

What You Should Know About General Agreements of Indemnity and Why You Should Know It

Summary

When a contractor (for purposes of this discussion, “contractor” includes subcontractor) first seeks surety credit, the surety company underwrites the contractor and evaluates whether it considers the contractor bondable. If the surety company determines that the contractor should be extended surety credit, the surety company will require that the contractor or subcontractor, as well as others, execute a general agreement of indemnity (GIA) before it will issue bonds on behalf of the contractor.

The GIA is a powerful legal contract that provides a surety issuing bonds with many enforceable legal rights against the indemnitors that signed the GIA. For instance, GIAs generally require the bonded principal and other indemnitors to hold harmless—or indemnify—the surety company from any loss or expense that the surety might sustain as a result of having issued the bonds. Because GIAs provide the surety issuing bonds with so many enforceable rights against the indemnitors, a wise contractor should review and understand the terms and conditions of a GIA before executing it. This article is intended to assist contractors in understanding some of the terms and conditions typically found in GIAs.

Introduction to General Agreements of Indemnity

A general agreement of indemnity, or GIA, is a contract between the surety company and the contractor and the other indemnitors. The GIA obligates the named indemnitors to protect the surety company from any loss or expense that the surety sustains as a result of having issued bonds on behalf of the bond principal. Therefore, pursuant to a GIA, if the contractor fails to fulfill its bonded obligation on a project and the surety suffers any loss, the indemnitors are legally bound to indemnify the surety for its losses.

A GIA is a standard document in the construction and surety industries. Surety companies will typically require a demonstration of commitment from the construction company’s owner through corporate and personal indemnity. A surety company that issues a bond on behalf of a contractor almost invariably requires that its principal and the individuals who control the company, and their spouses, and often affiliated companies execute the GIA.

By issuing the bonds, the surety assures that the principal will fulfil its obligations. If the principal does not do so, the surety must step in and bear the cost of satisfactorily

completing the contract and paying the principal's subcontractors and suppliers for money due and owing. While a bond principal has common law duties to indemnify the surety against any loss sustained as a result of having issued a bond, a surety will not just rely on those common law rights. The required GIA provides the surety with contractual rights that expand its common law rights against the individual and corporate indemnitors. In addition, the GIA provides a tool for the surety to secure the cooperation of the principal.

A surety bond is not like traditional insurance; rather, it is like an extension of credit. A surety, by issuing a bond, provides its credit to the principal in order for the principal to contract with the obligee. Because the surety extends its bonding credit on behalf of its principal, the surety underwriter evaluates the principal's financial capacity and ability to perform the contract. The surety, however, does not expect to incur a loss as a result of having issued the bond. Through the protections afforded the surety in the GIA, in addition to the surety's common law rights, the principal and third-party indemnitors, both individuals and business entities, are required, among other things, to reimburse the surety if the surety incurs a loss as a result of having issued bonds on behalf of the principal.

The GIA is a powerful instrument enhancing the surety's goal to avoid losses in resolving claims and seeking salvage. Principals should understand that courts will generally enforce the provisions of a GIA, as written. Contractors executing such agreements should know that the GIA generally provides: (1) the surety extending credit with favorable rights and remedies in the event of loss; and (2) the principal for whom the credit is extended and the indemnitors, including spouses, with responsibilities and obligations.

As with any contract, it is far better for you to read and understand the provisions of the GIA and to seek legal assistance, if needed, before executing it than to receive later a potentially unpleasant "surprise" when the surety seeks to enforce its contractual rights.

Selected Key Provisions of the General Agreement of Indemnity

The specific terms of the GIA will vary among surety companies, but most GIAs contain certain typical clauses. A bond principal should carefully review and understand the provisions of a GIA before executing the agreement. As will be discussed below, sometimes a specific GIA contains terms and conditions that are not typical and put the principal at risk of enterprise failure.

The following is a general discussion and explanation of some of the common provisions in GIAs about which bond principals should become familiar. This article is not—and is not intended to be—a comprehensive analysis of all provisions in the GIA.

