Dealing with Sureties
Why Won't They Do What You Want Them to Do?

An Insiders Look at the World of the Contract Bond Surety Claims

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Contrary to the inference that might be drawn from the title to this presentation, contract bond sureties serve a valuable role in the construction process. They do a great many things, and they do them well. They help to screen out unqualified contractors. They provide sound financial guidance for their principals. They provide credit enhancement that allows the construction process to proceed on what might be an otherwise C.O.D. basis. They shore up many a contractor before anyone else even knows there's a problem. And, they pay millions of dollars of claims every year and generally honor their obligations.[1]

Why, then, have many of the owners and general contractors who are obligees on their bonds become so cynical about sureties? Why is their first inclination, in a default situation, to expect delay, indifference, second-guessing, and defenses based on obscure and arcane legal theories from the surety and its representatives? The answer lies, in part, with the fact that most of us don't appreciate all of the things in the preceding paragraph that sureties do and do well. All we see is the owner and contractor for whom the process did not work and the natural reactions and emotions of human beings that must set about fixing something they never expected would break.

[1] If you ever begin to doubt the benefits of bonds, or need a little ammunition to justify the expense, take a look at some of the publications of the National Association of Surety Bond Producers (www.nasbp.org). They publish several good monographs, including: **When you Build…Bond, Contract Bonds: The Unseen Services of a Surety, Subcontract Bonds: Needless Expense or Needed Protection?** And for the public owner, **The Surety Safeguard: How Bonding Protects Taxpayer Dollars**.

I spent nineteen years representing sureties in all sorts of claims situations[2]. I submit that the vast majority of the time my clients and I made responsible, professional decisions that promptly and fairly remedied the problems at hand. There are, however, those out there who would claim, sometimes accurately, that we took delay and indifference, second guessing, and arcane defenses to a new high or low, depending on their perspective[3]. I don't intend this presentation to be a "tell all" story of the secret tricks and traps of the surety claims industry. Indeed, I hope that those in the industry would agree that the information is useful, accurate, and calculated to educate those who would make claims against them…for we all prefer an educated party on the other side of the table. I also don't pretend that this paper will be scholarly and legally

[2] For years, program chairpersons for various construction law courses have been looking for speakers on the subject of dealing with sureties in default situations. It was always hard to find any one person who had been up against enough of them to be very authoritative. And, those who were on the inside representing sureties weren't exactly jumping at the opportunity to give a talk that might be viewed as being in conflict with their clients' interests. Having left the practice of surety law to become a general contractor, I had occasion to make a few claims against sureties…with mixed results. That left me free to do a little introspection and a little preaching. This article was first written for a conference for the Construction Law Section of the State Bar of Texas, while I was still in the general contracting business. It was published in the Texas Lawyer and has been presented to a dozen different groups since. When I returned to the surety business, my first thought was to figure out how to find all copies of this paper in existence and destroy them. But, the fact is that I still believe everything I've written, and I am going to try my best to see that our surety business is conducted in a fashion that someone won't want to write this kind of paper about me!

[3] OK, they say confession is good for the soul. There were two instances that probably bordered on overzealous stretching of the facts and the law (OK…OK! There were more than two, but that's all I am confessing to right now). The first was a suggestion to a small town school district that their unreasonable demands against my client, a small surety, would undoubtedly come to the attention of the United States Government, who guaranteed my client's bonds under a program administered by the Small Business Administration. I don't know how exactly, but they may have been left with the impression that the U.S. government would probably want to look into many aspects of their district, including its desegregation efforts. They withdrew their demands and I never heard from them again. I never really stated that any of that would happen. Really. The second time was when a general contractor's lawyer just got carried away about how fast we were going to have to remedy a subcontractor's default. He making outrageous demands and was piling on attorneys fees, liquidated damages, extended overhead, and on and on. I said, jokingly, that if he weren't more reasonable, my client might just cancel its bond. Of course, sureties can't just cancel their bonds…(but, try to find a case that says just that)…I could tell that I had struck a nerve. When he asked, "Can they do that?" I may have been an eensy teensy bit more convincing than the current state of the law might have allowed. I'm sorry about that one too. Gosh, I feel better.

authoritative[4]. What I can provide, that not every reader can experience for himself or herself, is practical advice gleaned from many years of sitting on the surety's side of the table.

While I have focused this paper on a performance bond default situation, the observations are equally valid in a payment bond situation.

As hard as it is for you to believe, they never expected to see you. That's right. The surety wasn't expecting a loss. You've got to understand the difference between a bond and an insurance policy to understand where they are coming from. Insurance is written with the expectation; indeed, the actuarial certainty, that losses will occur. For the most part, an insurance company does very little underwriting to see whether they should charge more to let your 18-year-old son drive a car…they just charge more because he's 18. They may shy away from a wood shingled house and they may charge a lot more for life insurance for an 80-year-old lawyer than a 20-year-old poet, but they know that no matter how carefully they underwrite, they are going to have claims. Lightning will strike, cancer will show up, accidents will happen, and they just have to charge enough premiums overall to stay one step ahead of Mother Nature.

Sureties, on the other hand, underwrite for no loss. That is, they would never write the bond in the first place if they thought there would be a loss. They aren't playing the actuarial odds. They don't write the bond unless they believe that their principal has the character, capacity, and the capital to fulfill the obligations they are bonding. So, their

[4] Read that, "Don't take this paper as legal advice. Every fact situation presents an opportunity for many legal interpretations. If you have a legal issue facing you, please get competent legal help."

premiums are based more on the market value of enhancing the contractor's credit than in trying to anticipate total losses and charge enough to pay them and still have a profit.

