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Surety Liable on Performance Bonds Despite Obligee's Refusal to Permit Principal as Completion Contractor

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In a decision of great importance to the surety industry, New York's Appellate Division, First Department, held that a surety was not discharged from its performance bond obligations by an obligee's refusal to permit the surety to complete with the surety's preferred contractor, here the defaulted principal. The surety claimed that the obligee's refusal deprived the surety of completion options under the bonds, resulting in prior material breach by the construction manager. The motion court agreed. However, the appellate court reversed the decision, relying upon the bonds' incorporation of the terms of the prime contract regarding prior approval of subcontractors and granting the construction manager judgment on the bonds as a matter of law.

Bovis Lend Lease (LMB) v. Lower Manhattan Dev. Corp., 143 A.D.3d 597 (1st Dept. 2016) arose out of contracts for deconstruction and abatement of the

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They've Done It Again: Court Complicates Surety's Ability to Settle Affirmative Claims

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Suretyship is not insurance. Previously case law seemed to grasp this rather simple concept. But, the Sixth Circuit recently complicated a surety's right to settle its principal's affirmative claim by applying a duty similar to that owed by an insurance company to its insured. While the Court ultimately concluded that the surety did not breach its duty, the precedent may raise the standard and the duty owed by the surety to its principal when settling the principal's affirmative claim against an obligee.

The case at issue, *Great American Ins. Co. v. E.L. Bailey & Co.*, 2016 WL 6575085 (6th Cir. 2016), involved a public works project in Michigan and applied Michigan law. The principal, E.L. Bailey & Company, Inc. ("Bailey"), obtained bonds from Great American Insurance Company ("Surety") for a contract Bailey entered into with the State of Michigan ("State") for the construction of a prison kitchen at the Huron Valley Women's Correctional Facility ("Project"). Disputes arose on the Project between Bailey and the State. The State alleged that Bailey missed the completion dates for substantial completion and final completion, and it withheld money from Bailey for liquidated damages.[1] Bailey alleged that the delays were caused by defects in the State's design, which rendered it impossible to construct. The State acknowledged that its design contained a "serious design flaw."

Bailey and the State went to a mandatory mediation, in which the mediator recommended that the State pay to Bailey the sum of $220,400.75, an amount that Bailey rejected. The next step in the dispute-resolution process was a facilitation. In the interim, Surety received multiple lawsuits and bond claims from Bailey's subcontractors and suppliers alleging nonpayment. Surety paid some claims, and demanded collateral security from Bailey, but Bailey could not provide security sufficient to satisfy Surety's demand.

The day prior to the facilitation, Surety informed Bailey that Surety and the State reached an agreement. The State would pay the sum of $358,000 to Surety, representing the full and final payment to Bailey on the Project. The Surety then commenced an indemnity action against Bailey and its owner seeking indemnity for its remaining losses, costs, expenses, and attorneys' fees.

Surety asserted a cause of action against Bailey for a declaratory judgment that it had the right under the indemnity agreement to settle Bailey's affirmative claim

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Sign It Twice: Proof of Intent Needed to Hold Signatory Personally Liable

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A recent Second Circuit case demonstrates the need for clarity when a surety wants to hold an individual personally liable, under the indemnity agreement, for the actions of the principal. When there is no “clear and express intent” to be bound in an individual capacity on the part of the indemnitor, New York courts will not enforce that agreement against him or her personally.

In *Segouros Nuevo Mundo, S.A. v. Trousdale*, 2016 WL 64656664 (2d Cir. 2016), the surety, Segouros Nuevo Mundo, S.A. (“Segouros”) provided performance and payment bonds for its principal, a joint venture that contracted to design and build a prison for the Republic of Venezuela (“Venezuela”), the bond obligee. Following allegations that the joint venture breached its contract, Segouros paid out $12 million on the bonds to Venezuela.

Segouros then commenced an indemnity action in the Eastern District of New York to recover its costs and expenses from indemnitor B. Allen Trousdale (“Trousdale”), the owner of Grad Associates, P.A. (“Grad”), one of the entities comprising the bonded joint venture. Trousdale argued that the guaranty he signed during the bonding process was not a personal guaranty, but rather a signature as a representative of Grad. On a motion to dismiss, the trial court agreed.

