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Misconstruing the Indemnity Agreement Allows Affirmative Claims Against Surety

By Gregory R. Veal August 9, 2022

The U.S. District Court in Montana recently denied Sompo's motion to dismiss its principal's cause of action for breach of an implied covenant of good faith in the indemnity agreement (GIA). *See Bjorn Johnson Constr., LLC v. Sompo Int'l Holdings, Ltd.*, No. 2:22-cv-19-BMM, 2022 U.S. Dist. LEXIS 131605 (D. Mont. July 22, 2022).

The principal alleged the surety overpaid a claim in bad faith, thereby increasing the principal's indemnity debt wrongfully. The principal further alleged that, to add insult to injury, the surety reduced principal's bonding line due to the inflated debt, which also limited principal's ability to get bonding elsewhere. The principal specifically and expressly pled bad faith failure to investigate and intent to "punish" the principal for failing to pay the lower, undisputed amount on the claim.

Montana goes further than almost all other jurisdictions in allowing an affirmative contract action based entirely on breach of the covenant of good faith and fair dealing. A plaintiff can sue for bad faith allegedly committed during the contractual relationship despite pointing to no other duty breached by the defendant. Commentators have questioned the wisdom and usefulness of such a broad right. However, allowing affirmative bad-faith claims in the surety indemnity context is especially wrongheaded and truly counter-productive.

The principal requests bonding, which the surety has no duty to provide, and receives the bonds on the express conditions contained in the GIA. Those conditions include holding the surety harmless, never forcing the surety to investigate or pay claims in the first place, promising to reimburse anything the surety pays in good faith, and agreeing the surety owes no future bonding. The surety's obligations to the principal end upon issuance of the bonds; all of the other duties in the relationship run from the principal and indemnitors to the surety. Flipping that relationship around destroys it.

The court turned the GIA on its head. First, it read the good-faith standard for recovery of bond payments not as an outer limit on the surety's right to reimbursement but as an affirmative duty imposed on the surety to pay claims only in good faith. The court ruled as if the GIA said, "Surety hereby agrees it can be sued for paying any claim unless it can demonstrate a good-faith belief, after reasonable investigation, that the claim is owed." That's not what the GIA says, and it's not what the surety promised.

Next, the court read the surety's right to reduce or deny bonding, in its discretion, as somehow creating a right for the principal to receive bonding unless the surety can establish a good-faith basis for doing otherwise. Again, the court ruled as if the GIA said, "Surety hereby agrees it can be sued for failing to continue bonding principal at the same level unless surety can demonstrate a good-faith basis for reducing principal's bonding line of credit." That likewise is exactly opposite of what the agreement says.

This decision denied Sompo's motion to dismiss, so the case is a long way from resolving any claims or defenses. Moreover, the Montana Supreme Court just this year pointed out that the cause of action for bad faith breach of contract does not apply to *all* contracts. If any contract should be an exception to that cause of action, it is a surety's GIA.

Far beyond merely denying a motion to dismiss, though, the court unilaterally redefined the principal-surety relationship. Should the case end up establishing precedent, sureties may want to consider a "Montana rider" to the GIA that forecloses affirmative claims for breach of alleged duties the surety never intended to undertake.