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BAD FAITH CLAIMS AGAINST SURETIES

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INTRODUCTION

As a general rule, a breach of contract does not give rise to a cause of action sounding in tort. However, based upon the distinctive characteristics of the insurer/insured relationship, courts have crafted a "bad faith" exception to this rule in the insurance context to protect insureds from the "uneven playing field" often present in insurance policies and disputes. In addition, many states have enacted insurance claims handling regulations which, in some of those states, expose insurers to a private cause of action for "statutory bad faith."

In suretyship, the relative economics and bargaining power are unlike that in the insured/insurer relationship. Yet, some courts and legislatures have seen fit to equate suretyship with insurance and expose sureties to the same type of common law or statutory bad faith claims permitted against liability insurers. The question of whether it is proper to do so has been the subject of much litigation and debate; yet it remains an open question in many states. In only a few states has there been a decision by the state's highest court on this issue; and, while some states have specifically excluded surety and fidelity bonds from the reach of their insurance claims handling statutes or regulations, others have included them.

This paper will review some of the prominent court decisions addressing claims of bad faith in the suretyship context and will discuss the legal and policy arguments which have been successful in those states where courts have refused to permit bad faith claims against sureties. We will also discuss some claims handling practices which may help thwart a claim for bad faith in jurisdictions which permit such claims.

I. IMPORTANT DISTINCTIONS BETWEEN SURETYSHIP AND INSURANCE

Those courts which have refused to permit bad faith claims against sureties have consistently recognized the fundamental differences between insurance and suretyship and have appreciated the significance of those differences in the context of the claims handling process. Conversely, where courts have equated suretyship with insurance, based upon their superficial similarities, they have extended the concept of insurance bad faith to suretyship. Thus, where the law remains unsettled, it is important to educate courts on this crucial point.

As the United States Supreme Court succinctly stated, "suretyship is not insurance."[1] Rather, suretyship is a "contractual relation resulting from an agreement whereby one person, the surety, engages to be answerable for the debt, default, or miscarriage of another, the principal."[2] Thus, "[s]uretyship is a form of credit enhancement and is not 'insurance.'"[3]

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[1] Pearlman v. Reliance Ins. Co., 371 U.S. 132, 140 n.19 (1962).

[2] See, e.g., Eagle Fire Prot. Corp. v. First Indem. of Am. Ins. Co., 145 N.J. 345, 353 (N.J. 1996).

[3] 4A Philip L. Bruner & Patrice J. O'Connor, Bruner & O'Connor on Construction Law § 12.9 (2011); accord David W. Slaughter, Ch. 1, Introduction to the Surety's Rights as the Foundation for the Indemnity Agreement, in The Surety's Indemnity Agreement: Law and Practice 1, 4-5 (Marilyn Klinger, George J. Bachrach & Tracey L Haley, eds., 2d ed. 2008)(surety bond is not like an insurance policy which "afford[s] protection against accidental and generally foreseeable losses caused by a calamitous or catastrophic event….").

A surety bond, unlike an insurance policy, is a tripartite agreement among the surety, the principal and the obligee.[4] Under this arrangement, the surety and principal are liable to the obligee; but, as between the surety and the principal, the surety is secondarily liable and the principal retains the primary obligation to perform the contract.[5] In addition, a principal owes a common law duty to exonerate its surety.[6] If the surety is required to perform, it has a right of indemnity from the principal who thus ultimately bears the loss.

In the insurance context, upon assertion of a third-party claim against a policy, an insurer has a fiduciary obligation to protect its insured from a judgment exceeding the policy limits.[7] This fiduciary obligation arises because an insurance policy requires that the insured surrender to the insurer control over settlement of the claim. In contrast, a surety does not undertake such a fiduciary duty to either the obligee or the principal when it issues a performance bond.[8] A surety's refusal to settle a claim within its penal sum does not alter the rights of the parties to the tripartite surety arrangement in the way it impacts an insured on an insurance policy, i.e., potentially exposing that insured to damages not covered by the policy. Indeed, a bond principal often urges the surety not to settle a performance bond claim based upon the principal's defenses to the underlying contract action because the principal must indemnify the surety with respect to any loss or claim paid by the surety.[9] The penal sum of a surety bond (which is set by the obligee) serves to limit only the surety's liability. A principal is always exposed to damages above the penal sum where the claim exceeds that amount, with no responsibility retained by the surety as secondary obligor for such excess damages.

The conditional nature of the surety's obligations to the obligee, coupled with a surety's right to assert the defenses of its principal, demonstrate that a surety can have no special obligation to act for the benefit of an obligee. A surety has no obligation to defend either its principal or the obligee against third-party claims; nor does the surety have the right to represent the obligee's interests. Rather, because of the tripartite relationship, a surety must balance the interests of both the obligee and the principal.

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[4] See 74 Am.Jur.2d Suretyship §3 (1974).

[5] See Restatement (Third) of Suretyship and Guaranty §1-16 (1996) (surety as secondary obligor); Federal Ins. Co. v. Southwest Fla. Retirement Ctr. Inc., 708 So. 2d 1119, 1121 (Fla. 1998) (intent of a surety bond "is to have the financial responsibility of the surety standing behind the general contractor's completion obligations.").

[6] See Restatement (Third) of Suretyship & Guaranty §21 (1996); Admiral Oriental Line v. United States, 86 F.2d 201, 204 (2d Cir. 1936).

[7] Fiduciary duty is generally defined as "a duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person." Black's Law Dictionary 625 (6th ed. 1990); see, e.g., Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 65 N.J. 474, 496 (N.J. 1974); Boston Old Colony Ins. Co. v. Gutierrez, 386 So. 2d 783, 785 (Fla. 1980).

[8] See, e.g., Cates Construction, Inc. v. Talbot Partners, 21 Cal.4th 28, 56 (Cal. 1999); Great American Ins. Co. v. General Builders Inc., 934 P.2d 257, 263 (Nev. 1997).

[9] See Restatement (Third) of Suretyship & Guaranty §22 (1996); see, e.g., Fidelity & Deposit Company of Maryland v. Bristol Steel & Iron Works, Inc., 722 F. 2d 1160, 1163 (4th Cir. 1983).

