

**SIXTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
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GENERAL INDEMNITY AGREEMENT REVISITED

PRESENTED BY:

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The focus of this paper is a subject near and dear to the hearts of sureties -- the general indemnity agreement taken in connection with surety bonds. The general indemnity agreement is the thing that makes issuance of the bond a reality and that aims to protect the surety against loss.

To go back to basics a bit, in the typical situation a surety requires its principal, and perhaps others, to execute an indemnity agreement by which the principal and other indemnitors agree to reimburse the surety for any losses that the surety may sustain as a result of its issuance of bonds on behalf of the principal. Although that is the heart of agreement and it sounds rather simple, the typical indemnity agreement contains several other provisions governing the rights of the surety. Also, the situation can become complicated quickly when reluctant or even hostile indemnitors begin to think of creative ways to avoid their obligations to the surety under the agreement.

In analyzing a surety's rights when presented with a claim on a bond, it is essential to scrutinize the indemnity agreement with an eye toward remedies that the surety has against the indemnitors, and defenses that the indemnitors may present to a claim by the surety. This paper is organized to focus on particular provisions of the indemnity agreement that have been the subject of litigation in the very recent past. It highlights cases decided since 1993 and is organized to focus on specific provisions contained in the typical general indemnity agreement.

I. GENERAL INDEMNIFICATION PROVISION

Although the typical indemnification agreement consists of several paragraphs or pages, the heart of the agreement is the general indemnification clause. It typically provides that the indemnitors will

indemnify the surety against any and all liability, loss and expense of whatsoever kind or nature, including, but not limited to, court costs, attorney's fees, and interest, which the surety may sustain or incur (i) by reason of having executed or procured execution of any bond or bonds as surety for any of the undersigned, (ii) by reason of the failure of the undersigned to perform or comply with the agreement of indemnity, or (iii) to enforce any of the covenants and conditions of the agreement of indemnity.

(A) RECOVERY OF CLAIMS PAID

In a very brief opinion, the Federal District Court for the South District of New York relied on a similar clause in granting a motion for summary judgment in favor of a surety. The case, Northwestern National Insurance Co. of Milwaukee, Wisconsin v. Alberts, 822 F. Supp. 1079 (S.D.N.Y. 1993), is one of a few that we will discuss involving a financial guarantee bond. In Northwestern, the principal executed an assumption agreement in favor of a bank, assuming the obligation to repay the indebtedness of a corporation to the bank. The principal executed an agreement with the surety requesting the surety to issue a bond guaranteeing his obligations to the bank. The agreement also provided that he would indemnify the surety against all loss, cost, and expense, including attorney's fees, incurred by reason of the surety issuing the bond. The principal defaulted, and the surety was required to pay \$6,854,000, plus interest. Id. at 1080.

The principal failed to reimburse the surety, in violation of the terms of agreement. The surety sued and moved for summary judgment. The principal did not file an opposition to the motion. Using a simple analysis, the court first stated that the terms of the indemnity agreement were binding under New York law. It then quoted the general indemnification provision and found that the surety was entitled to judgment, including its attorney's fees and expenses. Id. at 1081. If only it were always that simple.

Another straightforward case was presented in Citizens State Bank v. Transamerica Insurance Co., 815 F. Supp. 309 (D. Minn. 1993). There, a surety issued a federal warehouseman's bond to a federally licensed grain storage facility to secure the facility's faithful performance of its obligations as a warehouseman. As a condition precedent to the issuance of the bond, officers of the company entered into a general agreement of indemnity with the surety. The surety ultimately was sued on the bond by two entities and filed cross-claims and third party demands against the officers for indemnification. Id.

at 311.

All but one of the indemnitors agreed on a settlement by which the surety paid the entire amount of the bond in exchange for a release by the creditors. The surety then sought summary judgment against the remaining indemnitor for the full amount paid by the surety and all expenses that it had incurred. The Minnesota federal district court quoted the general indemnification language from the agreement. Based on that language, the court concluded that the indemnitor personally agreed to reimburse the surety, that the surety was required to pay the creditors, and that the indemnitor was personally liable for the amount that the surety had paid. Id. at 313-14.

In International Fidelity Insurance Co. v. Spadafina, 596 N.Y.S.2d 453 (App. Div. 1993), an indemnitor raised a substantive defense to a claim that had been paid by the surety. The indemnitor was the president of a corporation that had contracted with the U.S. Government to install lights at an airport in Virginia. Under an indemnity agreement, the surety agreed to issue performance and payment bonds, and the indemnitor, individually and as president of the corporation, agreed to indemnify the surety. A subcontractor sued the surety, claiming it was owed money. The surety settled the suit. Id. at 454.

The surety then filed suit against the indemnitor for reimbursement and moved for summary judgment. The indemnitor's defense was that his company had tendered payment to the subcontractor, but that the subcontractor had refused, thereby releasing his company and the surety from liability. The district court had held that this created a genuine issue of fact as to whether the indemnitor was liable for the underlying debt and denied summary judgment to the surety. Id.

The New York appellate court reversed. It quoted a portion of the indemnity agreement which gave the surety the authority to

charge [indemnitor] for any and all disbursements made by it in good faith in and about matters herein contemplated by this Agreement under the belief that it is or was liable for the sums and amounts so disbursed, or that it was necessary or expedient to make such disbursements, whether or not such liability, necessity or expediency existed . . .

Id. The court noted that the validity of such contractual arrangements has been upheld and that payments made by sureties under such provisions are scrutinized only for good faith and reasonableness as to the amount paid. Under that analysis, the court concluded that it was irrelevant whether the indemnitor was actually liable on the underlying debt to the subcontractor. Because the surety had submitted proper documentation of payment of the settlement to the subcontractor as well as the fees and costs incurred in making the settlement, and because the indemnitor did not raise issues as to the "bona fides" of the settlement or as to the reasonableness of its amount, the court granted the surety's motion for summary judgment. Id. at 455.

