

**SEVENTH ANNUAL
NORTHEAST SURETY AND FIDELITY CLAIMS
CONFERENCE
OCTOBER 24-25, 1996**

WHAT SURETIES SHOULD KNOW ABOUT INSURANCE

PRESENTED BY:

Donna S. McCaffrey
Watt, Tieder & Hoffar, L.L.P.
7929 Westpark Drive - Suite 400
McLean, VA 22102

WHAT SURETIES SHOULD KNOW ABOUT INSURANCE

Surety bonds and insurance policies are separate methods of allocating risk. While the line between suretyship and insurance is very distinct; surety bonds are often misconstrued as a form of insurance. When sureties are equated to liability insurers, the line between suretyship and insurance becomes blurred, thus causing difficulties for both sureties and insurers. Although it would seem that sureties and insurance companies would frequently dispute responsibility for claims, in actuality, such disputes rarely arise because suretyship and insurance are so distinct. However, there are situations in which it must be determined whether claims are properly made under the surety bond or insurance.

To best protect the interests of the surety, surety claims representatives should be generally familiar with basic insurance policies relevant to construction such as builder's risk, commercial general liability, architect/engineer liability, wrap-up insurance, and boiler and machinery insurance, as well as the scope of the coverage of each type of policy. This article will distinguish between suretyship and insurance, review the general rule that sureties are not liable beyond the terms of the bond, and present the basic policies while incorporating descriptions of situations in which disputes have arisen over whether liability falls on the surety or the insurer.

I. Distinctions Between Surety Bonds and Insurance

Insurance is an indemnity contract wherein the insurer promises to indemnify the insured, for which the insured pays the insurer premiums based upon the insured's proportionate share of the risk. Insurance involves claims for property damage, loss and injury to persons and faulty or defective workmanship which arise from uncertain or contingent occurrences or events.

Unlike insurance, surety bonds protect against risks which typically cannot be insured. Suretyship involves answering for the debt of another and is often described as a tripartite relationship. Under a surety bond, the surety promises the obligee it will perform the obligation of its principal if the principal defaults. See Deutsch, Kerrigan & Stiles, Construction Industry Insurance Handbook § 16.1 at 264 (1991). The obligee is usually the owner of the project while the principal is the contractor whose construction contract with the owner generally obligates it to perform the work in accordance with the plans and specifications and pay the bills of its laborers, subcontractors, and suppliers. See Deutsch, § 16.1 at 264.

Whereas an insurer will not seek reimbursement from the insured when paying a claim, sureties do not expect to sustain losses. A surety will seek to be indemnified by its principal, or, if appropriate, to recover from the obligee. Because sureties do not expect to sustain losses, sureties require principals to execute general indemnity agreements to indemnify the surety against all losses incurred on account of bonds issued on behalf of the principal. See Deutsch, § 16.1 at 265. Unlike insurance, in a surety contact, the nature, size, and source of the possible loss to the surety is known from the start. Generally the surety's liability is limited to this predetermined amount.

II. Sureties Are Not Liable Beyond the Terms of the Bond

The general rule is that a surety is not liable beyond the terms of its bond. This general rule is effective in preventing insurance type claims from being made against bonds. An early case, John L. Roper Lumber Co. v. Lawson, provides an example of an attempt to make an insurance type claim against a surety bond. 143 S.E. 847 (1928). The court held that a bond provision concerning payment for material and labor did not extend to allow an action by an unspecified landowner along the right of way whose timber the contractor negligently burned. This case now stands for the proposition that the provisions of a bond should not be extended beyond the reasonable intent gathered from the purpose and language of the bond, and construed in connection with the proposals, plans, specifications and contract. Roper, 143 S.E. at 848.

In De Vries v. City of Austin, 110 N.W.2d 529 (Minn 1961), the court held that a statutory bond was not intended to cover liability for a contractor's negligent performance. A homeowner, whose house was destroyed by a gas explosion, brought an action against the city and the city subsequently interposed a third-party complaint against the public contractor and its surety. The bond was furnished to the city by the public contractor to assure payment for all labor and material furnished, and to assure faithful performance of the contract by the contractor. Based on the purpose of the bond, the court held that the bond did not protect the city against liability for damages resulting from the contractor's negligence. Similarly, in Healy Plumbing and Heating Co. v. Minneapolis-St. Paul Sanitary District, 169 N.W.2d 50 (1969), the court held that no action could lie against a surety by anyone not included within the statutory purpose for which the bond was given. In Healy, a corporate contractor who had a contract with the sanitary district brought an action against the surety on a bond given by another contractor who had a separate contract with the district. In Airlines Reporting Corp. v. United States Fidelity and Guar. Co., 37 Cal.Rptr.2d 563 (Cal. Ct. App. 1995), the court found that a surety bond which was to cover the default of the principal for failure to pay for airline tickets issued from blank ticket forms did not cover the default of the principal due to the theft of blank ticket forms.

