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***THE HAZARDS OF COMPLETION WITH A DIFFICULT PRINCIPAL***

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# THE HAZARDS OF COMPLETION WITH A DIFFICULT PRINCIPAL

## PREFACE

This paper assumes that the surety, before making its decision to actively or passively support its principal, either by performing or financing, has analyzed its principal's financial and construction capabilities. Further, the surety should exercise all the diligence and care that this paper suggests, plus weigh very carefully its other options before relying on the principal either as to information or as a completing contractor. If the principal is unscrupulous and this is known to the surety, the most sound course may be to simply avoid the principal in any completion process whenever possible.

This paper is not intended as a legal treatise, with exhaustive citations. It is intended as a practice guide with some reference to initial authoritative sources which may be of assistance in the real world of claims handling. The problems we address have a substantial basis in actual fact, but in some cases the facts have been modified for what we hope will be a better presentation.

## 1. THE SURETY'S BASIC RIGHTS TO REDUCE OR RECOVER ITS LOSS

### A. Indemnification and Exoneration, The Credibility Of The Basic Documents

#### 1. Indemnification, Exoneration, Subrogation, and Quia Timet.

The surety's basic rights arise under both legal and equitable principles. The basis of these rights is set forth in general and specific contracts of indemnity, and the fundamental equitable doctrines of subrogation and exoneration as well as the statutory and common law rights of indemnification, contribution, and Quia Timet.

*Subrogation* has been defined as “[t]he substitution of one person in the place of another with reference to a lawful claim, demand or right, so that he who is substituted succeeds to the rights of the other in relation to the debt or claim, and its rights, remedies, or securities.” Home Owners’ Loan Corp. v. Baker, 299 Mass. 158, 12 N.E.2d 199, 201 (1937). *Indemnification* is the right of a surety, on payment of the principal's debt, to be indemnified by the principal for the loss sustained by the surety in making payment of the debt. Artur, Adelbert & Stearns Stearns, Law of Suretyship, Elders Revision, 5th Edition, Sec. 11.38, pages 515 to 516. *Exoneration* provides a surety the right to appropriate relief to protect its interests when the surety is called upon to perform and is compelled to suffer the inconvenience and loss associated with such performance when the principal has no defense to its duty to perform. Restatement of the Law Third, Suretyship And Guaranty (1996), The American Law Institute, Section 21 Com. i. Relief that protects the rights of the surety with respect to the duty of the principal to refrain from conduct that impairs the expectation of the surety that the principal will honor its duty of performance is sometimes referred to as *Quia Timet*. Restatement of the Law Third, Suretyship And Guaranty (1996), The American Law Institute, Section 21 Com. j. General and specific contracts of indemnity, if executed, are contracts in which “one undertakes and agrees to indemnify the other against loss or damage arising from some contemplated act on the part of the indemnitor, or from some responsibility assumed by the indemnitee, or from the claim or demand of a third person, that is, to make good to him such pecuniary damage as he may suffer.” Black’s Law Dictionary, Fifth Edition at p. 692 (1979).

## 2. THE AUTHENTICITY OF THE BASIC DOCUMENTS

Before completing with a principal, "difficult" or not, the basic agreement must be authenticated. When any document, such as an Agreement of Indemnity, is the basis of establishing rights, the authenticity of the documents is immediately an issue. Contracts of indemnification must be properly executed by the principal and indemnitors to avoid authenticity (See Barnes v. Bank of Bourbon, 619 S.W. at 909 (Mo. App. 1981) and statute of fraud defenses. See First Nat. Bank of St. Johnsbury v. LaPerle, 117 Vt 144, 86 A2d 635, 638 (1952). The underwriters must exercise great care to assure that these simple but important steps are taken. The underwriter must assume that all principals will be "difficult." The underwriter should first be certain that the signatures of the principal and indemnitors, corporate or personal, are authorized signatures. Second, be certain that the witnesses' signatures, including that of a notary, are authentic. Third, be certain that the witness and notary actually saw the principal and indemnitors sign the documents.

