# *Surety's Good Faith Investigation*

## Gregory S. Arnold

**Presented at**

**The 1989 National Claims Conference, Chicago, Illinois, April 25, 1989**

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# THE 1989

# NATIONAL CLAIMS CONFERENCE

# MANAGING THE CLAIMS

# SURETY AND FIDELITY

THE 1989 NATIONAL CLAIMS CONFERENCE

MANAGING THE CLAIMS
SURETY AND FIDELITY

CHICAGO, ILLINOIS
APRIL 25, 1989

**AGENDA**

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|---|---|---|
| 8:00-8:30 | | REGISTRATION AND COFFEE |
| 8:30-8:45 | Roy Adams, Jr. | WELCOME/OPENING REMARKS |
| 8:45-9:45 | Gregory S. Arnold | SURETY'S GOOD FAITH INVESTIGATION |
| 9:45-10:00 | | MORNING BREAK |
| 10:00-11:00 | Stephen J. Trecker | WHEN AND HOW TO EXERCISE THE FINANCING OPTION |
| 11:00-12 noon | Paul M. Krystal | CONDUCTING A SUCCESSFUL RELET PROGRAM |
| 12:00-1:30 | | LUNCH |
| 1:30-2:30 | Robert L. Griffith | WHAT IS THE DIRECT COMPLETION OPTION-- HOW DOES IT WORK? |
| 2:30-3:30 | Charles C. Boucherle | THE FIDELITY INVESTIGATION |
| 3:30-3:45 | | AFTERNOON BREAK |
| 3:45-4:15 | | QUESTIONS AND ANSWERS |

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Mr. Arnold previously held home office positions with Great American Insurance Company, first as its bond claims manager for the western region of the United States, and then as the bond claims manager for the midwest region.

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# SURETY'S GOOD FAITH INVESTIGATION

I. Scope of this discussion.

II. The duty to investigate.

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B. "Fair Claims Practices Act"

1. Investigation must be thorough, prompt and fair.

-- Standard timing?

-- Must be reasonable under the circumstances.

-- Contents of acknowledgment letter.

-- Treat all claims as if arising in the toughest jurisdiction.

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-- Project manager/supervisor/administrator

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-- Credit reporting companies

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2. Results of the investigation must be promptly communicated, including denials.

3. Litigation must be properly managed.

4. Tortiuous conduct must be avoided.

III. Suggested procedures for handling bad faith suits.

IV. Recent developments in bad faith law as concerns surety companies.

# BIBLIOGRAPHY OF RELATED WRITINGS


Ray H. Britt, "Conducting the Good Faith Investigation", presented to the CMA 1987 National Conference on Surety Claims.

Ray H. Britt, "The Surety's Investigation", presented to the Fidelity and Surety Law Committee, January 29, 1989.

Bert Brumley, "Duty of a Shielded Surety to Investigate", presented to The Fidelity and Surety Law Committee, August 9, 1981. Also published in XVII The Form 266 (Fall 1981).

Cushman, Robert F. and Stamm, Charles H., Handling Fidelity and Surety Claims, John Wiley & Sons, New York, 1984.

Guy O. Kornblum, "Extra-Contract Actions Against Insurers: What's Ahead in the 80's", presented to the Torts and Insurance Practice Section, Atlanta, Georgia, August 3, 1983.

John J. Petro, "Good Faith, Fair Dealing and the Contract Bond Surety", presented to the CMA 1984 National Conference on Surety Claims.

Remmen, Albert, The Contract Bond Book, National Underwriter Co., Cincinnati, 1977.

C. Allan Reeve, "Conducting an Effective Surety Investigation", presented to the 1988 CMA National Conference on Surety Claims, Dallas, Texas, April 28, 1988.

Stephen J. Trecker, "Conducting the Good Faith Investigation", presented to the CMA 1988 National Conference on Surety Claims, San Francisco, CA April 1988.

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# SURETY'S GOOD FAITH INVESTIGATION

## SCOPE OF THIS DISCUSSION

There have been significant developments in the law of bad faith against sureties since Guy Kornblum, in 1983, stated that "...sureties...simply have not been successfully attacked."[1] At that point in the law's development it was not determined whether a tort remedy existed for a breach of the implied covenant of good faith and fair dealing in the surety law context.

