Multiple Questions to Consider

Settling the Hard-Fought Case

By John W. Dreste and Thomas K. O'Gara

What happens when the surety compromises after the sheen fades from the principal's defenses?

The modern General Indemnity Agreement (GIA) eliminates, or at least mitigates, many common law defenses to indemnity, but indemnity efforts still meet arguments of "bad faith" or reasonableness or both. Defenses often argue that a surety conducted an insufficient investigation of the underlying liability or otherwise failed to assert a principal's defenses to a claim. But what happens when a surety conducts an exhaustive investigation that culminates in litigation of a principal's substantive defenses, in addition to surety-specific defenses, but the surety settles just short of a trial? What happens in a subsequent indemnity action when the indemnitors argue the surety abandoned valid defenses previously asserted as meritorious in the underlying action? In at least one instance, a federal district court opined that evidence of aggressive, extended litigation of defenses, followed by settlement, can raise issues whether settlement by a surety was in "good faith." *See Lumbermens Mutual Casualty Co. v. Dinow, et al.*, 2012 WL 4498827 (E.D.N.Y. 2012).

Setting the Stage

Although *Lumbermens* provides a backdrop for this article, a survey of national treatment of similar and related issues is presented, in addition to what can reasonably be considered "bad faith" in a surety indemnity context. This is not a critique of the surety in *Lumbermens* because that decision is, at minimum, questionable. However, practical suggestions are made regarding mitigating the risk of a similar result in the future.

Claims, Defense, and Compromise

In *Lumbermens,* the surety issued various payment and performance bonds for the principal. The principal and its owners, the indemnitors, executed a GIA. Ultimately, various payment and performance bond claims were made against the bonds, two large claims on one project and one smaller claim on another. The large claims consisted of a performance bond claim for $2,250,000, in a New York State court, and a $454,287.99 payment bond claim, in federal court. The performance bond claimant

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added a $2,000,000 claim for punitive damages, and with the interest, the exposure exceeded $4,500,000. The principal and the surety were both named defendants.

The surety thoroughly investigated the claims, and it initially determined that the principal had strong substantive defenses and that there were surety-specific defenses as well, including material modification of risk and default by the obligee. On the payment bond claim, the surety alleged that the claim was untimely under the bond terms. The surety aggressively asserted the principal's and surety-specific defenses, and even funded the principal's attorneys' fees.

The federal court payment bond claim was settled while a summary judgment motion was pending. The principal was a party to the settlement agreement, acknowledging payment of $430,000 of the $454,287 claimed. The performance bond state court lawsuit, however, was hotly contested. In support of the summary judgment, the surety submitted a "Statement of Undisputed Material Facts," which included assertions that the obligee could not recover against the bond because, among other things, it had breached its contract with the principal by failing to pay for work performed. The surety also alleged that a cardinal change materially modified the underlying risk, discharging any bond exposure. The surety submitted an expert report concluding that because of these breaches, the obligee actually owed the principal $36,074.

These defenses were supported by a dual obligee rider, which added the named plaintiff as an obligee, but which mandated that the obligee "perform all the other obligations required to be performed under said Contract at the time and manner therein set forth." The "Statement of Undisputed Facts" also asserted that the obligee could not recover under the bond because it failed to comply with the bond's notice requirements. Thus, the surety asserted absolute defenses, based on the failure of the obligee to perform its contract duties and to discharge conditions precedent to claim.

The state court threw the surety a curve ball by reserving decision on the motion for summary judgment and advising that the motion would be determined during, if not after, the trial. As the trial approached, the sheen faded from the principal's defenses, in part based on the obligee's opposition to summary judgment. The performance bond action was settled for $975,000. The settlement agreement was signed by one indemnitor for the principal and with the written acknowledgement of the other indemnitor. The overall settlement sums, at least on their face, seemed favorable as a percentage of the totals claimed.

