SURETY TODAY PRESENTATION

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July 10, 2017

THE SURETY AND ARBITRATION

Mike: Our topic today is The Surety and Arbitration and I am going to start with a discussion of arbitration generally. Jason will follow with a discussion of the majority and minority views around the country as to whether the surety can be compelled to arbitrate. Next, I will talk about what to look for if the surety wants to try to avoid arbitration and some issues that can be raised there. Jason will then review the relevant issues concerning obtaining a stay of litigation against the surety pending the outcome of the arbitration. Finally, I will discuss the potential impact of not arbitrating. So, I'll jump right in here with a general overview.

ARBITRATION OVERVIEW

Arbitration, of course, is a form of alternative dispute resolution in which the parties contractually agree to submit their dispute to an arbitrator or panel of arbitrators for resolution. Because arbitration is a consensual dispute resolution method, the form of the arbitration can be dictated by the parties. Many contracts specify the rules and procedures that have been developed by the American Arbitration Association, which I'll refer to as the "AAA" and in particular the Construction Industry Arbitration Rules and Mediation Procedures. The AAA is a public service, non-profit organization that offers a range of dispute resolution services to many industries, including the construction industry. The format of an arbitration is more like a trial court proceeding, but depending on the rules adopted by the parties, can be substantially less formal than a trial court proceeding, especially with respect to the application of the rules of evidence.

In the early days, arbitration was disfavored by the courts and was viewed as an interference or an infringement on the jurisdiction of the courts. However, in more modern times, the pendulum, so to speak, has swung to the opposite extreme with courts sometimes stretching and straining to uphold arbitration agreements wherever possible and even finding agreements where it appeared none existed.

The majority of the states have enacted some version of the Uniform Arbitration Act. The Uniform Act provides for the validity and enforceability of arbitration agreements, gives arbitrators the authority to issue subpoenas, compels witness testimony and generally addresses such issues as (i) the process for challenging whether an agreement to arbitrate exists; (ii) the

appointment of arbitrators; (iii) hearings; (iv) awards; (v) fees; and (vi) vacating awards, etc. An arbitration award under the Uniform Arbitration Act can only be vacated where:

(1) The award was procured by corruption, fraud or other undue means;

(2) There was evident partiality by an arbitrator, corruption or misconduct by any of the arbitrators;

(3) The arbitrators exceeded their powers or authority; or

(4) The arbitrators unjustifiably refused to postpone a hearing or refused to hear evidence material to the controversy or otherwise conducted the hearing so as to substantially prejudice the rights of a party.

In Rhode Island the statute permitting arbitration expressly *includes* the surety in the arbitration if the claimant under a payment or performance bond is a party to a written contract with a provision for arbitration.

In that statute, the arbitration will decide all controversies including any liability of the surety under the bond. Conversely, in Georgia, the statute excludes from arbitration contracts of insurance as defined under Georgia Code to include sureties, so therefore, the argument could be made that the Georgia statute regarding arbitration excludes compelling the surety to arbitrate.

The federal government has enacted the Federal Arbitration Act (the other "FAA"). The FAA applies to any written contract involving "commerce" in which the parties agree to arbitrate and provides that such agreements shall be "valid, irrevocable, and enforceable." 9 U.S.C.A. § 2. "Commerce" is defined in the FAA very broadly to include all international or interstate commerce. 9 U.S.C.A. § 1. The Supreme Court has held that when state law directly prohibits the arbitration of a claim otherwise subject to the FAA, the FAA preempts the conflicting state law. *Marmet Health Care Ctr., Inc. v. Brown*, 565 U.S. 530, 533, 132 S. Ct. 1201, 1203–04, 182 L. Ed. 2d 42 (2012).

According to the AAA, in each of the last two years there were over 8,300 commercial cases filed with the AAA for arbitration. The total amount of claims and counterclaims in each year was between $12 and $13 billion.

The proponents of arbitration contend that arbitration is faster, cheaper and more streamlined than litigation and the case is decided by an arbitrator or panel of arbitrators that is knowledgeable about the construction industry, as opposed to judges or juries who may have no knowledge or experience with the industry. For sureties, the negatives relating to arbitration

include: (1) the fact that the legal rules and defenses protecting sureties may be loosely applied and/or ignored in arbitration; (2) the arbitrators are perceived to allow personal concepts of fairness to override the facts/law; (3) the very limited appellate review; (4) limited discovery and disclosure of defenses/claims which can lead to last minute surprises or ambushes at the hearing; and (5) limited explanation of awards.