Since that article by Kornblum, several papers have been written on the subject of good faith investigations by sureties, some of which are listed in the bibliography attached to this paper. This paper is not intended to be a synthesis of previous writings on the subject, but will make reference to some of them where helpful.

This paper will not address the investigation conducted by a surety for the purpose of deciding the best way to minimize the loss to the surety, e.g., relet, tender, finance, etc.. These decisions do not necessarily affect whether a surety has acted in good faith in investigating and settling a claim brought by a proper claimant under a bond.

These other surety issues will be addressed later in this conference by the other speakers. Charles Boucherle will be discussing The Fidelity Investigation as part of this conference, so I have intentionally omitted any references to the conduct of a good faith investigation in the fidelity context.

## COMMON LAW DUTIES: IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

Many contracts contain an implied covenant of good faith and fair dealing. This is whether the contract is oral, or, in the case of bonds,

written. Bad faith claims may arise from a surety's unreasonable refusal to discharge its obligations under a surety bond, because the same implied covenant of good faith and fair dealing applicable to first party insurance contracts may apply to surety bonds and guarantees.[2] Furthermore, failure of the surety to issue payment and performance bonds after a contractor has relied on the promise to issue them in submitting a bid could give rise to a cause of action for tortious breach of the covenant of good faith and fair dealing.[3] The remedy of bringing a tort action for breach of the implied covenant of good faith and fair dealing is limited to those instances involving first party claims brought by an insured rather than third parties.[4] In a surety context, these claims would come from the obligee on the bond, to whom the duty of performance is owed.

STATUTORY DUTIES: FAIR CLAIMS PRACTICES ACT

The McCarran-Ferguson Act[5] was passed by the United States Congress in 1945 as an expression of its intent that regulation of the insurance business be left to the individual states. That Act provides that the states have the power to regulate and tax the insurance industry. Only where a state does not regulate its own insurance laws will the Federal laws come into play. In order to ensure regulatory control, most states have passed legislation controlling the insurance industry within their own borders.[6]

There is little doubt that these statutes bring within their purviews the conduct of surety companies, even though suretyship is still distinct from insurance in several significant ways. In the California appellate case of General Ins. Co. v. Mammoth Vista Owners Ass'n, Inc. (1985) 174 Cal.App.3d 810, 220 Cal.Rptr. 291, it was held that a statutory "bad faith"

action may be maintained in that state against a surety because a surety is specifically included among the "classes" of insurers covered by that state's Unfair Claims Practices Act. Other states' statutes are quite specific in including sureties, such as Utah's Unfair Claims Settlement Practices Rule, which states:

> "'Insurance policy" or "insurance contract" shall mean any contract of insurance, indemnity, medical or hospital service, suretyship, or annuity issued, proposed for issuance, or intended for issuance by any person;" (Emphasis added).[7]

It is important to determine whether a particular unfair claims practices act confers a private cause of action by a claimant against the surety,[8] or whether it simply empowers the state to institute penalties against the surety. Penalties can be in the form of cease and desist orders, revocation or suspension of an insurers Certificate of Authority or similar document and the right to limit or regulate the insurer's line of business and the issuance of policies of insurance. If the act confers a private cause of action, plaintiff can be awarded punitive damages for the sake of punishment and to make an example of the surety.

## INVESTIGATION MUST BE THOROUGH, PROMPT AND FAIR

The various states generally have included within their respective unfair claims settlement practices acts a requirement that investigations must be thorough, prompt and fair. In Texas, an acknowledgment of a claim is presumed to be reasonably prompt if made within fifteen working days.[9]

Generally, in the case of a claim from a subcontractor or supplier, the surety's investigation begins with the letter acknowledging the claim. Form letters should be avoided, as they do not always indicate to the claimant

that the claim is being fairly responded to. Also, reliance on a form letter by the claims handler will influence him or her to defer even a cursory analysis until the first diary review, at which time it may be noticed that the claim is untimely. It would be best to simply spend a little extra time with each new claim and tailor the acknowledgment letter to each claim.

This requires more time at first, but can save a great deal of follow up correspondence and telephone calls. If the claim is late, deny it instantly, instead of sending out an acknowledgment letter and then a denial letter when the claim is reviewed thirty or more days later. If certain items are needed, such as a copy of the subcontract to analyze a retainage claim, let the claimant know right away. If the claim does not comply with statutory requirements, let the claimant know there is a defect, without necessarily advising the claimant how to cure the defect. For example, you can say something like "It is noted that your claim was not submitted pursuant to the mandatory requirements of (Act). Please resubmit your claim as required by (Act) before we can give your claim further consideration."

