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Common Law Bad Faith: No Affirmative Cause of Action For Indemnitors

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In *U.S. Specialty Ins. Co. v. Strategic Planning Assocs., LLC*[1], a Louisiana federal district court recently dismissed common law "bad faith" claims against a surety asserted by indemnitors as counterclaims to an indemnity action. The claims were based on the surety's settlement of disputes between subcontractor-principal Strategic Planning Associates, LLC ("SPA") and general contractor-obligee Core Construction Services, LLC ("Core") on a New Orleans charter school renovation project. The surety was U.S. Specialty Insurance Company ("USSIC").

In 2013, the Louisiana Department of Education Recovery School District, as owner, entered into a contract with Core for the project. Core, in turn, subcontracted with SPA for the fabrication and erection of steel. SPA obtained payment and performance bonds from USSIC.

As a condition of the bonding, SPA and its owners (the "indemnitors") executed an industry-typical General Indemnity Agreement ("GIA") which contained all of the customary obligations and assignments including: (1) that the indemnitors indemnify USSIC for all costs incurred by USSIC as a result of issuing the bonds; (2) that the indemnitors reimburse USSIC for any disbursements made in good faith; (3) the indemnitors assigned to USSIC all of their rights to claims that SPA might have against any party to a contract with SPA; (4) the indemnitors gave USSIC the right, in its sole and absolute discretion, to settle, prosecute or defend any claim in connection with any bond or contract; and (5) the indemnitors designated USSIC as their attorney-in-fact with the power to exercise all of the rights assigned under the GIA.

During construction, SPA and Core found themselves in a dispute as to who was causing significant delays and the attendant costs. Core ultimately terminated SPA's contract in 2015 and then made a demand upon USSIC under the performance bond. SPA disputed the termination and advised USSIC that it planned to pursue breach of contract claims against Core. USSIC initially denied Core's bond claims.

In response, Core filed suit against USSIC, alleging damages of nearly $1.5 million and additional damages for bad faith. USSIC chose to settle Core's claims, paid Core $450,000 and waived SPA's rights against Core. During this time, many of SPA's subcontractors and suppliers asserted payment bond claims and USSIC paid $720,438 to those claimants.

In August 2018, USSIC brought an action against the indemnitors pursuant to the GIA seeking over $1.3 million. The indemnitors asserted counterclaims which included breach of the common law duty of good faith and fair dealing: (1) "bad faith" breach of the GIA; (2) "bad faith" breach of the performance bond; (3) "bad faith" breach of the payment bond; and (4) "bad faith" breach of fiduciary duty. The counterclaims sought damages for loss of business assets, goodwill, bonding capacity, future business earnings and the opportunity to seek redress against Core. USSIC moved to dismiss all of the "bad faith" claims.

Looking first to the fundamental principles of suretyship under Louisiana law, the court noted that suretyship imposes a contractual obligation on the surety to the obligee but not to the (non-party) principal, though the surety gains rights against the principal, including

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Miller Act Bond: No Damage for Delay Clause Unenforceable Against Sub

NELL M. HURLEY

A federal court recently held that a subcontract's no damage for delay ("NDD") clause on a federal project was unenforceable against the subcontractor. The surety and general contractor asserted the NDD provision as a defense to the subcontractor's claims on the payment bond. A California federal district court held that the NDD clause was void because it did not satisfy the Miller Act's requirements for a waiver by the subcontractor of its rights to recover the increased costs alleged.[1]

The case stemmed from a dining facility project in Monterey, California for the United States Army Corps of Engineers for which Halbert Construction Company, Inc. ("Halbert") was general contractor and McCullough Plumbing, Inc. ("McCullough") a subcontractor. Western Surety Company ("Western") provided the payment bond under the Miller Act.[2]

After the work was done, McCullough claimed it was not paid for the full value of its services, and brought suit against Halbert and Western, asserting a claim for payment under the Miller Act payment bond. One component of McCullough's damages

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a right to reimbursement. Next, a "bad faith" payment by a surety does not give the principal an independent cause of action against the surety but, the court said, only affords it a defense to the surety's right of reimbursement. Finally, the court opined, the mere existence of a suretyship contract does not impose fiduciary duties upon the surety in favor of the principal.

Reviewing SPA's specific allegations, the court found that the bonds imposed no obligations upon USSIC in favor of SPA or the individual indemnitors. The language of the bonds does nothing more than enumerate the conditions under which USSIC's obligations to others (not SPA) are triggered, the court said.

Similarly, the GIA imposed no good faith and fair dealing obligations in favor of the indemnitors, held the court. Indemnity contracts differ from suretyship contracts under Louisiana law, the court noted, such that indemnitors can be bound to the surety in any manner they elect. The GIA plainly states that the indemnitors assigned their rights to SPA's claims, the court observed, designated USSIC as their attorney-in-fact to exercise those rights, and gave USSIC the right, in its sole and absolute discretion, to settle all claims.

