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UNAUTHORIZED BONDS:

THE CASE OF THE RUNAWAY AGENT

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I. INTRODUCTION

Sureties are periodically victimized by the issuance of unauthorized construction bonds.[1] Under one possible scenario, an agent in good standing issues bonds without securing prior approval from the underwriters and without notifying the company of the existence of the bonds after the fact. Under another scenario, an individual whose agency has been revoked by the company retains the necessary materials to issue facially valid bonds and issues bonds in the company's name sub rosa. Under either scenario,the agent pockets the premiums.

Unauthorized construction bonds are made possible because companies provide their agents with the necessary instrumentalities to issue facially valid bonds -- blank bond forms, power of attorney forms, and corporate seals --- but do not disclose to principals and obligees that the agent's authority is conditioned

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[1] See Herbert Construction Co. v. Continental Insurance Co., 931 F.2d 989 (2d Cir. 1991); Manufacturers Casualty Insurance Co. v. Martin-Lebreton Insurance Agency, 242 F.2d 951 (5th Cir. 1957); 284 S.E.2d 47 Auto Rental & Leasing Inc. v. Blizzard, 159 Ga. App. 533 (1981); Independence Indemnity Co. v. Industrial Realty Co., 46 Ga. App. 637, 168 S.E. 122 (1933).

on the securing of prior consent from an underwriter.

In most cases, a surety becomes aware of a person issuing fraudulent bonds after an obligee or a material furnisher files a claim. In the course of the investigation by the surety or criminal authorities, the surety will often learn of other fraudulent bonds issued by the agent on which claims have not yet been filed. Assuming that the principals are not parties to the frauds, the law must allocate financial responsibility for any pre-existing or future claims made on a fraudulent bond among three innocent parties; the surety, the principal, and the obligee.

There are three possible theories under which a surety can be held liable for bonds issued by its agent. First, the agent may be "explicitly authorized" to issue the bonds. In the context of a purported unauthorized bond, the question would be whether the surety had explicitly authorized its agent to issue bonds without securing prior approval from an underwriter.

Second, the agent may be deemed to have actual authority to issue the bonds, despite acting contrary to verbal instructions, by virtue of the doctrine of "agency by custom"[2] Under this doctrine, authority can be created by conduct of the principal which the

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[2] See, e.g., Lewis v. Travelers Insurance Co., 51 N.J. 244, 239 A.2d 4,8 (1968); Thetford v. Hartford Fire Insurance Co., 27 Tenn. App. 600, 183 S.W. 2d 314 (1944).

agent reasonably concludes evidences an intent by the principal to expand the scope of the agency. [3] The agent has authority to act in accordance with what he reasonably believes is the principal's intention even though his acts are contrary to the principal's actual intent.[4]

As an example of agency by custom, a company may become aware that an agent who is required to secure prior underwriting approval has repeatedly issued bonds unilaterally and then notified the surety after the fact. If the company knowingly allows this behavior to continue and later argues that a bond issued by the agent is invalid due to a lack of authority, say because the agent never reported the particular bond and retained the premium, a court may find that, by a course of conduct, the agent was impliedly authorized to issue the bond without prior underwriting approval. In that event, the company would be as responsible for the bonds as if its agency agreement had explicitly authorized the agent to issue bonds without first securing prior approval.

Third, a company may face significant exposure due to unauthorized bonds despite having taken no action to empower its agents to issue bonds sua sponte. The doctrine of apparent

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[3] Restatement of Agency Second, §26 at p. 100.

[4] Id,. at §44, p. 135.

authority may render the company responsible for the bonds in the event that the company held the agent out to the principal or the obligee as being authorized to issue the bonds and the principal or obligee reasonably relied on this representation.[5] It is the doctrine of apparent authority, rather than that of implied authority, that creates the greater impediment for a surety seeking to free itself from liability for an unauthorized bond.

This paper will evaluate the problem of unauthorized bonds from three perspectives. First, it will consider the consequences of the apparent authority doctrine in the context of litigation against a surety which has refused to honor an unauthorized bond. Second, it will address the options available to a surety upon initially becoming aware of unauthorized bonds. Third, it will consider certain prophylactic measures that a surety may adopt to minimize the likelihood of being victimized by unauthorized bonds.