"So what?!" you say. That's their problem. No. It's yours. You are the one that wants something from them. The more you know how they think, the better you will be able to deal with them. The whole insurance vs. surety dichotomy impacts many aspects of your dealings the surety, as we will see below.

The Surety didn't cause your problem. By the time the surety gets called in to a problem, tempers are hot, frustrations are high, and everyone is afraid that they are going to lose money. When the surety representative arrives on the scene, the obligee is ready to bite his or her head off; to blame the surety for all the problems, and to take everything out on the surety's messenger. The surety folks are used to it, but they are still human, and react predictably to pettiness and discourtesy. I've seen some bonehead positions taken by obligees and their lawyers…who let their frustrations overcome their good sense…and it cost them dearly. Examples:

- One of the nicest claims guys I know went to a meeting in another city called by an angry owner, fully prepared to do whatever it took to solve the owner's problem. He got lost on the way from the airport to the meeting and called for directions. The owner's (it was a school district) Director of Education berated him for getting lost, suggesting that he was ignorant and that such a "dumb move" was "about what he would expect from anyone stupid enough to have bonded" the defaulting contractor. After some futile attempts to put some civility in the meeting, the claims man got back in his rent car, drove to the airport, and went home. He wrote a letter the next

day, mostly out of frustration, denying all liability on the basis of some limited information in his file. I submit that he over-reacted, and that he didn't have good grounds to deny the claim, but he was human. The lawyers got involved and argued for months. Eighteen months later, the school district filed suit…, which was promptly dismissed on a one-year limitation defense…all because someone did not have the good sense to treat the man with the checkbook with some common courtesy.

- A general contractor was fed up with the failed promises and shoddy work of his bonded subcontractor. By the time the general declared a default, nobody was speaking in civil tones. When my client and I arrived on the scene to figure out how to get the job finished, the general contractor was so mad, he was going to take it out on us. All we wanted was a set of plans and copies of unpaid draw requests. He told us "No." He wasn't spending one more penny making copies or doing anything that would help the sub or his surety. He told us to get the documents from the sub. We responded by saying that, "surely a sub who was as incompetent as he suggested this one was, couldn't be trusted to give us accurate information." That didn't faze him. No plans, no documents, no nothing would be forthcoming. With nothing to work with, we couldn't do much to help. We had no choice but to tell him to solve the problem himself and let us know what he spent at the end of the job. The surety would have paid to finish the work had the general contractor been even slightly reasonable. The general contractor had to cash flow the completion work himself, only to have to come back to us hat in hand a year later seeking reimbursement.

One of the predictable statements from a frustrated obligee was usually something to the effect that the surety was responsible for the problem. It went something like, "Had they surety done a better job of underwriting, they would never have written the bond, and if they hadn't written the bond, nobody would be in this mess." OK, and your point is…? Just be glad they wrote the bond and you've got someone beside the broke contractor to look to for help.

Remember that the surety did not cause your problem. It may or may not be your friend, but it is the closest thing you have to a friend if you have a default on your hands. Don't run them off with petty problems and picky requests. Reach out to them, give them information, and treat their representatives with respect (unless and until they prove they don't deserve it). Don't stand on principle and demand that they do everything your way. Your cooperation will pay dividends.[5]

You are looking for ambulance drivers…not hearse drivers. Insurance claims adjusters were once likened to hearse drivers[6]. By the time they get involved, the patient is dead, the pipes have broken, the fire is out, or the wreck has happened. There's not much they can do to make it worse. Their only job is to determine if coverage exists and pay the appropriate amount provided by the policy. There seems to be no end to the kinds of squabbles that can arise in an insurance claims situation, but the physical and financial damage is already done by the time the adjustors arrive on the scene.

[5] My surety law mentor, Chuck McGuire, read this paper and said that the whole paper could be summed up with the following advice, "You will get more out of a surety with a smile and a chicken fried steak lunch than you ever will with a lawyer." He's probably right.

The surety claims person is more like an ambulance driver. If he or she drives fast or gives first aid, there is a chance the patient can be saved, the fire can be put out, the project loss lessened. One wrong move and it's not just how much the policy will pay for the first occurrence, there is a good argument that the claims person made it worse…he or she broke it…he or she caused a simple problem to become a big one… and most surety claims people know it. They live and work in "Second Guessers Heaven."

Some times, the surety will mistakenly hire a hearse driver to do an ambulance driver's work. If that happens, your job is to find an ambulance driver in the house. If you are dealing with the ambulance driver, know that this is not just an "adjuster," but also someone with the training, temperament, and attitude of a paramedic.

Why is it so hard to get one of those claims people to come to a meeting? I don't want to disparage insurance adjusters at all. But, the typical surety claim person is often better educated, often with a law degree, and has been entrusted with greater responsibility than their counterparts down the hall who inspect hail damage. And guess what, those kinds of folks cost the companies a whole lot more than property and casualty adjusters…which means you have fewer of them in a typical insurance company. And, if you have fewer of them, and they are all going to get second-guessed, you might as well have them all huddled together in relatively few places around the country…. and, Voila! You know now why there is almost never a surety claims person in the same town as your problem! Nope, they are in Hartford, Chicago, Los Angeles, Philadelphia, and other similar godless places. You aren't going to change that…you

[6] A very smart Dallas surety lawyer, Alan Wight, long gone before I started practicing, wrote the best article I ever read on surety claims handling. He came up with this analogy. I wish I could find the article.

aren't going to get them to be at your job site tomorrow morning. If face-to-face contact is important to you, and it should be in many cases, consider:

- Plan ahead and use bond forms like the AIA A312 that contemplates that the surety would attend a conference under certain circumstances. Put a meeting requirement in the general conditions of your contracts.