We have seen indemnitors deny their signatures on Agreements of Indemnity, and notaries before whom they allegedly appeared, assert the fifth amendment, when inquired of under oath, as to whether or not the signature is authentic. Such dramatic assertions by a notary may permit an adverse inference to be drawn against the notary's testimony in a civil suit (see Kaye v. Newhall, 356 Mass 300, 305-306, 249 N.E. 2d 583 (1969) and also generally Gerard v. Young, 20 Utah 2d 30, 432 P2d 343 (1967)), as notarizing a blank document or falsely notarizing a document is a crime. See Klink v. State of Indiana, 203 Ind 647, 179 N.E. 549, 18 USCS section 1016 (1932), Bloom v. Power, 21 Misc 2d 885, 193 NYS 2d 697 (1959), affd, app gr (2d Dept) 6 NY2d 1001, 192 NYS 2d 162. However, such assertions do not permit any inference that the indemnitors signatures are valid and are, therefore, of little help to the surety.

The lack of formality of document execution and failure to exercise proper procedures in obtaining signatures can be fatal. Indemnitors (to the extent they are even aware of the documents) as well as the bond agent, broker or even the underwriter do not always seriously consider the possibility of the documents being the basis of an adverse claim by the surety. It is not unknown for agents and brokers to mail the documents to the principal with instructions to have "Fred and Doris" sign as indemnitors, as well as the principal, have the signatures witnessed, notarized, and returned to the agent, broker or company.

## 3. THE INNOCENT INDEMNITOR

Fred, a mover in the rough and tumble business of construction contracting, and without any malicious intent, may sign his name, sign his wife's name without her knowledge, and sign as the officer of the corporate principal. He may also have a captive notary, who works at the principal's office, notarize all the signatures. He may have an unsuspecting secretary or employee "witness" the signatures. When truth of authenticity is brought into issue all the admonitions as to proper due diligence related to execution are of little help. If the signatures are invalid, proof of lack of due diligence, or even criminality, in execution, simply do not prove authenticity. By the time this is an issue, the "innocent" or "unaware" indemnitor may, in truth, deny his or her signature and have the support of corroborating testimony from the "witness" or notary. Now the witting or unwitting testimony of the non principal indemnitor is a major hurdle for the surety seeking indemnity. Our first lesson is to pay strict attention to the fundamentals in the basic underwriting.

In one surety loss where "Fred and Doris" were husband and wife, while the business of the principal prospered, there was no open disharmony in the marriage. Many of the marital assets, such as homes, cars, cash, securities and even the corporate stock (shares) of the principal were held jointly

or solely in the name of Doris. When the business faltered, Doris filed for divorce against Fred, seeking much of the marital estate while Fred continued to live at home. On the record, Fred fought the property settlement in the divorce. When claims were asserted against the surety, indemnity agreements were produced bearing what purported to be Doris' signature, but Doris denied her signature and the authority of anyone to sign her signature. A hand writing expert, engaged by the surety, confirmed the lack of authenticity of Doris' signature. The notary public, an employee of the principal, asserted his Fifth Amendment privilege when asked under oath if he had notarized the document. The surety now faced a situation where authenticity of the wife's signature was impossible to prove, placing a cloud over assets which may have been available to the surety in the event of a loss and whatever assets were still reachable were under a cloud since they would be thrown into the divorce court for resolution in the divorce proceeding. Whether the divorce was real or a sham and whether the signature was that of the notary, the surety was confronted with a serious issue which could have been avoided by following the relatively easy procedures of proper execution.

#### **4. ASSURING AUTHENTICITY OF THE BASIC DOCUMENTS**

The pre-claim informalities can often be rectified if the claims personnel and bond claims attorney are brought into the situation early enough. When the winds of disaster begin to blow, there is usually some awareness on the part of the surety. The awareness is often muffled by an unwillingness, especially amongst the underwriters, to accept that unpleasant likelihood. However, if the surety accepts reality, there is some recourse. The principal often does not want to face the reality of ensuing disaster and at this early stage is often, at least outwardly, cooperative with the surety. At this point a surety should begin with a written plan, inter alia, to "ratify, confirm and adopt all the terms and conditions of any indemnity agreement for the better protection of the surety," and have the indemnitors as well as the principal sign this ratification agreement. Should the principal and/or indemnitors balk, the surety will at least have surfaced the problem before it commits to a specific course of action. Our second lesson is to enter the situation as soon as possible and overcome, or at least surface, basic problems with the "difficult" principal.

