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**FORCED ARBITRATION OVER THE GAI: WHERE DO THEY COME
UP WITH THIS STUFF?**

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INTRODUCTION

You might know that a large number of courts bind a surety to arbitrate performance-bond disputes if the bond incorporates by reference a contract containing an arbitration clause. While such a result calls into question just how voluntary arbitration really is these days, at least the courts can argue the presumption that the surety knew what it was bonding and that the bonded contract required arbitration. A takeover agreement that, of necessity, defines its scope in relation to the bonded contract can be argued the same way: if the surety incorporates the bonded contract containing an arbitration clause, the takeover agreement can provide a basis for requiring the surety to arbitrate disputes with the obligee. (For a more in-depth discussion of arbitration and the performance-bond surety, see "Arbitration and the Performance-Bond Surety," Surety Claims Institute (2006).)

The General Agreement of Indemnity ("GAI") also is connected in some ways to the performance bond and the bonded contract. Almost always, the loss and expense covered by the GAI will have been incurred in connection with (actual or alleged) claims or defaults under the bonded contract, which may contain an arbitration clause. In fact, the GAI expressly references both the bonds issued by the surety on behalf of the principal and the bonded contracts into which the principal enters. Some of the indemnitors' obligations do not arise from or relate to bonded contracts, but most do. Still, no reported decision, or known unreported decision, ever has required the surety to arbitrate its claims for indemnification under the GAI.

That has not stopped creative and litigious indemnitors from trying. At least one court has allowed arbitration to delay, albeit not entirely replace, indemnity litigation, so this subject is not merely hypothetical. What follows are indemnitors' arguments, and the surety's counterarguments, over whether or not the indemnitors can force the surety to arbitrate disputes under the GAI in the absence of some other express agreement to do so.

ARGUMENTS PRO AND CON ON ARBITRATING UNDER THE GAI

1. Incorporation By Reference Of An Arbitration Clause

When a surety incorporates an arbitration clause into its undertakings, courts have bound the incorporating surety to arbitrate with the other party to the agreement containing the clause. *Employers Insurance of Wausau v. Bright Metal Specialties, Inc.*, 251 F.3d 1316 (11th Cir. 2001) (ratification agreement incorporated subcontract's arbitration clause, surety obligated to arbitrate under the subcontract with that subcontractor); *United States Fidelity & Guaranty Co. v. West Point Construction Co., Inc.*, 837 F.2d 1507 (11th Cir. 1988) (performance bond incorporated contract with arbitration clause, surety must arbitrate under that contract with obligee); *Transamerica Premier Insurance Co. v. Collins & Co., General Contractors, Inc.*, 735 F. Supp. 1050 (N.D. Ga. 1990) (subcontract performance bond incorporated subcontract with arbitration clause, surety must arbitrate with subcontractor).

Indemnitors have tried to leap from that principle to conclude that the construction contract's arbitration clause requires the surety to arbitrate disputes with them under the GAI. Such a leap has no legal support, no precedent, and no logic. First, the issues that would be arbitrated under the construction contract (breach and damages) are different from those under the GAI (surety's loss under the bond and its good faith). Who breached the construction contract, how much in damages resulted from that breach or breaches, whether subcontractors or the architect contributed to the damages—all of these may be questions relevant to liability under the construction contract, but they are not relevant to the indemnitors' liability under the GAI.

This is so because a surety's recovery under its indemnity agreement does not depend on being right about who breached the bonded contract or about how much money should be spent in responding to a claim on the bond. In the absence of bad faith, the surety is entitled to recover whatever it spent by reason of having issued the bond. *Transamerica Insurance Co. v. HVAC-Contractors, Inc.*, 857 F. Supp. 969 (N.D. Ga. 1994) (Carnes, J.); and *Reliance Insurance Co. v. Romine*, 707 F. Supp. 550 (S.D. Ga. 1989), *aff'd*, 888 F.2d 1344 (11th Cir. 1990). No GAI ties the surety's rights to a final determination of the rights and obligations of the parties to the construction contract. Arbitration between the owner and bonded contractor, or between a contractor and subcontractor, decides the issues between those parties but not whether and what the surety may recover from its indemnitors.

The issues for resolution between the indemnitors and the surety are the amounts the surety spent completing its principal's bonded projects or paying the bills and whether or not the surety acted in bad faith in spending those amounts. Those issues have nothing to do with who breached the construction contract, what damages were caused by breaches by either party, whether either of those parties (or even the surety) owes anything to the other under that contract or the bond, or any other question subject to the arbitration clause in the construction contract. The surety's obligation to arbitrate claims under the construction contract does not create any duty to arbitrate the different issues under the GAI. The surety never signed any agreement containing a clause agreeing to arbitrate those different GAI issues.

