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FIDELITY BONDS—DOES IT PAY TO RENEW THEM?—The question is raised by a recent Michigan case,[1] in which the facts are apparently illustrative of a normal practice in modern business. The employer purchases a fidelity bond to indemnify him against loss arising from the financial misconduct of one of his employees. The premium pays for protection, for the year 1928, to the amount of $5,000. A year later payment of a premium of the same amount results in his receiving a "renewal" or "continuation certificate." What is the legal, and what the practical, effect of the renewal?

The consideration being exactly the same, in amount, the average purchaser no doubt assumes that, at least in effect, he has bought another bond, to cover him for the new period. He probably figures that he is now protected (1) to the amount of $5,000, under the bond, against loss from the employee's misconduct during the year 1928, and (2) to an equal amount, under the renewal, against similar misappropriations during the year 1929. He

[1]Mich. Mortgage-Investment Corp. v. Amer. Emp. Ins. Co. (Oct. 1928) 244 Mich. 72, 221 N.W. 140.

realizes, of course, that there is some time limitation on his discovery of the defalcations. The increasing complexity of modern business has made it impossible for the employer to discover peculations on the evening of the day on which they occur; the traveling auditor may have his headquarters in New York, while the employee is located in San Francisco; the differences in dates between fiscal years, calendar years and the periods covered by surety bonds, make it necessary that there be some time during which the employee's accounts may be checked. Yet that time must have a reasonable limitation. Subject to this limitation, however, the employer doubtless assumes that he is "covered" against such loss from January 1, 1928 to December 31, 1929.

We may make another assumption, unfortunately none too violent; that the employer does not read his policy, nor the continuation certificate, until some time during the summer of 1929. The auditor has just disclosed the fact that the employee is "short" $12,000; $6,000 taken during the latter part of 1928, and the balance early in 1929. The bond and renewal are taken out of the company safe; the employer makes certain that the 1928 defalcations have been discovered in time; the insurer is notified of the loss; and the attention of the insured is directed to the "aggregate liability" clause.

That clause, in the continuation certificate involved in the recent Michigan case, read as follows:

> "Provided, however, that the aggregate liability of the Company from the effective date of said * * * Bond * * * to the date of the expiration of this certificate, * * *, shall not exceed the greatest amount for which the company shall have specifically guaranteed such employee since the effective date of the bond."[2]

The court divided, six judges to two, on the question of the legal effect of the clause. The minority judges were of the opinion that, since earlier Michigan cases[3] had adopted the theory of "multiple contracts,"[4] there was "no impediment" to double liability. The majority, admitting the existence of two contracts, held that extension of the liability beyond $5,000 would render the aggregate liability clause "meaningless." Other courts have reached the same conclusion.[5] And, frankly, it may not be doubted that the clause is inserted with the intent to limit the insurer's liability in accordance with the construction of the Texas, Illinois, and Michigan courts. Yet in a rather recent New York case,[6] the court reached the opposite conclusion in regard to a clause

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[2]The form sometimes reads "This Continuation Certificate is executed upon the express condition that the Company's liability under said bond and this and all continuations thereof *shall not be cumulative and shall in no event exceed* the sum of———."

[3]Ladies of Maccabees v. Ill. Surety Co., 196 Mich. 27, 163 N.W. 7, (bond); Brady v. Insurance Co., 11 Mich. 425 (fire policy).

[4]That is, that each renewal creates a new contract. See post, note 9.

[5]U. S. F. & G. Co. v. National Bank, 233 Ill. 475, 84 N.E. 670 (1908); Maryland Cas. Co. v. State Bank, (Texas Civ. App. 1924) 258 S.W. 584. See also Bank v. Guaranty Co., 110 Tenn. 10, 75 S.W. 1076, where the agreement was to "make good and reimburse * * * to the *extent of* $7,000 *and no further,* all and any pecuniary loss * * * occurring during the continuance of this bond or any renewal thereof."

[6]Campbell Milk Co. v. Guaranty Co., 161 N. Y. App. Div. 738, 146 N. Y. S. 92 (1914).

which stated that it was "mutually understood that it is the intention of this provision that but one (the last) bond shall be in force at one time." The court, relying on an earlier New York decision,[7] was of the opinion that it was *not* the purpose of such a clause to "cancel liability for an undiscovered misappropriation occurring during the term of the first bond, but simply to terminate all responsibility under the first bond as far as future misappropriations were concerned." It would be "unconscionable," in the opinion of that court, to provide that all liability for prior undiscovered misappropriations should be cancelled by the giving of the second bond. Yet the court seems to recognize an ability on the part of the insurer to so limit its liability, for it adds: "by neither bond or renewals *in express terms or necessary implication* is cumulative liability inhibited or aggregate liability under all definitely fixed. Thus the cases construing bonds and renewals *effectively* containing such provisions have no application."[8] Which leaves us with this unsatisfactory result: that it would be unconscionable for an insurer to attempt to relieve itself in this fashion, unless it has done so effectively.

