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SURETY BONDS AND INDEMNITY AGREEMENTS: ARE YOU STILL "ON THE HOOK"?

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It has been a long and fruitful fifty years, and Owen Owner of Construction Company Partners is ready to retire. Owen wants to sell his ownership interest in the company to his partners, but he is concerned about the indemnity agreements he and his partners signed in connection with the payment and performance bonds issued by their surety. Under the terms of the agreements, the liability of the partners as indemnitors is joint and several. Owen wonders whether he will still be liable on those agreements after he leaves the company.

First a little background.

There are many different types of bonds issued by a surety. In the construction context, there are three common types of bonds: (1) Bid bonds (which protect an owner if the chosen bidder fails to honor its bid); (2) Performance bonds (which protect an owner against failure by the contractor to fully and faithfully perform its obligations under the contract); and (3) Payment bonds (which protect subcontractors and labor and material providers against the contractor's failure to pay for labor and materials). The cost of the bond premiums is typically passed on to the owner as part of the cost of construction.

A surety bond is a written instrument based upon a three-party relationship. One party, the "principal," obtains the bond from the surety; the second party, in connection with performing or satisfying an underlying agreement with a third party, the "obligee." The surety binds itself to make payment to the obligee in the event the principal does not perform the primary agreement. A surety bond often provides for joint and several liability between the principal and the surety; thus, a claimant may seek recovery from either the principal, the surety, or both.

In the event of a default, the surety is generally obligated to step in and pay for the actual loss, up to the limit of liability set forth in the bond—the bond "penalty"—and, at the same time, the surety becomes subrogated to the rights and defenses of the owner-obligee, the claimants (*i.e.* any third-party beneficiaries under the bonds), and the principal. Unlike an insurer, which protects its insured against an unforeseen event and expects to pay its insured for a covered loss, a surety guarantees the performance of a known event and expects to be indemnified for its loss.

The surety's expectation is met through a written indemnity agreement executed by the principal and the individuals who control it and is part of the consideration for the bond. The written indemnity agreement includes the surety's rights under common law (*i.e.* exoneration, *quia timet*, indemnity, and contribution), as well as rights that go beyond those available at common law.

The core of the indemnity agreement is the provision under which the principal and indemnitors expressly agree to indemnify the surety for any losses. Although the specifics of any indemnity agreement are controlling, the following Model Agreement of Indemnity developed by the Fidelity and Surety Committee of the International Association of Insurance Counsel is illustrative:

> The Undersigned shall indemnify and keep indemnified the Company against any and all liability, loss and expense of whatsoever kind or nature, including, but not limited to, court costs, attorney's fees, and interest, which the

Company may sustain or incur (i) by reason of having executed or procured execution of any Bond or Bonds as surety for any of the Undersigned, (ii) by reason of the failure of the Undersigned to perform or comply with this Agreement, or (iii) to enforce any of the covenants and conditions of this Agreement.

Project Update 1995: Illustrative Provisions of a General Indemnity Agreement Taken in Connection with Contract Surety Bonds, 62 Defense Counsel Journal 259, 261 (1995).

Indemnification provisions are generally enforceable unless the surety has paid a claim in bad faith. Absent bad faith -- which is very difficult to prove -- the surety must be indemnified under such provisions and does not have to establish that its principal was liable for the claim paid. As stated by one court, “This agreement [does] not require [the surety] to be correct in its payment of claims, only to make them in good faith.” *Transamerica Ins. Co. v. H.V.A.C. Contractors, Inc.*, 857 F.Supp. 969, 974 (N.D.Ga. 1994).

And now back to Owen Owner:

Owen is still wondering about his liability under the indemnity agreements. So he drops in on the company attorney. “What can you tell me?” he asks.

The attorney first emphasizes that courts generally uphold indemnity agreements and enforce the surety’s right to indemnification. Fortunately for Owen, however, the agreements entered into by his company and the surety provide that any indemnitor is liable only with respect to bonds issued prior to the termination of that indemnitor’s involvement as an indemnitor. The indemnitor will not be liable for losses incurred pursuant to bonds issued after the indemnitor provides notice to the surety that he or she will no longer be an indemnitor.

The Model General Agreement of Indemnity provides that any one of the indemnitors may terminate the agreement “upon twenty days written notice” to the surety, but “such notice of termination shall operate only with respect to those of the Undersigned upon whose behalf such notice of termination shall have been given.” *See The Agreement of Indemnity, Practical Applications by the Surety* 289-90 (Tort & Insurance Practice Section, American Bar Association 1989).