II. WHETHER A RUNAWAY AGENT IS APPARENTLY AUTHORIZED

The test for apparent authority is in two parts. First, the principal must hold an agent out to a third party as being authorized to represent the principal in regard to an issue. Second, a third party must act in reasonable reliance on the

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[5] See Restatement of Agency Second, §8 at pp. 30-36.

principal's representations.[6]

There is a split of authority regarding whether the apparent authority doctrine sounds in contract or tort. Under one view, a contract is formed between the third party and the principal at the time that the third party accepts a contract offer from the agent in reasonable reliance on the principal's representations regarding the agent's authority.[7] Under the other view, apparent authority is a species of estoppel; the principal being obligated to the third party for whatever detriment it suffered as a result of its reliance on the principal's representations regarding the agent's authority.[8]

The question of whether apparent authority sounds in contract or tort is not merely an academic question. If the apparent authority creates a contract as of the time that a third party accepts an offer from an agent, there would be no requirement that the third part suffer detriment as a results of the principal's representations and the measure of the third party's recovery in a

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[6] Restatement of Agency Second, §8, at p. 30 and §27 at p. 103.

[7] Restatement of Agency Second §8 at p. 30.

[8] 3 Am. Jur. 2d Agency, §80 at p. 587.

suit against the principal would be the value of the contract.[9] If apparent authority is a species of estoppel, the third party has no cause of action against the principal unless it suffers a loss by virtue of its reliance on the principal's representations.[10] In this event, the amount of its recovery against the principal would be limited to the amount of its loss.

In the context of an unauthorized bond, either a principal or an obligee may be in the posture to assert a claim of apparent authority. The surety's representation of authority to each of these parties will be in the form of having cloaked the runaway agent with blank bond forms, power of attorney forms and corporate seal; with the agent then conveying these representations by issuing a facially valid bond.

The courts have held that the act of an insurance company or surety company in entrusting an agent with all of the attributes necessary to issue valid bonds or insurance policies is sufficient to satisfy the "holding out" requirement of the apparent authority doctrine.[11] Therefore, to the extent that the runaway agent

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[9] Restatement of Agency Second, §8 at p. 32-33.

[10] Id.

[11] See Pacific Mutual Life Insurance Co. v. Barton, 50 F.2d 363, 365-66 (5th Cir. 1930), cert denied, 284 U.S. 647 (1931); Fireman's Fund Indemnity Co. v. Boyle General Tire Co., 381 S.W. 2d

remains an agent in good standing as of the time of issuing unauthorized bonds, it is unlikely that a surety will be able to successfully argue that it did not hold out its agent to the obligee or the principal as having authority to issue the bonds. A surety may have more success in arguing that it did not hold out its agent as having the necessary authority where the agent's power of attorney status has been revoked prior to the issuance of the particular bonds. In any event, the surety's chance of defeating a claim of apparent authority is much more likely to depend on its ability to demonstrate that the principal's or obligee's reliance on the unauthorized bonds was not reasonable under the circumstances.

The decision in Herbert Construction Co. v. Continental Insurance Company[12] provides a paradigm of the implications of the apparent authority doctrine for unauthorized bond litigation. The runaway agent in Herbert had at one time been authorized to execute

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937, 938-39 (Tex. Civ. App. 1964); North River Insurance Co. v. Sanguinetti, 38 Ariz. 221, 298 P. 922, 923 (1931).

The case law also suggests that entrusting the agent with something less than all of the materials necessary to issue a facially valid bond may not be a sufficient holding out, onto itself. See Herbert Construction CO. v. Continental Insurance Co., 931 F.2d 989, 994 (2d. Cir. 1991).

[12] 931 F.2d 989 (2d. Cir. 1991).

bonds in the name of the surety subject to prior underwriting approval. Seven years prior to the issuance of the unauthorized bonds at issue, the surety discovered that the agent had issued a bid bond in an amount exceeding that for which he had authority for the particular project. As a consequence, the surety revoked the agent's power of attorney to issue bonds, but left intact his ability to solicit bonding clients. Officials from the surety physically removed from the agent's office whatever power of attorney forms they could identify, two corporate seals, and some financial statements from the surety. They did not remove blank bond forms and they did not advise the agent's clients of his changed relationship with the surety.

