FINANCING THE PRINCIPAL – A GUIDE TO UNDERSTANDING THE MOST MALIGNED SURETY PERFORMANCE OPTION

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I. INTRODUCTION

Upon the default of a bonded principal, the surety is faced with several options to choose from to respond to that default. The surety can finance the principal to cure the default or to complete, takeover and complete the bonded project with or without the principal, tender a completion contractor to the obligee with payment of any cost differential, buy out the bond or contest liability. The option that we will focus on in this article is the surety's right to finance the principal.

Many in the industry have strong views on financing as an option to address a principal's default. Indeed, some surety claims handlers assert that they will never finance. Commentators have shared their views on financing as well. One article referred to financing as "the most controversial and most maligned of the completion options available to the performance bond surety." [1] The authors stated that financing is "a danger-filled mine field which can lead to disaster."[2] Another commentator observed that "[f]inancing is always a potentially dangerous course of action."[3] Notwithstanding such views, financing can be a viable option for a surety to pursue in the right circumstances, with proper analysis and proper implementation.

This article will focus on the circumstances, analysis and implementation necessary for a successful financing. If a surety is going to finance it must know and understand its risks and work to minimize those risks throughout the financing process. Typical risks associated with financing include:

(1) That the surety's financing of the principal will not be recognized as performance under the performance bond by the obligee and that the penal sum of the bond will not be reduced by the amounts paid by the surety.
(2) That the surety may not be deemed to be a performing surety under the performance bond and may not obtain its rights to equitable subrogation.
(3) That the surety will be viewed as being in "control" of the principal which could lead to exposure for certain taxes or other claims.
(4) That the surety may not be deemed to be a performing surety under the performance bond and may jeopardize its indemnity rights.

[1] Thomas A. Joyce and William F. Haug, *Financing the Contractor,* BOND DEFAULT MANUAL (Richard S. Wisner ed., 1987).
[2] *Id.*
[3] Gilbert J. Schroeder, *Procedures and Instruments Utilized to Protect the Surety Who Finances a Contractor,* 14 Forum 830, 868 (1979).

These risks and others can be managed or even eliminated through a proper financing process.

II. THE SURETY'S FINANCING OF THE PRINCIPAL AS THE SURETY'S PERFORMANCE UNDER THE PERFORMANCE BOND

Before the surety makes the decision to directly finance the principal, the surety must determine whether it has the legal right in the first instance to perform its obligations under the bond in that manner. The surety must consider its ability and right to finance the principal, both as between the surety and the principal and as between the surety and the obligee. Under the common law there is no general right, duty or obligation for a surety to provide financing or funding to its principal.[4] Instead, the surety must look to the terms of its Indemnity Agreement or performance bond, or any applicable rules, statutes or regulations and, failing any express rights, seek a consensual agreement.

A. The Indemnity Agreement

Indemnity Agreements generally provide a surety with a broad spectrum of rights when the principal is in default under a bonded contract or in breach of the Indemnity Agreement. While Indemnity Agreements vary among surety companies and have varied over time, most typical Indemnity Agreements will contain provisions that permit, but do not obligate, the surety to finance the principal or otherwise provide funding.[5] A typical Indemnity Agreement might provide:

> In the event of Default, as defined above, Surety at its sole and absolute discretion is authorized by the Undersigned . . . To make or guarantee advances or loans in the Surety's sole and absolute discretion in connection with any Contract, without any obligation or responsibility as to the application thereof, it being expressly understood and agreed that the amount of all such advances or loans shall be

[4] *Fid. & Dep. Co. of Md. v. Douglas Asphalt Co.*, No. CV507-42, 2008 WL 5351039, at *9 (S.D. Ga. Dec. 22, 2008), *aff'd* 338 Fed. Appx. 886 (11th Cir. 2009) (holding that the surety had no duty to fund or otherwise permit a defaulted principal to participate in the takeover of a project absent a requirement in the indemnity agreement); *Granite Computer Leasing Corp. v. Travelers Indem. Corp.*, 582 F. Supp. 1279 (S.D.N.Y. 1984), *rev'd on other grounds*, 751 F.2d 543 (2d Cir. 1984) (no legal support for proposition that surety is obligated to finance its principal); *see also Lambert v. Md. Cas. Co.*, 403 So. 2d 739 (La. Ct. App. 1981), *aff'd*, 418 So. 2d 553 (La. 1982) (surety acted reasonably in withdrawing agreement to finance principal which surety reasonably believed was in a financially hopeless condition); *Safeco Ins. Co. of Am. v. Mountaineer Grading Co*., No. 2:10-cv-01301, 2012 WL 830158 (S.D.W.V. March 9, 2012) (rejecting the indemnitor's argument that the surety breached the covenant of good faith and fair dealing when surety provided initial round of financing it had agreed to but refused to provide anyfurther financing because the indemnity agreement did not require the surety to finance the principal); *but see Safeco Ins. Co. v. Siciliano, Inc*., No. 06-3162, 2009 WL 212081 (C.D. Ill. Jan. 29, 2009) (court denied surety's summary judgment motion based upon principal's allegation that surety acted in bad faith by promising to finance the principal without an intention to do so in order to induce the principal to sign voluntary default letters that surety used to seize control of the projects and obtain the bonded contract funds).

[5] *See* The Surety's Indemnity Agreement - Law & Practice 360-362, 425 (Marilyn Klinger, George J. Bachrach & Tracey L. Haley eds., Am. Bar Ass'n, 2d ed. 2008); Richard E. Towle, Sam H. Poteet, Jr., and Jeffrey S. Price, *Surety's Rights Under the General Indemnity Agreement to Minimize Loss, in* The Law of Performance Bonds 317-319 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009).

> conclusively presumed to be a loss hereunder for which the Undersigned is liable irrespective of the prospects for repayment thereof or the security therefore.

Another example of a standard Indemnity Agreement financing provision provides:

> The Company, at its sole election and discretion, is authorized and empowered, but not obligated, to advance or loan to the Contractor any money which the Company may see fit to advance to the Contractor in any form whatsoever, and to guarantee repayment of any loans made by others, but in no event, shall the Company be obligated to use either its own funds, or collateral provided by the Contractor (or a third party) to fund the Contractor (or any designee or assignee of the Contractor) to complete any contract. All money so loaned, advanced or guaranteed, as well as all costs, attorneys' fees and expenses incurred by the Company in connection with such loans, advances or guarantees, unless repaid with legal interest by the Contractor shall be a loss by the Company for which the Undersigned shall be responsible. The Undersigned hereby waive all notice of such loan, advance or guarantee. or of any default or any other act or acts giving rise to any claim under any such Bond, and waive notice of any and all liability of the Company under any such Bond or any and all liability on the part of the Undersigned to the effect and end that the Undersigned shall be and continue to be liable to the Company hereunder in spite of any notice of any kind to which the Undersigned might have been entitled and in spite of any defenses which the Undersigned might have been entitled to make.

If the surety's Indemnity Agreement contains similar provisions, the surety may advance or lend money to the principal, with such advances being conclusively deemed to be a loss to the surety for which the principal and the indemnitors are liable to reimburse the surety.[6]

B. **The Performance Bond**

In considering whether to provide financing to the principal, the surety must read the performance bond to see if there are any terms that may permit, prohibit, limit or condition the surety's right or ability to finance. Moreover, the fact that the Indemnity Agreement may authorize the surety to finance the principal does not mean that the obligee must accept performance of the bonded contract by the surety financing the principal. Thus, as an initial matter, the surety must review the performance bond and any governing statutes and/or regulations to determine whether financing the principal is an acceptable method for the surety to satisfy its performance bond obligations.

Some manuscript performance bond forms provide the right of the surety to perform by financing the principal. For example, a national general contractor's performance bond form provides:

[6] Notwithstanding the surety's right to advance or lend money to the principal in the Indemnity Agreement, the surety should review any co-surety agreements and reinsurance treaties to determine whether the surety requires prior approval by the co-sureties or the reinsurers before the surety commits to financing its principal.

> In the event Subcontractor shall require financing assistance to complete the Subcontract Work, the Surety may finance Subcontractor to completion of its Subcontract Work. Direct reasonable Project-related completion costs financed by the Surety and not refunded to Surety by Subcontractor, excluding interest expenses and other administrative expenses, shall reduce the penal sum of this Bond. The foregoing shall be subject to the prior written approval of the Obligee of the financing and the financing plan, as well as any deviations from the original financing plan.

While this performance bond provision expressly permits financing and recognizes a reduction of the penal sum, it also limits the right and requires advance approval. Obviously, compliance with a bond form's specific terms regarding financing is critical to successfully minimizing the surety's risks. More typically, the performance bond form will not specifically mention a right to finance, but will generally and broadly provide that the surety "may cure the default of the Principal." This right to "cure the default" is a broad enough right for the surety to argue that financing is a permissible method of performance under the terms of such bonds.

1. Miller Act Performance Bond

Neither the Miller Act nor the standard Miller Act performance bond form address the issue of whether a surety may perform by financing the principal after default. In addition, the Federal Acquisition Regulations (FAR) do not specifically address financing.[7] However, federal case law clearly provides that the surety's financing of its principal constitutes performance under the Miller Act.[8] In *Morgenthau v. Fidelity & Deposit Co. of Maryland*, 94 F.2d 632, 635 (D.C. Cir. 1937), the Circuit Court for the District of Columbia observed that a surety that provides financing is a performing surety to the same extent as a surety that takes over and completes the performance of the bonded contract work.[9] The *Morgenthau* Court stated that "[c]ertainly there can be no real difference between the completion of the work by the surety, as was done in the *Prairie Bank* Case, and the furnishing of the money to the contractor after his default - as was the case here - to enable him to perform the contract."[10]

Similarly, in *Aetna Casualty & Surety Co. v. United States*, 845 F.2d 971 (Fed. Cir. 1988), the Federal Circuit Court held that a surety that provides financing is a performing surety under a Miller Act performance bond.[11] The *Aetna* Court stated that:

[7] 48 CFR 49.404, entitled "Surety – Takeover Agreements" provides that "[s]ince the surety is liable for damages resulting from the contractor's default, the surety has certain rights and interests in the completion of the contract work and application of any undisbursed funds. Therefore, the contracting officer must consider carefully the surety's proposals for completing the contract. The contracting officer must take action on the basis of the Government's interest, including the possible effect upon the Government's rights against the surety." 48 CFR 49.404(b).

