UNDERSTANDING YOUR SURETY'S INDEMNITY AGREEMENT

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Understanding Your Surety's Indemnity Agreement

Authored by: Darren Rowles and Scott Cahalan

Contractors on public and private projects are often required to obtain surety bonds to secure their bidding, payment, and performance obligations under a construction contract.[1]

A bond is a three-party contract entered into by the surety, the principal (contractor) and the obligee (owner) in which the surety guarantees to the obligee that the principal will perform certain obligations under the contract between the obligee and the principal. For example, a surety on a performance bond guarantees the owner that the contractor will complete the project; and a surety on a payment bond guarantees the owner that the contractor will pay all intended claimants under the bond.[2]

Most surety companies are subsidiaries or divisions of insurance companies and both surety bonds and insurance policies are regulated by state insurance departments. However, a surety bond is not an insurance policy.

One major difference between insurance policies and bonds is that sureties do not expect to incur a loss under the bonds they issue. Before agreeing to bond a contractor, sureties typically require those with a financial interest in the contractor to sign a General Agreement of Indemnity ("GAI"). The GAI provides the surety with a

means to be reimbursed in the event that it incurs costs and losses under the bonds it issues to the contractor.

But is the surety's right to be reimbursed under the GAI absolute? No, but the case of *Cagle Construction, LLC v. The Travelers Indemnity Co.*[3] illustrates why contractors should understand the scope and application of their GAIs when a claim is made on a bond.

In this case, Cagle Construction, a general contractor, contracted with the Georgia Department of Defense ("GDoD") to perform work on four separate projects. Cagle Construction and its members (collectively "Cagle") executed a GAI in favor of the surety, which provided, in part, that

"[Cagle] will indemnify and save Surety harmless from and against every claim, demand, liability, cost, charge, suit, judgment and expense which the Company may pay or incur in consequence of having executed, or procured the execution of, such bonds, . . . including fees of attorneys, . . . and the expense . . . in bringing suit to enforce the obligation of any of the Indemnitors under this Agreement. In the event of payment by [the surety], [Cagle] agree[s] to accept the voucher or other evidence of such payment as prima facie evidence of the propriety thereof, and of [Cagle's] liability therefor to Surety."

And that

"[i]n the event of any breach, delay or default asserted by [GDoD] in any said Bonds, or [Cagle Construction] is suspended or ceased work on any contract or contracts covered by any said Bonds, . . . Surety shall have the right, at its option and in its sole discretion, and is

hereby authorized . . . to take possession of any part or all of the work under any contract or contracts covered by any said Bonds, and at the expense of [Cagle] to complete or arrange for the completion of the same, and [Cagle Construction] and [Cagle] shall promptly upon demand pay to Surety all losses, and expenses so incurred."

Before completion of the projects, the GDoD dismissed Cagle Construction and made demand on the surety to complete each of the four bonded projects, which it did, paying more than $700,000 above the unpaid balance of the contracts to do so.

After completion of the projects, the surety sought reimbursement for the cost overrun from Cagle. Cagle refused to pay. The surety then sued Cagle seeking reimbursement under the terms of the GAI.

Cagle did not believe the surety was entitled to reimbursement for at least three reasons. First, Cagle argued that Cagle Construction was never in default of the GDoD construction agreement. Second, Cagle argued that the amount paid by the surety to complete the work was unreasonable. Third, Cagle argued that the surety did not bring its lawsuit within the 1-year time period from substantial completion required for a claim on a public works payment bond under Georgia law.

Cagle Construction admitted that it was "ordered off the premises," but it denied that it was in default on any of the contracts. The Court held that that Cagle was obligated to reimburse the surety because the indemnity obligation under the GAI was triggered by the GDoD's assertion that Cagle Construction was in default, irrespective of whether Cagle Construction was truly in default.[4]

The Court also rejected Cagle's position that the surety paid too much to complete the work because the GAI provided that "[i]n the event of payment by Surety, [Cagle] agree[s] to accept the voucher *or other evidence of such payment as prima facie evidence of the propriety thereof*, and of [Cagle's] liability therefor to [Gulf]." The Court held that the surety's summary of expenses was sufficient to establish a right of indemnification, unless Cagle could show either bad faith by the surety or direct evidence that the surety did not in fact incur the expenses, even if the work could have been completed at a lower cost.

