

**THE SURETY'S LIABILITY FOR ITS PRINCIPAL'S
TORTS: A CAUTIONARY TALE**

Presented by

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RESPONSIBLE BONDING COMPANY
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Surety, USA

April 12, 1994

KNOWET & ALL, P.C.
Attorneys at Law
1 Defendall Court
Metropolis, USA

RE: Colossal Construction Company v. Responsible Bonding Company, et al.

Dear Attorney Knowet:

Enclosed you will find suit papers in the above-referenced action. I have reviewed this claim and trust you will agree it is frivolous. I am confident that your immediate motion for summary judgment will meet with great success.

As you will see from the Complaint, this is a claim under a subcontract performance bond which Responsible issued for Pipsqueak Roofing Company, a subcontractor to Colossal. The Complaint states that an employee of Colossal suffered severe personal injuries when he was pushed off the roof of the project in question by an employee of Pipsqueak. Incidentally, our investigator advises us that there is another civil action pending wherein the injured employee is making a claim against Pipsqueak and its employee, claiming that his injuries are a direct responsibility of Pipsqueak because of the negligent acts of its employees and alternatively, that the employee deliberately pushed him off the roof because of an on-going job site feud. At any rate, Colossal claims to have incurred medical expenses in excess of \$100,000.00. The Complaint references an Indemnity Agreement in the subcontract which reads as follows:

"... Subcontractor agrees to defend, indemnify and hold harmless Contractor ... from and against any claim, cost, expense, or liability (including attorneys fees) attributable to bodily injury, personal injury ... caused in whole or in part by ... subcontractor, its subcontractors, or their agents, or employees."

The subcontract performance bond is issued on a Colossal form, and while I am certain this is of no legal significance, you will note the condition of the bond is as follows:

" NOW, THEREFORE, if the said Principal shall fully indemnify and save harmless the Obligee from all loss, liability, costs, damages, penalty, attorneys fees or expense which Obligee may incur by reason of failure to well and truly keep and perform each, every and all of the terms of said subcontract on the part of said Principal to be kept and performed, ... then this obligation shall be of no effect, but otherwise it shall remain in full force and effect."

Please let us know when your motion for summary judgment has been granted.

Very truly yours,

L. O. Ball
Manager of Claims

NXP:rlm
Enclosures

BONDS, TORTS, AND THE SURETY'S EXPOSURE: A REFRESHER COURSE

Most of us have had an experience similar to that of attorney Knowet. Because surety counsel and their clients are well schooled in the distinctions between performance bond undertakings and policies of liability insurance, efforts to assert what are essentially liability claims under performance bonds are rarely taken seriously, at least in the initial stages of litigation. As Responsible and attorney Knowet will soon learn, there are cogent arguments - and supporting authority - which can be advanced in support of Colossal's claim, and Responsible's ability to prevail at the trial court level will depend upon its willingness and ability to educate a trial judge who may not appreciate the "frivolous" nature of Colossal's position.

CLAIMS BY THIRD PARTIES - WHY THE SURETY SHOULD WIN

Had suit been filed by Colossal's employee - perhaps under the theory that Pipsqueak failed to perform a contractual obligation concerning maintaining safety on the project and thus caused his injuries - Responsible's optimism would be understandable. As a general rule, the Courts have had little difficulty in distinguishing the proper scope of the performance bond from the role of the liability insurer. Under the majority view, third-party tort claimants may not proceed under a performance bond simply because as a matter of contract law they are neither expected nor intended beneficiaries and therefore cannot claim the benefit of the bond.¹

¹ A good summary of the cases in this area is provided by Ron Barker in an article titled "Third-party Tort Claimants and the Contact Bond Surety", *Construction Lawyer*, Vol. V, No. 1, Spring 1984.

