**SURETY TODAY PRESENTATION**

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# The Surety and Setoff Rights – The Bad and the Good

**(GEORGE)**

## Introduction

The surety's rights and ability to reduce its exposure to loss may be affected in a number of ways by the obligee's, the principal's, the payment bond claimants,' other third parties,' and the surety's exercise of their equitable and contractual setoff rights, including the surety's subrogation rights to the setoff rights of the obligee and the principal. As the title to this presentation suggests, the existence of setoff rights may be bad for the surety or they may be good for the surety. We will address both situations.

However, before we do so, we will define a party's equitable setoff rights and setoff rights under a written contract, and we will compare a party's setoff rights to a party's common law and contractual recoupment rights.

Setoff rights exist between two parties when each party is a debtor to and a creditor of the other party. The definition of setoff rights is that as between Party A and Party B, Party B has the right to set off against Party A's claim one or more independent transactions that constitute separate causes of action apart from Party A's claim. This can occur only when the two parties' rights are mutual – that is between the same parties in their own rights and capacities[1] – and the amounts owed to each are due and payable. A setoff is not part of a debt, but an equitable remedy to secure the payment of a debt. The objective of letting a party exercise its setoff rights is to prevent a circuity of actions by allowing parties that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making Party B pay Party A's claim when Party A owes Party B on another transaction.

The definition of recoupment rights is that the claims of each of the parties arise out of the same contract or transaction between the parties. A recoupment is a defense to a claim, not a separate affirmative claim for damages. For example, under a contract, Party A claims $100,000, but Party B claims a recoupment defense under the contract of $50,000. If both prevail, Party B would owe Party A the sum of $50,000.

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[1] The parties may be acting in either their individual or representative capacities. Party B, acting in an individual capacity, may not assert its setoff claim rights against Party A's claim when Party A is acting in its, his or her representative capacity, and vice versa. A joint debt cannot be set off against a separate debt, and vice versa. However, a separate debt may be set off against a joint and several debt, and a demand, which is joint and several, may be set off against a separate demand.

Today we will be addressing setoff and not recoupment. We will divide this presentation into three sections. The first concerns those instances when the surety's loss may increase because of another party's exercise of its setoff rights to the surety's detriment. The second concerns those instances when a surety may exercise its own setoff rights to reduce its loss. The third concerns those instances when a surety may be subrogated to the setoff rights of another – an obligee or its principal – that results in the surety's ability to reduce its loss. In all of these situations, the facts are substantively critical to the legal analysis as to whether setoff rights exist in the first instance and may, therefore, be exercised by one or both parties to the transactions.

(MIKE)

## I. The Exercise of a Party's Setoff Rights to the Surety's Detriment

### A. Generally.

Set off rights can be a double-edged sword. On the one hand, set off rights can benefit the surety by extending the surety's reach to additional funds to help reduce losses. On the other hand, set off rights can be used against the surety to its detriment. In this section, I will discuss the use or limitation of set off rights to the detriment of the surety. Generally, there are two primary forms of detriment that set off rights may cause: (1) through the exercise of set off rights a party may avoid all or part of its obligations to the surety, but the surety's obligations under its bonds to that party are not decreased; or (2) through the exercise of set off rights a party may take actions that deny the surety certain rights, such as the surety's subrogation rights, which results in an increase in the surety's loss. So, let's look at some of the detrimental uses of set off.

### B. The Obligee.

First, let's discuss the obligee's detrimental use of set off rights. The obligee may be owed an obligation or debt from the principal – whether it is a contract obligation or debt on a contract not bonded by the surety or a tax debt if the obligee is a governmental entity – and the obligee may attempt to set off against that debt by denying payment to the surety of the bonded contract funds. Generally, the surety that has performed under its performance bond may avoid such a setoff. The theory is that the surety's right to return performance, *i.e.*: payment of the bonded contract funds, takes priority over the obligee's non-contract related setoffs.

However, a surety that has only incurred losses under its payment bond may not be able to prevent the obligee's setoff. In *United States v. Munsey Trust Co. of Washington, D.C.*, 332 U.S. 234 (1947), the Supreme Court ruled that a surety who has only paid payment bond claimants is not subrogated to the government obligee's rights and the government may exercise its setoff rights against the remaining contract funds to the detriment of the surety. In *Munsey Trust* the principal completed 6 projects, but failed to pay all of its laborers and materialmen. The surety stepped in and paid the laborers and materialmen under its payment bonds. The government was holding retainage on those 6 completed projects. The same principal bid on and was awarded another contract with the government, but failed to enter into the contract, forcing the government to complete the project at a higher cost thereby damaging the government. The government set off its loss on the failed contract against the retainage it was holding on the completed projects to the detriment of the surety.

