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Alabama Federal Court Reinforces Surety's Completion Options Under Performance Bond

BY TODD R. BRAGGINS, ESQ.

A federal court in Alabama recently reinforced a surety's right to exercise its options under Paragraph 4 of an AIA A312 (1984) performance bond. In *Fidelity & Deposit Company of Maryland v. Jefferson County Commission*, 2010 U.S. Dist. LEXIS 129260 (Nov. 17, 2010 N.D. Ala.), the court discharged the surety from liability under the performance bond because the obligee materially breached the terms of the bond by refusing to allow the surety to complete the project work pursuant to Paragraph 4.2 of the bond.

The project owner and obligee, the Jefferson County Commission ("JCC"), contracted with Elevator Maintenance and Repair, Inc. ("EMR") for the installation of a new elevator system at the Bessemer Courthouse ("Project"). Plaintiff Fidelity & Deposit Company of Maryland ("F&D") issued payment and performance bonds on behalf of its principal, EMR. Shortly after construction

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Conclusory, Unsubstantiated Allegations Insufficient to Defeat Surety's Right to Indemnity

BY THOMAS K. O'GARA, ESQ.

Courts continue to require Indemnitors to submit credible evidence to defeat a surety's right to indemnity. Conclusory allegations of surety misconduct are deemed insufficient to defeat unambiguous language in an indemnity agreement. Recently, in *International Fidelity Insurance Company v. Moller & Moller, Inc., et al.*, this office was able to obtain a judgment for the Surety, despite the various defenses asserted by the Indemnitors. The Court held that the Surety was entitled to recover all of its bond losses and expenses because it could demonstrate that its payments were made in good faith and in compliance with the terms of the Indemnity Agreement.

This indemnity action arose after the bonded Principal was declared in default and the Owner made a demand on the Surety to complete the remainder of the Principal's work. At the request and recommendation of the Principal, the Surety hired a Completion Contractor to complete the Principal's remaining scope of work. At all times, the Principal was apprised of the substance of the negotiations between the Surety and the Completion Contractor. The Surety also utilized the services of an engineering consultant to advise and review the completion contract and remaining scope of work.

In addition to the Owner's performance bond claim, an unpaid Subcontractor to the Principal asserted a payment bond claim against the Surety. The Subcontractor commenced a lawsuit against both the Surety and Principal seeking full payment. While the Indemnitors alleged that they requested a tender of the Surety's defense, the Indemnitors failed to post the requisite collateral security equal to the amount of the claim, as required by the Indemnity Agreement. The Surety was consequently forced to defend itself in this action and, after discovery, the Surety settled with the Subcontractor.

The Surety later commenced an action against the Indemnitors seeking to recover all costs and expenses associated with the two claims mentioned above, including associated attorneys' and consultants' fees. The Surety moved for summary judgment and, in response, the Indemnitors raised various defenses. Principally, the Indemnitors alleged that their signatures on the Indemnity Agreement were not authentic, the Surety's claims were time barred and the Surety made payments voluntarily and in bad faith.

In reviewing the proof submitted by the Surety and the Indemnitors, the Court found that the Surety met its prima facie burden of proof by submitting a claim abstract, along with detailed affidavits explaining payments made and the circumstances surrounding each

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began, JCC experienced problems with EMR's performance, principally with scheduling delays and shop drawing deficiencies. After failing to address the concerns of JCC, EMR was terminated. JCC then demanded that F&D complete EMR's scope of work pursuant to F&D's performance bond ("Bond") obligations.

In response, F&D first looked toward EMR to complete the remaining work, pursuant to Paragraph 4.1 of the Bond, which requires the consent of the obligee. JCC rejected this option because it did not want EMR to complete the work. F&D then proposed to proceed pursuant to Paragraph 4.2 of the Bond, agreeing to undertake and complete the contract through a Takeover Agreement whereby F&D would engage W. G. Yates & Sons, Construction Company ("Yates") to act as general contractor for completion of the work. JCC rejected this proposal as an "unacceptable proposition" because it believed that Yates intended to use EMR as a subcontractor. Thereafter, JCC retained Mowery Elevator Company ("Mowery") to complete EMR's work.

