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SUPREME COURT OF FLORIDA

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CASE NO: 65,118

DIXIE NATIONAL BANK OF DADE COUNTY, etc.,

Plaintiff,

v.

EMPLOYERS COMMERCIAL UNION INSURANCE COMPANY OF AMERICA, etc.,

Defendant-Third Party Plaintiff-Appellant,

v.

DR. THOMAS F. CARNEY, etc., et al.,

Third Party Defendants-Appellees.

ON CERTIFIED QUESTIONS FROM THE UNITED STATES COURT OF APPEALS, ELEVENTH CIRCUIT, ON APPEAL FROM THE UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF FLORIDA

# INITIAL BRIEF OF APPELLANT

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## INTRODUCTION

The United States Court of Appeals for the Eleventh Circuit has certified to this Court, pursuant to §25.031, Florida Statutes, and Rule 9.150, Florida Rules of Appellate Procedure, two questions of Florida law which the Court of Appeals deems determinative of an appeal pending before it. This brief is filed by Employers Commercial Union Insurance Company of America ("Employers"), which appealed an adverse summary judgment entered by the United States District Court, Southern District of

Florida, on Employers' third party complaint against the defendants-appellees. In this brief, the abbreviation "R.___" will be used to refer to the page numbers of the original record on appeal, as certified to this Court by the Court of Appeals.

## STATEMENT OF THE CASE AND FACTS

The pertinent facts and procedural history of the case are accurately set forth at pages 3-7 of the April 2, 1984 opinion on certification by the Court of Appeals. For the convenience of the Court, Employers herewith sets forth that portion of the opinion verbatim, inserting parenthetical references to the portions of the record which support the factual statements of the Court of Appeals:[1/]

"The Dixie National Bank of Dade County ('the Bank') commenced this litigation in April, 1975, against the appellant Employers Commercial Union Insurance Company of America ('Employers') to recover on a 'banker's blanket bond' policy of insurance for an embezzlement loss resulting from the defalcations of the Bank's former cashier after the Bank's insurer, Employers, denied the claim. (R. 4-6). Employers filed a third party complaint in June 1975 against the directors of the Bank and American Home Life Insurance Company ('Home'), the directors'

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1/ Although the ensuing paragraphs of the Statement of the Case and Facts are quoted from the opinion of the Court of Appeals, we will nevertheless double-space the quoted material for greater ease in reading it.

insurer under a director's liability policy, asserting subrogations rights arising upon the payment of the Bank's claim. (R. 31-34).

"In June, 1976, Employers and the Bank settled their dispute and the Bank assigned Employers its right to any claims it might have against the third party defendants. The settlement agreement provided in part:

> By the execution of this Agreement, Dixie National Bank of Dade County does hereby set over, assign, transfer and convey all of its right, title and interest in and to any claims it may have against all parties which may have caused, directly or indirectly, any of the losses set forth in the Complaint referred to above now pending in the United States District Court for the Southern District of Florida. (R. 771).

"In May, 1981, the third party defendants filed a motion for judgment on the pleadings on the theory that the equitable nature of subrogation precludes a bank's liability insurer from seeking indemnity from the bank's directors for loss occasioned by the fraudulent acts of an employee of the bank. (R. 762-768). Specifically, the third party defendants argued that Employers did not have superior equities and therefore could not be subrogated to any claims the Bank may have against the directors and Home. (R. 763-768). They also alleged that Employers, as the Bank's fidelity insurer, could not assert via a subrogation right the directors' negligence as a basis for recouping its payment to the Bank since any such negligence was one of the risks assumed pursuant to the insurance agreement. (R. 766). Employers then filed a supplemental third party complaint alleging the June, 1976, settlement agreement as a supplemental basis for its claim against the directors and their insurer. (R. 410-431, 769-773).

