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**THE SURETY'S EXPOSURE FOR PROPERTY DAMAGE AND  
BODILY INJURY:  
IDENTIFICATION, ALLOCATION, AVOIDANCE OF THE RISK**

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# THE SURETY'S EXPOSURE FOR PROPERTY DAMAGE AND BODILY INJURY: IDENTIFICATION, ALLOCATION, AVOIDANCE OF THE RISK

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## Introduction

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There are few absolute principles that define a surety's liability for property damage or bodily injury. As discussed below, the conclusions drawn by courts throughout the country have been seemingly incongruous, often turning on specific fact patterns. Although purporting to apply general contract principles, and attempting to flesh out the intent of the parties, the decisions have been widely divergent, and frequently result oriented. Accordingly, there is no conclusive precautionary measure a surety can take to avoid such liability.

Fundamentally, a performance bond is a contract. Its language, sometimes incorporating terms of a construction contract and/or statute, is typically interpreted to determine the scope the surety's liability. Sureties usually contend that the sole purpose of a performance bond is to guarantee completion of the work, and then only upon the default of the contractor. Sureties do not underwrite bonds anticipating exposure for property damage or bodily injury. Most insist that is the exclusive province of the general liability insurance carrier. However, a survey of the cases addressing this issue reveals that this analysis is not always an accurate one. Pivotal factors may include the identity of the claimant, the nature of the claim being asserted, the type of damages sought, the time the claim arose, and the language of the bond, construction contract or applicable statute, if any. This paper will identify cases in which the courts have either accepted or rejected an overlap of coverage under insurance policies and performance bonds for property damage or bodily injury, and present considerations for identification, allocation and avoidance of this risk.

## Discussion

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It is generally accepted that surety bonds are not insurance policies. That is why owners usually require contractors to carry liability insurance to cover the risk of loss due to property damage or bodily injury during or after construction, which results from defective construction or negligent acts by the contractor.

The difference between performance bonds and insurance are primarily found in rights and liabilities assumed by each. The surety essentially lends its credit to make certain, if the conditions of the bond are violated, that the obligee will be protected in the event the principal is financially unable to comply with the conditions of the bond. If the principal can satisfy the obligation, the surety need not respond. The surety, unlike the liability insurer, is entitled to be indemnified by the one who should have performed the obligation. Under a contract of

suretyship, the surety expects no losses because the ultimate liability for any loss incurred always remains, at least theoretically, with the principal. Therefore, while the surety may incur liability, it is entitled to recover from the principal all amounts properly paid to the obligee or other claimants.

Liability insurance, by contrast, is a contract in which the insurer agrees to pay for the insured those obligations for which the insured legally may become liable by virtue of an unknown or contingent event that arises as a result of the insured's negligence. The insurer has promised to defend and indemnify the insured from the loss for which the insured will be liable to the third party. A liability insurer has no right to indemnification from the party who requested the policy of insurance.

Just as sureties have attempted to distinguish their bonds from insurance policies, insurance companies have consistently maintained that insurance policies are not performance bonds, usually in the context of declining coverage under the "your work" and "your product" exclusions. As a result, there is no shortage of cases suggesting that the risks covered by performance bonds and liability policies are mutually exclusive. Notwithstanding this, many courts continue to confuse performance bonds as a form of insurance, at times treating a performance bond surety as an insurer of all risks on a project. Ironically, in many instances, the courts have done so at the behest of insurance companies subrogated to the rights of performance bond obligees. The results are particularly unpredictable in those cases where the performance bond incorporates statutory or contractual provisions by which the principal and/or surety are required to indemnify the owner for negligent acts. Following is a discussion of several cases from various jurisdictions which demonstrate the breadth of the gamut.

In an early case favorable to a surety, *De Vries v. City of Austin*, 261 Minn. 52, 110 N.W.2d 529 (Minn. 1961), a home owner sued the city, the municipal board which furnished gas to customers in the city, the principal, and its subcontractor for property damages sustained when his home was destroyed during an explosion which occurred when the subcontractor severed the gas service line below the street during excavation for certain curb and gutter improvements. The city filed a third-party complaint against the principal's surety, and a cross-claim against the principal for indemnity. The principal filed a cross-claim against the city, the municipal board, and the subcontractor for indemnity. The jury returned a special verdict finding against all defendants except the subcontractor. The trial court determined that the city was not entitled to indemnity from the principal or its surety, dismissed the principal's cross-claims against the city, the municipal board, and the subcontractor, and the city, the municipal board, and principal appealed.

