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**KNOWING WHEN TO SAY "WHEN" -
PURSUING INDEMNIFICATION CLAIMS IN DIFFICULT
ECONOMIC TIMES**

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Knowing When to Say “When” – Pursuing Indemnification Claims in Difficult Economic Times

Courts across the country recognize the significant role sureties play in the construction industry. Therefore, when sureties have to discharge an obligation of a principal, they are generally entitled to enforce several common law rights, including the right to exoneration, *quia timet*, subrogation, contribution and common law indemnity. *Liberty Mut. Ins. Co. v. Aventura Engineering and Const. Corp.*, 534 F.Supp.2d 1290 (S.D. Fla. 2008).

In addition to these common law rights, sureties typically require the principal and individuals affiliated with the principal to execute an indemnity agreement as a precondition to the issuance of bonds. Indemnity agreements can provide sureties with extensive protections and broad forms of relief, in addition to those afforded to them under common law. However, it is important for a surety to keep apprised of the availability of remedies under applicable state law; because sureties generally use the same form indemnity agreement for each state in which they conduct business, they may not always be protected to the extent they believe they are or they may not be taking advantage of all of the protections to which they may be entitled.

Furthermore, obtaining a judgment, either for specific performance or monetary relief, is often only worth the paper upon which it is written. If the indemnitor has no assets to either post as collateral with the surety or from which a judgment may be collected, a surety may be throwing good money after bad by pursuing collection activities. To that end, it makes sense to investigate the assets of the indemnitors prior to getting too far down the collection road. This is particularly true in these difficult economic times. It is also important to consider how and when to continue to pursue claims when an indemnitor files for bankruptcy protection.

This article endeavors to provide general advice on handling indemnity claims in the current economy, including knowing when it is time to throw in the towel and write off the debt. It also provides recommendations regarding how sureties can better protect themselves through adjustments to the indemnity agreement and by implementing better underwriting procedures.

I. Claims Against Indemnitors upon Default of Principal

The surety's efforts to recover for bond losses should commence even before any losses occur. Attorneys often find that by the time an indemnity file makes it from the claims handler to their firms, the principal and indemnitors have already engaged in significant "asset protection" work. The claims handler's most prudent course for recovery, when claims are made or threatened, is to immediately contact an attorney to, at the very least, make sure that the surety's security interest is properly perfected and that its collateral is protected.

A. *What might not work — The "specific performance" remedies - quia timet, exoneration, posting collateral*

When bond losses are anticipated but not yet incurred, legal proceedings to protect the surety and recover in indemnity should be commenced immediately. Many states recognize various equitable causes of action and various other forms of injunctive relief that will protect a surety's security interests and collateral even before losses have been incurred. The effectiveness of these remedies varies from state to state and can vary from judge to judge.

The remedies of *quia timet*, exoneration, and injunction claims requiring an indemnitor to post collateral pursuant to the indemnity agreement are all equitable remedies, which require that the principal and indemnitors take certain action or refrain from particular conduct. The effort to obtain these kinds of injunctive relief can be difficult, particularly on an emergency or immediate temporary basis. Frankly, civil courts unfamiliar with the complexities of surety law often take a jaundiced view of efforts to secure proceeds pre-judgment. Outside of the surety context, and in the absence of an appropriate indemnity agreement, such efforts tend to be verboten.

Exoneration allows a surety to compel its principal to pay the principal's own debt, so that the surety never has to do so. To invoke this remedy, the surety must establish the existence and amount of the debt, that the debt belongs to the principal, and that the surety's liability is absolute. Exoneration is a right available at common law, and is also frequently contained in indemnity agreements between sureties and principals. *Doster v. Continental Cas. Co.*, 105 So.2d 83 (Ala. 1958)(recognizing surety's right of exoneration at common law).

Quia timet is a common law doctrine that provides a surety with a mechanism to obtain equitable relief against its principal before the surety sustains an injury, such as by depositing with the surety the anticipated cost and

expense of a loss under a bond. Further, a surety must have a *rational* basis to fear a loss to be entitled to *quia timet* relief. *Transamerica Premium Ins. Co. v. Calvary Constr., Inc.*, 552 So.2d 225, 227 (Fla. 5th DCA 1989).