"The district court treated the motion for judgment on the pleadings as a motion for summary judgment and entered partial summary judgment against Employers on the issue of ordinary negligence. (R. 823). In his order, the district judge adopted the reasoning of First National Bank of Columbus v. Hansen, 84 Wis. 2d 422, 267 N.W.2d 367 (1978), and held that no right of subrogation exists in favor of a fidelity insurer against its insured's directors for ordinary negligence in the conduct of their supervisory duties. (R. 819). On the issue of the Bank's assignment of its claims, the court rejected Employer's attempt to improve its position, holding that notwithstanding the assignment subrogation would be enforced only in favor of a meritorious claim and after a balancing of the equities. (R. 820-821). The court concluded that because Employers, a compensated surety, can not establish equities superior to those of the directors, a balancing of the equities precluded Employers from asserting a subrogation claim against the Bank's directors for their ordinary negligence. The court added that Employers would be entitled to subrogation upon proof of culpability by the third party defendants in the nature of fraud or bad faith. (R. 822).

"Thereafter, in order to narrow the remaining issues, the parties executed a pretrial stipulation and a set of stipulated and disputed facts. (R. 871-878, 901-906). In brief summary, these stipulations recited that the embezzling employee, Robert Hanson, was employed by the Bank commencing in 1964 and was a vice president/cashier of the Bank from 1971 until his discharge in May of 1974, following discovery of his defalcations. During the period of his employment at the Bank, particularly while he was a cashier, Hanson was a trusted employee and was head of its operations. (R. 874).

"The embezzlements consisted primarily of diverting checks for payment of interest on securities from correspondent banks to checking accounts rather than recording them in interest receivable accounts and diverting interest credits received on federal funds sold to checking accounts rather than crediting them to the Bank's income account. Hanson accomplished these embezzlements by preparing general ledger tickets that channelled the income and money of the Bank to his own account. (R. 874).

"The Bank's directors first became aware of Hanson's embezzlements during May of 1974. Prior to that time, the Bank had not been involved in any other defalcations by any other employees, and the directors were unaware of any problems involved with the handling of the Bank's funds. (R. 902). The parties stipulated that the directors did not personally gain or stand to gain from Hanson's embezzlements. (R. 875). Appellant also concedes that its proof does not establish actual knowledge of the embezzlement, dishonest purpose, or furtive design. Employers does contend that its evidence would establish that the directors were grossly negligent for failing properly to direct and manage the Bank's affairs. (Employers' Main Brief in Court of Appeals, page 8, footnote 1).[2/]

"The parties filed a joint motion for clarification in which they requested the court to define more specifically the meaning of "bad faith" as used in the court's order granting

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2/ While the Court of Appeals is correct in stating Employers' contention that its evidence would establish gross negligence by the directors, that statement is incomplete. It is also Employers' contention that it is not required to establish gross negligence to impose liability on the directors, particularly if it prevails on Point I of this appeal. Employers' contention is more fully set forth in footnote 1, at page 8 of its brief in the District Court of Appeal:

> Employers does contend (and the Court below did not hold otherwise) that its evidence of fault is more than sufficient to go to a jury on the issue of the Directors' liability under standards of proof generally recognized in cases brought by banks against their directors for negligence which permits defalcations by bank officers or employees.

Employers contends that it "steps into the shoes" of the Bank by virtue of the assignment of the Bank's rights. Since a director can be held liable to a bank for failing to use ordinary care to prevent fraud and misconduct by officers, agents, or co-directors of the bank, Employers should likewise be entitled to recover based on a showing of a lack of ordinary care by the directors. See, First State Bank of Hudson County v. United States, 599 F.2d 558, 562 (3rd Cir. 1979).

partial summary judgment. They asked the court to determine if proof of gross negligence without personal gain by the directors would be sufficient for Employers to sustain its cause of action. (R. 891-893). In response, the court entered an order stating that, in the context of a subrogation action by a compensated surety against the directors of its insured for an embezzlement loss, the term "bad faith" implies the conscious doing of a wrong because of dishonest purpose and requires a person to act affirmatively with furtive design or ill will. In this case, it would encompass actual knowledge on the part of the directors of Hanson's embezzlement scheme and their failure to act on such knowledge.

