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**THE SURETY'S DUTY TO THE PRINCIPAL AND OBLIGEE:
LIMITING BAD FAITH EXPOSURE
THROUGH CONTRACT**

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I. Introduction

It is well established that the duties of a surety extend far beyond its general obligation to pay or perform pursuant to a bond. The bounds of the surety duties are not set in stone, however. In particular, in some recent cases, courts have imposed bad faith liability on sureties in a manner that essentially treats them as insurers. Additionally, some courts have held that a surety may heighten its duty of good faith to the principal and obligee as a result of the language in the surety contract. These decisions raise significant questions and concerns regarding what duties a surety may have to undertake to avoid bad faith claims. This article discusses recent case law in which courts have imposed insurer-like duties on sureties and provides suggestions for drafting surety agreements to minimize the surety's bad faith liability.

II. Suretyship versus Insurance: Imposition of insurer bad faith liability on sureties

Suretyship and insurance have similar characteristics and are frequently discussed as related concepts. However, as many courts have noted, the relationships involved are distinct.¹ Insurance is a two party contract between the insurer and the insured, pursuant to which the insurer agrees to indemnify the insured against certain specific losses.² In the event of a loss, the beneficiary of the insurance policy has no obligation to repay the insurer.³ A surety relationship, on the other hand, is a tri-partite relationship among a surety, its principal, and the obligee, pursuant to which the surety agrees to take responsibility for the payment and/or performance upon a default of the principal.⁴ If the surety incurs losses, the principal is obligated to indemnify the surety for these losses.⁵

One court has concisely summarized the distinctions between insurance and surety relationship as follows:

A contract of surety creates a tripartite relation between the party secured, the principal obligor, and the party secondarily liable, and the rights, remedies, and defenses of a surety cannot be disassociated from this relationship....This tripartite relationship is always present in a surety contract, while an insurance contract in itself never creates a tripartite relation analogous to the surety relation. . . . Insurance has been defined as a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from an unknown or contingent event; whereas a contract of suretyship is one to answer for the debt, default, or miscarriage of another...⁶

¹ *Shannon R. Ginn Constr. Co. v. Reliance Ins. Co.*, 51 F. Supp. 2d 1347 (S.D. Fla. 1999); *Intercon Constr. Inc. v. Williamsport Municipal Water Auth.*, 2008 U.S. Dist. LEXIS 6022 WL 239554 (M.D. Pa. January 28, 2008); *Superior Precast, Inc. v. Safeco Ins. Co. of America*, 71 F. Supp. 2d 438 (E.D. Pa. 1999); *Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc.*, 938 S.W. 2d 501 (Ky. 1998).

² *Id.*

³ *Id.*

⁴ Bruner and O'Connor, *Suretyship: Assuring Contract Performance*, § 12:2 SURETYSHIP: A TRIPARTE RELATIONSHIP (2007).

⁵ *Id.*

⁶ *Meyer v. Building and Realty Serv. Co.*, 196 N.E. 250 (Ind. 1935).

Although suretyship and insurance are clearly distinct, courts disagree as to whether a surety relationship falls within the ambit of “insurance” and therefore, there is a split in authority as to whether a surety is subject to bad faith claims. In Florida, the courts and legislature have recently addressed this issue. In *Dadeland Depot, Inc. v. St. Paul Fire & Marine Insurance Co.*,⁷ the Supreme Court of Florida analyzed whether an obligee constituted an “insured”, which would entitle it to bring a statutory bad faith claim against a surety pursuant to § 624.155(b), Florida Statutes. Section 624.155(b) provides that any person may bring a civil action against an insurer when the insurer does not act in “good faith to settle claims when, under all the circumstances, it could and should have done so, had it acted fairly and honestly toward its **insured** with due regard for her or his interests.”⁸ The *Dadeland* court determined that the legislature intended to include sureties within the definition of insurers and therefore concluded that an obligee may maintain a statutory bad faith claim against the surety.

In *Dadeland Depo*, the alleged bad faith occurred prior to a 2005 legislative amendment that expressly excludes sureties from the bad faith statute. Specifically, the 2005 amendment provides that a “surety issuing a payment or performance bond on the construction or maintenance of a building or roadway project is not an insurer for purposes of subsection (1).” Therefore, sureties issuing those types of bonds are not liable for statutory bad faith in Florida following the 2005 amendment.

Similarly, an obligee may not maintain a common law bad faith claim against a surety in Florida. In *Reliance Insurance Co. v. Barile Excavating & Pipeline Co., Inc.*,⁹ the district court refused to allow an obligee to bring a bad faith claim against a surety based upon its conclusion that such a claim is analogous to a first party bad faith claim, which is not permitted under Florida law.¹⁰ The *Reliance* court reasoned that a claim brought by an obligee against a surety is akin to a first party bad faith claim because:

[u]nlike the typical third party situation, [the obligee] is in no danger of being found liable for a judgment in excess of its policy limit due to [the surety’s] action (or inaction); nor does [the surety] occupy a fiduciary’s role with respect to [the obligee] because it does not represent [the obligee] as attorney-in-fact in this matter. On the contrary, [the obligee] and [the surety] are in the type of adversary relationship which characterizes first party claims. There is a debtor/creditor relationship, not a fiduciary one.¹¹

Because Florida law does not recognize common law first party bad faith claims, an obligee may not bring a common law bad faith claim against a surety in Florida.