- Go to the surety's office. It will make an impression.

- Don't expect the defaulting contractor to get them there. The defaulting contractor is often in denial or in a big time stall mode. The last person the contractor wants at a meeting with you is someone who might agree with you. Call the surety yourself.

If they don't leave the home office, how do they get things done? Surety claims departments must rely, more so than their property and casualty counterparts, on third parties to do leg work. And, since our ambulance/hearse analogy suggests that just any outside adjuster won't do, they are more likely to enlist the aid of someone who has surety claims experience…a consultant who specializes in such things, or a surety attorney. We'll discuss both in a moment. To those who have not dealt with a surety before, it must be a little disconcerting to have your request for help answered by an attorney. If you have a wreck and call the insurance company, they send a guy with a camera and a clip board who, more often than not, smiles and tells you how to get your car fixed or gives you a check on the spot. You've got to be deep into most property and casualty claims before a lawyer shows up for the insurance company. While hiring a lawyer right off the bat may be a good way for sureties to send experienced capable

people to deal with a problem, I think sureties may not always appreciate the message that seems to be inferred from the early arrival of an attorney[7]…the message, perhaps unintended, that they are preparing for a fight, looking for legal defenses, or are escalating the fight. If you are representing a claimant, don't jump to that conclusion, but do be prepared to deal with these representatives, armed with the following insights.

Surety Consultants. There are dozens, perhaps, hundreds, of large and small consulting firms in the U.S. that specialize in handling all sorts of outside functions for surety companies. They will perform initial investigations of a problem and report back. They are hired to estimate the cost to complete a project. They do litigation support. And, they manage completion or re-letting of projects when the contractor is defaulted. There are good ones and not so good ones; responsive ones and slow ones. Some are wannabe construction managers. Some have accountants who will want to pore over the contractor's records. They come in all shapes and sizes. I'm going to get into trouble over-generalizing here[8], but if you do your homework on these companies, you will find that you can predict their recommendations with amazing accuracy. Don't get me wrong. Consultants can be your friends. I find that they are more inclined than their lawyer counterparts to look at a project from a practical perspective, saying to themselves…and hopefully their client…"We've got a problem here. What is the best

[7] By the way, the same goes for the obligee who has its attorney gladiator leading the charge at the first meeting. You've got one chance to make a good first impression. If I were an obligee with a contractor headed South and a desperate need for a surety to complete, I'd try to be all peaches and cream for the surety. You want them to start spending money to solve your problem. What on earth do you expect to accomplish if your first invitation for help is surrounded by threats and admonitions of the dire consequences of their failure to do what you want them to do? Save the D.T.P.A., treble damage, "attorney fees, litigations and court costs" letter for later.

[8] Dan Dz., Arnold A., Dave P., Bill S., Ron C., David T., Keith R., Brad B., Mary S., Phil W., Ron T., George B., (and the rest of my good consultant friends). I promise this is not about you. I will write a note to your clients if you like. Doug L., this is about you.

way to fix it?" If the surety lawyer is first on the scene, thoughts often first run to such things as, "This is a problem…I wonder if my client may have defenses to this claim?" If I wanted my project finished by the surety, I'd rather have the consultants arrive first…and I would treat them well.

One other point to remember…the consultants all attend the same conferences as the surety attorneys. As you will note below, some of the surety attorneys are living in the dark ages of the law. The consultants hear them talk at these conferences and don't have the legal background to know that what they are hearing is wrong…and they repeat it as if it came down personally from the Chief Justice of the United States Supreme Court. There's nothing more likely to be incorrect than a surety consultant quoting law.

The Surety Attorney. When I first started practicing in the mid 70's, I'd guess that there were no more than two or three hundred attorneys in the country who could call themselves full time surety attorneys. There are probably more than a thousand now, maybe thirty in Texas, but they remain a small and fairly closed group. They know each other. They know all the consultants. The sureties know them. Here's what you should know about them:

- They are a fairly prolific bunch, writing and speaking…mostly to each other…all the time. Chances are that you can get your hands on many papers and speeches that your surety claims attorney has written or given. Start with the proceedings of the Fidelity & Surety Subcommittee of the Tort & Insurance Practice Section of the

ABA[9], and then try such proceedings as the Surety Claims Institute, the Western States Surety Conference, or the Fidelity & Surety Committee of Defense Research Institute. The ABA Fidelity & Surety Committee publishes several excellent books on handling surety bond claims.[10] The next time a surety claims attorney offers up a takeover agreement or offers to finance a contractor to completion, there's a good chance that the documents are going to look a lot like those printed in those publications. You may find some clauses that your opponent has left out that ought to be included. They will have a hard time arguing when you offer up the language from one of those books.

- The fact that they are a fairly closed group also may lead them to a certain amount of paradigm paralysis. They tend to sound alike, act alike, and perpetuate the same myths and bad practices that their mentors did. Don't get me wrong. Some of the finest lawyers I know are surety practitioners. But, they are as predictable as any other close bar. The bankruptcy bar comes to mind as a good example.

- They can't help it…they're going to act like lawyers. When all you want to do is tell the surety that you think they have a problem with their principal, their lawyers make you feel like you are the one with the problem. They show up at a meeting called to

[9] All of them go to the Fidelity and Surety Committee meetings alternately held in New York City and San Francisco the last week in January each year. Don't even think about making a claim then. Nobody will be at home to take the call.