[8] *See Aetna Cas. and Sur. Co. v. United States*, 845 F.2d 971 (Fed. Cir. 1988); *Morrison Assurance Co., Inc. v. United States*, 3 Cl. Ct. 626 (1983); *Great American Ins. Co. v. United States*, 841 F.2d 1298, 1300 n.8 (Ct. Cl. 1973); *Admiralty Const., Inc. by Nat. Amer. Ins. Co. v. Dalton*, 156 F.3d 1217, 1222 (Fed. Cir. 1998); *Westchester Fire Ins. Co. v U.S.*, 52 Fed. Cl. 567, 574-75 (2002); *Insurance Co. of the West v. U.S.*, 243 F.3d 1367, 1370 (Fed. Cir. 2001); *Colonial Sur. Co. v. U.S.*, 108 Fed. Cl. 622 (2013); *Morgenthau*, 94 F.2d at 635.

[9] *Id.*

[10] *Id.*

[11] *Aetna Casualty*, 845 F.2d at 975.

> A performance bond gives the surety the option of completing performance or of assuming liability for the Government's costs in completing the contract which are in excess of the contract price. *Security Insurance Co. v. United States,* 428 F.2d at 841 n. 6. Neither formal termination of the contract by the Government nor execution of a take-over agreement by the surety is necessary in order for a surety to qualify as a performing surety. *Id.* at 839, 843. Thus, a performing surety may satisfy its obligation in various ways. For example, the surety may formally take over the project and contract for its completion, or it may allow the project to be defaulted and let the government complete or contract for the completion of the project, in which case the surety is responsible for costs in excess of the contract price. A performing surety may also satisfy its obligation by providing funds to an insolvent contractor to complete performance.

Aetna Cas. & Sur. Co., 845 F.2d at 975.

2. AIA A311 Performance Bond (1970 Ed.)

The A311 performance bond does not expressly identify financing as a surety's performance option in the event of the principal's default. The A311 performance bond provides in relevant part:

> Whenever Contractor shall be, and declared by Owner to be in default under the Contract, the Owner having performed Owner's obligations thereunder, the Surety may promptly remedy the default, or shall promptly
>
> (1) Complete the Contract in accordance with its terms and conditions, or
>
> (2) Obtain a bid or bids for completing the Contract . . .

The broad terms "promptly remedy the default" and promptly "complete the Contract in accordance with its terms and conditions" have been construed as authorizing the surety's financing of the principal as the surety's performance under the A311 performance bond.[12] In *Balfour Beatty Const., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82, 85–86 (D. Conn. 1997), the court observed that under an A311 performance bond, a surety has the option upon its principal's default to fund the principal to complete its work.[13]

3. AIA A312 Performance Bond (1984 Ed.) and (2010 Ed.)

As with the A311 performance bond, the A312 performance bond does not expressly reference the surety's financing of the principal as one of the surety's performance options.

[12] *See Fid. & Dep. Co. of Md. v. Casey Indus., Inc.*, 2014 WL 1096355, *16 n. 8 (D. Neb. 2014); *Balfour Beatty Const., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F.Supp. 82, 85-86 (D. Conn. 1997)(recognizing that surety may satisfy its completion obligation by funding the principal to complete its work under an A311 Performance Bond.); *Cooper Ind., Inc. v. Tarmac Roofing Sys., Inc.*, 276 F.3d 704 (5th Cir. 2002).

[13] *Balfour Beatty Const.*, 986 F. Supp.at 85–86 (*citing Granite Comp. Leasing Corp. v. The Travelers Ind. Co.*, 894 F.2d 547 (2d Cir. 1990)).

Rather, the A312 (1984) provides[14]:

> 4.1 Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract; . . .

Courts have recognized that the language of the A312 is broad enough to encompass financing the principal as the surety's performance.[15] In *St. Paul Fire & Marine Ins. Co. v. VDE Corp.*, 603 F.3d 119 (1st Cir. 2010), the court recognized that under paragraph 4.1 of the A312 performance bond, the surety can elect to complete the contract by financing the principal. The court stated "a surety electing to proceed under Paragraph 4.1 must *arrange for* the original contractor to perform and complete the construction contract with the owner's consent, by financing the original contractor's continuing performance. (citation omitted). Under this provision, the surety 'does not assume primary responsibility for completing the contract, and the owner is required to maintain an ongoing contractual relationship with the terminated contractor.'"[16]

As noted, a limiting feature of the A312 performance bond, paragraph 4.1 (1984 Ed.) and section 5.1 (2010 Ed.) performance option is the express requirement that the obligee consent to the completion of the bonded contract through the surety's use of the principal (the "Contractor").

There are numerous performance bond forms and manuscript bonds, especially those drafted by general contractors. Therefore, a complete review of the other performance bond forms is impractical and beyond the scope of this article. In the event of a potential or actual default the surety's option to finance must be reviewed on a bond by bond basis under the laws and statutes of the applicable jurisdiction. If the performance bond is silent, like the Miller Act performance bond form, then the cases that support the surety's financing of the principal as a performance bond option in the federal government context may be applicable to provide authority for the surety's financing option for performance bonds with similar language, including under the various Little Miller Acts, which are typically modeled on the Miller Act.

C. Financing the Principal Prior to a Declaration of Default

In some circumstances a surety may need to consider whether to provide financing when the principal has not been declared in default by the obligee. Quite naturally, the surety will be concerned that if it provides financing to the principal prior to a declaration of default such surety financing may be deemed to be the surety's acting as a "volunteer" and potentially losing its subrogation rights or any credit against the penal sum of the performance bond that it might otherwise have had if the financing was provided after an obligee declaration of default and/or

[14] The AIA A312 Performance Bond (2010 Ed.) has the same language in section 5.1 as the AIA A312 Performance Bond (1984 Ed.) has in paragraph 4.1.

[15] *See St. Paul Fire & Marine Ins. Co.,* 603 F.3d at 124; *Fid. & Dep. Co. of Md., supra* at *16 n. 8 ("The AIA A312 performance bond also allows a contractor to perform and complete the construction contract with financing from the surety . . . "); Richard S. Wisner & James A. Knox, Jr., *The ABCs of Contractors' Surety Bonds,* 82 Ill. B.J. 244, 245-246 (1994); 4A Philip L. Bruner & Patrick J. O'Connor, Bruner & O'Conner on Construction Law § 12:16 (2014); *See,* Charles W. Langfitt, Bennett J. Lee and Robert C. Niesley, *Performance Bond Options Available to the Surety, in* The Law of Performance Bonds 116-120 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009).

[16] *St. Paul Fire & Marine Ins. Co.*, 603 F.3d at 124.

with the knowledge and consent of the obligee. Research suggests that any determination of whether the surety could be considered to be a volunteer if it finances before a default declaration depends on a number of factors and a variety of considerations. Central to understanding the issues are the considerations of: (1) how a volunteer is defined; (2) what are the equities of the situation; and (3) what are the terms of the applicable performance bond or other agreements, statutes, rules or regulations.

There is a large body of case law that provides that a formal declaration of default is *not* required for a surety to be entitled to perform under its performance bond by financing the principal.[17] In *Royal Indemnity Co. v. United States*, 371 F.2d 462, 178 Ct.Cl. 46 (1967), the Court stated, "[n]o formal declaration of default is required." All that is necessary for the surety to prevail is that as a result of the principal's default, the surety has become obligated to pay under its bond.[18] Similarly, in *Massachusetts Bonding & Insurance Co. v. New York*, 259 F.2d 33 (2d Cir. 1958) the court held that the surety was a completing surety for purposes of asserting its subrogation rights when the surety financed a principal and no formal declaration of default was made. In rejecting an argument that the surety had no rights in the bonded contract funds, the Court observed "to analyze these facts so as to deprive the surety of its claim based on subrogation when it actually provided $136,000 of its own money to pay laborers and materialmen is too technical to warrant serious consideration."[19] Further, in *Aetna Casualty & Surety Co., supra.*, the Court observed "[n]either formal termination of the contract by the Government nor execution of a take-over agreement by the surety is necessary in order for a surety to qualify as a performing surety."[20] As is generally recognized, "[t]he doctrine of subrogation includes every instance in which one person pays a debt for which another is primarily liable, and which in equity and good conscience should have been discharged by the latter, so long as the payment was made under compulsion or for the protection of some interest of the one making the payment and in discharge of an existing liability."[21]

In *In re Ram Const. Co., Inc.*, 32 B.R. 758 (Bankr. W.D. Pa. 1983), the principal's lender argued that because there was no formal declaration of default, the financing surety's subrogation rights in the bonded contract funds were inferior to the bank's perfected security interest rights. The *Ram* Court ruled that the surety had priority to the bonded contract funds, observed that the bank's position sought to elevate formality over substance, and stated "[w]hether a formal default has been declared is arguing about angels on the head of a pin."[22]

[17] *See Great Am., supra.*; *Lacy v. Md. Cas. Co.*, 32 F.2d 48 (4th Cir. 1929); *Ind. Ins. Co. v. Lane Constr. Corp.*, 227 F. Supp 143, 148 (D. Neb. 1964); *Fid. and Dep. Co. of Md. v. United States*, 183 Ct.Cl. 908, 393 F.2d 834, 837 (1968); *Ins. Co. of the West, supra.*; *Morganthau, supra.; Aetna Cas. & Sur. Co., supra.; First Ala. Bank v. Hartford Acc. & Ind. Co.*, 430 F.Supp. 907, 911 (N.D. Ala. 1977); *Travelers Ind. Co. v. West Georgia Nat'l Bank,* 387 F. Supp. 1090, 1094 (N.D. Ga. 1974); *In re: Ram Construction*, 32 B.R. at 759; *Morrison, supra.; Royal Ind. Co.,* 371 F.2d at 464.

[18] *Id.,* 371 F.2d at 464.

[19] *Id., 259 F.2d* at 37-38.

