**SURETY TODAY PRESENTATION**
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**SURETY CASE LAW UPDATE**

**(MIKE)**

Today we are going to provide a "Surety Case Law Update." Our last case law update on Surety Today was on February 12, 2018. Jason and I have gone back to May 2018 and looked at the case summaries prepared by the SFAA up to the present and have selected several cases of interest to discuss with you today. In our selection process, we weed out cases that are more procedural in nature or that turn on trial or burden of proof issues, as those are more germane to outside counsel. We try to focus on cases that have some practical use and application for the claims handler.

Jason and I each went through the entire list separately, then we sat down and discussed which ones we thought were interesting and decided which one's we would discuss. As a result, today we are going to discuss cases dealing with waiver of Miller Act rights, whether a bond is a contract, representations of the agent, the importance of reading the bond and a host of other issues. So, without further ado let's get started.

**(JASON)**

The first case I will discuss is *Developers Surety & Indemnity Co v. Archer Western Contractors, LLC*, (M.D. Fla. 5/7/18), which was a ruling on cross motions for summary judgment. In that case, Archer Western Contractors, LLC ("Archer") contracted with the Florida Dept of Transportation on Central Florida Commuter Rail Transit Station Finishes Project in Feb 2012 ("Project"). In May of that year, Archer subcontracted with Prince Land Services, Inc. ("Prince") to perform landscaping & irrigation work on the project. Developers Surety & Indemnity Co. ("Developers") bonded Prince. Eventually, Archer defaulted Prince and notified Developers and made a claim on the performance bond. Developers responded by advising Archer that the claim lacked sufficient information, but that Developers would begin preliminary investigation. According to the Court, there were no further communications between Archer and Developers.

Three months later, Developers learned that Archer hired a completion contractor to complete Prince's scope of work. After it learned of the completion contract, Developers denied Archer's performance bond claim. In denying the claim, Developers stated that Archer failed to provide sufficient documentation to substantiate claim and that Archer had unilaterally performed the remaining work with the completion contractor without giving Developers the chance to mitigate. Ultimately, the completion contractor finished its work and Archer made demand upon Developers for $631,148.65, the excess cost to complete Prince's subcontract.

Developers filed a Declaratory Judgment action against Archer arguing that Archer had breached the bond by unilaterally completing it without giving Developers the opportunity to do so. Developers also argued that it did not have any obligation to Archer because Archer, as the obligee, failed to respond to Developers requests for additional documentation. Therefore, Developers claimed that it was unable to substantiate Archer's claim. Further, Developers argued that Archer breached the duties of good faith and fair dealing because it refused to provide such documentation.

Unfortunately, Developers lost here based on the terms of the bond, which incorporated by reference the parties' subcontract. The bond provided that, upon a declaration of default by the obligee, the surety had 15 days to take one of 4 actions:

(1) Complete the Subcontract Work;
(2) Obtain bids or offers from completion contractors acceptable to Obligee and tender a completion contractor;
(3) Tender to Obligee the penal sum of the Bond less any amounts expended by the Surety in financing the Subcontractor; or
(4) Deny its liability after conducting an investigation.

Archer argued that it provided notice of default to the surety, but then the surety did not respond as required by the terms of the bond. After 15 days, Archer retained its completion contractor to complete the remaining scope of the work. Developers cited an 11$^{th}$ Circuit Case, *International Fidelity Insurance Company v. Americaribel-Moriarty JV*, 681 Fed. App'x 771 (11$^{th}$ Cir. 2017), in which the 11$^{th}$ Cir held that obligee's immediate hiring of completion contactor after terminating the bond principal "thwarted" the surety's ability to choose among its completion options.

The court rejected this precedent, however. It held that Archer, did not hire the completion contractor until after the 15-day period under the bond. The facts here indicate, however, that the obligee had done everything but formally retain the completion contractor. It knew it was going to do so during the 15-day period, and the court held that there was no harm in doing so. And, unlike the *Americaribel* case, there is no indication that doing so "thwarted" the surety, because the surety was not aware of the completion contractor until some 4 months later.

