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**SURETY BAD FAITH CLAIMS: A SURVEY OF THE LAW**

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## SURETY BAD FAITH CLAIMS: A SURVEY OF THE LAW

Although the general rule is that a surety's liability is limited to the penal amount of its bond, bad faith liability is a significant and unpredictable exception to this rule. Bad faith claims are significant because they expose the surety to extra-contractual damages, including punitive damages. Bad faith claims are unpredictable because most of the applicable law arises in the context of insurance, and because judges often fail to recognize the difference between suretyship and insurance. This paper will survey the law of statutory and common law bad faith actions.

### A. Good Faith and Bad Faith Defined

The law imposes a duty of good faith and fair dealing in the performance and enforcement of all contracts on the parties thereto.<sup>1</sup> "Good faith is an intangible and abstract quality with no technical meaning or statutory definition, and it encompasses, among other things, an honest belief, the absence of malice and the absence of design to defraud or to seek an unconscionable advantage . . . In common usage this term is ordinarily used to describe that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation."<sup>2</sup>

The duty of good faith generally requires a surety to fulfill its obligations, deal fairly with those to whom the surety owes obligations, and to act reasonably within the context of the surety's risk.

"Bad faith" encompasses conduct which may be characterized as violating community standards of decency, fairness or reasonableness.<sup>3</sup> "Bad faith" has been defined as "[t]he opposite of 'good faith,' generally implying or involving actual or constructive fraud, or a design to mislead or deceive another, or a neglect or refusal to fulfill some duty or some contractual obligation, not prompted by an honest mistake as to one's rights or duties, but by some interested or sinister motive. The term 'bad faith' is not simply bad judgment or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; it is different from the negative idea of negligence in that it contemplates a state of mind affirmatively operation with furtive design of ill will."<sup>4</sup> As surety bonds and indemnity agreements are contracts, they are subject to the implied covenant of good faith and fair dealing.

### B. Consequences of Violating the Covenant of Good Faith and Fair Dealing

American law adopted the rule of Hadley v. Baxendale, 9 Ex. 341, 156 Eng. Rep. 145 (1854) which limits damages recoverable for breach of contract to those naturally arising from the breach or those which were within the contemplation of the parties at the time the contract was made. Contract law precludes recovery of special or consequential damages unless the parties knew of the particular risk of loss at the time of contracting. Extra-contractual damages are those damages beyond those naturally arising from a contractual breach, and which were

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<sup>1</sup> Restatement (Second) of Contracts ~ 205 (1981).  
<sup>2</sup> Black's Law Dictionary 623 (5th ed. 1979).  
<sup>3</sup> Restatement (Second) of Contracts ~ 231 cmt. a (1981).  
<sup>4</sup> Black's Law Dictionary 127 (5th ed. 1979).

not in the contemplation of the parties at the time of contracting. Extra-contractual damages include consequential or special damages, and punitive damages, and are only recoverable under tort law. A bad faith claim is a tort action and provides a vehicle to recover extra-contractual and punitive damages for breach of a contractual obligation. Thus, bad faith liability can exceed the penal sum of the bond at issue.

### **C. Differences Between Suretyship and Insurance**

Most reported decisions discussing bad faith issues arise in the context of insurance bad faith. As suretyship is fundamentally different from insurance, application of such cases to sureties can lead to inappropriate legal analysis of the surety's exercise of its rights and remedies. Suretyship differs from insurance in at least the following significant ways<sup>5</sup>:

1. Insurance is a two party contract between the insured and the insurer. A surety bond is a tri-partite relationship among the surety, the principal and the obligee;
2. Insurance is a contract whereby the insurer undertakes to indemnify the insured against loss, damage or liability arising from an unknown or contingent event. Suretyship is a contract whereby the surety is secondarily liable for the debt, default or miscarriage of another;
3. The surety's obligation to the obligee is an extension of standby credit, and the bond premiums are fees for this extension of credit;
4. A surety bond is usually not deemed a contract of adhesion, but is generally prepared by the obligee;
5. Sureties usually have no fiduciary obligations to obligees.

