MARCH 2004

The newsletter of the ABA Forum on the Construction

UNDER CONSTRUCTION

SURETY'S RIGHT TO SETTLE ITS PRINCIPAL'S CLAIMS

By Shannon J. Briglia

The surety's rights to settle claims in Virginia upon a principal's default were confirmed last December in *Bell BCI Co. v. Old Dominion Demolition Corp.*, 294 F.Supp.2d 807 (E.D.Va. 2003). Typical disputes arose between a contractor and subcontractor on two contracts involving new construction on an existing wastewater treatment plant. After significant delays, the contractor demanded that the subcontractor accelerate. Upon the subcontractor's refusal, the contractor terminated both subcontracts. It was later discovered that the subcontractor failed to pay certain subcontractors and suppliers so the surety paid the claims. The contractor ultimately filed suit against the subcontractor for breach of contract and against the subcontractor's surety under the performance bond. The subcontractor counterclaimed, asserting the contractor breached first. After having been notified that the subcontractor was insolvent and after its demand for indemnity and for deposit of collateral was ignored, the surety settled all claims, including the subcontractor's counterclaim. The subcontractor was not a party to the settlement negotiations or agreement.

The surety moved for enforcement of the settlement on the grounds that it was authorized under the indemnity agreement to settle the subcontractor's claims. The court granted the motion, finding that a default occurred when the surety received and paid claims which triggered the surety's rights under the indemnity agreement's assignment and attorney-in-fact provisions to settle and resolve all claims, including the subcontractor's affirmative claims. Following *Hutton Constr. Co. v. County of Rockland*, 52 F.3d 1191 (2d Cir. 1995), the court rejected the contractor's argument that the risk of bad faith settlements precluded allowing sureties to settle a subcontractor's claims against the general contractor. The court determined that allowing a surety to exercise its rights under the assignment and attorney-in-fact provisions of a general agreement of indemnity was not only the correct result under the contract but also "a commercially sensible result," without which sureties would be unwilling to enter into indemnity agreements

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REPORT OF THE NOMINATING COMMITTEE

The Nominating Committee of The Forum on the Construction Industry convened at The Forum's Mid-Year Meeting in San Francisco in January, and selected nominees for Chair-Elect and Governing Committee Members at Large. The nominees are: for Chair (automatic), James Duffy O'Connor; for Chair-Elect, Douglas S. Oles, Seattle, WA; for Governing Committee Members at Large, Adrian L. Bastianelli III, Washington, D.C.; George J. Meyer, Tampa, FL; Krista Lee Pages, Washington, D.C.; and David A. Senter, Greensboro, N.C. In accordance with The Forum's by-laws, the nominations will be presented to The Forum Membership for a public vote on May 6, 2004, as part of The Forum's Business Meeting, which takes place during its Annual Meeting in Scottsdale, AZ.

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MESSAGE FROM THE

CHAIR ELECT

James Duffy O'Connor,
Chair-Elect

A hero rides a horse, 16 hands high, its mane shining so black it hurts to stare at it. The cross stitch cresting the toes of his boots carries the dust of his work; he works quietly 7 day weeks to feed the country. A hero carries an axe in one hand and a child in the other; an oxygen tank strapped to his back that's hooked to a mask that veils equal parts of anguish and intensity. A hero holds a scalpel; dressed in drab greens, her hand as sure and correct as calculus, the very difference between mornings in the arms of others—or not. A hero teaches; treks; builds; scores; leads; saves; creates; protects; cares; cautions; and more.

But is a hero armed with paper and pen? Does he wear a two-piece suit, suspenders, a knotted neck tie and wing-tip shoes? Does he carry his tools in a shoulder bag? Does a hero use a cell phone, a computer, and a personal digital assistant? I think so, and I think he lives in Chicago.

Word has it he looks like what a mountain would look like if a mountain could compose the perfect sentence; he's as strong as The Missouri would be if The Missouri had as many friends; he's as true as North would be if the direction knew any different were false; he's as soft as the horns of cockle snails would be, if cockle snails would as willingly share their softness with others. He teaches, treks, builds, scores, leads, saves, creates, protects, cares, cautions and more. His name is Stan Sklar.

Please join us at The Forum's Annual Meeting & Program in Scottsdale, Arizona May 6-8, 2004 where The Forum will be honoring Stan, and publicly recognizing him for his many years of commitment and support of the organization. During our Business Meeting on the 6th we will present Stan with The Forum's Cornerstone Award. He'll be thrilled to see his friends there. It promises to be a wonderful time.