A suggested letter format, where it does not appear the claim can be denied or that other information is needed to begin the investigation, is as follows:

I Needa Bucks Now Co.
Street
City, State and Zip

Re: Principal: Lucky Construction, Inc.
Obligee: Get It Right, Inc.
Bond No.: XX XX XX
Project: Construction of Luxury Hotel
S/F Clmt.: I Needa Bucks Now Co. $Amount

Dear Mr. X:

This will acknowledge receipt of your notice of claim dated Month, Day, Year notifying Surety of your claim on the Labor and Materials Payment Bond in the amount set forth in the caption above.

As you may know, the obligation of a surety is normally no greater than that of its principal, and the principal has the primary duty to discharge any claims under the bond. Therefore, we will contact or principal and ask that this matter be reviewed by it and that a reply be directed to you within X days, with a copy of its response coming to my attention. Where necessary we will also contact the owner, architect, and others to determine any additional facts needed to analyze this claim.

We trust you shall be hearing from our principal, and nothing in this letter acknowledging receipt of your claim should be construed to waive or alter any of the rights of any of the parties involved in this matter. We specifically reserve all of our rights and defenses under the bond and applicable law.

Should you desire further correspondence with the surety on this matter, please direct it to my attention and use the above caption ~~so as to avoid any delays in responding to you~~.

Very truly yours,

NAME
Title

cc: Principal

cc: Underwriting

cc: Agent

cc: Others who can help or who should know

practice

In addition to merely sending a copy of this acknowledgment letter to the principal, it is a good idea to enclose it with a cover letter asking the principal to research its records and advise the surety of any disputes, payments, credits, offsets, backcharges or other matters of which the surety is unaware. This will often ~~obtain~~ facilitate a quicker prompter response from the principal, who might otherwise not appreciate the significance of the acknowledgment letter. Also, depending upon the relationship the surety has with the principal, it may be necessary to remind the principal and/or the indemnitors of the obligations under the General Agreement of Indemnity. It may not be wise to include this reminder in every first letter to the principal, as it could have a tendency to alienate a solvent principal with a good faith dispute to the claim.

OPTIONAL REMINDER

If a number of claims are received concerning the same principal, it is not necessary to send the cover letter with each copy of the acknowledgment, unless there is something unique about the claim as compared with others. This will only serve to pad the files of the surety and the principal. The best advise here is to establish a "stream of consciousness" with the principal, either over the phone or in person, as to how surety claims are handled and what information is required by the surety.

X

Once the initial letters in an average claim have gone out in connection with a claim it is appropriate to diary the file for a short period of time. The claim may already have been paid by the principal, and a phone call from the principal in a few days will answer that question and the file can be closed. Or, the claim could be in the process of being

average

settled by the principal, and to try to investigate the claim immediately would not be efficient use of time. Diary the file for an appropriate time period depending upon the jurisdiction in which the claim arises.

The issue of what constitutes a reasonable time to settle a claim can be partially answered by looking at a mandatory waiting period between giving notice of claim and filing of suit. For example, as concerns statutory bonds in Texas, a claimant must wait sixty days after mailing notice of claim before suit on the bond can be filed.[10] Thus, it would appear that sixty days should be afforded the surety for fully investigating the claim and communicating the surety's decision. Certain bond forms, such as AIA Document A312, will themselves specify the amount of time allowed for reporting to a claimant the results of the surety's investigation. Of course, the surety should make every effort to complete its investigation as promptly as possible, without regard to any statutory waiting periods for filing of suit or contractual periods stated in the bond.

A good rule of thumb is to examine the rules applying to insurers in the most demanding of jurisdictions. For example, if California has the toughest unfair claims practices act, become as familiar with that act as the others you are regulated by, and treat each claim as if it arose in that state. You should then be able to reduce to a minimum those occasions when a claimant alleges you may have done something improper.

