibit defenses to indemnity obligations, and possibly create a basis of recovery from financial institutions. Amazingly, there is very little written analysis of the benefits, limits, and pitfalls of “joint control accounts.” This paper addresses some of the legal developments and principles applicable to “joint control agreements” in the areas of Probate bonds and Construction bonds.

II. DEFINITION/MECHANICS/PURPOSES.

A “joint control agreement” or “trust account agreement” is a contract by a bonded principal and/or contractual indemnitor with a surety requiring certain funds to be deposited into an account with a designated financial institution, withdrawals from which are only allowed for certain limited purposes and which usually require the signature of both the principal and a joint control “representative” designated by the surety. The money covered by the agreement and required to be deposited into the joint control account typically consists of the funds subject to the principal’s control and dominion in connection with a bonded obligation. A bonded administrator or guardian may be required by the surety to place the money belonging to a bonded estate into a joint control account, withdrawals from which require not only the bonded principal’s signature, but also the signature of someone acceptable to the surety. In the construction setting, a bonded contractor may be required to deposit contract progress payments into a joint account, and checks drawn on such an account usually requires signature of one of the surety’s claims representatives for payment of payroll, materialmen, and suppliers.

The establishment of joint control accounts can occur pursuant to both written and oral agreements. There may be one agreement between the surety and principal/indemnitors for the establishment of a joint control account which establishes the scope of the agreement and rules applicable to deposits and withdrawals. There may be yet another agreement with the depository financial institution and the account owners establishing the requirements for withdrawals, which may or may not be subject to Uniform Commercial Code principles.

From an underwriting perspective, joint control agreements are used to limit the access a bonded principal has to money protected by the bond and to establish at least some modest review process on the expenditure/withdrawal of such funds. From a claims adjusting perspective, joint control agreements serve to marshal certain assets of the principal and ensure that those assets are paid correctly. Another practical purpose of the joint control arrangement at the claim stage is an acknowledgment by the principal and indemnitor of the indemnity obligation, recognition of the surety's right to contract proceeds, and at least tacit approval of the claims paid from the joint account.

III. CASE STUDY--GEORGIA COURTS TREATMENT OF JOINT CONTROL AGREEMENTS IN PROBATE SETTING.

One recent Georgia decision involving a probate joint control agreement, *Travelers Indemnity Company v. Trust Company Bank*, 97 FCDR 3915 (Ga. App. 10-22-97) has all the components of Sergio Leone's classic, "*The Good, The Bad, and the Ugly*."

In *Travelers*, the surety's principle wrote checks from the joint control account (required by the surety's underwriting department when it issued the bond) without the required signature of the joint control representative. As frequently is the case, the principal's attorney was the surety's joint control representative, but neither received account statements nor requested statements from the bank which also signed the joint control agreement with the principal, attorney and surety. After the surety was surcharged for the funds wasted by the principal, the surety sued the bank and its principal's attorney for the sums improperly drawn from a joint control guardianship account without the attorney's required signature. The surety claimed the bank breached the contract/joint control agreement by honoring the checks without the required signatures. The surety claimed the attorney breached the joint control agreement by failing to exercise control over the account and by failing to preserve the surety's rights against the bank.

A. JOINT CONTROL--THE GOOD

Historically Georgia Probate Courts and their predecessors have publicly decried joint control accounts (while privately--outside their opinions extolling their virtues. The written opinions of Georgia Courts regarding joint control accounts before *Travelers*, were based on principles likely available in other jurisdictions). Because guardians, conservators, administrators, executors, personal representatives and trustees are statutory fiduciaries, with not only the right but duty to possession, control and discretion of funds subject to their trust, Georgia Courts have historically held that joint control accounts improperly divest the court appointed fiduciary of the statutory powers of discretion and control. *Fidelity & Deposit Company of Md. v. Butler*, 130 Ga. 225, 60 S.E. 851 (1908). The *Butler* Court ruled that joint control agreements by a guardian violate the public policy of Georgia. In 1928 one court went so far as to suggest that even the execution of a joint control agreement by a testamentary trustee was a breach of fiduciary duty and could be grounds for removal. *Clark v. Clark*, 167 Ga. 1, 8, 144 S.E. 787 (1928). See also *First National Bank of Chatooga County v. Rapides Bank & Trust*, 145 Ga.App. 514, 517, 244 S.E.2d 51 (1978).

