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**ARBITRATION AND THE SURETY:
DO I WANT TO? DO I HAVE TO? WHAT IF I DON'T? WHAT IF I DO?**

PRESENTED BY:

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INTRODUCTION

Judging from the recent cases, the business of arbitration must be booming. Whether this trend is fueled by a desire to trim bloated caseloads in state and federal courts, or by literal interpretation and application of the Federal Arbitration Act, it is apparent that arbitration, as a system for dispute resolution, is a thriving enterprise.

Whether this is good or bad, of course, depends upon your perspective. For the construction surety, receiving a demand for arbitration may be something like being invited to a shotgun wedding, and the inevitable question arises: "What if I don't attend?"

This paper will address the basic problems, advantages and disadvantages of arbitration from the surety's perspective. Must the surety participate in an arbitration proceeding? What happens if the surety declines the invitation? How can the surety best utilize the dispute resolution process, while preserving the traditional legal and equitable rights which may be of little use in arbitration?

I. DO I HAVE TO?

At common law, agreements to arbitrate disputes were generally disfavored and rarely enforced. A typical statement of the law was offered by the Supreme Court of Alabama:

The public policy of this state is to encourage arbitration and amicable settlements of differences between parties; but public policy also holds void an agreement in advance to oust or defeat the jurisdiction of all courts, as to all differences between the parties.

Wells v. Mobile County Board of Realtors, Inc., 387 So. 2d 140, 144 (Ala. 1980).¹

The traditional view was clearly at odds with a federal policy favoring arbitration, as announced by the Federal Arbitration Act, passes by Congress in 1925. The Federal Act provided that:

A written provision in any maritime transaction or a **contract evidencing a transaction involving commerce** to settle by arbitration a controversy thereafter arising out of such contract or transaction ... shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

See 9 U.S.C. § 2 (emphasis added).

¹In Alabama, the bias against arbitration agreements was adopted by the legislature. Section 8-1-41 precluded specific enforcement of an agreement to submit "a controversy" to arbitration.

In 1995, the United States Supreme Court elected to review another decision from the Supreme Court of Alabama which had declined to compel arbitration between a homeowner and a termite control company. In *Allied-Bruce Terminix Companies, Inc. v. Dobson*,² decided originally in 1993, the Alabama Supreme Court upheld the trial court's ruling that an arbitration agreement contained in the homeowner's contract was not enforceable. The United States Supreme Court disagreed, and held that, because the contract in question involved interstate commerce, the Federal Arbitration Act and the federal policy in favor of arbitration would govern and control over inconsistent state law. *Allied-Bruce Terminix Companies, Inc. v. Dobson*, 115 S. Ct. 834 (1995). If the parties have agreed to arbitrate, and if the performance of the contract involves interstate commerce, arbitration will be required. *Id.*

Most bond forms, of course, contain language which incorporates by reference the provisions of the bonded contract. Does this language constitute an agreement to arbitrate? The clear majority of jurisdictions says yes. In *United States Fidelity & Guar. Co. v. West Point Construction Co.*,³ the court, treating the bond form as the best evidence of the surety's intent, held that the language of the underlying contract, incorporated by reference, required USF&G to arbitrate the claims of the general contractor/obligee against USF&G's principal/subcontractor.

There is little, if any, recent precedent for the proposition that a performance bond surety is not obligated to arbitrate.⁴ If invited, the surety must attend, or suffer the consequences by default.

II. SHOULD THE SURETY ARBITRATE?

Situations will frequently arise where the surety may have an option, but not an absolute obligation, to participate in arbitration. For example, a claimant may demand arbitration against the principal only. Alternatively, a principal, whose claims are at least conditionally assigned to the surety, may initiate claims in arbitration. What options are available to the surety?