Upon receipt of a disputed claim against a performance bond, the surety finds itself in the middle of that dispute, asserting its principal's defenses and its own defenses against the obligee and, at the same time, looking to the principal to indemnify it against any claim or loss. It is a relationship which creates what courts and commentators have recognized as "the classic dilemma of sureties." That dilemma has been described as follows:

> "The obligee demands performance, and the surety fails or refuses to perform upon pain of consequential damages, statutory penalties, interest, and attorneys' fees. On the other hand, the principal protests that because the principal is not liable to the obligee, neither is the surety liable; and further, if the surety does perform over the protest of the principal, the principal will raise defenses to the surety's claim for indemnity, and may assert affirmative claims for 'contract interference' and 'domination.'"[10]

The practical and legal distinctions between surety bonds and insurance policies are apparent and justify distinct treatment by legislatures and the courts: (1) In an insurance policy, the undertaking is to indemnify the insured from the consequences of its own negligence or to protect it against fortuitous events. In contrast, under surety bonds, the risk of loss remains with the principal, and the surety merely lends its credit to guarantee payment or performance in the event that the principal defaults; (2) Insureds seek protection from calamities rather than economic advantages, while obligees and principals on performance bonds seek the commercial advantage of obtaining a contract with each other, with the obligee obtaining additional financial security; (3) An insured, upon the denial of its claim, is left without any other source of recovery for its loss while it pursues its insurer. In contrast, the obligee has all of its contractual rights and remedies against the principal upon default, including its right to utilize remaining contract funds to retain a new contractor; (4) An insurance premium is paid by the insured and represents the insured's proportionate share of the risk of an entire class of insureds; and, when a claim is paid by the insurer, the insured is not required to indemnify the insurer. In contrast, the premiums charged by the surety are not based upon an actuarial computation of loss, but instead are fees based upon the credit-worthiness of the principal named in the bond;[11] and (5) It is the principal, and not the obligee, which makes the application for the surety bond and typically is obligated for the cost of the bond.[12]

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[10] Revenue Mkts, Inc. v. Amwest Sur. Ins. Co., 35 F. Supp. 2d 899, 907 n.17 (S.D. Fla. 1998), aff'd in part and reversed in part, 209 F3d 725 (11th Cir. 2000)(quoting John W. Hinchey, Surety's Performance over Protest of Principal: Considerations and Risks, 22 Tort & Ins. L.J. 133 (1986). See also PSE Consulting, Inc. v. Frank Mercede and Sons, Inc., 267 Conn. 279, 316-317 (Conn. 2004) ("sureties, by the nature of their business, may find themselves caught between Scylla and Charybdis.").

[11] See National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843, 845 (1st Cir. 1969).

[12] See 4A Philip L. Bruner & Patrick J. O'Connor, Jr., Bruner & O'Connor, Construction Law § 12:7; see also Henry Angelo & Sons, Inc. v. Property Development Corp., 574, 306 S.E.2d 162, 165-66 (N.C. App. 1983) (insurance and suretyship "involve different functions, relationships, rights and obligations; and have been recognized and treated by the profession as distinctive fields of law for generations"); Masterclean, Inc. v. Star Ins. Co., 347 S.C. 405, 412 (S.C. 2001)("[i]nequities in bargaining power are largely absent in the surety context because the obligee, not the surety, usually dictates the bond requirements."); Western World Ins. Co. v. Travelers Indemnity Co., 358 So. 2d 602, 604 (Fla. 1st Dist. Ct. App. 1978) (the "distinctions between a general liability insurance policy and a statutory penal bond are obvious.").

Yet, despite the marked differences between suretyship and insurance, the two continue to be confused by the courts, leading to the improper application of the unique rules governing insurance to surety claims. This confusion is often at the heart of those decisions which have permitted bad faith claims against sureties.

II. BAD FAITH CLAIMS AGAINST INSURERS

A breach of contract cannot give rise to remedies in tort in the absence of an independent duty owed by the alleged breaching party to the plaintiff. The mere failure by a party to fulfill obligations contained in its contract, including the implied duty of good faith and fair dealing, is not actionable in tort.[13] Indeed, it is fundamental that a party's liability for breach should be strictly limited to the foreseeable damages stemming from the breach of the contractual relationship. Thus, an independent tort action is not cognizable where there is no duty owed to the plaintiff other than the duty of the defendant arising out of the contract itself.[14]

An exception to this rule emerged when courts began holding that a breach by an insurer of its implied duty of good faith, coupled with the fiduciary duty of the insurer to its insured, created an affirmative claim in favor of insured for insurance "bad faith."[15] Courts recognizing such a cause of action often ruled that there is a "special relationship" between an insurer and its insured, based principally on the unequal bargaining power of the parties and fiduciary obligations of the insurer.

As the common law "insurance bad faith" claim was gaining recognition by courts throughout the country, the vast majority of state legislatures were in the process of enacting some version of the model "Unfair Claims Settlement Practices Act" ("UCSPA") adopted by the National Association of Insurance Commissioners ("NAIC") in 1991. The UCSPA sought to more specifically delineate the insurance claims handling provisions contained within the NAIC's model "Unfair Trade Practices Act".[16]

The model UCSPA lists the following fourteen categories of prohibited conduct that may give rise to liability on the part of an insurer if the prohibited act is performed "flagrantly and in conscious disregard of the Act" or "with such frequency to indicate a general business practice to engage in that type of conduct":

- Knowingly misrepresenting to claimants and insureds relevant facts or policy provisions relating to coverage at issue;
- Failing to acknowledge with reasonable promptness pertinent communications with respect to claims arising under its policies;

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[13] See, e.g., Saltiel v. GSI Consultants, Inc., 170 N.J. 297, 316-17 (2002).

[14] Int'l Minerals & Mining Corp. v. Citicorp North Am., Inc., 736 F. Supp. 587, 597 (D.N.J. 1990).

[15] See, e.g., Gruenberg v. Aetna Ins. Co., 510 P.2d 1032 (Cal. 1973).

[16] The model "Unfair Trade Practices Act" ("UTPA") was adopted by the NAIC in 1947 and established rules for the regulation of trade practices in the insurance industry. It was widely, but not uniformly, adopted by the states.