"Based on the stipulated facts, the court concluded that there was no evidence that the directors committed bad faith or fraud; therefore, Employers did not have a subrogable cause of action against the directors or Home to recover payments to the Bank on the embezzlement claim. (R. 929-930). Accordingly, the district court entered final summary judgment against Employers and this appeal ensued." (R. 930-931).

## CERTIFIED QUESTIONS

### POINT I

IN AN ACTION BY A FIDELITY BOND INSURER AGAINST THE DIRECTORS OF A BANK AND THE DIRECTORS' INSURER FOR THE DIRECTORS' NEGLIGENCE IN FAILING TO PREVENT EMBEZZLEMENT LOSSES, IF THE FIDELITY BOND INSURER OBTAINS RIGHTS AGAINST THE IN-

SURED'S DIRECTORS THROUGH LEGAL OR EQUITABLE SUBROGATION AND ALSO OBTAINS A WRITTEN ASSIGNMENT OF CLAIMS FROM THE BANK, DOES FLORIDA LAW REQUIRE THE FIDELITY INSURER TO ESTABLISH SUPERIOR EQUITIES AS BETWEEN THE FIDELITY INSURER AND THE DIRECTORS AND THEIR INSURER IN ORDER TO RECOVER?

POINT II

IF SO, DOES THE FIDELITY INSURER'S STATUS AS A PAID SURETY ESTABLISH SUPERIOR EQUITIES IN FAVOR OF THE INSURED'S DIRECTORS AND THE DIRECTORS' INSURER WHERE THE FIDELITY INSURER MERELY ASSERTS THE DIRECTORS' NEGLIGENCE AS THE BASIS FOR RECOVERY?

## ARGUMENT

### POINT I

IN AN ACTION BY A FIDELITY BOND INSURER AGAINST THE DIRECTORS OF A BANK AND THE DIRECTORS' INSURER FOR THE DIRECTORS' NEGLIGENCE IN FAILING TO PREVENT EMBEZZLEMENT LOSSES, IF THE FIDELITY BOND INSURER OBTAINS RIGHTS AGAINST THE INSURED'S DIRECTORS THROUGH LEGAL OR EQUITABLE SUBROGATION AND ALSO OBTAINS A WRITTEN ASSIGNMENT OF CLAIMS FROM THE BANK, FLORIDA LAW DOES NOT AND SHOULD NOT REQUIRE THE FIDELITY INSURER TO ESTABLISH SUPERIOR EQUITIES AS BETWEEN THE FIDELITY INSURER AND THE DIRECTORS AND THEIR INSURER IN ORDER TO RECOVER.

Although the Court of Appeals has determined that there is no clear, controlling precedent from the Supreme Court of Florida on this question, there is direct controlling Florida precedent in a decision of the District Court of Appeal, Third District. In Dispatch Services, Inc. v. Airport Bank of Miami, 266 So.2d 127 (Fla. 3d DCA 1972), the court held that an action for money damages based on a valid assignment proceeds on applicable legal principals as between the assignor and the party sought to be charged; it does not depend upon a balancing of the equities between the subrogee and the party sought to be charged.

In Dispatch Services, the subrogee, Aetna Casualty & Surety Company, had reimbursed its insured, Dispatch Services, Inc., for losses sustained when one of Dispatch's employees forged signatures to checks drawn on its checking account at the Airport Bank of Miami. Aetna, having obtained an assignment of Dispatch's rights, brought an action against the bank, alleging that it had improperly cashed the forged checks and had no right to charge them against Dispatch's account. The trial court dismissed Aetna's complaint for failure to state a cause of action, and the district court reversed in an opinion which squarely upheld Aetna's contention that:

> Aetna's right arises by reason of the contract between Aetna and Dispatch which provides for subrogation rights not dependent upon equitable considerations. (266 So.2d at 128; emphasis added)

In its opinion, the Third District referred to the two recognized types of subrogation and specifically held:

> In the instant case the subrogation arises out of a contract constituting conventional subrogation. (266 So.2d at 129).

