

## CAREFULLY CONSIDER A SURETY'S INDEMNITY AGREEMENT

By R. Carson Fisk (as seen in *Texas Construction* March 2010)

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To paraphrase a valued client, "A contractor without a bond really isn't a contractor." Bonds certainly allow for the performance of governmental work and opportunities for private work. A payment bond is intended to ensure payment to subcontractors and suppliers. A performance bond generally guarantees the completion of a contract if a contractor defaults.

To do so, a contractor must deal with a surety. The surety will almost certainly require the contractor to sign some form of indemnity agreement to encourage the surety to issue bonds and protect the surety from losses or expenses. It is entirely possible, and perhaps probable, that the surety will require that entities affiliated with the contractor also sign the indemnity agreement. Anyone signing the agreement will be separately responsible for indemnifying the surety.

If a project has reached a point where a surety gets involved, the problems are likely severe. Often the obligee on a bond (owner, subcontractor or supplier) will make a claim on a bond and the principal (the contractor) will dispute the claim. For example, an owner may claim that a contractor has defaulted under a contract by performing defective work and that the surety must complete construction under the performance bond. The contractor may take the position that there was no default and that problems arose from the owner providing inferior design documents. In addressing a bond claim, the surety decides whether to complete construction under a performance bond or issue payments under a payment bond. If it decides to complete construction or pay a bond claimant, it will seek reimbursement from any party having signed the indemnity agreement.

Despite potentially significant losses, few contractors take the time to review an indemnity agreement. If significant problems arise on a bonded project that cannot be resolved, the indemnity agreement will play a critical role in what almost assuredly will be a costly dispute. Any surety engaging in legal action against the contractor will have a well-developed body of law that strongly favors the surety and a contractor has few viable defenses to a surety's claim for indemnity.

A contractor, and anyone else signing the indemnity agreement, is responsible for indemnifying the surety even if it is ultimately determined there was no liability on the underlying claim. The surety does not owe the contractor any implied duty of good faith and fair dealing. Any such must be expressly included in the indemnity agreement. Generally, the reasonableness of any payment is not relevant. Many indemnity agreements state that payments made by the surety in good faith must be repaid in full by the contractor.

In such cases, the contractor may seek to show that the surety lacked good faith in making payments and is therefore not entitled to indemnity. This involves proving that the surety failed to meet a contractual condition precedent to recovery -- good faith. The lack of good faith has been held to be synonymous with bad faith. To show that a surety acted in bad faith, the contractor must show that the surety acted with an improper motive or willful ignorance of facts. Negligent or unreasonable conduct is not sufficient.

At least one court has recognized that if there is no mention of good faith and reasonableness, the surety is required to show that a payment was not only made in good faith but that it was reasonable.

Sureties are not known for their willingness to negotiate on the terms of the indemnity agreement. While some contractors may have luck in negotiating on the harsher terms, all should compare indemnity agreements to make an informed decision as to the surety to use. Standards of good faith or reasonableness should appear in the terms requiring indemnity. If not, the surety may settle claims and issue payments unchecked.

The contractor should be aware of where any resulting lawsuit is to take place. Many agreements for national sureties state that any suit is to be heard in a state that may be far from Texas. The contractor should be aware of any waiver of homestead rights. Some sureties seek to have the contractor waive homestead exemption rights. It is an issue that is best avoided. The contractor likely has limited negotiating power with a surety on the indemnity agreement.