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**ARBITRATION AND THE CONTRACT  
SURETY - AN UPDATE**

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The subject of arbitration, and the potential dilemmas arising from the surety's perspective therefrom, has not escaped the attention of the Southern Surety & Fidelity Claims Association. Eight years ago, Greg Veal presented a paper entitled Arbitration and the Surety: When You Should, How Far You Should, and What If You Don't. In the Spring of 1998, our program included a modest presentation which attempted to highlight practical problems encountered by the performance surety when presented with a demand for arbitration. The basic point of the authors in 1998 was that arbitration is an imperfect vehicle for resolution of suretyship disputes, and that these imperfections require corresponding creativity and imagination on the part of the surety to successfully navigate the process of arbitration.

Today, this conclusion is unchanged. Indeed, it has been strengthened by intervening experience. Arbitration continues to be a popular mode of dispute resolution, which presents unique challenges to the surety claim professional. This paper will review the basic nature of arbitration, will highlight basic differences between arbitration and traditional litigation, and will offer some practical suggestions on how the surety might seek to preserve, protect, and enforce its personal defenses as well as its rights of equitable subrogation, exoneration, and indemnity in the arbitration context.

### **The Nature of Arbitration**

Arbitration can best be thought of as a system of dispute resolution adopted by agreement of the parties. It is probably safe to say that rarely were arbitration provisions the subject of much substantive negotiation; rather, form arbitration provisions would be included in construction contracts, whether drafted by the American Institute of Architects or otherwise, primarily because it was felt by members of the AIA that arbitration was a more efficient and less expensive mode of dispute resolution in the context of construction industry disputes. Arbitration provisions are also found in a number of consumer contracts, and a number of commercial groups have undertaken to develop extensive rules and procedures for arbitration of various types of disputes.<sup>1</sup>

At common law, however, agreements to submit disputes to arbitration were met with hostility. Many state courts, including Alabama<sup>2</sup>, held that pre-dispute arbitration agreements were void as contrary to public policy, in that they represented an "ouster" of a litigant's right to the court system. The United States Congress, viewing the situation differently, responded with the *Federal Arbitration Act (FAA)*<sup>3</sup>; by its terms, the FAA makes a written arbitration agreement enforceable provided that the underlying contract "evidences a transaction involving interstate commerce". Thus, assuming that the underlying facts and circumstances relating to performance of the contract are such that interstate commerce is "involved", and

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<sup>1</sup> For example, the American Arbitration Association provides forty-nine different sets of arbitration rules and procedures on its web-site, [www.adr.org](http://www.adr.org). These rules and procedures include the *Accident Claims Arbitration Rules*, *Construction Industry Dispute Resolution Procedures*, *Patent Arbitration Rules* and *Wireless Industry Arbitration Rules*.

<sup>2</sup> See, *Headley v. Aetna Ins. Co.*, 202 Ala. 385, 80 So. 466 (1918).

<sup>3</sup> 9 U.S.C. §§ 1-16.

assuming that a claimant satisfies any procedural steps or conditions relating thereto, pre-dispute arbitration agreements are readily enforceable.<sup>4</sup>

### **Is An Arbitration Agreement Binding On The Surety?**

The courts - and doubtless any number of arbitrators - have reached different conclusions as to whether an arbitration provision in a contract which is the subject of a performance bond is binding upon the surety, or in other words, whether the performance surety must arbitrate disputes with the obligee.<sup>5</sup> The courts have taken basically two different approaches. Some courts, viewing the incorporation by reference provision as the equivalent of actual "consent" to arbitrate by the surety, hold that arbitration provisions are totally binding on the surety, such that the surety must submit to the arbitration and can also compel arbitration if sued by an obligee.<sup>6</sup> Other courts have held that notwithstanding an incorporation by reference clause, the arbitration provision is binding only upon the actual

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<sup>4</sup> Under Alabama law, and specifically the provisions of Ala. Code §8-1-41(3), the enforcement of contracts requiring the resolution of disputes by arbitration is prohibited as a matter of public policy. Consequently, such agreements are only enforceable in Alabama to the extent that they fall within the ambit of the FAA. That is, such agreements may only be enforced if the subject of the transaction or agreement "substantially affects" interstate commerce. See, Sisters of Visitation v. Cochran Plastering Co., Inc., 775 So.2d 759 (Ala. 1999).

