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PERFORMANCE AND PAYMENT BOND CLAIMS

Presented by

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Workshop N

This session will address the response of surety companies to performance and payment bond claims. Attendees will gain a better understanding of what to look for in analyzing claims, how to decide which claims are meritorious, and how to assess defenses and reduce exposures by careful risk management. Also, learn how to detect signs of surety financial trouble and what to do if a surety becomes insolvent. Current issues, such as the reliability of condition precedent payment clauses in the defense of payment bond claims and performance bond exposures connected with extended warranties, will also be addressed. Attendees should find themselves ahead of the curve in dealing with fluctuations in the construction industry and the bond claims that are likely to result.

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Mr. Katz is presenting Workshop N, "Payment & Performance Bond Claims." He is a partner in the law firm of Katz & Stone, L.L.P., with offices in Vienna, Virginia, Washington, D.C. and Rockville, Maryland, and specializes in resolving complex construction disputes. He has extensive experience in representing owners, contractors, sureties, and designers in complex construction litigation.

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Mr. Katz has conducted seminars for such construction trade associations as Associated Builders and Contractors; National Electrical Contractors Association; National Utility Contractors Association; American Subcontractors Association; World of Concrete; National Pavement Exposition; Associated General Contractors of America; Contractors Association of West Virginia; Virginia Building Material Association; Maryland General Contractors Association; Construction Management Association of America; National Association of Surety Bond Producers; Reliance Insurance; The St. Paul Companies; Bermuda Contractors Association; American Contractors Insurance Group; Barbados Association of Quantity Surveyors; Korean Contract Management Association; and China National Petroleum Corporation.

Mr. Katz is a frequent speaker at the IRMI Construction Risk Conference on contractual risk transfer, surety bonds, completed operations coverage, and other construction risk topics. He is a recipient of IRMI's Words of Wisdom (WOW) award.

Mr. Katz received both a Bachelor of Arts with Distinction and a Juris Doctor degree from the University of Virginia. Mr. Katz is a member of the Bars of the District of Columbia, Virginia, Maryland, United States Supreme Court, and United States Court of Federal Claims. He also serves as an arbitrator on the American Arbitration Association's Construction Industry Arbitration Panel, and is an Associate Member of The Chartered Institute of Arbitrators.

PERFORMANCE AND PAYMENT BOND CLAIMS

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PERFORMANCE AND PAYMENT BOND CLAIMS

I. The Surety's Duties

The surety's duties are defined by the bond, the indemnity agreement, and statute and common law. Each of these sources must be examined on a jurisdiction-specific basis to determine the surety's duties to the principal and obligee/claimant.

A. Duties to Principal

The surety's duties to the principal typically are defined in the indemnity agreement. These agreements clothe the surety with wide latitude in determining how to respond to claims.

1. Good Faith

In general, the surety must act in "good faith" in order to have recourse against the principal for losses suffered and to avoid claims by the principal. In *Arntz Contracting Co. v. St. Paul Fire & Marine Insurance Co.,* 54 Cal. Rptr. 2d 888 *(Cal. Ct. App. 1996),* for example, both the principal and surety appealed the lower court's determination of the amount the principal owed under an indemnity agreement. The agreement allowed the surety "at its option and in its sole discretion to take possession of all or part of the work of [the project] whenever, in its sole opinion, such action is *desirable or necessary,* and at the expense of [the principal] to complete, or to contract for the completion of the same." Id. at 898. (emphasis added.) The court held that:

> Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement. Here, [the surety] was given broad discretion in managing completion of the project, requiring its exercise of good faith. The covenant of good faith finds particular application in situations where one party is invested with a discretionary power affecting the rights of another. Such power must be exercised in good faith.

(quoting in part from *Carma Developers (Cal.), Inc. v. Marathon Dev. California, Inc.,* 826 P.2d 710 (Cal. 1992)).

Even if the surety exercised good faith, the court concluded, it did not have the "unconditional power to incur expenses in completing the project." *Id.* The court's inquiry required it to determine whether the surety had a good-faith belief that it was either desirable or necessary to take over the project. A "surety, in such a situation, must weigh the viability of competing claims and the consequences of its possible responses to those claims so that it can, in good faith, decide if it is 'desirable or necessary' to take over the project to protect its interest." *Id.* at 899. The court rejected the surety's claim that it should be indemnified by the principal for removing and replacing certain work because the trial court had correctly found that the surety had been "presented with overwhelming proof that those expenses were 'unnecessary and unwarranted,'" and the surety's authorization for those expenses was not rational and constituted an "unreasonable economic waste." In addition, the court agreed with the trial court's award against the principal for $2.7 million in completion costs incurred by the surety because, with regard to those expenses, the surety acted in good faith in determining it 'desirable or necessary' to take over and complete the project. *Arntz* demonstrates the interplay between the common law duty of good faith and the obligations imposed upon the surety under the indemnity agreement.

In concluding that the surety "was bound by its implied covenant of good faith to exercise its discretion in compromising the claim so that the reasonable expectations of all parties would be effectuated," the Oregon Court of Appeals in *City of Portland v. George D. Ward & Assoc.,* 750 P.2d 171, 175 (Or. Ct. App. 1988), stated:

> Parties to an indemnity agreement which subjects the right to compromise a claim against the principal to the sole discretion of the surety must reasonably expect that compromise and payment will be made only after reasonable investigation of the claims, counterclaims and defenses asserted in the underlying action. In order to prove lack of good faith in settling the claim, [the principal and indemnitors] needed only to prove that [the surety] failed to make a reasonable investigation of the validity of the claims against them or to consider reasonably the viability of their counterclaims and defenses, not that [the surety] acted for dishonest purposes or improper motives.

See also Bd. of Directors of Ass'n of Apartment Owners of Discovery Bay Condominium v. United Pac. Ins. Co., 884 P.2d 1134, 1138 (Haw. 1994)("the surety owes a duty of good faith and fair dealing to both the principal and the obligee on the bond").

The Supreme Court of Texas has expressed a contrary view. In *Associated Indem. Corp. v. CAT Contracting, Inc.,* 964 S.W.2d 276 (Tex. 1998), the Texas Supreme Court held that a bond surety does *not* owe a common law duty of good faith to either its principal or the obligee.

> Those jurisdictions recognizing an affirmative duty of good faith in surety contracts have generally done so either because they impose such duty in all contracts or because they equate suretyship with the business of insurance. We do not impose a duty of good faith in all contracts and we have concluded that suretyship and insurance are fundamentally different. Therefore, we hold that a bond surety does not owe a common law duty of good faith to its principal.

Id. at 282 (citations omitted). Nonetheless, although not imposed by the common law, the indemnity agreement itself, by its express terms, required the surety to settle claims in good faith. "Thus, good faith is a condition precedent to Surety's right of indemnity." *Id.* at 283. But the court agreed with the surety that "in the surety context bad faith requires more than an unreasonable or negligent investigation; it requires wilful misconduct or improper motive." *Id.* at 284.

> We hold that "good faith" in the surety agreement before us refers to conduct which is honest in fact, free of improper motive or wilful ignorance of the facts at hand. It does not require proof of a "reasonable" investigation by the surety. Stating the proposition conversely for purposes of our evidentiary review for this particular case [under which the court undertook to determine whether the principal established bad faith rather than determining whether they surety proved good faith], "bad faith" means more than merely negligent or unreasonable conduct; it requires proof of an improper motive or wilful ignorance of the facts.

Id. Despite this high threshold of proof, however, the court then affirmed the trial court's finding of bad faith. *Id.* at 285.

It appears that a surety's failure to act in good faith towards the principal by inappropriately settling a claim does not preclude the surety from recovering from the principal monies expended in good faith. In *The Hartford v. Tanner,* 910 P.2d 872 (Kan. Ct. App. 1996), the court affirmed the general proposition that a surety must exercise good faith in settling claims. The court held that the surety "did not conduct a thorough investigation. [It] simply paid the claims and sought indemnification." *Id.* at 881. Thus, the court found that the surety could not recover the entire amount paid to the obligee. The surety argued, however, that it should be able to recover "at least an amount that is reasonable," and the court agreed that if sufficient evidence were presented, the surety would be entitled to this amount. *Id*. However, "[b]ecause [the surety] offered no evidence on the amount that would have been assessed had the claims been protested, investigated, and negotiated, the [trial] court was left with no basis for a decision other than denying the claim in its entirety. It was [the surety's] responsibility to present such evidence." *Id.* at 882.

2. Surety Not Protected as a Volunteer

If, in fulfilling its perceived obligations to the obligee, the surety fails to fulfill its obligations to its principal, the surety runs the risk of losing its rights to recover losses incurred and, worse yet, may be exposed to additional liability to the principal. In *Gen'l Ins. Co. of Am. v. K. Capolino Constr. Corp.,* 903 F. Supp. 623 (S.D.N.Y. 1995), a performance bond surety sought to recover from its principal losses incurred in completing two construction projects. Based on its investigation, the surety concluded that its principal was in default on both projects and elected to perform under the performance bonds. The court held:

> Under New York law, it is well-settled that a party that pays a claim it is not obligated to pay is a volunteer and may not recover those expenses. Thus, [the surety] may not recover from [the principal] unless, under the terms of the performance bonds … [the surety] was obligated to complete the [two] projects.

Id. (citations omitted). Under the performance bonds at issue, the surety's obligation arose only "[i]f there [was] no Owner default." *Id.* at 627.

> The bonds do not say that the surety's obligation arises if the surety is satisfied that there is no owner default. Therefore, [the surety] is obligated to complete the contracts only if the [owner] was actually not in default.

Id. at 627. Because the owner's failure to pay the contractor constitutes a default by the owner, and there was a factual dispute as to whether the owner had properly made payment, the court denied the surety's motion for summary judgment. *See also R.J. "Bob" Jones Excavating Contractor, Inc. v. Fireman's Ins. Co. of Newark, N.J.,* 920 S.W.2d 483, 487 (Ark. 1996)("if a surety pays a claim when its principal is not liable, the surety is treated as a volunteer and cannot recover the payment from its principal").

B. Duties to Obligee

The bond itself enumerates the surety's duties to the obligee. Thus, the bond must serve as the surety's guide in responding to an obligee's claim. For example, the American Institute of Architects' Performance Bond (AIA Document A312, 1984 ed.) provides that, once the owner has properly defaulted the principal and so notified the surety, "the Surety shall promptly and at the Surety's expense take one of the … actions" enumerated in Paragraph 4. Furthermore,

> [i]f the Surety does not proceed as provided in Paragraph 4 with reasonable promptness, the Surety shall be deemed to be in default on this Bond fifteen days after receipt of an additional written notice from the Owner to the Surety demanding that the Surety perform its obligations under this Bond, and the Owner shall be entitled to enforce any remedy available to the Owner.

In addition to the surety's obligations imposed by the bond itself, several jurisdictions recognize a common law duty imposed on the surety to act in good faith toward the obligee. Finally, sureties must be aware of requirements imposed upon them by statute which establish fair claims settlement practices, the violation of which may result in additional liability.

II. The Surety's Investigation of Claims

A. How to Conduct an Investigation

Once a claim is made under either a performance or payment bond, the surety should undertake an investigation to determine the merit of the claim and any of the principal's defenses on which the surety may rely, as well as to evaluate the surety's potential financial loss. It is the result of the surety's investigation which will determine which of several possible responses it should make when presented with a claim.

Chapter 2, Sections A and B of the *Bond Default Manual,* William S. Piper and Kenneth M. Givens, Jr. (Duncan L. Clore ed., 2d ed. 1995), provides an excellent discussion of the surety's investigation of performance bond claims. The authors suggest a surety obtain the following:

> From both the obligee *and* principal (because the obligee and principal oftentimes have different versions of events, a prudent surety will request the following documents):
>
> - contract documents, plans, specifications and addenda
> - job schedules
> - photographs
> - substantial and final completion certificates
> - substantiation of the claim
> - correspondence between obligee and principal
> - applications for payment, payment certifications, canceled checks
> - notice(s) of breach or default
> - statement of account
> - punchlists
> - estimates of the remaining work
> - accounts payable and receivable (from the principal)
>
> From the underwriter/producing agent:
>
> - analysis of general competence of principal
> - job history
> - principal's financial condition

Along with obtaining the above-listed documents, the surety should also interview key personnel of the obligee and owner, and the project architect/engineer, if necessary. These interviews will breathe life into the documents and better enable the surety to evaluate the claim.

The investigation may lead the surety to the conclusion that it needs the help of consultants to fairly evaluate the claim. These consultants may include accountants, architects, engineers, attorneys, construction managers, or schedulers, to name a few. Retaining a consultant earlier rather than later will usually allow the surety to separate the wheat from the chaff at an early stage of the investigation and minimize the total expense of the investigation (and the surety's potential exposure).

Finally, the surety would do well to maintain accurate records of its investigation and the documents and information obtained therefrom. Such records may prove useful in defending against claims, asserted by the obligee or principal, of failure to investigate or act in good faith.

B. Payment Bond Claimant's Allocation of Debt

Provided the conditions of a payment bond are met, a surety must pay a claimant for labor furnished and materials supplied to the project *covered by the bond.* It is imperative that the surety closely examine the claimant's documents to ensure that it does not inadvertently pay for labor or material supplied to projects other than the one for which the bond was issued. A surety must guard against the situation where a supplier which sells materials to a contractor on several different projects, only one of which is covered by a payment bond, improperly claims that materials supplied to the unbonded jobs, for which it has not received payment, were in fact delivered to the bonded project. Therefore, a surety should require a payment bond claimant to allocate the debt owed among the various projects on which it has furnished labor or supplied material. An improper payment by a surety to a claimant for labor or materials supplied to a non-bonded project will likely preclude the surety from recovering indemnification from its principal to the extent of the improper payment.

