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NY Court Finds Direct Loss Under Fidelity Bond for Trading Loss By Dishonest Trader, Despite Payment to Third Party

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MF Global, Inc. ("Global") suffered a direct financial loss and was permitted to seek recovery against the fidelity bond for its trader's malfeasance, an intermediate New York appellate court recently held in *New Hampshire Ins. Co. v. MF Global, Inc.*, 108 A.D.3d 463 (1st Dep't 2013). Espousing the use of proximate cause to define the term "direct loss," the court upheld a lower court decision that Global suffered a direct loss under the bond due to an unauthorized trade that caused a loss of $141 million, even though the loss was incurred by the insured's payment of funds to a third party.

In this situation, Global was acting as a commodities futures broker, subject to the regulatory rules and oversight on the exchanges on which it executed trades, including the Chicago Mercantile Exchange ("CME"). As a part of this arrangement and its applicable regulations, Global and

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Dangers in Principal's Settlement Agreements for Sureties

MATTHEW D. BROWN

What happens when a surety tenders its defense to its principal when both are named defendants, the principal settles the case, but then fails to make payments? Without expressly releasing the surety in the settlement agreement, the surety may be on the hook for paying the settlement, according to a recent lower court decision in New York.

Colonial Surety Company ("Colonial") faced this predicament in *TLH Constr. Corp. v. Arkay Constr., Inc.*, 39 Misc.3d 1234[A], 2013 WL 2382260 (Sup. Ct., Kings County 2013). A payment bond lawsuit was commenced by TLH Construction Corp. ("TLH") against Colonial and its principal, Arkay Construction Inc. ("Arkay"). Colonial tendered its defense to Arkay, and Arkay's attorney represented both Arkay and Colonial. After a settlement conference, Arkay and TLH entered into a settlement agreement on the record, whereby Arkay agreed to pay TLH $75,000 in 12 monthly installments. Colonial was not mentioned in the settlement agreement, and Arkay subsequently failed to make any payments.

After Arkay's default under the settlement agreement, TLH brought an Order to Show Cause seeking to restore the case to the trial calendar and obtain a judgment against Colonial for the settlement amount.

Colonial's obligations under the payment bond read, in part, that the "bond shall be in no way impaired or affected by an extension of time, modification, omission; [sic] addition, or change in or of the said Contract or the Work to be performed" and that Colonial waives "notice of any and all such extensions, modifications, omissions, additions, changes, payments, waivers. . . ."

Colonial opposed TLH's motion, arguing that the settlement agreement extinguished all of TLH's prior claims under the bond and that Colonial was not a party to the settlement agreement. The court disagreed, holding that "absent an express release of the surety's obligations, it remained liable to plaintiff despite" the settlement. Because the surety's liability is derived from that of its principal, Colonial was liabile to TLH. The court found nothing in the record indicating any release of Colonial's obligations and instead found that Arkay's attorney, who also represented Colonial, failed to provide for such release in the settlement agreement.

Colonial next argued that the settlement agreement extinguished its obligations under the bond because the agreement altered the underlying contract between Arkay and TLH. The court rejected this argument as well holding that a compensated surety can only be discharged upon demonstrating actual prejudice arising out of the acts of the obligee such that its obligation was impaired. Here, the Court held that Colonial was not

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CME Clearing House became effective counterparties on each trade placed. Global assumed complete responsibility for the financial obligations attendant to all its trading activity by way of end-of-day or intra-day settlements with the CME Clearing House for all trades cleared through Global. Thus, to preserve the integrity of the exchange, Global had to settle with the CME Clearing House, regardless of whether Global's customers met their payment obligations. This set-up protects the market from risk of default by individual traders. New Hampshire Insurance Company ("NHIC") issued a fidelity bond to indemnify Global for direct losses sustained by the wrongdoing of an employee committed with the intent to obtain financial gain for the employee.

In February 2008, Evan Brent Dooley, a commodities broker associated with Global, executed a large number of trades on the CME from his personal trading account using Global's electronic trading system. The trade greatly exceeded his margin credit and, therefore, was unauthorized. Mr. Dooley took a giant risk that the price of wheat contracts would decrease when the CME opened in the morning. Instead, the price of wheat contracts increased, Mr. Dooley was forced to liquidate his positions, and he sustained a loss of over $141 million. CME initiated an intra-day settlement to cover the loss and Global immediately paid it, as it was obligated to do. Global then made a claim against NHIC under its fidelity bond.