These differences between suretyship and insurance must be kept in mind when evaluating the applicability of an insurance bad faith case to a surety bad faith claim.

### **D. Statutory Bad Faith**

Most states have enacted versions of both the National Association of Insurance Commissioners model Unfair Trade Practices Act and model Unfair Claims Settlement Act. Originally, the model Unfair Trade Practices Act included both unfair trade practices and unfair claims settlement practices. The model Unfair Trade Practices Act defines and prohibits conduct it defines as unfair, deceptive or unfairly competitive such as misleading advertising of insurance products, boycotts, collusion, and discrimination in premiums. The Unfair Trade Practices Act also enumerates various claims settlement practices which are prohibited as general business practices. The Unfair Trade Practices Act applies sureties because it defines "policy" in connection with prohibited trade practices as "[a]ny contract of ...suretyship...."<sup>6</sup>

The unfair settlement practices section of the Model Unfair Trade Practices Act was incorporated into the Model Unfair Claims Settlement Practices Act in 1990. The Model Unfair Claims Settlement Act is inapplicable to sureties because it specifically excludes contracts of fidelity and suretyship from the definition of "policy" or "certificate" governed by the Act.

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<sup>5</sup> The Fifty Most Important Questions a Surety Can Ask About Bad Faith

<sup>6</sup> Tasker, et al.; Practical Guide to Construction Contract Surety Claims, Section 17.6, p. 376-377 (1997).

However, of the states which have enacted unfair claims settlement practices acts, only Georgia, Maryland, Missouri, and Nebraska have adopted the Model Act's language excluding sureties from coverage.<sup>7</sup> The unfair claims settlement practices statutes enacted by Oklahoma and South Carolina specifically include sureties within their coverage. All unfair claims practices acts of other states are silent regarding whether they are applicable to sureties.<sup>8</sup>

Unfair claims settlement practices acts, when applicable to sureties, establish standards of conduct for evaluating surety bad faith claims. At least one commentator has noted that even if the statute at issue excludes sureties from its operation, a strong argument could be made that the standard of conduct established therein is an appropriate standard by which to evaluate surety claims handling.<sup>9</sup> Additionally, when an unfair claims settlement practices statute is silent regarding its applicability to sureties, the state insurance code must be examined to determine whether sureties come within the definitions of persons or entities subject to the statute. For example, Idaho, Michigan, Montana, New Hampshire, New Jersey, and North Carolina have enacted unfair claims practices statutes which apply to "any person." These states insurance codes define "person" as insurers and classify sureties as insurers. Arkansas, Colorado, Delaware, Iowa, Kansas, Massachusetts, Michigan, Pennsylvania, Tennessee and Vermont have insurance codes which include suretyship within the definition of "insurance policy" or "insurance contract." Thus, these states' unfair claims settlement practices acts probably are applicable to sureties despite their silence on this issue.<sup>10</sup>

The definitions of prohibited acts or practices contained in state unfair trade practices acts vary widely. Most states have adopted the following prohibitions from the Model Unfair Claims Practices Act:

1. Knowingly misrepresenting relevant facts or policy provisions to claimants or insureds;
2. Failing to acknowledge claims communications with reasonable promptness;
3. Failing to adopt and follow reasonable procedures for prompt investigation and resolution of claims;
4. Failing to promptly and equitably settle claims once liability is reasonably clear;
5. Refusing to pay claims without conducting a reasonable investigation;
6. Failing to affirm or deny coverage within a reasonable time after completing investigation of a claim;
7. Forcing insureds or beneficiaries to sue to recover amounts due under policies.
8. Making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration.<sup>11</sup>

A surety evaluating a statutory bad faith claim must first examine the relevant state unfair trade practices and/or unfair claims settlement practices statutes and state insurance

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<sup>7</sup> Ga. Code Ann. Section 33-6-31; Md. Code Ann. Section 27-302(b)(3); Mo. Rev. Stat. Sections 375.1000(2); Neb. Rev. Stat. Section 44-1538(1)(e).