Quia timet is only available pre-injury; by definition it anticipates future loss and does not deal with actual loss. *Quia timet* is most frequently used by sureties to seek collateralization. There is little Florida case law addressing *quia timet*. See, e.g., *Transamerica Premium Ins. Co. v. Calvary Constr., Inc.*, 552 So.2d 225 (Fla. 5th DCA 1989) (making clear that the indemnity agreement must contain a collateral security provision before an action for *quia timet* may be maintained); *Great American Inc. Co. v. General Contractors & Constr. Mgmt., Inc.*, 2008 WL 2245986 (S.D. Fla. May 29, 2008) (enforcing surety's right to *quia timet* relief and requiring principal to post collateral).

Indemnity agreements typically allow a surety to require the principal to place funds with, or collateralize, the surety in an amount the surety deems necessary to protect itself from anticipated liability, loss, or expense. This is essentially contractual *quia timet* relief. Typically, the funds must be given to the surety upon demand, regardless of whether the surety has made any payment under its bond, as long as the surety can demonstrate a reasonable basis for its fear of a loss. *Liberty Mutual Ins. Co. v. Aventura Engineering & Constr. Corp.*, 534 F. Supp.2d at 1321-1322 (S.D. Fla. 2008)(enforcing surety's entitlement to contractual right of collateralization); *Transamerica Premium Ins. Co. v. Cavalry Constr., Inc.*, 552 So.2d 225, 226-27 (Fla. 5th DCA 1989) (holding that temporary injunctive relief in the form of specific performance is appropriate to enforce an indemnity agreement's collateral security clause requiring a principal to post collateral in favor of a surety where principal conceded it owed amounts to third parties).

Although these remedies may appear to provide extensive protections to the surety, it is important to realize that because they would all essentially amount to an order awarding specific performance or mandatory injunctive relief, courts will often be hesitant to award them on a pre-judgment basis. General legal principals dictate that a party is only entitled to specific performance and mandatory injunctive relief where the party seeking the relief does not have an adequate legal remedy. *Walsh v. Paw Trucking, Inc.*, 942 So.2d 446 (Fla. 2d DCA 2006). Therefore, where the surety can be provided relief through an award of a money judgment, as is the case with a suit under an indemnity agreement, injunctive relief and specific performance are generally not available. *Castigliano v. O'Connor*, 911 So.2d 145 (Fla. 3d DCA 2005) ("Specific performance shall only be granted when 1) the plaintiff is duly entitled to it, 2) there is no adequate remedy at law, and 3) the judge believes that justice requires it."). Furthermore,

injunctive relief is available to prevent a threatened harm, but is not available to redress harm that has already occurred. *Lieberman v. Marshall*, 236 So.2d 120 (Fla. 1970).

Case law in many states suggests that the equitable remedies mentioned here have become less frequently utilized, and that courts have undertaken efforts to restrict the usefulness of those remedies. While these can be effective means of protecting collateral, attorneys and claims handlers must make early assessments concerning their effectiveness in the particular case they are litigating.

B. What works

When there has been an actual bond loss, one of the most obvious and certainly one of the most immediately necessary steps for complete recovery is the pursuit of a judgment against both the principal and the indemnitors for that loss. Most often the claims alleged arise principally from the parties' contractual indemnity agreement.

PRACTICE POINTER

- Even where the defaulted principal is defunct and uncollectable, it is often a good idea to name it in the action. A judgment against it will form the basis for successor liability claims, fraudulent transfer claims, and commencement of proceedings supplementary. Sometimes the very reason the principal is no longer viable is because it has conveyed its assets and working capital to another entity or individual. With a judgment against the principal, recovery may be had against other related parties.

Most courts have recognized that the difference between the right to common law indemnity and contractual indemnity is that “absent a written indemnity agreement, the surety’s common law indemnity rights exist only when there is actual liability. *Liberty Mut. Ins. Co. v. Aventura*, 534 F.Supp.2d at 1310. Florida courts have held that “a party seeking indemnification must [only] establish that the settlement was made based on his potential liability to the Plaintiff.” *Id.* at 1320.