[10] Check out http://www.abanet.org/tips/fslc/home.html or contact ABA Publication Orders at 800-285-2221 for any of these exciting titles, **The Law of Payment Bonds, Managing and Litigating the Complex Surety Case, Salvage by the Surety, The Most Important Questions a Surety Can Ask about Performance Bonds, The Most Important Questions a Surety Can Ask About Bad Faith Claims, The 50 Most Important Questions a Surety Can Ask about Bankruptcy, The Subrogation Database Case Concerning the Subrogation Rights of the Contract Bond Surety, Payment Bond Manual, 2nd Edition, Bond Default Manual, 2nd Edition, The Law of Suretyship, Subrogation Rights of the Contract Bond Surety**

solve a problem, and start using weasel words about "reservations of rights", "possible overpayments," "material alteration," "equitable this and exoneration that…" And, the best one…the project is in a shambles, claims from suppliers and subcontractors are being delivered by the box load, the contractor can't even be found…and they want to remind you that their "hands are tied until you have declared a default." Humor them. They're just doing what they've been doing for decades…even though some of what they are telling you isn't even remotely a correct statement of the law…it's just habit for them. And, just so you will be able to understand them a little better, I have attached a glossary of Surety Claims Terms to this paper. Learn just a few of the terms and you will be able to walk among the real surety attorneys undetected.

Sacred Ground. There are some things that surety company personnel, their consultants, and their lawyers really fear. Know their fears, and you will better know how to negotiate with them.

- "**Busting the Penal Sum of a Bond**" - Any surety could write a check for the penal sum of its bond and walk away when a claim is made. Seldom, however, does the claim approach that amount, and rarely will a surety avail itself of that opportunity. There is almost always a means of dealing with a default that can be handled for less than the penal sum. That is, until something goes wrong…completion costs skyrocket, defects in completed work are uncovered, or something catastrophic happens. If you want to observe some serious second guessing going on, watch the Vice President of a surety company inquiring with his claims department or with

outside counsel or consultants into why the loss exceeded or is about to exceed the bond penalty.

- "**Letting you finish up and send them the bill**" - You may be the most trustworthy, honest, and fair owner or bond obligee in the world, but the assumption is that you will run up the tab if they let you finish a defaulting contractor's work. And, chances are that you would…they've been burned too many times. And if they don't do anything else for you, they are essentially leaving the completion cost in your control…and they fear that.

- "**Letting the Contract Balances Get Away**" If the surety performs, it expects to have the contract balances available to do so. The surety has a right to expect that it won't go somewhere else. And, they have very strong equitable and legal rights that give them those funds over competing claims of third party creditors, the IRS, bankruptcy creditors, even banks with perfected security interests. They win those fights 99 times out of 100…unless you do something like give the money away or refuse to hold on to it for their benefit once asked. Listen to them. Cooperate. They win those fights. They feel so strongly that they will win, they will probably agree to indemnify you from claims by third parties if you agree to hold the money or fund it to them. Do something like refusing to stop payment, deciding you have to pay the IRS Agent because you are afraid of what he will do, or paying a trustee or other creditor without giving the surety a chance to intervene will just cause the surety to say, with

a fair amount of law and equity on their side[11], "That was stupid!" They are right, but for some strange reason, obligees did it to me all the time

Loose ends cost money. When a contractor gets in trouble on a job, there are always two sides to the story. What amazes me is that the obligee, with 50 things in his favor, will refuse to give in on the one or two that are legitimately in the favor of the principal…the ones that the principal has blown out of proportion and is using as an excuse for his poor performance. If the surety is looking for some negotiating room, guess which ones they will hang on to? Don't be greedy. Do yourself a favor and compromise on issues that deserve compromise. The more you can tidy up before the surety is called in, the more cut and dried your position is going to look, and the more likely you are going to get help.

Caught in the Middle. More often than not, the surety finds itself in the middle of a fight where its principal and its obligee are each claiming that the other is wrong. The surety really is in a predicament. If they perform for you, their principal claims they were a volunteer, and refuses to indemnify them. If they side with their principal, you're going to "finish the project and run up the bill." (See, Sacred Ground, above). If you need the surety to perform, now is not the time to demand that they take sides and agree with you. They aren't going to do it. But, if you are creative, you may be able to make it easier for the surety to help you out in the face of its principal's objections. Consider, for example, the possibility of warranting that a default exists and agreeing to pay back the loss if you are proven wrong. Consider compromising on some of your weaker points,

[11] See any of the texts mentioned in the immediately proceeding footnote.

taking away the defaulting contractor's talking points. Consider bringing in a facilitator or mediator now, not when a lawsuit has been filed, to try to bring the parties together.

They are not going to move as fast as you would like. Count on it…the surety is going to take longer to act than you want or need them to. Why? Well, remember that they usually live somewhere far away. They have to work through third parties. They didn't cause the problem, and they haven't been following it for as long as you have…they are playing catch up. They have to hear the other side of the story too. And, if they don't do a thorough job of figuring out what they have on their hands, they might do something that would send them to Second Guessers Heaven, like busting the penal sum of a bond. The louder you scream that they "must" do something immediately, the more they are going to wonder if they have some sort of defense because you didn't declare a default earlier. Or, the more likely they will say to you, "fine…you do something immediately and we'll talk when you are finished…" I submit that most sureties do move too slowly, but I've also observed human nature…the more I yell at my teenage son to speed up, the more he seems to slow down to show me I'm not in control. Sureties are no different. Give them the facts they need to make their decisions, explain the time constraints you are working under without all the theatrics and threats attached, and show some empathy. You will get more this way than you will with threatening letters.