[20] *Aetna Cas. & Sur. Co.,* 845 F.2d at 975.

[21] *Cagle, Inc. v. Sammons,* 254 N.W.2d 398, 403 (Neb. 1977) *(quoting Sheridan v. Dudden Implement, Inc.,* 119 N.W.2d 64 (Neb. 1962)).

[22] *Id.* 32 B.R. at 760.

1. The Requirement of "Actual Default"

The primary factor guiding the courts in concluding that a formal declaration of default is *not* required for a financing surety to be considered a performing surety and for the surety to be entitled to assert its subrogation rights to the bonded contract funds is that the principal be in "actual default."[23] In *Great American Ins. Co. v. United States.,* 481 F.2d 1298, 1308 (1973), the Court stated that "[i]t is not necessary that there be a formal declaration of the contractor's default. All that is necessary for the surety to prevail is that the contractor be in default as a matter of fact."[24]

A default exists when the principal is financially unable to perform its bonded contract.[25] The courts reason that because the principal is in default and unable to perform the bonded contract, the surety's financing of the principal to complete the performance of the bonded contract work is performance that the surety is obligated to provide under the terms of the performance bond. The existence of an actual principal default is also the basis for concluding that the surety is not acting as a volunteer.

The surety should exercise caution in generalizing or broadly relying on the body of case law holding that a declaration of default is not required for several reasons. A majority of the case law arises in the context of federal government bonded projects under the Miller Act. As noted above, the Miller Act performance bond, the Miller Act itself and the FAR do not have any language or terms that expressly require a declaration of default. Thus, the case law arising out of any Miller Act circumstances may not be persuasive in non-Miller Act situations or when the performance bond language addresses the issue of a declaration of a principal's default such as in the A311 performance bond and the A312 performance bond.

Further, close analysis of the cases addressing the lack of a declared default reveals that several such cases involve circumstances when the obligee was on notice of the surety's financing.[26] For example, the principal may have provided the obligee with a letter of direction stating that the surety is to receive future payments of the bonded contract funds, or an assignment of future payments to the surety was provided. In some cases, the principal issued a voluntary letter of default. While no default was formally declared by the obligee, in those cases when the obligee was on notice of the surety's financing of the principal, it could be argued that under the circumstances there was an obligee's de facto declaration of default or consent. Thus, the cases where the obligee had actual notice or knowledge of the surety's financing of the principal may be distinguishable from those circumstances when there was no obligee knowledge or consent.[27]

[23] *Colonial Sur. Co. v. U.S.*, 108 Fed. Cl. 622 (2013); *Great American Ins. Co.*, 481 F.2d at 1308; *Fid. & Dep. Co.,* 393 F.2d at 837; *Fischer Const. Co. v. Fireman's Fund Ins. Co.,* 420 F.2d 271, 276 (10th Cir. 1969); *First Ala. Bank,* 430 F. Supp. at 911; *Travelers Ind. Co. v. West Georgia Nat'l Bank,* 387 F. Supp. 1090 (N.D. Ga. 1974)*; Royal Indem. Co.,* 371 F.2d at 464.

[24] *Id., quoting Fid. & Dep. Co.,* 393 F.2d at 837.

[25] *Fischer Const. Co.,* 420 F.2d at 276.

[26] *Lacy, supra.*(letter of direction given to obligee)*; Kansas City, Mo. v. Tri-City Const. Co.,* 666 F. Supp. 170 (W.D. Mo. 1987); *Mass. Bonding & Ins. Co. v. Fago Const. Co.,* 82 F.Supp. 619 (D. Md. 1949); *USF&G v. Missouri Highway,* 738 S.W.2d 516 (Mo. App. 1990).

[27] It should be noted that even when there was some form of notice or knowledge on the part of the obligee, the courts in those cases did not specifically cite to such notice or knowledge as a basis for their analysis. One

2. Volunteer

In *Lacy v. Maryland Casualty Co.*, 32 F.2d 48 (4th Cir. 1929), the surety provided financing before any formal declaration of default. In response to an argument that the surety had no rights to the bonded contract funds, the Court observed that "there can be no question that the company did this [provided financing], not as a volunteer, but because of legal necessity, i.e., because it had guaranteed the performance of the contract and the contractor was financially unable to perform it."[28] The *Lacy* Court stated "[b]eing compelled because of its contract to advance money to prevent a breach of the contract of the principal, the surety is in no different position, we think, from what it would occupy if it had made the advancement after breach or had performed the contract itself. It is the payment under necessity because of the contract of suretyship, and not the breach of the principal's contract, which entitles the surety to subrogation."[29] It has been recognized that when one acts under compulsion or to protect its own interests and property, they are not thereby a volunteer.[30]

The voluntary payment defense is a narrow exception to the principles of subrogation and is necessarily limited to those rare cases where payment is truly voluntary, or what some courts call "intermeddling."[31] "Generally, the party making payment is a volunteer if, in so doing, he has no right or interest of his own to protect, and acts without obligation, moral or legal, and without being requested by anyone liable on the obligation."[32]

3. The Issue With A311 and A312 Bond Forms

An interesting issue arises where the performance bond has conditions precedent that must be satisfied before the surety has any obligation under the bond. If the conditions precedent include the condition that a default be declared and/or a termination occur, can the surety finance before such conditions are satisfied? Unfortunately, there are very few cases that address this issue. As noted above, the A311 performance bond requires that the principal not only be in default, but that the obligee actually declare the principal to be in default. Similarly, the A312 performance bond has a number of conditions that, according to the terms of that bond, must be satisfied before the surety's obligations arise under the A312 performance bond. Courts have routinely observed that the conditions of the A311 performance bond and the A312 performance bond are conditions

commentator has noted that "[t]here does not appear to be any case law requiring that the obligee actually know that the principal is in default or consent to the surety's financing of the principal in order for the surety's subrogation rights to arise." *See* Carol Z. Smith, *The Necessity of the Principal's Default, in* THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 195 (George J. Bachrach, James D. Ferrucci & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

[28] *Id.* at 53 (clarification added).

[29] *Id.*

[30] *Fid. & Dep. Co. of Md.*, 2014 WL 1096355 ("The doctrine [also] applies where a party is compelled to pay the debt of a third person to protect his own rights or interest, or to save his own property.").

[31] *Local Gov't Prop. Ins. Fund,* 2009 WL 2392140, at *2.

[32] *Id.* (quoting *Blackford v. Dickey,* 302 Ark. 261, 266, 789 S.W.2d 445 (1990). *See,* David W. Slaughter, *The Necessity of the Surety's Performance, in* The Contract Bond Surety's Subrogation Rights 210-216 (George J. Bachrach, James D. Ferrucci & Dennis J. Bartlett eds., Am. Bar Ass'n 2013) for a discussion of the fact that the surety's performance under its bonds must be made in discharge of the surety's legal obligations under the bonds in order for the surety to assert its subrogation rights to the bonded contract funds.

precedent, and, if those conditions precedent are not satisfied, the surety may be discharged and/or has no obligation to perform.

In the circumstance when the surety has no obligation under the performance bond because the conditions have not been satisfied, the question of whether the surety is a volunteer would appear to be a closer issue. In *Liberty Mutual Ins. Co. v. Construction Management Services*, 2004 WL 2271811 (N.D. Ill. 2004), the principal was financially unable to complete the performance of the work on the bonded contract. The surety agreed to finance the principal and a voluntary letter of default was issued to the obligee along with a letter of direction providing that the bonded contract funds were to be paid to the surety. With the surety's financing, the principal completed the bonded contract. Despite the letter of direction, the obligee sent the bonded contract funds to the principal. The surety sued the obligee asserting its subrogation rights to recover the bonded contract funds paid to principal. In its motion to dismiss, the obligee argued that only the obligee could declare a default under terms of the A311 performance bond and that such a declaration of default was a condition precedent to the surety's liability under the A311 performance bond. Therefore, the obligee contended that the surety was not legally compelled to act when it financed the principal and thus had no subrogation rights to the bonded contract funds.

The *Liberty* Court held that the A311 performance bond was clear on its face that an obligee declaration of default was required before the surety had any obligation under that bond. The *Liberty* Court referred to the L&A Contracting line of cases for the proposition that the obligee must declare a default before the surety's contractual duties are triggered under the terms of the A311 performance bond. The *Liberty* Court distinguished the *Lacy* case relied upon by the surety for the proposition that a declaration of default is not required, because that case did not have the same bond language as the A311 performance bond requiring a declaration of default. The *Liberty* Court held that notwithstanding the "informal default" declared by the principal, because the obligee did not declare a default, the surety was not entitled to step into the shoes of the principal and was not entitled to the bonded contract funds under the bonded contract.

However, the Court's analysis in *Liberty* did not address the concept of waiver. As the *Liberty* Court noted, there are numerous cases holding that an obligee's failure to satisfy the conditions precedent of an A311 performance bond or an A312 performance bond discharges or releases the surety from any liability under the bond. It may seem incongruous on the one hand for a surety to assert that if the conditions precedent for an obligee to make a claim under a performance bond such as an A311 performance bond or an A312 performance bond are not met, the surety is discharged, but, on the other hand, even if the conditions precedent are not met, the surety may still perform by financing the principal and yet avoid being considered a volunteer for the purposes of asserting its subrogation rights.

The justification for such a result may be found in the doctrine of waiver. The conditions precedent in the A312 performance bond (1984 Ed.), for example, requiring a notice and a meeting, the obligee to declare that the principal is in default and to formally terminate the principal's right to complete the performance of the bonded contract, and the obligee to agree to pay the remaining bonded contract funds to the surety (or a completion contractor) in accordance with the terms of the bonded contract, exist in the A312 performance bond (1984 Ed.), for the protection of the principal and the surety. As a general matter of contract law, the surety and the principal may waive those protections. Under contract law, upon waiver of the conditions precedent, the waiving party's obligation to perform becomes unconditional and performance of the duty originally undertaken becomes due. Moreover, when the waiver results in the satisfaction of the purpose of the performance bond, i.e., completing the performance of the work on the bonded project, the obligee is the beneficiary and should not be heard to claim that the surety was a volunteer by taking the actions that it did to perform, such as financing the principal.

