SIXTEENTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS CONFERENCE

Charleston, South Carolina
APRIL 21st - 22nd , 2005

THE SURETY'S RIGHT TO INDEMNIFICATION; AND WHAT IS GOOD FAITH ANYWAY?

PRESENTED BY:

GREGORY P. BROWN, ESQ.
PATRICK J. RISCH, ESQ.
ERIC E. PAGE, ESQ.
HILL, WARD & HENDERSON, P.A.
101 East Kennedy Blvd., Suite 3700
Tampa, Florida 33602
(813) 221-3900

The Surety's Right to Indemnification; and What is Good Faith Anyway?

By:
Gregory P. Brown
Patrick J. Risch
Eric E. Page

I. INTRODUCTION

The obligee has declared a default and payment bond claims are piling up. The claims handler flips through the underwriting file right past the general indemnity agreement ("GIA"). The president of the principal, who is an individual indemnitor, will not respond to phone calls or letters, and his secretary says something about a "homestead" in Florida. The GIA is of little comfort to the claims handler at this point. Her primary concern is not pursuing indemnity rights, but minimizing claim exposure and paying claims in a manner that will not jeopardize the surety's ability to pursue those indemnity rights in the future. The claims handler therefore must know exactly how to proceed in settling claims with an unresponsive or under responsive principal, who may rear its head long enough to object to various claim payments.

To recover under a GIA, most states hold that the surety needs to have acted in good faith. However, when determining whether an indemnity obligation will be enforced, courts reverse planes and will bar recovery where the principal proves the surety acted in bad faith in resolving claims. There are essentially three different standards used by states to define bad faith. This article first sets forth each standard and defines its parameters. We will then briefly review and discuss a recent state supreme court opinion that comprehensively surveys those standards and the effect of a right to settle clause on a bad faith defense. Next, this article addresses situations when the good faith determination is frequently at issue, leaving the final portion of the article to focus on a protocol to keep in mind when seeking to preserve the surety's indemnity rights.

As most surety practitioners are aware, a surety is not acting in bad faith in seeking indemnification from a principal simply because the principal objected to and raised colorable defenses to payments the surety made to the claimant. See, e.g., Transamerica Ins. Co. v. Avenell, 66 F.3d 715, 718, (5th Cir. 1995) (surety's settlement of litigation over principal's objections not bad faith); General Accident Ins. Co. of America v. Merritt-Meridian Construction Corp., 975 F. Supp. 511, 518 (S.D.N.Y. 1997) (no bad faith wherein surety settled claims despite possible defenses by principal). If this were the case, a surety would have to decide whether the principal or the obligee is correct when both claim the other breached the underlying contract; facing an interference lawsuit if the surety sides with the obligee, and a breach of contract suit if the surety supports the principal. See Good Faith, Suretyship, and the Ius Commune, 53 Mercer L. Rev. 581, Winter 2002.

Additionally, under indemnity agreements, it is not a requirement that a principal be liable for the claims upon which the surety seeks indemnification. See, e.g., Frontier Ins. Co. v. International, 124 F. Supp. 2d 1211, 1215 (N.D. Ala. 2000) (liability of principal not prerequisite to surety's right to reimbursement); United States Fidelity & Guaranty Co. v. Feibus, 15 F. Supp. 2d 579, 583 (M.D. Pa. 1998) (same); Employers Ins. of Wausau v. Able Green, Inc., 749 F. Supp. 1100, 1103 (S.D. Fla. 1990) ("courts have consistently held that the surety is entitled to

reimbursement pursuant to an indemnity contract for any payments made by it in a good faith belief that it was required to pay, regardless of whether any liability actually existed"); Fireman's Fund Ins. Co. v. Nizdil, 709 F. Supp. 975, 976-77 (D. Or. 1989) ("any claim asserted against the surety, regardless if it is valid or outside the scope of the bond triggers the obligation to indemnify the surety"); Fidelity & Deposit Co. of Maryland v. Fleischer, 772 S.W.2d 809, 816 (4th Cir. 1983) (surety "had the right to settle any claim in good faith whether or not liability, necessity or expediency existed"); International Fidelity Ins. Co. v. Spadafina, 596 N.Y.S.2d 453 (surety entitled to indemnification, regardless of whether principal liable on underlying debt); Hess v. American States Ins. Co., 589 S.W.2d 548, 551 (Tex. App. 1992) (liability of principal not condition precedent to surety's right of recovery on indemnity agreement). Therefore, the principal must object to something more than just the settlement of a claim.

