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**JEWELS IN THE INDEMNITY AGREEMENT,  
AND A LUMP OF COAL**

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## **JEWELS IN THE INDEMNITY AGREEMENT, AND A LUMP OF COAL**

*"The great, the jewel and the mother of battles has begun."*

- Saddam Hussein (b. 1937), Iraqi president. Speech at the start of the Gulf War, Jan. 6, 1991. Quoted in Independent (London, Jan. 19, 1991).

### **Introduction**

When a surety issues bonds on behalf of a principal, the principal and other individuals grant a General Indemnity Agreement to the surety as consideration for the issuance of such bonds ("GIA"). The GIA gives the surety certain rights in and to the funds and property interests of the indemnitors. The GIA contains several "jewels" to assist the surety in identifying, minimizing and discharging losses. Unfortunately, the GIA also may contain a "lump of coal" that may give rise to an increase of risk to the surety as well.

### **Jewel No. 1: The Big Jewel: The right to indemnification/reimbursement for fees and costs**

A surety is, as a general rule, "equitably entitled to full indemnity against the consequences of a principal obligor's default. This includes the right to reimbursement for legal fees incurred in defending an action brought against the principal". *Frontier Ins. Co. v. Lubiam USA, Inc.*, 1998 WL 265016, at \*2 (S.D.N.Y. 1998).

The surety is afforded a further, contractual right to indemnification in the GIA. Under the GIA, the indemnitors' obligation arises by reason of the surety having executed the bond. *American Home Assurance Co. v. Gemma Constr. Co.*, 713 N.Y.S.2d 48, 52, 275 A.D.2d 616, 620 (N.Y. App. Div. 2000)

The indemnitors' obligations are different depending on the language used in the GIA. The GIA can either provide for indemnification of the surety against liability or against loss, damage or injury.

Under an indemnification against liability clause, a surety has a right to recover from its indemnitors before it incurs a loss. Actual liability is not required for the surety to be entitled to the indemnity. *Frontier Ins. Co. v. Int'l, Inc.*, 124 F. Supp. 2d 1211, 1215 (N.D. Ala. 2000). The indemnitors' obligation arises when the surety makes payments in good faith, on the basis that the surety might be liable or that payments were necessary to protect the surety's rights or avoid or lessen its liability or alleged liability. *Frontier Ins. Co. v. Int'l Inc.*, 124 F. Supp. 2d at 1215; *U.S. Fid. & Guar. Co. v. Feibus*, 15 F.Supp.2d 579, 583 (M.D. Pa. 1998); *Tubb v. Bartlett*, 862 S.W.2d 740, 750 (Tex. App. 1993); *Employers Ins. of Wausau v. Able Green, Inc.*, 749 F. Supp. 1100, 1103 (S.D. Fla. 1990).

Under an indemnification against loss clause, a surety does not have a right to recover from its indemnitors until it either has a judgment entered against it for damages, or it has made payments or suffered actual losses. *Caliguri v. First Colony Life Ins. Co.*, 742 N.E.2d 750, 759, 318 Ill. App. 3d 793, 805, 251 Ill. Dec. 212, 221 (Ill. App. Ct. 2000).

In order to obtain indemnification, the surety must establish, by competent evidence, its reasonable fees and costs. "Competent evidence" can be in the form of affidavits of claims personnel, attaching an itemized list of claims and payments, cancelled checks, and the like. How the indemnitors may prove that the fees or expenses may not be recovered is dependent on the language in the indemnity agreement.

Some indemnity agreements provide that such vouchers or affidavits shall be prima facie evidence of the fact and amount of liability of the indemnitors to reimburse the surety. By submitting the indemnity agreements, along with a sworn itemized statement of loss and expenses, supported by copies of payment drafts, a surety will demonstrate a prima facie entitlement to reimbursement, at which time the burden will shift to the indemnitors to prove the existence of a genuine issue of material fact for trial. *Gundle Lining Constr. Corp. v. Adams County Asphalt, Inc.*, 85 F.3d 201, 210 (5th Cir. 1996) (payment vouchers evidencing fact and amount of liability shifts burden under Rule 56 to principals); *Cont'l Cas. Co. v. American Sec. Corp.*, 443 F.2d 649, 650-651 (D.C. Cir. 1970) (photocopies of cancelled checks and sworn affidavits were sufficient to support summary judgment). The indemnitors must then introduce evidence to controvert the amounts claimed.