Statutes and case law in several jurisdictions is in line with Florida law in refusing to recognize a bad faith cause of action against a surety. See *Intercon Const. Inc. v. Williamsport Mun. Water Auth.*, 2008 U.S. Dist. LEXIS 6022 (M.D. Pa. January 28, 2008) (court expressly distinguished surety relationship from insurance relationship in holding that a statutory bad faith action may not be maintained against a surety); *Travelers Cas. & Sur. Co.*

⁷ *Dadeland Depot, Inc. v. St. Paul Fire & Marine Ins. Co.*, 945 So. 2d 1216 (Fla. 2006).

⁸ Section 624.155(b), Florida Statutes.

⁹ *Reliance Ins. Co. v. Barile Excavating & Pipeline Co., Inc.*, 685 F. Supp. 839 (M.D. Fla. 1988).

¹⁰ A first party bad faith claim is an action by an insured against its insurer based upon the insurer’s failure to settle the insured’s claim. A third party claim is a suit against the insurer by the insured for the insurer’s failure to settle a third party claim for a reasonable amount.

¹¹ *Reliance Ins. Co.*, 685 F. Supp. at 841-842.

of America v. Amoroso, et al. 2004 U.S. Dist. LEXIS 17604 (N.D. Cal. 2004) (court disallowed bad faith claims against surety by both principal and obligee); *Cates Constr., Inc. v. Talkbot Partners*, 980 P.2d 407 (Cal. 1999) (California does not recognize common law or statutory bad faith actions against surety); *Cincinnati Ins. Co. v. Centech Bldg. Corp.*, 286 F. Supp. 2d 669 (M.D. N.C. 2003); *Superior Precast, Inc. v. Safeco Ins. Co. of Am.*, 71 F. Supp. 2d 438 (E.D. Pa. 1999); *Inst. of Mission Helpers v. Reliance Ins. Co.*, 812 F. Supp. 72 (D. Md. 1992); *Masterclean, Inc. v. Star Ins. Co.*, 556 S.E.2d 371 (S.C. 2001); *Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1*, 908 S.W. 2d 415 (Tex. 1995).

However, there are also a number of jurisdictions that do recognize bad faith tort claims against a surety based primarily upon the similarities between suretyship and insurance. See *Dodge v. Fidelity & Deposit Co. of Maryland*, 778 P.2d 1240 (Ariz. 1989) (recognizing differences between suretyship and insurance, but allowing common law bad faith claim against surety because legislature included suretyship in Arizona's Insurance Code); *Transamerica Premier Ins. v. Brighton Sch. Dist.*, 940 P. 2d 348 (Colo. 1997) (court allowed obligee to bring common law bad faith claim against surety because of similarities between surety relationship and insurance); *Int'l Fidelity Ins. Co. v. Delmarva Sys. Corp.*, 2001 WL 541469 (Del. Super. Ct. May 9, 2001) (court allowed obligee to bring common law bad faith claim against surety because relationship between obligee and surety is nearly the same as that between insured and insurer and legislature intended to include sureties as insurers in statutory scheme); *K-W Indus. v. Nat'l Sur. Corp.*, 754 P.2d 502 (Mont. 1988) (court allowed common law bad faith claim against surety because state legislature included sureties within general insurance code); *Szarkowski v. Reliance Ins. Co.*, 404 N.W. 2d 502 (N.D. 1987) (North Dakota statutory insurance scheme applies to sureties).

Recent case law suggests that sureties can take steps to insulate themselves from liability for bad faith claims by using surety agreements that do not impose duties on the surety that surpass those the surety intended to undertake, i.e., to secure payment and/or performance of the principal. In addition, as discussed in more detail below, some courts have held that a surety may specifically contract around certain obligations that otherwise may be imposed by case law. Finally, a recent Florida decision emphasizes the need to carefully draft settlement agreements to provide for the release of bad faith claims.

III. Avoiding Bad Faith Pitfalls in Surety Claims Handling

A. Beware of Contracts that heighten the surety's duty to investigate

Pursuant to the AIA-A312 performance bond, a surety agrees to provide a prompt response to claims made by an obligee. Under this payment bond, the surety is required to send an answer to the obligee within forty-five (45) days of receipt of the claim. Specifically, the pertinent language in the AIA-A312 performance bond states as follows:

6. When the claimant has satisfied the conditions of Paragraph 4, the Surety shall promptly and at the Surety's expense take the following actions:

6.1 Send an answer to the Claimant, with a copy to the Owner, within 45 days after receipt of the claim, stating the amounts that are undisputed and the basis for challenging any amounts that are disputed.