- Failing to adopt and implement reasonable standards for the prompt investigation and settlement of claims arising under its policies;

- Not attempting in good faith to effectuate prompt, fair and equitable settlement of claims submitted in which liability has become reasonably clear;

- Compelling insureds or beneficiaries to institute suits to recover amounts due under its policies by offering substantially less than the amounts ultimately recovered in suits brought by them;

- Refusing to pay claims without conducting reasonable investigations;

- Failing to affirm or deny coverage of claims within a reasonable time after having completed its investigations related to those claims;

- Attempting to settle or settling claims for less than amounts to which a reasonable person would believe insureds or beneficiaries were entitled by reference to written or printed advertising material accompanying or made part of applications;

- Attempting to settle or settling claims on the basis of applications that were materially altered without notice to, or knowledge or consent of, the insureds;

- Making claims payments to insureds or beneficiaries without indicating the coverage under which each payment has been made;

- Unreasonably delaying the investigation or payment of claims by requiring both a formal proof of loss form and subsequent verification that would result in duplication of information and verification appearing in the formal proof of loss form;

- Failing in the case of claims denials or offers of compromise settlements to promptly provide reasonable and accurate explanations of the basis for such actions;

- Failing to provide forms necessary to present claims within 15 calendar days of requests with reasonable explanations regarding their use; and

- Failing to adopt and implement reasonable standards to assure that the repairs are performed in a workmanlike manner by repairers owned by or that an insurer requires insureds or claimants use.[17]

In addition, the majority of states adopting some form of the UCSPA have added to the model act list a provision prohibiting insurance companies from “making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration” and/or a provision prohibiting insurance companies from delaying claims settlement “where liability has become reasonably clear under one portion of the insurance policy coverage in order to influence settlement under other portions of the insurance policy coverage.”

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[17] Uniform Claims Settlement Practices Act, 900-1 (1991).

Both the UTPA and the UCSPA provide that they are not meant to create a private cause of action. The UTPA states that "[n]othing herein shall be construed to create or imply a private cause of action for violation of this Act." Similarly, the UCSPA provides that "[t]his Act is inherently inconsistent with a private cause of action." However, in adopting these model acts, some states have omitted this language, leaving open the possibility of a statutory bad faith claim against insurers in those states.

Importantly, unlike the UTPA (which included suretyship within its definition of "policies" covered by its provisions), the UCSPA specifically excludes "fidelity" and "suretyship" from its definition of "policy" and provides, at section 1, that:

> [t]he purpose of this Act is to set forth standards for the investigation and disposition of claims arising under policies or certificates of insurance issued to residents of [state]. It is not intended to cover claims involving workers' compensation, fidelity, suretyship or boiler and machinery insurance.[18]

Not all states adopting the model act have incorporated the UCSPA's exclusion of fidelity and suretyship. Thus, the statutes and regulations governing claims handling can vary in important respects from state to state. Therefore, it is important to examine a state's statute and regulations to determine whether, or to what extent, the surety's claims handling practices are regulated in that particular jurisdiction.

III. ATTEMPTS TO APPLY INSURANCE BAD FAITH TO SURETYSHIP

Courts in several states have held that rules governing common law or statutory insurance bad faith claims in those jurisdiction are equally applicable to sureties. In most of those cases, the decisions were driven by the mistaken belief that sureties are sufficiently similar to insurers to justify this similar treatment. Specifically, state appellate courts in Arizona[19], Alaska[20], Oklahoma[21], Colorado[22], and Ohio[23] have recognized a common law cause of action for bad faith against a surety.

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[18] Id. (emphasis added)

[19] Dodge v. Fidelity and Deposit Co. of Maryland, 778 P.2d 1240, 1242 (Ariz. 1989) (relying upon Arizona legislature's inclusion of sureties within insurance statutes).

[20] Loyal Order of Moose, Lodge 1392 v. International Fidelity Ins. Co., 797 P.2d 622 (Alaska 1990) (largely adopting the reasoning of Dodge without any discussion of Alaska's statutes).

[21] Worldlogics Corp. v. Chatham Reinsurance Corp., 108 P.3d 5, 7 (Okla. Civ. App. 2004) (relying upon regulations under Oklahoma's insurance settlement practices act).

[22] Transamerica Premier Ins. Co. v. Brighton School District, 940 P.2d 348, 352 (Colo. 1997) (relying on Colorado's inclusion of sureties in its Deceptive Practices Statute).

[23] Suver v. Personal Service Ins. Co., 462 N.E. 2d 415 (Ohio 1984). However, in In re Commercial Money Center, Inc., Equipment Lease Litigation, 603 F. Supp. 2d 1095, 1122-25 (N.D. Ohio 2009), the federal district court noted that a performance bond is much different than the financial guarantee bond at issue in Suver and held that the Ohio Supreme Court was likely to refuse to recognize a bad faith claim by an obligee against a surety on a performance bond.

Those courts ruled that suretyship is similar to, and therefore should be treated like, insurance and relied upon the general inclusion of suretyship within the state's insurance regulatory scheme as evidence of that state's intention to treat sureties just like insurers, and as justification for imposition of the same obligations and penalties. These cases provide no consistent or precise definition of conduct constituting bad faith by a surety. In most contexts, courts require a dishonest purpose or conscious wrongdoing, and something more than negligence or poor judgment, to establish "bad faith."[24] In the cases recognizing bad faith claims against sureties it has been defined most commonly as an absence of a reasonable basis for refusal to honor bond obligations with knowledge that such conduct is unreasonable or with reckless disregard for the fact the conduct is unreasonable.[25] The Alaska supreme court, for instance, stated that a "surety may satisfy its duty of good faith to its obligee by acting reasonably in response to a claim by its obligee, and by acting promptly to remedy or perform the principal's duties where default is clear."[26] And, the Colorado supreme court held that "a commercial surety acts in bad faith when the surety's conduct is unreasonable and the surety knows that the conduct is unreasonable or recklessly disregards the fact that its conduct is unreasonable."[27]

Additionally, state appellate courts in Florida, Illinois, Montana, and North Dakota, have permitted statutory bad faith claims against sureties. In Dadeland Depot, Inc. v. St. Paul Fire and Marine Ins. Co.,[28] the Florida Supreme Court held that an obligee was included within the statutory definition of "insured" under Florida's civil remedy "bad faith" statute, which was passed in derogation of Florida common law[29]. The Dadeland court acknowledged that the amendment to Florida's civil remedy statute expressly excluding certain surety bonds would, going forward, preclude such bad faith claims against those surety bonds. In Fisher v. Fidelity and Deposit Co. of Maryland,[30] the court found that the surety was liable under Illinois' bad faith statute, noting that "the legislature preempted the field for recovery of punitive damages for refusal to pay, barring the common law action for such remedies." In K-W Industries v. Nat'l Surety Corp.,[31] the Montana Supreme Court held that a surety is subject to statutory bad faith

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[24] See, e.g., Engbrock v. Federal Ins. Co., 370 F.2d 784, 787 (5th Cir. 1967) ("But neither lack of diligence nor negligence is the equivalent of bad faith; and improper motive, which is not alleged, is an essential element of bad faith."); Frontier Ins. Co. v. International, Inc., 124 F. Supp. 2d 1211, 1214 (N.D. Ala. 2000) ("In the suretyship context, lack of good faith carries an implication of a dishonest purpose, a conscious doing of wrong."); see also Black's Law Dictionary 139 (6th ed. 1990)) ("Bad faith is not simply bad judgment or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity.").

