

**EIGHTEENTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
CONFERENCE**

New Orleans, Louisiana
APRIL 12TH & 13TH, 2007

**INDEMNITY WORKOUTS USING THE PRINCIPAL'S
AFFIRMATIVE CLAIMS- DEAL POINTS AND PRACTICAL TIPS**

PRESENTED BY:

**AARON L. BLANKENSHIP, ESQ.
TRAVELERS BOND AND FINANCIAL PRODUCTS
PATRICK E. GAAS, ESQ., DIRECTOR
COATS, ROSE, YALE, RYMAN & LEE, PC
3 E. Greenway Plaza, Suite 2000
Houston, TX 77046
(713) 653-7387
pgaas@coatsrose.com**

PATRICK E. GAAS is a Director in the law firm of Coats Rose Yale Ryman & Lee, P.C., with offices located in Houston, Austin, Dallas, San Antonio, and New Orleans. He was admitted to practice in Texas in 1988. He received his B.B.A. (Cum Laude) from Texas A&M University in 1985 and his law degree from the University of Texas School of Law (with Honors) in 1988. Mr. Gaas possesses considerable experience serving the construction and surety industries. Mr. Gaas is also a member of the Houston Bar Association, Texas Bar Association, and American Bar Association. Mr. Gaas is admitted to practice in all State and United States District Courts for the Southern, Northern, Western and Eastern Districts of Texas, as well as the Second, Fifth, and Ninth U.S. Circuit Courts of Appeal and the U.S. Supreme Court. He has handled disputes throughout the United States in several state and federal courts, and internationally. Mr. Gaas publishes and speaks regularly on important industry topics and was recently honored by Texas Monthly magazine as a *Texas Super Lawyer* in 2005 and again in 2006.

AARON L. BLANKENSHIP is an attorney with Travelers Bond & Financial Products. He serves as counsel to Travelers' Construction Services National Account Unit, which handles approximately 50 of Travelers' largest construction accounts. Mr. Blankenship advises underwriting personnel on contracting and bonding issues, and he also manages a broad spectrum of payment and performance bond claims. He currently works out of Travelers' Hartford, Connecticut home office. Prior to joining Travelers, Mr. Blankenship was in private practice in the Pacific Northwest. He became a member of the Oregon State Bar in 1999 and the Washington State Bar in 2000. While in private practice, Mr. Blankenship represented general contractors, subcontractors, material and equipment suppliers and developers. Mr. Blankenship received his undergraduate degree in political science from Linfield College and his law degree from Lewis & Clark College.

Introduction

At some point, the surety on a construction project may find itself at a crossroads of sorts. Consider for a moment that you, as the surety, have a principal on the brink of bankruptcy, there is an unfinished contract that suffers from substantial delays, an owner who has not paid your principal in over a year, you face an increasingly large number of payment bond claims, and the probability that the surety will incur a loss is high. Will you assist your principal? If so, what do you need to consider beforehand so that you can weigh your potential losses against your potential gains? This paper discusses evaluating the principal's claims, along with the deal points, practical problems, and a few practice tips to consider when presented with such a situation.

Evaluating the Principal's Claims

When a surety finds itself in the middle of a troubled construction project, it must consider what evidence it may need to assert its principal's affirmative claims, whether against the owner or otherwise. Given the complicated nature of construction litigation, proving such claims can be a daunting task. To evaluate its position then and in the foreseeable future, the surety may look to several sources for the information it needs to investigate and prove the principal's claims.

The principal's cooperation in the surety's efforts is crucial to the surety's ability to prove what happened on the job prior to the surety's involvement. First, the surety should gain access to, secure and review the principal's project documents. Next, the surety should interview the principal's construction managers and key job site employees. If the principal is struggling, it may be less than forthcoming, making this very difficult. However, before a surety contemplates potential deal points, begins negotiations or enters into any type of cooperative arrangements, it must evaluate and assess the value of the principal's claims and the likelihood of successfully prosecuting the principal's claims. The surety should not pursue its principal's claims unless it is confident that the claims are worth its time, expense, and aggravation.

