SURETY TODAY PRESENTATION
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A CORNUCOPIA OF SURETY LAW ISSUES.

I. Automatic Escalation of the Penal Sum Performance Bond (Justin)

The first topic I will discuss today is a rather interesting one that came across our desk recently which I will title "Automatic Escalation of the Penal Sum." First, I will give the (hopefully) simplified factual background. Then, I will pose the key question to our listeners to think about. Finally, we will provide a (possible) answer to that question.

Background

Okay – so let's say a general contractor agrees to a $1 million purchase order with a subcontractor to install cabinets. The subcontractor then gets its payment and performance bonds, each with a penal sum of $1 million. Subsequently, the subcontractor tells the general contractor that it is no longer financially able to complete the work. After the default, the general contractor calls on the surety. The surety responds and after investigation agrees to tender a completing contractor. After rebidding, the surety finds a completing contractor, but the net completion price, after deducting the remaining contract balance, is more than the $1 million penal sum of the performance bond. The surety proposes to pay the general contractor the $1 million penal limit of the performance bond to conclude the tender.

The general contractor comes back to the surety and says "wait a minute – we have some change orders, four of them to be exact, executed by the principal." These change orders increased the contract price to $1,250,000. Therefore, the general contractor demanded that the surety pay the additional contract sum, contending that the penal sum of the bond was increased automatically by the change orders. The surety responded that the penal sum of the bond has not changed and remains at $1 million. Additional facts - The surety waived notice of all changes, and the bond stated no change in the contract would alter the surety's obligation. Neither the bond nor the contract provided that a contract price increase would necessarily increase the penal sum of the bond.

<u>Question:</u>

That brings us to the question of the day: Does the penal sum of the performance bond automatically escalate as the contract price escalates?

<u>Answer:</u>

Let's look at one case that involves a different situation, but that helps with the analytical framework. It is a federal case from here in Virginia called *Centex Constr. v. Acstar Ins. Co*., 448 F.Supp.2d 697 (E.D. Va. 2006). In that case, the original contract price was for roughly $170,000. After eight change orders, the contract amount was up to over $2.4 million. Importantly, the bond stated as follows:

> *[A]ny increase* in the Subcontract amount shall automatically result in a *corresponding increase in the penal amount of the bond* without notice to or consent from the Surety, such notice and consent hereby being waived.

This language was the key to the Court's decision and is dramatically different from the factual scenario above. In *Acstar*, the surety and obligee agreed in the bond to a provision calling for a corresponding increase in the penal amount for ANY INCREASE in the subcontract price. The court naturally relied on that language to keep the surety on the hook for the full $2.4 million when the original penal sum was $170,000. The lesson learned in *Acstar* is to be on the lookout for language in the bond forms or underlying contracts relating to the penal sum of the bond.

If, as in our scenario, the bond obligee cannot point to language in the bond or underlying contract for support of its claim to funds above the penal sum, what does the law provide? There is an excellent discussion of this issue in a bankruptcy court case from Tennessee, *In re Tech For Energy Corp.*, 140 B.R. 214 (Bankr. E.D. Tenn. 1992). The facts of that case are strikingly similar to our fact scenario. The penal sum of the bond equaled the original contract price of about $3,900,000. Change orders increased the contract price to about $6,950,000. The bond waived notice of changes in the contract and provided that changes will not release the surety from liability under the bond. There was no automatic escalation language like that in *Acstar*. Nevertheless, the obligee argued that the surety was on the hook for the excess.

The Court undertook serious fact-finding on this question. In fact, both sides presented expert testimony from individuals deemed expert's in the surety field. Not surprisingly, the experts took diametrically opposed position on the issue of the standard practice. Given the difference of opinion, the Court stated, "[t]he evidence does not show that sureties linked consent to a contract change and consent to an increase in the penal sum." The Court highlighted that while a surety can consent in advance to contract changes, as here in our scenario, they do not necessarily consent to an increase in the penal sum. Said another way, consenting to a change in the contract does not necessarily lead to consent to the change in the bond.

