



Legal Beat

By MICHAEL SEAN QUINN

Surety Bonds and Insurance

Surety bonds certainly resemble insurance. If they are a species of insurance, they may be governed by common law bad faith and various provisions of the Texas Insurance Code, such as art. 21.21. That provision might well be called statutory bad faith. In the last couple of years, the Supreme Court of Texas has thought hard about the nature of surety bonds. It has concluded they are not insurance, so that the law of bad faith does not apply. One wonders if the court is right.

On the face of things

Surety bonds look like insurance. They cover contingent risks. They are sold by insurance companies. They are often brokered by insurance intermediaries. The adjustment process looks very much like insurance claims handling. Surety bond underwriting and insurance underwriting are almost iden-

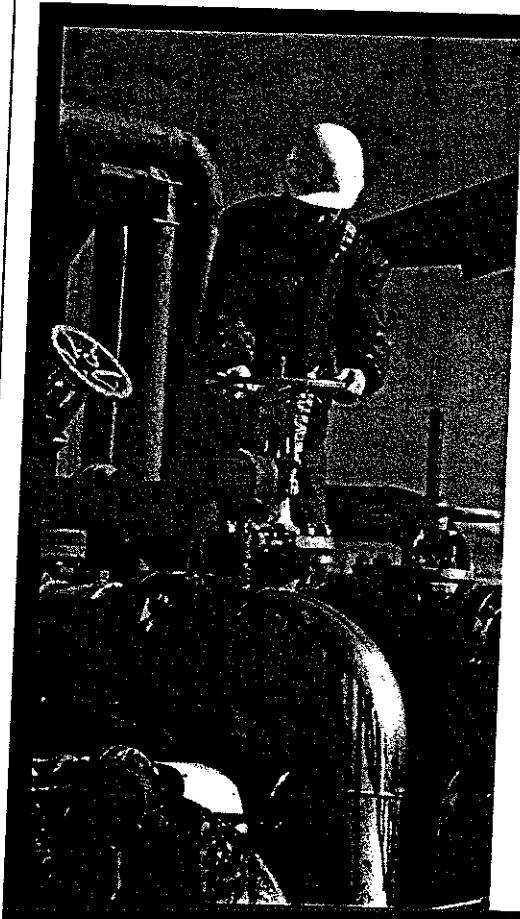
tical. Surety bond accounting and insurance accounting resemble one another closely.

Insurance text books include chapters on surety bonds. Some of these books emphasize the similarities between surety bonds and insurance. Surety bond matters are included in insurance courses in professional business schools (although not law schools). Some law school case books have chapters on fidelity bonds. Some states treat surety bonds as a form of insurance for some purposes.

So, how do surety bonds work? Many are sold in the construction business. Owner hires Contractor to build something (e.g., a bridge or a building). Contractor is required, sometimes by statute, to provide a surety bond financially guaranteeing its performance and perhaps some of its warranties on the project. Surety provides this bond. The bond is a contract which requires Surety



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to complete the project, to pay to complete the project, or to repair the project if bad things happen through the fault of Contractor. Sometimes, Surety will even administer the financial side of the completion of the project. Wallace Stevens, the greatest American poet of the 20th century in my eyes, did this sort of thing for Hartford Insurance, where he was in-house counsel and a kind of adjuster.

The kinds of bonds discussed here involve an unusual feature. Surety and Contractor form a side indemnity agreement, so that Contractor agrees to pay Surety, if Surety has to pay Owner. As a general rule, a number of other entities and persons are parties to the indemnity agreement. Such indemnifying persons often include principals in Contractor, their spouses, other relatives, sometimes investors and occasionally yet others. Under the indemnity agreement, the indemnitors promise to pay Surety whatever it pays out under the bond, if Surety has settled with Owner in good faith.

Obviously, Surety must have two great skills and must, therefore, understand both engineering and construction. First, Surety must be able to figure out whose fault caused the defects in the project. Second, it must be able to administer (or ride-herd upon) the completion or repair of the project, or at least knowledgeably audit the amounts

spent on the project.

In legal contemplation, surety bonds have three parties: Contractor, Surety and Owner. Insofar as Owner is considered the insured, surety bonds are very much like first party insurance. Insofar as Contractor is considered the insured, surety bonds resemble liability insurance.

Not a form of insurance

In late 1995, the Supreme Court decided once and for all that Owner should not be considered an insured, and that surety bonds are not a form of insurance. It did this in *Great American Insurance Company v. North Austin Municipal Utility District No. 1*, when it denied a motion for rehearing.

