

**THIRTEENTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
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**THE NEW SURETY CLAIMS PRACTICES ACT
REQUIREMENTS IN TEXAS**

PRESENTED BY:

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I. INTRODUCTION

CLAIMS SETTLEMENT PRACTICES IN TEXAS – “BAD FAITH”

The state of the law as to extra contractual, or so called “bad faith” causes of action against sureties in Texas has been very favorable to the industry in recent years. A number of sureties confronted with large verdicts took on the Texas plaintiff’s bar and, over the course of three or four years, completely altered the landscape of caselaw concerning virtually every type of extra contractual claim against sureties.

Probably the best known case, *Great American Insurance v. North Austin Utility*, 908 S.W.2d 415 (Tex.1995), held, essentially, that sureties have no duty of “good faith and fair dealing” in relation to the claims of obligees asserted under performance bonds. With respect to principals and indemnitors, in another case, decided three years later (in which our firm represented Universal Surety of America, Amwest Surety Insurance Company and Old Republic Surety Company, as amicus curiae), *Associated Indemnity Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276 (Tex. S.Ct. 1998), the Texas Supreme Court held that there was no duty of “good faith and fair dealing” on the part of a surety when dealing with its principal or indemnitors.

In connection with payment bond claims, *Universal Surety of America v. Central Electric*, 956 S.W.2d 627 (Tex.App. 1997) (in which our firm was lead counsel) held that a payment bond claimant was not a “consumer” for the purposes of the Texas Deceptive Trade Practices Act and, hence, was not entitled to any of the exemplary damage remedies provided by said Act.

In addition, *Tacon Mechanical Contractors, Inc. v. Aetna Casualty & Surety Co.*, 860 F. Supp. 385 (S.D.Tex. 1994) holds that a payment bond claimant has no right of action against a surety based upon an insurers duty of good faith and fair dealing. There are also a number of cases decided in the context of a third party claimant under an insurance policy, holding that such a claimant does not have a so called “bad faith” cause of action.

There have been several legislative attempts to bypass these holdings and subject sureties to liability for bad faith claims settlement practices. House Bill 548 is the most recent effort to impose specific claims handling procedures on construction payment bond sureties. As originally introduced, the bill would have permitted a claimant to recover 18% interest on the claim, plus attorney’s fees in an action brought against the surety. If a surety was found to have violated the claims procedures (contained in the bill) in “bad faith”, the surety would be liable for two (2) times the amount of the claim as additional damages. Further, any indemnification agreement which attempted to pass on the bad faith damages to the principal would be void and unenforceable. Fortunately, the general contractor and surety lobby was able to soften the legislation, but the trend of dissatisfaction with claims handling should not be ignored by the industry.

II. THE NEW REQUIREMENTS

The bill creates a new Article 7.20 to be incorporated into Chapter 7 of the Texas Insurance Code. The provisions of the new article are limited to and mandate certain claims handling procedures and requirements for construction payment bond sureties. The new provisions will

apply to prime as well as subcontract payment bonds issued for delivery on or after January 1, 2002.

- (i) Upon receipt of a claim, the surety is required to **acknowledge the claim, commence an investigation of the claim and request claim documentation within 15 days after the receipt of the notice.** (However, the notice of claim must be an actual demand or claim for payment.)
- (ii) **On or before the 30th day after receiving the documentation** requested by the surety, **the surety must notify the claimant, in writing, of the acceptance or rejection of the claim.** If the claim is denied, **the surety must state specific reason(s) for the denial** of the claim.
- (iii) If the **surety is unable to reject or accept** the claim within the 30 day period provided for analysis of the documentation requested by the surety, **the surety must respond** to the claimant, within the 30 day period, **stating the reasons the surety requires more time and specify any additional information the surety requires.**
- (iv) If the claim is approved, in whole or in part, the claim must be paid **on or before the 15th day from the date of the approval.** However, if acceptance of the claim is conditioned upon the execution of a document (a release or waiver), or the performance of an act, the surety **shall pay the claim not later than the 7th day after the surety receives the executed document or evidence that the act has been performed.**