The court also distinguished the case of American Surety Co. of New York v. Lewis State Bank, 58 F.2d 559 (5th Cir. 1932), upon which the defendant relied, on the ground that there, "subrogation was asserted as an equitable right constituting legal or equitable subrogation." The court contrasted the case before it by observing:

> Whatever the relationship between Aetna and Dispatch, it did not affect this debt owed by the bank to its depositor, Dispatch. (266 So.2d at 129)

The Dispatch Services' court, while noting that there had been "no Florida cases involving conventional subrogation of a surety", referred to a pertinent conventional subrogation decision by the Georgia Court of Appeals, First National Bank of Atlanta v. American Surety Company, 71 Ga. App. 112, 30 S.E.2d 402 (1944). The Florida appellate court stated:

> We adopt the reasoning and conclusion reached by the Georgia court in First National Bank of Atlanta and based upon this, appellants' second amended complaint alleging conventional subrogation should not have been dismissed for failure to state a cause of action on equitable grounds. (266 So.2d at 129; emphasis added).

The district court of appeals in Dispatch Services thus clearly held that a complaint for money damages based on conventional subrogation could not properly be dismissed for lack of superior equities. The court made it clear that the controlling relationship was that existing between the assignor-depositor and the tortfeasor bank; not that existing between the assignor and the assignee-surety.

The distinction between legal (or equitable) and conventional subrogation was plainly dispositive in Dispatch Services, since the court effectively held that the assignment eliminated the "balancing of the equities" aspect of the subrogation action. This is the exact interpretation accorded to the decision by Murray, Negotiable Instruments and Banking, 1972-73 Survey of Florida Law, 28 Mia. L. Rev. 63, 68:

> The claim of the bonding company under "conventional subrogation" principles should not be defeated by the "equitable subrogation" defense that since the bonding company is a paid surety and the bank has been guilty of no more fault than the surety, the bonding company is precluded from recovering from the bank on the basis that equities were equal.

Any possible doubt about the full import of the Dispatch Services holding is dispelled by its express adoption of the "the reasoning and the conclusions reached by the Georgia court in First National Bank of Atlanta ..." 266 So.2d at 129. The controlling facts in First National Bank of Atlanta were virtually identical to those in Dispatch Services. The insurer of a depositor in the defendant bank sued to recover the amount of check which had been paid out by the defendant bank on endorsements forged by the insured depositor's employee. The subrogated insurer appealed from an adverse judgment following a directed verdict at trial. The Georgia Court of Appeals, after an extensive discussion of the law of subrogation in which it noted "some confusion and conflict" in other jurisdictions, held:

> [I]n this State an action based on conventional subrogation of the type presented by this case, clearly established by an agreement reduced to writing or otherwise shown, in which no equitable relief in aid of the claim is prayed, is an action at law, and is not controlled by the principles appertaining to an action in equity, <u>and the conventional subrogees in this action did not have the burden of showing the superior equity as against the defendant in order to recover</u>. (30 S.E.2d at 407; emphasis added).

It is true that some states, like Wisconsin, Pennsylvania and Tennessee[3/] follow the rule that both legal (equitable) and conventional subrogation require a balancing of the equities. It is also true, however, that the rule followed by Georgia and Florida, that a balancing of the equities does not apply in conventional subrogation claims based on an assignment, has been applied in many other jurisdictions,[4/] and is recognized

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3/ See, <u>First National Bank of Columbus v. Hansen</u>, 84 Wis.2d 422, 267 N.W.2d 367 (1978); <u>American Insurance Co. v. City of Milwaukee</u>, 51 Wis.2d 346, 187 N.W.2d 142 (1971); <u>Associated Hospital Service v. Pustilnik</u>, 262 Pa.App. 600, 396 A.2d 1332 (1979); and <u>Castleman Construction Co. v. Pennington</u>, 206 Tenn. 261, 332 S.W.2d 669 (1968).