A second and somewhat more subtle argument is available under decisions from Appellate Courts of Louisiana, which have recognized that as a practical matter, utilization of performance bond proceeds for resolution of tort claims - at least where the injuries occur on public projects - would defeat the purpose of the legislature, which clearly intended the penal sum of the bond to be available for owners, laborers and material suppliers, as opposed to tort claimants.²

Another sensible explanation of this area is found in a 1971 decision from Utah, which highlights the differences between bonds and insurance policies:

"An insurance contract is one whereby one undertakes to indemnify another against loss, damage or liability arising from an unknown or contingent event. A contract of surety on the other hand is one whereby the surety promises to answer for a debt, or miscarriage of another. One company may be qualified to write a policy of insurance and also to issue a surety bond, but the same law does not apply to the same transactions.³

Our research has failed to disclose the existence of any reported decision wherein a third-party claimant - someone other than the obligee - has successfully recovered tort damages under a performance bond. While it would be unwise to suggest that no such precedent exists, the clear majority of the reported decisions are in favor of the surety.⁴ However, attorney Knowet can take little comfort in these decisions, since the plaintiff in the case at hand

² For example, see Ryder v. Baco Realty Company, 207 So.2d 155 (La. 1968).

³ 44 P.2d 156, 159 (Utah, 1971).

⁴ See Fields, Claim Against Surety for Personal Injury and Property Damage, October 1964 *Insurance Council Journal* at page 658 and cases cited therein; see also Linder, Liability Insurer v. Performance Bond Surety - Their Rights and Obligations to Each Other and to Third-parties, October 1982 *Insurance Council Journal* at page 508 and cases cited therein.

is the obligee on the subcontract performance bond. What arguments are available against Colossal's claim?

CLAIMS FOR INDEMNITY - THE GOING GETS TOUGHER

Claims for indemnity against the surety - or more precisely, claims against the surety for non-performance of indemnity obligations by the principal - are problematic. The "third-party beneficiary" argument are seemingly unavailable, because the obligee is making a direct claim. Moreover, the claim is context in terms of a breach of contract - not tort - and thus is traditionally within the scope of the performance bond. Is it time to post a reserve?

Colossal's counsel would say "Yes". His argument will be exceedingly simple: the subcontract requires Pipsqueak to indemnify his client against any "claim, cost, expense or liability" - including his fees - incurred by his clients wholly or partially because of the conduct of Pipsqueak's employees. Without question, his client has incurred the medical expenses. Without question, Pipsqueak has not reimbursed them. Where, asks opposing counsel, is his check?

Unfortunately for Responsible, there are cases which seem to allow recovery. In 1946, the Illinois Supreme Court permitted an owner to recover amounts paid to satisfy a judgment obtained by an adjoining property owner from the owner's contractors performance bond surety. There, the bond contained language of indemnity in favor of the owner for "negligent" performance of the contract. The Illinois Court, looking only at the nature of the claim and the language of the bond, permitted recovery.⁵

⁵ Sanitary District of Chicago v. USF&G, 63 N.E. 2d 364 (Ill. 1946).

Similarly, where an owner successfully sued a contractor's surety to recover sums paid by the owner to injured employees of the contractor in Safeway Stores, Inc. v. Massachusetts Bonding Company,⁶ a 1962 California decision. The Court's focus on appeal was the nature of the theory of indemnity; apparently, the surety conceded that the liability of the bonding company would be coextensive with the contractor.

A well reasoned but rarely cited Alabama decision suggests that a reserve may be premature. In Waterworks, Gas and Sewer Board of Oneonta v. P.A. Buchanan Construction Co.,⁷ the Supreme Court of Alabama rejected an obligee's effort to implead its performance surety and to enforce safety obligations imposed on the contractor/principal in favor of the owner. In affirming the trial court's judgment in favor of USF&G, the Alabama Supreme Court conducted a useful review of applicable law which could be of benefit to Colossal.

The Oneonta litigation arose from the explosion of a natural gas pipeline, installed by Buchanan Construction Co. in the early 1950's. USF&G issued a performance bond on behalf Buchanan in favor of the governmental Owner. The contract contained extensive provisions concerning safety and protection of the work, and it contained standard language requiring the contractor to maintain liability insurance and to indemnify the Owner and its engineers from any an all claims which might "result either directly or indirectly from the construction from any part of the work ... resulting from failure of material, inferior workmanship, neglect, obstruction of streets, excavation, collapsing structures, floating

⁶ 20 CA. Rptr 820 (1962)

⁷ 294 Ala. 402 (Ala. 1975).

of structures, water, breaking or eruption of pipelines, explosions, fires, and any and all other causes which may result from the construction of this project ..." Sixteen years after completion and acceptance, the pipeline exploded, damaging a building. The property owners filed suit against the board, the contractor and the engineers, who then filed a third-party claim against USF&G. Summary judgment was granted in favor of the surety, and the Board appealed.

