

TENDERING THE DEFENSE:
PROBLEMS, PRACTICALITIES,
AND A PROPOSED SOLUTION

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Despite all that surety claims experiences teaches, the basic underwriting assumption which prevails throughout the industry remains constant: If the bond is issued, the Principal WILL INDEMNIFY, and there will be NO LOSS!

The optimistic assumptions of the underwriter can be dashed rather suddenly where, for example, the contractor arrives at the surety's doorstep with tickets to the Bahamas in one hand and keys to the office in the other, or, perhaps, where the contractor, besieged with claims from hostile creditors, seeks asylum in one or more chapters of the Bankruptcy Code. When disasters of this nature strikes, the reality is usually that a "loss" will occur, and the claim professional's job generally becomes one of determining the scope and extent of the surety's obligation and the

most desirable means of discharging them. Defense of disputed claims ceases to become a primary concern.

But where the Principal is still "live and kicking", and disputed claims erupt into litigation, a different problem is presented: How can the surety best provide for its defense in the litigation, while preserving its right to reimbursement so that the underwriter's expectations can be fulfilled? Are there practical alternatives to placing the defense of the surety in the hands of the Principal?

This paper outlines some basic decisions which must be made by the claim professional when suit is threatened or filed. The focus of this paper is from the surety's perspective, and assumes a claim of at least moderate complexity, which is disputed by the Principal and results in litigation. We also assume, for purposes of our discussion, that our contractor/principal has resources which are substantially less than unlimited. We suggest herein that many of the assumptions which are associated with the decision to tender the legal defense of the surety to legal counsel selected and paid for by the Principal are too frequently found to be erroneous, and that the results in such arrangements are too often unsatisfactory. Finally, we conclude that the concept of monitoring counsel can be a useful and cost-effective tool to assist the surety claim professional in preserving and enforcing the surety's rights.

I. PRE-LITIGATION PROCEDURES - THINGS TO DO WHILE THE STORM CLOUDS GATHER.

A. Let's Get Acquainted.

- (1) Who (or what) is your claimant.
- (2) What is the nature of the claim; is there a potential for the claim to exceed bond coverage?
- (3) Who (or what) is your Principal?
- (4) Who (and where) are your Indemnitors?
- (5) Who is advising your Principal? Identify the lawyers, accountants, and insurance agents.

B. What is Your Principal's Current Financial Status?

- (1) Do you have current financial statements?
- (2) Are they audited?
- (3) Is your underwriter still on speaking terms with the contractor? If so, are bonds still being issued?
- (4) Are there other claims, demands, or suits in progress? How are they being handled?

C. Conducting the Independent Investigation.

- (1) What exactly is your Principal's position as to the claim in question?
- (2) What is the factual basis for your Principal's position?
- (3) What is the documentation for the factual basis?
- (4) Does your Principal have a legal opinion concerning his defense?

- (5) Is the Principal's position identical with that of the surety?
- (6) Consider "bad faith" implications.

D. The Surety's Decision - Basic Options.

- (1) Conditional denial based upon existing information with reservation of rights.
- (2) General denial, with reservation of rights.
- (3) Acknowledgement of liability and demand for direct payment by Principal.
- (4) Acknowledgement of liability and direct payment with demand for reimbursement.
- (5) Collateralization demand.
- (6) Declaratory Judgment remedies.

II. THE LAWSUIT ARRIVES: NOW WHAT?

A. Analysis of Legal Theories.

- (1) Determine what claims are being asserted against the bond.
- (2) Compare with totality of claims asserted against Principal.
- (3) Consider extra contractual theories of recovery.
- (4) Consider extra contractual claims for damages.
- (5) Is the position of the surety identical to that of the Principal?

B. Determine the Principal's Position.

- (1) Is there a viable defense.
- (2) Can the claim be economically defended?
- (3) Has the Principal considered settlement?
- (4) Are there alternatives to litigation?

C. Determine the Attorney's Position.

- (1) Is the surety comfortable with the attorney selected by its Principal?
- (2) Is the attorney comfortable with joint representation of Principal and surety?
- (3) Are there personal defenses, and should Principal's counsel assert them?

III. DUTIES OF MONITORING COUNSEL - A PROPOSED MODEL.

A. Factors to be Considered in Determining Whether Monitoring Counsel is Appropriate.

- (1) Nature of the claims asserted against surety.
- (2) The Principal's capacity to indemnify.
- (3) The Principal's willingness to collateralize the surety's exposure.
- (4) The existence of defenses which are personal to the surety.
- (5) The competency and experience of the attorney proposed to be retained by the Principal.

- (6) Irreconcilable conflicts between the surety, the Principal, and the Indemnitors.

B. The Function of Monitoring Counsel - An Overview.

- (1) Monitoring counsel will be selected by surety and will represent the surety's interest exclusively.
- (2) Monitoring counsel will review and evaluate surety's investigation.
- (3) Monitoring counsel will review pleadings and significant developments in the course of the litigation to ensure that the surety's defenses are preserved.
- (4) Monitoring counsel will continually review and evaluate personal and derivative defenses suggested by discovery.
- (5) Monitoring counsel will be prepared to assume the surety's defense at trial.

IV. THE FINAL BATTLE: THE NEED FOR SEPARATE TRIAL COUNSEL.

A. Practical Problems of Joint Defense of Surety and Principal at Trial.

- (1) Inability to prosecute the claims for indemnity.
- (2) Personal defense complications.

B. Strategic Considerations - Where is that Big Insurance Company?

SUMMARY

In complex litigation, the risks of not having independent representation of the surety outweigh the advantages of the traditional "tendered defense" option. By usage of independent counsel on a limited basis, the surety can decrease the risk of an unsuccessful litigation result, hopefully for little or no cost.

ARTICLES

1. Klein, Ethical and Other Pitfalls of Dual Representation and Surety Bond Litigation, paper presented at the Fidelity and Surety Law Committee, Annual Mid-Winter Meeting, January 25, 1991.

2. Allbritton & Langfitt, Legal and Practical Problems with Joint Representation of the Principal and Surety, Fidelity and Surety Committee Annual Meeting, August 13, 1991.

3. Brumley, The Duty of the Shielded Surety to Investigate, 17 Forum 226 (1981).

CASES

1. Central Towers Apartments, Inc. v. Martin, 453 S.W.2d 789 (Tenn. Ct. App. 1969).

2. Transamerica Insurance Company v. Bloomfield, 401 F.2d 357 (6th Cir. 1968).

3. Jackson v. Hollowell, 685 F.2d 961 (5th Cir. 1982).

4. United Riggers & Erectors v. Marathon Steel Co., 725 F.2d 87 (10th Cir. 1984).

5. United States v. F. D. Rich Co., Inc., 439 F.2d 895 (8th Cir. 1971).

6. United States v. USF&G, 656 F.2d 993 (5th Cir. 1981).

OTHER MATERIALS

See ABA Annotated Model Rules of Professional Conduct, Rule 1.7 (ABA Model Code of Professional Responsibility, DR 5-105).