The principle that a surety is chargeable only according to the strict terms of the bond and that this obligation cannot be extended either by implication or by construction beyond the confines of the bond was recently reaffirmed in Eagle Fire Protection Corp. v. First Indem. of Am. Ins. Co., 678 A.2d 699, 704 (N.J. 1996). In Eagle, the general contractor defaulted, and a supplier sued the surety which issued the general contractor's payment bond. The express language of this bond granted subcontractors standing to enforce the bond's provisions. The court held that the supplier had standing as a third-party beneficiary to enforce the bond. The court explained its holding by noting the policy of the law to favor materialmen and laborers in cases of doubtful or uncertain bond language. Eagle at 704-5, citing V. Petrillo & Son, Inc. v. American Const. Co., 371 A.2d 799, certif. denied, 379 A.2d 235 (1977). The court thus acknowledged that the general rule should be modified if the language of the bond is ambiguous.

Roper, De Vries, Healy, and Airlines Reporting Corp. exemplify the general rule that sureties are not liable beyond the terms of the bond; however, Eagle demonstrates that the general rule can be modified to favor materialmen and laborers. Based on these cases, surety claims representatives are advised to evaluate performance and payment bonds claims in light of not only the terms of the bonds, but also the purpose of the bonds.

III. Insurance Policies Relevant To Construction

A. Builder's Risk Insurance

Builder's risk insurance covers the risk of loss or damage to construction work during the construction process prior to permanent property insurance taking effect to cover the completed work. See Owen J. Shean and Douglas L. Patin, Construction Insurance: Coverages and Disputes § 7 at 213 (1994). The risk of loss or damage applies to permanent structures, as well as equipment and materials. A builder's risk policy is "a property loss insurance contract by which a builder seeks to insulate himself from losses which he might suffer because of damage to or loss of that which the builder has contracted to produce for a specified price or fee." Annotation, Coverage Under Builder's Risk Insurance Policy, 97 A.L.R.3d 1270, 1274 (1980). This type of policy provides protection against the risks that the parties agree upon and state in the policy. Although there is not a standard form used for builder's risk coverage, there are traditional forms used by insurance carriers.

If a contractor defaults before a construction project is completed, the surety should promptly examine the builder's risk policy to determine the extent of insurance coverage for damages prior to or as a result of the default. The surety should also be aware that the burden is on the insured to give timely notice of a loss or claim under a builder's risk policy. Furthermore, many policies require written notice of loss or damage.

An "all risk" policy is a special form of builder's risk insurance. An all risk policy extends to risks not usually contemplated under the builder's risk policy. Rather than naming the risks or perils which are covered, an all risk policy is defined by specific exclusions with unwritten limitations. In order to be covered under the policy, the loss or damage "must not result from intentional misconduct or fraud, and the risk insured must be lawful." See Shean, § 7.2 at 215 (citation omitted). All risk policies cover only fortuitous losses for which the insured does not have to prove the exact cause of the loss nor does it have to be specified by the policy. Thus, all risk policies cover cases in which it would be difficult for the insured to prove the precise cause of the damage. Thus, the scope of insurance coverage is likely to be greater under an all risk policy than under standard builder's risk policies.

Termination of coverage under a builder's risk policy is usually defined in the language of the policy. Some policies make reference to occupation of the building, while others do not.¹

¹ Compare two policies:

"WHEN COVERAGE BEGINS AND ENDS

We cover from the time the property is at your risk starting on or after the time this coverage begins, but we will not cover:

1. After the owner or buyer accepts the property;
2. When your interest ceases;
3. Beyond 30 days after completion of the project;
4. *When each building or structure is occupied for its intended purpose;*
5. When the property is leased or rented to others;
6. When you abandon the construction with no intention to complete it; or
7. When this policy expires or is canceled, whichever occurs first.