Finally, in analyzing the issue, it should be noted that when the surety's financing of the principal occurs before an obligee's formal declaration of default, the principal is generally actually in default as a matter of fact, and the surety and principal are attempting to avoid a formal obligee declaration of default and termination by financing so that the principal may continue to perform and complete the bonded project. Thus, requiring the surety to delay financing until after a formal obligee declaration of default and termination of the principal, elevates form over substance, delays what may become the inevitable result of the principal's actual default, and compounds the damage that may result to the obligee, the principal and the surety. Accordingly, it may be argued that the surety's action in financing the principal after an actual principal default but before an obligee declaration of default constitutes the surety's mitigation of damages. Under such circumstances, the surety's waiver of the conditions precedent in a performance bond such as the A312 performance bond, should not make the surety a mere volunteer with respect to the obligee and the surety's subrogation rights to the bonded contract funds.

A different circumstance may exist when the conditions precedent in the performance bond are for the obligee's benefit. For example, under the A312 performance bond, before the surety may exercise its performance option under paragraph 4.1 or section 5.1 (the surety's financing of the principal option), the surety must obtain the obligee's consent. Without the waiver of that condition by the obligee or its consent, a surety may not be able to finance the principal as a performance bond option after the principal's default and termination is declared by the obligee. However, it may be argued that the obligee's consent is only required after the obligee's declaration of default and termination of the principal's bonded contract. If the surety decides to waive the obligee's declaration of default and termination of the principal and is financing the principal on the basis of the principal's actual default, the surety may argue that the same waiver and mitigation of damages analysis discussed above should apply.

There is simply not enough development of the issues through case law to fully analyze the issue of whether a surety may finance the principal under an A311 performance bond or an A312 performance bond prior to an obligee declaration of default and satisfaction of the conditions precedent in both of those performance bonds. In the absence of clear case law authority, the surety faced with the decision of whether or not to finance the principal's performance of the work on a bonded contract should consider whether it should do so only with the knowledge and consent of the obligee and principal consistent with the terms of the relevant performance bond.

D. The Financing Surety as a Performing Surety – What Does the Surety Have to Pay and When in Order to Become a Performing Surety?

The sparse case law on the surety's financing of the principal rarely addresses in any detail the issue of what funding or payments the surety must make in order to constitute the performing surety's financing of the principal. The cases refer generally to funding from the surety to allow the principal to complete the bonded project and to pay the principal's subcontractors and suppliers. However, there is generally little discussion of the payment of field office overhead, home office overhead, apportionment of insurance costs, owned equipment costs (maintenance, fuel, tires, replacement parts, etc.) and other expenses that are spread over all of the principal's projects, bonded and/or non-bonded. In *Aetna Casualty & Surety Company v. United States, supra.,* the surety provided financing to fund the principal's "operations" under the bonded contracts.[33] The *Aetna* Court observed that not all funds provided to a principal would constitute the surety's performance and that the nature and extent of the surety's financing of the principal must be examined. The surety in *Aetna* paid its principal's subcontractors and suppliers as well as the principal's "current taxes, insurance and overhead." The Court noted that federal taxes were expressly part of the performance bond obligation under the Miller Act and that the "nature and extent of the financing in this case establishes that Aetna was acting as a performance surety."[34]

If the surety seeks an agreement with the obligee concerning the surety exercising its financing of the principal rights under the performance bond, the scope and application of the surety's payments to be made as part of the financing should be a part of the discussions and should be memorialized in any resulting obligee and surety consent and agreement. The surety and the principal will also need to reach an agreement as to what the surety will fund and pay as part of the financing agreement. Finally, there is the question of whether the payments made as part of the surety's financing of the principal may be applied to the performance bond or the payment bond, especially when the payments are to the principal's subcontractors, laborers and suppliers, which are categories of payments that may fall under either the performance bond or payment bond depending on the timing, the nature and the purpose of the payments. This issue mainly arises in the context of a surety asserting its subrogation rights to the bonded contract fund as a performing surety, and the parties contesting the surety's subrogation rights contending that the surety is a paying surety and not a performing surety.

In *Aetna Casualty & Surety Company, supra.,* the Court analyzed whether the payments that were made by the surety to the principal's subcontractors and suppliers were part of the surety's payment or performance obligation.[35] The Court stated "whether a surety is a performing or paying surety must be determined by an objective analysis of all the facts and circumstances of the particular case."[36] The Court looked to a number of factors, including the fact that the surety paid more than its payment bond obligation. The Court observed that payments to subcontractors and suppliers would have ceased once the penal limit of the payment bond was reached if the surety was simply satisfying its payment bond obligations. The Court further noted that the payments for the subcontractors and suppliers were initially made by the surety to the principal

[33] 845 F.2d 971 (Fed. Cir. 1988).

[34] 845 F.2d at 975-76.

[35] 845 F.2d 971.

[36] *Id.* at 975.

and not directly to the subcontractors and suppliers. Payments under a payment bond would typically be made directly to the claimants. When the surety did make direct payments to subcontractors and suppliers, it was doing so periodically as opposed to a one-time payment to satisfy a prior amount owed, indicating that the payments to the principal's subcontractors and suppliers were for their continuing performance of the work and supplying materials on the bonded project. Another factor considered was the intent of the surety in making the payments. In light of the overall facts and circumstances the *Aetna* Court concluded that the surety was a performing surety.

E. Penal Sum Issues – The Limit of the Surety's Performance Bond Liability

Another question of critical importance to the surety is the impact that the surety's financing of the principal may have on the reduction of the penal sum of the performance bond. Specifically, if the surety provides financing to the principal to enable the principal to complete the bonded contract, will that funding and those payments made by the surety in financing the principal reduce the penal sum of the performance bond for that bonded contract, thereby reducing the surety's liability for other costs and expenses that may arise under the performance bond?

If the surety is financing the principal with the knowledge and consent of the obligee, such as under either Paragraph 4.1 of the A312 Performance Bond (1984 Ed.) or Section 5.1 of the A312 Performance Bond (2010 Ed.), the issue of the reduction of the penal sum as a result of the surety's financing of the principal should be discussed with the obligee and should be made a part of the obligee's and the surety's consent and agreement. One of the potential disadvantages of the surety's financing of the principal without an agreement or understanding with the obligee may be that the surety's funding advanced to the principal under a financing agreement may not necessarily decrease the penal sum of the surety's performance bond.

It is generally recognized and held by the courts that the penal sum of the surety's performance bond is the limit of the surety's liability, absent extraordinary circumstances.[37] Because financing is recognized as a surety's performance option under many performance bonds (as discussed above), when the surety exercises the financing option, the surety should be entitled to the protection of the penal sum of the performance bond and the penal sum should operate in the same manner (and be reduced) as it may be reduced during the surety's performance under any other performance bond option.[38] Unfortunately, the authors have found no cases expressly discussing the issue to provide any authority.

[37] RESTATEMENT (THIRD) SURETYSHIP AND GUARANTEE § 73, comt. B (1996); *Trainor v. Aetna Cas. & Sur. Co.,* 290 U.S. 47, 52 (1933); *United States v. Seaboard Sur. Co.,* 817 F.2d 956, 963 (2d Cir. 1987); *cert. denied,* 484 U.S. 855 (1987); *Great American Ins. Co. v. N. Austin Mun. Util. Dist. No. 1,* 908 S.W.2d 415, 426 (Tex. 1995); *Mass. Bonding & Ins. Co. v. U.S.,* 97 F.2d 879, 881 (9th Cir. 1938); *See*, Keith A. Langley and Marchelle M. Houston, *Liability of the Performance Bond Surety for Damages (Under Contact of Suretyship), in* THE LAW OF PERFORMANCE BONDS 458, *note* 112 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009).

[38] *See Morgenthau*, 94 F.2d at 635-636 (recognizing that there is no distinction between a performing surety that discharges its obligations by taking over and completing a project and one that finances its principal in order to allow its principal to complete the bonded project.); *Morrison Assurance Co.,* 3 Cl. Ct. 626 (recognizing that by providing a principal with financial assistance prior to a formal default, a surety minimizes the delay in completion of the bonded project and protects the interests of the principal, obligee and the surety).

In some cases, the language of the performance bond may address the issue of the effect of the surety's performance on the penal sum of the performance bond. For example, the A312 Performance Bonds (both the 1984 Ed. and the 2010 Ed.) provide that upon exercising the performance options set forth in the A312 Performance Bond, the surety's obligation is limited to the penal sum of the A312 Performance Bond. Section 8 of the A312 Performance Bond (2010 Ed.) states that "[i]f the Surety elects to act under Section 5.1, 5.3 or 5.4 , the Surety's liability is limited to the amount of this Bond."[39] Paragraph 6 of the A312 Performance Bond (1984 Ed.) provides in relevant part that "if the Surety elects to act under Subparagraph 4.1, 4.2, or 4.3 above, then the responsibilities of the Surety to the Owner shall not be greater than those of the Contractor under the Construction Contract, . . . To the limit of the amount of this Bond." As discussed above, paragraph 4.1 of the A312 Performance Bond (1984 Ed.) and section 5.1 of the A312 Performance Bond (2010 Ed.) have been construed and interpreted to allow the surety's financing of the principal as one of the surety's performance bond options. Therefore, by the surety's financing of the principal under the terms of the A312 Performance Bond, the surety is entitled to limit its liability to the penal sum of the A312 Performance Bond, and that the penal sum should be reduced by the amount of the surety's financing. Other performance bonds may also limit the surety's liability to the penal sum of the performance bond if the surety finances the principal.[40]

It cannot be over-emphasized that the terms and provisions of the applicable performance bond must be reviewed, and the relevant case law must be considered, in addressing the issue of whether the surety's financing of the principal's performance of the work on a bonded contract, with or without the obligee's consent, will reduce the penal sum of the performance bond. However, obtaining the obligee's consent and agreement to any such reduction of the penal sum based upon a description of what the obligee and the surety agree are valid performance bond payments should, with respect to the obligee, reduce the penal sum of the performance bond for the surety's payments and loss for its financing of the principal for its performance of the bonded contract. The obligee's and the surety's agreement may also assist the surety in asserting its subrogation rights to the bonded contract funds as a performance bond surety ahead of the claims of other third parties (banks, taxing authorities, judgment creditors, etc.) pursuing their own claims against the bonded contract funds.

