

# Surety in the 21<sup>st</sup> Century: Everything Old is New Again

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At the end of the 1980's and throughout the 1990's, there were numerous contractor bankruptcies and insolvencies, which triggered defaults under the terms of construction contracts. This led to claims by owners against the insurance companies acting as sureties of the contractors, under performance and payment bonds. Surety companies, their consultants and attorneys were kept busy for several years.

Since that time, underwriting standards have improved, and there have been less claims on bonds. In recent years, industry veterans have noted that there does not seem to be the same understanding of the ins and outs of the surety claim process.

This article provides an overview of the suretyship and how it fits into the field of construction law. We will also underline some distinctions between the interpretation of the suretyship in the United States and Canada and will address the following points:

1. The difference between insurance and surety;
2. The underwriting of a surety bond and the indemnity agreement;
3. The different type of bonds: bid bonds, performance and payment bonds; and
4. Dispute resolution: must the parties go to Court?

## I. Insurance vs. Surety

One of the first questions asked by newcomers to the surety field is: if a bond is issued by an insurance company, why isn't it always interpreted in the same manner as an insurance policy? However similar they appear, the obligations between the parties are different, and the loss under the bond is ultimately the contractor's, that is, the principal under the bond. In the case of a first party insurance policy, the insurer pays the insured the amount of the loss, which the insurer may then seek to recover from the responsible third party, if possible. Under the terms of a CGL policy, the insurer will pay a third party for the liability of the insured.

There is a three-party relationship in a surety arrangement between the following parties: (1) the contractor/principal, (2) the owner/obligee, and (3) the insurance company/surety. The principal has a contract to perform for the obligee, and in case of default of the principal, the surety is bound to perform and fulfill all of the terms and conditions of the underlying contract. If the surety pays an amount to the obligee, it will seek recovery from the principal as well as those parties who signed an indemnity agreement in favor of the surety, as will be explained in

greater detail in the section on underwriting.

Under the terms of an insurance policy, there are only two parties to the agreement, the insurer and the insured. The insurer does not perform the insured's obligation, its obligation is to pay the insured or a third-party claimant upon the occurrence of an insured event.

Some courts respect the historical distinctions between insurance and suretyship, like the California Supreme Court in *Cates Construction Inc. v. Talbot Partners*.<sup>2</sup> However, certain jurisdictions are not as preoccupied with the differences between suretyship and insurance because, in certain states, sureties are treated like insurers, as may be seen in *Dodge v. Fidelity and Deposit Co. of Maryland*.<sup>3</sup> And in the more recent case of *Ewing Construction Co. v. Amerisure Insurance Co.*,<sup>4</sup> the Texas Supreme Court took a different approach, as it treated CGL coverage in a manner similar to an interpretation of a surety bond.<sup>5</sup>

Ewing Construction had entered into a standard AIA contract with a school district to build tennis courts.

After Ewing completed construction, the school district complained that the tennis courts were flaking, cracking and crumbling, rendering them unusable. The school district filed suit against Ewing, asserting claims for breach of contract and negligence. Ewing tendered the defense to its general liability carrier, Amerisure, which denied coverage. Ewing sued Amerisure in federal court in Texas, seeking a declaration that Amerisure had breached its duties to defend and indemnify it in the school district's suit. On cross motions for summary judgment, the district court ruled in favor of Amerisure based on the contractual liability exclusion. Ewing appealed to the Fifth Circuit, which affirmed the district court in a 2-1 opinion. On rehearing, in an unusual turn of events, the Fifth Circuit withdrew its opinion and sent the case to the Texas Supreme Court on certified questions:

1. Does a general contractor that enters into a contract in which it agrees to perform its construction work in a good and workmanlike

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<sup>2</sup> *Cates Construction, Inc. v. Talbot Partners*, 21 Cal.4th, 980 P.2d 407, 86 Cal. Rptr. 2d 855 (Cal. 1999).

<sup>3</sup> *Dodge v. Fidelity and Deposit Co. of Maryland*, 161 Ariz. 344, 778 P.2d 1240, 1242 (Ariz. 1989).

<sup>4</sup> *Ewing Construction Co. v. Amerisure Insurance Co.*, 420 S.W.3d 30, 2014 WL 185035, No. 12-0661 (Tex. 2014) (on

certified question from the United States Court of Appeals for the Fifth Circuit).

