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Surety Not Liable for Claimants' Fees and Expenses Under Common Law Payment Bond

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An arbitration panel rules on disputes between a contractor, its subcontractor and its supplier. The panel issues an award for damages against the contractor, including attorneys' fees and costs, filing fees, and arbitrator compensation fees incurred by the sub and supplier, as authorized in the parties' contracts. The contractor files for bankruptcy, and the sub and supplier look to the surety under the payment bond on the prime contract. The surety pays the damages and interest owed to each party but refuses to pay the fees and costs, arguing that they are not recoverable under the express terms of the payment bond. The court agrees, finding that the bond obligated the surety to pay claimants only for labor and materials used in the project.

The recent decision, *Owners Ins. Co. v. Fid. & Deposit Co.*,[1] from a federal district court in Missouri, stems from the private construction of a luxury apartment building in St. Louis County. The owner contracted with Blanton Construction, Inc. ("Blanton") for the project, and Fidelity & Deposit Co. ("F&D") issued a $24 million payment bond ("Bond"). The Bond provided that the surety, upon the principal's default, would be obligated "for all…labor and material used or reasonably required for use in the performance of the [prime contract]." The Bond permitted every claimant "who has not been paid in

CONTINUED ON PAGE 3

Procedure and Prejudice: Jury Correctly Applied *Spearin* Doctrine Despite Misleading Jury Instruction

BRIAN M. STREICHER

In allocating responsibility for construction-project defects, a majority of states take the view that a project owner, through its design professionals, warrants the accuracy and sufficiency of its plans and specifications to the contractor. This view was adopted nationally in 1918 by the Supreme Court in *United States v. Spearin*.[1] A majority of states have since adopted the "Spearin Doctrine," which holds that "if the contractor is bound to build according to plans and specifications prepared by the owner, the contractor will not be responsible for the consequences of defects in the plans and specifications."[2]

The doctrine is intuitive. Owners and their design professionals control the issuance of the plans and specifications. Contractors control the quality of their work. If a construction defect is the result of a defective design, the owner should bear responsibility. If a construction defect is the result of the contractor's failure to perform in a workmanlike manner, then the contractor should be liable.

But the scope of the *Spearin* Doctrine is not black and white. For example, how should courts allocate fault when a portion of a contractor's defective work is attributable to design defects, but other portions are attributable to the contractor's failure to perform in a workmanlike manner? Can comparative fault even be allocated when trying to pin down the source of a defect in a complex construction project? This tension in the scope of the *Spearin* Doctrine was recently put at issue before the Supreme Court of Washington State in *Lake Hills Investments, LLC v. Rushforth Construction Company, Inc.*[3]

In *Lake Hills*, the owner sued the contractor for breach of contract, alleging, among other things, that the contractor's work was defective. The contractor counterclaimed that the owner underpaid. At trial, an affirmative defense instruction (Jury Instruction 9) was given, stating that:

> "[the contractor] has the burden to prove that [the owner] provided the plans and specifications for an area of work at issue, that [the contractor] followed those plans and specifications, and that the [construction] defect resulted from defects in the plans or specifications. If you find from your consideration of all the evidence that this affirmative defense has been proved for a particular area, then your verdict should be for [the contractor] as to that area."

The jury returned a mixed verdict. On the question of whether the contractor had rendered defective work as to any area of work, the jury answered yes. It awarded damages of $1.4 million to the owner in six of eight areas of claimed defects. The jury also found that the owner had breached the contract in several respects and awarded damages to the contractor on its counterclaims. The net judgment to the contractor was $9.2 million.

On appeal, the intermediate appellate court held that Jury Instruction 9 understated the contractor's burden of proof and improperly allowed the jury to find that if any part of the construction defect resulted from the owner's plans and specifications, then the jury could find for the contractor. The court concluded that the error was not harmless, reversed, and remanded for a new trial.

On further appeal, the Washington Supreme Court reversed. That court noted the pro-

CONTINUED ON PAGE 2

IN THIS ISSUE

When is a Demand for Collateral Not a Demand for Collateral?

MATTHEW D. HOLMES

A concerning decision out of a Texas federal district court is a perfect example of why the language a surety uses in its demand letters to indemnitors can be important, if not pivotal. In *Guar. Co. v. RKM Util. Svces.*,[1] the surety's motion for a preliminary injunction seeking collateral was denied, in part, by its failure to make a demand to the indemnitors for payment of collateral in a way the court found consistent with the indemnity agreement.

The case involved a surety's 2020 indemnity suit against several indemnitors for claims and costs under multiple payment bonds issued for one of the indemnitor companies. At that time, the surety had established a reserve of over $8 million to cover claims against the bonds, and had incurred losses of over $6.4 million to resolve claims, including fees and expenses of approximately $175,000 to investigate. Claims against indemnitors included breach of the indemnity agreement, specific performance of the indemnity agreement, common law indemnity, exoneration and collateralization, and a request for a preliminary injunction, which later proceeded by motion.

