Bad Faith Claims – Episode Notes
Surety Today

Recorded: September 17, 2021 @12:30PM EST

Hosts: Thomas J. Moran and Justin A. Thatch

Two Types of Bad Faith

The courts that recognize surety bad faith draw it from two primary sources of authority: common law and statute. Regardless of the source, the concepts are borrowed from those established in the context of traditional liability insurance. Of course, typical liability insurers have bilateral contracts – they receive premium with the understanding that there will be risk in the form of a valid claim, and the policyholder that paid for the policy is entitled to the coverage it bargained for without a lot of struggle. An insurer's obligations only run in one direction. But as we all know from the *Pearlman* case, suretyship is not insurance. A surety doesn't only have obligations to the obligee for whose benefit the bond is written; it has a responsibility to ensure that it is not simply paying claims in bad faith, which would jeopardize its indemnity rights, or without investigation. The tripartite relationship between a surety, obligee and principal, and the secondary nature of the surety's liability to the obligee, leave a "round hole/square peg" dynamic when courts have applied insurance bad faith concepts to sureties. But that hasn't stopped some from trying. Justin will get into some of those specifics when he turns to the case law.

Common Law

Just about every jurisdiction recognizes the existence of a duty of good faith and fair dealing inherent in every contract. Each party that enters into a contract does so with the expectation that it will realize a benefit as a result. A party is not permitted to act in bad faith to interfere with its counterpart's right to obtain that benefit. In the insurance context, this right initially was limited to contractual damages, but as the case law developed, the majority of jurisdictions established a tort claim for bad faith, allowing collection of punitive damages and attorneys' fees. The basis for liability in tort is the special relationship between an insured and its insurer based on unequal bargaining power, the sophistication and resources of the insurer. In essence, when you buy a policy, you are supposed to receive coverage, and not a massive fight over irrelevant issues that you might not have considered when you bought the policy. In carrying the bad faith concept over to surety, some courts have analogized surety to insurance by comparing the obligee to a policy holder. In essence, the obligee is a third-party beneficiary of the promise obtained by the principal when it paid premium. Some courts have also held that insurance is sufficiently similar to surety such that the same rules should be applied to both. Others believe that the surety needs an incentive to pay valid claims rather than routinely deny them and dare the claimant to file suit.

The standard for applying common law bad faith liability to sureties varies by jurisdiction but for the most part something more than basic negligence or bad judgment is required. The standards contemplate "dishonest purpose," "ill will," behavior that the surety knows is unreasonable, or conscious wrongdoing. So while a surety generally doesn't stand to be hit with common law bad faith liability simply by inaction, the lack of responsiveness or failure to investigate can be an aggravating factor if the surety is accused of other acts that show an improper motive.

Statutory

Generally, the Unfair Claims Settlement Practices Act does not apply to sureties, which are explicitly excluded from the scope of the model Act. But states vary in their application of the model act, only incorporating some of it, or varying its terms. For those states where it is unclear whether the claims settlement statute applies to sureties, and especially in states where a court has ruled that it does, it is crucial to know the practices that can be punished.

There are about 15 categories of prohibited behavior. Most of them are spelled out in the model UCSPA and the state-specific statutes, and there are one or two more that have been added by states or are otherwise simply smart to avoid. These are paraphrased to aid in the discussion, but you should always consult the relevant act in the jurisdiction where the claim is pending for the pertinent language. A lot of these categories are going to be relevant to any common law bad faith determination as well.