6.2 Pay or arrange for payment of any undisputed amounts.

Courts have strictly construed the forty-five (45) day investigation period and held that the surety must provide an answer clearly indicating (a) the amount in dispute; and (b) the bases for disputing any amounts within this.¹² Courts have also held that surety may waive defenses or counterclaims by failing to raise them within the forty-five (45) day period. For example, in *Casey Industrial, Inc. v. Seaboard Surety Co.*¹³, the surety responded to the obligee's claim within the requisite period, but disputed only three items: (1) entitlement to payment for delays; (2) amounts and calculations of change orders; and (3) entitlement to interest and attorneys' fees.¹⁴ After expiration of the forty-five (45) day period, the surety sent a subsequent letter to the obligee in which the surety raised several additional grounds upon which it disputed the claim, such as claims against subcontractors.¹⁵ The Casey court held that the contract prohibited the surety from raising additional bases for disputing the claim after the forty-five (45) day period had lapsed.¹⁶ Accordingly, the court limited the surety to raising legal defenses and performing discovery regarding the three bases of dispute raised during the initial forty-five (45) day period.¹⁷

Similarly, in *J.C. Gibson Plastering Co., Inc. v. XL Specialty Ins. Co.*¹⁸, the Middle District of Florida held that the failure of a surety to answer a bond claim within the forty-five (45) day period resulted in the entire claim being deemed to be undisputed. In so holding, the court closely scrutinized the timeline of relevant events. On February 9, 2007, the obligee sent the surety its claim. The surety responded a little over a week later and requested copies of all cost records that would support the amount of obligee's claim. In addition, the surety's response advised the obligee that the surety was contacting the principal to obtain its position with respect to the claim.

On March 20, 2007, the obligee sent the surety the requested materials in support of its claim. The surety responded on the following day to acknowledge receipt of the materials. On April 3, 2007, the obligee sent a letter to the surety, declaring the surety in breach for its failure to appropriately respond within forty-five (45) days of the receipt of the obligee's claim. The surety responded on the next day, which was the forty-eighth day after the surety received the claim, and stated that it appeared that "a legitimate dispute exists on ... the project."

In ruling on the bad faith claim, the court held that the time within which the surety was obligated to answer began to run on the date it received the claim, not on the date it received the requested materials from the obligee. Furthermore, the court found that neither of the

¹² See *J.C. Gibson Plastering Co., Inc. v. XL Specialty Ins. Co.*, 521 F. Supp. 2d 1326, 1333-1334 (M.D. Fla. 2007); *Casey Indus., Inc. v. Seaboard Sur. Co.*, 2006 WL 3299932, *3 (E.D. Va. 2006)

¹³ 2006 WL 3299932 (E.D. Va. 2006).

¹⁴ *Id.* at *3.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *J.C. Gibson Plastering Co., Inc. v. XL Specialty Ins. Co.*, 521 F. Supp. 2d 1326, 1333-1334 (M.D. Fla. 2007).

surety's letters to obligee met the requirements of the answer the surety was required to provide under the contract, as they both failed to include the undisputed amounts and the bases for disputing the amounts set forth in the claim. Specifically, the court held that a letter from the principal's attorney challenging portions of the claims does not satisfy the surety's obligation to answer.¹⁹ Therefore, the court held that the surety waived its right to dispute any amounts set forth in obligee's claim.²⁰

The *J.C. Gibson* court specifically rejected the reasoning applied by the Massachusetts Superior Court in *Methuen Const. Co. v. Austin Co.*²¹, which recognized the significant burden placed on the surety by the forty-five (45) day investigation period. In the *Methuen* case, the surety responded to the obligee's claim within the forty-five (45) day period by acknowledging the claim and requesting that the obligee complete an "Affidavit of Claim." The court determined that this request was "an indication that [the surety] had not accepted and was disputing [the obligee's] claim..."²². The court also recognized that it would be "nearly impossible" for a surety to complete its investigation of a claim and to provide an answer within forty-five (45) days when the claim is related to large construction contracts.²³ Accordingly, the court held that the surety timely met its obligation by answering and requesting the affidavit of claim within the forty-five (45) day period.

The *J.C. Gibson* court held that the impracticability doctrine, relied on by the *Metheun* court, does not relieve a surety from obligations to which it agreed under the bond. In so holding, the *J.C. Gibson* court reasoned that "if it is clear that large construction projects require lengthy investigations, a surety cannot obligate itself to promptly answer claims on such projects and then complain that the size of the project renders a prompt answer impracticable."²⁴

Moreover, the *J.C. Gibson* court left open the question of whether the obligee is estopped from asserting the defense of the surety's waiver if the obligee fails to cooperate in the surety's investigation. The court avoided reaching the question by finding that the obligee did not delay the surety's investigation although the obligee took 26 days to provide records supporting the amount of its claim.²⁵

The rulings in *J.C.* and *Casey* have significant practical implications. The AIA-312 bond imposes a duty on the surety to evaluate all potential bases for defenses and counterclaims within forty-five (45) days of notice of the claim. However, obtaining, processing, and evaluating the facts surrounding the claim is not a simple task. The surety generally has little or no prior knowledge of the dispute between the principal and obligee, and principals are often not forthcoming in promptly disclosing complete facts or providing all necessary documentation with respect to claims made on a bond.