The Court supported this reasoning by turning to the Statute of Frauds. As a refresher, the Statute of Frauds is a legal doctrine that essentially sets forth the circumstances under which a contract has to be in writing. Under the Statute of Frauds, one circumstance where a writing is required "applies to a promise by one person to answer for another person's debt, default, or miscarriage," and a surety bond falls under this category. Therefore, a surety bond is required to be in writing and the penal sum is part of that written contract. Pointing to local law, the Court said that the penal sum of the bond is a material term of the contract. Because the statute of frauds requires the contract to be in writing, any change to a material term of that contract must also be in writing. Therefore, any change to the penal sum has to be in writing. Because there was no written consent by the surety of an increase in the penal sum, there can be no automatic increase. It violates the statute of frauds.

The opinion in *In re Tech,* is a worthwhile read, and I think this analysis was quite salient. A lot will depend on a particular jurisdiction's treatment of the Statute of Frauds, but I think in those places where the Statute of Frauds plays a key role, this analysis will be quite persuasive to a court. Furthermore, I like how this analysis fits right in with the *Acstar* decision. There, the surety did agree in writing to an automatic escalation because it agreed in advance to the language in the bond for the corresponding increases. Therefore, the automatic escalation does not violate the Statute of Frauds. These cases can also be read together to show that sophisticated parties are capable of expressly providing for automatic escalation clauses. *Acstar* is great evidence of that. When the parties do not expressly provide for such language, courts should be hesitant to read such a provision into the language, especially one based off of amorphous reasoning like "custom of the trade" or "industry practice."

I think these cases provide you with a very sensible way to look at the automatic escalation issue. While this may be a good guide, the surety must always make sure to check your bond, your contract, and the law of your jurisdiction with respect to these issues. But look to the law rather than a perceived "custom" because as the Judge said in *In re Tech* "[t]he court believes that the broad custom of the trade alleged . . . is not a custom of the trade at all but a common misunderstanding of the law." Therefore, just because it is being done one way does not mean a court is going to accept that as compatible with that jurisdiction's law.

II. <u>"Out With The Old In With The New" – Novation.</u> (Mike)

Many times over the course of my career I have run into the situation where the surety has multiple indemnity agreements that relate to a particular default. Sometimes, the multiple agreements arise because the surety is just up dating from an old form agreement to a new form. Sometimes new indemnitors are being added and sometimes indemnitors that were on the original agreement are not signatories to the new agreement – some drop off, some add on. Most recently, I had the situation where there was an original indemnity agreement executed in 2012 by the then husband and wife and their contracting company in which both were officers. Then, five years later a new indemnity agreement was executed by the husband and the original company and with a new corporate indemnitor added. The wife was not a signatory to the new agreement. It turns out the husband and wife were separated and she was no longer involved with the original company and had no involvement in the new company. As luck would have it, the new entity on the new indemnity agreement was the principal on several bonds that went into default and the wife that did not sign the new indemnity agreement was the only solvent indemnitor. So, an indemnity action was instituted against the wife and the other indemnitors.

Naturally, the wife filed a motion to dismiss asserting that she was no longer liable because the new indemnity agreement was a novation and the old indemnity agreement was no longer valid. We defeated her motion to dismiss thanks in large part to the language of the two indemnity agreements that made it very clear that neither agreement was intended to replace the other. So, I thought it would be a good idea to discuss the law of novation in case you run into this type of issue in the future. In addition, novation can come up in more circumstances than just multiple indemnity agreements. For example, if the surety enters into a settlement agreement where the principal and surety are settling with an obligee or other claimant.

Sometimes the broad language of a release could be construed as a novation of the indemnity agreement between the surety and principal. Another example could be a takeover agreement where the surety and indemnitor are both signatories, it is possible that the broad language of the integration clause in an agreement could give rise to a novation argument. Accordingly, the surety must be aware of novation and guard against an inadvertent application of the doctrine. To establish a novation, a party must prove that there was a valid original agreement, that all or some of the parties to the original agreement entered into a valid new agreement and that there was intent for the new agreement to extinguish the original agreement.[1] A novation can only arise when a new contract is made with the intent to extinguish an existing contract.[2] Thus, to establish a novation, a party must demonstrate that there was intent among the parties to extinguish the old obligation and substitute a new one for it.[3] The burden of proof will be on the party asserting the novation.[4]