A majority of reported decisions follow *Munsey Trust* and uphold the obligee's right to setoff unrelated debts against the bonded contract funds when the surety's losses are only payment bond losses.

However, there are a hand full of cases dealing with state law that have held that regardless of whether the surety's subrogation rights arise from payment bond obligations or performance bond obligations an obligee may not exercise its setoff rights ahead of the surety. *See Teamsters Health & Welfare Fund v. Net Constr., Inc.*, 334 F. Supp.2d 751 (E.D. Pa. 2004); *Commonwealth of Pa. v. Nat'l Sur. Corp.*, 349 F. Supp. 1370 (E.D. Pa. 1972); *N.Y. Cas. Co. v. Zwerner*, 58 F. Supp. 473 (N.D. Ill, 1944); *Aetna Cas. & Sur. Co. v. State*, 445 N.Y.S.2d 315 (App. Div. 1981). Moreover, the RESTATEMENT THIRD, SURETYSHIP AND GUARANTY §31, expressly rejects the *Munsey Trust* holding and takes the position that the surety's equitable subrogation right is superior to an obligee's right to set off a principal's debt against the bonded contract funds, even if the surety is only a payment bond surety. The Reporter's Note to Section 31 at comment (d) states "[t]his section rejects the doctrine articulated in [Munsey]. The Munsey Trust doctrine has been severely criticized since its inception . . . Moreover, the courts have severely limited the scope of the Munsey Trust doctrine." The question is whether the applicable court will adopt the decision of the Supreme Court in *Munsey Trust* or the position of the RESTATEMENT OF SURETYSHIP.

There are also some bond forms that limit the obligee's right to setoff. One such form is the AIA A-312 (2010) Performance Bond, which specifically prohibits the obligee from reducing or setting off against the bonded contract funds. Section 7 of the A-312 provides that "the surety shall not be liable to the obligee or others for obligations of the contractor that are unrelated to the construction contract and the balance of the contract price shall not be reduced or offset on account of any such unrelated obligations."

C. Other Third Parties.

Okay, so look at some other uses of setoff that are detrimental to the surety.

1. Banks.

Let's take a scenario where bonded contract funds are paid to the principal and are deposited into the principal's bank account. As is typical, the bank may have a variety of lending or credit facilities with the principal – line of credit, equipment loans, credit cards, etc. If the principal owes the bank money under one or more of those credit facilities, the bank may seek to exercise its setoff rights against the bonded contract funds deposited into the principal's bank account. In this situation the bank's setoff rights will prevail unless the bank had notice of the principal's defaults and the surety's rights to the funds. In jurisdictions where there is a trust fund statute or the courts recognize the surety's trust fund rights in an indemnity agreement, the surety may be able to defeat the setoff rights of the bank.

2. Governmental authorities and Departments of Labor.

In many instances, the obligee will be a governmental entity. Upon the default of the principal, other agencies of the governmental obligee may assert interests in the bonded contract funds and the obligee may exercise its setoff rights to deduct all or a portion of the bonded contract funds to satisfy the interests of the other agencies. In most cases, the performing surety through its equitable subrogation rights, will be able to assert a superior interest in the bonded contract funds. However, in the case of Department of Labor claims under Davis Bacon or the various state Department of Labor prevailing wage statutes, the surety's subrogation rights may not be enough to stop the governmental obligee's setoff. Some courts have taken the position that once the Department of Labor demands that the governmental obligee set aside portions of the bonded contract funds, such funds are no longer part of the bonded contract and the surety's subrogation rights do not apply.

Some of these cases are decided under the *Munsey Trust* doctrine distinguishing between payment bond subrogation and performance bond subrogation. Others, without much analysis, simply accord the DOL set aside demand some form of super-priority. These cases make little sense because the government has no liability to laborers, unpaid labor claims would not trump a performing surety's subrogation rights, and the statutory rights are no different than tax authorization statutes where sureties routinely have superior rights to tax authorities.
The bottom line is that surety's must be aware that there are a hand-full of cases out there that have given the DOL Davis Bacon setoff claim priority over the completing surety. Thus, it is always a good idea to figure out as soon as possible where the defaulting principal stands with Davis Bacon compliance when the surety is considering its options.