In affirming, the Supreme Court first noted that a public works surety is not liable to third-parties for injuries sustained by negligence of its principal, citing the general rule as follows:

"A bond to secure the performance of a municipal improvement contract is for the benefit and protection of the city and all property owners interested in the improvement, but it does not cover the claims of adjoining landowners for torts committed by the contractor in the performance of the work even though the contract provided that the contractor and his surety should be responsible for all damage caused by the contractor's operations."⁸

The Alabama Court was apparently influenced in large degree by Professor Stearns, who is quoted with approval as follows:

"Attempts have been made under statutory bonds to hold the surety for torts of the contractor or his employees. These attempts have been uniformly unsuccessful."⁹

The opinion then reviewed all of the contract language, as well as the language of the performance bond, and concludes that the bond issued by USF&G was governed and controlled by the terms of the statute. The conclusion has a pleasant resonance:

⁸ The Court cites 63 CJS Municipal Corporations, §1172 at p. 859 in support of this proposition. See also, United States v. Fidelity & Deposit Company of Maryland, 144 F.Supp. 322 (); United States v. Massachusetts Bonding and Insuring Company, 18 F.2d 203 (6th Cir.); TriState Insurance Company v. United States, 340 F.2d 542 (8th Cir.).

⁹ Stearns Law of Suretyship, Fifth Ed., Sect. 8.13, Pg. 269.

"The common practice of referencing in the surety bond the construction contract between the Board and the contractor does not change a statutory performance and completion bond into either a common-law bond or a liability insurance policy for the payment of tort claims.¹⁰

Unfortunately for Responsible, the Colossal bond is not governed by statute. As a subcontract performance bond, it will be construed simply as a common-law undertaking. Notwithstanding this lamentable difficulty, it would seem that Responsible's counsel could make the following arguments in opposition to the claim:

1. THE BOND SHOULDN'T COVER TORT CLAIMS DIRECTLY OR INDIRECTLY.

Although Colossal's claim is couched in terms of contract, it originates from a claim of negligence. The purpose of the bond is to provide the obligee with financial security as to the subcontractor's performance of the work. Colossal did not intend that the bond provide a means for it to obtain reimbursement of medical benefits paid to an employee.

2. THE INDEMNITY PROVISION SHOULD BE NARROWLY CONSTRUED.

Public policy should prohibit one party from extracting blanket indemnity from another, particularly where the agreement, if literally construed, would insulate the indemnified party from the consequences of its own misconduct. The Colossal indemnity goes too far and should not be enforceable, whatever may be the scope of the bond.

3. THE BOND IS NOT AN INSURANCE POLICY, AND IT IS ILLOGICAL TO SO CONSTRUE IT.

Colossal no doubt required Pipsqueak to provide liability insurance, or at least had the power to do so. Colossal could not have intended to shift the risk of negligent acts from an insurance policy to the bond, since the primary purpose of the bond is to protect Colossal and labor material suppliers and since the ultimate responsibility for payment of any claims under the bond would rest with Pipsqueak's indemnitors.

4. RESPONSIBLE DIDN'T PICK THE BOND FORM.

As all trial courts know, ambiguities in insuring agreements should be construed against the insurance

¹⁰ 294 Ala. 402, 408.

company. The trial court may not know that Responsible had nothing whatsoever to do with the selection of the bond form; indeed, it is probably that Responsible's underwriting department never saw the bond (nor the subcontract) until after issuance. Responsible should be entitled to a break notwithstanding the onerous terms of the bond.

5. **SURETYSHIP IS NOT INSURANCE.**

See above.

SUMMARY

The surety has plenty of ammunition with which to attack a claim by a third-party against a performance bond. However, restrictive concepts such as privity of contract are not fashionable these days, and efforts to expand the scope of the surety's liability are evident on many fronts. Therefore, Responsible's counsel should avoid total reliance on a contractual analysis, and should instead focus on the substantive distinctions between the intended functions of surety bonds and insurance policies. By concentrating on the basic purpose of the bond - to provide an economic guaranty of performance, as opposed to protection from unanticipated "occurrences" - Colossal's arguments can be attacked and hopefully defeated - at kneecap level.