Aside from gathering information from the principal itself, consulting experts can provide educated, accurate, and objective opinions of whether the surety has any viable claims worth asserting against the owner. Types of consulting experts that can provide much needed opinions include architects, engineers, accountants, and other specialized consultants familiar with the construction industry. If the principal is in dire need of assistance, it will more than likely describe the events surrounding the construction project in a favorable way. The principal will not view the situation from the owner's perspective, and may be overly optimistic about the viability and value of its claims. An independent consultant can furnish the much needed objectivity required in evaluating the principal's claims.

In addition, the surety should select an expert who is technically proficient and experienced as a witness. The expert must provide correct and accurate analysis and be capable of credibly explaining complex issues during the stress of a trial. The expert's experience against *Daubert* and similar challenges should be examined. The cost of an expert's time is also a consideration. If the surety is in the situation of completely financing the efforts in order to keep the principal afloat, the surety needs to be wary of how quickly litigation costs accumulate.

Further, the principal's failure to comply with various contract provisions may limit or nullify the principal's affirmative claims. Therefore, before the surety moves forward, it must review the requirements of the underlying contract carefully. For instance, construction contracts typically contain very detailed notice and claim provisions.

Notice Provisions

To a certain extent, it seems that provisions obligating a contractor to present claims to the owner promptly would be a welcome tool for facilitating prompt resolution and payment, not a bar to collection. However, in practice, many contractors find that notice provisions and related claim submission procedures obstruct rather than facilitate resolutions.

A contractor who fails to monitor the project constantly may find that it performed additional work without giving required notices necessary to preserve its claim. Thus, it is essential for the surety to review the contractual notice provisions during its claims investigations so that it can assess whether the contractor was in compliance. A principal that fails to comply with the notice provisions may waive its claims and right to recovery.

Interestingly, notice provisions may bind both the owner and the contractor. The AIA General Conditions obligate both the owner and the contractor to initiate their respective claims "within 21 days after the event giving rise to such claim or within 21 days after the claimant first recognizes the conditions giving rise to the claim, whichever is later."¹ This language recognizes that there may be significant delays between the occurrence of the events giving rise to a claim and the affected party's recognition that the claim exists. Pending final resolution of the claim, the contractor is to continue to proceed with the work and the owner is obligated to continue to make payments in accordance with the contract documents.² As a result, the principal's claims against the owner may be stronger if the owner did not comply with the contractual notice provisions.

While consistent with the contractor's best interests, compliance with notice provisions is not easy. Contractors often face pressure to just get the work done and leave the paper work for later. The Owner's project managers, representatives or construction managers may succeed in persuading the contractor to forge ahead with the additional work to avoid project delays. While the urgent pleas of the owner's representative may seem to the contractor like a waiver of the contract notice requirements, once the contractor completes the work, the owner and its representative may not agree. If the contract contains specific notice requirements that the contractor must satisfy, the surety must understand the risks of noncompliance.

No-Damage-for-Delay Clauses

In construction, additional time is likely to translate into additional costs for the contractor. Problems arise because not all delay costs are compensable. A contractor assumes full responsibility for project delays due to causes that it could reasonably anticipate, expect or control, like lead time for ordering materials, typical weather conditions or hiring sufficient qualified personnel to do the work.

However, many project delays are attributable to factors that the owner controls. These factors may include the owner's delay in issuing a notice to proceed, providing access to the job site, delivering project plans and specifications, arranging for corrections of design

errors, the design team's delay in responding to requests for information or processing submittals, late delivery of owner supplied materials, the owner's failure to obtain permits which were its responsibility or to coordinate the activities of the contractors which it hired directly.