¹⁹ *J.C. Gibson Plastering Co., Inc. v. XL Specialty Ins. Co.*, 521 F. Supp. 2d 1326, 1334 (M.D. Fla. 2007).

²⁰ *Id.* at 1337.

²¹ *Methuen Const. Co. v. Austin Co.*, No. 04-1207-G (Mass. Sup. Ct. filed Sept. 1, 2006).

²² *Id.*

²³ *Id.*

²⁴ *Id.* at 1335.

²⁵ *Id.* at 1337.

However, at least one court has held that the principal's failure to cooperate is a defense to a bad faith claim. In *Guning Lining Constr. Corp. v. Adams Co. Asphalt, Inc.*²⁶, the Fifth Circuit upheld summary judgment denying a principal's bad faith claim because the principal continuously failed to cooperate with the surety's efforts to investigate the claim. In *Guning*, the obligee made a claim on the surety bond and the surety disputed the claim. The surety made several attempts to contact the principal to learn the facts underlying the bond claim. However, the principal refused to cooperate and did not respond to any of the calls or letters from the surety. Eventually, the obligee offered to settle the claim with the surety, and provided a deadline for doing so. In response, the surety sent the following letter to its principal, in an attempt to gain its cooperation:

[Obligee] has offered and demanded to settle this claim for [\$ 121,060.99] until Monday, March 15, 1993, which does not include attorney's fees or interest. If you continue to fail to cooperate immediately, **[surety] will have no choice but to settle this case on the best terms possible under the circumstances, and then seek indemnity from you.**

... We have attempted to contact you every day this week in an effort to get your assistance in resolving this matter. However, you have failed to return any of our phone calls. As you must certainly realize, your cooperation is imperative; the failure to communicate or even return our phone calls leaves [surety] little choice but to settle on the best terms it can, **by paying up to the amount claimed by [obligee].**²⁷

The principal never responded and the surety accepted the obligee's settlement offer. Subsequently, the surety sued the principal for indemnification.²⁸ At trial, the principal did not contest the accuracy of the statements contained in the letter the surety sent to it. Nonetheless,²⁹ the principal argued that the surety failed to settle in good faith, as expressly required by the indemnity agreement:

Although the surety had a contractual duty to settle in good faith, the court held that the principal's failure to cooperate "belie[d] [principal's] contentions that [surety] failed to act in good faith. Therefore, the failure of the principal to cooperate may be an available defense to a bad faith claim.

²⁶ 85 F. 3d 201, 210-211 (5th Cir. 1996).

²⁷ *Id.* (emphasis in original).

²⁸ *Id.* at 211.

²⁹ The indemnity agreement contained the following language:

IV. (A) The liability of [principal] shall extend to and include all amounts paid by [surety] *in good faith* under the belief that: (1) [surety] was or might be liable therefore; (2) such payments were necessary or advisable to protect any of [surety's] rights or avoid or lessen [surety's] liability or alleged liability;

...

(C) the voucher(s) or other evidence of such payment(s) or an itemized statement of payment(s) sworn to by an officer of [surety] shall be prima facie evidence of the fact and extent of the liability of the [principal] to [surety].

PRACTICE POINTER: A surety must carefully track claims made and the respective deadlines for answers when using an AIA-A312 bond. All correspondence with the principal and obligee should be by a method that allows the surety to confirm receipt of the correspondence, i.e., via certified or registered mail.

Upon receipt of a claim, surety should immediately request supporting documentation from the obligee. Additionally, the surety should put its principal on notice of the claim, the date of the claim *and* that the surety must respond to such claim in good faith within 45 days. This notice should also include a request for the principal's position and supporting documentation. Next, the surety should continue investigating the claim. Finally, the surety must answer within the 45 day period with a specific statement of undisputed amounts and bases for disputed amounts.³⁰

Sureties should avoid using bond language that requires them to respond to claims made within an impractical time frame. In addition, sureties may want to consider including language that defines an answer or response as acknowledgement of receipt of the claim and a request for additional information from the claimant.

Moreover, the surety should keep detailed records of its attempts to contact the principal in an effort to gain cooperation and should make frequent efforts to follow up with unresponsive principal. If the surety is preparing to settle or otherwise pay the claim, it should send a certified letter to the principal detailing the principal's failure to cooperate and the importance of the principal's cooperation in the resolution of the bond claim.