Under Florida law, as with most states, it is well settled that the only defense to a contractual indemnity claim is if the surety acted in bad faith. *Id.* at 1319-1320. Courts have consistently upheld a surety’s contractual indemnity

rights as long as the surety acted in a good faith belief that it was required to perform or pay, regardless of whether any liability existed. *Id.* at 1316.

To establish a bad faith claim under Florida law, an indemnitor must demonstrate that the surety acted with “deliberate malfeasance” which means “an intentional wrongful act which the actor has no legal right to do, or any wrongful conduct which affects, interrupts, or interferes with the performance of a legal duty.” *Id.* Lack of diligence or negligence on the part of the surety does not constitute bad faith; even gross negligence is not the same as bad faith.” *Employers Ins. of Wausau v. Able Green, Inc.*, 749 F.Supp 1100, 1103 (S.D. Fla. 1990). Sureties often include “right to settle” clauses in their indemnity agreements, which put the indemnitor on notice that the surety may settle the claim to avoid the costs of litigation. Therefore, it is extremely difficult for an indemnitor to overcome contractual liability based upon bad faith. However, a surety should be careful in drafting its indemnity agreements, as state law varies widely regarding enforceability of certain provisions. This is discussed in further detail below.

Once a surety has brought indemnity claims against the indemnitors, it should consider whether it can avail itself of any prejudgment collection remedies, which vary greatly among the states.¹ In any event, the surety should proceed expeditiously with obtaining a final judgment against the indemnitors; often indemnitors attempt to buy themselves time by communicating their intentions to work something out. However, this may just be a stall tactic that will result in other creditors getting in line in front of the surety, or may result in giving the indemnitor time to transfer or otherwise dispose of assets that would have been available to satisfy a judgment. Therefore, it is prudent to obtain the judgment and agree to some forbearance on execution/collection efforts to allow the indemnitors time to propose a resolution.

Obtaining a money judgment on the indemnity agreement is often an even more effective path to reimbursing bond losses than the equitable claims mentioned in section I.A. above. The surety’s attorney is always forced to make prudent early decisions about expending appropriate resources in collection cases. Sometimes the best course is to forgo the early litigation of the equitable claims for the protection of collateral, in order to proceed quickly and economically to a money judgment for breach of the indemnity agreement.

¹ Florida law allows courts to issue prejudgment writs of attachment and garnishment, both of which, under appropriate circumstances, may be useful devices to prevent the dissipation of collateral.

PRACTICE POINTER

- Include a “right to settle” clause in the indemnity agreement.
- Consult with counsel regarding availability of prejudgment remedies.
- Proceed promptly to judgment; determine whether settlement is possible later.

C. *What are claims of interest and do they work?*

In an effort to better securitize the bonded obligation, sureties will often undertake to record liens or “claims of interest” in the public record as authorized by the indemnity agreement. Most frequently, this occurs after a bond default has occurred.

Sureties may include language in their indemnity agreements, which purports to broadly convey the indemnitor’s property interests to the surety. For example:

[T]he undersigned, and each of them agree to and by these presents, do hereby assign, transfer and convey to the Surety, all of their right, title, interest and estate in and to all of their property, real, personal or mixed, wherever situated or of whatever nature, in which the Undersigned presented have, or may hereafter obtain, an interest, including but not limited to the property hereinafter described, such assignment to be effective as of the date hereof, subject to being defeated in the event there is: no abandonment of, breach, delay, or default in the performance of any of the obligations contained in any of the Bonds . . .

However, sureties typically do not attach any list of properties, legal descriptions, addresses, etc. to the indemnity agreement. Furthermore, the indemnity agreement is generally not a recorded instrument. These two factors may invalidate the effect of this provision under applicable state law.

In addition to these two considerations, the protections provided to the indemnitor’s homestead property varies widely. For example, a few states, including Florida and Texas, provide absolute protection for a debtor’s homestead property; it is exempt from execution. Although sureties often include homestead waiver language in their indemnity agreements, courts may deem the

waiver language ineffective under state law, and, several states do not allow residents to waive their homestead rights under any circumstances.

Finally, it is important to know which states recognize tenancy by the entirety property. In those states, sureties need to have both husband and wife sign the indemnity agreement; otherwise, the debt will generally not be enforceable against any property titled to both the husband and wife.

