PAYMENT BONDS: COLLECTING ON WHAT YOU ARE OWED

Gerald I. Katz, Esquire
Katz & Stone, L.L.P.
8230 Leesburg Pike, Suite 600
Vienna, Virginia 22182
703.761.3000
703.761.6179 – fax
www.katzandstone.com

PAYMENT BONDS: COLLECTING ON WHAT YOU ARE OWED

by
Gerald I. Katz

I. Introduction

Payment surety bonds guarantee payment of the contractor's obligation under the contract for subcontractors, laborers, and material suppliers associated with the project. Since liens may not be placed on public jobs, the payment bond may be the only protection available for those supplying labor or materials to a government project. Moreover, payment bonds are being used more and more frequently to guarantee payments on private projects. Understanding how to collect what you are owed from payment bonds depends in large part on understanding the obligations and defenses of payment bond sureties.

II. The Surety's Exposure and Options

A. Exposure

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.

B. 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.

III. The Surety's Defenses

A. 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.") "[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 therefore.' 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).

In discussing the phrase "declared in default" in a 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 the 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.

B. 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 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 that enables the surety to determine whether the obligee is in default of its obligations under the bonded contract.

C. Defective Plans and Specifications

The Spearin doctrine was created in *United States v. Spearin*, 248 U.S. 132, 136 (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." The court stated further that a contractor's "duty to check plans did not impose the obligation to pass upon their adequacy to accomplish the purpose in view." Id. 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.

D. Obligee'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 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,

found that the subcontract was executed after the surety issued the payment bond. As a result, the court held that

> [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 part 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.

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

E. Principal's Fraud/Concealment

The Florida District Court of Appeals 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).

F. Modification of Contract

Courts may 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.

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 <u>material</u> 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 must only demonstrate a material variation, but 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, 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.").

F. Procedural Defenses

1. 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 private projects. On federal public projects, there is a great deal of case law when interpreting state and local payment bonds. Accordingly, a review of case law interpreting who is a proper claimant under the Miller Act is instructive.

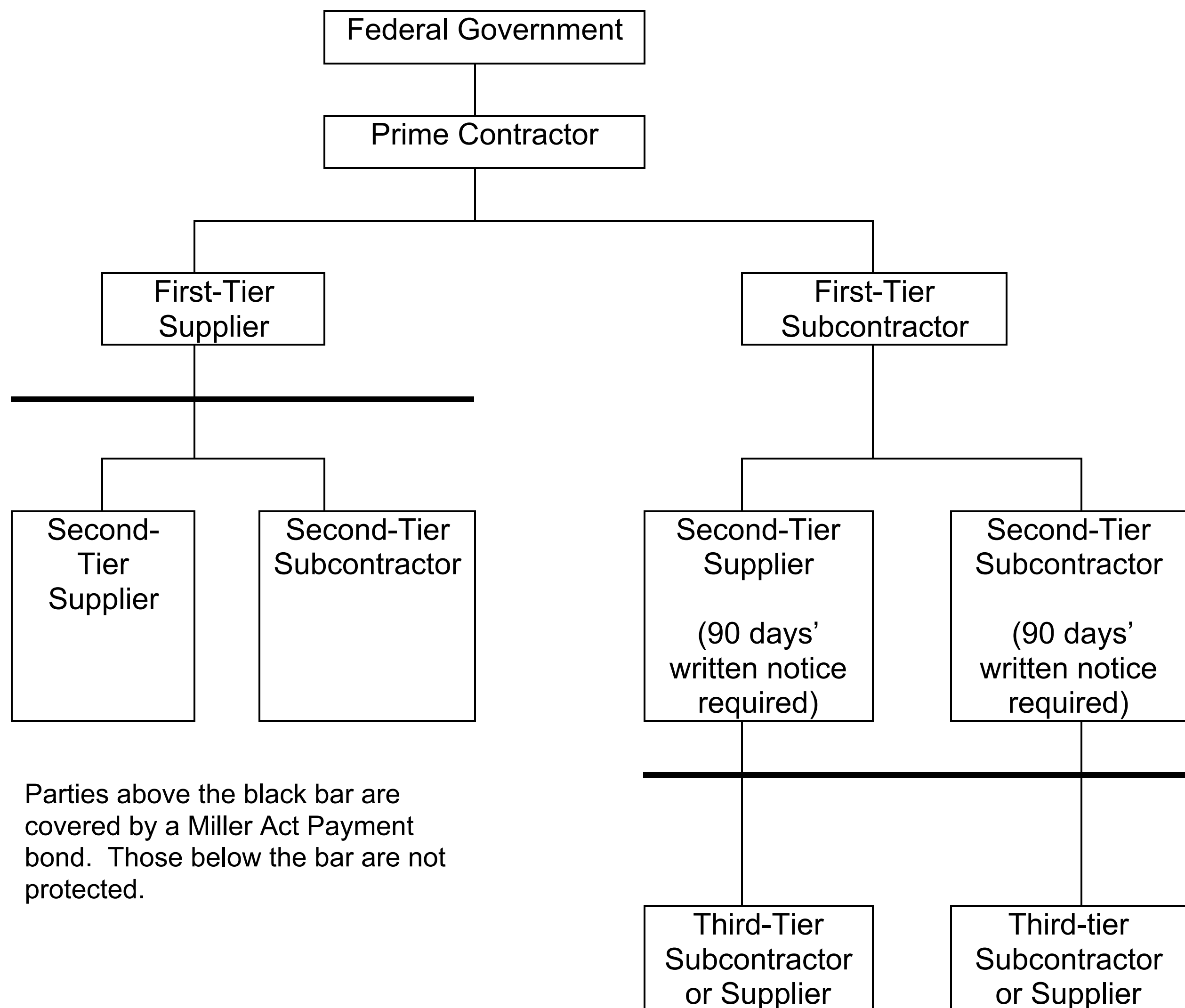
Relief under a Miller Act payment bond is limited to persons who furnish labor or material. The Miller Act "protect[s] those who have a direct contractual relationship with either [1] the prime contractor or [2] a 'subcontractor.'" *J.W. Bateson Co. v. United States ex rel. Bd. Of Trustees of the Nat'l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