2. Relationships Of The Parties And Other Agreements

A court could become confused if the owner/obligee, the principal/contractor, and the surety already are engaged in arbitration over liability under the bonded contract and the bond. If the indemnitors, one of whom is the principal, simultaneously seek to force the surety to join its GAI claims or respond to the indemnitors' defenses in the arbitration, the court may consider the facts to be so closely linked that joinder makes sense. Keeping the underlying issues straight is necessary to explaining that the outcome under the construction contract does not determine anything about amounts the surety already has incurred or otherwise is entitled to recover under the GAI regardless of a future award for or against its principal.

Suppose the indemnitors argue that they should not be required to deal with the surety's indemnity claims until the principal's rights and defenses under the construction contract have been determined in arbitration with the owner? If the surety already has incurred losses and expenses, the short answer is that no future resolution between the principal and the obligee will affect the indemnitors' obligation to repay the surety for those past amounts. Even if the surety is compelled to arbitrate with the obligee and does not yet know its ultimate liability on the bond, most GAI's require indemnitors to post collateral upon demand as soon as a bond

claim is made. The surety is not required to wait to obtain a judgment, and its priority for collection purposes, just because further events may affect the indemnitors' liability. Again, what the indemnitors have agreed to do for the surety is not entirely dependent on what the surety at the end is found liable to do for the obligee.

Even where other arbitration agreements come into play, the parties are different. The obligee may be able to compel principal and surety to arbitrate claims under the construction contract (subject to other defenses), but that vests no rights in individual indemnitors. Moreover, the obligee and its architect may be required to arbitrate under their separate contract, or subcontractors may be able to arbitrate with the principal contractor, but the indemnitors likewise have no standing to assert any of those parties' rights. Just because arbitration clauses may bind some of the parties to that form of dispute resolution, most of those parties are not subject to the GAI, and the surety is not subject to any of those parties' arbitration agreements. No authority supports dumping everyone in the same pot, disregarding their individual rights and agreements, and letting arbitrators sort it all out.

3. Alter Ego/Successor Theory

If the principal can require arbitration of disputes under the construction contract, the indemnitors may argue that they are closely linked to the principal and should be entitled to assert the same rights. The indemnitors and principal might even agree among themselves to arbitrate any issues arising under the GAI. (Such an agreement could be part of a strategy to ensnare the surety into arbitration.) Of course, in neither case would the surety have agreed to subject its rights under the GAI to arbitration, and certainly not just because the principal would be arbitrating about the contract or the GAI.

The indemnitors might try to argue that the surety, especially if it was required to pay or perform under the bond on behalf of the principal, became the principal's alter ego or successor and therefore is required to arbitrate because of the principal's agreement to do so. A surety who has entered into a takeover agreement in particular could face this argument, because that surety may have undertaken to perform for the obligee every duty owed by the principal. The surety may be overseeing the work (through a consultant), signing change orders and payment applications, buying materials and hiring others to perform labor, and attending jobsite meetings. The surety might actually be signing documents in its principal's name by virtue of the power of attorney in the GAI. A court, looking at the surety's actions and agreements, easily could be swayed by how much like the principal/contractor the surety has become. If the principal must arbitrate, the court might conclude that the surety must as well.

A surety has the duty, when its bond conditions are met, to perform its principal's obligations—in this case, to complete a construction contract. By no authority does that make the surety the principal's alter ego. The alter ego doctrine applies when one entity is a mere conduit or instrumentality for the actions of another. "Under the alter ego doctrine, equitable principles are used to disregard the separate and distinct legal existence possessed by a corporation where it is established that the corporation served as a mere alter ego or business conduit of another." *Kissun v. Humana Corp.*, 479 S.E.2d 751, 752 (Ga. 1997) (noting that veil-piercing, agency, and alter ego are related doctrines). Principal and surety share liability to a certain extent, but the surety is not a conduit or instrumentality for the principal's actions, and thus not an alter ego.

A surety's liability is not identical to that of its principal. The surety may not assert the principal's personal defenses, such as infancy, incapacity, or discharge in bankruptcy. *Hardaway Co. v. Amwest Surety Insurance Co.*, 436 S.E.2d 642, 644 (Ga. 1993). Sureties also have defenses that their principals cannot assert, most notably discharge by increased risk. Therefore, the scope of liability of principal and surety will not always be identical. The bond may require a surety to complete the principal's contract obligations, but that does not turn the surety into the principal or make the two alter egos.

