Construction Law Alert

A Stradley Ronon Publication

May 2009

Stradley Ronon Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Malvern, Pa.
Harrisburg, Pa.
Wilmington, Del.
Cherry Hill, N.J.
Washington, D.C.

Good News for Sureties in New Jersey

By Patrick R. Kingsley

Are sureties that issue performance and payment bonds in New Jersey liable for the bad faith denial of a claim? Surprisingly, no New Jersey appellate court has ever published a written decision addressing this issue. In a recent decision, a federal court sitting in Trenton, found that no such cause of action exists under New Jersey law.

This question has been addressed twice before by two federal courts, each interpreting New Jersey law with conflicting results. *In re Technologies for Energy Corp.*, 123 B.R. 979 (E.D. Tenn. 1991), offered the first interpretation. In that case, the court concluded that New Jersey law did not allow a tort claim for damages against a surety that allegedly refused in bad faith to make payment under a performance bond. The court concluded that although the New Jersey Supreme Court has recognized a bad faith claim against insurance companies, it did so only in the context of the "special relationship" existing between an insurer and an insured justifying the tort claim. The surety had no such "special relationship," negating the bad faith claim.

The issue was again reviewed in *U.S. ex rel. Don Siegel Construction Co., Inc. v. Atul Construction*, 85 F. Supp. 2d, 414 (D.N.J. 2000). *Atul* rejected the reasoning of *In re Technologies* and found that the cases relied upon therein had been either explicitly or implicitly overruled by subsequent New Jersey law.[1] The *Atul* court explained that, contrary to the predictions of *In re Technologies*, the New Jersey Supreme Court has broadly recognized that an insured can recover bad faith damages against an insurer. The court in *Atul* also found that although the relationship between surety and bond beneficiary is not identical to the relationship between insurer and insured, the suretyship relationship was "closely analogous." *Atul*, 85 F. Supp. 2d at 418. The *Atul* court, however, offered surprisingly little explanation justifying its decision to analogize suretyship with insurance or to fully extend the bad faith doctrine to suretyship.

Recently, another New Jersey federal court had a new opportunity to address this unsettled area of New Jersey state law in the case of *SBW, Inc. v. Ernest*

Bock & Sons, Inc., No. CV07-4199 (March 17, 2009). In that case, a general contractor was hired to work on two school construction projects. The general contractor, in turn, hired a subcontractor to perform the HVAC work. The general contractor's surety issued a payment bond to cover labor and materials supplied to these projects. As the project progressed, the general contractor refused to pay certain invoices from the subcontractor alleging poor workmanship. The subcontractor eventually sued both the general contractor and its surety. In the complaint, the subcontractor asserted a variety of claims against the surety, including the surety's bad faith refusal to pay on the bond and breach the implied covenant of good faith and fair dealing. The surety filed a motion to dismiss challenging the legal sufficiency of these claims.

In support of its motion to dismiss, the surety argued that a bad faith claim against sureties simply does not exist in New Jersey despite the predictions of the *Atul* court. Several points were advanced by the surety in support of this proposition:

- The *Atul* decision relies on the false assumption that the Federal Prompt Pay Act allows subcontractors to sue Miller Act sureties for penalties and attorneys' fees for non-payment on a payment bond. *See Atul*, 85 F. Supp. 2d at 416, fn. 1.

- The *Atul* decision relies on the relatively trivial point that sureties are referenced in certain statutes relating to insurance regulations. *See*, *e.g.*, *Masterclean, Inc. v. Star Ins. Co.*, 556 S.E. 2d 371, 374 (S.C. 2001) ("[t]he surety's presence in a regulatory scheme does not render common law duties of an insurer applicable to a surety. A bad faith tort action arises from the common law due to special characteristics of the insurance relationship, not simply because it is a regulated industry.").

- A far more substantive statutory scheme in New Jersey the Unfair Claims Settlement Practices Act expressly ***excludes sureties***. NJAC 11:2-17.2. The very purpose of that statute is to prohibit insurers from engaging in unfair claims settlement practices. NJAC 11:2-17.1. The surety's exclusion from this statutory scheme is far more significant than its inclusion in the more mundane regulatory scheme.

- The statute requiring that a public works payment bond be issued in the first place expressly recognizes that "no bond shall in any way be construed as a liability insurance policy." NJSA 2A:44-143; *See*, *e.g., New Jersey Property-Liability Ins. Guar. Assoc. v. Hill Int'l, Inc.*, 928 A.2d 836, 841 (N.J. Super. 2007) (citing this language with emphasis).

- The *Atul* court did not give due weight to the fundamental distinctions between suretyship and insurance. Courts both in New Jersey and beyond have recognized the importance of such a distinction.[2] *See*, *e.g.*, *Hill Int'l*, 928 A.2d, at 840 ("The nature of the risk assumed by the party in the role of 'insurer' is a major distinction between insurance and the arrangements of guaranty and surety."). Therefore, a claim on a surety bond is more like an ordinary commercial dispute than an insurance claim, thereby negating the policy considerations giving rise to a bad faith claim against insurance carriers.