Reviewing the case de novo, the Second Circuit affirmed, finding that the only evidence submitted in support of Segouros’s claim of personal liability was the guaranty agreement. On its face, this document demonstrates that Trousdale was “acting in [his] capacity of President” and “on behalf of” Grad, said the Court. Without more, the Court stated, the complaint failed to identify or point to “clear and explicit” evidence of Trousdale’s intent to assume personal liability for or to that of Grad. If there were other facts in support of such intent, Segouros failed to provide them on the motion and, thus, the complaint was dismissed.

The result would have been different if Segouros required two signatures from Trousdale on the guarantee agreement: one for the company and the second individually. E&D

CONTINUED “SURETY LIABLE ON PERFORMANCE BONDS DESPITE OBLIGEE’S REFUSAL TO PERMIT PRINCIPAL AS COMPLETION CONTRACTOR”

former Deutsche Bank Building (now 130 Liberty Street) in Manhattan, which was damaged by the terrorist attacks at the World Trade Center on September 11, 2001. The construction manager, Bovis Lend Lease (LMB), Inc. (“Bovis”) contracted with Lower Manhattan Development Corp. (“LMDC”), as owner, and Bovis entered into a subcontract with the John Galt Corporation (“Galt”). Arch Insurance Co. (“Arch”) issued surety bonds[1] on behalf of Galt, naming Bovis as obligee.

On August 18, 2007, a fire broke out at the project, resulting in the deaths of two NYC firefighters. The building’s standpipe, which supplied the only source of water to put out a fire, was dismantled by Galt. (In 2011, Galt was convicted of second-degree reckless endangerment). On August 28, 2007, Bovis terminated Galt and made a claim against Arch’s performance bonds. Bovis made it clear, however, that it would not permit Arch to use Galt to complete any of the remaining work. In light of that, and under a reservation of rights, Arch performed using another contractor.

Litigation ensued and Bovis and Arch submitted claims against each other relating to the project. Both sides moved for summary judgment, and the lower court ruled in favor of Arch.[2] The lower court held that Arch was discharged from its obligations under the performance bonds because Bovis interfered with Arch’s right to use a completion contractor of its choosing, an option under the performance bonds. The lower court relied on established case law that unless the language of the bond provides otherwise, a completing surety assumes liability for the remaining work and has the discretion to hire a contractor of its choosing, even the defaulted principal. This permits the surety to control the completion costs and the completion contractor acts as the surety’s agent.

The appellate court took a different view, finding that the language of the bonds bound Arch to perform “in accordance with the terms and conditions” of Galt’s subcontracts, which were incorporated by reference into the bonds. Similarly, the subcontracts incorporated the terms of the prime contract between Bovis and LMDC, which required prior written approval of any replacement subcontractor. Since Bovis’s termination of Galt made it clear that Bovis “expressly and unequivocally disapproved” of Galt’s continued performance, Bovis had the contractual right to prohibit Arch from using Galt to complete. In addition, the Court stated that Galt’s (later) conviction in 2011 demonstrated that it was a non-responsible contractor, which disqualified it from serving on the project.

The decision does not address the reasoning and case law cited by the lower court that when the surety chooses to complete, the contractor chosen for the work does so as the surety’s agent, not as its subcontractor. This decision makes it clear that a performance bond surety must comply with the terms of the underlying bonded contract, including any documents or provision that may be incorporated by reference. E&D

1 The language of the bonds was similar to that of the AIA A311.

2 2015 WL 1806062 (Sup. Ct. New York Co.).

against the State. Bailey raised numerous defenses, primarily relating to Surety's alleged bad faith by settling the claim without Bailey's knowledge and consent. Bailey also alleged that the Surety did not maximize the full value of the claim, but instead settled to protect its own interest.

The Court first addressed whether the declaratory judgment was the proper forum to raise the defense of bad faith. The Court distinguished previous cases from New York and Virginia, which require indemnitors to litigate the bad faith defense when the surety moved for summary judgment on its indemnity claim. Those cases held that the surety's right to settle claims was separate from the issue of whether the claims were settled in bad faith.

