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CHAPTER 32 PERFORMANCE BONDS

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§32.01 INTRODUCTION

A surety is one who is answerable for the debt, default, or miscarriage of another. This concept is hardly new. In fact, one of the earliest references to a surety appears in the story of Joseph in the Book of Genesis. After Joseph was sold by his brothers as a slave and then rose to prominence in Egypt, his father, Jacob, sent his other sons to Egypt in search of food. When the brothers arrived, they did not recognize him, but Joseph recognized his brothers and asked for his younger brother, Benjamin, whom Jacob did not send. The brothers returned to Jacob and explained that Joseph wanted to see all the brothers, including Benjamin. After losing Joseph, Jacob was concerned that a similar fate could befall Benjamin if he made the journey to Egypt. The oldest brother, Judah, eliminated his father's concern and became the first surety. Specifically, Judah stated: "I will be surety for him; of my hand shall thou require him; if I bring him not unto thee and set him before thee, then let me bear the blame for ever."[1] Other Biblical references to suretyship, however, come with grave warnings. For example, one famous warning is: "He that is surety for a stranger shall smart for it; and he that hateth suretyship is sure."[2]

Suretyship was a common part of the ancient economies. The first recorded suretyship is a tablet, from the Library of Sargon I, King of Accad and Sumer (circa 2750 B.C.). The tablet describes an agreement between a farmer who entered the king's army and a second farmer who agreed to cultivate the soldier's farm and return half the produce to the soldier. The tablet further states that the lessee's performance was guaranteed by a merchant from Accad.[3] Consequently, this surety was motivated by profit as opposed to love or affection.

In modern day construction, although some antiquated language survives, the concept of suretyship takes the form of a written performance bond. In fact, construction bonds play a unique and critical role in both public and private construction projects. In the ordinary course, a contractor enters into a contract with an owner for a particular construction project. The owner, in turn, may require the contractor to provide both a performance bond and a payment bond. On private construction projects, the owner decides if it wishes to incur the expense of a bond. On public projects, the requirements for surety bonds, and many times the exact terms of the bonds, are dictated by statute. Although the contractor purchases the bond, the cost is factored into the bid price. As a result, the owner indirectly absorbs the cost of the bond. On some projects, the contractor in turn may also require that its major subcontractors and suppliers obtain performance bonds naming the contractor as the obligee.

A performance bond is unique because it is a tri-party contract or agreement between the owner or "obligee," the contractor or "principal," and the surety. A performance bond is designed to protect the owner from a contractor's failure to complete the work. If the principal or contractor discharges its duties and completes the project, the surety is also discharged because the obligee or owner is entitled to only one aggregate performance.[4] If the principal, however, defaults on the underlying contract, the surety has a contractual obligation regarding the completion of the project. The scope of the surety's obligation, as well as any defenses it may possess, are fact specific and invariably depend on the language of the bond.

In 1996, the *Restatement (Third) of Suretyship and Guaranty* was published. The *Third Restatement* constitutes a reformation of the *Restatement of Security* to make the law of suretyship more accessible.

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[1]*Genesis* 43:9.

[2]*Proverbs* 11:15.

[3]Morgan, The History and Economics of Suretyship, 12 Cornell L.Q. 153 (1926). For a review of the development of the law of suretyship from ancient times through the modern performance bonds, see William H. Woods, *Historical Development of Suretyship from Prehistoric Custom to a Century's Experience With the Compensated Corporate Surety, in* The Law of Suretyship (Edward G. Gallagher 2d ed., ABA 2000).

[4]Restatement (Third) of Suretyship and Guaranty §19(a) (1996); *In re* Teerlink Ranch, Ltd., 886 F.2d 1233 (9th Cir. 1989).

Also, since the *Restatement of Security* was published more than 45 years ago, the *Third Restatement* also takes account of the changes in the law. The Restatement has also adopted a new vocabulary. The contractor who has the direct contractual relationship to the owner is called the "principal obligor" since it has the principal obligation on the underlying construction contract, while the surety is identified as the "secondary obligor."[5]

While there are many general rules of "suretyship," a performance bond remains a written contract. Therefore, although certain bonds are widely used, such as the A311 and A312 bonds promulgated by the American Institute of Architects, when confronted with a performance bond issue, the critical first step is to read the bond carefully because the full extent of the parties' rights, liabilities, and defenses are determined by the four corners of a particular bond. As a result, regardless of any general rules of suretyship outlined in this chapter or in any other treatise, the starting point must be the precise terms of the bond.[6] Fundamentally, it boils down to the written agreement to which the parties bound themselves. In other words, contract interpretation. Everything else is secondary.

In one form or another, performance bonds have been around since ancient times. As a result, the judicial decisions interpreting performance bonds are generally based on sound and long-tested principles. Because the cost and pace of large construction projects, both public and private, are increasing, it is no wonder that performance bonds have and will continue to generate a great deal of litigation. Although those handling performance bond issues have a well-developed body of both case law and excellent secondary resources available, the area that has generated the most uncertainty, and at times conflicting decisions, is the surety's exposure to extracontractual damages.[7] Once a claim is filed, the surety finds itself in the middle, with the owner or obligee on one side, and its principal and its indemnitors on the other. As a result, sureties face extracontractual damages from both sides. *Cates Construction, Inc. v. Talbott Partners, Inc.* was a significant case decided by the California Supreme Court, which denied a claim for extracontractual damages against a surety.[8]

As the cost and pace of large public and private construction projects are increasing, performance bonds have and will continue to generate a great deal of litigation. In addition to a well-developed body of state and federal case law, there are many secondary sources available to help address the myriad issues that confront owners, contractors, and sureties when performance bond claims are asserted.[9]

§32.02 THE INSURANCE MISCONCEPTION

Before examining what a surety bond is, it is important to define what it is not. A common and unfortunate misconception is to equate surety bonds with insurance policies. Sureties base their risk calculations on having rights and remedies that are unique to their status as sureties. Because some courts

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[5]Restatement (Third) of Suretyship and Guaranty §1 cmt. (d) (1995).

[6]*See* The Law of Suretyship (Edward G. Gallagher 2d ed., ABA 2000); Bond Default Manual (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox, eds., 4th ed. ABA 2015); The Most Important Questions a Surety Can Ask about Performance Bonds (Stephen J. Strawbridge & Lawrence Lerner ed., ABA 1997); Managing and Litigating the Complex Surety Case (Philip L. Brunet ed., ABA 1998). The authors have drawn considerable information from the efforts of these earlier works addressing the rights under performance bonds.

[7]*See* The Law of Suretyship (Edward G. Gallagher, ed., 2d ed. 2000); The Law of Performance Bonds (Lawrence R. Molemann & John T. Harris, eds., 1999).

[8]Cates Constr., Inc. v. Talbot Partners, Inc., 980 P.2d 407 (Cal. 1999).

[9]*See* The Law of Suretyship (Edward G. Gallagher, ed., 2d ed. ABA 2000); The Law of Performance Bonds (Lawrence R. Molemann, Matthew M. Horowitz & Kevin L. Lybeck, eds., 2d ed. ABA 2009); Bond Default Manual (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox, eds., 4th ed. ABA 2015).

equate construction surety bonds with insurance policies, at the critical times when sureties seek to assert those rights, sureties often find they are stripped of their special status and relegated to the more limited defenses and remedies of liability insurers.[10]

Although most performance bonds are issued by companies that have the term "insurance" in their names, a surety bond is not insurance and must not be analyzed under a traditional liability insurance framework. There are four fundamental differences between insurance and suretyship. First, the surety obligation or bond is a three-party agreement between the principal, obligor, and surety, while an insurance contract is an agreement between an insurer and its insured or beneficiary. Second, the surety does not anticipate any losses. If a surety pays a claim, it has a common-law right of indemnification. As added protection, a surety almost universally requires its principal to execute a broad indemnification agreement in connection with any bonds issued by the surety. As a result, sureties also have an express contractual right of indemnification by which they shift any ultimate cost or loss back to their principals. Insurers, by contrast, expect losses from fortuitous events over which there is no immediate control. After all, protection against losses caused by accidents and unforeseen events is why people obtain insurance in the first place. Third, sureties differ from insurers in the manner in which premiums are calculated. Unlike liability "premiums," bond "premiums" are not designed to create a pool of available reserves to draw upon when losses occur. Rather, the principal controls the risk of loss itself through its performance. Actually, the premium for a surety bond is similar to a service charge or fee that is in large part based on the economic and business strengths of the principal. Liability insurers, however, calculate their premiums over many policies using actuarial tables and loss experience data.[11]

The fourth and perhaps greatest difference between a surety and an insurer lies in the rights and remedies available in the event of a claim. With insurance, the insurer's rights and defenses are limited. If a claim asserted by an injured third party falls within the coverage provided by the insurance policy, the insurer must ordinarily pay the claim and absorb the loss. Although it may cancel its insured's coverage, it generally cannot look to shift the cost of that claim to its insured. Because a surety does not anticipate any losses, when confronted with a claim, a surety uniquely has a variety of rights and defenses it may assert against an obligee, and through common-law and contractual indemnification may also shift the cost of any claims or losses to its principal.

That said, considerable litigation has arisen over the status of bonds as within the inclusion of both statutory remedies and common law doctrines for the assertion of bad faith claims, exemplary damages, the imposition of attorneys' fees and like forms of recovery that go beyond providing funds for the completion of a construction contract and the payment of those who put value, either in labor or materials, into the project. On these complex issues, it is simply impossible to generalize. The outcome of every case will depend upon its own facts, the skills of legal practitioners, and the legal idiosyncrasies of the jurisdiction in which the controversy has arisen.[12]

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[10]10 Williston on Contracts §1213, at 708 (3d ed. 1967). For a discussion of the critical differences between a "surety" and an "insurer," see Great Am. Ins. Co. v. North Austin Mun. Util. Dist. No. 1, 908 S.W.2d 415 (Tex. 1995). *See also* Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407 (Cal. 1999), for a detailed discussion of the critical difference between performance bonds and traditional liability insurance policies.

[11]William H. Woods, *supra*, note 3.

[12]*See* Olympic S.S. Co. v. Centennial Ins. Co., 811 P.2d 673 (1991) ("an award of fees is required in any legal action where the insurer compels the insured to assume the burden of legal action, to obtain the full benefit of his insurance contract"); Dadelin Depot, Inc. v. St. Paul Fire and Marine Ins. Co., 945 So. 2d 1216 (Fla. 2006); Berlin Steel Constr. Co. v. Trataros Constr., Inc., 2007 WL 2482521 (Ct. Sup. Aug. 17, 2007); The Boldt Co. v. Thomason Elec., Inc., No. 6:07-CV-00697 (S.C. Sept. 17, 2007); King Cnty. v. Vinci Constr. Grands Projets/Parsons RCI/Frontier-Kemper, 2017 Wash. LEXIS 743 (Wash. Sup. Ct. July 6, 2017) ("the rule in Olympic Steamship applies to performance bonds in the surety context.

§32.03 CONSTRUCTION FRAMEWORK

Surety bonds are used on construction projects to shift the risk of the contractor's nonperformance from the owner/obligee to the surety. The two main construction bonds are performance bonds and payment bonds. The performance bond is designed solely for the benefit of the owner or obligee. The performance bond has a penal sum. The penal sum is the face amount of the bond. In general, the penal sum is equal to the total amount of the construction contract. The bond protects the owner from the contractor's inability or refusal to complete the project. If the contractor satisfactorily performs the obligations of the underlying construction contract, there can be no claim against the surety. If, however, the contractor fails to perform and the obligee makes a demand against the performance bond, the surety's rights, duties, and obligations are triggered. Since the bond provides the surety with certain rights and defenses, the surety generally has several options when called on to perform. A payment bond is designed to protect subcontractors and suppliers that provide labor and material to a project against nonpayment by the bonded contractor, and further protects the owner against potential mechanics' liens.[13]

The use of performance bonds is optional on private construction projects. When the owner is a federal, state, or local governmental body, whether a performance bond is required is ordinarily dictated by statute. On federal government projects, before any contract is awarded for any construction, alteration, or repair of any public building, the Miller Act requires the contractor post a performance bond.[14] Because the Miller Act performance bond only protects the federal government from the contractor's failure to complete the work, the statute also requires a contractor to post a payment bond for the protection of subcontractors and suppliers.[15] Furthermore, there are standard payment and performance bonds that have been adopted by the federal government.

Following the lead of the federal government, many states have enacted what are known as “little Miller Acts.” As this title suggests, the little Miller Acts statutes are designed to protect state and local governmental units on construction projects. Moreover, as under the Miller Act, the bond form required on state and local governmental projects generally is not negotiated. Rather, the enabling statute ordinarily establishes the exact text of the bond that the surety issues. Even though many state Miller Act follow the federal Miller Act and the federal case law, one must carefully read the appropriate state statute as well as the judicial interpretations because the scope of each bond's coverage differs from state to state.

Although the Miller Acts and many other state statutes mandate a separate performance bond and payment bond for each project, some states allow what is known as a combined bond. A combined bond permits a general contractor to obtain a single bond with a stated penal sum for the joint benefit of both the owner and subcontractors.[16] A combined bond with a single penal sum, however, may not provide either the owner or subcontractors or suppliers with the same protection as separate performance and payment bonds. In the event of a claim, if the total cost to complete the project plus the cost of unpaid subcontractors and suppliers exceeds the bond's penal sum, a combined bond will be inadequate. Under these circumstances, subcontractors and suppliers are forced to compete with the project owner for the financial protection provided by the bond. With a single bond, subcontractors and suppliers must carefully review the particular state's priority rules because often the owners will have statutory priority. As a result, while a combined bond may provide adequate protection for owners, it may afford subcontractors

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Although a statutory fee provision exists for public works contracts…it is not the exclusive fee remedy available”).

[13]*See* Chapter 33.

[14]40 U.S.C. §1331(b)(1).

[15]40 U.S.C. §1331(b)(2).

[16]*See, e.g.*, Wash. Rev. Code Ann. §39.08.010 (West 1997); Ala. Code §39-1-1 (1997); Ill. Comp. Ann. Stat. ch. 30, §550/1 (West 1998); Fla. Stat. Ann.§255.05 (1997).

and suppliers little protection.[17]

§32.04 SURETY'S RIGHTS AND OBLIGATIONS

[A] Before Default of Its Principal

Upon executing a performance bond, the surety's liability is secondary and contingent. This means that the contractor or principal has both the primary liability and obligation to fully discharge its contractual obligations (hence the *Restatement's* designation of "principal obligor"). In other words, although the surety faces a potential claim because it issued the bond (*i.e.*, it is the "secondary obligor"), the contractor must perform the work. Two critical points flow from this. First, the principal has the right to be free from interference from the surety in prosecuting the work. The corollary is that unless and until the owner properly issues a declaration of default in strict compliance with the terms of the bond and contract, the surety's contingent rights in the project have not vested.[18]

It may represent sound business practice for a surety to monitor its principal's work. Sureties however, frequently do not have either the expertise or the resources to actively monitor each project of every principal. Moreover, even if a surety monitors a project, the surety must not interfere or meddle in the affairs of its principal. As a result, the surety must allow the contractor to prosecute the contract work as the latter sees fit. This includes the principal's right to resolve disputes with the obligee. As is common on all construction projects, disputes or disagreements often develop between the owner and contractor regarding the progress of the work, the scope of change orders, and a variety of other items. Even though the surety may be aware of these disputes or disagreements, however, they do not provide the surety with the unilateral right to intervene on the side of either the contractor or the owner. Rather, these issues must be resolved between the owner and the contractor. In fact, if the surety interferes in its principal's business before a declaration of default, the surety faces a potential suit by its principal that it tortiously interfered with its principal's contract.[19] To the extent bonded projects have been assigned to the surety, and by virtue of the tripartite surety relationship, a surety can argue that the surety cannot interfere with its own contract.[20]

Consequently, prior to a default, a surety generally does not have a unilateral right to be involved in the project.[21] Rather, the surety's involvement in a construction project is ordinarily triggered only upon the obligee's decision to issue a declaration of default. In some circumstances, however, the indemnification agreement may provide the surety with some limited rights before the declaration of default. Moreover, some bonds specifically require the involvement of the surety before a formal default. For example, the AIA Document A312 Performance Bond provides that upon proper notification from the obligee, the surety is contractually obligated to attend meetings with the owner and contractor even though a formal default has not occurred.[22]

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[17]Mayor & City Council of Baltimore v. Fidelity & Deposit Co., 386 A.2d 749 (Md. Ct. App. 1978).

[18]*But see* §32.04[C].

[19]Gerstner Elec. Inc. v. American Ins. Co., 520 F.2d 790 (8th Cir. 1975).

[20]Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454 (Cal. 1994).

[21]Granite Computer Leasing Corp. v. Travelers Indem. Co., 894 F.2d 547 (2d Cir. 1989).

[22]AIA Doc. A312, Performance Bond (2010). The 2010 revisions to the 1984 version adds language clarifying that the owner's failure to comply with the notice requirements of Section 3.1 does not release the surety from its obligations under the bond except to the extent the surety demonstrates actual prejudice. The new form shortens the notice period for surety default under the bond from 15 days to 7 days. The penal limit of the bond does not apply if the surety elects to undertake and complete the contract itself. The A-312-2010 Payment Bond increased the period of time in which a surety must answer a payment bond claim from 45 to 60 days and, now, a failure of a surety to answer or make a

Even where the bond does not obligate the surety to attend meetings, some sureties attend pre-default meetings called by the obligee. Generally, an obligee may look to meet with the surety and contractor with the hope of preventing what the obligee perceives as a troubled project from becoming one in which the principal is default terminated. If the surety attends these meetings, it must be careful not to jeopardize or undermine its principal's position. The cautious and smart surety will support its principal in a bona fide dispute with the owner to avoid a potential tortious interference claim by its principal.[23] As a result, although an obligee may complain to the surety about the contractor's alleged shortcomings and deficiencies, these complaints ordinarily are not sufficient to trigger a formal response by the surety.

[B] Declaration of Default

Since the surety has no obligation to perform until its principal has been defaulted, the declaration of default is obviously a watershed event.[24] Because the declaration of default usually has a substantial financial impact on the surety, principal, and obligee, oftentimes contentious litigation follows. For the obligee, a wrongful or improper declaration of default is a double-edged sword. On the one side, if the owner wrongfully terminates the contract, it is liable to the principal for the resulting damages. On the other side, a wrongful termination also relieves the surety's performance bond obligations.[25] Consequently, and not surprisingly, owners oftentimes approach a potential default with great trepidation.

Determining when the surety is obligated to perform is, of course, defined by the terms of the particular bond. For example, under the AIA Document A311 bond, the surety's performance bond obligations are triggered "whenever [the principal] shall be, and declared by [the obligee] to be in default under the Contract, the [obligee] having performed, [its] obligations thereunder." Consequently, the three preconditions to the surety's liability under the A311 bond are (1) the default by the principal; (2) the obligee's declaration of default; and (3) last, that the obligee itself has not breached the contract. While the obligee's duty to terminate the principal's right to complete the work is implicit under the A311 bond, it is specifically stated in the AIA Document A312 bond. With an A312 bond, the surety is not obligated to perform unless the obligee has notified both the contractor and the surety in writing that the owner is "considering declaring a contractor default," has "declared a contractor default, and formally terminated the contractor's right to complete the contract," and "has agreed to pay the balance of the contract price to the surety," and last, is itself not in default.[26]

Although the declaration of default is the event that triggers the surety's liability, for the obligee determining what constitutes a "default" is not as straightforward as it may appear. Despite the fact that many contracts contain specific default termination provisions, the trigger for a declaration of default remains somewhat elusive. For example, a standard termination clause contained in the AIA Document A201 General Conditions gives the owner the right to terminate the contract if the contractor:

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payment in the time period specified is not a waiver of the surety's and contractor's defenses to the claim. Rather, the claimant may now be entitled to attorneys' fees.

[23]*See also* Restatement (Second) of Torts §§766, 766A (1979).

[24]Not all bonds, however, require the owner to issue a Declaration of Default before the surety is obligated to perform. For example, the New York City Department of Design and Construction Standard Bond Form in part states: "The Surety (Sureties), for value received, hereby stipulates and agrees, if requested to do so by the City, to fully perform and complete the Work to be performed under the Contract pursuant to the terms, conditions and covenants thereof, if the City determines the Principal for any cause, has failed or neglected to fully perform and complete such work."

[25]Cuddy Mountain Concrete v. Citadel Constr., 520 N.W.2d 473 (Minn. Ct. App. 1994).

[26]AIA Doc. A311, Performance Bond (2010); AIA Doc. A312, Performance Bond, paras. 3.1, 3.2, 3.3. *See also* Philip L. Bruner, et al., *The Surety's Analysis of Investigative Results: "To Perform or Not to Perform—That Is the Question," in* Bond Default Manual (Duncan L. Clore, Richard E. Towle & Michael J. Sugar ed., 3d ed. 2005).

1. persistently or repeatedly refuses to supply enough properly skilled workers or proper materials;
2. fails to make payment to subcontractors for materials or labor in accordance with the respective agreements between the contractor and the subcontractors;
3. persistently disregards laws, ordinances, or rules, regulations, or orders of a public authority having jurisdiction; or
4. otherwise is guilty of substantial breach of a provision of the contract documents.[27]

Implicit in this definition is a recognition that the contractor's breach or series of breaches must be material for the obligee to lawfully default the contractor.

In addition to a specific termination clause, in determining whether the breach or series of breaches is sufficiently material justifying a default, owners can look to §241 of the *Restatement (Second) of Contracts*. Although this is a fact-specific inquiry not susceptible to a precise and universal definition, the *Restatement* identifies five "circumstances that are significant" in determining whether the breach is "material." These are:

(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;
(b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
(c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;
(d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;
(e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.[28]

The requirement that the contractor's breach or series of breaches be material is especially significant with a construction contract. On virtually every construction project, there inevitably occur any number of arguable "breaches," ranging from delayed performance to a failure to pay subcontractors or suppliers in a timely manner, and everything in between. For the owner, however, not every "breach" is sufficiently material to justify defaulting the contractor.

The Fifth Circuit Court of Appeals, in what has become the leading opinion on point, addressed this critical issue in *L&A Contracting Co. v. Southern Concrete Services Inc.*[29] In *L&A*, the obligee alleged that the contractor failed to timely perform its obligations under the contract and also had committed additional other "breaches." These ultimately culminated in a letter by the owner requesting "that the Bonding Company take the necessary steps to fulfill the contract to prevent further delays and costs to the [owner]." The surety did not respond. Litigation followed. In distinguishing between "breach" and "default," the court stated:

> Although the terms "breach" and "default" are sometimes used interchangeably, their meanings are distinct in construction suretyship law. Not every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it. To constitute legal default, there must be a (1) material breach or series of material breaches (2) of such magnitude that the obligee is justified in

[27]AIA Doc. A201, General Conditions of the Contract for Construction, subpara. 14.2.1 (1997).
[28]Restatement (Second) of Contracts §241 (1981).
[29]17 F.3d 106 (5th Cir. 1994).

terminating the contract.[30]

After concluding that only material breaches are sufficient to justify terminating the contract and defaulting the principal, the *L&A* court also addressed the mechanics of and specificity required for a declaration of default.

The Fifth Circuit then rejected the owner's argument that its letter requesting the surety to step in and prevent additional delays constituted a "declaration of default." The court summarized the reasons, stating that:

> [S]erious legal consequences attend a "declaration of default," particularly in cases such as this case involving multi-million-dollar construction projects. Before a declaration of default, sureties face possible tort liability for meddling in the affairs of their principals. After a declaration of default, the relationship changes dramatically, and the surety owes immediate duties to the obligee. Given the consequences that follow a declaration of default, it is vital that the declaration be made in terms sufficiently clear, direct, and unequivocal to inform the surety that the principal has defaulted on its obligations and the surety must immediately commence performing under the terms of its bond.[31]

Thus, a declaration of default must be distinguished from the normal course of correspondence that may flow from an owner or obligee complaining about progress or other problems on a construction project. Consequently, since the court concluded that the owner's letter did not constitute a clear and unambiguous declaration of default, there was never a formal demand against the surety; hence, the award against the surety was vacated.[32] The award against the contractor, however, was affirmed.

The declaration of default continues to be a flashpoint in performance bond disputes. Since performance bonds are contracts, the need for a formal declaration of default is determined by the specific language of the performance bond and the construction contract between the obligee and the principal. Where the bond contains a specific requirement for a "declaration of default," it is generally enforced. Therefore, if the bond specifically requires a "declaration of default" and the owner fails to declare it in a sufficiently clear, direct, and unequivocal manner, the surety will not be liable.

For example, in *Elm Haven Construction Limited Partnership v. Neri Construction LLC*,[33] a general contractor who was an obligee sued a surety that had issued a performance and payment bond on behalf of a subcontractor, claiming that the surety breached its obligations under both bonds. The surety was granted summary judgment because the general contractor failed to comply with the terms of the performance bond that specifically required a declaration of default. Relying upon *L&A Contracting Co. v. Southern Concrete Services, Inc.*,[34] the court found that the series of letters sent by the general contractor to the surety do not contain an unequivocal declaration of default thereby triggering the surety's

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[30] *Id.* at 110 (citations omitted).

[31] *Id.* at 111 (citations omitted).

[32] *Id. See also* Balfour Beatty Constr. v. Colonial Ornamental Iron, 986 F. Supp. 82 (D. Conn. 1997), where the court granted the surety's motion for summary judgment as a result of the failure to issue a declaration of default. The court relied on *L & A Contracting v. Southern Concrete Services* and concluded that letters to the surety that only mentioned delays were insufficient as a matter of law to institute a formal declaration of default. Significantly, the court also found that as a result of the failure to provide the declaration of default, the surety was denied "the opportunity to exercise any of its options under the bond." *Id.* at 86.

[33] 376 F.3d 96 (2d Cir. 2004).

[34] 17 F.3d 106 (5th Cir. 1994). *See* §§32.04[B] and [C].

liability under the bond. Ultimately, the obligee in fact satisfied the bond's requirement for a proper declaration of default. By then, however, the obligee had already hired a completion contractor. The court found that surety was discharged because the obligee's decision to hire a replacement contractor denied the surety the opportunity to perform its obligations under the bond. The court also found that since the general contractor did not meet the definition of a "claimant," it could not invoke the payment bond.[35]

In addition to a declaration of default clause, some bonds delineate specific options available for a surety to discharge its obligations under a performance bond once a default is properly declared. Since a performance bond is a contract, an obligee's failure to permit a surety to exercise one of the options in the bond in responding to a default may also discharge a surety. In *St. Paul Fire & Marine Insurance Company v. City of Green River Wyoming*,[36] the surety responded to the default and agreed to take over the project and complete the work using employees of the defaulted principal. This was an option delineated in the bond. The owner objected and refused to permit the surety to proceed with the work using employees of the defaulted principal. The court found that by prohibiting the surety from exercising its rights under the bond to complete the work in the most cost efficient manner, the owner materially breached the bond, thereby discharging the surety. *See also Seaboard Surety Co. v. Town of Greenfield*,[37] where a public owner sent a performance bond surety a series of letters indicating that it was contemplating a declaration of default. Ultimately, the owner declared a default and the surety began its investigation and negotiating the terms of a possible takeover agreement with the obligee. The obligee was dissatisfied with the surety's proposed completion contractor, and without providing the surety the 15-day cure period in the bond, defaulted the surety and immediately hired a contractor to complete the work. The court found that the surety was discharged because obligee's conduct denied the surety the 15-day period during which it may attempt to cure the alleged breach prior to default and thus minimize its economic exposure.

The requirement for a formal declaration of default as a condition precedent for a suit against a surety, however, is not absolute. Rather, since a bond is a contract, courts that examine these issues start with the language in the bond. In a recent case, a court found that although an American Institute of Architects (AIA Doc. No. 311, Performance Bond), references a declaration of default, it does not require a formal declaration of default as a condition precedent to instituting legal action on the bond.[38]

[C] Notice to Surety

At common law, an obligee was not required to notify the surety if its principal was defaulted. Many modern bonds include a specific notice provision requiring timely notification of a default. In fact, this requirement was added to the bond to avoid the common-law rule that the surety is not entitled to notification when its performance is due.[39] In one case, for example, the surety was discharged because of the obligee's failure to provide the surety with notice of the default and the opportunity to respond as mandated by the bond before the obligee completed the project with its own contractor. The court reasoned that the obligee's conduct stripped the surety of its contractual right to limit its liability by selecting another contractor to complete the work. This court found that the obligee's conduct constituted

[35]*See also* Bank of Brewton, Inc. v. International Fid. Ins. Co., 827 So. 2d 747 (Ala. 2002).

[36]93 F. Supp. 2d 1170 (D. Wyo. 2000).

[37]370 F.3d 215 (1st Cir. 2004).

[38]Walter Concrete Constr. Corp. v. Lederle Labs., 99 N.Y. 2d 603 (Ct. App. 2003). *See also* Gloucester City Bd. of Educ. v. American Arbitration Ass'n, 333 N. J. Super. 511 (App. Div. 2000) (interpreting a New Jersey statutory bond required on public projects); Colorado Structures, Inc. v. Insurance Co. of the West, 106 P.3d 815 (Wash. App.), *cert. granted*, 126 P.3d 1279 (2005).

[39]L&A Contracting v. Southern Concrete Servs., 17 F.3d 106, 111 (5th Cir. 1994).

a material breach that rendered the surety's bonds null and void.[40] In cases where bonds do not contain an explicit notice provision, courts imply a duty to provide notice. A surety is generally entitled to relief only if it can demonstrate that the failure to provide notice resulted in increased damages or other substantial prejudice.[41]

Sometimes, however, the delay in the failure to notify the surety can be so gross that a court will exonerate the surety even in the absence of a demonstration of prejudice. Just such a situation arose in a case in the Eastern District of Virginia where the bond required immediate notice of default, but for some reason, the obligee waited nearly a year before notifying the surety. While holding that such a requirement mandated notification of the bonding company within a "reasonable" time, the court nonetheless granted the surety summary judgment, finding that while prejudice had been shown, this would not be necessary for dismissal.[42]

In contrast to the foregoing, a 2007 opinion by the Washington Supreme Court takes an approach to this issue that is basically unique in the reported case law.[43] The court essentially bifurcated the performance bond, an A311 form document, into two sections, one dealing with language of conditions, and the other dealing with language of promissory undertakings. Provisions in the bond calling for various steps to be taken in the event of default were deemed to be options that the obligee could pursue, but not such as to waive the prefatory condition of the bond remaining in force and effect unless the principal were to faithfully perform its obligations. Without declaring a default, the obligee

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[40]Dragon Constr., Inc. v. Parkway Bank & Trust, 287 Ill. App. 3d 29 (1997); *see also* 120 Greenwich Dev. Assoc., LLC v. Reliance Ins. Co., 2004 WL 1277998 (S.D.N.Y. June 8, 2004) (failure to provide notice to surety of default pursuant to the terms of bond discharged the surety of all obligations under bond); Seaboard Sur. Co. v. Town of Greenfield, 370 F.3d 215 (1st Cir. 2004) (After terminating the contractor for default, the town and the surety actively negotiated for the surety to complete the contract until the town broke off the discussions and hired another contractor. The town argued that the surety breached its bond by not performing quickly enough, but the court, in a 2-1 decision, held that the terms of the bond required the town to give the surety 15 days' notice and an opportunity to cure the alleged default, and that the town breached the bond by not giving the surety this notice.); *See also* Milton Reg'l Sewer Auth. v. Travelers Cas. & Sur. Co. of Am., No. 4-13-cv-2786, 2014 U.S. Dist. LEXIS 85557 (M.D. Pa. June 24, 2014) (court found that despite a myriad of letters sent by the public owner, it had not complied with conditions of the bond, requiring a meeting with the surety and providing the contractor an opportunity to cure); *but see* AgGrow Oils, LLC v. National Union Fire Ins. Co. of Pittsburgh, Pa., 420 F.3d 751 (8th Cir. 2005) (Under North Dakota law, surety waived compliance with default notice provisions to invoking performance bond when it declared that its contractor had completed construction project and that it would decline to complete project, thereby rendering further actions by owner to invoke bond a useless formality.).

[41]*See* Blackhawk Heating & Plumbing v. Seaboard Sur. Co., 534 F. Supp. 309, 316–18 (N.D. Ill. 1982) (finding that notice was an implied condition and a surety must have an opportunity to remedy the default or minimize damages and "that if the failure to give notice results in increased damages which could have been avoided if the surety had been notified, then the failure to give the notice bars recovery of the increase in damages…and [the surety] shall have the burden of proving that it has been prejudiced [by the] failure [of the obligee] to give notice"); Town of Clarkstown v. North River Ins. Co., 803 F. Supp. 827, 829 (S.D.N.Y. 1992) (implying a timely notice requirement in subdivision bonds); Conesco Indus. v. Conforti & Eisele Inc., 627 F.2d 312 (D.C. Cir. 1980); 1199 Housing Corp. v. International Fid. Ins. Co., 788 N.Y.S.2d 88 (N.Y.A.D. 2005) (Surety's failure to plead breach of notice requirement with specificity and particularity (as was required in New York) resulted in loss of this defense for surety.).

[42]New Viasys Holdings, LLC v. Hanover Ins. Co., 2007 WL 783179 (E.D. Va. 2007) (a bond titled Supply Bond, which the court analyzed to determine whether it was a performance bond or an indemnity bond, and decided it was an indemnity bond, despite its title).

[43]Colorado Structures, Inc. v. Insurance Co. of the West, 167 P.3d 1125 (Wash. 2007).

"supplemented" the contractor's forces, and the court held the surety to be nonetheless liable for these charges.

However, *Solai Cameron, Inc. v. Plainfield Community Consolidated School District No. 202*,[44] took a more orthodox route. Although the prime contractor obligee had corresponded with its subcontractor's surety prior to defaulting the sub, it delayed notifying the surety of default and hired a replacement before terminating the principal. The surety was granted summary judgment based upon the obligee's failure to allow the surety to exercise its completion options under paragraph 4 of the AIA bonds.

[1] Notices in Supplementation Cases

The approach taken in the Washington case involved an obligee's election to supplement the principal's forces, rather than to default. In such a situation, it would be illogical to both default and supplement, because an obligee cannot supplement a contract that has been defaulted. In such a situation, an obligee's notice to a surety that it is supplementing the principal's forces, with a request for some acknowledgment from the surety, or some involvement to mitigate losses, is sufficient.

[D] Duty to Investigate

Various difficulties and complexities arise for a performance bond surety once the obligee issues a declaration of default because it triggers the surety's bond obligations. If the principal contests the default, the surety finds itself in a difficult position. In fact, the surety is squarely in the middle, with the principal and obligee tugging in opposite directions with very different expectations from the surety. The obligee will claim that because the default was proper and justified, the surety must immediately honor its bond obligations and compete the project. Aware of its exposure under the indemnification agreement with the surety, the principal will insist that its surety support its position that the default was improper and, furthermore, that because of the obligee's breach of the construction contract, the obligee is not entitled to the surety's performance. Added to the mix is the surety's parochial desire to minimize its own costs. The default situation is made even more complex because, in addition to defenses of its principal, the surety also has many unique defenses based on its status as surety.

An often cited case from the Court of Appeals for the District of Columbia equates the ordinary circumstances of a large construction project with the entropy of a battlefield.[45] While it is certainly

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[44]871 N.E.2d 944 (Ill. App. 2007).

[45]Blake Constr. Co. v. C.J. Coakley Co., 431 A.2d 569 (D.C. 1981). There, the court stated:

> [E]xcept in the middle of a battlefield, nowhere must men coordinate the movement of other men and all materials in the midst of such chaos and with such limited certainty of present facts and future occurrences as in a huge construction project such as the building of this $100 million hospital. Even the most painstaking planning frequently turns out to be mere conjecture and accommodation to changes must necessarily be of the rough, quick and ad hoc sort, analogous to ever-changing commands on the battlefield. Further, it is a difficult task for a court to be able to examine testimony and evidence in the quiet of a courtroom several years later concerning such confusion and then extract from them a determination of precisely when the disorder and constant readjustment, which is to be expected by any subcontractor on a job site, become so extreme, so debilitating and so unreasonable as to constitute a breach of contract between a contractor and a subcontractor. This was the formidable

difficult for a trial judge to determine if a construction contract was breached, even with the benefit of expert testimony and hindsight, parties to a problem-ridden construction project are afforded neither hindsight nor time. Rather, they are often forced to make quick decisions based on less-than-complete information in an effort to prosecute the work, which may be behind schedule or on the threshold of unfavorable weather.

After the obligee takes the initial step of defaulting the principal, the ball drops in the surety's court. One of the first issues confronting a performance bond surety is whether it must investigate the project following the default. In general, a performance bond surety is obligated to conduct an investigation of a default claim quickly. This investigation should include possible claims by the obligee against the principal and vice versa, as well as any claims involving the principal and third parties. Essentially, the investigation should seek to determine whether the default termination was proper and what options the surety may have available in determining how and whether to cure the default while minimizing the surety's own costs.

Before responding to the obligee's declaration of default, the surety's investigation does not need to be a searching inquiry into every possible issue. Rather, the benchmark used by courts in evaluating the adequacy of a surety's investigation is whether it was "reasonable" under the circumstances.[46] Not surprisingly, the decisions do not offer nor could they contain a precise definition of what a reasonable investigation would encompass in all cases. Rather, it is a fact-sensitive inquiry measured against the unique facts and circumstances of each particular case. For although a surety is required to conduct a reasonable investigation in response to a performance bond claim, this does not require the surety "to create the plaintiff's claims."[47]

The critical issue confronting a performance bond surety regarding the scope of its investigation is the threat of a bad-faith claim. A performance bond surety faces this threat from the obligee, from its principal and indemnitors, and from materialmen and suppliers on a payment bond. Whether a performance bond surety faces potential bad-faith liability depends upon the law of the particular jurisdiction. In general, in jurisdictions that blur or have eliminated the distinction between traditional liability insurance and suretyship through either case law or statutes that subject sureties to unfair claims practices applicable to liability insurers, sureties may be subject to bad-faith claims. Moreover, a bad-faith claim may also lie in jurisdictions that impose a duty of good faith and fair dealing in all contracts.[48]

In a significant decision, the California Supreme Court reversed a $15 million judgment against a surety for breach of an implied covenant of good faith and fair dealing concluding that tort recovery is not appropriate for a claim on a performance bond. Rather, a performance bond surety's liability will be governed by contract theories, not tort theories.[49] Once, however, the surety conducts an investigation,

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undertaking faced by the trial judge in the instant case.

Id. at 575.

[46]Loyal Order of Moose Lodge 1392 v. International Fid. Ins. Co., 797 P.2d 622, 628 (Alaska 1990) ("failure by a surety minimally to investigate its principal's alleged default may constitute bad faith if that investigation would confirm the obligee's allegations in material part").

[47]Farmers Union Cent. Exch. v. Reliance Ins. Co., 675 F. Supp. 1534, 1542 (D.N.D. 1987).

[48]*See, e.g.*, Sons of Thunder Inc. v. Borden, Inc., 148 N.J. 396 (1997).

[49]Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407 (Cal. Sup. 1999) (*see* note 76, *infra*). *See also Bell BCI Co. v. HRGM Corp.*, 276 F. Supp. 2d 462 (D. Md. 2003) (finding that as a matter of law a surety is not liable in tort damages to an obligee for a breach of good faith and fair dealing); *Norwood Co. v. RLI Ins. Co.*, 2002 WL 485694 (E.D. Pa. 2002) (finding that the obligee may not assert a bad faith claim against a surety under Pennsylvania law); *Masterclean Inc. v. Star Ins. Co.*, 556 S.E.2d 371 (S.C. 2001) (finding that the principal may not sue a surety in tort for a bad faith refusal to pay a first-party claim); Cates Constr. Inc. v. Talbot Partners, 62 Cal. Rptr. 2d 548, 552 (Ct. App. 1997) (surety's bad faith was

even if limited, and determines that a genuine dispute exists as to its principal's liability, the surety has satisfied its duty to investigate and is not required to look any further.[50]

In addition to potential bad-faith claims by an obligee, the surety faces similar claims from the principal and its indemnitors. Cases on point generally involve allegations that the surety paid claims without conducting a sufficient investigation. The principal and indemnitors will contend that the surety's payment to either the obligee or the laborers or materialmen was improper. Although allegations of bad faith may be couched in terms of an affirmative claim, they generally amount to a defense that as a result of the surety's "bad faith" in failing to investigate properly, the surety is not entitled to enforce its indemnification agreement against the principal. In cases where the surety paid claims without conducting an adequate investigation or acted unreasonably, the surety was denied indemnification and thus absorbed the loss.[51]

The settlement of claims over a principal's objection is a flashpoint where the interests of the principal and surety conflict. In one case, a surety was entitled to indemnification even though it settled bond claims despite its principal's claims of a valid defense. Under that indemnification agreement, the surety had the right to settle all claims unless the principal requested that the surety litigate the claim and posted collateral with the surety to secure the amount of a possible judgment and the litigation expenses. There, although the principal requested the surety to litigate the claims, the principal failed to post the necessary collateral. Essentially the principal was litigating its claims with the obligee with the surety's money. As a result of the principal's failure to post the necessary collateral, the surety settled the claim and was entitled to indemnification. The only restriction upon the surety's right to settle claims was that the surety must act in "good faith."[52]

In some cases, although the jurisdiction may not impose a common-law or statutory good-faith requirement on a surety, if the indemnification agreement requires the surety to act in good faith, this could constitute a valid defense to a surety's claim for indemnification. In one recent case, a court found that under the indemnity agreement, the surety's good faith in setting claims was a condition precedent to

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based on two interrelated acts: Without conducting any investigation, the surety received an assignment of its principal's mechanic's lien, and then prosecuted its right under the lien); Transamerica Premier Ins. Co. v. Brighton Sch. Dist., 940 P.2d 348 (Colo. 1997) (finding a surely liable for a bad faith breach of the performance bond claim for failing to timely respond to the obligee's default termination of the principal). *See also* United States *ex rel.* Don Siegel Constr. Co., Inc. v. Atul Constr. Co., 85 F. Supp. 2d 414 (D.N.J. 2000) (finding that New Jersey would extend same rationale that permitted bad faith claims against insurers for failing to settle claims to sureties on Miller Act payment bond claims); International Fid. Ins. Co. v. DelMaura Sys. Corp., 2001 WL 541469 (Del. Super. 2001), *appeal denied*, 782 A.2d 264 (finding that a performance bond surety may be subject to a bad faith claim by an obligee).