In Transamerica Insurance Co. v. H.V.A.C. Contractors, Inc., 857 F. Supp. 969 (N.D. Ga. 1994), an indemnitor also raised the defense that some of the claims paid by the surety were not owed. There, a corporate contractor and three of its officers executed an agreement of indemnity to induce a surety to issue payment and performance bonds on behalf of the contractor. The surety issued bonds for subcontracts to provide construction services on five projects. Ultimately, the surety was called upon to complete the projects and to pay the contractor's obligations, and it did so. It then sued the three officers, seeking to recover more than \$150,000 under the indemnity agreement. Id. at 971-72.

The officers counterclaimed for negligence and breach of fiduciary duty due to alleged improper payment of bond claims by the surety. One of the defenses presented by the officers was that the surety had made double payments on some of the claims, totalling approximately \$35,000. The court rejected that argument, relying on the provision of the indemnity agreement entitling the surety to payment for any and all disbursements made by it in good faith whether or not liability for payment actually existed. The court concluded that the provision did not require the surety to be correct in its payment of claims, but only to make them in good faith. The court then rejected the officers' argument that the claims were paid in bad faith and granted the surety's motion for summary judgment. Id. at 974.

As to the officers' counterclaim, the court stated that the officers had "baldly" asserted that the surety breached a fiduciary duty to them when it disbursed funds and failed to consult with them. The court said that the officers had failed to cite any authority for the proposition that a surety owes a fiduciary duty to the indemnitors beyond the duties included in the contract. Thus, it granted the surety's motion for summary judgment, dismissing the counterclaim. Id. at 975.

The scope of the general indemnification clause was examined in a unique context in Abbott v. Equity Group, Inc., 2 F.3d 613 (5th Cir. 1993), another case involving financial guarantee bonds. The case is from the Fifth Circuit Court of Appeals, on appeal from the Eastern District of Louisiana, in New Orleans. The factual background is somewhat complicated.

A corporation had formed a limited partnership, becoming the managing general partner. The limited partnership was formed in Louisiana to acquire and operate an apartment community in Houston. The limited partners' investment was a combination of cash and two promissory notes. To obtain financing from two banks, the limited partnership pledged the notes to the banks. As additional security, a surety issued financial guarantee bonds in favor of the banks as permitted assignees, with the investors as principals, and the partnership as obligee. Among other things, the surety required each investor to sign an indemnity agreement protecting the surety against all losses in connection with the bonds. Id. at 616.

Because the limited partnership eventually failed to meet its financial obligations, the banks called the investors' notes. The investors defaulted, thus obliging the surety to make payments under the terms of the bonds. The surety, in turn, looked to the investors for a full accounting, but to no avail. Instead, over forty investors sued, among others, the managing general partner of the limited partnership, the surety, and the agent involved in procuring the bonds. The investors alleged violations of the Securities Act of 1933, the Securities and Exchange Act of 1933, the Louisiana Blue Sky Law, and Louisiana law for fraud and negligent misrepresentation. They sought damages and rescission. The

surety counterclaimed for enforcement of the indemnity agreements. Id. at 618.

At the basis of the investors' suit were alleged misrepresentations and material omissions in the solicitation initiatives of the managing general partner. The investors' claimed that the surety continued participation in the transaction, despite its alleged knowledge of misrepresentations and material omissions, violated federal securities laws and nullified the investors' indemnity agreements with the surety unenforceable. Id. at 615.

The district court ultimately granted summary judgment in favor of the surety, disposing of the investors' case and enforcing the indemnity agreement. The Fifth Circuit affirmed. In defending the surety's claim for indemnification, the investors relied on National Union Fire Insurance Co. v. Turtur, 892 F.2d 199 (2d Cir. 1993), arguing that when a surety receives an indemnity agreement from an investor in return for bonding the investor's obligations, and the subscription and indemnity agreements are executed contemporaneously, fraudulent inducement in the subscription agreement renders the indemnity agreement likewise fraudulently induced and thus unenforceable.

The Fifth Circuit rejected the argument. Because the investors failed to produce "more than a scintilla of evidence" that the surety actually was involved in the alleged fraud, neither federal nor Louisiana law supported the defense. Id. at 626. The court went on to state that under Louisiana law, when the words of a contract are clear, unambiguous, and lead to no absurd consequences, the contract is interpreted by the court as a matter of law. It examined the broad language of the indemnity agreement including the provision that "default occurs regardless of whether the Principal for any reason shall have no legal obligation to discharge his, her or its obligations under the Notes to the Obligee or the Permitted Assignee." Id. at 627. In view of that language, the court concluded that the indemnity agreement encompassed fraud. The court also rejected the investors' argument that Section 29(b) of the 1934 Act voided the indemnity agreement, concluding that the indemnity agreements, standing alone, were not made or performed in violation of the securities law. Id. at 627-28.

(B) RECOVERY OF ATTORNEY'S FEES

The indemnification clause almost invariably includes a specific reference to indemnification for attorney's fees. Those include fees incurred in defending claims on the bond, as well as those incurred in recovering under the indemnification agreement from the indemnitors. The subject of attorney's fees arose in several cases during the past couple of years.

A Nevada Supreme Court case presented some interesting issues. In Transamerica Premier Insurance Co. v. Nelson, 878 P. 2d 314 (Nev. 1994), a surety obtained an indemnification agreement and issued a bond. A claimant on the bond sued the surety. The principals refused to defend the action or to cooperate with the surety, so the surety defended itself, and got out of the litigation on a motion for summary judgment. The basis of the motion was that the work at issue was performed before the surety issued the bond. Id. at 315-16.