The appellate court held that the principal and city were liable to the home owner, that the city was entitled to contractual indemnity from the principal, that the municipal board was not liable to the owner, and that the bond furnished to the city by the principal to assure, among other things, faithful performance of contract by the principal, did not protect the city against liability for damages arising because of the negligence of the principal or its subcontractors in the performance of the work. Even though the specifications and the contract placed full responsibility on the principal for locating and protecting the gas pipes under the right-of-way prior to the commencement of the excavation, and even though the

contract established the city's right to be indemnified by the principal for such damages adjudged due from the city to the plaintiff, the court assigned no liability under the performance bond.

The court reasoned that it was clear from the provisions of the public works statute, as well as the local ordinance and the language of both the bond and the contract, that the purpose of the bond was not to protect the obligee therein against liability for damages arising because of negligence in the principal's performance of the work. The court inferred that had the bond been intended to cover the obligee's liability for the principal's negligence in the performance of the work, the contract provisions requiring him to furnish liability insurance covering such negligence for the city's protection would not have been added.

A similar result was reached in **Wychoff Township v. Sarna**, 136 N.J. Super. 512, 347 A.2d 16 (N.J. Super. A.D. Oct 23, 1975), where the real party in interest, an insurer of a municipality, sued the principal and its surety on a statutory performance bond for among other things, indemnification for amounts paid pursuant to a judgment in another lawsuit, to the grantors of an easement across which the principal had allegedly negligently constructed utility improvements for the municipality. Although the municipality had given approval and acceptance to the improvements some years before the institution of the lawsuit, the plaintiff's argued that principal and the surety committed a breach of the performance bond 'well and truly' to install the improvements. The argument proceeded that the judgment in the prior negligence action was based upon the negligent manner in which storm sewer pipe was installed, which demonstrated that defendants failed to comply with the terms of the bond. The plaintiff argued that both the principal and surety thus became obligated to the municipality, not only for their undertaking to install the improvements properly, but to indemnify the township for damages sustained by third parties as the result of such failure.

The trial court found defendants liable under terms of their performance bond, and defendants appealed. The appellate court reversed, holding in relevant part that neither the provisions of the municipal planning act pertaining to performance bonds, nor language of the bond, insured the municipality against liability to the grantors of the easement for negligence in connection with installation of storm sewer. The court reasoned that there was nothing in the statute to suggest that it was designed to insure the municipality against liability for its negligence in connection with the installation of such improvements or to indemnify it against negligence claims by third parties against it. Nor was there anything in the bond to support the interpretation that such was its purpose. The surety's relationship with the municipality arose solely out of a contract designed to protect the municipality against payment for the costs of certain improvements.

Although **Wychoff** was a subrogation case, there was no reference in the opinion about the scope of the prime contract's waiver of subrogation provision, if any. Unlike *De Vries*, nor was there any discussion of the scope of the prime contract's indemnification provision, if any, and whether that provision had been incorporated, with other language of the prime contract, into the bond. The bond in neither case contained a stand alone indemnification provision. Although both cases involved ultimate property damage to a third party, in **De Vries**, that damage occurred before the project was completed and accepted; in **Wychoff**, the project had long since been completed and accepted at the time of the occurrence. While the court in

**Wychoff** did not rely on the existence of a contractual requirement to furnish liability coverage in deriving the intention of the parties as the **De Vries** court did, the subrogation claim was in effect an attempt to re-assign liability which was covered by the owner's insurance policy. Both cases were public works projects involving statutory bonds, and both cases indicated a lack of any discernable intent from the statute to hold the surety liable for the consequences of the contractor's negligence.

