SURETY BAD FAITH: TORT RECOVERY FOR BREACH OF A CONSTRUCTION PERFORMANCE BOND

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This note examines tort recovery for breaches of performance bonds. In the construction industry, it is customary for the construction project owner to require the contractor to secure a performance bond. A performance bond is a contract in which the bonding company guarantees to the project owner that the contractor will faithfully fulfill its obligations under the construction contract. The author argues that the construction project owner should not be allowed to recover damages in a tort action for a breach of the covenant of good faith and fair dealing, which is implied in a construction performance bond.

The note begins by discussing how recovery for a breach of contract is traditionally limited to damages arising from the breach itself, not for a surety's breach of the covenant of good faith and fair dealing. Next, the author provides a background, detailing the development of allowing tort recovery for the breach of the covenant of good faith and fair dealing. Finally, the note analyzes the policies in favor of and against allowing tort recovery for a surety's bad faith.

The author asserts that courts should not allow a project owner to receive tort damages against a surety. Instead, courts should limit a project owner's recovery against a surety to traditional contractual remedies. Due to the nature of the construction industry and the fact that the surety is more of a third-party in the construction project, tort recovery is inappropriate.

I. INTRODUCTION

Construction is a risky business. As such, it is imperative for all parties related to the construction industry to realize that the successful completion of a construction project is far from a foregone conclusion.[1] General construction contractors are often susceptible to the risks associated with the construction industry and are no longer able to continue

1. *See generally* BRUCE M. JERVIS & PAUL LEVIN, CONSTRUCTION LAW: PRINCIPLES AND PRACTICE 81–97 (1988) (Jervis and Levin note all of the potential problems that may confront project owners on a construction project, including "shoddy workmanship, unexpected costs, and contractors that walk off the job.").

operations.[2] To combat the risk of a contractor being unable to complete a project, it is common for a construction project owner to require the contractor to secure a performance bond.

Unfortunately, the enforcement of performance bonds can sometimes result in complex litigation, usually involving large sums of money and unhappy litigants. As one text aptly observed:

> There is no simple scenario for a performance bond dispute. Most often a dispute will involve claims, counterclaims, charges, and countercharges. Seldom will any one party be altogether in the right. Often the parties are in a defensive posture when bond claims begin to surface. Usually, the project is behind schedule. Generally, prior to the time the surety is officially called upon to perform, lines have been drawn and personalities have clashed. It is no wonder that performance bond claims are fertile fields for surety litigators.[3]

A performance bond is defined as "[a] contract entered into between a contractor (referred to as the "principal") and a bonding company (referred to as a "surety") whereby the bonding company guarantees to the project owner (referred to as the "obligee") the contractor's faithful performance of its contractual duties and completion of the project."[4] From this definition, it is clear that a performance bond involves a tripartite contractual relationship.[5] The surety's contractual obligation to the project owner is limited to the "face amount" of the performance bond.[6]

A performance bond, like any other enforceable contract, generally contains an implied covenant of good faith and fair dealing[7] for all parties involved.[8] Because the implied covenant of good faith and fair dealing is generally viewed as an implied term of the contract, the general rule has emerged that a party may not recover in tort for a breach of the covenant

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2. *See* RICHARD H. CLOUGH & GLENN A. SEARS, CONSTRUCTION CONTRACTING § 7.1, at 172 (6th ed. 1994). In 1994, it was estimated that within seven years approximately fifty percent of the construction contracting firms then in existence would no longer be in business. *Id.*

3. WAYNE S. JENSEN & D. H. PURCELL, HANDLING FIDELITY AND SURETY CLAIMS, PERFORMANCE BONDS § 6.4, at 168 (Robert F. Cushman & Charles H. Stanm eds., 1984).

4. JERVIS & LEVIN, *supra* note 1, at 96. The most commonly used performance bond is distributed by The American Institute of Architects (AIA) in AIA Document A311. To view a sample of AIA Document A311, the "Performance Bond," see JERVIS & LEVIN, *supra* note 1, at 246–47.

5. For clarity and ease of understanding, this note will refer to the involved parties as "contractor," "surety," and "project owner" whenever possible. However, because other authorities often use the terms "principal" and "obligee," those terms will sometimes also be used.

6. JERVIS & LEVIN, *supra* note 1, at 82. Most often, the "face amount" of a performance bond ranges from approximately fifty to one hundred percent of the construction contract price. *See id.*; JUSTIN SWEET, LEGAL ASPECTS OF ARCHITECTURE, ENGINEERING AND THE CONSTRUCTION PROCESS § 33.06, at 734 (5th ed. 1994).

7. For a summary of the history and development of the covenant of good faith and fair dealing, see Jason Randal Erb, Note, *The Implied Covenant of Good Faith and Fair Dealing in Alaska: One Court's License to Override Contractual Expectations*, 11 ALASKA L. REV. 35, 37–43 (1994).

8. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

of good faith and fair dealing.[9] Rather, the nonbreaching party may only recover standard contractual damages under the contract itself.[10]

Traditionally, there has been only one exception to this general rule: in many states an insurer can be held liable in tort for a bad-faith breach of an insurance agreement with an insured.[11] In light of this, is a surety, like an insurer, subject to tort liability for a bad-faith breach of the covenant of good faith and fair dealing implied by law in a performance bond? Thus far, the state courts are split on this question. Some courts have found that sureties are sufficiently similar to insurers to justify tort recovery,[12] whereas others have found that sureties are distinguishable from insurers and should not be subject to any damages beyond those recoverable under the contract itself.[13] This note addresses whether a project owner should be able to recover damages in a tort action for a surety's breach of the covenant of good faith and fair dealing implied in a construction performance bond.[14]

In Part II, this note provides pertinent background and examines the development of allowing, or not allowing, tort recovery for breach of the covenant of good faith and fair dealing, especially in the context of a performance bond. Part III analyzes the various considerations and policies that courts must consider in determining whether to allow tort recovery for a breach of the performance bond. Part IV argues that courts should *not* allow tort recovery for such surety bad-faith breaches of the covenant of good faith and fair dealing. Accordingly, courts should limit a project owner's recovery against a surety to traditional contractual remedies.

II. BACKGROUND

A. The Development of the Insurance Exception

Traditional contract principles indicate that recovery for a breach of contract is limited to those damages that naturally arise from the breach itself or are in the contemplation of both parties at the time of the con-

9. *See* DOROTHY W. NELSON ET AL., CALIFORNIA PRACTICE GUIDE: INSURANCE LITIGATION § 12:28 (2000).

10. *See id*.

11. *See, e.g.*, Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407, 416 (Cal. 1999) (indicating that the California Supreme Court recognizes only one exception to the general rule that compensation for breach of the covenant is limited to contract remedies).

12. *See infra* notes 80–90 and accompanying text.

13. *See infra* notes 91–99 and accompanying text.

14. The scope of this note is necessarily limited to whether a project owner, the obligee, should have a tort remedy against a surety that has acted in bad faith. It does not address the similar, yet distinct, issues of whether the principal or a subcontractor should have a tort remedy in that instance. At least one commentator suggests that "[t]he tort of bad faith should certainly not be extended to allow a principal to assert such a claim against its surety." R. Cooper Shattuck, *Bad Faith: Does It Apply to Sureties in Alabama?*, 57 ALA. LAW. 241, 245 (1996).

tract.[15] Also, it is nearly uniformly accepted that a covenant of good faith and fair dealing is implicit in every contract.[16] The courts have recognized that because the covenant is essentially an implicit contractual term, the remedies for breach of the covenant are necessarily limited to contractual, rather than tort, damages.[17] Indeed, contract and tort remedies have fundamentally different objectives. Contract law is primarily designed to enforce agreements between the parties and to protect each party's reasonable expectations.[18] Tort law, on the other hand, is designed to advance a particular state's social policy.[19] This fundamental difference explains why courts have traditionally, and consistently, refused to grant tort remedies for breaches of the covenant of good faith and fair dealing.

However, one primary exception to this general rule has emerged over the years. Namely, some states have allowed tort damages in cases involving insurance contracts if the insurer breaches the agreement in bad faith.[20] Allowing such recovery "recognizes that the contract measure of recovery is sometimes inadequate to compensate a party that suffered damages not within the contemplation of the parties to the contract, or consequential damages, which generally are not recoverable under contract principles."[21]

Indeed, many states now allow tort recovery in the insurance context when the insurer fails to perform the contract in good faith.[22] The courts have been quick to point out, however, that the insurance exception is a "major departure from traditional principles of contract law."[23] Nevertheless, a bad-faith tort action is generally justified in the insurance context because of the unique policy considerations that arise out of the "special relationship" between the insurer and the insured.[24] Insurance policies implicate such policy considerations because they involve ele-

15. *See* Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. 1854).

16. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); *see also* Foley v. Interactive Data Corp., 765 P.2d 373, 389 (Cal. 1988) (noting that the implied covenant of good faith and fair dealing has been "recognized in the majority of American jurisdictions, the Restatement, and the Uniform Commercial Code").

17. *See Foley*, 765 P.2d at 389.

18. *See* Cates Constr. v. Talbot Partners, 980 P.2d 407, 427 (Cal. 1999).

19. *See id*.

20. *See Foley*, 765 P.2d at 390 ("An exception to this general rule has developed in the context of insurance contracts where, for a variety of policy reasons, courts have held that breach of the implied covenant will provide the basis for an action in tort.").

21. *See* Bernard L. Balkin & Keith Witten, *Current Developments in Bad Faith Litigation Involving the Performance and Payment Bond Surety*, 28 TORT & INS. L.J. 611, 611 (1993).

22. *See id*. at 615. Balkin and Witten list twenty-five states that now allow tort recovery in the insurer-insured context. *See id*. The scope of this note is limited to whether states that already recognize an insurance exception should extend it to the surety context. It has been correctly noted that "[i]t is unlikely that a . . . performance bond surety would be liable for [the tort of] bad faith in any jurisdiction that has not recognized bad faith as a viable claim in first-party insurance contracts." *Id.*

23. *Foley*, 765 P.2d at 394.