II. GOOD FAITH STANDARDS

In order to preserve its defenses to an indemnity claim, the principal must not only object to the settlement, but must also assert that the settlement was made in bad faith. Most courts require a surety to act in good faith, or use the term "bad faith" to define the standard when measuring a surety's conduct in resolving a claim. However, those same courts often fail to give any guidance as to what constitutes bad faith. See Thurston v. International Fidelity Insurance Co., 528 So. 2d 128 (Fla. 3d DCA 1988) (holding that a surety is entitled to reimbursement for any payments it makes under a good faith belief, regardless of actual liability, but failing to provide any insight as to what good faith might be). There is not one definition for good faith that jurisdictions utilize when evaluating a surety's conduct, and in fact some jurisdictions appear to require a surety to prove more that one standard to avoid an assertion of bad faith. See Employers Insurance of Wausau, 749 F. Supp. at 1102-03 (requiring the surety to prove both that (1) it used good faith and (2) that it was not deliberately malfeasant in issuing bonds for its principal).

While at least one jurisdiction has found no implied duty of good faith upon sureties,[1] there are three general standards of good faith that various jurisdictions apply. Some courts hold that evidence that the surety acted negligently may be enough on its own to prove bad faith. Other courts hold that the surety must have acted with at least an improper motive or dishonest purpose to demonstrate bad faith. Still other jurisdictions hold that bad faith is only proven when the surety acted fraudulently in settling the claim. These three standards are addressed below.

A. Bad Faith = Improper Motive/Dishonest Conduct

A majority of jurisdictions hold that the principal must prove something more than mere negligence to prove bad faith. These jurisdictions generally require proof that the surety acted with a dishonest purpose or an improper motive to support an allegation of surety bad faith. See, e.g., Travelers Casualty & Surety Co. of America, Inc. v. Jadum Construction Co., 2003 U.S. Dist. LEXIS 11861 (D. Mass. July 11, 2003) (dishonest purpose); Frontier Ins. Co., 124 F. Supp. 2d at 1214 (improper motive and dishonest purpose); Feibus, 15 F. Supp. 2d at 587 (improper motive; dishonest purpose); Safeco Ins. Co. of America v. Criterion Investment Corp., 732 F. Supp. 834,

---

[1] The Texas Supreme Court upheld its previous decision that an implied duty of good faith does not exist in all contracts, and that the surety/principal relationship, unlike the insured/insurer relationship, is not quite "special" enough to give rise to a duty of good faith. Associated Indemnity Corp. v. CAT Contracting, Inc., 964 S.W.2d 276 (Tex. 1998).

841 (E.D. Tenn. 1989) (improper motive); Ford v. Aetna Ins. Co., 394 S.W.2d 693, 698 (Tex. App. 1965) (improper motive). In Feibus, the court provided valuable insight for sureties to avoid bad faith allegations. Bad faith is not bad judgment, negligence, a lack of diligence, or even gross negligence. Id. at 585. However, bad faith is consciously doing a wrong because of a dishonest purpose or moral obliquity, acting recklessly, or acting with an improper motive based on self-interest or ill will. Id. (citations omitted).