The surety then filed a third-party complaint against the principals seeking indemnification for all costs and attorney's fees. The surety and the principals then filed cross-motions for summary judgment. The district court granted summary judgment in favor of the principals and against the surety, on the basis that the surety's expenses had not been incurred "on the bond" because the work at issue was outside of the scope of the bond. Id. at 316.

Fortunately, the Nevada Supreme Court reversed and remanded with instructions to grant summary judgment in favor of the surety. The court reasoned that even nonmeritorious claims brought on the bond would amount to a demand or "liability" on the bond, and would therefore be covered by the indemnification agreement. In addition, the agreement provided that the surety would be reimbursed for attorney's fees even if it had not been required to make a bond loss payment. Finally, the court made several public policy arguments in favor of the surety's right to reimbursement, including the argument that such an outcome would keep insurance premiums low. Id. at 317.

After concluding that the surety was due attorney's fees, the court addressed the issue of how

to determine the amount of attorney's fees that the surety was entitled to recover. This was an issue of first impression in Nevada. The court rejected the notion that the amount of fees due a surety pursuant to an indemnification agreement should be determined based upon the court's subjective analysis of the "reasonableness" of the fees under the circumstances. Instead, it "adopt[ed] a standard under which the courts should consider only whether the attorney's fees were incurred in good faith or in consequence of the issuance of the bond." Id. In adopting this standard, the court relied on the language of the indemnification agreement. It concluded that when parties contractually agree that good faith is the standard, undertaking a determination of anything other than good faith is inappropriate. Id.

The good faith standard also was used in American Employers' Insurance Co. v. Horton, 622 N.E.2d 283 (Mass. App. Ct. 1993). There, a painting subcontractor was employed by a general contractor on an elderly housing project. The subcontractor completed an application for a surety bond. A payment and performance bond was issued by the surety, naming the general contractor as obligee and the subcontractor as principal. The application for the bond contained an indemnification provision which included attorney's fees. It also provided that the surety had the exclusive right to determine whether a claim should be paid, and that the surety's decision, if made in good faith, would be final and binding on the indemnitor. Id. at 284.

The subcontractor was terminated by the general contractor on the grounds of poor performance, and the general submitted a claim to the surety. When the subcontractor brought suit against the general to recover the value of its work, the general joined the surety as a party and filed a counterclaim against the subcontractor and the surety. The surety hired its own lawyer to represent its interests. The litigation ultimately was settled. The surety then brought suit against the indemnitor, seeking reimbursement for the attorney's fees and expenses that it had incurred in defending itself against the general's counterclaim. The subcontractor's defense was that the surety had incurred the expenses

unreasonably and not in good faith. In particular, the subcontractor argued that if the surety had conducted an adequate investigation, it would have known that the general's counterclaim was frivolous and would not have incurred the fees and expenses. Id. at 284.

Both the Massachusetts trial and appellate courts were unimpressed with that argument, and concluded that the surety was entitled to summary judgment on its claim. The appellate court determined that the subcontractor had not shown any genuine issues of material fact as to whether the surety's decision to hire its own lawyer was not made in good faith. The court noted that the surety's exhibits in support of its motion included an affidavit from the subcontractor's prior trial counsel. The subcontractor also complained on appeal that the trial court had entered judgment without a hearing as to the reasonableness of the fees. The court rejected that argument, noting that the subcontractor never contested the reasonableness of the fees and expenses, and that, in fact, the reasonableness of the fees and expenses was confirmed by the subcontractor's own attorney. Id. at 285.

The case of James Constructors, Inc. v. Salt Lake City Corp., 888 P.2d 665 (Utah App. 1994), involved an award of attorney's fees to a surety after years of protracted litigation.

A \$2 million dollar lawsuit was brought against the principal and the surety, and the surety initially tendered its defense to the principal, limiting its involvement to monitoring the case. The principal's attorney then withdrew from the litigation and tendered the surety's defense back to counsel for the surety. The surety and the principal then entered into a stipulation whereby the surety agreed that the principal would not have to post collateral, and that in the event that the claimant on the bond was successful, the surety would be entitled to an immediate judgment against the indemnitors for the surety's costs and reasonable attorney's fees. Id. at 668.

It is important to note that the parties agreed that they would be bound by the court's determination of reasonableness. Thus, their agreement as to fees went beyond the original indemnification agreement. At the end of the litigation, the court awarded the surety \$115,000 in

attorney's fees and costs, plus \$56,000 in prejudgment interest. The indemnitors appealed. Id.

The appellate court affirmed the judgment of the trial court. The court rejected the indemnitors' argument that the trial court should have applied a standard of reasonableness that is unique to indemnification actions, citing Perkins v. Thompson, 551 So. 2d 204, 210 (Miss. 1989), and Central Towers Apartment, Inc. v. Martin, 453 S.W.2d 789, 799-800 (Tenn. App. 1969).¹ Instead, it concluded that Utah law was sufficient for determining the reasonableness of fees in the indemnity context. Following existing Utah law, it considered four factors: (1) the legal work actually performed; (2) whether the work was reasonably necessary to prosecute the matter; (3) whether the attorney's billing rate was consistent with rates customarily charged in the locality for similar services; and (4) additional factors, including those listed in Code of Professional Responsibility.

Analyzing the specific facts of that case, the court noted that (1) the principal on the bond was without assets, (2) the principal's parent company did not list the \$3 million claim in its financial statement, (3) the parent company had been reluctant to pay its own attorney resulting in the tender back of the defense to the surety, and (4) the indemnitors had failed to post collateral. Given those circumstances, the court concluded that it "was not unreasonable for [the surety] to determine that it was necessary to defend itself in the litigation to protect and preserve its interests." Id. at 670-71. The court held that the surety was not entitled to prejudgment interest on attorney's fees, however. It determined that when reasonable fees are to be fixed by a court, prejudgment interest is not applicable. Id. at 673.