Another policy lists five events ending coverage similar to items 1,2,3,6 and 7 listed above, with *no* reference to occupation of the building.

One policy's termination provisions are substantially the same except it

As a result, disputes arise as whether coverage terminates when the building is complete versus when it is occupied. More often, disputes arise based on the contractor's failure to obtain or maintain builder's risk insurance. Courts have reached different outcomes on these issues. As a result, whether or not a surety will be liable for property damage under a performance bond will turn on the specific terms of the policy and facts of the case.

Interpretation of the construction contract, specifically the effect of the termination provision contained in the builder's risk policy, was disputed in Hartford Fire Ins. v. Riefolo Construction Co., Inc., 410 A.2d 658 (N.J. 1980). In Hartford, a fire broke out in a school building which was occupied even though it was less than 100 percent complete. Hartford, the school board's insurer, brought an action as the board's subrogee against the contractors and their sureties seeking to establish the liability of the prime contractors to repair the fire damage to the building. The New Jersey Supreme Court held Hartford could recover because at the time of the fire, the risk of loss was on the contractors and therefore, the sureties could be held liable when the contractors failed to satisfy the claims.

In Hartford, the builder's risk policy provided coverage for damage to the "building or structure, *while in the course of construction*, including foundations (except as hereinafter excluded), additions, attachments, and all fixtures, machinery and equipment belonging to and constituting a permanent part of said building or structure." Hartford, 410 A.2d at 664. The trial court had found that the portion of the building in which the fire started was no longer "in the course of construction," and thus, that the builder's risk insurance was not maintainable. On remand, the court found that the proper standard for termination of builder's risk coverage was when the building "is ready for the use or occupancy for which it was intended." Hartford, 410 A.2d at 664. The court noted that repair of fire damage was the contractors' duty, and that the contractors had allowed the builder's risk coverage to lapse. Because the contractors failed to repair the fire damage and did not complete their contracts, the court found that the contractor's breach should be covered by the performance bond. See Hartford, 410 A.2d at 664.

Another case relied on Hartford in finding a surety liable for a contractor's failure to obtain a builder's risk policy as expressly required by the contract with the owner. See Carroll-Boone Water Dist. v. M.& P. Equipment Co., 661 S.W.2d 345 (Ark. 1983). In Carroll-Boone, the surety had knowledge of the failure to obtain the builder's risk policy because the same person was the agent for the both the contractor and the surety. As a result, the surety had notice of the failure to obtain a builder's risk policy. When the negligence of the engineering firm caused the loss of an insurable interest to the owner, the surety was not released from its obligations contained in the performance

states:

- e. Unless we specify otherwise in writing and charge additional premium:
- (1) 90 days after construction is complete; or
 - (2) When any Covered Property is:
 - (a) Occupied in whole or in part; or
 - (b) Put into use for other than testing purposes.

See Owen J. Shean and Douglas L. Patin, Construction Insurance: Coverages and Disputes § 7.16 at 250-51 (1994).

bond and therefore, the owner was entitled to recover from the surety.

A different result was reached in a Louisiana case. JCM Construction Co., Inc. v. Orleans Parish School Board, 663 So.2d 429 (La. Ct. App. 1995), writ denied 666 So.2d 1089 (La. 1996). In 1995, the Court of Appeal of Louisiana found that the surety could not be held liable for damage resulting from a fire when the construction company had failed to obtain a Builder's Risk policy. The surety, Integon Indemnity Corporation, was obligated to guaranty JCM Construction Company's performance of the contract; however, the contractor had not performed the precontractual obligation of obtaining builder's risk insurance. Because the contractor's failure to obtain the policy was not related to the performance of the work, the court dismissed the surety from the action.

Based on the examples set forth in Hartford, Carroll-Boone, and JCM Construction, surety claims representatives are advised to pay close attention to insurance coverage under builder's risk policies. In particular, attention should be given to whether the contract requires obtaining a policy and whether coverage terminates based on completion or occupation.

B. Commercial General Liability ("CGL") Policy

A Commercial General Liability policy is a standard policy relating to faulty workmanship claims. CGL policies cover only "insurable risks" which are risks based on a statistical loss probability, such as claims for "property damage" and "bodily injury" as opposed to risks which are within a contractor's control. See Robert J. Franco, Insurance Coverage for Faulty Workmanship Claims Under Commercial General Liability Policies, 30 Tort & Ins. L.J. 785 (1995). CGL insurance differs from suretyship because "unlike the surety on a performance bond, a CGL insurer has no recourse against a contractor for the employment of defective materials or shoddy workmanship on the construction project." Franco at 786 (citations omitted).