B. Include express language releasing bad faith claims in any release executed in favor of the surety.

A general release is not sufficient to release the surety from bad faith claims. In *Plumbing Service Co. v. Traveler's Casualty & Surety Co.*,³¹ the appellant sub-subcontractor, Plumbing Service Company, got into a dispute with the subcontractor regarding outstanding amounts owed for plumbing work. The work in dispute was covered by a payment bond held by appellee, Traveler's Casualty & Surety Company. Although Plumbing Service Company and subcontractor agreed as to amounts due, the subcontractor refused to pay and Plumbing Service Company filed suit against subcontractor for outstanding amounts.³²

While this suit was pending, Plumbing Service Company filed a "Civil Remedy Notice of Insurance Violation" pursuant to Florida Statutes, alleging that the surety had failed to acknowledge claims and act promptly, denied claims without conducting a reasonable investigation, failed to investigate claims in good faith, and failed to promptly settle claims. The surety, subcontractor and Plumbing Service Company eventually settled the claims, with the parties agreeing that the sub-subcontractor had a valid claim under the bond. Pursuant to the

³⁰ Morgan Streetman and Brian Lambert, *When is the notice the surety never received good enough?* (September, 2007), http://www.slk-law.com/resources/get_resource.aspx?rId=8fcf600f-7185-48e6-a4c3-b463c70edb6f.

³¹ 962 So.2d 1056 (Fla. 5th DCA 2007).

³² *Id.*

settlement, Plumbing Service Company agreed to dismiss the lawsuit upon receipt of payment and executed a release in favor of the surety and the subcontractor. The settlement agreement contained the following release language:

5. Progressive Plumbing, Inc. and TRAVELER'S CASUALTY & SURETY COMPANY, as Successor-in-Interest to Reliance Insurance Company for good and valuable consideration, the sufficiency of which is hereby acknowledged and confessed, hereby release, remise, waive, discharge and satisfy all causes of action whether known or unknown, demands of every kind of character and any and all claims they have or may have whether known or unknown against THE PLUMBING SERVICE COMPANY its employees and/or officers **from the beginning of the world through the date hereof**. This release specifically includes any and all claims that Progressive Plumbing, Inc. and/or TRAVELER'S CASUALTY & INSURANCE COMPANY, as Successor –in-Interest to Reliance Insurance Company has attained by assignment from Ascho Enterprises, Inc. d/b/a/ Metro Staffing Services or any other claims that they may have attained by assignment or otherwise.

6. Upon the payment and clearance of all settlement funds set forth hereinabove, [THE PLUMBING SERVICE COMPANY] shall release, remise, waive, discharge, and satisfy all causes of action whether known or unknown, demands of every kind of character and any [sic] all claims that Plaintiff has or may have whether known or unknown against Progressive Plumbing, Inc., Centex Rooney Construction Co., Inc./Construct Two Construction Managers, Inc., a joint venture and TRAVELER'S CASUALTY & SURETY COMPANY, as Successor-in-Interest to Reliance Insurance Company their employees and/or officers **from the beginning of the world through February 14, 2001** relating solely to the project that is the subject of the above-styled action that is more fully described in paragraph 5 f the Complaint herein. This release shall only be effective upon the payment and clearance of all settlement sums set forth hereinabove otherwise; it is void.³³

Plumbing Service Company subsequently brought a bad faith action against the surety, claiming that the surety acted in bad faith in handling the sub-subcontractor's claim. In its defense, the surety argued that the Plumbing Service Company's bad faith claim was barred by the release.³⁴

In reversing the lower court's order granting the surety's motion for summary judgment, the appellate court noted that "the release does not specifically mention which of the Appellant's claims are extinguished. Instead, the release uses general release-like language purporting to release 'all' claims."³⁵ Furthermore, the court noted that the release language

³³ *Id.* at 1057-1058 (emphasis in original).

³⁴ *Id.*

³⁵ *Id.* at 1058.

used in the section of the agreement related to Plumbing Service Company's release of claims against the subcontractor and surety was limited in time to claims through February 14, 2001, which was the date upon which sub-subcontractor and subcontractor met and agreed upon the outstanding amount owed on the bonded project. The court went on to hold that pursuant to Florida Statutes, sub-subcontractor's bad faith claim did not accrue until October 14, 2001; therefore, the bad faith claim was not covered by the scope of the release.³⁶

PRACTICE POINTER: In drafting releases, include express language releasing the surety from bad faith claims; be certain the time frame set forth in the release is broad enough to include the period when bad faith claims accrued.

C. Include express language in the indemnity agreement that provides the surety with broad discretion to settle claims on behalf of the principal.

A right-to-settle clause in the indemnity agreement is a contractual mechanism that gives the surety broad discretion to settle claims, even if it is ultimately determined that a principal did not have liability. For example, in *Auto-Owners Ins. Co. v. Southeast Floating Docks, Inc.*,³⁷ the court held that a surety did not act in bad faith in settling with the penal sum of the bond and in obtaining a release of only the surety.³⁸ The indemnity agreement at issue required the principal to indemnify the surety for "the full amount of any and all money paid **in good faith** by the surety..."³⁹ After receiving a claim against a performance bond, the surety elected to settle the claim with the obligee for the penal sum of the bond. The parties executed settlement documents that released the surety only and did not release the principal. Subsequently, the principal sued the surety for settling in bad faith.