The principal in Feibus had ignored the surety's repeated request for collateral security, ignored communications from the surety during claim settlement negotiations, and did not cooperate in settling the claims. Id. at 586-87. While the principal's actions in Feibus cannot be counted on in future cases to defeat a bad faith defense, the surety took actions in that case that all sureties should follow. Despite allegations of excessive payments, the surety in Feibus was able to recover its payments because they were made in exchange for extensions of time that allowed the surety to proceed with the project. Id. at 587. Additionally, the surety had considered other alternatives, but they were more costly and might have caused the liquidated damages clause in the contract to significantly increase the surety's liability. Id. Under these circumstances, the Feibus court held it to be irrelevant whether the payments were excessive and that the surety had not acted in bad faith. Id.

Other cases recognize the principal's right to avoid liability through the improper motive/dishonest conduct approach, but do so as an alternative to establishing a fraud defense. Engbrock v. Federal Ins. Co., 370 F.2d 784 (5th Cir. 1967). This approach requires the principal to plead and prove either fraud or a lack of good faith by the surety. Id. In support of this position, the Engbrock court noted that this requirement was neither against public policy nor unduly harsh. Additionally, the court rebutted the argument that such a standard would give a surety excessive power by stating what it considered to be the accepted rational that the "expense, delay, trouble, and risk of loss to the guarantee company is a sufficient safeguard against an unwarranted payment." Id. (citing Guarantee Co. of North America v. Pitts, 78 Miss. 837 (1901)). Other cases have clarified this approach. In Elmore v. Morrison Assurance Co., Inc., the Alabama Supreme Court approved the following jury instruction as a fair and accurate summary of the law:

> Lack of good faith carries an implication of a dishonest purpose, a conscious doing of wrong, a breach of a duty through motives of self-interest or ill will. That's what we mean by lack of good faith."
> 502 So.2d 378, 380 n.1 (Ala. 1987)

In other words, while improper motive is an essential element to establish bad faith, some courts do not appear to consider it the equivalent of bad faith and instead also require a showing that the surety consciously committed a wrong, acted with ill will or self-interest, and had a dishonest purpose. While some might consider this to be a semantic argument, courts have decided cases on less, and every available tool should be used to garner recovery for the surety.

The improper motive standard can cover a variety of actions by the surety. The most common improper motive involves actions by the surety that are done solely to protect it. However, even those actions do not always rise to the level of bad faith. Often times, as discussed in Section III (B), a surety is entitled to protect itself without regard to the principal's allegations of bad faith.

B. Bad Faith = Negligence

A smaller number of courts hold the surety's conduct to a far more exacting standard, and find bad faith in instances where the surety's actions were merely unreasonable or negligent. See, e.g., Rush Presbyterian St. Luke's Medical Center v. Safeco Ins. Co. of America, 712 F. Supp. 1344, 1346 (N.D. Ill. 1989) ("negligence and bad faith are synonymous" in the context of determining good faith); Arntz Contracting Co. v. St. Paul Fire & Marine Ins. Co., 47 Cal. App. 4th 464, 483 (Cal. Ct. App. 1996) (surety's bad faith can be demonstrated by proof of "objectively unreasonable conduct, regardless of the actor's motive"); Hawaiian Ins. & Guaranty Co., Ltd. v. Higashi, 67 Haw. 12, 14 (1984) ("burden of establishing that the amount paid in the settlement . . . was reasonable and in good faith [is] upon the indemnitee"); The Hartford v. Tanner, 22 Kan. App. 2d 64, 76 ("good faith requires a surety seeking indemnification to show that its conduct was reasonable") review denied 259 Kan. 927 (1996); Portland v. George D. Ward & Associates, Inc., 89 Or. App. 452, 458 (1988) (to prove bad faith in settling claim, indemnitors "needed only to prove that [the surety] failed 1) to make a reasonable investigation of the validity of the claims against them or 2) to consider reasonably the viability of their counterclaims and defenses, not that [the surety] acted for dishonest purposes or improper motives") review denied 305 Or. 672 (1988).

