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SETTLING PAYMENT BOND CLAIMS OVER THE OBJECTION OF THE PRINCIPAL-- ISSUES AND TACTICS

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Settling Payment Bond Claims Over the Objection of the Principal– Issues and Tactics

I. INTRODUCTION

Certain principals will repeatedly generate payment bond claims while resisting the surety's efforts to fairly investigate and resolve these claims. Some of these principals slow pay their subcontractors and vendors as a regular business practice and then assert claims and other pressure tactics against the lower tiers in order to generate financial concessions. In other cases, the principal may be experiencing serious cash flow problems and may be using its subcontractors and vendors to finance the completion of one or more projects. In yet other cases, the principal may be experiencing one very bad project, is anticipating attempting to recoup its losses through claims against the owner, and is adamant that its subcontractors and vendors should not be paid what is rightfully owing to them until the principal is also properly paid by the owner. Other cases may exhibit a combination of the foregoing scenarios.

In order to advance these objectives, these principals may refuse to cooperate in the surety's claims investigations and sometimes actively impede these investigations by concealing information or spreading disinformation. It may be difficult for the surety to determine the validity of claims and the amounts properly owed in light of these tactics. This may result in claimants filing payment bond litigation which would not have been necessary had the surety been fairly and timely apprised of the underlying facts, thereby generating unnecessary costs and attorney's fees for the surety and possibly exposing the surety to bad faith claims. Moreover, these principals may threaten the surety with bad faith defenses in the event that the surety pays a claim over objection and then initiates litigation against the principal for indemnification.

This paper summarizes the legal principles that inform the surety's responses to these tactics. The panel discussion that accompanies this paper will explore the tactics available to the surety to address these scenarios in light of the legal principles set out herein.

II. RESOLVING PAYMENT BOND CLAIMS OVER THE PRINCIPAL'S OBJECTION

As a secondary obligee, the common law affords the surety a right of reimbursement from its principal for claims paid as a consequence of a bonded obligation.[1] However, this common law right provides a remedy for the surety only where the claimant is in fact owed the amount paid.[2] The principal can defend against a common law claim by asserting it did not properly owe the obligation in whole or part.[3] This forces the surety into the shoes of the claimant in attempting to prove up its right of reimbursement against the principal.

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[1] Klinger, Judd, & Bachrach, ed., The Surety's Indemnity Agreement, at p.166 (ABA, 2002). See Fidelity & Deposit Co. v. Bristol Steel & Iron Works, Inc., 722 F.2d 1160, 1163 (4th Cir. 1983); Commercial Insurance Co. v. Pacific-Peru Construction Corp., 558 F.2d 948, 953 (9th Cir. 1977); Central Surety & Insurance Corp. v. Hinton, 130 S.W.2d 235, 238 (Mo.App. 1939).

[2] Id.

[3] Id.

The surety's recovery options against its principal broaden substantially where the principal has executed an Indemnity Agreement. Indemnity Agreements typically obviate the principal's right to assert the merits of the underlying claim as a defense to the surety's indemnity action.[4] Many indemnity agreements afford the surety absolute discretion in settling claims:

> To indemnify, and keep indemnified, and hold and save harmless the Surety against all demands, claims, loss, costs, damages, expenses and attorneys' fees whatever, and any and all liability therefor sustained or incurred by the Surety by reason of executing or procuring the execution of any said Bond or Bonds ... or sustained or incurred by reason of making any investigation on account thereof, prosecuting or defending any action brought in connection therewith, obtaining a release therefrom, recovering or attempting to recover any salvage in connection therewith or enforcing by litigation or otherwise any of the agreements herein contained. Payment of amounts due Surety hereunder together with legal interest shall be payable upon demand.
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> ....
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> The Surety shall have the exclusive right for itself and for the Undersigned to decide and determine whether any claim, demand, suit or judgment upon said Bond or Bonds shall, on the basis of liability, expediency or otherwise, be paid, settled, defended or appealed, and its determination shall be final, conclusive and binding upon the Undersigned

Other Indemnity Agreements explicitly afford the surety wide discretion in settling claims so long as the surety acts in good faith:

> In consideration of the execution and delivery by the Surety of a Bond or any Bonds on behalf of the Principal, the Undersigned agree to indemnify and hold the Surety harmless from and against any and all demands, liabilities, losses, costs, damages, attorneys' fees and expenses of whatever kind or nature which arise by reason of, or in consequence of, the execution by the Surety of any Bond on behalf of the Principal and whether or not the Surety shall have paid any sums in partial or complete payment thereof...The liability of the undersigned shall extend to and include all amounts paid by the surety in good faith under the belief that 1) principal was in default as hereinafter described in Section 3 of this agreement; 2) surety was or might be liable therefor; 3) such payments were necessary or advisable to protect any of surety's rights as to avoid or lessen surety's liability or alleged liability.