To determine the intent of the parties the courts will typically look to the language of the two contracts. In my case, the original indemnity agreement noted that it was a continuing agreement and the language clearly contemplated subsequent agreements and the possibility of additional indemnitors. Similarly, the later indemnity agreement clearly stated that the agreement was in addition to any other agreements and that it was not intended to replace any other agreements. Thus, the best defense to a novation argument is clear language in the

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[1] *I. W. Berman Props. v. Porter Bros., Inc.,* 276 Md. 1, 7 (1975); *Young v. Benton*, 131 P. 1051, 1052 (Cal. Ct. App. 1913); *Miran v. Convergent Outsourcing, Inc.*, No.: 3:16-CV-00692-AJB-JMA, 2017 WL 1410296, at *3 (S.D. Cal. Apr. 20, 2017).

[2] *I. W. Berman Props.*, 276 Md. at 7; *BarGale Industries, Inc. v. Robert Realty Co., Inc.*, 275 Md. 638, 646 (1975); *Leisner v. Finnerty*, 252 Md. 558 (1969); *District Nat'l Bank of Washington v. Mordecai*, 133 Md. 419 (1919); *Wells Fargo v. Bank of Am.*, 38 Cal. Rptr. 2d 521, 525 (Cal. Ct. App. 1995) ("Pursuant to California law, a 'novation is the substitution of a new obligation for an existing one.'") (quoting Cal. Civ. Code § 1530).

[3] *Adler v. Walker & Dunlop, Inc.*, 245 Md. 153, 159 (1967); *also Noor v. Katz*, No. B275176, 2017 WL 4129026, at *2 (Cal. Ct. App. Sept. 19, 2017).

[4] *Holzman v. Fiola Blum, Inc.*, 125 Md. App. 602, 627 (1999); *Howard v. Cty. of Amador*, 220 Cal. App. 3d 962, 977, 269 Cal. Rptr. 807, 817 (Ct. App. 1990).

agreements. In the context of a settlement agreement or takeover agreement, the best practice is to add a paragraph expressly preserving the surety's rights under the indemnity agreement.

In situations where one or more of the original indemnitors is not a signatory to the later agreement, courts throughout the country that have considered the effect of a later indemnity agreement have rejected the novation argument.[5] For example, in *National Surety Corp. v. Prarieland Construction, Inc.*, 354 F. Supp. 2d 1032 (E.D. Mo. 2004), indemnitors on an earlier indemnity agreement argued that a subsequent indemnity agreement that omitted them as signatories acted as a novation that released them from liability.[6] The court disagreed, stating that "[n]o reasonable factfinder could conclude from this evidence, even drawing all inferences in favor of the [indemnitor defendants], that National Surety intended to release them from their obligations under the 1999 agreement."[7] *Id.* In *Polartec, LLC v. 180S, LLC*, No. CIV. CCB-07-2396, 2009 WL 905609, at *5 (D. Md. Mar. 27, 2009), the Court noted that Maryland courts have found a novation only where there is evidence establishing a clear and definite intent to extinguish the original obligations, and that a change of parties alone is not enough to demonstrate that intent.

Finally, in my case, the indemnity agreement had an express provision for terminating an indemnitor's obligation under the agreement. But the original indemnitor failed to take any steps to terminate her obligations. In *United Pac. Ins. Co. v. Johnson-Gillanders Co.*, 280 F. Supp. 90 (D.N.D. 1968), the Court stated that "[a] contract of indemnity continues in force during the time provided by its terms."[8] The Court further observed that upon execution of the agreement of

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[5] *Dahl v. Brunswick Corp.*, 277 Md. 471, 482–84 (1976) (citations omitted).
[6] 354 F. Supp. 2d at 1038.
[7] Id., see also *Fed. Ins. Co. v. C.D. Henderson Inc.*, No. A-07-CA-982-SS, 2009 WL 10635909 (W.D. Tex. Jan. 27, 2009), *modified on reconsideration,* No. A-07-CA-982-SS, 2009 WL 10670098 (W.D. Tex. Feb. 20, 2009)
[8] 280 F. Supp. at 94 (citing *Employers Mutual Casualty Co. v. Piedmont Supply Co.*, 197 F. Supp. 159 (M.D.N.C. 1961); *Employers' Liability Assurance Corporation v. Tebbs*, 137 F. Supp. 869 (D. Wyo. 1956).

indemnity the indemnitors knew that it was a continuing obligation and could only be terminated by sending written notice of withdrawal to the surety as provided in the agreement. In *Allstate Enterprises, Inc. v. Heriford*, 772 P.2d 466, 469 (Utah Ct. App. 1989) the court in denying a novation argument held that the failure of the indemnitor to give the required notice resulted in the indemnitor continuing to be bound under the indemnity agreement and such failure was evidence of intent to continue to be bound.