[50]Brinderson Newberg v. Pacific Erectors, 971 F.2d 272, 282 (9th Cir. 1992) ("A court can conclude as a matter of law that an insurer's denial of a claim is not unreasonable, even if a court concludes the claim is payable under the policy terms, so long as there existed a genuine issue as to the insurer's liability.…[O]nce [the surety] understood [its principal's] interpretation of the contract and a genuine dispute over liability existed, [the surety] was under no further duty to investigate [the obligee's] claim on the bond.").

[51]St. Paul Fire & Marine Ins. Co. v. Pepsico, Inc., 160 F.R.D. 464, 466 (S.D.N.Y. 1995) (holding that the surety was not entitled to indemnification because it had "blindly paid on bonds without investigating or defending claims…[and it] did not act reasonably"); Windowmaster Corp. v. Morse/Diesel, Inc., 722 F. Supp. 1532 (N.D. Ill. 1988) (holding that whether the surety acted in good faith in settling claims with the obligee created an issue of material fact regarding a surety's claim for indemnification).

[52]GAIC v. Merritt-Meridian Constr. Corp., 975 F. Supp. 511 (S.D.N.Y. 1997).

its right to indemnification.[53]

Sureties continue to confront bad faith and extra contractual claims. These claims are being asserted on three separate fronts: by obligees or owners on performance bonds, by laborers and materialmen in payment bonds, and by principals and indemnitors in indemnity suits. Whether a surety is actually subject to bad faith or extra contractual claims depends on the specific jurisdiction.

[E] Options on Default

Following a declaration of default, many obligees are either surprised or disappointed that the surety does not march in the very next day with its own construction forces and complete the work. Rather, at the conclusion of its investigation of the entire project, the surety generally has five very diverse options when called upon to perform. These include (1) buying back the bond; (2) financing the principal; (3) taking over and completing the project; (4) tendering a new contractor to the obligee; or (5) simply allowing the obligee to complete the work. Some bonds specifically delineate or limit the surety's options on a default.[54] Where the bond does not specifically list the surety's options, the surety and obligee must

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[53]Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276 (Tex. 1998) (under Texas common law, a surety does not owe its principal a duty of "good faith." The indemnity agreement at issue, however, required the surety to exercise good faith in settling claims. The court concluded that the "good-faith" requirement is a condition precedent to the surety's right of recovery under its indemnification agreement. Since the court found that there was evidence that the surety did not act with good faith, the surety was denied indemnification.); Shannon R. Ginn Constr. Co. v. Reliance Ins. Co., 51 F. Supp. 2d 1347 (S.D. Fla. 1999).

[54]For example, under the AIA Document A312 Bond, when the owner has satisfied the conditions of paragraph 3, the surety shall promptly and at the surety's expense take one of the following actions:

> 4.1 Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract; or
>
> 4.2 Undertake to perform and complete the Construction Contract itself, through its agents or through independent contractors; or
>
> 4.3 Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and the contractor selected with the Owner's concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages as described in Paragraph 6 in excess of the Balance of the Contract Price incurred by the Owner resulting from the Contractor's default; or
>
> 4.4 Waive its right to perform and complete, arrange for completion or obtain a new contractor and with reasonable promptness under the circumstances.
>
> After investigation, determine the amount for which it may be liable to Owner and, as soon as practicable after the amount is determined, tender payment therefor to the Owner; or
>
> Deny liability in whole or in part and notify the Owner citing reasons therefor.

negotiate a mutually agreeable option, often with a reservation of rights so that any claims may be resolved at a later date without delaying the completion of the project. Whatever option is ultimately selected, the surety's primary goal is to fulfill its bond obligation at the lowest cost, while the obligee is looking to have its project completed as quickly as possible.[55]

[1] Buying Back the Bond

Here, the surety seeks to obtain a full release from the obligee by purchasing back its performance bond by paying a sum to the obligee up to the bond's penal limit. This option is best suited for a default that has occurred in the early stage of construction, and the surety's estimated cost to complete either approaches or exceeds the bond's penal limit. The advantage to the surety of this approach is that even though it may incur a substantial loss, the surety can fix its liability at an amount equal to or less than the bond's penal sum. Although this option may provide the obligee with a substantial cash infusion at a critical juncture, it still may not be willing simply to release the surety. After all, the project still must be completed, and with the surety off the hook, the obligee no longer has recourse to a third-party "deep pocket" to complete the work.

The primary risk to the surety using this approach is a potential claim by the principal and the indemnitors that the payment was either excessive or otherwise inappropriate. If a court sustains the principal's and indemnitors' position, this will either reduce or totally eliminate the surety's right to indemnification. One way to avoid this risk is to obtain the principal's and indemnitors' consent to buy back the bond before the agreement with the obligee is finalized. Another way is to include language in the indemnity agreement about the surety's right to exercise this option. Under any circumstances, it would be prudent to put the principal and indemnitors on notice of the agreement.

[2] Financing the Principal

Another option for the surety is to finance its principal.[56] Whether the financing takes the form of a direct loan to the principal or the surety's guarantying bank loans, the goal remains the same—namely, providing sufficient financial assistance to enable the principal to complete the bonded project or projects as quickly and economically as possible. Financing is a risky option for the surety, however. A surety generally considers financing as its best option when the majority of the work has been completed, the obligee is satisfied with the quality and pace of the principal's work, and the surety believes the principal's default resulted from temporary cash flow problems. Under these circumstances, the surety gambles that a quick and short-term capital infusion will enable the principal to proceed with the bonded project rather than risk default solely for want of adequate working capital.

Sureties also consider financing in less than ideal situations. These situations arise where financing the troubled principal would nonetheless be the surety's best option for completing the project at the lowest cost. For example, even if the principal is not a perfect candidate for financing, the surety may have little choice if the work is highly specialized, such as a complex process plant, or where the work is in a remote location, or where the contract provides for substantial liquidated damages and the project will lose time in the transition to a replacement contractor. In each of these circumstances, although the principal's problems may be more than merely the need of short-term capital infusion, financing the

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[55]For an overview of the surety's performance bond options, see Marilyn Klinger, James Diwik & Kevin L. Lybeck, *The Contract Performance Bonds, in* The Law of Suretyship (Edward G. Gallagher 2d ed., ABA 2000).

[56]For a more in-depth discussion of this option, as well as some standard clauses to include in a financing agreement, see George J. Bachrach, Michael A. Stover & Shane C. Mecham, *Financing the Principal, in* Bond Default Manual (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox, eds., 4th ed. ABA 2015).

principal may still represent the surety's least costly option for completing the project as quickly as possible.

Prior to deciding to finance the principal, the surety must conduct a thorough investigation because if the surety decides to finance, the surety will then be pumping its money directly into its principal's business. The surety's investigation addresses four main points. First, the surety must know how much it will ultimately cost. This includes not only how much it will cost to complete the bonded project but also the amount of cash the principal needs to meet its current expenses, including paying subcontractors and suppliers as well as general overhead expenses. The surety will also want to know what collateral the principal and its indemnitors may have to secure the surety's financing. Second, the surety must evaluate whether the principal and the indemnitors are sufficiently honest, trustworthy, and committed to completing the project. This is critical because once the surety decides to finance the principal, the surety is, in effect, in business with its principal. Third, the surety must decide if the principal has the technical ability to complete the work. Does it have the necessary manpower and expertise, both in the field and the home office, and does it have the ability to supervise and manage subcontractors and suppliers? Fourth, the surety must also conduct a general investigation into the reasons for the default and the current status of the work so as to minimize future expenses.

In addition to the direct dollar costs of financing the principal, the surety also incurs additional costs in monitoring the ongoing project. Because the surety will now be directly contributing its money to the principal and the project, a surety will generally monitor the project to see where and how its money is being spent. Although a surety may employ its own personnel for this purpose, more often than not a surety will engage an engineer or construction accountant to monitor the principal and the project. The degree and cost of these services vary with the facts and circumstances of each case, but the surety's goal remains the same: to ensure that its money is efficiently spent on completing the bonded work at the lowest cost. Of course, this monitoring effort also increases the surety's costs.

Although financing has certain benefits to the surety of allowing the work to proceed quickly, it does have substantial risks. The greatest risk arises from the fact that funds expended by the surety financing the principal do not reduce the bond's penal limit. As a result, the surety's performance bond exposure remains the same. Thus, financing could result in an ultimate loss to the surety in excess of the bond's penal sum because even after the surety has spent a large sum of money by financing its principal, the principal may nonetheless be defaulted, and the surety will then confront a performance bond demand by the obligee. Under these circumstances, the amount spent on financing the principal, plus the amount of the ultimate performance bond claim, may very well exceed the bond's penal sum. To avoid this predicament, before agreeing to finance its principal, the surety should seek the obligee's written consent that the amount contributed by the surety for financing reduces the bond's penal limit dollar for dollar. An obligee, however, may have very little incentive to enter such an agreement other than the enhanced prospect of completing the project on or near schedule.

In addition to the risk that the damages may exceed the bond's penal limit, the surety also faces claims by third-party creditors of the principal, and claims by the principal itself when the surety decides to finance its principal. In this situation, creditors may assert what has been described as an “alter ego” claim. For example, in *James E. McFadden v. Baltimore Contractors, Inc.*,[57] the surety entered into a financing arrangement with its principal. The plaintiff, a subcontractor on a nonbonded job, sued the surety, claiming that through the financing agreement the surety exercised total control over the principal so that the principal became an instrument of the surety. The court rejected this argument and found that the surety “did not take absolute control of [the principal], but rather that it took steps to minimize its risks as a major creditor of [the principal].”[58]

[57]609 F. Supp. 1102, 1105 (E.D. Pa. 1985).

[58]*Id.* at 1104–05 (providing useful guidance on the steps a surety can take in preparing a financing agreement to avoid an alter ego claim).

In addition to claims by third parties, principals and indemnitors have also asserted claims against sureties following unsuccessful financing arrangements. A typical theory is that through the financing agreement the surety so thoroughly dominated the principal's business management that the surety caused the principal's business to fail. One of the leading cases on this issue is *Lambert v. Maryland Casualty Co.*[59] Lambert was a large road contractor that began experiencing severe cash flow problems. Lambert looked to both its surety and its bank for money. The surety agreed to provide the requested funding and entered into a financing agreement with Lambert. Ultimately, Lambert's condition deteriorated, and the surety pulled the funding. Lambert filed for bankruptcy, and litigation followed. The Louisiana Supreme Court concluded that the surety's good-faith duties did not require it to support its principal "by the advancing of additional funds or by continuing to forebear in the exercise of its rights, contracted at arms length, for its own protection against further liability and loss as surety, guarantor, and creditor."[60] Furthermore, the court stated that the surety had a "legitimate and serious interest in the exercise of its legal rights reasonably believing that the corporation could not meet its obligations under the contracts and that continued financial support of the corporation would not prevent or reduce the ultimate loss to either the [principal] or surety."[61] Essentially the court found that when the principal's position became hopeless, the surety was not required to throw good money after bad in a futile effort to keep a sinking ship afloat. So, prior to entering a financing arrangement with its principal, the surety must be careful to avoid "dominating" its principal. Also, the financing agreement should vest the surety with the unilateral right to cut off the funding. This may help the surety avoid a claim that its decision to stop funding was a breach of the financing agreement or of a possible fiduciary duty.

Unintended consequences can also creep in as a result of financing. A North Carolina Federal court case illustrated a clash among sureties, where a bonding company that chose to finance brought suit against two of its principal's other bonding companies, alleging that they had been unjustly enriched as a result of the first surety's willingness to step up to the plate and provide actual money to keep the principal afloat. This claim got nowhere. For while the court agreed that the unrelated sureties had benefited from the financing, it nonetheless found significant that they had not induced the relationship and were at most incidental beneficiaries of action taken by the first surety to secure and advance its own business interests.[62]

[3] Takeover Agreement

Another option for the surety is to enter into a formal takeover agreement with the obligee.[63] Under this approach, the surety and obligee sign a formal agreement wherein the surety agrees to take over and complete the project either through a completion contractor or through a construction manager. This option is most attractive when the project is in an advanced state of completion, and completion by the principal is no longer an option. In this setting, the surety first enters into an agreement with the obligee to complete the remaining work. The surety then enters into a completion contract that includes all outstanding work with another contractor. In an effort to protect itself, the surety may require the completion contractor to obtain its own payment and performance bonds in the amount of the completion

[59]418 So. 2d 553 (La. 1982).

[60]*Id.* at 561.

[61]*Id.*

[62]Fireman's Fund Ins. Co. v. Safeco Ins. Co. of Am., 2007 WL 4233317 (W.D.N.C. 9/28/2007).

[63]For a more detailed discussion of the use of and some standard clauses in a takeover agreement, see Gregory L. Daily &Todd C. Kazlow, *Takeover and Completion, in* Bond Default Manual (Duncan L. Clore, Richard E. Towle & Michael J. Sugar ed., 3d ed. 2005); and for guidance on avoiding Claims Court jurisdiction preclusive issues with respect to the administrative requirements of the Contract Disputes Act, despite a takeover agreement, see Lumbermens Mut. Cas. Co. v. United States, 654 F.3d 1305 (Fed. Cir. 2011).

contract. It may also require the new completion contractor to obtain a “dual obligee” performance bond listing both the owner and the original surety as co-obligees.

The primary advantage for a surety in entering a takeover agreement is that it puts the surety in a better position to control the costs of completing the work. Moreover, through a takeover agreement, the surety can usually obtain some concessions from the obligee. Although obligees generally are not required to enter into takeover agreements, they often do so. In negotiating takeover agreements, sureties can seek to cap their liabilities to the penal sum of the bond. In drafting the takeover agreement, the surety will want to be clear as to whether pre-default costs paid by the surety post-default can be charged against the penal sum.[64] With careful drafting, the surety can maintain the cap on the penal sum for its own breaches.[65] Most obligees that will enter a takeover agreement will not accept any limit on the surety's liability short of the bond's penal limit. Oftentimes, however, by the time the takeover agreement is signed, either the project has passed its completion date and the obligee has the right to assess liquidated damages, or there is not sufficient time to complete the remaining work by the original completion date. As a result, through a takeover agreement, the surety can get the owner to waive liquidated damages for the principal's delay and establish a new completion date. This can be a substantial concession.

The greatest risk confronting a surety when entering a takeover agreement is that its liability is no longer capped by the bond. Rather, once it decides to complete the project, the surety becomes responsible to complete the work even if the cost exceeds the bond's penal sum. Through an adequate investigation, however, a surety can minimize this risk. Among the items the surety must consider are the following: the difficulty of the work, whether the project is well run, how responsible and responsive is the obligee, the prospect of numerous change orders, how well the plans and specifications are drawn, the quality of the work in place, and how far out is the project completion date. Quality information on these items will assist the surety in determining whether there are any hidden risks at the project and in making an intelligent choice whether to take over the contract.

Another flash point can be a claim by the obligee that rights and defenses are impliedly waived when the surety takes over the project, unless these are reserved in the takeover agreement (and even sometimes when they are). That argument failed in a federal court case involving a school district in Westchester County, New York. The court refused to find any such waiver and allowed the bonding company to defend the owner's counterclaims on the basis that termination was wrongful because substantial competition of the project had already been reached.[66]

[4] Tendering a New Contractor

Another option for the surety is tendering a new contractor. Under this approach, the surety investigates the current status of the work. At the conclusion of the investigation, the surety then solicits bids from new contractors to complete the remaining work. After selecting the lowest responsible bidder, the surety then tenders the new contractor to the obligee with a new bond from another surety. The surety also tenders the difference between the completion contract price and the remaining contract funds up to the penal limit of its bond. Unlike the takeover-and-completion option, when tendering a new contractor with a new bond, the surety also receives a release of its liability on the existing performance bond from the obligee. This option is accomplished with a contract between the surety and obligee. Sometimes obligees are unwilling to agree to the tender option unless it involves an agreement signed by the obligee, surety, and new contractor. The three-way tender agreement is becoming more common.

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[64]Allegheny Cas. Co. v. Archer Western/Demaria Joint Venture, No. 8:13-cv-128, 2014 U.S. Dist. LEXIS 116621 (M.D. Fla. Aug. 21, 2013).

[65]Deluxe Bldg. Sys. v. Constructamax, Inc., No. 2:06-cv-02996, 2013 U.S. Dist. LEXIS 126464 (D.N.J. Sept. 5, 2013).

[66]Travelers Cas. & Sur. Co. v. White Plains Pub. Sch., 2007 WL 935612 (S.D.N.Y. 2007).

This method is best suited for projects where the default occurred in the early stages of a project. The advantage to tendering a new contractor is that once the surety receives the release from the obligee, it has discharged its bond obligations and its costs are fixed. The surety can then close its file on that bond.

This option also has certain disadvantages. First, preparing the bid documents to obtain a completion contractor is both time consuming and expensive, and some obligees may grow impatient with what they perceive as the surety's delay in completing the work. As a result, an obligee may begin to complete the work and later sue the surety for breaching its agreement. Moreover, if the jurisdiction permits, the suit will undoubtedly include a bad-faith claim. Tendering also results in increased costs because the completion contractor is assuming full responsibility for completing the work. Accordingly, whether stated or not, the completion contractor's price will generally include a contingency fee for latent defects and other unknown cost factors that are inherent in stepping into a partially completed project. Generally, the more work completed, the greater the chances are that the new contractor will encounter latent defects it will be assuming the responsibility to correct.

The biggest obstacle to tendering is the obligee's refusal to consent.[67] First, although the obligee is obtaining a new bond from a new surety, most obligees are hesitant about releasing the original surety. Second, public owners are subject to public bidding statutes. Consequently, there is a concern that soliciting a completion contractor may violate the public bidding laws. As a result, public owners prefer the option of a takeover agreement where, although a completion contractor is hired, the original surety remains liable.

[5] Do-Nothing Option

The last option for the surety is to allow the obligee to complete the project and then pay the difference between the total adjusted contract balance and the cost to complete the outstanding work. In other words, the surety simply does nothing, waits until the dust settles and the obligee makes a demand for payment. The surety's payment, however, should not exceed the bond's penal sum. The advantage for the surety with the “do-nothing option” is that, although the surety bears the ultimate financial responsibility for completing the work, the surety avoids becoming the party primarily responsible for completing the work.

There are, however, two substantial risks. First, by allowing the obligee to complete the work, the surety has absolutely no control over costs. As a result, once the obligee presents the surety with the bill for completing the work, the surety may be in a difficult position to argue that the costs to complete were unreasonable or too high. The other pitfall to this approach is the potential for a bad-faith claim by the obligee based on the surety's decision to do nothing and leave the effort of completion to the obligee.

Any surety contemplating the do-nothing approach must carefully review the bond and applicable law to ensure that it is not breaching any obligation under the bond. For example, in *Continental Realty Corp. v. Andrew J. Crevolin Co.*,[68] the surety was found liable for damages over and above the penal sum of the bond as a result of its decision to do nothing. There, the bond required the surety to either take over and complete the project, or pay the obligee the reasonable cost of completion. Doing nothing, however, was not an option.

Under the AIA Document A312 bond, the surety essentially has a “do-nothing” type option. This option however, is not absolute. In other words, although the surety has the specific right not to complete the work, the surety cannot simply disappear. Rather, the A312 bond requires the surety to conduct an investigation, “deny liability in whole or in part and notify the Owner citing reasons therefor.”[69]

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[67]AIA Document A312 requires the owner's consent before tendering.

[68]380 F. Supp. 246 (S.D.W. Va. 1974).

[69]AIA Doc. A312 subpara. 4.4.2.

Consequently, although the surety is not required to step in and complete the project, the surety must tell the owner why it does not recognize an obligation to perform under the bond.

[6] Deny the Claim

As cautioned above, the surety may have an obligation to deny a claim, rather than do nothing in response to a performance bond claim. This requires skill to avoid increasing liability of the surety beyond the penal sum. In responding to a claim on an AIA 312 performance bond form, a surety should consider whether the language in Paragraph 6 limiting the surety's liability to the penal sum applies when the surety rejects the claim under Paragraph 4.4.[70]

[F] What the Performance Bond Covers

[1] Cost of Completing the Construction Contract

This is the most obvious expenditure that a performance bond may cover. In fact, some have argued that the cost to complete should be the only subject of the bond's protection.[71] This is the purpose of the performance bond. Should the principal default, the surety, but for its own insolvency, provides a source certain of funding so that the obligee may be placed in as good a position as it would have occupied had the principal not defaulted.[72] Although, as noted above, the surety has several options regarding the precise way in which the funding will be provided, the end result ought to remain the same: guarantying performance at the contract price for the obligee.

This can be illustrated through some simple arithmetic. Assume that the principal enters into a contract with the bond obligee to build a project for one million dollars. After $500,000 has been paid by the obligee, the principal defaults because difficulties encountered at another job site have drained its working capital. It will in fact take $500,000 to complete the balance of the project. Coincidentally, the surety secures a relet contractor who agrees to finish the job for just this amount. Hence, although the surety “fronts” the money to the relet contractor, it is ultimately reimbursed by the owner with the $500,000 of unpaid contract funds.

Of course, rarely is the situation as uncomplicated as the one just outlined, and rare indeed is the default where a surety sustains no loss. In fact, in such a situation, the incentive of the principal to remain at the job site and complete the work with its own forces would be quite high. That is because, by definition, the cost to complete the project will not exceed the contract balance and will, presumably, even afford the principal some profit.

A number of factors can go toward escalating the cost to complete that will exceed the contract balance still retained by the owner and, ultimately, cause the completing surety to sustain a loss. In the first place, either through ineptitude or a desire to keep cash flow moving at a potential risk to profit, the principal may have underbid the contract.[73] This discrepancy will manifest itself through a shortfall of revenues to costs during the completion phase. Second, the principal may have distorted the cost to

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[70]Northline Excavating, Inc. v. County of Livingston, 839 N.W.2d 693 (Mich. Ct. App. 2013) (this risk can be avoided where the bond clearly limits exposure to its penal sum, the state's common law recognizes the limit of the penal sum, and the lack of any conflicting language that would expand the surety's exposure beyond the penal sum).

[71]*See, e.g.*, Marshall Contractors v. Incorporated Peerless Ins. Co., 827 F. Supp. 91 (D.R.I. 1993).

[72]*See* Trainor v. Aetna Cas. & Sur. Co., 290 U.S. 47 (1933).

[73]In a competitive bidding situation, should the principal's number be at sufficient variance from those of its competitors, a surety may argue that the bid was accepted by the owner/obligee in bad faith and thus seek a discharge of its bond. The same might be true of grotesque front-end loading.

revenue ratio by “front-end loading” its requests for progress payments. This proverbial robbing of Peter to pay Paul in the early stages of performance will also manifest itself in enhanced completion costs at the back end of the job. Third, the costs for labor and materials can sometimes escalate dramatically during the ongoing prosecution of the work. Finally, when sureties hire completion or “takeover” contractors, contingencies for encountering and dealing with unknown and unknowable latent defects are usually built into fixed-price quotations.[74] In actual experience, all of these things are much more the norm rather than the exception, and any of them will lead toward a completion cost that will exceed the contract balance. The surety will have to make up the shortfall out of its own resources.

[2] Defective and/or Deteriorated Work

The principal's ultimate default is rarely an abrupt black-and-white type of occurrence. Instead, the pattern is more typically one of a gradual erosion of the contractor's finances, resources, capacity, and control, with their attendant, cumulative impact on the quality of the finished product. Few construction projects resemble an assembly line where the forces of production can effectively be turned on and off. Instead, a close monitoring of the precision of the effort is more often than not necessary to make certain that standards of quality are met.

A contractor in financial difficulty frequently loses these controls. Key supervisory people may leave or in any event have their loyalty or diligence compromised if payrolls are missed. Suppliers may impose more demanding terms of payment or suspend shipments. Corner cutting, in some form, is the almost inevitable result.

The consequence of any or all of the above is likely to be defective work. This concept covers a broad spectrum of conditions, from what is nonconforming, but acceptable, to that which is grossly improper or even dangerous. Perhaps understandably, when a default occurs, owners have a tendency to take a “fine-toothed-comb” approach in searching for defective work. Generally, it will be the owner's expectation that the surety will have to bear the costs of correcting any of this defective work, a cost that will presumably manifest itself in the enhanced price of its relet contractor and almost certainly add to the surety's loss. Generally, sureties have been held liable for these increased costs, particularly when defects are latent[75]—that is to say, when they would not have been detected in the course of a reasonably diligent prior inspection.[76]

It is also rare for sureties to take control of the project immediately following the events giving rise to default. In the first place, disputes between contractors and owners that give rise to termination scenarios are often evolutionary rather than revolutionary, and problems that will have to be rectified may have arisen far in advance of the actual termination date.[77] A common situation is where the surety's principal will contest the propriety and efficacy of its termination and protest any action by the surety that is in concert with the owner. Although this may compel the surety to investigate, investigations can be time consuming. Finally, the very nature of the work itself, particularly when exposure to the elements is a potential source of concern, may itself lead to enhanced completion costs. These, too, may enhance the surety's loss.

Courts have created exceptions, however, in the case of so-called “completion” bonds. Where roof

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[74]Of course, the surety has the option of hiring its relet contractor on a time and material basis, but in such a situation, the contractor has very little incentive to work quickly and efficiently and in so doing, minimize the surety's loss in the completion phase.

[75]American Sur. Co. v. United States, 317 F.2d 652 (8th Cir. 1963); Miracle Mile Shopping Ctr. v. National Union Indem. Co., 299 F.2d 780 (7th Cir. 1962).

[76]See below as to the existence of a defense on the part of the surety where grossly defective work has been paid for.

[77]To the extent that this may give rise to a defense on the part of the surety, see §32.04[G] below.

leaks in the project developed three years after the building was finished and occupied, and where the bond was conditioned on completion of the project, no recovery was allowed. The court found such a latent defect to be beyond the scope of the performance bond.[78]

[a] *Performance Guarantees*

In *AgGrow Oils, LLC v. National Union Fire Insurance Co. of Pittsburgh, Pa.*,[79] the court found that the performance bond covered the contractor's failure to meet the contract's performance standards. The performance bond covered a design and build contract for an oil seed processing plant. The contract included certain performance guarantees using extracting equipment from agreed upon manufacturers. After the contractor completed the work, the plant underperformed and did not meet the specified performance guarantees. The owner sued the contractor, the surety, and the equipment manufacturers. The court found the bond covered the cost of the corrective work, lost revenue, and lost profits. In reaching its conclusion, the court rejected the surety's argument that since the project achieved substantial completion, the surety's bond obligations were discharged.

[3] Delay and Liquidated Damages

Conceptually, altering the time that a project takes to complete is contractually distinguishable from the status of being complete. As a consequence, some have argued that although a performance bond may provide a source of funds to enable completion of the contract in the first place, it ought not to provide recompense for damages stemming from a lack of timely performance.[80]

However, because in the commercial world time is money and vice versa, construction contracts rarely lack a "time of the essence" clause. One effect of such a provision is to make the time of performance by the principal as cardinal an element of its agreement with the owner as the act of performing itself. Because most bonds contain language incorporating the underlying contract and effectively making it a part of the bond, timely performance by the principal becomes simply another element of performance, for which the bond provides protection. In such circumstances, sureties have been held liable for delay damages as well as sums figured in liquidated damages provisions that act as stipulated amounts for the types of economic harms that may arise from delay.[81]

[4] Consequential Damages

Consequential damages are really just a more expansive form of time-oriented-delay type of damages. As a general rule, it can be said that the bond looks to the contract for a definition of harms that will be covered. This is so, among other reasons, because a performance bond invariably incorporates the text of the bonded contract into the bond itself. As a general rule of contract law, those damages will be allowed that were reasonably foreseeable as a consequence of breach at the time the contract was entered into. This follows the rule set down long ago by the English courts in the seminal case of *Hadley v.*

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[78]Independence Sch. Dist. No. 74 v. Shurtleff-Gahareh, Inc., 2007 WL 2248159 (E.D. Okla. 8/2/0007).

[79]276 F. Supp. 2d 999 (D.N.D. 2003).

[80]*See* General Ins. Co. v. Hercules Constr. Co., 385 F.2d 13 (8th Cir. 1967).

[81]*See* Southern Roofing & Petroleum Co. v. Aetna Ins. Co., 293 F. Supp. 725 (E.D. Tenn. 1968). *Cf.* American Home Assurance Co. v. Larkin Gen. Hosp., 593 So. 2d 195 (Fla. 1992); Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407 (Cal. 1999). JMR Constr. Corp. v. Environmental Assessment and Remediation Mgmt., Inc., 198 Cal. Rptr. 3d 47 (Cal. Ct. App. 2015) (general contractor as obligee against drywall subcontractor's performance bond recovered damages that included delay damages for concurrent delays pursuant to a modified total cost calculation).

Baxendale.[82]

Depending upon the particular setting of the project involved, the applicability of the *Hadley v. Baxendale* approach can vary markedly. For example, many public works projects offer little guidance in terms of judging adverse economic consequences that flow in the wake of breach by the contractor. For example, how does one measure the cost to the municipality of the library that does not open on time or the bridge that can only handle six lanes of traffic, rather than eight, because of necessary corrective work before the job can be considered done? It could probably be said that it is for precisely these reasons that governmental contracts almost invariably contain liquidated damages clauses.

However, just the opposite is likely to be true in a commercial setting. People undertake commercial building projects for profit, and if something goes wrong with the project, whether it is structural, time oriented, or both, that profit tends to be adversely affected. The hotel with the leaky roof can mean empty rooms on the top floor. When completion of a process plant is delayed, the product cannot get to market. As one might imagine, mixed results have obtained in terms of permitting the recovery of consequential damages.[83]

[5] Claims by Others

When it rains, it pours. This adage can usually be applied to the morass in which the failed bonded contractor finds itself. In addition to defaulting on its duties to the obligee, more often than not, the principal will encounter difficulties on other fronts as well. Typically, the contractor on the way down will be delinquent in its obligations to everyone, including the government. Moreover, because it may have lost some of the control it once held over its organizational forces, the contractor may have run into difficulties with others on the job site, too. If anything, default and the subsequent emergence of the surety may induce a kind of feeding frenzy where a host of putative claimants will attempt to get their proverbial piece of the pie.

In the main, these efforts have proved legally ineffective. Among other reasons to defeat such claims, the general thinking is that availability of the penal sum of the bond, intended as it is to provide funds for completion of the project, may be compromised if those other than the owner/obligee are permitted to recover under it. Hence, in the following situations, those other than the named obligee were not allowed to recover: another prime contractor at the project,[84] personal injury claimants,[85] and adjacent property owners.[86]

However, this prohibition is hardly absolute. Some claimants have argued that they were specifically intended to be third-party beneficiaries of the contract between the principal and owner, performance of which was conditionally insured by the bond. In such a situation, it is reasoned that performance of an obligation to a third-party beneficiary is tantamount to any other kind of performance of the contract, including tasks that will directly benefit only the obligee. In such circumstances, courts have equated payments to third parties as classical “performance” of the bonded contract and hence within the scope of

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[82]9 Ex. 341, 156 Eng. Rep. 145 (1854). *See* Restatement (Second) of Contracts §351 (1981); *see* SP No. 54 Limited P'ship v. Fidelity and Deposit Co. of Maryland, 2005 WL 3555836 (Fla. App.) (court held that surety owed no general duty of care to owner with respect to its issuance of performance bonds to contractor for work on owner's projects and, thus, could not be held liable to owner for gross negligence or negligent misrepresentation; surety's only duty was to fulfill its express obligations under the bonds, and owner had no right to rely on the competency of surety's underwriting.).

[83]Hunt v. Bankers & Shippers Inc. Co., 423 N.Y.S.2d 718 (App. Div. 4th Dep't 1979) (loss of rents allowed as a measure of damages).

[84]MGM Constr. v. Education Facilities, Auth., 220 N.J. Super. 483, 532 A.2d 764 (Law Div. 1987).

[85]Foshee v. Daoust Constr. Co., 185 F.2d 23 (7th Cir. 1950).

[86]Tri-State Ins. Co. v. United States, 340 F.2d 542 (8th Cir. 1965).

the performance bond.

[6] The Penal Sum as a Limit of Coverage

Every performance bond contains a penal sum. As a general rule, this will be the face amount of the contract, but this need not be the case. In theory, a penal sum equal to the full amount of the contract price ought to be more than sufficient to cover the consequences of default. For example, even if the principal never started the project, theoretically an amount that would be equal to double the contract price would be available for completion, including not only the face amount of the performance bond but also the completely unpaid contract balance. The bidding mistakes of the principal would have to be serious indeed (in excess of 100%) to imperil the penal sum as a claim. Moreover, as the contract work progresses, while the contract funds are being drawn down and thus by definition will be unavailable to spend on completion should the principal default, work is being done as well. The value of the completed work will naturally mitigate the exposure of the surety.

Of course, the possibility exists that because of latent defective work, perhaps coupled with underbidding practices on the part of the contractor, it may actually cost more money to correct and complete the contractor's failed effort than the full amount of the contract price to begin with, even when counting on contract funds as yet unpaid to the principal. In such circumstances, however, the surety should not expect to pay or be liable for more than the penal sum of the bond. After all, were this not so, there would be little point in having a penal sum to begin with.

All of these considerations change when the surety, after default, takes over for its principal and effectively becomes the contractor on the job. The surety now becomes wedded to the work and hence obligated to complete the physical performance of the contract, whatever the cost may be.[87] To avoid this exposure, some sureties attempt to negotiate takeover agreements that expressly limit their monetary exposure even though they assume control of the work. While such a step may have some efficacy, it is hardly ironclad.[88] In such a situation, an owner may argue that the surety or its forces acted negligently in completing the work—that is to say, that the surety's own carelessness or improper activities actually aggravated the cost to complete the job properly. It would no longer be a matter of rectifying what the principal either had or hadn't done. An owner would seek to impose liability on the surety for its own errors, as opposed to its liability to perform corrective work to cure the errors of its principal.[89]

Some case law exists holding that a surety has an independent duty in a performance bond to come forward and complete its principal's contract itself. Where the surety fails to do so and the owner, now put to the expense of completing itself, incurs costs in excess of the penal sum, the surety has been held responsible.[90]

Generally, a performance bond surety's liability is capped at the penal sum of the bond. However, in *David Boland, Inc. v. Trans Coastal Roofing Co.*,[91] in answering a certified question from the United States Court of Appeals for the Eleventh Circuit, the Florida Supreme Court found a performance bond

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[87]*See* United States v. Seaboard Sur. Co., 817 F.2d 956 (2d Cir. 1987). *See also* Village of Fox Lake v. Aetna Cas. & Sur. Co., 534 N.E.2d 133 (Ill. App. Ct. 1989) (where a "reservation of rights" was not enforced).

[88]*See* Employers Mut. Cas. Co. v. United Fire & Cas. Co., 682 N.W.2d 452, 456–58 (Iowa App. 2004) (By taking over the contract as part of a settlement agreement, the surety effectively waived its protections under the terms of the bond, including the penal sum, and agreed to be bound as the principal. The original subcontract and penal sum were in the amount of $147,864, but the work agreed to under the settlement agreement ultimately exposed the surety to $847,390 worth of repair costs.).

[89]*See* Continental Realty Corp. v. Andrew J. Crevolin Co., 380 F. Supp. 246 (S.D.W. Va. 1974).

[90]However, this is a distinctly minority (and heavily criticized) view.

[91]851 So. 2d 724 (Fla. 2003).

surety an "insurer" for purposes of the Florida statute that permitted a prevailing party to recover attorneys' fees, and that those fees are recoverable even though the fees exceeded the performance bond's penal sum. Consequently, the claimant not only recovered on its $31,654 disputed work claim, but also received attorneys' fees of $276,950, even though the penal sum of the performance bond was only $167,800.

[G] Suretyship Defenses

Following the obligee's declaration of default, part of the surety's investigation will include possible defenses to the claim by the obligee. The surety, however, has two different types of defenses. First, to the extent its principal has a defense to the performance of its duty, the surety also has that defense. If the obligee breached the agreement relieving the principal's performance, the surety is likewise relieved. Second, the surety also possesses defenses against the obligee based on its unique status as surety. The surety's defenses can arise in three ways. These are (1) the obligee's impairment of the surety's rights against the principal; (2) modification of the underlying contract; and (3) the conduct of the obligee.[92]

The primary purpose of the performance bond is that in the event of the principal's default, the obligee can look to the surety for the performance to which it is entitled. The performance bond, however, does not guarantee an obligee performance to which it is not entitled. In other words, if the principal has valid defenses to the obligee's demand for performance of the underlying contract, the surety is likewise entitled to assert those very same defenses.[93] These defenses focus primarily on the obligee's actions, or lack thereof, while the principal was attempting to perform. Among the more common contractor defenses are the obligee's termination was improper; the obligee issued the declaration of default in bad faith; the obligee failed to issue a proper cure notice; the contractor substantially performed its obligation; the obligee breached express or implied duties regarding the project design; the owner improperly exercised its duty of cooperation; the owner was responsible for differing site conditions; the owner failed to properly administer the contract; and issues of impossibility or impracticality of performance that would relieve the contractor of its duty to perform.[94]

In addition to the defenses of its principal, the surety also has a number of "surety defenses." Defining the parameters of the surety defenses is not easy. In fact, there is "probably no area of suretyship law in which there is less consensus than the law of suretyship defenses."[95] Although the following defenses are generally available to a surety, it is still critical to read the bond carefully. After all, since the bond is a written contract, the surety may choose to waive any of its defenses either in the text of the bond or otherwise.[96]

The extent to which a "defense" discharges a surety has changed. At common law, sureties were favored. As a result, any modification of the underlying contract, no matter how insignificant or immaterial, discharged the surety. While these strict rules may have been acceptable for a surety whose motivation was friendship or affection, they sometimes provided a financial windfall for a compensated surety. Since compensated sureties were obtaining discharges because of immaterial changes or modifications to the underlying obligations, two things happened. First, courts began finding that sureties were entitled to only a *pro tanto* discharge—that is, a discharge to the extent the surety suffered tangible harm by the change or modification. Second, performance bonds were revised to specifically include what

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[92]*See* Restatement (Third) of Suretyship and Guaranty §§37-48 (1996).

[93]*Id.* at §33.

[94]*Strategic "Generalship" of the Complex Construction Surety Case, in* Managing and Litigating the Complex Surety Case (Philip L. Bruner ed., ABA 1998) (providing an excellent overview of defenses of the principal to performance of the underlying obligation).

[95]Restatement (Third) of Suretyship and Guaranty, Title B, Surety Defenses, Introductory Note.

[96]Restatement (Third) of Suretyship and Guaranty §48, Waiver of Suretyship Defenses, Consent (1).

now has become almost standard waiver clauses for certain types of modifications.[97] Sureties also now include language in their general indemnity agreements consenting to changes.[98]

At common law, any extension of the time for performance also provided a discharge to the surety. The modern rule is that this extension does not release the surety. Moreover, many bond forms contain an express waiver of this traditional defense. For example, the A311 bond states, "The surety hereby waives notice of any alternations or extensions of time made by the owner."[99] Consequently, an extension of the time for completion of the contract hardly ever provides a defense to the surety.

[1] Material Alteration

Many bonds explicitly permit the obligee to make changes to the scope of work in the underlying obligation. Also, virtually all construction contracts are incorporated into the performance bond, and the contracts almost universally allow changes in the work. In fact, changes in construction are so commonplace that basically all construction contracts contain specific clauses or provisions that lay out the mechanism for the owner to request additional or "change order" work. For example, the AIA Document A201 General Conditions explicitly state that changes in the work will not invalidate the contract.[100] Therefore, since changes or modifications in the underlying obligation are specifically authorized, they do not invalidate the contract or discharge the principal, nor do such changes discharge the surety.[101] But this principle is not absolute, and even in situations where the obligee has the contractual right to make changes in the plans and specifications, there are limitations. This limitation is known as a "cardinal change," often times referred to as a material alteration or material modification.

A cardinal change is a change comprising such a material modification of the underlying contract that it imposes risks on the surety that are fundamentally different from those present in the initial contract. In other words, a surety is discharged when the modification or change is one that the parties could not have reasonably anticipated as being within the scope of the underlying obligation. Furthermore, a series of modifications, no one of which is sufficiently fundamental but that in the aggregate represent a

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[97]*See*, *e.g.*, Federal Form 25 Performance Bond ("The above obligation is void if the Principal…(2) Performs and fulfills all the undertakings, covenants, terms, conditions, and agreements of any and all duly authorized conditions, and agreements of the contract during the original term of the contract and any extensions thereof that are granted by the Government, with or without notice of the Surety(ies) and during the life of any guarantee required under the contract,…").

[98]At least one surety has the following language in its general indemnity agreement: "The Surety is authorized and empowered, without notice to or knowledge of the Indemnitors to assent to any change whatsoever in the Bonds, and/or any contracts referred to in the Bonds, and/or in the general conditions, plans and/or specifications accompanying said contracts, including, but not limited to, any change in the time for the completion of said contracts and to payments or advances thereunder before the same may be due, and to assent to or take any assignment or assignments, to execute or consent to the execution of any continuations, extensions or renewals of the Bonds and to execute any substitute or substitutes therefor, with the same or different conditions, provisions and obligees and with the same or larger or smaller penalties, it being expressly understood and agreed that the Indemnitors shall remain bound under the terms of this Agreement even though any such assent by the Surety does or might substantially increase the liability of said Indemnitors."

[99]AIA Doc. A311 (1970).

[100]AIA Doc. A201 art. 7 (1997).