In Rush Presbyterian, the principals claimed that their surety failed to allege a defense to a bond claim, and that this failure breached the surety's contractual duty of good faith. 712 F. Supp. at 1345. Illustrating the difference between states, the Rush Presbyterian court rejected the surety's argument, which relied on Massachusetts and Alabama law and stated that the principal had to prove improper motives or dishonest conduct to establish bad faith, and instead followed Illinois authority that considers negligence and bad faith synonymous in the surety context. Id. at 1346. The root of this reasoning can be found in the same court's earlier opinion of Windowmaster Corporation v. Morse/Diesel, Inc., 722 F. Supp 1532 (N. D. Ill. 1988), where the court cited two Illinois state court decisions holding that the insuring relationship created by both insurance contracts and surety contracts include fiduciary duties. Neither of these cases attempted to justify the analogy between surety and insurance contracts, but rather tracked surety law back to its genesis - when a surety would indemnify a merchant against loss from the insolvency of customers. See People ex re. Kasson v. Rose, 174 Ill. 310 (1898). Since the Kasson decision was reached, neither the context, nor the applicability of the decision, seem to have been questioned or explained; despite the fact that applying Kasson in a contemporary commercial setting ignores the rights, interests and influences third parties have on suretyship relationships. See PSE Consulting, Inc. v. Frank Mercede and Sons, Inc., et. al., 267 Conn. 279, 317 (Conn. 2004) (recognizing that the tripartite relationship in the surety context creates complex scenarios in which similar actions may lead to different results depending on the circumstances).

Contrasting the negligence standard with the improper motive/dishonest conduct standard can be invaluable in evaluating a bad faith defense against a surety's claim for recovery. Under the improper motive standard, failing to investigate a claim before settling, while not recommended, is not automatically proof of an improper motive. However, if the negligence standard applies, failing to investigate a claim, where doing so would have shown that the claim was meritless, is much more likely to subject the surety to a valid bad faith defense by the principal.

C. Bad Faith = Fraud

The toughest burden for a principal to meet in order to avoid a surety's claim for recovery, and of course the most surety friendly standard, is found in those jurisdictions that apply a fraud standard. These jurisdictions require a showing of common law fraud or collusion before a surety's actions will rise to the level of bad faith. See, e.g., Fireman's Ins. Co. of Newark, New Jersey v. Todesca Equipment Co., 310 F.3d 32, 37 (1st Cir. 2002) (bad faith requires fraud or collusion under Rhode Island law); General Accident Ins. Co. of America v. Merritt-Meridian Construction Corp., 975 F. Supp. 511, 516 (S.D.N.Y. 1997) (a right-to-settle clause in an indemnity agreement is invoked only "in the absence of an indication of fraud or collusion"); Banque Nationale de Paris S.A. v. Ins. Co. of North America, 896 F. Supp. 163, 165 (S.D.N.Y. 1995) (analogizing to the business judgment rule, and ruling that absent self-interest or fraud, surety's decision should be regarded as presumptively correct); Reliance Ins. Co. v. Romine, 707 F. Supp. 550, 552 (S.D. Ga. 1989) (finding that the bad faith standard equated with the arbitrary or capricious standard for proving abuse of discretion), aff'd, 888 F.2d 1344 (11th Cir. 1989).

The court in Fireman's applied state law that permitted no deviation from the stringent language of indemnity agreement. See 310 F.3d at 37 (citing Massachusetts Bonding Insurance Co. v. Gautieri, 69 R. I. 70 (R. I. 1943)). The First Circuit further found that despite surety actions that were probably the equivalent of gross negligence, Id. at 34, the principals would have to allege and prove fraud or collusion to avoid the consequences of their agreement. Id. at 37. Controlling state law had not, and therefore the First Circuit could not, apply common law covenants of good faith of fair delaing as the strict language of the indemnity agreement precluded them. Id.[2]

The fraud standard gives the most latitude to the surety when settling a claim. For example, failing to investigate a claim would only be relevant if the principal could show that the surety deliberately failed to investigate the claim, and did so for fraudulent reasons. The fraud standard gives the surety virtually unfettered discretion to resolve claims without the fear that a principal will be able to later establish a good faith defense to avoid indemnifying the surety.