III. New Case Review – *Sonoma Springs Limited Partnership v. Fidelity & Deposit Company of Maryland*, 3:18-cv-00021-LRH-CBC, 2019 WL 3848790 (D. Nev. 08/14/2019) (Justin)

Duty of Good Faith and Fair Dealing

The *Sonoma Springs* case addresses a topic that is always working in the background of any claim process – the duty of good faith and fair dealing. Generally, this doctrine serves as a kind of referee that makes sure parties conduct their business above board. Or perhaps more simply, keep your motives pure.

This case involves an owner, general contractor, and surety. The owner wanted to build an apartment complex on its property, so it brought in the general contractor. The surety wrote the performance and payment bonds with the contractor as the principal and the owner as the obligee. The owner claimed that the contractor breached the contract therefore triggering the surety's obligations under the performance bond. The contractor claimed the owner breached the contract first. Multiple times the owner asked the surety to assume the contractor's obligations. The surety did not. The owner filed suit against the surety alleging 13 claims. A number of bond-related issues were resolved because the Court found that the owner did not satisfy all of the conditions precedent to trigger the surety's obligation under the AIA A312 performance bond.

However, in addition to breach of contract claims, the owner alleged that the surety breached its implied covenant of good faith and fair dealing. The Court looked at this issue in both the tort context and the contract context. First, under Nevada law, “where an insurer fails to deal fairly and in good faith with its insured by refusing without proper cause to compensate its insured for a loss” it may give rise to a cause of action. Nevada courts have held, however, that this tort liability does not apply in the surety context. Part of the discussion centered around who the plaintiff was – in this case, the owner. The Court emphasized that the “owner-surety relationship simply does not raise the same public policy concerns implicated in the insurance context.” Looking at it another way, there is just different dynamics between insurance companies and their insureds and sureties and their obligees.

The Court points to some factors that are good to keep in mind: (1) both parties are sophisticated – owner of a multi-million dollar project and a national surety; and (2) there was no vastly superior bargaining power as the parties used an AIA-A312 bond, a form bond routinely used in these relationships. Furthermore, the Court points out that the relationship between a surety and owner is not a fiduciary one. As the Court put it, “A surety simply lends its credit and agrees to step in where the principal defaults on its contract. This is not a fiduciary relationship, and therefore does not present the same concerns as the insured-insurer relationship.” This reasoning resolved five of the causes of action in the surety’s favor.

While Nevada recognizes a duty of good faith and fair dealing in the tort context, it also comes up in the more-familiar contract arena. Under Nevada law, all contracts “impose upon the parties an implied covenant of good faith and fair dealing, which prohibits arbitrary or unfair acts by one party that work to the disadvantage of the other.” While that is the standard under Nevada law, I think you will find many jurisdictions adopt similar standards. To go back to my referee analogy earlier, this standard is the "Let's have a clean fight" speech, no funny business, no shots below the belt, etc. Another important thing to remember about this covenant is that it can be breached even when the contract is not breached. As the Court put it here, the idea is to "determine whether, although the defendants complied with the literal terms of the contract, they deliberately or intentionally hindered the performance of the contract."

I think the owner's theory here was that by refusing all of its demands to perform that the surety deliberately violated the spirit of the contract or intentionally undermined the contract. The Court was very much unconvinced finding no evidence that the surety sought to undermine the contract. Therefore, yet another cause of action was thrown out.