[39] Amazingly, the A312 Performance Bond (2010 Ed.) provides that if the surety takes over the performance and completion of the bonded contract under Section 5.2, the surety's potential liability is not limited to the penal sum of the A312 Performance Bond.

[40] Miller Act bonds also may have penal sum limits. The FAR provides that the "[p]enal sum or penal amount means the amount of money specified in a bond (or a percentage of the bid price in a bid bond) as the maximum payment for which the surety is obligated or the amount of security required to be pledged to the Government in lieu of a corporate or individual surety for the bond." 48 CFR 28.001.

III. ADVANTAGES AND DISADVANTAGES IN FINANCING THE PRINCIPAL

A. Advantages in Financing the Principal

There are a number of apparent advantages and disadvantages to the surety's financing of the principal as a means of discharging the surety's performance bond obligations. The following is a list of the generally recognized advantages.[41]

1. Learning Curve - The principal is familiar with the construction means and methods employed on the bonded project site. A replacement Contractor will require time to organize and become familiar with the work prior to becoming productive and efficient. This "learning curve" for a completion contractor is expensive to a surety, and will be reflected in the completion contractor's bid price and in possible increased liquidated damages.

2. Demobilization and Mobilization/Job Momentum and Continuity - When the surety's financing of the principal enables the principal to continue with the performance and completion of the work on the bonded contract, the shutdown of the bonded project is avoided, job disruptions are minimized, the principal's subcontractors remain on the bonded project, and continuity of the work may be maintained. Claims for damages by both the obligee and subcontractors, including for delay, may be minimized.

3. Completion Contractor Mark-Up - The completion contractor must mark-up the bid price for both profit and overhead. Assuming that the principal is performing the work efficiently and economically, the additional contingencies, allowances and mark-up, overhead and profit of the completion contractor may be avoided by the surety financing of the principal.

4. Principal's Image and Presence and Preservation of Claims - Keeping the principal out in front and the surety in the background, may minimize many of the problems with obligees and the principal's creditors. The appearance of "business as usual" for the principal, whether or not the presence and assistance of the surety is known, may lessen claims and disputes and improve cash flow from the bonded contracts. The principal's witnesses and documentation necessary to substantiate various claims and backcharges remain available and accessible. Keeping the principal in place avoids as-built drawings, project records and documents, certifications, approvals, etc., on the project from getting "lost."

5. Subcontracts - Financing the principal prevents a declaration of default and termination and preserves the principal's subcontracts and purchase orders. It also avoids losing key subcontractors and suppliers as well as renegotiation and increased prices.

[41] *See* Charles W. Langfitt, Bennett J. Lee and Robert C. Niesley, *Performance Bond Options Available to the Surety, in* THE LAW OF PERFORMANCE BONDS 90-98 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009). *See also* Nicholas Seminara and Christopher Sheehey, Jr., *The Surety's Guide to Financing: Point Counterpoint* (unpublished paper submitted at the A.B.A. Tort and Insurance Practice Section Fidelity and Surety Law Committee annual meeting on January 22, 1999).

6. Reduce Potential Claims of the Principal and Indemnitors against Surety - Under typical financing procedures, the principal and indemnitors will be asked to request financial assistance in writing and be required to execute a financing agreement, which, among other things, will release the surety from any claims the principal and/or indemnitors may have had against the surety.

7. Salvage Considerations - The surety can obtain collateral from the principal and indemnitors, to the extent that they have it, as a condition to the surety rendering financial assistance. At the beginning of the financing arrangement, the principal and the indemnitors have the incentive and are more likely to provide their assets as collateral security to the surety for the financing being advanced because accepting the surety's financing may be preferable to a default and cessation of the principal's business operations. By obtaining collateral as a condition of financing, the surety reduces the possibility that the collateral will be deemed to be a preference in the event of a later bankruptcy proceeding filed by the principal and/or the indemnitors.

B. Potential Disadvantages in Financing the Principal

1. Possible No Credit Against the Performance Bond Penalty – Depending on the language of the bond, the law in the applicable jurisdiction, and/or the inability to reach agreement with the obligee, financing the principal may create a risk of the surety not receiving a reduction of the penal sum of the bond for financing payments made.

2. Fixing the Loss - The surety may be unable to fix or cap the amount of its loss if it finances the principal. The surety will not know the final amount of its loss until the last bonded contract is completed, the bonded contract funds are collected, and the financing ends. The surety takes the same risks as any other contractor, including the risks of bad weather, unreliable subcontractors, late deliveries, wrong deliveries, warranty items, lack of bona fide workers, etc. Re-letting the performance of the bonded contract work to a third-party completion contractor at a fixed cost (and obtaining performance and payment bonds from the completion contractor) may more clearly establish and limit the surety's loss.

3. Payment of Claims Not Covered by the Performance Bond - The surety financing the principal may have to satisfy the principal's debts that are not covered by either the performance bond or the payment bond. Specifically, the surety may deem it necessary to make a substantial contribution to the principal's overhead and general operating and administrative expenses ("overhead'). The obligee may object to payment of such expenses and may not allow a reduction of the penal sum for such amounts. However, in reality, the surety's cost to perform and complete the bonded contracts will necessarily include the costs for someone's overhead and general operating and administrative expenses, whether the work is performed and completed by the principal or some other completion contractor. If the bonded contract is completed by a completion contractor, the completion contractor will include overhead in its bid price. If the

obligee completes the work, it will make a claim for its overhead and general operating and administrative expenses against the surety's performance bond.

4. Nonbonded Projects - When the principal has extensive non-bonded contract work, the surety faces a dilemma. Unless the surety takes a security agreement and files financing statements to perfect its security interest in the non-bonded contract funds *and* is perfected ahead of any bank that may have lent money to the principal, the surety *should not finance* the non-bonded contract work. On the other hand, the surety must ensure that a portion of the overhead is collected from the non-bonded contract funds. There may also be multiple sureties who have bonded separate contracts for the principal. One of the sureties may want to finance the principal, and the others may not. While the first surety's financing of the principal may benefit the other sureties in some fashion, the first surety, without some agreement, may not be entitled to make a claim against the other sureties for unjust enrichment. *Fireman's Fund Ins. Co. v. Safeco Ins. Co. of Am.,* 2007 WL 4233317 (W.D.N.C. November 28, 2007) (The first surety acted for its own purposes and benefit to protect its own business interests. The other sureties did not solicit or induce the first surety to finance the principal. The fact that the other sureties may have received an incidental benefit from the first surety's financing was not unjust enrichment.).

5. Costs of Monitoring the Work/Administering the Process - The costs of monitoring the work of a financed principal may be large depending on the individual situation and number of on-going projects. The surety's representative may be required to spend substantial time at the projects, in the principal's office and with the principal's project managers to ensure that the work is being performed, the requisitions on the bonded contracts are being submitted and paid timely, and the appropriate bills of the principal's subcontractors, suppliers and others on the bonded projects are being paid. To the extent that any legal issues arise, the surety will incur additional attorneys' fees. Finally, when there are multiple bonded contracts and hundreds of checks involved, and a special operating account is being utilized, the surety frequently will retain an outside accounting firm or consultant. The outside accounting consultant will keep track of the cash flow, payments coming in and going out, losses and the receipt of the bonded contract funds. Such accounting may be required for reinsurance and later indemnity claims against the principal and the indemnitors.

6. Completing the Work - The "10% Problem" and "Tail-End Let-Downs" –

The achievement of substantial completion by the financed principal may be difficult. Many principals have a problem in completing the last 10% of the work under any circumstances. When the principal is going out of business, the principal and its employees may have less incentive and interest in completing the bonded projects. At the same time, there may be more of a desire to prolong the work in order to obtain a paycheck as opposed to completing the work and ending the surety's financing. Many problems may arise when the work towards substantial completion is reached, and all may cause serious time problems that increase the surety's loss.

7. Potential Risks to the Surety Beyond the Penal Sum of the Performance Bond –

There are certain risks to the surety's financing of the principal that may extend the surety's loss beyond the terms and penal sum of its performance bond. Those risks are more fully discussed later in this article. They include the concepts of the surety facing alter ego or domination liabilities, and the surety possibly acquiring or assuming certain of the principal's tax liabilities and/or the principal's environmental claim responsibilities.

IV. THE PRINCIPAL'S REQUEST FOR THE SURETY'S FINANCIAL ASSISTANCE

Regardless of how or when the surety learns of the principal's financial problems, there may come a time when the principal and the indemnitors request the surety's financial assistance to resolve those financial issues through the surety's financing of the principal's performance of the work on the bonded projects. The surety should require the principal and the indemnitors to formally request the surety's financial assistance. In response to the formal request, the surety should send the principal and the indemnitors a notice letter setting forth the information and documentation that the surety requires in order to analyze and address the principal's and the indemnitors' request for financial assistance. The notice letter will serve to initiate the surety's investigation into the principal's performance of the work on the bonded projects and the principal's and the indemnitors' financial situation generally in order to determine whether the surety will provide the principal with the surety's financial assistance. These steps may seem like mere formalities, but they are in actuality critical first steps in the process and serve to lay the foundation for the entire financing relationship.

A. The Formal Request for Financial Assistance

There are a number of reasons why the surety should require that the principal and the indemnitors provide the surety with a formal and written request for the surety's financial assistance. The request must be made because the surety has no obligation to finance and the principal and the indemnitors must understand and acknowledge that the principal's request for the surety's financial assistance does not mean that the surety has promised or agreed to provide the principal with such financial assistance or that the surety is somehow obligated. Further, it is important that the principal and the indemnitors formally, in writing, acknowledge the principal's financial difficulties, that the principal requires the surety's financial assistance, and that the indemnitors agree with and consent to the principal's request for the surety's financial assistance. This is especially true for indemnitors who are not involved with the operation of the principal and may not have been aware of the financial problems. This step can help to prevent the assertion of defenses later.