<sup>8</sup> *Id.*, Sections 17.6 and 17.10.

<sup>9</sup> *Id.*, Section 17.7.

<sup>10</sup> *Id.*, Sections 17.6 and 17.10.

<sup>11</sup> Model Unfair Claims Practices Act, 1 NAIC Proc. 493-518 (1972).

code to determine whether the statute applies to sureties. If the statute is applicable, the surety must then determine whether the statute creates a private cause of action. If the relevant unfair trade practices or unfair claims settlement practices act does not allow a private cause of action, only the appropriate state agencies or regulators can take action a surety thereunder. The Model Unfair Trade Practices Act and the Model Unfair Claims Settlement Practices Act state that they do not create a private cause of action. However, most states have not adopted the model acts verbatim, and thus states differ regarding whether enactment of an unfair trade practices or unfair claims settlement statute creates a private cause of action. Furthermore, analysis of whether a statute allows a private cause of action requires examination of case law construing the statute and the applicable insurance regulations in addition to the statute's language. In Georgia, Virginia, Kansas and Ohio the statutes do not create a private right of action.<sup>12</sup> Florida's Unfair Trade Practices Act allows a private right of action.<sup>13</sup>

A closely related issue is whether a state unfair trade practices and/or unfair claims settlement practices acts preempt private bad faith causes of action against sureties. This issue is significant because state statutes usually prescribe the penalties for their breach, typically a percentage of the claim, and/or attorneys' fees in prosecuting the claim. These statutorily prescribed penalties serve as a significant limitation on the sureties liability. State have come to different conclusions on the preemption issue. For example, Missouri's so called "vexatious refusal to pay" statute has been held to preempt any common law right of action.<sup>14</sup> In Illinois, the state courts have held that the "vexatious refusal to pay" statute preempts a common law cause of action<sup>15</sup>, while the United States District Court for the Northern District of Illinois has held that it does not.<sup>16</sup> Kansas, Missouri, and Louisiana have held that their respective statutes are the sole remedy for a surety's unreasonable delay in paying a claim.<sup>17</sup>

The preemption issue is more complicated for Miller Act sureties. The Miller Act is a federal law which, among other things, requires contractors on federal projects exceeding \$100,000 for "construction, alteration, or repair of any public building or public work of the United States" to provide a "payment bond for the protection of all persons supplying labor and material in the prosecution of the work...."<sup>18</sup> Federal law conflicts among jurisdictions regarding whether this Act preempts all state law claims against Miller Act sureties, or whether it precludes only those claims against the bond itself. Some courts have held the preemptive effect of the Miller Act is quite broad, and that the Miller Act protects sureties as well as bond claimants.<sup>19</sup> One court has held that the Miller Act mandates uniform national law regarding bonding on federal projects, and that consideration of state law claims in interpreting the Miller Act would defeat the purpose of giving federal courts exclusive jurisdiction over Miller Act

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<sup>12</sup> Ga. Code Ann. Section 33-6-37; Va. Code Ann. Section 38.2-510(B); Earth Scientists v. U.S. Fidelity & Guar. Co., 619 F. Supp. 1465 (D. Kan. 1985); Stack v. Westfield Co., 515 N.E.2d 1005 (Ohio App. 1986).

<sup>13</sup> Fla. Stat. Ann. Section 624.155(1).

<sup>14</sup> Mo. Rev. Stat. Section 375.420; Halford v. Am. Preferred Ins., 696 S.W.2d 40 (Mo. App. 1985).

<sup>15</sup> Fisher v. Fidelity & Deposit Co. Of Md., 466 N.E.2d 332 (Ill. App. 1984).

<sup>16</sup> Rush Presbyterian St. Luke's Medical Center v. Safeco Insurance Co., 722 F. Supp. 485 (N.D. Ill. 1989).

<sup>17</sup> Spencer v. Aetna Life & Casualty Ins. Co., 611 P.2d 149 (Kan. 1980); Howard Constr. Co. v. Terry Woods Constr. Co., 817 S.W.2d 849 (Mo. Ct. App. 1991); Bossier Medical Properties v. Abbott and Williams Constr. Co., 557 So.2d 1131 (La. Ct. App. 1990).

