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Fidelity and Surety

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Roger Sauer heads up a group of six lawyers who practice in the fidelity and surety field at Lindabury, McCormick & Estabrook, Westfield, New Jersey. After a year of physical therapy, Roger is back to timbering his own property for firewood, which is what brought about the need for the therapy in the first place.

Although Paul Mazer has just started in the firm's fidelity and surety group, he has proved to be a quick study.

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U. S. District Court Holds That Surety's Payment Of Legal Bills In Partial Violation Of Its Own Billing Guidelines Can Be Used As Evidence Of Bad Faith To Help Defeat Indemnity Claim

By Roger P. Sauer and Paul H. Mazer

We in the surety field live in a doctrinaire world. As with Newton's view of the universe, we move about guided by certain immutable principles: equitable subrogation, exoneration and the rule of *strictissimi juris*. Nils Bohr's ineffable quantum mechanics and Heisenberg's uncertainty principle have no kin in the law of suretyship. Surely this could be nowhere more true than with recoveries against indemnitors.

Or is there a parallel universe into which we sometimes collide? After all, the industry has had decade after decade to armor plate the indemnity agreement against potential challenges or claims of ambiguity. The indemnity agreement has become a profoundly homogenized document. At the dawn of the twenty-first century, any one looks pretty much like any other. The mere payment by the surety establishes its own prima facie case, and to overcome it, the indemnitor has to show that there was actual bad faith. And, really, folks, when is there ever bad faith? For if the surety's spending of money, at best, entitles it to recover that very amount spent from someone else, no net benefit accrues in having spent it in the first place. So, acting in bad faith is stupid from the get-go. Conversely, were there to be actual fraud or criminality by the surety's agents (pretty unthinkable), there should be no right to recover. It's all very simple and straightforward.

Or is it? While we acknowledge that the case under review simply ordered that some discovery be taken, we believe it is, shall we say, non-Newtonian, to continue our metaphor. It is also perhaps noteworthy that the case comes out of an East Coast urban federal

jurisdiction (Philadelphia) from a judge¹ who has an absolutely impeccable professional pedigree and is even a product of one of the nation's finest business schools (Wharton). Nor is there anything particularly arcane about the opinion. In the main, it appears to be a fairly run of the mill indemnity case, although as far as we can tell, it is the only opinion available in general circulation dealing with the precise issue that it does.

In the seemingly endless struggle between surety companies and indemnitors over the things for which reimbursement is sought, a frequent point of contention is the obligation to reimburse the bonding company for its legal fees. After all, what person with his or her feet planted firmly on the ground wouldn't acknowledge that legal fees have a way of getting, let us say, out of hand. That is one of the reasons, as we all well know, that insurance companies universally adopted "billing guidelines" to try to keep things under control. Now, suppose that the claims professional had actually paid a legal bill that violated one of these guidelines, the one that said that, at most, only one partner and one associate should work on a given case². Is this potential evidence of "bad faith" that could be used to help defeat the surety's motion for summary judgment? The Court held that it is.³

The Court's reliance in *RLI Insurance Company v. Bennett Composites, Inc.*, on the Third Circuit's earlier opinion in the *Fallon Electric* case, is, we believe, a misnomer.⁴ *Fallon* focused upon the reasonableness/bad faith dichotomy and agreed unequivocally with authority elsewhere that when the parties contractually agree that good faith is the standard, undertaking a judicial determination of anything other than good faith is unwarranted.⁵ In contrast, no suggestion was made in the *RLI* case that the practices of the surety's lawyers were unreasonable, unfair, unnecessary or otherwise inappropriate. It was simply that they violated the letter of the surety client's billing

guidelines.⁶

It goes without saying that sureties and their indemnitors are structurally equipped to bargain for a standard of review delimited as they see fit. For example, nothing in theory would prevent the establishment of a pure "reasonableness" standard, as found so distinguishable by the *Fallon* Court. Of course, to even suggest such a standard bespeaks its own lack of workability. Sureties, after all, seldom occupy positions in default settings like those of their principals. Suretyship is a regulated industry, where the participants are subject to a host of governmentally imposed prescriptions that can bring harsh sanctions if they are violated. Because they almost invariably have deeper pockets than the companies they bond, the "go for broke" strategy is seldom in the picture for the surety, and costly compromises often have to be made. Allowing the indemnitors to second-guess the surety would hamstring the claims representative to the point of immobility. Anyone can be second-guessed. Just consider politics.

On the other hand, is the sky the limit? Of course not. At some point, the brakes of good faith get applied. They have to. After all, no one should be able to profit from "bad faith." Numerous examples of this safety valve run throughout the civil law. The "good faith" of the obligee in accepting a bond where the principal has made fraudulent inducements to the surety is necessary to the bond's continued enforceability⁷ To be a holder in due course of a negotiable instrument, one must take that instrument in "good faith."⁸

Fortunately, the authorities that follow (a sampling of many opinions) embody an appreciation of the nature of the good faith/bad faith dichotomy, and equally importantly, the laudable commercial functions it serves. However, even if one presses the point that the "correct" cases outnumber the "incorrect" cases by a considerable multiple, the moral of the story remains that everything may not be always as it

seems in the world of indemnity claims. *Semper vigilantis* has to be the watchword of the claims professional – as though he/she probably didn't know that anyway. "Love those billing guidelines!" might be another apt reaction in the wake of *RLI*.

