STATEMENT FROM STUART S. ZISHOLTZ

Almost all public projects require payment and performance bonds. Many large private projects also require payment and performance bonds. I have written various articles about the time restraints associated with claims under each of the bonds. This article, however, will address the rights of the surety company in any claim brought against it.

A payment bond inures to the benefit of the subcontractors and suppliers. In the event a subcontractor and/or a supplier are not paid, they have the right to institute a claim against the surety for the balance due. The surety, in turn, will defend the claim utilizing various legal arguments but, most of all, will adopt all of the defenses of its principal.

A performance bond inures to the benefit of the owner. The principal on the bond guarantees performance of the contract with the owner. Failure to perform under the terms of the contract may result in the owner seeking to have the surety complete the project. Again, the surety's defenses are based solely on various legal arguments as well as adopting the position of the principal.

Once litigation commences, the surety usually has two options available to it. The surety may defend the claim using its own counsel or it may tender the defenses to the principal requesting that the principal pay all legal costs and retain its own counsel. However, if the surety tenders the defense but later on determines that it may be at risk in paying any of the claims under the bond, a conflict of interest between the surety and the principal may exist. The surety will ultimately seek reimbursement through an indemnification agreement that was executed with the principal at the time the bonds were issued.

In the event a loss has been sustained by the surety, which includes payment of legal fees in defending the claim, the surety has the right to seek indemnification from its principal. It also has the right to utilize a "hammer clause" to settle, dispose or discontinue any claim.

Many of the indemnification agreements with a surety contain a hammer clause and also the right by the surety to step in on behalf of the principal to resolve, settle or discontinue a claim. What that means is that if you are a principal on a bond and are seeking to collect money from an owner or a general contractor and the surety has already sustained losses, it may take over the claim in order to recover and recoup its losses.

Recently, a claim was made by a general contractor for more than $1,500,000 against the Village of Lynbrook. The Village of Lynbrook claimed that the work was deficient and maintained its own claim against the general contractor and the surety for more than $500,000. The surety retained its own counsel and had sustained losses.

After six weeks of trial, numerous witnesses and more than 225 exhibits, an offer was made to resolve the matter. The general contractor, who was the principal on the bond, refused to accept the offer. The surety, however, believed that the offer was satisfactory and believed that there was a strong possibility that the principal would not succeed for the full amount of its claim based upon the claims asserted by the Village of Lynbrook. The surety believed it was at risk and was unwilling to take that chance without the principal posting $500,000 in cash collateral.

As a result, the surety, using the hammer clause and the indemnification agreement, made an application to the court to enforce the hammer clause and to permit it to step into the shoes of the principal. The application was granted and the surety accepted the settlement proposal.

The lesson to be learned is that when you obtain a payment and performance bond and execute an indemnification agreement, you are not necessarily playing with your own cards. In the event there are losses sustained by the surety, it has the right to exercise the hammer clause in order to protect itself. While you may be "the plaintiff" in an action against an owner or general contractor, the surety, in the event it believes it is at risk, may step in and put an end to the litigation. This scenario could be favorable to you if you are the party seeking to collect from the General Contractor or the surety. The surety may do a cost analysis and decide it is better off resolving the claim than risking additional costs, fees and expenses in continuing the litigation. Using this thought process, the surety is more likely to settle a claim then permit the case to go to trial. As a defendant, the general contractor needs to be aware that the surety has the right to settle the claim. His defenses cannot be smoke and mirrors. If he has legitimate defenses, the surety will stand by him. However, when the surety is at risk, they will most likely cut their losses and utilize the hammer clause.

Never let your lien time run out!

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