Regardless of whether the indemnity agreement affords the surety absolute settlement discretion or "good faith" discretion, courts typically hold the surety to a good faith standard.[5]

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[4] See Frontier Insurance Co. v. International, Inc., 124 F.Supp.2d 1211, 1213 (N.D. Ala. 2000); General Accident Insurance Co. v. Merritt-Meridian Construction Co., 975 F. Supp. 516, 518 (S.D.N.Y. 1977); Employers Insurance of Wausau v. Able Green, Inc., 749 F.Supp. 1100, 1103 (S.D.Fla. 1990); Old Republic v. Palmer, 5 S.W.3d 357 (Tex.App. 1999); Fidelity & Deposit Co. v. Fleischer, 772 S.W.2d 809, 816 (Mo.Ct.App. 1989); Safeco Insurance Co. v. Gaubert, 829 S.W.2d 274, 282 (Tex.App. 1982).

[5] See, e.g., Engbrook v. Federal Insurance Co., 370 F.2d 784, 786 (5th Cir. 1967); Frontier Insurance Co. v. International, Inc., 124 F.Supp.2d 1211, 1215 (N.D. Ala. 2000); The Home Indemnity Co. v. Wachter, 115 A.D.2d (1985); Hartford Accident & Indemnity Co. v. Mills Roofing, 418 N.E.2d 645, 647 (Mass.App. 1981); Ford v. Aetna Insurance Co., 394 S.W.2d 693, 698 (Tex.Civ.App.1965).

The surety is entitled to indemnity from its principal so long as its decision to settle a claim over its principal's objection does not evidence bad faith.[6] The "bad faith" standard requires proof of intentional misconduct and improper motive on the part of the surety.[7] The surety's actions must have absolutely no reasonable basis and the surety must have engaged in these unreasonable actions knowing that its conduct was unreasonable or while purposely attempting to keep itself ignorant of the pertinent facts.[8] Lack of diligence, negligence, or gross negligence is not the equivalent of "bad faith".[9]

In the absence of a malicious motive, a surety can resolve a claim over its principal's objections either based on the underlying merits of the claim or in order to protect its own legitimate business interests.[10] The surety's right to indemnification for claims paid is not dependent on the underlying validity of the claim.[11]

A minority of courts require a surety to demonstrate the "reasonableness" of its settlement decisions, effectively subjecting the surety to a negligence standard.[12] However, these decisions seem to be at odds with the underlying public policies served by removing impediments and disincentives to a surety's ability to resolve claims with reasonable promptness. As such, these decisions are in a decided minority and there is no suggestion in the case law that this minority view is gaining favor.

Where the surety intends to settle a claim over its principal's objection, it needs to consider whether to provide the principal and its indemnitors with prior notice of the proposed settlement terms. Some courts have held that the Indemnity Agreement does not afford to the principal or its indemnitors a right of prior notice.[13] Other cases have held that a surety forfeits the wide settlement discretion afforded by the Indemnity Agreement where it fails to provide such notice.[14] It is generally advisable for a surety to keep its principal and its indemnitors fully and timely informed of its settlement decisions in order to preempt potential defenses that

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[6] Id.

[7] See Frontier Insurance Co. v. International, Inc., 124 F.Supp.2d 1211, 1214 (N.D. Ala. 2000); Farmer's Union Central Exchange v. Reliance Insurance Company, 675 F. Supp. 1534, 1538-39 (D.N.D. 1987); Fidelity and Deposit Co. v. Wu, 552 A.2d 1196 (Vt. 1988); Hess v. American States Insurance Co., 589 S.W.2d 548, 551 (Tex.App. 1979); Ford v. Aetna Insurance Co., supra. 394 S.W.2d at 698; Buckman v Peoples Express, 205 Conn. 166, 171 (1987).

[8] Id.

[9] Id.

[10] See Fidelity & Deposit Co. v. Bristol Steel & Iron Works, Inc., 722 F.2d 1160 (4th Cir. 1983).

[11] See, e.g., Fidelity & Deposit Co. v. Bristol Steel & Iron Works, supra, 722 F.2d at 1163; Commercial Insurance Co. v. Pacific-Penn Construction Co., supra, 558 F.2d at 953; Transamerica Insurance Co. v. Bloomfield, 401 F.2d 357, 362 (6th Cir. 1968); Engbrock v. Federal Insurance Co., supra, 370 F.2d at 786; Continental Casualty Co. v. Guterman, 708 F. Supp. 953, 954 (N.D.Ill. 1989).