Indemnity Forestalled

The surety demanded and then sued to recover $2,133,890.78 from the principal and Indemnitors. This amount consisted of the $1,425,473.42 paid on the claims, which included the $20,473.42 small, separate claim, and the loss adjustment expenses, which amounted to the remaining balance. The demand and the lawsuit seemed well supported, and the court acknowledged the strong rights afforded under the GIA, recognizing that the indemnitors agreed *"to indemnify and save harmless the Surety from and against any and all demands, liabilities, loss, costs, damages or expenses of whatever nature or kind,* including fees of attorneys and consultants and all other expenses, including but not limited to cost and fees of investigation, adjustment of claims." *Lumbermens,* 2012 WL 4498827, at *1 (emphasis supplied).

The court also noted that the GIA gave the surety broad discretion in settling or defending claims. The GIA included the following:

A. Surety shall have the right in its sole discretion to determine whether any claims shall be paid, compromised, defended, prosecuted or appealed.
B. Surety shall have the right to incur such expenses in handling a claim as it shall deem necessary, including but not limited to the expense for investigation, accounting, engineering and legal services.
C. Surety shall have the foregoing rights, irrespective of the fact that the Indemnitor may have assumed, or offered to assume, the defense of the Surety upon such claim or offered to post collateral in the amount of the Surety's potential exposure.
D. In any claim or suit hereunder, an itemized statement of the aforesaid loss and expense, sworn to by an officer of Surety, or the vouchers or other evidence of disbursement by Surety, shall be prima facie evidence of the fact and extent of the liability hereunder of the Indemnitor.

Lumbermens, 2012 WL 4498827, at *1–2. The facts demonstrated that the surety conducted an exhaustive investigation, aggressively litigated defenses, went as far in keeping the principal involved as paying for its counsel, and ultimately decided to settle, but for a fraction of the original exposure. Yet, the court denied the summary judgment to the surety.

Due to the *Lumbermens* case, sureties and practitioners representing them will want to consider two basic questions and some issues related to each. First, did *Lumbermens* apply the prevailing law, and second, what is bad faith?

When summary judgment was sought, the principal and one indemnitor were out of the picture for various reasons. The remaining indemnitor argued, and the court agreed, that the surety's "Statement of Undisputed Facts" in the state court performance bond action was admissible under Federal Rule of Evidence 801(d)(2)(A). With no legal support, the indemnitor argued that while liability of the principal may not color the question of good faith, the analysis must consider whether the surety was liable under the bonds. After considering the surety's expert report and "Statement of Undisputed Facts" in the state action, the court found that issues of fact on the surety's good faith existed. According to the court ruling,

> [f]urthermore, there are outstanding issues of fact surrounding the settlement of the [performance bond] case. Among these are whether [Obligee] satisfied the

conditions of the Dual Obligee rider and was entitled to make a claim against the performance bond in the first instance. There are also questions of fact as to whether [Surety] settled the [performance bond] and [payment bond] State Court cases in good faith and whether it should have settled the payment bond claim made by [smaller value claimant].

Good faith is still required, and it is uniformly recognized that a surety is entitled to indemnity upon meeting a prima facie showing that it made payments in good faith.

No discussion was presented on which standard of good faith the court applied or how the surety may have breached any standard. More troubling was the court's pronouncement that there was no contention that the obligee had proved its claims.

Despite citing the GIA terms, the court made no other mention of those surety rights, or why they did not dictate recovery by the surety. As for the principal and indemnitors signing off in agreement, at least on the performance bond settlement, the court said that the case raised an unsettled fact issue—what was intended in the GIA—but never identified an ambiguity in the document. In response to the question of why the indemnitors did not continue a defense of the performance bond action, the court seemed to sympathize with the indemnitors' claim that they were unable to do so after the surety stopped paying for the principal's attorneys.

This decision could not be immediately appealed because it did not result in a final disposition of the case, but the surety has since moved for reconsideration, and the request remains pending.