C. Surety's Response Time

When confronted with a claim against a payment or performance bond, under either the common law or the terms of most bonds, the surety must act in good faith, which typically requires the surety to "reasonably" investigate the claim. There is no set time frame by which a surety must reach a conclusion on a claim, and the facts of each case must be evaluated to determine whether the surety has acted reasonably.

Fisher v. Fidelity & Deposit Co. of Md., 466 N.E.2d 332 (Ill. App. Ct. 1984), provides an extreme example of a surety's delinquency in responding to a claim. In *Fisher,* after the principal stopped work altogether on the project, the obligee made demand upon the performance bond surety in April 1974. The surety advised the principal that "it was making a prompt inquiry of its principal." Finally, in 1976, the surety denied liability because the principal "had taken control of the project and abandoned it." However, the investigation leading to this conclusion had ended two years earlier. The obligee asserted a claim against the surety for "vexatious and unreasonable delay in handling claims" under a provision of the Illinois Insurance Code that is now 215 ILCS 5/155. The court held that "[a] cause of action for vexatious and unreasonable delay must allege facts showing conduct by the surety which is 'wilful, wanton, malicious, reckless, intentional or in bad faith.'" *Id.* at 339. Finding in favor of the obligee, the court stated that the surety's "lackadaisical attitude toward determining its principal's conduct and its own liability even after two years of legal action by [the obligee] and repeated requests for action does not demonstrate the good faith expected of a surety." *Id.*

III. The Surety's Exposure and Options

A. Performance Bond Exposure

1. Cost of Completing Principal's Work Up to Penal Sum

When faced with a valid claim under a performance bond, the surety generally has five options: (1) buy back the bond; (2) finance the principal; (3) tender a completion contractor to the obligee; (4) contract with a completion contractor; or (5) do nothing.

Under most circumstances, the performance bond surety's liability is limited to the bond's penal sum. "It is well settled that a performance bond is enforceable only to the extent of the obligee's actual damages. Likewise, when an obligee's actual damages exceed the penal amount of a bond, a surety's liability generally is limited to the penal sum of the bond." *Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1.,* 908 S.W.2d 415, 426 (Tex. 1995). As the United States Court of Appeals for the Fifth Circuit stated:

> If appellant's contention that the surety's liability may exceed the sum stated on the face of the bond is correct, and it is not, it would be futile to state any amount of liability in the bond. This contention completely overlooks the well-established rule in Texas and elsewhere that the sole object of stating the penalty in a bond is to fix the limit of the liability of the signers, and no recovery can be had on such bond against the principal or surety beyond the penalty named on the bond.

Bill Curphy Co. v. Elliott, 207 F.2d 103, 106 (5th Cir. 1953).

As explained in the following section, although performance bonds uniformly identify the penal sum of the bond, the penal sum does not always constitute the surety's maximum liability under the *bond.*

2. Liability Beyond Penal Sum

When a surety chooses to either finance the principal or contract with its own completion contractor, the surety is liable for the full performance of the bonded contract *regardless of the penal sum.*

As the United States Bankruptcy Court for the Eastern District of Tennessee stated:

> The typical performance bond gives the surety the choice of refusing to perform the contract after the contractor defaults. In that case the surety is liable to the owner for the damages caused by the contractor's default but only up to the penal sum of the bond.
>
> On the other hand, the penal sum does not limit the liability of a surety that takes over performance of the contract. The surety who takes over performance has a duty to complete the contract *without regard to cost.* Furthermore, the penal sum does not limit its liability for damages caused by its own default while performing the contract. A typical performance bond [allows the surety] to choose between (1) remedying the default or completing the [contract,] and (2) paying the damages caused by [the principal's] default up to the penal sum.

Public Serv. Elec. & Gas Co. v. Technology for Energy Corp., 123 B.R. 979, 982-83 (Bankr. E.D. Tenn. 1991) (emphasis added); *see also Aetna Cas. & Sur. Co. v. Butte-Meade Sanitary Water Dist.,* 500 F. Supp. 193, 197 (D.S.D. 1980) (surety "waived its bond limits when it set out to complete the project"); *Bd. of Supervisors of Stafford County v. Safeco Ins. Co. of Am.,* 310 S.E.2d 445, 450 (Va. 1983) (the surety "could either perform at its own expense or pay the cost of performance up to the face amount of the bonds"); Philip L. Bruner, Patrick J. O'Connor, Jr., and James J. Hartnett, IV, *Bond Default Manual* 115–16 (Duncan L. Clore ed., 2d. ed. 1995)(one of the disadvantages of financing the principal is that "this option … exposes the surety to open-ended liability beyond the penal sum of its bond;" "once a surety agrees to take over the project, its ultimate liability will no longer be limited by the penal sum of its bond").

Sureties should also note that they may be liable for accrued interest in excess of the penal sum resulting from the surety's failure to timely make payment. *See Ins. Co. of N. Am. v. United States,* 951 F.2d 1244 (Fed. Cir. 1991); *Fidelity N.Y., FSB v. Aetna Ins. Co.,* 651 N.Y.S.2d 58 (App. Div. 1996).

3. Cost of Warranty and Extended Warranty Obligations

Under a performance bond, the surety is liable for the principal's warranty obligations. In *Federal Ins. Co. v. Southwest Fla. Retirement Center, Inc.,* 707 So. 2d 1119 (Fla. 1998), the obligee discovered latent defects which constituted a breach of an express warranty nine years after project completion.

> [The surety's] performance bond guaranteed completion of the construction contract according to its terms and conditions. The intent of this guarantee is to have the financial responsibility of the surety standing behind the general contractor's completion obligations. We conclude that [the surety's] promise that the project would be completed according to the terms and conditions of the construction contract means that [the surety] would be liable for defective work performed by the general contractor upon the general contractor's default. … We find no logical reason to distinguish between patent defects and latent defects in respect to the coverage of the performance bond.

Id. at 1121. Similarly, in *McDevitt & Street Co. v. K-C Air Conditioning Serv., Inc.,* 418 S.E.2d 87 (Ga. Ct. App. 1992), the Georgia Court of Appeals held that the performance bond surety was responsible for the principal's one-year workmanship and materials warranty.

Construction contracts often contain warranties of varying durations. Because a surety guarantees the performance of its principal, the surety remains liable under these warranties. To protect themselves, sureties can include limiting language in the bond.

4. Design/Build Responsibility and Exposure

If the bonded contract imposes design responsibility upon the principal, the surety is responsible for the principal's design obligation in the event of a default. In *Nicholson & Loup, Inc. v. Carl E. Woodward, Inc.,* 596 So. 2d 374 (La. Ct. App. 1992), the principal was responsible for both the design and construction of a supermarket. The surety argued that because there were no defects in the construction, but only defects in the design, it was not liable to the obligee. The Louisiana Court of Appeal stated that:

> The jurisprudence on the issue indicates that contractor suretyship bonds are designed to secure performance of the contract referenced therein. In the instant case, the contract referenced in the surety agreement was a design/contract. … Since the suretyship contract must be strictly construed in favor of [the obligee,] the trial court properly applied the surety agreement to the entire design/build contract. Since the contract covered by the [performance bond] placed both design and build responsibilities on the principal, the surety contract, when interpreted strictly, must be construed to cover both aspects of the project. We find that the trial judge was not manifestly erroneous in determining that the surety contract at issue was broad enough to cover [the principal's] design responsibilities under the contract….

Id. at 390.

5. Liability to Principal When Principal *Not* in Default

When a surety improperly renders performance to the bond obligee, in addition to losing its right to indemnification from the principal and other indemnitors, the surety risks facing affirmative claims by the principal. These claims include interference with contract, interference with economic relations and the like. The viability of each of these causes of actions, and the damages recoverable, must be examined on a jurisdiction-by-jurisdiction basis.

6. Unique Claims

In *R. J. Griffin & Co. v. Continental Ins. Co.,* 497 S.E.2d 586 (Ga. Ct. App. 1998), the Georgia Court of Appeals addressed whether a performance bond surety was liable for its principal's failure to return the obligee's overpayment.

> The question presented is whether the obligation to "perform fully" includes the obligation to cure all breaches of the subcontract, not just the physical completion of the work. Under the plain language of the bond, we find that it does. The surety's contract is not limited to physical "work"—it obligates it to "perform fully" as well as "complete the work … in accordance with the undertakings, covenants, terms, conditions and agreements."

Id. at 587. Accordingly, the court held that the "subcontractor's wrongful retention of funds is a breach of the subcontract and covered under the terms of the bond." *Id.* at 586–87.

Where a performance bond provides that, in the event of default, the surety will "promptly" complete the bonded contract, in addition to liquidated damages provided in the bonded contract, the surety may be liable for the obligee's "actual damages, including lost income, attributable to the surety's alleged delay in completing the project." *International Fidelity Ins. Co. v. County of Chautauqua,* 667 N.Y.S.2d 172, 174 (App. Div. 1997).

B. Performance Bond Options

After investigating the merits of a claim, a performance bond surety has several options. A surety should be aware of the risks and benefits of each.

1. Buy Back the Bond

A quick and clean method of resolving a performance bond claim is to tender payment to the bond obligee, not to exceed the penal sum of the bond, in full and final settlement of the claim. The disadvantage of this option is that one of the other options might have been taken at a lower cost and, as with all of the surety's actions, the principal could claim that the settlement payment was too large or improvidently made and, as a result, the surety may not be entitled to indemnification from the principal.

2. Finance the Principal

When the obligee is satisfied with the work performed by the principal, and the main cause of the principal's problems is insufficient cash flow, the surety could choose to finance the principal. The primary disadvantage to taking this action is that the surety's liability is *not* limited by the penal sum of the bond.

3. Tender Completion Contractor to Obligee

The surety may also arrange for the obligee to enter into a contract with a completion contractor. Under this option, the surety is responsible to the obligee for the additional costs of the completion contract which exceed the amount for which the obligee would have been responsible under the principal's contract (had there been no default). The surety's liability is limited to the penal sum of the bond.

4. Contract with Completion Contractor

The surety itself may enter into a contract with a completion contractor. It is often the case that the surety will contract with the defaulting principal to perform the work because of the principal's familiarity with the obligee's requirements, the plans and specifications, and the overall project, and because the principal's forces and equipment may already be mobilized on site. Just as when the surety finances the principal, when the surety contracts with the completion contractor, the surety's liability is *not* limited by the penal sum of the bond.

5. Do Nothing

Finally, the surety may do nothing and allow the obligee to take whatever steps it deems appropriate. Under this options, most courts hold that the surety's liability is limited by the penal sum of the bond.

However, sureties should be aware of *Continental Realty Corp. v. Andrew J. Crevolin Co.,* 380 F. Supp. 246 (S.D. W. Va. 1974), in which the United States District Court for the Southern District of West Virginia held a performance bond surety liable for costs in excess of the penal sum because the surety chose to "do nothing." The performance bond at issue in *Continental* provided that, upon the principal's default, the surety would either take over and assume completion of the bonded contract or pay the obligee the reasonable costs of completion. The surety, however, did neither.

> For reasons which the Court will elaborate upon, [the surety's] argument that it can in no event be found liable for a sum in excess of the penal sum of the bond is, by virtue of its own misconduct, not viable. The terms of the performance bond were such as to obligate [the surety] to indemnify and save harmless [the obligee] from all costs and damages by reason of [the principal's] default or failure to faithfully perform its contract. The limitation of $4,050,754 [i.e., the penal sum] was the limit of its guarantee of [the principal's] obligations under the construction contract …
>
> In light of the general rule that a surety may not be held liable in excess of the penal sum of the bond, [the surety's] liability at the moment of [the principal's] default may well have been limited to [the penal sum. The surety,] however, chose not to exercise its right under the bond and its failure, by whatever designation, negligence, bad faith, error in judgment, mistake of law, etc., constituted a breach of its obligation to [the obligee,] the liability for which is limited only by the amount of damages sustained as a result thereof. The surety agreement entered into for the mutual benefit of [the surety] and [the obligee] contains no limitation of liability for its own breach.

Id. at 252 (citations omitted). Therefore, the court held that the surety was liable for the obligee's damages, including lost profits, in excess of the penal sum.

C. Payment Bond Exposure

1. Payments to Claimants up to Penal Sum

In general, a payment bond surety's aggregate liability to all claimants is limited to the penal sum. For example, the American Institute of Architects' Payment Bond (AIA Document A312, 1984 ed.) expressly provides that the "Surety's total obligation shall not exceed the amount of this Bond, and the amount of this Bond shall be credited for any payments made in good faith by the Surety." However, where the principal's contract is for "indefinite delivery, indefinite quantity," a payment bond surety's liability is not limited by the penal sum of the bond. *United States ex rel. B & M Roofing of Colo., Inc. v. AKM Assoc., Inc.,* 961 F. Supp. 1441 (D. Colo. 1997). The contract at issue in *B & M Roofing* "unambiguously instruct[ed the principal] and [the surety] that total bonding liability (for both the performance and payment bonds) [would be] calculated by adding the total value of the delivery orders that [had] been placed. This provision that automatically increases the bonding liability when additional materials or labor is supplied is uniquely suited to [indefinite delivery, indefinite quantity] contracts …" *Id.* at 1444.

D. Payment Bond Options

A payment bond surety has two choices when faced with a claim: pay the claimant or refuse to pay. A surety can make an informed decision on how to respond to such a claim only after it has conducted a reasonable investigation.