As to the award of attorney's fees incurred in enforcing the agreement of indemnification and

¹ The factors that the Utah court gleaned from the Perkins and Central opinions were: (1) The amount of risk to which the surety was exposed; (2) whether the principal was solvent; (3) whether the surety called on the principal to deposit with it funds to cover the potential liability; (3) whether the principal, on demand by the surety to deposit with it the amount of the claim, refused to do so; (5) whether the principal hired the attorney for both himself and the surety; (6) whether the principal notified the surety of the hiring of the attorney; (7) the competency of the attorney hired by the principal; (8) the diligence displayed by the principal and his attorney in the defense; (9) whether a conflict of interest exists between the parties; (10) the attitude and cooperativeness of the surety; and (11) the amount charged and diligence of the attorney hired by the surety. 888 P.2d at 669-70.

in prosecuting the appeal, the court found that such an award would be appropriate only if the indemnification agreement provided for it. In that case, the agreement expressly provided that the surety could recover any fees incurred in enforcing its general rights of indemnification. Thus, the court concluded that an award of the fees actually incurred was warranted. It then remanded the case to the trial court to award the surety its reasonable fees incurred on appeal. Id. at 674.

A Nevada Supreme Court case, Harvey v. United Pacific Insurance Co., 856 P.2d 240 (Nev. 1993), also involved the issue of the reasonableness of an award for attorney's fees to a surety against its indemnitor. The surety had issued a performance bond in favor of a contractor and had procured an indemnification agreement from the contractor. Litigation ensued, with the result that the surety paid the penal sum of the bond, \$25,000. The surety sought indemnification from the contractor for almost \$42,000 expended in the litigation. The contractor counterclaimed under every legal theory imaginable, from unfair trade practices to negligent infliction of emotional harm. After a two-week trial, a jury awarded the surety approximately \$138,000 in damages against the contractor, including attorney's fees incurred in prosecuting the indemnity action and defending the contractor's counterclaim. Id. at 241.

On the first of two appeals, the Nevada Supreme Court expressed its shock over the large size of the award, and remanded for a consideration of the reasonableness of the attorney's fees. On remand, the trial court concluded that it could not find a basis for reducing the award and "affirmed" its prior decision. On the second appeal, the Nevada Supreme Court affirmed the trial court's decision as well.

It noted that under the terms of the indemnity agreement, the contractor was liable for the attorney's fees incurred by the surety in the prior litigation, that the nine theories of liability advanced in the counterclaim were inextricably intertwined with the action under the indemnity contract, and that in the indemnity action, the contractor had acted in an obstructionist manner, interposing meritless counterclaims merely to defeat the indemnity action. Id. at 242. The dissenting opinion expressed

shock over the trial court's failure to follow its earlier order and expressed the view that the indemnity agreement did not permit the surety to recover attorney's fees when it is sued for a tort. Id. at 243 (Springer, J., dissenting).

Finally, the Supreme Court of Virginia also recently discussed attorney's fees in the context of indemnification agreements. In Rappold v. Indiana Lumbermens Mutual Insurance Co., 431 S.E.2d 302 (Va. 1993), a surety on a subcontractor's performance bond had obtained a general indemnification agreement from the president of the subcontracting company. The general contractor sued the subcontractor and the surety for \$175,000, claiming that the subcontractor had breached its contract and was in default. The surety filed a third party demand against the subcontractor, seeking indemnification. The subcontractor attempted to defend the claim for indemnification, arguing that the indemnification agreement was not valid because of an alleged alteration after execution.

The surety settled the general contractor's claim for \$12,000 and amended its claim against the subcontractor, seeking \$24,000 for the amount paid, plus attorney's fees. By the time of trial on the matter, the surety's claim had reached \$44,000. The trial court awarded the full sum. Id. at 304.

On appeal, the subcontractor contended that the surety could not recover its attorney's fees and costs incurred in bringing its action against the subcontractor for indemnity because the indemnity agreement did not have an express provision for such recovery. Rather, the subcontractor argued that the surety could recover only the amounts it had incurred in defending the general contractor's claim. The Virginia Supreme Court rejected this argument, relying on the broad language in the indemnification agreement, which provided that the surety would be held harmless "from and against any claim . . . sustained or incurred by reason of having executed said bonds." Id. at 303.

The subcontractor also argued that the surety did not establish the reasonableness of the attorney's fees, which was three hundred percent more than the amount for which the surety settled the claim. The court concluded that the fee was reasonable given the total amount of the underlying

demand, \$175,000, and the uncontradicted expert witness testimony, that the fees were reasonable.

Id. at 305-06.

(C) PROOF OF LOSS PROVISION

In determining the amount due a surety in an indemnification action, several recent opinions focused specifically on a provision in the general indemnity agreement to the effect that

vouchers or other evidence of payment made by the surety shall be prima facie evidence of the fact and amount of the liability to the Surety.

This provision obviously should simplify the surety's counsel's burden of proving its loss, and make summary judgment on indemnification claims easier to obtain. That result was reached in recent cases.

In a case discussed above, Transamerica v. H.V.A.C., 857 F. Supp. 969 (N.D. Ga. 1994), the court specifically relied on such a provision. That was the case in which the indemnitors tried to avoid the surety their indemnity obligations by alleging that the surety had paid some bond claims. In awarding the surety summary judgment, the court also quoted the proof provision of the indemnity agreement. Id. at 973. It concluded that the surety had submitted all claim vouchers and evidence of payment, and that the surety was entitled to summary judgment on its claim for indemnification.