24. Arnold v. Nat'l County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987); *Cates*, 980 P.2d at 416.

ments of (1) adhesion, (2) unequal bargaining power, (3) public interest, and (4) fiduciary responsibility.[25]

An insured places great trust in the insurer and depends upon the insurer to fulfill all of its obligations.[26] Certainly, an insured generally enters into an insurance policy as protection from misfortune, and therefore has some higher expectations of the insurer than a party to other types of contracts. Indeed, an insurance policy can be defined as "a contract written to obtain peace of mind and protection against calamity—as opposed to a commercial advantage."[27]

An insurance policy has further been characterized as "quasi-public" in nature because it allows individuals to contract to gain protection from potential economic loss.[28] The "quasi-public" notion of insurance policies is predicated in part upon the recognition that an insured is unable to find another insurance company in the marketplace to recover losses it has previously incurred as a result of an insurer's bad-faith refusal to pay a claim.[29] This situation has been characterized as an "economic dilemma" that is unique to the insurance context.[30]

Furthermore, insurance policies are often characterized as adhesion contracts, with the insured not being on equal footing with the insurer.[31] Indeed, such "take-it-or-leave-it" adhesion contracts notoriously govern contractual relationships in the insurance industry. Because the insurer usually drafts the insurance policy,[32] the insured is at a clear bargaining disadvantage. Thus, many courts have found it necessary to protect the insured, who is subject to the adhesion contract, by allowing recovery in tort for bad-faith breaches of the insurance contract by the insurer.

Some courts have also indicated that insurers have a fiduciary duty to insureds.[33] As one court explained, "[t]he *tort* action for breach of the implied covenant of good faith and fair dealing requires a special element of reliance or fiduciary duty."[34] Accordingly, if an insurer acts in bad faith in carrying out its duties, the insurer has breached its fiduciary duty and should be subject to damages beyond mere contractual damages.

Thus, due to the "special relationship" that exists between an insurer and its insured, coupled with the underlying policy considerations

25. *Cates*, 980 P.2d at 416, 421–22; *see also* Balkin & Witten, *supra* note 21, at 612–13 (listing the six attributes of an insurance contract that California courts have considered to justify a tort remedy for bad-faith breaches of an insurance policy by the insurer).

26. *See* Balkin & Witten, *supra* note 21, at 612.

27. *Id*.

28. *See Foley*, 765 P.2d at 390.

29. *See Cates*, 980 P.2d at 423.

30. *Id.*

31. *See* Balkin & Witten, *supra* note 21, at 612.

32. *See* NELSON ET AL., *supra* note 9, § 12:28.1.

33. *See* Balkin & Witten, *supra* note 21, at 612.

34. Great Am. Ins. Co. v. Gen. Builders, Inc., 934 P.2d 257, 263 (Nev. 1997) (per curiam) (citing A.C. Shaw Constr. v. Washoe County, 784 P.2d 9, 10 (Nev. 1989)).

that this relationship creates, many courts have concluded that an extracontractual remedy is justified against insurers that have breached the insurance agreement in bad faith.

B. The Extension to the Suretyship Context

Perhaps it was inevitable that courts would eventually be requested to extend this narrow insurance exception to cover similar relationships, such as those involved in a performance bond. This is exactly what has happened in the last decade.

In *Dodge v. Fidelity & Deposit Co.*,[35] the Supreme Court of Arizona became the first state supreme court to allow tort recovery in this context.[36] In *Dodge*, the contractor failed to complete the project according to the terms of the construction contract, and the project owner declared the contractor to be in default.[37] The project owner brought suit against the surety to recover under the performance bond and also stated a claim under a tort theory of bad faith.[38] The trial court granted the surety's motion to dismiss the tort claim and this order was affirmed by the Arizona Court of Appeals, which stated that "given the difference in the relationship created by casualty insurance and surety insurance, we see no compelling public policy reasons to expand the damages collectible against a surety beyond those traditionally provided for breach of contract."[39] The Supreme Court of Arizona reversed, holding that a surety was an insurer and was therefore subject to a tort action for failing to meet its obligation to act in good faith.[40]

The next year, the Supreme Court of Alaska decided *Loyal Order of Moose v. International Fidelity Insurance Co.*[41] and came to the same conclusion as the Arizona Supreme Court.[42] Indeed, the Alaska court relied heavily upon *Dodge* in finding that sureties are insurers and subject to bad-faith tort liability.[43] The court noted that a surety could avoid a bad-faith claim "by acting reasonably in response to a claim by its obligee, and by acting promptly to remedy or perform the principal's duties where default is clear."[44]

Significantly, several other state supreme courts have engaged in very similar analyses and have come down on the opposite side of this issue. Indeed, in *Great American Insurance Co. v. North Austin Munici-*

35. 778 P.2d 1240 (Ariz. 1989).
36. *See id*. at 1244.
37. *See id*. at 1241.
38. *See id*.
39. Dodge v. Fid. & Deposit Co., 778 P.2d 1236, 1239 (Ariz. Ct. App. 1989).
40. *See Dodge*, 778 P.2d at 1244.
41. 797 P.2d 622 (Alaska 1990).
42. *See id*. at 626–27.
43. *See id*. (basing their conclusion in part on the "persuasive reasoning of the Supreme Court of Arizona in Dodge v. Fidelity & Deposit Co. of Md.")
44. *Id*. at 628.

pal Utility,[45] a unanimous Texas Supreme Court held that "there is no common-law duty of good faith and fair dealing between the surety and the bond obligee comparable to that between a liability insurer and its insured."[46] In so holding, the court found that there was not a "special relationship" between the surety and obligee to justify the imposition of extracontractual remedies.[47]

In a slightly different context, the Nevada Supreme Court has also refused to make a bad-faith tort claim available when a surety fails to meet its obligations under a performance bond.[48] In *General Builders*, the contractor, General Builders, was awarded a public contract to construct a hospital.[49] However, the project owner then determined that General Builders had not submitted adequate performance and payment bonds, and gave General Builders ten days to provide acceptable bonds.[50] General Builders obtained the required surety bonds from Great American Insurance Company, who later revoked the bonds as being issued without proper authority.[51] This revocation caused the project owner to not award the contract to General Builders.[52] General Builders subsequently sued Great American for breach of contract under a bad-faith tort theory.[53] The jury awarded $947,566 in compensatory damages and $2.5 million in punitive damages.[54] The Nevada Supreme Court recognized the existence of the insurance exception, but reversed the punitive damages award, concluding that "[t]here is no insurance or other special relationship in this case."[55]

Two more recent state supreme court cases provide good examples of how courts have analyzed this issue and reached different conclusions. In 1997, the Colorado Supreme Court decided *Transamerica Premier Insurance Co. v. Brighton School District 27J*,[56] and allowed tort recovery for a surety's breach of the performance bond.[57] In contrast, in *Cates Construction, Inc. v. Talbot Partners*[58] the California Supreme Court explicitly denied tort recovery under very similar circumstances.[59]

In *Transamerica*, a school district entered into a contract with a mechanical contractor, which provided the school district with a perform-

45. 908 S.W.2d 415 (Tex. 1995).
46. *Id*. at 416.
47. *See id*. at 420.
48. *See* Great Am. Ins. Co. v. Gen. Builders, Inc., 934 P.2d 257 (Nev. 1997) (per curiam).
49. *Id*. at 259.
50. *Id*.
51. *Id*.
52. *Id*. at 260.
53. *Id.*
54. *Id*.
55. *Id*. at 263.
56. 940 P.2d 348 (Colo. 1997).
57. *See id*. at 353–54.
58. 980 P.2d 407 (Cal. 1999).
59. *Id*. at 427.

ance bond with Transamerica, a commercial surety.[60] The school district removed the contractor from the project after repeated notices that the contractor was behind schedule.[61] Accordingly, the school district immediately filed a claim against Transamerica to recover under the performance bond.[62] Transamerica eventually refused to pay for the remedial work to complete the contractor's unfinished work.[63] The Colorado Supreme Court held that "Colorado common law recognizes a cause of action in tort for a commercial surety's failure to act in good faith when processing claims made by an obligee pursuant to the terms of a performance bond."[64] In so holding, the court noted that Colorado had long recognized that an insured could assert a separate tort cause of action against an insurer that had breached its duty to act in good faith.[65] The Colorado court went on to conclude that "[a] special relationship exists between a commercial surety and an obligee that is nearly identical to that involving an insurer and an insured."[66]

The California Supreme Court faced a similar set of facts in *Cates*. In *Cates*, Cates Construction furnished the project owner, Talbot Partners, with a performance bond guaranteeing Cates' completion of the project.[67] At trial, the jury found that the surety breached the performance bond's implied covenant of good faith and fair dealing and awarded the project owner $28 million in punitive damages.[68] In reversing the award of a tort remedy, the California Supreme Court, by a four-to-three majority, concluded that a project owner could not recover in tort for a surety's bad-faith breach of a performance bond.[69] Indeed, the court held that "recovery for a surety's breach of the implied covenant of good faith and fair dealing is properly limited to those damages within the contemplation of the parties at the time the performance bond is given or at least reasonably foreseeable by them at that time."[70] In short, the court found that a surety was different than an insurer and a performance bond was not an insurance policy.[71] Further, the court examined the characteristics of a performance bond to determine if the policy considerations that justify the insurance exception were similarly involved.[72] The court concluded that a performance bond was not "a contract otherwise marked by elements of adhesion, public interest or fiduciary responsibil-

60. *Transamerica*, 940 P.2d at 349.
61. *Id*. at 350.
62. *Id*.
63. *See id*.
64. *Id*. at 353–54.
65. *Id.* at 351.
66. *Id*. at 352.
67. Cates Constr. v. Talbot Partners, 980 P.2d 407, 410 (Cal. 1999).
68. *Id*. at 412. The California Court of Appeals later reduced this award to $15 million, but otherwise affirmed the judgment. *Id*.
69. *See id*. at 427.
70. *Id*.
71. *See id*.
72. *See id.* at 421–26.

ity, such that an extracontractual remedy is necessitated in the interests of social policy."[73] Therefore, the insurance exception did not apply and the general contractual remedy was appropriate.[74]

However, the spirited dissent was not persuaded by the majority's arguments.[75] The dissent began by noting that the weight of authority has found sureties to be sufficiently similar to insurers to hold them liable in tort for bad-faith breaches of the performance bond.[76] The dissent agreed with the weight of authority and concluded that a performance bond was one type of insurance.[77] Thus, the dissent would have held that a tort remedy should have been available to the project owner for the insurer-surety's bad-faith breach of the performance bond.[78]

As can be seen from these decisions, there is a deep split in authority as to whether a tort remedy should exist in the suretyship context.[79] In large part, the issue boils down to whether a performance bond is sufficiently similar to an insurance policy to justify creating a tort remedy for bad-faith breaches of the bond.