In the motion, the surety asked that the indemnitors be required to, among other things, immediately collateralize the surety and grant the surety access to their books and records. To be successful, the surety had to establish the standard four factors, including a substantial likelihood that it would prevail on the merits.[2] The court evaluated each of the factors and found that none supported the surety's request.

Regarding the first factor, the surety argued that it would be successful on the merits because the indemnitors agreed to "reimburse and collateralize" the surety upon demand, and by executing the indemnity agreement, they "'confirm[ed] and acknowledge[ed] that the [surety] is entitled to injunctive relief for specific performance of their indemnity and collateral obligations." In addition, the surety referenced the indemnitors' "agree[ment] to pay to surety upon demand . . . [a]ll loss, cost and expenses of whatsoever kind and nature" and "[a]ny amount sufficient to discharge any claim made against surety on any [b]ond" in an amount deemed sufficient by the surety to protect it from loss.

The court rejected the surety's arguments, despite the surety's "demand letter" that was the basis of the complaint. The court found that the letter merely:

> "stated that its purpose . . . is to address the obligations of the Indemnitors under the [Indemnity Agreement] including their obligation to reimburse the Surety for loss already incurred on the Bonds"; (2) quoted the contract language requiring defendants to pay the surety "upon demand" and noted that failure to pay qualifies as an "Event of Default" under the indemnity agreement; and (3) requested "a meeting with the Indemnitors to discuss their collective plan of action for reimbursing the Surety…"

The letter did not trigger the indemnitors' obligation to provide collateral because there was no actual demand for payment of a stated sum, reasoned the court. The *RKM Util. Svces.* court relied on its own distinction between provisions of the indemnity agreement as to how and when the indemnitors must provide collateral security to the surety, and found the references to "reimburse and collateralize" insufficient to bind the indemnitors, without a further demand.

Similarly, the court found that the surety failed to show its demand for, or the indemnitors' denial of, access to their books and records under the indemnity agreement. Without such demands, the court determined that the surety failed to establish a substantial likelihood of success on the merits, which warranted denial of the motion for a preliminary injunction.

Preliminary injunctions in such situations can be difficult for a surety to obtain. Issues of irreparable harm to the surety, potential harm to the indemnitors and balancing the public interest all set a very high standard. Nonetheless, this case serves as an important reminder that courts will scrutinize the language of indemnity agreements and the specific actions taken by sureties, including what constitutes a "demand for collateral." Do not assume that quoting the indemnitor's obligations under the indemnity agreement, or even a request for "reimbursement and collateralization" is sufficient. Ask for payment. E&D

1 2021 U.S. Dist. LEXIS 181656 (N.D. TX 2021).

2 The other three factor are (1) a substantial threat that irreparable harm will result if the injunction is not granted; (2) the threatened injury [to the surety] outweighs the threatened harm to the indemnitors; and (3) the granting of the preliminary injunction will not disserve the public interest.

CONTINUED "PROCEDURE AND PREJUDICE: JURY CORRECTLY APPLIED *SPEARIN* DOCTRINE DESPITE MISLEADING JURY INSTRUCTION"

cedural rule in Washington that, where a jury instruction is merely misleading, the appellant bears the burden of proving that the misleading instruction prejudiced the appellant. The court concluded that Jury Instruction 9 was misleading, because it could either be interpreted as a requirement that the construction defects resulted solely from defective plans and specifications, or merely *partially* from the defective plans and specifications. Under Washington law, the defense was not an all or nothing gamble. Contractors are entitled to offset that portion of damages caused by the defective plans and specifications against the total construction defects.

The basis for reversal, however, was that the owner had not demonstrated prejudice from the misleading jury instruction. The court noted that the jury weighed the owner's separate claims and even awarded it $1.4 million in damages on six of its claims. While this award was overshadowed by a net award of $9.2 million to the contractor, the court stated that this split in allocation of damages demonstrated that the jury correctly interpreted the instruction as one allowing for comparative allocation of damages under the *Spearin* Doctrine.

The decision is a win for contractors and their sureties.[4] It extends the intuitive underpinning of *Spearin*—that those in control of design documents should bear proportionate liability for resulting defects. It also demonstrates that the law can and should be practical. Notwithstanding that Jury Instruction 9 was objectively misleading, the jury ultimately rendered the correct comparative fault result. A reversal and remand for a new trial would merely waste judicial resources and expose the justice system as rigid and pedantic, rather than functional and efficient. E&D

1 248 U.S. 132 (1918).

2 *Id.* at 136.