In analyzing the bad faith claim, the court analyzed the indemnity agreement, which included a broad right-to-settle clause. This clause gave the surety "the right, at its option and sole discretion, to adjust, settle or compromise any claim, demand, suit or judgment upon any Bond, unless any indemnitor ... providing a reasonable legal basis...shall request the Surety to litigate such claim or demand...and shall deposit with the Surety, at the time of such request, cash or collateral satisfactory to the Surety."⁴⁰ Moreover, the indemnity agreement included language that provided that evidence of payment of settlement funds is *prima facie* evidence of the amount of indemnitor's liability. As a result, the court found that once the surety established it had made payment in settling the bond claim, the burden was on the indemnitor to prove bad faith. Otherwise, the liability of the indemnitor extended to all money expended in settlement of the claims.

³⁶ *Id.*

³⁷ 2007 U.S. Dist. LEXIS 14252 (M.D. Fla. March 1, 2007).

³⁸ *Id.* at *47-48.

³⁹ *Id.*

⁴⁰ *Id.*

Similarly, in *Liberty Mutual Insurance Co. v. Aventura Engineering & Construction Corp.*⁴¹, the Southern District of Florida held that a right-to-settle clause precluded a principal's assertion of bad faith as defense to an indemnification claim brought against it by the surety. In *Liberty*, the principal and obligee were in disagreement as to the default status of the bonded project. Ultimately, the obligee made a claim against the bond and the principal demanded that the surety dishonor the obligee's claim and allow the principal to litigate its claim against the obligee. However, despite numerous demands from the surety that the principal post collateral sufficient to satisfy surety's exposure as a result of the bond claim, principal failed and refused to do so.

Throughout its communications with the principal, the surety continued to reserve its right to settle the claims pursuant to the terms of the indemnity agreement. Eventually, the surety settled the claims with the obligee and in doing so, exercised its power of attorney to execute a release of all claims the principal had against the obligee arising out of the bonded project. The surety then filed suit against the principal and indemnitors for indemnification, among other claims.

The principal and indemnitors defended the surety's indemnification suit on, *inter alia*, bad faith grounds. Specifically, the principal and indemnitors asserted that the principal could not release the principal's claims against the obligee and that the surety was not entitled to indemnification because the surety had acted in bad faith in settling with the obligee.

The right to settle language in the indemnity agreement provided as follows:

The surety shall have the right to adjust, settle, or compromise any claim, demand, suit or judgment upon the Bonds, unless the Contractor and the Indemnitors shall request the Surety to litigate such claim or demand, or to defend such suit, or appeal from such judgment, and shall deposit with Surety, at the time of such request, cash or collateral satisfactory to the Surety in kind and amount, to be used in paying any judgment or judgments rendered or that may be rendered, with interest, costs, expenses and attorneys' fees, including those of the Surety.

In granting the surety's motion for summary judgment, the court reasoned that "it is a well settled principle that a surety may settle claims regardless of whether liability for a claim actually existed . . . and for the sole purposes of avoiding the cost of litigation".⁴² The court noted that, although there are no Eleventh Circuit or Florida appellate decisions on the issue, the case law in other jurisdictions expressly recognizes the right of a surety to settle the principal's claims by virtue of the assignment and power of attorney provisions generally contained in an indemnity agreement. In applying those decisions to the facts before it, the *Liberty Mutual* court held that, because the indemnity agreement provided the surety with the right to settle or compromise bond claims at its option and sole discretion and had broad assignment, settlement and attorney-in-fact provisions, the surety had the right to release any claims the principal had against the obligee. The court also noted that the indemnity agreement provided a mechanism for the principal to protect its claims against the obligee but

⁴¹ 2008 U.S. Dist. LEXIS 11783, *6 (S.D. Fla. January 8, 2008).

⁴² Id. at *42 (internal citations omitted).

the principal failed to utilize that tool – although it requested that the surety deny the bond claims, it failed to post collateral to protect the surety from potential losses associated with the same.

Finally, one court has found that a surety can contract around the duty of good faith. In *Fidelity & Deposit Co. of Maryland v. Tri-Lam Co., Inc.*,⁴³ the indemnity agreement afforded the surety the unqualified right to settle claims on payment and performance bonds for projects to be performed by T.G. Services. The surety settled claims on the bonds for over three million dollars and subsequently sought indemnification from T.G. Services. Because the court found the surety contracted away the duty of good faith, it did not consider the reasonableness of the settlement in entering judgment against the principal based upon the indemnity agreement.⁴⁴ In so holding, the court noted that “the surety does not owe a common-law duty of good faith and fair dealing to its principal.”⁴⁵

PRACTICE POINTER: Include broad right-to-settle language in the indemnity agreement, which expressly includes the right to settle claims the principal may have against the obligee.