Obviously, there is at least a question as to whether a bond and its renewal (or continuation certificate), together, constitute one single contract; or whether each is a contract in itself. There is a distinct conflict of opinion on this point, though the modern tendency seems to incline toward the multiple contract theory.[9] Normally, upon the creation of two distinct contracts, distinct liabilities come into existence. It was claimed, however, at least in one case,[10] that a different situation prevails in the case of a renewal of a fidelity bond. The argument was that either (1) there was only one liability, or (2) that liability on the bond ceased with the effective issuance of the renewal, or (3) in any event, the total liability could not exceed the face amount of the original bond. The answer of the court, in that case, was most significant:

"No sane man would say that this was the intention of the defendant, and the court is most loathe to say that this was the intention of the plaintiff, a widely known insurance company, dependent upon the good will and esteem of the public and its customers for its commercial welfare, to so frame its contract of indemnity as to extract premiums from the insured without giving anything in return.

"Brief indeed would be its life of business prosperity and public esteem, were it known that it would be guilty of such a game of 'heads I win, tails you lose.'"

Apparently the contract did not contain an aggregate liability clause, the insurer's claim being that the very nature of the contract limited its liability to the face amount of the bond. And, strangely enough, this court made about the same comment as that made by the New York court,[11] as to the

[7] Hawley v. Guaranty Co., 100 App. Div. 12 (affirmed without opinion, 184 N. Y. 549).
[8] Italics ours.
[9] See note in 42 A. L. R. p. 834 *et seq.*
[10] Aetna Cas. & Surety Co. v. State Bank, 13 F. (2d) 474.
[11] The court added that "in the absence of a stipulation to that effect" the issuance of a renewal would not increase or diminish the amount for which the insurer had become liable under the original bond.

possibility of doing directly what it suggested would ruin the company's business if done by implication!

There is respectable authority, then, for these propositions: (1) that there is nothing in the nature of the bond-and-renewal transaction which, *per se*, limits liability to the face of the bond; (2) that a clause which states that the parties intend that only one bond shall be in effect at any given time, will not produce a limited aggregate liability; but (3) that a clear and concise statement which, by its very terms, limits the aggregate liability to the "greatest amount for which the company specifically guaranteed such employee since the effective date of the bond" will be given literal effect by our courts.

Though the two minority judges, in the Michigan case, found no impediment to double liability, there is no satisfactory answer, in their written opinion, to the argument of the majority on the matter of construction. Is there no satisfactory answer? It would seem that there is no ambiguity in the earlier portion of the aggregate liability clause. "The aggregate liability of the company from the effective date of said bond to the date of expiration of this certificate"—this phraseology does not appear to permit of any application of the doctrine of "strict construction" often invoked against the insurer. Is the balance of the clause immune to such attack? "Shall not exceed the greatest amount for which the company shall have specifically guaranteed such employee since the effective date of the bond"—is that phrase made "meaningless" if "the greatest amount" is construed to mean the *sum* of the five thousand dollars mentioned in the original bond and a similar sum arising from the issuance of the continuation certificate? Such a construction would seem to be no more strained than that of the New York court in relation to the clause which clearly provided that "but one bond (the last) shall be in force at one time." And yet, it must be admitted that the suggested construction would give no effect to the word "specifically," in the instant case; and, further, that such constructions, though only slightly strained, are not entirely satisfactory.

What of the practical effect of the insertion of such clauses in fidelity bonds? As pointed out by the minority judges in the Michigan case, the effect is, to put it mildly, surprising. It would appear that an employer could insure with A Company, for the year 1928, and with B Company, for the year 1929, and, in the event of a loss similar to that in the instant case, recover $5,000 from each company;[12] that is, recovery is possible, to the face of the policy, for *each* year. But if he insures with A Company and renews with the same company, his protection is reduced to a total of $5,000 for *both* years. Or, as one of the federal district judges[13] has pointed out: his original premium will buy $5,000 worth of protection for one year, but three such premiums (one original and two renewals) will buy exactly the same total of protection! Or, to put it in another way, if the employee has defaulted to the face amount

[12]There are of course many forms of insurance of this general nature. The practice, as to some of these forms, may not permit of this "switching of accounts." We assume a fidelity bond, of the schedule type, which does permit of the result suggested by the minority of the Michigan supreme court.

