

## No Obligee Bad Faith Claim: Surety's Duty Differs From Insurer's

CAVAN S. BOYLE

In a case of first impression for Indiana, the state's intermediate appellate court recently held that the common law duty of good faith recognized between insurers and insureds does not extend to a surety-obligee relationship under performance and payment bonds in construction projects.<sup>1</sup> The ruling resulted in the dismissal of the obligee's bad faith claim against the surety.

The decision stems from a construction contract between the owner-obligee, Posterity Scholar House, LP ("Posterity"), and the general contractor-bond principal hired to construct two apartment buildings. The contract required performance and payment bonds, which were issued by FCCI Insurance Company ("FCCI").

Alleging default by the general contractor, Posterity filed claims on the performance bond and demanded that unpaid subcontractors be paid under the payment bond. However, upon investigating Posterity's claims, FCCI determined that Posterity was in default, not the general contractor, and denied Posterity's claims. Posterity filed suit against FCCI for breach of contract and tortious bad faith.

FCCI moved for partial summary judgment on Posterity's bad faith claim, arguing that no duty of good faith exists between FCCI and Posterity. The trial court granted FCCI's motion and the Indiana Court of Appeals affirmed.

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## Statutory Bond as a Ceiling? Surety's Intent Not Always Determinative

MARINA S. DE ROSA

While many surety bonds explicitly state whether they are intended to be statutory or common law bonds, a case out of a Tennessee bankruptcy court serves as an important warning that such bond provisions will not always control as anticipated by the issuing surety.<sup>1</sup> Ultimately, commonly used bond language expressly designating it a statutory bond when state law requires the bond, and meant to substitute the state's bond terms, was deemed ineffectual. This resulted in the bonds' enforcement as common law bonds, providing for more generous terms and more lenient barriers than required by statute.

In the case, the surety had issued payment bonds on behalf of its bankrupt principal for two public works projects, each containing the following provision:

13. When this Bond has been furnished to comply with statutory or other legal requirement in the location where the construction was to be performed, any provision in this Bond conflicting with said statutory or legal requirement shall be deemed deleted herefrom and the statutory provisions conforming to such statutory or other legal requirement shall be deemed incorporated herein. The intent is that this Bond shall be construed as a statutory bond and not a common law bond.

("Paragraph 13"). An adversarial proceeding was held to determine whether the bonds were common law or statutory; the answer would shape the remaining litigation between bond claimants and the surety, among others. The heart of the dispute was whether Paragraph 13 was a "savings" clause to assure the bonds' compliance with the minimum terms required by statute, or a "deletion" clause that rendered any "greater rights" terms of the bonds ineffective, and substituting the terms of the statute.

The Tennessee bankruptcy court first concluded that the bond was properly characterized as a common law bond, using a three factor analysis as to whether the bonds (1) make explicit reference to the statute; (2) extend rights beyond those minimally required under statute; and (3) expressly contain notice or time limitations to commence an action.

First, it was undisputed that the bonds failed to specifically reference the applicable statute incorporated. Next, the court found that the bonds expanded the rights of claimants (and the scope of the surety's liability) by extending coverage beyond the statutory minimum by ensuring that *equipment* was paid for in addition to labor and materials.<sup>2</sup>

The court further decided that the bonds contained notice provisions that altered the statutory notice requirements by exempting first tier claimants from the statute's ninety day notice requirement applicable to all claimants.<sup>3</sup> Finally, the bonds extended the limitation period for claimants to commence an action under the bond, the court said, from the statutory minimum of six months to one year. Thus, the court concluded that the bonds were common law bonds.

The court then addressed whether Paragraph 13 operated as a "deletion" clause, or only as a "savings" clause. Since there was no controlling Tennessee law on the issue, the court analyzed interpretations of provisions identical to Paragraph 13 from other juris-

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## Contract's ADR Term Not a Condition Precedent

NELL M. HURLEY

All parties, including the sureties and the obligee in this declaratory judgment action, were likely surprised by the outcome of a recent New York federal district court decision. The obligee's motion to dismiss the sureties' complaint was denied, but not because the court found the underlying construction contract's ADR provision inapplicable to the sureties. Instead, it found the contract language failed to qualify the term as a condition precedent to commencing litigation and thus was no barrier to the Sureties' suit. The court decision<sup>1</sup> upheld the assigned magistrate's initial finding<sup>2</sup> and the magistrate's determination on the obligee's motion for reconsideration.<sup>3</sup>

In 2020, the plaintiffs-sureties in the matter, Travelers Casualty and Surety Co. and Liberty Mutual Insurance Co. (the "Sureties"), issued a \$41 million AIA A312 performance bond ("Bond"), and payment bonds, on an affordable housing project in Buffalo, N.Y. for which its principal was the general contractor. The obligees were the owner-developer and its financing company (together, "Silo City"). Problems arose, with Silo City ultimately terminating the contract, performing work and making a claim on the Bond. The Sureties denied the claim and immediately sought a declaratory judgment in federal district court that it was exonerated by virtue of Silo City's prior breach and/or failure to comply with the Bond's notice provisions, which thus precluded Silo City's Bond claim.<sup>4</sup>

Silo City moved to dismiss the Sureties' complaint based upon a provision in the construction contract that it claimed required that the Sureties mediate prior to suit. The provision stated:

Claims, disputes, or other matters in controversy arising out of or related to the Contract... shall be subject to mediation as a condition precedent to binding dispute resolution.