The decision is not the paradigm of clarity. What is clear is that the court believed that the surety's adoption and pursuit of the principal's and surety-specific defenses, memorialized in sworn papers and an expert report, somehow overrode a surety's ability to settle as allowed under the GIA. Settling under these circumstances, in the court's view, *could* constitute some notion of bad faith. The court appears to have suggested that the surety went too far in the litigation to then back out and settle. This case seems to be an outlier, and it seems unlikely that other courts will adopt the reasoning based on the weight of the authority. Hopefully, a reviewing court will modify it on reconsideration. However, this is uncertain, and so sureties have multiple questions to consider.

Questions and Issues to Consider

Due to the *Lumbermens* case, sureties and practitioners representing them will want to consider two basic questions and some issues related to each. First, did *Lumbermens* apply the prevailing law, and second, what is bad faith?

Did *Lumbermens* Apply the Prevailing Law?

Did *Lumbermens* apply the prevailing law? The short answer is no. New York law typically protects the rights of sureties in general, especially concerning the enforceability of a GIA. A detailed discussion of the New York view is found in *First National Ins. Co. of Am. v. Wunderlich*, 358 F. Supp. 2d 44, 51 (N.D.N.Y. 2004), which observed the following:

> Indemnity agreements, much like the agreement in our case, are valid and enforceable under New York law, and when a general contractor has agreed to indemnify the surety from any losses that may arise from contractor's default or claims arising out of surety bonds, such agreements fundamentally govern the relationship between the surety and contractor.… Contractors and sureties like any other party to a contract are "free to fashion terms of their agreement" that meet their respective needs and obligations and to solidify their contractual relationships.… *In this vein, a party, in order to receive a contractual benefit, can abandon rights and bestow them upon the other party* (i.e., assignments of rights, options to proceed, determinations of cost and the reasonableness, settlement clause thereof).

Id. (internal citations omitted) (emphasis added).

Sureties in New York are also provided broad discretion to settle claims under surety relationships governed by a GIA:

> Within these types of contracts, sureties are provided discretion and latitude to take whatever action necessary to settle claims and to complete the work at hand… [and] *whether the contractor actually defaulted will neither affect the surety's right to be indemnified for expenses paid nor defeat the surety's motion for summary judgment.*

Id. at 52 (internal citation omitted) (emphasis added).

Further,

> [a]s long as the indemnity agreement is unambiguous, a court must give effect to the express terms contained therein and such interpretation is a matter of law which may be determined on a motion for summary judgment. Disputes whether the contractor defaulted on his obligation or conclusory allegations of surety acting in bad faith are insufficient to defeat a motion for summary judgment.

Id. (internal citations omitted).

The Principal's Liability Should Be Irrelevant

The GIA terms cited by the *Lumbermens* court amply support the surety's right to indemnity. Yet, the court intimated that it had to determine whether the principal was liable to the obligee before indemnity could be obtained. This is contrary to prevailing law.

Lumbermens is also not supported under many other states' laws. In Georgia, handling of the principal's claims creates no fiduciary relationship between a surety and the indemnitors or the principal. *Fidelity and Deposit Co. of Md. v. Douglas Asphalt Co.*, 2008 WL 5351039, at *7 (S.D. Ga. 2008). In *Douglas Asphalt*, the surety settled over the principal's assertion that the obligee was in default for failing to pay for extra work. The surety demanded that the principal provide its documents and defenses regarding this claim and also demanded that the principal and indemnitors post

collateral security. *Id*. at * 2–3. The principal and indemnitors did neither, and the surety made various payments. *Id*. at * 3.