As I mentioned at the top of this segment, good faith and fair dealing is always something to keep in the back of your mind when handling a claim. As this case points out though, if the surety has defenses to an owner's demands the surety is justified in relying on those defenses. Here, the owner did not meet the conditions precedent for triggering the surety's obligation and despite the repeated efforts to get the surety to perform, the surety said no. This refusal was not a breach of the covenant of good faith and fair dealing on the part of the surety. It was simply an exercise of its rights. Put another way, you are not purposefully undermining the bond by refusing to perform on demand when the obligee making the demand has not done what it was supposed to do.

IV. New Case Review – *In re Kappa Development and General Contracting, Inc.*, 2019 WL 2867110 (Bankr. S.D. Miss. July 2, 2019)

Surety Right To The Funds

In the case of *In re Kappa Development and General Contracting, Inc.*, 2019 WL 2867110 (Bankr. S.D. Miss. July 2, 2019) money was deposited into the court's registry by two separate construction project owners and the debtor's surety and lender were fighting over the funds. The debtor took no position in the dispute because it knew that regardless of the outcome, the bank and surety had superior rights over the funds. The surety paid payment bond claims and the premium of a worker's compensation insurer, which was a performance bond obligation. The bank contended that it had a security interest in the debtor's accounts receivables, general intangibles and account proceeds that was perfected long before the bonds were even issued. In granting summary judgment in favor of the surety, the Court held:

> The right of a surety to retainage is superior to a creditor's security interest in accounts receivable, general intangibles, and account proceeds regardless of when the creditor's security interest was perfected.

The Court made quick work of brushing aside the bank's meritless arguments that the surety was a volunteer and that the funds were not retainage. Addressing the bank's argument that its security interest was perfected before the bonds were issued, the court stated that "[t]he right of equitable subrogation is not governed by the priority rules of the Uniform Commercial Code.[9] When the funds at issue are retainage, the surety's right of equitable subrogation is superior to the right of an assignee bank."[10] The Court observed that because "the surety's right of equitable subrogation is based on equity, not the U.C.C., it is immaterial whether the bank filed its financing statement before or after the bond was issued. Either way, [the surety] wins." The court cited to the authors of the treatise *The Law of Secured Transactions Under the Uniform Commercial Code* observing that the overwhelming weight of case law favors the surety for retainage regardless of whether the bonds were executed before the [bank's] security interest was perfected.[11]

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[9] *Id.,* 2019 WL 2867110 at *6; citing *Travelers Indem. Co. v. Clark*, 254 So. 2d 741, 746 (Miss. 1971) ("[W]e hold that a surety's right of subrogation is unaffected by the filing requirements of the Uniform Commercial Code.").

[10] *Id.*; citing *Canton Exch. Bank v. Yazoo Cty.,* 109 So. l, 7-8 (Miss. 1926).

[11] *See* 1 Barkley Clark & Barbara Clark, *The Law of Secured Transactions Under the Uniform Commercial Code* § 1.07[2]-[3] (3d ed.) (2018) ("Once the priority conflict is taken outside the confines of Article 9 [of the U.C.C.], the blue ribbon should be given to the surety, even when the bonds are executed after the bank's security interest is perfected."); *e.g., In re J.B. Constr. Co.,* No. BK 10-80880-TJM, 2011 WL 830101, at *2 (Bankr. D. Neb. Mar. 4, 2011)

The Court further noted that whether the bank has any rights in the retainage depends on whether the debtor had any rights in the retainage. A security interest is enforceable only if the debtor has rights in the collateral. An assignee's rights (like the bank) can rise no higher than the assignor's (the debtor). A defaulting contractor has no rights in the retainage.[12] Upon default, the remaining funds are to be used to complete the project and satisfy subcontractors and suppliers to the project.

The bank also argued that the surety was subrogated to the rights of the subcontractors and suppliers whose claims it satisfied and that such subcontractors and suppliers were mere general unsecured creditors in the bankruptcy. Thus, the bank argued the surety's rights are subordinate to the rights of the bank in bankruptcy because the bank was a secured creditor. However, the court noted that because the surety's right of equitable subrogation relates back to the date of the issuance of the Bonds, under bankruptcy law, the retainage never became property of the estate. At most, the bankruptcy estate could succeed only to the debtor's possessory interest in the retainage as mere legal title, not to the equitable interests of the subcontractors and suppliers.[13]