Because the bond incorporates the construction contract by reference, Silo City argued, the Sureties were required to mediate prior to filing the lawsuit. Since they had not done so, the Sureties' declaratory judgment action must be dismissed, Silo City said.

The Sureties maintained that the Bond's incorporation of the construction contract by reference does not apply to the contract's dispute resolution provisions for claims relating specifically to the performance bond, that the Bond permits litigation without condition and that, at most, the action should be stayed while mediation takes place, rather than dismissed.

The assigned magistrate reviewed the language of the contract's dispute resolution provisions and concluded that it need not even reach the Sureties' arguments, because:

"[the language] does not make mediation a condition precedent to commencing litigation – instead it makes mediation a condition only to "binding dispute resolution."

Reasoning that to "resolve" a dispute means to make a formal decision, and that commencement of litigation does not formally decide anything, the magistrate determined that "the mediation requirement is not a condition precedent to the right to sue."

The magistrate granted Silo City's motion for reconsideration, but adhered to the initial recommendation, pointing out that the language at issue differed from cases holding such clauses to be conditions precedent, including the absence of such language as "prior to" and "as a condition of" commencing an action or other binding dispute resolution proceeding. Other general conditions of the contract at issue, he noted, expressly permit the request for mediation to be made concurrently with filing of binding dispute resolution proceedings (rather than prior to) and allows the parties to

engage in mediation even during litigation. Thus the magistrate concluded:

"[t]he only clear condition precedent is contained in [a different provision], making mediation a "condition precedent to binding dispute resolution," rather than to binding dispute resolution proceedings such as the commencement of litigation."

After further objections by Silo City, the district court reviewed the matter *de novo*, but accepted the magistrate's recommendation, denying Silo City's motion to dismiss the Sureties' action.

Many surety and construction professionals might assume that the language at issue here creates a condition precedent to initiating litigation, with the larger question being whether it applied to the Sureties for performance bond-specific issues. The court's interpretation, however, shows that the New York standard for conditions precedent that the language be "unmistakably clear" remains an exceedingly strict one, and is still subject to interpretation. While the litigation between the parties continues in both state and federal court, with more motion practice likely, this result was a welcome, if unexpected, boost for the Sureties. **E&D**

<sup>1</sup> *Travelers Cas. & Sur. Co. v. Silo City Phase I, LLC*, 2023 WL 2815729 (W.D.N.Y. Apr. 5, 2023).

<sup>2</sup> 2023 WL 19335887 (W.D.N.Y. Dec. 27, 2022).

<sup>3</sup> 2023 WL 2848709 (W.D.N.Y. Feb 17, 2023).

<sup>4</sup> Five weeks after the federal action was commenced, Silo City sought mediation and brought a state court action against the contractor and the Sureties in Erie County Supreme Court.



E&D took advantage of the 2023 PGA Tournament at Oak Hill Country Club in Rochester. Shown here is Kevin Peartree (second from R) with E&D clients and friends. Todd Braggins gets photo credit, also partaking in that day's festivities.

## CONTINUED "STATUTORY BOND AS A CEILING? SURETY'S INTENT NOT ALWAYS DETERMINATIVE"

dictions. The surety urged the court to adopt a New Hampshire court's interpretation, which found that if the bond is provided because of a statutory requirement, it should be interpreted as a statutory bond, accepting as determinative the surety's statement of intent for how the bond would be construed.

The bankruptcy court disagreed, adopting instead a Michigan court's interpretation of Paragraph 13 as a savings clause, meant only to ensure that the bonds' terms meet the statutory minimum, operating as a "floor" for surety liability exposure, rather than a "ceiling." Agreeing with this rationale, the bankruptcy court stated that it:

"...cannot accept the more extreme interpretation that a single clause in the contract, apparently included to assure compliance with minimum state standards, should be construed as eliminating other significant contractual provisions that expanded the rights well beyond those minimum requirements."

Paragraph 13 was a savings clause, said the court, which would only supplant a bond term if that term failed to satisfy the statutory minimum requirements.

Although the interpretation of clauses such as Paragraph 13 varies by jurisdic-

tion, this decision should alert sureties that its language cannot be relied upon to convert an otherwise common law bond into a statutory bond if the terms exceed the statutory minimum. Even a surety's expressed intent may be insufficient to create the "ceiling" the surety desires.

**E&D**

1 *In re Pinnacle Constructors, Inc.*, 647 B.R. 352 (Bankr. M.D. Tenn. 2022).