With respect to Developers argument that the obligee breached the bond by not supplying sufficient information to Developers, the court held that there was nothing in the bond that required it. The takeaway is clearly to read the bond – RTFB – Read the Friendly Bond to understand your rights and obligations under it.

**(MIKE)**

The first case that I would like to discuss explores the issue of waiver under the Miller Act. In *United States of America f/u/b of McCullough Plumbing, Inc. v. Halbert Construction Company, Inc.*, 2018 WL 6601844 (S.D. Calif. 12/17/18), Western Surety issued payment and performance bonds on a Miller Act project for Halbert Construction Co. ("Halbert") for the construction of a dining facility for the USACE. McCullough Plumbing was a subcontractor on the project and it claimed that it had not been paid in full for the work it performed, that change orders had not been paid and that it had incurred damages caused by delay including extended overhead and personnel costs.

The surety and principal moved for summary judgment with respect to the alleged delay damages asserting that the no damage for delay clause in the subcontract barred such claim. The claimant argued that the no damage for delay clause was void under the Miller Act.

The Court noted that the law was rapidly evolving with respect to the surety's ability to rely on a no damage for delay clause and that the courts were divided. Starting its analysis, the Court observed that the issue was controlled by the Miller Act, not state law. The Court then stated that the "liability of a surety and its principal on a Miller Act payment bond is coextensive with the contractual liability of the principal only to the extent that it is consistent with the rights and obligations created under the Miller Act." Basically, the Court was saying that if the no damage for delay clause was void under the Miller Act, it is irrelevant if such a clause would be enforceable under state law.

The Court noted the remedial nature of the Miller Act and its purpose to protect those supplying labor and materials on federal projects. The Court also noted that in 1999 Congress amended the Miller Act to include a provision specifying the requirements for a valid waiver of Miller Act rights. The provision at 40 U.S.C. §3133(c) provides: A waiver of the right to bring a civil action on a payment bond required under this subchapter is void unless the waiver is: (1) In writing (2) Signed by the person whose right is waived and (3) Executed after the person whose right is waived has furnished labor or material for use in the performance of the contract.

The principal and surety argued that the no damage for delay clause only addressed the measure of the claimant's recovery not the timing of recovery and that the claimant's recovery for delays was a time extension. The Court noted that other courts had rejected such arguments and held that the no damage for delay clause was in effect an implied waiver of the Miller Act that did not comply with the requirements for a waiver under the Act.

As noted, there is a split among the courts. Many courts that have addressed the no damage for delay clause have made the distinction between clauses that affect the timing of recovery with clauses that affect the measure of recovery. These Courts have held that such clauses only affect the measure of recovery and not the timing and as such are not contradictory to the Miller Act and are valid and enforceable provisions. See: *U.S. ex rel. Kogok Corp. v.*

*Travelers Cas. & Surety Co. of America*, 55 F. Supp. 3d 852, 860 (N.D. W. Va. 2014); *Morganti Nat'l, Inc. v. Petri Mech. Co., Inc.*, 2004 WL 1091743 (D. Conn. May 13, 2004); *Chasney & Co. v. Hartford Acc. & Indemn.*, 2015 WL 3887792 (D. Md. June 22, 2015). The Court in *Morganti* observed that "[t]he "no damages for delay" clause, is one that affects the measure of damages, i.e., whether there is any liability for monetary damages. It simply delineates the extent of the general contractor's liability or, in the context of the Miller Act, what sums are "justly due" to the subcontractor. Accordingly, the "no damages for delay" clause just as much defines the liability of [surety] as it does the liability of [the bonded principal], and so, both parties are entitled to raise this clause in their defense.

The takeaway from this case is that the surety may not be able to rely on all of the underlying contractual defenses in the bonded contract if those defenses conflict with the requirements of the Miller Act, such that they constitute an impermissible waiver.