The surety does not become its principal, as the indemnitors might assert, but remains at all times the completing surety subject to the terms of the takeover agreement and the bond. Undertaking to complete the principal's duties, as required by the bond, cannot somehow turn the surety into its principal's alter ego so that the surety loses all of its rights and defenses, notwithstanding the common and express reservation of those same rights and defenses. A contrary result would be unprecedented and the mischief difficult to imagine.

4. Equitable Estoppel Based On Principal's Bonded Contract

Indemnitors may look to cases in other contexts where the courts have recognized exceptions to the general requirement that a party must have agreed to arbitrate before it can be compelled to do so. Incorporation by reference and alter ego are two such exceptions, but the broadest is equitable estoppel. In some cases, a party may act in such a way as to subject itself to arbitrate with an entity who otherwise would have no right to demand arbitration.

That was the theory in *MS Dealer Service Corp. v. Franklin*, 177 F.3d 942 (11th Cir. 1999), where the plaintiff's claims in fact depended on an arbitrable contract with the defendant, so that the plaintiff was estopped from litigating. To the same effect was *Sunkist Soft Drinks, Inc. v. Sunkist Growers, Inc.*, 10 F.3d 753 (11th Cir. 1993), where the signatory to the arbitration clause could not even prosecute claims against the non-signatory without relying on the contract containing that clause. The same point repeats in *McBro Planning & Development Co. v. Triangle Electric Construction Co.*, 741 F.2d 342 (11th Cir. 1984), which estopped an electrical contractor from litigating against the owner's construction manager for breach of duties assigned by the owner under the arbitrable contract with the contractor.

In *Lankford v. Orkin Exterminating Co., Inc.*, 597 S.E.2d 470 (Ga. App. 2004), the defendant's parent was allowed to rely on its wholly-owned subsidiary's arbitration agreement where the plaintiff's claims depended on that very agreement. The plaintiff could not rely on rights subject to arbitration without being estopped to deny the arbitrability of those same rights. In *Paine, Webber, Jackson & Curtis v. McNeal*, 239 S.E.2d 401 (Ga. App. 1977), the court expressly disregarded all federal law (except that of the United States Supreme Court), including an on-point case in the Northern District of Georgia, to allow a non-signatory to join an arbitration. There, the court allowed a joint-tortfeasor account representative to join a securities arbitration, if compelled, between his joint-tortfeasor principal and his customer, who was subject to arbitration.

In each of these cases, the party asserting rights subject to arbitration was required to honor its agreement to arbitrate, even though the other party was not a signatory. A signatory relying on an arbitrable contract was required by equitable estoppel to arbitrate its claims with a non-signatory whose liability could not be established without the arbitrable contract. Those cases have nothing to do with the surety's rights under its GAI, in which the surety never

agreed to arbitrate anything. Equitable estoppel cannot be applied to compel the surety to arbitrate under an agreement containing no arbitration clause. The surety is not relying on an arbitrable agreement and has done nothing to justify imposition by equity of an involuntary duty to arbitrate.

5. Presumed Lack Of Prejudice By Requiring Surety To Arbitrate

If indemnitors attempt to compel the surety to arbitrate, the surety may be forced to seek a stay or injunction of arbitration. If the surety sues the indemnitors in court, they may seek a stay of litigation. The cases addressing this type of issue have not focused on the general injunction standard, probably because of the more specific holdings that a party cannot be compelled to arbitrate absent agreement or one of the limited, recognized legal exceptions, as noted above. For example, courts regularly have addressed the question of staying or compelling arbitration without engaging in examination of the elements normally required for an injunction. See *Honor, Townsend & Kent, Inc. v. Hamilton*, No. 1:02-CV-2979-JEC, 2003 WL 23832424 (N.D. Ga. Sept. 29, 2003), and 2004 WL 2284503 (N.D. Ga. Sept. 30, 2004), and *Societe Generale de Surveillance, S.A. v. Raytheon European Management and Systems Co.*, 643 F.2d 863, 868 (1st Cir. 1981), cited with approval in *Industrial Risk Insurers v. M.A.N. Gutehoffnungshutte GmbH*, 141 F.3d 1434, 1449 (11th Cir. 1998).