So, according to federal court statistics and information from the AAA, the median length of a jury or bench trial in civil cases is 27.2 months, over 2 years. In comparison, the AAA contends that in construction cases in 2015 the median time from filing of a case with the AAA to award was 232 days, less than 8 months. So, they do have a claim to make that they are a little faster than litigation. Recently, the AAA has also introduced an optional appellate arbitration procedure, I guess to address that concern that people have that there is no review of an arbitrator's decision. Under this procedure the parties can agree in their contract up front or stipulate after the fact to submit an arbitration award for review by a AAA arbitration panel. The parties or the AAA can appoint the arbitration panel and the appeal will be determined based on the record and briefs submitted in accordance with a schedule and page limits. Oral arguments are permitted nut only based on request and at the discretion of the panel. After 30 days the panel must either (i) adopt the underlying award, (ii) substitute its own award or (iii) request additional information and time to render a decision. The entire appeal process is designed to take less than three months. The administrative fee is $6,000 for the filing, and if there is a cross-appeal, there is another $6,000. The appeal may be based on the grounds that the underlying award is based on: (1) an error of law that is material and prejudicial; or (2) determinations of fact that are clearly erroneous. So, the grounds for appeal under the new rules are much broader than the traditional grounds for a court to vacate an arbitration award.

Jason: As Mike indicated, there is a split of authority as to whether an arbitration provision in the bonded contract that is incorporated by reference into the bonds is enforceable as to the surety and binds that surety to arbitrate. The majority view is that it is. So the majority of jurisdictions in the country hold that where the bond incorporates by reference a bonded contract that contains an arbitration provision, the surety is bound to arbitrate. The Courts of Appeal for the 1st, 2nd, 3rd, 4th, 5th 6th, 7th, 10, and 11th Circuits have all joined in that majority view, put differently, the 8th, 9th and Federal Circuit have not.

MAJORITY VIEW

So, courts in the majority view cite generally three rationales in support of their view that incorporation by reference is sufficient to bind the surety.

1. The first rational that they cite is a national public policy that Mike mentioned established by the Federal Arbitration Act. Congress enacted the Federal Arbitration Act to abolish the common law rule that arbitration agreements are not, generally speaking,

enforceable. Congress also enacted the Federal Arbitration Act to establish a strong national policy favoring arbitration. So, courts in these majority view jurisdictions often point to the FAA's strong policy of favoring arbitration to support their view that incorporation by reference of an arbitration provision into a bond is sufficient to bind the surety to arbitrate.

2. A second rationale identified by this majority view is found in the language of the contract itself. Courts often point to the fact that the contract language that requires arbitration is, generally speaking, very broad. The clauses often require that all claims "arising of or relating to" the contract be subject to arbitration. If these clauses do not identify the parties who are bound to arbitrate, courts in these majority jurisdictions often hold that the surety must be bound to arbitrate. However, if the arbitration provision is specifically limited to specifically-named parties, then obviously courts are less likely to enforce that arbitration provision as to the surety.

3. Finally, a third factor cited by courts in the majority is how they view sureties generally and what role they believe sureties should play. So, in these jurisdictions, if a court views a surety as one who guarantees to do what its principal has promised to do, then the court is more likely to bind the surety to arbitrate, because these courts seem to believe that sureties should have the same rights, duties, and obligations as their bond principals. So, the thinking goes, that if the principal must arbitrate, then surety should have to arbitrate, too.

MINORITY VIEW

1. The minority view takes a much different approach. Although the reasoning identified by these minority jurisdictions is more fractious; however, the one thing that these minority jurisdictions hold in common is that in order to bind the surety to arbitrate where there is an incorporation by reference, there must be some clear indication that the surety intended to bind itself to arbitration, and it has to be more than incorporating the bonded contract by reference.

2. In Maryland, for example, our highest court held that merely incorporating another contract is not clear enough to show that the surety consented to arbitrate. The court stated that "the incorporation of one contract into another contract involving different parties does not automatically transform the incorporated document into an agreement between parties to the second contract." In other words, incorporation by reference is not enough to bind the surety.