D. PSE Consulting, Inc. v. Frank Mercede and Sons, Inc., 267 Conn. 279 (2004)

There is some industry concern that PSE Consulting and other recent decisions portend a movement toward a more exacting bad faith standard. In truth, the PSE Consulting Court shot right down the middle. In PSE Consulting, the Connecticut Supreme Court undertook an overview of the state of the law on the bad faith standard. Id. at 282. After considering all three standards, the court determined that it would define surety bad faith as requiring an "improper motive" or "dishonest purpose" on the part of the surety. Id. at 318. The court based its holding in part because this bad faith standard was in accord with the state's definition of bad faith in other situations. See Id. (citing Buckman v. People Express, Inc., 205 Conn. 166, 171 (1987) for the

[2] As noted below in the Harford discussion, where the negligence standard was selected, cases like Fireman's often contain the equivalent of a "conclusive evidence" or prima facie clause and the real issue becomes whether the court applies that clause strictly, as in Fireman's, or whether it finds it unconscionable and applies the states common law standard of good faith in a surety context. See Hartford 22 Kan. App. 2d 73-76 (applying a negligence standard), and PSE Consulting, 267 Conn. at 304-05 (applying the improper motive/dishonest purpose standard).

proposition that the bad faith jury instruction does not include "simply bad judgment or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity . . . it contemplates a state of mind affirmatively operating with furtive design or ill will"). The PSE Consulting court was swayed because it believed the improper purpose/dishonest motive standard "preserves a proper balance between affording the surety the wide discretion to settle that it requires, while ensuring that the principal is protected against serious and willful transgression." Id. at 305.

The court expressly pointed out that the improper purpose/dishonest motive standard does not require that the surety's conduct rises to the level of fraud. The court was quick to highlight this fact because requiring proof of fraud would destroy the protective effect of the covenant of good faith and fair dealing that was implicit in the GIA and explicit in many GIAs. The court also pointed out that good faith did not mean reasonableness; when evaluating a surety's actions, whether the surety's action were reasonable could be considered in analyzing bad faith, but it was not to be determinative. Instead, the PSE Consulting court held that unreasonable conduct is something that could be evidence of improper motive, and is a proper consideration where the contract that binds the parties gives or allows unmitigated discretion to one party. Id.

E. *Right to Settle Clauses*

In what has become an often cited case, the court in Hartford found a clause in a GIA that gave the surety total discretion in handling claims to be effectively the same as a "conclusive evidence clause" (or a prima facie clause), and thus contrary to public policy. Furthermore, such a clause would relegate a court to the ministerial task of entering judgment for the surety. 22 Kan. App. 2d at 73-74 (citations omitted). The court also noted that similar conclusive evidence or prima facie clauses existed in many of the cases that adopted the fraud standard. Id. Hartford, which was a case of first impression on the issue of what surety good faith entails, held that a surety must show its conduct was reasonable when seeking indemnification. Id. at 76. In so holding, however, the court focused solely on the fraud and the negligence standard alternatives, and in rejecting the fraud standard claimed it would leave the principal and claimant at the mercy of the surety's unreasonable conduct. Id. at 77. The Hartford court made one other important finding before selecting the negligence standard, it held that the conclusive evidence clause in the GIA was unconscionable – thus opening the door for implying a good faith duty on the surety under whatever standard the court found appropriate. Id. at 72-73.

In one regard, the Connecticut Supreme Court reached a similar conclusion in PSE Consulting; although that decision did not expressly find the prima facie clause of the indemnity agreement in that instance to be unconscionable, it may as well have when it implied a duty of good faith upon the surety despite the express language of the indemnity agreement. 267 Conn. at 291-93. The Connecticut Supreme Court held, and claimed that most other jurisdictions agreed, that the wide discretion a surety has under the right to settle clause in a GIA is not unfettered and is subject to an implied duty of good faith. Id. at 292-93. While we certainly do not recommend the surety exclude strongly worded right to settle provisions in the GIA, Hartford and PSE Consulting made clear that these provisions will not give the surety cart blanche to act as it chooses – in the claims settlement process.