3 494 P.3d 410 (Wa. 2021)

4 The Surety & Fidelity Association of America was one of many industry organizations that filed an amicus curiae brief.

CONTINUED "SURETY NOT LIABLE FOR CLAIMANTS' FEES AND EXPENSES UNDER COMMON LAW PAYMENT BOND"

full" to sue on the Bond "for such sum or sums as may be justly due…"

Stark Truss Company, Inc. ("Stark") supplied various roof trusses, wall trusses and other materials to the project, under a credit agreement with Blanton that imposed finance charges and authorized Stark's recovery of attorneys' fees, costs and other expenses. Blanton also subcontracted with Lindberg Waterproofing, Inc. ('Lindberg") for waterproofing work on the project. The subcontract provided that in any dispute between the parties, the prevailing party was entitled to its attorneys' fees, expert fees, and costs from the non-prevailing party. Disputes arose, and a multi-party arbitration through the American Arbitration Association ("AAA") ensued. F&D was not a party to the arbitration.

The arbitration panel issued an interim award against Blanton, and in favor of both Stark and Lindberg, awarding damages and declaring that each was entitled to various fees and costs. Blanton then filed for bankruptcy protection. F&D paid Stark and Lindberg the principal amounts of the interim award plus statutory interest. After the bankruptcy court modified the automatic stay, the panel issued its final award which included significant sums for claimants' attorneys' fees, AAA filing fees, arbitration panel compensation, and pre-judgment interest. For Stark, the award also granted financing fees under the credit agreement. F&D refused to pay the additional amounts, leading the claimants to seek court redress.

Upon cross-motions for summary judgment, the court considered the leading Missouri case[2] on the issue which ruled against the surety, based upon the broad terms of the applicable bond guaranteeing "payment…due" for a breach of *any* of the contractor's obligations (including its subcontract obligations). The bond language there obligated the surety if the contractor failed to perform *all* of its obligations under the bonded contract and pay for labor or materials. Further, the bonded contract contained a covenant requiring the contractor to comply with its own subcontracts, including payment of attorneys' fees.

The language of the Bond here, reasoned the court, is much narrower, guaranteeing payment only for labor and material used in performance of the prime contract, and there is no reference in the prime contract to payment of such fees and expenses. Thus, the court held that F&D's liability under the payment bond is limited to payment of claims for labor and materials used in the performance of the prime contract and that claims for attorneys' fees, costs and expenses are not recoverable under the express terms of the bond.

The court was unpersuaded by the claimants' reliance upon cases involving state statutory or federal Miller Act bonds when interpreting a private common law bond, like the Bond here. Such statutory bonds are interpreted based upon legislative intent, and are typically liberally drafted and construed to protect claimants, said the court, whereas the purpose of a private common law bond is to protect the owner.

This decision reminds us that the general rule of the surety's coextensive liability with that of its principal is not an absolute. The extent of the surety's liability ultimately depends on the language of the bonded contract and the bond itself, especially for a private construction project. F&D

1 2021 U.S. Dist. LEXIS 150364 (E.D. Mo., August 10, 2021).

2 Brooke Drywall of Columbia, Inc. v. Bldg. Const. Enterprises, Inc., 361 S.W.3d 22 (Mo. 2011).

Appearing as program panelists at the National Bond Claims Association Annual Meeting at Pinehurst Resort in October, 2021 are (L to R) Todd Braggins (Ernstrom & Dreste, LLP), Dennis O'Neill (Beacon Consulting Group, Inc.), Scott Olson (Markel Surety), Chad Melroy (Alan Gray, LLC), Emily Brennan (HMS Insurance Associates, Inc.), and Jim Thompson (Harkins Builders, Inc.).

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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

Todd Braggins, Brian Streicher and Matthew Holmes plan to attend the ABA/TIPS Fidelity & Surety Law Committee Midwinter Conference in Nashville, Tennessee January 20-21, 2022.

Matthew Holmes was a featured program speaker for the Surety Association of Syracuse's Surety Day on November 3, 2021 for the presentation "*Bid Errors: The Littlest of Things That Can Cause the Biggest of Problems*."

Todd Braggins and Brian Streicher attended the National Bond Claims Association Annual Meeting October 11-15, 2021 at Pinehurst Resort. Todd was a panelist for the program entitled "*Successful Claims Navigation Through a Tempestuous Project: Finding Fair Winds and Following Seas*."

Todd Braggins and Matthew Holmes were speakers at the Pearlman Association Annual Conference in Woodinville, Washington, September 8-10, 2021, co-presenting on the topic "*Silence is Golden: Using the Defaulted Principal When the Bond is Silent.*"

Brian Streicher attended the Surety Association of Syracuse Summer Event at Saratoga Race Track on August 18, 2021.

Kevin Peartree authored a chapter titled *ConsensusDocs 753: Standard Agreement Between Constructor and Prefabricator* for the annual supplement to the ConsensusDocs Contract Documents Handbook, to be published in 2022 by Wolters Kluwer.

Kevin Peartree will present his annual Construction Law Update for the Builders Exchange of Rochester on January 20, 2022.

Clara Onderdonk's appointment to the National Board of Directors for the Association of Legal Administrators was recently announced.