Oh, and a final word about Stan's suit. It doesn't burn. It's flame resistant.

MESSAGE FROM THE EDITOR

Patrick J. O'Connor, Jr.

This is the first issue prepared under my direction. For many years Cathy Bumb acted as Editor of *Under Construction.* Cathy has taken employment outside of the construction industry and has therefore decided to step down. Cathy did a marvelous job, and I am deeply indebted to her for leaving me such a strong publication. I will try to hew to the same true course. Please do not hesitate to contact me if you have something you believe should be published in our Newsletter.

Surety's Right

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or issue bonds.

Unfortunately for sureties writing in Virginia, the court breathed life into the previously comatose bad faith argument. In dicta, the court commented that the subcontractor could raise its allegations that the surety settled the claims in bad faith in the separate suit for indemnity pending in state court. Relying on a non-binding trial court case, *Transamerica Premier Ins. Co. v. Turf Specialists of No. Va., Inc.*, 1993 WL 945965 (Va. Cir. Ct. Feb. 18, 1993), the court encouraged the subcontractor to pursue the surety's alleged bad faith as a defense in the indemnification action, where, should it prevail, the subcontractor could not only defeat the surety's claim but also potentially recover the value of the counterclaim that the surety settled. See also *Lumbermans Mut. Cas. Ins. v. Darel Group U.S.A. Inc.*, 253 F.Supp.2d 578 (S.D.N.Y. 2003) (indemnitor liable as surety did not fraudulently induce it to purchase bond on theory that surety led indemnitor to believe bond did not cover penalties; bond's coverage was clear on its face).

What is Surety Bad Faith?

By Louis R. Pepe

In an extensive survey of surety bad faith law, the Connecticut Supreme Court recently set forth its most comprehensive statement of the law concerning the covenant of good faith and fair dealing as it applies to sureties — and, more particularly, the surety's right to collect under its indemnification agreement. In so doing, the Court surveyed and summarized decisions from other jurisdictions and the treatises on this subject, thereby providing a most useful compendium of the law on this issue.

In *PSE Consulting, Inc. v. Frank Mercede and Sons, Inc.*, 838 A.2d 135 (Conn. 2004), the Court was asked to reverse a judgment entered in favor of the indemnitors and against the surety, which was seeking indemnification for the $700,000 it had paid a subcontractor in satisfaction of its claim under the surety's payment bond. At trial, the jury had returned a verdict in favor of the indemnitors and a finding that the surety had breached the implied covenant of good faith and fair dealing in the indemnification agreement when it made the payment bond payments in question.

On appeal, the Court first rejected the surety's argument that the trial court's refusal to enter a directed verdict in its favor was error. While acknowledging that "indemnity agreements, such as the one here, typically guarantee the surety wide discretion in settling claims made upon a payment bond," the Court also noted "[that] discretion was not unfettered," because "the surety is entitled to indemnification only for payments that were made in good faith," as required by the implied covenant of good faith and fair dealing in every contract, including indemnity agreements.

Taking guidance from other jurisdictions, the Court concluded that, in order to prove a breach of that covenant, the indemnitor must "establish something more than mere negligence," but something less than fraud. *See also Travelers Cas. and Sur. Co. of Am., Inc. v. JADUM Const., Inc.*, 2003 WL 21653368 (D. Mass., July 11, 2003) (same). The indemnitor must show an "improper motive" or "dishonest purpose" on the part of the surety. Such a standard, the Court held, would provide the "proper balance" between the surety's discretion to settle and the indemnitor's right to be protected from "serious and willful transgressions."

Measuring the evidence adduced in the trial below against that standard, the Court concluded that the jury could have found the surety's investigation of the subcontractor's claim was "superficial" and in violation of the requirements in its own bond. The Court then went on to analyze and answer the question of whether an improper investigation, *by itself*, constituted bad faith. After again surveying the authorities from other jurisdictions, it concluded that "the failure to investigate, standing alone and not accompanied by other evidence of an improper notice, is not enough to constitute bad faith."

But that was not enough to save the surety, because the Court

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What is Surety Bad Faith?

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further concluded that the jury could have also found that the surety settled the payment bond claim to "protect its own self-interest;" *i.e.*, to avoid an investigation by the insurance commissioner (which had been sent some of the subcontractor's correspondence complaining about the surety's handling of the claim) and/or to obtain a release of the subcontractor's claim that the surety had acted in bad faith and had violated Connecticut's Unfair Trade Practices Act. Here again, the Court was careful to note that a self-interested settlement "unblemished by any other evidence of bad faith," would not constitute a *per se* violation of the covenant of good faith and fair dealing, but, combined with the "confluence of circumstances" surrounding the settlement in this case (including the principal's objection to or ignorance of payments by the surety to the subcontractor and the surety's initial support of the principal's rejection of the claims), the jury could have found that the "self-interested settlement" was made for an "improper motive," and that can constitute bad faith.