[101]*See Centex Constr. v. Acstar Ins. Co.*, 448 F. Supp. 2d 697, 701 (E.D. Va. 2006) (citing language from the bond and holding against the surety, "Any increase in the Subcontract amount shall automatically result in a corresponding increase in the penal amount of the bond without notice to or consent from the Surety, such notice and consent hereby being waived") (The court found "…that the escalation provision is unambiguous." Id, at 207).

fundamental change, will likewise discharge the surety.[102]

Determining whether a change is truly "cardinal," thereby discharging the surety, is a fact-sensitive inquiry based on the unique circumstances in each case. Generally, a cardinal change can take one of two forms.[103] The first one, far more common, is a material change in the scope of work.[104] To give an exaggerated example, adding a nuclear power station to a contract for a bus garage would constitute a cardinal change. Also, a change that dramatically increases the cost of the underlying contract will constitute a cardinal change.[105] The second circumstance where a cardinal change arises has been described as the "scope of completion" test. Under this test, a cardinal change occurs when a change would circumvent the competitive bidding process by adopting drastic modifications beyond the original scope of the contract.[106]

[2] Improper Payment

The owner's improper payment or release of contract funds also provides a defense for the surety to an obligee's performance bond demand. Most construction contracts contain specific payment clauses that generally permit periodic payments by the obligee to the contractor. The contractor, typically on a monthly basis, submits a requisition for payment for work performed the previous month. The owner's obligation or duty to pay the contractor is generally triggered by a certification by the architect that the work listed in the pay requisition has been satisfactorily performed. Contracts further permit the owner to withhold a certain amount from the periodic payments. This is known as "retainage." Retainage is ordinarily paid by the owner to the contractor when the project is completed or reaches substantial completion.

This method of payment provides both an incentive to the contractor and protection for the obligee and surety. The quicker the contractor completes the work, the quicker it earns its money. Thus, the contractor has the incentive to prosecute the work because it is not entitled to any payment until work is performed and accepted by the obligee. The obligee is protected because it is only required to pay for the work as it is completed. This protects the surety commensurately because, upon default of the contractor, the surety is entitled to the remaining contract funds. Therefore, once a demand is made upon the surety, the surety looks to the contract balances to defray the cost for completing the work. When, however, the owner releases contract funds before they are due, the surety has a defense. The scope of this defense differs.

Traditionally, an improper or premature payment of contract funds discharged the surety. This was so

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[102]Restatement (Third) of Suretyship and Guaranty §41 cmt. (e).

[103]*See* Bruner, *supra* note 94.

[104]*See Hancock Electronics Corp. v. WMATA*, 81 F.3d 451, 454 (4th Cir. 1996) (a non-surety case holding that "[a] cardinal change occurs…when the government demands a contractual alteration 'so drastic that it effectively requires the contractor to perform duties materially different from those originally bargained for'"). (Citations omitted.)

[105]*See Liquidation of Union Indem. Ins. Co. v. Superintendent of Ins.*, 632 N.Y.S.2d 788, 789 (App. Div. 1st Dep't 1995) (holding that two change orders that nearly doubled the value of the underlying contract without the surety's consent constituted a material alteration as a matter of law).

[106]*See* Cray Research Inc. v. Department of Navy, 556 F. Supp. 201, 203 (D.D.C. 1982) (stating that "[t]he 'cardinal change' doctrine prevents government agencies from circumventing the competitive procurement process by adopting drastic modifications beyond the original scope of a contract. The basic standard is whether the modified contract calls for essentially the same performance as that required by the contract when originally awarded so that the modification does not materially change the field of competition.").

without a showing of prejudice by the surety.[107] The modern trend, however, is that an improper payment by the owner does not provide an absolute discharge to the surety. Rather, the surety is discharged only to the extent it has been prejudiced by the overpayment. Under these circumstances, the surety has a *pro tanto* discharge to the extent of the improper payment.[108]

Merely because the contractor received a payment before it was due does not automatically constitute an "overpayment" defense for a surety. Rather, in determining whether the surety was prejudiced by the premature release of contract funds, some courts look to whether the release of the funds resulted in an increased risk to the surety. The inquiry here focuses on what the principal did with the money. If the money was dissipated and spent on items not related to the contract, the surety's risk obviously increased, and the surety is entitled to a *pro tanto* discharge.

Where, however, the principal pumps the prematurely released funds into the project by paying for labor or material on the project, the surety is not entitled to any discharge. The rationale for denying the surety any discharge under these circumstances is that although the obligee may have departed from the terms of the contract's payment clause because the funds were used by the contractor to prosecute the work, the surety has not been prejudiced. Thus, it is reasonable that since the money was used to advance the work, it benefited the surety because the money expended reduced the surety's liability.[109]

In addition to assessing how the principal used the money, some courts also examine the obligee's conduct in making the payment. These decisions recognize that a construction payment requisition is just an estimate of the work completed in that particular pay period and that evaluating a pay requisition is not an exact science; rather, it is an estimate of the amount and value of the work performed. In these circumstances, the courts look to whether the payment was made in good faith. If an overpayment was made on a good-faith but incorrect assessment of the work completed, the surety generally is not discharged. In one case, a municipal owner asserted the good-faith defense to a claim by the surety by arguing it relied upon its engineer's assessment of the work. The court found the good-faith defense inapplicable because the owner relied on certifications negligently made by its own employee as opposed

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[107]*See* Southwood Builders, Inc. v. Peerless Ins. Co., 366 S.E.2d 104, 108 (Va. 1998) (finding "[a] separate showing of prejudice to the surety is unnecessary because a material deviation, in itself, establishes prejudice.…[T]he material deviation is established by proof that the subcontractor was paid money before it was due and without approval by the architects.…[S]uch a procedure diminishes funds that should have been available to the surety in case of default.").

[108]Restatement (Third) of Suretyship and Guaranty:

> §42. Impairment of Collateral
>
> (1) If the underlying obligation is secured by a security interest in collateral and the obligee impairs the value of that interest, the secondary obligation is discharged to the extent that such impairment would otherwise increase the difference between the maximum amount recoverable by the secondary obligor pursuant to its subrogation rights (§§27-31) and the value of the secondary obligor's interest in the collateral.

[109]*See* Ramada Dev. Co. v. USF&G, 626 F.2d 517, 522 (6th Cir. 1980); Mergentime Corp. v. Washington Metro Area Transit Auth., 775 F. Supp. 14, 19 (D.D.C. 1991) ("In other words, a material modification to a contract is not the same as a modification that materially increases the surety's risk."); Honolulu Roofing Co. v. Felix, 49 Haw. 578, 604, 426 P.2d 298, 316 (1967) ("An immaterial deviation from the terms of the contract in the matter of making payments will not release the surety on the bond." (quoting Hustace v. Davis, 23 Haw. 606, 612 (1917)).

to an independent engineer. As a result, the surety was entitled to a *pro tanto* discharge.[110]

[3] Defective Work

In addition to situations where payments have been prematurely released for work not yet completed, a defense for the surety is likewise triggered if the obligee pays for patently defective work. Under these circumstances, to the extent the surety can demonstrate it was prejudiced, it can obtain a discharge because the obligee's improper release of contract funds increased the surety's risks. If the obligee has issued payments based on its reasonable reliance on pay requisitions approved by the architect, some courts have found that the surety's claim is not against the obligee but rather against the design professional.[111] Under many construction contracts, however, the design professional is an agent of the obligee. Therefore, the acts of the design professional in negligently approving defective work should be chargeable against the obligee, thereby reducing the surety's liability to the extent its risk increased as a result of the improper payment.[112]

[4] Statute of Limitations

Just as the failure to file a lawsuit within the time provided by the applicable statute of repose provides an absolute defense for any party, a surety likewise enjoys an absolute statute of limitations defense. Determining the appropriate limitations period is a coefficient of various factors, including the type of performance bond, statutory or private, the event that triggers the statute to begin to run, and the type of claim, such as a failure to perform the underlying obligation or a breach of a warranty obligation. Again, it is critical to read the bond because many bonds contain a specific suit limitations clause.[113]

Although private parties are generally free to provide their own limitations period for bringing suit, that freedom is not itself without limitation. Rather, courts generally permit private parties to agree on a limitations period shorter than that authorized by statute, as long as the period is reasonable. Some states, however, have a statutory prohibition preventing parties from agreeing to a period of time shorter than a statutory minimum time.[114] Under those circumstances, a party's freedom to contract has been trumped by the statute, and the statutory minimum limitations period controls. Parties, however, are generally permitted to expand the time within which to bring suit.

Most performance bonds contain a limitations period for bringing suit. For example, the AIA Document A311 bond requires that the suit must be filed within two years from the date final payment was due.[115] Consequently, on an A311 bond, the limitations period begins to run once the final payment

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[110]*See* Transamerica Ins. Co. v. City of Kennewick, 785 F.2d 660 (9th Cir. 1986).

[111]*See* City of Houma v. Municipal & Indus. Pipe Serv., Inc., 884 F.2d 886 (5th Cir. 1989).

[112]*See* Transamerica Ins. Co. v. Housing Auth., 669 S.W.2d 818 (Tex. App. 1984).

[113]*See* Snapping Shoals Elec. Membership Corp. v. RLI Ins. Co., 2005 WL 3434803 (N.D. Ga.) (Where bond incorporated a specific bond expiration date in the underlying contract, the fact that the owner unilaterally agreed to extend completion date for the contractor did not also extend the bond expiration date. This holding relied in part upon a Georgia law that dictated that "surety's liability will not be extended by implication or interpretation.").

[114]*See* Safeway Stores, Inc. v. Certainteed Corp., 687 S.W.2d 22 (Tex. App. 1984); GBMC LLC v. ProSet Sys. Inc., 2013 WL 1629162 (N.D. Fla. 2013); Stellar J. Corp. v. Argonaut Ins. Co., No. 3:12-cv-05982, 2014 U.S. Dist. LEXIS 53015 (W.D. Wash. Apr. 16, 2014) (under Washington law, any provision limiting the applicable statute of limitations period to less than one year is void. Because the bond required suit within one year from the delivery of materials, the court held that the provision was void. The bond title was "Supply Bond," but the language of the bond and a Dual Obligee Rider had a striking resemblance to a performance bond).

[115]AIA Doc. A311.

becomes due. This two-year limitations period has been upheld even where the owner did not discover a latent defect until after the two years had passed since the date of the final payment.[116] The same result obtained when seven years after occupancy of a hotel, the owners sued a construction manager and the latter brought claim against the sureties of subcontractors whose work was supposedly at fault.[117] The AIA Document A312 bond requires that the suit be filed within two years after contractor default, or within two years after the surety refuses or fails to perform its obligations under the bond, whichever occurs first. Occasionally a court will have a departure from the expected, allowing a shorter limitations period than otherwise provided by statute. One court enforced a suit limitation in a public contract performance bond requiring suit to be brought within two years following final payment under the contract, and found that final payment as defined in the contract was made despite the fact 1% of the contract amount had been withheld by the City. The bond also states that if the bond's suit limitations period is void or prohibited, then the minimum period of limitations available to sureties as a defense in the jurisdiction of the suit shall be applicable to bar any action.[118] The pendency of a surety's declaratory judgment suit, may not toll this limitations period.[119]

On public works projects, the bond is almost always authorized by statute. In these circumstances, the bond usually incorporates the statute by which it was authorized. Consequently, if there is a conflict between a limitations period established in the bond and statute, the terms of the statute will control if the bond contains language purporting to provide less than the statutorily mandated protection.[120]

In some jurisdictions, the limitations period for bringing a claim against the surety is longer than that for bringing a claim against the contractor. This creates an anomaly because under strict surety principles, the surety's liability is coextensive with that of its principal. Therefore, if the time to file suit against the principal has expired, the surety should concurrently be able to assert that same defense. In fact, the *Restatement (Third) of Suretyship and Guaranty* provides that if the obligee fails to pursue the surety within the limitations period for an action against the principal, the surety may be discharged.[121]

Predictably, where there is a difference in the statute of limitations period for suits against the principal and surety, there is no hard and fast rule. In some cases, sureties have successfully asserted their principal's statute of limitations defense.[122] Under circumstances where there is a specific statute of limitations applicable to sureties, the surety is subject to suit even if the statute has run against its

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[116]*See* Yeshiva Univ. v. Fidelity & Deposit Co. of Md., 116 A.D.2d 49, 500 N.Y.S.2d 24 (1st Dep't 1986).

[117]La Liberte, LLC v. Keating Bldg. Corp., 2007 WL 4323687 (E.D. Pa. Dec. 11, 2007).

[118]City of Yonkers v. 58A TVD Indus., Ltd., 981 N.Y.S.2d 736 (App. Div. 2014).

[119]Peekskill City Sch. Dist. v. Colonial Sur. Co., 6 F. Supp. 3d 372 (S.D.N.Y. Mar. 18, 2014).

[120]*See, e.g.*, Wichita Sheetmetal Supply, Inc. v. Dahstrom & Ferrell Constr. Co., 792 P.2d 1043 (Kan. 1990).

[121]Restatement (Third) of Suretyship and Guaranty §43, Delay in Enforcement: Running of Statute of Limitations as to Underlying Obligation. Under this section, the discharge of the surety based on the running of the statute of limitations for actions against the principal is governed by §39, Release of the Underlying Obligation; *see also* Nacimiento Water Co., Inc. v. International Fid. Ins. Co., 2015 WL 4554288 (C.D. Cal. July 28, 2015) (in a subdivision performance bond case, applying California Code of Civil Procedure section 359.5, a court held that "the expiration of the statute of limitations with respect to the obligations of the principal, other than the obligations of the principal under the bond, shall also bar an action against the principal or surety under the bond.").

[122]*See* County of Hudson v. Terminal Constr. Co., 154 N.J. Super. 264, 381 A.2d 355 (App. Div. 1977) (rejecting the obligee's argument that the statute was tolled because the claim involved a latent defect).

principal.[123] Sureties can address the risk of this anomaly in its indemnity agreements. For actions upon a liability created by statute, some courts might apply a shorter statute of limitations to the surety than that which is applicable to the principal. This can be the situation with subdivision performance bonds, because such bonds are statutorily required.[124]

[5] Fraud or Misrepresentation

[a] By Principal

Fraud or misrepresentation committed by the principal in procuring the bond will almost never discharge the surety's duty to the obligee. In these circumstances, although the principal may have committed fraud, the obligee is viewed as an innocent third party and is ordinarily entitled to the bond's protection.[1] As a result, unless the obligee is somehow involved in the principal's fraud, the surety is generally not discharged. Of course, the surety may have an independent cause of action in tort against the principal for any misrepresentations upon which the surety can prove justifiable reliance, in addition to its claims under the indemnification agreement.

[b] By Obligee

Where, however, the obligee either participates in a fraud or withholds information that would be material to the surety in determining whether to underwrite the risk, the surety can obtain a discharge. The *Restatement's* approach to fraudulent or material misrepresentation by the obligee is both technical and specific.[125] Under the *Restatement*, the surety is discharged when the following requirements are met: (1) the misrepresentation must be either fraudulent or material; (2) the misrepresentation must have induced the surety to issue the bonds; and (3) the surety must have reasonably relied on the representation.[126]

Discovered instances of an obligee's making either a fraudulent or material misrepresentation are rare. Examples include misrepresentations of financial strength of the principal to the surety. For example, where the obligee was aware that the principal was in dire financial straits and in default in some other obligation and concealed or withheld this information from the surety, the surety has obtained a discharged.[127] Other examples are where obligee misrepresents to surety the full scope of a construction project,[2] and where an obligee fails to disclose to the surety a secret collateral agreement.[3]

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[123]*See* Regents of the Univ. of Cal. v. Hartford Accident & Indem. Co., 147 Cal. Rptr. 486, 581 P.2d 197 (1978).

[124]For example, *see* California Code of Civil Procedure section 338(a), a three-year statute of limitations for actions "upon a liability created by statute." Otherwise, the applicable statute of limitations is four years, the usual statute of limitations for written contract actions, under California Code of Civil Procedure section 337.

[1] Chrysler Corp. v. Hanover Ins. Co., 350 F.2d 652 (7th Cir. 1965) (applying Indiana law).

[125]Restatement (Third) of Suretyship and Guaranty §12. See also a similar rule in 10 Samuel Williston & Walter H.E. Jaeger, WILLISTON ON CONTRACTS § 1249 (3d ed. 1967).

[126]*Id.* cmt. (a).

[127]*See* St. Paul Fire & Marine Ins. v. Commodity Credit Corp., 646 F.2d 1064 (5th Cir 1981).

[2] Employers Ins. of Wausau v. Constr. Mgmt. Engineers of Fla., Inc., 377 S.E.2d 119 (S.C. Ct. App. 1989). *See* also The Law of Performance Bonds, 2nd Ed., (2009), *supra,* at 18.

[3] Harris & Harris Constr. Co. v. Crain & Denbo, Inc., 123 S.E.2d 590 (N.C. 1962) (holding that the obligee had no duty to disclose alleged collateral agreement with the principal because it had not in fact been agreed to) (conversely, obligee does have this duty if in fact obligee and principal had agreed to a secret collateral agreement). For recission in general based upon misrepresentation or concealment by

Other cases permit the surety to maintain a defense based on the obligee's concealment. These courts place the burden squarely on the surety by requiring it to ask the right questions. In other words, the surety must demonstrate its diligence by seeking the information it deems material. This requires a showing that, before issuing the bond, the surety initiated contact with the obligee regarding the circumstances that form the basis of the fraudulent misrepresentation defense.[128] If, however, the surety did not undertake to obtain such information, it is difficult indeed to claim it relied on a misstatement by the obligee.

Fraud by obligee can also include concealment from the surety that a contractor bonded by the surety is not licensed as a contractor, and where obligee has reason to believe surety is not aware of the fact.[4] Where an obligee solicits a signature on a contract by a contractor that the obligee knows is not licensed as a contractor in the state of the project, and where obligee has reason to believe the surety is unaware of such lack of license, a surety can elect to consider its bond void *ab initio*. Such fraud can occur at any time during a project, and need not be in the category of fraud in the inducement. Where a court finds that a bond was procured by fraud, that finding would only invalidate the bond, not the underlying contract between obligee and principal.[5]

[6] Change of the Obligee or Principal

Absent a specific prohibition against an assignment, the obligee's assignment of its rights in the underlying contract does not release the surety.[129] When the obligee changes, although the surety and principal owe a duty to a new party, the scope of that duty as defined by the underlying obligation or contract remains the same. Consequently, since the surety's risk remains the same, it cannot obtain a discharge because the surety is unable to demonstrate prejudice.[130]

Changes in the principal, however, are more problematic for the surety. If the principal merely changes form—for example, from corporation to partnership—this generally will not discharge the surety as long as the change does not increase the risk to the surety. After all, a surety issues its bond solely on the economic strength of its principal, and as long as the change in the form of ownership does not change

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obligee, *see* Clarke, Bogda M.B., Ferrucci, James D. & Shahinian, Armen, *Fraud and Inducement as a Defense to Fidelity and Surety Claims*, 42 TORT & INS. LAW J.181 (Fall 2006).

[128]*See* Rachman Bag Co. v. Liberty Mut. Ins. Co., 46 F.3d 230, 235 (2d Cir. 1995) (finding a jury question regarding the circumstances surrounding whether an "obligee's failure to come forward with information it knows to be material [constitutes] fraud." The court further noted that "the policy behind surety bonds is not to protect a surety from its own laziness or poorly considered decision.…sureties must usually take the initiation and inquire about information they deem important."). *See also* Pinkerton Laws Inc. v. Marco Constr. Inc., 485 S.E.2d 797 (Ga. Ct. App. 1997) (prior to issuing the bond the surety was advised by the obligee that work in the field had not yet began. In actuality, however, work was well under way, and the obligee was already threatening to default the principal); Ground Improvement Techniques, Inc. v. Merchants Bonding Co., 63 F. Supp. 2d 1272 (D. Colo. 1999).

[4] See, e.g., *Bryan Builders Supply v. Midyette*, 162 S.E.2d 507, 512, 274 N.C. 264 (N.C. 1968) ("Owners, being a member of the class for whose protection G.S. 87-1 et seq. was enacted, and not being *in pari delicto* with (contractor) Bryan, were entitled to maintain an action for Bryan's breach of contract.") (Conversely, when an owner is *in pari delicto* with the contractor, it is not entitled to maintain an action, and the surety can elect to void its performance bond).

[5] Allied World Ins. Co. v. New Paradigm Prop. Mgmt., FN 7, LLC (E.D. Cal. 2017).

[129]*See* Hunters Pointe Partners Ltd. P'ship v. USF&G, 442 N.W.2d 778, 779–80 (Mich. Ct. App. 1989); *see also* Citibank v. Grupo Cupey, Inc., 382 F.3d 29, 32 (1st Cir. 2004) (holding that assignee had no right of action under performance bond that limited surety's liability to original named beneficiaries).

[130]*See* Leila Hosp. & Ctr. v. Xonics Med. Sys., 948 F.2d 271 (6th Cir. 1991).

the level of risk, the surety is not discharged. Once again, this defense requires a close examination of the facts and circumstances of each case because a change in the principal can form the basis of a defense for the surety when the change results in prejudice to the surety, such as a diminished financial capacity.[131]

A closely related issue is the impact upon the surety of the obligee's release of the principal. Traditionally, if the obligee released the principal, the surety was discharged.[132] Under the *Restatement*, however, the defense has been limited. The critical inquiry focuses on the intent of the obligee in releasing the principal, and the extent to which the surety was prejudiced. Where the obligee did not intend to release the surety, the release of the principal does not discharge the surety.[133] Where the obligee did not intend to release the surety in releasing the principal, but the obligee increased the surety's risk, the surety is discharged to the extent of the increase in risk.

[H] Surety's Remedies

Although a surety does not anticipate any losses in connection with the issuance of its bonds, losses do occur. Perhaps one of the surety's most powerful tools is its equitable right of subrogation. According to *Black's Law Dictionary*, subrogation is "(t)he substitution of one party for another whose debt the party pays, entitling the paying party to rights, remedies, or securities that would otherwise belong to the debtor."[134] Subrogation simply means substitution of one party for another; that is, one person is allowed to stand in the shoes of another and assert that person's rights against the defendant. Factually, the case arises because, for some justifiable reason, the subrogation plaintiff has paid a debt owed by the defendant.[135] Accordingly, the surety becomes subrogated not only to the rights of the principal on whose behalf it expended funds but also to the rights of the obligee and other claimants it has paid.

When the surety is called on to perform or pay money on either a performance or payment bond claim, the surety acquires various rights and remedies against other parties. The most common formulation of the surety's right of subrogation was articulated in the landmark Supreme Court decision of *Pearlman v. Reliance Insurance Co.*[136] In *Pearlman*, the Supreme Court stated: "[A] surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed."[137] What this means is that upon paying a lawful claim against its principal, the surety is subrogated to its principal's rights and also to the rights of the party it paid. The most significant right for the subrogated surety is its right to the remaining contract funds. As a result, subrogation provides substantial protection to the surety because in the event of a demand upon the surety, the surety can look to the remaining contract funds to offset any claims or losses the surety incurs in completing the work.[138]

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[131]*See* 95 Lorimer LLC v. Insurance Co. of the State of Pennsylvania, 6 Misc. 3d 500 (N.Y. Sup. Ct. 2004) (During the course of a demolition project, without notice to the surety, the owners of the principal set up a new legal entity and the obligee accepted the new entity as its contractor and paid for the work. A dispute arose as to performance and the owner called upon the performance bond. The New York court held that the substitution of a new principal was a material and substantial change to the bonded obligation and the surety was discharged.).

[132]*See* Restatement (Third) of Suretyship and Guaranty §39, Release of Underlying Obligation, cmt. (d).

[133]*Id.* illus. 3, 4.

[134]Black's Law Dictionary 1563 (9th ed. 2009).

[135]*Id.* at 1564.

[136]371 U.S. 132 (1962).

[137]*Id.* at 137.

[138]In addition to the right to the contract funds, the Restatement (Third) of Suretyship and Guaranty §28, Rights Obtained Through Subrogation, states:

a. To the extent that the secondary obligor is subrogated to the rights of the obligee, the secondary

Although subrogation is deeply rooted in our jurisprudence and is a doctrine of "pure unmixed equity having its foundation in the principles of natural justice,"[139] and is wholly independent of statutory or contract law, it is not an absolute trump card for the surety to place it ahead of other creditors of its principal. After all, defaults are frequently complex, and the defaulted contractor usually faces claims not only by the surety and obligee, but by other creditors as well.

If the surety incurs a performance bond loss, it generally has absolute priority to the contract funds. A surety that incurs a payment bond loss is, however, not entitled to absolute priority. Rather, the surety and other creditors, including banks, secured lenders, the Internal Revenue Service, or some state tax authority, subcontractors, suppliers, and/or a bankruptcy trustee may also assert a claim against the contract funds. Because contract funds in the hands of the owner may be the only assets arguably remaining to the principal, other creditors should not be expected to concede defeat and acknowledge under *Pearlman* that the surety has absolute priority to the contract funds. Rather, these creditors generally fight aggressively to assert their right to the contract funds. Although *Pearlman* is still good law, the surety does not always prevail.

Not surprisingly, the decisions vary from jurisdiction to jurisdiction, and some compelling themes are evident in several recent decisions. For some courts, priority for the remaining contract funds is solely a function of the rights in the owner/principal contract and the indemnity agreement. These courts also look to classify the funds held by the owner as either "retainage," "progress payment," or "final requisition." Other courts focus on priorities and rights confirmed under state statutory law. Still other courts seem to apply *Pearlman's* equitable doctrine and seek to protect the surety that has performed and paid either performance or payment bond claims.[140]

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obligor may enforce, for its benefit, the rights of the obligee as though the underlying obligation had not been satisfied:

b. against the principal obligor pursuant to the underlying obligations;

c. against any other secondary obligor for the same underlying obligation, unless the other secondary obligor is a sub-surety for the subrogated secondary obligor;

d. against any interest in property securing either the obligation of the principal obligor or that of any other secondary obligor against whom the rights of the obligee may be enforced; and

e. against any other persons whose conduct has made them liable to the obligee with respect to the default on the underlying obligation.

f. Recovery under this section is limited as follows:

g. the total recovery of the secondary obligor pursuant to subsection (1) may not exceed the secondary obligor's cost of performance of the secondary obligation;

h. the enforcement of the obligee's rights against a co-surety, and against any interest in property securing performance of the obligation of a co-surety, is limited to the amount that will satisfy the co-surety's duty of contribution (§55).

[139]Prairie State Nat'l Bank of Chicago v. United States, 164 U.S. 227, 231 (1896) (quoting Gladsen v. Brown, Speer, Eq., 37, 41 (Johnson, Ch.)).

[140]*See In re* Construction Alternative, 2 F.3d 670 (6th Cir. 1993); *In re* Capital Indem. Corp., 41 F.3d 320 (7th Cir. 1994); Universal Bonding v. Gittens & Sprinkle Enters., 960 F.3d 73 (3d Cir. 1994); *In re* Structures, Inc., 27 F.3d 73 (3d Cir. 1994); *In re* Comcraft, 206 B.R. 551 (D. Or. 1997); *In re* Alcon Demolition, 204 B.R. 440 (D.N.J. 1997). *But cf.* Nova Cas. Co. v. New York City Hous. Auth., No. 602527-208, 212 N.Y. Misc. LEXIS 55668 (Sup. Ct. Dec. 14, 2012), distinguishing performance and payment bond situations and giving the surety greater priority in the former. The surety's claim for subrogation is equitable in nature and continues to be a significant remedy for a surety. Recently, in

A recent opinion from the Fourth Circuit is instructive in the seemingly endless battle over contract funds between bankruptcy trustees and bonding companies. When given the opportunity, the court refused to hold that section 541 of the Bankruptcy Code legislatively overruled *Pearlman* by expanding the definition of "property of the estate" in the Bankruptcy Code. The opinion expressly negates any suggestion that *Pearlman* is no longer good law.[141]

Claims of equitable subrogation to a contract balance can also place under scrutiny claims to set-off by the obligee. As a rule, the performance bond's surety's right to the contract balance has been found to be superior to such competing claims. Typical is *Hanover Insurance Co. v. Blueridge General Inc.*[142] In that case, Blueridge, the obligee, had two contracts with Hanover's principal, Thayer Masonry, one of which was bonded and the other one was not. Both contracts contained a clause that permitted the GC to withhold from sums due on one contract offsets that had arisen on the other. However, its effort to do this in a way that would reduce the performing surety's entitlement on the bonded contract was not allowed. Hanover was allowed to recover free from the offset. These concepts were taken one step further in *Hartford Fire Insurance Co. v. United States*,[143] where the completing surety, Hartford, claimed that its rights of equitable subrogation had been prejudiced by the government disbursing funds to the bonded contractor on a second, unbonded job, rather than using these to offset the size of the loss on the first project. Reasoning that the surety succeeded to the rights of both principal and obligee, the Court of Claims reasoned that were the surety's claim to fail, the result would encourage sureties not to undertake the completion on their own, leaving the governmental obligee to proceed on its own and, itself, invoke available contract offsets. As a result, it held that the surety's claim of prejudice was justifiable.[144]

In addition to the surety's equitable right of subrogation, sureties have common-law rights of *quia timet* and exoneration and indemnification. *Quia timet* is a common-law bill in equity. On a construction project, a surety may seek quia timet relief if it has reasonable grounds to anticipate that its rights are being compromised. This can take many forms, including circumstances where the principal is diverting proceeds from the bonded contract. Exoneration is "the removal of a burden, charge, responsibility or duty—particularly the act of relieving a person or estate from a charge or liability by casting the same upon another person or estate."[145] On a construction project, exoneration takes two forms. First, the surety has the right to require that contract proceeds be used to pay obligations of the principal that, if unpaid, would become an obligation of the surety. Second, after there has been a demand made on the surety, either a performance bond claim by the obligee or a payment bond claim by materialmen or suppliers, the

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Department of Army v. Blue Fox, Inc., 525 U.S. 225 (1999), the U.S. Supreme Court held that federal courts did not have jurisdiction over a claim by a subcontractor asserting an equitable lien on funds held by the Army. Although the Blue Fox decision was limited to the issue of whether district courts have jurisdiction over a subcontractor's claims for an equitable lien on contract funds held by the federal government, the question has arisen as to whether the Blue Fox decision upsets the long-standing recognition of the surety's equitable right of subrogation. Blue Fox, however, should be limited to the facts of its case and should not be interpreted to overrule the long-standing equitable subrogation cases involving sureties.

Another troubling case is *M.E.S., Inc. & Travelers Cas. & Sur. Co. of Am. v. United States*, 104 Fed. Cl. 620 (2012), holding that the surety was not an equitable subrogee because it did not complete the project, although it had paid the government an agreed amount to settle a performance bond claim, and holding that the court had no jurisdiction under the Tucker Act to determine if the surety may recover from the government.

[141]Grochal v. Ocean Tech. Servs. Corp., 476 F.3d 238 (4th Cir. 2007).

[142]2013 WL 4590568 (E.D. Va. 2013).

[143]108 Fed. Cl. 525 (2012).

[144]108 Fed. Cl. at 532–34.

[145]Black's Law Dictionary 576 (6th ed. 1990).

surety can require that the principal pay the debt.[146]

In addition to these firmly rooted common-law rights, sureties also are entitled to indemnification. Here, a surety is entitled to common-law indemnification from its principal if the surety sustains a loss based on its principal's failure to perform. In addition to common-law indemnification, sureties also seek specific contractual protection. Prior to executing performance and payment bonds, sureties generally require that the contractor execute a rather broad and sweeping indemnification agreement. This indemnification agreement is usually signed not only by the contracting entity but also personally by its owners. As a result, this provides additional protection for the surety in the event of a claim.[147]

For a detailed discussion of a surety's subrogation rights, *see Insurance Company of the West v. United States.*[148] The decision also contains a fairly comprehensive review of the leading Supreme Court decisions on the surety's subrogation rights.

Contractual indemnity agreements that sureties require their principals to sign customarily contain provisions providing for an automatic assignment of the principal's claims on a project in the event of a breach of the indemnity agreement. Because construction projects gone bad typically support the adage that "when it rains, it pours," a breach of the indemnity agreement, or at the very least an alleged breach of it, will more likely than not be in the picture. In such circumstances, sureties are understandably quite prepared to take command of a principal's claims, particularly when such action may be the only practical way to mitigate a loss caused by the principal. Courts ordinarily enforce such provisions, even to the point of granting summary judgments to the bonding company.[149] In such circumstances, it is imperative that the settling party require the surety to document its authority to settle the principal's claim.

Sureties have also been successful in mitigating their losses on construction projects by pursuing claims against third parties. In the main, such actions have grown out of claiming subrogation rights from owners/obligees to whom payment has been made. Often, such claims will be against design professionals and related consultants for the certification of defective work. In such situations, the doctrines of equitable subrogation to the rights of others and privity of contract as a bar to relief

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[146]For a discussion of these issues, see Jay M. Mann, *Exoneration and Quia Timet, in* The Law of Suretyship (Edward G. Gallagher ed., 2d ed. ABA 2000). *See also* Hudson Ins. Co. v. Simmons Constr., LLC, CV-12-0407 (PHX-DGC), 2012 WL 5381457, at *3 (D. Ariz. Nov. 2, 2012), where the court granted the surety's motion for summary judgment on a demand for $3,900,000 of collateral, finding "that the GIA is enforceable under Ninth Circuit law and that Defendants are in breach of that agreement. Plaintiff has established a reserve of $3,900,000 and has deemed that same amount necessary to protect it from any loss, cost, or expense. Plaintiff need not wait until ultimate resolution of the indemnity claims to demand collateral, so long as that collateral is not dispersed until indemnifiable claims are determined and the remainder, if any, is returned to Defendants." Accordingly, the court granted plaintiff's motion for partial summary judgment." Ninth Circuit courts favor summary judgment as a remedy to enforce the indemnity agreement, and will apply Rule 65, Fed. R. Civ. P rather than the common law doctrine of *quia timet*. The same courts routinely issue orders for prohibitory injunctions to maintain the *status quo*, such as freezing assets, but find that mandatory injunctions, such as collateral orders, are "particularly disfavored." *See* Travelers Cas. & Sur. *Co.* of Am. v. W.P. Rowland Constructors Corp., CV-12-00390 (PHX-FJM), 2012 WL 1718630, at *2 (D. Ariz. May 15, 2012). The court held that, under Ninth Circuit authorities, economic injury by itself "does not support a finding of irreparable harm, because such injury can be remedied by a damage award." (*Id*. at *3).

[147]*See* Chapter 34.

[148]55 Fed. Cl. 529 (2003).

[149]Liberty Mut. Ins. Co. v. Aventura Eng'g & Constr. Corp., 534 F. Supp. 2d 1290 (S.D. Fla. 2008).

frequently clash, and courts have gone both ways on these issues.[150] Claims against lending institutions have also been brought as alleged aiders and abettors of defunct principals, but these are frequently difficult cases to bring home.[151] An infrequently used, yet successful, recovery method is to pursue recovery of surety losses and expenses under the principal's commercial general liability policies, or under the incidental contractual liability coverage where that coverage exists.[152]

§32.05 CONCLUSION

Certainly, Judah could not have anticipated the development of modern day performance bonds when he agreed to be surety for Benjamin's journey into Egypt. The issues facing the obligee, principal, and surety when a default occurs are usually complex. In examining these issues, the starting point must be the bond. After all, the bond is the contract to which the parties have bound themselves. After that, there is a considerable body of case law and numerous secondary sources that will help guide parties through the many issues.

[150]Carolina Cas. Co. v. R.L. Brown & Assocs., Inc., 2006 WL 2842733 (N.D. Ga. Sept. 29, 2006); Lyndon Prop. Ins. Co. v. Duke Levy & Assoc. LLC, 475 F.3d 268 (5th Cir. 2007); American Mfrs. Mut. Ins. Co. v. Payton Lane Nursing Home, Inc., 2007 WL 674691 (E.D.N.Y. Feb. 28, 2007).

[151]Fidelity and Guar. Ins. Underwriters, Inc. v. Wells Fargo Bank, N.A., 2006 WL 870683 (S.D. Tex. Mar. 31, 2006); United States Sur. Co. v. KeyCorp., 2007 WL 2331942 (N.D. Ohio Aug. 13, 2007).

[152]*See* Merrick Constr. v. Hartford Fire Ins. Co., 449 So. 2d 85 (La. Ct. App. 1st Cir. 1984), Spirco Envtl. v. American Int'l Specialty Lines, 555 F.3d 637 (8th Cir. 2009). *See also* CGL Builders' Risk Monograph, American Bar Association, 2004, pp. 43–44, Gregory S. Arnold, contributing writer.

THE DOUBTFUL IMPACT OF AN OPTIONAL FEDERAL CHARTER ON THE REINSURANCE COLLATERAL DEBATE

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I. INTRODUCTION

Standards and practices in the field of reinsurance supervision vary widely among jurisdictions, with prudential approaches varying from direct supervision of reinsurers to supervision through cedants to little or no supervision at all. The supervision of reinsurance is experiencing a convergence in significant jurisdictions, including the European Union and the United States. Important topics include the anticipated single passport to Europe and, in the United States, the reinsurance collateral debate and the potential move toward an optional federal charter. Who is behind these issues, and do the issues share common ground?

The European Union is progressing toward a single market for reinsurance and a federalized system of reinsurance regulation. Important principles of mutual recognition and at least minimal harmonization of rules are some of the important foundations being implemented to make that system work. If and when the 2005 Reinsurance Directive (E.U. law allowing for free movement of insurance and reinsurance among member states) is implemented, it will result in the complete elimination of reinsurance collateral requirements among E.U. member states, although European Union member states will be able to impose such requirements on reinsurers from countries outside the European Union.

Some E.U. spokesmen have suggested that the United States should learn from the European Union's experience and adopt a federal system of reinsurance regulation in lieu of the current system of regulation by individual states. These commentators suggest that there is a likely nexus between a possible federal system of regulation in the United states and the eventual abolishment of U.S. reinsurance collateral requirements.

In the United States, collateral from unauthorized reinsurers satisfies "credit for reinsurance" regulations in the various states. However, reinsurers that are required to post collateral are at a competitive disadvantage compared to those that are not required, and insurers may have fewer options.

To understand these issues, this paper will survey the reinsurance regulatory schemes of the European Union and the United States. For the law of the European Union, the article discusses the Reinsurance Directive as it pertains to the ability of E.U. insurers to require collateral of third-country reinsurers, including those domiciled in the United States. The analysis of law in the United States will include the current law of New York State, followed by a discussion of a recent regulatory proposal by New York State, that softens the collateral requirements, leads to mutual recognition, and sets the groundwork for minimal harmonization of rules between unauthorized reinsurers and New York State.

The balance of the article should appeal to both the historian and the scholar of insurance law. Lloyd's is a company with its head office in the United Kingdom, which is a member state of the European Union. Because Lloyd's is a strong proponent of elimination of collateral requirements in the United States, this section reviews the failure of the old "Lloyd's of London," along with legacy issues that have concerned U.S. insurance regulators. The new "Lloyd's" is then studied in view of its current self-regulation initiatives, its governmental oversight from the nascent Financial Services Authority (FSA), and the treatment given to it by the rating agencies.

The article concludes with a historical overview of the arguments for and against an optional federal charter in the United States, with an analysis

tailored to the purpose of this paper, which is refuting the unfounded notion that an optional federal charter is necessary for the elimination of reinsurance collateral requirements.

II. THE REINSURANCE COLLATERAL DEBATE

A. *Current Regulatory Scheme in the United States*

Ensuring the solvency of primary insurance companies, or cedants, is a focal point of insurance regulation. Regulators establish rules to ensure that cedants have adequate funds available to respond to claims. When a cedant enters into a reinsurance transaction with a reinsurer, the assets of the reinsurer become one source of funds to satisfy the obligations of the ceding insurance company to policyholders. One means by which insurance regulators guard against insolvency of cedants is exercising control over their reinsurers.

Regulators distinguish between authorized reinsurers, which are not required to post collateral, and unauthorized reinsurers, which are required to do so. Authorized reinsurers are licensed by and pay taxes in one or more states plus the District of Columbia, each with its own requirements with respect to credit for reinsurance.[1] Credit for reinsurance involves the ability of cedants to offset case reserves and unearned premium reserves by the amount of risk ceded to reinsurance companies. By either statute or administrative practice,[2] most states allow financial statement credit for reinsurance transactions with reinsurers licensed in the same state, or with reinsurers licensed in another state where the company meets the solvency requirements of the state where the credit is taken. Regulators permit cedants to rely upon the authorized status of these reinsurers simply by referencing the name and the National Association of Insurance Commissioners (NAIC) number of the reinsurer in the cedant's annual statements and other financial statements. In contrast, the credit for reinsurance laws requires unauthorized reinsurers to post collateral for purposes of consumer protection and solvency protection of their cedants. The collateral takes the form of trust funds, letters of credit, or funds withheld (all discussed below). Their collateral requirements are the subject of much discussion in the insurance com-

1. *See, e.g.*, Report of the National Association of Insurance Commissioners (NAIC) and the Federal Reserve System Joint Troubled Company Subgroup: A Comparison of the Insurance and Banking Regulatory Frameworks for Identifying and Supervising Companies in Weakened Financial Condition app. A-3 (Apr. 19, 2005) ("Credit for reinsurance is heavily regulated through statutes, regulations, statutory accounting and reporting rules."), *available at* www.federalreserve.gov/boarddocs/staffreports/naicfrs/naicfrs.pdf.

2. *Id.*

munity, even to the point of whether the requirements are necessary in any form.

Unauthorized reinsurers, including both foreign reinsurers and those domiciled in but not licensed in the United States, can participate in the U.S. marketplace on an authorized basis without collateral requirements simply by becoming licensed and consequently admitted in the states in which they wish to do business. Unauthorized reinsurers post collateral pursuant to regulator-imposed rules, which can be satisfied, at least partially, by contractual arrangements with cedants. As stated by New York State Insurance Superintendent Eric Dinallo, "[N]othing prevents insurance companies from negotiating their own collateral requirements or from choosing to do business with reinsurers who are willing to put up collateral, if that is what the insurance company prefers."[3]

The insurance regulatory scheme in the United States is unique in comparison with other countries discussed in this paper because the business of insurance in the United States has historically[4] been regulated by the insurance departments[5] of the respective states. As more fully discussed later in this paper, the authority of states to regulate insurance, to the exclusion of the federal government, was unqualifiedly confirmed initially in the 1868 case of *Paul v. Virginia*[6] and then codified in the McCarran-Ferguson Act (MFA), which included certain exceptions related to antitrust activities. "[I]t has been the insistent position of the Congress that regulation of the insurance industry be left to the states."[7] With Congress going to great lengths to avoid federal regulation of insurance, the insurance departments of the various states developed their own sets of rules and procedures for protection of policyholders through solvency, rate, and form regulation.