D. *Waiver of the homestead right*

An issue that is somewhat unique under Florida law is the state's unlimited homestead protection. The Florida Constitution provides that "no judgment, decree or execution shall be a lien" upon homestead property. See Art. X, § IV(a)(1), Fla. Const. Therefore, even where an indemnity agreement contains waiver of homestead language, it may be insufficient to constitute a waiver of homestead rights under Florida law.

In *Chames v. DeMayo*, 972 So.2d 850 (Fla. 2007), the court held that a waiver of homestead provision which was buried deep within a contract did not operate as a waiver. Specifically, the waiver provision at issue was on page four of a six page single-spaced contract and at the end of a 118-word sentence. The *Chames* court was concerned that this type of waiver language could be easily overlooked. Furthermore, the *Chames* court expressed concern that if permitted, homestead waivers would "become an everyday part of contract language for everything from the hiring of counsel to purchasing cellular telephone services."

In a recent unpublished, trial court opinion out of the Eleventh Judicial Circuit in Florida, the court entered an order striking a surety's recorded claims of interest on both homestead and non-homestead property. With respect to the homestead property, the court held that the following language was insufficient to constitute a valid waiver of homestead under Florida law:

Waiver of Exemptions. Each of the Undersigned does, jointly and severally, bind his or her property and does hereby release, and abandon, as to the Surety all right to claim any property, including their homestead, as exempt from levy, execution sale or other legal process under the law of any state, province or other government, as against the rights of the Surety to proceed against the Undersigned for indemnity hereunder.

Specifically, the court held that the claim of interest that had been recorded "impermissibly burdens the homestead property of" the indemnitors.

Similarly, Tennessee law prohibits a general waiver of homestead or personal property exemptions in an executory contract Tenn. Code Ann. § 26-2-301(d).

However, both Georgia and Alabama law allow for a general waiver of the homestead of personal property exemptions in an executory contract. See Ga. Code Ann. § 44-13-40 (2002); Ala. Cont. art. X, § 210; Ala. Code § 6-10-120 (2005). Therefore, sureties doing business in these states should be sure their indemnity agreements include valid waivers of these exemptions.

PRACTICE POINTERS

- Make sure to obtain an indemnity agreement executed by both the principal and individual indemnitors.
- If the state recognizes tenancy by the entireties property, have both husband and wife execute the indemnity agreement.
- Consider specific state homestead issues when drafting the indemnity agreement.
- Know when/how to obtain homestead/personal property exemption waivers.
- If the homestead property is the sole or primary asset of the indemnitor in a state that will not recognize waiver of homestead, require the posting of additional collateral on the front end, i.e., a letter of credit.

With respect to the non-homestead property in the above-referenced case, the Florida court held that the recorded claims of interest must be stricken because the indemnity agreement was not recorded and under section 695.01, Florida Statutes, no interest in real property is conveyed unless the instrument purportedly conveying the interest is recorded.² In addition, the court found that

² 695.01, FLA. STAT. Conveyances to be recorded

(1) No conveyance, transfer, or mortgage of real property, or of any interest therein, nor any lease for a term of 1 year or longer, shall be good and effectual in law or equity against creditors or subsequent purchasers for a valuable consideration and without notice, unless the same be recorded according to law; nor shall any such instrument made or executed by virtue of any power of attorney be good or effectual in law or in equity against creditors or subsequent purchasers for a valuable consideration and without notice unless the power of attorney be recorded before the accruing of the right of such creditor or subsequent purchaser.

the indemnity agreement failed to operate as a valid lien because it did not contain a specific designation of the real property that is the subject of the interest purportedly conveyed to the surety by the indemnitors. See *Williams v. Shuler*, 551 So.2d 585 (Fla. 1st DCA 1989) (instrument conveying an interest in real property must contain a specific description of the real property subject to the instrument). At the time the indemnity agreement at issue was executed, it did not have the legal description of any parcels of real property attached to it. In fact, the surety did not record the indemnity agreement until the indemnitors defaulted, together with a copy of the legal description of real property owned by the indemnitors, which was set forth in an affidavit of the surety attesting to the defaults. The court found this effort to be insufficient under Florida law to create a lien against the subject properties.