A similar result was reached in regard to a private bond in **Gateway Communications, Inc. v. John R. Hess, Inc.**, 208 W.Va. 505, 541 S.E.2d 595 (W.Va. Nov 06, 2000), where the project owner sued its architect, contractor and the surety for damages to the project caused by a water leak discovered approximately 5 years after final payment. Following the owner's settlement with the architect, and the contractor's voluntary bankruptcy petition, the surety's motion to dismiss on grounds of the two year contractual limitations period of the bond was granted. West Virginia did not apply the discovery rule to toll the limitations period for breaches of construction contracts.

On appeal, the court was asked to determine, among other things, whether the owner could hold the surety liable under its AIA A311 performance bond for the damages arising out of the negligent construction of its principal. The court concluded that the surety's liability under the performance bond did not extend to the contractor's negligent acts. The court inferred that the predicate "default" of the principal limited the surety's liability to breaches of the construction contract committed by the principal, and not to tortious conduct. To hold otherwise, the court reasoned, would transform the surety into the contractor's liability insurer. Notably, the project in question in **Gateway** had been completed and accepted at the time of the occurrence. Unlike **De Vries** and **Wychoff**, the property damage was to the work itself, and the original claimant was the owner. As stated in **De Vries** (and implicit in **Wychoff**), fundamental to the courts reasoning was the difference between a surety bond and a liability insurance policy.

Quite different from **De Vries**, **Wychoff**, and **Gateway**, a surety was held liable for an owner's property damage in **Haywood County Consolidated School System. v. USF&G.**, 43 N.C.App. 71, 257 S.E.2d 670 (N.C.App. Sep 18, 1979), notwithstanding a requirement for liability insurance in the prime contract. In that case, a school system sued a surety on its statutory performance bond for damages to a newly constructed school gym floor, caused by its principal installation of a defective pressure reducing valve. The principal, a plumber, contracted to perform repairs and alterations to a water cooler and the lines leading to it. The trial court entered judgment for the school system and the surety appealed.

The appellate court held that under the performance bond, the bond company was required to pay for damages to the school gym floor caused by the contractor's improper performance under his contract with the school system. The court construed the bond and the construction contract together to determine the intent of the parties. The bond obligated the surety to perform if the Contractor did not "well and truly perform and fulfill all the undertakings, covenants, terms, conditions and agreements of (the) contract." The contract referred to plaintiff as Owner. Subsection 4.18.1 of the contract provided in pertinent part: "The Contractor shall indemnify . . . the Owner . . . against all . . . damages, losses and expenses . . . arising out of or resulting from the performance of the Work, provided that any such . . .

damage, loss or expense (1) is attributable . . . to injury to or destruction of tangible property (other than the Work itself) . . . , and (2) is caused in whole or in part by any negligent act or omission of the Contractor." The surety argued unsuccessfully that it was not liable under this section of the contract because the contract by subsection 11.1.1 required its principal to carry liability insurance against "claims for damages because of injury to or destruction of tangible property." Notably, the court did not even mention the scope of the surety's undertaking under the statute. Moreover, the damaged property was not within the principal's scope of work.

Although ultimately reaching a result favorable to the surety, reasoning which may be problematic for sureties in regard to the incorporation by reference of prime contracts containing indemnification provisions was employed in **City of Marshall v. American General Ins. Co.**, 623 S.W.2d 445 (Tex.App.-Texarkana Sep 15, 1981) (NO. 8926). In that case, an adjoining property owner sued the city for damages caused by its contractor during construction of the project. The prime contract contained indemnification provisions and the city contended that the surety was bound by those provisions by virtue of having issued the statutory performance bond. The surety moved for and was granted summary judgment, which was affirmed on appeal. The court held that the obligations of the bond were limited to those in the statute, unless there were other provisions in the bond or in other relevant documents sufficient to render the undertaking a common law bond. Since the bond did not contain an indemnification provision, and since the city did not offer summary judgment proof of the indemnification provision in the contract, the city was not permitted to pursue its claim against the surety. Hence, while the result was similar to that in **DeVries, Wychoff, and Gateway**, the court indicated that the result may have been different had the defendant filed a proper summary judgment response, and offered summary judgment proof of the indemnity provision in the prime contract. Had proof been furnished that the bond incorporated an indemnification provision from the prime contract, the court may have interpreted the bond as a common law undertaking, expanding the scope of the surety's responsibility under the statute.