The Connecticut Supreme Court in *PSE Consulting, Inc. v. Frank Mercede and Sons, Inc.*, rejected the test of reasonableness as a determination of bad faith, but held that a surety's failure to conduct an adequate investigation of a payment bond claim, in consideration of other evidence, may be considered as evidence as evidence of the surety's bad faith.⁹ The Court also held that a surety's self-interested settlement on a claim, when considered with other evidence, may constitute bad faith.¹⁰

In *Mountbatten Surety Company, Inc. v. Jenkins*, the district court rejected the Plaintiff's assertion that bad faith must be proven by clear and convincing standard applicable to the insurance industry.¹¹ The Court explained "[t]he usual view, grounded in commercial practice, [is] that suretyship is not insurance."¹² In utilizing the preponderance of the evidence standard for the surety matter, the Court held that the Plaintiff failed to establish that the Defendant acted with the "improper motive" and/or "dishonest purpose" required to establish a surety's bad faith.¹³

The Second District Appellate Court of Illinois explained that other Illinois courts have held that the good faith of a plaintiff-surety is presumed, absent an affirmative showing of fraud or bad faith. *Mountbatten Surety Company, Inc. v. Szabo Contracting, Inc.*¹⁴ After reviewing the parties' surety agreement, the Court concluded that the agreement vests the surety with the discretion to demand indemnity if it has a good-faith belief that it may be liable for payment on an underlying bond.¹⁵ In reliance upon other Illinois decisions, the Court held that the discretion granted a surety gives rise to the presumption that the plaintiff surety acted in

good faith unless the Plaintiff is able to demonstrate that the surety acted fraudulently or in bad faith in paying any of the claims filed pursuant to the bond.¹⁶

Even the Maryland Court of Appeals decision in the *Ulico* case,¹⁷ which received a great deal of industry press, came close. In it, the Court grappled with a distinction between "coverage" and "liability" on a payment bond in a subsequent effort to recover a claim payment from indemnitors. The "reasonableness" requirement, engrafted onto the indemnity agreement by the Court was said to only "filter the most egregious, careless, or inattentive conduct, short of fraud, of a surety; such as making a payment on a bond that a surety clearly knows or should know is not covered by the bond."¹⁸

In addition to doing legal research, we also conducted some empirical research. In an e-mail that we made as succinct as possible, we solicited the viewpoints of approximately twenty five well-respected surety claims representatives and counsel for their take on the *RLI* holding. Of course, the sample group was distinctly partisan, and the question was a very unloaded one. Not a few answered that things might depend, the only other two possible answers being "yes (agree with holding)" and "no (disagree)". This was understandable, as our brief inquiry theoretically allowed one to conjure up some horrific set of additional variables not put into the question as posed.

While we told people that no one would be quoted, almost everyone responded in such a thoughtful way that we can hopefully put down two of the answers without attribution to their authors and still remain within our own "good faith" standard. One of the most intellectually incisive read as follows, "no, I don't believe it's necessarily evidence of bad faith. Guidelines are just that -- guidelines -- and not some strict, inflexible set of rules.....Interesting, imaginative argument. I don't buy it." We felt this person had missed his/her calling and ought

to be a speech writer in the district. However, our unabashed favorite was this response, "The Court is nuts. Of course I would not agree."

General McAuliffe would be proud.

Endnotes

1. Interestingly, in a prior opinion in the same case, in dealing with a related issue, the Court appears to have "gotten it right," as it were.
2. In the matter under consideration, two partners (!) got involved, as did another law firm, although one can't tell the extent of that involvement.
3. *RLI Insurance Company v. Bennett Composites, Inc.*, 2006 WL 263627 (E.D.Pa. 2006).
4. *Id.*
5. *Fallon Elec. Co. v. Cincinnati Ins. Co.*, 121 F.3d 125, 129 (3rd Cir. 1997).
6. *RLI*, 2006 WL 263627 at *2.
7. Restatement Of Suretyship And Guarantee, §§ 12 (1), 12(2).
8. UCC § 3-302(a)(2).
9. *PSE Consulting, Inc. v. Frank Mercede and Sons, Inc.*, 267 Conn. 279, 311 (Conn. 2004).
10. *Id.* at 318.
11. *Mountbatten Surety Company, Inc. v. Jenkins*, 2004 WL 2297405 *6 (E.D. Pa 2004).
12. *Mountbatten*, 2004 WL 2297405 at *6 (quoting *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 140 n.19 (1962)).
13. *Mountbatten*, 2004 WL 2297405 *8.
14. *Mountbatten Surety Company, Inc. v. Szabo Contracting, Inc.*, 349 Ill. App.3d 857, 872 (Ill.App.Ct. 2004).
15. *Id.* at 873.
16. *Id.*
17. *Atlantic Contracting & Material Company, Inc. v. Ulico Casualty Company*, 844 A.2d 460 (Md. 2004).
18. 844 A.2d, at 477.