In many jurisdictions the issue of whether to apply strict right to settle clauses has not been

addressed in the surety context. As noted in Hartford, such instances raise a different issue, that is, whether the state law requires strict adherence to express contract terms, whether it requires a court to find such terms unconscionable, or whether a court will simply choose to ignore the parties' agreed upon terms as in PSE Consulting. In practice, determining the effect a court will give a right to settle clause is a preliminary step before even considering the applicable bad faith standard.[3]

[3] Besides ignoring the option of adopting the improper motive/dishonest conduct alternative, the Hartford court joined the Rush Presbyterian decision in failing to justify its conclusory statement that insurance rules should apply to surety agreements because the areas of law are analogous. 22 Kan. App.2d at 74. Furthermore, the court chastised another decision as being overly broad in this regard, and then did the exact same thing by saying a surety must meet a reasonableness standard to have acted in good faith, thus implying that this standard should apply to all sureties in all contexts. Id. at 75-76. Since its decision, Hartford has been held out as a decision justifying the negligence standard, however, with so many leaps in its logic and reasoning it fails to adequately advocate for that standard.

III. AREAS WHERE BAD FAITH BECOMES AN ISSUE

A. *Investigation of a Claim*

Whether a surety acted in bad faith or good faith often becomes an issue when reviewing the surety's investigation of the claim. While it is not clear how much of an investigation a surety must do, it is clear that it is generally prudent for a surety to do some type of investigation. See, e.g., Continental Casualty Co. v. American Security Corp., 443 F.2d 649, 650 (D.C. Cir. 1970) (upholding summary judgment for surety where uncontradicted affidavits stated that all claims had been paid by surety "in good faith after investigation"), cert. denied, 402 U.S. 907 (1971); Banque Nationale de Paris S.A., 896 F. Supp. at 165 (summary judgment for surety where it was undisputed that surety "investigated and evaluated [the principal's] alleged defenses before settling"); United States v. D Bar D Enterprises, Inc., 772 F. Supp. 1167, 1170 (D. Nev. 1991) (parties seeking payment may expect a surety to settle only after conducting a reasonable investigation of claims, counterclaims, and possible defenses); Portland v. George D. Ward & Associates, Inc., 89 Or. App. 452, 457-58 (Or. Ct. App. 1988) (parties to indemnity agreement that assigned the right to compromise claims against the principal to the sole discretion of the surety must reasonably expect compromise and payment to be made only after investigation of claims, counterclaims and defenses asserted in underlying action). However, the following cases make clear that a shoddy investigation, by itself, will not support a bad faith defense. See, e.g., Frontier Ins. Co., 124 F. Supp. 2d at 1214 (allegations that a surety negligently investigated claims does not constitute bad faith in suretyship context where undisputed evidence showed good faith); Feibus, 15 F. Supp. 2d at 587 (rejecting principals' argument that surety had acted in bad faith where principals failed to submit evidence of dishonest purpose or improper motive in surety's failure to investigate claims); M. Klinger, G. Judd & G. Bachrach, The Surety's Indemnity Agreement: Law and Practice (2002) pp. 174-75 ("Cases addressing whether the surety exercised its settlement discretion in good faith . . . usually focus on the surety's claim handling activities. Factors courts consider include . . . whether the surety reasonably investigated the claim . . . ."); E. Gallagher, Suretyship (2d Ed. 2000) p. 497 (same); J. Hinchey, supra, 22 Tort & Ins. L.J. 149, citing Maryland Casualty Co. v. R & L Construction Co., 368 S.W.2d 134, 135 (Tex. App. 1963) ("the thoroughness of the investigation performed by the surety" is one factor to be considering in determining whether surety has settled in good faith).