[12] See Arntz Contracting Co. v. St. Paul Fire & Marine Insurance Co., 47 Cal.App.4th 464, 484 (1996); Hartford v. Tanner, 910 P.2d 872, 880 (Kan.App. 1996); City of Portland v. George D. Ward & Associates, Inc., 750 P.2d 171 (Or.Ct.App. 1988); Hawaiian Insurance & Guarantee Co. v. Higashi, 675 P.2d 767, 769 (Haw. 1984). See also General Accident Insurance Co. v. K. Capolino Construction Co., 903 F.Supp. 623 (S.D.N.Y. 1995) (Surety may be deemed a "volunteer" if it pays a claim that was not properly owing by its principal).

[13] See United States Fidelity & Guarantee Co. v. Feibus, 15 F.Supp.2d 579, 586 (M.D.Pa. 1998); International Brotherhood of Electrical Workers v. United Pacific Insurance Co., 697 F.Supp. 378 (D.Idaho1988); Safeco Insurance Co. v. Gaubert, 829 S.W.2d 274, 282 (Tex.App. 1982).

[14] See American Bonding Co. v. Nelson, 763 P.2d 814, 816 (Utah App. 1988); Palevac v. Mid-Century Non Auto, 710 P.2d 1389 (Nev. 1985); United States Fidelity & Guarantee Co. v. Paulk, 15 S.W.2d 100, 104 (Tex.Civ.App. 1929).

could be asserted in an indemnity action.

Many Indemnity Agreements allow an indemnitor or principal the power to preempt a surety's settlement authority by posting collateral in an amount sufficient to secure the surety against loss.

> If a claim is made against Surety or if Surety deems it necessary to establish a reserve for potential claims, and upon demand from Surety, the Undersigned shall deposit with Surety cash or other property acceptable to Surety, as collateral security in sufficient amount to protect the Surety with respect to such claim or potential claims and any expense or attorney's fees. Such collateral may be held by Surety until it has received evidence of its complete discharge from such claim or potential claims, and until it has been fully reimbursed for all loss, expense and attorney's fees.[15]

Where an Indemnity Agreement affords this option and the principal or indemnitors do not exercise this right, it can be persuasively argued that the principal and indemnitors have waived any possible defenses to the surety's right to indemnification for a claim paid over their objections.[16]

Where a principal exercises this option and posts sufficient collateral, the surety's financial incentive for settling a claim over its principal's objection is removed. However, in rare cases, the posting of collateral may pose a dilemna to a surety to the extent that it believes that there are no good faith defenses to a claim and the failure to pay the claim may expose the surety to bad faith claims asserted by the claimant.

In sum, the standard Indemnity Agreement affords a surety powerful weapons with which to settle claims over its principal's objections and secure indemnification for the costs related to these decisions.

III. SETTLING THE PRINCIPAL'S AFFIRMATIVE CLAIMS

In some cases, a surety may seek to settle its principal's affirmative claims in order to secure salvage. In other cases, a surety may need to settle its principal's affirmative claims where these claims are asserted against payment bond claimants in order to resolve pending bond claims. This is particularly likely where the principal's affirmative claims and the payment bond claim arise out of the same nucleus of operative fact.

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[15] Collateral security clauses are valid contractual obligations which are routinely enforced by the courts. See, e.g., American Motorists Insurance Co. v. United Furnace Co., 876 F.2d 293 (2d Cir. 1989); Safeco Insurance Co. v. Schwab, 739 F.2d 431 (2d Cir. 1984); American Motorists Insurance Co. v. Pennsylvania Beads Corp., 983 F. Supp. 437 (S.D.N.Y. 1997); United Bonding Insurance Co. v. Stein, 273 F. Supp. 929 (E.D. Pa. 1967).