NHIC denied coverage, asserting that Global had not suffered a "direct financial loss" and that the broker was not an "employee" under the bond. NHIC brought a declaratory judgment action seeking a determination as to the status of its bond obligations. The lower court denied NHIC's motion and, upon a search of the record and without a cross-motion, granted summary judgment in favor of Global, holding that NHIC was obligated to reimburse Global for the loss. The appellate court upheld the finding that the loss suffered by Global was a "direct financial loss" under the bond. But the court found an issue of fact regarding whether Mr. Dooley was Global's "employee" as defined by the terms of the bond.

In finding that Global suffered a direct financial loss, the court defined the term by using the general insurance loss standard of proximate cause. The cases cited by the court in defining direct financial loss related to determinations of cause within the property damage liability setting, not as related to fidelity bonds, which provide indemnity coverage. The court concluded that Mr. Dooley's conduct in making unauthorized trades above his margins were a direct and proximate cause of Global's loss. The court distinguished the case from the only fidelity-related precedent referenced, *Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co.*, 246 A.D.2d 202 (1st Dep't 1998), *lv. denied* 93 NY2d 805 (1999). In *Aetna*, the employee's improper conduct caused investors to lose money. When the investors sued the employer, the court held that a settlement of such a lawsuit was not a direct result of the employee's actions. Here, Mr. Dooley's wrongdoing caused "a near instantaneous shortfall" for which Global was "automatically and directly" responsible because of the applicable regulations. Unlike *Aetna*, the court found no "protracted causal chain" between the improper conduct and Global's loss because the conduct did not harm third parties who then sought redress from Global. Thus, the court concluded that Global's loss cannot be fairly viewed as simply satisfying a contractual liability to third party CME so as to take the claim out of coverage.

Summary judgment was not granted to Global because the issue of Mr. Dooley's status as an employee was never brought before the lower court. As such, there was a question of fact as to Mr. Dooley's status as an employee as defined by the bond which must still be determined by the lower court.

Nevertheless, the court's stated use of a "proximate cause" standard in determining direct loss under a fidelity bond, together with a finding of direct loss where the insured paid a third party, suggests cause for concern by fidelity professionals. This is especially true in light of the type of loss – the insured's refunding its clearinghouse for a significant trading loss. Historically, fidelity policies indemnify insureds for employee theft, but this decision could open the door to an expansion of fidelity liability without any corollary change in bond terms or intent by the parties. The issue of direct loss remains an unsettled area of fidelity law, and the result could have been different under a so-called "direct means direct" analysis, used in many jurisdictions. Fidelity professionals are wise to stay tuned. E&D

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prejudiced because: a) Colonial knew of the modification to the contract between Arkay and TLH, as Colonial's attorney in the lawsuit made the settlement agreement; b) the settlement reduced Colonial's potential liability; and c) the bond language allows for modification of the underlying agreement.

Colonial finally argued it was prejudiced because the settlement agreement extended the time by which Arkay had to pay TLH, increasing Colonial's risk. The court again rejected Colonial's argument. The general rule, according to the court, is that an extension of time granted to a principal by an obligee, without consent of the surety, releases the surety. In this situation, however, Colonial both knew about and consented to the modification and extension of time because Arkay's attorney also represented Colonial and did not object on behalf of Colonial.

The takeaway is sureties must be careful when their principal settles a case. While the settlement agreement in this case was oral, when possible a surety professional should review any settlement agreement entered into by the principal to ensure that the surety is released. This is particularly true when the surety tenders its defense to its principal, and the same counsel represents both the surety and principal. If the parties intend to release the surety entirely, it must be stated explicitly in any settlement agreement. E&D

Court Rejects Surety's Attempt to Prevent Disclosure of Consultant's Documents

THOMAS K. O'GARA

Surety consultants often wear two hats: one as a formally retained, non-testifying expert/consultant used to aid a surety in litigation and the other as a claims consultant used to evaluate the merits and options relating to payment and performance bond claims. While these roles are both important, they are viewed very differently by courts in terms of privileged communication and information when a surety finds itself in litigation. In *U.S. ex rel. Civil Constr. Tech., Inc. v. Hanover Ins. Co.*, 2013 WL 1810817 (M.D. Fl. 2013), a surety was placed in this difficult position when a payment bond claimant subpoenaed testimony and documents from the surety's non-testifying consultant.

In *Civil Constr. Tech.*, the surety's principal was declared to be in default and the obligee terminated its contract. The obligee looked to the surety's performance bond to complete the principal's contractual scope of work, which was substantial. The surety's law firm retained a consultant to prepare an invitation to bid and assist with any potential litigation on the project. The consultant communicated with potential bidders, participated in site inspections, responded to requests for information, and analyzed the bids.