C. Rationale for Allowing Tort Recovery

The theory behind extending the insurance exception to cover performance bonds has been stated very simply: "sureties are insurers; insurers are subject to bad-faith tort liability; therefore, sureties are subject to bad-faith tort liability."[80] The courts that have permitted tort recovery have basically used two separate grounds for concluding that performance bond sureties are insurers for purposes of applying the insurance exception. First, some courts have found sureties to be insurers based upon the fact that the state's insurance code includes "surety."[81] Indeed, in some states the insurance code lists a surety as a separate class of insurance and includes performance bonds within the surety "class."[82]

73. *Id*. at 427.
74. *Id*. at 421–27.
75. *See id*. at 428 (Mosk, J., concurring and dissenting).
76. *Id*. (Mosk, J., concurring and dissenting).
77. *See id*. (Mosk, J., concurring and dissenting).
78. *See id.* at 433 (Mosk, J., concurring and dissenting).
79. For a recent discussion of the split in authority on this issue, see *Int'l Fid. Ins. Co. v. Delmarva Sys. Corp.*, 2001 WL 541469, at *2–7 (Del. Super. Ct. May 9, 2001).
80. Dodge v. Fid. & Deposit Co., 778 P.2d 1240, 1241 (Ariz. 1989).
81. *See id.* at 1241–42; Gen. Ins. Co. of Am. v. Mammoth Vista Owners' Ass'n, 174 Cal. App. 3d 810, 824 (Cal. Ct. App. 1985); *Int'l Fid. Ins. Co.*, 2001 WL 541469, at *8–9; K-W Indus. v. Nat'l Sur. Corp., 754 P.2d 502, 504–05 (Mont. 1988); *cf.* Szarkowski v. Reliance Ins. Co., 404 N.W.2d 502, 504–05 (N.D. 1987) (concluding that because suretyship was regulated by the insurance code, a subcontractor could sue the general contractor's surety in tort for bad-faith breach of the performance bond).
82. *See, e.g.*, CAL. INS. CODE § 100 (West 2000) (listing "Surety" as a class of insurance); *id.* § 105(a) (including performance bonds within the "surety" class of insurance). The California statute is fairly representative of similar provisions passed by other states, and provides that "surety" insurance includes:

> [t]he guaranteeing of behavior of persons and the guaranteeing of performance of contracts (including executing or guaranteeing bonds and undertakings required or permitted in all actions or

These courts have found such inclusion sufficient to establish a surety as an insurer on the basis of legislative intent, and were therefore not concerned with the inherent differences between suretyship and insurance.[83]

Second, other courts have found sureties to be sufficiently similar to insurers after analyzing the relationships between the parties and have further concluded that similar policy considerations exist as in the insurer-insured relationship to warrant a tort remedy.[84] In general, the courts that authorize a tort action based on this conclusion conduct an analysis of the same policy considerations as those that deny a tort action. This analysis generally revolves around determining whether there is a "special relationship" between the parties.[85] These courts argue that a nearly identical "special relationship" exists in the surety context as between an insurer and its insured.[86] They have come to this conclusion despite recognizing the traditional differences between a surety bond and a traditional insurance policy.[87]

Furthermore, it is clear that one significant result of allowing tort recovery would be the availability of punitive damages. Indeed, if courts authorize tort actions, the potential for punitive damages would also exist, whereas under a simple breach of contract claim the amount of the performance bond limits a surety's potential liability. The courts that allow tort recovery find the availability of extracontractual damages, including punitive damages, compelling as a way to shape surety behavior. The court in *Transamerica* clearly explains this theory:

> Recognizing a cause of action in tort for a commercial surety's breach of its duty to act in good faith compels commercial sureties to handle claims responsibly. When the commercial surety withholds payment of an obligee's claim in bad faith, contract damages do not compensate the obligee for the commercial surety's misconduct and have no deterrent effect to prevent such misconduct in the future.[88]

Thus, an important policy consideration in justifying such a remedy is the deterrent effect of extracontractual damages.[89] The *Dodge* court

proceedings or by law allowed), other than insurance policies and other than for payments secured by mortgage, deed of trust, or other instrument constituting a lien or charge on real estate.

Id.

83. *See Dodge*, 778 P.2d at 1242.

84. *See* Loyal Order of Moose v. Int'l Fid. Ins. Co., 797 P.2d 622, 627–28 (Alaska 1990); *Dodge*, 778 P.2d at 1242–43; Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348, 352–54 (Colo. 1997).

85. *See supra* note 24 and accompanying text.

86. *See Loyal Order of Moose*, 797 P.2d at 627–28; *Dodge*, 778 P.2d at 1242; *Transamerica*, 940 P.2d at 352.

87. *See Loyal Order of Moose*, 797 P.2d at 627–28; *Dodge*, 778 P.2d at 1242; *Transamerica*, 940 P.2d at 352.

88. *Transamerica*, 940 P.2d at 353.

89. *See Dodge*, 778 P.2d at 1242 ("Imposing tort damages on a surety who in bad faith refuses to pay a valid claim will deter such conduct.").

noted that allowing a surety to "withhold performance of its obligations without reason would defeat the purpose" of the surety agreement.[90]

Accordingly, to some courts, the inclusion of suretyship in the state insurance code is extremely important. To others, the suretyship relationship involved with a performance bond is sufficiently similar to the insurer-insured relationship to justify applying the insurance exception.

D. Rationale for Denying Tort Recovery

The courts that deny a tort remedy for breach of the covenant of good faith and fair dealing in the performance bond context generally do so based upon the inherent differences between suretyship and insurance. To begin, however, the courts often must first dispose of the argument that the inclusion of a surety in the insurance code settles the question of whether a surety is an insurer.

Accordingly, these courts have found unpersuasive the argument that, because a surety is listed in the insurance code, they should be treated the same as an insurer. For example, in *Cates*, the Supreme Court of California addressed this issue at length[91] and concluded that "the mere inclusion of surety arrangements in the Insurance Code should not be determinative."[92] Rather, the courts have found that the differences between a performance bond and a traditional insurance contract warrant consideration.[93]

In this regard, the argument is simply that a performance bond does not implicate the same policy concerns as an insurance policy.[94] Indeed, these courts have analyzed the tripartite relationship involved in a performance bond and concluded that it does not involve the "special relationship" that is necessary to support a tort action.[95] The courts have reasoned that the surety-obligee relationship is not marked by the same elements of "adhesion and unequal bargaining power, public interest and fiduciary responsibility."[96] Therefore, the courts conclude that because the policy considerations underlying the insurance exception are not similarly involved in the surety context, the exception should not be extended.[97]

90. *Id*. at 1243.

91. *See generally* Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407, 418–21 (Cal. 1999) (discussing the inclusion of "Surety" as a class of insurance in California's insurance code).

92. *Id*. at 421.

93. *See, e.g.*, Great Am. Ins. Co. v. North Austin Mun. Util. Dist. No. 1, 908 S.W.2d 415, 420 (Tex. 1995).

94. *See Cates*, 980 P.2d at 421–26; Great Am. Ins. Co. v. General Builders, Inc., 934 P.2d 257, 263 (Nev. 1997); *North Austin*, 908 S.W.2d at 418–20.

95. *See Cates*, 980 P.2d at 421–26; *General Builders*, 934 P.2d at 263; *North Austin*, 908 S.W.2d at 418–20.

96. *Cates*, 980 P.2d at 421–22; *accord North Austin*, 908 S.W.2d at 418–19.

97. *See, e.g.*, *Cates*, 980 P.2d at 421–26.

Moreover, the *Cates* court also found unpersuasive the argument that a tort remedy was needed to ensure that a surety handled its claims responsibly and to provide a deterrent against misconduct.[98] The court reasoned that a tort remedy was not needed in this context for a variety of reasons: (1) the parties have relatively equal bargaining power in negotiating the instrument and can therefore provide for such things as liquidated damages; (2) contract remedies are adequate to compensate the parties for damages that were reasonably foreseeable at the time they entered into the bond; (3) sureties, which may be regulated under the state's insurance code, may be subject to administrative liability for misconduct; (4) a tort remedy may just as easily cause "harmful economic effects"; and (5) an extracontractual remedy may lead to increased litigation that may increase the cost of purchasing bonds.[99]

Thus, to these courts, neither the statutory inclusion of a surety in the insurance code nor the policy considerations accompanying the relationship between the parties warrant extension of the insurance exception to performance bonds.

III. ANALYSIS

Courts have generally examined several theories in determining whether or not tort recovery should be available to a project owner when a surety breaches a performance bond in bad faith. Some courts have found significance in the legislative inclusion of a surety in regulatory insurance statutes.[100] Additionally, courts have relied upon examination of the inherent similarities and differences between suretyship and insurance in determining whether the insurance exception should apply.[101] In either case, the primary issue becomes whether a surety is sufficiently similar to an insurer as to justify applying the insurance exception, thus allowing a project owner to recover in tort.