E. Extra-Contractual Claims

1. Claims Settlement Acts

Many states have enacted unfair claims settlement practices acts which regulate the conduct of insurers. Some of these statutes expressly include sureties in their definition of "insurer." *See, e.g.,* Mont. Code Ann. § 33–1–201(6) (2001); *Alvarez v. Insurance Co. of North America,* 667 F. Supp. 689 (N.D. Cal. 1987)("[f]or purposes of the [California] Insurance Code, one who issues surety bonds is in 'the business of insurance' and subject to the provisions prohibiting unfair and deceptive practices"). Even if such statutes do not create a private right of action in favor of an obligee or a claimant under a bond, violation of the statute may constitute a separate tort for which the surety may be liable. For example, in *K-W Indus. v. National Surety Corp.,* 754 P.2d 502 (Mont. 1988), the Montana Supreme Court held that "[i]t is also clear in Montana that a breach of the applicable provisions of [the Montana Unfair Claims Settlement Practices Act] by an insurer [which includes a surety] is conduct compensable in tort as to third parties to the insurance contract." *Id.* at 505. As with much of suretyship law, there are variations among jurisdictions, and thus sureties and contractors should always review the law from the applicable jurisdiction.

2. Tort of Bad Faith

Many jurisdictions recognize the independent tort of "bad faith" by a surety under the common law or statute. In *R.W. Granger & Sons, Inc. v. J&S Insulation, Inc.*, 754 N.E.2d 668 (Mass. 2001), the Massachusetts Supreme Judicial Court unanimously affirmed a trial court's substantial punitive judgment against a surety that had forced a claimant to litigate a valid bond claim. The surety had failed to effectuate settlement of a $203,000 payment bond claim even after the bond claimant, an insulation subcontractor, obtained a jury verdict against the project's general contractor. After the verdict was issued, but before the subcontractor's request for statutory attorneys' fees was resolved, the subcontractor demanded the surety pay the undisputed portion of the judgment (principal and interest). The surety, however, ignored the subcontractor's demand, raised what the court later described as "insincere defenses" and forced the subcontractor to litigate collection of the judgment. The resultant bond claim judgment of nearly a half million dollars, which was finally entered some ten months after the jury verdict, included the base claim for the subcontract balance, interest, and the attorneys' fees the subcontractor spent pursuing its claim. The general contractor ultimately paid the entire payment bond judgment to the subcontractor.

As a result of the surety's dilatory conduct, the subcontractor asserted a claim against the surety for unfair and deceptive insurance practices. The trial court agreed with the subcontractor and found that the surety's, "cavalier" attitude toward its legal obligations "manifestly" violated the Massachusetts' statutes in question, M.G.L. c. 93A and c. 176D. In rendering its decision on the unfair practices claim, the trial court found it particularly egregious that the surety could not explain why it waited more than four months to respond to the subcontractor's original demand, or why its only offer to settle the claim ($230,000.00 of $373,206.17) was "wholly inadequate" in light of the damages known to be due the subcontractor at the time of the offer. Pursuant to the Consumer and Business Protection Act (the "Act"), the surety was found liable for twice the amount of the underlying bond judgment plus interest and the attorneys' fees the subcontractor spent to recover the punitive damages award. Accordingly, the judgment against the surety arising out of the original $203,000.00 bond claim totaled $966,284.94 after the application of the Act. The surety appealed.

On appeal, the surety argued that since the underlying bond judgment had been fully paid, it was not liable for any amount at all. Alternatively, the surety argued that at the very least it was entitled to reduce the punitive damages judgment by $410,245.83 as a "credit" for the amount the subcontractor had already been paid directly by the general contractor. The Massachusetts Supreme Judicial Court, however, rejected the surety's arguments and affirmed "in all respects" the trial court judgment. The court noted that the surety's "unreasonable settlement practices" clearly denied the subcontractor prompt recovery of the money it was owed, a direct violation of the law. In addition, the court rejected the surety's argument that it was entitled to reduction of its punitive damages liability by a "credit" for the amount paid by the surety's principal. In rejecting this argument, the court stated that the insurance practice statutes were expressly designed to deter unfair and deceptive acts or practices by imposing an "in terrorem" sanction on defendants who violate the statute. The court stated that allowing the surety a credit against its punitive damages liability would undermine the plain language of, and legislative intent behind the applicable statutory framework.

In *TransAmerica Premier Ins. Co. v. Brighton Sch. Dist. 27J,* 940 P.2d 348 (Colo. 1997), the Colorado Supreme Court first noted that it had previously held that an insured could assert a cause of action in tort against an insurer for its breach of the duty to act in good faith. The issue in *TransAmerica* was whether that proposition should be extended to allow an obligee to assert such a tort against a *performance* bond surety. "We conclude that the rationale for providing insureds with a cause of action in tort for an insurer's bad faith in processing a claim applies with equal force in the commercial surety context." *Id.* at 351. The court held that "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." *Id.* at 353. A "commercial surety acts in bad faith when the surety's conduct is unreasonable and the surety knows that the conduct is unreasonable or recklessly disregards the fact that its conduct is unreasonable." *Id.* at 354.

Similarly, the Supreme Court of Arizona held in *Dodge v. Fidelity & Deposit Co. of Maryland,* 778 P.2d 1240 (Ariz. 1989), that sureties must act in good faith in responding to claims. In response to the surety's contention "that a surety agreement requires the surety to divide its loyalty between the principal and the obligee," the court held that "[w]e do not dispute that a surety has an enforceable obligation of good faith towards its principal. However, the duty imposed on a surety to deal in good faith with the obligee does not require it to act in bad faith with its principal." *Id. at 1243* (citation omitted). The court approvingly quoted the following from Brumley, *Duty of a Shielded Surety to Investigate,* 17 Forum 266, 280 (1981):

> [T]he surety often finds it difficult to decide whether to accede to the demand 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.

However, other states refuse to recognize the tort of bad faith against a surety. *See, e.g., Institute of Mission Helpers of Baltimore City v. Reliance Ins. Co.,* 812 F. Supp. 72 (D. Md. 1992). In *Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1,* 908 S.W.2d 415 (Tex. 1995), the Texas Supreme Court held that a bond surety does not owe a common law duty of good faith to the obligee. Although Texas recognizes the duty of good faith between an insurer and its insured, *see Associated Indem. Corp. v. CAT Contracting, Inc.,* 964 S.W.2d 276, 280 (Tex. 1998), it deems the relationship between surety and principal or obligee to not be the same as the relationship between an insurer and its insured.

3. Where the States Stand

The following chart summarizes the states' positions on recognition of an independent bad faith tort against sureties.

STATES RECOGNIZING INDEPENDENT TORT OF BAD FAITH

Alaska—*See, e.g, Loyal Order of Moose, Lodge 1392 v. Int'l Fidelity Ins. Co.*, 797 P.2d 622 (Alaska 1990).
Alabama—*See, e.g, Ruffin Bldg. Sys., Inc. v. Ft. Walton Beach Steel, Inc.*, 1992 U.S. Dist LEXIS 12119 (S.D. Ala. July 24, 1992).
Arizona—*See, e.g, Dodge v. Fidelity and Deposit Co. of Md.*, 778 P.2d 1240 (Ariz. 1989).
Colorado—*See, e.g, Transamerica Premier Ins. Co. v. Brighton Sch. Dist.*, 27J, 940 P.2d 348 (Colo. 1997).
Connecticut—*See, e.g, Blakeslee Arpaia Chapman, Inc. v. U.S. Fidelity & Guar. Co.*, 1994 Conn. Super. LEXIS 573 (Mar. 4, 1994).
Delaware—*See, e.g, Int'l Fidelity Ins. Co. v. Delmarva Sys. Corp.*, 2001 Del. Super. LEXIS 165 (May 9, 2001).
Georgia—See Ga. Code Ann. § 10-7-30 (2001).
Kansas—*See, e.g, The Hartford v. Tanner*, 910 P.2d 872 (Kan. Ct. App. 1996).
Louisiana—*See, e.g, Spartan Bldg. Corp. v. Madison County Sawing & Sealing, Inc.*, 1991 U.S. Dist. LEXIS 8399 (E.D. La. June 18, 1991).
Massachusetts—*See, e.g, R.W. Granger & Sons, Inc. v. J&S Insulation, Inc.*, 754 N.E.2d 668 (Mass. 2001).
Montana—*See, e.g, K-W Indus. v. Nat'l Sur. Corp.*, 754 P.2d 502 (Mont. 1988).
North Dakota—*See, e.g, Szarkowski v. Reliance Ins. Co.*, 404 N.W.2d 502 (N.D. 1987).
New Jersey—*See, e.g, U.S. ex rel. Don Siegel Constr. Co. v. Atul Constr. Co.*, 85 F.Supp.2d 414 (D.N.J. 2000).
New York—*See, e.g, Land Mine Enter. v. Sylvester Builders, Inc.*, 1989 U.S. Dist. LEXIS 5701 (S.D.N.Y. 1989).
Ohio—*See, e.g, Suver v. Personal Serv. Ins. Co.*, 462 N.E.2d 415 (Ohio 1984).
Washington—*See, e.g, Snohomish Sch. Dist. No. 201 v. Sportec Int'l, Inc.*, 1996 Wash. App. LEXIS 689 (1996).
Wyoming—*See, e.g, Continental Realty Corp. v. Andrew J. Crevolin Co.*, 380 F. Supp. 246 (S.D. W.Va. 1974).

STATES THAT DO NOT RECOGNIZE INDEPENDENT BAD FAITH TORT

California—*See, e.g, Cates Constr., Inc. v. Talbot Partners*, 980 P.2d 407 (Cal. 1999).
Maryland—*See, e.g, Inst. of Mission Helpers of Baltimore v. Reliance Ins. Co.*, 812 F. Supp. 72 (D. Md. 1992).
Pennsylvania—*See, e.g, Superior Precast, Inc. v. Safeco Ins. Co. of Am.*, 71 F. Supp. 2d 438 (E.D. Pa. 1999).
South Carolina—*See, e.g, Masterclean, Inc. v. Star Ins. Co.*, 556 N.E.2d 371 (S.C. 2001).
Texas—*See, e.g, Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1*, 908 S.W.2d 415 (Tex. 1995).

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STATES THAT HAVE CONSIDERED BUT NOT DECIDED THE ISSUE

Arkansas—*See, e.g, R.J. "Bob" Jones Excavating Contractor, Inc. v. Firemen's Ins. Co. of Newark*, N.J., 920 S.W.2d 483 (Ark. 1996).
Florida—*See, e.g, Shannon R. Ginn Constr. Co. v. Reliance Ins. Co.*, 51 F. Supp. 2d 1347 (S.D. Fla. 1999).
Hawaii—*See, e.g, Bd. of Directors of the Assoc. of Apartment Owners of the Discovery Bay Condominium v. United Pac. Ins. Co.*, 884 P.2d 1134 (Haw. 1994)(tort may be available if liability exists on underlying bond).
Illinois—*See, e.g, Premier Elec. Constr. Co. v. Am. Nat'l Bank and Trust Co. of Chicago*, 603 N.E.2d 733 (Ill. App. Ct. 1992).
Kentucky—*See, e.g, Curry v. Fireman's Fund Ins. Co.*, 784 S.W.2d 176 (Ky. 1989).
Nebraska—*See, e.g, J.B. Contracting Serv., Inc. v. Universal Surety Co.,* 624 N.W.2d 13 (Neb. 2001).

IV. The Surety's Defenses

A. Performance Bond Claims

1. Principal Not in Default

A surety is not liable to the obligee unless the principal is in default. *See, e.g., United States v. Seaboard Surety Co.,* 817 F.2d 956, 959 (2d Cir. 1987)("a surety may, of course, also challenge the propriety of the default termination, thereby, in effect denying liability on the bond.")

In discussing the phrase "declared in default" in a performance bond, the United States Court of Appeals for the Fifth Circuit stated that:

> Although the terms "breach" and "default" are sometimes used interchangeably, their meanings are distinct in construction suretyship law. Not every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it. To constitute a legal default, there must be a (1) material breach or series of material breaches (2) of such magnitude that the obligee is justified in terminating the contract.

L & A Contracting Co. v. Southern Concrete Serv., Inc., 17 F.3d 106, 110 (5th Cir. 1994). In addition, the court discussed the requisites of a proper "declaration of default":

> A declaration of default sufficient to invoke the surety's obligations under the bond must be made in clear, direct, and unequivocal language. The declaration must inform the surety that the principal has committed a material breach or series of material breaches of the subcontract, that the obligee regards the subcontract as terminated, and that the surety must immediately commence performing under the terms of its bond.

Id. at 111. Thus, a principal is not in default unless it has materially breached the contract and, under most bonds, the surety is not obligated to perform until the obligee has declared to the surety that the principal is in default.

2. Obligee in Default

Nearly all bonds provide that the surety's obligation arises only if there is no "owner default." As the Virginia Supreme Court stated, "before an owner can recover under a bond, he must show that he has performed the conditions set forth in the bond." *Southwood Builders, Inc. v. Peerless Ins. Co.,* 366 S.E.2d 104, 107 (Va. 1988). The most typical defaults by an owner are its failure to make payment to the principal when payment is due, and paying the principal more money than is due. It is the surety's investigation which enables the surety to determine whether the obligee is in default of its obligations under the bonded contract.

3. Defective Plans and Specifications

The Spearin doctrine was created in *United States v. Spearin,* 248 U.S. 132 (1918), where the Supreme Court held that, "if [a] contractor is bound to build according to plans and specifications prepared by the owner, the contractor will not be responsible for the consequences of defects in the plans and specifications." *Spearin* at 136. The court stated further that "[t]he duty to check plans did not impose the obligation to pass upon their adequacy to accomplish the purpose in view." *Spearin* at 137. In essence, under the Spearin doctrine, the owner warrants that the plans or specifications are accurate and the contractor's reliance thereon will not expose the contractor to liability for non-conformance.

If appropriate, a surety may defend against a claim on the basis that the owner's plans and specifications were defective. The defective plans and specifications establish that the obligee, and not the principal, is in default, and therefore the surety need not perform under the performance bond.