<sup>5</sup> The material regarding the *Ewing Construction* decision is adapted from David W. Kash and Bruce Kahn, "Bad News for Construction Insurers Might Be Good News for Sureties," in the IADC Fidelity and Surety Newsletter, March 2014. The authors thank Mr. Kash for his kind permission in allowing use of portions of this article.

manner, without more specific provisions enlarging this obligation, “assume liability” for damages arising out of the contractor’s defective work so as to trigger the Contractual Liability Exclusion.

2. If the answer to question one is “Yes” and the contractual liability exclusion is triggered, do the allegations in the underlying lawsuit alleging that the contractor violated its common-law duty to perform the contract in a careful, workmanlike, and non-negligent manner fall within the exception to the contractual liability exclusion for “liability that would exist in the absence of contract.”

The answer to the first question was “no” and therefore, the court did not answer the second question. The Texas Supreme Court determined that because under every construction contract there is an implicit obligation for contractors to perform their work in a good and workmanlike manner, the existence of a construction contract does not expand a

contractor’s liability or cause the contractor to assume any liability beyond that which the common law imposes. In so holding, the Texas court would appear to equate a contract claim for failing to perform in a good and workmanlike manner with a tort claim allegations of negligent performance. Consequently, it rejected the application of the contractual liability exclusion and allowed the claim under a tort/negligence theory.

Amerisure argued that the Court’s interpretation of the contractual liability exclusion would turn the insurance policy into a performance bond—essentially requiring the insurance company to guarantee the contractor’s performance of its contract. The court rejected this argument, noting two critical differences between an insurance policy and a performance bond: (1) the insurance policy’s requirement for resulting personal injury or property damage; and (2) the existence of other common “business risk” policy exclusions which were not before the court.

In Canada, the courts have recognized the difference between the two,<sup>6</sup> and more interestingly, the Quebec Civil Code sets out the definitions of suretyship and insurance in distinct chapters of the code.<sup>7</sup>

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<sup>6</sup> See *Lac La Ronge Indian Band v. Dallas Contracting Ltd.*, 35 C.L.R. (3d) 236; Canada does not impose upon a surety the obligations of an insurer.

<sup>7</sup> Suretyship in Chapter XIII of the section on nominate contracts, and insurance in Chapter XV.

## II. Underwriting a surety bond and the indemnity agreement

The surety's underwriting process closely resembles the granting of a credit facility by a lender. For example, a lender may grant an operating line of credit to the contractor and will obtain a security interest on its land and buildings and demand other forms of security to cover the contractor's indebtedness. The lender will most likely request additional documents and undertakings from its client.

A surety will make similar demands upon the contractor, including an indemnity<sup>8</sup> from the contractor/principal, its related companies and, in most instances, its main shareholders and possibly their spouses. The surety may also register a security interest against the contractor, if appropriate.

Similar to a lender, the surety underwriter will look to the three C's of credit: capital, character and capacity. For capital, the underwriter will require that the contractor have significant equity on its balance sheet. For character, the dedication of the owners of the construction company is important, as is their reputation in the field. The question of capacity concerns not only the financial capacity of the contractor to perform the contract but also their experience, equipment and ability of management to complete the work.

An example of lack of capacity is the road contractor who decides to bid on a significant tunneling job; this does not usually end well.

The courts have recognized the surety's right to claim against the principal under the executed indemnity agreement. Common defenses raised by indemnitors are the surety's failure to obtain the indemnitor's signature, and the lack of legal consideration from the surety to the indemnitor. Obviously, the surety should obtain a valid indemnity prior to issuing any bonds. As for the lack of consideration, this can be overcome by agreements stating that the indemnitors have a substantial, material and beneficial interest in the principal being able to obtain bonds.

In Canada, under both common and civil law, upon payment of losses incurred as a result of the issuance of a bond, the surety can institute legal proceedings against the principal for the amount of the loss.

The indemnity agreement sets out various other obligations of the principal and the indemnitors towards the surety, including for example:

- Obligation to perform the bonded contract;
- Allow access to the books and records of the company

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<sup>8</sup> General Agreement of Indemnity.

upon request of the surety, and provide all relevant financial information as determined by the surety underwriter;

- Acknowledge that receivables on bonded contracts must be held in trust by the principal and indemnitors, and used only to pay the contract obligations;
- Grant an assignment of rights on the assets of the principal including the receivables on the bonded contract. In the United States, the surety that files the indemnity agreement as a financing statement under the Uniform Commercial Code gets a perfected security interest in the assets of the principal and the indemnitors. In Canada, the surety will register under the Personal Property Security Act or will register movable hypothecs under the Quebec Civil code;
- Grant the surety the right to use the principal's equipment and material to perform the bonded contract;
- Acknowledge the surety's right to intervene under the terms of a bonded contract;

- Acknowledge that the surety is entitled to request the advancement of funds to perform its obligations under the bonds;
- Acknowledge the surety's right to settle claims under bonds, and be reimbursed for reasonable expenses;
- Acknowledge the surety's right sue the principal and the indemnitors; and
- Grant the surety the right to settle claims and be reimbursed for reasonable disbursements.