F&D commenced an action seeking a declaratory judgment that JCC's refusal to permit F&D to complete the project was a material breach of the Bond, thereby relieving F&D from any duties or obligations under the Bond. JCC, citing allegedly contradictory provisions in the bonded contract, maintained that it was within its contractual rights to retain Mowery and complete EMR's work.

The court initially found the language of Paragraph 4 of the Bond to be unambiguous and acknowledged JCC's right to object to F&D's use of EMR to complete the work pursuant to Paragraph 4.1. However, the court concluded that in contrast to Paragraphs 4.1 and 4.3, both of which explicitly require the obligee's consent as to the completion contractor, Paragraph 4.2 does not require the obligee's consent. "By its express terms, Paragraph 4.2 places no restrictions on whom F&D can use to complete the project." Therefore, JCC's failure to allow F&D to proceed pursuant to Paragraph 4.2 of the Bond was a breach of the Bond terms.

The court went on to reject JCC's argument, finding that the default provisions of the Bond and the termination provisions of the bonded contract were not inconsistent. Instead, the court noted the bonded contract's language gave JCC the right to complete the work upon a termination for cause "*subject to any prior rights of the surety.*" The court then concluded that the surety's "prior rights" included the right to take over the Project and assume EMR's contractual obligation pursuant to Paragraph 4.2 of the Bond:

> Although the JCC may have had the right under the construction contract to hire Mowery to complete the project, it did not have the right to do it without first allowing F&D to exercise its rights under the Performance Bond. One of the express terms in the Bond was to accept a takeover by F&D, if that was the remedy chosen by F&D in the case of default by EMR. When the JCC did not accept the takeover agreement and instead went outside the terms of the bond (and construction contract) and hired its own contractor to complete the Project, the JCC breached the terms of the bond. As such, it is not entitled to relief under the Bond.

This decision serves as a reminder that in instances where the principal represents the most efficient and cost-effective means to complete the work, a recalcitrant obligee does not hold all the cards. F&D

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payment. The burden then shifted to the Indemnitors to establish their defenses.

The Indemnitors first claimed that their signatures on the Indemnity Agreement were forged. However, the signatures were notarized, creating a presumption that the signatures were authentic and the Indemnity Agreement was duly executed. In making this allegation, Indemnitors did not submit any supporting factual or documentary evidence, but rather relied solely upon mere conclusionary statements that the signatures were not genuine. The Court rejected this argument, holding that without more proof, bare, self-serving affidavits are insufficient to rebut the presumption of validity created by a notarized signature.

The Indemnitors next alleged that the Surety's claim was barred by New York's six-year statute of limitations for claims of indemnity. The claim abstract submitted by the Surety detailed every payment the Surety made in discharge of its bond obligations. Some of these payments were made more than six years from the date the lawsuit was commenced. However, the Surety was able to demonstrate that the payments made more than six years from commencement were credited to the account of the Indemnitors by virtue of the remaining contract funds the Surety recovered from the Owner. The Court noted that these amounts, paid more than six years from the date of commencement, would have been untimely, but since the Surety was not seeking to recover such sums in this action, none of the Surety's claims were time-barred.

Finally, the Court dismissed Indemnitors' allegation that the Surety's payments were voluntary and made in bad faith. The Court noted that the Surety was acting under its obligations under the bonds and its actions fully complied with the terms of the Indemnity Agreement. The Indemnitors' claim of bad faith was based upon the Surety's

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When in Doubt, Don't Throw it Out: Spoliation of Evidence

BY THOMAS K. O'GARA, ESQ.

Courts in New York, and around the country, have levied stiff penalties against parties who intentionally or negligently destroy documents or property when litigation is pending or imminent. Pursuant to a theory of spoliation of evidence, Ernstrom & Dreste, LLP recently obtained a dismissal of claims on behalf of a Contractor who was sued for property damages after it allegedly struck the underground wires/cables of a utility company.

The Contractor was performing excavation work on the Project. Before commencing any excavations, the Contractor called DigSafeNY to have all relevant utility lines marked. However, when Contractor began its work, utility lines were marked for location only, not depth. (There was some dispute as to whether the utility lines were properly marked). The Utility Company alleged that its underground wires/cable and conduit were hit during the excavation. Some of the Utility Company's customers temporarily lost service and repairs were quickly made. Months later, the Utility Company determined that the repaired wires/cables needed to be completely replaced.