The surety was granted summary judgment for indemnity despite allegations of bad faith. The court noted that the surety outlined all of the steps that it took to investigate the principal's claim, despite the principal's failure to provide documents or information. *Id*. at * 3–4. The court rejected the notion that the surety was a fiduciary of the indemnitors or principal, stating that the surety did not even have to assert the principal's claims or defenses, let alone maximize their value. In fact, "[s]ureties have no independent duty to investigate a claim." *Id*. at * 8 (citing *Transamerica Ins. Co. v. H.V.A.C. Contractors, Inc*., 857 F. Supp. 969, 975 n. 11 (N.D. Ga. 1994)). The court also noted the indemnitors' failure to post collateral security, stating an "indemnitors failure to request that the surety defend against a claim and failure to post security collateral, when required to do so under the terms of the indemnity agreement, defeats the defense of bad faith." *Id*. at * 8. *See also Fidelity and Deposit Co. of Md. v. C.E. Hall Const. Inc.,* 2013 WL 5328344, at * 3–4 (S.D. Ga. 2013) (reiterating and applying *Douglas Asphalt*).

Settling Does Not Make Surety a "Volunteer"

What seemed particularly to trouble the *Lumbermens* court was that settlement was made despite the surety's assertion of absolute defenses under the bond instruments, including the dual obligee rider. Without saying so, the court seemed concerned that the surety had acted as a volunteer. However, this also should have been unavailing.

New York courts recognize that allegations of bad faith are not supported by showing that a surety had possible unasserted defenses. In *North American Specialty Ins. Co. v. Montco Construction Co., Inc*., 2003 WL 21383231 (W.D.N.Y. 2003), a principal could not escape indemnity by alleging that the surety failed to assert surety-specific defenses, such as material modification of the underlying agreement or that the obligee was in default. Arguments that a surety acted as a "volunteer" by making payments arguably released by material alteration of the underlying contract are not dispositive on whether a surety acted in good faith. The court reiterated that an alleged breach by the obligee, and the surety's knowledge of the breach, would not support a "volunteer" argument in the face of a clear indemnity agreement with a settlement clause. *Id*. at * 7. While the volunteer doctrine may apply when a surety seeks indemnification when an express indemnity agreement does not exist, or when an indemnity agreement does not include a settlement clause, this was not the case in *Montco.* 2003 WL 21383231, at * 7 (citing *Gen. Accident Ins. Co. of America v. Merritt-Meridian Constr. Corp*., 975 F. Supp. 511, 517 n.4 (S.D.N.Y. 1997)).

This rule was reiterated in *Frontier Ins. Co. v. Renewal Arts Contracting Corp*., 784 N.Y.S.2d 698 (N.Y. App. Div. 2004). There, a principal also resisted an indemnity action, claiming it was not liable under the contract with the obligee because any default in performance was caused by the obligee's failure to make payments when due. The *Frontier* court rejected that argument and observed that an actual default by the principal or obligee is irrelevant to liability under an indemnity agreement and concluded that

> [u]nder that agreement [the surety] had the exclusive and binding authority to assess the merits of any claim brought under its bonds. As a result, any factual issue as to liability under the bonds would be immaterial unless [the principal] also showed that [surety] decided to accept liability and pay the obligee's claims in bad faith.

784 N.Y.S.2d at 700.

The court in *HRH Const., LLC v. Fidelity and Guaranty Ins. Co.*, 04-CV-1606 (PKC) (S.D.N.Y. 2005), applied *Frontier*, holding that when the parties' relationship is governed by an indemnification agreement, any default by the obligee is irrelevant to liability under the indemnity agreement. *Id*. at 12. *See also Old Republic Sur. Co. v. Palmer*, 5 S.W.3d 357, 361 (Tex. App. 1999) (holding that "[w]here the surety is given the unqualified right to settle claims, it is immaterial whether the surety and its principal are legally liable on the bond"). *In HRH*, the court also found helpful that the GIA itself established a standard for good faith, defined "as the absence of deliberate or willful malfeasance." *Id*. at 7.