While this is not an exhaustive list of the obligations which are set out in indemnity agreements, it does illustrate certain similarities between what a financial institution may request when it grants a credit facility and the surety underwriter's requirements prior to issuing bonds also known as a surety facility.

A few recent cases illustrate the continued trend toward acknowledging the surety's right to recover from its principal. In *Far West Insurance Co. v. J. Metro Excavating Inc.*,<sup>9</sup> the court ordered the indemnitors to post collateral despite their allegations of breaches of the surety's fiduciary duty. The court did not deem questions concerning the surety's good faith in allowing a claim for the full amount relevant to the indemnitor's

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<sup>9</sup> 2008 WL 859182 (N.D. Ind. Mar. 28 2008).

obligation to post collateral. In *International Fidelity Insurance Co. v. Anchor Env'tl, Inc.*,<sup>10</sup> the court granted a preliminary injunction requiring the principal to post collateral. The court made the injunction permanent because the terms of the indemnity agreement remained unchanged, and all of the elements were already satisfied for establishing a permanent injunction.

### III. Types of bonds

#### 1. Bid bond

Under the terms of a bid bond, the surety undertakes to pay a specified penalty to the obligee, if the principal fails to enter into the underlying contract.

The principal could refuse to enter into the construction contract for many reasons, including mistakes in its tender. The obligee's right to obtain payment under the bid bond can be affected by certain facts. For example, the owner could have had constructive notice of the contractor's error simply because it was significantly lower than the other bids. A claim under a bid bond could also be dismissed if the mistake is apparent on the face of the tender or bid.

The bid bond penal sum is the maximum amount of the surety's liability.

The surety may be entitled to defend a claim under a bid bond if it

is able to identify an error on the part of the owner/obligee. The obligee must fulfill its obligations under the invitation to bid, the bid document and the procurement statutes. If the obligee does not award the contract within the time stated in the invitation to bidders, the surety is not liable under the bid bond unless it has expressly agreed to an extension of time. Once the obligee declares the principal in default, it must promptly contract with the next lowest bidder to mitigate any damage claim against the surety.

#### 2. Performance bond

Performance bonds guarantee the performance of the construction contract. In most circumstances, a performance bond only covers a claim from the named obligee, the owner of the project. However, the bond may also name a co-obligee or dual obligee, usually the bank or lender which is financing the construction project.

The performance bond wording under the AIA Document A312 – 2010 defines the surety's obligations as follows:

1. The Contractor and Surety, jointly and severally, bind themselves, their heirs, executors, administrators, successors and assigns to the Owner for the

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<sup>10</sup> 2008 WL 1931004 (E.D. Pa. May 1, 2008).

performance of the Construction Contract, which is incorporated herein by reference.

2. If the Contractor performs the Construction Contract, the Surety and the Contractor shall have no obligation under this Bond, except where applicable to participate in a conference as provided in Section 3.
3. If there is no Owner Default under the Construction Contract, the Surety's obligation under this Bond shall arise after
  - i. The Owner first provides notice to the Contractor and the Surety that the Owner is considering declaring a Contractor Default. Such notice shall indicate whether the Owner is requesting a conference among the Owner, Contractor and Surety to discuss the Contractor's performance. If the Owner does not request a conference, the Surety may, within five (5) business days after receipt of the Owner's notice, request such conference. IF the

Surety timely requests a conference, the Owner shall attend. Unless the Owner agrees otherwise, any conference requested under this Section 3.1 shall be held within ten (1) business days of the Surety's receipt of the Owner's notice. IF the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract, but such an agreement shall not wait the Owner's right, if any, subsequently to declare a Contractor Default;

- ii. The Owner declares a Contractor Default, terminates the Construction Contract and notifies the Surety; and
- iii. The Owner has agreed to pay the Balance of the Contract Price in accordance with the term of the Construction Contract to the Surety or to a contractor selected to



perform the  
Construction Contract.