III. BENEFITS TO THE SURETY

A. Waiver

On the positive side, the surety is protected in relation to a waiver problem that arises in Texas. Specifically, many sureties, as a result of the multi jurisdictional dimension of their claims handling, utilize proof of loss or claim forms. In the absence of proper reservations by the surety, the use of these forms may give rise to an argument that the surety has waived technical and strict compliance with the requirements of the applicable statutes and that all a claimant must do is complete the form and return it to the surety to “perfect” a claim. See *United Benefit Fire Insurance v. Metropolitan Plumbing Co.*, 363 S.W.2d 843 (Tx.Civ.App. – El Paso 1963) (failure to point out deficiency in claim in combination with promise to act equaled waiver). *Trinity Universal Insurance Co. v. McLendon*, 290 S.W.2d 399 (Tx.Civ.App. – Texarkana 1965) (telephone “not to worry” conversation equaled waiver), but compare *Barker v. Bratton Steel Works, Inc.*, 541 S.W.2d 294 (Tx.Civ.App. – Dallas 1976) (conversations between principal and claimant not enough). At 7.20, Sec.2 (b), the bill provides that “Nothing in this article exempts a claimant from compliance with any applicable statutory or contractual notice requirement.” Logically, it follows that the surety may argue that acknowledgement and providing a claim form is mere compliance with the article and its rights to insist on strict compliance with the provisions of the applicable statutory or bond notice requirement are reserved by operation of this provision of the Insurance Code.

B. Effective Notice.

Sureties may now require notice to be sent to a certain place to be effective, but this address must be provided in the bond. See Article 7.20, Sec. 2 (c).

C. Certain Defenses available to the Surety

The new code provisions set forth various allowable bases for rejection of a claim. Specifically, the new article provides that a legitimate dispute between the principal and the claimant is a defense for the surety. This may be interesting in the case of cross default provisions in the claimant's contract. Where, previously, the surety may not have been able to assert the defenses available under such a contract clause, that may now be adjudicated to be a legitimate dispute between the principal and claimant. Similarly, the sureties tenuous defense under "pay if paid" clauses (See *U.S. v. Con-Real Support Group*, 950 F.2d 284 (5th Cir. 1992)) may be revived by the language of this provision of the bill. The bill also makes it clear that the claimant's failure to provide "documentation reasonably requested by the surety" is a basis for denial of the claim.

IV. ENFORCEMENT

No private cause of action is created under the revised version of the bill. However, the Department of Insurance will be given the authority to take disciplinary action against a surety that violates the claims handling requirements as a general business practice. The law applies to all bonds

An "engrossed" copy of the bill appears below, at Section VII.

V. ISSUES TO CONSIDER

A. What is a Notice of Claim?

As a result of this legislation, sureties will need to review and possibly adjust their claims handling procedures. For example, many claimants use software programs to print out preliminary notices of their intent to file a bond claim. These forms are typically used to satisfy notice requirements in multiple jurisdictions. Normally, these forms would be considered "routine" notices, not requiring response under the new code section. However, many such forms, as well as forms promulgated by Texas claimant attorneys contain "Demands for Payment". The question will certainly arise as to whether or not this type of notice constitutes a demand or claim for payment.

To avoid any potential misunderstanding, the claims person should acknowledge the claimant's letter and inform the claimant that the surety is not handling the notice as a claim or demand for payment unless it is notified otherwise. On the other hand, if the surety receives a second similar notice which states the claimant has not been paid, the surety may be well advised to handle the matter as a claim notwithstanding any apparent failure of the claimant to expressly demand or state a claim for payment.

B. Response Timing

The claims person will also need to notify its principal of the new claims handling procedure. The principal should be notified that its failure to respond to the claim notice within the required period will leave the surety with no alternative than to base the surety's decision on the information it has received from the claimant. The surety's failure to notify its principal of the need for a timely response to the claim, in writing, which results in the surety's payment of a claim the surety subsequently learns was disputed may impact the surety's indemnity rights.

C. Complete Response

In the event there is a basis for denial, the surety is well advised to specifically identify every basis the surety reasonably has for rejecting the claim. Although not stated in the new claims handling procedure, a court might hold that any objection to the claim that is not raised in the surety's denial of the claim is waived by the surety.

VI. SAMPLE ACKNOWLEDGEMENT LETTER

STATUTORY BONDS ONLY (LETTER TO CLAIMANT ACKNOWLEDGING CLAIM AND REQUESTING ADDITIONAL INFORMATION)

Re: Principal:
Obligee:
Claim No.:
Project:

Dear _____:

_____ (“_____”) acknowledges receipt of your letter dated _____, 200_, wherein you make claim for the amount of \$_____ against the bond issued by _____ for the above-referenced project.