Finally, the Court recognized that the "unique nature of the tripartite relationship among surety, principal and claimant" will often confront the surety with the dilemma of bad faith claims from the claimant for not paying or bad faith claims from the principal and indemnitors for paying. That dilemma was not resolved in the proper manner by the surety in this case.

While perhaps not breaking any significant new ground on the law of suretyship, this decision did put a much sharper point on the application of the covenant of good faith and fair dealing in the indemnity agreement, and, in so doing, provided an invaluable survey of the law on that point and related issues.

Does terminating for convenience require a change in circumstances?

by Buck Hinkle

The Kentucky Supreme Court has limited the public owner's right to terminate a construction contract for convenience. In *RAM Engineering & Construction, Inc. v. University of Louisville*, 2003 WL 22971158 (Ky. Dec. 18, 2003), the Court ruled that a "substantial change in circumstances" is now a prerequisite to invoke a termination for convenience provision.

The case arose from the construction of the University of Louisville's Papa Johns Cardinal Stadium, home to U of L's football team (the too frequent victor over the University of Kentucky's beloved but hapless Wildcats). The procurement was regulated by the Kentucky Model Procurement Code ("KMPC")

After receiving bids for the site development package, U of L determined that the budget had been exceeded. Following negotiations with the three lowest bidders, U of L declared RAM to be the low bidder. MAC Construction, the low bidder on the original numbers, protested. U of L denied the protest and issued a notice to proceed. MAC then filed suit and sought to enjoin commencement of construction. MAC and U of L quickly arranged for an Agreed Order declaring the award to RAM null and void and requiring U of L to relet. U of L issued a second invitation for bids. RAM was the low bidder but at $599,000 less than its previous bid. RAM's second bid was accepted but RAM then filed a protest of its own objecting to the reduction in the contract amount.

U of L denied the protest on the grounds that no previous contract existed or, assuming one existed, it was terminated for convenience: RAM sued for breach of the original bid contract.

The Supreme Court reversed the decisions in U of L's favor by the trial court and intermediate appellate court. Relying on the implied covenant of good faith present in

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Terminating

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every contract, an express requirement of good faith in the KMPC and the stated purposes of the KMPC, the Court held that even a termination for convenience clause cannot supersede the good faith duty to do "everything necessary" to carry out the contract. This duty must be measured by a change in circumstances standard. The Court stated:

While contractors ought to expect the government to terminate a contract when it is In its best interest to do so, It is also reasonable for them to expect that the government's interest will only change if the circumstances surrounding the contract substantially change.

The Court held that there had not been a substantial change in circumstances justifying the termination of RAM's first contract. MAC's suit notwithstanding, the project was not delayed. A provision in the contract illustrated that the parties anticipated possible legal delays "without suggesting that [U of L] could terminate in the event of such a delay." The Agreed Order in the MAC litigation, which the Court likened to an exculpatory clause, was no excuse because U of L was responsible for it. Kentucky's "changed circumstances" test is materially more difficult to trigger than the federal government's bad faith test. Under the federal standard, as enunciated in *Custom Painting Co. v. United States*, 51 Fed. Cl. 729, 733-34 (2002), the "Court must presume that the Government acted in good faith in contracting, and this presumption may be overcome only by 'well-nigh irrefragable proof' that the Government acted in bad faith."

In Memoriam: Erwin L. Corwin (1927 – 2004)

by Leslie O'Neal-Coble

Anna Quindlen wrote, "We are defined by who we have lost." The Forum lost a great friend, leader and role model with the loss of Erwin L. "Ed" Corwin, who died on February 6, 2004, at age 76.

Not only was Ed a great lawyer and mentor, he was also a delightful person with great enthusiasm for life and for the practice of law. He served the Forum as a leader in various capacities, from Division I Steering Committee chair to Governing Committee member and, finally, as Forum Chair. However, even after his term as chair was over, he was always willing to serve the Forum wherever needed, no matter how mundane the task. In appreciation for his leadership and service, the Forum honored him

with the Cornerstone award in 2001.