Threats Generally Don't Work. They've heard them all, but obligees keep using them.

- **"If you don't do such and such, we won't accept any more of your bonds!"** Trust me, by the time you start making that threat, they probably don't want to issue any more bonds in your favor anyway.

- **"We're going to the Insurance Department to complain about this!"** Most sureties are sensitive to complaints to the Insurance Dept., but all you are likely to do is delay your claim while the surety explains carefully to the Department of Insurance that there was a bona fide dispute, and that they are investigating vigorously and doing such and such. In the end, all you will have accomplished is to have the front line claims person mad at you, have him or her resolved to come up with an action plan that supports the course of action he or she was on in the first place, and the Insurance Dept. can't do much anyway, unless they find that the surety has made a habit of being non-responsive. They will not let you use the complaint to leverage your position. But, if you are dealing with any insurance company that does not answer letters or calls, a complaint to the Insurance Department might well be appropriate.

- **"We'll sue!"** Most surety claims folks would like to do the right thing. What that might be isn't always obvious. One sure way to take them off the hook is to file suit. Then, it become very easy for the guy with the checkbook to say, ''It's out of my hands now.'' I've never known a single performance bond default that got better at the courthouse or ended up in a good result for anyone. Keep working at it.

- **"If that's the law, we'll get it changed!"** I heard this one more times than you would imagine, usually from a government attorney who had let the one-year statute

of limitations of performance bond claims pass. I never saw anyone try to change the law…until the last two sessions of the State Legislature. As a result of the decision in the Great American case discussed below under Bad Faith, sureties have not been subject to the various "bad faith" causes of action imposed on first party insurance carriers. Two bills filed in the 76th Session of the Texas Legislature, and another in the 77th, sought to overturn Great American and subject surety to statutory causes of action for "bad faith" claims settlement practices. None of the bills passed in their original form, but a message was sent to the surety industry, and a new law allows the Texas Department of Insurance greater oversight with respect to payment bond claims handling.[12]

They are living in the dark ages. Once upon a time, sureties were the darlings of the law, given every benefit of the doubt, cloaked with equitable defenses and remedies[13],

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[12] . **HB 2493 in 1999** by Representative Jim Keffer would have subjected sureties to Article 21.21 of the Insurance Code and it would have mandated specific claims handling requirements (such as requiring the surety to acknowledge and investigate a claim within 15 days of receipt of the notice of claim and to accept or reject a claim within 45 days thereafter). Failure to comply would have resulted in the claimant being able to recover 18% interest on the claim plus attorney's fees in an action brought against the surety. Further, a surety that violated the claims procedures in "bad faith" would be liable for 2 times the amount of the claim as additional, statutory damages. HB 2493 died in the House Calendars Committee. Representative Keffer reportedly had a close friend who had been treated quite badly by a surety, and he was out to prove a point. While the bill did not pass, no one in the surety industry should doubt for a second that he would re-file the bill if he caught wind of some sharp practices by sureties. He may do it anyway. **HB 3041 in 1999** by Representative John Smithee sought to amend Article 21.55 of the Insurance Code relating to first party liability claims handling practices. As originally filed, HB 3041 removed the statutory exemption for surety, title insurance, mortgage guaranty insurance, and marine insurance. When the bill was voted out of Committee, the exemptions were reinstated. HB 3041 passed both the House and Senate with the exemptions for surety, title insurance, *et al.*; however, there were differences in the House and Senate versions , which could not be worked out in Conference Committee, and HB 3041 died. **HB 548 in 2001** by Representative Keffer did pass and amended the Insurance Code to establish some time periods in which sureties should respond to payment bond clams and gave the Texas Department of Insurance additional tools to deal with sureties who simply don't answer their mail or return phone calls.

[13] Impress your surety friends by being able to both pronounce and give a definition of *Quia Timet*. I never really knew what it meant…it had something to do with the surety being able to sue its principal because the surety feared something bad was going to happen. Every once in a while we would work for an old

and their liabilities were very narrowly and strictly determined[14]. Those were Biblical times…or days of Knights of the Round Table…but long before sureties were simply departments of highly regulated insurance companies, charging premiums for their bonds, and writing modern bonds on modern contracts…but somebody forgot to tell most of the surety claims people. It is amazing how often a surety will raise a defense that has some basis in terms of antiquated common law rhetoric, but is completely at odds with the written terms of the contract and bond terms they have undertaken. But, some of the mystery of sureties remains, and if they say these things convincingly, you'd be surprised at how many times they get away with it[15]. Walk them through the terms of the bond and the contract, and ask for case authority…other than something from the Queen's Bench…and their positions will often crumble. They don't do it with the intent to raise groundless positions…they really believe some of the things they have been saying for fifty years.

Bad Faith. Talk about a roller coaster. The law on surety's bad faith changes constantly. One day, the courts say that if they guess wrong and side with the wrong person, they're toast. Then, another court says they can do no wrong. Right now, the sureties are feeling pretty smug about Great American Insurance Company v. N. Austin Utility[16] and Associated Indemnity Corp. v. Cat Contracting, Inc.[17] In Great American, the Texas Supreme Court said that a surety does not owe a duty of good faith and fair

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timer at the Surety's home office (which was usually in a state where law and equity had not been merged and they still used Demurrers and Pleas in Rejoinder and things like that). He'd insist that we file a "Bill in Quia Timet." Let's just say that the Dallas County District Clerk's office looks at you kinda funny when you file a pleading with that title on it…

[14] *Strictissimi Juris* was the rule…until sureties started getting paid for writing bonds.