<sup>18</sup> 40 U.S.C. Sections 270a-270f.

<sup>19</sup> U.S. ex. rel. Pensacola Construction Co. v. St. Paul Fire & Marine Ins. Co., 638 F. Supp. 710 (W.D. La. 1989); U.S. ex. rel. General Elec. Supply Co. v. Minority Elec. Co., 537 F. Supp. 1018 (S.D. Ga. 1982); U.S. ex. rel. Cool Temp, Inc. v. All Am. Bldg. Sys., Inc., 857 F. Supp. 69 (N.D. Ga. 1994).

suits.<sup>20</sup> Such precedent may allow a Miller Act surety facing a state law bad faith claim from a payment bond claimant to argue that the Miller Act preempts state law bad faith claims.

## E. Common Law Surety Bad Faith Actions

The common law surety bad faith action is based on breach of the implied covenant of good faith and fair dealing. As suretyship is a tri-partite relationship, the surety owes a duty of good faith to both the obligee and the principal. It is this dual obligation of good faith which often subjects the surety to bad faith allegations. Sureties bad faith allegations can be raised by obligees, payment bond claimants, by the principal, and by indemnitors.

### 1. Obligees' Bad Faith Claims

The law throughout the country varies greatly regarding whether a performance bond obligee can maintain a bad faith action against a surety. For example, Florida, Maryland, Missouri, New Jersey, and the Second Circuit Court of Appeals have refused to recognize obligees' bad faith claims against performance bond sureties.<sup>21</sup> Pennsylvania federal courts have issued conflicting opinions on this issue. Previously, Pennsylvania federal courts have refused to recognize obligees' bad faith claims against sureties<sup>22</sup>, but a recent case from the United States District Court for the Eastern District of Pennsylvania, interpreting Pennsylvania law, held that sureties may be liable for bad faith failure to honor a bond obligation.<sup>23</sup> On the other hand, Alaska, Arizona, Colorado, Montana, North Dakota, New York, Ohio and West Virginia have upheld the viability of bad faith causes of action against performance bond sureties.<sup>24</sup> Alaska, Montana and North Dakota also allow payment bond claimants to assert bad faith claims against sureties.<sup>25</sup>

There is no uniform or clear definition of bad faith, and obligee's asserting such claims against sureties have alleged a wide variety of conduct constitutes bad faith. Aside from recitations of conduct prohibited by the state unfair trade practices act or the unfair claims settlement practices act, obligees' bad faith allegations against sureties typically include the following:

1. Failure to investigate bond claims;
2. Misrepresenting relevant facts or bond coverage;
3. Failing to conclude prompt and fair settlements after liability has become reasonably clear;
4. Forcing obligees and claimants to litigate to recover amounts due under bonds;

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<sup>20</sup> U.S. ex. rel. Pensacola Construction Co., Id.

<sup>21</sup> Halford v. American Preferred Ins., 698 S.W.2d 40 (Mo. Ct. App. 1985); Reliance Ins. Co. v. Barile Excavating & Pipeline Co., 685 F. Supp. 839 (M.D. Fla. 1988); In re Technology for Energy Corp., 123 B.R. 979 (Bankr. E.D. Tenn. 1991); United States v. Seaboard Surety Co., 817 F.2d 956 (2nd Cir. 1987); Republic Ins. Co. v. Board of County Commissioners, 68 Md. App. 428 (1986).

<sup>22</sup> Tudor Development Group, Inc. v. United States Fidelity & Guar. Co., 692 F. Supp. 461 (M.D. Pa. 1988).

<sup>23</sup> Reading Tube Corp. v. Employers Insurance of Wausau, 944 F. Supp. 398 (E.D. Pa. 1996).