In most jurisdictions, a surety's failure to investigate a claim as a reasonably prudent person would generally not be enough to constitute bad faith when standing alone. However, if other evidence of bad faith exists, the failure to investigate a claim before settling will prove troublesome to the surety's claim. As previously mentioned, if the negligence standard of bad faith applies, the failure to investigate by itself could prevent recovery. If a surety intentionally fails to investigate and chooses to remain ignorant because the surety believes an investigation would reveal facts which support the principal's defenses, the surety may be found to have acted in bad faith. See Funding Consultants, Inc. v. Aetna Casualty & Surety Co., 187 Conn. 637, 644 (1982); superceded on other grounds by the 1991 revisions to Article 3 of the UCC as noted in Champaigne v. Scarso, 1999 WL 54851, (Conn. Super. Jan. 27, 1999). Therefore, a court may consider a surety's failure to conduct an adequate investigation of a claim upon a payment bond, and if the surety's failure can be shown to have been intentional and motivated by a desire to avoid meritorious issues, it may lead to a finding of bad faith on the surety's part.

B. Settlement Motives

Another area where a surety's actions often bring on a bad faith defense is where a principal challenges a surety's motives for settling a claim. Many times, a surety settles a claim for its own motives, motives that may not be related to any defenses of the underlying claim. The case that is most often cited in regard to the issue of self-interested settlement is Fidelity & Deposit Co. of Maryland v. Bristol Steel & Iron Works, Inc., 722 F.2d 1160 (4th Cir. 1983). In Fidelity, the United States Court of Appeals for the Fourth Circuit held that sureties were entitled to indemnification for a settlement even though the sureties reached their decision to settle solely to protect their own self-interests. Id. at 1165. The sureties had originally asserted the principal's defenses and disputed a claim on a performance bond. Id. at 1164. However, in response to the sureties' action, the Pennsylvania DOT, which was the original party to the construction contract with the principal, declared the principal and its sureties in default on the construction contract. Id. Additionally, the Pennsylvania DOT disqualified the sureties from issuing bonds on any of its subsequent construction projects. Id. Faced with being blacklisted, the sureties settled. The trial court awarded the sureties indemnification, and the Fourth Circuit affirmed, stating that it could find "no justification for a finding of bad faith or fraud simply because [the sureties] made the payment to secure their removal from [the Pennsylvania DOT's] blacklist as a surety on road work in Pennsylvania." Id. at 1165.

The court in Fidelity started out by reciting the basic rule that applies to sureties: sureties must be indemnified for payments made in good faith. Despite the broad language of this statement, the facts of Fidelity suggest that it cannot be broadly applied in other cases. In Fidelity, there was no other evidence, besides the sureties' desire to obtain removal from the Pennsylvania's DOT's blacklist, that they settled the claims for an improper motive or dishonest purpose. Additionally, the principal was aware of the sureties' payment and settlement of the claims and never objected to either. Id. Actually, the principal acknowledged in a letter that the sureties' actions were reasonable under the circumstances, and the sureties did not pay the claims until after they received this letter. Id. at 1165. Accordingly, it is not surprising that the court in Fidelity held that the sureties did not act in bad faith because aside from the self-interest of the settlement, the principal had no other evidence of bad faith and had acknowledged that the settlements were reasonable.

The facts of Fidelity will be distinguishable from many cases. Obviously, if the principal is aware of and consents to the payment, a claim for bad faith settlement against the surety will be very weak. However, it is more likely the principal will be either unaware of the settlement payments, or once the principal becomes aware of the payments, will object to such payments immediately. In a case where the principal objects to a surety's settlement and apprises the surety of possible defenses, the surety's settlement is far more likely to face a bad faith claim.

Because a surety will often face a defense when it has settled a case for its own purposes, it will often be caught between a proverbial rock and a hard place. In this situation, the individual case will determine the outcome. However, while self-interested settlements may constitute evidence of bad faith in some circumstances, a self-interested settlement will in no way constitute a per se bad faith tactic. See Arntz Contracting Co., 47 Cal. App. 4th at 485-86 ("[a] surety's exposure to . . . [a] bad faith claim may be a reasonable ground for settling bond litigation that will not preclude indemnification").