Technically, the court held three things. First, it held that Owner could not press a common law bad faith claim against Surety. The court gave three reasons for this holding. (1) Surety did not control the situation in the way insurers often do. (2) Suretyship involves a tripartite relationship rather than a bilateral contract. (3) Sureties may rely upon all of Contractor's defenses when resisting having to pay Owner.

None of these reasons is particularly convincing. (1) Even though surety bonds involve widely-used (and even legally prescribed) forms, sureties are frequently more powerful financial entities than either con-

tractors or owners. Besides, insurance companies insure large economic entities, and those large economic entities have bad faith rights, even though they are powerful. Moreover, insurers frequently must use legally prescribed forms. (2) The fact that surety bonds are three-cornered arrangements means nothing. So are workers' compensation insurance policies, according to the Texas Supreme Court, and there are bad faith rights there. (3) Insurers have all sorts of defenses to having to pay under their contracts. The origin of those defenses is probably irrelevant. Besides, liability insurers, in effect, rely upon their insured's defenses.

As a second holding, the court said that art. 21.21 does not apply to surety bonds. The court wrote abstrusely on this topic, but it was convinced—in the end—by three simple considerations. (A) Suretyship could not be insurance, because there was suretyship at a time when there was not insurance. Hence, the two could not be identical. (B) Under insurance arrangements, the insurer never has a right of indemnity as against the insured. (Insurers may not subrogate against their own insureds, for example. Finally, (C) if Surety had art. 21.21 exposure to a bond obligee, it could not enforce all of its rights because it would take a tort risk in asserting against Owner its contractual defenses or those of Contractor.

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As before, these considerations are not convincing. (A) Before there was something called "insurance," there was suretyship, which people did not realize was insurance, even though it was. Consciousness lags behind history. (B) Insurers do, under some arrangements, have something like indemnity rights against their insureds. This is what so-called "fronting policies" are about. Retrospective premium arrangements are also like this. Finally, (C) insurers have to be careful about asserting their contract, and other, defenses because of the specter of statutory and common law bad faith. For the most part, they have learned how to do this cautiously or carefully. Sureties can do the same. Besides, common law insurance bad faith has not proved dangerous in business contexts.

Readdressing the issue

In the late spring of 1998, the court took up the topic of surety bonds again. This time it denied rehearing in *Associated Indemnity Corporation v. CAT Contracting, Inc.* This case focused upon the relationship between Surety and Contractor, as opposed to Surety and Owner.

The *CAT Contracting* dispute concerned a leaky pipeline. Owner contended that the leaks were the fault of Contractor, while Contractor contended that the Owner's design was defective. Surety paid for repairs to the job, but the repairs were unsuccessful. In the end, Surety also paid Owner a substantial, additional sum by way of settlement. At no time was it ever really clear whose fault caused the defects.

Surety sued Contractor on the bond and also sued the indemnitors. The defendants counterclaimed for breach of contract, and bad faith, among other things. The idea of bad faith played two roles in this lawsuit. Contractor and Indemnitors alleged that Surety violated the duty of good faith and fair dealing it owed them as a result of the surety contract. It contended that the suretyship contract was one of insurance. In addition, Indemnitors claimed that Surety breached the indemnity agreement by not exercising the contractually prescribed good faith in administering the surety arrangements.

In the trial court, Contractor and Indemnitors prevailed. Contractor obtained a judgment for over \$4 million in lost profits and over \$425,000 under the construction contract. Individual principals in Contractor and individual Indemnitors received \$700,000 in mental anguish damages on bad faith theories. The court of appeals affirmed in part and reversed in part. Ultimately, however, the state supreme court reversed all of the monetary awards.

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"a surety does not owe a common law duty of good faith to its principal." Secondly, it held that the good faith required in the indemnity agreement is not identical to the good faith required of insurance companies. The majority thirdly held that there was some evidence to support the proposition that Surety had been guilty of bad faith in the administration of the surety arrangement. This holding took Indemnitors off the hook. Two justices dissented from the last of these three holdings.

The court unanimously held that common law insurer bad faith does not apply to the relationship between a surety and its principal for several reasons. (i) The court was unimpressed with the idea that there was inequality of bargaining power as between Surety and Contractor. After all, the language of surety bonds is virtually mandated by statute, since a key market for surety bonds is government construction projects. Further, the language of those bonds is standard throughout virtually all construction markets.

(ii) Contractor is not at a striking disadvantage in the claims process, because Contractor is a sophisticated insured, often with some financial power. Oppression is not the problem it sometimes is in insurance.