The surety's decision should include an evaluation of the inherent advantages or disadvantages of arbitration. A few of the more obvious factors are as follows:

COST: One alleged benefit of arbitration is that supposedly, it **costs** less. This may or may not be true. Consider that under the construction rules, filing fees are determined as a percentage of the amount in controversy. To assert a \$1 million claim in arbitration requires the payment of a filing fee of approximately \$9,400.00. Additionally, the parties will have to pay arbitrator compensation, which is generally a per diem fee normally ranging between \$1,000 and \$2,000 per day for each day

² 628 So. 2d 354 (Ala. 1993).

³ 837 F.2d 1507 (11th Cir. 1988).

⁴ Ohio and New York do not recognize the incorporation by reference doctrine. See *Windowmaster Corp. v. B. G. Danis Co.*, 511 F.Supp. 157 (S.D. Ohio 1981); *Fidelity and Deposit Company of Md. v. Parsons & Whittemore Contractors Corp.*, 397 N.E.2d 380 (N.Y. 1979).

of “preparation time” and actual hearing time, plus “evaluation time” spent in the final decision making process. Arbitration is not cheap. Indeed, the cost of arbitration, even in a relatively simple case, can easily exceed the cost of litigating a similar dispute through conclusion.

DISCOVERY RIGHTS: One traditional criticism of arbitration is that the parties sacrifice their discovery rights. Most construction arbitration agreements now expressly reserve discovery rights, which would at least ensure that the parties will exchange documents and submit representatives for deposition. Arbitrators have subpoena power and can compel the attendance of witnesses at hearings and at depositions. In most cases, the arbitrator (or the panel of arbitrators) will require the parties to submit all exhibits at least thirty (30) days before a final hearing. In most construction cases, this would be a massive effort.

EVIDENTIARY CONTROLS: Forget it. There are none. Unauthenticated documents, unsubstantiated opinions, conclusions, and the rankest forms of hearsay are routinely admitted and “considered” by arbitrators. The Rules of Evidence, state or federal, have limited, if any, application.

STARE DECISIS: Forget it, too. Arbitrators are not bound by the law. They can “do equity.” What is fair, just and reasonable in accordance with established legal precedent may be the opposite of what the arbitrator considers to be a desirable, just and reasonable result.

FINALITY: If you like finality, you will love arbitration. Absent proof of outright fraud, there is virtually no argument on appeal. The arbitrator’s award can be quickly converted into a judgment and execution will follow summarily. The client must understand and appreciate that the arbitrator’s justice will be swift, sure, and for all practical purposes, absolutely final.

RATIONALE FOR DECISION: It is not necessary for the arbitrator to explain his or her decision. Go figure!

SETTLEMENT INCENTIVES: In most litigated cases, there are several milestone events which can and should give rise to serious settlement analysis and evaluation. Mediation, of course, is another tool available in the litigation process. Arbitration has no similar structure; the basic concept of arbitration is that there **will be** a hearing, that the parties **will present** all evidence, and that the arbitrators **will decide** the case, once and for all. This is good for the AAA, good for the arbitrator, and good for the party that wins the arbitration. Settlement prospects generally have to be created by the lawyers, and the client should be aware of these inherent characteristics.

LIMITATION ON DAMAGES: Undoubtedly, the assumption of most defendants in arbitration is that an arbitrator, unlike a jury, will rarely allow emotional issues to

result in catastrophic awards of punitive damages. Is arbitration a safe haven? Courts have disagreed. Compare Alabama (*punitive damages are available in arbitration if agreement is broad enough to allow it*)⁵ and New York (*power to impose punitive damages is reserved solely for the state*).⁶

III. WHAT HAPPENS IF I DON'T?

If the surety, for whatever reason, declines to participate in arbitration, is the outcome binding?

In most cases, the answer is “yes”, or at least probably so. Because of the application of the doctrines of *res judicata* and collateral estoppel, the in absentia surety may be bound by the resolution of a disputed issue between a claimant and its principal in arbitration or in traditional litigation. Neither *res judicata* nor collateral estoppel require complete identity among the parties, but only that the party against whom the doctrines are asserted was in privity with a party to the prior action. *N.A.A.C.P. v. Hunt*, 891 F. 2d. 1555 (11th Cir. 1990). Courts have recognized that “judgments can bind persons not party (or privy) to the litigation in question where the non-party’s interests were represented adequately by a party in the original suit.” *West v. City of Mobile*, 689 So. 2d 14 (Ala. 1997).