In 1983 Georgia adopted a new constitution and revised and reorganized its statutory laws. Quietly, a new statute promoted by the surety industry was enacted expressly authorizing joint control accounts--withdrawals from which could require written consent of the surety or an order from the court. O.C.G.A. § 33-24-49. Despite this statute many Georgia probate judges adhered to the prior view that joint control agreements were invalid and constituted an improper relinquishment of control by a fiduciary unless expressly approved by the court. Even if submitted for approval by the Court, Probate Courts frequently imposed limitations on joint control arrangements, which for all practical purposes rendered the surety's ability to control expenditures of the money from the accounts meaningless. Despite the existence of O.C.G.A. § 33-24-39, Georgia Probate Judges were of the opinion that the statute authorized joint control agreements only with respect to non-fiduciary matters.

The bank and attorney in *Travelers* (mindful of *Butler* and its progeny and the view of Georgia Probate Courts) argued that as a matter of law, the surety had no claim because the joint control agreement violated public policy and was therefor void. The *Travelers* court disagreed.

The *Travelers* decision changed the law in Georgia, and overruled *Butler* and its progeny as far as probate estates are concerned based on the enactment of the statute cited above authorizing joint control agreements. “What the legislature allows cannot be contrary to public policy.” Joint control agreements in Georgia are valid--even in Probate settings. The surety claims adjuster and even the underwriter should determine whether other states have statutorily approved joint control agreements.

The approval of joint control agreements in Probate settings is the “good” part of *Travelers*. The rest of the *Travelers* decision is “bad” and even “ugly.”

B. No Control--The Bad

The surety’s claim against the bank was principally a breach of contract claim--based on the joint control agreement signed by the bank requiring two signatures for withdrawals from the joint account. The bank in *Travelers* argued, in the face of the surety’s breach of contract claims, that it was not liable because of the failure of the surety or any other customer to notify the bank of the missing necessary signatures within 60 days from the mailing of statements referencing the items honored without all the required signatures. O.C.G.A. § 11-4-406 (Georgia’s version of the Uniform Commercial Code is in Title 11 of the Official Code of Georgia Annotated). The surety argued that the joint control agreement was a separate and independent contract, and that it could maintain a breach of contract action even if it had not satisfied the 60 day notice requirements imposed upon a customer by the UCC in § 4-406.

Georgia’s version of the UCC § 4-406 is significantly different from the standard version. For many years, under the Georgia statute, a bank customer has been required to notify the bank of any unauthorized signature¹ or alteration on the face of an item honored by the bank within 60 days from the time the bank mails a statement containing or referencing the items containing an unauthorized signature or alteration. (The standard UCC provision allows the customer up to six months to provide this notice.) If a customer in Georgia fails to provide notice within the required 60 day period, the customer “is precluded from asserting against the bank such unauthorized signature or alteration.” This time limitation applies even if the customer does not receive the statement, as long as the bank mails it. *Decatur Federal Savings and Loan Ass’n v. Litsky*, 207 Ga.App. 752, 429 S.E.2d 300 (1993).

For years surety advocates (including the author) have been using the executed joint control agreement breach-of-contract theory as a sword to avoid the 60 day UCC § 4-406 defense asserted by banks. Another arrow in the surety’s quiver has been that the banks have not sent the statements to the surety or to its joint control representative and thus § 4-406 is not applicable. Amazingly (and despite frequent advice to the surety that such would not be the result) financial institutions have routinely capitulated and paid the surety the entire amounts improperly withdrawn from joint control accounts when confronted with these arguments. (In some instances, sureties have recovered hundreds of thousands of dollars). After *Travelers* this source of salvage recovery will evaporate in Georgia.