3. So, for example, in Maryland where we are located, our highest court, which is called the Court of Appeals, has held that incorporating another contract is not clear enough to show that a surety intended to bind itself to arbitration. I'll quote a little bit of the opinion.

"The incorporation of one contract into another contract involving different parties does not automatically transform the incorporated document into an agreement between parties to the second contract." In other words, incorporation by reference is not enough to bind the surety. There has to be something else that shows the surety intended to bind itself to arbitration.

3. The 8th Circuit and some other federal courts have reviewed the issue through the 1984 edition of the A312 performance bond, and they held that the language in the bond was too ambiguous because it referred to both arbitration and litigation, and for them, it was not sufficiently clear to them that the surety intended to bind itself to arbitration.

So the takeaway here is that if you are in a majority jurisdiction, the arbitration clause is more likely to be enforced if it is incorporated by reference into the bond and is not limited to specific parties. In a minority jurisdiction, however, incorporation by reference is probably not enough. There must be some other indication, whether in the bond or elsewhere, that the surety intended to bind itself to arbitration.

Mike: In this next section, I want to talk about the issues to consider if you don't want to arbitrate.

Issues To Consider If You Don't Want To Arbitrate

If you're in one of those jurisdictions that Jason was talking about that generally will compel the surety to arbitrate, but you don't want to arbitrate, there are some arguments to consider. Jason mentioned some of them that might help in getting the surety out of the arbitration.

1. First, consider the language of the bond. As noted earlier, one of the primary basis for compelling a surety to arbitrate is the fact that the bond incorporates the underlying contract by reference and the underlying contract has an arbitration provision. In *Dunn Industrial Group, Inc. v. City of Sugar Creek*, 112 S.W.3d 421 (Mo. 2003), the court held that a guarantor on a construction contract performance guarantee was not bound to an arbitrate because the clause in the underlying contract was only "referenced" in the guaranty as opposed to being "incorporated" into the guaranty. This wasn't a bond case technically, but this guarantee was a performance guarantee in a construction project; it was very similar to a bond. In *Dunn*, the underlying contract was attached to the guaranty and the guaranty even stated that the guarantor "guarantees prompt and satisfactory performance of the attached Contract in accordance with all its terms and conditions." The Court stated that "mere reference to the construction contract in the guaranty is insufficient to establish that [the Guarantor] bound itself to the arbitration provision of the construction contract." So, that's the first place to look. What is the language of the bond and is there any way to get around. I've seen some of these various

bond forms out there that only reference the contract, they don't say that it is "incorporated herein by reference for all purposes;" or that sort of thing. So that might give you something.

2. Second, review the language of the arbitration provision. Jason noted this, but as noted earlier arbitration is a consensual and contractual dispute resolution process. A party cannot be compelled to arbitrate unless it has agreed to do so. A corollary to that rule is that the scope of the arbitration will be governed by the language of that arbitration provision. This principle can manifest itself in a variety of ways, for example:

(a) The arbitration provision may state that it is only applicable to the parties to the contract, as Jason said. It has a limitation that it is only applicable to the two parties to the contract. If the provision is expressly limited to the contracting parties then an argument can be made that even if the underlying contract is incorporated into the bond it is limited to the just those parties.

(b) Another aspect is the arbitration provision may limit the scope of disputes to which it applies. In one case the provision was limited to issues relating to issues relating to the performance of the work. The surety argued that its dispute with the claimant related to surety defenses and not to the performance of the work, specifically the surety contended that the claimant did not comply with conditions precedent in the bond. The court held that the surety was not obligated to arbitrate those issues.

(c) Sometimes the arbitration provision in the contract may contain an exclusion for claims arising under federal law. For example, the AIA 1987 version of the Standard Agreement between a Contractor and Subcontractor at paragraph 6.5 provides that arbitration "shall not be deemed a limitation of rights or remedies which the Subcontractor may have under Federal law, . . ." A court in the Eastern District of Virginia addressed this contract provision in *U.S. ex rel. Am. Sheet Metal Corp. v. Travelers Ins. Co.*, 222 F. Supp. 2d 789, 791 (E.D. Va. 2002), and noted that since the Miller Act is federal law, and the claimant was pursuing a Miller Act claim, the arbitration provision did not apply because the scope of the provision excluded federal law claims. So, one just look at the terms of the arbitration provisions in order to determine if there are any grounds to contest being compelled to arbitrate.

