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Surety Power: The general indemnity agreement really is enforceable

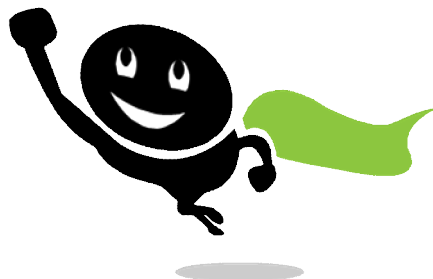
Having and maintaining a relationship with a surety bonding company is necessary (some say a necessary evil) for a contractor to undertake public construction work in Texas. Texas law requires that public owners compel prime contractors to secure surety bonds for construction projects over \$25,000.

For a contractor to secure a surety bond, it will have to undergo surety scrutiny and underwriting. As part of the underwriting process, and to induce a surety to issue bonds, the surety will require the contractor (and usually the owner or sometimes the principal officers) to execute an indemnity agreement, often termed a "general indemnity agreement." The indemnity agreement assures the surety that the indemnitors will reimburse the surety for any and all loss or expense that the surety sustains as a result of issuing bonds.

The indemnity agreement contains many provisions that protect the surety

a claim than is truly owed, simply if it is expedient to do so. The determination of expediency belongs to the surety, and the surety's decision will stand absent bad faith.

If a contractor defaults, the indemnity agreement generally assigns to the surety the contractor's rights to the contract balance and to recover any claims (change orders, extra work, etc.). This



is significant because sometimes a contractor legitimately becomes embroiled in disputes with an owner, and progress slows or stops. The owner may choose to raise the stakes by default terminating the contractor and demanding that its surety honor its performance bond, and complete the project.

An overreaching owner may even contrive a default by the contractor so that it can negotiate with the surety concerning the contractor's extra work or other claims. The owner's goal may be to diminish or eliminate the contractor's claims since the surety may be less inclined to fight for the contractor's rights. Indeed, since the surety then owns the contractor's contract balance and claims, the surety can settle the rights to recoup such money for just a few cents or no cents on the dollar.

To prove its loss and expense, a surety may only have to provide an itemized sworn summary of loss pay-

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Lawyer Quips and Quotes



"And so I ask the jury...is that the face of a mass murderer?"



DoveApprentice...

"I thought I was guilty until my lawyer straightened me out on that."

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An Observation by Sandra Day O'Connor: "There is no shortage of lawyers in Washington, DC. In fact, there may be more lawyers than people."

-TCR-

The surety can settle claims regardless of actual liability.

and enhance the prospects of reimbursement of prospective loss or expense. For example, the indemnity agreement generally permits the surety to settle claims on its bonds regardless of liability. Stated another way, the surety can pay a claim whether or not the money is actually owed.

The indemnity agreement generally permits the surety to resolve claims if it is expedient to do so. This means that the surety can, for example, overpay a claim, that is, pay more money to settle

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ments.

In *Parks v. Developers Surety and Indemnity Co.*, 2010 WL ____ (Tex.App. — Dallas 2010), the trial court granted summary judgment to a surety against a contractor and indemnitors in an indemnity action. The contractor had been defaulted from a City of Fort Worth contract involving improvements for three parks, for allegedly not properly completing the projects. The City made demand on the surety to perform under its performance bond. The surety paid to resolve performance and payment bond claims, and sued the indemnitors to recover the payments.

The surety filed a motion for summary judgment supported by an affidavit from an assistant claims manager with a detailed summary of loss and expense payments. The trial court granted summary judgment to the surety and the indemnitors appealed. On appeal, the appellate court rejected the indemnitors' argument that there was a failure of proper proof, noting that the indemnity agreement permitted such proof. Courts generally will uphold the contract as the law between the parties.

Under a typical indemnity agreement, an indemnitor is reduced to alleging and proving a "bad faith" case, which is a difficult proposition under ordinary circumstances. For a detailed explanation, see the *Associated Indemnity* case on page 4.

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Primer on Suretyship: The Performance Bond

The issuance of surety bonds for a construction project establishes a tripartite relationship between and among the obligee (bond recipient), principal (contractor), and the surety. A performance bond generally requires the surety to respond to a declaration of default by the obligee of the principal. In other words, there need be no surety response until a default declaration. In fact, the surety has no obligation even to monitor its principal's work prior to default.

The surety's response can take many forms. The surety will first focus on limiting its liability to no more than the penal sum of the bond. The surety

will usually investigate the nature and extent of the default, and may retain its principal or a third party to resolve the default. The surety may proffer a three party agreement to be signed by obligee, completion contractor, and surety. The surety may instead proffer a take-over agreement for obligee and surety to sign, with a separate completion agreement for completion contractor and surety.

The surety may opt to do nothing for a variety of reasons. The surety may wish to await the completion of the project by the obligee and second guess the obligee's costs. Or the surety may contend that obligee's conduct has somehow discharged the surety's liability.