<sup>5</sup> Under Alabama law, the arbitrability of disputes is a matter for the Court, and not the arbitrator, to decide. See, Jim Burke Automotive, Inc. v. McGuire, 826 So.2d 122, 132 (Ala. 2002) (Holding that "[a] trial court should not order arbitration of the issue of arbitrability except upon 'clear and unmistakable evidence' that the parties agreed to arbitrate that issue.").

<sup>6</sup> See, James D. Ferrucci, Effect of an Arbitration Provision in The Principal's Contract with the Obligee, presented to the American Bar Association Mid-Winter Surety Program, Fidelity & bSurety Law Committee, January 28, 2000; see, e.g., Commercial Union Ins. Co. v. Gilbane Bldg. Co., 992 F. 2d 386 (1<sup>st</sup> Cir. 1993); Sue Klau Enters, Inc. v. American Fidelity Fire Ins. Co., 551 F. 2d 882 (1<sup>st</sup> Cir. 1977); J&S Constr. Co. v. Travelers Indem. Co., 520 5d 809 (1<sup>st</sup> Cir. 1975); Thomson-CSF, S.A. v. American Arbitration Ass'n, 64 F. 3d 773 (2<sup>nd</sup> Cir. 1995); Exchange Mut. Ins. Co. v. Haskell Co., 742 F. 2d 274, 276 (6<sup>th</sup> Cir. 1984); Gingiss Int'l, Inc. v. Bormet, 58 F. 3d 328 (7<sup>th</sup> Cir. 1995); United States Fidelity & Guar. Co. v. West Point Constr. Co., Inc., 837 F. 2d 1507; 1508 (11<sup>th</sup> Cir. 1988); Firemen's Ins. Co. of Newark, N.J. v. Edgewater Beach Owner's Ass'n, Inc., 1996 WL 509720 at \*1 (N.D. Fla. June 25, 1996); Rashid v. United States Fidelity & Guar. Co., 1992 WL 565341 \*1 (S.D.W.Va. September 28, 1992); Transamerica Premier Ins. Co. v. Collins & Co., Gen. Contractors, Inc., 735 F. Supp. 1050, 1051 (N.D. Ga. 1990); Hoffman v. Fidelity and Deposit Co. of Md., 734 F. Supp. 192, 193 (D.N.J. 1990); Thomas O'Connor & Co. v. Insurance Co. of N. Am., 697 F. Supp. 563 (D. Mass. 1988); Loyal Order of Moose, Lodge 1392 v. International Fidelity Ins. Co., 797 P. 2d 622 (Alaska 1990); Matson, Inc. v. Lamb & Assocs. Packaging, Inc., 947 S.W. 2d 324 (Ark. 1997); Boys Club of San Fernando Valley, Inc. v. Fidelity & Deposit Co. of Md., 8 Cal. Rptr. 2d 587, 589 (Cal. Ct. App. 1992); Henderson Inv. Corp. v. International Fidelity Ins. Co., 575 So. 2d 770 (Fla. Dist. Ct. App. 1991); St. Paul Fire & Marine Ins. Co. v. Woolley/Sweeney Hotel #5, 545 So. 2d 958, 958-59 (Fla. Dist. Ct. App. 1989); Bolingbrook Park Dist. V. National - Ben Franklin Ins. Co. of Ill., 420 N.E. 2d 741 (Ill. App. Ct. 1981); Buck Run Baptist Churc, Inc. v. Cumberland Sur. Ins. Co., 983 S.W. 2d 501 (Ky. 1998); Kearsarge Metallurgical Corp. v. Peerless Ins. Co., 418 N.E. 2d 580 (Mass. 1981); Powers Regulator Co. v. United States Fidelity & Guar. Co., 388 N.E. 2d 1205 (Mass. Ct. App. 1979); Sheffield Assembly of God Church, Inc. v. American Ins. Co., 870 S.W. 2d 926 (Mo. Ct. App. 1994); Fidelity & Deposit Co. of Md. V. Parsons & Whittemore Contractors Corp., 397 N.E. 2d 380 (N.Y. 1979); City of Piqua v. Ohio Farmers Ins. Co., 617 N.E. 2d 780, 781 (Ohio Ct. App. 1992); Rashid v. Schenck Constr. Co., 438 S.E.2d 543 (W.Va 1993).