3. Third, if the claim is on a Miller Act bond, some courts have held that such claims are not subject to arbitration because they are within the exclusive jurisdiction of the federal courts pursuant to the terms of the statute. In *Lee & Rua Co. v. Great Am. Ins. Co.*, 2008 WL 1868633 (W.D. Wash. Apr. 23, 2008), the Court observed that the Miller Act provides an exclusive federal cause of action. The Miller Act also have a waiver provision that only prevents waiver under three conditions and in that case, the arbitration provision does not meet those conditions. In other words, it treated the arbitration provision as an attempt to waive the right under the Miller Act, so since there wasn't a proper waiver, the court held that the arbitration clause did not apply. Those three conditions are: (1) in writing; (2) signed by the person whose

right is waived; and (3) executed after the person whose rights are waived has furnished labor or material for use in the performance of the contract.

4. Fourth, you should carefully review the terms of the underlying contract. As we noted, the underlying contract being corporate is the basis for the decisions ordering or compelling the surety to arbitrate. In some cases, the contract itself will say that it is not intended to create any kind of contractual relationship between any other parties other than those to the contract. So, the argument can be made that that provision basically nullifies any argument that there is an intent by the parties incorporating the contract into the bond that there is an intent of the parties to be bound to the arbitration provisions. The contract is saying that it won't create that kind of agreement between any other parties.

5. Fifth, you can look at the facts and they may indicate there may be a waiver in the case, and I have to tell you that this is something that is very difficult to prove, but there is a precedent out there for parties waiving their rights to arbitrate. The best example would be where a party files suit and pursues litigation, or if they're sued, continues to pursue the litigation and doesn't raise arbitration. Other times you can find a waiver by accepted delay or if a party actually waives the arbitration rights in writing, then you could argue a waiver.

Jason: If the surety is sued separately from its bond principal at the same time the bond principal is in arbitration, the surety may want to stay the litigation and potentially intervene into the arbitration or see how the arbitration plays out. So, we thought we would raise some arguments that the surety could address with the court to try to persuade the court to stay the litigation to allow the arbitration, however that plays out.

1. The surety may want to raise with the court the possibility that there may be inconsistent verdicts if the litigation and arbitration proceed on separate courses. Obviously, if there are the same claims being adjudicated in two different venues, it could strongly lead to the possibility of inconsistent decisions in different forums.

2. If the surety litigates or is forced to litigate against a claimant while arbitration is pending, a decision in the litigation could decide issues that should more properly be decided in the arbitration. As I thought about it, it seemed to me that an obvious example of it might be that of a payment bond payment. For example, as between a surety and a principal, the principal is most often in a better position to determine whether a particular payment bond claimant actually performed work on the project or is entitled to payment of a specific amount. The principal may have the claimant's pay applications, may have reviewed the schedules of values, may have actually inspected the quality of the claimant's work. So, as between the principal and the surety, the principal is usually in a much better position than the surety to determine how much, if anything, that claimant should receive. Therefore, the surety can present the court with the

option of staying the litigation in order to allow the principal, which is in a better position to determine how much, if anything, that bond claimant should receive.

3. Another argument to be raised with the court is, if the surety litigates against a claimant while arbitration is pending, will that simultaneous adjudication frustrate the purpose of the arbitration? As Mike indicated at the beginning, arbitration was created because congress and others believed that it would be cheaper and faster. Statistics, at least from AAA, seem to bear that out, at least as to the length of time. However, if the same claim or substantially similar claims are being adjudicated in two different forum at the same time, that obviously undercuts one of the primary purposes of arbitration, saving money.

There are a couple of additional tactics that we've identified that a surety can use to try to convince the court to stay litigation pending arbitration.

1. First, there is the "first to file rule." The first-to-file rule "generally favors pursuing only the first-filed action when multiple lawsuits involving the same claims are filed in different jurisdictions." A surety may argue that if there is arbitration already pending at the time the surety is sued, the first to file rule supports staying that litigation in favor of the first filed arbitration case.