The reinsurance collateral debate does not involve issues of antitrust, and there are no legal issues involving the courts. The study of insurance

3. *N.Y. Moves to Level Playing Field on Collateral for All Reinsurers*, Ins. J. (Oct. 18, 2007), *available at* www.insurancejournal.com/news/national/2007/10/18/84395.htm.

4. There was an exception of a period of less than one year, following the case of *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), which prompted enactment of the McCarran Ferguson Act of 1945, 15 U.S.C. §§ 1011–1015 (MFA), confirming the federal grant of power to the states to regulate the business of insurance.

5. "Insurance commissions were established by New Hampshire in 1851 (N.H.Laws 1851, c. 1111); by Massachusetts in 1852 (Mass. Laws 1852, c. 231); by Rhode Island in 1855 (R.I. Pub. Laws, October 1854, p. 17, § 17). By 1890, when the Sherman Act became law, seventeen states had established supervisory authorities. Patterson, *The Insurance Commissioner in the United States* (1927) p. 536, n. 62." *South-Eastern Underwriters*, 322 U.S. at 584 (Jackson, J., dissenting).

6. 75 U.S. 168 (1868).

7. Mackey v. Nationwide Ins. Co., 724 F.2d 419, 423 (4th Cir. 1984).

regulation often involves tension between agencies and the courts, but there are no such issues in this debate. This debate is one involving economics and politics and, in particular, the efforts of unauthorized reinsurers to effect insurance regulatory reform in the United States. The tension in this debate exists between reinsurers from various countries and the insurance regulators of the individual U.S. states.

Alien reinsurers argue that if collateral requirements were eliminated, the increased capacity would be $2 billion, or 1.3 percent globally.[8] These costs and related discrimination arguments from alien reinsurers serve as the major points of contention in the debate over whether alien reinsurers should be required to post such collateral. These same alien reinsurers make no reference regarding who is really picking up the cost of the reinsurance collateral requirements.

> There is no doubt that there are costs involved with maintaining [letters of credit] and trust funds and while the actual (cost) is funded by the reinsurer, it is built into the price paid by the buyer for reinsurance coverage. Many U.S. ceding insurers view these balances as a small price to pay for the added security provided by collateral, whatever form it takes.[9]

1. Prominence of New York State in the Collateral Debate

The insurance regulations of New York State are especially important in the analysis of the reinsurance collateral debate. New York is widely accepted as a leader in the field of insurance regulation in the United States, and through its Appleton Rule[10] controls what insurance companies in other states can and cannot do. New York City is widely regarded as the financial hub of the world, and "New York remains the most prominent reinsurance business center in the United States."[11] For the foregoing reasons, the insurance regulations of New York, and regulatory reform proposals from New York's insurance regulator, will be used as examples in this analysis of the reinsurance collateral debate.

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8. National Association of Insurance Commissioners Reinsurance Task Force of the Financial Condition (E) Committee, U.S. Reinsurance Collateral White Paper 28 (Mar. 5, 2006) [hereinafter NAIC].

9. *Id.* at 27.

10. This provision of the New York Insurance Code requires insurance companies licensed in that state to follow specific New York laws even when operating outside of the state. N.Y. Ins. Law § 1106 (1984). Violation can result in the suspension or termination of the operations of a New York–licensed insurer. *Id.*

11. Robert M. Hall, *Pre-Answer Security and Reinsurance Arbitrations*, XII Mealey's Reinsurance Rep. No. 18, at 20, *available at* www.robertmhall.com/articles/Pre-AnswerArt.htm.

2. Current New York State Insurance Regulations: Regulation No. 20 (11 N.Y.C.R.R. 125)

In order for an unauthorized reinsurer to be "accredited" or permitted by the New York State Department of Insurance (NYSID) to operate as an authorized reinsurer, it must meet the collateral requirements set forth in Regulation No. 20, which states in pertinent part as follows:

> (c)(1) In the case of an alien [i.e., unauthorized] assuming insurer, not otherwise entered as a United States branch in another state, such assuming insurer meets the standards of solvency required of licensed insurers of like character, such terms and conditions as prescribed by the superintendent, and otherwise complies substantially with related requirements, and such assuming insurer has deposited and continues to maintain in one or more New York state banks and/or members of the Federal Reserve System located in New York state, a trust fund or trust funds, constituting a trust surplus, in cash, readily marketable securities, or letters of credit, in an amount of not less than $20,000,000 for the protection of the United States insurers, and United States beneficiaries under reinsurance policies (contracts) issued by such alien assuming insurers. Such trusteed amount shall be in addition to any other trust fund required by this department, including, but not limited to, a trusteed amount at least equal to the liabilities attributable to United States insurers and United States beneficiaries under reinsurance policies (contracts) issued by such alien assuming insurers.[12]

Regulation 20 references two specific categories of collateral (discussed below), followed by another category of collateral required specifically of a "Lloyd's plan."

One category is the "trusteed amount" in the sum of liabilities under individual reinsurance contracts with ceding insurers. Individual ceding companies often require such collateral in their respective, private reinsurance arrangements with reinsurers, both authorized and unauthorized, and this category of collateral is not the subject of regulation in New York.

The other category of collateral is the trust surplus funds in the amount of $20 million per unauthorized reinsurer as a surplus over and above each unauthorized reinsurer's liabilities under individual reinsurance contracts. For unauthorized reinsurers (other than Lloyd's (previously "Lloyd's of

12. 11 N.Y.C.C.R. 125 (2003), *available at* www.ins.state.ny.us/r_finala/2003/pdf/fr20a9tx.pdf. A proposed revision would qualify the regulation's initial reference to *alien assuming insurer* to mean "non-U.S. assuming insurer" and require the balance of subsection (c)(1) to substitute *non-U.S. assuming insurer*. This is presumably a response to the sensitivity of European reinsurers who take offense at the word *alien. See* www.ins.state.ny.us/press/2007/rp071018rein.pdf (proposed revision). This proposed change is in addition to more sweeping reforms proposed by NYSID and discussed later in this article. *See infra* Part II.F.

London")), it is this trust fund requirement that is the crux of the reinsurance collateral debate.

Finally, in the case of "a group located outside the United States whose members consist of individuals incorporated assuming insurers who are not engaged in any business other than underwriting as a member of the group and individual unincorporated assuming insurers" (referring to Lloyd's-style reinsurers without mentioning any company or market names), there is an additional requirement of trust surplus funds in the amount of $100 million.[13] Lloyd's has always been a market, not a company or insurance corporation, and it thus appears that this section refers to Lloyd's. Thus, Lloyd's is required to post collateral equal to (a) liabilities under reinsurance contracts, plus (b) trust surplus funds in the amount of $20 million, plus (c) trust surplus funds in the amount of $100 million. Therefore, as discussed later in this section, it is not surprising that Lloyd's is the most vocal opponent of U.S. reinsurance collateral requirements and is the leader of the pan-European effort to abolish such requirements.

New York law permits several methods of collateralizing reserves for unauthorized reinsurers. The most popular methods are single beneficiary trusts and letters of credit (LOCs), followed by multiple beneficiary trusts, funds held, and ceded balances options. "The vast majority of reinsurance collateral is funded via trusts or LOCs that are negotiated with an individual beneficiary."[14] It is presumed that reinsurers, cedants, and state insurance regulators take account of those private dealings when determining what balance of funds must be trusteed with the state insurance regulators.

a. Single Beneficiary Trusts—Under the NAIC model laws and those of New York and other states, a ceding insurer obtains credit for reinsurance ceded to an unauthorized reinsurer to the extent of funds held in a trust acceptable to the insurance regulator for the exclusive benefit of the ceding insurer as security for the payment of obligations under the reinsurance agreement. This vehicle is known as a single beneficiary trust (SBT).

b. Letters of Credit—"The use of LOCs has become predominant over trusts, as the maintenance costs for LOC's have fallen"[15] and cedants prefer the relative ease of negotiating LOCs. Cedants and regulators prefer LOCs because they are backed by the credit of the bank, not the reinsurer. A failure of a bank to honor an LOC exposes the bank to sanctions under federal law.

13. 11 N.Y.C.C.R. 125 § 125.4(c)(5)(d)(1)(iv)(a), *available at* www.ins.state.ny.us/r_finala/2003/pdf/fr20a9tx.pdf.

14. NAIC, *supra* note 8, at 10.

15. *See* truthaboutlloyds.com, a website of the American Names Association, which distinctly has the tone and orientation of an advocate in favor of American Names and against Lloyd's. *See* http://truthaboutlloyds.com.

According to the NAIC *U.S. Reinsurance Collateral White Paper* report (*NAIC Collateral White Paper*), the acquisition cost of an LOC is between forty and sixty basis points.[16] Also, there are associated bank charges from drawing down an LOC.[17] These are significant enough to incline a reinsurer to pay a claim from other available funds. This further advances the convenience interests of cedants and regulators because the party that draws down on an LOC has some administrative paperwork in preparing sight drafts and cover letters and in tracking deadlines. When a reinsurer pays with separate funds, the beneficiary/cedant can simply advise the reinsurer and issuing bank that the cedant releases any interest in the LOC, or the LOC can remain in place to secure other, or future, obligations of the same reinsurer to the same cedant.

c. Multiple Beneficiary Trusts—Multiple beneficiary trusts (MBTs) are another means by which unauthorized reinsurers may meet their collateral requirements. These are more expensive to administer; and, as mentioned above, in addition to the calculated reserve requirements per individual reinsurance contract, unauthorized reinsurers are required to fund a trust surplus account of $20 million,[18] with Lloyd's syndicates collectively funding an additional trust surplus reserve account in the amount of $100 million.[19] As an illustration of the market share of Lloyd's, as of December 2004, Lloyd's credit for reinsurance MBTs were valued at $7.39 billion, compared with non-Lloyd's MBTs valued at $7.14 billion.[20] This market share helps explain why Lloyd's is so prominent in making demands of the insurance regulators in the United States to change their regulations with respect to reinsurance collateral requirements.

Unlike LOCs, MBTs are not easy for cedants or liquidators to negotiate. The *NAIC Collateral White Paper* notes the following difficulties:

> Companies must go through the entire claims process first in order to put a claim into the trusts. For example, liquidation officers have indicated that the process of collecting from a MBT is extensive, expensive and time consuming. Unlike a LOC, which can be quickly and easily drawn and collected upon, it can take years and significant expense to collect from a MBT. The process of collecting from Lloyd's MBT is first to meet the contractual requirements for submitting proofs of loss, which almost no reinsurer honors for an insolvent cedent, requiring many rounds of documentation and

16. NAIC, *supra* note 8, at 9–27. A basis point is a unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01 percent (1/100th of a percent), or 0.0001 in decimal form.
17. *Id*. at 14.
18. 11 N.Y.C.C.R. 125.
19. *Id.*
20. NAIC, *supra* note 8, at 10, citing data received from the New York State Department of Insurance as of Dec. 31, 2004.

> explanation far beyond contractual requirements. When the cedent finally loses patience at this vexatious conduct, an arbitration demand is the only resort. After getting an award (which can take 18 months to 2 years), they must file for a confirming award in a court and weather possible appeals. Once you have an unappealable award you must initially try to collect from Names, and then the Central Fund, all without success, and then finally you try to access the Lloyd's MBT. What liquidator or cedent in their right mind would go through that process.[21]

d. Funds Held Accounts—For the purpose of a reinsurer satisfying the required trust surplus accounts, a reinsurer can agree to the "funds held" option. Rather than funding an LOC in a private arrangement with a cedant or placing trusteed accounts with a regulator, reinsurers can agree to permit cedants to maintain premiums at the ceding company level. Cedants in this case do not remit funds to the reinsurer via an immediate payment or bordereau[22] credit transaction. This can involve considerable opportunity cost for the reinsurer because the latter loses the potential investment income on the premium it would have otherwise received in the normal course of business (unless netted out partially or wholly in a bordereau transaction). Thus, the funds held option must be carefully weighed against the collateral alternatives discussed in this section.

B. *Proposed Reinsurance Regulatory Reform in the United States*

The proposed National Insurance Act of 2007[23] was introduced in both houses of Congress with support from both sides of the aisle. The goal was to establish an optional federal charter (OFC) allowing insurance companies to choose to be regulated by a newly created federal insurance regulatory authority instead of by state insurance departments pursuant to state law. The sponsors reintroduced this landmark legislation for the purpose of bringing "uniformity and predictability to how life and property/casualty insurance is regulated."[24] "Neither the House nor the Senate version made it out of committee."[25]

The proposed OFC would provide insurers with an option, or alternative, to be regulated by the federal government rather than multiple

21. *Id.* at 13. NYSID Regulation No. 20 specifically requires 100 percent collateral of reinsured obligations with respect to cedants in liquidation.

22. A bordereau is a report by an insurance company to its reinsurer listing and summarizing certain insurance transactions affecting the reinsurance.

23. S. 40, 110th Cong. (2007); H.R. 3200, 110th Cong. (2007).

24. Press Release, John E. Sununu, Sununu, Johnson: Marketplace Demands Insurance Regulatory Reform. Senators Re-introduce "National Insurance Act" to Respond to the Needs of America's Insurers and Consumers (May 24, 2007), *available at* http://sununu.senate.gov/pressapp/record.cfm?id=275014.

25. *Top Insurance Stories in 2007*, Ins. J. (Dec. 31, 2007), *available at* www.insurancejournal.com/news/national/2007/12/31/86018.htm.

state governments. It is assumed that insurers choosing to be regulated by one supervisor would experience benefits in terms of saving on costs and time in the filing of rates and forms, delivering insurance products, and generally complying with various other regulations promulgated by state regulators. The federal government would provide charters to companies and licenses to agents and brokers and regulate the business of a national insurer. Using the dual federal banking system as a model, the act proposed that the states continue taxing the business of insurance conducted within their borders. In addition, state law would regulate guarantee funds, unclaimed property under escheat laws, participation in assigned risk plans and other mandatory residual market mechanisms, and compulsory coverage of workers' compensation or motor vehicle insurance.

Included within the Senate proposal[26] is a section contemplating credit for reinsurance, as follows:

> **1222. Credit for Insurance Ceded by a National Insurer or Federally Licensed Reinsurer**
>
> (a) Credit for Insurance Ceded to a National Insurer or a Federally Licensed Reinsurer—A national insurer may establish an asset or reduce its liabilities, to the extent of such liabilities, for insurance ceded to another national insurer or federally licensed reinsurer.
> (b) Other Asset or Reduction from Liability for Insurance Ceded—A national insurer may establish an asset or reduce its liabilities, to the extent of such liabilities, for insurance—
> (1) that is ceded to—
> (A) a State insurer;
> (B) a United States branch entered through a State; or
> (C) a non–United States insurer; and
> (2) if such insurance is ceded consistent with the standards established by the Commissioner pursuant to subsection (c).
> (c) Regulation—The Commissioner shall establish, by regulation, standards governing insurance ceded by a national insurer, as the Commissioner may determine to be necessary to protect the policyholders of a national insurer.

The House of Representatives version of the bill[27] is similar.

These proposals are relevant to the collateral debate. Both proposed versions of the National Insurance Act of 2007 contain references to "collateral,"

26. S. 40, 110th Cong. (2007).
27. H.R. 3200, 110th Cong. (2007).

but not in the context of credit for reinsurance. Cedants (referred to in the bills as "national insurers") may rely on reinsurance provided by "another national insurer or federally licensed reinsurer."[28] The source of the reinsurance (domestic or foreign) does not matter provided it "is ceded consistent with the standards established by the [to-be-established National Insurance] Commissioner."[29] These standards are addressed to security "in order to protect the policyholders of a national insurer" and are to be established by regulation.[30]

It should be noted that the OFC is supported by the Reinsurance Association of America,[31] which has historically been a proponent of collateral requirements.[32]

There is no language in either version of the proposed OFC to suggest that a federal charter would lead to suppression of U.S. collateral requirements for alien reinsurers. To the contrary, the bills, as presently introduced, literally set forth a framework for a federal regulator to demand collateral from unauthorized reinsurers. This is consistent with the treatment of reinsurance under current state regulation, not a major departure to be embraced by alien reinsurers hoping for a break from collateral requirements.

C. *Reinsurance Regulatory Scheme in the European Union*

The business of primary or direct insurance[33] has some history of regulation in Europe, but the business of reinsurance has been mostly unregulated. Now, reinsurance regulation in Europe is experiencing a convergence.[34]

28. *E.g.*, S. 40, 110th Cong. § 1222(a) (2007).
29. *Id.* § 1222(b)(2).
30. *Id.* § 1222(c).
31. *See* Press Release, *supra* note 24. Other supporters of the National Insurance Act, according to this press release, include "the Agents for Change, the American Bankers Association, the American Bankers Insurance Association, the American Council of Life Insurers, the American Insurance Association, the Council of Insurance Agents and Brokers, the Financial Services Forum, the Financial Services Roundtable, the Life Insurers Council, the National Association of Independent Life Brokerage Agencies." *Id.*
32. *See, e.g.*, Letter from Reinsurance Association of America to John Oxendine, Comm'r, NAIC (Sept. 21, 2007) (on file with author).
33. The first insurance company in England was established in 1696. This was a company called Contributors for Insuring Houses, Chambers or Rooms from Loss by Fire by Amicable Contributionship (Amicable Contributionship). It was nicknamed "Hand-in-Hand" because of its fire mark, one hand clasping another, symbolizing aid and assistance. Mutual Assurance Society of Virginia, *available at* www.mutual-assurance.com/newInsInAmerica.asp (last visited Oct. 20, 2008).
34. One commenter refers to this as a "global regulatory maelstrom" (tumultuous changes in global regulation of (re)insurance) spreading across Europe. The phrase implies sweeping and universally accepted change, which is not necessarily the case. *See* David Howell, The Global Regulatory Framework, Address at the Global Conference of Actuaries (Feb. 15, 2005), *available at* www.ficci.com/media-room/speeches-presentations/2005/feb/actuaries/feb15-actuaries-David-Muiry.ppt.

This is due to approval of a November 2005 law known as the Reinsurance Directive.[35] The approval was given by the European Parliament, which is the legislative body of the European Union.

The Reinsurance Directive is the result of E.U. efforts toward a unified regulatory and supervisory market for reinsurance. If the latest revised schedule holds, the majority of the E.U. member states will incorporate the Reinsurance Directive into their respective national laws no later than October 2008.

The Reinsurance Directive contains three essential provisions, including (1) the establishment of a single "passport" to Europe,[36] (2) the elimination of collateral requirements within the European Union,[37] and (3) prudential[38] rules for the supervision of reinsurance companies and finite reinsurance.[39]

In studies known as Solvency I and Solvency II, commissioned by Europe's executive body, the European Commission, the focus was on prudential rules relating to assessment of risk management, finance methods, accounting, supervision, actuarial analysis and practices, and financial reporting. Studies have been protracted and frustrated with compromise, an example of which is inclusion in the Reinsurance Directive of "optional"

35. Council Directive 2005/68/EC, 2005 O.J. (L 323) 1 [hereinafter Reinsurance Directive]; *see also* Amending of the European Parliament and of the Council of 16 November 2005 on reinsurance and amending Council Directives 73/239/EEC, 92/49/EEC as well as Directives 98/78/EC and 2002/83/EC, *available at* http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_323/l_32320051209en00010050.pdf.

36. The passport is the ability to conduct reinsurance business throughout Europe on the basis of a single authorization from a reinsurer's home member state. Reinsurance Directive, *supra* note 35, art. 4.

37. Collateral requirements are referred to as "pledged assets" in Article 32 of the Reinsurance Directive. "Member States shall not retain or introduce a system with gross reserving which requires pledging of assets to cover unearned premiums and outstanding claims provisions if the reinsurer is a reinsurance undertaking authorized in accordance with this Directive or an insurance undertaking authorized in accordance with Directives 73/239/EEC or 2002/83/EC." *Id.* art. 32. This arguably leaves open the possibility of requiring collateral of U.S. reinsurers. These pledged assets are sometimes referred to as "deposit accounts." *See, e.g.*, Ralph Vogelgesanga & Matthias Kubicek, *Toward a Global Approach to Reinsurance Regulation*, Geneva Papers 32, 413–25 (2007), *available at* www.palgrave-journals.com/gpp/journal/v32/n3/full/2510136a.html.

38. *Prudential* is defined as exercising prudence, good judgment, or common sense. Reinsurance Directive, *supra* note 35, art. 2.

39. *Finite reinsurance* is defined in Article 2(q) of the Reinsurance Directive as "reinsurance under which the explicit maximum economic risk transferred, arising both from a significant underwriting risk and from a timing risk transfer, exceeds the premium over the lifetime of the contract by a limited but significant amount, together with at least one of the following two features: (i) explicit and material consideration of the time value of money, (ii) contractual provisions to moderate the balance of economic experience between the parties over time to achieve a target risk transfer." *Id.*, art. 2(q).

provisions relating to finite reinsurance.[40] According to one observer, this "is but the latest example of the sheer impossibility of Europe agreeing on a common vision pertaining to specific aspects of reinsurance."[41]

The Reinsurance Directive contains three provisions concerning reinsurance dealings with third countries, such as the United States. These are Article 26 of Title III, Conditions Governing the Business of Reinsurance; and Articles 49 and 50 of Title VI, Reinsurance Undertakings Whose Head Offices Are Outside the Community and Conducting Reinsurance Activities in the Community.

Article 26, Cooperation Agreements with Third Countries, provides for the concluding of cooperation agreements with competent authorities of third countries regarding the exchange of information.[42] The article provides for guarantees of secrecy for the disclosure of information. In the United States, the competent authorities are the insurance regulators of the various states. Such exchange of information is intended only for the performance of the supervisory tasks of the respective regulatory bodies.

Article 49, Principle and Conditions for Conducting Reinsurance Business, forbids a member state from applying to reinsurers having their head offices outside the European Union and operating in the European Union, a provision resulting in "treatment more favourable than that accorded to reinsurance undertakings having their head office in that Member State."[43]

Article 50, Agreements with Third Countries, sets forth rules by which the European Commission may submit proposals to the European Council for the negotiation of agreements with third countries regarding the means of exercising supervision of (a) reinsurers that have their head offices in a third country and conduct reinsurance business in the European Union and (b) reinsurance undertakings that have their head offices in the European Union and conduct reinsurance business in a third country.[44] In particular, these agreements shall "seek to ensure under conditions of equivalence of prudential regulation, effective market access for reinsurance undertakings in the territory of each contracting party and provide for mutual recognition of supervisory rules and practices on reinsurance."

40. Recital No. 31 of the Reinsurance Directive states thus: "This Directive should be applicable to finite reinsurance activities; therefore, a definition of finite reinsurance for the purposes of this Directive is necessary; owing to the special nature of this line of reinsurance activity, the home Member State should be given the option of laying down specific provisions for the pursuit of finite reinsurance activities. These provisions could differ from the general regime laid down in this Directive on a number of specific points." *Id.* recital no. 31.

41. Michael Haravon, *The Harmonization of European Reinsurance: In Whose Interest?* Nat'l Underwriter, Prop. & Casualty / Risk & Benefits Mgmt. Ed. (Sept. 5, 2005), *available at* www.milbank.com/en/NewsEvents/NewsByPractice/Reinsurance+and+Insurance+Articles.htm.

42. Reinsurance Directive, *supra* note 35, art. 26.

43. *Id.* art. 49.

44. *Id.* art. 50.

This article also provides for ensuring that the competent authorities of the contracting parties "are able to obtain the information necessary for the supervision of reinsurance undertakings."

Finally, Title VII, Subsidiaries of Parent Undertakings Governed by the Laws of a Third Country and Acquisitions of Holdings by Such Parent Undertakings, provides for the provision of information from member states to the commission and addresses third-country treatment of E.U. reinsurance undertakings.[45] Article 52 requires that member states "inform the Commission of any general difficulties encountered by their reinsurance undertakings in establishing themselves and operating in a third country or carrying on activities in a third country."

Prior to the Reinsurance Directive, reinsurance regulation in Europe had not been uniform. For example, "France has enacted only a few supervisory rules that essentially regulate the market entry of reinsurance entities, and some of which have not even been fully implemented."[46] France has used collateral as a proxy to direct reinsurance regulation, creating extra costs for foreign reinsurers doing business in that country.[47] "Hannover Re, a German company, for example, estimated that additional charges and administrative costs linked to collaterals added $618 million annually to operating costs."[48]

This has resulted in criticism of France as being discriminatory against reinsurers from other E.U. member states. Sufficient pressure was applied by the European Union to force France to agree to abandon its collateral requirements effective October 2008.[49] It remains to be seen whether France will cooperate.

As for reinsurance in the United Kingdom, change has come and more change is certain. Lloyd's and the London insurance market in general have gone from no external regulation[50] to regulation by FSA starting in 2002.

45. *Id*. arts. 51, 52.

46. Haravon, *supra* note 41.

47. Countries requiring collateral include the United States, Canada, France, Germany, and Portugal. As planned, France and Portugal eliminate collateral requirements in October 2008, per anticipated full implementation of the Reinsurance Directive.

48. Haravon, *supra* note 41 (citing La Trib. (Feb. 12, 2004)). Compare to the reported $500 million transactional costs for all alien reinsurers combined to operate in the United States. News Centre, Credit for Reinsurance, What It Means for Lloyd's, *available at* www.lloyds.com/News_Centre/Credit_for_reinsurance/What_it_means_for_Lloyds.htm.

49. Conspicuous by its absence is any prohibition in the Reinsurance Directive preventing member states from applying collateral requirements to non-E.U. businesses. *See* Freshfields Bruckhaus Deringer, Insurance and Reinsurance News (July 2005), *available at* www.freshfields.com/publications/newsletters/sectors/iandr-news/12310.pdf.

50. As stated by one Name, "We know the 300-year-old history; it was like the monarchy. That was our mistake. Lloyd's failed us and it should not be allowed to regulate itself any more." *See* Cathy Gunn, Nightmare on Lime Street: Whatever Happened to Lloyd's of London? 148 (Smith Gryphon Publishers, London, 1993).

Only time will tell what has really changed at Lloyd's other than its name (as stated, it is now simply "Lloyd's"). As a result, and with particular regard to Lloyd's, it may be premature for U.S. regulators to assume that the business of reinsurance is now regulated to such an extent in the United Kingdom, France, and the European Union generally that American regulators should have confidence that the solvency of their insurers is protected, thus permitting a wholesale abandonment of reinsurance collateral requirements.

D. *Framing the Debate: Competing Arguments Regarding Reduction or Elimination of Reinsurance Collateral in the United States*

1. The Level Playing Field Issue

The most frequent phrase encountered in the reinsurance collateral debate is *level playing field*. Alien reinsurers claim that the U.S. collateral rules unfairly discriminate against them such that there is not a level playing field.[51]

State law requires the posting of collateral if a cedant wants or needs to take credit for reinsurance transactions. New York's Regulation 20 mandates collateral from alien and domestic unauthorized reinsurers, but ceding companies, at their own discretion, can waive it. However, without such collateral, the ceding company is not permitted to take advantage of the accounting and statutory benefits of "credit for reinsurance" as against surplus. Breaking it down, it appears that the focus of alien reinsurers is the requirement of trusteed funds in the amount of $20 million and, in the case of Lloyd's, an additional $100 million.

The U.S. response to this part of the collateral debate is discussed throughout the balance of this paper.

a. Origin of E.U. Reforms: E.U. Member State vs. E.U. Member State—The E.U. Reinsurance Directive includes suppression of an E.U. reinsurance company collateral requirement because the reinsurers in the member states desire to eliminate collateral for commercial or economic reasons. The provision was not an inevitable result of the single passport to Europe, which might be viewed as a corollary to an optional federal charter in the United States. The prohibition of the collateral requirement in Europe came as a result of the desired integration of the European market. Maintenance of collateral requirements among E.U. members impedes the freedom of services within the European Union; thus, the Reinsurance Directive makes much sense for Europe.

51. If alien reinsurers are making distinctions between the required trusteed funds and the collateral demanded by cedants in their respective contractual arrangements, it is in private conversations and not making it to the press.

b. E.U. Hope for Transport of E.U. Experience to the U.S. Reinsurance Collateral Debate—Articles commenting upon this collateral debate make statements such as "U.S. and foreign reinsurers agree that the dispute over the fairness of U.S. collateral requirements for alien reinsurers can be mitigated by the availability of an optional federal charter."[52] These articles do not give objective reasons why this should be so. Alien reinsurers certainly cannot point to their own experience with reinsurance reform and claim that they have done away with reinsurance collateral requirements among themselves or that they have a comprehensive reinsurance regulation for all of Europe. Such articles thus appear to make conclusory statements or arguments and do not fairly advance the debate.

Despite unmet and rescheduled deadlines, the apparent stubbornness of France, the difficulty in building sufficient consensus and momentum, and other shortcomings, the E.U. reinsurers claim to have made great strides toward uniformity in their approach to reinsurance regulation. Alien reinsurers hope to expand that perceived momentum to the United States with a design to suppress, or eliminate, collateral requirements, as if the United States should want "to be like" the Europeans.

Credit for reinsurance laws, with variations from state to state, are at the heart of the collateral controversy. The European Union has threatened action against the United States before the World Trade Organization unless the United States drops its strict rules governing alien reinsurers. As early as September 11, 2001, Lloyd's chairman Lord Peter Levene was calling for a significant overhaul of the U.S. trust fund requirements relative to non-U.S. reinsurers.[53] "Following the Sept. 11 attacks Lloyd's says it had to come up with over $3 billion in 6 months."[54] Levene noted as follows:

52. David Pilla, *Agreeing to Disagree: In a Best's Review Roundtable About U.S. Collateral Requirements, Reinsurers Clash on U.S. Regulation, but United on the Need for Universal Rules*, Best's Rev., Dec. 1, 2006, at 33. Contrast the more logical argument that E.U. reforms regarding collateral might have some impact on U.S. reforms regarding collateral, short of any suggestion that this would be accomplished through enactment of a federal charter in the U.S. *See* Meg Green, *Alien Forces at Work (Regulation: Reinsurance/Capital Markets)*, Best's Rev., Aug. 1, 2005, *available at* http://goliath.ecnext.com/coms2/gi_0199-4613154/Alien-forces-at-work-Regulation.html. "Now that the European Union has agreed to a single reinsurance protocol to regulate the industry, some say the United States will face increased pressure to simplify its regulatory structure, including reducing or eliminating its collateral requirements for foreign reinsurers doing business within its borders." *Id.; see also* A.M. Best Co., Inc., Face to face: The Forthcoming Reinsurance Directive Will Be a Factor as Renewal Talks Begin in Monte Carlo in September (2006), *available at* www.thefreelibrary.com/Face+to+face:+the+forthcoming+Reinsurance+Directive+will+be+a+factor . . . -a0149508523. "The Reinsurance Directive will end collateralization within the European Union, something that is likely to strengthen the argument from Europe for an end to collateralization requirements in the United States." *Id.*

53. *Insurers Again Call for U.S. Reinsurance Collateral Changes at World Insurance Forum*, Ins. J. (Feb. 24, 2006), *available at* www.insurancejournal.com/news/international/2006/02/24/65886.htm.

54. *Id.*

> [T]he reinsurance industry is essentially global and as such 80 percent of the reinsurance utilized by the U.S. primary market is supplied by companies outside of the U.S. Alien insurers are being discriminated against and that is totally unacceptable. . . . What is happening at the moment amounts to protectionism and the market wants to see a level playing field.[55]

Those who closely follow this collateral debate view both Lloyd's and the U.K. lobby in general as the primary sources for the anticollateral campaign in the United States.[56] As discussed in Part II.F, New York State's insurance regulator is listening and proposing reforms that should meet most of the demands of the alien reinsurers.

(i) Unfair, Anticompetitive Regulation—Alien reinsurers argue that maintaining collateral, reserved to burdensome "gross liabilities" standards, is unfair and anticompetitive. When assets are not allocated where they are most needed, the result "is inefficient, costly, and gives an unfair preference to some customers at the expense of others."[57] The gross liabilities argument may not be accurate with respect to trust funds as the combined exposures of each alien reinsurer, on a contract-by-contract, exposure-by-exposure basis, would likely far exceed the statutory collateral requirements, and collateral balances are not always effectively monitored by the various states. On the other hand, the gross liabilities argument may be accurate with respect to cedants in receivership or liquidation as 100 percent collateral is required from unauthorized reinsurers in such cases. This allocation issue goes to the diversification point addressed below.

Those in favor of the status quo argue that "the purpose of the collateral requirements is not simply to have assets within the United States, but to have them where they are accessible to the ceding company and to regulators if there is a dispute or if the reinsurer is simply unwilling or unable to pay."[58] Collection difficulties would be exacerbated if assets were located outside the United States, requiring pursuit under foreign judicial systems with the associated delays and added expense of obtaining and enforcing judgments on foreign soil. The issue of enforcement of foreign judgments will be discussed in greater detail.

"The U.S. stakeholder's view is that the U.S. credit for reinsurance system is not discriminatory because it provides options that are available to both U.S. and non-U.S. entities."[59] Non-U.S. reinsurers have alternatives.

55. *Id.*
56. *See* truthaboutlloyds.com, *supra* note 15.
57. NAIC, *supra* note 8, at 32.
58. *Id.*
59. *Id.* at 37. Thus, it is not a violation of the 1977 World Trade Organization (WTO) regime for liberalizing trade in financial services, including insurance and reinsurance. WTO has no jurisdiction over state regulatory authorities and does not tell governments how to

They can domesticate in the United States, and they can become licensed in the United States. Due to the high costs of licensing and taxes, these alien reinsurers prefer to operate offshore as unauthorized reinsurers. This comes at the cost of posting collateral when dealing with state regulators in the United States.

Lloyd's does not have the option of domesticating or becoming licensed in the United States because of its unique structure, i.e., a market rather than a company. The legal framework and capital structure of Lloyd's are discussed below.

(ii) Failure to Properly Reserve and Unrecoverable Reinsurance—"(U)nrecoverable reinsurance has been an ingredient in some of the largest insurance insolvencies."[60] A major component of reinsurance company insolvency is a failure to adequately reserve for losses, with prime examples being Lloyd's and HIH Insurance Group of Australia.[61]

"The British tax regime was partly to blame for the state of affairs at Lloyd's."[62] The structure of that tax regime was such that the very wealthy faced incredibly high income tax rates. It thus made sense to join Lloyd's for tax purposes, i.e., to pay cash calls and obtain favorable tax treatment based upon such participation. "'Lloyd's had not written insurance for profit for years', said one former underwriter in 1972."[63] Accordingly, at least until quite recently, U.S. insurance regulators have had mistrust for Lloyd's. It does appear that Lloyd's, under its new name and management, along with governmental oversight from the nascent FSA, has shown improvement in its business management and operations. This is likely to be influencing NYSID in its proposed reinsurance reforms.

(iii) Enforceability of U.S. Judgments Overseas—The U.S. State Department claims that there is a problem with enforcement of valid U.S. judgments in foreign jurisdictions. "[T]he law and practice in most foreign countries is not generally favorable to the prompt, predictable enforcement of U.S. civil judgments."[64] "There is no international counterpart to the 'full faith and credit' clause of the U.S. Constitution."[65] Experts engaged in assisting clients to collect from reinsurance companies in certain parts of the world struggle with first obtaining a judgment in one country;

conduct their trade policies. WTO only has a direct impact on a government's policies where disputes are brought to it for resolution. *See generally* What Is the WTO? www.wto.org/english/thewto_e/whatis_e/whatis_e.htm.

60. NAIC, *supra* note 8, at 11.

61. Sungard Ambit Erisk, Case Study: HIH Insurance (Nov. 2001), *available at* www.erisk.com/Learning/CaseStudies/HIHInsurance.asp.

62. Gunn, *supra* note 50, at 34.

63. *Id.*

64. NAIC, *supra* note 8, at 34.

65. *Id.*

then domesticating that judgment in another, where they are lucky to have some comity and uniformity of judicial systems; and finally attempting to collect on the domesticated judgment.[66]

A frequent debate topic is "the historical difficulties of collecting reinsurance recoverables from non-U.S. reinsurers in the case of a cedant's insolvency."[67] "Receivers have reported that having access to collateral makes a tremendous difference in the collection process, both in getting timely responses to billings and other correspondence as well as tempering the extreme positions taken by some reinsurers."[68]

(a) NYSID Proposed Reform: Memorandum of Understanding on Enforcement of Judgments—As part of the reforms suggested by NYSID, collateral requirements will be relaxed for alien reinsurance companies that "[a]ccept required contract terms, including consent to the jurisdiction of U.S. courts for disputes" and "[h]ave a primary regulator that has a memorandum of understanding with the NYSID that addresses information sharing and considers such matters as regulatory equivalency and enforceability of judgments."[69] Whether a memorandum of understanding that "considers such matters as . . . enforceability of judgments" equates with actual recognition and enforcement of judgments may be an open issue. Perhaps the insurance regulators in the E.U. member states will find a way to overcome the hurdles presented by international enforcement of judgments, hurdles that have not been overcome even by the ambitious Hague Choice of Court Agreements Convention.

(b) Hague Choice of Court Agreements Convention—The *NAIC Collateral White Paper*[70] suggests that the Hague Choice of Court Agreements Convention, adopted by the Hague Conference on Private International Law on June 30, 2005, may lead to better enforcement of judgments related to reinsurance contracts in the international marketplace.

Although many efforts have been made over the years to negotiate more comprehensive international treaties for mutual recognition of judgments, significant differences between legal systems have caused negotiators to narrow their focus. Nevertheless, despite its limited scope, a recently negotiated treaty represents a significant step forward because if it is imple-

66. Tom Riddell & Michael Maccallum, Presentation to UCONN School of Law (concerning the conduct of insurance company insolvency in the United Kingdom) (Mar. 15, 2007) (on file with author).

67. *NAIC Members "Dialogue" with European Commission, Supervisors: CEIOPS Hosts NAIC-EU Regulation Dialogue in Frankfurt*, Int'l Rep. no. 19 (Mar. 2005), *available at* www.naic.org/documents/committees_g_spring05_int_report.pdf.

68. NAIC, *supra* note 8, at 12.

69. *N.Y. Moves to Level Playing Field on Collateral for All Reinsurers*, *supra* note 3.

70. NAIC, *supra* note 8, at 35.

mented, it will allow the parties to control the forum in which contractual disputes are resolved.[71]

One of the limitations on the international enforcement of reinsurance treaties, at least in the United Kingdom, is the U.S. requirement of preappearance security. Most states in the United States have preappearance security statutes, the majority of which are based on the NAIC Model Unauthorized Insurers Process Act adopted in 1949. That act does not use the term *reinsurer* or *reinsurance*. It uses the term *unauthorized insurer*.[72] The purpose of the act is as follows:

> The purpose of this Act is to subject certain insurers to the jurisdiction of courts of this state in suits by or on behalf of beneficiaries under insurance contracts. The legislature declares that it is a subject of concern that many residents of this state hold policies of insurance issued or delivered in this state by insurers while not authorized to do business in this state, thus presenting to these residents the often insuperable obstacle of resorting to distant forums for the purpose of asserting legal rights under these policies.[73]

As to a remedy, the act provides thus:

> Before any unauthorized foreign or alien insurer shall file or cause to be filed any pleading in any action, suit or proceeding instituted against it, the unauthorized insurer shall deposit with the clerk of the court in which the action, suit or proceeding is pending, cash or securities or file with the clerk of the court a bond with good and sufficient sureties, to be approved by the court, in an amount to be fixed by the court sufficient to secure the payment of any final judgment which may be rendered in the action; or procure a certificate of authority to transact the business of insurance in this state.[74]

Several states have adopted preappearance security statutes that are variations on the act. New York's statute requires that security be deposited with the court but provides that "the court may in its discretion, make an order dispensing with such deposit or bond if the superintendent certifies to it that such insurer maintains within this state funds or securities in trust or otherwise sufficient and available to satisfy any final judgment which may be entered in the proceeding."[75]

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71. *Id*. at 34–35. This refers to the Hague Choice of Court Agreements Convention. *See also* Anthony J. Woodhouse, *The Importance of Jurisdiction and Choice of Law Clauses: A European Perspective*, 42 Tort Trial & Ins. Prac. L.J. 1027 (2007), which discusses service of suit and arbitration clauses, but not enforcement of judgments, in the United Kingdom, United States, Australia, and France. Pages 1031–32 discuss the English Civil Jurisdiction and Judgments Act of 1982 and the civil procedure rules, concluding that "[t]he rules on jurisdiction over insurance contracts do not apply to reinsurance."

72. Hall, *supra* note 11.

73. Model Unauthorized Insurers Process Act, NAIC Model Laws, Regulations and Guidelines 850–51, § 1.

74. *Id*. § 3.

75. N.Y. Ins. Law §§ 1101(b)(2)(G), 1213(c)(1)(A) (1985 & Supp. 1996).

A common argument against the deposit of preappearance security is that trust funds are deposited with the relevant state and are sufficient to cover the reinsurance dispute. Further, requirements for preappearance security may contravene British common law[76] and, thus, with reference to litigation involving reinsurers in the United Kingdom, could impair an otherwise enforceable judgment under the Convention.[77]

There is also a reference in the Convention to nonenforceability of asbestos claims.[78] If asbestos-related claims are not enforceable under the Convention, this could dilute any practical application of the treaty to enforcement of judgments between and among insurers and reinsurers. Under the Convention, this would not be exclusive to U.S. insurers versus non-U.S. reinsurers. It could also prevent application between and among E.U. entities.

An additional complication is the fact that the Convention only deals with private matters. "The Convention relates to private international law only and not public law matters."[79] As state-mandated insurance reserves or trust funds are not private matters, it would appear that disputes regarding reserves or trust funds would not be addressed under the Convention. In recognition of the private matter versus public matter distinction under the Convention, NAIC has commented that collateral requirements "are a fundamental part of state-based solvency regulation, (i.e., not 'private' for purposes of the Convention) and as such they fall under the 'prudential' exception in the international trade rules."[80]

With all of these international law complexities, and despite the reform proposals of NYSID, there is seemingly little chance that the demands of alien reinsurers for complete elimination of U.S. collateral requirements are going to be met, at least not anytime soon.

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76. *See, e.g.*, Muhl v. Ardra Ins. Co., 6 Re. L.R. 206, No. 484 (Berm. S. Ct. 1997) (refusing to enforce a New York security award because, *inter alia*, award offended British and Bermudian notions of substantial or natural justice); *see also* Barry R. Ostrager & Mary Kay Vyskocil, Modern Reinsurance Law and Practice, § 13.02 (Pre-Appearance Security Requirements) (2d ed. 2000).