[25] 4A Philip L. Bruner & Patrice J. O'Connor, Bruner & O'Connor on Construction Law § 12.7 (2011).

[26] Loyal Order, 797 P.2d at 628.

[27] Brighton School District, 940 P.2d at 354; see also Dodge, 778 P.2d at 1243-44 (stating that the "absence of a reasonable basis for denying a claim" constitutes bad faith, but also stating that bad faith liability does not arise unless a surety "intended its act or omission, lacking a founded belief that such conduct was permitted by the policy").

[28] 945 So.2d 1216, 1231 (Fla. 2006).

[29] Id. at 1230.

[30] 125 Ill.App.3d 632, 641 (Ill.App. 5 Dist. 1984).

[31] 754 P.2d 502, 504 (Mont. 1988).

claims under the Montana Unfair Claim Settlement Practices Act). And, in Szarkowski v. Reliance Ins. Co.,[32] the North Dakota Supreme Court held that a surety is subject to a statutory bad faith claim under the North Dakota Act.

While proponents of bad faith claims against sureties often rely upon the decisions from Florida, Illinois, Montana, and North Dakota to suggest a "trend" toward state recognition of a cause of action against sureties for bad faith, each of those decisions merely recognized the existence of a statutory claim in that jurisdiction and not a common law claim. As such, those decisions effectively (and in some cases, expressly) recognized that, in the absence of those statutory claims, there would be no bad faith claim allowed against sureties in those states. Thus, the decisions from Arizona, Alaska, Oklahoma, and Colorado[33] represent the decidedly minority view on whether a performance bond surety should be subject to a common law claim for bad faith.

IV. CASES REFUSING TO RECOGNIZE BAD FAITH CLAIMS AGAINST SURETIES

In 1999, the Supreme Court of California, in Cates Construction, Inc. v. Talbot Partners,[34] undertook what remains the most comprehensive, detailed and penetrating analysis of the question whether a surety bond obligee ought to be permitted to assert a claim against a surety for bad faith in resolving claims under a performance bond. The Cates court soundly rejected the argument that the inclusion of sureties within the state's general regulatory scheme applicable to insurance companies evidenced an intention by the legislature that sureties should be treated as insurers for all purposes; and it criticized holdings in other jurisdictions (Alaska, Arizona and Colorado) that had put undue emphasis upon the inclusion of sureties within general regulations applicable to insurers. The Cates court held that "[b]ecause the covenant of good faith and fair dealing essentially is a contract term that aims to effectuate the contractual intentions of the parties, compensation for its breach has almost always been limited to contract rather than tort remedies," and that the insurance policy cases represent "a major departure from traditional principles of contract law."[35]

The Cates court properly focused upon the crucial differences between surety bonds and insurance policies in explaining why surety bonds should not fall within that narrow exception. Indeed, the Cates court found that surety bonds do not share the unique aspects of insurance policies which trigger the policy considerations underlying tort recovery against insurers for bad faith, noting that insurance policies are drafted by insurers and characterized by elements of adhesion and unequal bargaining power, whereas surety bonds are generally chosen by the obligee or mandated by statute.

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[32] 404 N.W.2d 502, 505-06 (N.D. 1987).

[33] While the Ohio supreme court, in Suver v. Personal Service Ins. Co. 462 N.E. 2d 415 (Ohio 1984), recognized a bad faith claim against a surety, that case involved a claim against a financial guarantee bond, rather than a performance bond. In In re Commercial Money Center, Inc., Equipment Lease Litigation, 603 F. Supp. 2d 1095, 1122 -25 (N.D. Ohio 2009), the federal district court noted that a performance bond is much different than the financial guarantee bond at issue in Suver and held that the Ohio Supreme Court was likely to refuse to recognize a bad faith claim by an obligee against a surety on a performance bond.

[34] 980 P.2d 407 (Cal. 1999)

[35] Id. at 416-17 (internal quotation marks and citations omitted).

A second important factor which is present in the insurance context but totally absent from the surety context is the existence of a fiduciary duty running from an insurer to its insured. The crux of a bad faith cause of action against insurers is the need to protect uniquely situated insureds because of the unequal bargaining power in the insurer/insured context and the "special relationship" between an insurer and its insured. The court in Cates explained:

> Contrary to [plaintiff's] assertions, there is little basis for concluding that the relationship between a surety and an obligee is fiduciary or quasi-fiduciary in nature. Although a performance bond serves to shift the risk of the principal's nonperformance from the obligee to the surety, the conditional nature of the surety's obligations and its right to assert the defenses of the principal distinguish the surety-obligee relationship from the insurer-insured relationship. The fact that insurance regulations exempt sureties from many of the fair claims settlement standards applicable to issuers of insurance policies is consistent with and supports the conclusion that a surety does not stand in a fiduciary or quasi-fiduciary position with respect to an obligee.[36]

Ultimately, the Cates court concluded:

> A construction performance bond is not an insurance policy. Nor is it a contract otherwise marked by elements of adhesion, public interest or fiduciary responsibility, such that an extra contractual remedy is necessitated in the interests of social policy. Obligees have ample power to protect their interests through negotiation, and sureties, for the most part, are deterred from acting unreasonably by the threat of stiff statutory and administrative sanctions and penalties, including license suspension and revocation.[37]

In Great American Insurance Company v. North Austin Municipal Utility District No. 1[38], the Texas Supreme Court similarly held that there is no common law duty of good faith between the surety and the bond obligee comparable to that between an insurer and its insured. It also found that the derivative nature of a surety's liability and its right to rely upon the defenses of its principal entitled the surety, like its principal, to test the merits of an obligee's claim without the imposition of extra-contractual duties to the bond obligee. Further, citing "the unique character, rights and obligations of suretyship and the complexities that would result by the imposition of liability under [that article of the Texas insurance code which creates a private cause of action for unfair claims handling]," the court rejected the notion that the legislature intended to include a surety as engaging in the "business of insurance" for purposes of that article even though suretyship was included in the definition of that term within other sections of the Texas Insurance Code.[39]

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[36] Id. at 424 (internal citations and footnotes omitted).

[37] Cates, 980 P.2d at 427.

[38] 908 S.W.2d 415 (Tex. 1995).

[39] Id. at 420-24.