#### **5. EXONERATION - THE CREDIBILITY OF THE BASIC INFORMATION**

The problem that arises under the doctrine of exoneration, in that the right of exoneration is not predicated solely upon written signed documents, may not involve the same types of hazards we have just described. But other, similar problems will appear. If the principal is "difficult", completion problems may arise out of the principal's character and/or competence. We have touched upon one area of the importance of character. Other obvious areas involved are the credibility of financial and construction documents and information. If this documentation and information is not credible, the end result may be the same, whether the information is intentionally inaccurate or simply inaccurate due to the ineptitude of the principal and others. It is, therefore, essential that the surety exercise considerable care in verifying information at the time of its initial "look see", before it commits to any course of action involving the principal. The use of expert accounting, construction and legal advice at this early stage will undoubtedly provide comfort, but more importantly will reduce end result losses. Our third lesson is to verify accounting and other significant documents as soon as possible.

## **B. THE RELIABILITY OF ACCOUNTING AND CONSTRUCTION DATA**

It is often useful for a completing or financing surety to use equipment, inventory and real estate of the principal in the completion process. In some cases the equipment and inventory is pledged as security to a financing bank. An event which triggers a default, such as failure to pay the bank monthly payments, can be avoided by the surety making these payments. However, if the surety is relying upon equipment lists of its principal and or construction data of its principal which is inaccurate, intentionally or otherwise, the surety may make such payment and have available to it an inventory, and equipment worth less than the unpaid balance due to the bank. Even if the information is accurate the surety may be confronted by a suit filed by the financing bank, claiming that the surety used its posture, to better its position to the detriment of the bank. (See e.g. Heller v. INA, 410 Mass. 400, 573 N.E. 2d 8 (1991). The surety, acting in good faith, should prevail. Heller supra. However, since the risk of costly litigation is present, the surety should carefully verify the information. A "difficult" principal can expose the surety to substantial additional loss if the principal's information is faulty and if the surety acts upon it.

## **C. CREDITORS AND FINANCING INSTITUTIONS**

### **1. The Surety's Ability to Use The Principal's Assets**

In one case, the principal was involved in a multi-contract performance and payment problem. The principal's primary business was that of furnishing and installing roofing on public buildings. The principal had a substantial inventory of roofing materials and other equipment. It also owned real estate from which it operated its business. In addition, it had documents and schedules as to the percentage of completion, the amount of payments and sequencing. The inventory and assets were all pledged to financing institutions, which had made UCC filings and held first and second mortgages on the real property. Some of the equipment was rolling stock which required possession of the titles to perfect UCC recordings. Some of the equipment and inventory had been consumed, moved from site to site, lost, stolen or even sold without regard to the formalities of UCC compliance. When the surety became aware of the principal's plight, it became obvious that the inventory and the real estate could be difficult to use in the completion process. Without the inventory and the use of the real estate, the surety's cost could escalate dramatically in the completion process as it sought to purchase the inventory and use real estate held by the mortgagee banks or, in the alternative, purchase massive new inventory in the market place and rent a business site with the resulting moving delay and cost increase. The surety simply elected to pay off the first mortgagee and take an assignment of that position. The second mortgagee was not informed of the assignment and the documentation established that there was no equity value after the satisfaction of the first mortgagee's interest. The remaining inventory and other equipment was used to complete the projects. The surety continued to pay the second mortgagee. The second mortgagee, Heller Financial ("Heller"), when it became aware of the surety's action, claimed that the surety used its position and inside information to the detriment of the secured party, Heller. But, how was the second mortgagee, Heller, hurt? Its notes were kept current and there was no evidence that Heller could have done better in a "hammered" down forced sale or any orderly market sale. See Heller v. INA, 410 Mass. 400, 573 N.E. 2d 8 (1991). The court ruling for the second mortgagee at the trial level (unreported decision) held that the surety had engaged in unspecified "unconscionable" conduct. The Massachusetts Supreme Judicial Court reversed and held that:

If NERCO (the principal) was the party who paid GBT (the first mortgagee), then the mortgage was extinguished and GBT's assignment to INA (the surety) was void. (Citations omitted.) NERCO, however, was practically insolvent at the time of the

assignment; it was impossible for NERCO to have paid GBT out of its own funds. Although NERCO signed the note to CSB (the lending bank of NERCO with INA's guaranty) for \$1,700,000, it was INA's guarantee which made the loan possible. If we focus on the substance of the transaction and not on the form, it was INA that borrowed the money from CSB, and it was INA, not the mortgagor NERCO, who paid GBT. Since INA did not have an obligation to pay the debt, the mortgage was not extinguished. Thus, the assignment to INA was valid. (Citations omitted.)

Here, since NERCO (the principal) was nearly bankrupt, INA took a financial risk in guaranteeing the CSB loan. It is true, as Heller (the second mortgagee) argues, that INA guaranteed the loan for a reason of self-interest: It wanted to make sure that NERCO remained solvent so that INA would not lose money on the bonded contracts. The fact that INA was looking out for its own interests, however, does not lead us to conclude that equity mandates that INA's mortgage be subordinated to the mortgage held by Heller.

INA did not act inequitably in not providing that information to Heller.

In addition, Heller has failed to establish that it was injured as a result of the assignment of the 1981 mortgage to INA.

The Supreme Judicial Court also dismissed the second mortgagee Heller's claim that the surety violated the state's consumer protection punitive damage statute. The Court held:

8. *General Laws, 93A*. Heller argues that the judge erred in concluding that INA and GBT did not commit "unfair or deceptive acts or practices" within the meaning of G.L. c. 93A. We have stated that a practice or act will be unfair under G.L. c. 93A, section 2, if it is (1) within the penumbra of a common law, statutory, or other established concept of unfairness; (2) immoral, unethical, oppressive or unscrupulous; or (3) causes substantial injury to competitors or other business people. (Citations omitted.)

[W]e already have stated that INA did not have either a legal or ethical obligation to inform Heller of the financial support of NERCO.

The Supreme Judicial Court ignored the trial court's findings of unspecified "unconscionable" conduct. The language of the appellate opinion is worthy of note because it suggests that the surety's rights are not absolute, but rather contingent upon good faith, albeit motivated by self interest. Should future courts expand this dicta and should the principal be "difficult", uncooperative or dishonest, the surety could be pitted against the secured bank on the fact issue of good faith. It would seem likely that the bank would still have to prove damage causally related to the surety's action before the bank could recover.

In the Heller case, the matter was factually complex. However, the surety had gone to great lengths to document the basic facts through the use of experts in the accounting and construction fields. The material was then synthesized and confirmed in a detailed series of documents prepared by the surety's attorneys. The lesson again is, know your principal's position and document it before committing to and embarking on a course of action.

The surety must independently verify the credibility of the principal and the principal's documents, document its position and act in good faith to protect its own interest. The documents should

include written evidence that the surety is under no obligation to the first mortgagee, that payment is made for the better protection and benefit of the surety, and that following the assignment to the surety the principal has no obligation to the first mortgagee bank related to the mortgage that has been assigned to the surety in exchange for valid consideration. The substance of the transaction must be clear from the documents.

## **2. The Suspicious Records**

In another case, the accountants retained by the attorneys to investigate the accuracy of the principal's financial records were unable to reconcile the inventory with other records. Preparatory to committing the surety to any action, the attorneys had prepared an interim agreement, under the terms of which the principal acknowledged under oath that the information it provided was "true and accurate to the best of its knowledge and belief". The agreement further stated that "this agreement and the information and documents referred to herein shall constitute a material representation upon which the surety relies in determining what action, if any, it will take."

The documents included the basic inventory cost information and supporting back up purchase slips. The sellers of the specially fabricated material had gone out of business. The original purchase slips were simple pre-printed slips with the number and quantity of the item together with its price set forth in hand written felt tipped pen and signed as having been received by an employee of the principal. Each individual price seemed extremely high when market sources were checked by the surety's experts.