Under a CGL policy, "liability coverage comes into play when the insured's defective materials or work cause injury to property other than the insured's own work or products." Franco at 787. Similar to coverage under a builder's risk policy, an occurrence is limited to fortuitous acts. A CGL policy covers "property damage" arising from an "occurrence." Franco at 787. An "occurrence" is defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." Franco at 788. Property damage is defined as:

- (a) Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of physical injury that caused it; or
- (b) Loss of use of tangible property that is not physically injured. All such loss shall be deemed to occur at the time of the "occurrence" that caused it.

See Franco at 789. The definition of "property damage" differentiates between physical damage to tangible property and intangible property losses, such as economic interests because courts do not consider the latter types of losses to be "property damage." See Franco, at 789.

While coverage under a CGL policy is among the broadest commercial coverage available, CGL policies also contain a number of exclusions limiting coverage. Because CGL policies often provide coverage in conjunction with other policies, surety claims representatives should review each of the policies to determine the extent of coverage.

For example, a surety recovered from an insurance company under a general liability policy in Western World Ins. Co. Inc., v. Travelers Indemnity Co., 358 So.2d 602 (Fla. Dist. Ct. App. 1978). In Western World, a surety and its principal brought suit on its performance bond against the principal's general liability insurer to recover money that it paid on a judgment against its principal. Because the surety had a right to indemnification from the principal, the surety had the right to be subrogated to any rights which the principal had against the insurer.

C. Engineer/Architect Liability Policy

An architect/engineer liability policy is actually a form of malpractice insurance which protects the architect/engineer from claims and suits arising from professional undertakings and those based upon allegations of professional negligence, i.e. "rendering or failing to render any professional service." Because most CGL policies exclude professional services from the scope of their coverage², an architect/engineer's policy is maintained in addition to a CGL policy. The typical architect/engineer's policy provides that the insurer will pay "those sums" that the insured becomes legally obligated to pay as damages because of claims to which insurance applies.³ The term "claims" means a claim arising during the policy period or an error, omission, or negligent act giving rise to a claim that occurred prior to the policy, but after the retroactive date specified in the declarations. See Shean, § 8.6 at 264. Many architect/engineer policies qualify coverage on a "claims-made" rather than

² "The typical exclusion provides in pertinent part:

This insurance does not apply to "bodily injury," "property damage," "personal injury," or "advertising injury" arising out of the *rendering or failure to render any professional services* by or for you, including:

1. The preparing, approving, or failing to prepare or approve maps, drawings, opinions, reports, surveys, change orders, design or specifications; and
2. Supervisory, inspection or engineering services."

See Owen J. Shean and Douglas L. Patin, Construction Insurance: Coverages and Disputes § 8.3 at 258 (1994) (emphasis added).

³ "What We Insure

We will pay those sums in excess of the deductible that you become legally obligated to pay as damages because of "claims" to which this insurance applies arising from conduct of your professional practice. We will have the right and duty to defend any claim seeking those damages. But:

1. The amount we will pay for damages and "allocated claims expenses" is limited as described in Section II - Limits on Insurance.
2. We may investigate any claim or suit and settle it in accordance with Condition B.
3. Our right and duty to defend and pay on your behalf ceases when we have used up the applicable limit of insurance in payment of judgments or settlements or allocated claims expenses."

See Owen J. Shean and Douglas L. Patin, Construction Insurance: Coverages and Disputes § 8.5 at 263-64 (1994).

“occurrence” basis to restrict coverage to claims actually asserted during the period of coverage. This affects the scope of the coverage as well as the duties of the insured in disclosing the existence of potential claims for professional malfeasance. See Shean, § 8.6 at 265 (emphasis added).

As design professionals, architects and engineers may be liable for their own negligence in drafting plans and specifications or as an agents of the owner. Because the owner often seeks the architect/engineers’ advice concerning the furnishing of bonds, “standard provisions of the architect/engineer liability policy exclude from coverage claims arising from advising or requiring the maintenance of any form of insurance, suretyship or bond.” See Shean, § 8.14 at 285. In addition, the exclusion disclaims coverage if the insured fails to maintain appropriate insurance.