The surety may offer to pay money for a release of the bond. The offer may be some or all of the bond's penal sum. The surety may negotiate to release some or all of the principal's contract balance and claims for extra work, as the rights to recover such money are generally assigned to the surety upon the event of default by the contractor.

The surety's obligations cannot be extended by implication and will be strictly limited to those set out in its

Upon default, the surety may opt to do ... nothing.

bond. The surety can rely on and insist upon the terms of the bonded contract being strictly followed. The surety may be released from its obligations with a material alteration in, or deviation from, the terms of the contract without the surety's consent, and to its prejudice.

For example, if the contract requires that a design professional certify that the contractor has earned payment, the surety can rely on that process occurring. If there is no or an inappropriate certification, the contractor may be overpaid considering the nature and extent of the defective or incomplete work, and the surety may be discharged. Although many contracts state that the surety consents to and waives notice of changes, courts will generally disregard changes that affect the essential terms of the bonded contract, and impose additional obligations on the surety.

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The Editor's Corner

*The Construction Report is published periodically by Quilling, Selander, Cummiskey & Lownds, P.C., to highlight construction matters of interest to at least the Editor, Brian W. Erikson. The information we provide is a community service and is not intended to displace the legal judgment of your attorneys. Write us c/o **Brian W. Erikson**, 2001 Bryan Street, Suite 1800, Dallas, Texas 75201. Call us at (214) 880-1844.*

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Lawyer Quips & Quotes II

I never think of the future — it comes soon enough.

—Albert Einstein, physicist

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If a cluttered desk is the sign of a cluttered mind, what is the significance of a clean desk?

—Dr. Lawrence J. Peter, educator

**

Nothing is impossible. Some things are just less likely than others.

—Jonathan Winters, comedian

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Lawyers and Alligators

Two alligators sit on the edge of a swamp. The small one turns to the big one and says, "I don't understand how you can be so much bigger than I am. We're the same age, we were the same size as kids... I just don't get it."

"Well," says the big alligator, "what have you been eating?"

"Lawyers, same as you," replies the small alligator.

"Well, where do you catch 'em?"

"Down at that law firm on the edge of the swamp."

"Same here. How do you catch 'em?"

"Well, I crawl under a BMW and wait for someone to unlock the door. Then I jump out, bite 'em, shake the crap out of 'em, and eat 'em!"

"Ah!" says the big alligator, "I think I see your problem. See, by the time you get done shakin' the crap out of a lawyer, there's nothing left but lips and a briefcase..."

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(Continued from "Lesson" on page 4)

tractor and demanded that Surety complete the project. As part of its investigation, Surety met with Contractor. At that meeting, according to Contractor, Surety represented that the two were a "team," and that Surety would act only in Contractor's best interest and keep Contractor informed.

To investigate the pipeline and minimize liquidated damages, Surety proposed that the leaks be repaired, but with a full reservation of rights for all parties. Contractor offered to make the repairs since its equipment and crews were already in place, but neither Owner nor Surety accepted the offer. Surety decided to contract with one of Contractor's competitors, Mercer, to repair the leaks on a time and materials basis with a percentage markup.

Surety retained a construction consultant to assist in its investigation and to monitor the repairs. The consultant wrote to Surety that unstable soil conditions made it "next to impossible to restrain the pipe while it is being laid over a long distance," so that Owner's design may have created an "impossible spec to achieve." The consultant recommended that Surety retain an engineer to analyze the design, but Surety did not do so.

Mercer charged \$242,123 for the repairs. A pressure test following Mercer's repairs revealed 12 leaks. Surety advised Contractor that there was a "good case" that Owner's engineers were at fault, and that Surety would notify Contractor before making any final decision to settle Owner's claim.

Shortly thereafter, without notice to Contractor, Surety settled with Owner. Surety paid Owner \$380,000 for a complete release of just Surety, not Contractor, allowed Owner to keep Contractor's contract balance (including retainage) of about \$425,000, and released all of Surety's claims against Owner. Surety then demanded reimbursement of \$835,000 from Contractor and the indemnitors under the indemnity agreement. When Contractor refused to pay, Surety filed this suit. Contractor counter-claimed for breach of contract, breach of fiduciary duty, breach of the duty of good faith and fair dealing, and other claims. Contractor claimed that Surety failed to keep it informed, failed to ade-

quately investigate and assert Contractor's faulty design claim, and failed to protect Contractor's interests during the settlement process.

The trial court found that Surety breached a common law duty of good faith and fair dealing, breached the indemnity agreement by failing to act in good faith, breached a fiduciary duty owed to Contractor, and committed fraud, tortious interference with contract, and negligent misrepresentation. The trial court denied indemnity to Surety, and rendered judgment against Surety for \$4,163,305 in lost profits and \$425,579 for contract balance, and for \$700,000 in mental anguish damages to the individual indemnitors.