4. Obligee's Fraud/Concealment

An obligee's fraud or concealment of material facts may release a surety from its obligations. In *St. Paul Fire & Marine Ins. Co. v. Commodity Credit Corp.,* 646 F.2d 1064 (5th Cir. 1981), the United States Court of Appeals for the Fifth Circuit discussed this issue with respect to performance bonds issued to ensure a farming association's obligations under a loan agreement:

> A surety is one who assumes secondary liability for the performance of an obligation; he agrees to pay if another does not. Nevertheless, as a general rule, the creditor, or obligee, to whom the surety's assurance is given is not bound to disclose to the surety unrequested information concerning the secured transaction. If a surety fails to seek important information that is available to him, he cannot, in the absence of fraud, assert as a defense ignorance of facts which he should have known and considered prior to the execution of the contract. The law does not favor the indifferent,

> unseeing surety who fails to help himself. Unless the creditor is aware that the surety is mistaken as to the duty, or there is a request for information by the surety, or the bond is executed in the presence of someone associated with the creditor, a creditor cannot be charged with withholding information that could have been discovered by the surety.
>
> In some respects, however, the suretyship bond is fragile, easily broken by the conduct of the creditor. The validity of the contract may be vitiated ab initio by the creditor's actions during its creation. A creditor who, during negotiations, actively and fraudulently conceals pertinent facts cannot then turn to the surety for reimbursement. Similarly, the surety has a defense to liability if, before the obligation is undertaken, the creditor knew of facts unknown to the surety and which he had reason to believe were not known to the surety, the facts materially increased the obligor's risk and the creditor had adequate time to disclose them but failed in his responsibility. So, for example, a party must be given actual or constructive notice of a custom that will vary the terms of the contract.

Id. at 1072-73. The court held that the sureties were released from their obligations under the bonds because, at the time they were executed, the obligee "failed to disclose two facts objectively probative of material risk," a previous shortage of capital and the probability of future shortages. *See also Rachman Bag Co. v. Liberty Mut. Ins. Co.,* 905 F. Supp. 95 (E.D.N.Y. 1995)(surety was relieved of its obligations by proving affirmative defense of obligee's fraudulent concealment of material fact).

In *Pinkerton & Laws, Inc. v. Macro Constr., Inc.,* 485 S.E.2d 797 (Ga. Ct. App. 1997), the Georgia Court of Appeals held that the surety was discharged from its duties under the performance bond at issue because of the obligee's fraudulent misrepresentations concerning the bonded contract, despite the surety's failure to obtain a copy of the executed contract before issuing the bond. The surety presented evidence that it "followed ordinary industry practice, and that it is common to take the word of the obligee … regarding certain bonding considerations …. [The surety] therefore presented evidence that it exercised due diligence before issuing [the bond]…." *Id.* at 799.

In addition, a surety may assert as a defense the obligee's fraudulent inducement of the bonded contract. *See, e.g., Taylor & Jennings, Inc. v. Bellino Bros. Constr. Co.,* 393 N.Y.S.2d 203 (App. Div. 1977).

5. Principal's Fraud/Concealment

The Florida District Court of Appeal addressed the effect of a principal's fraud upon the surety:

> The general rule is that fraud practiced by the principal upon the surety does not affect the liability of the surety to the obligee unless the obligee was a party to the wrongdoing or concealed material facts from the surety when it was his duty to disclose them. This holding is often explained on the ground that where one of two innocent parties must suffer from the fraud of another, the loss must be borne by the one who through his negligence or misplaced confidence has enabled the third party to consummate the fraud.

National Union Fire Ins. Co. of Pittsburgh, Pa. v. Robuck, 203 So. 2d 204, 206 (Fla. Dist. Ct. App. 1967).

6. Modification of Contract

Historically, courts have strictly construed bonds issued by accommodation or uncompensated sureties, and therefore have discharged such a surety if *any* change was made to the bonded contract without the surety's consent. This no longer appears to be the rule in most jurisdictions as to compensated sureties, however. In order to discharge a compensated surety, the modification must be a *material* modification.

The Virginia Supreme Court has held that "compensated sureties do not deserve the special treatment accorded accommodation sureties." *Southwood Builders, Inc. v. Peerless Ins. Co.,* 366 S.E.2d 104, 107 (Va. 1988). In order to be discharged in Virginia, a compensated surety need only demonstrate a material variation, and need not show it suffered any prejudice. "A separate showing of prejudice to the surety is unnecessary because a material deviation, in itself, establishes sufficient prejudice. In this case, the material deviation is established by proof that the subcontractor was paid money before it was due and without approval by the architects [i.e., obligee's overpayment to principal]." *Id.* at 108; *see also Food Lion, Inc. v. S.L. Nusbaum Ins. Agency, Inc., 202 F.3d 223 (4th Cir. 2000). Cf. Fisher v. Fidelity & Deposit Co. of Md.,* 466 N.E.2d 332, 337 (Ill. App. Ct. 1984) ("The change in the method of paying for the work, the omission of one exterior window, a slight increase in the height of the building, and a written adjustment in the size of an interior window which was never installed do not constitute a material alteration in the contract sufficient to discharge the surety's liability.").

Other jurisdictions, however, also require a showing of injury or prejudice to the surety. The United States District Court for the Southern District of New York has stated:

> As a general rule, a material or prejudicial variation of the terms of a building contract discharges a surety who has guaranteed the contract. In addition, "[a]ccording to the weight of authority in American jurisdictions, … a material departure by the owner, without the consent of the surety, from the express requirements of a construction contract with regard to the times or amounts of payments made to the contractor, the retention of percentages, or the exaction of certain certificates, estimates, or receipted bills, operates to release or discharge the surety on the contractor's bond from liability to the owner, at least to the extent that such unauthorized payments result in injury or prejudice to the surety.

Aniero Concrete Co. v. New York City Constr. Auth., 1998 WL 148324, 1998 U.S. Dist. LEXIS 3938 (S.D.N.Y. Mar. 30, 1998). *See also Mergentime Corp. v. Washington Metro. Area Transit Auth.,* 775 F. Supp. 14, 19 (D.D.C. 1991) ("A number of courts of appeals which have recently considered the circumstances under which a compensated surety may be discharged from its bond obligations have required a showing of injury or prejudice to the surety as well as proof of material modification to the underlying contract.").

As a practical matter, the surety's defense based on the obligee's material modification of the contract by changes is not available because most performance bonds waive notice of any change in the contract. *See*, *e.g.*, the American Institute of Architects' Performance Bond (AIA Document A312, 1984 ed.) ("The Surety hereby waives notice of any change, including changes of time, to the Construction Contract or to related subcontracts, purchase orders and other obligations.").

7. Procedural Defenses

   a. Claimant is Not a Proper Claimant

      The surety owes the duties required under the performance bond to the bond obligee, and no other person. Accordingly, only the bond obligee may properly assert a claim under the bond.

Although it is rare that a claimant under a performance bond is, in fact, not the true bond obligee, such was the case (at least initially) in *Fisher v. Fidelity & Deposit Co. of Maryland,* 466 N.E.2d 332 (Ill. App. Ct. 1984). *There,* C&E Productions contracted with a general contractor for the construction of a recording studio. The Small Business Administration provided funding for the construction and required the general contractor to secure bonding. The performance bond identified the owner as the SBA. Ultimately, C&E Productions filed suit against the surety alleging the principal's default. The court then "reformed the bond to substitute [C&E Productions] for the SBA as owner." Presumably, had the court not made the reformation, the surety could have argued that C&E Productions was not a proper claimant.

b. Notice Provisions

Most performance and payment bonds require the obligee to notify the surety in writing of a claim. For example, the American Institute of Architects' Performance Bond (AIA Document A312, 1984 ed.) provides: "If there is no Owner Default, the Surety's obligation under this Bond shall arise after … [t]he Owner has notified the Contractor and the Surety … that the Owner is considering declaring a Contractor default."

Unless an obligee complies with the requirements of the bond, which may include giving written notice, it may not recover from the surety. In *Dragon Constr., Inc. v. Parkway Bank & Trust,* 678 N.E.2d 55 (Ill. App. Ct. 1997), the performance bond surety successfully defended a claim by the obligee based on the obligee's failure to provide the contractually-required seven days' notice to the surety of the termination of the general contractor.

> An obvious reason for this requirement was to allow [the surety] to exercise its right under the performance bond to participate in the selection of a successor contractor. Since the [obligee] replaced [the principal] … before informing [the surety] that [the principal] was to be terminated and without consulting [the surety] as to the successor, [the surety] was stripped of its contractual right to minimize its liability under the performance bond by ensuring that the lowest bidder was selected to complete the job.

Id. at 58. The court then held that such action "constituted a material breach of contract which rendered the surety bonds null and void." *Id. See also Lynbrook Glass & Architectural Metals Corp. v. Elite Assoc., Inc.,* 638 N.Y.S.2d 622 (App. Div. 1996)(claimant who failed to comply with ninety-day notice requirement under payment bond may not recover against surety).

c. Statutory and Contractual Limitations Periods

Like other obligations with which the obligee must comply in order to recover against the surety, the obligee must file suit against the surety within the time required under the bond or by statute. In *Gen'l Ins. Co. of Am. v. Interstate Serv. Co.,* 701 A.2d 1213 (Md. Ct. Spec. App. 1997), at issue was a subcontractor's claim under two payment bonds, one of which required suit to be filed within one year "from the date … on which the last labor or service was performed by anyone or the last materials or equipment were furnished by anyone under the Construction Contract," *id.* at 1215, and the other of which required that suit be filed within one year after the principal ceased work. The court reviewed the enforceability of the limitations provision under the law of Maryland, the District of Columbia and Virginia. If Maryland law were applicable, the court held, the Maryland Code expressly provides that insurance and suretyship contracts are void to the extent they shorten the limitations period provided by statute. Maryland's statutory limitations period for claims under a payment bond is twelve years. Accordingly, the one-year bond limitations period would be ineffective in Maryland. The District of Columbia, however, does not prohibit contractual limitations provisions. In Virginia, the parties to a contract may shorten a limitations period as long as it is not against public policy or unreasonably short, and the Virginia Code expressly provides that an insurance policy may not limit the time in which to bring the action to less than one year.

Whatever the limitations period, the obligee's failure to file suit within the prescribed period will generally bar its recovery. *See, e.g., Quin Blair Enters., Inc. v. Julien Constr. Co.,* 597 P.2d 945 (Wyo. 1979) ("We hold that [the obligee's] suit against [the surety] was not timely brought under the terms of the performance bond and must be dismissed."); *Nat'l Tea Co. v. Plymouth Rubber Co.,* 663 So. 2d 801 (La. Ct. App. 1995) (performance bond surety not liable where obligee failed to file suit within two-year limitations period.).

d. Venue Provisions

Bonds, or the contracts incorporated into the bonds, typically include a venue provision which requires the parties to resolve disputes before a certain court and/or in a certain locale. The Miller Act, 40 U.S.C. § 270a *et seq.* (2002), provides that payment bond claims "shall be brought … in the United States District Court for any district in which the contract was to be performed and executed and not elsewhere." 40 U.S.C. § 270b(b). In *United States ex rel. Tech Coatings v. Miller-Stauch Constr. Co.,* 904 F. Supp. 1209 (D. Kan. 1995), the surety argued that the claimant's suit was improperly filed in the United States District Court for the District of Kansas because the parties' contract provided that disputes would be resolved "in the Circuit Court of Jackson County, Missouri." The court held that "[t]he venue requirement under the Miller Act, 40 U.S.C. § 270b(b), is like any other conventional venue provision; it can be contractually waived by a valid forum selection clause…. When venue is improper, the court may, in the interest of justice, transfer the case to a district court in which it could have been brought. If upon refiling in the new venue the action now would be barred by the statute of limitations, then it is in the interest of justice and 'particularly appropriate' to transfer." *Id.* at 1213–14. Because the one-year limitations period had already expired, rather than dismiss the case, the court transferred it to the Western District of Missouri. *Cf. United States ex rel. Mechanical B & D Contractors, Inc. v. St. Paul Mercury Ins. Co.,* 70 F.3d 1115 (10th Cir. 1995) (contract provision which required disputes to be resolved in a state trial court was void as an attempt to divest the United States District Court of jurisdiction over the Miller Act suit).

8. Obligee's Overpayment to Principal

If a principal defaults under its contract and the surety endeavors to complete the principal's work, the surety is entitled to the remaining payments due from the obligee under the bonded contract. When an obligee improperly makes payment to the principal in advance of when payment is due or in an amount greater than due, the obligee thereby diminishes a source of funds which would otherwise be due the surety. In such a circumstance, the surety is discharged from its obligations. In *Southwood Builders, Inc. v. Peerless Ins. Co.,* 366 S.E.2d 104 (Va. 1988), the obligee (a general contractor) made advance payments to the principal (the subcontractor) before such payments were due. The court stated:

> A separate showing of prejudice to the surety is unnecessary because a material deviation [the obligee's overpayment], in itself, establishes sufficient prejudice. In this case, the material deviation is established by proof that the subcontractor was paid money before it was due and without approval by the architects. Such a procedure diminishes funds that should have been available to the surety in case of default, eliminates the architect's assurance that payments to the contractor are being used

> for the job, and undermines the inducement to the contractor to finish the work on schedule in order to be paid.

Id. at 108; *see also Airtrol Eng'g Co. v. United States Fidelity & Guar. Co.,* 345 So. 2d 1271, 1273 (La. Ct. App. 1977) ("The bonding company is entitled to expect that payments will be made in accordance with the contract.").

However, an obligee who, in good faith, mistakenly overpays the principal based on certificates or estimates of an architect or engineer, may not be precluded from recovering against a performance bond surety. *Balboa Ins. Co. v. Fulton County,* 251 S.E.2d 123 (Ga. Ct. App. 1978); *see also Argonaut Ins. Co. v. Town of Cloverdale, Indiana,* 699 F.2d 417, 419 (7th Cir. 1983) ("a surety is not discharged by reason of an unauthorized payment made in good faith reliance on an engineer's or architect's certificate of progress").