Ed practiced construction, bankruptcy and anti-trust law in New York City for 50 years, founding the firm of Corwin, Solomon & Tanenbaum. After his retirement, he frequently served as a mediator and arbitrator in complex commercial and construction cases.

A man of great warmth and charm, Ed had a wonderful sense of humor. His lively wit and infectious grin could brighten up the dreariest occasion. He was passionate in his love for the arts and for legal education.

He was devoted to his wife, Judy, and their two children, Michael and Sarah, and his grandson, Shane, who survive him.

The Forum would not be the organization that it is today without Ed's contribution. He is greatly missed, but will be fondly remembered by his many friends and colleagues.

Cornerstone Award News Release

The ABA Forum on the Construction Industry, at its 2004 Annual Meeting, will award the Cornerstone Award to Stanley Sklar, partner with BELL, BOYD & LLOYD of Chicago. A founding member of the Forum – Stan still remembers sharing cold bacon and eggs with approximately 25 initial Forum members at the first Annual Meeting – he has served as a mentor and teacher to a generation of construction lawyers. Stan, a former Division 9 Chair, has long supported the involvement of attorneys representing trade contractors and suppliers in the Forum. He has also served as a speaker at countless construction seminars and has chaired or co-chaired several Forum programs including the initial "Sticks and Bricks" program. Stan is a prolific author and has written several articles for *The Construction Lawyer.* He has every issue of *The Construction Lawyer* in his office and recalls that one of the early articles was on *Hadley v. Baxendale*; in fact, Stan believes that the article was written by an attorney that represented one of the parties (who was a friend of his). Stan's good humor and love for the construction industry and its advocates is always evident. Please join the Forum on May 6 in honoring Stan Sklar, a friend of the construction industry.

New From The ABA Forum On The Construction Industry

Construction Damages And Remedies

Charles M. Sink, C. Allen Gibson, Jr., Douglas S. Oles, Allen Holt Gwyn, Leslie O'Neal-Coble

The latest Forum book, *Construction Damages And Remedies*, should be of value to every practitioner in the construction field. It can serve as a useful reference when evaluating a claim for settlement, drafting complaints and answers, negotiating risk allocation terms in a construction or design contract, or offering quantum evidence at trial.

Five experienced and highly regarded construction lawyers from across the country have produced the best available combination of:

- The historical sources and applications of various damages theories and equitable remedies, and the elements of proof by which they can be established and defeated.
- The array of damages to which participants in the construction process – owner, designer or constructor – are exposed.
- Practical suggestions based on the authors' substantial collective experience about the best techniques for presenting damages in a dispute.

Not only will the reader find extensive citations to leading case law in *Construction Damages And Remedies*, but in a unique innovation, the authors have also included citations to the West key number system, enabling the reader conveniently to cite additional case authorities both before and after publication of the book.

Construction Damages And Remedies is a resource that will be indispensable to any construction industry lawyer, from the newly involved to the seasoned veteran.

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AAA Adopts revised Code of Ethics for Arbitrators

On March 1, 2004 the American Arbitration Association adopted a newly Revised Code of Ethics for Arbitrators in Commercial Disputes. The Code was originally drafted in 1977 by a joint committee consisting of representatives from the AAA and the ABA. The Revised Code was also prepared jointly with the ABA. The 2004 Revised Code maintains many of the elements of the 1977 Ethics Code, while bringing it in line with modern practice. The most substantive changes to the 2004 Revised Code include:

Presumption of neutrality: (neutrality is presumed to apply to all arbitrators, including party-appointed arbitrators)

Duties of party-appointed arbitrators: (party-appointed arbitrators are required to disclose whether they are acting as a neutral or non-neutral arbitrator as early in the arbitration as possible).