In the absence of a prima facie provision in the indemnity agreement, the indemnitors may defend their liability for fees and costs by demonstrating fraud or lack of good faith by the surety in discharging its obligations under the bond. *Frontier Ins. Co. v. Int'l, Inc.*, 124 F. Supp. 2d at 1214 (citations omitted). Some courts hold that a surety is not entitled to indemnification unless it acted in good faith and that it acted reasonably. See *General Accident Ins. Co. of America v. Merritt-Meridian Constr. Corp.*, 975 F. Supp. 511, 516-17 (S.D.N.Y. 1997). See also *James Constructors, Inc. v. Salt Lake City Corp.*, 888 P.2d 665, 668 (Utah Ct. App. 1994); *Harvey v. United Pacific Ins. Co.*, 856 P.2d 240, 241, 109 Nev. 621, 623-24 (Nev. 1993); *Perkins v. Thompson*, 551 So. 2d 204, 209 (Miss. 1989).

"Bad faith" is difficult to establish, however. Bad faith is not simply negligence or bad judgment, but implies the "conscious doing of a wrong because of a dishonest purpose or moral obliquity." *Feibus*, 15 F. Supp. 2d at 585.

The courts have been more instructive in defining what is not bad faith. For instance, a lack of diligence or negligence is not the equivalent of bad faith. *Feibus*, 15 F. Supp. 2d at 585. Similarly, overpayment or negligent investigation of claims does not constitute bad faith. *Id.* at 587; *Employers Ins. of Wausau*, 749 F. Supp. at 1103. Even evidence that the surety paid claims to lessen its own liability or to remove itself from the obligee's "blacklist" does not support a finding of bad faith. *Fidelity & Deposit Co. of Maryland v. Bristol Steel & Iron Works*, 722 F.2d 1160, 1166 (4th Cir. 1983). The fact that a surety makes a payment or settles a claim without giving notice to the principal is not evidence of bad faith. *Feibus*, 15 F. Supp. at 586; *Transamerica Ins. Co. v. Avenell*, 66 F.3d 715, 719 (5th Cir. 1995).

In fact, a surety has no duty to mitigate its damages by collecting partial payment for work that the principal had performed before the surety seeks recovery from the indemnitors, even if such mitigation would reduce the liability of the indemnitors. *Four Seasons Envtl, Inc. v. Westfield Cos.*, 638 N.E.2d 91, 93-94, 93 Ohio App. 3d 157, 160-61 (Ohio Ct. App. 1994).

So what fees and expenses are indemnifiable? The surety has the right to be reimbursed for unpaid bond premiums. *Olympic Dev. Group, Inc. v. American Druggist, Inc.*, 333 S.E.2d 622, 628, 175 Ga. App. 425, 430 (Ga. Ct. App. 1985) *cert. denied* (1985). The surety also has the right to be reimbursed for any judgments, settlements or compromises that resulted from the principal's default. *Hutton Constr. Co. v. County of Rockland*, 52 F.3d 1191, 1193 (2d Cir. 1995).

A surety is authorized to incur expenses for investigating and defending the claims asserted against it and to employ accountants, attorneys and investigators to perform this service. *Transamerica Ins. Co. v. Bloomfield*, 401 F.2d 357, 362 (6th Cir. 1968).

A surety is entitled to be reimbursed for attorneys fees and related litigation expenses if provided for in the GIA. *Abbott v. Equity Group, Inc.*, 2 F.3d 613 (5th Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

The courts are split on whether the costs incurred in establishing the right to indemnification are recoverable. The better cases uphold the right to recover fees for the suit against the indemnitors. For cases holding that such expenses ARE recoverable, see *Morgan v. U.S. Fid. & Guar. Co.*, 191 So. 2d 917 (Miss. 1966); *Rappold v. Ind. Lumbermens Mut. Ins. Co.*, 431 S.E.2d 302, 304, 246 Va. 10, 13 (Va. 1993); *United Rentals Sys., Inc. v. Safeco Ins. Co.*, 273 S.E.2d 868, 872, 156 Ga. App. 63, 68 (Ga. Ct. App. 1980); for cases holding such expenses are NOT recoverable, see *State v. Laconco, Inc.*, 430 So. 2d 1376, 1385 (La. Ct. App. 1983).

At least one court has held that a surety is entitled to recover its attorneys' fees in connection with its defense against the principal's suit against it and its own cross claim. *English v. Century Indem. Co.*, 342 S.W.2d 366, 370 (Tex. App. 1961).