9. Obligee's Extension of Time

An obligee's extension of the time in which the principal must perform may constitute a material modification of the contract which serves to discharge the surety. In *Keene Corp. v. Int'l Fidelity Ins. Co.,* 736 F.2d 388 (7th Cir. 1984), a performance bond surety argued that it was discharged from its obligations because the obligee gave the principal a time extension to manufacture certain machinery without the surety's consent. However, the United States Court of Appeals for the Seventh Circuit analyzed two applicable rules under Illinois law and found that, under both, the surety was not discharged. First, "[u]nder Illinois law a compensated surety is not discharged by an extension of time … unless the extension is supported by valid and sufficient consideration." *Id.* at 391-92. The court found that the obligee's extension of time had not been granted in exchange for new consideration from the principal. In addition, in Illinois, "[w]here the obligee of a surety bond, by agreement with the principal and without the consent of the surety, gives additional time for performance of the obligation by the principal, the surety is discharged to the extent of the injury accruing to it as a result of the modification." *Id.* at 392. The court found that the obligee's damages were a result of the principal's ultimate failure to construct the machinery, not the time extensions themselves. Accordingly, the court held that the surety was not discharged.

In Wisconsin, however, it appears that such an extension of time will discharge a surety even if the time extension was not supported by consideration or the surety cannot show that the obligee's damages were a result of the time extension:

> It is similarly well settled under Wisconsin law and under the majority view that a binding agreement by which the creditor gives an extension of time for performance is a material alteration of the guarantor's obligations under the principal agreement and thus discharges a guarantor who has not consented to the extension of time. There are two fundamental reasons for discharging the guarantor when a creditor extends the time of performance on the principal contract: first, the extension is a material alteration which increases the guarantor's risk by increasing the probability of the principal's default and decreasing the principal's ability to reimburse or exonerate the guarantor; second, the extension limits the guarantor's right to pay at any time and proceed immediately against the principal by way of subrogation.

Federal Deposit Ins. Corp. v. Manion, 712 F.2d 295, 297-98 (7th Cir. 1983).

10. Failure to Mitigate Damages

When faced with a principal's default, an obligee must act reasonably in mitigating its damages. Although an obligee's failure to mitigate damages will generally *not* discharge a surety from its obligations, "[f]ailure to mitigate damages is properly considered in determining damages rather than liability." *Aniero Concrete Co. v. New York City Constr.*

Auth., 1998 WL 148324, 1998 U.S. Dist. Lexis 3938 (S.D.N.Y. Mar. 30, 1998). *See also Fisher v. Fidelity & Deposit Co. of Md.,* 466 N.E.2d 332, 340 (Ill. App. Ct. 1984)(an obligee's "[f]ailure to mitigate damages is an affirmative defense [of the surety] and must be pleaded and proved by the [surety]").

11. Exoneration Acts

Many states have enacted "exoneration acts" which entitle a surety to require an obligee to file suit against the principal. If the obligee fails to do so, then the surety is released from its obligations. *See, e.g.,* Mo. Rev. Stat. § 433.010 (2001) ("Any person bound as surety for another in any bond … for the payment of money or delivery of property, may, at any time after an action has accrued thereon, require, in writing, the person having such right of action forthwith to commence suit against the principal debtor and other parties liable."); Okla. Stat. Ann. tit. 15, § 379 (2002) ("A surety may require his creditor to proceed against the principal, or to pursue any other remedy in his power which the surety cannot himself pursue, and which would lighten his burden; and if in such case the creditor neglects to do so, the surety is exonerated to the extent to which he is thereby prejudiced."); Va. Code Ann. § 49-25 (2002) ("The surety … of any person bound by any contract may, if a right of action has accrued thereon, require the creditor … to institute suit thereon…. [The creditor's] failure to act will result in the loss of the surety … as security for the debt …").

B. Payment Bond Claims

1. Principal Not in Default

Given that a surety's liability is coextensive with that of its principal, the surety can only be liable if the principal is in default. "[T]he very definition of a surety is 'one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.' Absent a default by the principal, the surety incurs no liability." *Wm. R. Clarke Corp. v. Safeco Ins. Co. of America,* 938 P.2d 372, 378 (Cal. 1997).

2. Claimant in Default

Because the surety is entitled to assert a principal's defenses, a default by the claimant under its contract will serve to discharge the surety in part or in whole with respect to the claimant's claim. The surety should review in detail the claimant's contract to ensure that the claimant has performed its duties thereunder.

3. Conditional Payment

a. Principal's Use of Conditional Payment Clause

Many construction subcontracts contain conditions which the subcontractor must satisfy before a general contractor's obligation to pay arises. Among other things, subcontracts often contain language conditioning the general contractor's payment obligations upon the general contractor's receipt of payment from the owner. For instance, a subcontractor may be faced with subcontract language which provides:

- Payment to the subcontractor shall be made within seven (7) calendar days after receipt by the Contractor of payment from the Owner for such Subcontract Work;

- Payment to subcontractor shall not become *due unless and until* Contractor receives payment for such Work from the Owner; or

- Final Payment *shall not become* due *unless and until* the following *conditions precedent* to Final Payment have been satisfied: approval and acceptance of Subcontractor's Work by Owner, Architect and Contractor; and *receipt of Final Payment for Subcontractor's Work by Contractor from Owner.*

In an effort to shift the risk of owner nonpayment or owner insolvency to their subcontractors, general contractors have increasingly added conditional payment clauses, known as "pay-if-paid" clauses, to their subcontract forms. As a result, issues surrounding those clauses have recently become the focus of many court decisions.[1]

A majority of courts have concluded that, unless the parties *explicitly and unambiguously* provide otherwise, a general contractor typically bears the risk that an owner might become insolvent or that an owner may refuse to make one or more payment(s). Under the majority rule, a payment clause, such as the clause first listed above, does not create a condition precedent to the general contractor's obligation to pay its subcontractors. Instead, the clause merely establishes a time for payment, and, if the owner does not pay the general contractor for reasons outside the subcontractor's control, the general contractor must pay the subcontractor within a reasonable time after the subcontractor completes its work. *See, e.g., Thos. J. Dyer Co. v. Bishop Int'l Eng'g Co.,* 303 F.2d 655 (6th Cir. 1962); *Power & Pollution Serv., Inc. v. Suburban Power Piping Corp.,* 598 N.E.2d 69 (Ohio Ct. App. 1991); *Berkel & Co. Contractors v. Christman Co.,* 533 N.W.2d 838 (Mich. Ct. App. 1995); *DEC Electric, Inc. v. Raphael Constr. Corp.,* 558 So. 2d 427 (Fla. 1990); *Mrozik Constr. Inc. v. Lovering Assoc., Inc.,* 461 N.W.2d 49 (Minn. Ct. App. 1990). For a detailed discussion of the use and enforceability of conditional payment clauses, as well as each state's position on conditional payment clauses in subcontracts, see Gerald I. Katz, *Conditional Payment Clauses, in Construction Risk Management,* Ch. XI(E) (International Risk Management Institute, Inc. ed. 1998).

In light of the majority rule, and the influx of bankruptcies involving developers in the late 1980's and early 1990's, general contractors began to use subcontract language that effectively shifted the risks of nonpayment to their subcontractors. They did so by adding explicit language, such as that found in the third example listed above, that asserts that the parties intend for the owner's payment to be a *condition precedent* which must be satisfied before the general contractor's duty to pay the subcontractor arises.

b. Availability of Condition Precedent Payment Defense to Surety

Whether they resort to statutory language or public policy concerns, many courts have refused to permit payment bond sureties to rely upon conditional payment clauses in their principals' subcontracts. As a result, general contractors who use such clauses may still be liable for payments to subcontractors by virtue of their duty to reimburse their payment bond sureties for payments made to bond claimants. For instance, courts will consider public policy in cases that involve Federal Miller Act payment bond claims and state Little Miller Act payment bond claims. On public projects, although the law is not completely settled, courts are unlikely to preclude a subcontractor from recovering on a payment bond suit as a result of a conditional payment clause. *See United States ex rel. Walton Tech., Inc. v. Weststar Eng'g, Inc., 2002 U.S. App. Lexis 9605 (9th Cir. May 22, 2002); United States ex rel. T.M.S. Mech. Contractors v. Millers Mut. Fire Ins. Co. of Tex.,* 942 F.2d 946 (5th Cir. 1991). For the most part, the courts have concluded that an essential purpose of the statute is to protect subcontractors from nonpayment. To enforce a condition precedent payment provision would fly in the face of that established purpose.

[1]Such clauses are to be distinguished from "pay-when-paid" clauses which merely define the time within which payment must be made.

The United States District Court for the Eastern District of Virginia recently reviewed the enforceability of conditional payment clauses in relation to private, non-Miller Act bonds. In *Moore Bros. Co. v. Brown & Root, Inc.,* 962 F. Supp. 838 (E.D. Va. 1997), *aff'd*, 207 F.3d 717 (4th Cir. 2000), the court held that, even though the two subcontracts in question contained condition precedent payment clauses, the payment bond surety was required to pay two subcontractors outstanding monies due on their subcontracts. In *Moore,* the subcontractors sued both the general contractor and its payment bond surety for outstanding monies earned as "early completion bonuses" and for additional work performed (previously awarded by an arbitration panel).

The surety argued that it was not required to pay the subcontractors because it was entitled to assert all defenses available to its principal, the general contractor, including the conditional payment defense. Alternatively, the surety argued that it was not required to pay the subcontractors because the claims at issue were not "sums due" under its bond. The bond contained typical language which provided, in part, that claimants may sue on the bond "for such sum or sums as may be *justly due* claimant, and have execution thereon." (Emphasis added.) The surety asserted that, because the owner had not yet paid the general contractor, the monies at issue were not "sums justly due" to the subcontractors.

The court, however, rejected the surety's arguments because the surety had not *explicitly* incorporated the terms and conditions of the subcontracts into the payment bond. The bond also did not include an explicit claim to the general contractor's defenses. The court stated, "[a]bsent such clear language or clear incorporation of the subcontracts, the surety cannot rely on the prime's defense to payment." The court concluded that the only conditions precedent for payment in the bond were the passage of 90 days and the *principal's* failure to pay. Because those conditions had been satisfied, and because the parties did not dispute the completion or value of the work, the court held the surety must pay the subcontractors.

The court added that the surety's arguments ran counter to the very purpose of payment bonds in the construction industry. That is, like Miller Act bonds, private payment bonds exist to ensure that subcontractors are paid if the general contractor fails to pay them for work and materials. *See also Wm. R. Clarke Corp. v. Safeco Ins. Co.,* 938 P.2d 372 (Cal. 1997)(surety could not rely on conditional payment clause in a subcontract in defense of a subcontractor's payment bond claim).

Thus, in light of the decision in *Moore Bros.*, sureties and principals should be aware that a surety is more likely to preserve the conditional payment defense if (1) the bonded contract expressly provides that the surety is entitled to rely on the conditional payment clause, (2) the bond expressly reserves the surety's right to rely on each and every defense of the principal, or (3) the bond incorporates by reference the subcontract.

c. Where the States Stand

The following chart summaries the states's positions on whether sureties may rely on conditional payment language in their principal's contracts:

STATES BARRING CONDITIONAL PAYMENT DEFENSE BY SURETIES

California—*See, e.g., Wm. R. Clarke Corp. v. Safeco Ins. Co. of Am.*, 938 P.2d 372 (Cal. 1997).
Maryland—Md. Real Prop. Code Ann. § 9-113(b) (2001) and Md. State Fin. & Proc. Code § 17-108(d) (2001).
New York—*See, e.g., West-Fair Elec. Contractors v. Aetna Casualty & Sur. Co.*, 661 N.E.2d 967 (N.Y. 1995).
Pennsylvania—*See, e.g., Walker Diving Contractors, Inc. v. The Travelers Indem. Co.*, 1989 U.S. Dist. LEXIS 4420 (E.D. Pa. Apr. 25, 1989).
Virginia—See, e.g., *Moore Bros. Co. v. Brown & Root, Inc.,* 962 F. Supp. 838 (E.D. Va. 1997), *aff'd*, 207 F.3d 717 (4^{th} Cir. 2000)("pay when paid" clause no defense when not expressly incorporated and preserved in bond).

STATES PERMITTING CONDITIONAL PAYMENT DEFENSE BY SURETIES

Florida—Defense available if bond is conditional in compliance with Florida Statutes § 713.245, **and** claimant's contract contains conditional payment language. *See, e.g., N. Am. Specialty Ins. Co. v. Hughes Supply, Inc.*, 705 So. 2d 616 (Fla. Dist. Ct. App. 1998); *WMS Constr., Inc. v. Palm Springs Mile Assoc., Ltd.*, 762 So. 2d 973 (Fla. Dist. Ct. App. 2000)
Georgia—*See, e.g., Peacock Constr. Co. v. West*, 142 S.E.2d 332 (Ga. App. 1965).
Tennessee—*See e.g., Allen Elec. Co., Inc. v. Fidelity and Deposit Co. of Md., Inc.*, 1989 Tenn. App. LEXIS 385 (May 24, 1989).
Wisconsin—Surety entitled to assert conditional payment defense if principal can. *Riley Constr. Co. v. Schillmoeller & Krofl Co., Inc.*, 236 N.W.2d 195 (Wis. 1975).