A. Statutory Inclusion of a Surety as a Type of Insurance

State courts have split on whether statutory inclusion of a surety as a type of insurance in the insurance code is sufficient to establish a per-

98. *See id*. at 425 ("[W]e are not convinced that tort remedies are necessary to achieve such objectives.").

99. *Id*. at 425–26.

100. *See* Balkin & Witten, *supra* note 21, at 614–15; *see also* Dodge v. Fid. & Deposit Co. of Md., 778 P.2d 1240, 1241–42 (Ariz. 1989) (noting that surety is included within the state's insurance code and finding that the Arizona legislature had clearly expressed its intent to "include sureties within the coverage of the insurance statutes").

101. *See, e.g.*, *Cates*, 980 P.2d at 418–26 (conducting extensive analysis of the differences between sureties and insurers and between performance bonds and other insurance policies); Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348, 351–53 (Colo. 1997) (examining the nature of performance bonds to determine if they are sufficiently similar to insurance policies to justify tort recovery).

formance bond as an insurance policy.[102] Indeed, the *Dodge* court went so far as to recognize that inherent differences exist between sureties and other types of insurers, but maintained that legislative intent was to control whether a surety was to be classified as an insurer.[103] Specifically, the Arizona Supreme Court found the following language from *General Insurance Co. v. Mammoth Vista Owners Association*,[104] a California court of appeals decision, persuasive: "We recognize liability insurance is not identical in every respect with suretyship. But we are not concerned with the differences between suretyship and liability insurance. We are concerned with whether the Legislature included suretyship among the classes of businesses it intended to regulate under the Insurance Code."[105]

Interestingly, the California Supreme Court came down differently on this issue. In *Cates*,[106] the court expressly considered the decision in *Mammoth Vista*, and found that it was unhelpful in this context.[107] The California Supreme Court explained, "the availability of tort recovery in the insurance policy cases derives from policy considerations pertaining to the particular characteristics of such contracts and the relationship between the contracting parties; it has never been predicated upon the existence of legislation regulating the insurance business."[108] Thus, the court concluded that inclusion of surety in the insurance code was not determinative, and that the performance bond should be analyzed to determine whether the same policy considerations exist to justify the availability of a tort remedy.[109]

Of course, a state's legislature may regulate sureties as insurers by including a surety as a type of insurance.[110] But such a legislative decision does not necessarily mean that sureties are to be treated as insurers in all potential situations.[111] This is especially true in the tort liability context because tort liability has been imposed on insurers based upon special policy concerns, with little or no emphasis being placed on the fact that insurers are separately regulated under an insurance code.[112] One authority suggests that "[t]he inclusion of suretyship in the Insurance Code

102. *Compare Cates*, 980 P.2d at 421, *with Dodge*, 778 P.2d at 1242.

103. *See Dodge*, 778 P.2d at 1242.

104. 220 Cal. Rptr. 291 (Cal. Ct. App. 1985).

105. *Dodge*, 778 P.2d at 1242 (quoting Gen. Ins. Co. v. Mammoth Vista Owners Ass'n, 220 Cal. Rptr. 291, 298 (Cal. Ct. App. 1985)).

106. 980 P.2d 407.

107. *Id*. at 416–17.

108. *Id*. at 417. The court also noted that the court in *Mammoth Vista* expressly refused to decide the issue of whether a surety could be held liable in tort for breaching the covenant of good faith and fair dealing. *Id*.

109. *Id*. at 421.

110. *Id*. at 420 ("The legislative branch is free to regulate suretyship, and, assuming a rationale basis, may require sureties and surety bonds to adhere to the same regulations and requirements that apply to insurers and insurance policies.").

111. *Id.* at 419–21.

112. *Id*. at 420.

is derived from the need for control of the surety business by a state agency and does not imply that the underlying natures of insurance and suretyship are the same."[113] The courts that have relied heavily upon legislative intent to regulate sureties as insurers[114] have not adequately explained how such legislative intent translates into treating performance bonds as insurance policies for purposes of common-law theories of tort liability.[115] Indeed, as one commentator observed, these cases merely use the legislative inclusion of surety in the insurance code as a "jumping off point to clear the hurdle to common-law bad-faith liability otherwise imposed by the historical distinctions between suretyship and insurance."[116] From that "jumping off point" some courts have landed at the conclusion that a surety is an insurer for purposes of common-law tort liability.[117] Presumably, if a surety may be considered to be an insurer for purposes of bad-faith tort liability solely because "surety" is included within the insurance code, then a surety could be considered an insurer for almost all other purposes as well. This would be a major departure from traditional notions of suretyship as "surety bonds have been distinguished from insurance policies in statutory, regulatory and decisional law . . . ."[118] Such a leap is not justified.

Even though regulated as a class of insurance, there is little doubt that suretyship "differs in material respects" from other types of traditional insurance policies.[119] These differences become vital because the insurance exception developed with respect to insurance policies not under the umbrella of the statutory scheme, but rather for "policy reasons pertaining to the distinctive nature of such contracts and the relationship between the contracting parties."[120] Accordingly, because the insurance exception is based upon policy considerations apart from the need for a state agency to regulate insurers, the mere inclusion of a surety in an insurance code should *not* be determinative on whether a surety is an insurer for this purpose. Courts must conduct a deeper evaluation of the

113. WILLIAM CONNERS, CAL. SURETY AND FIDELITY BOND PRACTICE § 1.4, at 6 (Cont. Ed. Bar 1969).

114. *See, e.g.*, Dodge v. Fid. & Deposit Co., 778 P.2d 1240, 1242 (Ariz. 1989).

115. *See Cates*, 980 P.2d at 421 (noting that even though a surety is listed as one type of insurance under California's insurance code, it does not necessarily follow that a surety bond should be considered to be an insurance policy under common law).

116. John J. Aromando, *The Surety's Liability for "Bad Faith": Claims for Extra-Contractual Damages by an Obligee Under the Payment Bond*, 47 ME. L. REV. 389, 404 (1995). Aromando further suggests that a court is exceeding its role when it mixes pieces of a statutory scheme with common-law theories of liability. *Id*. at 405. Not only could this approach be viewed as comparing "apples and oranges," but it may actually impede, rather than further, the legislature's intent to develop its insurance code. *Id*.; *see also* Marquis v. Farm Family Mut. Ins. Co., 628 A.2d 644, 652 (Me. 1993) ("Allowing, in addition, an independent tort action . . . 'might well thwart the legislature's intent to craft a comprehensive insurance code . . . .'") (quoting Seabury Hous. Assocs. v. Home Ins. Co., 695 F. Supp. 1244, 1249 (D. Me. 1988))).

117. *See supra* text accompanying notes 80–82.

118. *Cates*, 980 P.2d at 420.

119. *Id*. at 419 (quoting Amwest Sur. Ins. Co. v. Wilson, 906 P.2d 1112 (Cal. 1995)).

120. *Id*. at 420.

differences between performance bonds and other liability insurance policies and examine how these differences effect the relevant policy considerations.

B. The Inherent Differences Between Suretyship and Insurance

As one authority clearly states, "[a] surety bond is not an insurance policy."[121] Indeed, even the courts that have allowed tort recovery under the insurance exception recognize that there exist inherent differences between an insurance policy and a performance bond.[122] The issue, then, is not whether differences between suretyship and insurance exist, but rather, whether those inherent differences are significant enough to remove a surety from being an insurer for the purpose of tort liability. Although there are numerous differences between insurance and suretyship,[123] the two most important differences for the present purpose are (1) the existence of the tripartite relationship and (2) the potentially different purpose for which they are obtained.[124] A close analysis of these inherent differences is critical in determining whether a surety should be included under the insurance exception to the general rule.

1. The Tripartite Relationship

The most obvious and important difference between a performance bond and other insurance policies is that a performance bond involves a tripartite relationship.[125] In contrast to general liability insurance policies, in which an insurer contracts directly with an insured, a performance bond is a three-party arrangement in which a surety contracts with a construction contractor to guarantee to a third party, the project owner, that the contractor will fulfill its obligations under the construction contract.[126]

121. CLOUGH & SEARS, *supra* note 2, § 7.1, at 172.

122. *See* Balkin & Witten, *supra* note 21, at 614; *see also* Loyal Order of Moose v. Int'l Fid. Ins. Co., 797 P.2d 622, 627–28 (Alaska 1990) (noting that there are differences between surety bonds and insurance policies but still finding them to be analogous); Dodge v. Fid. & Deposit Co., 778 P.2d 1240, 1242 (Ariz. 1989) (recognizing that liability insurance is not identical to suretyship); Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348, 353 (Colo. 1997) ("While there may be differences in the form of the suretyship agreement and the obligations of the parties, its substance is essentially the same as insurance.").

123. *See* Balkin & Witten, *supra* note 21, at 614 (summarizing the traditional differences that have been recognized between a surety and an insurer).

124. *See* Shattuck, *supra* note 14, at 246 (indicating that two of the primary differences between suretyship and insurance are the tripartite relationship and the purpose for which a bond is obtained).

125. *See* 74 AM. JUR. 2D *Suretyship* § 3 (1974).

