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No Wiggle Room: AIA A312 Bond's Notice Provisions Require Strict Compliance

MATHEW HOLMES

A recent decision out of New York County Supreme Court, *Independent Temperature Control Services, Inc. v. Parsons Brinkerhoff, Inc.*,[1] reinforces the legal principle that to trigger a surety's obligations under a bond, the obligee must comply with all of the conditions precedent, including the notice provisions.

In this case, the surety, Travelers Casualty and Surety Company of America ("Travelers") provided a performance bond on a construction project led by the New York Power Authority ("NYPA"). Parsons Brinkerhoff, Inc. ("PB") was NYPA's construction manager and engineer, and was the bond obligee. The bond was a standard AIA performance bond, the A312-2010. The principal-contractor, Independent Temperature Control Services, Inc. ("ITC"), subcontracted a portion of the work, which was separately bonded (using the same bond form) by RLI Insurance Company ("RLI").

After significant work had been performed, PB notified ITC that it

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Insured Strikes Out: No Coverage for Theft and No Expansion of Bad Faith Standard

NELL HURLEY

An Indiana communications company that lost over $5 million to theft was denied coverage under both its crime insurance policy and its commercial property policy. Then it failed to convince the Seventh Circuit Court of Appeals to certify the question on an expansion of the bad faith standard to include bad faith in handling an insurance claim without proof of ill will by the insurer.

The case, *Telamon Corp. v. Charter Oak Fire Insurance Co.*,[1] stems from an arrangement Telamon Corporation ("Telamon") had with consultant Juanita Berry to do work for it in New York and New Jersey. Berry oversaw Telamon's AT&T Asset Recovery Program, including the removal of old telecommunications equipment from AT&T sites and its sale to salvagers. Berry did this, but pocketed the profits, resulting in criminal convictions and a prison term. Berry, through her one-woman company, J. Starr Communications, Inc. ("J. Starr"), and Telamon executed a series of consulting services agreements. Berry's responsibilities, however, expanded well beyond those described in the agreements such that she was eventually Telamon's Vice President of Major Accounts, and its senior manager in the region. The details of the arrangement with Berry were pivotal in the denial of Telamon's claims under both policies. Under the crime policy, Telamon was denied coverage because Berry was *not*, legally speaking, an employee. But coverage under the commercial property policy was denied because, in practice, Berry *was*.

Telamon brought suit against both insurers, Travelers Casualty & Surety Co. of America ("Travelers") and Charter Oak Fire Insurance Co. ("Charter Oak"). It argued that Berry's actions were covered under both policies and that each insurer had breached its duty of good faith in handling its claim. Since the two insurers are subsidiaries of a larger Travelers entity, they had worked together, at Telamon's request, to avoid duplicate claims investigations. Nonetheless, Travelers and Charter Oak stood by their respective coverage determinations and denied all bad faith allegations. The U.S. District Court for the Southern District of Indiana agreed with the insurers and granted summary judgment against Telamon.

On appeal, the Seventh Circuit considered the coverage issues first, which were governed by Indiana law. The crime policy coverage turned on whether Berry was an "employee", a term that included a worker under a lease agreement. The question was whether Berry's corporate entity, J. Starr, was a "labor leasing firm" under the policy. The court held that it was not, finding instead that it was just Berry's vehicle for providing her own services, a simple legal convenience, especially since J. Starr had no other workers besides Berry. Thus, Travelers' denial of coverage under the crime policy was upheld.

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The commercial property policy covered the risk of direct physical loss but Charter Oak claimed that Berry fell under the policy exclusions for "authorized representatives" and anyone who is entrusted with "the property for any purpose." The court rejected Telamon's argument that unless Berry was authorized under the agreements to do the specific activity that gave rise to the theft, she was not an "authorized representative." Though the agreement did not expressly mention making contracts to sell AT&T equipment, the court relied upon Berry's actions clearly indicating her broad authority to act on Telamon's behalf, including operational oversight in the region, running meetings, and hiring and firing Telamon employees. Berry was in charge of managing the AT&T account, the court found, and thus authorized to conduct the very activity that led to her crime. She was also a person to whom Telamon entrusted the property, the court reasoned, since she was entrusted with the equipment she stole.

