

Rhode Island HB 7766: Bad Faith in Probate Surety Bond

Description of the Bill and its Application to Surety Bonds

House Bill 7766 would create a cause of action for "any obligee, principal or claimant, under any fiduciary bond submitted or filed under a probate court order" to sue the surety on the bond for bad faith failure to pay or settle a claim. A surety bond is a three-party contract in which the surety guarantees that the principal obligor will perform its obligations to a third party, the obligee, and possibly other claimants. Under a probate bond, the principal is the executor or administrator of the estate or guardian of a ward. Rhode Island General Laws § 33-17-1 sets forth the conditions of the bond by which the surety guarantees the fiduciary's obligation to: (1) make and return to the probate court an inventory of the deceased's or ward's property; (2) administer the estate or manage the property of the ward in accordance with the law; (3) render an accounting; and (4) (in the case of an administrator or guardian) settle his or her account and pay over and deliver all property remaining in his or her hands. The surety guarantees the fiduciary's obligation, while the fiduciary remains primarily responsible for the obligation. Therefore, in the event of a default and payment by the surety, the surety can seek indemnification from the fiduciary.

Why Bad Faith Actions Are Inappropriate for Surety Claims

An insurance policy shifts the risk of loss to the insurer. The insurer is primarily obligated to pay any valid claim, and it has no recourse against the insured to recover its loss. The insurer handles the claim and pays with its own money. Under a surety bond, on the other hand, the surety is entitled to indemnity from the principal and pays with the principal's money. The principal, therefore, has a vital interest in resolution of the claim.

In a claim situation, the principal may insist that the surety should not pay the claim. Upon investigation, the surety often finds that there is a legitimate dispute between the principal and the claimant. If the surety pays the claim over the principal's objection, it effectively forecloses the principal's opportunity to assert its side of the dispute with the claimant. Moreover, a claim involving a probate bond can involve multiple claimants with legitimate disputes. In fact, the law provides the courts the discretion to waive bonds, and among the factors to consider are the number of possible claimants and the extent to which there appear to be issues or conflicts among the claimants. Presumably, a bond would not be waived in a situation where there are several potential claimants (heirs at law) who have issues or conflicts.

State legislatures have recognized that the claims handling process with respect to a surety bond is different. Claims handling and settlement practices statutes that regulate how a claim is to be handled routinely exempt the surety line of business. Notably, the Rhode Island statute that addresses unfair claims and settlement practices exempts surety. R.I. Stat § 27-9.1-1.

Insurance policies are typically contracts drafted by the insurer. Bonds are typically drafted or selected by the obligee, or in the case of a probate bond, approved by the court. R. I. Gen. Laws § 33-17-7. The one-sided contract and unequal bargaining power often encountered in insurance claims simply does not exist in the context of surety bonds. Court oversight of probate bond forms ensures that the bond terms are fair and in compliance with the law.

The factors that lead many states to impose bad faith damages on insurers do not apply to surety bonds. There is no unequal bargaining power. In recognition of this fact, most states that impose bad faith liability on insurers exempt surety bonds. In some states bad faith is imposed by court decision, and the exemption of surety is similarly articulated by the courts. For example, in *Cates Construction, Inc. v. Talbot Partners*, 980 P.2d 407 (Cal. 1999), the California Supreme Court stated that characteristics that are observed in insurance policies that justify the application of bad faith (unequal bargaining power) are not present with respect to surety bonds. In addition, if an insured under an insurance policy suffers a loss caused by some calamity, the insured has no source of protection other than the insurance policy. Under a surety bond, the obligee or claimant has recourse against the principal, who remains primarily liable.

In Pennsylvania, 42 Pa. Cons. Stat. Ann. §8371 provides remedies for bad faith by an insurer toward an insured. Courts in Pennsylvania have consistently held that there is no cause of action against a surety under section 8371. See, for example *Superior Precast, Inc. v. Safeco Ins. Co. of America*, 71 F. Supp.2d 438, 448-454 (E.D. Pa. 1999).

A surety is often caught in the middle of a dispute between its principal and the claimant. The principal will have to reimburse the surety and vehemently argues that the claim is not valid. The claimant equally vehemently argues that the principal owes it the amount claimed, the claim is valid and the claims of competing claimants are invalid. HB 7766 would force the surety to either pay the claim at the principal's expense or risk bad faith damages. If this bill becomes law, every surety claim in Rhode Island will include an automatic bad faith allegation. Even in cases where the surety ultimately prevails, the bad faith claim will add to the cost of handling the claim and any litigation. Most bonds are required by statute to serve a public purpose. The increased costs resulting from HB 7766 will ultimately fall on the public in the form of higher costs to the bond principal and the surety.

HB 7766 does not recognize that the bond principal is a party to the bond and primarily obligated to pay anything owed under the bond. The surety will be liable as a guarantor if the principal is unable to pay, but the primary obligation is the principal's. That is one of the fundamental differences between bonds and insurance policies, and one of the reasons other jurisdictions have refused to impose bad faith claims on sureties.