(iii) Neither Contractor nor Indemnitors are liable to Surety for any amounts except those which are paid in good faith. That limitation provides Surety with an incentive to pay, in the claims process, only that for which Contractor may be liable. Thus, the indemnity agreement constitutes a governor on the behavior of Surety which is not present in genuine insurance contexts. Thus, Surety does not have exclusive control over the processing of claims. Because of the sophistication of contractors it is unlikely that sureties will arbitrarily deny claims, and because of the good faith requirement in the indemnity agreements, it is unlikely that they will pay too much.

Finally, (iv) Contractor does not really expect Surety to protect him from loss. Suretyship is merely a financing arrangement to get projects completed. Since contractors are not genuinely transferring risk to sureties, suretyship should not be viewed as insurance. After all, the transfer of risk—and not merely its temporary placement—is the essence of insurance.

As in *Great American Insurance*, the arguments in *CAT Contracting* are not really persuasive. Sophisticated insurers have access to the law of bad faith, so why shouldn't construction companies. Anyone who has studied the way sureties complete construction projects knows that they have substantial control over the administration of the claim. The legal abstractions relied upon the court to not reflect reality. Finally,

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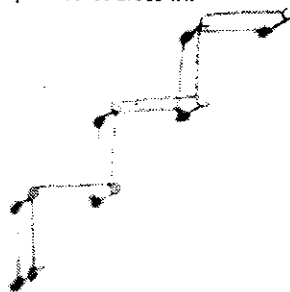
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risk is transferred, even if only temporarily. As already discussed, some sophisticated forms of insurance are also like this. Moreover, not all insurance is risk transfer. Whole life insurance, for example, has a savings element, as well as a risk-transfer element.

In a second, more or less independent, section of the *CAT Contracting* opinion, the court explored the good faith clause of the indemnity contract. Under that agreement, the exercise of good faith is a condition upon Surety's right to indemnity, according to the

court. It is "not a promise by Surety to exercise good faith." It cannot, therefore, be a foundation for a damage award.

It is Surety's responsibility to prove that it had exercised good faith in settling the claims. Most significantly, a good faith requirement in the indemnity agreement requires more than a negligent investigation, or some defective claims reasoning. Rather, "it requires willful misconduct [actual dishonesty] or improper motive." The court agreed on this standard unanimously.

At this point, the court split seven to two. The majority, led by Chief Justice Phillips, thought that there was some evidence to support the proposition that Surety had an improper motive. The two person minority, Justices Owen and Hecht, disagreed and thought, at most, that there was evidence of negligent processing of the claim.

Unquestionably, the claim was not well handled. At the same time, it is difficult to find out-and-out dishonesty. Perhaps the Chief Justice thought that substantial arbitrariness might constitute some evidence of the evil motive. In a supposedly rationale, fair-minded and dedicated business world, this may be a reasonable inference.

Texas' current stand

Suretyship is a fractured and fragmented body of law. Different states look at this corpus quite differently. Texas is aligning itself with those states which are most favorable to sureties. On the surface, anyway, this trend appears to be favorable to that sector of the insurance industry which provides surety bonds. But is it good for the brokerage segment of the insurance business?

One wonders. Certainly, sureties should not be exposed to irrational lawsuits, where damage awards are unpredictable. At the same time, contractors need protection from defects in the claims process. The good faith standard building into the indemnity contracts does not really protect them from arbitrariness. It protects them from unscrupulousness, but that is not the major problem. Contractors need more than protection from dishonesty and fraud. They need protection from inattention, incompetence, unfairness, obtuseness and obstinacy.

Buried in the *Cat Contracting* opinion is an interesting idea. The supreme court is suggesting that contractors get involved in claims processes and monitor them carefully. Contractors should not sit back and let the surety claims process take its course. Of course, if Surety shuts Contractor out of the claims process, that will be evidence of an evil motive, and Contractor should document lock-outs carefully. Of course, this norm does not help if Contractor is insolvent, and has neither the personnel nor the energy to keep going, nor the wherewithal to hire a lawyer to go forward in its place.

Still, the hints of the court may be helpful to some contractors. Obviously, under the right circumstances, insurance intermediaries will need to discuss these matters with their contractor client-customers. ■

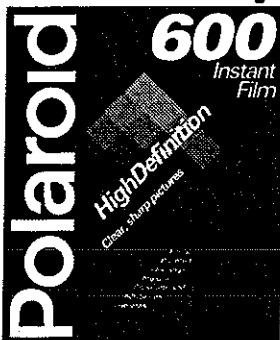
Quinn is an Austin-based attorney with the law firm of Sheinfeld, Maley & Kay. He was recently selected to receive the 1998 Outstanding Law Journal Article Award by the Texas Bar Foundation.

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