Finally, the court reached Telamon's assertion that both insurers had acted in bad faith, a standalone tort under Indiana law. Conceding that the currently applicable grounds for a bad faith claim did not apply, Telamon sought a certification to the Supreme Court of Indiana on the basis that Indiana's courts were on the cusp of approving an additional ground for bad faith, one that does not require any "ill will" on the part of the insurer. The court was unpersuaded and declined to exercise its discretion to grant the certification.

While acknowledging that two Indiana cases left open the possibility of an expansion of grounds that would support the tort of bad faith, the court noted that it had been many years since those cases and no Indiana court had embraced Telamon's proposed expansion. Indeed, one of the cases explicitly refused to recognize the claim-handling ground Telamon advocated, the court reasoned. The court concluded that because the answer to the question was clear, certification was unnecessary. The court further commented that there was no support for finding ill will on the part of the insurers. Telamon argued that the insurers' decision to delay disclosure of coverage determinations until after the Travelers adjuster spoke to his Charter Oak counterpart was suspicious. In light of Telamon's request that the two investigations be coordinated, the court dismissed this argument as "flimsy."

For now, the bad faith standard in Indiana remains as it is in most jurisdictions, where a finding of bad faith requires some showing of ill will or a state of mind reflecting a dishonest purpose by the insurer. F&D

1 *Nos. 16-1205, 16-1815, 2017 U.S. App. LEXIS 4207 (7th Cir. March 9, 2017).*

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was cancelling the contract for the "best interests of the NYPA." Shortly thereafter, ITC notified its subcontractor of the termination. ITC sued PB for payment and, after PB answered, brought suit against the subcontractor and its surety, RLI. PB asserted a claim against the Travelers bond and alleged the work of ITC or its subcontractor was defective. Though both sureties argued that there was not proper notice under Section 3.1 of the bond, or compliance with Section 3.3, the dismissal of the claims here turned on when and how the two sureties were notified, as required by Section 3.2.

In particular, Travelers argued that PB failed to comply with the notice provision contained in Section 3.2 of the bond which requires, after termination of the contract, that the obligee "notif[y] the Surety." Section 12 specifies that notice to the surety "shall be mailed or delivered to the address shown" on the bond. Under Section 5, said Travelers, its obligations were only triggered "[w]hen the Owner [obligee] has satisfied the conditions of Section 3, ..." Such a failure, Travelers contended, relieved it from any obligation to perform under the bond.

PB argued that it had notified Travelers, providing two affidavits as to its practice and procedure for mailing. PB's former officer stated that he notified ITC of its termination by letter but could not recall if he personally sent the letter to Travelers or not. He stated that the letter would have gone out if he asked someone to send it out. PB's Senior Counsel said it was "PB's practice" to notify the surety, but he could not definitively state whether the letter was actually mailed to Travelers. Counsel did notify Travelers by telephone a few months later.

PB's notice efforts were insufficient, said the court, as there was no proof of mailing. Since PB was unable to establish that it notified Travelers either by "mail or delivery," it failed to comply with the bond's notice provisions and its bond claim against Travelers was dismissed. The court relied on both longstanding and recent case law strictly enforcing a bond's notice provisions as conditions precedent to any obligation for performance by the surety, even in the event actual notice may have been received.

The subcontractor's surety, RLI, was also relieved of any obligation under its bond, since the first notice RLI received was ITC's complaint containing its bond claim. The court rejected the argument that ITC's notice was appropriate because ITC did not understand that PB's letter was a declaration of default and did not know of any alleged defective work until it received PB's answer to the ITC complaint. Though there is no specific time limit specified under Section 3.2 for notice, said the court, construing service of the complaint as timely notice deprived RLI of any opportunity to meet its bond obligations. ITC's bond claim was thus dismissed. F&D

1 *2017 WL 318654 (NY Cty Sup Ct January 20, 2017).*

Sureties Do Not Have to Establish Good Faith to Meet Their Initial Burden on Summary Judgment

MATTHEW HOLMES

The ongoing dispute in *Safeco Insurance Company of America v. M.E.S., Inc.*,[1] 2017 WL 1194730 (E.D.N.Y. March 30, 2017) continues to provide valuable lessons for sureties seeking to enforce their indemnification rights. The most recent decision in the ongoing saga between the bond principals, the indemnitors, and the surety arising from bonds securing three separate projects is no exception.

In this decision, the surety sought summary judgment for recovery of losses and expenses incurred because of the principals' defaults on the three projects (the "Indemnity Action"). In a separate, consolidated action, the indemnitors cross-moved for summary judgment against the surety, relying on claims of bad faith, fraud, and tortious interference with contract.