The Second Circuit approved *Frontier's* reasoning regarding when a surety may be deemed a "volunteer." *Traveler's Casualty & Surety Co. v. Crow & Sutton Assoc., Inc*., 172 F. App'x 382, 384 (2d Cir. 2006). The U.S. District Court in New Jersey also agreed in *Hartford Casualty Ins. Co. v. Cal-Tran Assoc. Inc*., 2008 WL 4165483, at *5 (D. N.J. 2008), finding that the weight of authority supported the *Frontier* conclusion. Most recently, the *Frontier* rule was reiterated in *Berkeley Regional Ins. Co. v. Weir Bros., Inc*., 2013 WL 6020785 (S.D.N.Y. Nov. 6, 2013).

Apart from defining what cannot rise to a level of bad faith, the most common statement in New York courts is that a surety should prevail in indemnity "[i]n the absence of an indication of fraud or collusion between [the surety] and the claimants."

Whether surety-specific defenses relate to material modification of a bonded obligation or a possible default by an obligee that arguably prevents a condition precedent that the obligee be free of fault, the broad terms of a GIA should still allow a surety to settle in good faith.

Settlement Alone Cannot Constitute Bad Faith

In *Lumbermens*, the court appears to have concluded that good faith was not shown because the settlements were made in the face of possible defenses. This is contrary to prevailing law. But *Lumbermens* is also unclear on which standard of good faith the court applied, if any, further compounding its frailty.

New York courts routinely reject allegations that a surety did not act in good faith by failing to conduct a proper investigation, analysis, or assessment of the circumstances surrounding an alleged default by a principal. Such proof cannot serve to "impugn the good faith of [a surety] in making a settlement payment." *Peerless Ins. Co. v. Talia Constr. Co.,* 708 N.Y.S.2d 223, 224 (N.Y. App. Div. 2000). *Lumbermens* presented mirror opposite allegations because the surety undeniably fully investigated and even pursued various defenses of the principal and surety-specific defenses. It seems implausible that there could be a rule that a surety is excused from a failure to conduct an investigation but that later indemnity may be thwarted after settling claims after an extensive investigation and litigation. Sureties must act in good faith, but the rationale of the *Lumbermens* court should not support arguments that good faith did not exist simply because a surety settled claims.

Swinging to the other extreme, certain jurisdictions have held that mere negligence or unreasonableness may constitute bad faith. In these jurisdictions, bad faith may be based on a showing that a surety's actions were not reasonable.

What Is Bad Faith?

The *Lumbermens* decision did not articulate a standard of good faith, and the rationale applied by that court should not be acceptable to demonstrate a want of good faith under New York law. However, good faith is still required, and it is uniformly recognized that a surety is entitled to indemnity upon meeting a prima facie showing that it made payments in good faith. So what definition of good faith should have been applied in the *Lumbermens* case?

New York's and the Most Favorable Standard

In New York, all contracts imply a covenant of good faith and fair dealing in the course of performance. This covenant embraces a pledge that neither party shall do anything that will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract. This means that "[w]hile the duties of good faith and fair dealing do not imply obligations inconsistent with other terms of the contractual relationship they encompass any promises that a reasonable person in the position of the promisee would be justified in understanding were included." *511 W. 232nd Owners Corp. v. Jennifer Realty Co.*, 773 N.E.2d 496, 501 (N.Y. 2002) (internal citations and quotations omitted). Applying this standard to a GIA should resolve most questions, especially with recognition that a party, to receive a contractual benefit, can abandon rights and bestow them upon the other party. *See Wunderlich,* 358 F. Supp. 2d 44, 51 (N.D.N.Y. 2004). GIA terms are usually clear: Principals and indemnitors freely enter into them to receive surety credit, and they should not be permitted to challenge the rights that they freely granted to a surety once the relationship has gone awry. Yet, courts still struggle with the perceived one-sided nature of a GIA and often seem to need to refine the good-faith standard.