1. Indemnification Provision

The keystone language of any GIA is the indemnification provision, which varies from form to form. In the typical provision the indemnitors agree to indemnify the surety for all loss, costs, and expenses incurred by the surety as a result of having issued the bonds. An example follows:

The Indemnitors will exonerate, hold harmless, and indemnify the Surety from and against any and all liability, loss, costs, damages, fees of attorneys and consultants, and other expenses, including interest, which the Surety may sustain or incur by reason of, or in consequence of, the execution of such bonds and any renewal, continuation or successor thereof, including but not limited to, sums paid or liability incurred in settlement of, and expenses paid or incurred in connection with claims, suits, or judgments under such bonds.

This broad indemnity language covers all types of anticipated costs. The GIA generally requires the named indemnitors to indemnify the surety for all losses incurred by reason of its having issued the bond, regardless of the surety's actual liability under the bond. Courts have repeatedly enforced such contractual indemnity provisions.

2. Right to Enforce the GIA Provision

The typical GIA provides sureties with a contractual right to sue the principal and indemnitors for their failure to comply with any of the obligations stated in the GIA. An example of such enforcement language is the following:

The Principal and Indemnitors shall indemnify the Surety from and against all loss, including attorneys' fees, expenses and costs by reason of the failure of the Principal and Indemnitors to perform or comply with the covenants and conditions of this Indemnity Agreement.

Such obligations that a principal might fail to perform include, among others, the duty to deliver collateral to the surety, the duty to hold contract funds in trust, and the duty to make books and records available to the surety. Upon the principal's breach of these and other obligations stated in the GIA, sureties have recovered their attorneys' fees, expenses, and other losses arising from the breach.

Courts will look to the language in the GIA to determine whether attorneys' fees are recoverable in such enforcement proceedings. As set forth in the sample language

above, attorneys' fees incurred by the surety in enforcing its contractual rights would be recoverable by the surety. This attorneys' fees provision in the GIA allows a contractual end-run around the so-called American Rule, which provides that, unless there is a statute that provides for recovery of attorneys' fees or an agreement otherwise, each litigating party pays for its own attorneys' fees.

3. Right-to-Settle Provision

A typical provision in a GIA provides that the surety has the sole and exclusive right to decide whether any claims against the bond should be paid, settled, or defended. The principal and indemnitors agree that the surety's decisions on such matters will be final and binding on them. An example of a typical right-to-settle provision is the following:

The Surety shall have the exclusive right for itself and for the Undersigned to decide and determine whether any claim, demand, suit, or judgment shall, on the basis of liability, expediency or otherwise, be paid, settled, defended or appealed. . . . In the event of any payment by the Surety, the Undersigned agree that in any accounting between the Surety and the Undersigned, the Surety shall be entitled to charge for any and all disbursements made by it in good faith in and about the matters contemplated by this Agreement under the belief that it is or was liable for the sums and amounts so disbursed, or that it was necessary or expedient to make such disbursements, whether or not such liability, necessity or expediency existed.

A right-to-settle provision is included in GIAs so that a surety can avoid an argument by the principal and indemnitors that the surety acted as a "volunteer," thereby forfeiting its right to indemnification by settling a claim over the principal's or indemnitors' objections. Absent the surety's fraud or lack of good faith, courts have held that the surety's decision to settle a claim is within the surety's sole discretion and is binding on the principal and indemnitors.

4. Prima Facie Evidence Provision

In addition to the surety's right to settle claims, courts will also enforce language that provides that vouchers or other evidence of payments will be prima facie evidence of the amount of the indemnitors' liability to the surety. A typical provision provides as follows:

Vouchers or other evidence of payments or an itemized statement of payments sworn to by an officer of the Surety shall be prima facie evidence of the fact and extent of the liability of the Indemnitor to the Surety.

Such language imposes on the indemnitors the burden of proving the surety's fraud or lack of good faith in settling claims and incurring expenses in order to avoid their indemnity obligations.

5. Collateral-Deposit Provision

The collateral-deposit provision in the GIA provides the surety with the right to demand and obtain collateral from the principal or indemnitors to cover potential liability. Under this provision, when a surety receives a demand on its bond, the principal and/or indemnitors must deposit with the surety, upon demand, funds or other collateral sufficient to secure the surety against the claim. A sample collateral-deposit provision follows:

Immediately upon demand, the Undersigned will deposit with Surety, as collateral security, money or other collateral satisfactory to Surety, equal to (1) the liability of Surety, if established; (2) the liability asserted against Surety; or (3) the reserve established by Surety, or any increase thereof, to cover any liability for any loss or expense for which the Undersigned may be obligated to indemnify Surety under the terms of this Agreement. Surety shall have the right to use the collateral, or any part thereof, in payment or settlement of any liability, loss or expense for which the Undersigned is or would be obligated to indemnify Surety under the terms of this Agreement.