1. Knowing misrepresentation of relevant facts or policy provisions relevant to coverage. So if you're telling an obligee what the terms of the bond say, or relating facts that you learned about the project from a consultant or the principal, you need to be sure that you're getting your facts straight.
2. Failing to acknowledge pertinent communications relating to claims with reasonable promptness. Make sure your paper trail of communications is in order. Save and archive those emails. Take notes of phone conversations. If you need more documents or access to reach a decision or consider a plan of action, say so in an email and confirm that the recipient is going to undertake efforts to cooperate. Set calendar reminders to respond to an inquiry within 2-3 days (or sooner if necessary under the circumstances).
3. Failing to adopt reasonable standards for prompt investigation and resolution of claims. We all know that there is no one-size-fits all approach for dealing with a performance bond claim. But there are basic guidelines that can be adopted. Time frames for response once the initial supporting have been requested and received. Meetings with the principal, site visits, books and records reviews.
4. Not attempting to effectuate prompt, fair and equitable settlement of claims where liability is reasonably clear. This is the "lost cause" provision. If your principal has just fallen on its face, clearly can't complete the job, isn't paying its subcontractors and suppliers, has defective work, and no valid purpose would be served by denial of the claim or failing to select from the performance options under the bond, you can't simply hide your head in the sand. You have to act to deal with the claim, and can't just fight a lost cause to make life difficult for the obligee.
5. Compelling insured to file suit to recover amounts due by offering substantially less than the amount ultimately recovered. This is the "lowball" rule. This may not be as applicable in the performance bond context, but certainly would apply in responding to a payment bond claim. Be careful in offering a low sum to resolve a payment bond claim.

Make sure there's a justifiable basis for the amount you're offering. Whether there's a dispute over the value of the services or materials provided, or if there is some problem with documentation that would create risk for the claimant, or if there is some wiggle room created by questionable notice. Document the reasons for the number in the offer letter, and reserve your rights as to other defenses and arguments.

6. <u>Refusing to pay claims without conducting a reasonable investigation.</u> What is reasonable under the circumstances? Certainly you need to determine why the obligee isn't happy with what is happening on the project, and why the principal is struggling. You need to reach out and get the principal's view, ideally getting documents from both. Often a qualified engineering consultant will be needed to get to the job site to view the affected work and interview key personnel. Sometimes you may run into an obligee that refuses to take the time to support its claim with documentation, saying "it's your problem now, deal with it." And while that is frustrating, depending on the language of the bond and the jurisdiction, that may be justified. Always be aware of the language of the bond and how it affects the lengths to which you'll be required to go to properly investigate the claim.
7. <u>Failing to affirm or deny coverage within a reasonable time after investigation is complete.</u> You can't rest on your laurels. Once you've obtained the documents you've asked for, you've completed your site visit and interviewed key personnel, you need to move swiftly to reach a decision on which course of performance to select under the bond, or whether to deny coverage and invite a lawsuit. Again, a reasonable time is going to depend largely on the size and complexity of the project, and cooperativeness of other entities. This is another reason why the ordinary bad faith rules just aren't a good fit in the surety context. In life insurance, auto accidents, casualty, many claims are straightforward and turn on a few well-worn factual patterns and common policy provisions. If you're listening to this podcast, you know that every construction project is different, different specs, different site conditions, different owners, contractors, etc. A one-size-fits-all rule is impossible.
8. <u>Attempting to settle or settling claims for less than amounts to which reference was made in advertising material accompanying the application.</u> Probably not relevant in the surety context as the principal making the application is not the party that's going to be asserting a claim.
9. <u>Attempting to settle or settling claims on the basis of applications that were materially altered without notice to, or knowledge or consent of the insureds.</u> This one is also probably not applicable in the surety context for the same reason. It should be obvious that nothing on a principal's application should be altered without consent.
10. <u>Making claim payments to insureds or beneficiaries without indicating the coverage under which each payment has been made.</u> Could be applicable in a multiple default situation where your principal is working several projects for the same obligee. Any time you make payment to an obligee or another party under the bond, make sure there's some writing, whether a release, takeover agreement, completion agreement, ratification, or transmittal letter, that documents which project and which obligation the payment applies to. If you're issuing a check, document the info on the check, if possible.
11. <u>Unreasonably delaying the investigation or payment by requiring a formal proof of loss form and subsequent verification that would duplicate the information being provided.</u> This is another one that's probably only relevant in the realm of payment bond claims. If

you're using a proof of claim form, and you should, make sure that you review what is attached to it by the claimant and you're not repeating requests for information that have already been responded to. Be up-to-date on the state of your file.