In the Indemnity Action, the court rejected the indemnitors' argument at the summary judgment stage, the surety bears the initial burden to demonstrate that its payment was made in good faith. Instead, the court reaffirmed that pursuant to the indemnity agreement and established law, the surety need only make an initial showing that it made payment pursuant to the bond(s). Once the surety establishes payment, its *prima facie* burden is satisfied, and the burden then shifts to the indemnitors to show that the surety acted in bad faith.

The court also rejected the indemnitors' corollary argument that the surety must have an "honest belief" that it was liable under the bonds. In examining the actual language of the indemnity agreements at issue, the court held that "[B]y their very terms, the Agreements rebut the MES Defendants' arguments that good faith be defined as having an 'honest belief in liability' or that Safeco bears the burden initially to show good faith, defined as such, in the event of a contract dispute." Furthermore, "the Indemnity Agreements not only allow Safeco to settle claims made against the bond without an 'honest' belief in liability," but also grant "Safeco this right where Safeco has no belief in liability and simply acts out of 'expediency or otherwise." The court went on to reiterate that the indemnitors must demonstrate that the surety acted in bad faith, which requires fraud or collusion. Finding such evidence lacking, the court held that the indemnitors failed to raise a triable issue of fact with respect to the bad faith claim, denied the indemnitors' motion, and granted summary judgment in favor of the surety for indemnity.

This decision clearly articulates the ease of the surety's *prima facie* showing pursuant to a written indemnity agreement, clarifying and distinguishing some case law that suggests otherwise. The surety's initial burden is to establish payment, after which the burden shifts to the indemnitors to establish its affirmative defenses. In addition, the "honest belief" defense offered by the indemnitors, which flies in the face of the plain language of most indemnity agreements, was similarly rejected. The onus on disproving entitlement to indemnity is back where it belongs: on the shoulders of those who promised to pay. Finally, the bad faith standard was properly curbed by the court, reaffirming that a surety is not required to pursue every defense raised by the indemnitors: "...failure to investigate a claim fully or pursue a viable defense does not constitute bad faith." E&D

1 *2017 WL 1194730 (E.D.N.Y. March 30, 2017).*

Matthew D. Holmes joins firm

Matt supports other attorneys in the firm and works with sureties, corporations, contractors, subcontractors, design professionals, and construction managers on a wide array of commercial, construction, and surety issues. His practice includes all aspects of contract review and negotiation, all phases of state and federal court litigation, including analysis of claims, preparation of pleadings, document discovery and depositions, motions, settlement negotiations, trial preparation and appeals.

Matt received his Juris Doctorate cum laude from Syracuse University College of Law. In law school, Matt was very active in Syracuse's advocacy programs. In 2014, he won the American Association for Justice Trial Advocacy Scholarship. In 2015, he and his wife won the Bond Schoeneck & King Alternative Dispute Resolution Competition. Also during law school, Matt developed his advocacy capabilities by competing in multiple state and national trial competitions for Syracuse University College of Law's National Trial Team. Matt's experience in law school also includes an externship with the Honorable David E. Peebles, United States Magistrate Judge for the Northern District of New York. E&D

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Ernstrom & Dreste, LLP also publishes the ContrACT Construction Risk Management Reporter. If you would like to receive that publication as well, please contact Clara Onderdonk at conderdonk@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste, LLP's website (ernstromdreste.com).

FIRM NEWS

Tom O'Gara presented "How the Obligee's Failure to Comply with the Performance Bond's Conditions Precedent and the Obligee's Other Obligations Thereunder Impacts the Surety's Performance Bond Obligations and Liability" at the spring meeting of the ABA Fidelity and Surety Law Committee in Naples, Florida.

Todd Braggins is a co-author and will co-present on the topic of "Avoiding Problems in Taking Assignments" at the Surety Claims Institute Annual Meeting in June, 2017.

Todd Braggins will author and present on the topic of the One Hundredth Anniversary of the Spearin Doctrine at the annual Pearlman Conference in Seattle, Washington in September, 2017.

E&D, LLP hosted two seminars for its clients and friends on May 24 and 25 at Oak Hill Country Club in Rochester, NY. Consultant Dennis O'Neill of Beacon Consulting Group joined E&D, LLP attorneys Tim Boldt and Todd Braggins in the presentation of case studies that highlighted real-life project issues and a discussion of troubled job indicators and surety responses to a job in distress.