In addition, the request must set forth the types and kinds of financial assistance that the principal requests from the surety, which may include the payment of its payroll, subcontractors and suppliers, and possibly some of the principal's overhead and other general and administrative expenses. As a result of applicable bankruptcy case law, the principal's and the indemnitors' request for the surety financial assistance should also contain an acknowledgment of their fiduciary duties and obligations under the trust fund provision in the indemnity agreement, any other contract provisions, any applicable state statutes and regulations, and/or any other applicable law to hold the bonded contract funds from the bonded contracts in trust for the surety's benefit and for the payment of the principal's obligations to its subcontractors, suppliers and laborers on the bonded projects.

B. **The Surety's Response Notice Letter**

Upon receipt of the principal's letter requesting the financial assistance, the surety should respond to the principal's letter in order to initiate an investigation into the principal's performance and financial status on the bonded projects and the principal's and the indemnitors' financial status generally in order to protect the surety from loss. It is important for the principal and indemnitors to acknowledge and execute the notice letter so that everyone is clear on what is required for the investigation and hopefully avoid in push-back or stonewalling later. The surety's notice letter should request:

1. The principal's authorization to review the principal's books, records, accounts and files.
2. To visit the bonded/nonbonded project sites, to initiate discussions with the principal's officers, employees and other outside professionals, and to communicate with the principal's creditors, including the obligees on the bonded projects and the potential payment bond claimants on the bonded projects.
3. The principal and the indemnitors must acknowledge their execution of the Indemnity Agreement and the fact that the principal's request for financial assistance is a breach of their obligations to the surety under the Indemnity Agreement. The principal and the indemnitors also reaffirm their obligations and duties to the surety under the indemnity agreement.
4. Agreement to provide financial information and tax returns to the surety.
5. Generally, address all of the unique issues, information and documentation that the surety deems necessary for its investigation and analysis.

V. THE SURETY'S INVESTIGATION – THE INFORMATION, DOCUMENTATION AND ANALYSIS THAT IS NECESSARY PRIOR TO THE SURETY'S MAKING THE DECISION TO FINANCE THE PRINCIPAL

The surety's investigation is directed towards finding the most efficient means of fulfilling the surety's performance and payment bond obligations. When the surety initiates its investigation to determine whether or not to finance the principal, it looks at the principal's ability and willingness to perform the work on the bonded projects.[42] When faced with the decision on

[42] *See* William S. Piper and Carl C. Coe, Jr., *The Surety's Investigation* and Kenneth M. Givens, Jr. and Thomas J. Burke, *The Surety's Use of Consultants in Connection with Contract Bond Defaults, in* BOND DEFAULT MANUAL 43-76 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr. eds., Am. Bar Ass'n, 3d ed. 2005), which go into great detail concerning the information and documentation that must be gathered during the surety's investigation when there is a performance bond default; George J. Bachrach, Francis J. McGrath and Adam Cizek, *The Financing Surety as a Performing Surety - Law and Practice* 19-24 (unpublished paper submitted at the Northeast Surety and Fidelity Claims Conference in Atlantic City, New Jersey on September 18, 2003) for a detailed discussion and listing of the information that the surety must obtain prior to financing the principal; and Charles W. Langfitt, Bennett J. Lee and Robert C. Niesley, *Performance Bond Options Available to the Surety, in* THE LAW OF PERFORMANCE BONDS 60-68 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009) (including, at *note 2*, page 60-61, a listing of various state laws and regulations that may govern the manner and timing of the surety's investigation); and *see* Philip L. Bruner, Patrick J. O'Connor and Tracey L. Haley, *The Surety's Analysis of Investigative Results: "To Perform or Not to Perform – That is the Question," in* BOND DEFAULT MANUAL 77-154 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr. eds., Am. Bar Ass'n,

whether to finance the principal, the surety must review and analyze the information and documentation collected during the investigation process, and consider the four "C's" - the principal's *cash, capacity, character and collateral* that may be available to reduce the surety's actual or potential loss.

A. Cash

1. How Much? – Generally, when a principal seeks financing from the surety, the principal lacks sufficient cash to continue the performance of the work and to pay all bills of laborers, subcontractors and materialmen on the bonded contracts. Accordingly, through the investigation, the surety must determine how much cash the principal has and how much more cash the principal will need (i) to pay the costs to complete the performance of the work on the bonded contracts; (ii) to pay the current and outstanding bills of the principal's subcontractors, suppliers and laborers on the bonded projects; (iii) to replace payments from obligees that may be delayed because of the principal's disputes with the obligees, real or otherwise; (iv) to replace payments the principal has already received from the obligees and used on other contracts, bonded or non-bonded, and/or for other purposes; and (v) to fund the overhead and general operating and administrative expenses required to maintain the principal in business. The analysis must be extended to estimate the principal's cash requirements (both the principal's cash flow and total cash needs) in the future as the performance of the work progresses.

2. Other Sources of Cash – It is important to remember in the investigation process that the principal may access to other sources of cash. The principal may have lines of credit on which to draw. The principal may have receivables from unbonded contracts (i.e., contract balances, retainages and claims) that may be used to pay certain bills, including overhead items. The principal may have real and personal property, including excess equipment that may be sold to generate additional cash over time. The indemnitors may have cash or assets that can be converted to cash to fund the principal. Finally, depending upon the circumstances, banks or other lenders, with or without the surety's guarantee, may be willing to lend funds to the principal.

B. Capacity

A surety can address the principal's needs for cash through the financing process, but it is far more difficult for a surety improve the principal's capacity to perform the work. When we speak of "capacity" we are referring to the principal's technical ability to perform the work, ability to manage the work and supervise its subcontractors and suppliers, and ability to effectively and timely close out projects. Consultants can be utilized in this regard, but that increases the costs. Accordingly, prior to considering financing the principal, the surety must determine whether the principal is capable of performing the work and that it has the technical ability to perform the work.

The investigation must show that the principal has the proper field and home office expertise to perform the work on the bonded projects. The principal must demonstrate that it has or can secure the necessary properly skilled and numbers of workers required to timely perform the work and satisfy the bonded contract requirements. The principal must satisfy the surety that

3d ed. 2005), which addresses the analysis the surety must perform prior to deciding how to fulfill its performance bond obligations.

its project managers, supervisors, and foremen know what they are doing, have the technical construction expertise to timely perform and complete the work on the bonded contracts, and are willing and/or otherwise financially committed to remain with the principal until the bonded contracts are completed. The surety must believe that the backup services at the principal's home office (i.e., accounting expertise, record keeping, etc.) are sufficient and accurate in order to ensure that the principal's progress in performing the work on the bonded contracts and that proper costs and expenses can be measured and computed. The surety should review the relationships between the principal and the obligees and between the principal and its subcontractors and suppliers. If these relationships are strained and dysfunctional, the principal's performance of the work may take more time and be more expensive. If the work being performed is not managed properly in a competent, coherent and organized manner, financing the principal may not obtain the objectives that the surety wants to reach.

Another key factor to consider under capacity is the principal's historical capacity to close out and finish projects. The principal's inability to substantially complete the work and close out the bonded contracts will extend the time and cost of the surety's financing of the principal's performance and completion of the work and its overhead and general operating and administrative expenses. Increased time equals an increase in the surety's loss.

C. **Character**

The principal's and the indemnitors' character, including their honesty, integrity, trustworthiness and commitment to performing and completing the work on the bonded contracts is critical. The surety must rely on the principal and the indemnitors putting forth their best efforts to complete the work on the bonded contracts, providing ready access to their books, records and other necessary information and documentation, and attempting to minimize the surety's loss. The surety must have confidence that the principal will try its best to provide prompt and accurate information and answers to the surety's questions. If, in the surety's opinion, the principal and the indemnitors lack the character, honesty, integrity, trustworthiness and commitment that is necessary for a successful financing arrangement, then the surety should immediately stop its consideration of financing the principal as a performance bond option.

D. **Collateral**

As part of the financing process, the surety should consider obtaining collateral security from the principal and/or indemnitors at the beginning of the relationship. Obtaining collateral early in the process as a condition of financing will generally lead to the principal and indemnitors being more likely to provide collateral so that they can obtain the financing. By taking the collateral security, the surety may avoid the need to initiate an immediate indemnity or exoneration action against the principal and the indemnitors, which avoids an immediate adversarial situation with the principal and the indemnitors. If the surety incurs losses, the surety has a readily available source of salvage for those losses. Obtaining interests in collateral early may allow the surety to perfect its interests in such collateral before other creditors or other parties start looking for collateral. Because the surety is not required to finance the principal, the surety's financing may be considered to be new value given to the principal and the indemnitors that will allow the liens on the collateral security to remain in effect in the event that the principal and/or the indemnitors subsequently file bankruptcy proceedings.[43]

While collateral security given to the surety is an option when assets of sufficient value exist, there are other ways that the surety may benefit from the existence of collateral security without actually taking a lien on the assets. One such option is a guaranteed bank loan (discussed below). The surety may work with the principal's bank to provide the collateral security to the bank in return for a loan from the bank to the principal. With the principal being in financial difficulties, the surety may have to guarantee the bank loan for the principal. Banks are more familiar with issues of collateral security, including foreclosures on real estate and auction sales of personal property. The bank may be more willing than the surety to take the collateral security. A surety guarantee is normally required in the event the collateral security does not bring sale proceeds sufficient for the bank to be repaid in full.[44]

E. **Summary**

The surety's analysis of the information provided by the principal and the indemnitors during the investigation will almost always conclude that the principal lacks sufficient cash to complete the bonded contracts. Therefore, the principal's capacity to perform the work and the character of the principal and the indemnitors in their commitment to indemnify and hold harmless the surety become critical. If either of these two factors do not exist to the surety's satisfaction, financing the principal is *not* a viable option in the handling of the performance bond claims. The existence of collateral security can be a factor, but collateral security only reimburses the surety for its loss. It does not complete the performance of the work on the bonded contracts. Furthermore, the value of that collateral security can decrease over time, both as a result of market factors and because of the surety's "investments" in the collateral security (mortgage payments, taxes, upkeep, insurance, etc.).