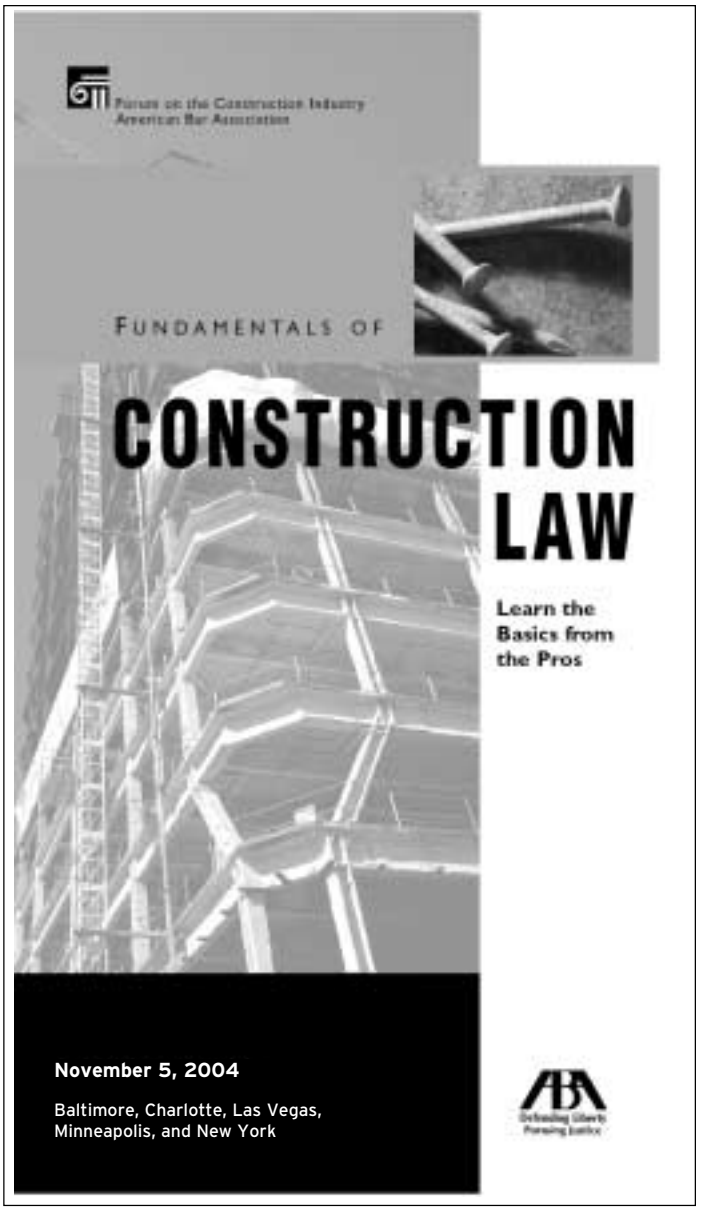
Duty to disclose interests and relationships: (all arbitrators, whether neutral or non-neutral, have the same disclosure requirements)

Communications with the parties/other arbitrators: (new guidelines are established regarding communications between party-appointed arbitrators and the chair of the tribunal in tripartite arbitrations)

Arbitrator's Suitability: (arbitrators are required to evaluate not only impartiality but also competence and availability to serve).

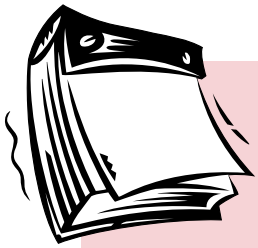
You can find the newly Revised Code on the AAA website at http://www.adr.org

New Seminar Series



Positions open: Associate Editor and Case Note Editors for The Construction Lawyer

Are you interested in acting as Associate Editor or a Case Note Editor for the Construction Lawyer? The Construction Lawyer is the flagship publication of the ABA's Forum on the Construction Industry. It regularly contains indepth articles covering important subject areas to the Forum's members as well as breaking judicial and legislative news. If you are interested in working on this important publication, please contact the Forum's Chair, John R. Heisse II at jrheisse@thelenreid.com or (415) 369-7225.



Don't Miss the Next Forum Meeting!

ANNUAL MEETING 2004

WHEN: May 6-8, 2004

WHERE: Hyatt Regency Gainey Ranch, Scottsdale, Arizona

TITLE: Winning Advocacy: From Contracts through Trial, Sophisticated Strategies for the Construction Lawyer

TELL ME MORE: The presentations will address very practical problems faced by all construction lawyers whether seasoned by years of experience or just embarking on their careers. We will examine how to satisfy the expectations of in-house counsel, how to help our clients manage the risks in the construction process, and how to effectively manage the complex construction case. Further, the program will include an insightful primer on the business practices of construction entities. We will also examine strategies for challenging experts, innovations in the computation of impact damages, and the mistakes commonly made in the use of technology in the courtroom. One half day will be devoted to trial advocacy — two leading practitioners will first share their theories on how to effectively argue to a judge or jury, followed by mock arguments to both a distinguished jurist and a locally selected jury panel. Critical evidentiary issues, an exploration into both the world of damages from every perspective, and standard of care issues impacting designers and contractors in a world where clients' needs change at an ever-increasing pace, are the subject of other presentations.

To register for the program, call TREX at 877-309-1565. To request a brochure or download a registration form, see the Forum's website at: www.abnet.org/forums/construction/home.html

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