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## II. The Surety Exercises its Setoff Rights to Reduce its Loss

While numerous parties may attempt to exercise their setoff rights against a surety to the surety's detriment, the surety has only three parties against whom it may exercise its own setoff rights, namely those parties with whom the surety has a contractual relationship or third-party beneficiary obligation.

We have not done an exhaustive research project to find cases that fit the following situations. Rather, we hope to raise your antenna as to the possible instances when a surety may exercise its own equitable or contractual setoff rights to reduce its exposure to loss.

<u>One note of caution</u> – if the party against whom the surety is attempting to assert its setoff rights is in bankruptcy, the automatic stay, Section 362(a)(7), requires a party to obtain relief from the automatic stay in order to exercise the right to "setoff of any debt owing to the debtor that arose before the commencement of the case … against any claim against the debtor."[2]

### A. <u>The Obligee</u>.

The surety and the principal may have executed multiple bonds in favor of an obligee. The obligee may have defaulted the principal on a contract covered by Bond A, and the obligee and the surety may have entered into a takeover agreement with respect to the surety's

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[2] *See also* Chad L. Schexnayder, *Ch. 12, Bankruptcy*, in THE LAW OF PAYMENT BONDS 673-681 (Kevin L. Lybeck et al. eds., Am. Bar Ass'n, 2d ed. 2011).

performance of the Bond A contract and project. Subsequently, the obligee may default the principal on a contract covered by Bond B and make a claim against the surety. In the meantime, the surety may have performed under the takeover agreement for the Bond A contract and project, but the obligee refuses to pay the surety the contract funds under the takeover agreement.

Question: May the surety deny the obligee's claim under Bond B due to the obligee's breach of the takeover agreement for Bond A as a result of the obligee's failure to pay the contract funds to the surety? This is, effectively, a surety's setoff claim – "I don't owe you, Mr. Obligee, under Bond B because of your failure to pay me, the surety, under the takeover agreement for performing under Bond A." Depending upon the performance bond language and the particular jurisdiction, there are risks to the surety in denying an obligee's claim under Bond B and failing to perform, so the surety has to be correct with respect to the obligee's default and failure to pay the surety under the takeover agreement for the surety's performance under Bond A.

B. <u>The Principal</u>.

Because of the extensive rights that a surety may have against a principal under an indemnity agreement to obtain reimbursement for its losses under the bonds (such as payments made in good faith, the right to settle claims, the right to demand collateral, and many others), there appear to be only a few instances when a principal is owed a debt from the surety and can, therefore, reduce its reimbursement obligations to the surety for the surety's bond losses. Four come to mind, however, and either or both the principal and the surety would want to have a setoff right to each of their detriment and benefit.

First, the principal may be entitled to a premium refund from the surety for one or more of the bonds. The surety does not want to pay premium refund money to the principal when the principal owes money to the surety for the surety's bond losses.

Second, the surety may be an insurer of the principal, and the principal may have a valid claim against the surety/insurer under an insurance policy, such as a principal's claim for $100,000 against its CGL policy. If the surety/insurer are the same entity as required by the mutuality concept for equitable setoff, then the surety/insurer may set off the $100,000 it would otherwise owe the principal under the CGL policy to reduce its surety loss under the bonds by $100,000. The surety/insurer should not have to pay the $100,000 CGL claim to the principal and then hope to get the funds back after successfully pursuing its indemnity and reimbursement claim for an amount in excess of $100,000.

Third, if the surety is found to be in bad faith for its handling of the claims under one bond, and the principal obtains a judgment against the surety, the surety could reduce its obligations under the bad faith judgment to the principal on other bonds executed by the same principal and the surety where the surety acted in good faith and incurred bond losses.

Finally, a subcontractor principal may have claims against the surety on bonds that the surety executes for another, unrelated general contractor principal, and also have obligations to reimburse the surety on other bonds executed by the same subcontractor principal and the surety to various obligees. As a claimant, a subcontractor principal may have a valid claim against the out of business general contractor and the common surety under Bond A. But, as the surety's principal on other bonded subcontracts, the subcontractor principal may owe the surety money as a result of defaults on those other bonded subcontracts. The surety does not have to pay the claimant subcontractor principal on Bond A when that claimant subcontractor is the surety's subcontractor principal that has the obligation to indemnify and reimburse the surety on the other bonded contracts.