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

A second-tier subcontractor or supplier may only recover under the Miller Act if it contracted with a first-tier subcontractor, but may <u>not</u> 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.



"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 post a performance bond.

- There is a backcharge for the cost of correcting the supplier's mistakes.

- There is a 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.

2. 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 materials 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]

VIA REGISTERED MAIL

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

RE: [*Identify applicable construction project]*

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,

____

3. 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 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. § 28-b(b). This limitation raises a question, however, as to what type of work qualifies as "last labor" or "last materials" and triggers 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,

such as the installation of an air-conditioning filter. While this would be "original work," courts frown upon situations in which the performance of this part of the work is manipulated in order to come within the filing period. Generally, neither the mere correction of a defect nor 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 of 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).

In *Gen'l Ins. Co. of Am. v. Interstate Serv. Co.*, 701 A.2d 1213, 1215 (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," 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 laws 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 Eners., 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.).

4. 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).

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 the 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

My Commission Expires: _________________

5. 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 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 . . . 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 Circ. 1983)

6. 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 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 subcontractor. They did so by adding explicit

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

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 courts 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 may 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.

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

The surety argued bond surety for outstanding monies earned as "early completion bonuses" and for additional work performed (previously awarded by an arbitration panel). 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 that, "[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 was 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 P2d 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.*, the 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 shows the position taken by some states as to 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 (4th 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).

7. 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 case law 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 materials 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 benefited 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 through 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).

IV. Arbitration and the Surety

A. The Surety's Duty and Right to Arbitrate

The case law is not uniform as to whether a surety has the duty or right to arbitrate with a bond obligee 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 obligee 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 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 Appeals 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 court 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 [the obligee] under the provisions of the performance bond, the question of [the principal's] liability may not be relegated 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 a default judgment against a principal 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).

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 Miler 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.

V. 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 cancelled by court order the following month, leaving thousands of subcontractors and suppliers on ongoing projects without the security of contractors' 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 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 subcontractors and suppliers on public and private projects who would otherwise be left holding the bag.

---

[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,* 2002; (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.

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 monies into 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 within 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 then $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).

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. 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.

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 Appeals of California found that the city had breached two statutory obligations in accepting 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 10 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 choosing not 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 payments 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*.