Seven years after losing his power of attorney status, the agent issued unauthorized bonds to a general contractor/obligee guaranteeing the performance of a subcontractor. The agent had regained possession of one of the power of attorney forms in his name, soon after the surety's visit to his office, when a bid bond was returned to his office by a client after the bid had been rejected. The agent deleted the date on the form and made several copies. In order to issue the unauthorized bonds, he attached a doctored power of attorney form and a two year old financial statement from the surety and stamped the bonds using the corporate

seal of another company.

The surety became aware of the fraud after the subcontractor was terminated and the general contractor made claim on the performance bond. The surety also became aware of other unauthorized bonds issued by the agent. The surety refused to honor the unauthorized bonds at issue in Herbert. In the course of litigation brought by the contractor, the parties filed cross motions for summary judgment. The trial court granted summary judgment in favor of the contractor but the appeals court reversed the summary judgment and remanded the case for a trial on the merits before a jury.

Though the appeals court's decision did not resolve the controversy, it does provide an excellent blueprint of the kinds of issues and evidence that are likely to be central to "unauthorized bond litigation". In the context of Herbert, these issues can be broken down as follows.

A. Whether Continental had dispelled the agent's authority?

The court noted initially that the jury in Herbert would need to decide whether, in light of the removal of the agent's power of attorney, the surety had ceased to hold out the agent as having authority to issue bonds as of the time that the bonds had been

issued to the contractor.[13] The contractor argued that the surety had continued to represent the agent's authority as a matter of law; relying on the Restatement of Agency Second which states that a principal who terminates an agency relationship but who is unsuccessful in securing the return of all of the indicia of the agent's authority bears the risk of any subsequent deception of third parties.[14] However, the court was concerned that there might be minimal causal connection between the surety's conduct and the manner by which the agent had reclaimed a power of attorney form. The court therefore held that the case should be remanded to a jury to determine whether the surety "was responsible" for the agent having been able to hold himself out as being empowered to issue bonds.[15] In particular, the jury was to consider whether the agent's designs could have been frustrated had the surety taken additional actions to prevent fraud, such as numbering and dating each of its power of attorney forms or requiring the use of original rather than facsimile forms. The court cautioned that the surety's failure to remove blank bond forms from the agent was not sufficient to impose liability as a matter of law since, standing

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[13] 931 F.2d at 993-94.

[14] Restatement of Agency Second, §130 at p. 328.

[15] 931 F.2d at 994.

alone, these forms were not sufficient to allow an agent to issue facially valid bonds.[16]

The standard applied by the court in Herbert appears to sound in negligence; freeing a surety which has revoked an agent's authority from liability for the subsequent acts of the agent so long as the surety has taken reasonable steps to dispel any prior representations regarding the agent's authority. If this is a proper reading of Herbert, the court's decision is inconsistent with traditional "apparent authority" principals. Apparent authority is not a negligence standard. So long as a principal has held out an agent as having authority and a third part reasonably relies on this representation, the doctrine shifts responsibility for the agent's misconduct to the principal even if the principal has acted with due care and in a manner entirely consistent with standard business practices.[17]

Irrespective whether the holding in Herbert is doctrinally consistent, a surety enmeshed in litigation regarding the enforceability of unauthorized bonds should cite Herbert for the broadest possible proposition; that it can only be held accountable for unauthorized bonds if it in fact acted in a negligent fashion.

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[16] Id.

[17] Restatement of Agency Second, §8 at pp. 32-33.

B. Whether the obligee reasonably relied?

The court in Herbert ruled that the question of whether the obligee reasonably relied on the unauthorized bonds was also a matter to be resolved by the jury.