signatories to the contract.<sup>7</sup> The surety, in such cases, will most likely be bound by the result in arbitration between its principal and the obligee; however, it is probable that the surety, in such jurisdictions, will be able to assert any personal defenses which it may have if the principal loses an arbitration and the obligee sues the surety to enforce the award. In other contexts, the surety may be bound to arbitrate a dispute where it has undertaken to complete a project and thereby “assumed all obligations” of the bonded contract<sup>8</sup>, or where statutes may require and compel the surety to arbitrate.<sup>9</sup>

To ask the question whether the surety has agreed to arbitrate a dispute concerning its liabilities with an obligee is, we submit, an imperfect inquiry. The real question is whether the surety will be bound by the result in arbitration in which it does not participate, or whether its personal defenses may be deemed to be submitted to arbitration together with any issues relating to its principal’s liability, or lack thereof. Before returning to these questions and issues, a brief review of the shortcomings inherent in arbitration, at least in the surety’s perspective, may be useful.

### **Problems With Arbitration**

Before returning to the question of whether the surety must submit to arbitration, or can decline an invitation to arbitrate with comfort, it is helpful to keep in mind some basic distinctions between the arbitration process and traditional litigation under federally styled Rules of Civil Procedure. A meaningful comparison of the advantages and disadvantages of arbitration litigation is an essential step in deciding how the surety should respond to an arbitration demand. The following is a general summary of a few of the critical distinctions:

### **Where Do Arbitrators Come From?**

Arbitrators are individuals who are selected by the sponsor organization based upon their experience and qualifications in an area of expertise. In the construction context, most disputes are administered by the American Arbitration Association, which has an extensive panel of arbitrators who have agreed, in exchange for payment of a per diem fee, to hear and resolve disputes. Arbitrators are not required to have any legal training; a typical Panel of potential arbitrators for construction disputes consist of a mixture of attorneys, architects, engineers, and construction industry executives.

Under the current construction industry rules, the arbitration provision governs the number of arbitrators. Typically, three arbitrators are selected. If the arbitration provision is silent as to the number of arbitrators, the current rules provide for the appointment of a single arbitrator, unless the AAA, in its “discretion” decides otherwise.

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<sup>7</sup> Loyal Order of Moose, Lodge 1392 v. International Fidelity Ins. Co., 797 P. 2d 622 (Alaska 1990); Raymond Int’l Builders, Inc. v. First Indem. Of Am. Ins. Co., 516 A. 2d 620 (N.J. 1986).

<sup>8</sup> See, Thompson-CSF, S.A. v. American Arbitration Ass’n, 64 F.3d 773 (2<sup>nd</sup> Cir. 1995); Buck Run Baptist Church, Inc. v. Cumberland Surety Insurance Co., Inc., 983 S.W.2d 501 (Ky.1998); International Fidelity Insurance Co. v. Saratoga Springs Public Library, 653 N.Y.S.2d 729 (N.Y.App.Div. 1997);

<sup>9</sup> See, R.I. Gen.Laws § 10-3-21 (WESTLAW through end of 1999 Gen. Assembly).

### **Who Pays For Arbitration?**

Arbitration fees are paid by the parties. There are basically two types of fees. First, the claimant (the party initiating arbitration) must pay a filing fee based upon the size of its claim. For example, pursuant to the Construction Industry Dispute Resolution Procedures, an initial non-refundable filing fee of \$1,250.00 is required for claims valued from \$75,000.00 to \$150,000.00. Filing fees are recoverable as damages in the arbitration. Additionally, the parties must share in the per diem arbitrator expenses; typically, the AAA will require a substantial advance deposit pending the development of some consensus about how long the arbitration will take; arbitrator compensation is billed in advance of the hearing.

