

## Spoliation: Adverse Inference Upheld for Failure to Provide E-Mails

NELL M. HURLEY

A New York federal court recently affirmed sanctions in the form of an adverse inference against a fidelity insurer, finding that the insurer failed to produce internal emails related to the underlying claim. The court held that the insurer's conduct was grossly negligent, but found that, even if the insurer was "merely negligent," there was sufficient evidence of relevance to warrant the finding of spoliation. The insurer's reliance upon a change to its retention policy to explain some of the missing e-mails was unconvincing to avoid the adverse inference.

In *Dataflow, Inc. v. Peerless Ins. Co.*,<sup>1</sup> an insured brought a claim under an employee dishonesty policy after its accounting manager misappropriated \$1.2 million and later pled guilty to various felony criminal charges. The insurer, Peerless Ins. Co. ("Peerless"), responded that it would cover only \$75,000 of the theft, and a lawsuit ensued.

The insured served numerous requests for documents, including for emails relating to internal communications and investigations of Peerless regarding this claims. Peerless's responses failed to include all relevant emails or any indication that relevant emails were deleted. In depositions, it was disclosed that Peerless regularly used email to communicate about claims. Peerless subsequently asserted that its emails were unavailable because of a

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## Supplementing the Principal's Work: Put it on the Surety's Tab

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It starts with a simple, standard notice of default letter. Due to repeated failures on the project, the obligee is declaring the principal in default and making a claim against the performance bond.

During the course of the surety's investigation, however, it learns that the obligee has supplemented the principal's work for months, without notice to the surety. The obligee shrugs off the supplementation as inconsequential. After all, the principal was struggling and the obligee was only trying to complete the project on time to avoid costly liquidated damages or consequential damages, which would have been charged back to the principal. Besides, the obligee argues, it had the contractual right to supplement the principal's work and followed all the contractual procedures. What's a surety to do?

As with many issues confronting sureties, the answer is, "it depends." Based on case law, depending on the bond form used, the surety may legitimately argue that it should have received prior notification. Unfortunately for the surety industry, the case law is unclear and conflicting.

### Conflicting Case Law

At least one court has implied that supplementing a principal's bonded work without notice to a surety under the A312 performance bond nullifies the surety's obligation to later perform under the bond.<sup>1</sup> In *Solai*, the court weighed the surety's mitigation rights under the bond and at common law against the obligee's contractual right to supplement the principal's work. The court held that the surety's rights under the A312 performance bond were superior. Under the bond, the surety had the exclusive authority to determine how the principal's work was to be completed if the principal did not comply with its contractual obligations.

By supplementing, and eventually completing, the principal's work, the court found that the obligee extinguished the surety's remedies under the A312 performance bond, leaving payment as the surety's only option for complying with its bonded obligations. Because the obligee failed to permit the surety to exercise its rights under the A312 performance bond or to mitigate its damages, the obligee was not permitted to recover against the surety on all aspects of the projects, including the obligee's costs for supplementing and completing the principal's bonded scope of work.

The court acknowledged the obligee's right under the subcontract to supplement the principal's work. Under the subcontract, the obligee could supplement the principal's work, and the surety could not have object to such supplementation. If the obligee chooses this path, however, it is precluded from claiming against the performance bond for the costs it incurred to supplement work. The obligee would have to look exclusively to the principal for those costs. The *Solai* court was able to give meaning to the terms of the subcontract, while still recognizing the surety's rights under the bond. It found that the obligee elected its remedy by choosing to supplement the work and was therefore barred from later pursuing the bond.

In contrast, under essentially the same set of facts, an appellate court in Georgia ruled against the surety, finding that supplementation of the principal's work did not require notice to the surety under the A312 performance bond to trigger the surety's obligation to later perform.<sup>2</sup>

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CONTINUED "GETTING IT RIGHT: COURT APPLIES LANGUAGE IN INDEMNITY AGREEMENT"

In *Commercial*, the principal stopped paying certain laborers and suppliers and was not progressing its work in accordance with the schedule. To ensure timely performance of the project, the obligee began supplementing the principal's work with another contractor. Prior to supplementation, the obligee detailed the principal's failures to the surety, but did not give the surety an opportunity to perform under the A312 performance bond. At the end of the project, the obligee sued the surety for the costs incurred to supplement and then complete the principal's work.

The *Commercial* court recognized the competing interests of the surety under the performance bond and the obligee under the subcontract. To reconcile the competing interests, the court examined the language used in each document. The A312 performance bond contained detailed notice provisions in the event of a default but did not address the issue of supplementation before default. The subcontract contained detailed and expedited notice terms for supplementation and did not require prior notice of the supplementation. Using general laws of contract interpretation, the court found that the more specific supplementation provision of the subcontract prevailed over the "broader" default provisions of the performance bond.