Because of the contractual relationship between the principal and the surety, some indemnity agreements have a written provision in the indemnity agreement that authorize a surety's contractual right of setoff in the circumstances described above.

C. The Payment Bond Claimants (third party beneficiaries under the Payment Bond).

Whether it is called a setoff or recoupment, a surety may have a defense against a payment bond claim when the claimant subcontractor or its first or second tier subcontractors or suppliers have failed to perform or have supplied defective materials on the bonded project.[3]

A different situation arises when a payment bond claimant may have a valid claim against the surety on Bond A (for example, for $100,000), but the surety may have a valid claim against the payment bond claimant on a separate bonded contract, Bond B (for example, for a surety loss of $50,000 on Bond B). The surety's loss on Bond B may be as a result of the payment bond claimant's failure to perform the work for the surety's general contractor, its failure to supply the correct materials and equipment, or for supplying defective materials and equipment. Both parties may have setoff rights that may be enforced to either their benefit or detriment, and the surety may be able to exercise its set off rights to reduce its payment on Bond A to the claimant to the amount of $50,000. However, the party claiming an affirmative recovery against the other party would have to assert an affirmative claim in any litigation to recover more than the setoff amount.

There is one possible caveat to this issue – whether the surety has collected bonded contract funds from the contract covered by Bond A that are subject to the jurisdiction's trust fund statute. We have not researched the issues for today, but if the bonded contract funds collected by the surety on Bond A are impressed with a trust for the benefit of the payment bond claimant, the surety may not be able to set off against that claim amounts that may be due to the surety from another project such as Bond B.

## III. The Surety's Subrogation Rights to the Setoff Rights of Others

The surety may assert its subrogation rights to the rights of a party it paid or for whom it performed an obligation under the bonds – and they are the obligee, the principal and the payment bond claimants. Many of these issues are covered in depth in the FSLC book, THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS. Chapter 14 of that book is entitled *Common*

[3] James A. Knox, Jr. and Stacy Hipsak Goetz, *Ch. 11, Defenses,* in THE LAW OF PAYMENT BONDS 561-568 (Kevin L. Lybeck et al. eds., Am. Bar Ass'n, 2d ed. 2011).

*Obligee Theory and Other Setoff Rights – The Surety's Subrogation Rights to the Obligee's or Principal's Setoff Rights.* We will address those surety subrogation rights next.

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A. The Obligee.

It is generally recognized that a performing surety, through its equitable right of subrogation, may exercise the setoff rights of the obligee. The RESTATEMENT THIRD, SURETYSHIP AND GUARANTY §28(1)(C) states that the surety's subrogation rights reach any interest in property of the principal obligor against which the obligee's rights can be enforced.

1. Common Obligee Theory

Under the common obligee theory, a surety may, under certain circumstances, assert its subrogation rights in order to exercise the obligee's setoff rights against the principal to recover funds the obligee would otherwise owe to the principal under other unrelated bonded or non-bonded contracts. Using the setoff rights to extend the surety's reach beyond the bonded contract may help reduce the surety's losses. Under the common obligee theory, the surety steps into the shoes of the obligee and is entitled to assert any rights that the obligee may possess against the principal, even on other contracts.

A simple example demonstrates the principle – obligee and principal enter into two contracts, Contract A to build a school and Contract B to build a shopping center. The school project, Contract A, is bonded by a surety, Contract B is not bonded. The principal completes the shopping center, the Contract B project, and is owed $100,000 by the obligee. But then the principal defaults on the school project, Contract A, and the surety steps in to complete Contract A. The surety is paid all of the Contract A funds, but incurs a loss of $100,000. Because the surety performed and completed Contract A, it is subrogated to all rights of the obligee with respect to the principal. In this example, one right that the obligee would have if the surety did not perform is the right of setoff between Contact A and B. If there were no surety in this scenario, the obligee would have completed Contract A and incurred the $100,000 loss and would have said to itself "I owe the principal $100,000 on Contract B, but the principal owes me $100,000 on Contract A, so I will set off the two amounts and keep the $100,000 owed on Contract B to cover my losses on Contract A and the principal gets nothing, but owes nothing." With the surety present, the surety simply does what the obligee would have done, it collects the $100,000 on Contract B to offset the surety's loss on Contract A.