Similarly, in Transamerica Premier Insurance Co. v. Nelson, 878 P.2d 314 (Nev. 1994), also discussed earlier, the Supreme Court of Nevada relied on that provision. Because the surety had submitted a "detailed list of expenses for all legal work done in connection with the suit on the bond and the suit against [the principal] for indemnity," the court found that it had complied with the letter of the general indemnity agreement. Id. at 318. Furthermore, the principal had introduced no evidence to show that the costs were inaccurate or incurred in bad faith. Therefore, the court remanded the case to the lower court, with instructions to enter judgment for the surety in the full amount of costs incurred. Id.

In another case in which proof issues were raised on appeal, a surety was successful in getting

a jury verdict for over \$1,000,000 against indemnitors. See Rhodes v. Amwest Surety Insurance Company, 428 S.E.2d 581 (Ga. App. 1993). In Rhodes, one indemnitor appealed the jury's verdict, pro se. He argued that the computer-generated summary of claims and expenses paid by the surety under the bonds was inadmissible because the summary was not supported by documents accessible to the court and the parties. Id. at 582. It was undisputed that most of the supporting records were not readily accessible. Although the court did not expressly refer to any provision in the indemnification agreement regarding proof, the court ruled that there was no error because the auditor who prepared the document testified at trial regarding its identity and contents. Id. at 583.

The indemnitor also argued that there was no evidence to sustain the jury's verdict as to attorney's fees paid by the surety. However, the court found that the expenses in the computer-generated report included the fees and again relied on the testimony of the auditor. Id.

II. CONTINUING NATURE OF INDEMNIFICATION CLAUSE

The agreement of indemnification normally is continuing in nature. That is, the surety is indemnified not only with regard to bonds issued on the day that the agreement is executed, but with regard to subsequently issued bonds as well. A provision to that effect might read

This agreement applies to all bonds executed or procured by the surety for the principal, in his own name or as co-adventurer with others, whether prior or subsequent to the execution and delivery of this agreement, and from time to time until this agreement is terminated in accordance with its terms.

When an indemnification agreement is executed some time prior to the issuance of bonds, and more than one bond is issued by a surety, indemnitors attempting to avoid their obligations may contend that they were unaware of the continuing nature of their liability. Such a situation was presented in State University Construction Fund v. Aetna Casualty & Surety Co., 592 N.Y.S.2d 490 (App. Div. 1993).

There, a surety successfully sued for indemnification about eleven years after being sued on a

\$9.8 million performance bond. The surety brought its indemnitors into the suit by way of a third-party demand. The demand was based on a general contract of indemnification that the indemnitors had entered into in 1965 on a construction project prior to the project at issue. The agreement covered any bond that the surety might execute in favor of the indemnitors for an indefinite period of years. Id. at 491.

The indemnitors argued that the surety's claim was barred by laches, and that the indemnity agreement was intended to apply only to the project that was ongoing when the agreement was executed. The court said that, even assuming that laches could apply, the indemnitors had failed to show that its application was warranted. It could not be said that they lacked knowledge or notice of the surety's potential claim against them. The court also concluded that the agreement clearly and unambiguously provided that the personal indemnity would extend to all bonds executed by the surety on behalf of the indemnitors over an indefinite period of time. It refused to allow the indemnitors to introduce parol evidence to alter the terms of the agreement. Id. at 492.

The continuing nature of an indemnification agreement also was at issue in St. Paul Fire & Marine Insurance Co. v. Russo Brothers, Inc., 641 A.2d 1297 (R.I. 1994). There, the surety had issued a statutorily required cigarette and tobacco tax bond on behalf of a wholesale distributor of tobacco products. The bond was in the amount of \$100,000 and was renewed yearly on review of the company's financial statements by the surety. In 1982, at the time for the annual renewal, the surety refused to renew the bond unless the corporation and its principals executed an indemnity agreement. The bond was renewed for the next two years, and its amount increased to \$155,000. The corporation failed to meet its tax obligations, and the state sought payment from the surety, who paid more than \$114,000. The surety subsequently brought suit against the indemnitors to recover the money, and was awarded summary judgment by the trial court. The indemnitors appealed. Id. at 1298.

On appeal, the indemnitors argued that they were not liable under the indemnity agreement

because at the time that they executed the agreement, an agent told them that it was effective for only one year. They allege that they did not read it when they signed it. The Rhode Island Supreme Court relied on the parol evidence rule, that in the absence of fraud or mistake, parol or extrinsic evidence is not admissible to vary, alter, or contradict a written agreement. The indemnitors argued that the rule was inapplicable because the agent's statements were evidence of fraud or misrepresentation affecting the contract's validity. However, the court concluded that the indemnitors had failed to plead or introduce any evidence to support the proposition that they had relied on any such misrepresentation in executing the agreement. Thus, the parol evidence rule precluded admitting evidence of a contemporaneous oral agreement to vary the terms of the written agreement. Id. at 1299-1300.

Further, the court expressed the opinion that the indemnitors' asserted reliance on oral characterizations may have been unreasonable as a matter of law because they were sophisticated business people and because their characterizations contradicted the plain language of the indemnification agreement. Id. The court affirmed the summary judgment in favor of the surety. The dissenting opinion was just as long as the majority opinion. The dissenting judge viewed the case as a "definitive textbook instance in which the parol-evidence rule does not apply and one in which summary judgment should not have been granted." Id. at 1301 (Murray, J., dissenting).