The case law often fails to define good faith, instead determining whether facts presented rise to a level of bad faith. In *Frontier*, conclusory allegations of possible collusion between the surety and obligee, and excessiveness of amounts paid, could not raise a question of material fact as to bad faith. *Frontier*, 784 N.Y.S.2d at 700. What was decidedly not considered bad faith in *Frontier* was settlement by the surety even though potential defenses existed, and whether or not the principal was actually in default or liable under its contract with the obligee.

Proof that a surety failed to investigate claims fully also cannot impugn the good faith of a surety in making payment. *Berkeley*, 2013 WL 6020785, at * 11 (citing *Peerless*, 272 A.D.2d 919). It has been found that hiring a consultant to assist a surety in investigating claims, with an ultimate conclusion that claims were reasonable and accurate, supports a showing of good faith. *Wunderlich*, 358 F. Supp. 2d at 53. In the context of the *Lumbermens* decision, the fact that upon further reflection, consultants changed their opinion and determined that claims should be paid actually would support a showing of good faith.

Apart from defining what cannot rise to a level of bad faith, the most common statement in New York courts is that a surety should prevail in indemnity "[i]n the absence of an indication of fraud or collusion between [the surety] and the claimants." *General Accident Ins. Co. of Am. v. Merritt-Meridian Constr. Corp.*, 975 F. Supp. 511, 516 (S.D.N.Y. 1997). *See also, Berkeley*, 2013 WL 6020785, at * 10 (citing *BIB Constr. Co., Inc. v. Fireman's Ins. Co. of Newark, N.J.*, 650 N.Y.S.2d 550, 553 (N.Y. App. 1995)). Other jurisdictions apply a similar standard. *See Fireman's Ins. Co. of Newark, New Jersey v. Todesca Equipment Co., Inc.,* 310 F.3d 32 (1st Cir. 2002) (applying Rhode Island law, broad discretion under indemnity agreement requires indemnitor to allege and prove fraud or collusion to avoid repayment); *Hess v. American States Ins. Co.,* 589 S.W.2d 548 (Tex. App. 1979) (fraud by surety required to avoid indemnity obligation).

The Intermediate Standard

A survey of national standards reveals other, less protective definitions of good and bad faith. While such definitions are not uniform, a widely accepted definition, as articulated in *Bruner & O'Connor Construction Law,* states that bad faith examines

> not… whether the surety conducted a reasonable investigation or otherwise acted reasonably in handling a claim but whether the surety's conduct was manifested by a lack of improper motive. Under this standard, mere evidence of negligence, lack of diligence, negligent ignorance, or even mistake of law by the surety in paying a claim, is insufficient to establish that the surety has commit-

ted a breach of its duty of good faith to an indemnitor.

Philip L. Bruner & Patrick J. O'Connor, Jr., Bruner & O'Connor Construction Law §10:108 (2008) (internal quotations omitted). *See also Fid. & Deposit Co. of Md. v Douglas Asphalt Co.*, 2008 WL 5351039, at *9 (S.D. Ga. 2008) (surety's exercise of its contractual rights under an indemnity agreement, such as settling a claim, without more, should not establish bad faith); *H.M. Ford v. Aetna Ins. Co.*, 394 S.W.2d 693, 698 (Tex. Civ. App. 1965) (negligent ignorance in a surety's investigation, as a matter of law, does not amount to bad faith absent an improper motive). Gross negligence, bad judgment, and excessive payments are not bad faith. *Frontier Insurance Co. v. International, Inc.*, 124 F. Supp. 2d 1211, 1215 (N.D. Ala. 2000). *See also Employers Ins. of Wausau v. Able Green, Inc.*, 749 F. Supp. 1100, 1103 (S.D. Fla. 1990) (surety's failure to obtain the underlying construction contract and paying claims to forgo litigation may have been negligent, but did not meet the exceedingly high standard of bad faith).