**(JASON)**

The next case I'd like to discuss is *Associated Construction/AP Construction, LLC v. Hanover Insurance Co*, (D.Conn. 2018). This case addresses, in part, the surety's liability for the actions of the bonding agent. Associated Construction/AP Construction, LLC ("Associated") entered into a guaranteed maximum price contract to build a residential apartment complex in Stamford, CT. Associated subcontracted the framing, drywall and sheetmetal work to Intext Building Systems, Inc., ("Intext"), for $4.5M. To accomplish the subcontracting for the work, Associated entered into 3 separate subcontracts with Intext – $1.9M for Framing; $1.8M for Drywall, and $642k for sheetmetal.

Associated required Intext to obtain payment and performance bonds for the work, and Associated introduced Intext to a bonding agent. According to the obligee, the agent informed the obligee that while it did NOT have the surety's authority to issue a $4.5 million bond, the agent could split up the bonds among the 3 subcontracts, but that the bond would "operate as one bond" with a $4.5 million penal sum. The agent issued 3 bonds, each in the penal sum of the subcontract values, $1.9M, $1.8M, and $642.

Intext got into trouble and was unable to complete its subcontracts and the obligee called on the surety to complete. The surety conducted an investigation and proposed to allocate the completion costs across the 3 bonds and to pay the bonds' penal sums toward completion costs of the separate work scopes. The obligee, however, argued that the 3 bonds should be treated as one bond – with a penal sum of $4.5 million. The obligee incurred substantial completion costs on one of the 3 subcontracts that far exceeded that bond's penal sum. The crux is that the obligee sought to have the penal sums of all 3 bonds combined into one. Each bond referenced a separate subcontract and each bond separately contained a different penal sum in the amount of that subcontract. However, and this is where the acts of the agent can become important.

The obligee stated that on various occasions the agent promised the obligee that the bonds would act as one bond with one penal sum. The obligee asserted that it relied upon those representations by the agent in agreeing to accept the bonds, and that it would not have otherwise done so.

As I discussed in the prior case, the maxim RTFB - Read the Friendly Bond, again comes to mind. The court held that regardless of what the agent may have promised the obligee, the bond said what it said and the agent's alleged misrepresentations cannot change that. The court relied on the parole evidence rule, which is a rule applicable to the interpretation of contracts, that says prior verbal agreements cannot be used to contradict the terms of a written agreement. And, the reasoning is clear – if the parties intended for a verbal agreement to be binding, they would have incorporated those terms into the written contract.

Unfortunately, the surety did not escape completely. Although the court refused to construe all 3 bonds as one, it did hold that if the agent misrepresented things to the obligee, then the surety potentially could be liable for those misrepresentations. We see this increasingly around the country and here in Maryland and DC. Obligees are attempting to attribute to the surety all of the wrongful acts of the agent. Therefore, the agent's scope of authority from the surety must be absolutely clear. Similarly, don't forget about the agent. If a dispute arises regarding the scope of the bond or the coverage, it may be useful to find out what the agent may have done or said to the principal or even the obligee.

**(MIKE)**

The next 2 cases I will discuss deal with the issue of whether a surety can sue the obligee on a bond for breach of contract. Of course, we have heard repeatedly that a bond is a contract; and indeed, is a tripartite agreement between the surety, principal and obligee. But, can an obligee be held to a breach of contract standard? My two cases come down on opposite sides of the issue.

First, in *Hunt Construction Group, Inc. v. Cobb Mechanical Contractors, Inc.*, 2018 WL 5114151 (W.D. Texas 10/18/18), the Court said no cause of action existed. This case grew out of the construction of a hotel project on which Liberty Mutual bonded a mechanical subcontractor. The principal defaulted and Hunt notified Liberty of the default and termination and advised that Hunt intended to arrange for another subcontractor to perform the work. Liberty investigated and advised Hunt that the bond had been released by Hunt's actions in completing the principal's work.