4/ <u>Liberty Mutual Ins. Co. v. Thunderbird Bank</u>, 113 Ariz. 375, 555 P.2d 333, 337-338 (1976) (adopting rule of <u>First National Bank of Atlanta, supra</u>); <u>Maryland Cas. Co. v. Employers Mut. Liability Ins. Co.</u>, 208 F.2d 731, 733-734 (2d Cir. 1953) (opinion by L. Hand, holding that where liability insurer's policy expressly granted subrogation rights, insurer became, in effect, an express assignee of the (cont.)

and approved by eminent textbook authorities on the subject.[5/] There is no valid reason why the rule of Dispatch Services, which has reliably guided the insurance industry, business entities, and litigants for the past twelve years, should now be abandoned.

Since Florida does not impose a "balancing of the equities" test in an action for conventional subrogation based on an assignment, the first certified question should be answered, "No." If the Bank had a cause of action against the directors, then Employers acquired that right of action by virtue of its assignment and is not required to establish superior equities as

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insured, and "need not rely on the interposition of any equitable right of subrogation"), Home Indemnity Co. v. State Bank, 233 Iowa 103, 8 N.W.2d 757, 769 (1943) ("[T]he assignment simply gave the surety company the right to enforce such action which the [insured] had at that time against the defendant bank"); American Surety Co. of New York v. Baker, 172 F.2d 689, 692 (4th Cir. 1949) (holding under North Carolina law that where a liability insurer paid a railroad for the loss of hogs being transported by it and obtained an assignment of the railroad's claims against the persons who had converted the hogs, the insurer acquired complete legal title to the claim by virtue of the assignment and was not limited in its right of action by the equitable doctrine of subrogation).

5/ See, 16 Couch on Insurance 2d, §61:3 (1983), discussing the superiority of conventional subrogation in which "the rights of the parties are controlled by the contract rather than the equities normally prevailing", and recognizing that: "In some jurisdictions the subrogation claimant is in a better position when he claims by way of conventional rather than legal subrogation". And see, 11 Appleman, Insurance Law and Practice, §6502, note 23 at page 439 (1981), where Professor Appleman qualified his statement in the text that one invoking "the doctrine [of subrogation] must show that he has a better equity", by a footnote with the heading: "Not Where Conventional Subrogation"; followed by a summary of Dispatch Services which conforms exactly to the treatment given that decision by Employers.

between it and the directors in order to enforce the rights which the bank would have had against its directors.

## POINT II

IF POINT I IS ANSWERED "YES", DOES THE FIDELITY INSURER'S STATUS AS A PAID SURETY ESTABLISH SUPERIOR EQUITIES IN FAVOR OF THE INSURED'S DIRECTORS AND THE DIRECTORS' INSURER WHERE THE FIDELITY INSURER MERELY ASSERTS THE DIRECTORS' NEGLIGENCE AS A BASIS FOR RECOVERY.[6]

Since this Court's answer to the first certified question should be "No", there should be no reason for considering the "compensated surety" issue raised by the second certified question. However, even if this Court should decide to reject the settled rule of Dispatch Services, there is still no valid basis under Florida law for concluding that the equities preponderate in favor of the directors simply because Employers was compensated by the bank to be a surety for the bank.

The rationale of Hansen, supra, the decision on which the directors and the district judge chiefly relied, does not comport with Florida law and should be rejected by this Court.

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6/ As discussed earlier in footnote 2 of this brief, Employers contends that it is entitled to recover upon a showing that the directors failed to use ordinary care. Nevertheless, as the opinion on certification shows at page 6, Employers also contends that its evidence is sufficient to show gross negligence in directing and managing the Bank's affairs, if it is required to do so. Employers, does, however, concede that it cannot prove that the directors had actual knowledge of the embezzlement, that they stood to gain by it, or that they were guilty of any dishonest purpose or furtive design.