Should the obligee fail to send a notice within the prescribed period, the surety will only be released from its obligations to the extent that it demonstrates actual prejudice.

When the obligee and the surety both acknowledge that there is a default, the surety will undertake one of the following actions: (1) arrange for the Principal to complete the contract; (2) undertake to complete the contract itself or through its agents or independent contractors; or (3) obtain bids or negotiated proposals from qualified contractors acceptable to the obligee and see to the execution of a new construction contract to be signed by the new contractor and the obligee. If required, the surety will pay to the obligee the difference between the balance of the original contract funds, and the amount of the new contract.

After investigation, the surety may also decide to make a payment to the obligee, or deny liability in whole and in part and notify the obligee of its reasons for the denial.

The bond also provides that if the surety elects to arrange for the principal to complete or arranges for a new contractor to sign a construction contract with the obligee, its liability is limited to the amount of the bond. Alternatively, if the surety decides to pay an amount to the obligee, its liability is also

limited to the amount of the bond. The question has arisen as to whether the surety's liability could surpass the amount of the bond should it decide to complete the work itself. This is not a common outcome, for obvious reasons.

There are other provisions in the bond including the limitation regarding the scope of the responsibilities of the surety to the obligee, that is, they are not greater than those of the principal under the construction contract. The obligations of the obligee to the surety also remain limited to its obligations as set out in the underlying contract.

The AIA performance bond acknowledges the surety's right to investigate a claim under a performance bond which usually includes a determination of the contract balances as well the cost to complete the project including the variable costs (cost of the work performed by the principal), fixed costs (cost of work under fixed price subcontracts) and other costs (liquidated or actual damages resulting from completion delays; unpaid subcontractors, workers and suppliers and contingency). The scope of the incomplete work must also be established. All of these factors, as well as the financial viability of the principal, will assist the surety in identifying its correct response to a claim under the performance bond.

The surety may also have a defense under a performance bond where there is a material breach by the obligee, and not the principal. This could result from the premature release of retainage or other security. The obligee may also be prevented from claiming under the performance bond if it has made payments under the contract in excess of the amounts certified and approved. Also, the material alteration of the scope of the bonded contract may preclude the obligee from claiming against the surety. This might also be the case if the obligee releases the principal from liability or if it has somehow released the surety's rights of subrogation against third parties. Lastly, the surety may use any of the principal's defenses against the owner/obligee.

In Canada, bond wordings have yet to include the conference provision set out in the AIA bond form. However, the principles of interpretation are similar.

Performance bonds contain express conditions precedent, which must be respected to enforce rights against either the surety or the obligee. An example of the latter is found in *United States Fire Insurance Co. v. United States*.<sup>11</sup> After the government terminated the contractor and made a demand upon the surety, a takeover agreement was entered into between the surety and the

government. The surety sued the government, asserting that the government's payments to the contractor while it was in default resulted in significant overpayments for incomplete and defective work that eroded the contract balance available to the surety to complete the bonded work. The court rejected the surety's claim, finding that the failure of the surety to put the government on notice to withhold progress payments from the contractor precluded its recovery on an equitable subrogation claim based on the government's alleged improper progress payments.

### **3. Labor and material payment bonds**

These bonds cover a claim for the payment of unpaid labor and material furnished to the principal for the completion of the construction project:

- The AIA Document 312 Labor and material payment bond covers claimants for all labor and material used in performing the contract. A claimant which does not have a direct contract with the principal must furnish a written notice of non-payment to the principal, stating with substantial accuracy the amount

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<sup>11</sup> 78 Fed. Cl. 308 (Fed. Cl. 2007).

claimed and the name of the party to whom the materials or equipment was supplied within a specific time period.

- Miller Act Payment Bonds cover all persons supplying labor and material for work under a federal construction contract. Coverage is limited to those in a direct contractual relationship with the principal or its subcontractor. Claimants having a direct contractual relationship with the principal are **not** required to provide a notice of claim. Claimants with a direct contractual relationship with a subcontractor, but not with the principal, must give notice of the claim to the principal within 90 days after the last of the labor or material was supplied. No claimant may sue more than one year after the last labor or material was supplied.
- “Little Miller Acts” are state laws or public works statutes requiring payment bonds to protect subcontractors, laborers or suppliers on public work projects. Most state statutes are very similar to the Miller Act, but may vary with

regard to notice provisions, the time for filing suit, and protected parties.