Hunt sued Liberty and Liberty filed a counterclaim against Hunt, alleging, among other things, that Hunt breached the bond. Hunt moved to dismiss the breach of bond claim arguing that Texas law did not recognize such a claim. The Court agreed with Hunt that Texas law did not recognize such a claim and that Hunt owed no duties to Liberty under the bond, the bond was a one-way agreement. The Court explained that while certain actions of an obligee may provide the surety with a defense, that is the most that is available. The Court stated that Hunt was a beneficiary of the bond, but it took on no affirmative obligations and cannot be liable for breach.

Unfortunately, there was no discussion of the bond form or terms. There are many bond forms where the obligees do have numerous obligations to the surety – to hold a meeting, to satisfy conditions precedent, to pledge the contract balance to completion, to not have been in default under the contract. Additional obligations can also be included in the bond through the doctrine of incorporation by reference.

The second case is *Travelers Casualty & Surety Company of America v. Harlingen Consolidated Independent School District*, 2018 WL 7204025 (S.D. Tex. 11/2/18). In this case, Travelers bonded the general contractor and the School District was the obligee on a project to build a school. The project was deemed substantially complete, however, the School District identified $2,382,899 in unfinished work, the punch list was not completed and serious defective work had been discovered. Notwithstanding these circumstances, the School District, without the consent of the surety, released $1,238,493 in retainage, leaving only $100,000 in retainage. Thereafter, Travelers paid $272,730 in payment bond claims. Travelers contended that the School District breached the bond by releasing the retainage without its consent.

The Court found that the contract required the School District to obtain the consent of surety before releasing retainage. The Court further observed that a public entity-obligee may be fond liable for a surety's losses on a payment bond where the public entity fails to hold retainage as provided for under the bonded contract. The Court stated "The duty devolves upon the project owner to administer the contract during the course of its performance in a way that does not materially increase the risk that was assumed by the surety when the contract was bonded." This duty arises because in contracts for services that include payment in installments or upon completion, "unearned progress payments and retainage are security or collateral ensuring discharge of the obligations created by the underlying contract." The Court found that the School Districts release of retainage was a material breach and that Travelers had a cause of action for breach of the bond.

Numerous cases recognize these general principles of surety law. *Nat'l Sur. Corp. v. United States,* 118 F.3d 1542, 1546 (Fed. Cir. 1997), *citing U.S. Fid. & Guar. Co. v. United States,* 201 Ct.Cl. 1, 475 F.2d 1377, 1384 (1973); *Argonaut Ins. Co. v. United States,* 434 F.2d 1362, 1368, 193 Ct.Cl. 483 (1970)(the government has a duty to exercise its discretion with respect to the contract balance responsibly and to consider the surety's interest in the administration of the contract); *Balboa Ins. Co. v. U.S.*, 775 F.2d 1158, 1164 (Fed. Cir. 1985).

The doctrine of "impairment of suretyship" began as a defense that a surety could assert to avoid enforcement of its bond obligation on the grounds that the obligee had taken improper actions which prejudiced the surety by increasing its financial risk. One ground for discharge is when the obligee has prejudiced the surety by improperly overpaying the principal in a manner inconsistent with specific payment schedules, conditions, or retainage provisions in the bonded contract. Overpayments to the principal prematurely deplete the bonded contract fund to which the surety has a right of equitable subrogation in the event that the principal defaults and the surety is required to perform. Thus, by wasting the contract funds in contravention of the contract's terms, the obligee impairs the surety's future right of equitable subrogation and increases its risk of loss, thereby discharging it from its bond obligation pro tanto. *See, e.g., United States v. Cont'l Cas. Co.,* 512 F.2d 475, 478 (5th Cir. 1975) ("[A] surety is entitled to be subrogated to the benefit of all securities and means of payment under the [obligee's] control, and any act by the [obligee] depriving the surety of this right discharges it pro tanto.... [The obligee] ... must act in good faith and not unreasonably prejudice the surety's right to subrogation."); *Fort Worth Indep. Sch. Dist. v. Aetna Cas. & Sur. Co.,* 48 F.2d 1, 4 (5th Cir. 1931) (" It is well settled that a stipulation in a building contract that a percentage of the price shall be retained until the final completion and acceptance of the work, is as much for the benefit of the surety as for the protection of the [obligee], and a failure to comply therewith releases the former in so far as the rights of the latter are concerned.").