A no-damage-for-delay clause recognizes that these potential causes of delay could excusably prevent the contractor from completing its work on schedule, and obligates the contractor to agree that if such delays occur due to causes outside the contractor's control, its sole remedy is an extension of time.³ Usually, if the contract does not bar recovery and factors outside the contractor's control delay the project, the contractor's delay claims should succeed.⁴ Thus, in evaluating claims, the surety may need to investigate whether the project incurred any delays attributable to the contractor, and whether the contract contains an enforceable no-damage-for-delay clause.

Waiver of Consequential Damages Clause

Another contractual provision that may affect a potential recovery by the surety is a waiver of consequential damages. The provision may waive damages incurred by the contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit except anticipated profit arising directly from the work.⁵ Therefore, it would be prudent for the surety to be able to recognize this provision and its potential effect on any claims, especially if the contract is a product of creative drafting.

Differing Site Conditions Clause

Unanticipated site conditions are a significant factor that can increase the cost and time of a contractor's performance. Contractors should know that even with standard agreements, they are assuming a degree of risk related to what lies beneath the surface, but many contracts shift more risk to the contractor by requiring it to assume additional responsibility in connection with its preconstruction investigation of the site.⁶

Typically contractors can recover costs associated with site conditions that differ from the conditions described in the contract documents; however, most construction contracts require the contractor to diligently apply its knowledge and experience in becoming familiar with the project site and the contract documents.⁷ The basis of a claim for differing site conditions must be an unexpected condition that the contractor could not have anticipated reasonably.

Generally, a contractor is responsible for reviewing and analyzing the contract documents and test results the owner makes available before construction commences. Increased costs associated with differing site conditions is another factor that the surety should be aware of when it evaluates claims, otherwise its determination of the value of a claim may be inaccurate.

Contractual ADR Provisions

Due to the high costs and duration of construction litigation, owners often seek to shorten the process by including an alternative dispute resolution ("ADR") clause in the

contract, which establishes a preliminary claim procedure that the contractor must follow before going to court or arbitration. These provisions seek to provide a mechanism for promptly raising and resolving claims while work moves forward. Contractors familiar with the AIA documents are aware of the provisions which require that all claims be presented to the project architect for an “initial decision” as a “condition precedent to mediation, arbitration or litigation of all claims between the Contractor and Owner arising prior to the date final payment is due; . . .”⁸ If the architect does not render a decision within thirty days, this requirement is waived; and, in any event, if the owner or contractor are dissatisfied with the decision, they may move on to another forum.⁹ Because of the impact this type of “condition precedent” language has on claim viability, the surety must be aware of these types of clauses.

Deal Points and Practical Problems

Notwithstanding the surety’s subrogation and contract rights, the surety should not assume that the principal will live up to past assurances. This is especially true when the surety’s relationship with its principal deteriorates before the surety needs the principal’s help. Giving the principal sufficient reasons to provide timely and effective cooperation may require creative negotiations. However achieved, it is a good idea for the surety to negotiate a freestanding agreement between itself and the principal that defines the level of cooperation the principal must provide. In addition to potentially enhancing the surety’s rights, such agreements can increase the principal’s emotional commitment to the process of assisting the surety.

First, one deal point that may be crucial from the inception of negotiations is how to define the principal’s level of “cooperation.” If the parties agree that the principal will have a high level of cooperation, contractual provisions may include requiring the principal to provide all of its documents and records, making all of its personnel available before and during the litigation process, and other types of assistance in formulating the litigation strategy.

Other types of deal points involved with an agreement of this type may relate to the surety’s exact role in the process. One issue may be whether the surety can pursue its own claims along with the principal’s claims. Also, can the surety prosecute the claims of or pursue claims against “downstream entities” such as subcontractors, suppliers, or claims against lenders, architects, or engineers? More importantly, the parties may want to specify whether the surety must be involved for the entire duration of the claim prosecution, or whether it can walk away should it deem that to be its best option. Further, can the surety still settle the principal’s claims on its own or must it involve the principal in any settlement negotiations?