This language provides that the surety has a right to use the collateral to pay any and all liability under its bonds. The principal's and indemnitors' failure to meet a surety's collateral demand is a breach of the GIA.

6. Assignment Provision

A typical assignment provision provides the surety with certain rights in the principal's contract funds, equipment, and materials upon receipt of a claim on the bond or default under the GIA. A sample assignment provision follows:

As security for the performance of all the provisions of this Agreement, each Indemnitor hereby:

- A. assigns, transfers, pledges and conveys to Surety any and all claims of such Indemnitor against, or any sums due and owing to such Indemnitor by, the Principal and (effective as of the date of each Bond) all rights in connection with any Contract, including but not limited to:
 - 1. all subcontracts made in connection with a Contract and subcontractors' Surety bonds;

2. all rights, title, and interest of Principal in and to all machinery, facilities, equipment, tools, materials or supplies which are used or required in connection with the Contract, including all materials ordered for the Contract, whether located at the site of the work under such Contract, or elsewhere;
3. all accounts receivable, including any and all sums due or which may thereafter become due under a Contract and all sums due or to become due on all other contracts, bonded or unbonded, in which any Indemnitor has an interest;
4. any and all real property owned by Indemnitor, including all fixtures; and
5. all rights arising out of insurance policies held by any Indemnitor, or of which any Indemnitor is a beneficiary.

One of the purposes of the above assignment provision is to assign to the surety the proceeds of all contracts, bonded or unbonded, in which the principal and any indemnitor has an interest. The assignment provision can be triggered by notice of claims, failure of the principal to perform, or other events of default under the GIA.

7. Right to Examine Books and Records Provision

GIA's typically contain a provision that provides the surety with the right to examine the books and records of the principal and indemnitors. A typical such provision follows:

Upon Surety's request, Principal and Indemnitors shall immediately turn over to Surety, or its designee, as often as requested and at a time and place and in a manner determined by Surety, such books, records, accounts, documents, computer software and other electronically-stored information, as and when requested by Surety.

This right to examine given to the surety is intended to allow the surety to conduct a proper and timely investigation of bond claims.

8. Duty to Cooperate Provision

Most GIA's contain a provision that requires the principal and indemnitors to cooperate with the surety in the investigation, litigation, or arbitration of claims. A typical such provision follows:

The Undersigned shall give the Surety prompt notice of any claims, demand, suit, arbitration proceeding or other action which purports to be instituted on any bond and shall cooperate with the Surety in the defense thereof.

Conclusion

The above discussed provisions of the GIA are examples of some of the substantial rights and protection that a GIA affords to a surety. There are other provisions typically found in a GIA to assist the surety in enforcing its rights, and it is critical to review all of the provisions. It should be well noted that the language of GIAs varies from surety to surety and that few sureties will negotiate the terms of their specific GIA. In addition, different jurisdictions might interpret provisions of the GIA differently. Prudent contractors and subcontractors should consider seeking advice from knowledgeable legal counsel before executing a GIA.

In addition to reviewing GIAs to understand their obligations to the surety issuing bonds on their behalf, prudent contractors and subcontractors should carefully review GIAs to ensure that there are no provisions in the GIA that are too risky to the business and should, therefore, not be executed. Recent case law illustrates the negative impact of certain GIA provisions and courts' willing enforcement of unambiguous provisions in a GIA.

The lessons learned from these cases are simple and important: (1) contractors and subcontractors seeking to obtain bonds should always review and understand the provisions in the GIAs they are asked to execute, prior to execution; (2) contractors and subcontractors should not necessarily rely on the impact of a statement, whether oral or written, that is not specifically incorporated into an executed legal agreement; and (3) courts will readily enforce the unambiguous provisions in general agreements of indemnity.

Contractors seeking to obtain bonds should read and carefully consider the provisions of a surety's GIA. The GIA provisions discussed in this article are only some of the significant clauses that are typically found in a GIA. In some cases a contractor might consider the terms of a GIA too onerous to execute it. Bond principals and any entity or individual who signs a GIA will be responsible for, among other things, indemnifying the surety for any loss it sustains as a result of having issued the bonds.