2 In this case, equipment also included utilities such as gas, water, power, light, and other costs.

3 Those claimants in direct privity with the contractor-principal are considered "first tier."

## CONTINUED "NO OBLIGEE BAD FAITH CLAIM: SURETY'S DUTY DIFFERS FROM INSURER'S"

On the appeal, Posterity argued that Indiana's common law duty of good faith found between an insurer and its insured under insurance policies should extend to the contractual relationship between surety and bond obligee, thus permitting surety liability on the bad faith claim.

The appellate court noted that the case presented an issue upon which states are divided. The court examined the Indiana Supreme Court decision that established a good faith duty between insurers and insureds based on their "special relationship"<sup>2</sup> and rejected Posterity's argument, finding that "special relationship" lacking between the surety and the bond obligee.

The court observed contractual differences between the insurer-insured and surety-obligee relationships and determined the essential nature of the promises differ. The insurance contract, the court explained, is a bilateral agreement whereby the insured shifts its risk of loss to the insurer. A suretyship, by contrast, is a "tripartite arrangement in which one party (the surety) guarantees that a second party (the principal) will perform its contractual obligations to a third party (the obligee)." Under this arrangement, the principal retains the risk of loss. In this sense, the court reasoned, "a surety bond is a financial credit product, not an insurance indemnity product."

Next, the court found the state's inclusion of surety bonds as a class of insurance under the Indiana Insurance Code is not determinative. What gives rise to an insurer's common law duty of good faith is the special relationship between insurer and insured, not its inclusion in a regulated industry, said the court.

Finally, the court confirmed the special relationship between insurer and insured is a fiduciary relationship that arises from an insurer's duty to defend an insured against claims born out of the close, arms-length transac-

tion of purchasing the insurance policy. This relationship does not exist between a surety and bond obligee, the court observed, where the surety bears no responsibility to defend an obligee against third party claims, nor has any right to represent the obligee's interest by virtue of the surety bond. Instead, that type of relationship is present only between the surety and its bond principal.

The issue of surety vulnerability to obligee bad faith claims is an important one nationwide. Adding Indiana to the states that recognize the important distinctions between surety and insurance on this subject is a positive result for the surety industry. Still, some states' laws are more nuanced and will imply into every contract a duty of good faith and fair dealing, and surety bonds are treated no differently. However, unless expressly set forth under the terms of the principal-obligee contract, a surety's duty of good faith to the obligee may arise only upon a formal declaration of default made by the obligee, at which time the surety must investigate the claim in good faith.<sup>3</sup> Prior to that, in such states, the surety may owe no duty to the obligee other than what the principal owes under the contract, and what constitutes good faith or lack thereof depends upon the facts of each case.<sup>4</sup> Thus, the *Posterity* decision is a valuable reminder that to truly evaluate the risk of bad faith claims, the surety must be aware of applicable state law and, depending on the jurisdiction, the terms of the underlying bonded contract. **E&D**

1 *Posterity Scholar House, LP v. FCCI Ins. Co.*, 205 N.E.3d 1018 (Ind. Ct. App. 2023).

2 *Erie Ins. Co. v. Hickman*, 622 N.E.2d 515 (Ind. 1993).

3 See *U.S. Fid. & Guar. Co. v. Braspetro Oil Servs. Co.*, 369 F.3d 34, 64 (2d Cir. 2004).

4 See *PSE Consulting, Inc. v. Frank Mercede & Sons, Inc.*, 838 A.2d 135, 160 (Conn. 2004).



925 Clinton Square  
Rochester, New York 14604

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## FIRM NEWS

Todd Braggins, Brian Streicher, and Marina De Rosa attended the 2023 ABA/TIPS Fidelity & Surety Law Committee Midwinter Conference held in Washington, D.C. E&D was a sponsor of the After Hours Party.

Brian Streicher participated in the Surety Association of Syracuse's golf event held at the Turning Stone Resort in Verona, New York on May 31, 2023.

Todd Braggins took part in the Philadelphia Surety Claims Association's Annual Golf Outing at Bala Golf Club on June 5, 2023.

Brian Streicher and Todd Braggins will participate in the 2023 Pearlman Association Conference held in Woodinville, Washington in September.

Todd Braggins and Brian Streicher plan to attend the National Bond Claims Association 2023 Annual Meeting at Horseshoe Bay Resort in Texas in October.

Todd Braggins will be a presenter at the January 2024 ABA/TIPS Fidelity & Surety Law Committee Midwinter Conference in New Orleans. He will speak regarding surety claims handling considerations related to varying contract delivery methods.

Kevin Peartree, Martha Connolly, and Brian Streicher presented on "*Controlling Risk in Construction and Project Delivery Systems*" to the AGC NYS Construction Leadership Academy at a session in Rochester, New York on May 24, 2023.

E&D is pleased to announce the addition of another professional to our legal services team. Recent Penn State graduate Gia Denaro joins us as a paralegal to assist with document management, discovery, and important filings on construction and surety matters.