

Fidelity and Surety

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Appellate Court holds that Claims for Indemnification for Legal Fees Incurred in Underlying Lawsuits Begin to Accrue When the Legal Fees Begin to Accrue and Should Have Been Resolved in the Underlying Actions.

Roger P. Sauer and Thomas J. Sateary report on a recent New Jersey case in which contractual indemnity claims are barred under the State's infamous "entire controversy doctrine."

About the authors...

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Tom Sateary is the latest conscript into the firm's fidelity and surety group. To date, he seems to really like it.

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Quotes from the wildly popular television series, *The Sopranos* are, to residents of the Garden State, practically as near and dear as quotes from one of the State's favorite adopted sons, Yogi Berra.ⁱ Among those of us in the legal community, the following is considered particularly precious: Meadow [on explaining to her dad why she wants to be a civil rights lawyer]: "The State can crush the individual." Tony: "[You mean] New Jersey?" Well, yes. Charles Hoens, longtime icon of the surety field and mentor to one of your authors was wont to tenderly deride decisional law in various far flung jurisdictions as, "the law west of Pecos". Truth be told, however, New Jersey has its own arcane trap for the unwary, which bears the seemingly innocuous label, the "entire controversy doctrine".ⁱⁱ

IN THEORY

It all sounds so deliciously simple. So tantalizingly straightforward, rational and efficient. After all, even the Federal Rules of Civil Procedure contain provisions for mandatory counterclaims.ⁱⁱⁱ It has a salutary ring:

The ECD is an equitable preclusionary doctrine designed to encourage comprehensive and conclusive adjudications, promote judicial economy and efficiency, and achieve party fairness. It requires that, whenever possible, all claims that arise from the same transactional facts should be brought in one lawsuit."^{iv}

Who could possibly object to any of this?

However, note the breadth and/or sketchiness of some of the language. After all, what does "wherever possible" mean in application? And how far do we look for "all claims"? In multi-party litigation, does it mean any claim between or among two or more of the parties? And how about those not yet joined?

It is your authors' belief that the New Jersey ECD carries within itself inherent and unavoidable doctrinal conflicts that, ultimately, can never be resolved, but instead, of necessity, spawn (and have spawned) an endless shifting of the decisional fulcrum on a case by case basis. Under such circumstances, it is not surprising at all that a patchwork quilt of case law has developed over the years, sometimes with major shifts in appellate thinking.^v The adoption of an entirely new Court Rule in 1990, with Amendments in 1992 and 1998 basically just codified the chaos, rather than resolving it.^{vi}

In the most rational of all worlds, will it always make sense from the viewpoint of both the litigants and the Court, to cram every conceivable component of a given controversy into a single vessel? We think not. The ECD is fundamentally a two-dimensional view of the universe, where any component of the dispute occupies the same planar space as any other. Many disputes, however, are three-dimensional, or perhaps more accurately put, stratified. Holding subordinate questions in abeyance may often result in their never having to be reached. Forcing them to the surface, conversely, could result in having to decide issues which might otherwise fall to the wayside in the dynamic of dispute

resolution. In the end, a strict application of the ECD can backfire and engender more (or expanded) litigation, not less. Moreover, whether the doctrine works and accomplishes its goals can only be discerned in retrospect.

All of these concerns are underscored in what might be called the "subsidiary" claim. This is a situation where a given controversy generates sub-issues that might have to be, but don't necessarily have to be, decided in order to resolve the "main" claim. A good example of this syndrome would be the contractual indemnity claim, something of paramount and recurring importance to everyone in the surety field.^{vii} When a case with indemnity offshoots is underway, does/should the ECD require that the indemnity claims be resolved as well? *Salovaara v. Eckert*, a case decided within the past three months by the Appellate Division determines that the answer to this question is probably "yes".^{viii}

HOW IT ALL BEGAN

One of the earliest and most definitive statements of the New Jersey ECD was made by Justice William Brennan, then sitting on the New Jersey Supreme Court shortly before his appointment by President Eisenhower to the Supreme Court of the United States. The goal, he said, was, simply, to provide for "the just and expeditious determination in a single action of the ultimate merits of an entire controversy between litigants."^{ix}