Some jurisdictions apply the same test but add an element of reasonableness, such as examining the reasonableness of a surety's investigation. An inadequate investigation, accompanied by other evidence, can establish an improper motive and bad faith. *PSE Consulting v. Frank Mercede and Sons, Inc.,* 838 A.2d 135, 153 (Conn. 2004). As the Connecticut Supreme Court explained, "Whether a surety's actions were reasonable properly may be considered when analyzing bad faith… because [un]reasonable conduct can be evidence of improper motive and is a proper consideration where parties are bound by a contract that gives unmitigated discretion to one party." *Id.*

The Minority Restrictive or Strict Standard

Swinging to the other extreme, certain jurisdictions have held that mere negligence or unreasonableness may constitute bad faith. In these jurisdictions, bad faith may be based on a showing that a surety's actions were not reasonable. *See Atlantic Contracting & Material Co., Inc. v. Ulico Cas. Co.,* 844 A.2d 460 (Md. Ct. App. 2004) (holding that "a standard of reasonableness also should be implied in the good faith analysis of a surety's actions in determining whether it may recover against the principal"). *See also Arntz Contracting Co. v. St. Paul Fire & Marine Ins. Co.,* 47 Cal. App. 4th 464, 483 (1996) (good faith can be breached for objectively unreasonable conduct, regardless of motive); *City of Portland v. George D. Ward & Assoc., Inc.*, 750 P.2d 171, 174 (1988) (reasonableness standard applies to a surety investigation and consideration of counterclaims and defenses, a dishonest purpose or improper motive not required); *The Hartford v. Tanner*, 910 P.2d 872, 874 (Kan. Ct. App. 1996) (good faith requires a surety seeking indemnification to show that its conduct was reasonable).

The actions of the surety in *Lumbermens* certainly pass muster under the favorable New York standard. Bad faith should also be difficult to demonstrate under the "improper motive" test, even if a layer of reasonableness is applied. The bar set by a mere negligence or reasonableness standard may cause concern, but the surety undeniably conducted a detailed investigation, supported the participation by the principal, kept the principal in the loop on settlement, and acted out of a reasonable desire to mitigate the exposure to both the surety and the indemnitors. The key is the extent and detail of the narrative to support a prima facie showing by the surety.

The Role of GIA Defaults by Principal and Indemnitors

Apart from standards of good and bad faith, one issue that should trump other considerations is whether a principal breached its obligations to a surety under a GIA. In particular, courts find a failure by principals or indemnitors to post collateral as required under a GIA to solidify the propriety of subsequent actions by a surety. *See Montco, supra; Liberty Mutual Ins. Co., v. Conmas, Inc.,* 2011 WL 5008303, at *3 (N.D.N.Y. 2011) (failure of principal to post collateral among breaches by principal, supporting finding good faith of surety); *Douglas Asphalt,* 2008 WL 5351039, at *9 (S.D. Ga. 2008) (failure to post collateral defeats defense of bad faith).

In circumstances such as in *Lumbermens,* it is wholly unreasonable to deny a surety indemnity once defenses proffered by a principal have lost their sheen. It should be irrelevant whether the gloss disappears early or after extensive litigation. That a surety drops unresolved surety-specific defenses should be of no moment, especially when the end result is settlement for a significant amount less than the total exposure amount, which benefits both the surety and indemnitors. However, there are considerations that may be taken into account by sureties confronted with a scenario similar to the one in *Lumbermens* in the future that may strengthen later claims for indemnity.

Although a GIA may have relatively straightforward requirements for asserting a prima facie case for indemnity, it is wise to include greater detail concerning how and why a settlement determination was made.

Planning for a *Lumbermens*-Inclined Court

Courts, such as the one in *Lumbermens* may feel sympathetic toward indemnitors in the face of a surety's request for repayment. Apart from making sure that a court receives the full rationale explaining why a surety should prevail, surety professionals may consider other steps that may mitigate the risk of a *Lumbermens*-type result.