The court rejected the notion that either an obligee or a principal on a bond has an obligation as a matter of law to inquire of the surety as to the scope of the agent's authority.[18] Though there is some older precedent that appears to stand for that proposition, the court correctly pointed out that the effect of requiring all third parties to make such inquiries would be to negate the apparent authority doctrine.[19] The court further noted that to the extent that some cases reference such a requirement, the reference was no more than an alternative means of stating that reliance on the agent's authority based on the principal's prior representations was not reasonable under the circumstances.[20]

As demonstrated by the analysis in Herbert, the task of ascertaining the reasonableness of an obligee's reliance on what is in fact an unauthorized bond requires consideration of at least

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[18] 931 F.2d at 995.

[19] Id.

[20] Id.

three factors; the facial appearance of the bond, the circumstances surrounding the execution and tender of the bond, and the standard practices in the construction field. The Herbert court stated that a jury could consider the facts that the financial statement attached to the bond was two years old and that the corporate seal was from a different insurance company. The jury could consider whether it was significant that the subcontractor had tendered the bond five months after its contract with the contractor had been executed. The jury could also consider whether or not obligees routinely consult sureties at the outset of construction projects to confirm the validity of tendered bonds.

In most cases, the primary defense available to a surety victimized by an unauthorized bond is that the principal's or obligee's reliance on the bond was unreasonable under the circumstances. While the strength of such a defense will vary from case to case depending upon the particular facts, it is not unreasonable to speculate that neither judges nor juries are likely to look favorably upon an "insurance company" which holds its agents out as having authority to issue bonds and then attempts to escape what appears to be a bonded obligation to the detriment of a government entity or a locally based contractor or materials furnisher.

III. THE INITIAL RESPONSE TO UNAUTHORIZED BONDS - PRE-LITIGATION

The source of a surety's initial knowledge regarding a runaway agent is often through a claim on an unreported bond. Through communications with the principal on the bond, the surety may become aware of other unauthorized bonds issued to the same principal. It is also likely that once the scheme has been uncovered, the runaway agent will disclose the existence of unauthorized bonds issued to other clients.

To the extent that a claim has been made on an unauthorized bond, the surety is faced with the limited alternative of either paying the claim or renouncing the bond. If the surety declares the bond to be void, litigation will almost inevitably be instituted either by the principal, the obligee, or a payment bond claimant. Unless the payment bond claimant reviewed the bond prior to contracting with the principal or was aware of other representations made by the surety regarding the agent's authority, its claim of apparent authority is unlikely to succeed. As discussed above, the principal or the obligee have a reasonable likelihood of validating the bonded obligation so long as either can prove that its reliance on the bond was reasonable.

If the surety finds itself enmeshed in litigation regarding an unauthorized bond, it should seriously consider joining the runaway

agent and his/her agency as third party defendants. An agent who exceeds the scope of his authority is liable to its principal for breach of fiduciary duty and is responsible for all consequential damages incurred by the principal.[21] The agency which employs the agent may also be responsible for these damages under respondeat superior principles. If either the agent or the agency has errors and omissions coverage that may arguably be apposite, the inclusion of these parties will create an additional "pocket" for purposes either of settlement or for shifting the financial onus of an unfavorable verdict.

If there are political factors which weigh against a surety bringing suit against its agent or agency, these parties may also be jointed in "unauthorized bond" litigation by the principal on the bond. An agent which enters into a contract on behalf of its principal impliedly warrants his/her authority to act on behalf of the principal.[22] If the agent in fact lacks the necessary

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[21] Manufacturers Casualty Insurance Co. v. Martin-Lebreton Insurance Agency, 242 F.2d 951 (5th Cir. 1957); Benner v. Farm Bureau Mutual Insurance Co., 96 Id. 311, 528 P.2d 143 (1974).

[22] Restatement of Agency Second §329 at p. 81. See Fogarty v. State of Hawaii, Haw. App. 616, 705 P. 2d 72 (1985); Husky Industries, Inc. v. Craig Industries, 618 S.W. 2d 458 (Mo. App. 1981); Progressive Casualty Insurance Co. v. Blythe, 350 So. 2d 1062 (Ala. Civ. App. 1977); Robinson v. Pattee, 222 S.W. 2d 786 (Mo. Sup. Ct. 1949).

authority, s/he is liable, as if an original party to the contract, for breach of a warranty of authority.[23] If the warranty of authority is breached by an agent, his/her agency should also be liable under respondeat superior principles.[24]