<sup>24</sup> Loyal Order of Moose, Lodge 1392 v. International Fidelity Insurance Co., 797 P.2d 622 (Alaska 1990); Dodge v. Fidelity and Deposit Co., 778 P.2d 1240 (Ariz. 1989); Transamerica Premier Insurance Co. v. Brighton School District, 940 P.2d 348 (Colo. 1997); K-W Industries v. Nat. Surety Corp., 754 P.2d 502 (Mont. 1988); Spancrete Northeast, Inc. v. Travelers Indem. Co., 477 N.Y.S.2d 502 (App. Div. 1984); Szarkowski v. Reliance Ins. Co., 404 N.W.2d 502 (N.D. 1987); Suver v. Personal Serv. Ins. Co., 462 N.E.2d 415 (Ohio 1984); Continental Realty Corp. V. Andrew J. Crevolin Co., 380 F. Supp. 246 (S.D. WV 1974).

<sup>25</sup> Loyal Order of Moose, *supra*; K-W Industries, *supra*; Szarkowski, *supra*.

5. Protracting litigation to delay payment;
6. Failing to provide a reasonable explanation for denial of a bond claim;
7. Failure to consider the claimant's economic condition and the impact of delay in processing and payment of the claim;
8. Failing to affirm or deny the claim within a reasonable time after documentation is submitted;
9. Delaying claim investigation or payment by requiring the claimant to submit preliminary claim reports and then requiring the claimant to submit formal proof of loss or claim forms containing substantially the same information;
10. Failing to use an independent consultant to investigate and evaluate a bond claim;
11. Tendering defense of the claim to the principal, and allowing the principal and/or its attorney to represent the surety in investigation, negotiation and litigation with the bond claimant.
12. Failing to review pleadings, discovery documents and deposition transcripts during the course of litigation of a claim; and
13. Failing to attend trial of a claim except through counsel.

Very few of these allegations have been upheld by the courts as establishing bad faith on the part of a surety.<sup>26</sup>

The most frequent cause of surety bad faith liability is failure to investigate bond claims adequately. One of the earliest cases recognizing surety bad faith liability for failure to investigate a claim properly was Dodge v. Fidelity & Deposit Insurance Co. Of Md.<sup>27</sup> In Dodge, the contractor/principal contracted to build a home for the obligees/plaintiffs. The principal defaulted, but despite evidence of the principal's default, the surety refused to investigate the obligees' performance bond claim. The court reasoned that sureties should be subject to the same bad faith liability as insurers because the state insurance code included sureties within the definition of "insurer." The court concluded a special relationship exists between a surety and a performance bond obligee. The Court further reasoned the law implies duties in this special relationship which not imposed in other contractual relationships, and breach of this special relationship gives rise to tort liability where (1) the plaintiff contracted for security and protection rather than for profit and commercial advantage, and (2) where permitting tort damages would provide a substantial deterrence against breach by the party deriving commercial benefit from the relationship. The Court found both these factors present here where the obligees were homeowners and the performance bond was for a home building project. The Court held the surety was acting as a liability insurer to protect the obligees from catastrophe, and that obligees could maintain a bad faith cause of action against the surety because the surety's refusal to investigate their performance bond claim was unreasonable.

Similarly, in Loyal Order of Moose Lodge 1392 v. International Fidelity Insurance Co.<sup>28</sup> the Alaska Supreme Court held that a surety's unquestioning reliance on its principal's assertions and its failure to investigate its principal's alleged default even minimally, may constitute bad faith if the investigation would have confirmed the obligee's allegations.

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<sup>26</sup> The Fifty Most Important Questions a Surety Can Ask About Bad Faith, pages 59-61.

<sup>27</sup> 778 P.2d 1240 (Ariz. 1989).

<sup>28</sup> 797 P.2d 622 (Alaska 1990).