### **Jewel No. 2: The right to require specific performance of the deposit of collateral security**

One of the strongest prejudgment and predefault rights the surety has under the GIA is the right to require indemnitors to pay claims with their own funds, by virtue of demanding that the indemnitors provide a deposit of collateral security with the surety.

Unlike indemnification, which is the "payment of money to the plaintiff, as its property," collateral security is paid to the surety to be held in trust while claims are pending. *American Motorists Ins. Co. v. United Furnace Co.*, 876 F.2d 293, 300 (S.D.N.Y. 1989). Under such a provision, the surety has the right to use the collateral to pay any and all liabilities it has under the bond, or to reimburse itself from the collateral for claims already paid. If the surety does not pay the claims, or if the claims are determined to be unmeritorious, the collateral funds (or any part not used) are returned to the indemnitors. *Safeco Ins. Co. of America v. Schwab*, 739 F.2d 431, 433 (9th Cir. 1984); *United Furnace*, 876 F.2d at 300.

Collateral security clauses have been routinely upheld under the rationale that "[i]f a creditor is to have the security position for which he bargained, the promise to maintain the

security must be strictly enforced” and therefore the courts have granted specific performance to protect the surety’s bargain. *Schwab*, 739 F.2d at 433 (citations omitted). See also *Feibus*, 15 F. Supp. 2d at 588.

The surety has the power to choose the triggering event requiring the deposit of collateral security by inserting the appropriate language in the GIA. Such event may include (a) when any claim is made against the bond; (b) when the surety sets up reserves; or (c) when liability exists.

The amount to be posted is in the discretion of the surety, who chooses the language in the indemnity agreement which sets out the triggering event, and will be upheld as long as the amount is “reasonable”. *U.S. Fid. & Guar. Co. v. J. United Elec. Contracting Corp.*, 62 F. Supp. 2d 915, 922 (E.D.N.Y. 1999); *BIB Constr. Co., Inc. v. Fireman’s Fund Ins. Co.*, 625 N.Y.S.2d 550, 552, 214 A.D.2d 521, 523 (N.Y. App. Div. 1995). The surety can minimize its exposure to loss if it structures the GIA to require deposit of collateral security in the amount of any claim it receives.

If the indemnitors refuse to post collateral upon demand, or if the assets of the indemnitors are dissipating, the Surety can seek to enforce this provision by means of an equitable action for specific performance of a contractual agreement. See generally *Milwaukie Constr. Co. v. Glens Falls Ins. Co.*, 367 F.2d 964, 966 (9th Cir. 1966); *United Bonding Ins. Co. v. Stein*, 273 F. Supp. 929, 929 (E.D. Pa. 1967); *Schwab*, 739 F.2d at 433.

A surety seeking to obtain specific performance of a contractual obligation must demonstrate (1) there is a valid contract, (2) the movant has substantially performed under the contract and is willing and able to perform its remaining obligations, (3) defendant is able to perform its obligations, and (4) movant has no adequate remedy at law. *J. United*, 62 F. Supp. 2d at 921; *La Mirada Prods. Co. v. Wassall PLC*, 823 F. Supp. 138, 140 (S.D.N.Y. 1993).

The surety can easily establish that it has substantially performed its portion of the agreement by establishing that it issued bonds on behalf of the principal.

As a practical matter, the surety can include a statement in the GIA that the indemnitors acknowledge that their failure to provide or pay collateral security shall cause the surety irreparable harm, for which the surety has no adequate remedy at law, and therefore the surety shall be entitled to specific performance of the indemnitors’ collateral security obligation.

Specific performance will be granted when the surety establishes that a legal remedy for subsequent damages will not suffice. A surety will meet this burden if it establishes that its obligations under the bonds are continuing, and therefore the total loss to the surety is not yet ascertainable. For example, in *J. United*, specific performance was granted where the surety alleged its investigation was continuing, it was completing the project, and that as additional claims were received, its losses, costs and expenses would increase. 62 F. Supp. 2d at 921.

