Michigan Law Review

Volume 35 | Issue 2

1936

# PRINCIPAL AND SURETY - FIDELITY BONDS - EFFECT OF FAILURE TO MAKE DISCLOSURES REGARDING BONDED EMPLOYEES

Francis T. Goheen
*University of Michigan Law School*

PRINCIPAL AND SURETY — FIDELITY BONDS — EFFECT OF FAILURE TO MAKE DISCLOSURES REGARDING BONDED EMPLOYEES — The defense on a fidelity bond given by the cashier was the failure of the officers of the obligee bank to disclose that prior to the execution of the bond the bank examiner had discovered and advised the officers that the cashier had, without the knowledge and consent of the officers and directors, become indebted to the bank in the sum of $889.60 by paying his own checks drawn on the bank. When the overdraft was called to his attention the cashier immediately repaid the bank. The surety insisted that despite the fact that the officers of the bank may have in good faith believed in the cashier's honesty, the fact of his shortage was so material to the risk that the failure to disclose it was fraudulent as a matter of law. On this theory the trial judge directed a verdict for the surety. It was *held* on review that the surety should be released only if there was fraud in

fact; that there was no fraud in fact if the officers of the bank sincerely believed the employee to be trustworthy unless, knowing that the bond would not be issued if the insurer knew the facts, they deliberately withheld them to obtain its execution, and that the question of the belief and the intent of the officers was one for the consideration of the jury. *First State Bank v. New Amsterdam Casualty Co.*, (C. C. A. 5th, 1936) 83 F. (2d) 992.

There is no little confusion concerning the extent of the employer's obligation to disclose to the surety any facts within his knowledge which have a bearing on the risk assumed by the surety.[1] There is, however, very general agreement upon the proposition that if the employer has knowledge of past misappropriations amounting to criminality, his failure to disclose such facts invalidates the surety's obligation on the bond.[2] There is uniformity in the acceptance of the rule, but an utter lack of uniformity in its application. Certainly in the instant case the act of the cashier was in violation of a banking statute.[3] The results in the individual case are often influenced by factors other than the nature of the employee's act. If the bond is not procured at the solicitation of the employer, if the employer is not present at its execution, and if there is no communication between the surety and the employer, the cases

[1] It is generally asserted that the continuation of the employment is a tacit representation of the fitness of the employee. Cases on the libaility on guaranty or surety obligations obtained by fraud are collected and annotated in a note in 21 L. R. A., 409 (1893). Cases on discharge of surety on fidelity bond by failure of employer to notify surety of delinquency of employee are collected and annotated in 11 Ann. Cas. 1031 (1909). See also the note in 63 Am. St. Rep. 327 (1898). It is generally held that there is no duty to disclose to the surety on an official bond the past acts of a government employee. Independent School Dist, v. Hubbard, 110 Iowa 58, 81 N. W. 241 (1899). But see Sooy v. State, 39 N. J. L. 135 (1877).

The fact that a surety is required may indicate that the employer is unwilling to trust solely the skill and honesty of the employee. 21 R. C. L. 991, § 40 (1918). When the information concealed does not relate to the business which is the subject of the suretyship, it has been held that there is no duty of disclosure. Thus, in Atlas Bank v. Brownell, 9 R. I. 168 (1869), the court held that the failure of the bank to disclose that, before the execution of the bond, the cashier had lost money gambling did not discharge the surety. If the prior act of the employee does not evidence a moral delinquency there is no duty to give information. Palatine Ins. Co. v. Crittenden, 18 Mont. 413, 45 P. 555 (1896). Cases are collected and annotated in 60 A. L. R. 160 (1929).

[2] Hebert v. Lee, 118 Tenn. 133, 101 S. W. 175, 12 L. R. A. (N. S.) 247 (1907). Cases are collected in 40 A. L. R. 1036 (1926). See also collection of cases on the duty to notify insurer that the employee has overdrawn his account in 4 A. L. R. 558 (1919).

[3] The opinion in the principal case places the act of the cashier in the category, not of a criminal taking of funds, but of an irregular use by overdraft of the bank's credit. In support of this proposition, the court cited United States Fid. & Guar. Co. v. Oklahoma, (C. C. A. 10th, 1930) 43 F. (2d) 532; in the cited case, the cashier had permitted overdrafts by a customer of the bank; by an Oklahoma statute the cashier, who permitted an overdraft, was made liable to the bank, in case the overdrawing customer failed to repay the overdraft.

have generally limited the extent of the employer's obligation of disclosure.[4] In the instant case it does not appear at whose request the bond was executed but it is certain that the employer made no written application or oral representation in order to obtain the bond and apparently the surety made no effort to secure information relative to the fitness of the employee. Under such facts it is not unusual for a court to submit to the jury a question of the good faith of the employer.[5] Other cases assert that the motive of the employer is of no importance and that the only test is the materiality of the fact which the employer has failed to communicate.[6] The instant case would base the result on the belief of the employer in the honesty or the dishonesty of the employee and there is in the language of the court no requirement that the belief entertained be a reasonable one. It is, however, submitted that in a strong enough fact situation this court would not hesitate to declare that the failure to disclose the prior act of the employee relieved the surety as a matter of law. On the question of intent and motive generally the apparent conflict of authority is largely one of language rather than one of result, which depends upon such considerations as the nature of the employee's past act, the opportunity of the employer to disclose the same, and the effort of the surety to obtain information. Quaere to just what extent results in the principal case may have been influenced by the fact that the surety was a professional.[7]

*Francis T. Goheen*

[4] Traders' Ins. Co. v. Herber, 67 Minn. 106, 69 N. W. 701 (1897); Home Ins. Co. v. Holway, 55 Iowa 571, 8 N. W. 457 (1881); Magee v. Manhattan Life Ins. Co., 92 U. S. 93, 23 L. Ed. 699 (1876). The factors of lack of opportunity of disclosure and lack of effort of the surety to obtain information are usually given only as additional grounds for the decision and, in general, the courts insist that the nature of the act concealed is the primary test. But see Aetna Life Ins. Co. v. Mobbett, 18 Wis. 667 (1864), holding the surety under a duty of inquiry.

[5] The court in Sherman v. Harbin, 125 Iowa 174 at 183, 100 N. W. 629 (1904), declared that "there must be an intent in some way to mislead, either by silence or what is said, for without an improper motive there can be no fraud such as to invalidate the contract." See also Bostwick v. Van Voorhis, 91 N. Y. 353 (1883).

[6] The English court in the leading case of Railton v. Mathews, 10 Cl. & Fin. 934 at 943, 8 Eng. Rep. 993 (1844), in releasing the surety declared, "If the facts were such as ought to have been communicated, if it was material to the surety that they should be communicated, the motive for withholding them, I apprehend, is wholly immaterial." See also Sooy v. State, 39 N. J. L. 135 (1877).

[7] The tendency of the early cases was to require a rather full disclosure of all the facts which might influence the surety in assuming the obligation. Thus, in Lee v. Jones, 17 C. B. (N. S.) 481, 144 Eng. Rep. 194 (1864), it was held that the failure of the employer to disclose that the employee was already in debt to him relieved the surety. But the rigorous doctrine of the early cases has been somewhat relaxed. The reason for this relaxation might be found in the more repeated entrance of the compensated or the professional surety into the picture; however, the language of the courts makes no distinction between the amateur and the professional in regard to the extent of the requirement of disclosure and a study of the cases does not reveal that this factor has produced any marked difference in the results in the individual cases.