¹ In most jurisdictions, including Georgia, a check honored without a necessary signature is treated as a check bearing an unauthorized signature. *Trust Company Bank of Atlanta v. Atlanta IBM Credit Union*, 245 Ga.262, 264-265, 264 S.E.2d 202 (1980). See also *Knights Communications, Inc. v. Boatmen’s National Bank of St. Louis*, 805 S.W.2d 199, 201-202 (Mo. App. 1991).

The *Travelers* court cited a case from New Jersey virtually on point, *American Insurance Company v. Fidelity Bank & Trust Co. of New Jersey*, 244 N.J. Super. 600, 583 A.2d 361, 363 (N.J. App. 1990) and adopted its reasoning. The *American Insurance* court held that the joint control agreement did not elevate the surety's status above that of a "customer" under the UCC. "Because the bank sent regular statements to the only person to whom it had been directed, . . . the surety's untimely failure to request statements or notify the bank of improperly honored checks barred its claims." This is the "bad" aspect of *Travelers*, although not completely surprising.

The ruling in *American* raises some questions, the answers to which are not clear. The court in *American Insurance* observed that the joint control agreement at issue "neither expressly confers a greater right to [the surety] nor imposes an additional obligation upon the bank to notify or monitor the account than would be incumbent in the normal joint-signature arrangement." What would have happened if the *Anderson* joint control agreement had specifically stated that UCC § 4-406 did not apply? Could a breach of contract claim withstand § 4-406 if a different period of time for notification to the bank were set forth in the agreement? Would the result be different if the agreement required bank statements to be mailed to the surety or joint control representative? Would a bank even sign such an agreement?

The lesson from *Travelers* and *American Insurance* applies to sureties in both the probate bond and construction bond settings. The time within which to notify a bank of unauthorized signatures and material alterations may differ according to the version of the UCC in a particular jurisdiction. Nevertheless, failure to promptly receive and review bank statements and the instruments referenced in those statements is fatal to claims against the bank. Indeed, the failure to receive a bank statement every 30 days is itself a warning sign. The statement and instruments will frequently contain evidence of improper conduct, which if promptly reviewed will not only preserve the ability to recover from the bank, but may also alert the surety to other problems with its principal. There simply is no good reason not to request copies of bank statements, cancelled checks, and establish a procedure for their prompt review in joint control agreement situations.

C. Out of Control--The Ugly

1. Probate Bonds - Does the Joint Control Representative Answer to Anyone?

Probate sureties more and more frequently through their underwriters require joint control accounts by their bonded principals. Frequently surety underwriters insist upon joint control accounts and will allow the attorney for the principal to sign a very general "joint control agreement" with the financial institution identifying the principal's attorney as the surety's joint control account representative, and specifying that withdrawals from the designated joint control account require the signature of the principal and the joint control representative. These agreements seldom (if ever) contain any language about damages for breach by any party; they do not direct the bank to provide copies of the account statements to the surety or its representative; they do not specify any duty by the joint control representative to the surety to monitor the purpose of the withdrawals; they do not provide for liability by the joint control representative for breach of any duty to the surety; they do not specify that the bank will be liable for honoring checks presented without all required signatures; they do not attempt to specify the time within which notice must be given to the bank or otherwise attempt to vary UCC principles.

Some sureties allow their selling agents to act as joint control representatives. But because of the demands of their business in selling bonds and other insurance policies, only the exceptional agent will actively monitor joint accounts requiring the agent's signature.

In almost all Probate situations, the bank statements and canceled checks are mailed only to the bonded principal--without copies or any notice of any type to the surety or its joint control representative. No system exists for sureties to verify mailing of statements by banks or receipt and review of statements by joint control representatives.

