



SB 2229: Bad Faith in Surety Bond Claims

Description of the Bill and its Application to Surety Bonds

Rhode Island Senate Bill 2229 would create a cause of action for "any obligee, principal or claimant under any performance or payment bond" 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. Under a performance or payment bond, the principal is a construction contractor, and the surety guarantees that the contractor will complete the work and pay its obligations, and often the obligations of its subcontractors. The contractor, however, remains primarily liable, as the surety is a guarantor and is entitled to indemnity from the contractor for any payment.

Insurance Policies vs. Surety Bonds---A Comparison

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.

Insurance policies are typically contracts of adhesion drafted by the insurer. Bonds are typically drafted or selected by the obligee. The one-sided contract and unequal bargaining power often encountered in insurance claims simply does not exist in the context of surety bonds. As the party requiring the bond and mandating the form it will take, the obligee can include whatever rights it wants, including attorneys' fees or deadlines for payment of claims. Of course, if the obligee makes the terms too onerous, the principal and surety can refuse to provide the bond. Bonds are commercial contracts bargained for between commercial entities well able to protect themselves.

Why Bad Faith Actions Are Inappropriate for Surety Claims

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, contracts of adhesion or individual claimants unable to protect themselves. 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 at 980 P.2d 427:

A construction performance bond is not an insurance policy. Nor is it a contract otherwise marked by elements of adhesion, public interest or fiduciary responsibility, such that an extracontractual remedy is necessitated in the interests of social policy.

In *Great American Ins. Co. v. North Austin Municipal Utility District No. 1*, 908 S.W.2d 415, 418 (Tex. 1995), the Texas Supreme Court stated:

Second, concerns that a surety may take advantage of a bond obligee in the claims resolution process ignore the fundamental differences between a liability insurance contract and a surety bond. While a liability insurance contract involves only two parties, the insurer and the insured, suretyship involves a tripartite relationship between a surety, its principal, and the bond obligee, in which the obligation of the surety is intended to supplement an obligation of the principal owed to the bond obligee.

In states that mandate bad faith damages against insurers by statute, sureties are routinely exempted. For example, Section 624.155, Florida Statutes, grants a cause of action against an insurer for bad faith failure to pay, but it specifically exempts surety bonds. Subsection (9) states, "A surety issuing a payment or performance bond on the construction or maintenance of a building or roadway project is not an insurer for purposes of subsection (1)"

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 and the claim is valid. SB 2229 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 SB 2229 will ultimately fall on the public in the form of higher costs to the bond principal and the surety.

These higher costs will be passed on to the public. For example, R.I. Gen. Laws §§37-12-1, et seq. requires bonds from contractors on public works. Those contractors will include the cost of the bonds in their bids. If the contractor, as bond principal, and the surety have to pay to defend even invalid bad faith claims, those costs will increase.

SB 2229 does not recognize that the bond principal is a party to the bond and primarily obligated to pay anything owed under the bond. The bond principal, most commonly a construction contractor, will pay the costs and damages. 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.