## SOURCES OF INFORMATION

### The Principal

"You sureties are all alike. All you do is take the word of your principal and close your file." How many times have you heard that from a claimant, or, more likely, a claimant's attorney? Could this be true of the style of your investigations? Sometimes it may only be necessary to

correspond with the principal or its attorney to investigate a claim. The bond claims person can verify the principal's defenses to a claim from simply reviewing the principal's documents. If the postmark on a required notice to the principal shows the claim is untimely, there is no need to investigate further. Or perhaps the principal has adequately demonstrated to the surety that it has a bona fide backcharge or offset against the claimant. In these situations, it is a fair practice to take the results of that limited investigation and base the surety's position thereon.

The situation is much different, however, if the principal tells the surety, "That claim is no good and we're not going to pay the S.O.B." Or, worse yet, the principal may never respond to the surety's letters or phone calls which are an effort to investigate the claim. If the principal is an older contractor who doesn't seem to appreciate the seriousness of a claim on a bond, given today's regulations, a personal visit to his office would be in order. Go through his records with him and show him how a bond claim is analyzed. Explain to him the requirements of your state's unfair claims practices act and what actions the oblig likely to take if the claims on a project are not promptly paid. At a minimum, you'll be able to document that you have done everything possible to get the principal's response to a claim, even if the principal is still uncooperative.

For purposes of this paper, you are meeting with the principal simply to determine which of the claims are disputed.[11] You will want to receive a narrative description from the principal concerning the details of the dispute and to receive copies of any documentation that supports the dispute. For purposes of this paper, you are not interested in knowing all about the principal's financial condition and what the status of each job

is. That has nothing to do with whether a particular claim should be paid. However, you will want to know something about the financial condition of the principal,[12] at least to determine for yourself if a poor financial condition may be motivating the principal to dispute claims that it would otherwise promptly pay. If you think that is the case, you will want to scrutinize the disputes more closely and without delay.

In discussing the principal's position on the claims, ask the principal specific questions such as: "are any of the claimants' billings improper"; "are there backcharges against the claimants"; "did the claimants perform pursuant to the subcontracts or furnish materials as specified"; "are the claimants delaying the job"; and "are there any other reasons for refusing to pay the claimants"?

If any of the claimants are derivative, i.e., do not have privity of contract with the principal, determine if the principal has a record of receiving the proper preliminary notice from the claimant. Determine if the subcontractor to the principal is in default, able to pay the obligations, and/or bonded. Determine how much is due this subcontractor by the principal, including retainage, and whether the principal is willing to withhold this amount from any defaulted subcontractor to pay these derivative, or lower-tiered claimants. Do not do anything or say anything to the principal that would have the appearance of exercising control over the principal's business, but suggest that the principal might consider consulting its attorney concerning certain ways of protecting itself.

Underwriters On The Account

Discuss the claim or claims with the underwriter on the account, who should know a great amount of detail about the financial condition of the

principal. Ask the underwriter what the current net worth and net quick (CA/CL) of the principal are. Is the principal in a financial position to discharge the claims and/or withstand an adverse judgment in connection with all of the claims? Ask the underwriter to give you a copy of the latest financial statement on the principal and/or major indemnitors, and for a copy of reports from any credit reporting agencies, such as Dunn & Bradstreet. Also, ask for copies of the line sheet showing all of the bonds which have been issued to that principal and determine which ones have been or should be cancelled. Discuss the uncompleted jobs with the principal to get a better feel for what bills the principal is paying on time. If a pattern of late payment is evident, you will want to more fully confirm any disputes the principal describes in connection with the claims.

Agent On The Account

The agent will oftentimes be of great assistance to the bond claims handler in investigating a claim. The agent will generally know where the principal can be located if the surety's files don't contain the principal's latest address. The agent may also have previously advised the principal to document a defense to a potential claim long before the surety receives formal notice of the claim, and can speed the surety's investigation with that information.

Perhaps the greatest assistance an agent can provide is when the surety receiving the claim no longer writes bonds for the principal, and the principal therefor feels no compelling need to cooperate with the surety. The surety can inform the agent of the problem and ask for the agent to do what it can to get the principal to cooperate. If the principal is still using that agent to place bonds for it, although through another surety, the

In this situation, the principal will want to convey the impression to its agent that the principal has the character, capacity and capital to discharge all of its obligations, ~~or at least~~ still the principal will ~~try to convey that appearance.~~ Thus, an uncooperative principal can be expected to call or write to the surety once the surety has contacted the agent and asked for help.

However, agents can tend to be a bit too optimistic about the principal's ability to resolve its own problems. Remember that contacting the agent is only one of the many suggestions for investigating a claim, and that other methods should be employed at the same time. Also, if the agent which placed the bonds for the particular principal no longer has a business relationship with that principal, any efforts to assist the surety are much less successful.