77. *See* NAIC, *supra* note 8, at 35 ("[I]ndustry analysis of case law indicates that U.S. state insurance code requirements such as pre-answer security could render a judgment unenforceable under public policy exceptions in British Common Law and Swiss Law.").

78. *Id.* at 35–36. The Convention allows jurisdictions to declare that certain matters are not subject to the Convention as adopted in that jurisdiction. Matters dealing with asbestos have been of noted concern among particular countries during negotiation of the Convention. The language of the Convention addressing insurance does not provide a specific exception to the declaration provisions, so the declaration provisions will likely take precedent over the insurance provisions and will allow a country to refuse enforcement of insurance and reinsurance obligations related to such matters. *Id.*

79. *Id.* at 36.

80. *Id.* at 35–36.

(iv) Comparison of U.S. and International Accounting Standards—U.S. insurance regulators are concerned about "the challenges in understanding the non-U.S. reinsurers' finances given the lack of a single solvency framework—or even a single system of insurance accounting."[81] The global reinsurance industry has not been able to agree on acceptable standards of prudential regulation or accounting methods. Some countries have nascent regulatory schemes with little uniformity and transparency.

There is no mutual recognition (a) among the U.S. states and (b) among E.U. states concerning acceptable accounting standards. This must be achieved before there can be any meaningful discussion regarding mutual U.S.-E.U. recognition of the respective countries' accounting practices.

There are two main accounting standards used in the United States: generally accepted accounting principles (GAAP) and statutory accounting principles (SAP). The unique differences underscore the respective underlying philosophies of the two systems. GAAP is intended to fulfill the needs of various business users of financial statements (not regulators or policyholders), whereas SAP is intended to answer the concerns of regulators and policyholders. Consequently, GAAP emphasizes the measurement of emerging earnings, comparing quarter to quarter, whereas SAP stresses measurement of the ability of a reinsurer to pay claims.

In the European Union, only the GAAP accounting standard is used. The rating agencies make reference to U.K. GAAP, E.U. GAAP, and U.S. GAAP.[82] There is no reliance upon the SAP standard for insurance accounting. Thus, any contention that all countries and regulators are on the same page with respect to accounting methods and principles is simply unrealistic.

2. The Diversification Issue

Lloyd's wants to be able to use assets currently tied up in trust funds in the United States for diversification. "It had long been argued by some that removing burdensome collateral requirements on foreign reinsurers in the United States will unlock capital that could be used to provide more reinsurance and allow companies like Lloyd's to spread risk around the world. Diversify, that is."[83]

The same argument can be made for unauthorized U.S. reinsurers that are required to post collateral, so this is not a uniquely foreign problem.

81. *Id.*

82. *See, e.g.*, Standard & Poor's Rating of the Lloyd's Market (Sept. 2007), *available at* www.lloyds.com/NR/rdonlyres/59A74C5D-E7A8-4833-AE51-7EEA53F5AA66/0/SandPFALSeptember2006.pdf.

83. David Dankwa, *Insurers Disagree with New York View of Rate Reductions as Benefit of Collateral Reduction*, InsuranceNewsNet.com, www.insurancenewsnet.com/article.asp?neid=20071029200.1_4268002b953557cc.

The argument also skirts the protective purpose of the collateral requirements. As pointed out in the *NAIC Collateral White Paper*,

> [i]f collateral requirements were reduced for qualified professional reinsurers, what would these reinsurers do with those funds earmarked to pay claims for U.S. policyholders? One likely scenario of concern to regulators is that the reinsurers would leverage those funds in writing additional business globally, thus putting at risk precisely those monies ultimately owed to U.S. policyholders.[84]

3. The Capacity Issue

NYSID has recognized this lack of reinsurance capacity. According to New York State Insurance Superintendent Dinallo, "There is a growing need for reinsurance in . . . New York to deal with risks from terrorism and from natural catastrophes such as hurricanes."[85]

New York State's proposed reinsurance reforms are intended to increase capacity by relaxing collateral requirements. It is thus not clear that foreign reinsurers need to motivate U.S. regulators to budge on the collateral issue; it seems there is sufficient internal motivation in the United States to increase reinsurance capacity.

Not all agree that New York's proposed reforms would increase capacity. "Nowhere has anybody ever shown that a reduction in collateral will ever increase capacity," said Mike Koziol, assistant vice president and counsel for the Property Casualty Insurers Association of America.[86]

4. The Pricing or Rate Reduction Issue

The more frustrated alien reinsurers become with what they see as little to no movement of the United States on its collateral requirements, the more they develop new arguments. The latest argument being debated in the insurance news circles is that collateral pushes up reinsurance pricing and rates. According to one reporter, "The reinsurance collateral debate, until now, has been framed as a capacity issue, and hardly connected to pricing decisions."[87] "What role, if any, collateral requirements play in setting reinsurance and insurance rates wasn't really part of the debate."[88]

The United States relies heavily on foreign reinsurance, including the London market. Alien reinsurers argue that collateral requirements force premiums for reinsurance to be higher than they otherwise would be and

84. NAIC, *supra* note 8, at 27.
85. *N.Y. Moves to Level Playing Field on Collateral for All Reinsurers*, *supra* note 3.
86. Roberto Ceniceros, *N.Y. to Ease Reinsurer Collateral Requirements*, Bus. Ins. (Oct. 22, 2007), *available at* http://goliath.ecnext.com/coms2/gi_0199-7295809/N-Y-to-ease-reinsurer mobile.businessinsurance.com/palm/issuearticle.vmc?articlelink=cgi-bin/article.html.pl.
87. Dankwa, *supra*, note 83.
88. *Id.*

that a reduction or elimination of collateral requirements would lead to greater availability of reinsurance to the world market, including, notably, the United States.

E. *Legacy Issues: U.S. Distrust of European Insurance Regulation and the Rebuilding of Confidence*

Some non-U.S. reinsurers argue that their regulatory schemes are as good as those in the United States. Time will tell if this is true. For any observer of the London insurance market, it will take a long time for recovery from the failed Lloyd's of London, both in terms of new regulatory control by the nascent FSA and the indelible scar on British pride. The industry will not quickly forget that a self-regulated Lloyd's of London failed to adequately reserve for "delayed manifestation asbestos, pollution and health (APH) claims," "predominantly arising from exposures in the U.S. market."[89] This was the same company that had to mortgage its own Central Fund, sell its building, and demand fresh capital infusion from its brokers and the Names to deal with unreserved losses.

Perhaps there is a little patriotism and politics, and not just economics, that go along with sizing up competitors from foreign countries. This is certainly true of the British as they struggled with whether to join the European Union and become "European." The same may hold true for how Americans view Europeans in modern-day business transactions, and no doubt this somehow colors one's thinking when considering the collateral debate.

Lloyd's of London was a venerable institution, filled with mystery. Centuries old and thought to be as solid as the Rock of Gibraltar, it disappointed thousands when it came to its agonizing end, gasping its last breath as its remaining assets, and what could be collected from market participants, were transferred to the legally independent Equitas for runoff. At the same time, the new Lloyd's was surfacing and declaiming about its "latest" self-regulatory reforms, including its new Franchise Performance Directorate.[90]

A hard and evenhanded look at the new Lloyd's reveals some truly redeeming changes, perhaps the most significant of which is the option to avoid unlimited liability. Even the Names have new options to convert to limited liability. Corporations are now eligible for membership, and,

89. *See* Scott Moser, Equitas CEO, Presentation to the University of Connecticut School of Law Insurance Law Center's London Insurance Markets Course in London (Mar. 12, 2007), *available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1001&context=gregory_arnold.

90. Guy Carpenter, The Lloyd's Market in 2004, at 16, *available at* www.guycarpenter.com.

of course, they have limited liability as the only option.[91] To this extent, any argument that Lloyd's may be arrogant in demanding elimination of collateral in the United States when it demands collateral of its Names is greatly diluted. The syndicates are still required to place trust funds into the Lloyd's Central Fund, but at least the individual members, the Names, no longer face personal bankruptcy in the event of a syndicate failure.

The Lloyd's market and its syndicates have been rated by one or more of the rating agencies since October 1997. These agencies include A.M. Best, Fitch Ratings,[92] Moody's, and Standard & Poor (S&P). Moody's rates the syndicates but not the market.

1. Lloyd's Market Ratings

The exposure of the various syndicates is partially mutualized through the vehicle of the Lloyd's Central Fund. The Lloyd's market ratings apply to all business written by all syndicates post-1992, the year the long-tail exposures of Lloyd's of London, especially asbestos exposures, were re-insured into Equitas. "As a result of implementation of phase one of the Equitas agreement with National Insurance Company, Lloyd's exposure to uncertainty related to Equitas has been substantially reduced,"[93] leading to A.M. Best's upgrading its financial strength rating (FSR)[94] for Lloyd's from A– (Excellent) to A (Excellent) on July 19, 2007. All of the rating agencies that rate the Lloyd's market have given it high ratings.[95]

2. Lloyd's Syndicate Ratings

Although market ratings are the principal measure of financial strength for those analyzing the strength of Lloyd's, the demand for syndicate-specific information has increased. S&P does not deem syndicate-specific FSRs to be meaningful. It argues that the effective mutualization of all market risks through the Central Fund means that, for Lloyd's, the defaulting entity

91. *Id*. at 3. In 2004, the capital base of Lloyd's had limited liability corporate vehicles supplying 87.5 percent of the market's capacity and unlimited liability Names the remaining 12.5 percent. *Id.*

92. *See* Lloyd's website, www.lloyds.com/search/Search.aspx?q=Fitch.

93. *See* A.M. Best, 2007 Special Report: Lloyd's—2006 Market Review (July 17, 2007), *available at* www3.ambest.com/bestweek/purchase.asp?record_code=134784&AltSrc=26.

94. "A Best's Financial Strength Rating is an independent opinion, based on a comprehensive quantitative and qualitative evaluation, of a company's balance sheet strength, operating performance and business profile." "A Best's Financial Strength Rating (FSR) is an opinion of an insurer's ability to meet its obligations to policyholders." *See* A.M. Best's website, www.ambest.com/ratings/guide.asp.

95. As of the last report for each agency, these ratings are A.M. Best A (Excellent), *see* A.M. Best's website, www.ambest.com/ratings/guide.asp; Fitch Ratings A+ (Strong) (upgrade Mar. 28, 2007), Stable Outlook, *available at* www.fitchratings.com/corporate/ratings/issuer_content.cfm?issr_id=80361962; S&P A+ (Strong), Stable Outlook, *see* S&P's Rating of the Lloyd's Market (Sept. 2006), *available at* www.aecunderwriting.it/public/sandpfal.pdf.

would be the market as a whole rather than individual syndicates or their members.[96] For those interested in differentiations among syndicates, not just in terms of pure credit quality but also in terms of likely syndicate continuity, S&P started publishing Lloyd's Syndicate Assessments in September 2002. These are evaluations of the degree to which a syndicate is dependent upon Lloyd's Central Fund, brand, licenses, infrastructure, and, ultimately, Lloyd's market's FSR itself.

F. *New York's Response to E.U. Criticism: Leveling the Playing Field*

1. Past Accommodations

It is probably fair to say that New York insurance regulators have been accommodating alien reinsurers, at least Lloyd's, starting as early as the 1995 NYSID audit of Lloyd's for the period ended December 31, 1993. This audit found an $18.5 billion Lloyd's deficiency in required trusteed funds.[97] There was also a shortfall in new cash infused into Lloyd's/Equitas in September of 1996, required for Lloyd's of London's rehabilitation program known as Reconstruction & Renewal. In short, NYSID did not demand immediate funding of accounts to make up the shortfall, but worked with Lloyd's in overcoming its problems.

The degree of state regulation of insurance under the federal MFA is not great. The act states, in relevant part, as follows:

> No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, unless such Act specifically relates to the business of insurance: Provided, that after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended (15 U.S.C. 41 et seq.), shall be applicable to the business of insurance to the extent that such business is not regulated by State Law.[98]

As stated earlier in this paper, the collateral debate does not involve tension between agencies and courts. There are no federal versus state debates in a legal sense (only in the sense of a possible federal regulation in the possible OFC context). Because there are no acts of Congress challenging New York's arguably lax oversight of the trust funds, which allowed the shortfall in required trusteed funds, there have been no discussions about that audit in the context of the MFA.

96. Carpenter, *supra* note 90, at 22.

97. *See* truthaboutlloyds.com, *supra* note 15; *see also* Green, *supra* note 52. "For 2004, reinsurers had posted about $98 billion in collateral, with about $88 billion coming from reinsurers outside the United States and the remaining $10 billion coming from U.S. reinsurers operating in states where they aren't licensed, according to the RAA." *Id.*

98. 15 U.S.C. § 1012(b) (1948).

2. Current Accommodations of the European Union: Proposed Reform to Collateral Requirements

The superintendent of insurance for NYSID has announced proposed new reinsurance collateral rules.[99] Alien and domestic unauthorized reinsurance companies with the highest credit ratings will be treated the same as authorized companies. Weaker reinsurance companies will be required to post collateral on a sliding scale from 10 percent to 100 percent. Unauthorized reinsurers with a triple A credit rating from two rating agencies would not have to post collateral. Unauthorized reinsurers with a double A or equivalent rating would have to post collateral equal to 10 percent of claims; single A, 20 percent; and triple B, 50 percent. Unauthorized reinsurers having a credit rating below triple B would still be required to post 100 percent collateral.

Other requirements would be as follows:

An unauthorized reinsurer must:

Meet the standards of solvency, including standards for capital adequacy, established by its domestic regulator;
Be authorized in its domiciliary jurisdiction to assume the specific kind of reinsurance it is offering;
Maintain a policyholder's surplus or equivalent in excess of $250,000,000;
Accept required contract terms, including consent to the jurisdiction of U.S. courts for disputes;
Have a primary regulator that has a memorandum of understanding with the NYSID that addresses information sharing and considers such matters as regulatory equivalency and enforceability of judgments;[100]
Be domiciled in a country that allows U.S. reinsurers access to its market on similar terms; and
Post 100 percent collateral upon the entry of an order of rehabilitation, liquidation or conservation against the ceding insurance company.

Collateral requirements will not change for authorized reinsurers; they will still not be required to post any collateral. However, new safeguards will be put in place to help ensure the ability of these reinsurers to cover claims and thus protect consumers.

Insurance companies ceding risk to reinsurers have responsibility for vetting those reinsurers and developing risk management plans for their reinsurance placements.

99. *See N.Y. Moves to Level Playing Field on Collateral for All Reinsurers*, *supra* note 3.

100. Note that there is "some legal debate whether states can compel a foreign regulator to take or require specific legal actions against a company domiciled there." *See* Meg Fletcher, *New York Set to Relax Reinsurer Collateral*, Bus. J., July 7, 2008, *available at* www.businessinsurance.com/cgi-bin/article.pl?articleId=25319 (last viewed Oct. 6, 2008).

> The Superintendent of Insurance will retain final authority over any particular transaction.[101]

The new collateral regulation was subjected to a comment period and, as of July 2008, was still undergoing the vetting process.

This schedule is in advance of the October 2008 anticipated effectiveness of the E.U.'s Reinsurance Directive, which involves complete elimination of collateral among E.U. member states, while New York's proposed reform falls short of that. The New York proposed reforms are encompassing, however, and come at a time when New York has also announced its principles-based insurance regulation reform initiatives.

As recently as November 2007, NYSID took the lead in the United States as the first insurance department to endorse European-like[102] principles-based insurance regulations, some of which are identical to those unveiled by the United Kingdom's FSA earlier this year.[103] (See Table 1 for a striking, side-by-side comparison of the language of the respective insurance regulation schemes.)

"Principles-based regulation requires aligning regulatory compliance with business goals while protecting consumers," Dinallo said. "The goal here is an effective, efficient reinsurance industry that will maximize the capital available to insurers and help insurers meet consumer needs."[104] Dinallo refers to "business-to-business transactions" where New York is moving to let the market decide. According to Dinallo, "[t]his risk-focused approach means principles-based regulation is being applied to all reinsurers."[105]

New York State's proposed relaxation of reinsurance collateral requirements for unauthorized reinsurers is the first major accommodation of alien reinsurers to date. With the exception of Florida,[106] the other U.S. insurance regulators have thus far not embraced widespread changes in the requirements for posting of collateral related to reinsurance transactions with unauthorized reinsurers, either domestic or international. With New York and Florida demonstrating strong leadership, however, other states are sure to follow.

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101. *N.Y. Moves to Level Playing Field on Collateral for All Reinsurers*, *supra* note 3.

102. The news articles about NYSID's principles-based insurance regulations are silent as to the particular author of the proposed reforms, with an inference that they are the idea and creation of Insurance Superintendent Dinallo. The fact that FSA published a document with substantially similar, and in some cases, identical, wording, with the exception of *must* in FSA and *shall* in NYSID, strongly suggests that NYSID "borrowed" the idea and language from FSA.

103. *N.Y. Insurance Department Advances First Principles-Based Regulation*, Ins. J. (Nov. 5, 2007), *available at* www.insurancejournal.com/news/east/2007/11/05/84761.htm.

104. *N.Y. Moves to Level Playing Field on Collateral for All Reinsurers*, *supra* note 3.

105. *Id.*

106. *See* Florida Rule 69O-144.007, Ratings Based Collateral Requirements (Nov. 11, 2007) (draft), *available at* www.floir.com/pdf/ReinsuranceCollateralRule.pdf.

Table 1: Side-by-Side Comparison of Principles-Based Regulation, NYSID and FSA

FSA	NYSID
Principles for Business*	Principles for the Insurance Industry**
1. A firm must conduct its business with **integrity**.	
2. A firm must **conduct its business with due skill**, care **and diligence**.	1. A licensee shall lawfully **conduct its business with integrity**, **due skill, and diligence**.
3. A firm must **take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems**.	2. A licensee shall **take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems**.
4. A firm **must maintain adequate financial resources**.	3. A licensee shall **maintain adequate financial resources**.
5. A firm must **observe proper standards of market conduct**.	4. A licensee shall **observe proper standards of market conduct**.
6. A firm must **pay due regard to the interests of its** customers **and treat them fairly**.	5. A licensee shall **pay due regard to the interests of its** clients **and treat them fairly**.
7. A firm must **pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading**.	6. A licensee shall **pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading**.
8. A firm must **manage conflicts of interest fairly, both between** itself **and its** customers **and between** a customer and another client.	7. A licensee shall **manage conflicts of interest fairly, both between** the licensee **and its** clients **and between** clients.
9. A firm must **take reasonable care to ensure the suitability of its advice and discretionary decisions for any** customer who is **entitled to rely upon** its judgment.	8. A licensee shall **take reasonable care to ensure** the appropriateness or **suitability of its advice and discretionary decisions for any** person or other entity that **is entitled to rely upon** such.
10. A firm must arrange **adequate** protection for **clients' assets** when it is **responsible** for them.	9. A licensee shall ensure that the **assets** of any **client** for which the licensee is **responsible** are adequately protected.
11. A firm must deal with its **regulators in an open co-operative way, and** must **disclose to the** FSA appropriately anything **relating to the** firm **of which the** FSA **would reasonably expect notice**.	10. A licensee shall interact with the superintendent and other **regulators in an open** and **cooperative way, and** shall **disclose to the** superintendent **any** information **relating to the** licensee **of which the** superintendent **would reasonably expect notice**.

* *See* www.fsa.gov.uk/pubs/other/principles.pdf at 9.

** *See* www.insurancejournal.com/news/east/2007/11/05/84761.htm.

III. EUROPEAN INTEREST IN AN OPTIONAL FEDERAL CHARTER IN THE UNITED STATES

European reinsurers are hopeful that the United States will adopt a federal charter system of regulating insurance. This appears to flow, at least in part, from an unfounded assumption that a federal charter would in and of itself beget suppression or elimination of reinsurance collateral requirements. The single passport to Europe, however, is not necessarily tied to suppression of collateral requirements in the European Union, and there is no reason to assume that an OFC would necessarily lead to suppression or elimination of collateral requirements in the United States. The United States is not confronted with the same common market or economic integration issues facing the European Union. An analysis of the proposed OFC and a review of legal history and treatment of insurance in the United States dispels any notion that an OFC would have the results desired by the European Union.

NYSID has recently proposed reinsurance regulatory reform that would significantly relax, and in some cases eliminate, unauthorized reinsurer collateral requirements. This would be based upon a proposed system of credit rating. This proposed reform comes at a time when there has been no announcement of a projected date when an OFC might be a reality, if ever.

Whether an OFC will ever be a reality and the question of whether an OFC is a predicate to reform of collateral requirements are two separate studies. For the legal historian, and by way of review, it should be emphasized that Congress has never wanted to regulate the business of insurance. The prospect of federal regulation of insurance was anathema to Congress, so much so that the U.S. Supreme Court, starting with *Paul v. Virginia*[107] and continuing through a curious progeny of cases leading up to *United States v. South-Eastern Underwriters Ass'n*,[108] advanced the fiction[109] that insurance is not commerce.

In *Paul*, the U.S. Supreme Court held that "[t]he issuing of a policy of insurance is not a transaction of commerce . . . even though the parties be domiciled in different States, but is a simple contract of indemnity against loss,"[110] thus effectively, but only temporarily, establishing case law removing the business of insurance beyond the legislative reach of Congress.

107. 75 U.S. 168 (1868).

108. 322 U.S. 533 (1944).

109. *Id.* at 1190 (Jackson, J., dissenting). "In contemplation of law, however, insurance has acquired an established doctrinal status not based on present-day facts. For constitutional purposes a fiction has been established, and long acted upon by the Court, the states, and the Congress, that insurance is not commerce."

110. *Paul*, 75 U.S. at 3.

With respect to the fiction theory, the *Paul* court was not presented with any facts concerning international insurance or reinsurance or the business of "ceding" or "accepting" versus "issuing" of reinsurance. *Paul* does not contain a single reference to reinsurance, but a careful review of the case leads to the conclusion that such lack of reference to reinsurance is of no consequence. The Court did seriously consider other instruments of commerce; and it appears that had the court specifically considered international aspects of reinsurance, it would have come to the same conclusion, i.e., "[t]he issuing of a policy of insurance is not a transaction of commerce." Thus, the fiction referenced by Justice Jackson would have still been advanced.

Paul was overruled in *South-Eastern Underwriters*.[111] From a review of the dissents by Justices Jackson and Stone in that case, it is clear they shared the opinion that the *Paul* majority continued to advance the fiction that insurance was not commerce because Congress did not want to occupy the field of insurance. Justice Stone agonized over how the majority opinion would simply result in forcing the hand of Congress to take action it did not want to take.[112] With the enactment of the MFA, Congress acted but has effectively stayed its hand by leaving the regulation of the business of insurance to the states.

IV. CONCLUSION

The Europeans have had a unique experience with respect to pending elimination of reinsurance collateral requirements among the E.U. member states. The Reinsurance Directive has yet to be implemented into national law by the respective E.U. member states, and three member states still impose reinsurance collateral requirements on reinsurers in other E.U. member states.[113] That experience has been one motivated not so much by the usual regulatory interests in solvency and consumer protection, but by continental economics and a desire to become commercially competitive with third-country reinsurers. The E.U. interest in abolition of collateral in the United States has nothing to do with integration of the

111. 322 U.S. 533.

112. Justice Stone's preference, as stated in his dissenting opinion, would have been to ignore the issue of whether insurance is commerce and simply allow the Sherman Act to control insurance companies in the same way it would control other commercial endeavors. Current reform proposals would have that same effect. One reform proposal is to allow the MFA to exist but without the antitrust exemptions. As presently worded, there are no antitrust exemptions for boycott, intimidation, or coercion by insurance companies.

113. The US Reinsurance Collateral Debate: The Latest "Red Herring" (Nov. 6, 2007), *available at* www.lloyds.com/news_Centre/Features_from_Lloyds/The_US_Reinsurance_Collateral_Debate_the_latest_red_herring_061107.htm.

United States or world reinsurance markets but has everything to do with feeling discriminated against and wanting to be better able to compete in the United States.

There is no evidence to support the notion that federal regulation of insurance in the United States would in itself lead to any different results with respect to the credit for reinsurance laws that require collateral from alien reinsurers. NYSID is already setting the groundwork for regulatory reform, which will lead to relaxation of collateral requirements for alien reinsurers; Florida is following closely behind, and other states are sure to follow. This is proof that there is no necessary nexus or overlap in these two areas.

Congress has historically shown no interest in occupying the field of insurance regulation, resisting every early opportunity to change its course on this issue. This was made clear by Justices Jackson and Stone in the *South-Eastern Underwriters* case and Congress's immediate enactment of the MFA to ensure that the states would continue regulating the business of insurance. Neither *Paul* nor the MFA excludes the federal government from regulating insurance. *Paul* simply held that a state regulatory statute did not interfere with interstate commerce, and the MFA actually contemplates that the federal government may pass laws dealing with insurance as long as Congress specifically mentions insurance in the body of the statute. The proposed National Insurance Act has not passed both houses of Congress, despite being introduced last year.

NAIC has been proactive in responding to criticisms against the system of state regulation, and all indications are that it is willing to accept the role of a de facto nationwide regulator, addressing collateral and other issues as effectively as a de jure federal regulator would while at the same time maintaining the current system of state regulation of insurance.

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SEPTEMBER 21st and 22nd, 2006

ISSUES AND PRACTICAL CONSIDERATIONS FOR THE SURETY IN USING SUBCONTRACTOR RATIFICATION AGREEMENTS

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I. ***Introduction***

Where a contractor/principal is subject to a default termination and the surety decides to facilitate the completion of the bonded project ("the terminated project"), it may be advantageous to the surety to have one or more of its principal's subcontractors ("the original subcontractors") complete the work within the scope of their original subcontracts under the prices, terms and conditions of those subcontracts. The advantages may include the following:

- *Price*. The subcontract price of the original subcontract may be less than the price that could currently be negotiated on the open market. This could reflect numerous factors, including: a change in market conditions given the passage of time since the original subcontract was negotiated; greater knowledge regarding the complexities or problems associated with the job or the job's reputation in the subcontractor community; the risks associated with having to complete another company's work; or the perception in the subcontractor community that the pressures on a surety facing a "terminated project" would compel the surety to accept an above-market subcontract price with an above-market profit margin.
- *Availability.* The original subcontractors may have their equipment on the job site and should already have factored the completion date for the project into their work schedules.
- *Promptness.* The original subcontractors could presumably re-start their work immediately with no need for substantial mobilization or planning. Contracts with vendors would often be in place. In contrast, a new subcontractor would need to fit a completion project into its schedule, mobilize, and purchase materials that may have long lead times.
- *Knowledge.* The original subcontractor's knowledge of the job may translate into cost-savings, greater speed, or fewer unanticipated problems once the completion work had begun.

- *Unique Skills.* There may be no other subcontractor in the area that has the skills necessary to complete the work.
- *Defective Work.* The original subcontractor has an incentive to address its own pre-existing defective work in a cost-effective and time efficient fashion. A new subcontractor may have contrary interests depending on the terms of its subcontract.
- *Warranties and Guaranties.* Continuity in the trade should minimize issues regarding the effectiveness of manufacturer's and trade warranties. The hiring of a new subcontractor may jeopardize or complicate warranty and guarantee issues.
- *Claims.* To the extent that there are unresolved change order issues or the principal has claims to assert against the owner, the continued involvement of the original subcontractors may assist in the most favorable resolution of these issues given the original subcontractor's knowledge base and possibly its financial interest in the outcome.

In many cases, one or more of the original subcontractors may take the position that the principal's termination by the owner terminates the subcontractor's remaining obligations under its original subcontract or that, in the face of a termination of the contractor, the subcontract allows the subcontractor to terminate the subcontract unless the contractor's termination is remedied within a reasonable period of time.[1]

Where a surety facing a terminated project determines that it will participate in the completion of the project and that it would be advantageous for one or more of the original subcontractors to complete their work under their original subcontracts, the available mechanisms for returning the original subcontractors to the project will likely include the following or some variation of the following:

[1] See Carolina Casualty Insurance Co. v. Ragan Mechanical Contractors, 584 S.E.2d 646 (Ga.Ct.App. 2003). Compare Employers Insurance of Wassau v. Bright Metal Specialties, 251 F.3d 1316 (11th Cir. 2001).

- Facilitating the direct assignment of the original subcontractor's subcontract from the principal to a party that would be responsible for completion;
- Entering into a ratification agreement with the original subcontractor under which, inter alia, the subcontractor would ratify the original subcontract and agree to complete its work according to its terms in exchange for payments made by the surety for sums allegedly owed to the original subcontractor and possibly other concessions; or
- Facilitating the efforts of the obligee or a completion manager or contractor to negotiate an entirely new agreement with the Original Subcontractor.

Alternatively, if a cooperative principal has not yet been terminated, it may be possible to have the principal assign the bonded contract to a completion contractor or convince the obligee to rescind a termination in order to facilitate an assignment.

The methodology best suited in a given context for returning the original subcontractor to the project will depend on numerous considerations, including the arrangement that the surety enters into with the obligee by which the surety participates in the completion of the Project. Depending on the terms of the bond and the positions of the owner, the surety's completion options may include the following or variations of the following:

- Entering into a take over agreement with the obligee and contracting with a new completion contractor/manager for the completion of the work;
- Entering into a tender agreement with the obligee under which the surety tenders a new contractor and pays some or all of the difference between the bonded contract balance and the new contractor's completion price, if any;
- Buying out its exposure by making a cash payment to the obligee in exchange for a release of the performance bond obligation; or

- Proposing the return of the principal to the Project through a tender or through a take over and completion contract with the principal, with possible financing of the principal, where appropriate.[2]

Once the surety identifies the likely completion options, it can make a more reasoned decision regarding the mechanism for returning an original subcontractor to the project, though this decision will still be colored by numerous fact specific variables.

This paper will address the legal and practical considerations that bear on a surety's decision regarding the mechanism by which it attempts to bind original subcontractors to complete their work on a terminated project. The primary focus of the analysis will address the advantages and disadvantages of ratification agreements and issues relating to the drafting and content of such agreements, though alternative options will be discussed as well.

II. ***Assignments of Subcontracts***

In the event of a default termination of the principal, there may be three methods of assignment by which an initial subcontract remains binding on the initial subcontractor.

A. The Assignment Clause of the Indemnity Agreement

Most Indemnity Agreements include an Assignment Clause with language much like the following:

> The Contractor, the Indemnitors hereby consenting, will assign, transfer and set over, and does hereby assign, transfer and set over to the Surety, as collateral, to secure the obligations in any and all of the paragraphs of this Agreement and any other indebtedness and liabilities of the Contractor to the Surety, whether heretofore or hereafter incurred, the assignment in the case of each contract to become effective as of the date of the bond covering that contract, but only in the event of: (1) any abandonment, forfeiture or breach of any contracts referred to in the Bond or of any breaches of any said Bonds; or (2) of any breach of the provisions of any of the paragraphs of this Agreement;…(a) All of the rights of the Contractor in and growing in any manner out of all contracts referred to in the Bonds; (b) All of the rights, title, and

[2] If the surety is able to convince the owner to rescind the principal's termination, issues regarding the continued operative effect of the original subcontracts should, in most cases, be obviated.

> interest of the Contractor in and to al machinery, equipment, plant, tools, and materials which are now or may hereafter be, about or upon the site or sites of any or all of the contractual work referred to in the Bonds or elsewhere , including materials purchased for or chargeable to any and all contracts referred to in the Bonds, materials which may be in process of construction, in storage elsewhere, or in transportation to any and all of said sites; (c) All the rights, title and interest of the Contractor in and to all subcontracts let or to be let in connection with any and all contracts referred to in the Bonds, and in and to all surety bonds supporting such subcontracts….[3]

As discussed below, many construction subcontracts include language that would bind the subcontractor to an assignment of the subcontract. In the absence of such language and in the absence of an express contract provision prohibiting an assignment, an executory bilateral contract which does not involve personal skill, trust, or confidence is generally assignable in the absence of consent from the other party so long as the assignment does not materially alter the responsibilities and duties of the contracting party.[4] As a construction contract is generally not deemed to be a personal services contract, a surety exercising the Assignment Clause of an Indemnity Agreement should be able to take a valid assignment of one or more of its principal's subcontracts regardless whether the subcontractor consents to the assignment.

The primary advantage of exercising rights under an Assignment Clause is that this may bind the original subcontractor to complete its work on the project under the terms specified in its original subcontract with no legal right to re-negotiate those terms.

The practical problems or drawbacks in invoking the Assignment Clause include the following:

- Generally, an assignee assumes the rights and obligations of the assignor, including the assignor's liabilities under the assigned contract.[5] Therefore, the surety's exercise of its

[3]This language is derived from a model agreement drafted in 1965 by a subcommittee of the Claims Advisory Committee of the Surety Association of America.
[4] See Smith v. Cumberland Group, 687 A.2d 1167 (Pa. Super. 1997); Restatement Second of Contracts §§ 317, 318.
[5] Restatement Second of Contracts, §335. See Kunzman v. Thorsen, 740 P.2d 754 (Or. 1987).

assignment rights might subject it to exposure to all of the subcontractor's claims against the contractor which arise under the subcontract. These could include claims for lost profits or other consequential damages which would not be compensable under the payment bond. At a minimum, if the surety exercised an assignment of one of the original subcontracts, it could be exposed to reasonable demobilization and mobilization costs and would likely be exposed to delay damages, including unabsorbed home office overhead and extended field conditions, from the time of the contractor's termination until the date that construction

resumed.[6]

- In order to avoid subjecting a subcontractor to an indefinite period of uncertainty, a court would likely read into the Assignment Clause a reasonable time period subsequent to the principal's termination after which the subcontract would be deemed to be in breach and the rights afforded under the Assignment Clause would be deemed to have expired. It is difficult to imagine that the period would be greater than 90 days. Whatever a safe period of time within which a surety could weigh the option of asserting its assignment rights, the time allowable may not be sufficient to allow the surety to conduct a reasonable investigation of all pertinent factors, including, but not limited to, whether the contractor's termination was lawful, whether it was advisable to assist the owner in the completion of the project and, if so, through what kind of contractual arrangement, whether the construction company completing the project would accept a further assignment of the subcontract that the surety contemplated assuming, the quality of the subcontractor's work,

[6] This concern, while always of significance, may be somewhat of a lesser magnitude to the extent that courts have extended the range of exposures under public works payment bonds. Compare D&P Corp. v. Transamerica Insurance Co., 881 F.Supp. 1505 (D.Kan.1995) (surety liable under Miller Act payment bond for delay damages and lost profits) and Mai Steel Service, Inc. v. Blake Construction Co., 981 F.2d 414 (9th Cir. 1992) (surety liable under Miller Act payment bond for delay damages caused by the owner) with Consolidated Electrical & Mechanical, Inc. v. Biggs General Contracting, Inc., 167 F.3d 432 (8th Cir. 1999) (Miller Act surety is not liable for lost profits).

and the extent of the additional exposures to which the surety would be exposed if it accepted the assignment of a particular subcontract.

For the foregoing reasons, the exercise of the rights afforded under the Assignment Clause may not be practical or desirable. Nonetheless, there are circumstances under which the exercise of these rights may be practical and cost effective. Consider the following scenarios:

- Assume a situation where the principal is unable to commence work on a Project due to its own internal financial problems or abandons a job soon after commencing work due to its financial problems. The surety may decide to tender a contractor as a means of satisfying its performance bond obligation and it may be able to do so with reasonable promptness. The surety's exercise of its assignment rights in relation to certain key original subcontracts may make it possible for a new contractor to more quickly submit a price and to submit a lower price than if the contractor needed to solicit new subcontract bids. The assertion of the assignment right may preclude an original subcontractor from choosing not to work for the new contractor or from attempting to re-negotiate its subcontract with a new contractor. At a minimum, the assertion of an assignment may provide leverage in any negotiations with the original subcontractor. Assuming that the principal's work on the job had not commenced or had hardly commenced, the surety's risk of financial exposure to claims outside of the scope of the payment bond might be minimal and a reasonable risk to assume given the possible benefits of an assignment.
- Assume that a solvent and competent principal is terminated on a bonded project. As a means of addressing a performance bond claim, the surety may decide to tender its principal to the owner or take over the project and use its principal as the completion contractor. Alternatively, the principal may have its own suggestions for completing the work that may involve the intervention of another construction company selected by the principal. The principal may also be able to hold the surety harmless financially from any

additional exposures that could result from the surety exercising assignments over one or more of the original subcontracts. If, under this fact pattern, certain subcontractors would be reluctant to return to the project or would be inclined to do so only if they could re-negotiate their subcontracts with the principal, the assertion of an assignment might facilitate their return to the project under either the terms of the original subcontract or terms close to those of the original subcontract with little or no risk of added exposure to the surety.

- Assume that a competent principal is terminated on a bonded project solely due to cash flow or other financial problems. Assuming that the surety is prepared to finance the principal and that the owner is not prepared to revoke the termination, the surety may be able to decide within a short period after the termination to tender its principal to the owner or take over the project and use its principal as the completion contractor. The cooperating principal may be able to demonstrate to the surety that there were few if any exposures to subcontractors beyond those covered under the payment bond. If, under this scenario, certain subcontractors would be reluctant to return to the project or would be inclined to do so only if they could re-negotiate their subcontracts with the principal, the assertion of an assignment might facilitate their return to the project under either the terms of the original subcontract or terms close to those of the original subcontract with little or no risk of added exposure to the surety.

Extrapolating from these hypotheticals, it is possible to generalize that exercising assignment rights under the Assignment Clause may be an attractive option in circumstances which evidence some combination of the following characteristics: the termination occurs early in the project; the surety's investigation can be quickly completed; the principal is competent and willing to complete the project and is either solvent or a suitable candidate for financing; a completion proposal, either involving the principal or a new construction company, can be

formulated relatively quickly; and the principal's exposures to its subcontractors which are beyond the scope of the payment bond obligation can be identified quickly and or manageable under the circumstances. Under certain combinations of these characteristics, the prompt exercise of the assignment rights under the Assignment Clause may either convince a recalcitrant subcontractor to return to the project under the terms of the original subcontract or may provide significant leverage in the course of re-negotiating the terms of the original subcontract and other claims issues.

B. The Assignment Provisions of the Subcontract and the Prime Contract

Many subcontracts and contract forms include complementary provisions under which the owner has the right to take by assignment one or more of the contractor's subcontracts in the event that the contractor is terminated.

The following provisions from the AIA forms A401 and A 201, 1987 edition, and A401 and A201, 1997 edition, are illustrative.

1987 EDITION

A401 (subcontract form)

7.3 ASSIGNMENT OF THE SUBCONTRACT

7.3.1 In the event of termination of the Prime Contract by the Owner, the Contractor may assign this Subcontract to the Owner, with the Owner's agreement, subject to the provisions of the Prime Contract and to the prior rights of the surety, if any, obligated under bonds related to the Prime Contract. If the work of the Prime Contract has been suspended for more than 30 days, the Subcontractor's compensation shall be equitably adjusted.

A201 (prime contract- general conditions)

5.4 CONTINGENT ASSIGNMENT OF SUBCONTRACTS

5.41. Each subcontract agreement for a portion of the Work is assigned by the Contractor to the Owner provided that:

.1 assignment is effective only after termination of the Contract by the Owner for cause pursuant to Paragraph 14.2 and only for those subcontracting agreements which the Owner accepts by notifying the Subcontractor in writing; and

.2 assignment is subject to the prior rights of the surety, if any, obligated under bond related to the Contract.

5.4.2 If the Work has been suspended for more than 30 days, the Subcontractor's compensation will be equitable adjusted.

14.2 TERMINATION BY THE OWNER FOR CAUSE

14.2.2 …[T]he Owner…may without prejudice to any other rights or remedies of the Owner…terminate employment of the Contractor and may subject to any prior rights of the surety:

….

.3 Accept assignment of subcontracts pursuant to Paragraph 5.4….

The analogous provisions from the 1997 editions of A401 and A201 differ from those in the 1987 versions by the following terms in bold:

1997 EDITION

A401 (subcontract form)

7.4 ASSIGNMENT OF THE SUBCONTRACT

7.4.1 In the event of termination of the Prime Contract by the Owner, the Contractor may assign this Subcontract to the Owner, with the Owner's agreement, subject to the provisions of the Prime Contract and to the prior rights of the surety, if any, obligated under bonds related to the Prime Contract. **In such event, the Owner shall assume the Contractor's rights and obligations under the Subcontract Documents.** If the work of the Prime Contract has been suspended for more than 30 days, the Subcontractor's compensation shall be equitably adjusted.

A201 (prime contract- general conditions)

5.5 CONTINGENT ASSIGNMENT OF SUBCONTRACTS

5.41. Each subcontract agreement for a portion of the Work is assigned by the Contractor to the Owner provided that:

.1 assignment is effective only after termination of the Contract by the Owner for cause pursuant to Paragraph 14.2 and only for those subcontracting agreements which the Owner accepts by notifying the Subcontractor **and Contractor** in writing; and

.2 assignment is subject to the prior rights of the surety, if any, obligated under bond related to the Contract.

5.4.2 **Upon such assignment,** if the Work has been suspended for more than 30 days, the Subcontractor's compensation will be equitable adjusted **for increases in cost resulting from the suspension**.

14.2 TERMINATION BY THE OWNER FOR CAUSE

14.2.2 …[T]he Owner…may without prejudice to any other rights or remedies of the Owner…terminate employment of the Contractor and may subject to any prior rights of the surety:

….

.3 Accept assignment of subcontracts pursuant to Paragraph 5.4….