Finally, the court held that USSIC owed no fiduciary duty to SPA in its use of the GIA's power of attorney provision, since USSIC could act for its own benefit and was not required to act for the benefit of SPA. The suit is one in indemnity, not suretyship, and thus the GIA forms the law between the parties and governs its terms, reasoned the court. All of the indemnitors' "bad faith" claims were dismissed.

While "bad faith" litigation against a surety is more likely to arise from a claimant or an obligee on the bonds, or under a state's "bad faith" or unfair practices statutes, this case squarely addressed the surety's common law obligations to its principal and indemnitors. As such, the result should provide solace to the surety and its counsel that the implied duty of good faith and fair dealing, at least relative to the principal and the indemnitors, was not expanded to create an affirmative claim sounding in tort. E&D

1 2019 U.S. Dist. LEXIS 10709 (E.D. La., January 23, 2019).

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was for costs incurred as a result of delay in completion of the project, including extended overhead and personnel costs. Halbert and Western moved for partial summary judgment based upon the subcontract's NDD clause which stated, in part:

> Should [McCullough's] performance be delayed, hindered, interfered with or otherwise disrupted by any act of the Contractor [or others]...whether avoidable or unavoidable, reasonable or unreasonable, or foreseeable or unforeseeable, [McCullough's] sole and exclusive remedy shall be an equitable extension of time... [McCullough] shall not be entitled to and hereby expressly waives any claim for any increase in the subcontract price or additional damages or compensation as a consequence of such delays...

McCullough argued that the Miller Act rendered the NDD clause void.

The court first acknowledged that the availability of a NDD defense for a surety is a field of law that is rapidly evolving, that no controlling Ninth Circuit authority applied, and that California federal district courts are divided on the issue. The court then noted that because the Miller Act provides a federal cause of action, McCullough's recovery is a question of federal law, not California law. The fact that California state law supports the enforcement of NDD clauses, as Halbert and Western argued, would only be relevant if the NDD provision complies with the Miller Act, the court stated. After examination, the court concluded that it did not.

The purpose of the Miller Act is to grant security to those providing labor and materials on government projects, said the court, and it must be construed liberally to effect that goal. As part of that security, the Act limits the manner in which these rights can be waived, the court explained. Specifically, a waiver must be clear and explicit, signed and in writing, and executed after labor or material is provided to the project in order to comply with the Act, said the court.

The court was unpersuaded by the efforts of Halbert and Western to circumvent the strict waiver requirements by casting the NDD clause as merely a measure of McCullough's recovery in which such damages were limited to an extension of time. The court found instead that:

> permitting Halbert and Western to use the NDD provision to preclude McCullough's recovery from the Miller Act bond of additional costs arising out of delays for which McCullough is not responsible is, in effect, enforcing the provision as an implied waiver of McCullough's rights under the Miller Act.

Such a waiver is impermissible under the Act, the court held, and thus the NDD provision is void and unenforceable. McCullough was permitted to pursue its claims under the bond for delay damages.

Long gone are the days where federal courts rejected the recovery of delay damages against the Miller Act surety because they were not costs of labor and materials provided to the job. Indeed, cases such as *McCullough* demonstrate that the surety is often not protected by its principal's subcontracts on federal projects, at least not where they conflict with the subcontractor's Miller Act rights. Strict construction of the provisions of the Miller Act may well supersede suretyship principles, such as liability co-extensive with the principal. Surety professionals and practitioners beware. E&D

1 U.S. ex rel. McCullough Plumbing, Inc. v. Halbert Constr. Co., 2018 U.S. Dist. LEXIS 212121 (S.D. Cal. Dec. 17, 2018),

2 40 U.S.C. §§ 3131 et seq.

Incorporation by Reference Binds Surety to Forum Selection

BRIAN M. STREICHER

Unless it manifests intent to the contrary, a surety is bound to the forum selection of the incorporated bonded contract, even where that contract incorporates another contract by reference containing the forum selection clause. That was the message communicated by a Pennsylvania federal district court in *Pioneer Mechanical Services. LLC v. HGC Construction Co.*[1]

In *Pioneer*, the surety was named as a third-party defendant in an action filed by the subcontractor-principal against the contractor-bond obligee on a performance bond. During construction, the principal allegedly defaulted. The obligee claimed to have incurred costs to complete the principal's work and made a claim on the bond. The principal asserted that it was not paid what was owed by the obligee.