126. *See* JERVIS & LEVIN, *supra* note 1, at 82, 96. Under this arrangement, it is the contractor, rather than the surety, that is primarily liable for performing the act covered under the performance bond. *See* 74 AM. JUR. 2D *Suretyship* § 3 (1974). The surety is merely "bound in an accessory or collateral capacity" so that the surety only becomes liable to the project owner if the contractor fails to perform its obligations under the construction contract. *Id.*

This tripartite relationship puts the surety in a quite different position than an insurer in a traditional two-party insurance contract. Under a performance bond, a surety owes a duty of good faith and fair dealing not only to the project owner but also to the contractor. In arguing for denial of a tort remedy, sureties have argued that this relationship presents a dilemma that is not faced by insurers.[127] However, this argument has largely not been accepted.[128] In rejecting this argument, the Supreme Court of Arizona stated that "the duty imposed on a surety to deal in good faith with its obligee does not require it to act in bad faith with its principal."[129] In reaching this correct conclusion, the *Dodge* court relied upon the following language:

> [T]he surety often finds it difficult to decide whether to accede to the demands of the claimant [obligee] or abide by the position desired by the principal. Notwithstanding this difficulty, the surety is in a position of having accepted a premium in exchange for its promise to pay or perform in case of specified events. . . . Additionally, it makes its promise with full knowledge that at times it will possibly be called upon to perform when it can do so only at some risk of losing its recovery rights against or inviting suits from its [principal]. Given the nature of a corporate surety's business, and its knowledge of the inherent risk it entails, it can have no real confidence that a "middle man" plea on its part . . . will find a favorable reception with the court.[130]

However, as one commentator has observed, this ruling was not reconciled with the traditional rule that a surety's liability is generally limited to the "face amount" of the bond.[131] Further, the ruling was not reconciled with the well accepted proposition that a breach of the implied covenant of good faith and fair dealing results in only contractual, rather than tort, damages. Indeed, it is not disputed that the surety will continue to owe both the obligee and the principal an obligation of good

127. The surety's dilemma has been clearly described as follows:

> Clearly, the surety owes a duty of good faith and fair dealing to *both* the principal and the obligee on the bond. If the surety pays too quickly to the obligee, it may invite liability claims from the principal. Conversely, if it refuses to pay anything pending an arbitration or judicial proceeding to determine its liability on the bond, the surety may incur liability to the obligee for failing to act promptly on a valid claim.

Board of Dirs. of Ass'n of Apartment Owners v. United Pac. Ins., Co., 884 P.2d 1134, 1137 (Haw. 1994) (citations omitted).

128. *See* Loyal Order of Moose v. Int'l Fid. Ins. Co., 797 P.2d 622, 627 & n.8 (Alaska 1990); Dodge v. Fid. & Deposit Co. of Md., 778 P.2d 1240, 1243–44 (Ariz. 1989); Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348, 353 & n.4 (Colo. 1997). *But see* Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407, 425–26 (Cal. 1999) ("When contract disputes arise between an obligee and a principal as to whether the principal is in default, it may prove difficult for the surety to determine which party is in the right and whether its own performance is due under the bond.").

129. *Dodge*, 778 P.2d at 1243.

130. *Id*. (alterations in original) (quoting Bert Brumley, *Duty of a Shielded Surety to Investigate*, 17 FORUM 266, 280 (1981)).

131. *See* Balkin & Witten, *supra* note 21, at 620.

faith and fair dealing. Rather, the dispute centers around whether a tort remedy is proper given the surety's unique dilemma.

A tort remedy in this situation could substantially shift the balance in the tripartite relationship, resulting in a nonlevel "playing field."[132] As the California Supreme Court suggested, the availability of a tort remedy "may allow obligees to gain additional leverage with sureties that principals do not have in contract disputes."[133] Such a shift in the balance of the tripartite relationship may have several negative consequences. First, it may encourage a project owner to allege contractor default more readily than it would if only traditional contractual damages were available.[134] Second, a tort remedy may compel sureties to pay questionable claims in order to avoid the risk of tort liability and large punitive damage awards.[135] Third, such increased leverage by the obligee may give them "sufficient power to detrimentally affect the interests of principals when disagreements arise during construction."[136] These concerns have no parallel in the insurance context because of the lack of a tripartite relationship. Therefore, it is clear that the unique relationship that exists in the performance bond context argues against extending the insurance exception to include sureties.

2. The Purpose of a Performance Bond

Arguably, another potential difference exists in that a performance bond may be secured for different reasons than an insurance policy. Unlike most other contracts, an insurance policy is not purchased to gain a profit or commercial advantage, but rather to gain security and peace of mind in the event of misfortune.[137] The Supreme Court of Arizona recognized that one of the most important factors in determining whether a tort remedy might be justified is whether the party "contracted for security or protection rather than for profit or commercial advantage."[138] The *Dodge* court found that the purpose of the performance bond "was not for [the project owner's] commercial advantage, but to protect [the project owner] from calamity—[the contractor's] default on

132. *See Cates*, 980 P.2d at 426 (noting that "construction disputes may be complicated enough to resolve when all three parties are on a level playing field").

133. *Id*.

134. *Id*.

135. *Id*.

136. *See id.* The *Cates* court describes several ways in which a project owner might detrimentally affect an innocent contractor. *Id*. If a claim is made by a project owner against the contractor, in hopes of pressuring the surety into paying on the claim, the contractor may have difficulty in securing bonding for other projects. *Id*. Additionally, such leverage may lead sureties to actively attempt to avoid bad-faith tort liability by actively seeking to find coverage for project owners, while charging their investigation costs to the contractor. *Id*. In that respect, a contractor may be adversely affected even if the surety eventually concludes that the contractor was not in default. *Id*.

137. *See supra* text accompanying notes 25–27.

138. *See* Dodge v. Fid. & Deposit Co., 778 P.2d 1240, 1242 (Ariz. 1989).

the contract."[139] The Colorado Supreme Court agreed, citing *Dodge* for the proposition that an "obligee is essentially insuring itself from the potentially catastrophic losses that would result in the event the principal defaults on its original obligation."[140] Accordingly, these courts found that the purpose of a performance bond was nearly identical to an insurance policy.[141]

However, one construction industry authority has suggested that a performance bond is designed to guarantee the faithful performance of a contractual duty, as distinguished from protecting a party against the risk of loss.[142] Similarly, the *Cates* court found the purpose of a performance bond to be distinct from the purpose of an insurance policy.[143] According to *Cates*, "the general purpose of a construction performance bond 'is to protect the creditor [the owner/obligee] against the danger that he will be unable to collect from the debtor [the general contractor/principal] for any failure in the performance of the contract.'"[144] Therefore, instead of seeking security against some future misfortune, the project owner requires a performance bond to seek "the commercial advantage of obtaining a contract with the principal which provides additional financial security."[145] This purpose is further evidenced by the fact that, in general, the contractor is required to obtain and pay for the performance bond.[146]

Moreover, besides the primary advantage of gaining additional security that the project will be completed according to the project's construction contract,[147] the project owner receives a second benefit from requiring a performance bond. The project owner receives the benefit of having the surety "prequalify" the contractor.[148] Indeed, before a surety will agree to bond a contractor, the "contractor must undergo a thorough

139. *Id*.

140. Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348, 352 (Colo. 1997) (citing *Dodge*, 778 P.2d at 1242).

141. *Dodge*, 778 P.2d at 1242; *Transamerica*, 940 P.2d at 351 ("[C]ommercial sureties receiving consideration for the issuance of surety bonds serve a purpose similar to that of insurers.").

142. *See* CLOUGH & SEARS, *supra* note 2, § 7.1, at 172. Clough and Sears contend that a performance bond is not an insurance policy; rather, it is an "extension of credit" by the surety in the form of an endorsement of the contractor. *Id*. The bond becomes an endorsement of the contractor because sureties will not bond just any contractor. *See* JERVIS & LEVIN, *supra* note 1, at 83. Instead, "to keep their level of risk reasonable, sureties try very hard to write bonds only for contractors that will complete their projects." *Id*. Indeed, "contract bonds, like loans, are written based on the financial integrity of the principal, premised on the idea that no losses should follow." T. Scott Leo, *The Construction Contract Surety and Some Suretyship Defenses*, 34 WM. & MARY L. REV. 1225, 1232 (1993). This is in contrast with an insurance policy, which is based upon the actuarial computation of the certainty of loss. *See* Balkin & Witten, *supra* note 21, at 614.

143. *See* Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407, 422–23 (Cal. 1999).

144. *Id*. (alterations in original) (quoting Regents of Univ. of Cal. v. Hartford Accident & Indem. Co., 581 P.2d 197, 205 (Cal. 1978)).

145. *Id*. at 423 (quoting Shattuck, *supra* note 14, at 246).

146. *See* Balkin & Witten, *supra* note 21, at 614.

147. *See* JERVIS & LEVIN, *supra* note 1, at 82–83 (noting that the primary advantage to the project owner of obtaining a performance bond is to be able to complete the project if the contractor defaults).

148. *Id*. at 83.

evaluation."[149] "This extensive evaluation of a contractor's history, abilities, and financial situation can only benefit a project owner. . . . The owner knows that at least one reputable corporate surety has sufficient faith in the contractor to take that contractor on as a risk."[150] With this additional benefit to the project owner, it is difficult to conclude that a project owner enters into a performance bond merely to protect itself against calamity.

Thus, although at first glance it appears that a project owner is seeking protection against the risk of financial loss due to a specified event (i.e. contractor default), a closer inspection reveals that the owner is actually seeking the commercial advantage of a financially secure contract with the contractor. The commercial advantage that a project owner receives under a performance bond has no parallel in the insurance context, and thus also weighs against the appropriateness of a tort remedy.

C. Policy Considerations Justifying a Tort Remedy

A common-law tort remedy is justified in the insurance context due to the "special relationship" that exists between an insurer and its insured.[151] This "special relationship" gives rise to policy considerations that do not exist in other contracts. In particular, insurance policies have been found to implicate such policy considerations because they involve elements of (1) adhesion, (2) unequal bargaining power, (3) public interest, and (4) fiduciary responsibility.[152] Thus, if a tort remedy is to be similarly justified in the performance bond setting, these same elements must be sufficiently satisfied.

1. Adhesion

Obviously, insurance contracts are well known for being adhesion contracts, in which the insured has very little input.[153] Indeed, insurance contracts are generally unilaterally written by the insurance company itself or are promulgated within the insurance industry. The insured usually has little, if any, involvement in preparing the terms and conditions of the insurance policy, and is therefore subject to the provisions drafted by the insurer. This is the prototypical adhesion contract.