Nearly a quarter of a century would pass before the real wakeup call. This occurred in *William Blanchard Co. v. Beach Concrete Co. Inc.*^x *Blanchard* was a multi-party controversy involving the construction of the New Jersey Blue Cross/Blue Shield building. As with so many complex construction disputes, it entailed a whole battery of potential claims, counterclaims, crossclaims, third and fourth party claims and all the rest. There was even the overlay of arbitration clauses in some contracts but not others. After war had been waged for approximately five years, the owner and the general contractor, who up to then had decided to present a "united front" to those suing them, as far as their claims *inter se* were concerned, now sought to amend and at last tackle those claims. Despite the parties' complete willingness to proceed one against another, both offensively and defensively, the trial court nonetheless refused the amendments, also holding that any subsequent litigation of them would be barred by the New Jersey EDC.^{xi} The Appellate Court affirmed. It appeared to do so on two bases: First, that the claims by the litigants one against the other were really against yet other litigants, as pass throughs, and, second, the unfair taxation of the "entire justice system".^{xii} A third ground, which the authors believe was textually erroneous, had to do with New Jersey's "mandatory counterclaim rule". The owner and the general contractor did not have counterclaims against one another. *Blanchard* instead created a mandatory crossclaim rule.

FROM CLAIMS TO PARTIES

In 1989, another plateau was reached. In *Cogdell v. Hospital Center at Orange*,^{xiii} two medical malpractice suits were started. In the first, the plaintiff brought an action against an emergency room physician in connection with the birth of a child born with cerebral palsy. When that case was lost, she instituted a second action against the hospital, the

members of the operating team, and several hospital administrators. None of these had been parties to the first lawsuit. While recognizing the difference between joinder of claims among those already parties and the joinder of extraneous individuals, together with a varied set of rules for each circumstance, the Supreme Court nonetheless perceived a "commonality of purposes in both the party joinder and claims joinder rules" so as to render both situations "conceptual subsets of the entire controversy doctrine."^{xiv}

In the end, however, ambivalence crept into *Cogdell*. Holding the bar of the ECD applicable, the Court nonetheless made the rule prospective only (two judges dissenting on this issue) and concluded its opinion by stating that, "the contours of this rule are not fixed precisely by this decision. Its contents and bounds can evolve with experience in the course of the exercise of this Court's regulatory authority over practice and procedure, either through formal rule making or case by case adjudications."^{xv}

Cogdell was followed in *Circle Chevrolet Company v. Giordano, Halleron and Ciesla*.^{xvi} The case concerned the application of the ECD to a malpractice action against an attorney who represented a client in the underlying transaction. Reasoning that the entire controversy doctrine "applies to constituent claims that arise during the pendency of the first action that were known to the litigant", the Court held that the legal malpractice claim should have been brought in the first suit.^{xvii}

Historically, *Circle Chevrolet* was the proverbial opening of the floodgates. For while its immediate impact was to preclude prosecution of the later asserted legal malpractice claim in that case, it effectively mandated the assertion of all such claims in the underlying litigation, anytime the competence of a lawyer could causally be called into question with the underlying events. Lawyers were getting sued left and right. Something had to be done.^{xviii}

Something was done. In 1998, the Rules were changed to take mandatory party joinder out of the entire controversy doctrine and instead place it under the provisions of R.4:5-1(b)(2) entitled, "notice of other actions and potentially liable persons".^{xix} As the comments to the Rule indicate, it permits not only the voluntary intervention by potentially interested parties, but also confers judicial authority to join additional litigants *sua sponte*. However, in retreat of earlier expressions of policy, we are told that, "ordinarily, the framing of the scope of the litigation, whose expense and duration is often a function of the number of parties is, in the usual course, best determined by the litigants and by those who are not litigants but who have a potential interest and are noticed of the action's pendency."^{xx} The pendulum had swung.

ON TO INDEMNITY

The seminal case in the indemnification arena occurred in *Harley Davidson Motor Company v. Advanced Die Casting Inc.*^{xxi} There, a rider who was injured in a motorcycle accident brought a products liability action against the motorcycle manufacturer, and the case settled. During the pendency of the personal injury litigation, Harley Davidson filed a declaratory judgment action against a parts supplier and its insurer. Harley claimed the

defective part was the real cause of the accident. In deciding the ECD applied, the Court held that at least as far as common law indemnification was concerned, claims for "upstream" indemnification would be within the doctrine.^{xxii} Without going any further, it also noted that there may be a "class of indemnity claims" which would not be subject to the entire controversy doctrine because they were not yet accrued. It is probably also noteworthy that the Supreme Court found the manufacturer's "vouching in" of the parts supplier (as opposed to formally joining it in the litigation) to have sufficed under ECD analysis.