Although the law is clear that sureties must conduct reasonable investigations of bond claims, it offers little guidance regarding what constitutes a reasonable investigation. The United States District Court for North Dakota has held that a surety has no duty to assemble the factual data necessary to prove a bond claimant's claim, but does have a duty to corroborate the accuracy of properly documented claims.<sup>29</sup> There is also authority suggesting that a surety's investigation must consist of more than simply obtaining information regarding the claim from its principal.<sup>30</sup> Furthermore, an investigation which is merely negligent should not subject a surety to bad faith liability.<sup>31</sup>

## 2. Bad Faith Claims of Principals and Obligees

The general agreement of indemnity gives sureties wide discretion to settle claims, make other payments to reduce the risk of loss. The indemnitors must reimburse the surety for all payments made in good faith where the surety has an apprehension of liability.<sup>32</sup> As the only recognized defenses to surety indemnification actions are bad faith or unreasonable action on the part of the surety in paying or not paying a claim, sureties attempting to enforce their indemnification rights are often confronted with allegations of bad faith. Principals and indemnitors have asserted bad faith both as a defense to indemnification and as a counterclaim seeking an affirmative recovery from the surety.

The cases addressing indemnitors' bad faith claims demonstrates that investigation and communication are essential. For example, the Oregon Court of Appeals held that a contractor/indemnitor could prove bad faith and defeat an indemnification action by proving the surety failed to conduct a reasonable investigation prior to settling with the obligee.<sup>33</sup> In Rush Presbyterian-St. Luke's Medical Ctr. v. Safeco Insurance Co. Of America,<sup>34</sup> the United States District Court for the Northern District of Illinois held that a surety can be liable to its principal and indemnitors compensatory and punitive damages for negligently entering into a settlement agreement with an obligee which failed to give "equal consideration" to the interests of its principal. The Minnesota Supreme Court has held that a surety's failure to communicate a bond claimant's settlement offer to its principal prevented the surety from collecting more than the amount of the settlement offer from the principal under the indemnity agreement. The court reasoned that failing to communicate the settlement offer to the principal unfairly deprived the principal of the right to exercise its own business judgment in settling a claim for which it was liable.<sup>35</sup> In Republic Insurance Co. v. Prince Georges County,<sup>36</sup> A surety's failure to pay the amount initially demanded by the obligee for estimated project completion costs resulting from the principal's default, precluded the surety from recovering the higher actual project completion costs subsequently paid to the obligee from the indemnitor. The court limited the surety's recovery to the initial, lower amount, reasoning that the increase was caused by the surety's failure to pay after the obligee's initial demand.

The Texas Supreme Court has recently held that a surety owes no common law duty

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<sup>29</sup> Farmers Union Central Exch. v. Reliance Ins. Co., 675 F. Supp. 1534 (D.N.D. 1987).  
<sup>30</sup> Piombo Corp. v. Castlerock Properties, Docket Nos. A036552/A038290/A039050 (Cal. App. 1st Dist., Div.2 January 5, 1990).  
<sup>31</sup> McQueen Contracting, Inc., v. Fidelity & Deposit Company fo Md., 863 F.2d 1216 (5th Cir. 1989); Szumigala v. Nationwide Mut. Ins. Co., 853 F.2d 274 (5th Cir. 1988).  
<sup>32</sup> Fidelity & Deposit Co. Of Md. v. Bristol Steel & Iron Works, Inc., 722 F.2d 1160 (4th Cir. 1983).  
<sup>33</sup> City of Portland v. George D. Ward & Assoc., Inc., 750 P.2d 171 (Or. App. 1988).  
<sup>34</sup> 712 F. Supp. 1344 (N.D. Ill. 1989).  
<sup>35</sup> New Amsterdam Cas. Co. v. Lundquist, 198 N.W.2d 543 (Minn. 1972).  
<sup>36</sup> 608 A.2d 1301 (Md. App. 1992).