Architect For The Project

If you can't get any satisfactory responses from the principal as to whether a claim is disputed, or, if you want to confirm a dispute, a good contact person is the architect. Generally, the architect will have to certify portions of a project as being completed in compliance with the drawings, plans and specifications and any approved change orders. If the principal disputes a claim on the basis that the claimant did not perform pursuant to the plans and specifications, or that the claimant did not supply the materials as specified in the contract documents, call the architect and ask what he thinks of the quality of that claimant's workmanship or supply of materials. If the architect says the same thing as the principal, you can write to the claimant and report the results of your investigation. Either ask the claimant for any information it may have to rebut the defenses, or, in a proper situation, simply send a prompt denial

of the claim.

On the other hand, if the architect is satisfied with the claimant's contribution to the project, but the principal still asserts a defense which it cannot document to the surety's satisfaction, the surety will want to strongly consider asking the principal to post collateral pursuan to the GI A to cover any potential losses the surety may suffer in discharging its obligations on the bond in connection with that claim, or making other arrangements to effectuate a prompt and fair settlement where liability has become reasonabl clear.

Determine if the owner has designated a particular engineer as a representative of the owner on the project. The engineer may be able to provide additional assistance to the surety investigator.

Public Records

Claimants on a project will not always give the surety notice of a lien against a project. The claimants may properly file lien affidavits with the appropriate public official and give a copy to the owner, but the owner does not always give notice of same to the surety. The statutes of some states allow the lien claimants to collect on the bond, so long as the lien was perfected, regardless when the surety receives notice.

While the surety does not try to solicit claims, there are times when the surety needs to know the details of these lien filings, such as when the owner demands that all liens of record be released before final contract balances can be released. The owner should identify for the surety the liens it has knowledge of. Where there is a breakdown in communication or cooperation, however, it might behoove the surety investigator to check the public records personally and ensure proper, prompt action is taken to

remove the liens. This can be done by informing the lien claimant that the lien is defective, and should be removed, or by paying the claim or bonding around it.

Surety Consultants

Although surety consultants cannot generally be a source of original information for use by the surety in investigating a claim, they can certainly be of assistance to the surety in discharging its duty of investigation under the bonds. A typical section of an unfair claims settlement practices act prescribes penalties against an insurer/surety for failing to adopt and implement reasonable standards for prompt investigation of claims arising under its policies.

If a surety becomes swamped with claim activity such that it cannot give the claims the necessary attention, and does not hire more employees or retain consultants to provide assistance, it in effect can violate the provisions of such an unfair claims practices act. You should be encouraged to draw upon the expertise and manpower of a surety consultant whenever it appears you will not be able to give your files the attention you know they should receive. Most surety consultants are willing to take any assignment, regardless of the size or complexity.

PROMPTLY COMMUNICATE THE RESULTS OF THE INVESTIGATION

Don't require a claimant to call or write in order to determine the status of a claim. Take the initiative and let the claimant know the status of the investigation, even if it is not complete. If you intend to deny the claim, do it immediately, and explain the basis for the denial.

If the claim file is incomplete, ask the claimant for any information that is still required, such as delivery tickets, invoices, statements, or other proof in support of the claim. Let the claimant know who you have contacted and what information you are seeking from others. Give the claimant some idea of how long you think it will take you to complete the investigation, without committing yourself to a specific time, over which you may not be in control.

LITIGATION MUST BE PROPERLY MANAGED

A bond claims handler will receive many claims which the principal may dispute. The surety will analyze these disputes and, where appropriate, agree with the principal that the defense has merit. Once the claimant knows that the surety agrees with the principal, both the principal and surety may be named as co-defendants in a lawsuit. The principal's attorney will generally provide a defense for both the principal and surety at the principal's cost, as allowed under the General Agreement of Indemnity. At the surety's option, the surety can obtain separate counsel of its own choosing, also at principal's expense.

This litigation must not be simply dumped into the laps of the attorneys, with the surety representative ~~simply~~ requesting status reports every six months. The surety representative must actively manage the course of the proceedings, by suggesting special affirmative defenses of the surety which the attorney may not have appreciated, and by other follow up once the responsive pleadings have been filed. The bond claims handler must do all things which are reasonable under the circumstances to ensure that the litigation proceeds as quickly as possible.