These industry norms were the facts of *Travelers*. The *Travelers* court held that the only agreement the principal's attorney made with the surety in the counter-signature agreement in that case was to co-sign checks. The court further held that no reasonable interpretation of the counter-signature agreement in that case required the joint control representative to actively monitor the account, supervise the guardian, or otherwise manage the ward's affairs. The *Travelers* court also ruled that the surety had no claim against the attorney standing in the shoes of the ward, because the attorney was not the representative of the ward when the joint account was established (if he had ever been). Those surety advocates among us who see this ruling in *Travelers* as "Ugly" are not just paranoid. The author has filed several complaints (and obtained recovery) against attorneys who failed to monitor joint control accounts. These joint control representatives/attorneys frequently received bank statements and canceled checks written and signed only by the principal. (On one occasion I opened *for the first time* bank statements that were 4-5 years old sent to a principal's attorney who acted as a joint control representative). The joint control representatives our surety clients have sued provided no notice to either the surety or to the banks. (As a practical matter we all realize that a principal who forges a joint control representative's signature is not going to call the bank and advise them that "I forged JCR's signature on check number 5555." Such a principal is also unlikely to notify the surety). Thus, if the joint control representative does not monitor the account, the joint control account is useless.

Likewise, if the joint control representative has no obligation to the surety other than to co-sign checks, the joint control agreement is meaningless. Under the rule in *Travelers*, the joint control representative can either sign the checks or not. If the joint control representative does not sign the checks, the surety has no recourse. If he signs the checks, but they are for an improper purpose, the surety has no recourse. His only obligation is to co-sign checks, but if as in *Travelers* he does not co-sign checks he is not liable. Therefore, in these situations, the funds are beyond the surety's control. The situation is out of control when the joint control agreement is not specific and detailed with a list of the duties and consequences of breach.

2. OUT OF CONTROL CONSTRUCTION BOND JOINT CONTROL AGREEMENTS

Sureties in the construction bond area are not as vulnerable (as probate bond sureties) because of the development of sophisticated joint control agreements and more importantly because the joint control representative is frequently the surety's claim representative, who actually receives the bank statements and canceled checks. There are however, some concepts which should be borne in mind, specifically bankruptcy preference claims.

We are all well aware that bankruptcy trustees are empowered to avoid “preferences” payments by debtors. Transfer to debtors of more than \$600.00 within 3 months/90 days of the bankruptcy petition are presumed voidable preference payments. 11 U.S.C. § 547. Transfers by a bankrupt debtor to insiders within one year of the bankruptcy are voidable preferences. *Id.*

In light of these preference principles, the critical question the surety needs to consider is whether a surety which funds payments to bond claimants from a joint control agreement with a principal who may file bankruptcy be subjected to “double indemnity?” The answer is “yes” when laborers and materials suppliers are forced to disgorge their receipts from a joint control account to the bankruptcy trustee as preferences under 11 U.S.C. § 547.

To establish that a payment to any insolvent's creditors is an avoidable preference, the trustee must prove five elements by a preponderance of the evidence: that the payment (1) benefits the creditor; (2) is for an antecedent debt; (3) is made while debtor was insolvent; (4) is within 90 days before bankruptcy (or one year in the case of an insider creditor); and (5) enables the creditor to receive larger share of estate than if transfer had not been made. 11 U.S.C.A. § 547(b); see also *Union Bank v. Wolas*, 502 U.S. 151 (1991). Although the trustee may readily be able to meet this standard, there is an important exception to the preference rule that can greatly benefit (although maybe indirectly) a surety involved in a joint control agreement with an insolvent contractor.

The Bankruptcy Code exempts otherwise preference payments made to the debtor's creditors in the “ordinary course of business.” 11 U.S.C. § 547(3)(2). To determine whether a payment was made in the “ordinary course” of business, courts “have generally focused on the prior conduct of the parties, the common industry practice, and, particularly, whether payment resulted from any unusual action by either the debtor or creditor.” 5 *Collier on Bankruptcy* ¶ 547.04(2)(a) (Matthew Bender 15th Ed. 1997). This standard cannot be met unless the debtor had prior dealings with the creditor to which the payment in question is made. *In re Brown Transport Truckload, Inc.*, 152 B.R. 690 (N.D. Ga. 1992). Furthermore, the purpose of the “ordinary course” exception to preference payments is to encourage trade creditors and other suppliers of goods and services to continue dealing with troubled debtors without fear of the trustee's avoidance powers. *In re Peterson Distributing, Inc.*, 197 B.R. 919, 927 (Utah 1996).