V. *Trombley Enterprises, LLC v. Sauer, Inc.*, No. 5:17-cv-04568-EJD, 2019 WL 3804710 (N.D. Cal. 8/13/2019) (Justin)

Economic Duress/Fraudulent Inducement

This case involved a federal project where the general contractor contracted with a subcontractor to provide painting work on the project. The surety issued a payment bond for the

(quoting *US. Fid.* & *Guar. Co. v. APAC-Kansas, Inc.,* 151F.Supp.2d 1297, 1300 (D. Kan. 2001)) ("[The contractor] has not cited, nor has this court found, any authority requiring that the surety's interest predate another creditor's interest for the doctrine of equitable subrogation to control.").

12 *United States v. TAC Constr. Co.*, 760 F. Supp. 590 (S.D. Miss. 1991).

13 *See In re Jones Const1: & Renovation, Inc.,* 337 B.R. 579, 583-84 (Bankr. E.D. Va. 2006) (quoting *Pearlman,* 371 U.S. at 135-36) ("The Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors.").

general contractor. The project was supposed to begin June 2015 and end no later than March 2016. Well, the project went off the rails. There were numerous delays that had nothing to do with the subcontractor. It was not until January 2016 – 7 months after the project was supposed to start – that the general contractor told the subcontractor to begin painting. Oh, and they told the subcontractor to start painting when the buildings were not even complete!

In February and March 2016, at the general contractor's direction, the subcontractor dispatched a fully manned and equipped crew to the job site. However, it was still not ready to paint. As of the end of March 2016, not one of the eight buildings to be completed was done. The subcontractor began working in March 2016, but the work was delayed because some areas were not ready to be painted. Other work was done out of sequence. Lastly, the subcontractor had to work around other trades working in the same area.

On June 22, 2016, a year after the work was supposed to begin, the general contractor asked that the subcontractor complete the work by October 13, 2016. The subcontractor protested because the original time gave them eleven months to complete and they now had to finish in only seven months. The general contractor agreed to pay the additional cost of the labor to meet the new deadline.

The subcontractor submitted change orders that were ignored. There was a meeting in July 2016 where the subcontractor voiced concerns about payment, and the general contractor confirmed that it would pay for all costs associated with the delays and issues faced by the subcontractor. Between November 2015 and October 2016, the subcontractor submitted at least 32 change orders totaling about $630,000.00. The general contractor agreed to nine that increased the contract price by about $105,000, but the difference had not been paid. The subcontractor eventually completed all work, including some extra painting requested by the general contractor. After completion, the general contractor presented the subcontractor with a Partial Waiver and Lien Release for $41,351.56. The subcontractor failed to identify any claims or changes that were excluded from the broad terms of the release. The subcontractor eventually brought claims under the Miller Act payment bond for unpaid amounts.

The Court believed that the circumstances in this case could ultimately rise to the level of economic duress that would invalidate the waiver. Essentially, the general contractor knew there were serious issues with the schedule of the project. Asked the subcontractor to commit excess labor and supplies. This work required it to forgo other projects it could have had. All the while, it was promising full payment. Yet, when the time came, it refused to pay. Where the duress comes in is that by requiring the waiver in order for the subcontractor to receive small payments, the general contractor was forcing the subcontractor's hand. Having expended all those resources, the subcontractor was in need of cash to keep the business going. Therefore, the general contractor held the small amount of cash over its head in exchange for the release of all claims. The Court did not validate this exploitative behavior.

The Court also said that the subcontractor raised issues of facts with respect to the claim of fraudulent inducement. The subcontractor argued that the general contractor lied about promising to pay in full simply in order to get the waiver signed. Because the subcontractor relied on the promises of payment, it was fraudulently induced to sign the waiver. The Court accepted there was sufficient facts to allow this claim to go forward.

This affects the surety because there was now a question as to whether the release was a valid waiver of the subcontractor's right to bring a payment bond claim. Ultimately, that right was going to turn on the validity of the release and therefore, the ultimate decision by the fact-finder on whether the claims of economic duress and/or fraudulent inducement were established.

This case indicates the kinds of circumstances that should be investigated and evaluated when faced with a claim for payment. Just because there is a waiver does not mean everyone gets off clean.