The court also considered the surety's express obligations under the subcontract. The surety was bound by a subcontract provision requiring it to pay the obligee for any losses, damages, expenses, and attorney's fees incurred resulting from the subcontractor's breach or failure to perform. These dual obligations of the surety to the obligee distinguish this case from the more common situation when the surety's obligations arise only from the performance bond.

### What's a Surety to Do?

The case law is not definitive regarding whether supplementation of a principal's work constitutes a default sufficient to require notice to the surety under the A312 performance bond, triggering the surety's right to mitigate its damages. The ultimate determination on this issue will be driven by the specific facts of a situation. A thorough argument in support of the surety's entitlement to notice of supplemental work may carry the day. In addition to the *Solai* case, there are further arguments a surety can make, regardless of the bond form used.

First, courts have acknowledged a surety's common-law right to mitigate its damages.<sup>3</sup> In addressing the surety's general, common-law right to mitigate damages, the *St. Paul Fire* court held that a performance bond surety has the right to select the lowest-cost option for its performance. Any actions by the obligee that deprive the surety of that right render the bond null and void. Some courts, however, disregard the surety's common-law right to mitigate its damages and require no notice to the surety or opportunity for the surety to choose its method of performance, unless the bond explicitly says so.<sup>4</sup> Always consult the law in the applicable jurisdiction to see if this argument may help.

In addition, the surety may be able to use the language of the contract as proof that the supplementation was a default, which may require notice to the surety. Certain contracts will specify what constitutes an event of default. The identical reason for supplementing the principal's work might be a contractually defined event of default.

For example, under the AIA A201(2007), a party is in default if it repeatedly refuses or fails to supply enough properly skilled workers or proper materials. The AIA A401 has a similar provision. Other contractually defined defaults may include a failure to follow the schedule or timely progress the work. These specified events of default might also provide the basis for supplementation, bolstering the surety's argument that the termination was a default that required notice to the surety.

Furthermore, it can be argued that, by paying another contractor to supplement the principal's work, the obligee has prejudiced the surety's rights by depleting the contract funds and creating a disincentive for the principal to complete the project. The obligee has also prejudiced the surety's rights by delaying the start of any investigation. Many bonds give the surety the opportunity to investigate, in part, to determine if it can assist the principal prior to default, such as by providing financing. Failing to notify the surety of supplementation deprives the surety of its contractual right to investigate and potentially mitigate its damages.

If a surety receives notice that its principal's work is being supplemented, the surety will be well served to immediately investigate. First, the surety should verify that the obligee is contractually permitted to supplement the principal's work and, if so, determine whether the obligee properly followed the contractual requirements. If there is a significant amount of extra work, then the surety should encourage the principal to complete the work in the principal's original bonded scope in order to reduce the surety's exposure under the bond. Finally, if change-order work is at issue, it may be advisable to have a surety consultant investigate to identify and compare the principal's bonded scope to proposed or pending change-order work. Disputes are common regarding payment terms for extra work, yet the obligee may consider itself entitled to force the principal to perform, even to the point of supplementing work on the yet to be finalized change-order work.

Supplementation by an obligee takes work out of the principal's bonded scope. Under most bonds, after the principal's default, the surety has the exclusive right to determine the means and methods by which the principal's work will be completed. It is only after the surety defaults under the bond that an obligee is permitted to choose the manner in which to complete the principal's work. Any contrary holding deprives the surety of its inherent right to mitigate its damages and violates the bond language giving the surety the exclusive right to complete the principal's work. Under many standard and manuscript contract and bond forms, a surety's rights in a supplementation scenario may be treated the same as a full-blown termination for default. **ESD**

1 *Solai & Cameron, Inc. v. Plainfield Cmty. Consol. Sch. Dist. No. 202*, 871 N.E.2d 944, 960 (Ill. App. Ct. 2007).

2 *Commercial Cas. Ins. Co. of Georgia v. Maritime Trade Ctr. Builders*, 572 S.E.2d 319 (Ga. Ct. App. 2002).

3 *St. Paul Fire & Marine Ins. v. City of Green River*, 93 F. Supp. 2d 1170 (D. Wyo. 2000).

4 See *Walter Concrete Const. Corp. v. Lederle Lab.*, 788 N.E.2d 609 (N.Y. 2003).

CONTINUED "MILLER ACT BOND TIME LIMIT NOT JURISDICTIONAL; FEDERAL COURT PERMITTED TO RULE ON MOTION TO STAY ACTION"

"system change," in which emails not actively marked for preservation were deleted. Peerless argued that the current retention policy was not in effect until after the system change occurred and that the loss of the emails was unintentional, inadvertent, or otherwise insufficient to warrant a sanction for spoliation.

At the outset, the court noted the duty to preserve arises "once a party reasonably anticipates litigation." This requires the party to suspend its routine document-retention policy and put in place a litigation hold to preserve relevant evidence. If a party's conduct is grossly negligent, reckless, or intentional, sanctions can be imposed without proof that the destroyed items are relevant to the action. Where the party's conduct amounts to mere negligence, spoliation sanctions are appropriate if there is any likelihood that the destroyed evidence "would have been of the nature alleged by the party affected by its destruction," such that it is relevant to that party's claim.