Courts have similarly relied on the differences between suretyship and insurance to hold that a bond principal cannot assert a claim for bad faith against the surety. In Masterclean, Inc. v. Star Ins, Co.,[40] the South Carolina Supreme Court distinguished suretyship from insurance and held that the principal could not sue the surety for its bad faith refusal to settle an obligee's claim. Similarly, in Great Am. Ins. Co. v. Gen'l Builders Inc.,[41] , the Nevada Supreme Court held that there was no fiduciary or other special relationship between the surety and the principal and that therefore the principal could not assert a bad faith claim against the surety for revoking performance and payment bonds.

Since Cates was decided, several federal district courts have followed its lead and, relying upon the distinctions between insurance and suretyship, have refused to recognize a cause of action for bad faith against a surety on a performance or payment bond. In In re Commercial Money Ctr., Inc., Equip. Lease Litig.,[42] the court held that Ohio courts would refuse to recognize a bad faith tort claim by an obligee against a surety on a performance bond. In so doing, the court distinguished the Ohio supreme court's decision in Suver v. Personal Service Ins. Co., explaining that the financial guarantee bond at issue in Suver was more akin to insurance and not at all like a performance bond. In U.S. ex rel. SimplexGrinell, LP v. Aegis Ins. Co.,[43] the court discussed in significant detail the differences between surety bonds and insurance policies and concluded that the Pennsylvania legislature did not intend for its insurance "bad faith" statute to apply to sureties. In Cincinnati Ins. Co. v. Centech Bldg. Corp.,[44], the district court concluded that the North Carolina Supreme Court would not recognize a cause of action for bad faith by a bond obligee against a surety. And in Inst. of Mission Helpers v. Reliance Ins. Co.,[45] the court held that an obligee could not sue the surety for bad faith under Maryland law and was instead limited to its contractual remedies.

Finally, in one of the more colorful explanations for why the rules governing insurers should not be applicable to sureties simply because surety bonds have been held to be "in the nature of insurance contracts," a North Carolina appeals court held that "this, of course, no more justifies the conclusion that sureties are insurers and performance bonds are contracts of insurance than does the commonly known fact that sheep are somewhat like goats justify the conclusion that sheep are goats."[46]

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[40] 556 S.E.2d 371 (S.C. 2001).

[41] 934 P.2d 257, 263 (Nev. 1997).

[42] 603 F. Supp. 2d 1095, 1122-1125 (N.D. Ohio 2009).

[43] 2009 WL 90233, at *3-4 (M.D. Pa. Jan. 14, 2009); see also Superior Precast, Inc. v. Safeco Ins. Co. of Am., 71 F. Supp. 2d 438, 448-454 (E.D. Pa. 1999) (same holding)

[44] 286 F. Supp. 2d 669, 689 (M.D.N.C. 2003); see also Rutherford County v. Bond Safeguard Insurance Co., C.A. No. 1:09-cv-292 (W.D.N.C. March 2, 2011) (court held that subdivision bond was not subject to the North Carolina unfair claim settlement practices act).

[45] 812 F. Supp. 72 (D. Md. 1992); See also Republic Insurance Co. v. Board of County Commissioners, 511 A.2d 1136 (Md. Ct. Spec. App. 1986) (reversing a judgment in favor of the obligee on its bad faith claim against a surety, holding that the obligee could not maintain a tort action against surety for bad faith refusal to pay a claim).

[46] Henry Angelo & Sons, Inc. v. Property Dev't Corp., 63 N.C.App. 569, 578 (N.C. App. 1983).

Decisions recognizing bad faith claims against sureties ignore the practical, legal and commercial differences between surety bonds and insurance policies which render the bad faith remedy inappropriate, unnecessary and inherently problematic in the surety context. The Cates decision provides a "road map" for the arguments against the recognition of a common law cause of action for bad faith against sureties in those jurisdictions where there has been no definitive ruling by that state's highest court. The arguments in Cates are especially effective in those states where sureties have been expressly excluded from the state's claims settlement practices act or its regulations and where the state has existing caselaw recognizing the distinctions between insurance and suretyship. It makes perfect sense for states to look to the California supreme court for guidance on this issue, because California's supreme court was at the forefront of the creation of insurance bad faith with its decision in Gruenberg v. Aetna Ins. Co.,[47] which guided the other states in the recognition of such claims.

In fact, neither party to an underlying bonded contract is like an insured, and to designate or treat either party as the "insured" would inappropriately skew the contractual playing field in that party's favor. Indeed, courts have often recognized that a bond is a contract and is therefore subject to the general law of contracts and should be enforced as written.[48] Construction disputes are not at all like insurance claims and highlight the inherent danger of attempting to treat them as one and the same. The obligee typically asserts that the principal was in default of its contract and responsible for the entire cost of corrective work on the bonded project. The principal may contend that the defects were not its responsibility and refuse to perform all the corrective work demanded by the obligee. When the obligee calls upon the surety to complete the corrective work under its performance bond, the surety is often presented with these diametrically opposed views of the operative facts and is forced, in a short time frame, to exercise one of its bond options. Under the AIA A312 bond form, those options include the right to either perform the contract or deny liability. Absent reasonable proof that its principal is in fact in breach and responsible for the alleged incomplete, deficient or improper work and that the obligee's termination of the principal is proper, the surety's most prudent and appropriate action may be a denial of liability, allowing the parties to arbitrate or litigate their dispute as provided in construction contract. If the parties' negotiated playing field is altered by arming obligees with extra-contractual remedies against the surety any time that the surety exercises its contractual right to deny liability pending resort by the principal to the bonded contract's dispute resolution procedure, a surety may suffer undue pressure to side with an obligee, to the detriment of its principal.

It is for these reasons that courts should follow the lead of California and Texas and refuse to create a cause of action for "bad faith" against a surety, limiting obligees, claimants and principals to their contractual remedies.

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[47] 510 P.2d 1032 (Cal. 1973).

[48] See, e.g., American Home Assurance Co. v. Larkin General Hospital, Ltd., 593 So.2d 195, 197 (Fla. 1992) ("the liability of a surety should not be extended by implication beyond the terms of the contract, i.e., the performance bond" and that "a surety on a bond does not undertake to do more than that expressed in the bond, and has the right to stand upon the strict terms of the obligation as to his liability thereon."); Eagle Fire Prot. Corp. v. First Indem. of Am. Ins. Co., 145 N.J. 345, 353 (N.J. 1996) (surety "'is chargeable only according to the strict terms of its undertaking and its obligations cannot and should not be extended either by implication or by construction beyond the confines of its contract").