III. COLLATERAL DEPOSIT PROVISION

Whether as a part of the general indemnification provision or as a separate provision, indemnification agreements typically include a collateral deposit provision. An example of a the basic part of such a provision is:

The Undersigned will deposit with the Company as collateral security, immediately upon demand, a sum of money, at the option of the Company, equal to (1) the liability of the Company, if established; (2) the liability asserted against the Company; or (3) the reserve established by the Company, or any increase thereof, to cover any liability, loss, expenses or possible liability for any loss or expense for which the Undersigned may be obligated to indemnify the Company under the terms of this Agreement.

Although the indemnity agreement does not provide that the surety is obligated to exercise its rights under the collateral deposit provision, and, quite often, the surety knows that making a demand for collateral will be futile, whether the surety makes such a demand on its indemnitors may be considered by the court when the surety brings an action for indemnification against the indemnitors.

In James Constructors, Inc. v. Salt Lake City Corp., 1994 WL 715254 (Utah App. 1994), discussed earlier, one of the factors that the court considered in analyzing the reasonableness of the surety's claim for attorney's fees was the fact that the surety had demanded a deposit of collateral but the principal had "stubborn[ly] refus[ed] to post collateral or to provide other adequate and acceptable security to" the surety. Id. at *5.

IV. TAKEOVER PROVISION

In the construction arena, parties executing a general indemnification agreement typically agree that the surety has the power to take over the principal's work under a contract if the principal defaults.

A typical provision is:

If an event of default occurs, surety, at its discretion, shall have the right, but not the obligation, and is hereby authorized, with or without exercising any other right or option conferred upon it by law or by the terms of this agreement, to take possession of any part or all of the work under any contract, and, at the expense of principal and indemnitors, to complete or arrange for the completion of the work, and to take such other steps which, at its discretion, surety may deem advisable or necessary to obtain surety's release or to avoid loss.

In at least one recent case, a surety's takeover rights were at issue. There was a contest for funds between a surety and its principal in Howell Construction, Inc. v. United Pacific Insurance Co., 824 F. Supp. 105 (W.D. Ky. 1993). The Government had awarded the principal a contract worth close to \$1 million to paint buildings at an army base. When the principal could no longer perform, the surety and the Government executed a takeover agreement, whereby the surety agreed to complete the

project. Id. at 106.

At the time that the surety took over, the principal had submitted invoices for about \$376,000, but had been paid only \$32,000. Pursuant to the takeover agreement with the surety, the Government eventually tendered approximately \$800,000 to it. The principal objected on the basis that it was owed more than the remaining \$200,000 for its partial performance. The surety told the principal that it would not profit from the takeover, but would reimburse the principal after deducting its reasonable expenses. The surety ultimately was left with a balance of \$250,000, for which the principal brought suit. Id. at 107.

The issue was whether, under Kentucky law, the principal was entitled to the money. The court concluded that it was. Based on a 1939 Kentucky Court of Appeals case and comments in American Jurisprudence,² the court opined that a surety who discharges the obligation of its principal, even under an assignment, may not thereafter realize a profit. It limited the surety's gain to its premium. It explained that its most compelling reason for doing so was the surety's written admission that it could not profit from the takeover.³ In the opinion of the court, "[j]ust as a surety when called upon must carry out its performance in a manner that will not bring harm to its principal, a surety may not likewise seize the circumstance of its principal to turn a profit over and above its bargain with the principal on the suretyship arrangement." Id. at 110.

V. PROVISION PROHIBITING ORAL MODIFICATIONS

Like many other written contracts, an agreement of indemnity may contain a provision prohibiting oral and unauthorized written modifications of the agreement, such as

The rights and remedies afforded to the surety by the terms of this agreement may not

² See Napier v. Duff, 281 Ky. 779, 136 S.W.2d 1083 (1939); 74 Am. Jur. 2d Suretyship § 205 (1974).

³ On reconsideration, the court held that the contractor's settlement with the government had no effect on its prior ruling.

be waived or modified orally and no written change or modification shall be effective until signed by an officer of the surety.

Such a provision can be useful to the surety when disgruntled indemnitors start thinking of novel ways to attempt to alter the terms of the indemnity agreement. In a recent case, my partner and I, representing a surety in an indemnity action, were faced with an argument by an indemnitor that the surety had orally agreed to waive all of its rights to indemnification. Fortunately, we were able to defeat that claim.

The case of Transamerica v. H.V.A.C. Contractors, 857 F. Supp. 969 (N.D. Ga. 1994), discussed above, also involved a claim that an indemnification agreement had been altered orally. One of the indemnitors' defenses to the surety's claim was that the surety orally agreed that it would obtain the approval of one of the officers before paying claims and that the surety breached that oral modification of the written agreement. The court rejected that argument, relying on the provision of the agreement which gave the surety the right to adjust, settle or compromise any claim on the bond, unless the indemnitors requested that the surety litigate the claim and deposit collateral with the surety. The court noted that the officers had made no such request or deposit. Further, the court concluded that the provision in the indemnity agreement prohibiting oral modifications to the agreement was enforceable. Id. at 973.

VI. TRUST PROVISION

Another common provision in the indemnification agreement is a trust provision, such as

The undersigned will hold all payments received pursuant to any contract as a trust fund for the payment of obligations incurred for labor, materials, and services furnished for use in the prosecution of work required by the contracts.

The case of In Re Wm. Cargile Contractor, Inc., 151 B.R. 854 (Bankr. S.D. Ohio 1993), involved a surety's use of the trust fund provision in the context of a bankruptcy. In that case a surety on a performance bond moved for direct payment of funds held in trust to subcontractors of a Chapter

11 contractor. The surety argued that the subs were secured creditors based on properly filed mechanic's liens. The liens were filed after the contractor had filed for bankruptcy, but they arguably related back to the first day that work was performed on the project. The surety also argued that the funds were not a part of the bankruptcy estate because of trust provisions found in the indemnity agreement and in the contract between the contractor and the owner. Id. at 855. The court disagreed.