[15] See footnote 1, above.

[16] 908 S.W.2d 415 (Tex. 1995)

[17] 964 S W.2d 276 (Tex. 1998)

dealing to a claimant. In Associated Indemnity, the Supreme Court held that there is no implied duty of good faith and fair dealing between a surety and its principal. My prediction: Smugness will turn to arrogance. Arrogance will turn to bad facts. And bad facts will make bad law for sureties who don't conduct their business with an attention to professionalism and responsiveness[18]. There will always be a cause of action…maybe we don't even know what it is called yet…to take care of businesses that do not act responsibly. If a surety tells you they aren't worried about bad faith liability, watch for their name in the next bad faith report. It will happen sooner or later. Right now, you can rattle the bad faith sword and it won't get much attention. That will change.[19]

Don't Be Greedy. Contract bonds are obligations to fulfill certain contractual obligations. They are not open checkbooks, an opportunity to cure all ills, nor a source of funds to relieve the emotional distress of a contract default. Don't get greedy and try to solve all your problems with the one bond you did take from a subcontractor. You will get caught…and then you're going to have trouble getting what you are entitled to get. Surety lawyers love to catch obligees double dipping and getting greedy. You don't want to know what happens next.

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[18] And, even now, there may be an even more ominous problem looming on the horizon for the surety industry…something, I submit, has arisen because some sureties just don't take care of business. It is first party "contractor default insurance." This insurance product provides a contracting party with insurance against the losses suffered as a result of another party's default. There are big deductibles, and the terms of these policies are evolving, but the concept is very appealing to those who have suffered the frustrations of non-responsive surety claims department. Invite me back again and we will have a whole program on the pros and cons of contractor default insurance vs. surety. Selfishly, I would like to say that it is a flawed product that couldn't possibly be better than the surety product that the surety industry offers.That may well turn out to be the case, but you deserve a whole lot more information on the topic than I can give you today.

[19] In the meantime, for a really good overview of this issue, take a look at Robert Bass's paper on *Extra-Contractual Claims Against Sureties*, from the 10th Annual Construction Law Conference of this Section. He covers it all. E-mail him at RBass@Winstead.com and he will e-mail a copy back to you. If he doesn't, I will.

All Sureties are not Created Equal. They get painted with a pretty broad brush, and that's not fair. Some go overboard to do the right thing, employing bright people who understand the need for prompt decisions. Some don't. And some try, but just don't quite get there[20]. If you are facing a bond default situation, do your homework. Some are more inclined to finance a contractor to completion. Some would rather write a check than manage completion. Some use attorneys; some prefer consultants, and some handle everything themselves. We surety attorneys really are pretty gossipy. It's not hard to get the inside scoop on most companies.

Mediate. It works. It works very well. The sureties generally are receptive to it. Don't wait until a lawsuit is filed. If you are reaching an impasse on how the pieces are going to be picked up and how a project is going to be completed, call in a mediator, preferable someone who knows the various options…or can think of new ones…to get a project completed. There are a number of sureties currently contemplating adding some form of facilitated settlement conference or mediation to their bond forms. It would be a good idea for you to consider.

In Summary. Why don't sureties do what you want them to do? Because they are run by humans, with human sentiments, human feelings, and human failings. If you will go

[20] For years, Dallas construction law guru, Joe Canterbury, kept a favorite letter that he had received. His client, a Dallas general contractor, had made a claim against a Dallas subcontractor, who had defaulted on a Dallas public school project. Joe wrote a letter to the Attorney-in-Fact in Dallas who had signed the bond, requesting action. The response came from the surety's headquarters somewhere in New Jersey. They wrote, on August 12, 1977, "Mr. Canterbury, Without waiving any rights or defenses which may be available to us, we acknowledge receipt of your claim of January 2, 1977. In order to give this matter the attention it deserves, we are forwarding your letter to our claims department in Los Angeles, California…" If you are sitting next to someone at this luncheon who is reading this over and over and can't figure out what's so funny about this, they probably work for a surety company.

into a claims situation armed with a little of the insight I have provided, and ready to deal with a person, not a company, you're likely to do just fine.

About the Author

- Steve Nelson practiced construction and surety law in Dallas, Texas for 19 years. He has been the chief executive officer of one of the largest commercial building contractors in Texas. He currently chairs the Texas Building Branch, Associated General Contractors Legislative Committee. He has served as the Chair of the Construction Law Section of the Dallas Bar Association, the Construction Law Section of the Travis County Bar Association, and the Construction Law Section of the State Bar of Texas. He is a Fellow of the American College of Construction Lawyers and an Adjunct Professor at the University of Texas at Austin School of Civil Engineering. While working with a company than includes a surety company as one of its holdings takes most of his time, Steve keeps his hands in the construction law arena by serving as a mediator in complex construction disputes...especially those involving disputes between sureties and their obligees.

Glossary of Surety Claims Terms…some of which you won't find in Black's Law Dictionary

Agent. Most bonds are written (signed) by agents. These agents are really double agents…as in the insurance agent for the contractor and an agent with power of attorney for the surety. Given that status, consider the possibility that information conveyed to an agent might not reach both of its principals. The agent is the one who procured the bond for the contractor and may be a good source of information. They seldom have any authority at all to deal with clams. If you are not dealing directly with the bonding company in a claim situation, you may not be dealing with the right person or entity. But, don't rule them out as a source of help either. The relationship between a contractor and his surety agent is a close one. The surety bond agent may be of immense help in dealing with some problems that arise.