4. Claimant's Fraud/Concealment

The United States Court of Appeals for the Second Circuit addressed the issue of a payment bond claimant's alleged fraud upon the surety in *Cam-Ful Indus., Inc. v. Fidelity & Deposit Co. of Maryland,* 922 F.2d 156 (2d Cir. 1991). In *Cam-Ful,* the claimant/subcontractor executed a subcontract with the principal based on the principal's assurances that "if wood sheeting were to be required for areas other than the manholes, [the subcontractor] was to be paid for that work by [the principal]." *Id.* at 161. Ultimately, the owner required the general contractor to provide the additional wood sheeting, and the general contractor, in turn, required the subcontractor to provide the additional sheeting. In response to the subcontractor's claim under the payment bond, the surety argued that the subcontractor should have advised the surety of the extra work. The United States Court of Appeals for the Second Circuit, however, held that the subcontract was executed *after* the surety issued the payment bond:

> A surety does not have to pay a claimant who "during negotiations, actively and fraudulently conceals pertinent facts," nor is the surety liable if "before the obligation is undertaken, the creditor knew of facts unknown to the surety and which he had reason to believe were not known to the surety, the facts materially increased the obligator's risk and the creditor had adequate time to disclose them but failed in his responsibility." The [trial] court found no evidence of fraud on the party of [the subcontractor,] nor was [the subcontractor] privy to material information that was unknown to [the surety] before [the surety] undertook its payment bond obligation.

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Id. at 162 (citations omitted). Accordingly, the court held that the payment bond claimant had not committed fraud against the surety.

5. Principal's Fraud/Concealment

   For a discussion of the principal's fraud upon the surety, see Section IV(A).

6. Modification of Contract

   As with performance bonds, courts may also discharge a payment bond surety from its liability if changes are made to the bonded contract without the surety's consent.

   In *R.P. Richards, Inc. v. Chartered Constr. Corp.*, 83 Cal. App. 4th 146 (2000), the general contractor and subcontractor settled their progress payment dispute without obtaining the consent of the general contractor's payment bond surety or making the surety a party to the settlement agreement. When the general contractor defaulted on a settlement payment, the subcontractor sought payment from the surety. The trial court entered judgment for the surety, and the appellate court affirmed, on the finding that its principal's original obligation had been altered without the surety's consent. As a result, under California law, the surety was exonerated from any liability under the bond.

   As a practical matter, however, the surety's defense based on modification of the contract is not available because most payment bonds waive notice of any change in the contract. *See*, *e.g.*, the American Institute of Architects' Payment Bond (AIA Document A312, 1984 ed.)("The Surety hereby waives notice of any change, including changes of time, to the Construction Contract or to related subcontracts, purchase orders and other obligations.").

7. Procedural Defenses

   a. Claimant is Not a Proper Claimant

      One of the first issues a surety should resolve is whether the purported claimant is, in fact, a proper claimant under the bond. The bond itself often defines the class of claimants, i.e., those who are protected by the bond. This is particularly true with respect to payment bonds. On federal public projects, there is a great deal of caselaw applying and interpreting the Miller Act, and courts oftentimes rely on this caselaw when interpreting state and local payment bonds. Accordingly, a review of caselaw interpreting who is a proper claimant under the Miller Act is instructive.

      Relief under a Miller Act payment bond is limited to persons who furnish labor or material. The Miller Act "protect[s] those who have a direct contractual relationship with either [1] the prime contractor or [2] a 'subcontractor.'" *J.W. Bateson Co. v. United States ex rel. Bd. of Trustees of the Nat'l Automatic Sprinkler Indus. Pension Fund,* 434 U.S. 586 (1978).

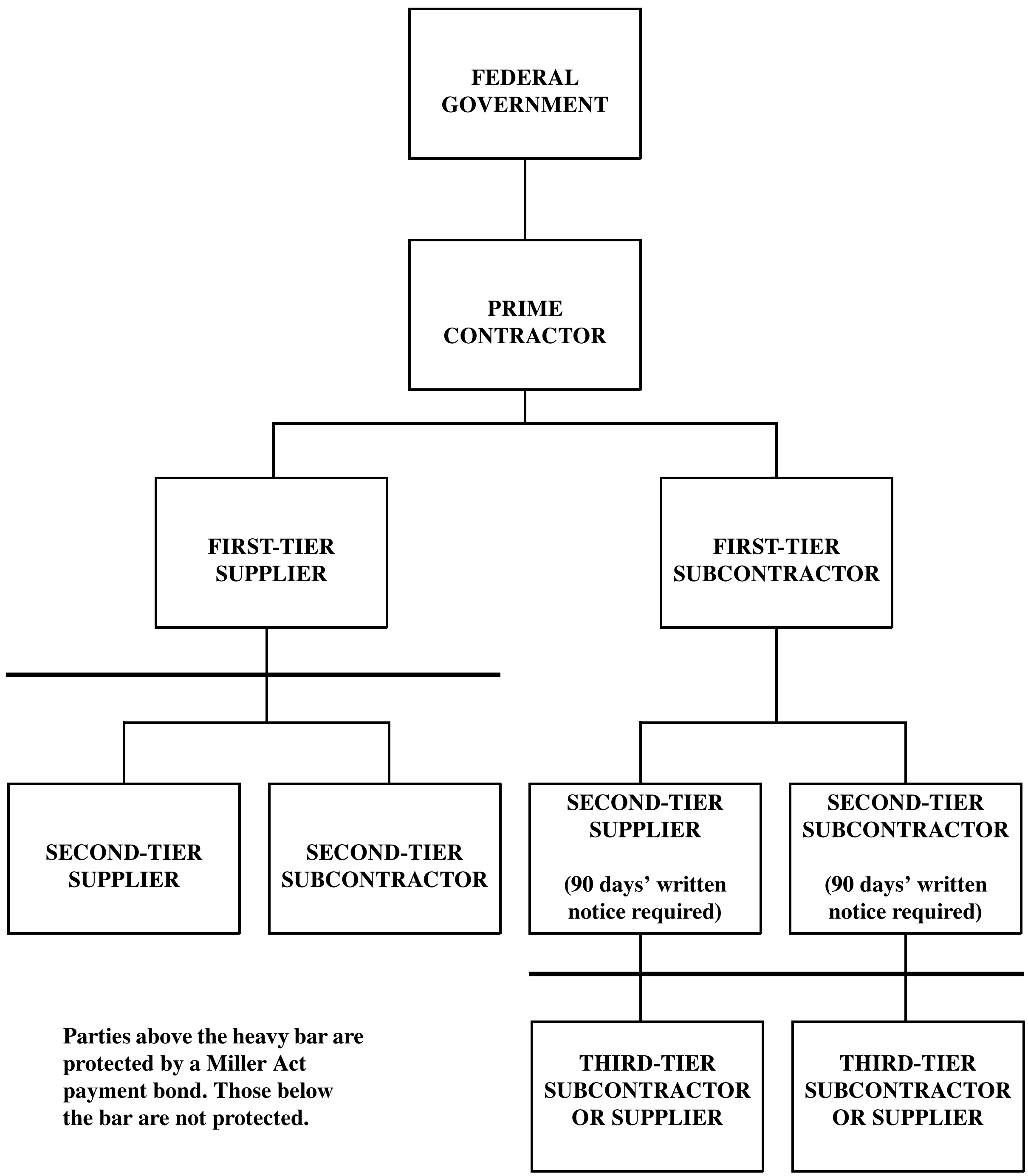
      First-tier subcontractors and suppliers are proper claimants under the Miller Act (provided they have satisfied the requirements of the Act). *Bateson,* 434 US. 586.

      A second-tier subcontractor or supplier may only recover under the Miller Act if it contracted with a first-tier "subcontractor," but may *not* recover if it contracted with a first-tier supplier. *Bateson,* 434 U.S. 586; *F.D. Rich Co. v. United States ex rel. Industrial Lumber Co.,* 417 U.S. 116 (1974).

Third-tier (and lower-tier) subcontractors and suppliers are never proper claimants under the Miller Act. *Bateson,* 434 U.S. 586.

The chart which follows identifies the proper claimants under the Miller Act:

PARTIES PROTECTED BY A MILLER ACT BOND



Subcontractor or Supplier? The United States Supreme Court has defined a "subcontractor" as "one who performs for and takes from the prime contractor a specific part of the labor or material requirements of the original contract." *Clifford F. MacEvoy Co. v. United States ex rel. Calvin Tompkins Co.,* 322 U.S. 102 (1944).

Factors weighing in favor of a subcontractor relationship:

- the product supplied is custom-fabricated
- the product supplied is a complex integrated system
- a close financial interrelationship exists between the companies
- a continuing relationship exists with the prime contractor as evidenced by the requirement of shop drawing approval by the prime contractor or the requirement that the supplier's representative be on the jobsite
- the supplier is required to perform on-site
- there is a contract for labor in addition to materials
- the term "subcontractor" is used in the agreement
- the materials supplied do not come from existing inventory
- the supplier's contract constitutes a substantial portion of the prime contract
- the supplier is required to furnish all the material of a particular type
- the supplier is required to post a performance bond
- there is a backcharge for the cost of correcting the supplier's mistakes
- there is system of progressive or proportionate fee payment

See United States ex rel. Conveyor Rental & Sales Co. v. Aetna Casualty & Sur. Co., 981 F.2d 448 (9th Cir. 1992).

Factors weighing in favor of supplier/materialman relationship:

- a purchase order form is used by the parties
- the materials come from pre-existing inventory
- the item supplied is relatively simple in nature
- the contract is a small percentage of the total construction cost
- sales tax is included in the contract price.

See id.

The Miller Act requires that a payment bond claimant file suit "in the name of the United States for the use of the person suing." 40 U.S.C. § 270b(b). Therefore, if the contractor also chooses to file other causes of action (such as breach of contract) in the same suit, it should assert them in its own name. Failure to do so is subject to an appropriate motion.

b. Notice Provisions

A claimant under a payment bond may only recover against the surety if it complies with the requirements of the bond, including notice requirements. For example, in *Lynbrook Glass & Architectural Metals Corp. v. Elite Assoc., Inc.,* 638 N.Y.S.2d 622 (App. Div. 1996), the payment bond provided that "[n]o suit or action shall be commenced hereunder by any claimant … [u]nless claimant shall have given written notice to the … Principal, the Owner, and the Surety … within ninety (90) days after such claimant did or performed the last of the work or labor, or furnished the last of the materials for which said claim is made." Thus, the court held that the claimant's failure to give the requisite notice within the ninety-day period precluded it from recovering under the bond.

In the case of Miller Act payment bonds, those who have a contract with the subcontractor, but not with the general contractor (i.e. sub-subcontractors and materialmen), have the right to sue on the bond within 90 days after the last day on which they furnished labor or material, provided however that they furnish *written* notice to the general contractor within those 90 days. 40 U.S.C. § 270b. The notice must state the amount claimed with substantial accuracy, and the name of the party to whom the labor or material was furnished, and it must be served by "any means which provides written, third-party verification of delivery" (i.e. not limited to registered mail) to the contractor at any place he maintains an office, conducts his business, or has a residence. The purpose of this requirement is to protect the contractor by notifying him to withhold money from the subcontractor due to claims of the sub-subcontractor. There is no such notice requirement for the subcontractor's claim.

An example of a Miller Act notice letter to the general contractor follows:

[DATE]

<u>VIA REGISTERED MAIL</u>

Prime Contractor
Address [any place where he
maintains an office, conducts
business, or resides]

RE: <u>[Identify applicable construction project]</u>

Dear Sir:

In accordance with the provisions of the Miller Act, 40 U.S.C. § 270b, and the terms of the Payment Bond furnished by you for the above-referenced project, notice is hereby given of our claim against the Payment Bond in the amount of $ [state total dollar amount of claim with substantial accuracy]. This amount is due and owing to the undersigned for labor and/or materials furnished to [insert name of the party to whom the labor and/or materials were furnished].

Very truly yours,

____

c. Statutory and Contractual Limitations Periods

A claimant may not recover under a payment bond unless it files suit within the time required under the bond or applicable statute.

Under the Miller Act, no suit can be commenced after the expiration of one year from the day on which the last labor was performed or materials furnished. §270b(b). This limitation raises a question, however, as to what types of work qualifies as "last labor" or "last materials" and trigger the running of the one-year filing period, as well as the 90-day notice period discussed above. In view of the fact that these limitations periods are jurisdictional under the Miller Act, the answer to this question is important.

Contractors often attempt to protect themselves by intentionally delaying the performance of some minor aspect of the original work, for example, the installation of an air-conditioning filter. While this would be "original work," courts frown upon situations in which the performance of this last part of the work is manipulated in order to come within the filing period. Generally, neither the mere correction of a defect or the making of repairs on original work, even when done pursuant to a warranty requirement, count as supplying labor and thus cannot extend the time for giving notice or filing suit. *General Insurance Co. of America v. United States ex rel. Audley Moore & Son,* 409 F.2d 1326. (5th Cir. 1969), *cert. denied,* 396 U.S. 902 (1969). However, furnishing work under the base or original contract, even if late, may result in an extension of the one-year limit. *United States ex rel. Lank Woodwork Co., Inc. v. CHS Contractors, Inc.,* 452 F. Supp. 922 (D.D.C. 1978). In this vein, calibration of cooling system equipment and conduct of a maintenance class for equipment operators has been found to be the last work performed for the purposes of the 90-day notice. *Johnson Services Co. v. Transamerica Insurance Co.,* 349 F. Supp. 1220 (S.D. Tex. 1972), *aff'd,* 485 F.2d 164 (5th Cir. 1973).

d. Venue Provisions

Miller Act payment bond suits also are required filed in the United States district court with jurisdiction over the location where the contract was to be performed, irrespective of the amount in controversy. 40 U.S.C. § 270b(b).