VI. THE METHODS OF THE SURETY'S FINANCING OF THE PRINCIPAL

There are a number of methods for the surety to provide financial assistance to the principal. Some of the methods are more direct than others. During the time period for any method of surety financing, the surety must be assured that the bonded contract funds collected from the bonded contracts in the future will be used by the principal to complete the performance of the work on the bonded contracts and to pay the bills of the principal's subcontractors, suppliers and laborers on the bonded projects. Therefore, the surety will require a "special account" for the collection of the bonded contract funds from the bonded contracts and for the surety's funding through its advances and loans, and for the surety's control over the use of those bonded contract

[43] *See* Jan D. Sokol, Preference Actions, in THE SURETY AND BANKRUPTCY 215-230 (J. Blake Wilcox, Steven H. Rittmaster, Alberta "Ali" L. Adams & Patricia Wager eds., Am. Bar. Ass'n 2010); Chad L. Schexnayder and J. Blake Wilcox, Bankruptcy, in THE LAW OF PERFORMANCE BONDS 864-871 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009); T. Scott Leo, The Financing Surety and the Chapter 11 Principal, 26 TORT & INS. L. J. 45 (1990).

[44] The ideal situation is to have the bank agree to foreclose on part or all of the collateral security before it calls on the surety's guarantee. If the bank does foreclose, it should give notice to the surety. If the surety is required to pay first under its guarantee, the bank should assign its remaining interest in the collateral security to the surety.

funds and the surety's funding in the future. The direct and indirect methods for the surety to provide financial assistance to the principal include the following.

A. Advancing or Lending Money to the Principal

Initially, the surety may immediately pay the principal's payroll and certain critical subcontractors and suppliers for a short period of time to maintain the status quo during the surety's investigation, and may have to fund certain overhead items such as the home office payroll, insurance premiums, equipment lease payments, etc., to keep the bonded contracts going forward. This "look-see" financing keeps the principal afloat and keeps the bonded contracts moving, thereby giving the surety time to perform its investigation (to "look") and to determine its course of action (to "see" what the surety wants to do). It is recommended that the principal and the indemnitors be advised both verbally and in writing that such "look-see" financing "is a temporary means to give the surety time to complete its investigation and in no way commits the surety towards financing or any other course of action."[45] The surety's "Notice Letter to the Principal and the Indemnitors," should address the surety's possible "look-see" financing and clearly state the surety has no obligation under the Indemnity Agreement, the bonds or otherwise at law or in equity to provide any financial assistance to the principal and point out that at this stage the surety has not made any commitment to provide any interim or final financial assistance to the principal. Furthermore, in the event that the surety provides the principal with interim or "look-see" financing, the surety, the principal and the indemnitors will execute an Interim Financing Term Sheet or other such agreement that sets forth the understandings of the parties with respect to any such interim financing.

B. Guaranteed Bank Loan

As noted above, when the principal and the indemnitors have assets with which to provide collateral security to the surety, the surety may determine it is best to have the collateral security provided to a bank instead in order for the principal to obtain a bank loan guaranteed by the surety. Guaranteeing a bank loan will usually be used only when there is a realistic possibility that the contractor will be able to pay it off or the assets will cover any loss. The pledging of the assets to the bank in consideration for the bank loan should shelter the assets from attack as voidable preference under the Bankruptcy Code. On federal projects, the government does not recognize assignments to sureties, but it will recognize assignments to financial institutions. In addition, it is possible that the Anti Assignments of Claims Act may prevent the United States from offsetting against the contract fund.

C. "Back Door Financing"

"Back Door Financing" is a bit of a misnomer because it occurs when the surety "indirectly" finances the principal by directly paying the principal's bills from its subcontractors and suppliers on the bonded projects as payment bond claims. The surety should require the principal and the indemnitors to acknowledge that they are liable to indemnify and reimburse the surety for the "back door financing," and the surety should attempt to obtain collateral security immediately for its payments. "Back door financing" may quickly jump start the principal's

[45] *Joyce and Haug, supra*. note 1 at p. 22.

performance of the work on the bonded projects and possibly prevent one or more performance bond claims. Such "financing" may not be the surety's most effective and safe course of action when there are numerous payments that must be made and/or there are multiple bonded projects which require such payments.

D. Providing Additional Bonds to the Principal

Another method of "indirect financing" is for the surety to provide additional bonding credit to the principal in an effort to rehabilitate the principal. The strategy is that the principal can solve its problems if additional work and additional bonded contract funds become available over time. This may work if the principal has several claims against obligees that have not been resolved, thereby affecting the principal's cash flow and balance sheet. The surety must be extremely selective in this method of financing. Providing additional bonds does not cure the initial problem of a lack of cash to complete the performance of the existing work and to pay current bills on the bonded contracts. The lag time from bid to award to payment of the first requisition (after the principal has expended monies for the bonds, mobilization, and the first month or two of the performance of the work, etc.) will not provide cash on a timely basis. Additionally, providing bonds that produce immediate new work for the principal may hinder the principal's ability to perform the remaining work on the existing bonded contracts in a timely manner, thereby increasing the cost of the performance of the work and the overhead expense. Furthermore, the additional bonds may also stretch out the principal's work program beyond a comfortable time frame for the surety. Finally, in fact, the principal has severe problems that go beyond the temporary shortage of cash, providing additional bonding for projects that may not be profitable may exacerbate the surety's performance bond claim handling problems in the future, increasing the number of bonded contracts in default and ultimately increasing the surety's loss.

VII. INTERCREDITOR AGREEMENTS

In many instances successfully financing the principal requires the surety to work with the principal's other creditors, primarily the bank, but also equipment and vehicle lenders and lessors and others through what is referred to as an Intercreditor Agreement. Intercreditor agreements are used to add some structure and certainty to an otherwise uncertain and fluid situation. The parties to the intercreditor agreement understand that they must give up something to get something, but what all of the parties want and obtain is a roadmap to follow for a period of time until the circumstances of the principal's financial difficulties are resolved or they change to the point where further discussions are necessary to maintain, change or end the intercreditor agreement provisions. The purpose of the intercreditor agreement is for the Surety and bank to cooperate and work together so that neither the surety nor the bank will take any actions or measures that will prevent the principal from performing the work on the bonded projects while the surety is financing the principal's efforts. Intercreditor agreements typically address a number of issues, including but not limited to:

1. Whether the principal's line of credit with the bank will remain in use or not;

2. Whether the surety's financing will be accomplished through the principal's existing accounts at the bank, with the bank agreeing not to exercise its set off rights against the principal's accounts;
3. The rights of the parties to various of the principal's assets, including the bonded contract funds;
4. Periodic payments to the bank for the principal's continued use of its real property in order to preserve the value of the assets during the principal's continued use while performing the work on the bonded projects;
5. The parties agreeing to forebear from exercising their rights; and
6. Addressing any other specific issues that may be involved.

VIII. INTERIM FINANCING

A. Introduction – Why Does the Surety Interim Finance the Principal?

If the principal is unable to timely pay its subcontractors, suppliers and laborers on the bonded projects payment bond claims may arise and/or the unpaid subcontractors, suppliers and laborers may refuse to perform thereby causing a payment bond situation to become a performance bond default because the principal is unable to continue the timely and satisfactory performance of the work on the bonded projects. In that situation, the surety may provide interim financing to the principal to allow the surety more time to complete its investigation into all of the bonded projects and determine its next steps. The primary steps to interim financing include the surety identifying which of the principal's obligations will be paid through the surety's financial assistance in order for the principal to continue its performance of the work on the bonded projects, and obtaining the documentation and rights that the surety needs in order to continue financing the principal or to take some other action to fulfill its performance bond obligations.

B. Documentation

1. Interim Financing Term Sheet/Agreement - The Term Sheet describes the documents that the principal and indemnitors must acknowledge as binding upon the principal and the indemnitors, which includes: (a) the indemnity agreement, (b) the principal's and the indemnitors' letter to the surety requesting the surety's financial assistance, and (c) the surety's notice letter to the principal and the indemnitors. Such documents also include any documents that the surety requires both for interim financing and in the event that the surety provides future financing to the principal, including: (a) letters of direction for each of the bonded contracts; (b) voluntary letters of default and termination for each of the bonded contracts; (c) assignment and power of attorney; and (d) a promissory and confessed judgment note. The term sheet will identify conditions precedent prior to the surety's providing interim financial assistance to the principal, including the principal's execution and delivery of the letters of direction, the voluntary letters of default and termination, and the assignment and power of attorney to the surety. The term sheet will also require the indemnitors to provide information and documents related to their financial status, such as tax returns, listings of real property and personal property. The terms will also describe and define the amount of the surety's financial assistance during the interim financing

period as well as the schedule or time frame for the interim financing. Certain funding, mechanics and procedures must be established to pay the principal's payroll as well as its subcontractors and suppliers on the bonded projects. The Term Sheet may also provide for some funding of the principal's overhead and general and administrative expenses.

2. Promissory and Confessed Judgment Note – In order to confirm and memorialize the amount of the surety's interim financing made available to the principal, and the indemnitors' obligations to reimburse the surety under the indemnity agreement for the interim financing, the surety should obtain a promissory and confessed judgment note in the amount of the projected surety interim financial assistance.

IX. PROCEDURES AND MECHANICS FOR THE SURETY'S FINANCING OF THE PRINCIPAL

A. Generally

When the surety's decision is made to finance the principal, whether for one bonded contract or for many bonded contracts, the surety requires a separate agreement regarding such financing with the principal and the indemnitors. Whether the agreement is referred to as a "Joint Control Trust Agreement," a "Financing and Collateral Agreement," a "Financing, Collateral and Special Account Agreement," a "Loan and Security Agreement," or some other name, certain provisions in an agreement are necessary concerning the procedures and mechanics governing the financial arrangements between the surety and the principal and the indemnitors.