2. Second, a surety may look to the Federal Arbitration Act in support of the stay. The Federal Arbitration Act expressly provides that where there is an agreement to arbitrate and one of the parties to the litigation seeks a stay pending arbitration, the court must stay the case pending arbitration.

3. Third and finally, a surety may also seek the principal's assistance by having the principal intervene in the litigation in order to join in a motion to stay the case pending arbitration.

These are obviously not all the issues to consider or all of the issues to be raised with the court, but we hope they provide some guidance and new ideas to try to convince the court to stay the litigation.

Mike: The last topic I want to talk about is the potential impact of refusing to arbitrate.

Potential Impact Of Refusing To Arbitrate

So far we have been talking about how to avoid arbitration, but the surety must ask itself what happens if the surety does not participate in the arbitration? The old adage "beware of what you wish for because you might get it" could apply. Of course, if the surety does not participate

in the arbitration and the principal prevails such that it is determined that the claimant's claim is invalid then the surety should avoid any liability. General principles of surety law hold that the surety's liability is coextensive with that of its principal. As a consequence, in the absence of liability on the part of the principal, the surety cannot be held liable. In this instance, the surety will, of course, look like a genius in deciding to oppose arbitration because it will have avoided the costs and fees of such a process.

But, what happens if the principal loses in the arbitration and cannot satisfy the arbitration award? There is a split in the jurisdictions as to the affect of an adverse arbitration ruling on the surety. In some jurisdictions, if the surety was aware of the arbitration and had an opportunity to participate in the arbitration, the surety will be held to be bound to the arbitration award. Some courts reach this result by concluding that the surety is in privity with the principal and thus under the principal's *res judicata* and/or collateral estoppel the surety can be bound by the award. Other courts hold that because the surety was obligated to arbitrate it is bound by the award even if it didn't participate.

In *United States ex rel. Skip Kirchdorfer v. M.J. Kelley Corp.,* 995 F.2d 656 (6th Cir.1993), the court applied that principle to an arbitration award against the surety and held that the surety was liable because it had knowledge or was aware of the arbitration proceeding, and chose not to participate. It held that the surety was aware of it and had an interest identical to that of the contractor, and therefore, was in privity with the contractor.

If *res judicata* and/or collateral estoppel are the basis for holding the surety liable, if the surety can establish that it was not provided sufficient notice or did not have a full and fair opportunity to contest its liability, it may escape the preclusive effect of an arbitration award. Further, an arbitration award was not given preclusive effect against a surety where the award was essentially a default judgment and the surety did not have a chance to present its defenses in the arbitration proceeding. So that may be another avenue to attack a judgment coming at you from an arbitration award. A further challenge could be based on the lack of a record or proof of what issues were actually litigated in the arbitration. However, those issues would be important to refute a *res judicata* based argument

Other courts hold that an arbitration award is determinative of the issue of the principal's liability to the claimant, but does not preclude the surety from subsequently raising surety defenses such as failure to meet notice requirements under the bond, failure to disclose material facts, impairment of security, overpayment, etc. Still, other courts hold that an arbitration award is not absolutely binding on the surety, but establishes merely a rebuttable presumption of the principal's liability. In some jurisdictions, the issue is controlled by statute. For example, in California the code provides that: "An arbitration award rendered against a principal alone shall not be, be deemed to be, or be utilized as, an award against his surety." Cal. Civ. Code § 2855.

Similarly, in West Virginia, the Code provides that regardless of whether the surety had notice of the arbitration, no award in a proceeding to which the surety was not a party is binding on the surety and notwithstanding such award the surety shall be allowed to make any defense in any proceeding instituted against it as could have been made in the arbitration. W. Va. Code Ann. § 45-1-3.

So that includes our presentation on Arbitration. Hopefully, we included all of the relevant issues. The next Surety Today presentation will be on Monday, August 14 at 12:30, and our topic will be "Statute of Limitations." I've been working on a case for quite a while now where we've gotten over a hundred bonds involved, and part of the process of how to determine the statute of limitations applicable to the bond. These bonds are all over the country so we've had to look at a lot of different statutes and a lot of different issues that come up, so next month I would like to talk about statutes of limitations.