[16] See Transamerica Insurance Co. v. Avenell, 66 F.3d 715 (5th Cir. 1995); American Insurance Co. v. Egerton, 59 F.3d 165 (4th Cir. 1995); United States Fidelity & Guarantee Co. v. Feibus, 15 F.Supp.2d 579, 586 (M.D.Pa. 1998); Banque Nationale de Paris S.A. v. Insurance Company of North America, 896 F.Supp. 163, 164 (S.D.N.Y. 1995); Employers Insurance of Wausau v. Able Green, Inc., 749 F.Supp. 1100, 1103 (S.D.Fla. 1990); Fidelity & Deposit Co. v. Fleischer, 772 S.W.2d 809, 816 (Mo.Ct.App. 1989);

A surety's right to settle its principal's affirmative claims arises out of the assignment and attorney-in fact clauses which are typically incorporated into an Indemnity Agreement.[17] The content of these clauses typically approximates the following:

> As security for the performance of all of the provisions of this Agreement, the Undersigned hereby assign, transfer, pledge and convey to the Surety (effective as of the date of each such Bond or Bonds, but only in the event of Default referred to in preceding Section 3)...
> all rights in connection with any Contract, including but not limited thereto:... 3. Any and all sums due or which thereafter may become due under any Contract and all other sum or sums due or to become due on all other contracts, bonded or unbonded, in which any of the Undersigned have an interest...[and] 4. All rights arising out of insurance policies, notes, and accounts receivable, and chooses in action.
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> The Indemnitors irrevocably constitute, appoint, and designate the Surety as their attorney-in-fact with the right, but not the obligation, to exercise all rights of the Indmenitors assigned to the Surety, and, in the name of the Indmenitors, to execute and deliver any other assignments or documents deemed necessary by the Surety to effectuate and exercise the rights given it under this Agreement...The Indemnitors hereby ratify and confirm all acts and actions taken by the Surety as attorney-in-fact.

A principal or indemnitor may assert that a surety acted wrongfully in settling the principal's affirmative claims as part of an overall settlement of a payment bond claim. Where this allegation is asserted as a defense to an indemnity action, a court may apply any of three standards for evaluating such a defense.

First, it can be argued that the assignment created by the Indemnity Agreement is absolute and that the surety therefore has the absolute and unreviewable right to settle the principal's affirmative claims.

Alternatively, a court may subject a surety's settlement of its principal's affirmative claims to the kind of good faith standard applicable to the surety's settlement of payment bond claims asserted against it.[18]

As a third possibility, a court could conclude that since the surety' settlement rights are derived from a security interest created by the assignment clause, the terms of the assignment should be governed by the provisions of the Uniform Commercial Code which govern the

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[17] See Hutton Construction Co. Inc. v. County of Rockland, 52 F.3d 1191 (2d Cir. 1995); James McKinney & Son, Inc. v. Lake Placid 1980 Olympic Games, Inc., 462 N.E.2d 137 (N.Y. 1984).

[18] See General Accident Insurance Co. v. Merritt-Meridian Construction Co., 975 F. Supp. 516, 518 (S.D.N.Y. 1977). See also Walsh v. Seaboard Surety Co., 94 F.Supp.2d 205 (D.Conn. 2000).

disposition of collateral.[19] UCC §§ 9-607 and 9-608 requires that a creditor which disposes of its debtor's collateral over objection has the affirmative duty of demonstrating that it acted in a "commercially reasonable manner". Application of these provisions would shift the burden of proof to the surety and require the surety to demonstrate reasonable conduct as opposed to conduct devoid of bad faith. The disposition of collateral is considered to be "commercially reasonable" under the UCC if it is made "in the usual manner on any recognized market" or comports with prevailing commercial practices in the industry.[20] In evaluating whether the settlement of an unliquidated claim is commercially reasonable, the courts weigh heavily the speculative nature of recovery and the costs in litigating the claim to judgment.[21] While these standards should not be difficult for a surety to satisfy from an objective perspective, the broadening of any of a principal's or indemnitor's defenses necessarily creates a disincentive for a surety to resolve payment bond claims over its principal's objection, particularly where such conduct may ultimately be scrutinized by a jury.

IV. CONCLUSION

The standard Indemnity Agreement provides the surety with powerful weapons with which to settle payment bond claims over its principal's objection. These tools provide the context within which the surety can create strategies for responding to a difficult principal who attempts to impede the surety's ability to administer and resolve payment bond claims in a sensible and cost-effective fashion.

[19] See Associated Indemnity Corp. v. CAT Contracting, Inc., 964 S.W.2d 276 (Tex. 1998) (applying UCC standards to assess a surety' settlement of its principal's affirmative claims). But see National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969); Transamerica Insurance Co. v Barnett Bank, 540 So.2d 113 (Fla. 1989). See also Klinger, Judd, & Bachrach, ed., The Surety's Indemnity Agreement, at p.186-87 (ABA, 2002)

[20] UCC § 9-627(b).

[21] Klinger, Judd, & Bachrach, ed., The Surety's Indemnity Agreement, at p.186-89 (ABA, 2002). See Frank Briscoe Co., Inc. v. Travelers Indemnity Co., 65 F.Supp.2d 285, 300 (D.N.J. 1999).

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