V. FEDERAL COURT DECISIONS CREATING STATE LAW BAD FAITH CLAIMS

A surety may find itself in federal court on diversity grounds and face a bad faith claim where the relevant state court has never definitively addressed the issue of whether that state recognizes such a claim against sureties. Some federal courts have weighed in on the issue of common law or statutory surety bad faith in the absence of such direction from the pertinent state court. As discussed above, several of those courts have refused to recognize such a cause of action, relying upon the reasoning in Cates and cases from other jurisdictions. However, some federal courts have predicted that the applicable state supreme court, if presented with the question, would create a cause of action for bad faith against sureties.[49]

When faced a bad faith claim in federal court, where there is no guiding state court decision on the issue, the federal court should be reminded that it is under no obligation to predict whether a state supreme court is likely to create a cause of action where none exists; but rather it is "[g]uided by the principle that as a federal court sitting in diversity, [its] task is to apply state law and not to form it."[50] Indeed, even where a particular federal court has previously recognized a cause of action for bad faith against sureties, the surety should not take it for granted that such federal court decision properly reflects state law.

For example, New Jersey, like most states, recognizes a claim for bad faith against insurers.[51] However, no New Jersey state appellate court has ruled either way on the issue of whether a surety can be subjected to a similar claim of bad faith. In 2000, a federal court judge in United States ex rel. Don Siegel Construction Co., Inc. v. Atul Construction Co.,[52] predicted that the New Jersey supreme court would extend insurance bad faith to suretyship on a payment bond claim. For the last ten years, this poorly-reasoned decision empowered claimants and obligees to threaten and allege claims of "bad faith against sureties on New Jersey bonds. While the Atul decision was seemingly ripe for attack on several grounds, its existence stood as an unnecessary obstacle to the swift dismissal of bad faith claims and often complicated resolution of the underlying dispute.

Earlier this year, in what could prove to be a benchmark decision, a New Jersey district court judge effectively overruled Atul and held that New Jersey law does not currently recognize a cause of action for "bad faith" breach of a surety bond and that the New Jersey Supreme Court is unlikely to recognize such a cause of action in the future. In Deluxe Building

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[49] See, e.g., United States ex rel. Don Siegel Construction Co., Inc. v. Atul Construction, 85 F. Supp. 2d 414 (D.N.J. 2000); Old St. Paul Missionary Baptist Church v. First Nation Insurance Group, 707 F. Supp. 2d 811 (E.D. Ark. 2010)

[50] State Farm Mut. Auto. Ins. Co. v. Coviello, 233 F.3d 710, 716 (3d. Cir. 2000) (emphasis added); see also Vargus v. Pitman Mfg. Co., 675 F.2d 73, 76 (3d. Cir. 1982) ("the appellant here is asking that we anticipate the birth of a state law doctrine in the 'womb of time, but whose birth is distant.' We have been asked to deliver prematurely a new doctrine of Pennsylvania tort law, and as a federal court we are unwilling to do so."); Ryan v. Royal Ins. Co. of America, 916 F.2d 731, 744 (1st Cir. 1990) (refusing to extend New York's law of bad faith, noting that a plaintiff in a diversity action "cannot expect that new trails will be blazed").

[51] Pickett v. Lloyd's, 131 N.J. 457 (1993).

[52] 85 F. Supp. 2d 414 (D.N.J. 2000).

Systems, Inc. v. Constructamax, Inc.,[53] the court dismissed the obligee's bad faith count against the surety and, at the same time, denied the motion of a subcontractor to amend its complaint to add a count for bad faith. The surety argued, and the Deluxe court agreed, that because New Jersey law recognizes that suretyship is fundamentally different from insurance, the New Jersey supreme court is not likely to extend insurance bad faith to sureties.

The Deluxe decision followed an oral decision two years earlier by a different federal judge in New Jersey, in SBW, Inc. v. Ernest Bock & Sons, Inc.,[54] where the court similarly dismissed a bad faith claim by a payment bond claimant. The SBW court held that "there being no authoritative New Jersey statute or case law establishing that there is such a cause of action, this Court is satisfied that at this time, at least, Count 14 [for bad faith] does not state a cause of action under New Jersey law,"[55] In dismissing that bad faith claim, the SBW court found that the prediction in Atul had not been accurate, holding that:

> there have been nine — almost nine years elapsed since this 2000 decision in the District of New Jersey, and construction disputes happen all the time. It's sad to see how many public projects degenerate into construction disputes and claims on surety bonds. And we've got not even Appellate Division much less New Jersey Supreme Court authority picking up on the prediction that the Atul case made.[56]

New Jersey's courts, like those in many states, have recognized and discussed the fundamental differences between suretyship and insurance. For instance, in N.J. Prop.-Liab. Ins. Guar. Ass'n v. Hill Int'l, Inc., the New Jersey appellate division described the key differences as follows:

> The nature of the risk assumed by the party in the role of "insurer" is a major distinction between insurance and the arrangements of guaranty and surety. As a broad general rule, the risk can be characterized in terms of the degree to which the contingency is within the control of one of the parties. In the classic instance of insurance, the risk is controlled only by chance or nature. In guaranty and surety arrangements, the risk tends to be wholly or partially in the control of one of the three parties….

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[53] 2011 WL 322385 (D.N.J. Jan. 31, 2011).

[54] Civil Action No. 07-4199 (MLC) (D.N.J. March 17, 2009).

[55] Id., Transcript of Oral Argument at 28:17-21 (Docket Entry 46).

[56] SBW, Inc., Civil Action No. 07-4199, Tr. of Oral Arg. at 26:17-28:24 (Docket Entry 46). The SBW court also noted that, because it involved a Miller Act bond, the ruling in Atul ran contrary to the Supreme Court's holding in F.D. Rich Co. v. United States ex rel. Industrial Lumber Co., 417 U.S. 116 (1974) that the "Miller Act provides a federal cause of action, and the scope of the remedy as well as the substance of the rights created thereby is a matter of federal not state law." Id. at 127; see also U.S. ex rel. Metric Electric, Inc. v. EnviroServe, Inc., 301 F. Supp. 2d 56 (D. Mass. 2003) (holding that the Miller Act preempts state law claims for enhanced damages for failure to investigate or pay a Miller Act claim). Thus, the court in Atul likely lacked subject matter jurisdiction to create a "bad faith" claim against a surety under New Jersey law.