### **Scope Of Discovery In Arbitration.**

A traditional criticism of arbitration in general is that no discovery rights exist. This criticism appears to have been addressed by the AAA in the revised construction industry rules, which divide cases into three “tracts” based upon their size and complexity. For “fast track” cases, which apply to claims of less than \$75,000.00, little if any discovery is contemplated; the AAA contemplates a 60-day “standard” for case completion, with no provision for conducting discovery. For “regular track” cases, the arbitrators are given authority to “control the discovery process”; typically, the Panel will allow the parties to discover and exchange documents, subpoena documents from third parties if necessary, and conduct a reasonable number of depositions. The scope and extent of these discovery procedures is typically handled through discussion and consensus.

In complex cases, the current rules expressly contemplate that the arbitrators will exercise their authority to regulate discovery, including depositions. The construction industry rules, however, are not specific as to how the discovery process is to be regulated, and unlike civil litigation, there is very little opportunity for a party in arbitration to know with certainty that relevant documentation has in fact been produced.

### **Evidentiary Considerations**

Federal Courts are subject to not only the *Federal Rules of Civil Procedure*, but the *Federal Rules of Evidence*. Most state court systems have similar rules which are designed to limit evidence in contested matters to documents and testimony which is reliable, relevant, and material. Efforts to introduce improper evidence in litigation are subject to objection, and improperly admitted materials can be stricken in appropriate cases. Equally important, issues regarding questionable evidence, or materials which have little or no probative value but which may have prejudicial impact, can be addressed by the court in limine before submission to the fact finder. This is particularly true in the area of expert testimony and matters involving scientific knowledge.

In Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 519, 113 S. Ct. 2786, 125 L. Ed. 2d 469 (1993), the Supreme Court established specific guidelines for determining the admissibility of scientific expert testimony under the Federal Rules of Evidence. Pursuant to these guidelines, the court is to independently evaluate all proffered expert testimony to assure that it is at least minimally reliable. Additionally, the court must determine whether the

testimony “fits” the facts of the case or, in other words, whether it is relevant. The Daubert criteria applies not only to scientific testimony, but also to testimony regarding technical and other specialized knowledge. See, Kumho Tire, Inc. v. Carmichael, 526 U.S. 137, 119 S. Ct. 1167, 143 L. Ed. 2d 238 (1999).

Sadly, none of these controls are present in arbitration. The concept of the judge as “gate keeper” who must regulate the flow of evidence does not exist in arbitration; indeed, there is not even a “gate”. Almost anything - hearsay, double hearsay, mental impressions, damage summaries based upon “projections” and “profit histories” are routinely admitted in arbitration, and must be considered by the arbitrator. Once the record is “closed” following the conclusion of the hearing, additional “evidence” by affidavit may be offered by both sides and received by the arbitrator. Indeed, one of the few ways an arbitration award can be challenged would be for an arbitrator to refuse to admit proffered evidence.

### **Third-Party Practice**

A key disadvantage in arbitration from the surety’s perspective is that there is no procedure in arbitration for involving third parties, such as the principal and indemnitors, or subcontractors or design professionals who may be liable over to the surety. Under the Federal Rules and under most state court systems, any party who may be “liable over” to a defendant can be joined and required to litigate. No such system exist in arbitration and accordingly, the surety is frequently required to consider whether it must institute a parallel action pending disposition of the arbitration, assuming that the third-party defendants are unwilling to participate in the arbitration.