Therefore, the attorney tells Owen that when he knows the date of his retirement, he should notify the surety that he is off the risk. Owen must prospectively cancel his obligation to the surety under the indemnity agreement. The remaining partners should also contact the surety to let the surety know what is going on. Keeping the surety apprised of current events is just good business.

Owen breathes a sigh of relief, at least with respect to the post-termination bonds. But what about potential liability for those pre-termination bonds? Well, Owen had the foresight to include in the partnership agreement a provision that the remaining partners would indemnify him for any and all obligations owed to the surety under the indemnity agreements.

Suppose, however, that Owen did not have the foresight to enter into such an agreement. That means Owen is on the hook for any money he has to pay out pursuant to his obligations under any pre-termination bonds. Owen could ask the remaining partners for a novation that would completely remove him from any liability on the pre-termination bonds. The partners might be more receptive to such a request if Owen agrees to a short-term consulting contract with the remaining partners, let’s say two years.

It is important to distinguish between any obligations owed by the partnership to the surety and any agreements among the partners to indemnify a retiring partner for those obligations. If the partnership has agreed to indemnify Owen for his share of the partnership’s obligations to the surety, Owen will not have to look to his personal pocket. But, absent such an agreement or a novation, Owen will not only be liable to the surety, but will have to pay that liability himself.

However, regardless of any agreements reached between Owen and his partners, the indemnity agreement between the partnership and the surety remains in effect. Therefore, it probably will not matter to the surety what kind of arrangement is made among the partners. If Owen and his partners cannot reach an agreement, the partnership may be adversely affected, but the surety is not at risk.

Owen may be out of the woods with respect to his potential obligations to the surety, but the company attorney has to be careful not to violate any ethical canons when giving advice to Owen. The departure of Owen and his consequent termination as indemnitor may have an impact on the creditworthiness of the company. Has a conflict of interest now arisen between the Owen and the company? If so, can the attorney still represent both the company and Owen?

As explained by one court:

> Where the interests of the two parties are in some manner antagonistic to one another, before any lawyer is authorized to assume dual representation (or continue if the adversity appears after he has been retained), he must first satisfy himself that there is no objective reason why he cannot, despite such divergence of interest, faithfully represent them both. If this cannot be met, the lawyer should not accept employment in the first place (or terminate it, if begun). Secondly, even if the lawyer reasonably (and from an objective point of view) believes he can faithfully represent dual parties with adverse interests, he still must fully explain all implications of the advantages as well as the risks of his representation to both parties, and assure himself that they both have given knowing and informed consent.

Hartford Acc. & Indem. Co. v. Foster, 528 So.2d 255, 268 (Miss. 1988).

In conclusion, counsel to construction companies—particularly small partnerships—may want to advise their clients of these issues before they arise rather than after someone wants to leave the company.

AIA STANDARD AGREEMENTS AND COPYRIGHT INFRINGEMENT

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Attorneys and their clients need to be aware of potential copyright infringement when using American Institute of Architect (AIA) agreement forms. AIA documents can be obtained in paper or electronic form.

The electronic forms consist of 3 disks that are downloaded onto your computer's hard drive. The forms will work only through their own AIA software, which runs under Windows. The forms are not compatible with either Word Perfect or Word. The AIA software does not permit saving the contract in other file formats. Thus, in order to maintain access to the contracts you have prepared, you must pay a yearly license fee.

If you are frustrated because you are no longer able to access documents on your computer, it is probably due to the expiration of your license. The software automatically stops access every January unless you pay for, receive and install AIA's yearly software.

AIA acknowledges two goals by limiting access to its form contracts only through its proprietary software. First, and most obvious, the limited access encourages users to renew their yearly license to AIA's service. Second, it keeps users of these materials up to date on changes made to the form documents by the AIA.

For those who prefer the 1987 version of the B141 and A201, there will be no issuance of a license to use the old forms. The last time computer access was available to the 1987 versions of these forms was the 1998 license. It is the intent of the AIA to totally remove usage of these older forms.

Users who have scanned obsolete versions of the AIA contracts into their computer need to be aware that no license is available to use those old contracts. It is the AIA's position that usage of the 1987 (and earlier) B141 and A201 and other form contracts is an infringement of the relevant copyrights.

If you are interested in obtaining AIA documents on electronic format, they can be ordered at 1-800-246-5030. Paper forms can be obtained from your local AIA office. In Portland the number is 503-223-8757.