Attorney-in-fact. The person who has a power of attorney to sign on behalf of the bonding company; usually, the agent. The only way to know the limit of an attorney-in-fact's authority and power is to look at the Power of Attorney that should be attached to a bond.

Bad Faith. What a roller coaster this topic is. One year, a surety will do something awful…like "Do Nothing" in the face of obvious liability …and get nailed for big damages in some state. This will make for lots of papers at the next Midwinter Meeting and sour stories of how the good ol' days are gone. For a while, the sureties will behave and darn near give away the store to avoid bad faith liability…but after a while, another case comes down that says that the surety can do no wrong, and they get mischievous again. Yes, this is a gross overstatement that is not applicable to all sureties, but you get the idea. Some worry about it more than others.

Big Aetna or Little Aetna? There are or were two different insurance companies named Aetna. I never knew the difference, but *real* surety attorneys always knew to ask "Big Aetna or little Aetna?" when you said the word "Aetna." It's a way to tell the real ones from the wannabes…except now you know and the secret is out.

Bond. This is the instrument that gives you rights. Its wording controls unless there is an overriding statute (as with statutory payment bonds). Many claimants forget and think that bonds are like insurance…that a judgment against the principal binds the surety. Not so. I used to win cases all the time when the plaintiff would forget to introduce the bond in evidence, or couldn't get it admitted at trial. Bonds should be signed by both the principal and the surety's representative, and a power of attorney should be attached evidencing the power and authority of the attorney-in-fact to sign for the surety. Statutory payment bonds on Texas private works jobs are also signed by the obligee (owner).

Bond Underwriters. These are the folks who decided to write the bond in the first place. You probably won't deal with them in a claim situation. Bond Claims people are second-guessed all the time. Underwriters exist so that Bond Claims people will have someone to second-guess themselves.

Claimant. Usually an unpaid supplier or subcontractor making a claim against a payment bond. The obligee is usually not referred to as a claimant on the bond, but rather just as the "obligee"…or with some less responsive sureties, "the plaintiff."

Claims Attorney. This is usually a reference to the in-house claims representative for the surety. Don't call him or her an "adjustor." I'm not sure why, but many are not attorneys at law…just attorneys in fact, but they use the title anyway.

Common Law Bonds. Bonds that are not statutory and under which the parties obligations are determined by the language of the bonds and the common law. Subcontract bonds, maintenance bonds, bid bonds, and performance bonds on private construction projects fall into this category. One of the common mistakes I saw in the surety claims business, on both sides, was the incorrect characterization of one party's liabilities on such a bond by someone who had never even read it. Read the bond form!

Completion by the Surety. When the surety, with its own forces or even the forces of the original defaulting contractor, finishes up the work, often supervised by a Surety Consultant.

Consultants. These are the people who give the biggest and best parties at the Midwinter meetings of the Fidelity & Surety Section. Some of them used to be principals and decided that it was a good racket to get into. Some are former in-house bond claims people. Some are contractors or engineers or accountants who have made a market representing sureties in bond default situations. They are often the eyes and ears of the surety in a bond claim situation. You want to be nice to them, at least until they turn on you and help the surety concoct some frivolous defense…which they usually don't want to happen, because they want to get paid a lot of money to manage the project to completion.

Do Nothing Option. When the surety decides it may have defenses to liability, or just thinks you are being a jerk, or decides it is better off doing nothing to fix the problem, but chooses to respond later in damages, this is sometimes called the Surety's Do Nothing option[21] in a default situation. You generally don't want to find yourself with the surety exercising this option, no matter how great you think your subsequent lawsuit is going to be. It's hell on your cash flow.

Domination. This is not a cult sex thing, but a hot topic about 15 years ago when a Louisiana contractor recovered a huge judgment against its surety for allegedly ignoring the contractor's rights, siding with the owner, and generally running amok. The case was successfully appealed.

Fidelity Bonds. These really are more like insurance than bonds, and they have nothing to do with construction, but more with embezzlement from banks and such, but many surety attorneys and home office claims persons also handle fidelity cases. The only sure fire way to determine if a surety attorney also handles fidelity cases is to find

[21] Actually, there's a lot of debate about what the Do Nothing Option is and isn't. Some would argue that the term only applies to a surety who simply relies on its principal's position without any independent verification. Others argue that it applies in any situation where the surety doesn't perform. It's industry jargon and has no real legal significance, so don't worry about the definition.

him after 1pm on the last Friday of January…that's when the fidelity portion of the Midwinter meeting is held. The non-fidelity lawyers and consultants go off to lunch and brag to each other about which home office claims people they snagged for dinner at the Cocktail party the night before.

Financing the Principal. In some situations, the surety will help prevent a default or cure an existing one by financing the contractor's ongoing performance. This can be a little dicey. First, see the notes about busting the penal sum below. Secondly, they may just be throwing good money after bad if the contractor is not competent or trustworthy. Thirdly, the surety will usually end up having to finance a lot of non-bonded obligations at the same time.

Material Alteration. This is a defense based on the theory that the surety bonded one contract, yet the parties agreed to a different one that the surety did not agree to bond. Overpayment may or may not be a material alteration. Adding a third floor to a two-story project might be. Adding the construction of a building to a contract that only provided for site grading would certainly be.

Miller Act. The popular name of bonds issued on federal projects pursuant to 40 U.SC. 270.

New York. As in, "Will you be in New York in January?" (scene of the Fidelity and Surety law Midwinter meeting forever…only now it sometimes goes to San Francisco every other year, to the bewilderment of *real* surety lawyers who have trouble coping with change.)