### **Appellate Review of Arbitration Awards**

With few exceptions, awards in arbitration are absolutely final. Judicial review of arbitration awards is governed by the principles of the FAA, and is narrowly limited. See, Mays v. Lanier Worldwide, Inc., 115 F.Supp.2d 1330, 1334 (M.D.Ala. 2000) (citing Brown v. Rauscher Pierce Refsnes, Inc., 994 F.2d 775, 778 (11<sup>th</sup> Cir. 1993)). The scope of this review was recently articulated by the Alabama Court of Civil Appeals in McKee v. Hendrix, 816 So.2d 30 (Ala.Civ.App. 2001):

Where parties, as in this case, have agreed that disputes should go to arbitration, the role of the courts in reviewing the arbitration award is limited. Transit Casualty Co. v. Trenwick Reinsurance Co., 659 F.Supp. 1346 (S.D.N.Y.1987), *affirmed*, 841 F.2d 1117 (2<sup>nd</sup> Cir.1988); Saxis Steamship Co. v. Multifacs International Traders, Inc., 375 F.2d 577 (2<sup>nd</sup> Cir.1967). On motions to confirm or to vacate an award, it is not the function of courts to agree or disagree with the reasoning of the arbitrators. See, Application of States Marine Corp. of Delaware, 127 F.Supp. 943 (S.D.N.Y.1954).

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A court cannot set aside the arbitration award just because it disagrees with it; a policy allowing it to do so would undermine the

federal policy of encouraging the settlement of disputes by arbitration. United Steelworkers of America v. Enterprise Wheel & Car Corp., 363 U.S. 593, 80 S.Ct. 1358, 4 L.Ed.2d 1424 (1960); Virgin Islands Nursing Association's Bargaining Unit v. Schneider, 668 F.2d 221 (3<sup>rd</sup> Cir.1981).

McKee, 816 So.2d at 32-33.

Pursuant to the FAA, and specifically the provisions of 9 U.S.C. §10(a), the decision or award of an arbitrator may be attacked on the following grounds:

- (1) Where the award was procured by corruption, fraud, or undue means.
- (2) Where there was evident partiality or corruption in the arbitrators, or either of them.
- (3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.
- (4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

See, 9. U.S.C. §10(a). The second of these factors, "evident partiality or corruption of the arbitrators", has recently been addressed by the Alabama Supreme Court. In Waverlee Homes, Inc. v. McMichael, 203 WL 329159 (Ala. February 14, 2003), the Alabama Supreme Court, in reliance upon the decisions of other jurisdictions, adopted a "reasonable impression of partiality" standard. Waverlee Homes, 2003 WL 329159 at 14. Under this standard, the alleged partiality must be "direct, definite and capable of demonstration rather than remote, uncertain and speculative." Waverlee Homes, 2003 WL 329159 at 14 (quoting Middlesex Mut. Ins. Co. v. Levine, 675 F.2d 1197, 1201 (11<sup>th</sup> Cir. 1982). Additionally, the "mere appearance of bias or partiality is not enough to set aside an arbitration award." Waverlee Homes, 2003 WL 329159 at 11 (citing Consol. Coal v. Local 1643, United Mine Workers, 48 F.3d 125, 129 (4<sup>th</sup> Cir. 1995)).

The reversal of the decision or award of an arbitrator is difficult at best. Because the FAA expresses a presumption that arbitration awards will be confirmed, see Booth v. Hume Publ'g, Inc., 902 S.2d 925, 932 (11<sup>th</sup> Cir. 1990), the burden on the party seeking to challenge or vacate an arbitration award has been described as "very heavy". See, Mays, 115 F.Supp.2d at 1335; see also, O.R. Sec., Inc. v. professional Planning Assoc., 857 F.2d 742, 748 (11<sup>th</sup> Cir. 1988); Amicizia Societa Navegazione v. Chilean Nitrate and Iodine Sales Corp., 274 F.2d 805, 808 (2<sup>nd</sup> Cir. 1960).

### **To Arbitrate or Not - Is the Surety Bound?**

To return to our central question, what options are available to the surety when a demand for arbitration is presented? The answer would depend upon the nature of the demand, the law of the governing jurisdiction, the nature of the dispute, and the surety's assessment on the merits of the case, as well as the solvency of its principal and commitment to the defense of the claim. The surety's specific options will be dependent upon the context in which the demand for arbitration arises. The three most likely scenarios are: (1) Claimant v. Principal and Surety, (2) Claimant v. Principal only, and (3) Claimant v. Surety only.