FEDERAL MILLER ACT UPDATE

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In late 1999, the US Congress adopted a number of revisions to the federal Miller Act. The first significant revision is that waivers of bond claim rights are void unless they are: (1) In writing; (2) Signed by the person waiving his rights; and (3) Executed <u>after</u> the potential claimant has begun work on the project. In other words, anticipatory bond right waivers are generally not enforceable.

The second significant revision is that the required notice of claim may now be sent via "any means which provides written, third-party verification of delivery." Previously, the notice could be served only by <u>registered</u> mail.

Now, Miller Act notices may be sent by any means that permits independent, third-party verification. This could be registered or certified mail, return receipt requested, FedEx or even by certain e-mail services. In any event, the notice still must be sent to the prime contractor at any place it maintains an office or conducts its business or to its residence.

Finally, remember the Federal Acquisition Streamlining Act of 1994, which states that the Miller Act does <u>not</u> apply to federal acquisitions under $100,000. Thus, if the total contract price is under $100,000, there <u>may</u> be no bond on the project. Counsel should advise their clients to always actually obtain a copy of the bond, or establish that there is no bond, before even filing a bid on any project.

ORS 87.057 MEANS WHAT IT SAYS

In a recent decision by the Marion County Circuit Court, a construction lien claimant who prevailed on the validity and foreclosure of its lien nevertheless was denied attorney fees because it had failed to plead and prove compliance with ORS 87.057(2). ORS 87.057(3) provides:

> A plaintiff or cross-complainant seeking to foreclose a lien in a suit to foreclose shall *plead and prove* compliance with subsections (1) and (2) of this section. No costs, disbursements or attorney fees otherwise allowable as provided by ORS 87.060 shall be allowed to any party failing to comply with the provisions of this section. (Emphasis added)

The unambiguous language of the statute places the burden of both pleading and presenting evidence of compliance with <u>each</u> of the subsections squarely on the lien claimant. The Marion County Circuit Court declined the lien claimant's post-trial invitation to treat non-compliance as an affirmative defense.

It should be noted that the form complaint for foreclosure of a construction lien appended to Chapter 14 of **2 Construction Law** (Oregon CLE 1989) does <u>not</u> include an allegation of compliance with ORS 87.057(2). It does, however, allege that the notice of intent to foreclose required by ORS 87.057(1) was sent.

A conclusory allegation such as "Plaintiff has fully complied with all other obligations of ORS 87.057(1) and (2)" should suffice (added to Paragraph 9 of the CLE form complaint) <u>unless</u> the lien claimant received a demand for information pursuant to ORS 87.057(2). In that situation, a more specific allegation of a timely response to the demand would be advisable.

Also, if you are representing a construction lien claimant at trial, remember to include proof of compliance with ORS 87.057(1) and (2) in your case in chief and again (after you win on the merits) in support of your attorney fee application.

It is likely that the Marion County case will be appealed. Keep watching the advance sheets.

OREGON CASE LAW UPDATE 2000

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During the year 2000, the Oregon Court of Appeals issued five opinions directly dealing with issues of construction law. This article briefly summarizes the rulings in these cases.

<u>Parthenon Const. & Design, Inc. v. Newman</u>, 166 Or.App. 172, 999 P.2d 1169 (2000)

This case involved a construction contractor who brought suit against the owner for breach of contract and lien foreclosure. (The contractor also brought a claim for specific performance for conveyance of real property but that portion of the opinion is not summarized here.) The contractor's claims were dismissed at the trial court level because the contractor did not maintain continuous registration with the Construction Contractors Board during the course of the project.

The contractor's registration lapsed for one 16-day period during 1994 and for one 49-day period during 1995. The contractor argued that ORS 701.065 only barred it from recovering sums incurred during the actual period of time in which it was unregistered. Alternatively, the contractor argued that it substantially complied with the registration requirements and therefore could recover for all its work on the project.

The Court of Appeals rejected the contractor's first argument by holding that the term "work" in ORS 701.065 means "the contractor's entire performance as defined by the parties' agreement." 166 Or.App. at 179. The Court of Appeals also rejected the contractor's substantial compliance argument, refusing to judicially import such a qualification into the statute.

The Court went on to say that even if substantial compliance could be read into the statute, the contractor's direct non-compliance with the statute could not be termed as substantial compliance. Accordingly, the Court of Appeals upheld the trial court and refused the contractor payment for any of its services because of its lapses in registration.