Actual payment and proof of loss need not be made prior to instituting a suit for specific performance of the collateral security clause where the GIA provides that the surety is entitled to such funds upon its receipt of any demand from a claimant. For example, in *American*

*Motorists Ins. Co. v. United Furnace Co.*, the U.S. Court of Appeals for the Second Circuit reversed a lower court's ruling that a surety's suit for specific performance of the collateral security provision was not ripe. 876 F.2d 293, 300 (S.D.N.Y. 1989). The lower court held that where the surety did not actually make any payment yet, the nature of the surety's ultimate liability on the bond was speculative, and therefore the surety had not alleged any injury "sufficiently real and immediate" so as to warrant adjudication of the principal's liability to deposit collateral security. *Id.* at 299. The Court of Appeals reversed, finding that the surety faced the exact situation that it had sought to protect itself against when it included the collateral security provision in the GIA. The Court of Appeals stated that the fact that the principal had defenses to the claim, and the claimant expressed a willingness to consider such defenses did not alter the fact that the surety specifically bargained to have access to collateral security upon its receipt of a demand by a claimant. Since the surety had received such a demand, it was entitled to specific performance of the collateral security provision. *Id.*

The courts have not been persuaded by indemnitors' claims that forcing them to deposit collateral security would bankrupt the indemnitor. In *American Motorists Ins. Co. v. Penn. Beads Corp.*, the court consider such a situation, and nevertheless ordered the deposit, stating that the possibility of the indemnitor's bankruptcy was not a valid justification "for denying the surety access to the security that it specifically bargained for". 983 F. Supp. 437, 441 (S.D.N.Y. 1997). In reaching its decision, the court stated that other courts have repeatedly upheld the collateral security provisions and have declined to find them unconscionable or void as against public policy. *Id.* at 440.

### **Jewel No. 3: The right to require specific performance of establishment of a trust fund**

When the principal is on the cusp of a potential default, the surety's rights and remedies are limited. In the period just prior to a default, every dollar received by the principal on a bonded project which is not used on the job will create a dollar loss to the surety. When the principal receives money and spends it in some manner other than paying for productive work on the bonded project, the surety's loss increases concomitantly.

Although the surety's rights of subrogation and indemnification will not ripen until the surety pays a loss, the surety can demand and enforce its trust fund rights before default and before any loss occurs.

Of all the rights contained in the GIA, among the most powerful are those arising out of the trust fund provisions. Among the ways it can be utilized are in gaining control over the contract funds before a default is declared, and before any payments are made by the surety. In addition, by leveraging the trust fund provisions the surety has a strong position in the bankruptcy court, and it also can be useful in forcing indemnitors to treat contract money in an appropriate way, namely to use contract money on contract expenses or face a claim for indemnification by the surety which is not dischargeable in the event of their personal bankruptcy.

Most states have codified the requirements for a trust, and although the specific language may vary somewhat, the general concepts are fairly uniform. For example, Georgia

requires that in order for an express trust to exist, it must be in writing, there must be an intent to create the trust, there must be trust property, a beneficiary, a trustee, and duties of the trustee. See O.C.G.A. §53-12-20. In most cases, no formal words are required to create an express trust. See O.C.G.A. §53-12-21.

The language of the typical GIA plainly shows an intent to create a trust. The GIA states that "all funds due or to become due . . . are Trust Funds" and has a mandate to "hold all monies . . . as a trust"; it even provides that "all monies due and to become due under any contract . . . are Trust Funds". There is no requirement that the intent to create the trust must have been communicated to beneficiaries, who in this instance are subs and suppliers.

The typical GIA also clearly identifies the trust res as contract proceeds owed or paid to the principal. The fact that contract funds are not due to the principal at the time the GIA is executed does not bar the ultimate creation and recognition of the trust. There is no requirement that the trust property be in existence at the time the document is executed. The trust will be recognized as soon as the contract proceeds are in fact due and payable.

The GIA identifies the beneficiaries of the trust when it states it is for the benefit of those who are claimants under the bond, and if the surety discharges its claims under the bond, then the surety is entitled to be a beneficiary. The GIA also identifies the trustees when it provides that the principal and indemnitors are to hold the funds in trust.

As trustees, the principal and indemnitors have a fiduciary duty to the beneficiaries of the trust. A violation of such duties may have consequences under state and federal law.

The Bankruptcy Code provides that an obligation arising out of a defalcation by a fiduciary is not dischargeable. 11 U.S.C.A. §523(a)4. There are cases establishing that where the individual indemnitor misuses contract proceeds by using money which should have gone to subs on the bonded project to pay personal expenses or to pay subs on other projects, then the individual indemnitor has violated the trust fund provisions, and his indemnity obligations will not be discharged. *In re Jenkins*, 110 B.R. 74, 76 (Bankr. M.D. Fla. 1990).