If liability at a certain stage of the litigation has become reasonably clear, and the attorney for the principal and surety has not initiated settlement negotiations, the surety representative should do what is necessary to encourage settlement. To do otherwise would indicate the surety did not attempt in good faith to effectuate prompt, fair and equitable settlement of the claim when liability became reasonably clear. This, of course, is one of the better known violations of the unfair claims practices acts.

## SUGGESTED PROCEDURES FOR HANDLING BAD FAITH SUITS

In the typical litigation context, where no bad faith allegations are made, the surety feels fairly comfortable in allowing the principal's attorney to defend both the principal and the surety from a claim. The issues are generally fairly clear, e.g., the claimant did not perfect under a mechanics' lien statute or clearly did not perform pursuant to specifications in the subcontract.[13] Since the liability of the surety in this situation is no greater than that of the principal, and since the surety did not do anything to contribute to the claimant's/plaintiff's alleged loss, it is expedient and efficient to allow the dual representation by the principal's attorney.

However, the procedure is not as prudent when the surety has a <u>special</u> defense not shared by the principal, or the surety determines a <u>severe</u> conflict of interest exists, or the surety has been sued for bad faith in refusing to pay a claim on the bond. One of the major considerations for a surety in this situation is what procedures it should implement to handle this type of litigation. Each case should be analyzed on its own merits.

The primary consideration is the degree of conflict of interest between the surety and the principal.

The case of Jackson v. Hollowell, 685 F.2d 961 (5th Cir. 1982) has addressed some of these issues in the context of an indemnity action for reimbursement of surety's separate counsel's legal fees. The court listed the following factors to be considered:

1. Whether there is a conflict of interest between surety and principal;
2. Whether surety has requested principal to defend the suit;
3. Whether principal has retained competent counsel and requested surety not to incur separate legal costs; and
4. Whether principal can furnish sufficient funds to indemnity surety against the claims asserted.

Judge Garwood's concurring opinion in that case is as follows:

> "..except in the most extraordinary circumstances or where actual bad faith is involved, it is, as a matter of law, reasonable and necessary for any party formally made a defendant in almost any lawsuit to at least initially retain counsel of its own selection, having primarily loyalty to it, as opposed to relying exclusively on counsel to be retained by a co-defendant or potential indemnitor. Litigation has simply too many deadlines, 'deemed' notices and waivers, potential surprises and unexpected developments to warrant any substantial second-guessing of the decision to hire separate counsel by one formally hailed into court as a party defendant.
>
> "Accordingly, where the bonding company itself has been formally made a party defendant in a suit on the bond, and the principal has expressly agreed to indemnity the bonding company for 'all...attorneys' fees...in...defending any action which may be brought in connection' with the bond or the equivalent, it would have to be a most unusual case before the bonding company's good faith retention of its own separate counsel could legitimately be found so unnecessary and unreasonable as to justify denying the bonding company recovery for any of its counsel's fees." (Page 969, Court's emphasis.)

If the surety has done a thorough, fair investigation of the claim and promptly communicated its position to the claimant in good faith, a bad

faith suit would have no merit. If the surety is nevertheless sued for bad faith, and if, subsequent to analyzing the complaint, believes there is no serious exposure to the surety, it might allow the principal's attorney, if believed competent, to defend the surety against the bad faith suit. In addition, the principal should pay the expenses of the defense, including the bad faith portion. If the principal's counsel does not appear to be familiar with surety law, bond defenses, and the law of insurance bad faith defense in general, it would be appropriate, under the holdings in Jackson, supra, for the surety to retain separate counsel of its own choosing and require the principal to reimburse those fees to the surety.

On the other hand, if the surety has done something or omitted to do something which has the appearance of bad faith, then it would be most appropriate for the surety to obtain separate counsel at its own expense, and to bear the loss resulting from any judgments against it. The law of indemnity in general will not permit one to be indemnified by another for his own gross negligence or willful misconduct, and there does not appear to be any reason why the same principle of law should not apply to the General Agreement of Indemnity.

## CONCLUSION

The duty of a surety to investigate claims made against its bonds arises from both a common law covenant of good faith and fair dealing and from the statutory obligations contained in the unfair claims practices acts of the various states. Some of these statutes confer a private cause of action against the sureties. Sureties are vulnerable to suit for bad faith in both first-party and third-party actions.