The court of appeals affirmed in part, holding that Contractor was entitled to recover for Surety's breach of both a common law and contractual duty of good faith. The appellate court reduced the award of lost profits to \$406,506 and the mental anguish award to \$600,000. The appellate court held that Surety owed no fiduciary duty to Contractor, and affirmed the denial of any recovery by Surety under the indemnity agreement.

Both parties appealed to the Texas Supreme Court. The Supreme Court rejected Contractor's contention that Surety had a duty of good faith to Contractor. The Court observed that it had previously held in *Great American Ins. Co. v. North Austin Municipal Utility Dist. No. 1*, 908 S.W.2d 415 (Tex. 1995), that a surety owed no common law duty of good faith to the performance bond obligee (in that case, the owner). The Court noted but rejected Contractor's complaint of unequal bargaining power, and Surety's demand that Contractor sign the indemnity agreement "take-it-or-leave-it." The Court also refused to impose a good faith obligation on Surety concerning Contractor's contract balance.

The Court also rejected the lower courts' declaration that a surety must

demonstrate good faith by undertaking a reasonable investigation before paying or settling a claim. Instead, the Supreme Court held that the inquiry should be whether the surety acted in bad faith. The Court noted that for a surety to act in bad faith, it required more than an unreasonable or negligent investigation. The Court stated that the surety must engage in willful misconduct or possess an improper motive. The Court construed the indemnity agreement to permit recovery for disbursements made by Surety in good faith under the belief that it is or was liable for the amount so disbursed or that it was necessary or expedient to make such disbursements, whether such liability, necessity or expediency existed or not. The Court observed that the indemnity agreement language gave the surety discretion "limited only by the bounds of fraud," and held that such broad discretion did not violate public policy, but rather advanced the public interest in promoting suretyship. The Court concluded that a surety's recovery was limited only by bad faith, which exceeds negligence or even gross negligence. Simply put, an improper motive or fraud was required to preclude an indemnity recovery.

Recapping its holding, the Supreme Court stated that "good faith" for the indemnity agreement at issue referred to conduct which is honest in fact, and free of improper motive or willful ignorance of the facts at hand. The Court held that Surety did not need to prove that its investigation was "reasonable."

The Court found that there was some evidence of Surety's bad faith settlement since Surety's own consultant suspected that leaks were caused at least in part by faulty design specifications, and recommended that Surety retain suitable engineering expertise. When Surety chose not to and instead to settle, the implication was that Surety simply figured it could recoup the settlement money from indemnitors. Finally, the Supreme Court declined to impose any fiduciary duty on Surety since there were no prior dealings between Contractor and Surety justifying a special relationship of trust and confidence. The Court reversed the court of appeals in part, and rendered judgment that all parties take nothing.

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A lesson in indemnity agreement power

Associated Indemnity Corp. v. CAT Contracting, 964 S.W.2d 276 (Tex. 1998), explores the bounds of a surety's rights under an indemnity agreement. There a contractor ("Contractor") agreed to construct 8 miles of concrete pipeline for a public owner ("Owner"). Contractor secured surety bonds from Surety to guarantee its obligations under the contract. To induce Surety to issue bonds, Contractor (and its individual owners) signed an agreement to indemnify Surety for any losses or expenses that Surety incurred under the bonds.

The indemnity agreement vested Surety with exclusive authority to determine whether and for how much any claim under the bonds should be settled. It stated that Surety's decision to settle a claim if "made in good faith," was binding on Contractor, and required Contractor to reimburse Surety for the settlement amount. Finally, the agreement provided that Contractor's default of the

construction contract would assign to Surety Contractor's claims, if any, against Owner as "collateral security" for Contractor's indemnity obligation.

The project was star crossed. As excavation began, Contractor became concerned that the soil was too unstable to accommodate the pipeline design. Contractor wrote to Owner's design engineer ("Engineer") to advise that the



soil and gravel bedding were too unstable for a concrete pipeline and would rupture the pipeline's joints. The contract made Owner responsible for Engineer's design errors, such as a flawed bedding design. Engineer assured Con-

tractor that the design was fine, and ordered Contractor to continue construction. Contractor encountered several other problems which resulted in delay and extra work, including materially different subsurface soil conditions and unmarked underground utilities. Contractor did not complete within the 300 days allowed by contract. Contractor claimed that Engineer assured it that Owner would grant extensions due to weather delays and problems beyond Contractor's control.

When Contractor pressure tested the pipeline, it found 14 leaks. Contractor contended that the Engineer's design caused the leaks, and demanded additional payment to make repairs. Owner denied fault, and blamed the leaks on improper installation. Owner demanded that Contractor repair the leaks, and issued a 10-day cure notice to Contractor and Surety. By that time, Contractor had not been paid by Owner in 8 months, and was owed more than \$400,000. When Contractor did not make the repairs, Owner defaulted Con-

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