When design professionals have duties under the contract to resolve disputes or to interpret specifications and plans, design professionals may find that they are also affecting the interest of the surety. Sureties may assert claims that the defaulting contractor could have asserted, including alleging design errors if the design professionals necessitated costly changes beyond what was bid or if the design professionals delayed the project and created added costs of construction. See James E. Ruiz and Andrew J. Palmer, Design Professionals’ Insurance and Surety Programs, in 2 Architect and Engineer Liability: Claims Against Design Professionals § 3.9 at 64 (Robert F. Cushman and G. Christian Hedemann, eds., 1995). The surety can also claim that the design professional’s improper certification of partial completion or certification of payments to suppliers and subcontractors were the actual cause of any loss and thus seek to recover any loss it incurred from the design professional. See Ruiz, § 3.9 at 64. As a result, surety claims representatives should be aware of the specific architect/engineer liability policy as well as how design professionals can be affected by a contractor’s default in the event that the surety can assert claims against the contractor and design professionals.

D. Wrap Up Insurance

With wrap-up insurance, one party, usually the owner, procures an insurance policy protecting the owner and the various contractors covering general liability insurance, builder's risk insurance, and worker's compensation insurance. See Shean, § 9.9 at 300. Wrap-up insurance has the benefit of reduced costs from establishment of uniform coverages, the elimination of redundant coverages, and improved management of losses. See Shean, § 9.9 at 300. On the other hand, wrap-up insurance may create administrative problems and complicate the bidding process.

Along with wrap-up insurance, there are additional policies known as Excess Insurance and Reinsurance. Excess insurance coverage begins after a predetermined amount of primary coverage is exhausted while Reinsurance is a mechanism for insurers to distribute the risk they incur under policies of insurance issued to insureds. Because the goal of wrap-up insurance is to bring all claims under one insurer, at first glance, it would seem that surety claims representatives would encounter fewer problems; however, "wrap-up coverage presents broader questions that simply the interpretation and operation of specific policy provisions." See Shean, § 9.9 at 305.

E. Boiler and Machinery Insurance

For projects which involve the installation of boilers and heavy machinery, there is a separate form of property and liability insurance, referred to as boiler and machinery insurance. This insurance "provides coverage for direct loss to the boiler and machinery, indirect loss, loss to other property owned by the insured, loss to the property of third-parties, and bodily injury caused by a boiler and machinery accident." See Annotation, Boiler and Machinery Insurance: Risks and Losses Covered by Policy or Provision Expressly Covering Boilers and Machinery, 49 A.L.R. 4th 336, 398-416 (1986 & Supp. 1990). The provision relating to this type of insurance policy as set out in the sample form from the American Institute of Architects General Conditions of the Contract for Construction reads:

11.3.2 Boiler and Machinery Insurance

The Owner shall purchase and maintain boiler and machinery insurance required by the Contract Documents or by law, which shall specifically cover such insured objects during installation and until final acceptance by the Owner; this insurance shall include interests of the Owner, Contractor, Subcontractors and Sub-subcontractors in the Work, and the Owner and Contractor shall be named insureds.

Disputes between sureties and insurers over coverage under boiler and machinery policies are not common because of the scope of the coverage of the insurance. Because sureties guarantee the completion of a general contractor's work on the project and/or payment of the subcontractors, there are few disputes over boiler and machinery coverage that would fall under a surety's performance bond or payment bond. Disputes that do arise concerning coverage under boiler and machinery insurance tend to focus on whether the subcontractor or contractor is liable, rather than whether the surety is responsible.

VIII. Conclusion

Suretyship and insurance are separate and distinct, but suretyship is often misconstrued as insurance. While insurance is an indemnity contract wherein the insurer promises to indemnify the insured, suretyship involves answering for the debt of another when a principal defaults. Under a surety bond, a surety is generally not held liable beyond the terms that are stated; however, courts have modified the rule and made exceptions. As a result, surety claims representatives should familiarize themselves with basic insurance policies and situations which may arise in which coverage could be disputed. Disputes arise over the requirement to obtain coverage as well as when coverage terminates. Builder's risk policies, commercial general liability, architect/engineer liability policies, and wrap-up insurance are the main policies with which sureties should be familiar. While disputes arise infrequently, knowledge of the policies will provide surety claims representatives with the ability to determine whether conflict with insurers will arise.