> There is also a difference in the liability of a classic insurer and that of a surety/guarantor. An insurer is the primary party liable upon the occurrence of the contingency, and ... must bear the ultimate loss. In the classic case of surety or guaranty, on the other hand, the "insurer" is essentially liable secondarily (regardless of how the liability may be labeled for legal analysis). A surety is ordinarily entitled to indemnity from the principal in case the surety is compelled to perform.[57]

In sum, the Hill court held that, "[w]hile surety bonds have been included within definitions of insurance for some purposes, suretyship is not generally considered to be insurance."[58] Such holding undermined the Atul court's linchpin holding that suretyship is analogous to insurance. Indeed, the Atul court did not discuss at all the fact that New Jersey Administrative Code § 11:2-17.2 (2003) expressly excludes surety bonds from the operation of the New Jersey unfair insurance claims handling statute, N.J. Stat. Ann. § 17:29B-4(9) (2007), and thus did not consider the New Jersey public policy reflected in that exclusion.[59] Additionally, the New Jersey Bond Act, which governs the form of the performance and payment bond required for public projects, provides that: "A surety's obligation shall not extend to any claim for damages based upon alleged negligence that resulted in personal injury, wrongful death, or damage to real or personal property, and no bond shall in any way be construed as a liability insurance policy."[60]

In the ten years since the dubious Atul ruling was rendered, performance and payment bond claimants have used that decision to assert or threaten to assert bad faith claims against sureties in New Jersey in an effort to gain an unfair advantage. The rulings in Deluxe and SBW have, in effect, overruled the Atul case and give sureties in New Jersey the basis for obtaining the dismissal of bad faith claims, thereby ensuring a level playing field for adjudication of the contractual dispute.

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[57] N.J. Prop.-Liab. Ins. Guar. Ass'n v. Hill Int'l, Inc., 395 N.J. Super. 196, 202-03 (App. Div. 2007) (quoting 1 Lee R. Russ & Thomas F. Segalla, Couch on Insurance §1:18 (3d ed. 2005)). A construction contract typically requires both liability insurance and a performance bond, as occurred in this case. The general liability policy insures against injury to persons or property arising from accidents or fortuitous events but does not cover "business risks," chief among which is the contractor's failure to perform its contract. Thus, a performance bond is required because its very purpose is to secure faithful performance of the contract. See Weedo v. Stone-E-Brick, Inc., 81 N.J. 233, 239-41 (1979) (contrasting contract damages for failing to perform the contract, which are "business risks" that do not give "rise to insurable liability," id. at 240, to injury to persons or property resulting from faulty workmanship, the occurrence of which is accidental and therefore does give rise to tort liability that is insurable); George H. Tinker, Comprehensive General Liability Insurance – Perspective and Overview, 25 Fed'n Ins. Couns. Q. 217, 224 (1975) ("It is not the function of the CGL policy to guarantee the technical competence or integrity of a business management. The CGL policy does not serve as a performance bond …."), cited in Weedo, 81 N.J. at 239; Robert J. Franco, Insurance Coverage for Faulty Workmanship Claims Under Commercial General Liability Policies, 25 Tort & Ins. L.J. 785, 789 n.23 (1995) ("A breach of contract cannot constitute an occurrence because there is no accident or fortuitous loss").

[58] Hill, 395 N.J. Super at 202; see also Taxation v. Selective Insurance Co. of America, 399 N.J. Super. 315, 325 (App. Div. 2008) (court reiterated that "we have recognized that suretyship and liability insurance are different").

[59] New Jersey's statutory treatment of sureties is aligned with that of California. Compare Cates, 21 Cal.4th at 56 with N.J.A.C. 11:2-17.2 (2003) (excluding sureties from New Jersey's fair claims handling regulations).

[60] N.J. Stat. Ann. §§ 2A:44-143 to 147 (2000) (emphasis added).

VI. PERMITTING BAD FAITH ACTIONS BY OBLIGEES IS AGAINST PUBLIC POLICY

In suretyship, the relative economics and bargaining power are unlike those in the classic insured/insurer relationship which has caused legislatures and courts to protect insureds from the "uneven playing field" often present in insurance disputes and litigation. No such need exists in the surety context and there is no evidence that the absence of a bad faith remedy results in any harm to obligees or payment bond claimants. In contrast, there is a real danger in vesting an obligee with rights greater than those set forth in the bond or contract and thereby handing one party to the tripartite relationship a proverbial club to use against the others. Vesting the obligee with rights greater than those set forth in the contract or bond serves no legitimate purpose and would have the effect of tilting the contractual playing field unfairly in favor of that obligee. The principals and obligees on large construction projects are typically sophisticated parties who have provided for their respective rights and obligations in complex agreements which are usually drafted by the obligee initially but subject to extensive bargaining. There is no legitimate public policy to be served by granting the obligee the unique protections afforded insureds who are generally subjected to policies which are dictated by the insurer.

The court in Cates discussed the absence of the policy concerns which gave rise to insurance bad faith in the suretyship context and the overriding danger of altering the negotiated playing field between an owner and a contractor by injecting “bad faith” into the equation:

> Unlike insurance relationships, which involve the interests of only two parties, the surety relationship is a tripartite one implicating the separate legal interests of the principal, the obligee and the surety. When contract disputes arise between an obligee and a principal as to whether the principal is in default, it may prove difficult for the surety to determine which party is in the right and whether its own performance is due under the bond. As one text explains: “There is no simple scenario for a performance bond dispute. Most often a dispute will involve claims, counterclaims, charges, and countercharges. Seldom will any one party be altogether in the right. Often the parties are in a defensive posture when bond claims begin to surface. Usually, the project is behind schedule. Generally, prior to the time the surety is officially called upon to perform, lines have been drawn and personalities have clashed. It is no wonder that performance bond claims are fertile fields for surety litigators.”
>
> As the foregoing suggests, construction disputes may be complicated enough to resolve when all three parties are on a level playing field. But it is rational to assume that making tort remedies available may encourage obligees to allege a principal's default more readily than they would in the absence of such remedies. It is also reasonable to conclude that allowing obligees to wield the club of tort and punitive damages may make it easier to pressure sureties into paying questionable default claims, or paying more on properly disputed claims, because the sureties will be reluctant to risk the outcome of a tort action. <u>Thus, permitting obligees to sue sureties in tort may allow obligees to gain additional leverage with sureties that principals do not have in contract disputes.</u>

> With such increased leverage, obligees will have sufficient power to detrimentally affect the interests of principals when disagreements arise during construction. Claims of default by the obligee may impair the principal's ability to secure bonding on other projects, thus automatically disqualifying the principal from bidding on all public projects and many private ones. Moreover, indemnity agreements executed by principals often give sureties the right to pursue them for reimbursement of any loss, including legal expenses and the costs of investigation. In efforts to avoid bad faith liability, sureties may strive to "find" bond coverage for obligees while, at the same time, charging their investigation costs to the principal. Accordingly, even if the surety's investigation ultimately leads to the conclusion that the principal is not in default, the faultless principal may still suffer adverse consequences. These considerations, which have no parallel in disputes involving insurance policies, weigh against the recognition of extra contractual liability in the performance bond context.[61]

The potential impact of the bad faith claims against sureties would likely be felt more dramatically by contractors than by sureties. An insurer, upon the occurrence of the contingency, must bear the ultimate loss, while a surety is entitled to indemnity where it is compelled to perform its principal's obligation. If a surety is threatened with the prospect of tort liability arising out of performance claims – i.e., a bad faith claim in addition to the underlying dispute – it will invariably be motivated to exert pressure upon the principal to accede to the obligee's demands and the principal, as indemnitor, may be intimidated by this pressure.