Further, because the surety’s rights are generally measured by those of its principal, courts have held that a judgment against a principal, whether in arbitration or in traditional litigation, is binding against a surety where the surety had notice of the action and an opportunity to defend, but failed to do so. *See United States ex rel. Skip Kirchdorfer, Inc. v. M. J. Kelley Corp.*, 995 F.2d 656 (6th Cir. 1993); *United States ex rel. Aurora Painting, Inc. v. Firemen’s Fund Ins. Co.*, 832 F.2d 1150 (9th Cir. 1987); *Frederick v. United States*, 386 F.2d 481, 485 n. 6 (5th Cir. 1987); *Seaboard Surety Co. v. Westwood Lake, Inc.*, 277 F.2d 397 (5th Cir. 1960); *Lake County v. Massachusetts Bonding & Ins. Co.*, 75 F.2d 6 (5th Cir. 1935).⁷ The reported decisions have demonstrated little sympathy for the surety who, with notice and an opportunity to participate in a trial or arbitration, elects not to do so, and later takes the position that it is not bound by the outcome. As noted by a federal judge in New York:

The reason for the rule . . . is based upon common sense and reason. A surety cannot stand idly by with full knowledge of an action pending against its principal, permit a judgment to be taken against the principal, and later on, when an action is brought upon its bond,

⁵*See Ex parte Costa and Head*, 486 So. 2d 1272 (Ala. 1986).

⁶*See Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976).

⁷There are exceptions. In West Virginia, a statute insulates the surety from responsibility for a judgment rendered against a principal if the surety was not “regularly served with process.” W.Va. Code § 45-1-3 (1997). If the surety had no notice of the action, or if judgment against the principal is obtained by default, courts have been more sympathetic. *See, e.g., Monmouth Lumber Co. v. Indemnity Ins. Co. of North Am.*, 122 A.2d 604 (N.J. 1956).

require the plaintiff to retry his case. This would result in two trials of the same issue.

U.S. ex rel Vigilanti v. Pfeiffer- Neumeyer Constr. Corp., 25 F. Supp. 403 (E.D.N.Y. 1938).

The somewhat negative image of a surety “standing idly by” is at one extreme, and a wide range of factors must be considered in analyzing whether a judgment adverse to the principal is binding on the surety. These factors will include the nature and extent of the notice to the surety, whether the surety, in fact, had a reasonable opportunity to defend itself, whether there are significant personal defenses available to the surety, whether issues relating to the bonded obligation were, in fact, the primary focus of the initial dispute resolution proceeding, and so forth. Depending upon these factors, an equally wide range of results is possible: the surety may be found to be conclusively bound by the initial action;⁸ the first result will be held to establish a rebuttable presumption concerning the surety’s liability or will be deemed “*prima facie* evidence” as to the surety’s obligation;⁹ or, the first judgment will be found to have no effect whatsoever.¹⁰ The surety must weigh the advantages and disadvantages of initial participation with all these factors in mind.

What if the principal wins in arbitration? Ordinarily, the surety should be entitled to a summary award in its favor if the claimant seeks to re-litigate against the surety. In Wescott Constr. Corp. v. Firemens Fund of N.J.,¹¹ a federal court not only found in favor of a surety, but awarded sanctions against the general contractor which attempted a “second bite” after receiving an award in arbitration which was satisfied by the surety’s subcontractor/principal.

What about personal defenses? Assume, for example, that the surety’s investigation discloses facts which strongly suggest that there has been a cardinal change in the scope of the bonded contract, or that the claimant did not comply with contractual or statutory provisions requiring notice to the surety. If arbitration ensues between the claimant and principal, and the principal loses, are the surety’s personal defenses lost?