The discussion in the Court's opinion demonstrates a very strict rule that if the contractor is not continuously registered during a project, it cannot recover any payment, even if that lapse in registration lasted for just one day.

<u>International Broth. Of Elec. Workers Local No. 48 v. Oregon Steel Mills, Inc.</u>, 168 Or.App. 101, 5 P.3d 1122 (2000).

An electrical workers' union, trustees of the union trust fund for an employee benefit plan, and the collection agent for union administrative funds for an employee benefit plan recorded a lien and sought to foreclose it in Multnomah County Circuit Court. The trial court granted the owner's motion to dismiss for failure to state a claim, holding plaintiffs lacked standing to bring a lien claim under ORS 87.010(1) and that ERISA preempted a lien under ORS 87.010(4).

The Court of Appeals upheld the trial court with regard to ORS 87.010(1), holding that the union and the collection agent didn't have standing to record and foreclose a lien on someone else's behalf. The Court held that the trustees did not have standing because they were expressly given a lien right under ORS 87.010(4). The Court reversed the trial court on the preemption issue, finding that ERISA does not preempt ORS 87.010(4).

<u>George v. Myers</u>, 169 Or.App. 472 (2000).

A framing subcontractor's employee fell from the third story of a house while attempting to move a banded bundle of boards that was impeding framing on an exterior wall. Plaintiff brought suit against the landowner, who was also the general contractor, alleging violation of the Employer Liability Act (ELA), and for common law and per se negligence. Defendant obtained summary judgment at the trial court level.

The Court of Appeals affirmed. It held the ELA did not apply because defendant did not meet any of the three requirements for an "indirect employer": common enterprise, retained control or actual control. Specifically, the Court found defendant was not involved in moving the bundle, did not provide defective equipment that caused the injury, did not control the method or manner of plaintiff's performance and the subcontractor alone determined how to move the bundle.

The Court held that OSHA and OSEA standards in this context did not exceed the requirements under the federal Construction Safety Act (CSA) and thus a general contractor is not an employer and therefore not subject to negligence per se liability. The Court also held that OSEA does not extend its coverage to indirect employers.

Finally, the Court held that defendant owed plaintiff no duty of care to provide fall protection because the subcontractor was hired for its specialized expertise in framing and there was no evidence that defendant had any knowledge or expertise regarding appropriate fall protection in framing multi-story houses.

Coats v. ODOT, 170 Or.App. 32 (2000).

ODOT appealed from a grant of summary judgment on a breach of contract claim in favor of Coats. Coats entered into a contract with ODOT for construction of a portion of highway. Coats owned a ranch about 10 miles away and used rock from a quarry on the ranch in the construction. ODOT withheld a $100,000 payment under the contract, claiming that Coats failed to pay the prevailing wage rate to workers at the quarry.

Coats sued for breach of contract and obtained summary judgment at the trial level. ODOT also moved for summary judgment claiming that the failure to pay the prevailing wage rate breached the contract. The trial court determined that Coats did not have to pay the prevailing wage rate to quarry workers because the quarry had been established before plaintiff bid on the contract and because the quarry was not an "on site" quarry. The trial court granted Coats summary judgment.

The Court of Appeals, although it disagreed with the trial court, affirmed the judgment. The Court held that prevailing wages must be paid to "workers upon all public works." The Court also held that a quarry 8-10 miles away could not be considered "upon" a public work and therefore the prevailing wage rate statute was inapplicable.

Associated Builders and Contractors v. Tri-Met, 170 Or.App. 271 (2000).

Tri-Met issued a decision exempting from competitive bidding the contract to construct a light-rail extension to the Portland Airport. ABC, a trade association for non-union contractors, sought to overturn this decision. The trial court ruled in favor of Tri-Met. ABC appealed the ruling on the merits and Tri-Met and Bechtel appealed claiming ABC did not have standing.

The Court of Appeals upheld the trial court. The Court examined the legislative history of the relevant statutes and found that ABC qualified as a "person" for purposes of ORS 279.019(3) and therefore had standing to bring the action. The Court also held that, in deciding whether to exempt the general contract with Bechtel from competitive bidding, Tri-Met was not required to consider alternative contracting methods or the effect on subcontractors who wanted to work on the project.

I am always looking for additional material for this column. If you have a unique take on an Oregon case or find a ruling from another jurisdiction or a trial court that you think is particularly interesting, please contact W. Frank Elsasser at (503)-228-2525 and let me know.

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