of good faith to its principal. Associated Indemnity Corp. v. Cat Contracting, Inc.,<sup>37</sup> involved a contractor/principal which contracted to build a concrete pipeline for a water district. The contractor warned that the soil was too unstable to support the pipeline, but the obligee responded that the design was sound and ordered the contractor to complete the project. The pipeline leaked after installation, and after the contractor refused to repair the pipeline without additional compensation, the obligee default terminated the contractor and demanded that the surety complete the work. The surety agreed repair the leaks under a reservation of rights. The pipeline leaked again after the repairs were made. Although the contractor/principal continued to assert that the obligee's design was defective, the surety, without the contractor/principal's knowledge, settled with the obligee. The surety then sought \$835,000 from the contractor/principal for the repair costs, the settlement and other alleged expenses. The contractor counterclaimed for breach of the common law duty of good faith and for breach of the indemnification agreement. The trial court ruled in favor of the contractor/principal, and the court of appeals affirmed, holding that the contractor could recover from the surety for the surety's breach of the common law duty of good faith as well as the indemnity agreement's good faith duty. The Supreme Court of Texas reversed on this point and ruled that a surety does not owe its principal a common law duty of good faith. The Texas Supreme Court noted this duty exists in insurance agreements because of the special relationship that exists between an insurer and insured. The court further noted the factors giving rise to this special relationship such as unequal bargaining power, the nature of insurance contracts, and the inadequacy of a penalty when an insurer with exclusive control of the settlement process, arbitrarily denies coverage or delays payment, are lacking in the surety relationship. The court recognized that there is no unequal bargaining power in the surety claims resolution process because unlike insured's, contractors have considerable business sophistication. Furthermore, exclusive control of the settlement process, present in the insurance context, does not extend to suretyship as the principal does not look to the surety for protection against loss. The court concluded that absent these factors, there was no need to impose a common law duty of good faith upon the surety. The court also recognized that imposing a duty of good faith on the surety in favor of the principal might cause the surety to be "reluctant to satisfy an obligee's valid claims under a performance bond (even though such a bond exists for the benefit of the obligee) for fear of incurring tort liability to the principal.

Regarding the contractor/principal's claim that the surety breached the indemnity agreement's good faith requirement, the Texas Supreme Court observed that the indemnity agreement gave the surety the exclusive right to pay or refuse to pay any bond claim, and that the surety's decision in such matters was binding on the indemnitors if made in good faith. The court determined that under the indemnity agreement, the surety's good faith in settling claims was a condition precedent to indemnity from the contractor for such payments. The court held that "good faith" is conduct that is honest in fact and free from improper motive or wilful ignorance. Notably, the court held that good faith does not require proof of a reasonable investigation.

The Texas Supreme Court held that there was evidence that the surety acted in bad faith which precluded the surety from obtaining indemnification from the principal. The surety's claims manager ignored his construction consultant's advice to hire an engineering firm to determine whether the pipeline failed because of defective design, and instead chose to rely

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<sup>37</sup> No. 96-0387, 1998 Tex. LEXIS 27, WL 58987 (Feb. 13, 1998).

on his own engineering training and the opinions of the obligee's engineers and the replacement contractor. The court found it significant that the claims manager had no expertise in the cause of the leaks, and that the interests of the obligee and the replacement contractor, a competitor of the principal, created potential conflicts of interest.

## **F. Surety Defenses to Bad Faith Claims**

In response to a bad faith claim by a performance bond obligee and/or a payment bond claimant, a surety may rely on all its principal's defenses.<sup>38</sup> Additionally, the surety has its own defenses to bad faith claims. These defenses include:

1. Existence of a legitimate dispute regarding the facts surrounding a claim or regarding application of the law to those facts at the time the surety denied the claim.<sup>39</sup> This defense may insulate the surety from bad faith liability even if the surety ultimately is wrong in the dispute.
2. Inadequate standing or privity under the bonded obligation;
3. Failure of a bond claimant to adequately document or support its claim;
4. Comparative bad faith of the obligee, claimant or indemnitor such as fraud or misrepresentation;
5. Release of the principal by the claimant prior to the alleged bad faith;
6. Constitutional defenses based on the Excessive Fines Clause of the Eighth Amendment, the Fourteenth Amendment's Due Process Clause, etc.

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<sup>38</sup> Great American Insurance Co. v. NorthAustin Municipal Utility District, 908 S.W. 2d 415 (Tex. 1995).

<sup>39</sup> Bossier Medical Properties v. Abbott & Williams Const. Co. Of La., 557 S.2d 1131 (La. App. 1990).