The court drew a distinction between liens filed under private and public projects. It determined that although private project liens may relate back, public project liens cannot. The court explained that because the liens were filed after the bankruptcy petition, they violated the automatic stay and were void. Id. at 858. The court also refused to allow the contractual trust fund provisions, including the one in the indemnity agreement, to enable unsecured creditors to be paid ahead of secured creditors. It concluded that such a result would be contrary to the priority scheme set forth under Ohio state law and under the Bankruptcy Code. It refused to allow the subcontractors to be paid directly from the retained contract funds. Id. at 859-60.

Another surety used the trust fund provision creatively, but to no avail, in In Re Construction Alternatives, Inc., 2 F.3d 670 (6th Cir. 1993). There, a contractor had entered into a contract with an Ohio school district to remove asbestos from four schools. The surety provided a payment and performance bond for the contractor. The IRS filed two notices of tax liens against the contractor. The day after the second tax lien was filed, the contractor filed a Chapter 11 petition. On that day, its work was completed and it was due its final progress payment; however, it had not paid all of its bills for the project. The surety paid subs and suppliers. The money due from the school district was paid into a fund, against which the IRS and the surety asserted claims. Id. at 673.

The IRS argued that it was entitled to the fund because it had a lien on the fund. The surety

argued that the IRS had no lien and that even if the IRS had a lien, the surety's lien or interest had priority. The Sixth Circuit found for the IRS. The court decided that when the contractor filed for bankruptcy, it had earned the right to receive the final progress payment and thus, had a property interest in the payment. As a result, the government could and did acquire two valid tax liens on the fund and was entitled to the fund. Id. at 674.

The court rejected a number of creative arguments on behalf of the surety, including its argument that the tax lien could not attach to the fund because the contractor held the fund as the surety's trustee under the indemnity agreement. Id. at 676 The court disagreed, finding that under Ohio law neither a constructive nor an implied nor an express trust had been created. Because the agreement did not require the principal to keep the funds in a separate trust fund, there was no trust corpus, and thus, no trust was created under Ohio law. Id. at 677. The court also rejected the surety's argument that the indemnity agreement created a security interest that would prime the tax lien under the federal tax lien statute.⁴

Finally, in Howell Construction, Inc. v. United Pacific Insurance Co., 824 F. Supp. 105 (W.D. Ky. 1993), discussed above, one of the factors that the court considered in determining that the surety could not profit from a takeover of the principal's contract was the existence of a trust provision in the indemnity agreement. The court explained that the surety held amounts in excess of its liability as fiduciary for the benefit of the principal, and that the trust provision evidenced that "fiduciary principle."⁵ Using cryptic reasoning, the court concluded that the trust provision limited the surety's

⁴ The court quoted the provision of the general indemnity agreement providing that the agreement constituted a security interest and a financing statement. 2 F.3d at 677, n.6. It concluded that before the surety's alleged security interest would take priority under the federal tax lien statute, the surety would have been required to perfect it by filing a financing statement in the appropriate office. Id. at 678.

⁵ The court also relied on the provision in the agreement of indemnity appointing the surety as the principal's "attorney-in-fact." 824 F. Supp. at 108.

rights to those of indemnification and did not disclaim a surety's fiduciary obligations. Id. at 108.

VII. NOTICE PROVISION

One of the most simple but important provisions in an indemnification agreement can be the notice provision, which states that all notices required by the agreement should be sent to the surety at a specific address. Such notices would include notice to the surety that the principal or indemnitors have received notice from an obligee that it has put the principal in default or that the principal has failed to perform some contract obligation.

Such a provision was examined in the context of a bankruptcy in National Union Fire Insurance Company v. Broadhead, 155 B.R. 856 (S.D.N.Y. 1993), which involved a financial guarantee bond. There, a surety issued a bond guaranteeing that the principal would pay certain notes held by a bank. The principal and the surety entered into an indemnity agreement. The agreement required the principal to reimburse the surety for any payments it made on his behalf under the bond to cure any default by him on the notes, and for interest and expenses incurred in obtaining reimbursement. One paragraph of the indemnity agreement provided that all notices directed to the surety be sent to a specific address, with the notation "Attention: Special Programs Division." Id. at 857.

The principal failed to make payments on the note, and the surety paid over \$50,000 on his behalf. The principal then filed for bankruptcy. He included the surety as an unsecured creditor, but failed to specify "Attention: Special Programs Division" as required by the indemnity agreement. The bankruptcy court issued an order discharging the principal from his debts. In the later proceeding, which is the cited case, the surety denied ever receiving notice of the bankruptcy proceedings. Id. at 857-58. Apparently, the notice never got to the "Special Programs Division."

The surety moved for summary judgment, and the principal did not file an opposition. The court first granted the surety's motion, finding that the surety's claim was not discharged because it was not

given adequate notice of the bankruptcy proceeding. The principal then moved for reconsideration due to the excusable neglect of his attorney and a line of cases apparently overlooked by the court. Id. at 858.

The court vacated its prior opinion granting the motion for summary judgment. It concluded that the notice that the surety was sent sufficiently complied with the Bankruptcy Code, explaining that there is no statutory requirement that one identify the specific division of a company on a bankruptcy notice. However, all was not lost. The court pointed out that while the notice complied with due process, it did not comply with the indemnity agreement. In vindication of its contract rights, the court allowed the surety thirty days to demonstrate that it could have affected the outcome of the bankruptcy proceedings to its advantage if it had received the notice for which it had contracted. Id. at 859.