12. Failing in the case of claims denials or offers of compromise settlements to provide a reasonable and accurate explanation of the basis. If you're denying a claim, say why. Cite the specific bond provision or contract provision you're relying on. If you're closing your file after not hearing back from a claimant despite a request for information, send a letter saying so.
13. Failing to provide forms necessary to present claims within a certain number of days along with reasonable explanations on their use. Again, not relevant when dealing with a sophisticated obligee, but when dealing with a payment bond claimant, keep in mind that you may be dealing with a sub or laborer that has never had to submit a claim before. Send a letter along with the proof of claim for and make it clear that the information and documents need to be accurate and up-to-date, and explain that what is provided will be used in evaluating the extent to which the claim will be paid.
14. Failing to adopt standards to ensure repairs are performed in a workmanlike manner. Applicable to property or casualty policies, not to surety. Any work performed by the surety's completion contractor or under tender is going to be controlled by agreements executed pursuant to the bond and the contract documents.
15. Having a policy of appealing from arbitration awards in favor of claimants for the purpose of compelling them to accept settlements or compromises less than the award. We often think of arbitration awards as being unappealable, but at the Pearlman conference last week during a very good point-counterpoint presentation on arbitration, I was reminded that issues can be reserved for appeal by agreement. If you do that and get an unfavorable outcome in arbitration, you can't use the right of appeal as a sword in order to broker a compromise.
16. Delaying claims settlement where liability has become reasonably clear as to one portion of coverage in order to influence settlement under other portions. If there is one part of a claim that's undisputed, you can't drag your feet on it to strongarm the claimant as to disputed portions of the claim. Move swiftly to get the undisputed portion paid and leave the fight to the parts that are undisputed.

A lot of these may seem elementary, and for the most part they are. But that is the point. These bad faith rules, where they are applicable, set a baseline for tolerable conduct by sureties. I'll now turn the mike over to Justin, who will discuss in more detail some of the relevant and recent case law impacting the surety's potential bad faith liability.

Case Law Review

With respect to the Surety and Bad Faith, I am going to take a look at some cases in the arena of bad faith. Now, as you may imagine, bad faith case law touches on a number of different areas. As with any legal topic, the first matter to take notice of is the policy or law of the particular jurisdiction you are in. Some jurisdictions have codified surety bad faith policies in statutory form. Others allow surety bad faith claims as a matter of common law or court-created law. Other jurisdictions do not allow bad faith claims against sureties at all. Therefore, my discussion is designed to simply look at a few examples out there of how courts discuss surety bad faith in different contexts.

I will start with an important case, one some of you may already know, called Cates Construction, Inc. v. Talbot Partners, 21 Cal.4th 28 (1999) from the Supreme Court of California. This case deals with a common law claim of bad faith against a surety. To simplify the facts down a bit, this case involved the surety's liability to a real estate developer for the alleged default of the general contractor on a condominium project. A dispute arose between the owner and GC regarding payment. Cates sought additional money from the owner that the owner refused to pay – alleging that the owner had already paid several hundred thousand dollars more than the cost of the work. Cates threatened to abandon the project over non-payment and the Owner made a demand on the surety to perform under the bond. The surety's position was that the Owner breached the contract by failing to make payments to the GC and that it would not perform under the Bond citing to the dispute between the parties.

At the trial stage, it broke down in two ways. First, there was the contract side. Ultimately, the Court found that Cates and the surety were liable for Cates' breaches of contract and were liable to pay. A result to which the surety, generally, did not object. However, the owner also sued the surety in tort for the breach of the covenant of good faith and fair dealing, i.e. bad faith.