Even before the Bankruptcy Code was amended to include the “ordinary course of business” exception, courts recognized payroll payments as exceptions to the trustee's preference-avoidance power. See, e.g., *Zelmer v. Esher*, 1 B.R. 599, 601-602 (Bkrptcy. D. Conn. 1979).

The delinquency of payments to creditors also weighs heavily in courts' determinations of whether the payments were “ordinary.” As long as the payment was not more than 45 days late, and there existed a pattern or practice of tolerance for payment payments, the “ordinary course of business” exception should apply. In *In re A.W. & Associates, Inc.*, 196 B.R. 900, 904 (Bkrptcy. N.D. Fla. 1996), the debtor/contractor was 30 days late in paying its concrete supplier, but since it had been established that the contractor typically paid this supplier late, the court held that the payment was in the ordinary course of business and thus not avoidable.

To be avoided as a preference, a payment must diminish or deplete the debtor's estate. See *Coral Petroleum, Inc. v. Banque Paribas-London*, 787 F.2d 1351 (5th Cir. 1986). Therefore, “payments made by [a] . . . surety or guarantor are not preferential because there is no transfer of the debtor's property.” 5 *Collier on Bankruptcy*, ¶ 547.03(2), 21 (Matthew Bender 15th Ed.

1997). In a joint account situation, the contractor/debtor would have some property interest in any money that passed through the account. To make certain that the money deposited by a surety into the joint account does not become a preferential payment, it must be "earmarked," *i.e.*, the money must be designated to pay a specific creditor for a specific debtor and it must be used to do this. *McCuskey v. National Bank of Waterloo*, 859 F.2d 541, 566 (8th Cir. 1988). Simply stated, the debtor cannot decide what to do with the money (or who to pay) after receiving the money for the surety. Rather, it must be predetermined because the estate of the debtor will be determined to be diminished by the payment if the debtor controls the deposition of the funds and designates which creditors will receive the payments. *In re Kemp Pac. Fisheries, Inc.*, 16 F.2d 313, 316 (9th Cir. 1994).

CONCLUSION

While there is only sparse reporting of decisions involving joint control agreements, the lessons from those cases reported are important from both the underwriting and claims perspective. Joint Control agreements are and remain useful tools to prevent losses, control losses, and diminish indemnity defenses. There are however pitfalls for the unwary, which may even increase the exposure to the surety through the use of these accounts. The Uniform Commercial Code, tax consequences and the possibility of bankruptcy by the principal should always be minimum consideration by the surety before relying on these devices. Joint Control representatives need to be accountable to the surety and care should be taken to create consequences for their disregard of the duties as a joint control representative. Such consequences and duty of loyalty to the surety is obvious when the representative is the surety's claims adjuster. The consequences and duties are likely only imaginary when the joint control representative is an attorney or representative of the principal without contractual duties to the surety.

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Timothy J. Burson, a member of Bovis, Kyle & Burch LLC, graduated from The University of Alabama School of Law in 1985 (J.D.): officer-- Bench and Bar legal honor society; member-- John A Campbell Moot Court Board; Dean Thomas Christopher Award -- leadership. He received his Bachelor of Arts degree from The University of Alabama in 1982. Mr. Burson is admitted to the bars of Georgia and Louisiana, and is admitted to practice before the United States Court of Appeals for the Fifth and Eleventh Circuits, various of the United States District Courts in those Circuits, and the United States Claims Court.

In addition to representing sureties in connection with performance and payment bond claims and employee dishonesty claims, a significant amount of Mr. Burson's legal work involves defending sureties from claims against bonds issued for fiduciaries. Mr. Burson represented the surety in *Continental Insurance Company v. Gazaway*, 216 Ga. App. 125, 453 S.E.2d 91 (1994) where he obtained reversal of a trial court ruling holding a surety liable under the principle of apparent authority when a probate court took a bond from an agent whose powers had been revoked by the surety without notice from the surety to the probate court.

Mr. Burson is also a co-author of a number of articles, including "Crime Policies and Other Insuring Agreements (or Policy Interpretations Become Curiouser and Curiouser)," ABA National Institute on Fidelity Bonds, November 1991. He is a member of the American Bar Association, and the Association of Trial Lawyers of America.