Other points to consider involve the issues of attorney client privilege and confidentiality. A provision may be included in the cooperation agreement ensuring privilege and confidentiality; however, this may be a difficult issue especially if the parties are still contemplating the possibility of bringing claims against each other in the future. With that in mind, the parties may negotiate whether any releases will be included in the cooperation agreement. Of course the parties may agree to either provide no releases of any kind, have the principal release its claims against the surety, have the surety release its claims against the principal or possibly modify it’s the principal’s indemnification obligations, or agree that both the principal and surety will mutually release their claims against each other.

Finally, the parties will need to address how the surety and the principal negotiate, collect and distribute any recovered funds. Deal points may include whether the principal will share in any potential recovery the surety may obtain beyond its initial loss, and the precise arrangement for the payment of attorney's fees and other litigation costs and expenses. In the event that there is some sort of disagreement between the principal and the surety regarding the recovery and/or disbursement of funds, the parties may want to include a provision that would provide the parties with a type of claim resolution. For example, with respect to the disbursement of funds by the surety, will its decision be final or will the principal and surety be required to resolve any dispute through mediation, arbitration or litigation?

In addition, negotiations with the principal to ensure its cooperation may not be without its share of other complicated issues. For example, consider a situation where the principal is struggling financially, and the surety can only secure the principal's much needed assistance by keeping the principal afloat until the surety resolve the principal's claims. Key issues include: i) the existence of other projects on which the principal needs financial assistance; ii) whether the surety's financial assistance includes the payment of taxes or other current debts; iii) the need to maintain friendly creditor relations with the principal's bankers, landlords and vendors; and iv) the impact a surety request for collateral may have on the principal's creditors.

Practical Tips

It is well known that the surety is solely responsible for mitigating its losses. Therefore, it is important for the surety to keep a few practical tips in mind when mulling over what to do with its troubled principal's claims.

First, the surety should determine the potential downside if the principal defaults. Will the surety lose a valuable account, have to assume unfinished bonded work, battle project owners over unexpended contract balances, battle other indemnitors for reimbursement of costs, or will there be a complete loss with no chance of recovery?

The surety should also evaluate whether the principal is healthy enough to prosecute a claim on its own. The principal may ask the surety to provide completion assistance on projects unrelated to the claim, service debts to maintain creditor relations, or pay the principal's federal, state, and/or local taxes. Therefore, the surety should consider requesting security from the principal, and the surety must also consider whether its intervention may cause the principal to run afoul of any existing obligations.

Before you fund or begin to prosecute claims, consider entering into a written cooperation agreement with the principal. The surety also needs to determine the viability of the principal's claims. When evaluating claims, always try to be objective and avoid overly optimistic claim valuations, skewed document interpretation, and discounted levels of fault. For a viable claim, consider the burden of proof. Overcoming that burden may require the retention of expensive experts and consultants such as architects, engineers, accountants, and other specialized consultants.

With that in mind, consider the expense and potential length of litigation. Not only must a surety absorb the typical litigation costs and expenses, but it may also be asked to pay for the salaries of certain managers, accountants, bookkeepers, and attorneys during litigation.

Finally, the surety should always consider the potential defenses and counterclaims the owner may have, as well as the possibility of any contractual roadblocks. Even if the surety can prove the claims, there still may be some type of bar to recovery. Also, the owner may bring counterclaims such as breach of contract or negligence, or there may be additional damages stemming from project delays. The existence of viable defenses and/or counterclaims may defeat or totally offset any potential recovery that the surety expects to receive.

¹ AIA A201 ¶ 4.3.2 (1997).

² AIA A201 ¶ 4.3.3 (1997).

³ AIA A201 ¶ 8.3.1 (1997).

⁴ AIA A201 ¶ 8.3.3 (1997).

⁵ AIA A201 ¶ 4.3.10 (1997).

⁶ AIA A201 ¶ 3.2.3 (1997).

⁷ AIA A201 ¶ 3.2 (1997).

⁸ AIA A201 ¶ 4.4.1 (1997).

⁹ AIA A201 ¶¶ 4.4.1, 4.4.5 (1997).