### **Claimant v. Principal and Surety**

The performance surety named in the demand for arbitration with its principal should first determine the law of the controlling jurisdiction. If it is clear that the surety is bound by the arbitration clause and must litigate any and all issues in arbitration, the basic issues for the surety will be whether to conduct its own defense or tender to the principal, and how active a role it intends to play in the arbitration. This decision will ultimately be affected by its assessment of the merits of the claim, the financial stability of the principal, whether or not its exposure is collateralized, and its general assessment of the merits of the claim. If there are personal defenses available to the surety, and if the law of the local jurisdiction is clear that the surety does not have to present such defenses for resolution in the arbitration, steps should be taken in the arbitration to reserve and insulate these issues from inadvertent decisions by the arbitrator. Ideally, these issues can be addressed in a formal non-waiver agreement, to be executed by the surety, principal, and the obligee; even better, an Order should be entered in the arbitration insuring that all issues relating to personal defenses will not be deemed to have been decided in arbitration, notwithstanding the ultimate form of the final award.

### **Claimant v. Principal Only**

In this scenario, the surety may receive a copy of the Demand for Arbitration from the claimant, perhaps with notification to the effect that the claimant will deem the surety to be bound by the result in arbitration, but the surety is not named in the demand. In this situation, the surety's basic question is whether its liability will be determined by the result in arbitration, such that the surety will be precluded from re-litigating the issues. Here again, it is necessary to know the law of the local jurisdiction. If it is clear that all issues will be deemed to be resolved in arbitration, and if the surety's investigation indicates the existence of facts which could support viable personal defenses, intervention in the arbitration, and direct participation by the surety may be indicated. If it is less clear that the surety will be bound by the result, particular attention should be paid to the nature of the claims asserted against the principal. Allegations of property damage, coupled with claims of "negligence" or other tortious conduct, may trigger insurance coverages which could be harnessed to good advantage during the course of the arbitration. Rarely, if ever, should the surety assume that its fate will not be determined, in whole or in part, by an arbitration commenced solely against its principal.

### **Claimant v. Surety Only**

If the surety finds itself in a “super incorporation” jurisdiction, its options in terms of responding to the demand are limited. The surety will be deemed to have agreed to arbitrate *any* dispute arising out of the issuance of the bond or performance of the underlying contract, including issues and disputes involving personal defenses. In such cases, it is probable the surety will have all of its eggs placed squarely in the arbitration basket. Presumably, the surety could consider tendering its defense to its principal; this decision, of course, will be determined by its assessment of how solvent, skillful, and motivated the principal might be in undertaking the surety’s defense. If the surety’s investigation indicates that there are third parties who may be responsible for all or some portion of the loss, an independent action against said parties, or some effort to involve all parties in the arbitration, would be indicated.

In a “limited incorporation” jurisdiction, the surety would have the option of declining the obligee’s invitation to arbitrate, and requiring the obligee to arbitrate directly with the principal. Assuming the obligee and the principal proceed with arbitration, the surety will likely be bound by the result to the extent that its principal is found to be liable, except with respect to personal defenses available to the surety. These defenses, and third-party rights, would not be subject to preclusion arguments when suit is filed by the obligee to enforce the award, and the surety would presumably be able to enforce any third-party rights contemporaneously with the litigation of its personal defenses. Alternatively, should the principal have bankrupted or absconded, the surety in a “limited incorporation” district could require the obligee to litigate its dispute.

It is entirely possible, however, that the surety may find itself in a jurisdiction which has not squarely addressed the effect of the incorporation by reference laws on an arbitration provision. Under this scenario, the surety will want to make certain that it has completed a thorough investigation of the underlying facts and circumstances, including analysis of any personal and defenses which may be available to the claim. Armed with this information, the surety must then attempt to make some judgments about how the local jurisdiction will react to its response. Finally, the surety must chart a course of action designed to maximize its chance for a favorable outcome while preserving its principal defenses and third-party rights.

### **Conclusion**

Like it or not, arbitration is a daily reality which must be understood and addressed by the surety. It will rarely be appropriate for the surety to totally abstain from participation in the arbitration, whether the surety is named directly or whether its liability is indirect. Successful management of an arbitration claim requires an advanced degree of the knowledge of the process and utilization of the surety’s rights to achieve a successful outcome.