[13]Judge Lindley, in Aetna Cas. & Surety Co. v. State Bank, supra.

of the original bond during the first year, the second year's renewal premium may buy nothing. Insurance counsel might prefer to state it this way: when purchasing a renewal the employer agrees to a limitation of the total liability on both the bond and renewal, though, by hypothesis, a liability on the original bond has already accrued and one on the continuation certificate will soon accrue.[14] However, phrase it as we will, it is certain that one purchaser may, by paying the original premium,[15] recover the maximum amount under the bond; while another, paying two such premiums, may suffer twice the loss (half of the total during each of the two years) and recover the same aggregate amount as does his neighbor.

It may be said that the situation resembles that involved in insuring (and renewing insurance on) a house against fire; that it is clear that, upon paying the renewal premium, the insured does not secure fire insurance protection to twice the face of the original policy. But, obviously, the situations are not parallel. For example, there may have been a loss to the maximum amount of the bond, before the continuation certificate is issued.[16] Assuming full coverage on the house, no valid renewal could issue, in January, 1929, if the house had been completely destroyed in December, 1928. The two types of insurance are inherently different. When the owner of a house renews, effectively, his house stands there, unharmed; no liability, known or secret, has accrued on the original policy. Not so with the employer; as he renews the employee may be making away with funds taken during the term of the original bond. It may well be that sureties, in olden days, were willing to extend the term of their obligations because it was certain, when it came time to renew, that they faced no accrued liability on the original bonds; that sureties, like fire insurers, were simply extending the time of the old agreement. It is submitted that, under modern business conditions, this is no longer true.

It may be argued that the protection which results from decisions like those cited is just the sort of protection which the companies mean to offer to employers; that the rates are based upon the assumption that the insurer's liability is as the courts have construed it; and that the rates would have to be much higher than at present, if companies do not so limit their liability. And this is no doubt true. Yet it must be admitted that the present situation produces some incongruous results. There would seem to be no good reason for (and many valid ones against) a system which would require local agents to represent several companies, instead of one; which would force the local agent to advise his client, the insured, to insure in different companies in alternate years; or which will permit one man to get protection to the amount

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[14] Assuming, of course, a lack of knowledge of prior defalcations, by the particular employee, on the part of the employer.

[15] For example, by paying the original premium and simply not renewing; or by suffering a loss during the first year only.

[16] There is no doubt but that the insurer means to give this protection to the insured. Should the employee default, to the amount of $5,000 in 1928, and not take any funds during the year 1929, the company will reimburse the insured to the full amount of the 1928 loss; the limitation on liability is applicable to the total loss, whether it occurs during one year or is spread out over the period covered by both the bond and the renewal.

of only $5,000, after paying two premiums and suffering a loss of $10,000 during the years 1928 *and* 1929, while his neighbor recovers $5,000, lost in 1928 *or* 1929, on the payment of one half the premium total paid by the other. Perhaps the competition between insurers which has resulted in the lengthening of the period for discovery—which appears to have been increased from three months to three years—is in part responsible for an unhealthy condition. Perhaps the initial rates are too low. Whatever the cause, it appears incredible that the present situation can be permitted to continue. The suggested relief—that the insured change companies periodically—appears to be contrary to the best interests of the company and the insured. It would seem axiomatic that a system which would call for repeated interruption of relations between an otherwise satisfied employer and his insurer is basically unsound.

Yet, despite Judge Lindley's prediction, the commercial welfare of the companies selling this sort of protection seems not to have been greatly impaired; and this, though they have done by express terms of the contract what he declared would bring disaster. The "heads I win, tails you lose" implication which he refused to draw is apparently in universal use by express agreement of the parties to the contract. It may be argued that this indicates the lack of any necessity for relief; that the companies are now offering a type of insurance which satisfies the purchaser, and that the buyer is getting just what he pays for. This may be true, and yet it is possible that employers are not being offered the protection they need. In the absence of action by the legislatures, which may at any time declare that the companies shall not be permitted to continue to use the aggregate liability limitation, it would seem that the only proper relief can come from the companies themselves. If the abandonment of the limitation on liability should result in too great a load, under present rates, and it should seem impracticable to increase the rates, it would appear that the period for discovery could be shortened. Under present business conditions the three year period may be unnecessarily long; perhaps the employer will submit to a reduction in this period, which will relieve the insurer of a part of the present load; and the shifting of this expense feature may make possible the abandonment of the liability limitation.

P. A. L.