Five years later, in *K-Land Corporation No. 28 v. Landis Sewerage Authority*,^{xxiii} the Court reiterated that "our interest in mandatory claim joinder should not be viewed as encouraging or requiring the filing of premature or unaccrued claims".^{xxiv} However, it was not until *Salovaara* that the question of contractual indemnity was squarely approached.

Although the case involves neither bonds nor a surety, many salient parallels exist. The plaintiff, Salovaara, and the defendant, Eckert, once co-workers at Goldman Sachs, left that firm in the early '90's to found a series of private investment funds. Plaintiff and defendant then had a parting of the ways, both literally and metaphorically, and their co-ventures cratered. Over twenty lawsuits followed. One of them was Salovaara's claims for indemnification of his legal expenses incurred in the underlying actions against both former partners. Evidently, there were partnership agreements that required, at a minimum, a written demand for indemnification before the right to sue would arise. The plaintiff argued that issue preclusion could not take place on an unaccrued cause of action, and because he sued promptly after making his written demand, his claim should not be barred.

The Appellate Court was unpersuaded. In disposing of Mr. Salovaara's arguments, it basically just reiterated the ancient cornerstones of the entire controversy doctrine: judicial economy, at least as it construed the concept, and unfairness to one of the litigants. It reasoned:

If Salovaara's argument were accepted, the trial judge would be faced with the task of reviewing, in depth, four separate lawsuits that are intertwined with a controversy that has lasted thirteen years and encompassed twenty-two separate actions in order to determine whether indemnification was appropriate, considering the specific factual circumstances of each case. This is exactly the type of predicament that the ECD was designed to prevent.

Requiring a single judge or jury to determine whether indemnification is appropriate in a potentially unlimited number of separate lawsuits is neither practical nor wise. Salovaara's argument, if accepted, would permit him to toll the accrual of his indemnification claims indefinitely, because he could have made a written demand anytime he chose.

...claims for contractual indemnification could be brought years after the underlying litigation is resolved. Such a result would be unfair to litigants and unduly burdensome on the judiciary.

The Court was thus satisfied that indemnification for legal expenses incurred in each of the underlying actions began to accrue when the legal fees began to accumulate and should have been resolved in those actions.^{xxv} The Court was also impressed with the fact that the plaintiff was (Heaven forbid) a law school graduate and hence "should have foreseen that indemnification for his legal expenses would be disputed."

To complicate things further, the waters are muddied by *McNally v. Providence Washington Insurance Company*.^{xxvi} This was an action against a prep school for alleged sexual molestation of a youngster by one of the faculty. The follow on suit was against the school's carrier. Citing what it perceived to be the Supreme Court's "obvious disinclination to draw clear lines between the kinds of indemnification claims which are accrued for entire controversy purposes and those which are not, the Court simply held, without specifying what they were, that there "exists a class of indemnification cases which will truly not have accrued until the conclusion of the underlying litigation and which therefore should escape the strictures of the entire controversy doctrine."^{xxvii} It held that this excludes joining insurers in tort cases or reinsurers in insurance coverage cases, but was otherwise non-prescriptive.

Of course, one can conjure up a host of hypotheticals that could, from a functional and practical point of view, justify suspension of the surety's actions to secure indemnity.^{xxviii} After all, the same friend/foe dualism that pervades the principal/surety relationship mirrors the very tensions and inconsistencies that are the hallmarks of the ECD. Ironically, strategic pragmatism in a performance bond suit often militates for the "united front" approach taken (and discredited) over thirty years ago in *Blanchard*. At the very least, however, the history of the case law over the past decades would seem to make this a very risky proposition. Presumably, no company wants to be the first one to spawn a full-blown reported preclusive opinion.^{xxix}

So, as you cross the Hudson or the Delaware into the Garden State^{xxx}, be careful. But under any circumstances, don't stop believing.^{xxxi}

Endnotes:

- i Although Berra was born in St. Louis, MO, he has lived with his wife in Montclair, NJ basically since his Yankee playing days.
- ii Our research discloses no other jurisdiction that follows New Jersey's approach, certainly not to the same degree.
- iii Rule 13(a) states that, "A pleading shall state as a Counterclaim any claim which at the time of serving the pleading the pleader has against any opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim and does not require for its adjudication the presence of third parties of whom the court cannot acquire jurisdiction. Conversely, paragraph (g) of the same Rule makes all Crossclaim permissive.
- iv *Harley Davidson Motor Co. Inc. v. Advanced Die Casting Inc.*, 150 N.J. 489 (1997), at 497.
- v Mandatory joinder of claims under the doctrine is undefined, it having been and remains still the Supreme Court's view that development of the substantive content of the doctrine is best left to case law. Rules governing the Courts of the State of New Jersey, Pressler Ed., comment to R.4:30A, at 1452.
- vi R.4:30A simply states that the "non joinder of claims required to be joined by the entire controversy doctrine shall result in the preclusion of the admitted claims to the extent required by the entire controversy doctrine..." A tautology. Although party, not claim, joinder was finally excised in the 1998 changes.
- vii Although the focus of this article is the pure contractual indemnity claim under a GIA in a surety setting, we believe that kindred, if not identical, principles would obtain in the fidelity setting, for example, looking to hold the malefactor ultimately responsible.
- viii This is only available as a Westlaw citation, 2007 WL 1436496. Ordinarily, your authors would not spend time on an (as yet) unreported opinion. However, we likewise recognize the significance of indemnity to sureties everywhere, and the fact remains that this is the only case that there is.
- ix *Ajamian v. Schlanger*, 14 N.J. 483 (1954), at 485.
- x 150 N.J. Super. 277 (App. Div. 1977).
- xi As the Appellate opinion aptly noted, invocation of the ECD was technically premature, because the application of the doctrine ordinarily has to await **subsequent** litigation, i.e., assertion of a claim in a lawsuit that follows one in which the ECD holds the claim should have been brought in the first place. 150 N.J. Super., at 298-299.
- xii 150 N.J., at 295.
- xiii 116 N.J. 7 (1989).
- xiv 116 NJ, at 7.
- xv 116 NJ, at 18.
- xvi 142 NJ 280 (1995).
- xvii 142 NJ, at 290.

- xviii Even before the Rule change, discussed below, the Supreme Court retrenched on its ruling that mandated lawyers to be sued sooner rather than later. *Olds v. Donnelly*, 150 NJ 424 (1997). *Circle Chevrolet's* reign of terror only lasted two years.
- xix The full text of the Rule reads as follows:
(2) Notice of Other Actions and Potentially Liable Persons. Each party shall include with the first pleading a certification as to whether the matter in controversy is the subject of any other action pending in any court or of a pending arbitration proceeding, or whether any other action or arbitration proceeding is contemplated; and, if so, the certification shall identify such actions and all parties thereto. Further, each party shall disclose in the certification the names of any non-party who should be joined in the action pursuant to R. 4:28 or who is subject to joinder pursuant to R. 4:29-1(b) because of potential liability to any party on the basis of the same transactional facts. Each party shall have a continuing obligation during the course of the litigation to file and serve on all other parties and with the court an amended certification if there is a change in the facts stated in the original certification. The court may require notice of the action to be given to any non-party whose name is disclosed in accordance with this rule or may compel joinder pursuant to R. 4:29-1(b). If a party fails to comply with its obligations under this rule, the court may impose an appropriate sanction including dismissal of a successive action against a party whose existence was not disclosed or the imposition on the noncomplying party of litigation expenses that could have been avoided by compliance with this rule. A successive action shall not, however, be dismissed for failure of compliance with this rule unless the failure of compliance was inexcusable and the right of the undisclosed party to defend the successive action has been substantially prejudiced by not having been identified in the prior action.
- xx Rules Governing the Courts of the State of New Jersey, Pressler Ed., Comment at 1060.
- xxi 150 NJ 489 (1997).
- xxii 150 NJ, at 497.
- xxiii 173 NJ 59 (2002).
- xxiv 173 NJ, at 74.
- xxv 2007 WL 1436496.
- xxvi 304 NJ Super. 83 (App. Div. 1977).
- xxvii 304 NJ Super., at 95.
- xxviii Particularly thorny is the interplay between a tender of defense, the ECD and RPC 1.7(b)(4). The latter precludes the principal's counsel from pressing a claim under the GIA, but the ECD may require it.
- xxix Feech LaManna (Robert Loggia): "It's all about setting precedent." *The Sopranos*, 1999 season.
- xxx While no case has expressly confronted the issue, at least one Federal opinion treats the New Jersey ECD as substantive under *Erie*. *Hulmes v. Honda Motor Company, LTD*, 924 F. Supp. 673 (CNJ 1996).
- xxxi Many GIA's contain a waiver of the ECD. No case has yet tested the enforceability of such a provision.