Expansion of the surety's undertaking to include bodily injury by virtue of the "common law bond" analysis is precisely what occurred **Bullard v. State of Louisiana (Department of Transportation and Development)**, 394 So.2d 626 (La.App. 1 Cir. Nov 10, 1980), where a father brought a wrongful death and survival action against the State of Louisiana (DOT), its contractor, and the contractor's surety seeking damages arising out of the injury and death of his son, whose vehicle was struck by a fallen rotten tree as it was being driven along Interstate 10. The DOT sued the contractor and its surety for indemnity. The surety moved for and obtained a summary judgment on the basis that its liability on the statutory bond was limited by the statute, the additional indemnification obligations in the bond notwithstanding. The appellate court reversed the summary judgment, reasoning instead that the statute did not prohibit the surety from voluntarily contracting to assume additional liabilities. The court expressed an awareness of possible future prejudice of this holding to bond claimants otherwise intended to benefit from the protections of the statute through the impairment of the penal sum, but declined to allow such considerations to prevail over contractual considerations. This impact of this case may have been superceded by a subsequent amendment to the applicable statute, discussed below.

The importance of the language of the bond was demonstrated in ***People v. Westchester Colprovia Corp.***, 1 A.D.2d 724, 147 N.Y.S.2d 185 (N.Y.A.D. 3 Dept. Dec 23, 1955), where the State of New York sued a contractor and its surety on a performance bond furnished in connection with contract to treat a concrete highway. The lawsuit sought to recover the amount which, pursuant to another separate lawsuit, the State had been required to pay by reason of its own negligence for injuries sustained by a passenger in an automobile which skidded on the oiled surface of the highway. The performance bond obligated the principal and the surety to protect the State and to pay "all amounts, damages, costs, and judgments which may be recovered against said State or its officers or agents or which the said State of New York may be called upon to pay to any person or corporation by reason of any damages, direct or indirect, arising or growing out of the doing of said work, or from the negligence, non-feasance, mis-feasance or malfeasance of any officer, agent or employee of the State, or Department thereof, or suffered or claimed on account of said Treatment during the time thereof and until the final completion and acceptance of the work, or the manner of doing the same, or the neglect of the said Principal, or his agents, or servants, or the improper performance of the said work by the said Principal, or his agents, or servants, or from any other cause."

The State sought a judgment on the pleadings and a summary judgment, both of which were denied by the trial court. The obligee plaintiff appealed. The surety argued that the performance bond was essentially an insurance policy issued by the contractor to the state, and hence, since the contractor and surety thereby agreed to indemnify state against its own negligence, the bond was contrary to public policy as requiring contractors, though not licensed pursuant to insurance laws of state, to insure the state against its own negligence. The appellate court construed that the disputed portion of the performance bond was a contract to indemnify the State against its own negligence, and held that such an agreement was neither illegal, nor a policy of insurance issued by the principal. As such, the appellate court reversed the trial court in regard to this defense, holding that the defense was insufficient as a matter of law. However, the court recognized as vital whether the work on the highway was completed and accepted by the State prior to the accident. Based on this defense, the appellate court held that these defenses were not insufficient in law and that the obligee's motion, insofar as it was addressed to their dismissal, was properly denied. The appellate court also held that the trial courts denial of summary judgment on this defense was proper. Significantly, the court did not limit the surety's liability to the purposes expressed in the statute. Ironically, although the bond was expressly held not to be a policy of insurance, that is essentially how the court construed it, in holding the indemnity provision otherwise enforceable.

One case which declined to apply the "common law bond" analysis concerning indemnity agreements is ***Water Works, Gas & Sewer Bd. of City of Oneonta v. P.A. Buchanan Contracting Co.***, 294 Ala. 402, 318 So.2d 267 (Ala. Jul 31, 1975), where the water works, gas and sewer board of city was sued for damages resulting from an explosion of natural gas line pipe laid by a contractor pursuant to a contract with the board. The explosion occurred approximately 16 years after the completion of the project, and damaged a building owned by one plaintiff and occupied by another. The basis of the claims was that the pipe was negligently laid and as a proximate consequence the building was damaged. The board filed a third-party complaint against, among others, the contractor and its surety on the statutory performance bond. The board's position was that the performance bond was a common law

bond which incorporated the contract between the principal and the owner, including a provision requiring the principal and its surety to indemnify the owner from any loss.