Alabama, Georgia, and Tennessee have similar statutory requirements. See Ala. Code 7-9A-108 and 35-4-90 (2008) (description of property is sufficient if it reasonably identifies what is described); O.C.G.A. § 44-14-31 (2008) (“No particular form is necessary to constitute a mortgage. However, a mortgage must clearly indicate the creation of a lien and must specify the debt for which it is given and the property upon which it is to take effect.”); and T.C.A. 66-5-103 (Michie 2008) (requires a description of property in a mortgage).

PRACTICE POINTER

- Attach appropriate legal descriptions to the indemnity agreement at the time of execution and record the indemnity agreement promptly following execution.

II. Knowing When You Are Throwing Good Money After Bad

Even experienced indemnity claims handlers can find themselves incurring significant litigation expenses before considering the extent to which judgments will ultimately be collectable. It almost always makes sense to evaluate the extent to which a judgment will be collectable before commencing an indemnity action.

A. Basic Asset Search

As preliminary matter, prior to engaging in any extensive collection activities, it is advisable to perform, at a minimum, a basic asset search. For example, search public records for any interests in real property and perform an

(2) Grantees by quitclaim, heretofore or hereafter made, shall be deemed and held to be bona fide purchasers without notice within the meaning of the recording acts.

auto-track search of vehicles, boats, etc. for individuals so you have a better idea of whether your judgment is worth the paper upon which it is written.

B. *Consider hiring an outside investigator*

Depending upon the size of your judgment, if your in-house, basic asset search does not turn up much, if you have suspicions that the indemnitors may be concealing and/or transferring assets, or if you are dealing with an entity, which makes it more difficult to search for assets, you may want to consider hiring an outside investigative service. This is often well worth the expense; as an example, in the Tampa Bay area, basic, “due diligence” asset search from a third party firm will cost about \$2,500 per individual or entity. This basic due diligence includes the following:

- Verification of the subject's identity (address and social security number check to prevent false identification fraud)
- Civil and criminal background check
- Name screening on government terrorist and criminal lists
- Nationwide bankruptcy search
- Property search
- World-wide media review
- Reputation inquiry
- Analysis of corporate holdings and affiliations
- Professional license and credential verification
- Lien and judgments search
- Whether the targets or their companies are being investigated by any government regulatory agency

This is money well spent in most cases, as a creditor can burn through \$2,500 in legal fees attempting to locate assets through discovery in aid of execution in no time. Pay careful attention to the results of any investigation. You may find that even with clear paths to paper judgments, collection efforts are not worth the expense when recovery is out of reach.

C. *Consider state law exemptions*

As most people know, Florida is a debtor’s haven. In addition to the unlimited homestead protection discussed above, Florida law protects a broad range of personal property from execution by creditors. Chapter 222, Florida Statutes, sets forth the exemptions available to debtors under state law, and includes pensions and retirement benefits (§222.21, Fla. Stat.), wages for head

of household (§222.11, Fla. Stat.), life insurance policies (§§ 222.13 and 222.14), and annuity contracts (§ 222.14, Fla. Stat.).

Georgia law provides far fewer protections to debtors, as set forth in Ga. Code Ann. §44-13-100. For example, a Georgia resident is only entitled to a \$5,000.00 homestead exemption and is not afforded any exemption for wages.

Alabama residents are entitled to a \$5,000 homestead exemption, extensive, although not absolute, wage protections, unlimited protection of life insurance proceeds, and unlimited protection for IRAs and other specified trusts or retirement accounts. Ala. Code §§ 6-10-2, 6-10-7, 6-10-8, and 19-3-1.

Tennessee provides similar protections to its residents - \$5,000 homestead exemption, extensive, although not absolute wage protection, and complete exemption for health, accident, disability and life insurance. Tenn. Code Ann. §§ 26-2-301, 26-2-1-6, 26-2-110, and 56-7-203. In addition, it is important to remember that Tennessee recognizes and protects tenancy by the entireties property; therefore, be sure to have both husband and wife execute any debt instruments, including an indemnity agreement. Otherwise, any property held as tenancy by the entireties will be exempt from execution. *Ray v. Dawson*, 14 B.R. 822 (E.D. Tenn. 1981).

PRACTICE POINTERS

- Make sure both husband and wife execute the indemnity agreement to allow for collection against tenancy by the entities property.
- Be aware of other state law exemptions; many of the items set forth as “assets” on the indemnitors’ financial statements may be exempt from execution.