In contrast, it is clear that performance bonds do not similarly involve elements of adhesion. "Unlike insurance policies . . . [perform-

149. *Id*. Jervis and Levin give the following as an example of a contractor evaluation: "Do they have a history of successfully completing projects of this nature? Do they have the technical and administrative expertise that will be required for successful completion? And finally, does the company have access to sufficient capital to complete the project?" *Id*.

150. *Id*.

151. *See* Arnold v. Nat'l County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987).

152. *See supra* notes 24–25 and accompanying text.

153. *See supra* text accompanying notes 31–32.

ance] bond forms are not drafted unilaterally by the surety or the surety industry."[154] In fact, it is generally the project owner that "decide[s] the form of the bond which they will accept from the principal."[155] Indeed, the project owner sometimes drafts the performance bond that it will accept, thus leaving the surety with the option to either accept that form of the bond or refuse to enter into the agreement.[156] Significantly, when the project owner controls the form of the bond, the roles are reversed from the insurer-insured relationship with the surety being placed in a "take-it-or-leave-it" position.

Furthermore, probably the most commonly used form of the performance bond is the one promulgated by the American Institute of Architects (AIA), which has no affiliation with the surety companies.[157] As a standard form contract that is drafted by an uninterested third party, it is difficult to imagine how the commonly used AIA performance bond could be construed as an adhesion contract against a surety. Indeed, as the court in *Cates* stated in concluding that there was no adhesion: "It is of no significance that the bond terms here appeared on a standard form published by the American Institute of Architects (AIA). That organization, as its name suggests, is not one that exists to advance the interests of surety companies."[158]

Thus, unlike the typical insurance contract, a performance bond is not marked by elements of adhesion. Accordingly, the first factor used to justify the insurance exception—adhesion—cannot similarly be used to justify a tort remedy for a project owner.

2. Unequal Bargaining Power

Most courts have recognized that an obligee under a performance bond, a construction project owner, is not similar to an individual insured in terms of bargaining power and sophistication.[159] Indeed, in many cases

154. Leo, *supra* note 142, at 1229.

155. Shattuck, *supra* note 14, at 246.

156. Leo, *supra* note 142, at 1230–31.

157. *See supra* note 4. The AIA has developed a widely used set of standard form contracts to govern the relationships between parties to a construction project. "The AIA generally promulgates its forms pursuant to an inclusive drafting policy that encourages input from a variety of outside groups and individuals." Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407, 422 n.16 (Cal. 1999) (citing Mark H. McCallum et al., *The 1996 Editions of AIA Design/Build Standard Form Agreements*, CONSTRUCTION LAW., Oct. 1996, at 38.

158. *Cates*, 980 P.2d at 422 n.16.

159. *See* Blackfeet Tribe of the Blackfeet Indian Reservation v. Blaze Constr., Inc., 108 F. Supp. 2d 1122, 1142 (D. Mont. 2000) (finding that the parties were not in inherently unequal bargaining positions); *Cates*, 980 P.2d at 422 (concluding that "[performance] bonds do not reflect the . . . unequal bargaining power that [is] inherent in insurance policies"); Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348, 353 (Colo. 1997) (admitting that the parties to a suretyship contract are on "equal footing" when entering into the agreement); Great Am. Ins. Co. v. Gen. Builders, Inc., 934 P.2d 257, 263 (Nev. 1997) (concluding that both parties were experienced commercial entities and therefore did not have unequal bargaining power); Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1, 908 S.W.2d 415, 420 (Tex. 1995) (indicating that the transaction was entered into at "arm's length").

where a project owner requires a contractor to obtain a performance bond, the project owner is an experienced commercial entity with considerable bargaining power.[160] Furthermore, it is also relevant here that it is generally the project owner, and not the surety, that controls the form of the bond that it will accept.[161] To illustrate the vast bargaining power of a project owner, the *Cates* court stated: "If the obligee does not agree with the terms of the bond secured by the principal, it may consent to a modification of the underlying contract or may end bargaining altogether."[162] The project owner, therefore, is in a position to contract for whatever remedies are necessary to protect itself from economic loss.[163]

Finally, as the *Cates* court correctly notes, performance bonds incorporate by reference the construction contract between the project owner and the contractor.[164] The terms and conditions of the construction contract, in which the surety has no input, largely define the scope and nature of the surety's obligations under the performance bond.[165] Hence, not only does the project owner have the ability to require that certain terms be in the performance bond, but it also has significant bargaining power to get favorable provisions in the underlying construction contract.

For these reasons, it seems clear that the project owner and surety are on equal footing when entering into a performance bond. Thus, the second justification usually given for the insurance exception is also inapplicable in the performance bond context.

3. Public Interest

Traditionally, courts have relied on considerations of public interest to justify the availability of a tort remedy when an insurer refuses in bad faith to pay on a claim by its insured.[166] Indeed, insurance has been said to be "quasi-public" in nature because "individuals contract with insurance companies 'specifically in order to obtain protection from potential specified economic harm.'"[167] Thus, unlike a party to a commercial contract, an insured has no recourse to the marketplace to recover costs already incurred.[168] This situation creates a unique "economic dilemma"

160. *Cf. Gen. Builders, Inc.*, 934 P.2d at 263 (indicating that the parties to the performance bond, the contractor and surety, were experienced entities and therefore not in "inherently unequal bargaining positions").

161. *See supra* text accompanying notes 153–57.

162. *Cates*, 980 P.2d at 422.

163. *See Transamerica*, 940 P.2d at 354 (Kourlis, J., dissenting).

164. *Cates*, 980 P.2d at 422.

165. *See id*.

166. *See, e.g.*, Foley v. Interactive Data Corp., 765 P.2d 373, 390 (Cal. 1988) (noting that the insurance exception is based upon various policy considerations, including protection of the public interest).

167. *Cates*, 980 P.2d at 423 (quoting *Foley*, 765 P.2d at 396).

168. *Id*.

that is not faced by a nonbreaching party to a commercial contract.[169] Finally, a significant public interest consideration is the possible deterrence of bad-faith handling of claims by sureties if tort damages were available.[170] However, none of these public interest factors are sufficiently involved in the performance bond context to warrant a tort remedy.

a. "Quasi-Public" Nature

The notion that insurance is "quasi-public" goes directly to the nature of the industry and the purpose for which a policy is purchased, namely the protection against calamity.[171] In cases involving a "quasi-public" contract, there can be no "efficient breach" of contract because the very nature and purpose of the contract is negated.[172] It has been argued that this "quasi-public" notion extends with equal force to the performance bond setting as being requisite to protecting the real estate development market.[173] However, such a conclusion undervalues the inherent differences between liability insurance and a performance bond.

As previously discussed, a performance bond is not obtained for identical purposes as an insurance policy.[174] Instead of being procured in order to obtain peace of mind and protection against catastrophe, a performance bond is obtained for the project owner's commercial advantage.[175] The commercial advantage to the project owner is twofold: (1) gaining additional financial security in its contract with the contractor;[176] and (2) having the surety "prequalify" the contractor who is to perform the work.[177] Thus, the very nature and purpose for which the project owner required the performance bond is not negated when a surety refuses to perform its obligations—even if in bad faith. The project owner still has received the initial benefit of having the contractor "prequalified" by the surety. Further, the project owner still receives additional financial security by virtue of the fact that it now has contractual recourse against both the principal and the surety. The importance of this benefit becomes clear when viewed in light of the probable absence of

169. *Id*.

170. *See, e.g.*, Dodge v. Fid. & Deposit Co., 778 P.2d 1240, 1242–43 (Ariz. 1989); *Cates*, 980 P.2d at 425–26.

171. *See Cates*, 980 P.2d at 423, 430 (Mosk, J., concurring and dissenting).

172. *See id*. at 431 (Mosk, J., concurring and dissenting).

173. *See id.* at 430–31 (Mosk, J., concurring and dissenting). It is vital to note that this conclusion is based on the proposition that a performance bond is obtained for the same purpose as other insurance. *See id*. (Mosk, J., concurring and dissenting) (comparing the purposes of obtaining a performance bond and insurance and concluding that a performance bond is acquired for the same reason as an insurance policy, i.e., to shift risk).

174. *See supra* Part III.B.2.

175. *See supra* text accompanying notes 142–50.

176. *See Cates*, 980 P.2d at 422–23 (discussing the general purpose of a construction performance bond); Shattuck, *supra* note 14, at 246 ("The surety is . . . like a standby creditor of the principal.").

177. *See* JERVIS & LEVIN, *supra* note 1, at 83 (discussing how sureties evaluate contractors before issuing performance bonds).

any "economic dilemma" faced by the project owner.[178] A project owner, unlike an insured, can still turn to the marketplace to complete the construction project, and then seek recourse against both the principal and surety for any resulting damages. Under those circumstances, there is no public interest in protecting real estate development; rather, the interest to be protected is the project owner's interest in receiving the commercial benefit for which it contracted.

Therefore, the nature of a performance bond does not implicate the same "quasi-public" concerns as liability insurance.

b. The "Economic Dilemma"

In the insurance context, when an insurer refuses to pay a claim in bad faith, the insured is unable to turn to the marketplace in order to find performance—thus the "economic dilemma."[179] The marketplace is unavailable because no other insurance companies would be willing to pay for losses that have already been incurred.[180] This dilemma is linked to the availability of a tort remedy in insurance cases.[181] However, this same "economic dilemma" is generally not faced by a project owner when a surety refuses to pay a claim.

To begin, for traditional contract principles to remain effective, the "economic dilemma" must be distinguished from the ordinary breach of a commercial contract that may have adverse financial effects on the nonbreaching party.[182] Contract remedies remain appropriate in those instances. With this distinction in mind, the California Supreme Court concluded that "[a]lthough a construction surety's breach of the implied covenant might very well have financial significance for a performance bond obligee, the obligee does not face the same economic dilemma as an insured."[183] This conclusion rested primarily on the fact that the project owner not only has recourse against the surety, but also has the right to recover from the defaulting contractor.[184]

However, the right to recover from the contractor may or may not be a significant right.[185] Indeed, in many cases of contractor default there has been a "catastrophic occurrence,"[186] which may indicate that the con-

178. *See* discussion *infra* Part III.C.3.b.