In accordance with the Texas Insurance Code, your notice appears to be a “routine” notice under the statutes applicable to the bond issued by _____. As a result, except as stated in this letter, we do not intend to take any action to respond to your claim. You may make a demand for payment in response to this letter and we will respond to such a demand as a formal notice of claim, as that term is defined in the Texas Insurance Code.

If you respond with a demand for payment, in order to completely evaluate your claim, we need additional information from you. Specifically, we need to know the date on which the labor was performed and/or the materials were delivered to the project, to the extent included in your claim. If labor was performed and/or materials were delivered on different dates, then a breakdown, by price must be provided together with the date on which each item of material was delivered. We must be provided information sufficient to determine the value of the labor and/or materials supplied by you or a month-to-month basis. Such information may include copies of your agreement, delivery tickets, invoices, statements, time sheets, billings and correspondence. In addition, if any other notices have been sent by you, please provide them to us. Once we have had a chance to review all of the information we need (additional requests may follow), we will provide you with _____’s position on your claim.

This letter is also to advise you that _____’s bond was issued pursuant to the statute applicable to the project. Texas’ statutes provide for strict notice requirements, both as to time and to form. _____ will insist upon strict compliance with the terms of the applicable statute. Compliance with the applicable statute is a condition precedent to your recovery against the bond. _____’s investigation should not be construed as a waiver of any of the requirements of the statute or as a waiver of any other rights or defenses that may exist at law or in equity.

VII. THE BILL

1-1 AN ACT

1-2 relating to the conduct of the business of certain surety
1-3 companies.

1-4 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

1-5 SECTION 1. Chapter 7, Insurance Code, is amended by adding

1-6 Article 7.20 to read as follows:

1-7 Art. 7.20. CONSTRUCTION PAYMENT BOND OF SURETY_COMPANY;

1-8 PROMPT PAYMENT

1-9 Sec. 1. DEFINITIONS. In this article:

1-10 (1) "Claimant" means a person directly entitled to
1-11 payment under a construction payment bond.

1-12 (2) "Construction payment bond" means a surety
1-13 agreement or obligation issued to guarantee or assure payment by a
1-14 principal obligor for work performed or materials supplied or
1-15 specially fabricated for a public or private construction project.

1-16 (3) "Notice of claim" means a written notification by
1-17 a claimant who makes a claim for payment from the surety company.
1-18 The term does not include a routine statutory notice required by
1-19 Section 53.056(b), 53.057, 53.058, 53.252(b), or 53.253, Property
1-20 Code, or Section 2253.047, Government Code.

1-21 (4) "Surety company" means a licensed surety or
1-22 guaranty company that executes and delivers a construction payment
1-23 bond as a surety for a principal obligor.

1-24 Sec. 2. ACKNOWLEDGMENT AND INVESTIGATION OF CLAIM. (a) A
2-1 surety company that has issued a construction payment bond shall,
2-2 not later than the 15th day after the date of receipt of notice of
2-3 claim under the bond:

2-4 (1) acknowledge receipt of the claim;

2-5 (2) begin any review or investigation necessary to
2-6 determine whether the surety company is obligated to satisfy the
2-7 claim under the bond; and

2-8 (3) request from the claimant each document, item of
2-9 information, accounting, statement, or form that the surety company
2-10 then reasonably believes will be required from the claimant.

2-11 (b) Nothing in this article exempts a claimant from
2-12 compliance with any applicable statutory or contractual notice
2-13 requirement.

2-14 (c) If the construction payment bond provides an address of
2-15 the surety company to which claims should be submitted, the notice
2-16 of claim is effective on receipt of the notice at that address.

2-17 Sec. 3. ACCEPTANCE OR REJECTION OF CLAIM. (a) Except as
2-18 provided by Subsection (c) of this section, a surety company shall
2-19 notify a claimant in writing of the acceptance or rejection of a
2-20 claim not later than the 30th day after the date the surety company
2-21 receives all documents, items of information, accountings,
2-22 statements, and forms requested by the surety company as provided
2-23 by Section 2 of this article.

2-24 (b) If the surety company rejects all or part of the claim,
2-25 the notice required by Subsection (a) of this section must state in
2-26 specific terms the reasons for the rejection known to the surety
2-27 company at that time.