Even when its search reveals assets or significant net worth, the surety should instruct its attorney to consider the extent to which exemptions may preclude recovery. There is no point in pursuing assets where the property the surety contemplates attaching will prove to be exempt.

D. *What to do when the indemnitor files bankruptcy*

As the economy crashes, the number of bankruptcy filings – both business and consumer - naturally increases. Although there is no way for a surety to completely protect itself from this risk, there are several things it can do to increase the likelihood of recovery.

If an indemnitor files for bankruptcy prior to the surety making payment on the claim, the surety should file a “contingent” proof of claim for the full amount of the claim, indicating that it is contingent upon the surety investigating and determining that the claim is valid. If the indemnity agreement has an attorneys’ fee provision in it, indicate that you intend to seek repayment of attorneys’ fees incurred as well. If the surety ultimately pays the claim, file an amended proof of claim and attach proof that the claim was paid.

If the indemnitor files for bankruptcy after the claim is paid, file a proof of claim for all amounts paid, including attorneys’ fees. Continue to monitor the case for objections to your proof of claim and be prepared to provide evidence to the debtor, trustee and/or the court supporting your claim.

When a party files for protection under the Bankruptcy Code, the debtor becomes entitled to the protection provided in 11 U.S.C. § 362, commonly referred to as the “automatic stay.” The automatic stay prevents creditors from taking any action from collecting on a debt once the debtor has filed; this includes sending demand letters and setting off any collateral that may have been posted. If the debtor has posted collateral pursuant to the terms of the indemnity agreement, the surety should seek relief from the automatic stay to allow it to use the collateral to satisfy the debt. Willful violations of the automatic stay may result in the court awarding damages in favor of the debtor. Therefore, a surety should make sure to stop any automatic demand/collection notices upon learning of the debtor’s filing and should cease all efforts to collect from the debtor, absent obtaining relief from stay from the bankruptcy court.

It is important to remember that the automatic stay only protects the party that filed for bankruptcy – it does not apply to co-indemnitors. Co-obligors may attempt to use one indemnitor’s bankruptcy as a basis to stay litigation the surety commenced pre-bankruptcy; however, the automatic stay only extends to co-defendants in rare circumstances. *In re Sunbeam Securities Litigation*, 261 B.R. 564 (S.D. Fla. 2001) (protections of automatic stay generally do not apply to third party non-debtors). Therefore, a surety is free to, and should continue to pursue non-bankrupt indemnitors, as this is likely a better source of recovery than through the bankruptcy process.

The extent to which the surety ought to pay an attorney to monitor its claim against the bankrupt debtor, or litigate proceedings to protect its right to a distribution recover on that claim, will be a function of the likely amount of the distribution in bankruptcy. An experienced bankruptcy lawyer often has a profound ability to predict the likely amount of the distribution, and can provide

fair advice concerning the amount of legal expense the surety ought to incur in participating in bankruptcy case.

PRACTICE POINTERS

- Retain counsel to enter an appearance and monitor the bankruptcy case.
- Calendar the proof of claim bar date.
- File a proof of claim in advance of the bar date, even if the surety has not yet paid the bond claim.
- Update the claim once the claim is paid, include attorneys' fees incurred, assuming your indemnity agreement has an attorneys' fee provision.
- Pursue any co-indemnitors who have not filed for bankruptcy protection as soon as you learn of the bankruptcy case; the automatic stay does not protect them.
- Monitor the bankruptcy case for objections to your claim; be prepared to provide evidence to support your claim.