The attorneys submitted one of the slips to infra red photography. Clearly exposed in this inexpensive procedure was the original writing on the document which had been written with a ball point pen showing the per foot item to be \$3.75 per lineal foot. The felt tipped pen had been used to overwrite the \$3.75 and change it to \$8.75, simply by closing the loops on the number 3, making it an 8. The attention to detail made it possible to reconcile the actual cost status of the project and gain the reluctant cooperation of the principal who saw new life in the truth and admitted this "terrible mistake". The surety was then able to determine its course of action with reliable information.

## **D. THE PRINCIPAL AND ITS COZY SUBCONTRACTOR**

The difficult principal can cause problems in the best of circumstances. When circumstances are not the best, the difficulties only multiply. Take, for example, the principal or general contractor who works closely with a subcontractor. The subcontractor has the inside track on a project but has insufficient bonding capacity for the project. The general contractor bids the job as the general and provides the required bond, then subcontracts out a substantial amount of the project to the friendly subcontractor. According to the principal contractor, they have an unwritten agreement to share the profits on the project. The "unwritten" agreement, a "joint venture", is not documented by the records of the principal. The general contractor gets into difficulties on other projects, as well. Construction costs soar, particularly as they relate to the subcontractor's work. The subcontractor blames the general for the increased cost. The payment bond is a basic form, and there are no defenses to the claim of the subcontractor except that the relationship was that of a joint venture and not one of subcontractor vs. contractor. The subcontractor makes claim upon the surety. The general contractor's records do not show the true status of payments and performance of the subcontractor, as it alleges the relationship was in reality a joint venture. The contractor claims the losses the subcontractor claims as part of its additional costs were in fact losses of the joint venture and thus not in the job cost figures related to the subcontractor. The principal claims it only maintained records of the contract performance as it interpreted the contract. The once friendly subcontractor denies the joint venture relationship and

asserts a claim against the surety for over one million dollars. Payment and performance schedules are unreliable. The surety's defenses depend entirely upon the credibility of the general contractor and its documents. The trial court accepted the subcontractor's version of the facts and the surety is held liable on the payment bond.

This was a particularly difficult problem for the surety, as there was little, if any, evidence to raise the "joint venture" issue from the documents available when the surety made its initial investigation. The principal's chief operating officer signed an affidavit for the surety setting forth the principal's "joint venture" position but was uncooperative by the time trial commenced.

Not every situation has a ready solution. This one did not. However, with the perfect vision of hindsight, the surety should carefully scrutinize the relationship of large subcontractors when there are substantial unpaid balances, particularly if contract balances make little sense when compared to payment schedules and requisitions. Even when all due diligence is exercised the surety still has the risk of relying upon the difficult principal.

## **E. THE PRINCIPAL AND THE FRIENDLY LANDLORD**

Consider another situation on a major project underway in an urban area where space is at a premium. The general contractor principal has a very friendly relationship with the land owner who owns a strategically located hazardous waste site, upon which the general has stored its equipment and materials. The general rents space at the site to use as a shakeout and storage area for the project. The storage includes heavy equipment which at times leaks oil. The EPA notifies the land owner to clean up the site. In the meantime the general's business founders and the principal call upon the surety for financial help. The surety consults with its experts including its attorneys. The surety agrees to provide limited financial assistance under joint control and other safeguards. After financing began the general and its friendly landlord turn on the surety and claim that the surety by funding the "rent account" became a tenant and is responsible, in part at least, for the hazardous site conditions and must pay for the clean up.

Before the claims arose, the attorneys representing the surety anticipated the problem and wrote the landlord and principal, and informed them that the surety was not claiming any control or dominion over the site, was not a tenant and was merely guaranteeing the principal's obligation to pay a monthly amount for the use of the site, which the surety referred to as a license. The sabers were briefly rattled, but the claim was not pursued. Documentation again proved decisive.

## **F. THE PRINCIPAL AND THE FRIENDLY EMPLOYEES**

Then there is the case where the general and a few of its longtime employees try to snooker the surety. The general suffers financial losses and turns to the surety for financial assistance to complete work in progress. The surety agrees to assist. Among the financial aid is an agreement to fund the payroll. One of the key employees is very friendly with the principal's majority shareholder and president, the projects are completed and then the key employee makes claim upon the surety alleging that he was an employee of the surety and the surety failed to fund his pension, retirement, and insurance plans. He also claims that he is entitled to unemployment benefits to be charged against the surety's account. The general supported the employee.