The surety's options are somewhat broader in regard to unauthorized bonds which are not yet the subject of claims. In regard to these bonds, the surety may consider notifying each principal and obligee that it considers the bonds to be invalid.[25] To the extent that the obligee is a government entity for which suretyship is mandatory, the obligee may exert significant pressure on the principal to secure new bonds. To the extent that the principal is eligible for bonding and its only hesitancy to secure new bonds is the cost of the additional premium, it may be financially advantageous for the obligee and the pre-existing surety to share the additional cost with the principal. Moreover, to the extent that the principal on an unauthorized bond is on

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[23] Id.

[24] An agent's liability to a contractor based on unauthorized bonds would terminate if the surety was deemed bound by the bonds based on the doctrine of apparent authority. See Berner v. Farm Bureau Mutual Insurance Co., supra, 528 P.2d at 195.

[25] The decision regarding the surety's posture should be made after a complete investigation and should be informed by the case law regarding bad faith.

notice regarding the agent's lack of authority, is eligible for a new bond, but chooses not to purchase one, the surety may be able to defend against a subsequent claim on the unauthorized bond on the grounds that the principal's and obligee's reliance on the original bonds had ceased to be reasonable as of the time of notice regarding the agent's lack of authority.

IV. PROPHYLACTIC MEASURES

There are a number of measures which a surety could adopt to either obviate or significantly reduce the likelihood of a runaway agent issuing unauthorized bonds or which would significantly improve a surety's litigation posture in the event that such bonds were issued. Examples are set out below. In each instance, the question for the surety is whether the disadvantages of the prophylactic measure, generally inconvenience, outweigh the advantages of minimizing exposure to unauthorized bonds.

A. Restricting or eliminating dissemination of power of attorney forms and corporate seals

An agent's ability to issue unauthorized bonds stems from the surety's decision to accord the agent all of the tools necessary to issue facially valid bonds while failing to disclose to third parties that the agent is in fact not authorized to issue bonds without securing prior approval from the company's underwriters. The resulting lack of symmetry between authority and capacity could

be eliminated either by granting the agent full authority to issue bonds up to a given amount sua sponte or by having the underwriters retain the corporate seal and the power of attorney form and release individual forms only after a particular bond has been approved.

B. Requiring the use of numbered, dated and original power of attorney forms

The numbering of power of attorney forms would allow a surety to better account for all such forms issued to an agent in the event that the agent's authority is revoked. A surety could also conduct periodic inventories of an agent's power of attorney form to ascertain whether all missing forms had been attached to bonds which had been reported to the company.

The requirement of original forms would limit the mischief making capacity of an agent who had retained forms after his/her power of attorney had been revoked. In order to fully realize the advantages of these tactics, the power of attorney form would need to state that any documents in facsimile form were without validity and should not be relied upon by either obligee or principal.

C. Imposing a duty of inquiry on both principals and obligees

Though the surety in Herbert was unable to convince the court to impose a duty of inquiry as a matter of law, the same result

could be obtained as a matter of contract. Power of attorney forms and bond forms could disclaim the operative effect of any bond unless the principal and obligee had first contacted the surety to confirm the validity of the bond. In this fashion, sureties could in effect change the standard practice in the construction industry and make it unreasonable for an obligee or principal to accept a bond based solely on its facial validity or the say so of an agent.[26] In the event that an unauthorized bond incorporated such a disclaimer and the obligee had failed to seek confirmation from the surety, the surety could defeat the obligee's claim of apparent authority based on the argument that the obligee's reliance on the bonds had not been reasonable.

V. CONCLUSION

By virtue of the apparent authority doctrine, there is a considerable risk that a surety will be compelled to honor the unauthorized bonds issued by one of its agents or former agents. In light of this risk and the resulting financial exposure, sureties should continually re-evaluate the costs and benefits of

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[26] The Surety Association of America has issued a publication entitled "The Bond Authenticity Program - Obligee's Guide", which encourages obligees to validate each tendered bond with the purported surety. See Styers, Guarding Against Fraudulent Bonds, as set out in Shaping the Future of Public Construction and Suretyship (ABA Publication).

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