179. Foley v. Interactive Data Corp., 765 P.2d 373, 396 (Cal. 1988).

180. *Id*.

181. *See, e.g.*, *id.* at 395–96 (using the absence of this dilemma in the employment context as a reason not to bring in a tort remedy).

182. *See id.* at 396 (noting that a breach by a supplier may financially harm the dealer and its employees); Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407, 423 (Cal. 1999) (restating the same).

183. *Cates*, 980 P.2d at 423.

184. *See id*. ("In contrast to an insured who typically can look only to the insurer for recovery in the event of a covered loss, an obligee also has a right of recovery against the principal.").

185. *Compare id*. ("[A]n obligee's right of recovery against a principal is, in most cases of default, a meaningful right."), *with id*. at 431 (Mosk, J., concurring and dissenting) ("Not surprisingly, [the contractor] went out of business after it defaulted; there was no recourse against it.").

186. *See* JERVIS & LEVIN, *supra* note 1, at 84.

tractor would be unable to satisfy any judgment that a project owner could obtain. If the contractor is insolvent, and unable to satisfy a judgment, then the right to recover from the contractor can hardly be said to be "meaningful." In that instance, the right to recover from the contractor cannot be said to cure the "economic dilemma" that a project owner might face.

However, a more satisfactory solution can be found in the payment structure used on most construction projects, coupled with the project owner's ability to turn to the marketplace to complete the project.[187] On nearly all construction projects, contractors are paid through a series of periodic payments of which a certain percentage is often retained by the project owner until final completion.[188] Thus, even if the contractor defaults and the surety fails to perform, the project owner should still have funds available to seek completion of the work.[189] If so, then the project owner will almost certainly be able to contract with another contractor to finish the project.[190] Unlike the insurance context, the marketplace will not be closed to the project owner because replacement contractors would not be assuming previously incurred losses. Once the project owner has completed the project using a replacement contractor, it can attempt to recover the cost of completion from both the defaulting contractor, if solvent, and the surety.[191] Therefore, the project owner is not faced with the situation of having nowhere to turn in order to accomplish its objective—it faces no "economic dilemma." Instead, like any other commercial contract, the project owner can simply look to the marketplace to finish the work and subsequently recover the costs of doing so.

c. Deterrence of Surety Bad Faith

Although not specifically labeling it as a public interest policy consideration, the courts have also discussed whether deterring the surety from acting in bad faith should justify a tort remedy.[192] Several courts have concluded that the availability of extracontractual damages, especially punitive damages, is necessary to prevent sureties from handling claims in bad faith in the future.[193] In effect, these courts are saying that ordinary contract remedies are not adequate to compensate the project

187. *Cates*, 980 P.2d at 423–24 (setting forth the payment structure and marketplace availability as additional reasons why a project owner does not face an "economic dilemma").

188. *See* CLOUGH & SEARS, *supra* note 2, § 6.17, at 145–47.

189. *Cates*, 980 P.2d at 424.

190. *Id*. at 424 n.20. To be sure, there are some problems and increased costs related to having a replacement contractor finish the project. *See* JERVIS & LEVIN, *supra* note 1, at 84. For example, the project is "usually in total disarray," and therefore contractors are often reluctant to accept the unfamiliar project without charging a premium. *Id*. However, under the terms of the performance bond itself, "[t]hese increased costs will have to be picked up by the surety, not the project owner." *Id*.

191. *Cates*, 980 P.2d at 423.

192. *See supra* text accompanying notes 87–89, 97–98.

193. *See, e.g.*, Dodge v. Fid. & Deposit Co., 778 P.2d 1240, 1242 (Ariz. 1989); Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348, 353 (Colo. 1997).

owner.[194] Insofar as these courts believe that a tort remedy is necessary to adequately compensate a project owner and deter future surety misbehavior, their belief is misplaced.

In most cases, ordinary contract remedies will "provide adequate compensation for breach of the [performance] bond."[195] Indeed, in most commercial contracts, a breach of the implied covenant of good faith and fair dealing gives rise only to contract damages.[196] This is because "[t]he purpose of awarding contract damages is to compensate the injured party,"[197] not to punish or shape the behavior of the breaching party.[198] There is no compelling reason to part from that general rule for bad-faith breaches of the performance bond. Rather, because the losses that the project owner ultimately occurs are foreseeable at the time the contract is entered into, the surety will be liable for all losses necessary to make the project owner "whole."[199] Thus, the injured party—the project owner—would be fully compensated for its injury.

Also, punitive damages are probably not generally required in order to compel sureties to perform their obligations in good faith. Instead, project owners have significant bargaining power that can be used to compel sureties to fulfill their obligations.[200] For example, project owners can negotiate for provisions in the bond that require the surety to pay attorney's fees, interest, or liquidated damages should they breach the contract.[201] Additionally, in states that regulate sureties under the insurance code, a surety that breaches a performance bond may be subject to fairly sizeable administrative penalties.[202] These additional penalties, especially when coupled with provisions in the contract that may increase potential liability, provide substantial incentive for a surety to fulfill its obligations under a performance bond.

Moreover, besides not being necessary to adequately compensate the project owner or shape surety behavior, the availability of a tort rem-

194. *See Transamerica*, 940 P.2d at 353.

195. *Cates*, 980 P.2d at 425; *see also* Blackfeet Tribe of the Blackfeet Indian Reservation v. Blaze Constr., 108 F. Supp. 2d 1122, 1142 (D. Mont. 2000) (denying a tort recovery in part because the project owner failed to prove how regular contract damages would not be adequate to compensate them for their loss).

196. Foley v. Interactive Data Corp., 765 P.2d 373, 389 (Cal. 1988) (en banc).

197. RESTATEMENT (SECOND) OF CONTRACTS § 355 cmt. a (1981).

198. *See* Matthew J. Barrett, Note, *"Contort": Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing in Noninsurance, Commercial Contracts—Its Existence and Desirability*, 60 NOTRE DAME L. REV. 510, 526 & n.94 (1985).

199. *See* Great Am. Ins. Co. v. Gen. Builders, Inc., 934 P.2d 257, 263 (Nev. 1997) (noting that extracontractual damages are only appropriate when necessary to make the nonbreaching party "whole").

200. *See Cates*, 980 P.2d at 425.

201. *See Cates*, 980 P.2d at 425; Shattuck, *supra* note 14, at 246.

202. *See Cates*, 980 P.2d at 425. To illustrate, under California's Unfair Trade Practices Act, a surety who breaches a performance bond may be subject to the following liability: $5,000 for each act; $10,000 for each willful violation; an injunction to cease-and-desist from further violations; $55,000 for each willful violation of a cease-and-desist order; and suspension or revocation of their license for recurring violations. CAL. INS. CODE §§ 790.035, .05, .07 (West 1993).

edy may even have several negative consequences.[203] Indeed, allowing a tort remedy could have several harmful consequences, including unduly shifting the relationship balance toward the project owner[204] and increasing the amount of litigation.[205] With these potential consequences in mind, it appears likely that the end result of allowing a tort remedy, with the attendant punitive damages, would be to increase the cost of acquiring a performance bond.

The *Cates* case provides a good example. In *Cates*, after recovering approximately $3 million in compensatory damages, the project owner was awarded $28 million in punitive damages.[206] Had this result stood, the surety's liability would have increased by over 900 percent. With this increased exposure to risk, a surety is almost certain to increase the cost of obtaining the bond. These higher costs will then likely be passed on to all project owners.

Although the "public interest" policy considerations are somewhat compelling, they do not provide sufficient grounds to support a tort remedy. Rather, due to the inherent differences between suretyship and insurance, these factors also weigh against extension of the insurance exception to the performance bond context.

4. *Fiduciary Responsibility*

The last policy consideration that courts have cited as justifying a tort remedy is the fiduciary responsibility owed by the insurer to the insured.[207] Fiduciary duty is defined as follows: "A duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person. It is the highest standard of duty implied by law."[208] From this definition, it seems clear that a surety does not take on any type of fiduciary duty when it enters into a performance bond.

It is significant to note that of the courts that have allowed a project owner to recover from a surety in tort, none of them have explained (or even mentioned) why a surety should be considered to have undertaken

203. *See Cates*, 980 P.2d at 425 (observing that "for whatever benefits might accrue from permitting such [tort] remedies, harmful economic effects appear at least as likely to occur").

204. *See supra* notes 132–36 and accompanying text. This potential negative consequence is a direct result of the existence of the tripartite relationship, thus having no counterpart in the insurance context. Once again, the differences inherent between suretyship and insurance stand in the way of extending the insurance exception.

205. *See Cates*, 980 P.2d at 425–26.

206. *See id*. at 412.

207. *See, e.g.*, *id.* at 421–22; Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348, 354 (Colo. 1997) (Kourlis, J., dissenting); Great Am. Ins. Co. v. Gen. Builders, Inc., 934 P.2d 257, 263 (Nev. 1997) ("The tort action for breach of the implied covenant of good faith and fair dealing requires a special element of reliance or fiduciary duty.").

208. BLACK'S LAW DICTIONARY 625 (6th ed. 1990).

fiduciary or quasi-fiduciary obligations.[209] Indeed, *Cates* has been the only court to grapple at length with whether a surety is obligated by the same type of fiduciary responsibility as an insurer.[210] The *Cates* court stated that "there is little basis for concluding that the relationship between a surety and an obligee is fiduciary or quasi-fiduciary in nature."[211] This conclusion was primarily based upon two distinctions between suretyship and insurance. First, the court noted that a surety was in a different position than an insurer because of the "conditional nature of the surety's obligations and its right to assert the defenses of the principal."[212] In this regard, the court found significance in the fact that California's insurance regulations exempted sureties from certain claim settlement standards.[213] In all probability, if a surety is permitted to assert defenses of the principal against claims made by the obligee, then the surety can be under no special obligation to act for the benefit of the obligee.