Another employee, injured on the project, where the principal failed to pay for insurance for the employee for a work related injury, becomes aware of the keyman claim. The other employee's injuries were substantial. The employee claimed that suit papers were lost by the surety's accountants at the principal's office. The surety's accountants were monitoring the principal's accounting records for

the surety, but denied any knowledge of any suit papers.

At the time the surety commenced its financing, the surety had documented its position in writing. The surety had informed the principal that it would fund certain specific jointly controlled accounts and other related records which stand in the principal's name, for the "better protection of the surety". Payroll checks were issued under one of those jointly controlled accounts. The surety did not control the principal's employees either as to their daily performance or in any other way. The signed completion documentation made this clear. When the key employee first raised the question of his employment status, he was told in writing that "you are not an employee of the surety. You are an employee of the General Contractor. If you are unhappy with your position you are free to look elsewhere for employment. The surety has only guaranteed your wages and nothing else. Neither the surety nor its representatives tells you what to do or how to do it. Your day-to-day working orders and directions come solely from the General Contractor." The key employee did not pursue his allegations.

The injured worker attempted to join the surety in a pending action against liability carriers but was not successful. The accountants (the "monitors") were engaged directly by the surety's attorneys and reported to the attorneys. The "monitors" were not always at the principal's office and undertook, by the engagement letter made directly with the surety's attorneys, only to monitor the surety's interest and the documentation supports the accountant's and the surety's position. Efforts by the employee to obtain the monitors' reports and records were resisted by the surety on the grounds that they constituted work products of attorneys to whom they reported. The employee, unable to obtain any information from the monitors, settled the claim with no contribution from the surety. Detailed documentation and agreements again served the surety well. Total, complete control of the principal should be exercised only with the greatest care in order to avoid becoming the *alter ego* of the principal contractor. See generally My Bread Baking Co. v. Cumberland Farms, Inc., 353 Mass 614, 233 N.E.2d 748 (1968).

## **G. THE DIFFICULT PRINCIPAL AND THE DIFFICULT OBLIGEE.**

There are times when even with a difficult principal, the surety can successfully manage or avoid a loss despite an even more difficult obligee. In surety relationships which involve the contractor construction manager as the obligee, and a principal as a subcontractor, the obligee may try to use its powerful position in order to squeeze a subcontractor into default or bankruptcy and inflate any subsequent claim to the surety.

Documentation in this context is paramount. Often good documentation becomes very sparse as you go down the subcontractor chain. In one case, a subcontractor was working with defective plans and specifications for which neither the contractor, construction manager, nor designer would accept responsibility. The construction manager and the design team decided that the shortfall resulting from the inadequate design, which was impossible to complete, was going to be assessed against the subcontractor. The subcontractor tried to assert the arbitration clause in the contract and the contractor construction manager immediately rushed into state court in Maine where the contracts were signed, even though the work was being done in South Carolina, in order to block the arbitration and try to impose a separate claim procedure incorporated into a later phase subcontract. The clause was not in the first phase contract, the one at issue in the state court case. The contractor also joined the subcontractor's surety into the court battle. The surety, knowing that the principal was competent but not the strongest on details and documentation, saw no real alternative than to passively back the principal in the litigation but with no monetary support. Despite the principal's victory on jurisdiction at the trial court level, the decision was appealed. The appellate court vacated the lower court order and remanded, for further hearings. The principal and the surety then decided to make a bold move and use the interstate dynamics to their advantage and go into U. S. District Court in South Carolina and petition

the court to order arbitration under the federal arbitration statute. The court took the matter in hand and ordered arbitration and stayed the action in Maine until the arbitration award was rendered. The principal at that point had the obligee in the South Carolina forum where the project was being performed, witnesses were available and at reasonable cost to the principal. The principal went on to recover over a million dollars with no loss to its surety. The surety had done its homework and had investigated the principal's competence. Despite the lack of clear documentation, the surety's support, by joining in the principal's strategy and cooperating with the principal, proved successful and wise.