Where the surety sees that job money is not going back into the project, the surety can and should immediately make a demand upon both the principal and the indemnitors that they should strictly abide by the trust fund provisions. The surety's letter to an indemnitor reminding the indemnitor of fiduciary obligations should be addressed to two audiences: the indemnitor and a bankruptcy judge who may read it at a later time. The indemnitor should be reminded and cautioned in fair and straightforward language to treat contract proceeds as trust funds. The letter should be structured to persuade a bankruptcy judge that the debtor was playing fast and loose and ignoring fiduciary duties.

By reminding the individual indemnitor of his or her fiduciary obligation and the fact that a violation of it could result in a bar discharge in the indemnitor's individual bankruptcy, the surety may be able to produce the desired result of having the indemnitor use contract funds to pay the obligations on that construction project.

When the principal has declared bankruptcy, the automatic stay will keep the surety from making demands and instituting an action outside of the bankruptcy court regarding the trust fund. However, the automatic stay will not bar the surety's demand to individual indemnitors to treat contract proceeds as trust funds, and will not bar the surety from reminders as to the implications of failing to abide by the trust fund provision.

The overwhelming majority issues in the bankruptcy court are concluded by negotiation. The surety's forceful and effective invocation of the trust fund provisions give it an additional negotiating tool in the battle over contract funds in the bankruptcy court. This negotiating tool is effective before the declaration of a formal default or payment of a claim, both with a bankruptcy pending and in non-bankruptcy matters. As a practical matter, the indemnitor may not resist the surety's position that funds are trust funds if she is worried about the implications in the event of personal bankruptcy.

#### **Jewel No. 4: The right to settle claims (Including affirmative claims of the principal)**

Under a typical scenario, a surety receives a payment bond claim and the principal denies that the amount is owed, or claims that it has offsets to the amount claimed. Similarly, under a performance bond claim, the principal denies that it was in default, or that the default was caused by actions of the owner or its representatives, and claims that it has an affirmative claim against the owner.

Under the GIA the surety is empowered to settle such claims, unless the indemnitors request the surety litigate the claims and post collateral to secure the amount of a possible judgment and the expenses of litigation. If the indemnitors fail to deposit collateral, absent a finding of bad faith, the settlement will be upheld. *Merritt-Meridian*, 975 F. Supp. at 516.

Sureties enjoy such discretion to settle claims because of the important function they serve in the construction industry, and because the economic incentives motivating them are a sufficient safeguard against payment of invalid claims. *Merritt-Meridian*, 975 F. Supp at 516. Suppliers and small contractors need prompt payment to stay in business.

A surety's determination, in good faith, whether based on liability or expedience, that a claim or expense should be paid, compromised, defended or appealed, will be upheld as long as the surety acted in good faith. *Safeco Ins. Co. of America v. Gaubert*, 829 S.W.2d 274, 280 (Tex. App. 1992); *Bloomfield*, 401 F.2d at 362; *Gen. Ins. Co. of America v. Singleton*, 115 Cal. Rptr. 291, 293-94, 40 Cal. App. 3d 439, 443 (Cal. Ct. App. 1974).

It is irrelevant whether the principal is actually liable for such claims or whether the principal actually defaulted on its contract with the owner. *Merritt-Meridian*, 975 F. Supp. at 511.

The Fifth Circuit held that a surety's settlement of a claim that was still being litigated by the principal was not evidence of bad faith on the part of the surety. *Avenell*, 66 F.3d at 721.

In another case, a court found that although a GIA did not contain an express grant of authority to “settle” the principal’s affirmative claims, the Attorney in Fact Clause coupled with the Assignment Clause unambiguously gave the surety such a right. *Hutton Constr. Co., Inc. v. County of Rockland*, 52 F.3d 1191 (2d Cir. 1995). In *Hutton*, a contractor appealed a New York trial court’s holding that upon the breach of the principal’s duty to indemnify the surety, that under the Indemnification Clause, all of the principal’s rights arising out of the contract with the owner and any monies due the principal on the contract were assigned to the surety, giving the surety the ability to settle the owner’s claims against the principal. The lower court also held that the Attorney in Fact clause appointed the surety as the principal’s attorney in fact with the power to exercise all rights assigned to the surety under the GIA, including the principal’s rights under the contract. Therefore, according to the lower court, the surety was empowered to settle the principal’s affirmative claims against the owner. See *Hutton Construction Co. v. County of Rockland*, 1993 WL 535012 (S.D.N.Y. 1993). The Court of Appeals agreed, stating that the GIA unambiguously provided that all of the principal’s rights “growing in any manner” out of the insured contracts were assigned to the surety when Hutton breached the GIA by failing to indemnify the surety upon demand. The Court of Appeals stated that it did not matter that the Settlement Clause did not furnish the surety the right to settle Hutton’s affirmative claims, because the Assignment Clause coupled with the Attorney in Fact Clause conveyed such rights to the surety.