Few cases have addressed this issue. Logically, a non-participating surety should not lose its personal defenses merely because its principal suffers an adverse result in arbitration. However, under the traditional doctrine of *res judicata*, a court which views the surety’s liability and identity as interchangeable with its principal could well conclude that an adjudication as between the principal and claimant would bind the surety, notwithstanding the fact that any personal defenses of the surety may not have been considered by the arbitrator. Conversely, a court which applies the traditional rules of collateral estoppel would not find that the surety’s personal defenses are lost, because the issues concerning said defenses were not **in fact**

⁸See Ward v. Federal Ins. Co., 106 S.E.2d 169 (S.C. 1958).

⁹See Restatement of Security, § 139(2) (1941).

¹⁰See United States v. Maryland Casualty Co., 204 F.2d 912 (5th Cir. 1953).

¹¹996 F.2d. 14 (1st Cir. 1993).

addressed. All things considered, it would seem that a surety that chooses not to participate in arbitration may be risking more than just derivative defenses.

IV. TACTICAL CONSIDERATIONS

Faced with an arbitration dilemma, what remedies are available to the surety? A practical and successful approach is illustrated by the case of *Huntsville Golf Dev., Inc. v. Brindley Constr. Co.*,¹² which involved a dispute between a condominium owner and a general contractor. There, the owner, HGD, initiated arbitration proceedings against both the general contractor and Aetna, its surety. The dispute involved a number of issues and damage claims which Aetna deemed to be beyond the scope of its bond. Aetna unsuccessfully asked that it be dismissed from the arbitration proceeding, and thereafter sought injunctive relief in state court prohibiting HGD from pursuing its claims for delay and consequential damages in arbitration. The preliminary injunction order stated that Aetna would be bound by the decision of the arbitrators with respect to “punch list” items. HGD and Brindley proceeded with arbitration, which resulted in an award in favor of the owner in the amount of \$376,316.75. HGD then sued in federal court to enforce the award against Aetna. The surety filed a motion for summary judgment arguing, among other things, that the award should not be enforced against it because it did not specifically award damages against the surety.

In an interesting opinion, the District Court agreed, and dismissed the surety. The Court used the unexplained and “lump sum” nature of the award to Aetna’s advantage:

The Court’s task is made more difficult by the fact that the arbitrators’ award was stated in terms of a lump sum. In *Raiford, supra*, the Court was faced with a lump sum award by an arbitration panel which stated no legal or evidentiary justification for the award. The Eleventh Circuit, in affirming the District Court’s confirmation of the award, noted:

We conceivably could vacate the award and recommit the case to the arbitration panel for a statement of reasons for its award. With such a statement, the District Court, and this Court, could more actively review the award under the manifest-disregard and arbitrary-capricious standards. However, “arbitration proceedings are summary in nature to effectuate the national policy favoring arbitration;” therefore, arbitrators have never been required to explain their awards.

...

¹²847 F.Supp. 1551 (N.D. Ala. 1993).

When the parties agreed to submit to arbitration, they also agree to accept whatever reasonable uncertainties might arise from the process. (Citations omitted).

Although Aetna was a party to the arbitration, and HGD sought damages for “punch list” and warranty items, the arbitrators awarded no damages against Aetna. The court concludes that the arbitrators must have found no basis for an award based upon punch list, delay or consequential damages. This Court therefore has no basis upon which to enter a judgment against Aetna. Aetna’s Motion for Summary Judgment will therefore be granted.

Huntsville Golf Dev. Inc. v. Brindley Constr. Co., 847 F.Supp. 1551, 1557 (M. D. Ala. 1993)(emphasis added).

The surety’s basic objective in *Huntsville Golf Dev.* was to limit the scope of the arbitration. The result exceeded the surety’s expectations. Essentially, Aetna opted for the middle ground between full participation and doing nothing. This approach deserves careful consideration.

CONCLUSION

The uncertainties of arbitration present additional challenges for the surety industry. The trend toward enforcement of arbitration agreements is continuing, and the surety’s basic question is no longer whether it is required to arbitrate, but how deeply it should become involved in the dispute resolution process. There is clearly room for innovation and imagination in managing the uncertainties of the arbitration process.