The first step to bringing a Miller Act payment bond suit is obtaining a copy of the bond from the public entity. An example of a letter requesting a copy of the bond follows:

[DATE]

Comptroller General of the United States
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

RE: Request for Copy of Miller Act Payment Bond
for [identify applicable construction project]

Dear Sir:

In accordance with the provisions of the Miller Act, 40 U.S.C. § 270c, we request that you furnish us with a certified copy of the payment bond and contract for which it was given on the above-referenced project.

The undersigned has supplied labor and/or materials for work performed on the above-referenced project, and payment therefor has not been made.

We will reimburse you for any of the costs of responding to this request.

Very truly yours,

____

STATE OF ___________________

CITY/COUNTY OF _____________

This day personally appeared before me, the undersigned Notary Public, _______________________, who acknowledged to me that the above statements are true and correct to the best of his/her knowledge, information and belief.

____

Notary Public

8. Recoverable Costs and Damages

Sureties and principals should always determine whether each category of damages sought by a claimant (such as taxes, insurance premiums, delay damages, attorneys' fees and interest) is recoverable in the jurisdiction where suit is pending. Two of these categories of damages, delay damages and attorneys' fees, are discussed below.

a. Delay Damages

Depending on the project, out-of-pocket costs incurred as a result of delays can be staggering. Claimants often attempt to recover these costs through a payment bond claim. The recovery of such damages depends on the jurisdiction in which the claim is asserted.

In interpreting Florida's Little Miller Act (and relying on caselaw interpreting the Miller Act), the United States District Court for the Southern District of Florida disallowed the recovery of delay damages. *W.S.A. Inc. v. Stratton,* 680 F. Supp. 375 (S.D. Fla. 1988). Whether this remains the law of Florida, in light of *United States ex rel. Pertun Constr. Co. v. Harvesters Group, Inc.,* 918 F.2d 915 (11th Cir. 1990) is unclear. There, the United States Court of Appeals for the Eleventh Circuit, which includes Florida, held that a claimant may recover delay damages under a Miller Act payment bond:

> Despite the possibly misleading use of the term "damages," [the lower court's] award represented compensation for [the claimant's] increased out-of-pocket costs caused by the delay for labor and materials [the claimant] actually furnished in performing its contractual obligation. The essential question presented thus becomes: are these increased costs "sums justly due" for labor and materials provided or are they really damages for the prime contractor's breach? … Surety liability for out-of-pocket costs of delay is consistent with both the language and the purpose of the Miller Act. The statute provides for recovery of the costs of labor and materials furnished or used by the subcontractor in performing contractual obligations. Only by allowing a full recovery of these costs, including those portions caused by delay, can the purpose of the statute—to afford the subcontractor the financial protection of an action against the surety—be achieved.

Id. at 918. Thus, the court found that the claimant's increased costs of performance were "sums justly due." Interestingly, the court also held that the subcontract's "no damages for delay" clause did not preclude the subcontractor from recovering delay damages under the bond. "Because [the claimant's] contractual waiver of its damages remedy was limited by a condition precedent - the extension of time to complete performance - which was neither fulfilled nor excused, we hold that it cannot operate to preclude [the claimant's] recovery." *Id.* at 920; *see also Mai Steel Serv. Inc. v. Blake Constr. Co.,* 981 F.2d 414, 420 (9th Cir. 1992)("subcontractor may recover from the general contractor's Miller Act surety all of its increased labor and material costs resulting from construction delays for which it is not responsible, even if those delays are caused by someone other than the general contractor"); *United States ex rel. T.M.S. Mech. Contractors, Inc. v. Millers Mut. Fire Ins. Co. of Tex.,* 942 F.2d 946 (5th Cir. 1991)(out-of-pocket costs caused by delay are recoverable under Miller Act payment bond).

b. Attorneys' Fees

Not all construction projects run perfectly, and when disputes arise, the parties often retain counsel. Payment bond claimants often seek to recover their attorneys' fees from sureties. Under the Miller Act, however, such fees may *not* be recovered unless they are allowed by contract or another federal statute, or the surety acts in bad faith during the litigation:

> The so-called "American rule" governing the award of attorneys' fees in litigation in the federal courts is that attorneys' fees "are not ordinarily recoverable in the absence of a statute or enforceable contract providing therefor." … [T]he Miller Act [does not] explicitly provide for an award of attorneys' fees to a successful plaintiff. The Miller Act provides a federal cause of action, and the scope of the remedy as well as the substance of the rights created thereby is a matter of federal not state law. Neither respondent nor the court below offers any evidence of congressional intent to incorporate state law [which might allow recovery of attorneys' fees] to govern such an important element of Miller Act litigation as liability for attorneys' fees … The American rule has not served, however, as an absolute bar to the shifting of attorneys' fees even in the absence of statute or contract. The federal judiciary has recognized several exceptions to the general principle that each party should bear the costs of its own legal representation. We have long recognized that attorneys' fees may be awarded to a successful party when his opponent has acted in bad faith, vexatiously, wantonly, or for oppressive reasons, or where a successful litigant has conferred a substantial benefit on a class of persons and the court's shifting of fees operates to spread the costs proportionately among the members of the benefitted class.

F.D. Rich Co. v. United States ex rel. Industrial Lumber Co., 417 U.S. 116, 126–30 (1974). For a detailed discussion of the federal courts' inherent power to impose sanctions for bad faith, vexatious, or wanton conduct during litigation (and *not* pre-litigation conduct), *see Chambers v. NASCO, Inc.,* 501 U.S. 32, 54 (1991)(the trial court "did not attempt to sanction petitioner for breach of contract, but rather imposed sanctions for the fraud he perpetrated on the court and the bad faith he displayed toward both his adversary and the court throughout the course of the litigation"); *see also Lamb Eng'g & Constr. Co. v. Nebraska Pub. Power Dist.,* 103 F.3d 1422, 1437 (8th Cir. 1997)("the district court's inherent power to award attorney fees as a sanction for bad faith conduct does not extend to pre-litigation conduct").

Some state statutes expressly provide for the award of attorneys' fees to a successful plaintiff under a Little Miller Act suit. For example, in the event a claimant brings a payment bond claim under California's Little Miller Act, the court will award "a reasonable attorneys' fee." Cal. Civ. Code § 3248(b) (2001). *But see Salvino Steel & Iron Works, Inc. v. Fletcher & Sons, Inc.,* 580 A.2d 853 (Pa. Super. Ct. 1990) (payment bond claimant cannot recover attorneys' fees under Pennsylvania's Little Miller Act).

V. Arbitration and the Surety

A. The Surety's Duty and Right to Arbitrate

The caselaw is not uniform as to whether a surety has the duty or right to arbitrate with a bond claimant based on the bond's incorporation of a contract which, in turn, contains an arbitration clause. If the surety is found to have agreed to arbitrate, however, the surety may also compel the claimant to arbitrate. *Henderson Inv. Corp. v. Int'l Fidelity Ins. Co.,* 575 So. 2d 770, 772 (Fla. Dist. Ct. App. 1991)("if a surety can be bound [to arbitrate,] it should also be allowed to invoke arbitration as well").

In *Hoffman v. Fidelity & Deposit Co. of Maryland,* 734 F. Supp. 192 (D.N.J. 1990), for example, the owner initiated an arbitration proceeding against the general contractor, and the owner also served a demand for arbitration on the performance bond surety "in which [the owner] asserted a claim under the Bond." *Id.* at 193. The surety refused to participate in the arbitration and requested the United States District Court to declare that the obligee's claims against the surety were not arbitrable. The surety and obligee then agreed that the surety "will be bound by the decision of the arbitrators on the underlying Contract dispute," but the surety still sought to "exclude from the arbitration process . . . its defenses to liability on the Bond (e.g. waiver, alteration of risk)." *Id.* The obligee argued that by incorporating the construction contract into the performance bond, the surety agreed "to arbitrate all issues relating to the Bond, including any defenses." *Id.* The court noted that the "Eleventh, Sixth, Fifth, Second and First Circuits, and several district courts have required sureties to arbitrate issues relating to a performance bond where the performance bond incorporates by reference a contract containing an arbitration clause." *Id.* The court thus held that the surety was bound to arbitrate its defenses under the bond.

The California Court of Appeal for the Second District reached a similar conclusion in *Boys Club of San Fernando Valley, Inc. v. Fidelity & Deposit Co. of Maryland,* 8 Cal. Rptr. 2d 587 (Cal. Ct. App. 1992). The *Boys Club* court held that "[a]n agreement need not expressly provide for arbitration, but may do so in a secondary document which is incorporated by reference." *Id.* at 589. The court further stated:

> Because of the nature of [the surety's] obligations under its performance bond, it is logical to assume that the parties (including [the surety]) intended not merely that [the surety] would be bound by the result of arbitration between [the obligee] and [the principal,] but that [the surety] would join in arbitration of disputes between the parties to the contract in view of the fact that such disputes necessarily affect its liability under the bond.

Id. at 591. Furthermore, the court rejected the proposition that, although the surety might be bound by the determinations made in the arbitration as to the respective liabilities of the obligee and principal, "the surety did not agree that separate and distinct controversies which might arise under the terms of its performance bond between the surety and the general contractor as obligee would be submitted to arbitration." *Id.*

The Maryland Court of Appeals, however, reached a different conclusion. In *Hartford Accident & Indem. Co. v. Scarlett Harbor Assoc. Ltd. Partnership,* 695 A.2d 153 (Md. 1997), the contract between the condominium developer and contractor contained an arbitration clause, and the contract was incorporated into the contractor's performance bond. Ultimately, the counsel of unit owners of the condominium filed suit against the developer and, in turn, the developer filed third-party actions against the contractor and its performance bond surety. The contractor and surety moved to compel the developer to arbitrate its disputes with them and stay the court action. The question presented on appeal was, "[m]ay a surety that issued a performance bond which incorporated by reference a mandatory arbitration provision from a contract between the obligee and the principal enforce the arbitration agreement against the obligee in an action on the bond?" *Id.* at 155. In short, the court responded "no."

> By incorporating into the bond … the contract that contains [the obligee's] promise to arbitrate with [the principal, the surety] literally has incorporated as to [the obligee] only [the obligee's] promise to arbitrate with [the principal.] … It is important to point out that [the surety's] argument is devoid of any element of a consensual modification by [the obligee] of the scope of its promise to arbitrate with [the principal.] … Here the judicial power to enforce an agreement to arbitrate cannot properly be exercised because there is no agreement by [the obligee] to arbitrate with [the surety.]

Id. at 156-57 (footnote omitted).

The *Hartford* court seems to have identified at least one situation in which the surety would have the duty and the right to arbitrate. In a footnote, the court noted that the construction contract provided that:

> The covenants of one party inure to the benefit of "successors" to the other party. The [surety] makes no argument that it is a successor to [the principal]. We point out that the instant matter is not a case in which the surety took over completion of the work promised to be performed by its principal.

Id. at 156 n.6. Thus, it appears that had the surety elected to complete the project (or, presumably, finance the principal), the court might have recognized the surety's right to compel arbitration.

B. Effect of Arbitration Award on Non-Participating Surety

The obvious risk to a surety in not participating in an arbitration between the principal and obligee is that the surety will be bound by the arbitration award.

The New York Court of Appeals directly addressed this issue in *Fidelity & Deposit Co. of Maryland v. Parsons & Whittemore Contractors Corp.,* 397 N.E.2d 380 (N.Y. Ct. App. 1979). In *Parsons,* the performance bond obligee filed a demand for arbitration against the principal and surety. The surety attempted to stay the arbitration. The court stated that:

> A critical distinction must be drawn between disputes arising under the subcontract between [the obligee] and [the principal] (in the resolution of which [the surety] on the performance bond has a very real and practical interest) and possible unrelated differences which may arise between [the surety] and [the obligee] as to the liability of the surety company under the terms of its performance bond …. As to disputes between the general contractor and the subcontractor concerning failure of performance by the latter, those two parties expressly agree that their differences should be submitted to arbitration for resolution. By contrast, there was no agreement on the part of any party that controversies arising as to rights and obligations under the terms of the performance bond would be submitted to arbitration. In defining the agreement made by the surety company it is accurate to say that it cannot be held to have agreed to participate in arbitration proceedings with respect to any dispute whatsoever. Certainly there is no language in the performance bond on which to base any argument that it was obligated to submit disputes arising under its performance bond (as distinguished from disputes arising under the subcontract) to resolution by arbitration …. Although it did not agree to participate in any arbitration, it did accept the agreement of the general contractor and the subcontractor that disputes between them would be settled by arbitration. *An implicit corollary of the acceptance was agreement by the surety company that for purposes of later determining its liability under its performance bond, it would accept and be bound by the resolution reached in the arbitration forum of any dispute between the general contractor and the subcontractor* … If there be an arbitration award adverse to [the principal] and if it thereafter becomes necessary to adjudicate the obligations of [the surety] to [the obligee] under the provisions of the performance bond, the question of [the principal's] liability may not be relitigated but the arbitration award will be binding both on [the surety] and [the obligee.]

Id. at 382 (emphasis added).

In addressing this issue under West Virginia law, the United States District Court for the Southern District of West Virginia held that:

> To require [the obligees] to proceed separately against [the surety] after having prevailed against [the principal] in arbitration would be inconsistent with [the bond's] provision for joint and several liability. [The surety's] consent to arbitration is the mechanism

> for settling disputes under the contract and is accordingly deemed to be the equivalent of an express agreement to pay a judgment based on an arbitration award rendered against [the principal.]

Rashid v. United States Fidelity & Guar. Co., 1992 WL 565341 (S.D. W. Va. Sept. 28, 1992).