Over time, the doctrine has evolved to encompass not only a defense, but also an affirmative cause of action that allows a surety to seek damages from an obligee after performing its bond obligation despite having an impairment of suretyship defense. *See* Restatement (Third) of Suretyship and Guaranty § 37(4) ("If the obligee impairs the [surety's] suretyship status ... the [surety] has a claim against the obligee with respect to such performance to the extent that such impairment would have discharged the [surety] with respect to that performance."); *id.* cmt. a (noting that "this section and §§ 39– 44 provide rules discharging the [surety] from liability ... and providing for recovery from the obligee if the loss has already occurred because the [bond] obligation has been performed"). When a surety performs even though it would have had a right to withhold some amount of performance had it asserted a *pro tanto* discharge defense, the surety has effectively overpaid on its bond obligation. In such cases, "the [surety] is harmed and, but for [a cause of action to recover the excess amount paid], the obligee would receive a windfall." *Id.* at § 37(4) cmt. D; *see also RLI Ins. Co. v. Indian River School Dist.,* 556 F.Supp.2d 356, 363 -364 (D.Del. 2008)(*citing Nat'l Union Indem. Co. v. G.E. Bass & Co.,* 369 F.2d 75, 77 (5th Cir. 1966).

The takeaway is that in the right circumstances a surety may have a claim for breach of the bond against the obligee and this right should be explored.

**(JASON)**

The third case I'm going to discuss is *Colonial Surety Company v. New York Housing Authority*, (NYS 2018). In this case, the New York Housing Authority contracted with Pioneer Construction to perform restoration work at a 13-building development owned by the Housing Authority in Brooklyn. The contract value was roughly $4M. Colonial was the surety. The contract required the principal to complete the work by July 19, 2014. On February 20, 2014, roughly five months before the completion deadline, the Housing Authority declared the principal in default and made a claim upon the surety's performance bond to complete. The surety hired a completion contractor and timely completed the work for about $2 million.

After receiving final payment, the surety filed a claim with the Housing Authority as a result of the elimination of roughly half of the contract value. Often a surety will be ecstatic from a reduction in the contact sum because it may also reduce the cost to complete a defaulted project. Not here, in fact, the case indicates that the deletion of the work increased the surety's cost to complete. And, it sought an equitable adjustment from the obligee for these increased sums. Not surprisingly, the obligee refused, and the surety filed suit.

The Housing Authority filed a motion to dismiss, which the court granted. The Housing Authority argued first that the surety's claim was stale because it filed too late under the terms of the contract, and second that under the terms of the contract, it had to set aside the default before seeking any affirmative claims.

Notice

First, the Housing Authority argued that under the terms of the contract, the contractor (and thus the surety) had to submit notice of its claim within 20 days of the accrual of that claim. In this case, the surety submitted its notice of claim almost a year after it completed the project. However, the suety argued that the 20 days ran from the date of final payment, when it contends that the obligee only finally removed the additional work. The court rejected this argument, holding, in effect, that the surety should have known about the claim much earlier and that its failure to timely submit notice within 20 days barred the claim.