The surety does not have a duty to inform the principal or the indemnitors of the claim, its decision to defend, or its eventual settlement of the claim. *Gaubert*, 829 S.W.2d at 280. Nor does the surety have a duty to assert the defenses of the principal.

In *Fidelity & Deposit Co. of Maryland v. Bristol Steel & Iron Works, Inc.*, the Pennsylvania DOT asserted a performance bond claim. 722 F.2d 1160 (4th Cir. 1983). Based in part on the principal’s claim that it was not in default, the surety denied the claim. When the DOT threatened to disqualify the surety from writing any future performance bonds for the DOT, the surety reversed its position and settled the claim. The court found that under the Right to Settlement clause in the GIA, the surety properly settled the claim, and that even if the settlement was in the surety’s best interests, the indemnitors did not demonstrate that the surety acted in bad faith.

### **Jewel No. 5: The right of assignment**

The GIA contains an assignment of collateral clause which gives the surety rights in bonded and unbonded accounts receivables, equipment and material necessary to complete the work.

The assignment clause may also give the surety rights to all subcontracts and bonds covering the subcontracts, all claims and actions against the subcontractors, laborers and materialmen.

The right to assignment is usually triggered by an event of default, as identified in the GIA. By way of example, an event of default may be defined as the receipt of claims, the failure or inability of the principal to perform, a default in obligations under the GIA, or a declaration of default by the owner.

The surety can take an assignment of the principal's subcontracts, and can compel a subcontractor to ratify subcontracts with the takeover surety. The surety can also maintain actions for warranty or latent defect issues.

The surety can also take an assignment of the principal's property. The surety's rights in the property is enforceable against the principal and the indemnitor, but the GIA may need to be filed as a financing statement in order to perfect the surety's rights over other creditors' secured interests. The GIA will often contain authorization to record the GIA as a financing statement. Alternatively, the surety can use the Power of Attorney clause to authorize the recording of the GIA.

The GIA grants the surety the right to take immediate possession of the contract funds due the principal. This enables the surety to complete the work as economically and efficiently as possible. To assist the surety in its quest to complete the work, the surety possesses all rights, title and interest of the principal in the tools, materials and supplies to complete the work. Additionally, the surety is authorized under the Power of Attorney provision to execute any necessary documents to complete the transfer of title to such equipment, supplies, and material.

The surety can immediately enforce the rights granted in the assignment by an action for specific performance.

The power of this assignment is demonstrated in the case of *James McKinney & Son, Inc. v. Lake Placid 1980 Olympic Games*, 462 N.E.2d 137, 61 N.Y.2d 836 (N.Y. 1984). In *James McKinney*, the contractor was terminated from the project for failure to meet design specs. The contractor filed for bankruptcy. The GIA signed by the principal and the indemnitors provided that "all rights" of the principal "in or growing in any manner out of" a contract guaranteed by any bond issued by the surety in the event that the principal failed or was unable to complete a contract guaranteed by any bond or became involved in any proceeding of bankruptcy. The surety took over the contract and when it could not complete, it reached a settlement with the project manager. The contractor later brought suit against the owner claiming defective design prevented it from completing the project. The court granted summary judgment to the owner, holding that pursuant to the assignment clause in the GIA, the contractor was no longer the real party in interest, and the surety had the authority to enter into a valid and enforceable settlement agreement.

#### **Jewel No. 6: The right to inspect obtain books, records and obtain financial information**

The GIA grants the surety the right to demand the principal and indemnitors provide it with information from the books, records and accounts of the principal and the indemnitors.

Under the GIA, the principal and the indemnitors agree to supply information regarding the status of the work, the payment obligations incurred, books records and accounts of the principal and indemnitors. The GIA also gives the surety the right to examine books, records, accounts, and the right to request financial information from third parties.