At issue was the bond's incorporation of the terms of the subcontract, specifically the venue selection. The bond stated that the subcontract was "by reference made a part [of the bond]." The subcontract itself was a rider to, and incorporated by reference, a certain master subcontract agreement ("MSA") which, in turn, contained a mandatory forum selection clause for litigation in the state or federal courts in Hamilton County, Ohio.

The principal filed suit against the obligee in the Western District of Pennsylvania. The obligee moved to change the venue of the lawsuit, including its third-party action against the surety, to the Southern District of Ohio pursuant to the subcontract's forum selection clause. The surety aggressively opposed the move, arguing that, since it was not a party to the MSA, it was not bound to its terms. The obligee maintained that the bond incorporated all of the provisions of the subcontract, the subcontract incorporated all of the provisions of the MSA, the MSA contained the mandatory forum selection clause and, thus, the bond incorporated the mandatory forum selection clause, binding the surety.

The court agreed with the obligee, holding that the bond incorporated the subcontract's venue selection clause, and transferred the case to the Southern District of Ohio. The court noted that the bond made clear reference to the subcontract, referring to it by contract number. The court reasoned that the surety stepped into the shoes of the principal, who was bound by the clause through traditional principles of incorporation by reference.

The court rejected the surety's argument that the clause could only bind the original parties to the MSA and that the "multi-layered" nature of the incorporation rendered the clause unenforceable. The court all but chided the surety, stating that it would "declin[e] to assume that a sophisticated party such as the surety here would fail to read past the [R]ider to the [MSA] when agreeing to ensure that all work under the [S]ubcontract would be performed."

Instead, the court suggested that, to avoid this dilemma, the surety can change the language of the bond. Citing other federal cases, the court stated: "[w]here a bond is involved, if the bond places limits on the incorporated agreement, those limits may evidence the intent of a surety not to incorporate all of the terms of the [incorporated] contract." The court observed that the bond in this case "does not limit which of the terms of the [s]ubcontract was incorporated. Nor does it include its own forum selection clause."

The decision does not reveal the specific bond form used by the parties. Yet, given that bonds typically do not address dispute resolution or forum choice specifically, results like this suggest it may be time for sureties to consider doing so, at least when bond forms are not designated by the bond obligee and terms can be negotiated. At minimum, this is a good reminder to sureties and their counsel of the importance of specifically reviewing all bonded contracts for forum and venue selection provisions prior to issuance of the bond, including all documents incorporated by reference into the bonded contract. E&D

1 2018 U.S. Dist. LEXIS 209349 (W.D. Pa. Dec. 12, 2018).

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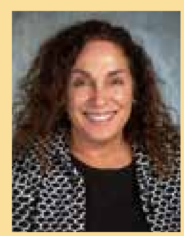
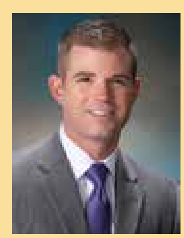


Andrea Morano Quercia

Andrea Quercia, Of Counsel, rejoins colleagues at Ernstrom & Dreste after a career spent in a variety of positions of increasing responsibility in private practice, government and corporate environments, most recently as the Vice-President and General Counsel of a $2B aerospace and defense division of a publicly traded company. Andrea's background encompasses not only a wide range commercial and government contract experience, including construction litigation, but also expertise in labor and employment matters, and in ethics and compliance investigations.

Andrea received her Juris Doctorate cum laude from Albany Law School and is a graduate of the Executive Business Leadership Program at The Wharton School, University of Pennsylvania.



Brian M. Streicher

Brian Streicher joins the firm as an associate attorney and commercial litigator, bringing with him extensive experience representing financial institutions in commercial and construction financing, residential financing, and bankruptcy proceedings. Brian practiced law for seven years representing financial institutions in the dynamic market of South Florida before coming to Ernstrom & Dreste, where he will litigate and practice in the areas of Construction & Surety Law, Banking, Creditors' Rights and Bankruptcy. He recently passed the New York bar exam and will be admitted to the New York bar in June.

Brian earned his Juris Doctor degree from Case Western Reserve University School of Law. 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

John Dreste is now admitted to practice law in Vermont to serve client needs and Todd Braggins has reactivated his law license in New Mexico.

Brian Streicher passed the February 2019 New York bar exam and will be admitted to the New York bar in June. Brian practiced law in Florida for seven years before joining E & D.

The National Association of Surety Bond Producers recently appointed Todd Braggins to its Attorney Advisory Counsel.

Todd Braggins will co-chair the 2019 Pearlman Association Annual Conference in Woodinville, Washington in September 2019. Matthew Holmes will also attend and present at the Conference on the topic of surety considerations when tendering a completion contractor to the bond obligee.

Todd Braggins attended the ABA Fidelity & Surety Law Committee's 2019 Spring Conference in Austin, Texas in May.