- New Jersey law has long recognized that a surety's liability is limited to the terms of its bond and cannot go beyond those terms. *See*, *e.g. Monmouth Lumber Co. v. Indemnity Ins. Co. of N. Am.*, 122 A.2d 604 (N.J. 1956) ("It has long been settled that a surety is chargeable only according to the strict terms of its undertaking and its obligation cannot and should not be extended by implication or by construction beyond the confines of its contract.")[3] That proposition of law is inconsistent with the possibility that a surety could be liable for extra-contractual damages that might theoretically be larger than the penal sum of the bond.

- New Jersey law also embraces the notion that a surety's liability can be, at most, coextensive with that of its principal. *See*, *e.g.*, *Hill Int'l*, *supra*. This proposition of law is inconsistent with a bad faith claim against a surety inasmuch as a surety could be found to have denied a claim in bad faith (for lack of

investigation, etc.) regardless of the culpability of its principal. In that case, the surety's liability might extend vastly beyond that of its principal even though they both declined to pay the same claim.

The *SBW* court found the surety's arguments persuasive and concluded in a verbal opinion issued from the bench that no cause of action for bad faith refusal to pay on a bond exists in the state of New Jersey. The court also noted, *sua sponte*, that despite the fact that *Atul* had been a published decision for almost nine years, no New Jersey appellate court had ever embraced the doctrine predicted by *Atul*. The court found that the *Atul* court's prediction of New Jersey law was erroneous and dismissed the bad faith claim against the surety because such a cause of action simply does not exist under New Jersey law.[4]

The final word on whether New Jersey will accept or reject bad faith claims against sureties awaits a decision from the New Jersey appellate courts. However, until then, the law may have just been made a little clearer.

---

[1] *In re Technologies* predicted that no bad faith claim would be recognized by New Jersey relating to the denial of first party claims. However, in *Pickett v. Lloyd's*, 621 A.2d 445 (N.J. 1993), the New Jersey Supreme Court recognized a bad faith damages claim against an insurer on a first party claim.

[2] *United States v. Aegis Ins. Co.*, 2009 WL 90233 (M.D. Pa. 2009) (recognizing at least six differences between insurance and surety bonds); *Cates Const., Inc. v. Talbot Partners*, 980 A.2d 407 (Calif. 1999) (recognizing that suretyship is a credit accommodation rather than insurance); *Great Am. Ins. Co. v. North Austin Utility*, 980 S.W. 2d 415 (Tex. 1995) (discussing the differences between sureties and insurance).

[3] *See also State v. Tuthill*, 912 A.2d 146, 148 (N.J. Super. 2006); *State v. Clayton*, 825 A.2d 1155 (N.J. Super. 2003).

[4] The court also found that the breach of the covenant of good faith and fair dealing does not apply to a surety because a surety bond does not vest the surety with discretion and, therefore, no abuse of discretion is theoretically possible. The court recognized the distinction between a *decision* made by a surety on a claim and a discretionary act. The surety's denial of the bond claim was not an exercise of discretionary authority and thus could not give rise to this claim.

About the Author

Patrick R. Kingsley

A partner in the firm's Litigation Practice Group, Patrick Kingsley has handled construction matters for more than 17 years.

Mr. Kingsley represents owners, contractors, subcontractors, sureties, insurance companies, design professionals and manufacturers of construction products. He has handled claims relating to delay, acceleration, unforeseen site conditions, lost productivity, defective workmanship, design errors, as well as payment and performance bond claims.

Patrick has tried cases throughout the United States before juries, judges, arbitration panels and referees. He has handled complex construction and surety matters involving construction projects all over the world, including a surety claim involving the largest building ever built in Saudi Arabia.

David M. Burkholder

Mr. Kingsley successfully argued the motion to dismiss the *SBW* case with briefing assistance from David Burkholder.

For more information, contact Mr. Kingsley at 215.564.8029, or by e-mail at pkingsley@stradley.com.

STRADLEY RONON
ATTORNEYS AT LAW

Stradley Ronon Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103

Attn: Cheryl Jackson

Stradley Ronon's Construction Practice Group

Patrick R. Kingsley, co-chair	215.564.8029	pkingsley@stradley.com
Jeffrey D. Grossman, co-chair	215.564.8061	jgrossman@stradley.com
David M. Burkholder	610.640.5807	dburkholder@stradley.com
Michelle K. Carson	215.564.8137	mcarson@stradley.com
Christopher E. Cummings	610.640.5812	ccummings@stradley.com
Christine M. Debevec	215.564.8156	cdebevec@stradley.com
Leslie Miller Greenspan	215.564.8022	lgreenspan@stradley.com
Eric M. Hurwitz	856.321.2406	ehurwitz@stradley.com
Andrew S. Levine	215.564.8073	alevine@stradley.com
Christopher J. Lowe	215.564.8040	clowe@stradley.com
Francis X. Manning	856.321.2403	fmanning@stradley.com
Nancy L. Margolis	215.564.8118	nmargolis@stradley.com
Karen M. McWilliams	610.640.7970	kmcwilliams@stradley.com
Michael P. Migliore	302.576.5874	mmigliore@stradley.com
Karl S. Myers	215.564.8193	kmyers@stradley.com
Lee A. Rosengard	215.564.8032	lrosengard@stradley.com
Heather M. Tashman	215.564.8076	htashman@stradley.com