The surety should also include language that clearly provides that the indemnitor is obligated for all amounts paid in conjunction with the surety settling the claim. Include a waiver of the duty of good faith in the general indemnity agreement

Include language in the agreement that provides that when principal has provided evidence of payment of the claim, that proof is *prima facie* evidence of indemnitor’s liability.

IV. POINTS TO PONDER

The fact that some jurisdictions are treating sureties as insurers raises concerns that courts may extend good faith duties that have been traditionally limited to insurers to sureties. Two such duties include the duty to disclose coverage and the duty to inform of steps necessary to preserve coverage.

A. What if the duty to disclose coverage is extended to sureties?

In the insurance context, the duty of good faith requires the insurer to act contrary to its pecuniary interests by disclosing coverage, even if the insured is unaware of the coverage. In *Dercoli v. Pennsylvania National Mutual Insurance Company*, 554 A.2d 906 (Pa. 1989), the Supreme Court of Pennsylvania specifically identified this duty to inform:

⁴³ 2007 WL 1452632 (W.D. Tex. May 15, 2007).

⁴⁴ *Id.* See also *Great American Ins. Co. v. McElwee Bros., Inc.*, 2007 WL 861152 (E.D. La. March 19, 2007) (citing a line of cases allowing surety to contract away the duty of good faith).

⁴⁵ *Id.*

The duty of an insurance company to deal with the insured fairly and in good faith **includes the duty of full and complete disclosure as to all of the benefits and every coverage** that is provided by the applicable policy or policies along with all requirements, including any time limitations for making a claim.

Id. The plaintiff in *Dercoli* was injured in car accident caused by her husband. During the claims process, Plaintiff's insurance agent voluntarily advised her that independent counsel was unnecessary and advised her of the nature and extent of benefits available. During the period in which the insurer advised plaintiff, the Supreme Court of Pennsylvania abolished the defense of interspousal immunity as a bar for personal injuries caused by the negligence of the injured victim's spouse. The insurer did not inform plaintiff of the potential impact such decision had on her ability to obtain benefits. Years later, the plaintiff learned of the change in case law, and sued the insurer for, *inter alia*, breach of the duty of good faith and fair dealing. *Id.*

In its holding, the court overruled its prior decision by imposing on the surety a duty to inform of all benefits provided by the coverage. Although the court recognized that the insurer undertook to advise and counsel the insured, the duty was not limited to such facts. In particular, the court reasoned:

We have long recognized that: "the utmost fair dealing should characterize the transactions between an insurance company and the insured." *Fedas v. Insurance Company of the State of Pennsylvania*, 151 A. 285 (Pa. 1930). The appellees' agents in this case voluntarily undertook to provide assistance and advice to appellant and in the process advised her against retaining independent legal counsel. The appellees were bound to deal with the appellant on a fair and frank basis, and at all times, to act in good faith. **The duty of an insurance company to deal with the insured fairly and in good faith includes the duty of full and complete disclosure as to all of the benefits and every coverage that is provided by the applicable policy or policies along with all requirements, including any time limitations for making a claim.**⁴⁶

Similarly, in *Gatlin v. Tennessee Farmers Mutual Insurance Company*,⁴⁷ the court imposed a duty on the insurer to inform the insured as to coverage and policy requirements when:

(1) it is apparent to the insurer that there is a strong likelihood that its insured only can be compensated fully under her own policy and
(2) that the insured has no basis to believe that she must rely upon her policy for coverage.

⁴⁶ *Id.*

⁴⁷ 741 S.W. 2d 324, 326 (Tn. 1987).

Under *Gatlin*, the duty to inform appears broad, as the insurer is also required to make at least an initial determination or inquiry as to the wealth or resources of the insured and whether the insured believes coverage is available.

An alternative theory upon which the duty to disclose may be based is the Reasonable Expectations Doctrine (the “RED”), developed by Judge and former Harvard Professor Robert E. Keeton.⁴⁸ The RED is a theoretical principal rooted in modern contract theory and real world experience. Specifically, the RED recognizes that most policyholders play no role in drafting or negotiating insurance contracts. In most cases, the policyholders do not even have the opportunity or choose not to read the policy before purchasing the product. RED can be extended into the context of suretyship where, like the insured, the obligee does not usually play a role in the negotiations and drafting of the bonds. In response to the lack of bargaining power of the insured, the RED provides that courts should apply the reasonable expectations of the policyholder to determine the parameters of the duty of good faith. One such expectation is much like that duty to disclose: the insured reasonably expects the insurance company will clearly set forth the claims procedure, whether a claim is accepted or rejected, and if rejected, the reason for the rejection.