3-1 (c) If the surety company is unable to accept or reject the
3-2 claim within the period specified by Subsection (a) of this
3-3 section, the surety company shall provide written notice to the
3-4 claimant, not later than the date specified under Subsection (a),
3-5 that the surety company is unable to accept or reject the claim
3-6 within that period. The notice provided under this subsection
3-7 must:

3-8 (1) state the reasons for which the surety company
3-9 needs additional time to accept or reject the claim; and

3-10 (2) include a request for any additional information
3-11 reasonably needed by the surety company to process the claim.

3-12 (d) Not later than the 30th day after the date a surety
3-13 company notifies a claimant under Subsection (c) of this section,
3-14 the surety company shall notify the claimant in writing of the
3-15 acceptance or rejection of the claim. If the surety company
3-16 rejects all or part of the claim, the surety company shall state in
3-17 specific terms the reasons for the rejection known to the surety
3-18 company at that time.

3-19 (e) In addition to any other contractual or statutory basis
3-20 for denying a claim, the surety company may reject all or any part
3-21 of a claim:

3-22 (1) that is the subject of a legitimate dispute
3-23 between the principal obligor and the claimant; or

3-24 (2) for which the claimant has failed to provide
3-25 supporting documents or information reasonably requested by the
3-26 surety company.

3-27 (f) The time limits provided by this section and Section 2
4-1 of this article may be varied by any statute requiring a
4-2 construction payment bond.

4-3 (g) This section does not preclude a surety company from
4-4 asserting any defense in any action brought by a claimant against
4-5 the construction payment bond if a good faith effort is made to
4-6 inform the claimant in accordance with this section of reasons for
4-7 rejecting all or part of the claim.

4-8 Sec. 4. PAYMENT OF CLAIM. (a) If a surety company notifies
4-9 a claimant under Section 3 of this article that the surety company

4-10 accepts a claim or part of a claim, the surety company shall pay
4-11 the claim not later than the 15th day after the date of the notice.
4-12 (b) If payment of the claim or part of the claim is
4-13 conditioned on the execution of a document or performance of an act
4-14 by the claimant, the surety company shall pay the claim not later
4-15 than the seventh day after the date the surety company receives the
4-16 executed document or evidence that the act has been performed.
4-17 (c) For purposes of this section, payment of a claim occurs
4-18 when the surety company places the surety company's check or draft
4-19 in the United States mail properly addressed to the claimant or the
4-20 claimant's representative.
4-21 Sec. 5. RULES. The commissioner may adopt rules enforcing
4-22 this article in cases in which a surety company violates this
4-23 article as a general business practice.
4-24 Sec. 6. CONSTRUCTION. (a) This article shall be construed
4-25 to encourage prompt payment of just claims made under construction
4-26 payment bonds of surety companies. This article does not foreclose
4-27 any other remedy available to a claimant by law or contract.
5-1 (b) This article may not be construed to:
5-2 (1) create a private cause of action;
5-3 (2) be a precondition to judicially enforcing
5-4 obligations under a construction payment bond;
5-5 (3) diminish any other obligation of a surety company
5-6 that exists by law; or
5-7 (4) prohibit a surety company from asserting a defense
5-8 against a construction payment bond claim in a proceeding to
5-9 enforce a claim.
5-10 Sec. 7. MODIFICATION PROHIBITED. Any term contained in a
5-11 construction payment bond that is inconsistent with this article is
5-12 void.
5-13 SECTION 2. This Act takes effect September 1, 2001, and
5-14 applies only to a claim made under a construction payment bond, as
5-15 that term is defined by Article 7.20, Insurance Code, as added by
5-16 this Act, that is delivered, issued for delivery, or renewed on or
5-17 after January 1, 2002. A construction payment bond that is
5-18 delivered, issued for delivery, or renewed before January 1, 2002,
5-19 is governed by the law as it existed immediately before the
5-20 effective date of this Act, and that law is continued in effect for
5-21 that purpose.

President of the Senate

Speaker of the House

I certify that H.B. No. 548 was passed by the House on April
27, 2001, by a non-record vote.

Chief Clerk of the House

I certify that H.B. No. 548 was passed by the Senate on May
16, 2001, by a viva-voce vote.

Secretary of the Senate

APPROVED: _____

Date

Governor