Nevertheless, a surety can satisfy the general injunction standard if it even is applicable to staying arbitration. The surety has a likelihood of success on the merits due to the absence of an agreement to arbitrate under the GAI and the failure of any alternative theory to compel the surety to arbitrate. Obvious irreparable harm would result from being required to arbitrate instead of receiving the advantages of litigation, including application of the law, procedural protections (like summary judgment), the right to discovery, the ability to obtain meaningful review on appeal, and lower administrative expense.

This irreparable harm to the surety is not outweighed by any harm to the indemnitors, who did not insist on arbitration when they signed the GAI in the first place. They suffer no harm at all by defending themselves in court, the usual forum for indemnity enforcement. Merely initiating an arbitration that then is stayed does not count as prejudice, especially since the arbitration was self-inflicted. Finally, no public interest is implicated in the private-party dispute over indemnity. The surety can meet each requirement for an injunction, if those requirements apply.

The question of prejudice to the surety is a likely pressure point for the indemnitors' arguments in light of the courts' widespread preference for arbitration. The indemnitors may challenge the surety to criticize arbitration as a procedure in the face of that preference. In arbitration, though, parties do give up both substantive and procedural rights afforded by the courts. See *Continental Insurance Co. v. Equity Residential Properties Trust*, 565 S.E.2d 603, 604 (Ga. App. 2002) (insureds cannot be compelled to give up their common law right of access to the courts in insurance disputes). If insureds cannot be compelled to arbitrate even when they have agreed to do so, how can a surety be compelled when it has not? Arbitrators may fashion remedies that a court of law would not or could not grant, and such a result is no ground for appeal. *Ordner Construction Co., Inc. v. Parkside Crossing, 300, LLC*, 624 S.E.2d 206, 208 fn. 3 (Ga. App. 2005). Arbitration simply does not protect a party's rights as well or as certainly as litigation.

Indemnitors may note that an arbitration award may be appealed on the ground of “manifest disregard of the law” and argue that this protects the surety to the same extent as judicial appeal. The cold comfort of this empty promise is that, for example in Georgia, they will find not one decision since that ground was enacted in which the award was overturned for manifest disregard of the law. See, e.g., *id.* While arbitrators in their unlimited discretion may (or may not) grant certain discovery and procedural concessions, even the rules of such widely used ADR providers as the American Arbitration Association demonstrate that arbitration is designed to be far less thorough and far more summary than litigation under the Federal Rules of Civil Procedure or similar state procedures. When arbitrators err and a participant is prejudiced, no effective remedy exists. The many differences between litigation, which is the surety’s right, and arbitration are obvious and prejudicial if the surety is compelled to arbitrate in the absence of its agreement to do so.

No one would argue that arbitration is unsuited to any dispute, that arbitrators cannot be fair and wise, or that only erroneous awards ever result. Sureties have arbitrated disputes with parties at all levels of the construction process and have prevailed in many of those ADR proceedings. Usually, sureties are more willing to arbitrate pure construction disputes rather than subject their bond defenses to the unrestrained discretion of arbitrators. Under the GAI, the issues, parties, magnitude of claims, and nature of defenses are entirely different, and the surety simply did not agree to arbitrate those matters. If sureties are reluctant to have bond defenses arbitrated, submitting indemnity rights to arbitrators usually will be even less tolerable.

A procedural consideration is the state of finality in determining the surety’s total loss and expense to be reimbursed by the indemnitors under the GAI. If the surety sues before that amount is liquidated, or if indemnitors attempt a pre-emptive arbitration over the GAI at an earlier point, a court may look at the status of other actions, suits, or arbitrations in deciding whether to grant a discretionary stay of the surety’s right to proceed in court. To the extent of a court’s power to control its docket and the pace of a lawsuit (which is a very broad extent, both legally and practically), the surety may find its final relief on hold while other matters affecting the indemnity quantum are resolved. The GAI expressly contemplates enforcement of the surety’s rights at the earliest moment, but the court may prefer waiting until claims are liquidated and all of the disputes can be resolved once and for all.

CONCLUSION

Since arbitration is a creature of agreement, sureties might not expect indemnitors to try compelling or courts to seriously consider forcing a surety to arbitrate over its GAI. The arguments are illogical and the few marginal authorities distinguishable. A success for such indemnitors would be unprecedented, but it is not unimaginable. Courts have been expanding the class of non-signatories who can be compelled to arbitrate based on equitable principles. A well-heeled indemnitor who seeks to postpone the day of reckoning and improve the chances of whittling down the debt may well draw on those expansive decisions in seeking to drag the unwilling surety into arbitration. The above points demonstrate that the surety should be able to stand fast on its rights under the GAI.

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