File an Early Dispositive Motion in an Underlying Bond Claim

If a strong technical defense is available, such as statute of limitations or failure of a condition precedent, consider filing a motion on that basis at the earliest practical date. While some federal courts in particular may restrict the availability of early motions for summary judgment, other avenues, such as a motion for judgment on the

Settling, continued on page 90

Settling, from page 65
pleadings or an outright motion to dismiss may be possible. Regardless, pulling that trigger early may mitigate the risk that a trial court will simply sit on a later motion, as happened in *Lumbermens*, thus forcing a surety's hand.

Assert Rights to Collateral Security

If one theme emerges from a detailed review of the case authority, it is that courts seldom, if ever, find that a surety acted in bad faith after a principal failed to post collateral security as required under a GIA, or when a principal otherwise breached its GIA obligations other than repayment. In some instances, courts have gone as far as to say that the failure of a principal to post collateral security when required defeats any later claim of bad faith. In the *Lumbermens* scenario, it is unclear whether or not a demand for collateral was made, but an opportunity was presented no later than when the surety considered the need to settle the claims.

Consider Inserting a Definition of Good Faith in a GIA

Courts have approved self-defined standards of good faith. For example, in the *HRH* case cited above, the GIA, within the settlement clause, provided that the surety had the ability "to compromise and settle any such right or claim on such terms as it considers reasonable under the circumstances in its sole and absolute discretion, subject only to the requirement that it act in good faith, which shall be defined as the absence of deliberate or willful malfeasance." Whatever definition is chosen, a surety may gain greater certainty in subsequent claims for indemnity by contractually setting the applicable standard of good faith.

Button Down Uncertainties in Bond Claim Settlement Documents

The two settlement agreements in the *Lumbermens* matter were signed by the principal, and the performance bond settlement document was also signed by the individual indemnitor subject to the later summary judgment motion on indemnity. Both agreements provided that the right of the surety to enforce the GIA was unencumbered, but the court later found that these agreements were not dispositive on the reasonableness of settlements, without identifying why. Practitioners may consider inserting additional terms within bond claim settlement documents, particularly if the principal or indemnitors or both are required as parties, perhaps confirming the following: "The Parties to this agreement acknowledge that the surety performed a thorough and good faith investigation into the claim asserted by (Obligee/Claimant), and the settlement amount paid by the surety is reasonable."

If a GIA adopts a defined good-faith standard, the language should be modified to mirror those terms.

Provide a Court with Full Details of a Settlement Determination

Although a GIA may have relatively straightforward requirements for asserting a prima facie case for indemnity, it is wise to include greater detail concerning how and why a settlement determination was made. Statements detailing the investigation, cooperation, or the opposite, of the principal, materials provided by the claimant in support of the settlement, any breaches by the principal under the GIA, including failing to post collateral, and other cost-benefit analyses may be considered. To demonstrate a good-faith cost-benefit analysis, a surety may consider obtaining and including a budget estimate from its counsel detailing anticipated litigation costs that a settlement will avoid because such a savings also inures to the benefit of indemnitors.

Conclusion

The *Lumbermens* decision is contrary to prevailing New York law, and it also is unlikely to be supported in most other jurisdictions. A surety must be able to assert and pursue all defenses freely, both of the principal and of a surety-specific nature. However, even if such defenses are aggressively litigated, a surety must also be free to settle when circumstances develop that indicates it is the prudent course of action. Principals and indemnitors, for their part, at any point in the process, are provided with the opportunity to post collateral with the surety, holding the surety harmless from the consequences of continuing a defense, and the inability or refusal to post collateral should remove any question about the reasonableness of the surety's subsequent decision. This is the bargain that was struck in entering into a GIA to gain the benefit of surety credit. Regardless, planning ahead and providing a court with full details on the rationale for any underlying settlement could help guide a court to the proper conclusion in a subsequent indemnity effort. FD