In this decision, the Court provides an excellent discussion of the distinction between insurance and suretyship. This is importance because the insurer-insured relationship is a limited exception to the rule that the recovery for a non-breaching party to a contract is the remedies provided by that contract. Therefore, if an insurer acts in bad faith in failing to honor its insurance contract, it can be liable in tort for additional damages, including possible punitive damages. The owner in this case sought to apply this theory to a contract bond surety.

In California, like in other states, suretyship was listed under the Insurance Code of the state statutes as a class of insurance. While the Court goes through some great analysis that is worth reading in full, it sums up the issue by stating, "Although suretyship is listed in the Insurance Code as a class of insurance, it does not follow that a surety bond equates to a policy of insurance under the common law or common law theories of liability. Nor does it follow that the unique policy reasons which justify extraordinary remedies in the insurance policy context are similarly implicated for bonds guaranteeing the performance of a commercial construction contract."

On a related note, I particularly like a quote from North Carolina Court of Appeals case in talking about how suretyship is often considered "in the nature of insurance." It said: "But this, of course, no more justifies the conclusion that sureties are insurers and performance bonds are contracts of insurance than does the commonly known fact that sheep are somewhat like goats justify the conclusion that sheep are goats."

The Court next looked at the policy side to find that construction performance bonds were not marked by the same elements of adhesion and unequal bargaining power, public interest and fiduciary responsibility that characterize insurance policies. Basically, a project owner is in a lot stronger position in the marketplace than an insured.

Lastly, the Court looked at other consequences of imposing bad faith liability on sureties. The Court found that "making tort remedies available may encourage obligees to allege a principal's default more readily than they would in the absence of such remedies" and it would make it easier "to pressure sureties into paying questionable default claims, or paying more on properly

disputed claims.” The Court also feared that the threat of tort liability would give obligees additional leverage over sureties that it did not have over principals that would ultimately harm principals.
Overall, the Court found that there was no claim for bad faith in tort against a surety. This case has been cited by other courts for the same proposition and is found to be particularly persuasive as California was a pioneering jurisdiction in terms of recognizing bad faith claims in the insurance context. Therefore, I think that gives the decision some added weight.

Next, I will look at a case involving the statutory side of things from Georgia. Ga. Code Ann., § 10-7-30, which states in part “In the event of the refusal of a corporate surety to commence the remedy of a default covered by, to make payment to an obligee under, or otherwise to commence performance in accordance with the terms of a contract of suretyship within 60 days after receipt from the obligee of a notice of default or demand for payment, and upon a finding that such refusal was in bad faith, the surety shall be liable to pay such obligee, in addition to the loss, not more than 25 percent of the liability of the surety for the loss and all reasonable attorney's fees for the prosecution of the case against the surety.”
In United States v. All Am. Bldg. Sys., Inc., 857 F. Supp. 69, 70 (N.D. Ga. 1994), a Miller Act payment bond claim was brought against a contractor and its surety. In Count II of the Complaint, the subcontractor sought recovery of the statutory penalty and its attorneys fees under the statute just discussed. Relying on a previous case, the Court found that “because Congress did not intend to incorporate state law with respect to the award of fees in a Miller Act case, the recovery of any state law penalties would not be allowed.” This stemmed from the Supreme Court’s F.D. Rich decision that explained that the remedies available in a Miller Act case are determinable by federal law. “The Miller Act provides a federal cause of action and the scope of the remedy as well as the substance of the rights created thereby is a matter of federal not state law.” Therefore, in states that allow statutory bad faith claims against sureties, that relief cannot be added on to a federal Miller Act claim.