The concept is simple enough in theory and it serves to further the purposes of both subrogation and setoff. However, in practice it is not quite so simple. Some courts have recognized and allowed the common obligee theory. Examples include: *Travelers Casualty and Surety Company of America v. Paderta,* 2013 WL 3388739 (N.D. Ill. July 8, 2013); *Transamerica Ins. Co. v. US.*, 989 F.2d 1188 (Fed. Cir. 1993); *In re Larbar Corp.*, 177 F.3d 439 (6th Cir. 1999); *District of Columbia v. Aetna Ins. Co.*, 462 A.2d 428 (D.C. 1983); *USF&G v. Housing Authority of the Town of Berwick,* 557 F.2d 482 (5th Cir. 1977). Other courts have rejected it. Some courts reject the theory because they take an overly restrictive view of subrogation and hold that the surety's subrogation rights are limited solely to the bonded contract and the bonded contract funds. *See Lacy v. Maryland Cas. Co.*, 32 F.2d 48 (4th Cir. 1929) and *Western Casualty & Surety Co. v. Brooks*, 362 F.2d 486 (4th Cir. 1966). Based on the case law there are a number of issues that can potentially affect whether a given jurisdiction will recognize the theory. Some of those factors are:

1. In jurisdictions where the distinction is recognized between the subrogation rights of a payment bond surety versus a performance bond surety, a payment bond surety may not have the necessary subrogation rights to obtain the obligee's setoff rights.

2. The surety must have a loss on the bonded contract from which it asserts its subrogation rights.

3. The obligee must owe the principal on the other project.

4. The obligee must be a mere stakeholder with respect to the other contract funds, thus if the obligee has independent rights against the Principal for example the IRS seeking taxes that may result in rejection of the common obligee theory.

5. The obligee must actually possess setoff rights against the principal, contractual or statutory rights might limit or prevent setoff.

6. The principal does not dispute the obligee's rights, if there is a dispute between the principal and the obligee over whether the principal owes the obligee anything such as the principal challenging the default or asserting change orders or affirmative claims, those facts may result in rejection of the application of the common obligee theory at least until the disputes are resolved.

7. The principal's Trustee in Bankruptcy does not claim the funds. If the principal's bankruptcy trustee has superior rights over the obligee to the funds, the surety's set off rights under the common obligee theory will not be successful.

The takeaway here is that the surety, through the common obligee theory, may have rights against other funds to help offset losses on the bonded job if the common obligee has set off rights that can be enforced. There are a number of potential hurdles to utilizing this doctrine so it is not a certainty, but it is definitely worth pursuing.

B. The Principal.[4]

The surety may compel its principal to exercise its setoff rights against an obligee or a payment bond claimant to reduce the surety's liability. This is especially true when the principal is insolvent and, yet, is owed money by the obligee or a payment bond claimant. The surety would want to set off the money owed to the principal by the obligee or payment bond claimant to reduce the surety's bond obligations to either one. Why should the insolvent principal, or its bankruptcy trustee, get the payment owed to the principal/debtor when the surety may incur a loss to that obligee or payment bond claimant as a result of the principal's failure to pay either one of them.

There are some limitations, such as if the principal is solvent and objects to the surety's exercise of the principal's setoff rights, or the surety has not exhausted the collateral that it has obtained from the principal to protect the surety from loss.

C. The Payment Bond Claimants.[5]

The surety may also compel a payment bond claimant to setoff any funds that would otherwise be owed to the principal for unrelated debts to reduce the surety's liability to that payment bond claimant. Again, if the payment bond claimant owes money to the principal, and yet makes a claim against the surety under the payment bond for the principal, the surety would want to require the payment bond claimant to pay itself first from the amounts it is holding for the principal before the surety pays that balance of the obligation, if any.

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[4] Jarrod W. Stone, *Ch. 14, Common Obligee Theory and Other Setoff Rights—The Surety's Subrogation Rights to the Obligee's or Principal's Setoff Rights*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 543-557 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013); James A. Knox, Jr. and Stacy Hipsak Goetz, *Ch. 11, Defenses*, in THE LAW OF PAYMENT BONDS 561-568 (Kevin L. Lybeck et al. eds., Am. Bar Ass'n, 2d ed. 2011) (the payment bond surety's right to assert its principal's counterclaims). *See also*, Chad L. Schexnayder, *Ch. 12, Bankruptcy*, in THE LAW OF PAYMENT BONDS 673-681 (Kevin L. Lybeck et al. eds., Am. Bar Ass'n, 2d ed. 2011) (the surety's setoff and recoupment rights as a defense in bankruptcy).

[5] Id.