The 1997 documents are arguably an improvement over the 1987 editions from the owner's perspective in that the updated A201, Subparagraph 5.4.2, indicates that in the event of the owner exercising its assignment rights following the termination of the contractor, the subcontractor's remedy following a thirty day suspension of the work is limited to an equitable adjustment for increases in the actual costs caused by the suspension. The intent underlying the 1997 changes was to prevent a subcontractor from attempting to make a better deal with the owner after the contractor had been terminated.[7] Contract and subcontract provisions such as those quoted above implicate all of the practical problems implicit in the surety exercising assignment rights over initial subcontracts, see supra, with the additional complication that these rights run in favor of the owner and not the surety. For this reason, in the limited situations where the exercise of assignment rights may be advantageous to the surety, the surety would likely invoke the rights afforded by the Assignment Clause of the Indemnity Agreement in lieu of attempting to benefit from those afforded to the owner. Nonetheless, in situations where the owner and surety are working together after a relatively straightforward termination and where it is likely that a completion option such as a tender or buy out could be in place within a relatively brief period of time, there may be reasons why it would be advantageous for the surety to have the owner invoke its own assignment rights in

[7] Though the A401 Subcontract appears to require the terminated contractor's consent before an owner can assume the assignment of a subcontract, it appears from the pertinent language of A201 and A401, when read together, that the contractor's consent to an assignment is given as of the time that the prime contract is executed, with the consent to become operative and the assignment effective upon the contractor's termination and the owner's decision to invoke its assignment rights.

lieu of those available to the surety, particularly, if the re-negotiation rights of the subcontractor were explicitly made narrow by terms the bonded contract such as those embodied in Subparagraph 5.4.2 of A201, 1997 edition. The owner's willingness to invoke these rights for the benefit of the surety may dependent, in part, on the surety's willingness to hold the owner harm less against any additional claims from the subcontractor that may arise as a consequence of the assignment.

C. *Consensual Assignments by the Contractor*

As construction contracts are typically not treated as personal service agreements, a terminated contractor could presumably agree to assign one or more of the original subcontracts to its surety even in the absence of an Assignment Clause in an Indemnity Agreement. See p. 5-6, supra. The practicalities and advantages and disadvantages of this option are identical to those set out in connection with the surety's exercise of the Assignment Clause, with the additional element that the principal must consent to and initiate the assignment. See pp. 6-9, supra.

In sum, the exercise of assignment rights afford an excellent legal mechanism for binding initial subcontractors to complete their work on terminated projects under the terms specified in their initial subcontracts. However, given the practical problems associated with this option, such assignments are only likely to be feasible in a limited number of default situations.

III. **Assignment of the Bonded Contract**

Assuming that the principal is cooperative and that surety involvement commences before the bonded contract is terminated, it may be possible to have the principal assign the bonded contract to a completion contractor, with the surety paying the difference between the completion contractor's price and the undisbursed contract funds. In some cases,

it may be possible to convince an obligee to rescind a termination to facilitate such an assignment.

A principal advantage to assigning a bonded contract is that the subcontracts arguably remain fully operative and pass to the completion contractor, thereby obviating or reducing the leverage of a subcontractor to renegotiate its terms or walk away from the subcontract work in its entirety. As the surety is not a party to the transaction, there is no risk that the surety will be exposed to additional obligations beyond the scope of the bond.

The advisability of these kinds of assignments is discussed in a prior paper presented to the Northeast Surety and Fidelity Claims Conference.[8] Suffice to say for current purposes that where the assignment of a bonded contract is an available completion option, a principal advantage of this option is that it keeps intact the contractor/subcontractor relationship.

IV. **Ratification Agreements**

An alternative to the process of directly assigning the original contractor's subcontracts to a party that would be responsible for project completion is the use of ratification agreements. When the Surety decides to utilize the original subcontractors in completing the defaulted project due to one or more of the reasons outlined in Section I above, ratification agreements are implemented more often than the assignment of contracts process. The reason for this is likely because ratification agreements allow the Surety and the original contractor to specifically define their relationship so that the Surety knows what its risks and exposures are. In the assignment process, however, the Surety steps into the shoes of its defaulted principal. Consequently, the Surety becomes exposed to the principal's liabilities under the assigned contract without the protection of the penal sum of the payment bond. Many of these liabilities would not necessarily be items that could be claimed against the payment bond Surety (such

[8] See Matthew Horowitz, *Resolving Performance Bond Exposures Through Assignments of Bonded Contracts,* 15th Annual Northeast Surety and Fidelity Claims Conference (September 30, 2004).

as lost profits).[9] The Surety is cautioned, however, not to allow a novation of the subcontract to occur that could arguably result in the cancellation of warranties and other rights that the original contractor may have had.[10]

Simple and straightforward ratification agreements serve the purposes of having the original subcontractor reaffirm its commitment to complete its work under the rights, duties and obligations of its original subcontract and defining the current financial status of the subcontract. Circumstances may dictate, however, that the Surety will either want to or be motivated by critical subcontractors to address many more issues in the ratification agreement than a subcontractor's commitment to the project and definition of the financial status of its subcontract. In strategizing the utility of ratification agreements in a given situation, the Surety will want to consider what it wants to accomplish by ratifying some or all of the original subcontractors, what clauses in a ratification agreement will best serve the Surety's goals, and various project completion scenarios in which ratifying subcontracts may or may not be useful.

This paper's analysis of ratification agreements is divided into two sections. The first section addresses issues relating to the content of a ratification agreement. The second section addresses the desirability of using ratification agreements and the issues posed by their use depending upon the completion option selected by the Surety.

A. Clauses to Consider Including in a Ratification Agreement

There are a number of draft ratification agreements contained in various surety publications.[11] One form of sample ratification agreement is attached as Exhibit A to this

[9] Certain courts have held, however, that where a surety executes a ratification agreement that incorporates a subcontract, the surety becomes bound by an arbitration clause in the subcontract. See Employers Insurance of Wassau v. Bright Metal Specialties, Inc., 251 F.3d 1316 (11th Cir. 2001); Structural Steel Fabricators, Inc. v. Travelers Casualty & Surety Co., 801 N.Y.S.2d 242 (N.Y.Sup.Ct. 2005).

[10] James W. Smirz, Takeover Agreement and Maintaining Existing Subcontractors and Suppliers For the Takeover Contract (unpublished paper submitted at the A.B.A. Tort and Insurance Practice Section Fidelity & Surety Law Committee annual meeting in New York, NY on August 12, 1986.

[11] See, e.g., Practical Guide to Construction Contract Surety Claims, Tasker, Richard E., Murphy, G. Wayne, and Schwartzkopf, William (Aspen Law & Business, 1997), Forms 10-8 and 11-8; Bond Default Manual, 2d ed., Clore, Duncan L., editor (American Bar Association, 1995), Exhibit 5.7.

article. The form in Exhibit A and the ones footnoted below are similar in that they are simple forms.[12] The Surety is generally better served by attempting to keep the ratification process as uncomplicated and straightforward as possible. The more issues that the Surety tries to resolve in a ratification agreement, the more complex it becomes and the more likely it is that the subcontractor will engage counsel. Having to address the issues that may be raised by a sophisticated subcontractor, such as delay and impact claims, complicates and delays the ratification agreement process.[13]

The sample "Exhibit A" ratification agreement attached hereto contains clauses that: 1) identify the subcontract documents that will govern the subcontractor's completion effort; 2) define the financial status of the subcontract; 3) get the subcontractor to reaffirm its commitment to completing the work under the terms defined in the agreement and the subcontract incorporated therein; 4) assign to the Surety any claims that the Subcontractor may have against the original contractor and the owner except for retainage and waive all other claims (including any claims against the Surety); 5) lock in the price for the completion of the Subcontractor's work; and 6) get the Subcontractor's consent for the Surety to assign the agreement to another entity that may complete the project. In exchange for these understandings, the Surety consents to issue an agreed upon payment immediately upon execution of the agreement.

A ratification agreement will grow in complexity the more goals the Surety tries to accomplish in the agreement and the more key subcontractors try to either settle or reserve disputed claims. First and foremost upon default of the original contractor, the subcontractors want to get paid as soon as possible for labor and materials furnished to the project prior to default. The subs' claims for nonpayment will likely include unresolved change orders and

[12] Care should be taken to adapt these forms to the laws of a particular jurisdiction and/or the particular terms of the original subcontract or the bonded contract.

work that has been furnished but not yet billed, inspected and/or approved by the owner. In any project halted by default, there are typically a number of change order issues that have not been fully formalized where, despite the language of the general contract and the subcontracts, work has at least been partially performed on the change order work without written authorizations and executed change orders. Flushing out these pending change order issues is critical also to the Surety in negotiating the terms of a takeover or tender agreement with the owner and the respective financial responsibilities of the parties. Furthermore, reaching agreements on pending change order issues minimizes the Surety's risk of making commitments to a subcontractor without getting commitments of commensurate payment from the owner for the extra work. The Surety and subcontractor can then attempt to resolve payment and change order issues by adjusting line items in the ratification agreement that address change orders, adjusted subcontract amount, value of work completed, and sums currently due (see, line items (b), (c), (d) and (h), Exhibit A) or they can agree to reserve the subcontractors' claims for extras. Disputes as to the percentages of work completed should be resolved as the subcontractor recommences its work and bills the completion contractor for the work performed.

Secondly, the subcontractor will sometimes seek payment for delay and impact claims, as well as demobilization and remobilization expenses allegedly caused by the original contractor prior to as well as stemming from the default. Legally, the Surety may have any number of defenses to the consequential damages claimed by the subcontractor. Practically speaking, however, the Surety may be motivated to negotiate settlement of these claims if the subcontractor is acknowledged to be critical to job completion. If a critical subcontractor's claims for impact and delay are left unresolved, or worse, headed to litigation with the Surety, its motivation and cooperation during the completion phase of the work will be questionable

[13] Attached as Exhibit B is a Ratification Agreement memorializing the results of a complicated negotiation and

even if payment for its prior contract work is settled (as above) and its revised completion contract price is resolved (as below). As significantly as the subcontractor's motivation and cooperation, the Surety risks overpayment of the sub's claims if it negotiates a revised completion price with sub (as below) and reserves the settlement or litigation of the sub's impact and delay claims for a later date. A wise and savvy subcontractor will undoubtedly minimize its risk for claim nonpayment by hiding at least part of its claim costs in its proposed completion price to the Surety.

Lastly, the Surety may find it prudent to negotiate revised completion prices with some key subcontractors during the ratification agreement process. Regardless of how quickly the Surety performs its default investigation, subcontractors will frequently take the position that their subcontracts terminated when the original contractor's contract was terminated for default. As discussed in Section I above, the Surety may have a variety of contractual provisions at its disposal to argue against the automatic termination of subcontracts depending on the terms of the general contract, the subcontracts and the General Agreement of Indemnity. Despite the legal arguments that may be available to the Surety, subcontractors may have little or no interest in returning to a troubled job, especially when re-commencement of work has been long delayed. Where a subcontractor is deemed critical to job completion due to any number of factors, including the reasons set forth in Section I above, and the estimated cost of hiring a replacement subcontractor is high, the Surety may look to negotiate a revised contract price with the sub during the ratification agreement process.

In situations where the Surety resolves outstanding contract payments, change orders, demobilization and remobilization costs, delay and impact claims and revised costs to complete in the ratification agreement process, the Surety would amend the accounting line items of the ratification agreement accordingly. The Surety would increase the value of the

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incorporating the kind of detailed provisions that may be demanded by a sophisticated contractor.

approved change order line (see, line item (b) in Exhibit A) in order to increase the value of the revised subcontract (line item (c), Exhibit A). Then it can funnel some of these funds to the subcontractor (to pay for delay and impacts prior to default, for example) at the time that the agreement is executed by adjusting the value of the work completed to date and the amount currently due (line items (d) and (h), Exhibit A). The balance of the agreed upon funds would be disbursed to the subcontractor by the completion contractor as completion of the project progresses.

One of the major difficulties in negotiating a revised completion price with a subcontractor during the ratification agreement process is that the completion contractor or construction manager has not yet been contracted. Therefore, the completion construction schedule will likely not have been established. Consequently, the sub does not know when it will start its work and when it is expected to be completed. The start and stop dates may affect the subcontractor's price, particularly if it could involve winter work or traditional periods of high activity such that the sub would have to employ a great deal of overtime labor in order to meet the completion contractor's schedule. If a subcontractor insisted that such matters be negotiated and addressed by a ratification agreement, the Surety could estimate the start time and the duration of work for the subcontractor so that it could estimate its cost. The Surety could insert a clause in the ratification agreement that would allow for an escalation in price if the completion construction schedule is not met for reasons for which the sub is not responsible (see Exhibit B, paragraph 4). In jobs with sophisticated and sensitive equipment that was exposed to the elements during the project shut down period (for example pumps, switch gear, motor control panels), a subcontractor would likely not be able to give a revised completion price until the equipment is inspected and tested. Furthermore, depending on the extensive nature of testing or its invasiveness, the sub may not even want to price the cost for such testing. Paragraph 8 in Exhibit B address this issue and the pricing for patent defects

that are identified during the inspection and testing process. The overhead and profit figures are numbers taken from an underlying contract in an actual case and are not intended to be representative of the typical scenario. Paragraph 9 in Exhibit B is intended to address latent defects that are not identified during the inspection and testing phase but which arise during construction.

B. Practical considerations regarding how the surety's decision on completion options bear on the desirability of using ratification agreements

Once a ratification agreement has been executed, it can be assigned to a completion contractor, a construction manager, the owner or remain with the Surety. Contemporaneously with the ratification agreement negotiation process, the Surety is continuing its claim investigation and evaluating the best course of action for completing the defaulted project. In the course of its investigation, the Surety will either determine itself or obtain from consultants an estimate of the cost to complete the defaulted project. A good estimate will have broken down the various items of work left to complete along with cost estimates to perform each segment of the work. This cost estimate will assist the Surety in negotiating the completion of the project regardless of the method chosen by the Surety to complete the project. What follows is a discussion regarding the practical considerations facing the Surety in choosing from a variety of methods to complete a job and some recommended suggestions for resolving problems that may arise in the different scenarios.

1. The Surety Completes Itself:

An increasing number of sureties have hired an internal staff of engineers and accountants to complement their claims professionals. Depending on the scope and complexity of the job completion at issue, the Surety may choose to complete the project using its own in-house resources. Regardless of the mechanism chosen to complete a project, each job completion effort typically needs to employ a project manager, a job superintendent and

accounting or bookkeeping back-up to process pay applications, change orders and progress payments. These functions could be staffed by the Surety's own personnel or through the employment of consultants.

When the Surety elects to complete a job itself as the completion contractor, the option of using of ratification agreements will generally be desirable for the Surety, with the ratification agreements remaining with the Surety throughout the completion process rather than being assigned to a third party. The Surety's in-house project manager (typically the claim professional or the Surety's chief engineer) and the project superintendent (the Surety's chief or staff engineer) would manage and direct the work of the ratified subcontractors. The Surety would have each subcontractor name the Surety as an additional insured on its insurance policies. However, before embarking on this option, the Surety should nonetheless obtain project-related insurance in its own name not only to fulfill the insurance requirements of the general contract, but to protect itself from any gaps of coverage that would remain after the subcontractors have named the Surety as an additional insured. Naturally, the option where the Surety completes the project itself would be the most labor-intensive choice for the Surety. However, it may be the Surety's best option if the job is a straightforward construction project with few or no complicated systems left to install. Also, this option would seem more viable the farther the defaulted contract was toward completion. A word of caution is warranted, however, in that the Surety must determine whether it needs to have a general contractor's license in order to execute construction work in a given jurisdiction.

Where the Surety acts as the completion contractor, there is no entity other than the Surety to perform the general conditions function on the job. One method to cover the general conditions on the project would be to hire a construction company to perform such functions as general project clean up, general and rough carpentry, spot painting and a number of other issues that arise on such jobs. Another method for satisfying the general conditions

coordination on the project is to expand the ratified subcontractors' responsibilities through the appropriate change orders. For instance, the original contractor may have been supplying a crane, hoist elevator and/or scaffolding to the project for various subcontractors to use. Rather than execute new subcontracts to arrange for such services, the Surety may expand the ratified subcontract of one or more subcontractor by change order.

Despite the fact that this option would tax the internal personnel resources of the Surety, the Surety may chose this as its most desired option if the estimated or actual re-let premium that a completion contractor or construction manager would charge is deemed to be exorbitant. Should the Surety decide that it either does not have the in-house resources to manage a contract completion itself or through the use of consultants or if the re-let premium from a completion contractor is deemed to be reasonable, the Surety may chose another completion option.

2. The Owner Completes

Whether by design or due to the break down in negotiations between the Surety and the owner, the owner may choose to complete the defaulted project itself. The desirability of using ratification agreements where it appears that the owner intends to complete depends on the circumstances, including the particular relationship between the owner and the Surety. Where ratification agreements are executed and it later becomes evident that the owner intends to complete, the use of the agreements will also depend on the particular circumstances.

The downside of executing ratification agreements where the owner later decides to complete is that the owner may decide not to use the ratified subcontractor, thereby possibly resulting in the Surety receiving no net financial benefit in exchange for any financial concessions made to the subcontractor. On the other hand, ratification agreements may prove to be financially advantageous to the Surety even where the owner decides to complete.

If the relationship with the owner is friendly or, at least not strained, the Surety may be able to assign the ratification agreements to the owner. The owner could then assign the agreements to the completion contractor it obtains to accelerate the completion process, thereby theoretically reducing the project's completion cost. Should the relationship between the Surety and the owner be acrimonious or break down entirely such that the owner would not accept assignment of the ratification agreements, the completion prices contained in the ratification agreements would at least provide a benchmark for the completion cost for which the Surety believes it is responsible. The collective value of the ratification agreements together with some estimated costs for general conditions and contract items that had not been bought out by the original contractor would form the basis for determining the Surety's financial responsibility. The Surety would likely argue that the owner would be responsible for any completion costs in excess of the ratification agreement prices and limited additional estimated costs. Should the Surety's performance bond responsibility have to ultimately be determined by litigation, the Surety would then be in a better settlement or litigation posture by having the majority of its completion cost estimate comprised of subcontractors' prices locked in by ratification agreements rather than comprised solely from an estimate of completion prices. A completion price based solely on an engineer's estimate can be rebutted by empirical data compiled by the owner during the completion process. The Surety would be primarily left with having to argue about the unreasonableness of the owner's completion prices and its failure to mitigate damages.

Therefore, ratification agreements may or may not be a valuable tool where an owner decides to complete, depending on the particular circumstances.

3. The Surety Completes Using a Completion Contractor

The Surety will generally favor the use of ratification agreements where it successfully negotiates a takeover agreement with the owner and determines that its best course of action

for completing the defaulted project is to hire a completion contractor. In this circumstance, it becomes incumbent on the Surety to carefully coordinate the text of its ratification agreements with the text of the contract negotiated with the completion contractor so that the Surety realizes the full benefit from the ratification agreements.

Typically, the Surety will incorporate the original contract by reference into the completion contract. Therefore, the contracted delivery system for project completion would be the same as the one contracted for by the original contractor. There would then be no dissimilarities between the general contract incorporated by reference into the ratification agreements and the general contract that the completion contractor agreed to perform. If the terms of the completion contract deviate from those of the bonded contract, it is critical that the Surety assess how these deviations should either be addressed in a ratification agreement to be negotiated or how these deviations bear on the utility of previously executed ratification agreements once these are assigned to the completion contractor.

The Surety will want to have the completion contractor break down its price among the various divisions of work necessary to complete the project. The timing of the Surety's negotiations on ratification agreements is an important consideration for the completion contractor. If the completion contractor intends to use the original subcontractors to complete the project then it needs to incorporate the subcontractor's prices into its completion price. Furthermore, the completion contractor needs to evaluate and analyze the project completion and discuss it with the subcontractors it is going to use to complete the job in order to develop its strategy for project completion.

The completion contractor may break the project down differently from the original contractor. It may then look to shift some of the contractual responsibilities around so that the subcontractors have slightly different scopes of work to complete from that which remained in their subcontracts at the time of the default. If the ratification agreement prices are already

locked in, then theoretically, an increase in scope of work to one subcontractor would be offset by a commensurate decrease in the scope of work of another subcontractor. However, the Surety will have to be involved in the price discussions for the changed scope of work so that the cost resulting from shifting scopes of work around does not unnecessarily escalate the overall price. The Surety would not have to revise its ratification agreement prices, but the ratification agreements would be amended by the completion contractor after assignment in order to address the shifting work scopes.

Additionally, the subcontractors' scope of work may change as the completion contractor seeks to incorporate items of work into the ratified subcontracts that were not previously bought out by the original contractor. The Surety will be responsible to the completion contractor for the increased prices resulting from the additional scope of work to subs from the buy out gaps caused by the original contractor. However, the Surety should evaluate whether the issues in question resulted from true buy out gaps of the original contractor, unresolved change orders or inaccurate or false interpretations by the subcontractors as to the scope of its original or revised subcontract. Alleged buy out gaps may actually be a second attempt by subcontractors to convince a contractor to pay for a scope of work that the subcontractor missed in its bidding process but for which it subcontracted to perform nonetheless. By ratifying its subcontract, the subcontractor has recommitted to performing its work at the price quoted in the ratification agreement. It must complete the full scope of its work, including punchlist and warranty work, and it should not have the opportunity to re-negotiate its price to cover the price of items that it inadvertently omitted from its original bid.

On the other hand, the owner and/or its design and engineering team may look to inadvertently or intentionally shift the financial responsibility for some change order work that had not been executed prior to default to the Surety. Allegations of buy out gaps may actually camouflage design deficiencies so that the owner may try to get the Surety to pay for work that

is not depicted on the project's plans and specifications. Ratification agreements do not resolve this problem that would exist whether or not the original contractor was defaulted. However, the ratification agreement process should flush out these issues.

Further complications arise when the completion contractor either refuses to use a particular subcontractor that executed a ratification agreement or insists on using its own subcontract, thus disregarding the ratified subcontract. In both instances, the Surety is still protected by the ratified subcontractors' prices. In the first situation, the Surety has a benchmark price to compare against the completion contractor's price for the same division of work. As long as the scope of work for the sub that the completion contractor wants to use and the ratified sub are essentially the same, the Surety may refuse to pay the completion contractor the excess cost caused by that contractor's desire to engage a different subcontractor. Hopefully, the two parties can reach a negotiated solution should the completion contractor refuse a reduction in its completion price (whether this matter can be resolved may depend on the reasons for the completion contractor's reluctance to use the ratified sub).

More difficult to resolve is the second situation above where the completion contractor agrees to use the former subcontractor but insists that the subcontractor either execute the completion contractor's own form of subcontract or consent to the incorporation of specific clauses into the ratified subcontract. For example the completion contractor may insist on the inclusion of "no damage for delay" or "termination for convenience" clauses that were not included in the original subcontract. Or the completion contractor may require that the subcontractor be responsible for actual damages in addition to liquidated damages in the event that the sub causes a project delay. Consequently, the subcontractor would likely come back to the Surety seeking additional funds claiming that its risks of financial exposure on the job have increased. If the Surety is unsuccessful in convincing the completion contractor to drop

its contractual demands or unable or unwilling to provide a hold harmless agreement to the completion contractor to cover the exposures that the contractor wants to pass down to the subcontractor, the Surety may have to pay the subcontractor or completion contractor more money. The Surety could revise the amounts currently due under the ratification agreement or enter into a side agreement capping the additional funds to be paid by the Surety upon the subcontractor's presentation of documented additional completion costs actually incurred during the completion process resulting directly from the completion contractor's additional contract terms. This problem may be prevented or at least mitigated if the Surety and the prospective completion contractor reach understandings regarding the use of the original subcontracts during the completion bidding process.

In sum, ratification agreements will likely be a valuable tool where the Surety takes over a contract and retains a completion contractor, but there is a compelling need in these contexts to carefully coordinate the text of the ratification agreements with that of the completion contract.

4. The Surety Tenders a Completion Contractor or Construction Manager to the Owner

Under the ideal tender scenario, the owner accepts a tender from the Surety of a completion contractor along with a check representing the difference between the remaining contract balance and the estimated completion cost, the owner releases the Surety from further exposure under the performance bond, the completion contractor agrees to complete the original contract, and the completion contractor agrees to use the original subcontractors bound by ratification agreements. Under this scenario, the use of ratification agreements can assist the Surety in securing relatively smooth closure to a performance bond claim. Having executed ratification agreements reduces the unknowns associated with typical default project completion and goes a long way toward convincing the owner that the tendered check by the

Surety will cover all anticipated completion costs and convincing the completion contractor to accept a more reasonable completion price.[14]

Tender negotiations are sometimes far more complicated than that described above and these complications can, in turn, raise issues as to whether the use of ratification agreements would be desirable and, if so, the content and timing of such agreements.

One problem may arise in the event that the completion contractor insists on using its own subcontract form or incorporating certain provisions of its subcontract form into the ratified subcontracts. Another problem may arise if the completion contractor is not inclined to use one or more of the original subcontractors. These issues are discussed above in the context of the takeover and completion of a project. However, unless the Surety has worked out the subcontract issues with a tendered contractor beforehand or a tri-party agreement is used to accomplish the tender arrangement, the issues posed in the tender context may differ from those in the context of a take over since the Surety may not be in control of the negotiations with the tendered completion contractor. The Surety would then be left with having to try to convince the owner to insist that the completion contractor use the original subcontractors and the form of subcontract used by the original contractor. However, the owner may not wish to make such an insistence. The likelihood of these issues arising may cause the Surety to consider the desirability of using ratification agreements to the extent that it appears that the performance bond claim will be resolved by a tender.

Another complicating factor bearing on the use of ratification agreements is where the owner looks to use a different project delivery system for job completion from the one contained in the original contract and wants to structure a tender arrangement on that basis. One implementation of a new delivery system would be changing from a hard bid lump sum

[14] However, if the tender agreement does not release the surety from further financial responsibility for latent defects or defective work, the Surety will likely still want to be involved in evaluating the responsibility for latent

contract to a construction manager with fixed fee or fee at risk. Depending on the complexity of the project and the surrounding market conditions, there may be a paucity of qualified, competent contractors willing to bid on a lump sum completion contract with unknown risks. Additionally, holding fast to a competitively bid, lump sum contract price approach on a complex job with significant unknown risk may result in an arbitrarily high completion price as the contractor has to build in contingencies for the risk it is being asked to assume. Allowing a construction manager to study the project and evaluate risks while initiating some construction may on its face present the best opportunity to deliver the project in an expeditious fashion while avoiding price escalation for unknown risks through the closed bid, lump sum price approach.

Under the circumstances described above, the Surety may consent to the owner's wish to engage a construction manager with at least a partially guaranteed fee as the tendered contractor rather than a lump sum price contractor. A reason for the Surety's consent could be that it is trying to reach some accommodations with the owner to increase the chances for an expeditious project completion in exchange for owner concessions on liquidated and/or actual damages resulting from the default, contested change orders and other factors.

The owner's interest in accepting a buy out from the Surety and funding a completion mechanism different from that in the bonded contract may complicate negotiations regarding a tender in innumerable respects. There may, however, be reasons why a Surety would be prepared to discuss a tender under these circumstances. Under these circumstances, having a completion contract different from the original contract raises questions as to the efficacy of using ratification agreements since these would incorporate a different general contract from the new one to be used in project completion. Where an owner seeks a tender predicated on a revised delivery mechanism, the Surety will need to carefully consider whether ratification

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defect work and work damaged during the project shut down period that could be covered by insurance and not

agreements would yield a net benefit. If a Surety facing a "tender/revised contract" scenario has entered into one or more ratification agreements, it will want to analyze the construction management agreement offered to the completion contractor in order to identify clauses that may result in completion price escalation. There may be additional risks passed on to the construction manager in the construction management agreement compared to the risks assumed by the original contractor. The construction manager may, in turn, pass the additional risks on to the subcontractors, especially if the construction manager uses its own subcontract form that incorporates the new "general contract" by reference. The subcontractors may take the position that their ratification agreements do not bind them to complete a different contract and may use this argument to either look to the Surety to give them more money due to increased risk, or increase the completion prices that they submit to the construction manager. Naturally, the construction manager will pass these increased costs on to the owner and the owner will seek to increase the buy out price offered by the Surety.

Nonetheless, even under this complicated scenario, the use of ratification agreements may, depending on the particulars, yield a net benefit. Ratification Agreements or a variant of these agreements may be desirable in order to secure a commitment from a subcontractor to return to the project while the terms of a settlement of a performance bond claim are being negotiated. In addition, having many of the original subcontractors under ratification agreements, allows the Surety to easily calculate the price associated with the accommodation to the owner in consenting to a different delivery system. The owner would be receiving a benefit from the increased chance for expeditious project completion rather than facing further delays stemming from a protracted lump sum completion process that would involve development of a re-bid package, perhaps a revised set of drawings that conform to all the changes and explanatory sketches developed prior to default (this would be more likely on a

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the performance bond.

very complex and sophisticated project), and the delays that will undoubtedly result from arguments over patent and latent defects because the contractor had insufficient time to study the project during the competitive bidding process. Arguably, the price for this convenience is the difference between the collective ratified subcontracts along with additional estimated costs for general conditions and buy out gaps and the price submitted to the owner from the construction manager after getting revised prices from the subs due to the increased risks and costs passed down to the subs under the new delivery system. Thus, depending on the circumstances, ratification agreements may facilitate complicated negotiations between the Surety and the owner regarding a tender or buyout price even where the owner introduces the additional complication of a different completion mechanism.

In sum, ratification agreements may facilitate the Surety's successful exercise of a tender, though their desirability and the content of these agreements in these contexts depend on a careful evaluation of the unique facts underlying the available completion options.

IV. ***Conclusion***

A critical issue in a Surety's evaluation of a defaulted project is whether to facilitate the return of the original subcontractors to complete their work on the project and, if so, the most effective and cost efficient vehicle for doing so. The primary tool for binding the original subcontractors to the project remains the ratification process, though the invocation of an assignment option may sometimes be advantageous. While it is possible to identify issues and considerations that may arise in the course of this process, every completion context is ultimately unique. Therefore, strategies for addressing the original subcontractors should be developed on a case by case basis only after a careful and particularized analysis of the issues posed by the defaulted project.

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Mr. Horowitz graduated from Tufts University in 1973 and New York University School of Law in 1976. He is a member of the Connecticut, Massachusetts, District of Columbia and Texas Bars. Over the last thirty years, he has engaged in a varied litigation practice. For the past nineteen years, his practice has focused primarily on fidelity and surety claims. He has co-chaired the surety presentation at the ABA Fidelity and Surety Mid-Year Meeting and presented papers at the ABA Fidelity and Surety Mid-Year Meeting, the Northeast Surety and Fidelity Conference, the National Bond Claims Association Conference, and the Surety Claims Institute. He is a Co-Chair for the ABA Fidelity and Surety Committee. He is co-editor of the TIPS CGL/Builder's Risk Monograph and is a contributor to the numerous TIPS publications, including the Miscellaneous Bond Monograph, the Law of Miscellaneous & Commercial Surety Bonds, and The Law of Payment Bond Manual.

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Christopher Morkan is member of FORCON International located in Avon, Connecticut with almost twenty years experience in the surety and insurance industries. Chris began his career in the surety claim department of Travelers Indemnity Company and since held management positions with Continental Guarantee & Credit Corporation and Aetna Casualty & Surety Company. In addition, he was a founding member of the surety department of Orion Specialty Insurance Company and he later oversaw the development and management of a variety of specialty insurance programs on behalf of Orion and Frontier Insurance Group. Chris holds a number of insurance designations including his Associate of Fidelity and Surety Bonding and is a licensed insurance producer and claims adjuster in the State of Connecticut.

GREGORY ARNOLD

Gregory Arnold is a Bond Claims Professional with The Hanover Insurance Group, Inc., in Worcester, Massachusetts, where he responds to contract surety, commercial surety and fidelity claims.

Greg grew up in Schenectady, New York. After high school he served as a military courts-martial reporter in the United State Marine Corps, with duty stations in Okinawa, Japan and the Philippines. Greg then graduated from Union College and University in Schenectady, New York with a Bachelors of Science in Political Science, *Cum Laude* and with Departmental Honors, in 1980. He received his Juris Doctorate from Western State University College of Law in Fullerton, California in 1984. Greg is currently matriculated in the LL.M (Insurance Law) program at The University of Connecticut School of Law, Hartford, Connecticut.

Greg started his surety claims career with Great American Insurance Company in Orange County, California and then transferred to Great American's Home Office in Cincinnati, Ohio. He then accepted an officer's position in the Claims Department of Highlands Insurance Company in Houston, Texas. Before accepting a position in the Bond Claims Department of Hanover, Greg founded Claims Management Associates, Inc, providing primarily desk relief and run-off assistance to smaller sureties in transition.

Greg is a regular attendee at surety industry events, such as the TIPS Mid-Winter Meetings; The Forum on the Construction Industry; the Surety Claims Institute Annual Meetings; the National Bond Claims Association Annual Conferences; the annual Northeast Surety & Fidelity Claims Conferences; the Chicago Surety Claims Association Monthly Meetings; and others.

Greg was quoted in *Insurance Week* Magazine, *If It's Not Illegal...It's Bondable*, March 1998, was a contributing writer for the TIPS *CGL, Builder's Risk, and Surety Claims* Monograph published in 2004 by the American Bar Association, and has presented papers and participated on panels during various national surety educational events. These include: "The Surety's Good Faith Investigation", presented at the CMA Group, Inc. National Claims Conference in Chicago, IL, April 25, 1989; "The Good, Bad and Ugly - Lawyers, Consultants and Company People - Traveling Down The Same Road Together", a panel presentation at the National Bond Claims Conference, Pinehurst, NC 1994; and *Treatment of Pay-When-Paid Clauses Under Federal Law on Bond Projects in Virginia*, presented at the Surety Association of South Texas, San Antonio, May 17, 2000.

Greg is licensed as a Property and Casualty Claims Adjuster by the Texas Department of Insurance.

EXPERT REPORT OF GREGORY S. ARNOLD, 2014 Misc. Filings LEXIS 6987

UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON

Case No. 3:12cv5982

April 17, 2014

Reporter
2014 Misc. Filings LEXIS 6987 *

STELLAR J CORPORATION, a Texas Corporation, Plaintiff, v. ARGONAUT INSURANCE COMPANY, an Illinois corporation, Defendant. UNISON SOLUTIONS, INC., an Iowa Corporation, Defendant -- Third Party Plaintiff, v. TRAVELERS CASUALTY AND SURETY COMPANY OF AMERICA; XCHANGER, INC, a Minnesota corporation; and ROHDE BROTHERS, INC., a Wisconsin corporation, Third-Party Defendants.

Expert Name: ***Gregory S Arnold***, , J.D., , LL.M.

Judges

[*1] HONORABLE RONALD B. LEIGHTON

Text

EXPERT REPORT OF STELLAR J CORPORATION IN CONNECTION WITH THE MEDIATION COMMENCING APRIL 30, 2014

I, ***Gregory S. Arnold***, reviewed portions of the following materials in preparation for this report:

➢ The Argonaut Insurance Company Claim File, consisting of twelve 3-ring binders of Bates-stamped documents;

➢ The Pleadings, Motions, and Deposition Transcripts in this case, consisting of three 3-ring binders of documents, including the April 16, 2012 Order On Defendant's Motion For Summary Judgment;

➢> The Law of Performance Bonds, Second Edition (2009);

➢ The Construction Law Handbook (2009); and

➢ The case of Colorado Structures v. Insurance Company of the West.

I was not given any instructions by Stellar J Corporation (hereinafter simply **[*2]** "Stellar J") or its attorneys on the content or structure of this report. This report contains my own observations, impressions and conclusions, without influence from any company or person.

My qualifications include almost thirty (30) years of handling surety claims of all types as both a surety company claims adjuster and as an outside consultant. I have a JD and an LL.M (Insurance Law). Part of my LL.M curriculum was a course in Fidelity and Surety Law. I received my in-house training from Great American Insurance Company. A large percentage of my experience includes the handling of performance bond claims. I have handled surety claims in all regions, and most states, in the United States. I have responded on behalf of surety companies to performance bond claims in the state of Washington. I have been qualified as an expert in other surety cases. [1] Based upon my experience and education, I believe that I am qualified to provide an expert opinion in this case.

[*3]

Background on the Methodology of Handling a Performance Bond Claim:

A surety claims professional, or adjuster, learns a standard initial approach to responding to a claim against a bond. The first task is to confirm coverage, so as to avoid acknowledging a claim that is on a project or contract not bonded by that particular surety, and perhaps, because of mistaken assumptions by the claimant, by no surety. With modern technology the coverage confirmation can be immediate by resort to computer databases. Sometimes there are unrecorded bonds or some other delay or issue, so confirmation can sometimes take longer than one might expect.

Next is to prepare a response letter to a claimant as soon as possible, but ideally no later than the time required by state statute. Sometimes a claim is not acknowledged within the required time, and an adjuster attempts to explain the reasons for the delay to the claimant, with an apology. The acknowledgement, or first response letter, is typically based upon a template, sometimes referred to a form letter. Details of the bond and the claim, such as the bond number, claim number, project and obligee, are included in a caption, and the name of **[*4]** the claimant and its address are inserted in the proper places. In the case of payment bond claims, the acknowledgment letter is often accompanied by a blank proof of loss form, which the adjuster asks the claimant to complete and return with any claim support documents not already received by the surety. In the case of a performance bond claim, it would be rare for such a proof of claim form to accompany an acknowledgment letter.

Typical information requested from an obligee in the case of a performance bond are copies of contracts; copies of change orders; copies of approved payment estimates between the obligee and the claimant; plans, drawings, specifications pertaining to the principal's scope of work; communications between the obligee and claimant pertinent to any disputes; and similar documents within the control of the obligee.

In addition to the acknowledgment letter, a standard letter to the principal is prepared, usually also based upon a template. The principal is also an indemnitor, so writing to the principal is also writing to at least one of typically several indemnitors on an account. The letter to the principal encloses the notice of claim from the claimant, plus **[*5]** any claim support documentation received to date.

Depending upon the severity of the claim or number of other claims already received against the bonds of the same principal or account (an account can be more than one named principal or group of

[1] Bank One Texas, N.A. v. Highlands Insurance Company, Highlands Underwriters Insurance Company, Brown-Carpenter Curtainwall Systems, Inc., Brown Carpenter & Company, Dee Brown Masonry, Inc., and Carpenter Carruth & Hover, 113th District Trial Court, Superior Court, Harris County, Texas (1997) (Trial Docket 91-23339).

companies that are somehow related for underwriting purposes), the adjuster may take immediate action to commence the independent surety investigation, and prior to receipt of anything in response from the principal, other than perhaps a first telephone call with the principal. This immediate investigation can include review of the documents received, self-education about the technical issues involved in the claim and, where complex materials, equipment, systems, etc. are involved, the lining up and/or actual retention of a technical consultant or expert, such as an independent engineer or surety consulting company. Typically a surety consulting company will be staffed by engineers. Where they do not have the requisite expertise for an assignment, they will retain a properly credentialed and/or experienced person to help respond to the claim.

Also, depending upon the severity of the claim or number of other claims already received against **[*6]** the bonds of the same principal or account, the adjuster may or may not send a letter to all of the several indemnitors, including the principal/indemnitors. Such letters are also based upon a template or form letter, with appropriate modifications. In the case of low-risk assessment in response to a claim, such a letter to indemnitors may never go out. Where there is a reassessment of risk, leaning to higher risk, such a letter usually gets mailed by the adjuster or its outside counsel, and is typically sent several weeks or months after the initial letters to the claimant and principal have gone out.

Where the adjuster immediately perceives significant risk against one or more bonds, the surety company typically reacts in a team approach, involving the agent, underwriter and claims department. Risk assessment can involve outside counsel and surety consultants early-on in the life of a claim. The result of this surety company team approach, with or without the assistance of outside professionals, is the mailing of certified letters to the indemnitors to, at a minimum, ensure all indemnitors are on notice of the claim(s) and, occasionally, demanding immediate action by the indemnitors, **[*7]** including settlement of any undisputed claims and/or the posting of collateral to secure the surety against its exposure. Where the General Indemnity Agreement among the surety and the indemnitors requires it, the surety company posts reserves prior to demanding any collateral from the indemnitors.

Depending upon the experience, skill level and particular practice of the surety claims handler, he or she may also at this time look for dispositive issues, such as failure to perfect a claim by giving notices as required by the bond, contract and/or statute, and such issues as the possible expiration of the statute of limitations. The adjuster may also seek an outside legal opinion, especially when handling a claim in an unfamiliar state, and an adjuster may give some consideration to the filing of a declaratory judgment action, or paying a claim amount into the registry of a court, as a means of handling a disputed claim.

The claims handler may also review the Bond File and the Underwriting File that are maintained by the surety's underwriters, and/or ask the procuring agent for certain documents relevant to one or more particular bonds or the underwriting process in general (financials **[*8]** statements, for example). Other claim handlers will await receipt of a proof of loss form (if a payment bond claim) or other supporting documents from a claimant before performing this additional analysis. Depending upon the type of claim, severity of claim, or other concerns of a surety with respect to a claim, this underwriting review becomes more important and more immediate.

If the matter ends up in suit before the dispositive issues analysis can be done, the handler will typically defer to counsel for the notice perfection and statute of limitations issues analysis, while monitoring and directing that litigation. When handling a claim in unfamiliar territory, a claims adjuster will typically confer with a local attorney to ensure there are no surprises in an analysis even before a claim goes to suit. The idea is to respond timely and handle a claim fairly so as to avoid unnecessary litigation. Sometimes the claims adjuster has little control over whether suit is filed, either because the claimant takes an

unreasonable position or because the claims adjuster is convinced (sometimes wrongly) that his or her analysis of dispositive issues (notice perfection and statute of limitations) **[*9]** is correct.

In this case, according to the April 16, 2014 Order On Defendant's Motion For Summary Judgment, denying Argonaut's Motion For Summary Judgment, the Court stated that Argonaut's interpretation of the statute of limitations was wrong, and the limitations period stated in its bond was impermissible and void under Washington law.

Typically, the review of the underwriter's records will still be performed by the surety claims handler, regardless of the pendency of any litigation.

Argonaut Insurance Company's Claims Handling:

Initial Claims Response:

The March 29, 2012 Claim Acknowledgment Letter:

From an initial administrative perspective, Argonaut handled the Stellar J claim the same as most surety companies would. After receipt of the March 26, 2012 notice of claim from Stellar J [2], there were internal communications between the underwriting department and the claims department, and there were communications involving the agent. A timely response letter dated March 29, 2012 [3], was sent to Stellar J, acknowledging the claim. For the most part, at this point in the claims response process, Argonaut's handling of the Stellar J claim was fairly standard, at least on **[*10]** the surface

However, there were some irregularities.

One such irregularity was the content of the acknowledgment letter to Stellar J. There was no mention of a claim number, and surety claim acknowledgment letters invariably contain some reference to a claim number in the caption. Some surety companies use the bond number followed by some code as the claim number. Argonaut's claims department may do this, but there is no indication one way or the other.