Cagle's final contention was that the surety's indemnification claim was barred by the one-year statute of limitation for claims on a public works payment bond under Georgia's "Little Miller Act," O.C.G.A. § 13-10-65. The Court found that the surety's suit was brought under the terms of the GAI, which the parties entered into separate from the surety bonds on the four contracts, making the statute of limitations for a Little Miller Act claim inapplicable. Thus, the surety's claim for indemnification under the GAI was a claim on a contract, not a claim on a payment bond.

Normally a claim on a written contract that is not for the sale of goods, like the GAI, would have a six (6) year statute of limitations in Georgia.[5] But in this case, the GAI was signed "under seal" because it included a recitation in the body and above the signature lines that stated "the [i]ndemnitors have hereunto set their hands and affixed their seals," and the letters "L.S." appeared opposite the handwritten signatures of the parties, which made it subject to a twenty (20) year statute of limitations.[6]

While only recognized in a few states, contractors should be wary of the repercussions of signing a document under seal. In Georgia, a

document is considered signed under seal if only two requirements are met: (1) there is a recital in the body of the document stating that it is given "under seal," and (2) the end of the signature line itself must include the word "seal" or "L.S."[7] As a result, the surety's lawsuit on the GAI was timely.

There are many lessons that contractors can learn from *Cagle Construction, LLC v. The Travelers Indemnity Co.* For instance, this case demonstrates the importance of reviewing and understanding a GAI before it is signed. As a practical matter, a contractor's ability to negotiate a GAI with a surety is limited. But a contractor may be able to get the surety to agree to some changes to the GAI, including removing the language that the GAI was signed "under seal."

In addition, Cagle Construction could possibly have done more to convince the GDoD and the surety that Cagle Construction was not in default of the four GDoD contracts, rather than raising this issue in response to the surety's claim for indemnification under the GAI, which had little chance for success given the language of the GAI and the case law.

Cagle Construction could also have asked the surety to allow Cagle Construction to continue performing the contracts once the surety took over the contracts. Sureties typically have the right to require that the owner allow the principal to continue performance of the bonded contract, which would have allowed Cagle Construction to avoid the unreasonable costs that it later alleged were incurred by the surety.

Cagle Construction may have done some or all of these things. The point remains, however, that raising these issues in defense of an

indemnification action on the GAI is oftentimes like shutting the barn door after the horse is out.

[1] In the private sector, payment and performance bonds are a discretionary owner requirement. On public projects, federal, state and local governments often require the contractor to obtain payment and performance bonds. In Georgia, for example, the law requires payment and performance bonds on all public works projects in excess of $100,000, except for local-government projects necessitated by an emergency. *See* O.C.G.A. § 13-10-1, *et seq.*; O.C.G.A. § 36-91-40, *et seq.* If the amount of the performance bond does not exceed $300,000 for contracts with the State or $750,000 for contracts with local or other governmental entities, an irrevocable letter of credit may be accepted in lieu of a performance bond. O.C.G.A. §§ 13-10-41, 32-2-70, 36-91-71.

[2] An intended claimant depends upon the applicable statute, caselaw, and terms of the payment bond. For example, Georgia's public works statutes requires that the contractor provide a payment bond "… for the use and protection of all subcontractors and all persons supplying labor, materials, machinery, and equipment in the prosecution of work provided in the contract." O.C.G.A. § 13-10-60. Despite use of the word "all", this statute has been interpreted to limit intended claimants to those persons supplying labor, materials, machinery, and equipment who have a direct contract with either the prime contractor, a first-tier subcontractor, or a second-tier subcontractor.

[3] 305 Ga. App. 666, 700 S.E.2d 658 (2010).

[4] Paragraph 18 of the GAI provided that a "default *asserted by* [GDoD] in any said [b]onds" authorized the surety to take possession of the work and triggered liability in Cagle.

[5] O.C.G.A. § 9-3-24.

[6] O.C.G.A. § 9-3-23 provides that an instrument signed under seal has a twenty (20) year statute of limitations within which to bring claims.

[7] *See, e.g.*, *Chastain v. L. Moss Music Co.*, 83 Ga. App. 570, 64 S.E.2d 205 (1951).