The trial court granted the surety's motion for summary judgment and the board appealed. The appellate court held that since the bond was an ordinary performance bond as required by statute, the surety was not liable for injuries to a third party caused by any alleged negligence of its principal. The court stated that a public works bond surety is not liable to third parties for injuries caused by negligence of the contractor-principal. The court further reasoned that the common practice of referencing in the surety bond the construction contract between the board and the contractor does not change a statutory performance bond into either a common-law bond or a liability insurance policy for the payment of tort claims.

Notably, the court treated this claim as that of a third party, and not as an indemnity claim. Although the court emphasized that insurance was required by the prime contract and read the statute into bond for the purpose of deriving the parties' intentions, the court clearly did not jointly construe the bond and the prime contract (which expressly mentioned the surety's indemnification obligation).

Another case limiting the application of an indemnity provision actually contained in a bond is ***State Highway Admin. v. Transamerica Ins. Co.***, 367 A.2d 509, 521 (Md. 1976). In that case, the State brought action against the principal and the surety under a performance bond seeking, among other things, damages for alleged negligence in the performance of such the prime contract, particularly in regard to the principal's wasting operation which occurred and caused damage on private property. On this point, the trial court entered judgment in favor of the surety. The appellate court held, inter alia, that provision of bond saving State harmless from 'any damages growing out of the negligence of the said Contractor,' applied only with respect to work to be performed under construction contract, and therefore, surety was not liable for contractor's negligent acts in its wasting operation on private property, which operation the State had no authority to control, either as sovereign body or under the construction contract.

Unlike the forgoing cases, the decisions of the courts are much more predictable and in the surety's favor where the claimant is a third party. Courts have been very reluctant to permit third parties to pursue claims directly against performance bonds. For instance, in ***Foshee v. Doaust Construction Co.***, 185 F.2d 23 (7th Cir.(Ind.) Nov 06, 1950), plaintiff's decedent was injured during a collision between the engine of a passenger train on which he was riding and a tournapull which was owned and operated by a contractor on a State of Indiana project. The district court granted the motion to dismiss of the contractor and its surety for failure to state a claim. This was affirmed on appeal. Among other grounds cited, the court of appeals reasoned that the statutory performance bond was not made for the benefit of the public, including plaintiff's decedent.

A similar result was reached in ***Long v. City of Midway***, 169 Ga.App. 72, 311 S.E.2d 508 (Ga.App. Nov 29, 1983), where a property owner sued the city and the surety on statutory performance and payment bonds, alleging that utility contractor caused, among other things, flooding to his property. The appellate court affirmed a summary judgment in favor of the

surety. The appellate court held that unless surety contracts expressly provide for third party liability coverage, third party claimants should look for coverage under the liability insurance provided by the contractor.

To eliminate some of the confusion created by the courts, some states have enacted legislation addressing the surety's liability for property damage and bodily injury. For instance, in Louisiana, Statute LSA-R.S. 38:2241 (1950) governing public contracts states: A b o n d issued pursuant to this Section shall not create, nor shall such bond be construed to create, any cause of action in favor of the public entity, or any third party, for personal injury or property damages sustained by any third party during the effective period of the bond. Unclear is whether the statute would be applicable to personal injury or property damages sustained by third party after the effective period of the bond. There appears to no interpretive law on whether the surety would remain vulnerable for this situation.

In Washington, Statute West's RCWA 19.72.107 (1992) states that a surety bond shall not be liable for damages based upon or arising out of any: (a) Tortious injury, including death, to: (i) Any person; or (ii) Any real or personal property; or (b) Failure to have any or adequate insurance coverage, even if liability under (a) or (b) of this subsection is imposed on the surety's principal or the surety by contract, surety bond, strict liability, ordinance, statute, or common law. This statute applies to both private and public works.