Also, while a performance bond claim acknowledgment letter typically requests several enumerated relevant contract documents from the claimant to support the claim, Argo's March 29, 2012 letter did not request a single document by either document name or type. Rather, Argonaut requested "...that your company complete and return the enclosed Proof of Claim form and the supporting documentation requested in the form." The Proof of Claim form [4] requested the types of documents one would request from a payment **[*11]** bond claimant, such as paragraph 4, "Type of material supplied or labor furnished"; paragraph 8 (F) "Total Payments Received to Date"; paragraph 9 "Date of Notice to Owner"; paragraph 10 "Date of Notice of Nonpayment to Bonded Principal"; paragraph 11 "Date of Notice of Nonpayment to Surety"; paragraph 15.d, "Copies of all checks received from the principal (whether on this project or any other project), including joint checks, since you started work on this project"; and paragraph 1.e., "A copy of any ledger or similar record listing the dates and amounts of all payments received from the principal or on behalf of the principal". An obligee does not supply material or furnish labor to its own material supplier. An obligee does not receive payments from its own material supplier. An obligee does not give a notice to owner in connection with a claim against its own material supplier. An obligee does not give a notice of nonpayment to its own material supplier. An obligee does not give a notice of nonpayment to a surety of its own material supplier. An obligee does not receive checks from its

[2] Bates AIC 006690.

[3] Bates AIC 006884.

[4] Bates AIC 006692.

own material supplier. An obligee does not maintain a ledger or similar record of payments received **[*12]** from a principal, because an obligee does not receive such payments from a material supplier. Rather, an obligee makes payments to a material supplier, unless the material supplier is in breach of its own materials agreement.

In my experience in working for small, medium-sized and large surety companies, such Proof of Loss or Proof of Claim forms go only to payment bond claimants. Occasionally, because of inexperience or the volume of claims, or secretarial / administrative oversight, a claims handler will mistakenly allow a proof of loss form to go out to an obligee. I have made the same mistake myself. It is embarrassing, and one typically met with a phone call from an obligee asking if I really wanted the obligee to complete a form meant for a payment bond claim. An apology and instruction that there is no need to complete the form is sufficient to resolve the mistake. I have never seen a proof of loss form for a performance bond claim. They might exist in some surety company claims **[*13]** departments, but I've never seen one.

Argonaut's Claims Handling Post Initial Response:

Argonaut was seriously concerned about its principal during the first week of having received the Stellar J claim. As early as April 2, 2012 [5], a very short period of time after receipt of the Stellar J. March 26, 2012 notice of claim, Argonaut was sending certified letters to its indemnitors, demanding collateral. The text of paragraph 2 of 3 paragraphs is as follows:

"Please be advised that due to recent events and activities, the Surety has grown concerned about a direct adverse affect on the Surety's risk under the Bonds. As such, at this time, in accordance with the terms and conditions, specifically contained in paragraph 3, of the General Indemnity Agreement, ("GIA"), signed by each of you, a copy of which **[*14]** is enclosed for your review, the Surety hereby makes formal demand on the Indemnitors to immediately deposit $ 500,000 with the Surety, which is a sum of money equal to the anticipated liability and losses under these Bonds. Such funds will be held by the Surety as collateral against potential future Losses or if need be, can be used by the Surety to pay losses."

The next day, on April 3, 2012 [6], Argonaut sent another letter to the same indemnitors, addressing collateral demand issues. The second of five paragraphs states verbatim as follows:

"Please be advised that due to recent events and activities, the Surety has grown concerned about a direct adverse impact on the Surety's risk under the Bond(s). As such, in accordance with the terms and conditions, specifically contained in Paragraph 10, of the General Indemnity Agreement, ("GIA"), signed by each of you, a copy of which has been previously provided to you, the Surety may, in its sole discretion, determine one or more of the **[*15]** following: (a) the Indemnitors financial condition has been or is believed to be deteriorating; or (there has been or is believed to be some other challenge that adversely impacts the Surety's risk, under the Bond(s), Argo may at any time demand that within thirty (30) days of such demand, the Indemnitors shall procure a full and complete release of any and all bond(s) issued by the Surety to any of the Indemnitors by providing competent written evidence of release-satisfactory to Argo. Furthermore, failure on the part of the Indemnitors in procuring a full and complete release of any and all bond(s) issued by the Surety to any of the Indemnitors by providing competent written evidence of release satisfactory to Argo of any bond(s) within thirty (30) days of such

[5] Bates AIC 006951-AIC 006956, Letter "Argo Surety" to Jan Scott and Dave Broihahn on behalf of Unison Solutions, Inc., and to Jan Scott and Dave Broihahn in their capacities as individual indemnitors.

[6] Bates AIC 007203.

demand, the Indemnitors shall, within seven (7) additional days thereafter, deposit with the Surety collateral amount of one hundred percent (100%) of all unreleased liability under the bond(s)."

Although demanding collateral early was a prudent course of action for Argo, because of its serious and growing concerns about Unison's financial ability and claims exposure, Argonaut was not showing the same level of concern about **[*16]** beginning a genuine investigation of the performance bond claim filed by Stellar J.

While Argonaut was seriously concerned about its own exposure and protecting its self-interests with relation to its indemnitors, Stellar J was anxious about its exposure, as evidenced by placing a telephone call to Vince Miseo, sending a letter dated March 26, 2012, and following up with an e-mail on March 27, 2012, stating:

"Attached is Stellar J Corporation's claim notice to Argo's regarding the subject supply bond as well as a copy of Claim # 1 to Unison. We will send remaining claim notices and costs in the near future."

Additional Claim Notices:

Additional claim notices were filed by Stellar J on April 12, 2012 and April 14, 2012. These were recognized using the word "acknowledge" in Argonaut's letters dated May 1, 2012, June 1, 2012, and June 18, 2012. Recognizing or mere "acknowledging" is not the same as meaningfully responding. A surety should contemporaneously acknowledge and meaningfully respond to each notice of claim from an obligee, and not wait to recognize several claims notices in a wholesale fashion in letters forwarding a principal's response, asking for items that cannot **[*17]** legally be required (notice of default), or denying the various claims. None of the letters showed an appreciation for the urgency of Stellar J's claims. None of the letters addressed the details of the problems on the job or demonstrated an interest in resolving the issues before they became more serious.

The Completed Proof of Claim Dated April 10, 2012:

The completed Proof of Claim form was returned by Stellar J to Argonaut on April 10, 2012. [7] The claims decision was not communicated until June 18, 2012 [8], several days more than the statutory time [9] within which to communicate the decision, and there was no request for an extension of time.

The April 30, 2012 Letter from the Attorney for Unison Solutions:

Attorney William E. McCardell, of DeWitt Ross & Stevens, on behalf of Unison, wrote a letter on April 30, 2012 [10], addressed to Stellar J, and much anticipated by Argonaut to support **[*18]** its defensive posturing in lieu of investigation. The letter states in part as follows:

"Stellar J is an Additional Obligee under the June 22, 2009 Dual Obligee Rider to Supply Bond SUR0001957 of same date issued by Argonaut Insurance Company, (the "Supply Bond")." McCardell letter, page 1, first paragraph.

"First, Unison has no contractual obligation to Stellar J. Unison's only contractual obligations with respect to the Project are those found in the purchase order negotiated and executed between Unison and

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[7] Bates AIC 007246-AIC 007249.

[8] Bates AIC 007215-AIC 007216.

[9] See note 23, infra.

[10] Bates AIC 007529.

AFT..." Third, the Supply Bond covers only Unison's performance of its defined contractual obligations with AFT. Fourth, AFT has failed to pay all sums due and owing Unison strictly in accordance with the purchase order. As such, neither AFT nor Stellar J can make claims against the Supply Bond. Fifth, Stellar J has failed to make a claim according to the express terms of the Supply Bond, and any such further attempted claim is otherwise untimely. Finally, Unison owes no **[*19]** independent duty to Stellar J that might allow Stellar J to pursue any negligence claim against Unison. The bottom line is that, if Stellar J wishes to pursue remedies for any losses it has incurred on the Project, Stellar J will need to do so from AFT (and its Surety, if any), not from Unison" McCardell letter, page 1, second paragraph.

On page 7, sixth paragraph, Mr. McCardell states: "There exists no contract whatsoever between Unison and Stellar J with respect to the Project. Instead, Unison worked on the Project solely through the July 10 AFT PO. Since Unison has no contractual obligation to Stellar J. Stellar J cannot hold Unison liable under any breach of contract claim."

Also on page 7, last paragraph, Mr. McCardell wrote: "The injuries Stellar J claims do not arise from the breach of any independent duty owed it by Unison." On page 8, Mr. McCardell stated in paragraph six, "...AFT itself confirmed in April 2010 that Unison's performance was '[e]xcellent.'"

On page 8, last paragraph, and continuing onto page 9, Mr. McCardell wrote: "Stellar J has no basis for making any claim against Unison or Argonaut Insurance Company under the Supply Bond. If you persist **[*20]** in bringing these spurious claims, not only will we vigorously defend Unison and Argonaut against your claims, we will prosecute our own action against you and Stellar J for pursuit of knowingly frivolous claims." [underlining emphasis added.]

Mr. McCardell recognized Stellar J's position as a Dual Obligee on the bond Argonaut issued on behalf of principal, Unison. The bond is a three party contract. As part of that three-party contract, Unison has contractual obligations to Stellar J. Stellar J has reciprocal obligations to Unison under the same bond. Argonaut had obligations to Stellar J under the bond. Whether any of the parties breached their respective obligations under that bond is something to be determined in the course of the litigation. For purposes of this review, the point is that Mr. McCardell is incorrect when he claims there is no contractual relationship between Unison and Stellar J. The same holds for Mr. McCardell's statement that "… the Supply Bond covers only Unison's performance of its defined contractual obligations with AFT." The Material Contract was by and between Unison and AFT. That is correct. But, a clear condition in the contract between Stellar J **[*21]** and AFT was that Unison agree to bind itself to Stellar J by the vehicle of the performance bond naming Stellar J as an Additional Obligee. Also, Mr. McCardell's letter sidesteps the fact that, from November 2010 forward, Unison worked directly under Stellar J, and to the extent Stellar J was billed by Unison, Stellar J paid Unison directly. As recognized by The Honorable Ronald B. Leighton in his April 16, 2012 Order on Defendant's Motion For Summary Judgment, "Unison obtained a supply bond (Bond) from Argonaut, which guaranteed both Stellar J. and AFT that Unison would perform." [Order, page 1, emphasis added]. Judge Leighton further stated as follows:

"But, Unison's obligations under the contract did not end with delivery. Indeed, it would not even be paid the last 10% of the price until its materials had undergone successful testing." [Order, page 2.]

With respect to the statement that "...AFT itself confirmed in April 2010 that Unison's performance was '[e]xcellent.'", same was made by AFT in a Status Report to Argonaut Insurance at a time when AFT was embroiled in its own disputes with Stellar J, and it would not have been in AFT's best interests to admit that it, **[*22]** or any of its suppliers or other vendors, had problems with their respective portions of the project. As such, the statement is self-serving and not reliable. In my experience, obligees occasionally make statements on such Status Reports which they recant when questioned by a surety company or other interested party.

The May 1, 2012 Letter from Argonaut to Stellar J:

On May 1, 2012, Vincent Miseo of Argonaut wrote to Robert J. Kinghorn, commenting upon Unison's response drafted by attorney McCardell, in part as follows:.

"Argo Surety ('Argo' or the 'Surely') received your letters, enclosures and executed Proof of Claim, Specifically, we received documents from you on March 26, 2012, April 12, 2012, and April 24, 2012. We "are in the process of independently investigating your company's claim. Should we determine in the course of our investigation that we need additional information from you, we will advise you. [emphasis added.]

"Also, it is our understanding that on May 1, 2012. Unison Solutions sent you its-response asserting its position on Stellar J's claims under the bond. We were copied on Unison's response letter. If for some reason you are not in receipt of **[*23]** this response, please let us know and we can provide them to you. Because we are continuing our independent investigation, we ask that you please provide us with a written response and any new documents that have not been previously provided that support Stellar J's response to Unison's position within seven (7) days from the date of this letter."

The final paragraph is a standard disclaimer paragraph.

As mentioned above, rather than conduct a reasonable investigation of the claim, Argonaut instead waited for a written response from the attorney for its principal, Unison and, once the final, formal version of the April 30, 2012 letter was received on May 1, 2012, [11] simply forwarded that along to Stellar J and asking Stellar J for its own response to principal's attorneys' letter -- all without investigation; without asking probing questions; without making observations (at least none recorded in the Claim File); and without making other comment. It appeared Argonaut had all it needed from Stellar J, because it did not request anything, and stated "Should we determine in the course of our investigation that we need additional information from you, we will advise you." There **[*24]** was no follow-up asking for anything, other than a June 1, 2012 letter, that feigned a search for additional documentation, but was fashioned to show some additional effort at "investigating" before the denial letter was sent on June 18, 2012.

This May 1, 2012 letter was an opportunity for Argonaut to let Stellar J know whether Argonaut Insurance adopted the positions and threats of Unison Solutions, Inc., and to correct any misstatements or unfounded conclusions stated in the Unison letter, as they applied to Argonaut. For example, Argonaut should have, but failed to, inform Stellar J that there is in fact a contractual relationship between Unison and Stellar, contrary to the position taken by Unison's counsel. Furthermore, with respect to Unison's attorney's statement "If you persist in bringing these spurious claims, not only will we vigorously defend Unison and Argonaut against your claims, we will prosecute our own action against you and Stellar J for pursuit of knowingly frivolous **[*25]** claims.", Argo should have taken the opportunity in this letter of May 1, 2012, to inform Stellar whether Argonaut adopted Unison's threat to prosecute their own action against Mr. Kinghorn and Stellar J. These are strong positions to take, especially when the limitations period and language stated in the Argonaut bond were impermissible and void under Washington law and Unison had walked off a project with problems that were its responsibility.

As Argonaut did not send such a letter to Stellar, and since we have no record of Argonaut sending a letter to Unison or its attorneys disclaiming any of the positions stated by Unison's attorney in the April 30, 2012 letter from attorney McCardell, it appears that Argonaut in fact adopted the entirety of the Unison response as the response of Argonaut.

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[11] Bates AIC 007259.

The June 1, 2013 Letter from Argonaut to Stellar J:

This third letter, dated June 1, 2012, treated the performance bond claim as a payment bond claim and asked for an item not required under Washington law, i.e., a written notice of default. Specifically, the letter requested:

"1. Written evidence (delivery ticket(s), labor time cards, service ticket(s), etc.) supporting the verified **[*26]** statement contained in Stellar J's executed Proof of Claim that the date labor ended or materials last supplied (not including warranty period) was November 14, 2011; and

"2. A copy of Stellar J's written notice to the Surety of Unison's default under the Material Contract, as that term is defined in the June 22, 2009 Supply Bond."

With respect to some confirmation that the date labor ended or material was last supplied was November 14, 2011, the Court, in ruling on Argonaut's Motion For Summary Judgment, did not have a problem coming to this conclusion. The Court did not require delivery tickets, labor time cards, service tickets, to reach this result. This is because such items have no place in a performance bond claim, as they are the types of documents that would support a payment bond claim.

With respect to the request for a copy of "Stellar J's written notice to the Surety of Unison's default under the Material Contract, as that term is defined in the June 22, 2009 Supply Bond", this was not a legitimate request, and the term was not defined in the Supply Bond or elsewhere.

Surety adjusters and outside counsel alike are taught from their first day of training on performance **[*27]** bond claims handling that an obligee must first declare a default before the surety can be expected to respond favorably to an obligee's performance bond claim. The L & A Contracting Company v. Southern Concrete Services, Inc. [12] case and its progeny are regarded as gospel in surety company claims departments. Other surety claims handlers have run afoul of the minority jurisdiction holding in Colorado Structures, but few, if any, have been held accountable for their lack of understanding of the special rules in Washington. I personally learned about the Colorado Structures case a year or two after it was decided, and after first responding to a performance bond claim in Washington in a manner based upon my indoctrination of the L & A case and its progeny. Mistakes can and will happen, but it is how a surety responds after learning of its mistakes that can determine whether it has acted unfairly or deceptively in response to a claim.

Being a surety claims adjuster **[*28]** is admittedly a hard job. The adjuster typically works in a surety company that is authorized to write bonds in all states and territories, or at least a majority of them. As such, the adjuster may be a specialist with respect to the laws of the state where he or she resides, and the adjuster may be admitted to the bars of one or more states. However, the adjuster is frequently confronted with claims in states where the adjuster rarely sees claims, and, in this case, this was the first claim of any sort that Argonaut had received in the state of Washington.

When faced with a claim, a surety adjuster consults standard claims and legal reference materials. These include The Law of Performance Bonds, [13] with second edition in 2009. The reference give guidance on handling claims in Washington, and specifically mentions the Colorado Structures case. "In Colorado Structures the court expressly stated that L&A Contracting was 'wrongly decided' with respect to the default and notice of default as 'conditions' of the surety's liability. The Washington Supreme Court found

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[12] *17 F.3d 106 (5th Cir. 1994)*.

[13] The Law of Performance Bonds, American Bar Association (2009), pages 37-39.

that 'by the plain terms of the bond, the obligee was not required to formally declare the principal in default..." [14] **[*29]** "The court's reasoning in rejecting L&A Contracting is based upon the 'condition clause' of the performance bond and the use of the word 'otherwise' with that clause." [15]

Another resource that was available to Argonaut at the time was The Construction Law Handbook, [16] which contains a chapter on Performance Bonds authored by Roger P. Sauer, Esq., one of the most qualified surety attorneys in the country and, who, incidentally, is the attorney for Argonaut in this case. There were two other authors of the Performance Bond chapter. There is a 2013 Annual Update. I assisted attorney Sauer with that update.

The "Performance Bonds" chapter in **[*30]** The Construction Law Handbook makes reference to cases that do not require a declaration of default by the obligee to invoke performance bond coverage.

§ 34.04 [B] Declaration of Default

…

§ 34.04 [B], last paragraph:

"The requirement for a formal declaration of default as a condition precedent for a suit against a surety, however, is not absolute. Rather, since a bond is a contract, courts that examine these issues start with the language in the bond. In a recent case, a court found that although an American Institute of Architects (ALA Doc. No. 311, Performance Bond), references a declaration of default, it does not require a formal declaration of default as a condition precedent to instituting legal action on the bond.[36]"

…

"In contrast to the foregoing, a late 2007 opinion by the Washington Supreme Court takes an approach to this issue that is basically unique in the reported case law.[41] The court essentially bifurcated the performance bond, an A311 form document, into two sections, one dealing with language of conditions, and the other dealing with language of promissory undertakings. Provisions in the bond calling for various steps to be **[*31]** taken in the event of default were deemed to be options that the obligee could pursue, but not such as to waive the prefactory condition of the bond remaining in force and effect unless the principal were to faithfully perform its obligations. Without declaring a default, the obligee "supplemented" the contractor's forces, and the court held the surety to be nonetheless liable for these charges."

"FN 36. *Walter Concrete Constr. Corp. v. Lederle Labs., 99 N.Y. 2d 603 (Ct. App. 2003)*. See also *Gloucester City Bd. Of Educ. V. American Arbitration Ass'n, 333 N. J. Super. 511 (App. Div. 2000)* (interpreting a New Jersey statutory bond required on public projects); *Colorado Structures, Inc. v. Insurance Co. of the West, 106 P.3d 815 (Wash. App.)*, cert. granted, *126 P.3d 1279 (2005)*."

…

"FN 41. *Colorado Structures, Inc. v. Insurance Co. of the West, 167 P.3d 1125 (Wash. 2007)*."

Comparison of Bond Forms -- West and Argonaut:

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[14] *167 P.3d at 1130*.

[15] See note 13, supra, at 37.

[16] Aspen Publishing (2009).

I have set forth verbatim, in the Attachment to this report, the texts of both the ICW and Argonaut bonds, plus the Argonaut Dual Obligee Rider. I have highlighted the use of the word **[*32]** "otherwise" in both bonds, plus the labels [A] -- [D] and drawn a bifurcation line between [B] and [C] of both bonds. The tri-partite relationship among obligee, surety and principal are identical, and would line up perfectly if graphical transparency overlays were used as an exhibit. Of course, both bonds involve an owner and a project, and those labels have been included in the diagrams at Figures 1 and 3.

I have set forth both bonds the way the Colorado Structures Court did, and the way Stellar J Court is likely to do. I have made some observations in the footnotes to the texts of those bonds. The Attachment to this report also contains some verbatim language of the Argonaut General Indemnity Agreement which I find helpful to the analysis of the Argonaut response to the Stellar J performance bond claim.

Neither Jaime Perkins nor Vince Miseo testified in their depositions that they consulted any particular treaties, hornbooks, or manuals for guidance. Although not specifically asked, they did not mention referring to either The Law of Performance Bonds or The Construction Law Handbook.. There was testimony that Argonaut's Surety Claims Department learned of the case of **[*33]** Colorado Structures through a communication from one of the surety law firms on the West Coast at about the time of the Stellar J claim. Although there was some guidance on the issue if one were to consult The Law of Performance Bonds and / or The Construction Law Handbook, I personally am not critical of Argonaut for not knowing about the Colorado Structures case in the initial stages of its claims handling.

The standard reference materials mentioned above do not contain references to the Washington Administrative Code ("WAC"), the Washington Insurance Fair Conduct Act ("WIFCA" or "IFCA"), or the claims handling statutes or acts in other states. Both Mr. Miseo and Ms. Perkins are licensed adjusters in the State of Texas, where they would be required to have a good understanding of the Texas Unfair Claims Settlement Practices Act, the Texas Deceptive Trade Practices Act, and the Texas Insurance Code in general. They would not be expected to be intimately familiar with the insurance statutes of the other states, with the possible exception of California, which, until Colorado Structures, was universally regarded as the state to watch, because of its comprehensive laws that served as **[*34]** a yardstick for behavior in all other states.

In their depositions, Vince Miseo and Jamie Perkins both state that they consulted the Washington Administrative Code "(WAC") and the Washington Insurance Fair Conduct Act ("WIFCA" or "IFCA") early on and as a normal course of responding to the claim. Mr. Miseo first became aware of these laws "At the inception of when we received notice from Mr. Kinghorn." (Miseo 69:18). This research was done online (Miseo 70:14). This is interesting because, although the WACs apply to all claims, including third party claims, the Washington Insurance Fair Conduct Act ("WIFCA") only apply to first party claims, not third party claims such as payment bond claimants. From a review of the Claim File, it appears Argonaut was of the opinion it was acknowledging a payment bond claim.

May 10, 2012 E-mail From Agent Jack Anderson re April 30, 2012 Letter From Unison's Attorney:

From my review, it is clear that Argonaut review the April 30, 2012 letter from attorney McCardell. Argonaut's comments to the letter were solicited by Mr. McCardell. Moreover, as evidenced by Jack Anderson's May 10, 2012 e-mail, Argonaut was waiting for this important letter to **[*35]** confirm a decision whether to continue with its demand for the $ 500,000 ILOC collateral.

The May 31, 2012 Memo from Jaime Perkins to Vince Miseo:

The May 31, 2012 Memo from Jaime Perkins to Vince Miseo [17] evidences a claim posture begging for investigation, but ends in a denial eighteen (18) days later based upon "insufficient information".

The memo states on page 2, "There was no formal notice of default or termination of Unison." The section commenting upon Unison's attorneys' April 30, 2012 letter contains four bullet points, as follows:

➢ "Unison's response dealt mostly with items not relative to Argo Surety

➢ "The only items relating to the bond claim were (a) that the bond only covered the Purchase Order and (b) that it was untimely.

➢ Unison asserts that it provided all items contained in the 5/18/12 purchase order as was later modified by the 7/10/09 purchase order. Unison also confirms AFT's approval of the delivery and Unison's **[*36]** performance was 'excellent,', as of April 2012.

➢ Unison also asserts that Stellar J's bond claim is time barred because the claim was due no later than January 19, 2011. Yet, Stellar J Waited over a year and gave notice of its claim on March 26, 202. Therefore, according to Unison, the bond claim is lime barred.

That is a lot of information from the April 30, 2012 McCardell letter. Ms. Perkins stated in her deposition that she did not read this letter.

Also on page 2 of the Perkins' Memo, she comments upon "Argo's investigation. This consists of one bullet point, as follows:

➢ "Argo has sent correspondence to both Stellar J and Unison soliciting facts, information and any supporting documents to support the respective positions. After over 2 months, Argo has obtained voluminous documents and information from Stellar J and Unison. Currently, it has been a month since any new information has been forthcoming. Currently, this claim is ripe for determination as the result of no new information or supporting documentation."

This comment simply mentions the voluminous documents received and correspondence sent as part of an administrative function. There was no **[*37]** "adjusting" or "analysis" involved in this. This status statement of Argonaut's investigation represents no representation whatsoever. This is contrasted with the heavy reliance upon the four bullet points of the McCardell letter on behalf of Unison, where Perkins is relying heavily on the firming up of defensive issues such as the statute of limitations defense. Two of the four bullet points mention the timing of the claim. One bullet point commented upon Unison's assertion that it provided all items contained in the applicable purchase order and repeated the self-serving AFT statement that Unison's work was "excellent".

Later in Perkins' memo, page 2, she acknowledges that "(t)he most significant issue that has come up for all 3 of Stellar J's claims is that there is a material fact question that looms...There is a material fact as to whether Unison supplied all materials according to the purchase orders. Based on this, Argo must deny the claim because we are not in a position to be a determiner of fact."

On page 3 of her memo, she goes so far as to appreciate that "...there is an issue as to whether any of these claims are latent defect type claims." Also, "..in Stellar J's executed **[*38]** proof of claim, they state that the last material and/or labor supplied was 11/14/2011. I am not sure what they are referring to but if it is materials last delivered, that could be an issue. Before we deny on this basis, it may be worthy of requesting more information on this issue from Stellar J. to be absolutely certain."

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[17] Bates AIC 006894-006896.

The next paragraph references that "...there is no notice of default or termination anywhere in the provided information and documentation". Also, "As far as I can see in the provided documentation, Unison has never been formally defaulted or terminated. Again, before we deny on this basis, it may by [be] worthy of requesting more information on this issue from Stellar J to be absolutely certain."

"The admitted existence of "material facts" does not equate to "insufficient information". There was a material fact whether Unison supplied all materials according to the purchase orders. That is something to investigate, not something to call "insufficient information".

The statement, "Based on this, Argo must deny the claim because we are not in a position to be a determiner of fact," is odd and not true. Argonaut is not forced to deny a claim. There is no "must" **[*39]** about it. There are several options for a surety, that have already been mentioned in this report. One can inform a claimant that an investigation has been completed, if that is honest and true, and that the surety cannot determine if the obligee is right or the principal is right. In such a case, the parties should resort to the help of a fact finder, and seek guidance from their dispute resolution clauses, if any, in there agreements. Here, there do not appear to have been such clauses, so Argonaut could not point to a contract clause, but could point the parties in the direction of a mediator, arbitrator or court of competent jurisdiction (the Court where the matter is now).

Perkins made reference to possible latent conditions and the fact she wasn't sure what Stellar J was referring to with respect to when items were last delivered. These are the types of questions that drive honest investigations; not the types of problems that get ignored in favor of determining one has "insufficient information".

There is mention of possibly denying the claim because of all of these unsolved questions that were not investigated -- but rather only noted. There is even mention of possibly denying **[*40]** the claim because there was no proof of a written notice of default. In light of this "smoking gun" memo, Argonaut cannot hide its true motivations for the denial. Argonaut can spin the denial letter as being based upon "insufficient information", but the obvious justifications were that Argonaut was convinced that the statute of limitations had run and it could defend on the basis that there was no written notice of default.

The June 18, 2012 Denial Letter:

As the Proof of Claim was received by Argonaut on April 10, 2012, [18] the claim decision was due May 9, 2012. It was given late on June 18, 2012. It stated as follows:

"Dear Mr. Kinghorn.

"As you will recall, Argonaut Insurance Company ('Argo' or the 'Surety') received your company's supporting documents and acknowledged same by way of letter dated May 1, 2012, a copy of which is attached. As you will further recall, the aforementioned May 1 letter advised you that we were in the process of investigating your **[*41]** company's claim and should we determine in the course of our investigation that we needed additional information from you, we would advise you.

"In performing our independent investigation, we determined that we needed additional information. As such, we sent you a letter dated June 1, 2012, a copy of which is attached, whereby we requested the following:

[18] Bates AIC 003710-003711.

"1. Written evidence (delivery ticket(s), labor time cards, service ticket(s), etc.) supporting the verified statement contained in Stellar J's executed Proof of Claim that the date labor ended or materials last supplied (not including warranty period) was November 14, 2011; and

"2. A copy of Stellar J's written notice to the Surety of Unison's default under the Material Contract, as that term is defined in the June 22, 2009 Supply Bond."

"We requested that you provide Argo with this information on or before June 8, 2012. To date, we have not received this important information,

"As a result, based upon our independent review of all of the documents made available to us. Argo has determined that there is insufficient information to determine the validity of Stellar J's bond claim. Therefore, Argo must respectfully **[*42]** deny Stellar J's payment bond claim.

"If you intend to proceed with this matter, it is requested that you provide documentation not previously submitted that may warrant the Surety's further consideration of this claim. Please forward them to the attention of the undersigned."

The last paragraph is a standard disclaimer paragraph.

There was no mention of being beyond 30 days to provide a response from the time of receipt of the Proof of Loss, and there was no apology. There is no claim number.

This fourth letter, dated June 18, 2012, continued to treat the performance bond claim as a payment bond claim and regurgitated the position that Argonaut was entitled to a written notice of default, despite not being entitled to insist upon that pursuant to applicable law.

The statement "[u]pon our independent review of all the documents provided to us, Argo has determined that there is insufficient information to determine the validity of the bond claim," does not make sense under the circumstances. There was no review other than to receive and pass on the April 30, 2012 letter from Unison's counsel. There was no conscientious effort to correct the misstatements in Unison's counsel's **[*43]** letter regarding the existence of a contract between Unison and Stellar J, to or disclaim any intent to file a claim by Argonaut against Stellar.

There were "voluminous documents" as represented in the Memo from Jaime Perkins to Vince Miseo. According to Jaime Perkins April 25, 2012 e-mail to Bill McCardell, "...at this point, we have received 5 different packages with correspondence and voluminous documents from Stellar J. However, we have not yet received a formal written response from Unison as to any of these claims. We are looking forward to receiving a (sic) this written response, which we hope will be forthcoming." Elsewhere, as referenced by the underwriters, the quantify of documents received by Argonaut was "twice the size of the Bible". Argonaut did not ask specific questions about the materials supplied by Unison to the project, so as to overcome any supposed lack of information. The statement that "[t]herefore, Argo must respectfully deny Stellar J's payment bond claim" makes no sense under the circumstances. There is no requirement that Argo "must" deny any claim. It can honor a questionable performance bond claim. It has this right in its GIA, and is required to by **[*44]** law, to honor a claim when liability has become reasonably clear. It can seek additional information, where warranted, in lieu of denying a claim. It can state that, unless additional information is received, where warranted, it may deny a claim. It can also retract a denial that was made in haste or in bad judgment, or otherwise. It could have sought a declaratory judgment, paid money into the registry of the court, or sought an independent, objective legal opinion from qualified surety counsel in Washington.

The reference to "payment bond claim" is incorrect and should have been corrected with A follow-up letter.

In her deposition, Ms. Perkins insisted that Argonaut denied the claim, for "lack of information" (Perkins depo 64:14). In their deposition, both Ms. Perkins and Mr. Miseo admitted that what they had really been waiting for was the written notice of default (Perkins 192:9) and (Miseo at 67:5-12). The line of questioning in Vincent Miseo's deposition was as follows:

Q: Why did you deny the claim?

A. Insufficient information.

Q. What insufficient information?

A. It's outlined by Ms. Perkins twice.

Q. Tell me what sufficient information would have **[*45]** been.

A. Any kind of written notice that Stellar J. had declared Unison in default, something as simple as that.

This admission that "sufficient information" would have been as simple as a "written notice that Stellar J. had declared Unison in default" belies any argument from Argonaut that the denial was based upon "lack of information". Argonaut put false hope in a search for a written document that would do it no good, and which put it off the correct course of investigating a claim rather than posturing for the defense of a claim. Argonaut outsmarted itself, and boxed itself into a corner. It had spent its time protecting itself under its rights in its GIA with its indemnitors and huddling with its principal's counsel. Up against a deadline to provide a response to a claim, and without having conducted a true investigation of the claim, it crafted a denial letter based upon the thinly disguised reed of "insufficient information."

When Argonaut realized that it cannot demand such a written notice of default under the Colorado Structures case, it could have changed its position and put a genuine investigation into place. Instead, it dug in, compounding its problems, and leading **[*46]** to a situation exposing it to damages for WIFCA and WAC violations.

Parallels Between the Colorado Structures Case and the Stellar J Case:

1. Argonaut's Focus was Protecting Its Self-interest Under the Indemnity Agreement

Argonaut's (a) early focus on protecting its self-interest vis-à-vis its indemnitors, and (b) lack of investigation of the performance bond claim, are two of many parallels with the Colorado Structures case. From my review, the first two letters in the Argonaut Claims File were the March 29, 2012 claim acknowledgment letter and March 29, 2012 letter to the attorneys for Unison. [19] The March 29, 2012 letter to Unison is curious, because it makes reference to letters dated April 12, 2012 and April 14, 2012. I am not sure what to make of that, but the paradox should be evident to any reviewer of the file.

[*47]

[19] Bates AIC 007253. "Mr. McCardell: Please be advised that Argo Surety, the surety for your client has now received 5 sets of documents with correspondence from Stellar J dated March 26, April 12 and April 14, 2012. It is also my understanding that at this time, you have received copies of all of these. However, if I am mistaken and you are not in receipt of these, please let me know and I will provide these to you. I have requested Stellar J respond to your letter. A copy of our letter is enclosed. Presuming I receive their response, I will for (sic) it to your attention for reply. Very truly yours, Jaime Perkins".

The next two letters, dated April 2, 2012 and April 3, 2012, were to the indemnitors, demanding collateral. In Colorado Structures, the Court was critical of West because, rather than investigate the claim, one of the first things West did was to obtain a judgment against its indemnitors "for an amount that included potential payment to Structures on the performance bond." [20]

Like ICW who did not send an adjuster or other representative to Vancouver, WA to investigate in the Colorado Structures, [21] case, Argonaut did not send any adjuster or other representative to meet with Stellar J or to inspect the project in Roosevelt, WA.

[*48]

2. Argonaut Insisted That Obligee Stellar J Provide Written Notice of Default

Vince Miseo testified that, despite insisting that the reason for the denial of the claim was "insufficient information", the reason for the denial included the lack of proof of a written notice of default (Miseo deposition, 67:5-12).

Even in a case in a different state, where declaration of default is required according to case law, when a surety tenders to an obligee a Proof of Claim form, there is a question in my mind whether a surety should not also insist upon a declaration of default. [22]

Also, from a tactical perspective, some surety companies learned not to send a Proof of Loss or Proof of Claim form, even to payment bond claimants, in one state. Under old Texas law, a payment bond claimant was required to send a "Sworn Statement of Account" with a notice of claim, lest it fail to properly perfect a claim, and **[*49]** hand the surety a reason to deny the payment bond claim. Adjusters learned it would backfire on them to send a Proof of Loss form to those claimants, because the claimants could and would argue that the Sworn Statement of Account requirement was waived by the surety curing that defect for them. An experienced adjuster handling Texas payment bond claims would be sensitive to the sending of a Proof of Loss form to any claimant, whether a first party obligee or a third party payment bond claimant. This raises some question whether a surety would ever send a Proof of Loss form to an obligee, even on a case-by-case basis, and even if the Proof of Loss did not specifically inquire about the facts of any alleged "default".

The gravamen of the Colorado Structures case was that West insisted it had no liability under the performance bond without its principal first being declared in default. West was wrong. Argonaut is also wrong. The parallel between the Colorado Structures case and the Stellar J case, is clear.

3. Argonaut, Like West, Did Not Have Appropriate Procedures in Place For the Prompt and Fair Investigation of a Performance Bond Claim in the State of Washington

A. Argonaut Did **[*50]** Not Have Appropriate Claim Forms

A performance bond acknowledgment letter contains a list of contract documents that a surety would like to review. It does not ask the obligee to complete and return a proof of loss form. A surety claims

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[20] Colorado Structures, at 585.

[21] Colorado Structures, at 583 ("...Structures asked West's surety manager to attend an on-site meeting in an attempt to discuss Action's difficulties and Structures' supplementation of Action's crews. However, despite Structures' multiple please to the bonding company, West refused to send a representative to visit the site and discuss the situation. West refused to participate in discussions regarding Action's performance or to comment on Structures' chosen remedy. Structures continued to supplement Action's crews to minimize cost and delay and complete the project on time").

[22] The attorneys for Stellar J also commented upon this in the First Amended Complaint, page 13, line 16.

department typically has appropriate follow up letters to send to an obligee claimant, and none of those ask for documents that only relate to payment bond claims.

B. Argonaut Did Not Have A Proper Procedure to Investigate This Performance Bond Claim

This was Argonaut's first surety claim in Washington. It was the front-line adjuster's first performance bond claim to handle without shadowing another adjuster. Argonaut handled the claim to some extent as it would handle a claim outside of Washington. In other ways, it didn't handle the claim in any standard manner. The claim was too urgent and complicated to handle by "telephone adjusting" or "paper pushing". Rather than administration, the claim required a "boots on the ground" investigation, with experienced technical people to size up the exposure, confirm claim exposure, and advise Argonaut on how to fairly resolve the claim. Argonaut's procedures either included such practices and they **[*51]** weren't followed, or such practices are not part of Argonaut's procedures, and should be. After this case, these will likely be Argonaut's procedures and practices in Washington.

4. As In Colorado Structures, Stellar J Chose to Supplement Rather Than Terminate

Both cases refer to obligee's interest in supplementing rather than default terminating, because of the lost productivity from a default shut down; the desire to mitigate liquidated damages; and the desire to maximize overall efficiency and profit on a troubled job. As stated by Judge Leighton in his Order on Defendant's Motion For Summary Judgment, "The project did not go as planned, and Unison ended up walking away without performing" [Order, page 1]. Default terminating can be an unnecessarily legally complicated procedure, and is not as efficient as supplementing on a time-sensitive project. This interest of the obligees tracks clearly through both the Colorado Structures and Stellar J cases.

5. Like the Performance Bond in Colorado Structures, The Performance Bond in Stellar J Has the Word "Otherwise" in the Condition Paragraph

The Colorado Structures Court found that use of the word "otherwise" in the condition paragraph **[*52]** evidenced that the bond only had one condition. This is set out in the Attachment to this report.

There are the above parallels between the Colorado Structures and Stellar J cases, and there is the one irrelevant difference. The Stellar J case involves a Dual Obligee Rider. As an Additional Obligee, Stellar J has a direct right against Argonaut, without resort to any argument that it is a beneficiary of one type of another. More importantly, there are serious difference in the two cases. In the Stellar J case, Argonaut has much more at stake than faced by West in Colorado Structures. Not only is Argonaut's performance bond penal sum much larger than that of West in the Colorado Structures case, but in addition to exposure for Olympic Steam Ship damages, as in Colorado Structures, Argonaut faces a plaintiff obligee that is "seeking it all" -- by leveraging the Colorado Structures case to ask for something not sought in that case -- i.e., treble damages under WIFCA.

Based upon the foregoing background, observations and arguments, it is fair to conclude that Argonaut has some exposure under WIFCA and the WACs. A review of those, with comments, follows:

RCW 48.30.015 Unreasonable **[*53]** denial of a claim for coverage or payment of benefits.

(1) Any first party claimant [Stellar J] to a policy of insurance [performance bond] who is unreasonably denied a claim for coverage or payment of benefits by an insurer [surety] may bring an action in the superior court of this state to recover the actual damages sustained, together with the costs of the action, including reasonable attorneys' fees and litigation costs, as set forth in subsection (3) of this section.

Argonaut's insistence upon being provided by Stellar J with a written notice of default before there could be a finding of liability on the bond was an unreasonable denial of a claim for coverage or payment of benefits under the bond. The Memo dated May 31, 2012, along with the deposition testimony of the Argonaut claims adjusters, prove the true reasons for the denial were a belief that the statute of limitations had run and a written notice of default was a condition precedent to bond coverage. Argonaut did not feel comfortable admitting that these were its reasons for denial, and instead used the justification of "insufficient information".

(2) The superior court may, after finding that an **[*54]** insurer [surety] has acted unreasonably in denying a claim for coverage or payment of benefits or has violated a rule in subsection (5) of this section, increase the total award of damages to an amount not to exceed three times the actual damages.

This is for the Court to decide, but it is clear there is sufficient evidence to support treble damages.

(3) The superior court shall, after a finding of unreasonable denial of a claim for coverage or payment of benefits, or after a finding of a violation of a rule in subsection (5) of this section, award reasonable attorneys' fees and actual and statutory litigation costs, including expert witness fees, to the first party claimant [Stellar J] of an insurance [surety] contract who is the prevailing party in such an action.

This is for the Court to decide, but it is clear there is sufficient evidence to support an award of reasonable attorneys' fees and actual and statutory litigation costs, including expert fees, to Stellar J.

(4) "First party claimant" means an individual, corporation, association, partnership, or other legal entity asserting a right to payment as a covered person under an insurance policy or insurance **[*55]** contract [surety bond] arising out of the occurrence of the contingency [failure of Unison to perform] or loss covered by such a policy or contract.

Stellar J, as an obligee, is a first party claimant. The parties do not dispute this. Failure of Unison to faithfully perform is the occurrence of the contingency, a condition subsequent in the bond.

(5) A violation of any of the following is a violation for the purposes of subsections (2) and (3) of this section:

(a) WAC 284-30-330, captioned "specific unfair claims settlement practices defined";

(1) Misrepresenting pertinent facts or insurance policy [bond] provisions

Argonaut misrepresented that the term "default" was defined in the bond when there is no such definition in the bond. This was arguably the result of intentional misrepresentation and not a failure to simply read the full bond, as this was a representation of what the bond said, as opposed to overlooking something really contained in the bond.