After completion of the Project, the Utility Company commenced an action against Contractor to recover the costs associated with the replacement of the Utility Company's underground facilities. However, after replacing the underground facilities, the Utility Company disposed of the allegedly damaged material without giving Contractor, or its representative, an opportunity to inspect the damage.

Approximately one year after the lawsuit was commenced, it was learned that Utility Company no longer was in possession of the damaged and replaced facilities. This office brought a motion seeking to dismiss Utility Company's claims based upon spoliation of evidence.

Ernstrom & Dreste, LLP argued that without an opportunity to inspect the damaged wires/cables, Contractor had no ability to determine the condition of the wires/cables at the time of the accident and, if the facilities were actually damaged, the extent of any damage. In addition, without an examination of the facilities, Contractor argued that it was impossible to assess the reasonableness of the damages incurred by Utility Company. Furthermore, it was argued that storing the allegedly damaged wires/cables would have been relatively easy, as they could have been placed in a warehouse or stored outside with appropriate protection. As a result, this office argued, the Contractor was severely prejudiced due to its inability to inspect the destroyed materials.

In response, Utility Company offered no explanation for the destruction of the wires/cables, but argued that an inspection was unnecessary because any information the Contractor was seeking about the damaged facilities or replacement process could be obtained through documents or the testimony of witnesses. With this information, the Contractor would allegedly suffer no prejudice from its inability to inspect the subject facilities. The Utility Company further argued that an inspection of the wires/cables was unnecessary because the facilities were damaged so severely that permanent repairs were not viable. However, the only evidence in support of this theory was the assurances made by the Utility Company's own employees.

In dismissing the Utility Company's claims, the Court determined that "[t]he integrity of our judicial system depends on the ability of litigants to locate and identify relevant proof without fear that the truth-seeking process will be thwarted by spoliation of evidence," and that the allegedly damaged facilities were the "most eloquent impartial witness" to what actually happened and the damages sought. Further, without an inspection of the evidence, the Contractor could not properly defend itself, because it would be forced to accept the Utility Company's conclusions about the allegedly damaged material. Also, photographs and other circumstantial evidence did not negate the Contractor's right to have its own expert examine the physical evidence.

While this decision is being appealed, it does follow the national trend of courts imposing penalties on those who destroy documents or other evidence relevant to a lawsuit. One federal court in Maryland recently determined that a party's spoliation of documents not only warranted partial summary judgment for the other party, but civil contempt resulting in jail time for the spoliators! *Victor Stanley, Inc. v. Creative Pipe, Inc.*, 269 F.R.D. 497 (D. Md. 2010). The court later substituted jail time with the obligation to pay the other party's attorneys' fees totaling $337,796.37.

The extent of the party's spoliation in *Victor Stanley* was severe. The party intentionally delayed its document production, deleted electronic documents on the eve of scheduled discovery, failed to preserve an external hard drive and did not have a litigation hold on any of its documents. The court did not accept the party's argument that its spoliation of evidence was negligent. Instead, while acknowledging the severity of its decision, the court reminded all attorneys of the duty to speak with their clients concerning document preservation.

The message of these court decisions is clear: preserve **all** potentially relevant evidence, physical and electronic, whether litigation is pending, anticipated or even just being considered. If there is any doubt as to whether anything is relevant, or may become relevant, make sure to preserve and save it. E&D

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failure to tender to the Indemnitors its defense in the Subcontractor's payment bond action and Surety's payment of more money than it should have to settle the lawsuit and complete the Project.

The Court proclaimed that a surety acts in good faith if it "pays the claims in the honest belief that it was liable for such claims." *John Deere Ins. Co. v. GBA/Alasia Corp.*, 57A.D.3d 620, 621 (2d Dep't 2008). The proof submitted by the Surety established that it only made payments after its investigation revealed that such claims had merit. Further, the Surety was able to submit proof regarding the circumstances of each payment and its efforts to communicate with Indemnitors regarding the same.

In sum, the Surety was able to present well-documented evidence to support its entitlement to summary judgment as a matter of law. To the contrary, the Indemnitors' claims were only supported by self-serving statements, which were not documented or otherwise capable of verification. This case serves as a reminder of the importance to adequately document the facts and circumstances surrounding bond each expenditure. Detailed documentation will go a long way should litigation become necessary. E&D