The final area I will touch on is cases in the indemnity context. Basically, it goes that a surety, in seeking indemnity against its indemnitors, cannot recover for payments made in bad faith. Essentially, the indemnitor can raise the surety’s bad faith as an affirmative defense to an indemnity claim. One example of this argument being made is in Devs. Sur. & Indem. Co. v. Renew Maint. & Constr., Inc., No. CV 1:17-00495-KD-N, 2018 WL 6185999, at *2 (S.D. Ala. Oct. 5, 2018). In this matter, the surety settled a performance bond claim with the obligee for $400,000. However, “the mere payment of claims --“even those for which the principal has a valid defense -- does not amount to bad faith.” Likewise, gross negligence or self-interest is not synonymous with bad faith. Rather, bad faith means a dishonest purpose, a conscious wrongdoing, or a breach of duty motivated by self-interest or ill-will (e.g., that the surety acted with deliberate malfeasance (an intentional wrongful act which the actor has no legal right to do) or any wrongful conduct which affects, interrupts, or interferes with the performance of official legal duty). “A surety's failure to conduct an adequate investigation of a claim upon a ... bond, when accompanied by other evidence, reflecting an improper motive, properly may be considered as evidence of the surety's bad faith.”
An important point that arises out of this case and others is that in order to bring a bad faith defense in an indemnity context, the indemnitor must comply with all of its obligations under the indemnity agreement. In this case, and others like Employers Ins. of Wausau v. Able Green, Inc.,

749 F. Supp. 1100 (1990). In these cases, the indemnity agreements, like many, contained clauses allowing the principal request the surety litigate the claims or post-collateral on demand, or both. In both of these cases, the indemnitors failed to post collateral on demand of the surety. Because of this, the defense of bad faith is not available. "[I]f an indemnitor fails to post contractually required collateral, a surety's paying or settling a claim cannot amount to bad faith" or said a little more generally "federal courts within the Eleventh Circuit have held that a bad faith defense is not available to a principal/indemnitor who fails to post collateral upon demand under an indemnification agreement."

Additional Tips for Avoiding Bad Faith Liability

- If an investigation is taking longer than you'd ordinarily expect, document and share the reasons why. Obligees and claimants need to know what is frustrating the investigation so that they can provide assistance, if necessary. Delay and unresponsiveness are routinely at the heart of bad faith claims against sureties and insurers. It looks far better if there is a real time record of the issues being faced in the investigation and an open line of communication.

  Remember that this is an independent investigation. Where possible, try to corroborate what the principal is telling you about the job. This can be with the obligee, subs, the owner, your own consultant, or backup documents. Responding to a claim with a rundown of what the principal told you isn't going to be convincing because the obligee is obviously going to have a different version of what the problems are on the job. Ideally the surety is going to have information from more than one source and make an independent determination based on its evaluation of all it, rather than just parroting the principal's talking points.

- Hire outside consultants or outside counsel when necessary. Whether it's an engineer, accountant, or attorney licensed in the jurisdiction, this can help with the independence angle as well that we just discussed.

- Keep a written record. This is easy for emails, but keep a log of phone conversations as well. This is helpful for a number of reasons. It helps litigators like me if you need to go to war on the claim itself, but it also shows that you're thoughtfully documenting what is going on in the file as it happens. For the purposes of bad faith, the process is as important here as the end result. You may find that you lose the case but at least you can convince the jury or judge that you approached the claim in a reasonable fashion and avoid bad faith liability.

- Don't give in to emotion or flippancy especially in written communications. This can be harder than it sounds when you're dealing with a frustrated obligee who may feel like they've bent over backwards to keep the principal on the job, and they've got the government or a private owner breathing down their neck to get the project back on schedule. You are also likely to be dealing with a principal whose world is crumbling around them. Remember, these are humans going through what may be one of the most stressful times of their professional lives, in a stressful industry. Brush off attacks or angry or accusatory language, and respond professionally.

- Don't make threats or allude to the cost of litigation. This will look like the surety is trying to get an unfair advantage due to the unequal resources between itself and the claimant. And it is a pretty good bet that anyone you're responding to knows that litigation is costly.

- Know the local requirements and any contractual requirements for response/decision times. Some state statutes spell out when you have to respond to a claim, as do some well-known bond forms. Know when you're required to provide a response and set those calendar reminders.