The court found that Peerless was grossly negligent in its failure to preserve its

emails, because it was in violation of its own later retention policy. Peerless failed to show that its prior retention policy was any different, the court said, noting that the absence of the earlier retention policy from the record was due to Peerless's own failure to provide it in discovery. The court further rejected Peerless's contention that its representatives deleted certain emails with its supervisor in good faith. This explanation failed to account for the absence of the emails in the supervisor's records. More important, the court said, was that requiring the insured to substantiate the existence and content of particular emails would place too strict a burden on the insured to develop a record of destroyed communication, especially since Peerless had been "less than forthcoming during discovery." Placing a strong burden on the innocent party allows a party that destroyed evidence to profit from that destruction.

Finally, the court concluded that even if Peerless's conduct regarding the emails was merely negligent, the insured provided sufficient evidence of the relevance of the emails, so spoliation sanc-

tions were still appropriate. Reference to several deleted or not-produced emails were likely related to the defenses asserted by Peerless. In addition, the fact that Peerless acknowledged the loss of emails during the system change, and had been "purposefully sluggish" in admitting that any emails even existed, provided evidence that the emails may have been more generally harmful to Peerless, the court concluded.

Lessons from this case are plentiful. The implementation of, and compliance with, a clear retention policy is critical for all business, but perhaps especially for fidelity insurers and surety companies that routinely face litigation. Fidelity and surety professionals, and their counsel, are prudent to reflect the spirit of cooperation in discovery, if for no other reason than this cautionary tale: the failure to keep or produce relevant documentation or communication can come back to haunt you with potentially serious consequences. **E&D**

1 No. 3:11-cv-1127 (LEK/DEP), 2014 WL 148685 (N.D.N.Y. Jan. 13, 2014).

## You're Out!: Second Circuit Upholds Judgement Against Claimant for Failure to Comply with Discovery, Spoliation of Evidence

NELL M. HURLEY

A federal district court's entry of judgment against a subcontractor/bond claimant was not an abuse of discretion according to a recent Second Circuit Court of Appeals decision<sup>1</sup> affirming the dismissal of the subcontractor's action against the surety and the judgment against it in favor of the bond principal. The subcontractor repeatedly failed to comply with the district court's discovery orders and, despite sanctions and attorney's fees, continued to willfully ignore them.

In *Metro*, the subcontractor sued the surety in federal court, alleging it had not been paid for work performed under contracts with the bond principal. The surety brought a third-party action against the bond principal for indemnification and the principal counterclaimed against the subcontractor. Throughout the course of the litigation, the subcontractor failed to respond to the discovery requests of the principal, even after it

was ordered by the court to do so, variously claiming that the items were not relevant or were lost. The court imposed sanctions by prohibiting the subcontractor from introducing into evidence any responsive documents not produced and ordered that it pay the principal's costs and attorney's fees. Ultimately, when the principal moved for a default judgment, the subcontractor was given one last chance with a warning that judgment would be entered if it failed to comply. When this warning was ignored, the district court entered judgment against the subcontractor and in favor of the principal and the surety.

The Second Circuit rejected the subcontractor's claim that the district court had abused its discretion in awarding the sanctions under FRCP Rule 37. The court found that the subcontractor had acted willfully in its non-compliance and that its conduct extended over a

long period of time. Multiple warnings by the court and the imposition of lesser sanctions had been ineffective in obtaining compliance. Given this, the district court's determination was not clearly erroneous and there was no abuse of discretion. The court further found that the dismissal of the claims against the surety based upon spoliation of evidence was proper, given the broad discretion courts have in crafting a proper sanction. The court acknowledged that dismissal is a drastic remedy meant for only extreme circumstances, but upheld it here because the lesser sanction of preclusion of the same documents had failed to motivate the subcontractor to comply. **E&D**

1 *Metro Foundation Contractors, Inc. v. Arch Ins. Co.*, 551 Fed. App'x 607, 2014 WL 103994 (2d Cir. Jan. 13, 2014).



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## FIRM NEWS

### O'Gara Named Partner

Ernstrom & Dreste, LLP is proud to announce its promotion of associate Thomas O'Gara to partner in the firm effective July 1, 2014. Mr. O'Gara's practice is focused in the area of commercial litigation, with particular emphasis in the fields of construction and surety law.

### E&D Presenting on Various Industry Issues

John Dreste, Kevin Peartree, and Timothy Boldt recently gave a presentation on the AIA contract documents. An upcoming presentation titled "Contracts for Every Construction Project, Every Party and the Bottom Line" will be given by Kevin Peartree, Martha Connolly, Timothy Boldt, and Thomas O'Gara.