However, an arbitration award against the principal, entered by default, may not be conclusively binding upon a surety. In *Rouse Construction, Inc. v. TransAmerica Ins. Co.,* 750 F.2d 1492 (11th Cir. 1985), the payment bond obligee demanded arbitration against the principal and filed suit against the surety. The principal defaulted in both the arbitration and the court proceeding to confirm the arbitration award, and the obligee thereafter sought to hold the surety liable based upon the default entered against the principal. "The effect of a judgment against a principal in a later suit against the surety is a substantive matter to be determined by state law." *Id.* at 1493. Applying Georgia law, the court held that "[i]n a Georgia suit against a surety by the obligee, evidence of a default judgment against the principal establishes a rebuttable presumption of the principal's liability to the obligee." *Id.* at 1493-94. Whether the default judgment is conclusively binding upon the surety is the subject of disagreement among the courts. *See Gearhart v. Pierce Enters., Inc.,* 779 P.2d 93, 94 (Nev. 1989)(no); *Drill South, Inc. v. Int'l Fidelity Ins. Co.*, 234 F.2d 1232 (11th Cir. 2000)(yes).

The issue of the preclusive effect of an arbitration award against the principal on a payment bond surety is more complicated in Miller Act cases because, under the Miller Act, a payment bond claimant must bring suit "in the United States District Court for any district in which the contract was to be performed and executed and not elsewhere." 40 U.S.C. § 270b(b). In *United States Fidelity & Guar. Co. v. Hendry Corp.,* 391 F.2d 13 (5th Cir. 1968), the United States Court of Appeals for the Fifth Circuit held that a claimant's state court judgment against the principal had no preclusive effect upon a Miller Act surety. The court first noted that state courts do not have jurisdiction over Miller Act cases and then stated that:

> [i]f a Miller Act surety is bound by a state court judgment recognizing a supplier's claim against the principal—it is mere word-juggling to say that the suit in state court is not a suit under the Miller Act …. Since only federal courts may determine a surety's liability on a Miller Act bond, a state court judgment that would bind a surety on his Miller Act bond offends the congressional mandate. In these circumstances, 28 U.S.C. [§] 1738 [the full faith and credit statute] has no application.

Id. at 18.

The United States Court of Appeals for the Ninth Circuit squarely rejected the *Hendry* court's conclusion. In *United States ex rel. Aurora Painting, Inc. v. Fireman's Fund Ins. Co.,* 832 F.2d 1150 (9th Cir. 1987), a payment bond claimant obtained an arbitration award against a principal, and thereafter, the state court confirmed the arbitrator's award. The surety was not named in either the arbitration or the state court action. Then, the claimant filed suit against the surety under the Miller Act in federal court. The surety contended "that the federal court erroneously gave preclusive effect to the state court decision because the Miller Act gives federal courts exclusive jurisdiction to determine the surety's liability." *Id.* at 1152 (citation omitted). The court held:

> The full faith and credit statute, 28 U.S.C. § 1738, requires federal courts to give the same preclusive effect to state court judgments they would have in the rendering jurisdiction … [T]he Miller Act did not, by its terms, create an exception to the full faith and credit statute … Normally, a judgment against a principal conclusively establishes against a surety the fact of and the amount of the principal's liability as long as the surety has notice of the proceeding against the principal.

Id. at 1152-53. After determining that the surety had notice of the proceeding against its principal, the court held that the state court judgment confirming the arbitration award established the surety's liability under its payment bond.

VI. Legal Remedies Available When Sureties Become Insolvent

Even before September 11th, the surety bond industry was suffering. Analysts blame, among other things, a decade of intense competition, unrestrained and uneconomic bond writing, and the high loss ratios for sureties, and even higher losses for their reinsurers, that have inevitably resulted.[2] A dramatic sign of the growing crisis was the declaration of insolvency of Amwest Surety Insurance Company, a significant player in the bond market, in June, 2001. More than 5,000 outstanding bonds, even those deemed "non-cancelable," were canceled by court order the following month, leaving thousands of subcontractors and suppliers on ongoing projects without the security of payment bonds to guarantee that they would be paid for their work.[3]

Then, of course, the tremendous damage caused by the terrorist attacks subjected insurers to unprecedented losses, and the Enron fiasco has only served to further reduce the financial stability of those in the surety industry.[4] At least two other large sureties, Far West Insurance Company and Frontier Pacific Insurance Company, have since been declared insolvent and their bonds cancelled, and it is feared that more sureties will exit the market, voluntarily or involuntarily.[5] These events naturally leave owners, subcontractors and suppliers to wonder what recourse they have if the security provided by their contractors' surety bonds disappears along with the surety's solvency. As it turns out, there are several remedies available to claimants on public and private projects who would otherwise be left holding the bag.

A. Statutory Protections

Several states have, by statute, created "insurance guaranty associations" ("IGAs") to step in for insurers that have become insolvent. Generally chartered as nonprofit corporations, IGAs are established to service pending, and often some new, claims by and against policyholders of insolvent insurers that are members of the association. The statutes creating the IGA usually mandate that, to be licensed by the state, each insurer must be a member of the state's IGA and, most importantly, pay dues toward the fund from which covered claims are paid by the IGA. Maryland's IGA, for example, was created by Md. Insurance Code Ann. § 9-301 *et seq*. (2001), which provides that, with respect to surety bonds, "the [IGA] shall be obligated to the extent of the covered claims existing on or before the determination of insolvency, or arising with 18 months after the determination of insolvency." § 9-306(b)(1). The Maryland IGA's obligation to pay claims on the bonds of insolvent sureties, however, is limited by claim amount: "The obligation of the [IGA] … shall include only that amount of each covered claim … that is in excess of $100 and less than $300,000," and the IGA "is not liable for an aggregate amount in excess of $1,000,000 under any one surety bond." §§ 9-306(b)(2)-(3).

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[2]*See, e.g.,* Maryland Surety Assoc., Inc., *Looking Forward to 2002,* Bonding Perspectives, Fall 2001; Rolf A. Neuschaefer, *Surety Credit Basics,* IRMI.com, January 2002 (www.irmi.com/expert/articles/neuschaefer004.asp); *Sept. 11 and a cyclical downturn have shaken the surety industry. Pay close attention.,* Small Business Exchange (www.sbeinc.com/article.cfm?article_id=463).

[3]*See* Maryland Surety Assoc., Inc., *Amwest,* Bonding Perspectives, Fall 2001.

[4]Neuschaefer, *supra* note 1; *see also Enron, Kmart failures may raise bond costs,* Cape Cod Times, Jan. 24, 2002; Mary Kelleher, *Insurers seen cautious with surety bonds after Enron,* Reuters, March 1, 2002.

[5]*See* Maryland Surety Assoc., Inc., *supra* note 1; Neuschaefer, *supra* note 1; Small Business Exchange, *supra* note 1.

The downside of IGAs for subcontractors and suppliers is that many of the states that have created IGAs have also limited the types of insurance to which they apply to exclude surety bonds. *See*, *e.g.*, California Insurance Code § 1063.1(c)(3) (2001)("'covered claims' does not include obligations arising from . . . [f]idelity or surety insurance including fidelity or surety bonds, or any other bonding obligations").

In a similar effort to establish sources of funds from which claimants against sureties that become insolvent might be paid, some states have statutorily conditioned their licensing of sureties upon the sureties depositing monies and/or securities with the state. Sections 624.466 and 624.468 of Florida's Insurance Code require insurers, including sureties, to deposit cash or securities totaling $100,000 with the state, and to maintain such a deposit in that amount, in order to become and remain authorized to issue bonds in the state. Oregon even forbids sureties to withdraw their deposits for three years after the sureties discontinue business within the state. Or. Rev. Stat. § 731.648 (1999). In Ohio, in order to obtain payment from the deposit of an insolvent surety, claimants must bring a civil action against the surety in a certain Ohio court "to determine the rights of all parties claiming any interest in such deposit, to subject the deposit to the payment or satisfaction of all liabilities, and to distribute such fund among the persons entitled thereto." Ohio Rev. Code Ann. § 3903.74 (Anderson 2001).

B. Public Projects

On public construction projects, there also may be a way for subcontractors and suppliers faced with a worthless surety bond to recover monies directly from the government. Some state courts have held public entities liable to bond claimants for failing to adequately investigate the solvency of the sureties and surety bonds on their construction projects. In the recent case of *Walt Rankin & Assoc., Inc. v. City of Murrieta*, 84 Cal. App. 4th 605 (2000), a subcontractor on a municipal construction project in California alleged negligence by the city in accepting the bond of a surety which turned out not to be licensed by the state and which went out of business without paying the subcontractor's claim. The Court of Appeal of California found that the city had breached two statutory obligations in accepting the surety: it did not either ensure that the surety was licensed with the state or require the general contractor to provide additional surety coverage, and it did not require the surety to provide all documentation required by the California Civil Code. Accordingly, the court found the city directly liable to the subcontractor.

Similarly, in *Hall County Sch. Dist. v. C. Robert Beals & Assoc., Inc.,* 498 S.E.2d 72 (Ga. Ct. App. 1998), several unpaid subcontractors sued a school board when the payment and performance bonds provided by the general contractor proved to be invalid. The appellate court upheld the lower court's denial of the school board's motion for summary judgment, finding that the board had failed to investigate and approve the solvency of the surety, as required by Georgia law. As the California court had in Walt Rankin, the court in *Hall County* concluded that the public entity was not entitled to immunity for its breach of a statutory duty. *See also Warren v. Glen Falls Indem. Co. of Glen Falls, N.Y.,* 66 So.2d 54 (Fla. 1953)(school board members held liable for failing to obtain bond for school construction as required by Florida law). While *Walt Rankin* and *Hall County* hold out hope for unpaid subcontractors and suppliers, however, it should be noted that those decisions are only helpful in the state and local construction realm: the federal government is not liable for failing to investigate the financial worth of a surety or for failing to ensure that a Miller Act bond is posted on a project. *See The Hardaway Co. v. United States Army Corps of Eng'rs,* 980 F.2d 1415 (11th Cir. 1993).

Public entities may be required by state law not only to be actively involved in ensuring the solvency of sureties and bonds when the project begins, but also to consider stepping in and completing the project if sureties and bonds later prove insolvent. Nearly identical statutes in Minnesota and New Mexico provide that, when a surety is deemed insolvent, a public entity may require the contractor to furnish new or additional bonding within ten days. Minn.

Stat. § 574.30 (2001); N.M. Stat. Ann. § 13-4-20 (2001). Should the contractor not comply, the public body can halt the project until such bonding is provided. *Id*. However, the public entity can alternatively choose to take over and complete the project at the expense of the contractor and surety. *Id*. In this way, the existing subcontractors and suppliers can continue to work and be paid, and the burden of recovering from the insolvent surety and its principal is shifted to a public body better able to bear it. Of course, it should be noted that both statutes expressly leave the decision whether to take over the project to the public entity's discretion. As a result, it is unlikely that a public body would be held liable for not choosing to complete a project itself.

C. Architects' Liability

Recent caselaw from two states suggest one final means of recovery in the wake of insolvent or non-existent sureties or bonds: the liability of architects for certifying payments to the general contractor without sound surety bonding in place. In *Boren v. Thompson & Assoc.*, 2000 Okla. 3, 999 P.2d 438 (2000), the general contractor on a public project was statutorily required to obtain performance and payment bonds for the project. Though the contractor never submitted a payment bond, the architect was apparently not aware of this fact and, despite having the authority to withhold certification of payments to the contractor if it failed to pay its subcontractors, certified payments throughout the first several months of the project. When the architect learned of one subcontractor's nonpayment, he discovered that no payment bond had been submitted and withheld certification until the nonpayment dispute with that subcontractor was resolved. However, the architect, now fully aware of the absence of a payment bond, nonetheless began certifying payments to the contractor again, until he became aware that several other subcontractors had not been paid.

The unpaid subcontractors eventually brought suit against the architect for negligence in certifying payments in the absence of a statutorily required payment bond. The trial court ruled in favor of the subcontractors, but the appellate court reversed the decision, finding that the subcontractors bore the responsibility of ensuring that sufficient bonding was in place. The Supreme Court of Oklahoma, however, vacated the appellate court decision. Despite precedent absolving public entities of liability for failing to secure a surety bond, and despite finding that it was the contractor's responsibility to ensure that a payment bond was obtained, the court ruled that a private, for-profit architect charged with overseeing a public construction project could be held liable for "negligence in failing to ascertain that there was no payment bond and in making unauthorized payments to the contractor after he discovered that no payment bond existed." 2000 Okla. at 17. The court stated:

> We recognize that an architect is not a guarantor, nor may architects ordinarily be responsible for supervising a contractor's disbursements to subcontractors. Nevertheless, once a public entity has contracted with a private party to oversee a construction project, subcontractors should be able to assume that the private party responsible for certifying payments has verified the existence of the bonds.

Id. at 19.

The next year, the South Carolina Supreme Court made a similar finding with regard to a private construction project in *Cullum Mech. Constr., Inc. v. S. Carolina Baptist Hosp.*, 344 S.C. 426, 544 S.E.2d 838 (2001). There, as in *Boren*, the general contractor was required to, but did not provide, a payment bond, but the architect, apparently unaware of this fact, nevertheless proceeded to certify payments to the contractor. When the architect was alerted that subcontractors were not being paid, he requested a copy of the payment bond from the contractor, which instead submitted a copy of its indemnity agreement. Though now aware that no payment bond was in place, the architect did not recommend that the owner terminate the general contractor and continued to certify payments to the contractor. An unpaid subcontractor brought suit against the architect for breach of a duty to use reasonable care in the administration of the contract provisions that were designed to ensure payment to the subcontractors. The trial court granted the architect’s motion for summary judgment, and the appellate court affirmed that decision. However, the South Carolina Supreme Court reversed, finding that, while “[g]enerally, an architect does not have a duty to assure payment to subcontractors; . . . special conditions in these contract documents may have given rise to a special relationship with subcontractors, and therefore a duty of care.” 344 S.C. at 433. Accordingly, the court overturned the grant of summary judgment and directed a “further inquiry into the facts of the case.” *Id*.

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