Equitable Adjustment

Second, with respect to the claim for equitable adjustment, the court agreed with the obligee. The contract stated that if the obligee found the principal to be in default, that determination precluded the principal from bringing a claim for damages unless the principal sought to overturn the default. Here, the bond incorporated the terms of the contract, so the surety was bound to the obligee under the contract in the same way as the principal was bound to the obligee. Therefore, to seek damages, the surety had to first set aside the principal's default, which it did not do. Therefore, it could not bring its claim for damages.

The takeaway here is two-fold. First, I've harped a couple of times on the importance of Reading the Friendly Bond. Perhaps just as important is the old Maxim that I am now making up – Read the Subcontract Too – RTST. We all know that the subcontract will not always be incorporated by reference into the bond and we all know that, depending on your jurisdiction, it may have a different impact even if it is incorporated by reference. However, in my experience, the subcontracts can often be overlooked as a sword in addition to a shield. For example, the surety should review the subcontract carefully to make sure the obligee did everything it was supposed to do prior to terminating the bond principal. If it didn't, that may excuse the surety's performance completely.

The second takeaway is to make sure you are communicating with your obligee. The facts of this case are not clear as to why the surety believed the claim did not begin until final payment. However, the court clearly believed that the surety should have known earlier. Even if all of the facts are not yet known, if there is enough to put the surety on notice of a claim, that may be enough to trigger a notice deadline. If so, communicating with the obligee becomes critical to inform the obligee of that claim – even if all of the facts surrounding it are not yet known.

**[BONUS MATERIAL THAT WAS NOT DISCUSSED DURING THE PRESENTATION]**

**(MIKE)**

The next case I will discuss is the case of *Liberty Mutual Ins. Co. v. SBN V FNBC, LLC*, 5:17-CV-82-BO, 2019 WL 346707 (E.D. NC 1/28/19). Liberty bonded 48 projects for DeVere

Construction Company in various jurisdictions around the country. A lender provided loans to DeVere for its operations and the lender obtained a security interest on all accounts receivable and general intangibles. DeVere abandoned the bonded projects forcing Liberty to complete performance and pay subs and suppliers. Ultimately, Liberty obtained a judgment against DeVere and its indemnitors for $23,274,628. DeVere's lender was also owed $14,089,911 under its loans.

On five of the bonded projects the contract receivables exceeded Liberty's losses on those projects in the total amount of $865,537. It is these excess receivables that were in dispute in the case because both Liberty and the lender claimed a priority interest in the excess receivables. Accordingly, Liberty initiated a declaratory judgment action against the lender seeking a declaration that Liberty had a priority interest in the contract receivables. Liberty sought summary judgment arguing that it was entitled to the receivables under its equitable subrogation rights to assert the owner's right to set off. The lender contended that its perfected security interest had priority over Liberty.

Liberty only sought to recover on the projects where there were common obligees. Thus, Liberty only sought to recover on projects where Liberty had incurred a loss and the owner of that project was also the owner of a project on which there were excess contract funds. Liberty's approach is known as the Common Obligee Theory of recovery. The North Carolina District Court denied Liberty's motion and held that Liberty may not use its equitable right of subrogation to overcome the lender's perfected security interest, as each bonded project must be treated separately. The Court observed that the Fourth Circuit had never recognized the right of a surety to use set off rights obtained through subrogation to defeat a secured creditor. The Court also pointed to Fourth Circuit cases purportedly holding that subrogation is limited to the specific bond from which it arose. The Court brushed aside the fact that the Fourth Circuit cases cited did not involve a project owner's set off rights and one of the cases was decided under Ohio law. The Court believed that the lender's secured right was stronger that Liberty's subrogated rights of set off, in the absence of clear Fourth Circuit authority.

The "Common Obligee" theory that was rejected in this case has been adopted by many other courts. 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 and including the Obligee's right of set off. Set off of course is a common law right that is frequently memorialized in contracts. 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 – 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

Courts that have recognized and allowed the common obligee theory 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). 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. 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 Obligee Theory and Other Setoff Rights – The Surety's Subrogation Rights to the Obligee's or Principal's Setoff Rights.*

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.