The surety which conducts a thorough, prompt and fair investigation of

claims, and communicates the results of those investigations promptly to the claimants, should have no problems concerning bad faith allegations. The surety which has conducted an investigation in good faith should be entitled to separate counsel of its own choosing, and at the expense of the principal and indemnitors on the bond, in the event the surety is sued for bad faith.

THE OPINIONS STATED IN THIS PAPER
ARE THOSE OF THE AUTHOR AND NOT
OF HIGHLANDS INSURANCE COMPANY/
HIGHLANDS UNDERWRITERS INSURANCE COMPANY
OR ANY OF THEIR AFFILIATED COMPANIES

1. Guy O. Kornblum, "Extra-Contract Actions Against Insurers: What's Ahead in the 80's?", presented to the Fidelity and Surety Law Committee of the Torts and Insurance Practice Section of the American Bar Association at the Annual Meeting in Atlanta, Georgia, on Tuesday, August 3, 1983.

2. Pacific-Southern Mortgage Trust Co. v. Insurance Co. of North Am. (1985) 166 Cal.App.3d 703, 212 Cal.Rptr. 754.

3. L.F. Pace & Sons, Inc. v. Travelers Indem. Co. (Conn. 1986) 514 A.2d 766.

4. Christopher C. Pappas, "Unfair Claims Settlement Practices And The Emerging Duty of Good Faith and Fair Dealing", The Houston Lawyer, July-August, 1987, page 27.

5. 15 U.S.C. Sections 1011-1015 (1975).

6. See, e.g., California Insurance Code Section 790.03; Texas Insurance Code, article 21.21-2; Utah Insurance Department Rule 540-89-4E.

7. Rule 540-89-4E. As set forth in an April 14, 1989 Utah Insurance Department Rules Notice, this Rule has certain proposed revisions, with a comment period ending 5-17-89. However, the only change to the cited portion is a relettering form Rule 540-89-4E to Rule 540-89-4F.

8. The Texas Supreme Court has recently recognized that activities prohibited in its Unfair Claims Settlement Practices Act can serve as the basis for the imposition of extra-contractual damages against first party insurers in a private cause of action. The court rejected the insurer's argument that article 21.21-2 required a finding that the insurer's act must be committed "without cause and performed with such frequency as determined by the State Board of Insurance". Instead, the court ruled that "frequency" is not a requisite element of any of the acts defined in article 21.21-2 as unfair trade practices; rather, "frequency" is a prerequisite to the issuance of cease and desist orders by the Board." Vail v. Texas Farm Bureau Mutual Ins. Co., 31 Tex. Sup. Ct. J. 392, 395 (May 11, 1988). See also Scott Patrick Stolley, "Lifting the Veil: The Vail Case and the Expansion of Extracontractual Liability", Texas Insurance Law Reporter, Vol 6, No. 2 (August 1988). "Third-party insurers in Texas have been subject to extra-contractual liability for almost six decades.", Ibid, legal citations omitted).

The Utah Legislature has eliminated any question as to whether a private right of action is created in its rules. "This rule is regulatory in nature and is not intended to create a private right of action." Rule 540-89-3 "Scope" (proposed 1989 amendment of similar present language).

9. The Houston Lawyer, Ibid.

10. Article 5160, Revised Civil Statutes of Texas, commonly known as the McGregor Act (Public Work); and Chapter 53 of The Property Code of

Texas (Private Work).

11. For examples of forms for the recording of claims, see the exhibits to Ray H. Britt's paper, "Conducting The Good Faith Investigation", presented to The 1987 National Conference On Surety Claims, Philadelphia, Pennsylvania, May 5, 1987. The same forms are attached as exhibits to Stephen J. Trecker's paper, "Conducting The Good Faith Investigation".

12. For a suggested checklist of items to assist the investigator in quickly assessing certain aspects of the principal's financial condition, see Trecker's paper, Ibid., pp. 10 and 11.

13. If, however, the surety disagreed with the principal's defenses, it would be entitled to demand collateral to cover its possible losses and expenses in connection with the claim and it might consider a quia timet action against the principal. If the principal has already incurred a loss on the claim, or set a reserve in anticipation of such a loss, it could institute an indemnity action against the principal and/or indemnitors, seeking specific performance of the promises made in the General Agreement of Indemnity.