In evaluating any settlement, courts should be mindful of the public policy supporting the discretion afforded a surety under an indemnity agreement. GIAs make it possible for a surety to compensate unpaid subcontractors and vendors, or to complete a project in response to a performance bond claim, without having to await the adjudication of every possible defense by the principal. See, e.g., Transamerica Ins. Co. v. Bloomfield, 401 F.2d 357, 363 (6th Cir. 1968) (finding that indemnity agreements are intended to facilitate settlements and provide sureties with protection from unnecessary litigation).

Despite the latitude afforded sureties when settling claims, even in those settled in their own self-interest, many cases approve those settlements by finding that the settlement was in some way done in good faith. See, e.g., Gundle Lining Construction Corp. v. Adams County Asphalt, Inc., 85 F.3d 201, 210 (surety did not act in bad faith by settling claim when principal refused to cooperate); Bloomfield, 401 F.2d at 362 ("the surety had the right to settle and compromise the claims which were asserted against it but in so doing it was required to act in good faith"); Feibus, 15 F. Supp. 2d at 586 (upholding surety's right to indemnification "for claims paid to protect its own interests, as long as the payments were made in good faith"); Employers Ins. of Wausau, 749 F. Supp. At 1103 (surety did not act in bad faith by settling claims where principal failed to request that surety litigate claims or post collateral to cover legal expenses as required under indemnity agreement); Windowmaster Corp. v. Morse/Diesel, Inc., 722 F. Supp. 1532, 1534 (N.D. Ill. 1988) (surety had exclusive right "to determine in good faith how to handle suits upon validly issued bonds"); Arntz Contracting Co., 47 Cal. App. 4th at 486 ("it is certainly true that indemnification is not precluded just because a surety is motivated to settle a case 'for its own benefit'"); Safeco Ins. Co. of America v. Gaubert, 829 S.W.2d 274, 282 (Tex. App. 1992) ("as long as [the surety] acted in 'good faith,' its determination [to settle] would have been 'final and conclusive'").

IV AVOIDING A GOOD FAITH/BAD FAITH DEFENSE TO RECOVERY

There is no set formula to follow that will completely protect the surety from facing a defense that they did not settle a claim in good faith, or acted in bad faith. If the principal objects to the settlement, the surety is likely to see a bad faith argument. In avoiding a bad faith assertion from the principal, the following should prove helpful:

- Investigation of the claim. There is no standard on how much time must be spent investigating a claim, and what must be done in investigating the claim can vary from state to state. Obviously, if the principal advises the surety of defenses to the claims, investigation of those matters becomes important. For instance, ignoring amounts in controversy that the principal disputes under a bond increases the strength of a later asserted bad faith settlement defense. Additionally, while a principal’s failure to produce collateral can help defeat a bad faith defense, a surety’s demand for unreasonable collateral can just as easily strengthen the defense.

- Honestly evaluate settlement motives. If the surety’s settlement is based to some degree on self-interest, the surety must be mindful of that influence and evaluate the overall circumstances objectively in light of other interests that exist. Simply volunteering payment in response to claims, where there is no legal responsibility to do so under the bond will strengthen a bad faith defense. Additionally, settling solely out of a fear of exposure to causes of action from third parties, or insurance commissions,

can bolster a bad faith defense.

- Documentation, Documentation, Documentation. Lastly, it is always important to document what was done via e-mails, letters, memorandums, and/or other record keeping. If a lawsuit arises, documents become very important. A surety's testimony that he did a variety of things to investigate the claim without proper documentation will not hold a candle to another surety who is deposed and sets forth what he did for his investigation of the claim and then produces the documents that support the testimony. As noted in Feibus, documentation of a surety's repeated attempts to communicate with a principle regarding the settlement of disputes can in large measure defeat a principal's assertion that the surety acted in bad faith. 15 F. Supp. 2d at 587.