Similarly, in New Jersey, Statute N.J.S.A. 2A:44-143 (1996), states: A surety's obligation shall not extend to any claim for damages based upon alleged negligence that resulted in personal injury, wrongful death, or damage to real or personal property, and no bond shall in any way be construed as a liability insurance policy. It remains to be seen whether these and other statutes have the intended effect of limiting a surety's performance obligation to the cost of completing its principal's work.

Finally, there also exists authority holding a surety liable for a contractor's failure to furnish insurance to cover property damage to the project. This was addressed in ***Carroll-Boone Water District V. M. & P. Equipment Company***, 280 Ark. 560, 661 S.W.2d 345 (Ark. Nov 14, 1983). In that case, the contractor was required to furnish but did not furnish a builder's risk policy. After a water intake structure was damaged by blasting, the owner filed a lawsuit against the contractor, its subcontractor and surety, and eventually a cross claim against the project engineer. At trial, the surety obtained a finding of material alteration, since no builder's risk insurance was provided.

Distinguishing between a breach of contract and a material alteration, the appellate court held that the trial court improperly presented the jury with the question of material alteration, because, among other reasons, the surety was not placed in a different position from that which it promised to guarantee. Instead, the court ruled that the surety was not released from its obligations in the performance bond, and the owner was entitled to recover its damages from the surety. Like ***Gateway***, the damage in this case was to the work itself, and the claimant was the owner.

Similarly, in ***Hartford v. Riefolo***, 81 N.J. 514, 410 A.2d 658 (N.J. Jan 17, 1980), where the principal contracted to insure the building against fire damage until completion, but allowed

its builder's risk insurance to lapse, the surety was held liable for damages sustained by the obligee as a consequence of a fire of undetermined origin. Likewise, the court in ***Santa Rosa County v. Raymond Blanton Construction Co.***, 138 So.2d 518 (Fla. 1<sup>st</sup> DCA 1962), concluded in dicta that the surety could be held responsible for the principal's default on its contractual obligation to furnish liability insurance, should the obligee be damaged by such failure.

## **Conclusion**

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Although most courts purport to determine the issue on the basis of general contract law, the decisions on whether a surety is liable for property damage or bodily injury are not uniform. Third party claims for property damage or bodily injury urged directly against the surety are almost universally denied; however, first party claims, including indemnity claims, yield far less predictable results. These cases are usually determined on the basis of a number of factors, including the identity of the claimant, the nature of the claim being asserted, the type of damages sought, whether the claim arose before or after completion and acceptance of the project, the existence of insurance, and the language of the bond, construction contract or applicable statute. Following are a few guidelines of issues to consider for minimizing the exposure for such claims:

- 1) Beware of language of the performance bond imposing broad obligations on the surety traditionally reserved for insurance companies.
- 2) Beware of language in the prime contract imposing broad indemnification obligations on the principal, which may be incorporated by reference into the bond.
- 3) Determine whether the bond is a statutory bond, and whether the statute defines the surety's liability or otherwise limits the surety's exposure for property damage or bodily injury.
- 4) Beware of other statutes that may preempt contractual provisions and impose or relieve liability.
- 5) Determine whether the language of the performance bond or the underlying contract limit the duration of the surety's exposure to a specified period of time or event (i.e. final acceptance or final payment).
- 6) Ensure that the bond principal actually procures insurance coverage required by the prime contract.
- 7) Beware of broad indemnity language, either in the bond form or the prime contract, exposing the surety to liability for the torts of its principal.
- 8) Determine whether the prime contract contains a broad waiver of subrogation provision.
- 9) Consider whether to include an enforceable contractual limitations period in the bond form.

- 10) Upon final acceptance, consider requesting a written statement from the obligee that the principal has "fully performed" the contract.
- 11) Consider whether by virtue of the indemnification agreement or common law, the surety can subrogate against the Principal's liability insurance carrier.
- 12) Consider when taking over a project, to require (a) broad indemnification from the completion contractor, enforceable under local law; (b) being named as an additional insured on the completion contractor's liability insurance policy; and (c) broad waivers of subrogation in both the takeover and completion agreements.
- 13) Consider alternatives to takeover, such as tri-party tender agreements.