VIII. ASSIGNMENT PROVISION

Among the standard provisions in the indemnity agreement is an "assignment provision." In the case of In Re Four Star Construction Co. v. Buckeye Union Insurance Co., 151 B.R. 817 (Bankr. N.D. Ohio 1993), that provision read:

[S]hould the debtor default in connection with any contracts covered by such bonds or any of the terms of this Indemnity Agreement . . . the [Debtor] assigned to [surety] and [surety] shall have the right to collect and receive all reserve percentages and all money due and to be come due the [Debtor] under any such contracts and to hold and apply the same as collateral to this agreement . . .

Id. at 822. In In Re Four Star, the surety was successful in asserting subrogation rights in the bankruptcy arena based in part on that provision. The surety had paid claims on payment and performance bonds issued on behalf of a bankrupt contractor. In the contractor's bankruptcy, the surety sought reimbursement from contract funds that had been retained by one of the project owners, arguing that it was subrogated to the contractor's rights in the funds held by the owner. Id. at 818-19.

The issue was whether the surety was subrogated to the contractor's rights, and, thus, whether

the contract funds were estate property. In a detailed opinion, the court examined provisions of the former Bankruptcy Act, the Bankruptcy Code, principles of subrogation as enunciated by other bankruptcy courts, the terms of the bonds, and the indemnity agreement executed by the contractor. Based in part on the assignment provision, it concluded that the surety was properly subrogated to the retainage funds and any other funds held by the project owner for the benefit of the contractor. The court decided that the retained contract funds were not estate property to the extent of the surety's subrogation rights. Id. at 822-23.

IX. VALIDITY OF AGREEMENT IN GENERAL

Finally, the Alabama Supreme Court was presented with an interesting case in Acstar Ins. Co. v. American Mechanical Contractors, Inc., 621 So. 2d 1227 (Al. 1993). The case did not focus on any specific provision of an indemnification agreement, but, rather, on the validity of the agreement in general. The facts are complicated, but worth reciting.

A general contractor was awarded contracts with the U.S. Government for construction of a "multi-storage training facility" in Virginia and a mail processing center in Florida. A subcontractor was awarded subcontracts on the mechanical and plumbing work, totalling almost \$4,000,000. Id. at 1228. The subcontractor needed performance and payment bonds and contacted its insurance broker, who, in turn, contacted the surety. The surety agreed to execute the bonds in return for a premium, an "irrevocable letter of credit" in the amount of \$250,000, plus an executed indemnification agreement. Two stockholders and their spouses executed the indemnity agreement. Id.

A bank issued the \$250,000 irrevocable letter of credit to the surety on behalf of the subcontractor. The Bank then assigned its rights under the letter of credit to another bank. The letter of credit was to become effective on issuance of the payment and performance bonds. The surety's ability to draw down on the letter of credit was conditioned "in the event you deem it necessary be

reason of your having executed bond(s) on behalf of" the subcontractor. Id.

The surety issued the bonds and forwarded an invoice to the broker, and the bonds were delivered to the general contractor by the subcontractor. Apparently, general chaos then ensued. The general contractor wrote to the subcontractor saying that the surety was not on its approved list, and that the bonds as submitted were not acceptable. The subcontractor then forwarded the letter to the surety, asking for help and information. The surety then wrote to the subcontractor, providing financial information. However, in concluding its letter, the surety said that in view of the general contractor's letter and because the bonds had not been paid for, it expected the immediate return of the bonds for cancellation because they were null and void. Id. at 1229.

The subcontractor did not seek return of the bonds, and, after receiving additional information, the general contractor decided to accept the surety. The surety also wrote to the general, stating that its rejection of the bonds rendered them null and void. The subcontractor wrote to the surety promising payment the next day, stating that general had accepted the surety, and that if the surety was not willing to accept the premium payment, it should call the subcontractor. The general contractor then wrote to the surety, stating that the surety could not unilaterally void the bonds and that the general contractor considered the bonds to be in force. Significantly, the surety did not refuse the premium payment or call the subcontractor and did not thereafter declare the bonds null and void. Within the following months, the subcontractor went into default on both projects. Id.

When claims were made on the bonds, the surety reaffirmed its cancellation of the bonds and denied all claims. The surety then drew on the letter of credit. The general contractor sued the surety, seeking to recover losses in excess of \$1,000,000 and punitive damages for alleged bad faith on the part of the surety. The surety filed a third party demand against the indemnitors, and the bank petitioned the court to intervene as a defendant and asserted a cross-claim against the surety. The surety ultimately settled with the general contractor, paying it \$680,000. The indemnitors and the surety then filed cross-

motions for summary judgment. Id. at 1230.

The trial court granted the indemnitors' motion, and denied the surety's motion. The court concluded that the bonds were null and void. As a result, the surety was precluded from pursuing any claim arising from the indemnity agreement entered into in relation to the bonds, despite its payment to the general contractor. Further, it ordered the surety to return to the subcontractor the unearned premium, plus interest. In a final blow to the surety, it also ordered the surety to pay the bank the principal amount of the letter of credit, plus interest. The surety appealed. Id. at 1230.

The Supreme Court of Alabama reversed. It concluded that as of the date that the surety accepted the premium payment, the surety intended the bonds to be valid. According to the court, the fact that the surety may have declared the bonds null and void at some point in time did not relieve it of its obligation under the original agreement between it and the subcontractor to undertake the role of surety. The court found that the surety validated the bonds by its silent acceptance of the premium. Because the bonds were valid, the court concluded that the indemnification agreement also was valid. It reversed the summary judgment in favor of the individual indemnitors. It also reversed the judgment in favor of the bank. Id. at 1234.

One justice dissented from the opinion of the court. It was his opinion that to permit the surety to argue before the trial court that the bonds were null and void and then to argue on appeal that they were valid seemed "legally inappropriate." Id. at 1235 (Maddox, J., dissenting).