Shortly thereafter, a subcontractor/claimant of the principal commenced a payment bond lawsuit against the surety, alleging that it was owed money for work performed through the date of the principal's termination. The surety submitted a counterclaim, asserting the principal's claim against the claimant for delays and other costs. The claimant then served the surety's consultant with subpoenas seeking documents and a deposition, claiming that the consultant had relevant information concerning delay issues and the surety's counterclaim.

The surety moved to quash the subpoenas and sought a protective order to prevent the consultant from producing any documents or information that were protected from disclosure by the work-product and joint-defense privilege. The surety also sought to prevent the deposition of the consultant, asserting the same privileges. The claimant insisted that its subpoena was carefully constructed and only sought information from the consultant in its capacity as a fact witness, not as a non-testifying expert. After review, the court agreed and the motion to quash the subpoenas and for a protective order was denied.

The court started its analysis with a balancing test, weighing the claimant's interest in obtaining the information against the surety's interest in keeping it confidential. In recognizing the dual role played by the consultant, the court stated that information created or learned by the consultant while working with the surety, or its attorneys, in preparing for and litigating claims and defenses were privileged. Excluded from any potential privilege were information and documents created or learned by the consultant by virtue of its participation in the rebid process. This included all communications with non-parties (potential bidders).

But the consultant's communications and information exchanged with the surety were not defined due to the dual role played by the consultant. The surety's first assertion of privilege was the work-product privilege, which protects information gathered in anticipation of litigation and opinion work product of an attorney's mental impressions and opinions. But only a party can assert the work-product privilege, and the consultant was not a party to this lawsuit. The subpoenas were crafted to exclude any potential work product from the surety, so the subpoenas could not be quashed on that ground. The court did state that after the consultant produces documents, the surety could then assert privilege with respect to the subpoenaed documents, but the court warned, any ambiguity regarding the consultant's role as a non-testifying expert or fact witness must be resolved in favor of disclosure of the information.

The next privilege asserted by the surety was the joint-defense privilege. The surety alleged that some of the documents subject to the subpoena were exchanged with the principal for the purpose of assisting in a common litigation and, therefore, protected from disclosure. The court stated that in order to claim the common-defense privilege, the information must have been privileged at the time it was exchanged. The fact that information was shared between entities with a common litigation interest does not, alone, make the information privileged.

The court's holding favoring production of a consultant's files is consistent with New York law, as recently articulated in *Safeco Ins. Co. of Am. v. M.E.S., Inc.*, 20II WL 6102014 (E.D.N.Y. 2011). In M.E.S., a surety seeking indemnity was forced to turn over a claim analysis performed by a consultant because, the court determined, the analysis was not prepared in anticipation of litigation. The court held that surety companies routinely investigate and evaluate claims. Here, there was no proof that this claim analysis was prepared in anticipation of litigation, as opposed to prepared in the ordinary course of the surety's business.

These cases serve as a reminder that a surety's communications with its consultants are not always privileged and that the consultant may have to produce its documents, if litigation is commenced. The burden of claiming privilege is on the surety, so it is imperative that the surety produce a privilege log, affidavits, or other evidence establishing that the consultant was acting as a non-testifying expert, as opposed to a claims consultant gathering information on behalf of the surety. E&D

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FIRM NEWS

Braggins and O'Gara to Speak at Upcoming Events

Ernstrom & Dreste, LLP attorneys Todd Braggins and Thomas O'Gara will be speaking at upcoming surety events. Mr. Braggins will be a panelist at National Bond Claims Association Seminar in San Antonio, Texas in October. The panel will discuss "The Project Investigation Responsive to the Default: Assessing the Scope of Work to Complete and Quality of Work in Place." In September, Mr. O'Gara will present to the Philadelphia Surety Claims Association on the topic "Damned If You Do or Damned If You Don't? Avoiding Indemnity Pitfalls If Principal's Defenses Fail."

Braggins and Peartree join list of Super Lawyers; Boldt and O'Gara Rising Stars

Ernstrom & Dreste, LLP is pleased to announce Todd Braggins, managing partner, and Kevin Peartree, partner, have both been named 2013 New York Super Lawyers. Mr. Braggins and Mr. Peartree join in this achievement with fellow partners John Dreste and Martha Connolly who are already recognized as Super Lawyers. Timothy Boldt, also a partner with the firm, and associate Thomas O'Gara, have both been named 2013 New York Super Lawyers Rising Stars.