Second, a surety does not have any "responsibility to defend an obligee against third-party claims and has no right to represent the obligee's interests by virtue of the surety bond."[214] This is in stark contrast to the obligations of a liability insurer, who generally has the responsibility to defend against, and negotiate settlements of, third-party claims.[215] Such responsibilities form a "principal basis for recognizing tort liability in the context of liability insurance."[216] In their absence, tort liability is most likely inappropriate.

Additionally, the tripartite relationship makes it inappropriate to conclude that a surety owes a fiduciary duty to a project owner. If a surety were required to act in the best interests of the project owner—as would be required if a fiduciary duty existed—the tripartite balance would be shifted toward the project owner. Under those circumstances, a contractor would be in the unenviable position of having its surety be required to act for the benefit of the project owner in settling claims. This is especially dangerous given the fact that "the surety is entitled to indemnity from the principal . . . for any loss, liability, cost, damages, or expense incurred by reason of the execution of the concerned bonds."[217]

These differences illustrate that a surety does not have a duty to subordinate its own interests in order to act for the project owner's bene-

209. *See* Loyal Order of Moose v. Int'l Fid. Ins. Co., 797 P.2d 622 (Alaska 1990); Dodge v. Fid. & Deposit Co. of Md., 778 P.2d 1240 (Ariz. 1989); *Transamerica*, 940 P.2d at 348; K-W Indus. v. Nat'l Sur. Corp., 754 P.2d 502 (Mont. 1988).

210. *Cates*, 980 P.2d at 424–25.

211. *Id*. at 424. The dissent in *Cates*, like other courts that have allowed a tort remedy, failed to address whether a surety stood in a similar fiduciary capacity as a liability insurer. *See id*. at 428–33 (Mosk, J., concurring and dissenting). Rather, the dissent is primarily grounded upon considerations of public interest and deterrence. *See id*. (Mosk, J., concurring and dissenting).

212. *Id*. at 424.

213. *See id*.

214. *Id.* at 424–25.

215. *Id*. at 424.

216. *Id*.

217. Balkin & Witten, *supra* note 21, at 624.

fit. Certainly, this is not a relationship that justifies imposing "the highest standard of duty implied by law." Instead, a surety's obligation to the project owner should be determined only with reference to the implied covenant of good faith and fair dealing.[218] Thus, like any other commercial contract, the parties to a performance bond probably do not owe each other any special fiduciary responsibility. Accordingly, this policy consideration also weighs against the extension of the insurance exception.

IV. RESOLUTION

Tort recovery for a project owner against a surety who has breached the covenant of good faith and fair dealing in a performance bond by acting in bad faith should *not* be allowed. Rather, surety liability should be limited to traditional contract damages—the appropriate remedy in most cases. Accordingly, the proper measure of damages for a surety's bad-faith breach of the performance bond should be those damages normally allowable for a breach of any commercial contract.[219] The well-settled rule that tort remedies are not appropriate for mere breach of contract should not be broken in this context. Therefore, courts that consider this issue in the future should not extend the insurance exception to include surety bad-faith breaches of the performance bond. Although such a conclusion goes against the weight of authority thus far, it is certainly the proper result.

The justifications given by courts in finding that the insurance exception should apply to sureties are unpersuasive. To begin, the mere statutory inclusion of suretyship within a state's insurance code is insufficient to provide grounds for allowing a tort remedy against a surety.[220] The courts that have found significance in this inclusion have done so on the basis of legislative intent to treat sureties as insurers.[221] Obviously, if it were the state legislature's intent to make sureties liable in tort for bad-faith breach of a performance bond, then courts would be bound to follow that intent. However, this simply has not occurred up to this point. Rather, legislatures have merely expressed their desire to regulate sureties by including them in the insurance code. It is not proper to translate this regulatory measure into a legislative intent to treat sureties as insurers for all purposes, especially for common-law theories of tort liability. Indeed, such a conclusion would largely eliminate the traditionally recognized differences between suretyship and insurance.

218. *See id.*

219. Traditional contract principles would generally limit the proper award of damages to "those damages within the contemplation of the parties at the time the performance bond is given or at least reasonably foreseeable by them at that time." *Cates*, 980 P.2d at 427.

220. *See supra* Part III.A.

221. *See supra* Part III.A.

Moreover, common-law tort liability arising under the judicially created insurance exception was never based upon any type of legislation governing the insurance industry. On the contrary, it is based upon special policy considerations that courts concluded were implicated by the "special relationship" that exists between the parties to an insurance policy. Therefore, absent a clear legislative expression to impose tort liability on sureties, it should be largely irrelevant whether a surety is governed under the state's insurance code. Rather, the proper inquiry is whether suretyship and liability insurance are sufficiently similar, and involve the same policy considerations, to warrant an extension of the insurance exception.

The inherent differences between a surety under a performance bond and a typical insurer argue against extending the insurance exception to bad-faith breaches of the performance bond.[222] First, the tripartite relationship involved in a performance bond creates a unique situation faced by sureties: to act in good faith to both the project owner and the contractor.[223] Allowing a project owner to recover in tort from a surety may significantly shift the delicate balance between the three parties to a performance bond. Such a shift is likely to result in several negative consequences[224] and could fundamentally alter how the parties to a performance bond—and conceivably other suretyship contracts—act and relate.

Second, unlike an insurance policy and like any other commercial contract, a performance bond is entered into for the project owner's commercial advantage.[225] A performance bond is entered into by a project owner for at least two distinct commercial advantages: (1) to obtain a more financially secure construction contract and (2) to gain the surety's "prequalification" of the contractor.[226] Accordingly, a performance bond should be viewed as a commercial contract entered into to gain a commercial advantage, rather than as insurance to protect against some future misfortune. However, just as the statutory inclusion of suretyship in the insurance code should not be dispositive of allowing a tort remedy, the inherent differences between a surety and an insurer should not be dispositive of denial. Instead, the policy considerations that underlie the insurance exception must be analyzed to determine if they are applicable despite these differences.

The policy considerations generally given to justify the existence of the insurance exception—adhesion, unequal bargaining power, public interest, and fiduciary responsibility—are not similarly involved in the performance bond relationship.[227] Certainly, performance bonds do not

222. *See supra* Part III.B.1–2.
223. *See supra* Part III.B.1.
224. *See supra* text accompanying notes 132–34.
225. *See supra* Part III.B.2.
226. *See supra* notes 140–48 and accompanying text.
227. *See supra* Part III.C.1–4.

raise the same concerns of adhesion as traditional insurance policies,[228] nor is there any unequal bargaining power between the parties to the bond.[229] Similarly, fiduciary responsibility, which is one of the primary foundations for assessing tort liability in the insurance context, is not undertaken by a surety.[230] The most compelling arguments for extension to the performance bond setting involve considerations of "public interest."[231] However, these arguments also fail to persuade.

Unlike insurance, a performance bond does not implicate "quasi-public" concerns because it is not solely obtained to protect a party against calamity. The performance bond's commercial nature privatizes the interest, thus removing any "public interest" in its faithful execution. Moreover, a project owner typically has the ability to turn to the marketplace to fulfill its objectives. In that regard, a performance bond is similar to any other commercial contract.

Finally, traditional contract remedies will generally be sufficient to compensate a project owner for its losses. If so, contract law has served its purpose—to compensate an injured party for its loss. A tort remedy, then, would only be justified if required to deter sureties from handling claims in bad faith in the future. It is not clear that such deterrence is required. On the contrary, the availability of a tort remedy may actually have negative impacts on both surety behavior and the cost of acquiring performance bonds.

In sum, although there are similarities between insurance and suretyship, the advice of one court should be followed: "We must . . . consider with great care claims that extension of the exceptional approach taken in [the insurance] cases is automatically appropriate if certain hallmarks and similarities can be adduced . . . ."[232] Great care requires courts to refuse to extend the insurance exception to performance bonds.

V. CONCLUSION

Due to the unpredictable nature of the construction industry, and the many potential difficulties in successfully completing a construction project, project owners often require performance bonds from their contractor. Unfortunately, commercial sureties do not always fulfill their obligations under these bonds in good faith. Under normal circumstances, liability for such a breach of the covenant of good faith and fair dealing implicit in every contract would be limited to traditional contract remedies. Perhaps predictably, however, in states that recognize an insurance exception to this general rule, project owners have also sought,

228. *See supra* Part III.C.1.
229. *See supra* Part III.C.2.
230. *See supra* Part III.C.4.
231. *See supra* Part III.C.3.
232. Foley v. Interactive Data Corp., 765 P.2d 373, 394 (Cal. 1988).

and often successfully recovered, tort damages. However, application of the insurance exception—and the resulting award of extracontractual damages—to a surety under a performance bond is improper.

It should not be forgotten that allowing a tort remedy for breach of the implied covenant of good faith and fair dealing is a drastic divergence from longstanding principles of contract law. Without maintaining the distinctions between the two, "contract law would drown in a sea of tort."[233] In that light, a tort remedy is only justified in exceptional circumstances. Those circumstances are not involved when a surety breaches a performance bond, even when that breach is in bad faith. Indeed, this is one instance where the general rule fully applies and provides an adequate remedy to the injured party. The denial of extracontractual damages, including punitive damages, correctly acknowledges the inherent differences between a performance bond and insurance and preserves the balance that is central and necessary to the tripartite relationship. If a tort remedy is needed then it should be the state legislature, not state courts, that should provide for one.

233. E. River Steamship Corp. v. Transamerica Delaval Inc., 476 U.S. 858, 866 (1985) (stating that products liability stems from policy notions that consumers need additional protection from unsafe products beyond what is accorded under warranty law; but, "if this development [is] allowed to progress too far, contract law would drown in a sea of tort.").