The surety's ability to obtain information from the principal, such as a cash analysis of each job to determine the status of the work/determine principal's cash flow problems, whether payments to principal have been timely, whether there is money due to the principal, how much money is left in the contract, what the cost to complete the work is, the amount of principal's overhead, how long it will take to complete the work, and the amount of money coming in from other projects assists the surety in making an accurate determination of the nature and extent of its liability, and how best to discharge its obligations.

Additionally, financial information from the principal and the indemnitors assists the surety in determining the extent the indemnitors can contribute to solving any of the problems. It also conveys important information for the surety to use in its assessment regarding the surety's claims for indemnity, and its determination how best to obtain exoneration, indemnity or reimbursement from principal and indemnitors. Of course, it also permits the surety to determine the assets of the principal and indemnitors that can be used to mitigate any loss to the surety.

The GIA grants the surety the ability to request similar information regarding the principal, the indemnitors and the project from third parties, such as banks, credit reporting services, subcontractors or suppliers. Additionally, the Power of Attorney clause permits the surety to execute any authorizations on behalf of the principal or indemnitors for the release of such information.

### **Jewel No. 7: The Power of Attorney Clause and a Lump of Coal**

The indemnitors will typically grant the surety a power of attorney, in a clause similar to the following:

The Contractor and Indemnitors hereby irrevocably nominate, constitute, appoint and designate the Surety as their attorney-in-fact with the right, but not the obligation, to exercise all of the rights of the Contractor and Indemnitors assigned, transferred and set over to the Surety.... The Contractor and Indemnitors hereby ratify and confirm all acts and actions taken and done by the Surety as such attorney-in-fact.

Such a clause gives the surety the power to act on the rights given to it under the GIA (especially under the assignment clause).

The attorney in fact provision and the assignment provision can be used to execute other lien documents, UCC-1's, mortgages, deeds of trust. It can also be used by the surety to assign, mortgage, transfer, sell or liquidate any collateral in the surety's possession.

The surety can use the Power of Attorney provision to sign or endorse checks made payable to the principal, and to complete and submit progress or final payment requests.

Although the power of attorney clause is a powerful tool to aid the surety in mitigating its losses, it appears to be a double-edged sword. The Eleventh Circuit Court of Appeals has

recently held that a surety was liable for a default judgment obtained against its principal by the general contractor even though the surety had answered the complaint on its behalf and had filed a cross-claim against the principal under the GIA. *Drill South v. Int'l Fid. Ins. Co.*, 234 F.3d 1232 (11th Cir. 2000).

In *Drill South*, Enviro-Group was the general contractor on a federal project at the Redstone Arsenal in Alabama. Enviro-Group subcontracted the drilling work to Drill South, who in turn, hired a second-tier subcontractor. International Fidelity Insurance Company issued payment and performance bonds on behalf of the general contractor. The general contractor defaulted, and the second-tier subcontractor brought suit under the Miller Act and Alabama law against Drill South, the general contractor, and International as the general contractor's payment bond surety. Drill South asserted its own Miller Act and Alabama law claims against the general contractor and International. The surety filed an answer and a cross-claim against its principal (the general contractor) under the GIA. The general contractor did not answer or otherwise respond to the lawsuit, and Drill South moved for default judgment. International represented to the court that it took "no position on a default judgment against its principal", provided that the default judgment against the principal was not deemed binding on International as the surety. The District Court entered judgment against the general contractor, and several months later concluded that the default was binding against International and that International was liable to Drill South.

The Court of Appeals affirmed the District Court's decision, rejecting the surety's argument that it could not be bound by the default because it was actively defending itself and asserting its own claims against the principal in the same action. The Court of Appeals noted that even though the surety did not have a duty to defend its principal, the GIA made the surety the "Attorney in Fact" for the principal for settling claims and therefore it had a duty to defend the claim asserted by Drill South. The Court of Appeals rejected the authority of the other courts that reached opposite conclusions as nonbinding and nonpersuasive.

The holding in *Drill South* creating conclusive liability on a surety could arguably apply to all forms of judgment against a principal, and not just to default judgments. The surety should be mindful of the principal's interests when the principal may not be attentive to the demands, motions, hearings and other issues involved in a lawsuit.

A contractor that ignores a lawsuit, either through neglect or through a conscious decision based on reasons such as financial solvency, should be counseled that it may still risk being exposed if it has provided a performance or payment bond on a project. A surety found liable for a default judgment (or any judgment) against its principal can seek indemnity from the principal's indemnitors under the GIA.