Argonaut misrepresented that a written notice of default was necessary before there could be coverage under the bond. This was a misstatement of law and fact Argonaut did not disclaim adoption of **[*56]** Unison's position that there was no contract between Unison and Stellar J. Failure to disclaim is arguably an adoption, and the statement by Unison was a misrepresentation of fact. The arguable adoption of the statement by Argonaut was also a misrepresentation of pertinent fact.

(2) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies [bonds]

Argonaut promptly acknowledged the first notice of claim, but failed to Promptly acknowledge additional notices of claim, and then attempted to Excuse that failure by referring to all claims as being one under the label "multi-part claim"

Argonaut failed to provide its claims decision within the statutory time [23] from receipt of the completed Proof of Loss from Stellar J, and had not requested an extension of time.

[*57]

(3) Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies [bonds]

Argonaut did not have reasonable standards for the prompt investigation of the Stellar J performance bond claim. Rather than conducting a fair investigation, it pushed papers in an administrative fashion, relied upon information from its indemnitors without verification; and relied upon its preliminary analyses of hopeful dispositive surety defenses. It did not obtain an objective legal opinion regarding its defenses, such as statute of limitations, and its reliance upon a limitations period in its bond that was impermissible and void under Washington law.

(4) Refusing to pay claims without conducting a reasonable investigation

Argonaut refused to pay Stellar J or reimburse Stellar J for its costs in supplementing Unison's Materials Contract and/or correcting defective materials supplied by Unison. Argonaut did not conduct a reasonable investigation of the Stellar J performance bond claim. Rather than conducting a reasonable investigation, processed the claim in an administrative fashion, relied upon information from its indemnitors **[*58]** without verification; and relied upon its preliminary analyses of hopeful dispositive surety defenses. It did not obtain an objective legal opinion regarding its defenses, such as statute of limitations, and its reliance upon a limitations period in its bond that was impermissible and void under Washington law.

(5) Failing to affirm or deny coverage of claims within a reasonable time after fully completed proof of loss documentation has been submitted

The claim decision was given more than the statutory number of working days [24] after the completed proof of loss documentation was received. There was no request for an extension.(6) Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonable clear

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[23] § 284-30-380. Settlement standards applicable to all insurers

(1) Within fifteen working days after receipt by the insurer of fully completed and executed proofs of loss, the insurer must notify the first party claimant whether the claim has been accepted or denied. The insurer must not deny a claim on the grounds of a specific policy provision, condition, or exclusion unless reference to the specific provision, condition, or exclusion is included in the denial. The denial must be given to the claimant in writing and the claim file of the insurer must contain a copy of the denial.

(3) If the insurer needs more time to determine whether a first party claim should be accepted or denied, it must notify the first party claimant within fifteen working days after receipt of the proofs of loss giving the reasons more time is needed. If after that time the investigation remains incomplete, the insurer must notify the first party claimant in writing stating the reason or reasons additional time is needed for investigation. This notification must be sent within forty-five days after the date of the initial notification and, if needed, additional notice must be provided every thirty days after that date explaining why the claim remains unresolved.

[24] See note 23, supra.

Argonaut attempted to rely upon limitations language in its bond that was impermissible and void under Washington law. Argonaut relied upon its early analysis of the claim without investigation, and **[*59]** had convinced itself that it could prevail on the void limitations clause and insistence upon a written default notice, despite Washington law forbidding a surety from demanding such a document in the analysis and adjustment of the bond claim. Despite having accumulated what it described as "voluminous documentation", and without revealing its true motivations for not paying the claim, Argonaut chose to deny the claim on the basis of "insufficient information". In depositions, its claims adjusters admitted that "sufficient information" would have been satisfied by the very written notice of default that Washington case law says a surety cannot demand of an obligee claimant on a performance bond.

11. Delaying the investigation or payment of claims by requiring a first party claimant [bond obligee] or his or her physician to submit a preliminary claim report and then requiring subsequent submissions which contain substantially the same information

Argonaut was not satisfied with the "voluminous documentation" it had received directly from obligee first party claimant Stellar J. Rather than accept the fact that it had substantial claim documentation suitable for purposes of **[*60]** advancing a fair and reasonable investigation of the performance bond claim, Argonaut chose instead to act in an administrative, paper-pushing exercise, repeatedly asking Stellar J to confirm this was all the information, to confirm information that was not relevant to the claim; to confirm information that related to a payment bond claim when what was presented was a performance bond claim; and to have the bonded principal confirm what the obligee claimed and then ask the obligee to confirm what the principal claimed. All of this was a waste of time and poor substitute for a surety investigation of relevant issues; all at a time of urgency when obligee was trying to mitigate the liquidated damages being charged against it by the owner on the project.

(13) Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement

There was no offer of a compromise settlement.

The explanation for the denial of the claim was not reasonable. The stated reason was "insufficient information". The true fact was there was "voluminous documentation" and **[*61]** what was insufficient was the nature of the surety's investigation. The basis the surety had developed behind the scenes, early on in the claim process, was that the statute of limitations had expired and a written notice of default had to be presented to the surety before there was any coverage on the bond. The limitations in the bond was determined by the Court to be impermissible and void under Washington law. The case of Colorado Structures cited frequently in this report states that a surety cannot demand a written notice of default before finding coverage on the bond. Rather than stating its true reasons for denying the claim (both reasons would have been unreasonable), Argonaut fashioned a different, but equally unreasonable explanation, i.e., "insufficient information". Argonaut had all the sufficient information it needed just below its nose had it care to use it as a reasonable starting point for sending qualified personnel to the project site in Roosevelt, Washington, to conduct a "boots on the ground" reasonable and fair surety claim investigation;

(b) WAC 284-30-350, captioned "misrepresentation of policy [bond] provisions";

(c) WAC 284-30-360, captioned "failure **[*62]** to acknowledge pertinent communications";

(d) WAC 284-30-370, captioned "standards for prompt investigation of claims";

(e) WAC 284-30-380, captioned "standards for prompt, fair and equitable settlements applicable to all insurers" [sureties]; or

§ 284-30-380. Settlement standards applicable to all insurers

(1) Within fifteen working days after receipt by the insurer of fully completed and executed proofs of loss, the insurer must notify the first party claimant whether the claim has been accepted or denied. The insurer must not deny a claim on the grounds of a specific policy provision, condition, or exclusion unless reference to the specific provision, condition, or exclusion is included in the denial. The denial must be given to the claimant in writing and the claim file of the insurer must contain a copy of the denial.

(2) If a claim is denied for reasons other than those described in subsection (1) and is made by any other means than in writing, an appropriate notation must be made in the claim file of the insurer describing how, when, and to whom the notice was made.

(3) If the insurer needs more time to determine whether a first party claim should **[*63]** be accepted or denied, it must notify the first party claimant within fifteen working days after receipt of the proofs of loss giving the reasons more time is needed. If after that time the investigation remains incomplete, the insurer must notify the first party claimant in writing stating the reason or reasons additional time is needed for investigation. This notification must be sent within forty-five days after the date of the initial notification and, if needed, additional notice must be provided every thirty days after that date explaining why the claim remains unresolved.

(4) Insurers must not fail to settle first party claims on the basis that responsibility for payment should be assumed by others except as may otherwise be provided by policy provisions.

(5) Insurers must not continue negotiations for settlement of a claim directly with a claimant who is neither an attorney nor represented by an attorney until the claimant's rights may be affected by a statute of limitations or a policy or contract time limit, without giving the claimant written notice that the time limit may be expiring and may affect the claimant's rights. This notice must be given to first party **[*64]** claimants thirty days and to third party claimants sixty days before the date on which any time limit may expire.

(6) The insurer must not make statements which indicate that the rights of a third party claimant may be impaired if a form or release is not completed within a specified period of time unless the statement is given for the purpose of notifying the third party claimant of the provision of a statute of limitations.

(7) Insurers are responsible for the accuracy of evaluations to determine actual cash value.

Note: Statutory Authority: RCW 48.02.060 and 48.30.010. 09-11-129 (Matter No. R 2007-08), § 284-30-380, filed 5/20/09, effective 8/21/09; 78-08-082 (Order R 78-3), § 284-30-380, filed 7/27/78, effective 9/1/78.

(f) An unfair claims settlement practice rule adopted under RCW 48.30.010 by the insurance commissioner intending to implement this section. The rule must be codified in chapter 284-30 of the Washington Administrative Code.

(6) This section does not limit a court's existing ability to make any other determination regarding an action for an unfair or deceptive practice of an insurer [surety] or provide for any other remedy that is available **[*65]** at law.

…

[2007 c 498 § 3 (Referendum Measure No. 67, approved November 6, 2007).] Notes: Short title -- 2007 c 498: "This act may be known and cited as the insurance fair conduct act." [2007 c 498 § 1.]

RCW 48.30.010 Unfair practices in general -- Remedies and penalties.

(1) No person engaged in the business of insurance shall engage in unfair methods of competition or in unfair or deceptive acts or practices in the conduct of such business as such methods, acts, or practices are defined pursuant to subsection (2) of this section.

(2) In addition to such unfair methods and unfair or deceptive acts or practices as are expressly defined and prohibited by this code, the commissioner may from time to time by regulation promulgated pursuant to chapter 34.05 RCW, define other methods of competition and other acts and practices in the conduct of such business reasonably found by the commissioner to be unfair or deceptive after a review of all comments received during the notice and comment rule-making period.

(3)(a) In defining other methods of competition and other acts and practices in the conduct of such business to be unfair or deceptive, and after **[*66]** reviewing all comments and documents received during the notice and comment rule-making period, the commissioner shall identify his or her reasons for defining the method of competition or other act or practice in the conduct of insurance to be unfair or deceptive and shall include a statement outlining these reasons as part of the adopted rule.

(b) The commissioner shall include a detailed description of facts upon which he or she relied and of facts upon which he or she failed to rely, in defining the method of competition or other act or practice in the conduct of insurance to be unfair or deceptive, in the concise explanatory statement prepared under RCW 34.05.325 (6).

(c) Upon appeal the superior court shall review the findings of fact upon which the regulation is based de novo on the record.

(4) No such regulation shall be made effective prior to the expiration of thirty days after the date of the order by which it is promulgated.

(5) If the commissioner has cause to believe that any person is violating any such regulation, the commissioner may order such person to cease and desist therefrom. The commissioner shall deliver such order to such person direct **[*67]** or mail it to the person by registered mail with return receipt requested. If the person violates the order after expiration of ten days after the cease and desist order has been received by him or her, he or she may be fined by the commissioner a sum not to exceed two hundred and fifty dollars for each violation committed thereafter.

(6) If any such regulation is violated, the commissioner may take such other or additional action as is permitted under the insurance code for violation of a regulation.

(7) An insurer engaged in the business of insurance may not unreasonably deny a claim for coverage or payment of benefits to any first party claimant. "First party claimant" has the same meaning as in RCW 48.30.015.

Conclusions:

Argonaut did not have systems, procedures, practices or proper forms in place to properly acknowledge and investigate a performance bond claim in the state of Washington.

Argonaut should not have sent a denial letter for any reason. "Lack of information" is not a reason to deny a claim. Where it is true that a surety needs more information or documentation, then that is a reason to send a letter either stating that the file will be put in a pending **[*68]** status until more information is received, or a letter stating that, if more information is not received be a specific date, the

surety might deny the claim for failure to maintain the claim or because it appears it may have been abandoned.

From my review of the materials, it appears Argonaut had all the information it needed and should not have been asking for more information. This is typically how a claims handler responds when he or she either (a) does not have time to look at a file, (b) mistakenly does not think the file contains what it should, or (c) does not want to look at a particular claim file, based upon laziness or improper analysis leading to a conclusion that it is not ready for review.

From my review of the Perkins and Miseo depositions, it appears the "big elephant in the room" reason for denial was a misplaced assumption that Stellar needed to issue a declaration of default and the statute of limitations defense was not thoughtfully considered, yet relied upon. The limitations stated in the performance bond is impermissible and void under Washington law, as confirmed by the Court hearing this case.

Argonaut can still retract its denial letter. Nothing required **[*69]** that Argonaut "must" have denied the claim. Nothing prevents a surety that has made a mistake on a coverage issue from learning from that mistake and correcting its course of action. Argonaut has had its education. It has learned Washington surety law is different, and that it needs to abandon the idea that coverage under the bond requires Stellar J to provide written notice of default.

Stellar provided any required notices, through claims correspondence and in its pleadings. It complied with the request that it complete a Proof of Loss form. It does not have additional hurdles such as the notice of default Argonaut insists upon.

Respectfully submitted,

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Appendix

[SEE ATTACHMENT A STELLAR J CORPORATION EXPERT REPORT IN ORIGINAL]

End of Document

Attachment A

Stellar J Corporation Expert Report

Figure 1

Tri-Partite Relationship of the ICW Performance Bond

Colorado Structures, Inc. v. Insurance Company of the West*, aka *CSI v. ICW* or *CSI v. West

OBLIGEE
Colorado Structures, Inc. ("CSI" or "Structures")

OWNER –
Wal*Mart Stores

PROJECT – Wal*Mart Store,
Vancouver, WA
$472,290

SURETY
Insurance Co. of
The West
("ICW" or "West")

PRINCIPAL
Action Excavating and
Paving, Inc.
(sewer subcontractor)

Attachment A

Stellar J Corporation Expert Report

Figure 2

West's Bond Language:[1]

[A] Action Excavating & Paving, Inc…, hereinafter called Principal, and Insurance Company of the West…, hereinafter called Surety, are held and firmly bound unto CSI Construction Co…, hereinafter called Obligee, in the amount of…$472,290…

[B] WHEREAS, Principal has…entered into a subcontract with Obligee…, which subcontract is by reference made a part hereof, and is hereinafter referred to as the subcontract, NOW

THEREFORE, THE CONDITION OF THIS OBLIGATION IS SUCH THAT, if Principal shall promptly and faithfully perform said subcontract, then this obligation shall be null and void; otherwise it shall remain in full force and effect.

--------Bifurcation of Bond by the Court. Above "Supplement", Below Default Terminate---------

[C] Whenever Principal shall be, and declared by Obligee to be in default under the subcontract, the Obligee having performed Obligee's obligations thereunder:

(1) Surety may promptly remedy the default, subject to the provisions of paragraph 3 herein, or;

(2) Obligee after reasonable notice to Surety may, or Surety upon demand of Obligee may arrange for the performance of Principal's obligation under the subcontract subject to the provisions of paragraph 3 herein;

(3) The balance of the subcontract price, as defined below, shall be credited against the reasonable cost of completing performance of the subcontract. If completed by the Obligee, and the reasonable cost exceeds the balance of the subcontract price, the Surety shall pay to the Obligee such excess, but in no event shall the aggregate liability of the Surety exceed the amount of this bond. If the Surety arranges completion or remedies the default, that portion of the balance of the subcontract price as may be required to complete the subcontract or remedy the default and to reimburse the Surety for its outlays shall be paid to the Surety at the times and in

[1] Yellow highlighting, [A] – [D], and yellow break line, by virtue of the Court's analysis of this bond form.

the manner as said sums would have been payable to Principal had there been no default under the subcontract. The term "balance of the subcontract price," as used in this paragraph, shall mean the total amount payable by Obligee to Principal under the subcontract and any amendments thereto, less the amounts heretofore properly paid by Obligee under the subcontract.

[D] Any suit under this bond must be instituted Before the expiration of two (2) years from date on which final payment under the subcontract falls due.

Attachment A

Stellar J Corporation Expert Report

Figure 3

Tri-Partite Relationship of the Argo Performance Bond is Identical to that in the *Colorado Structures* Case

DUAL OBLIGEES
Applied Filter Technology, Inc. ("AFT") – Primary Obligee
Stellar J Corporation ("Stellar") – Additional Obligee

OWNER –
Klickitat County PUD

PROJECT –
Construction of Inlet
Blower Package to Klickitat
PUD, H.W. Hill Landfill Gas Expansion,
Roosevelt, WA

May 18, 2009 - $3,671,113.00 then
Modified by July 10, 2009 - $3,520,322.00

SURETY
Argonaut Insurance
aka Argo

PRINCIPAL
Unison
Solutions, Inc.

Attachment A

Stellar J Corporation Expert Report

Figure 4

Argonaut's Bond Language:[2]

[A] KNOW ALL MEN BY THESE PRESENTS; That Unison Solutions, Inc., 5451 Chavanelle Road, Dubuque, IA 52002, called the Principal, and Argonaut Insurance Company, an Illinois corporation, called the Surety, are held and firmly bound unto Applied Filter Technology, Inc., 19524 75th Avenue SE, Snohomish, WA 98296, called the Obligee, in the amount of Three Million Six hundred Seventy One Thousand One Hundred Thirteen & No/100 U.S. Dollars ($3,671,113.00), for the payment whereof Principal and Surety bind themselves, their heirs, executors, administrators, successors and assigns, jointly and severally, as provided herein.

[B] WHEREAS, Principal entered into that certain material contract with the Obligee dated May 18, 2009 for Inlet Blower Package to Klickitat UPD, HW Hill Landfill Gas Project, Roosevelt, WA, a copy of which is by referenced made a part hereof ("Material Contract").

NOW, THEREFORE, if Principal shall faithfully comply with all terms and conditions of said Material Contract, or if the Principal shall pay, indemnify, and hold harmless the Obligee from all direct damages sustained by the Obligee as a result of any default by the Principal under the Material Contract, then this obligation shall be void, otherwise, to remain in full force and effect.

---Bifurcation of Bond Likely to be Made by the Court. Above "Supplement", Below Default Terminate---

[C] PROVIDED, however, that it is a condition precedent to recovery under this bond that written notice of any default claimed under the Material Contract be provided to Surety at the following address: Argo Surety, 20333 State Hwy 249, Suite 200, Houston, TX 77070.

[D] PROVIDED, further, that any suit by the Obligee under this bond must be instituted before the earlier of: (a) the expiration of one year from the date the Principal was obligated under the

[2] Yellow highlighting, [A] – [D], and yellow break line, added by Greg Arnold to show parallels with the bond form in the *Colorado Structures* case, and how the Court in this case might analyze the Argonaut bond consistent with the analysis in the *Colorado Structures* case. Notice the use of the word "otherwise" in the seventh line of [B]. The errors "referenced"[reference], third line in [B] and "th" [the], sixth line in [D], are original. The Argonaut performance bond, without the Dual Obligee Rider, consists of 429 words, contrasted with the ICW performance bond, which consisted of 368 words, based upon using the word count function in the Word program.

Material Contract to deliver the materials to the Obligee, or (b) the expiration of one year from the date any other default by the Principal under the Material Contract.[3] If the limitation set forth in this bond is void, prohibited by law or unenforceable for any reason, the minimum period of limitation available to sureties as a defense in the jurisdiction of th suit shall be applicable, and said period of limitation shall be deemed to have accrued and shall commence to run no later than the earlier of (y) the date the Principal was obligated under the Material Contract to deliver the materials to the Obligee or (z) the date of any other default by the Principal under the Material Contract; and

Provided, further that no right of action shall accrue on this bond to or for the use of any person or corporation other than the Obligee named herein or its successor.

[3] On April 16, 2014, Judge Ronald B. Leighton provided his "Order On Defendant's Motion for Summary Judgment", ruling that the claim against the "performance bond" (page 1) was filed timely. "But, Unison's obligations under the contract did not end with delivery" (page 2). The Court went on to state "Indeed, it would not even be paid the last 10% of the price until its materials had undergone 'successful test'" (page 2).

Attachment A

Stellar J Corporation Expert Report

Figure 5

Dual Obligee Rider (Concurrent Execution):[4]

This Rider is executed concurrently with and shall be attached to and form a part of performance bond No. SUR0001957.

WHEREAS, on or about the 18th day of May, 2009, Unison Solutions, Inc. (hereinafter called the "Principal", entered into a written agreement with Applied Filter Technology, Inc. (hereinafter called the "Primary Obligee") for the construction of the Inlet Blower Package to Klickitat PUD, HW Hill Landfill Gas Project, Roosevelt, WA (hereinafter called the "Contract"); and

WHEREAS, Principal is required by the Contract to provide a performance bond and Primary Obligee has requested that Stellar J Corporation, 1363 Down River Drive, Woodland, WA 98874, be named as an additional obligee under the performance bond; and

WHEREAS, Principal and Argonaut Insurance Company (hereinafter referred to as "Surety") have agreed to execute and deliver this Rider in conjunction Performance Bond No. SUR0001957 (hereafter referred to as "Performance Bond")

NOW, THEREFORE, the undersigned hereby agree and stipulate that Stella J Corporation shall be added to said bond as a named obligee (hereinafter referred to as "Additional Obligee"), subject to the conditions set forth below:

1 The Surety shall not be liable under the Bond to the Primary Obligee, the Additional Obligee, or any of them, unless the Primary Obligee, the Additional Obligee, or any of them, shall make payments to the Principal (or in the case the Surety arranges for completion of the Contract, to the Surety) strictly in accordance with the terms of said Contract, as the payments and shall perform all other obligations to be performed under said Contract at the time and in the manner therein set forth.

[4] As opposed to insurance policies, where changes or additions are accomplished with "endorsements", "riders" are used for surety bonds. In this rider, Stellar J was added as a first party to whom Argonaut owed obligations as a surety to an obligee. The rider uses the words "performance bond" six times. In addition, it contains the word "perform" one time and the word "performed" one time. Taken as a whole, under the eight corners rule of contract interpretation, and Argonaut's chosen language in its manuscripted bond forms, the instrument issued by Argonaut was a performance bond.

2. The aggregate liability of the Surety under the Bond, to any or all of the obligees (Primary and Additional Obligees), as their interests may appear, is limited to the penal sum of the Bond; the Additional Obligee's rights hereunder are subject to the same defenses Principal and/or Surety have against the Primary Obligee, and the total liability of the Surety shall in no event exceed the amount recoverable from the Principal by the Primary Obligee under the Contract. At the Surety's election, and payment due under the performance bond may be made by joint check payable to one or more of the obligees.
3. The Surety may, at its option, make any payments under said Performance Bond by check issued jointly to all of the obligees.

Except as herein modified, the Bond shall be and remains in full force and effect. Signed this 22nd day of June, 2009.

Attachment A

Stellar J Corporation Expert Report

Figure 6

The Court is Expected to Interpret These Bond Forms As Follows:

Argonaut's Bond Language:[5]

[A] KNOW ALL MEN BY THESE PRESENTS; That Unison Solutions, Inc., 5451 Chavanelle Road, Dubuque, IA 52002, called the Principal, and Argonaut Insurance Company, an Illinois corporation, called the Surety, are held and firmly bound unto Applied Filter Technology, Inc., 19524 75th Avenue SE, Snohomish, WA 98296, called the Obligee, in the amount of Three Million Six hundred Seventy One Thousand One Hundred Thirteen & No/100 U.S. Dollars ($3,671,113.00), **[or three times this amount, plus Olympic Steam Ship damages]** for the payment whereof Principal and Surety bind themselves, their heirs, executors, administrators, successors and assigns, jointly and severally, as provided herein.

[B] WHEREAS, Principal entered into that certain material contract with the Obligee **[Applied Filter Technology, Inc. and Stellar J Corporation]** dated May 18, 2009 for Inlet Blower Package to Klickitat UPD, HW Hill Landfill Gas Project, Roosevelt, WA, a copy of which is by referenced made a part hereof ("Material Contract").

NOW, THEREFORE, if Principal shall faithfully comply with all terms and conditions of said Material Contract, or if the Principal shall pay, indemnify, and hold harmless the Obligee **[Applied Filter Technology, Inc. and Stellar J Corporation]** from all direct damages sustained by the Obligee **[Applied Filter Technology, Inc. and Stellar J Corporation]**as a result of any default by the Principal under the Material Contract, then this obligation shall be void, **otherwise [emphasis added]**, to remain in full force and effect.

---Bifurcation of Bond Likely to be Made by the Court. Above "Supplement", Below Default Terminate---

[5] Red text added by Greg Arnold. Yellow highlighting, [A] – [D], and yellow break line, added by Greg Arnold to show parallels with the bond form in the Colorado Structures case. Notice the use of the word "otherwise" in the seventh line of [B]. The errors "referenced"[reference], third line in [B] and "th" [the], sixth line in [D], are original. The Argonaut performance bond, without the Dual Obligee Rider, consists of 429 words, contrasted with the ICW performance bond, which consisted of 368 words, based upon using the word count function in the Word program.

[C] PROVIDED, however, that it is a condition precedent to recovery under this bond that written notice of any default **[written notice of any default is not required pursuant to Washington law as enunciated in the *Colorado Structures* case. Also, any demands for repayment of monies paid by Stellar in supplementing Unison's Material Agreement would be analyzed under [A] and [B] above]** claimed under the Material Contract be provided to Surety at the following address: Argo Surety, 20333 State Hwy 249, Suite 200, Houston, TX 77070.

[D] PROVIDED, further, that any suit by the Obligee under this bond must be instituted before the earlier of: (a) the expiration of one year from the date the Principal was obligated under the Material Contract to deliver **[this is the surety's manuscripted bond form and does not contain a definition of the word "deliver", nor does it state anything about the timing for anything in connection with the word "deliver", and any ambiguity in a surety's own bond form should be construed against the surety. Also, the Court is likely to analyze parts [A] and [B] of this bond only]** the materials to the Obligee, or (b) the expiration of one year from the date any other default by the Principal under the Material Contract. If the limitation set forth in this bond is void, prohibited by law or unenforceable for any reason, the minimum period of limitation available to sureties as a defense in the jurisdiction of th suit shall be applicable, and said period of limitation shall be deemed to have accrued and shall commence to run no later than the earlier of (y) the date the Principal was obligated under the Material Contract to deliver **[same comments as above with respect to use of the word "deliver"]** the materials to the Obligee or (z) the date of any other default by the Principal under the Material Contract; and

Provided, further that no right of action shall accrue on this bond to or for the use of any person or corporation other than the Obligee named herein or its successor.

Attachment A

Stellar J Corporation Expert Report

Figure 7

Dual Obligee Rider (Concurrent Execution):[6]

This Rider is executed concurrently with and shall be attached to and form a part of performance bond No. SUR0001957.

WHEREAS, on or about the 18th day of May, 2009, Unison Solutions, Inc. (hereinafter called the "Principal", entered into a written agreement with Applied Filter Technology, Inc. (hereinafter called the "Primary Obligee") for the construction of the Inlet Blower Package to Klickitat PUD, HW Hill Landfill Gas Project, Roosevelt, WA (hereinafter called the "Contract"); and

WHEREAS, Principal is required by the Contract to provide a performance bond and Primary Obligee has requested that Stellar J Corporation, 1363 Down River Drive, Woodland, WA 98874, be named as an additional obligee under the performance bond; and

WHEREAS, Principal and Argonaut Insurance Company (hereinafter referred to as "Surety") have agreed to execute and deliver this Rider in conjunction Performance Bond No. SUR0001957 (hereafter referred to as "Performance Bond")

NOW, THEREFORE, the undersigned hereby agree and stipulate that Stella J Corporation shall be added to said bond as a named obligee (hereinafter referred to as "Additional Obligee"), subject to the conditions set forth below:

1. The Surety shall not be liable under the Bond to the Primary Obligee, the Additional Obligee, or any of them, unless the Primary Obligee, the Additional Obligee, or any of them, shall make payments to the Principal (or in the case the Surety arranges for completion of the Contract, to the Surety) strictly in accordance with the terms of said Contract, as the payments and shall perform all other obligations to be performed under said Contract at the time and in the manner therein set forth.

[6] Red text and underlining added by Greg Arnold to highlight how he expects the Court to analyze this Dual Obligee Rider. As opposed to insurance policies, where changes or additions are accomplished with "endorsements", "riders" are used for surety bonds. In this rider, Stellar J was added as a first party to whom Argonaut owed obligations as a surety to an obligee. The rider uses the words "performance bond" six times. In addition, it contains the word "perform" one time and the word "performed" one time. Taken as a whole, under the eight corners rule of contract interpretation, and Argonaut's chosen language in its manuscripted bond forms, the instrument issued by Argonaut was a performance bond.

2. The aggregate liability of the Surety under the Bond, to any or all of the obligees (Primary and Additional Obligees), as their interests may appear, is limited to the penal sum of the Bond **[except in cases of WIFCA violations, in which case damages can be trebled, plus *Olympic Steam Ship* damages for attorneys' fees, expert fees, *etc.*]**; the Additional Obligee's rights hereunder are subject to the same defenses Principal and/or Surety have against the Primary Obligee, and the total liability of the Surety shall in no event exceed the amount recoverable from the Principal by the Primary Obligee under the Contract. **[This ignores the fact that a first party claimant, such as an obligee, can obtain damages against a surety that exceed the amount recoverable from the principal by an obligee under the contract. This can happen in cases of WIFCA violations, in which case damages can be trebled, plus *Olympic Steam Ship* damages for attorneys' fees, expert fees, *etc.*]** At the Surety's election, and payment due under the performance bond may be made by joint check payable to one or more of the obligees.

3. The Surety may, at its option, make any payments under said Performance Bond by check issued jointly to all of the obligees.

Except as herein modified, the Bond shall be and remains in full force and effect. Signed this 22nd day of June, 2009.

Attachment A

Stellar J Corporation Expert Report

Figure 8

Argonaut Insurance Company

General Indemnity Agreement

July 27, 2009

[The General Indemnity Agreement contains 26 numbered paragraphs. For purposes of this litigation, some of these paragraphs are relevant in my expert analysis. These are as follows:]

Definitions

…

The term "Losses" shall mean any and all (a.) sums paid by Surety to claimants under the Bonds, (b.) sums required to be paid to claimants by Surety but not yet, in fact, paid by Surety, by reason of execution of such Bonds, (c.) **costs and expenses incurred in connection with investigating, paying or litigating any claim under the Bonds, including, but not limited to legal fees and expenses, technical and expert witness fees and expenses** [emphasis added by Greg Arnold] and (d.) all costs and expenses incurred in connection with enforcing the obligations of the Indemnitors under this Agreement including, but not limited to interest, legal fees and expenses and (e.) all accrued and unpaid premiums owing to Surety for the issuance, continuation or renewal of any Bonds and (f.) all other amounts payable to Surety according to the terms and conditions of this Agreement.

As an inducement to the Surety and in consideration of the Surety's execution or procurement of the Bond(s), the Surety's refraining from cancelling one or more Bond(s), and/or the Surety's assumption of one or more Bond(s) and for other good and valuable consideration, the receipt and sufficiency of which the Indemnitors hereby acknowledge, the Indemnitors hereby agree, for themselves, successors, and assigns, jointly and severally, as follows:

…

2. Indemnity. To indemnify, hold harmless and exonerate Surety from and against any and all Losses, as well as any other reasonable **expenses**[7] [emphasis added] that the Surety may incur or sustain as a result of or in connection with the furnishing, execution, renewal, continuation, or substitution of any Bond(s). Expenses include, but are not limited to: (a) the **cost incurred by reason of making an independent investigation in connection with any Bond(s)** [emphasis added] or this Agreement; (b) **the cost of procuring or attempting to procure the Surety's release from liability or a settlement under any Bond(s) upon or in anticipation of Losses, including the defense of any action brought in connection therewith** [emphasis added]; and (c) the cost incurred in bringing suit to enforce this Agreement against any of the Indemnitors. Payments of amounts due the Surety hereunder, including interest, shall be made immediately upon the Surety's demand. Vouchers, affidavits, or other **evidence of payment by the Surety shall be prima facie evidence of the Indemnitors' liability for any such Losses or other expenses.** [Emphasis added.][8]

3. Surety Reserves. The Surety may, in its sole discretion, establish a reserve to cover any actual or anticipated, liability, claim, suit, judgment, or Losses under any Bond. [Losses include "costs and expenses". See the third unnumbered paragraph under Definitions, as set forth above. Greg Arnold.] **In such event** [emphasis added by Greg Arnold][9], the Indemnitors will, immediately upon demand, deposit with the Surety a sum of money equal to such reserve, and any subsequent increase thereof, to be held by the Surety as collateral security on the Bond(s). Such funds will be used by the Surety to pay Losses or may be held by the Surety as collateral against potential future Losses. The Indemnitors hereby grant to the Surety a security interest in all money and other property now or hereafter delivered by such Indemnitors to the Surety for deposit in such reserve, and all income (if any) thereon. Any funds remaining after the Indemnitors' settlement or payment of all Losses will be returned to the Indemnitors within thirty (30) days from the date of the Indemnitors' settlement or payment of the Losses.

…

8. Default. The Indemnitors shall be in default of this Agreement if:…(c) Indemnitors fail to provide collateral in response to a proper request made by the Surety; ..and/or (e) Surety establishes reserves against Losses in connection with Bond(s) pursuant to Section 3 above.

…

[7] Stellar J is has not been made aware how the indemnitors have arranged for payment of any expenses incurred by Argo in this matter, and / or what reserves were posted to justify a collateral demand under the GIA.

[8] Argo had the right under the GIA to settle the Stellar J claim, with or without the consent of the Argo indemnitors.

[9] The establishment of a reserve is a condition precedent to Argo's demand for collateral. Stellar J has not been made aware of the establishment of reserves by Argo. Any amendment to the GIA must be by a writing, according to paragraph 16.

10. Surety's Rights to Releases or Bonds and Indemnitors Waiver.

This paragraph also addresses the rights of Argo to demand collateral "…to mitigate actual or potential Losses [including costs and fees, see Definitions, above] under any and all Bond(s) written in accordance with this Agreement."

11. The surety may execute or procure Bond(s) that guarantee the obligations or performance under one or more contracts (each a "Bonded Contract"). The Indemnitors shall be considered in default of a Bonded Contract if any of the following occur: (a) a declaration of default by any Bonded Contract owner;[10] (b) an actual breach or abandonment of the Bonded Contract;[11] and/or (c) an improper diversion of Bonded Contract funds or Indemnitors' assets to the detriment of the Bonded Contract obligations.

In the event of a default under a Bonded Contract, Indemnitors grant to Surety a security interest in all equipment, machinery, inventory, materials and all proceeds and products in connection with any Bonded Contract. This Agreement shall for all purposes constitute a Security Agreement and Financing Statement for the benefit of Surety in accordance with the Uniform Commercial Code ("UCC") and all similar statutes. In the event there is an act of default under any Bonded Contract, Indemnitors hereby irrevocably authorize Surety, without notice to any of the Indemnitors, to perfect the security interest granted herein by filing this Agreement or a copy or other reproduction of this Agreement.[12] Surety may add schedules or other documents to this agreement as necessary to perfects its rights. The failure to file or record this Agreement or any financing statement shall not release or excuse any of the obligations of Indemnitors under this Agreement. The Surety's exercise of any of its rights as a secured creditor under this Agreement shall not be a waiver of any of the Surety's legal or equitable rights or remedies, including the Surety's right of subrogation.

12. The obligee or beneficiary under certain Bonds(s) may make a demand for payment ("Demand") against the Bond(s). **When such Demand is made, the Surety must pay the amount of the Demand, not to exceed the penal sum of the Bond(s), as well as all necessary fees, within the time period required by the Demand**. [Emphasis added.][13] **Under such**

[10] This includes general contractor as an obligee.

[11] A principal would not want there to be a record of a declaration of default by any bonded contract owner, or a general contractor as obligee, or other status of obligee. This, by itself, would likely lead to a demand for collateral, failure to post which would lead to an argument by the surety under paragraph 8 that the indemnitors are considered in default of the indemnity agreement itself, and thus be at risk of receiving no other bonds from the surety and/or the surety demanding collateral.

[12] Stellar J has not been informed whether Argonaut in fact filed the GIA as a UCC-1 Financing Statement in one or more jurisdictions / states.

[13] Argonaut was aware of this obligation, but ignored it. Obligee Stellar J made such a demand, giving a time for response, but Argonaut did not meet that demand. "Stellar J. Corporation demands an acceptable cure plan delivered to Stellar J from Argos (sic) and/or Unison by close of business April 20, 2012. The cure plan must provide the date of installation of equipment needed to remediate this failed control system."

Bond(s), the Surety, [emphasis added] with the knowledge and consent of the Indemnitors, **has expressly waived all defenses to making such payment**. [Emphasis added.] If the Indemnitors receive notice from the Surety that a Demand has been made against the Bond(s) by the obligee or beneficiary, at least five (5) business days before payment of such Demand is due to the obligee, Indemnitors shall pay the Surety the full amount of the Demand, which amount shall not exceed the penal sum of the Bond, as well as all necessary fees. Such payment will be made by wire transfer or otherwise in immediately available funds to the bank account specified in the notice provided to the Indemnitors by the Surety.

The Indemnitors waive, to the fullest extent permitted by applicable law, each and every right which they may have to contest such payment. Failure to make payment to the Surety as herein provided shall cause the Indemnitors to be additionally liable for any and all **costs and expenses, including attorney's fees**, [emphasis added] incurred by the Surety in enforcing this Agreement, together with interest on unpaid amounts due the Surety, interest shall accrue, commencing the date the Surety pays the amount of the Demand, at the prime rate of interest in effect on December 31 of the previous calendar year as published in the Wall Street Journal. Indemnitors stipulate and agree that the Surety will suffer immediate irreparable harm and will have no adequate remedy at law should Indemnitors fail to perform this obligation, and therefore the Surety shall be entitled to specific performance of this obligation.

…

16. Amendment. This Agreement may be amended or terminated only by a **document executed by all parties** [emphasis added by Greg Arnold][14], or their respective successors or assigns.

…

[14] Stellar J is not aware of any document executed by all parties waiving the requirement that Argonaut first establish reserves before demanding collateral from its indemnitors. Sometimes this amendment can be addressed in a tender of defense to principal's / indemnitors' counsel or similar correspondence or agreement, but Stella J has not been made aware of any such document. Sometimes this can be addressed in correspondence to separate surety counsel, with an understanding that the surety will either be reimbursed by the indemnitors for fees paid by the surety company to separate surety counsel, or that the indemnitors will pay those fees directly. Stellar J has not been made aware of any such document that would amend the terms of the GIA. Accordingly, Stellar J assumes that Argo posted reserves.

Surety's Good Faith Investigation

Gregory S. Arnold, JD

Presented at

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

This paper was presented in 1989 shortly after I began my surety claims career. It was presented along with five others at CMA's 6th Annual Surety and Fidelity Claims Conference. Some of the presenters were my peers, others were legends who are no longer with us. This was CMA's final annual claims conference, and CMA no longer exists.

My paper was included in a spiral-bound conference book. I scanned the pages in 2021 so that the paper could be uploaded in digital form for easy sharing on the Internet. The cover for the publication has also been preserved, scanned into digital form, and included in this sharable paper. This paper was delivered more than 30 years ago. Much has changed, so much needs to be updated before anyone should rely upon the cases and statutes cited in the paper.

If this modest paper can give new surety professionals some guidance, and especially help keep sureties out of trouble, then my objectives will have been accomplished.

January 13, 2022

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THE 1989

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MANAGING THE CLAIMS

SURETY AND FIDELITY

THE 1989 NATIONAL CLAIMS CONFERENCE

MANAGING THE CLAIMS
SURETY AND FIDELITY

CHICAGO, ILLINOIS
APRIL 25, 1989

AGENDA

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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GREGORY S. ARNOLD

Gregory S. Arnold is the Bond Claims Superintendent of Highlands Insurance Company in Houston, Texas. He is responsible for the administration and handling of all contract surety claims nationwide.

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.

Mr. Arnold received his Bachelor of Arts degree in Political Science from Union College in Schenectady, New York, and his Juris Doctor degree from Western State University, Fullerton, California.

SURETY'S GOOD FAITH INVESTIGATION

I. Scope of this discussion.

II. The duty to investigate.

A. Implied covenant

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.
- Sources of information
  - Underwriters on the account
  - Principal
  - Project manager/supervisor/administrator
  - Agent
  - Credit reporting companies
  - Architect
  - Engineer
  - Surety's consultant

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

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

Guy 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.

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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 performance bond surety for the purpose of deciding the best way to minimize the loss to the surety, *e.g*., relet, tender, takeover, 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. Some contracts contain express covenants of good faith and fair dealing, and this may result in different obligations or exposures.

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 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;…".[7]
>
> (Emphasis added).

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 Need a Bucks Now Co.
Street
City, State and Zip

Re: Principal:	Lucky Construction, Inc.
Obligee:	Get It Right, Inc.
Bond No.:	XX XX
Claim No:	CS-1989-001122
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.

Very truly yours,

NAME
Title

cc: Principal

cc: Underwriting

cc: Agent

cc: Others who can help or who should know

In addition to merely sending a copy of this acknowledgment letter to the principal, it is a good practice 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 facilitate a 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.

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 managed and what information is required by the surety.

Once the initial letters have gone out in connection with a routine claim or trouble notice, it is appropriate to diary the file for a brief 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 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 or what is reasonable under the circumstances.

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 on a Texas project 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 outside limits, such as 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 unreasonable or 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 occasionally 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, with more than mere alleged defenses, that it has a *bona fide* backcharge or offset against the claimant. In these specific 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 old-school 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 obligee is 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, 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 copies of reports from 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. This is particularly helpful if the principal is still using that agent to place bonds for it, although through another surety. In this situation, the

principal will want to convey the impression to its agent that the principal still has the character, capacity and capital to discharge all of its obligations. 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 pursuant to the GAI 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 reasonably 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 of 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. A surety claims handler 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

Do not 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 after conducting a reasonable investigation, do it promptly, and provide a detailed explanation for the denial. If you have conducted a thorough and reasonable investigation, but cannot determine who is right and who is wrong, then a denial is not prudent. It is better to review the bonded agreement and, where there is a clear dispute resolution clause in that agreement, point it out and rely upon it to hold the claim file open pending resolution by the method spelled out in the agreement between the parties. This may include mediation and/or arbitration.

If the claim file is incomplete, ask the claimant for any information that is still required, such as copies of delivery tickets, purchase orders, 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 have 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 merely 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 attorneys for the principal and surety have 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, there is a documented genuine dispute, 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 special defense not shared by the principal, or the surety determines a severe 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 manage this rare 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 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 a reasonable 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 and knowledgeable about surety law, 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 amounts to 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 duty or 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, increasingly, third-party actions.

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

1. Guy 0. 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 540-89-4£.

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 Bureau Mutual*, 31 Tex. Sup. Ct. J. 392, 395 (May 11, 1999). 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 anticipated 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. Not all GAIs have the requirement of already incurring a loss or setting a reserve, so read the agreement carefully in each case.