Furthermore, if the insurer breaches its duty to disclose, it may be liable for fraudulent misrepresentation. For example, in *Weber v. State*,⁴⁹ the insurance company failed to inform the insured of benefits available under the uninsured motorist coverage. Upon summary judgment, the court held “to the extent that in connection with the fraudulent nondisclosure claim the defendant was under a duty to exercise reasonable care to disclose the uninsured motorist coverage of the policy.”⁵⁰ Note that a fraudulent misrepresentation claim permits recovery of punitive damages, which can be very costly.

Surety Implications

In the surety context, the broad duty to inform presents several practical problems. For example, in many cases, a bond provides wide-ranging coverage for work performed pursuant to a contract. Therefore, unlike an insurance coverage determination, determining whether to honor a bond claim generally requires a judgment call concerning whether work was performed properly pursuant to a contract. In the insurance context, the insurer need only determine whether the type of damage or accident falls within the coverage. In addition, practical problems arise where a bond shortens the applicable statute of limitations. If the surety becomes aware of a claim on the bond near the end of such statute of limitations, it may not have sufficient time to investigate the claim, make a determination as to coverage, and inquire into the resources and coverage expectations of the obligee--especially in large, complex construction projects. If the surety did not bind itself to a time frame for accepting or rejecting a claim, the broadened duty to inform appears to implicitly require the surety to make such determination before the statute of limitations runs. Otherwise, the surety may face bad faith by allowing the statute of limitations to lapse without informing the claimant of available coverage.

⁴⁸ Robert E. Keeton, *Reasonable Expectations in the Second Decade*, 12 FORUM 275 (1976).

⁴⁹ 767 S.W. 2d 336 (E.D. Mo. 1989).

⁵⁰ *Id.*

B. What if the duty to disclose steps to preserve coverage is extended to sureties?

Where the insured is not informed of the steps to preserve coverage, the insurer may be tempted to keep its mouth shut. However, case law shows that the insurer is not permitted to avoid known liability by keeping silent. The insurer's duty of good faith extends to notifying the insured of the necessary steps to preserve coverage and keeping silent can have severe legal implications, such as the unavailability of defenses, as discussed below.

In *Bowler v. Fidelity & Casualty Co.*,⁵¹ the New Jersey Supreme Court refused to allow an insurer to raise the statute of limitations as a defense where the insurer breached its duty to inform. The insured in *Bowler* became disabled while he had insurance coverage in place. The policy allowed the insured a lump sum payment if he was diagnosed as permanently disabled by the 200th week of disability. Prior to the 200th week, both an independent doctor and a doctor hired by the insurer determined that the insured was permanently disabled. Thereafter, the insurance company gave the insured a number of forms to complete but never explained the necessary procedure to secure coverage. The insured completed and returned the forms, but never heard from the insurance company. The court held that the insurer was estopped from raising the statute of limitations defense because the insurer had a "duty to speak and disclose." In so holding, the court stated the following:

In situations where a layman might give the controlling language of the policy a more restrictive interpretation than the insurer knows the courts have given it and as a result the uninformed insured might be inclined to be quiescent about the disregard or nonpayment of his claim and not to press it in a timely fashion, the company cannot ignore its obligation. It cannot hide behind the insurer's ignorance of the law; it cannot conceal its liability. **In these circumstances it has the duty to speak and disclose, and to act in accordance with its contractual undertaking. The slightest evidence of deception or overreaching will bar reliance upon time limitations for prosecution of the claim.**⁵²

The court added that the insurer cannot simply issue a "mere naked rejection" of a claim. Rather, the proper fulfillment of the duty to inform requires:

[a] full and fair statement of the reasons for its decision not to pay the benefits, and by a clear statement that if the insured wished to enforce its claim, it will be necessary from him to obtain the services of an attorney and institute a court action within the appropriate time. The "appropriate time" means the time remaining under the policy or the applicable statute of limitation within which the suit must be brought. Failure on the insurer's part to follow such a course will bar reliance on the statute of limitations or a time restriction on court action expressed in the policy.⁵³

⁵¹ 53 N.J. 313 (N.J. 1969).

⁵² *Id.* (emphasis added).

⁵³ *Id.*

Surety Implications

The principles underlying the duty to disclose are certainly present in the surety context because laymen, the obligees, are determining whether coverage exists. However, if the duty is expressly extended, it would seem to present an undue burden upon the surety because of the lack of complexity involved in the surety claims process. Unlike the insurance context, bond coverage is very specific: under a payment bond, the surety assumes payment responsibilities under the bonded contract where the principal fails to do so; under the performance bond, the surety steps in to perform where the principal fails its duty to perform. Any limitations or special notification procedures are usually clearly spelled out in a relatively short contract. Additionally, the duty to inform in the surety context is an over-protective measure. The obligees are commercial entities that usually have experience with bonds and making claims on bonds.

V. Conclusion

The language used in the bond and indemnity agreement presents an important opportunity for the surety to limit its exposure to bad faith claims. By taking the time to clearly delineate the scope of the surety's responsibilities under the operative documents on the front end, the surety can significantly decrease its exposure to suits based upon claims that the surety failed to fulfill its duties to its principal and obligee.