Arming an obligee with a claim for bad faith in the performance bond context would inevitably open the door to increased, and often successive, litigation of claims. Faced with that prospect, sureties would be forced to increase the premiums charged for bonds. An increase in the cost of obtaining bonds adversely affects contractors, project owners and, ultimately, the general public. Imposing such costs where the primary effect of creating "bad faith" liability exposure is merely to unfairly skew the contractual playing field in favor of the bond obligee and coerce payment of inflated or improper claims at the expense of the contractor/principal, serves no legitimate purpose.

Importantly, a finding that an obligee may not sue a surety for bad faith refusal to settle its claim does not leave an obligee without recourse, because it retains all of its bargained-for contractual remedies. Nor would such a finding lessen a surety's incentive to fairly address performance bond claims; a surety remains motivated to promptly resolve such claims. Often a surety can limit its damages if it determines that an obligee's termination was proper and it is then able to promptly arrange for completion of the project. On the other hand, where a surety waives its right to complete or denies liability, it ultimately might be faced with a damage claim far in excess of the cost for which it could have completed the work.

[61] Cates, 980 P. 2d at 425-26 (citations omitted; emphasis in original); see also Superior Precast, Inc. v. Safeco Ins. Co. of America, 71 F. Supp. 2d 438, 452-454 (E.D. Pa. 1999)(explaining that a cause of action or remedy that would not be available as against a principal should not be available as against the surety because it would subject a surety to greater liability than its principal might otherwise have had in violation of fundamental principle of suretyship law).

Finally, if tort liability were permitted against surety bonds, every breach of contract could give rise to a tort action for "bad faith," because the covenant of good faith and fair dealing is implied in every contract. That is contrary to the general rule that mere failure to fulfill obligations encompassed by the parties' contract, including the implied duty of good faith and fair dealing, is not actionable in tort.

VII. RECOMMENDED PRACTICES

As discussed above, there is little concrete guidance in the cases allowing bad faith claims as to what precise conduct would subject the surety to liability. The state unfair claims practices acts and regulations, which to a large extent mirror the model act, provide guidance as to the practices which a surety should avoid. Those practices generally fall into four categories: (1) misrepresenting policy provisions; (2) failing to promptly investigate claims; (3) failing to promptly acknowledge and address claims; and (4) unreasonably refusing to pay or investigate claims. And, of course, if the surety is subject to a particular state statute or regulation with respect to a particular claim, such regulations should be followed.

While the following practices may not avoid the assertion of bad faith claims, they may certainly help to thwart such claims:

a) Respond promptly, and in writing, to communications from obligees and claimants. Allegations of delay are often at the heart of threats or claims of bad faith. A significant difference between surety claims and insurance claims is that there seldom is a "typical" performance bond claim. Investigations of complicated claims not only takes time, but it is usually not possible to precisely estimate how long it will take. It is important during an investigation to communicate with obligees and claimants as to any factors which are complicating that investigation, especially if there is additional information needed from the obligee or claimant, so that any supposed "delay" is explained and documented. Also, where phone calls take place, it is helpful to confirm the substance of the call in writing so that the obligee or claimant cannot later claim a different understanding of what was conveyed on the call.

b) Do not rely entirely upon the principal's version of the facts without documentation or other verification of legitimacy of defenses. Another common allegation of bad faith is that the surety failed to perform an independent, reasonable investigation of the claim. A surety does not have to make the right decision in order to insulate itself from bad faith liability; it need only demonstrate that it came to that decision in good faith. It is important for the surety's file to reflect that its decision came after an investigation which did not merely begin and end with a letter from its principal stating a generalized, unsupported denial of liability. If the dispute involves a technical or complicated legal issue, consider retaining an outside consultant or attorney. Retaining such a consultant or attorney can further demonstrate the surety's efforts to reach an informed, objective decision.

c) Be detailed in communicating the denial of a claim. Always consider that a letter denying liability will be a key document in any litigation arising out of that denial, especially if a bad faith claim is asserted. If a surety denies a claim after an extensive investigation, its declination letter should reflect the facts and legal positions considered in reaching that decision. Of course, the letter should end by noting that it is not

intended to recite every possible defense and that all other existing or later-acquired defenses are expressly preserved and should note that the surety may not be aware of facts going to other defenses.

d) Provide the basis for an offer to compromise. When communicating a settlement offer, be sure to communicate the defenses which give rise to the decision to offer less than the amount claimed. In so doing, the surety can thwart an argument that the surety was just "bullying" the claimant into accepting a lesser amount on a valid claim. Again, preserve all other defenses in doing so.

e) Avoid making threats of litigation. One of the best arguments against bad faith liability for sureties is that surety bond claims are run-of-the-mill contract disputes which should be resolved without interjecting tort elements. It is important not to threaten a claimant, principal or obligee with prolonged litigation or say anything that could be construed as suggesting that the surety is seeking an unfair advantage stemming from an unequal bargaining position.

f) Comply with any applicable statutory deadlines or procedures. As discussed above, sureties are excluded from some state's claims handling statutes and regulations. If the claim arises in a jurisdiction which does not do so, be certain to comply with any stated time frames or procedures.

CONCLUSION

Often threats of bad faith claims, or inclusion of such claims in pleadings, are more a function of the temperament of the claimant or its attorney than a reflection upon the handling of the bond claim. Many times, such claims are strategically asserted to gain leverage in a dispute where the underlying claim of the obligee or payment bond claimant is of dubious merit and hotly contested by the principal. As such, a surety claims professional must always be wary of potential bad faith claims regardless of whether such claims have any factual or legal basis. As discussed above, bad faith claims are subject to legal attack in many jurisdictions. However, there is such uncertainty in the law that the surety should be both mindful of the possible assertion of such claims and alert to possible legal challenges that may be available to the surety. In those states which have yet to address the issue of whether a surety can be sued for bad faith, it is far better to approach the potential legal battle over the propriety of such a claim armed with a good set of facts. Sound claims handling, including reasonable efforts to make informed, independent decision, make for good facts.

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