Obligee. This is the person in whose favor a bond runs. The owner in a performance bond is a ***named obligee***. Occasionally, lenders will be added as ***dual obligees***. Payment bond claimants are obligees, although unnamed, but are usually referred to as claimants, rather than obligees. Take "insured" and "insurance company" out of your vocabulary when dealing with sureties.

Overpayment. This defense is based on the premise that you overpaid the contractor for what he has done, thus depleting the funds available to complete at default to the surety's detriment. An overpayment may also so deviate from the terms of the contract that it is a material alteration of the underlying contract, releasing the surety from further obligations. While the surety seldom pursues this one to a conclusion, it creates wonderful leverage and can be used to back you off your claims, as in "And so, Mr. Obligee, if the principal is such a low life bloodsucking scumbag who should never have gotten a bond in the first place, and hasn't done a thing right since the beginning of this job, as your lawyer has so forcefully stated in his hateful letter inviting us to this meeting…then, why have you paid him 85% of the total contract amount?" This one bites folks who are genuinely trying to help avoid a default by shelling out money faster than the contract provides to a contractor to improve his cash flow. Try to avoid getting in the situation where the surety can claim this.

Penal Sum or Penalty. The amount of the bond, usually an amount equal to the amount of the underlying contract. If there are separate performance and payment bonds, there are two penal sums available. A surety "busts" the penal sum when they

do something that makes them liable for more than the penal sum of the bond. One way to do this is to start financing a contractor without the obligee's agreement that every dollar spent will reduce the surety's ultimate exposure. If the financing/shoring up doesn't work, the obligee is going to say, absent an agreement to the contrary, "OK, Mr. Surety, you've got the entire penal sum of your bond left to satisfy this problem." Surety claims people and their lawyers who bust penal sums usually skip one year of the Cocktail Party as a penance, mostly because others will whisper about them behind their backs.

Perfecting a Claim. This is a payment bond term. A claim that is made against a payment bond in the manner and within the time limits set forth in the bond or applicable statute is said to be perfected. Texas is the only state I know of that has a statutory scheme for bonds on private construction projects. In most states, payment bonds on private construction projects are common law bonds and perfection is a matter of following the requirements printed in the bond.

Principal. The contractor who is obligated on the bond.

Ratification Agreements. When a contractor defaults, the surety may try to reach an agreement with the existing subcontractors to hold their prices for the surety or a completing contractor. If the general contractor has defaulted in its obligations to the subcontractor, the sub probably is not obligated to sign such an agreement, but nothing in this business is ever black and white and there is usually an implied promise of speed or slowness in the payment of past due funds owed to the sub by the general when these negotiations are underway.

Re-let. When the surety in a default situation does not want to prop up or finance the defaulting contractor, the surety may, or may cause the owner to, "re-let" the remaining work to another contractor. Often some money changes hands to cover the shortfall roughshod over the contractor's business. Here in Texas, the topic came up again in Cat Contracting, but both cases were overturned on appeal. It was sometimes fun to watch the principals pushing their sureties around in the interim.

Specialty Sureties. This is a nice term for sureties who don't underwrite exactly like I described in this paper…to a zero loss. Rather, they take collateral or guarantees by the Small Business Administration to hedge against a loss. They serve a valuable role in providing bonding to smaller contractors, subcontractors, and others who would not otherwise qualify for bonds. Some of them are wonderful in their claims handling (they get a lot of practice) and some aren't.

Subrogation Rights. A distant cousin to subrogation in the insurance defense business, this usually refers to the rights of a surety to the contract balances in the event of a contractor default. With very very few exceptions, the surety gets to use them…ahead of the IRS, the contractor's bankruptcy trustee, a lender with a perfected security interest in receivables, and judgment creditors. Sureties get really upset if you let that money get away, or try to give it to one of those other folks. It is theirs and you better save it for them. Don't, and expect the Do Nothing Option to be exercised

Surety Attorney. The outside counsel for sureties often refer to themselves as surety attorneys or surety lawyers. There are relatively few attorneys in the U.S. who the "real" surety attorneys consider to be "real" surety attorneys. In general, "real" surety attorneys spend at least half of their practice representing sureties AND have gone to the Midwinter Meetings for the Fidelity & Surety Law Committee of the Tort & Insurance Practice Section of the ABA for the last umpteen years. Pecking order among surety attorneys tends to be based on the number of Midwinter Meetings attended, and not necessarily skill or competence.

Surety. The bonding company; usually an insurance company. Do not confuse the surety with the insurance agency or agent. The latter two are agents of both the surety and the contractor and generally have no liability to an obligee.

Tender. When the surety in a default situation does not want to prop up or finance the defaulting contractor, the surety may "tender" a completing contractor to the obligee, usually with some money to cover the amount in excess of contract balance that the completing contractor is going to charge. Some bond forms define how this is done, but mostly it is a process that is negotiated as a means of finishing up a project.

The Cocktail Party. The one on Thursday night at the Fidelity & Surety Midwinter Meeting, of course. This is when about 1300 consultants and surety attorneys troll about the Grand Ballroom of the Waldorf in New York or the Fairmont in San Francisco looking for home office bond claims people to take to expensive restaurants…but there aren't enough home office bond claims people to go around, so the consultants and surety attorneys go ahead and go to Lutece or Le Cirque and spend an uncomfortable evening wondering which one is going to pick up the tab.

Underpayment. The flipside of an overpayment defense; this one suggests underpayment constituting a prior default by the owner. A prior default by the obligee would excuse a principal's performance, thus releasing its surety. You're in trouble either way. Be careful.