The central fallacy of Hansen was that it failed to recognize the distinction between the bank and its directors, in applying the rule that an insurance company may not sue its own insured. Hansen, 267 N.W.2d at 372. That fallacy was effectively exposed by Manufacturers Bank and Trust Co. of St. Louis v. Transamerica Insurance Co., 568 F.Supp. 790 (E.D. Mo. 1983) which "respectfully decline[d] to follow the holding of the Hansen court ...", and held:

> By denying recourse against third parties responsible for or contributing to a loss which might otherwise had been avoided, the surety is denied the rights of an ordinary subrogee.
>
> Clearly the Bank has a cause of action against the negligent acts of its directors and officers.... Denying subrogation would confuse the bank as a corporate entity with its agents (emphasis added, citation omitted) 568 F.Supp. at 792.

It is true that Florida follows the general rule that an insurer may not sue its own insured. 18A Fla. Jur. Insurance, §945. That rule has no application here, however, because Employers is not suing its insured, the Bank. It is suing the Bank's directors. The directors are not the Bank.

The rule that an insurance company may not sue itsown insured does not preclude an action by an insurer against the negligent employees of its insured. See American Home Assurance Co. v. City of Opa Locka, 368 So.2d 416, 419 (Fla. 3d DCA 1979), and Annot., "Subrogation of Employer's Liability Insurer to

Employer's Right of Indemnity Against Negligent Employee", 53 ALR3d 631, 635 and 638. There is no reason why any different rule should apply as against the directors of corporations, particularly since it is so well recognized that a director can be held liable to his corporation for negligence in permitting mismanagement or defalcation by officers or employees. 25 ALR 3d 941. The rule prohibiting an insurance company from suing its own insured is especially inappropriate here, since the bankers blanket bond expressly excludes the directors from coverage (R. 21; Exclusions, §2(d)).

It is true that as between Employers and the Bank, Employers "assumed the risk" of negligence on the part of the Bank and its agents, and Employers has never contended otherwise. However, it is difficult to see how these factors shift the equities in favor of the defendant directors. The directors cannot, under any view of corporate or banking law, be deemed to be the Bank itself, and there is no justifiable reason for treating them as though they were.

While Employers was concededly a paid surety, it fully performed the services for which it was compensated when it paid the Bank for the embezzlement losses. The directors, on the other hand, did not fulfill their responsibilities to the Bank. By their negligent failure to supervise and audit, they afforded Hanson the opportunity to steal from the Bank without detection. These are the facts which have been alleged by Employers and which can be proved, given the opportunity.

There is no justification in law or logic for concluding from these facts that the equities preponderate in favor of the negligent Directors simply because of Employers' status as a paid surety. Certainly there is no reason why the equities should favor American Home, which is itself a "compensated surety" whose policy provides coverage to the directors for the very type of liability with which they are charged.

Finally, there are no valid reasons of public policy which militate against imposing liability on the directors and their insurer. In fact, sound public policy will be promoted, rather than harmed, by permitting this action. One of the aims of the interpretive rulings of the Controller of the Currency is "to preserve incentives for sound banking principles" (R. 813, Corporate Practices Interpretive Rule 7.5217). A greater incentive will be provided by a rule which holds bank directors and their insurers responsible for their negligent failure to guard against embezzlement than by a rule which overlooks those failures.

## CONCLUSION

Based on the foregoing reasons and authorities, the first certified question should be answered "No". If the first certified question is answered "Yes", making it necessary to address the second certified question, that question should be answered "No".

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CERTIFICATE OF SERVICE

WE HEREBY CERTIFY that a true and correct copy of the foregoing Initial Brief of Appellant was mailed to Edward G. Rubinoff, Esq., of PREDDY, HADDAD, KUTNER, HARDY & JOSEPHS, P.A., Attorneys for the Directors, 12th Floor, Concord Building, 66 West Flagler Street, Miami, Florida 33130; and to Michael J. Cappricio, Esq. of FOWLER, WHITE, BURNETT, HURLEY & KNIGHT, P.A., Attorneys for American Home Assurance Company, 5th Floor, City National Bank Building, Miami, Florida 33130, this 24th day of April, 1984.

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