The Court distinguished those cases because they dealt with the surety paying claims, as opposed to receiving money for affirmative claims. When a surety pays claims, the issue of bad faith can be litigated when the surety seeks indemnification of those payments. On the contrary, the Court held, when a surety receives money for an affirmative claim, the declaratory judgment action may be the only opportunity for the principal to litigate the bad faith issue, because the surety will not be seeking indemnification for a payment it receives. Therefore, the Court permitted Bailey to raise the defense that the Surety settled the affirmative claim in bad faith in response to Surety's declaratory judgment cause of action.

Perhaps the most troubling aspect of this decision was the Court's use of a lower standard, typically applied in the insurance context, when defining bad faith. The definition of bad faith is not uniform across the country. But, a majority of courts have held that the indemnity agreement has an implied covenant of good faith and fair dealing, which is breached if the surety acts with an improper motive or dishonest purpose. *See PSE Consulting, Inc. v. Frank Mercede and Sons, Inc.*, 267 Conn. 279 (2004).

The Court noted, "insurance is not identical to suretyship," but then applied a bad faith requirement typically reserved for insurance companies. Therefore, in addition to the covenant of good faith and fair dealing, the Court imposed a bad faith standard to the Surety's settlement of Bailey's affirmative claim. While stating, "honest errors of judgment are not sufficient to establish bad faith," the Court stated: "there can be bad faith without actual dishonesty or fraud, such as when the insurer is motivated by selfish purpose or by a desire to protect its own interest at the expense of its insured's interest."

The Court held that, when settling a principal's affirmative claim, a surety can breach its duty to the principal in the absence of a dishonest motive or improper purpose, which contradicts a majority of courts. In this context, the Court entertained Bailey's argument that Surety acted in bad faith because it failed to investigate Michigan's law regarding liquidated damages, Surety settled to mitigate its own interest, and Surety failed to notify Bailey of the settlement discussions.

Addressing the merits, the Court found many facts favoring Bailey's argument that Surety acted in bad faith. For example, Surety misapprehended Michigan's law regarding the applicability of liquidated damages. Next, Surety did not inform Bailey that it was in settlement discussions with the State until the Surety settled with the State. The lack of notice and an opportunity to prevent an undesirable settlement supported Bailey's argument that Surety was motivated by a selfish purpose.

When looking at the record as a whole, the Court concluded that Surety did not act in bad faith and was entitled to settle Bailey's affirmative claim with the State. First, the Court noted that Surety and Bailey shared an interest in securing the highest possible settlement from the State. In addition, the Surety was able to secure a payment of $358,000, which was significantly higher than the mediator's recommendation of $220,000. Finally, the settlement negotiations between the State and Surety portrayed a genuinely adversarial negotiation. Surety was able to push for and negotiate terms with which the State "strenuously," "strongly," and "adamantly disagreed."

The Court ultimately concluded that a "simple disagreement with the monetary amount reached by settlement is generally insufficient to establish bad faith on its own." Bad faith primarily concerns a party's state of mind during the settlement process, not its results.

The case is troubling in that it suggests that a surety may be required to ignore its legitimate business interest to ensure that it is considering the principal's interest when settling an affirmative claim. In a situation when an early settlement may favor the surety's business interest over the principal's interest, the surety could be required to hold out for more money. E&D

1 The Court's decision did not identify the number of days of liquidated damages assessed against Bailey or the amount of money withheld by the State.

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FIRM NEWS

Ernstrom & Dreste, LLP is excited to be participating in the revitalization of downtown Rochester by relocating its offices to 925 Clinton Square, Rochester, New York 14604.

Kevin Peartree spoke at the 2016 Construction Super Conference on December 6th in Las Vegas, on the topic "Which Standard Form Design-Build Contract is Right for You and Your Project".

Kevin Peartree will be presenting a "2017 Construction Law Update – Recent Court Decisions and New Regulations Every Contractor Should Know" for the Builders Exchange of Rochester on January 24th.