III. How to Better Protect Yourself on the Front End

A. Indemnity Agreement drafting suggestions

Collateralizing a bonded obligation and providing for appropriate post default recovery rights in the indemnity agreement, is always a balancing act – the surety wants the maximum protection and the principal wants the use of its working capital and the equity in its real property assets. The indemnitors, of course, want to pledge as little as possible. Depending upon market conditions, bonds may be underwritten principally on creditworthiness, as opposed to the amount of collateral or prospects for post-default recovery. However, when collateralizing the obligation and contracting for indemnity and default remedies, a little care can greatly increase the prospect of recovery. Consider the following when drafting the indemnity agreement:

- Make sure the indemnity agreement contains a “collateral security provision”³ in order to allow the court to provide quia timet relief where appropriate.
- Make sure the indemnity agreement expressly provides for the posting of collateral based upon anticipated losses, and expressly and specifically provides the mechanism for posting collateral.
- Consider the necessary requirements for perfecting/recording a post-default claim of interest or lien, and make sure the indemnity agreement contains the appropriate language and property descriptions, and makes clear that the surety is entitled to and will record the agreement to perfect its lien.
- Determine whether the jurisdiction in which your indemnitors are located allows for the waiver of a homestead provision, and make sure your indemnity agreement appropriately accomplishes the waiver.

B. *Know Who and What You are dealing with*

While this may seem obvious, it is imperative that the surety have a clear handle on the true viability of the principal it is bonding and the indemnitors guarantying the obligation, the nature of the principle’s business and the precise nature of the obligation it is bonding. Surety attorneys frequently find that these things were not evaluated with much precision during the underwriting process.

1. *Do not rely on financial statements provided by indemnitors.*

Indemnitors often do not provide sureties with complete or accurate financial statements. Therefore, depending upon the amount at issue, you may consider hiring an outside service on the front end to confirm the assets of the indemnitors. This is particularly significant with respect to indemnitors’ real property assets; as discussed above, if you want to obtain a valid lien interest in these assets, the legal description needs to be attached to the indemnity agreement when it is signed and should be recorded in the public record.

If the penal sum of the bond does not justify the expense of retaining an outside service to perform an asset search, consider using a law firm to search

³ In fact, the provision should contain these very words.

public record information or obtaining a subscription to a service that allow you to perform a basic asset search in-house. At a minimum, require the indemnitors to execute a sworn financial statement; although some people will still lie under oath, it will likely make some of them think twice about it. Also, consider whether you want to impose an obligation on the indemnitors to provide updated financial information on an annual basis.

2. *Review the contract you are bonding.*

Although this may seem like a rudimentary piece of advice, it is important for a surety to understand the terms of the contract it is bonding so that it issues the bond, and obtains security for it, with a full understanding of what obligations it may have to pay or perform. Attorneys frequently find that issues arise in which a surety receives a proof of loss and questions whether it is obligated for items included in the claim – i.e., interest, late fees, penalty provisions, etc. Not having a clear understanding of the contract the surety is bonding may result in it undertaking more liability than it intended and not obtaining sufficient collateral to secure the risk associated therewith.

3. *Draft the indemnity agreement to clearly specify the remedies to which the surety is entitled in the event of a default.*

This also probably seems like a very basic piece of advice; however, look back at your indemnity agreement. Does it clearly state that, in the event of a default, the surety is entitled to draw the full amount of any collateral the principal or indemnitors posted as consideration for issuance of the bond? Principals and indemnitors will always argue that all the surety is limited to drawing the actual amount of the actual loss, sometimes, courts will accept this argument, and it is never what sureties intended.

For example, a surety receives a \$50,000 proof of loss, investigates, and makes payment to the obligee. Part of the collateral the indemnitor posted in favor of the surety is a \$100,000 letter of credit. If the indemnity agreement does not clearly provide that upon an event of default, the surety is entitled to draw on the full amount and hold the excess proceeds as liquid collateral to cover future losses, the indemnitor may argue it is limited to a draw of \$50,000 and that the letter of credit is reduced accordingly.

PRACTICE POINTERS

- Conduct an independent investigation of the indemnitors' assets.

- Understand the contract the surety is agreeing to bond; consult legal counsel if necessary.
- Be certain the indemnity agreement clearly sets forth that the surety is entitled to draw on any and all collateral in the event of a default.

IV. Conclusion

Given a trial court's frequent suspicion of, and lack of familiarity with, the unique relationship between the surety, its principal and indemnitors, considerable care must be taken in properly documenting the scope of the indemnity agreement and available collateral. Further, careful consideration must go into the decision to pursue particular remedies, and the decision to pursue the indemnitors at all post-default. This is never more necessary than it is in a down economy. Proper pre-suit investigation and prudent intra-suit decisions about whether to continue are necessary to keep the surety from investing poorly in its aggregate recovery efforts.