#### **H. THE COMPETENT BUT CONTENTIOUS "DIFFICULT PRINCIPAL"**

Assume the case in which the difficult principal has a project manager who is competent, but contentious. The principal is a large masonry subcontractor on a very substantial high rise in a major metropolitan area. The project is a disaster from the time of inception. The schedules are tight with little float time. The subcontract has a "no damage for delay" clause. The foundation was built by a third contractor who bid directly to the owner. The foundation was delayed in construction, and when finished, the building does not fit the foundation. Design modifications are required with the concurrent delays. The masonry work requires that the steel frame be in place before the masons "wrap" the building. The steel is delayed and the masons cannot sequence their work in a circular "wrap" as originally scheduled. Steel begins to arrive piecemeal and the structure rises from the foundation in the same manner. Coordination and sequencing became a virtual impossibility. The principal vigorously complains to the general and asks for relief from the dramatically escalating costs. The general blames the owner, the designer, the principal and various subcontractors for the delay. The principal, believing its position to be correct, becomes contentious. With no economic relief in sight, the principal threatens a work stoppage. There is no express provision for work stoppage in the contract. Progress requisitions are based upon a percentage of completion which has no relationship to the cost of the work as incurred under job conditions. Without the knowledge or approval of its surety, the principal stops the masonry work. The general contractor calls upon the surety to complete. Under all the estimates, the masonry shortfall, assuming best case timely performance, is over two million dollars. There are few masonry subcontractors in the area with the resources to mobilize and complete the project without still further delays. The surety can complete the project (but the general refuses to allow the principal back on the job), try to buy out of the debacle (but the general, facing over fifty million dollars in claims from the owner and subcontractors, refuses to discuss the option) or do nothing and back its subcontractor, while relying on its rights of indemnification and exoneration.

The general contractor then sued the subcontractor and surety in Texas where the general has its home office and where the contract was, at least arguably, signed and the bond furnished. The subcontractor demanded arbitration in the jurisdiction where the contract was being performed and successfully stayed the Texas litigation. The subcontractor and its indemnitors recognize their responsibility relative to indemnification and exoneration, but refuse to post collateral. The principal defends the action on behalf of the surety and itself, at no cost to the surety. The surety weighs its exposure and decides not to actively intervene, but to passively support its principal. The general attempts to force the principal into one large arbitration with all claimants, a cost prohibitive solution for the subcontractor. The principal successfully resists being compelled to engage in the overall arbitration. The general counterclaims in the arbitration brought by the subcontractor. After days of hearings, the arbitrators award the general two hundred thousand dollars, which the subcontractor pays and obtains a release for it and the surety.

In the hearings, the principal's contract manager appeared competent but contentious. The general contractor claimed that the contentious attitude was the main cause of the delay and the over two million dollars in cost overruns on the subcontract. His competence could not be disproved. By

stopping the job with the surety's passive consent and the surety not intervening, the principal avoided most of the cost overrun which it could have been assessed, based on the no damages for delay clause in the contract. The surety's understanding of this complex matter and the personalities involved proved to be a proper course of action.

In this case the surety stood passively by and, in effect, supported its difficult principal which ultimately inured to the benefit of the surety. Aggressive "strong" action is not always the best solution. A well reasoned analysis of the problem, an understanding of the personalities involved, an in depth understanding of the surety's exposure and a thoughtful approach by the surety may be the surety's best and least costly response when deciding whether or not to complete with a difficult principal.

## **CONCLUSION**

Surety claims management does not always require complex brilliant legal solutions to every problem with a difficult principal. More often than not, studious attention to detail, coupled with common sense and documented by prudently drafted documents will effectively serve the interest of the surety. Experienced experts and attorneys will save time and reduce cost in the claims handling process. Nothing, however, is more important than the claim personnel's ability to recognize and understand the issues and risks before making a decision as to what action to take with the difficult principal. Not every difficult principal is dishonest. The solutions to the problem of the difficult principal are as varied as are the situations. Hard work, attention to detail and experienced experts and attorneys should be of considerable help to claims personnel and decision makers.