The surety’s total obligation under the payment bond shall not exceed the amount of the bond.<sup>12</sup> If claims exceed the penal sum of the bond, the surety should interplead this amount into court for distribution on a pro rata basis.

A claimant under a labor and material payment bond will be precluded from claiming under the bond if it does not institute proceedings in the appropriate time. The surety’s liability under the bond is derivative of the principal’s liability. The surety will be discharged to the extent the principal has settled the claim on its own or, if the principal is entitled to, present a counterclaim or back-charge against the claimant.

Courts have construed Federal Miller Act and Little Miller Act bonds liberally in favor of claimants, thereby granting them the right to pursue an action for payment. In *Evco Sound & Elecs., Inc. v. Seaboard Sur. Co.*,<sup>13</sup> the court held that the limitation periods within which the sub-subcontractor was required to provide notice to the general contractor of its claim and to file suit began to run when the sub-subcontractor provided training

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<sup>12</sup> In Quebec, the Civil Code provides: “**2343.** Suretyship may not be extended beyond the limits for which it was contracted.”

<sup>13</sup> 223 P.3d 740 (Ida. 2009).

sessions, installed part of a television system, and completed as-built drawings, all of which were done as part of the original sub-subcontract scope.

In *United States ex rel. McKenney's Inc. v. Government Technical Servs. LLC*,<sup>14</sup> the surety defended a subcontractor's claim under the Miller Act by relying upon the pay-when-paid clause in the subcontract. The court rejected the defense, holding that allowing the contract language to trump a federal remedy available under the Miller Act conflicted with the intent of the Act and was, therefore, unenforceable.

Sometimes a surety issues bonds for both the contractor and the subcontractor. If a payment is made to a claimant under the subcontractor's bond, could the surety seek to recover from both the contractor and the subcontractor? The answer depends on which party was ultimately liable for the payment. Since the supplier's payment claim against the subcontractor was covered by the bond issued to the subcontractor, the surety could not seek indemnity from both the contractor and the subcontractor as determined in *First National Insurance Co. v. Cam Painting*.<sup>15</sup>

#### IV. Dispute resolution

The question of dispute resolution arises when the parties are unable to settle their differences and must apply to the appropriate forum for a decision. Courts will not usually compel sureties to arbitrate unless they are direct signatories to a contract containing an arbitration provision. This may vary by jurisdiction.

For example, in *United States ex rel. Lighting & Power Services Inc. v. Interface Construction Corp.*,<sup>16</sup> a sub-subcontractor was not forced to arbitrate its Miller Act claim because the sub-subcontract did not contain an arbitration agreement, even though the subcontract did include such a provision. Similarly, in *Liberty Mutual Insurance Company v. Mandaree Public School District No. 36*,<sup>17</sup> an obligee was not permitted to enforce its contractual right to arbitrate against the surety where the bond did not contain an arbitration provision, even though the bonded contract between the surety's principal and the obligee did contain such a clause.

#### V. Conclusion

This article has provided an overview of suretyship. Situations may arise which complicate the

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<sup>14</sup> 531 F. Supp.2d 1375 (N.D. Ga. 2008).

<sup>15</sup> *First National Ins. Co. v. Cam Painting Inc.*, 173 Cal.App.4th 1355 (Cal Ct. App. 2009).

<sup>16</sup> 553 F.3d 1150 (8th Cir. 2009).

<sup>17</sup> 503 F.3d 709 (8th Cir. 2007).

surety's investigation and the eventual claim settlement process.

There may be cases where the surety determines that its best option is to finance the principal. This will occur after an in-depth financial analysis and the surety has determined that the principal's bid on the contract was on target. Also, there must be easy access to the bonded contract receivables with excellent collaboration on the part of the principal and the indemnitors. This latter condition is essential given that the surety may find itself satisfying debts which are not covered by the performance or the payment bonds, such as overhead.

In a bankruptcy or insolvency situation, the surety should meet with the various owners to determine the advancement of the project, secure its undertaking to pay the available contract balances and, if possible, obtain all information regarding the work, including the names of the sub-contractors and suppliers. Depending on the advancement of the work, the surety may decide to engage the services of a consultant to see to the completion with the least delay or if it is at its initial stages, it may recommend that the second lowest qualified bidder enter into a contract with the owner. In such a case, the surety may minimize its exposure and may even not have to pay any amounts, all depending upon the available contract funds.

The surety should also meet with the contractor's financial institution to negotiate a standstill regarding the bonded contract receivables.