The Agreement should set forth certain provisions and recitals documenting the principal's request and need for the surety's financial assistance, reaffirming the principal's and the indemnitors' indemnity obligations to the surety, defining the "Surety's Losses" under the Agreement and the indemnity agreement, providing collateral security to the surety for its agreement to finance the principal, providing voluntary letters of default and termination to the surety, providing for the establishment of a special account or some other bank account arrangement for the receipt and collection of the bonded contract funds and the monies advanced or loaned by the surety to the principal, and for the payment of the bills incurred by the principal on the bonded contracts. The Agreement must further contain a description of the bills to be paid and the procedures for paying the bills from the special account, provide, when appropriate, for the sale of the collateral security granted by the principal and the indemnitors, and for the reimbursement and repayment of the surety for its financing of the principal. The Agreement should provide certain takeover rights in the event that the surety arranges for the completion of the performance of the work under one or more of the bonded contracts by a third party completion contractor, grant additional consideration to the surety for its financing of the principal, such as a release and a waiver of jury trial rights and set forth the provisions for terminating the Agreement. Finally, the Agreement should also provide certain provisions that will apply if the principal and/or the indemnitors file bankruptcy proceedings after the execution of the Agreement.

B. Voluntary Letters of Default and Termination

A key component of implementing financing is the execution by the principal of Voluntary Letters of Default and Termination addressed to the obligees for each of the bonded contracts. These letters are held by the surety until such time as the surety, at its sole option and discretion deems it necessary and in the surety's best interests to provide one or more of the letters to obligees on bonded projects. These letters give the surety the flexibility to determine how it wants to address specific projects and avoid any future disputes with the principal over whether the surety can take the action it deems necessary.

C. The Special Account for the Surety's Financing

1. Establishing the Special Account – Another important part of the financing of the principal involves creating and operating the "Special Account." In choosing the financial institution in which to establish the Special Account, the surety must ensure that it avoids any banks that have loans to or debts from the principal that would allow the bank to set off the funds in the account with the principal's obligations to the bank. For this reason, sureties typically open Special Accounts in the surety's name, through third party administrators who are the sureties' agents and who operate the Special Accounts under the guidance and control of the surety and its representatives.

2. Joint Control Special Account - One type of Special Account can be a "joint control account" that is opened in the names of the principal and the surety. Each check from the Special Account requires the signature of the surety's representative and the principal's representative. This type of account is time consuming and creates logistical problems.

3. Two Special Accounts and a Special Operating Account - Another type of Special Account is to use two Special Accounts and a Special Operating Account. The Special Operating Account is in the name of the principal and requires the sole signature of the principal for transfers from the Special Operating Account. It is a zero-balance account that draws its funding from the second Special Account. No money is held in the Special Operating Account. All bonded contract funds and any monies advanced or loaned by the surety to the principal are deposited into the first Special Account, which is solely in the surety's name. The principal presents the surety with a request for the payment of bills along with checks drawn on the Special Operating Account that requires only the principal's signature. The surety and the principal then agree to the bills to be paid. The surety then transfers the necessary amount of funding from the first Special Account to the second Special Account (in the surety's sole name) to cover the checks drawn on the Special Operating Account. The surety and the principal then give approval to the bank to transfer the agreed upon amount of funds from the first Special Account to the second Special Account. The surety or the principal then transmit the checks from the Special Operating Account to the payees. When the checks are returned to the bank on the zero-balance Special Operating Account, funds are immediately drawn by the bank from Special Account No. 2 to cover the checks presented on the Special Operating Account.

4. Cash Collateral and Zero Balance Special Accounts - Another form of Special Account involves the use a Cash Collateral and Zero Balance account format. This format

is designed to protect the bonded contract funds from misappropriation by the principal as well as from garnishment or levy by the principal's other creditors. Under this format, the bonded contract funds are held in trust for the benefit of the surety by a cash collateral agent and in an account known as a cash collateral account (the "Cash Collateral Account") in the surety's name. Contemporaneously with the establishment of the Cash Collateral Account, the principal establishes a zero balance account (the "Zero Balance Account") at the same bank in the principal's name, and authorized daily sweeps from the Zero Balance Account to the Cash Collateral Account. As needed, the principal forwards its request for approval for checks to the surety. The surety's representative then reviews these proposed checks, and approves or disapproves them on an item-by-item basis. To the extent that the surety approves the payments, the principal is notified that it may release the check to the named payee, who then presents the check for payment on the Zero Balance Account. Upon presentment, the check is flagged for scrutiny to confirm that the "issue information" matches the data approved by both the surety and the principal. The bank then honors and pays the check only if the "issue information" matches the information transmitted to the bank, and that had been approved by the surety.

Payment of the check from the Zero Balance Account triggers an automatic transfer of sufficient funds from the Cash Collateral Account, which holds the bonded contract funds and any advances or loans made by the surety. This heightened security feature is known in banking parlance as a "controlled disbursement account" and was is designed to help thwart fraud and the alteration of negotiable instruments. At the close of each business day, all funds remaining in the Zero Balance Account are automatically transferred back to the Cash Collateral Account.

5. Third Party Administered Special Account - In this type of Special Account, the surety, with the principal's consent, opens and establishes the Special Account in the surety's name at a bank chosen by the surety through a third party such as an accounting firm or consulting firm. Any "agreements" for the opening of Special Accounts are between the surety (on its own or through the third party administrator) and the bank, and not the principal. The surety, through the third party administrator, decides and determines all of the procedures, mechanics and operational issues for the Special Account – the title for or the name on the Special Account, and the authorized signers and the number of signers for each transfer or check (withdrawal) from the Special Account. The principal and the indemnitors acknowledge and agree that the surety is the owner of the Special Account, the principal and the indemnitors have no beneficial interest in the Special Account. When the Special Account is established, all of the bonded contract funds and all monies advanced or loaned by the surety to the principal are deposited into the Special Account. The procedures and mechanics for the principal to request payments from the Special Account are very similar to those used for the prior kinds and types of Special Accounts, but now the transfers and checks come from one Special Account and are made immediately upon the principal's and the surety's agreement concerning what gets paid and when.

6. Letters of Direction - Letters of Direction are executed by the principal and addressed to the obligee requesting that the bonded contract funds be made payable as the surety and the principal may agree and such funds would then be deposited into the Special Account. The surety may date and use the Letters of Direction, individually as to each separate bonded contract or as to all of the bonded contracts in the surety's sole option and discretion as the surety deems necessary in its best interests. The principal executes an Assignment and Power of Attorney

authorizing the surety to endorse the checks received from the obligees in which the principal is named as a payee and to deposit the checks into the Special Account. Furthermore, if the principal receives any of the bonded contract funds directly, not only are they held in trust for the surety's benefit, but the principal is also obligated to give the bonded contract funds to the surety for deposit into the Special Account.

D. Use of the Funds From the Special Account

1. Use of the Funds – Mechanics and Procedures Generally - The funds in the Special Account are used solely for the payment of all labor and material costs incurred by the principal and the principal's subcontractors and suppliers, which are necessary and/or actually used to complete the performance of the work under the bonded contracts and for which the surety may become liable under its bonds. The funds in the Special Account may also be used to repay and reimburse the surety.

2. Payment of the Principal's Subcontractors and Suppliers – The principal provides the surety with a written request or summary sheet, signed by the principal, and sufficient backup documentation for each payee for each invoice or payment that the principal requests the surety to pay from the Special Account. The principal must acknowledge and represent that the amount of the payment is currently due and owing to the payee named to receive the payment. The surety collects and reviews all of the backup documentation in order to assure itself that the payments are due on the bonded projects and are in the correct amounts. To the extent that the bonded contract funds in the Special Account are insufficient to make the payments requested by the principal and approved by the surety, the surety may advance or loan monies to the principal through the Special Account for the payment of those invoices. The Agreement should provide that any such advances to, loans to or funding of the principal or the Special Account: (a) shall be at the principal's signed written request; (b) shall be conclusively presumed to be a part of the Surety's Losses; and (c) shall constitute and be deemed to be trust funds in the Special Account.

3. The Principal's Labor - Frequently, the principal has an automated system for the payment of its payroll, including the net pay for each employee, taxes to be withheld, and all other fringe benefits and/or deductions. Unless otherwise agreed, many times it is easier for the surety to fund the principal's existing payroll account directly from the Special Account rather than prepare checks for each employee on a weekly or bi-weekly basis from the Special Account. There are three risks in funding the principal's existing payroll account directly from the Special Account: (a) the funds transferred from the Special Account to the principal's existing payroll account are no longer subject to the surety's control; (b) the funds transferred from the Special Account to the principal's existing payroll account at the bank are no longer "trust funds"; and (c) the funds transferred from the Special Account to the principal's existing payroll account are at risk to the attachments or garnishments of judgment creditors of the principal and federal and state tax liens, and no longer have any trust fund characteristics.

4. The Principal's Overhead and General Operating and Administrative Expenses - Realistically, in any financing arrangement, certain expenses of the principal must be paid that are not attributable to direct bonded contract costs for which the surety would be liable under its bonds. These may include home office salaries and expenses,

insurance of some or all types (general liability, automobile, health, life, etc.), rent, telephone, photocopying, postage, legal and accounting services, etc. The surety may require its review and approval of all payments of the principal's overhead. To the extent that the surety consents to the payment of the principal's overhead from the Special Account, such consent is at the surety's sole option and discretion. Alternatively, the surety may provide a set percentage of the monthly bonded contract funds collected from the bonded contracts to be used to pay for the "surety's portion" of the principal's overhead.

5. Reimbursement of the Surety's Losses from the Special Account -When a surety incurs a loss, it wants to be repaid and reimbursed as soon as possible. The financing agreement must provide for the surety's prompt repayment and reimbursement from either the excess bonded contract funds in the Special Account or the proceeds of any sale of collateral. The terms of the financing agreement should describe the principal's and the indemnitors' indemnity and reimbursement obligations to the surety to repay and reimburse the surety's losses. The financing agreement should define the surety's losses as follows:

> In the event that the Surety makes any payments under the Bonds, or, in accordance with the terms of this Agreement or the Indemnity Agreement, the Surety, in its sole discretion, makes any loans or advances directly to or for the Principal's benefit, or the Surety makes any other payments or the Surety incurs any other losses of whatsoever kind or nature, including but not limited to costs, expenses, attorneys' fees, accounting fees, consulting fees, interest and any other payments or losses as specified in the Indemnity Agreement (hereinafter referred to collectively as the "Surety's Losses")…

The definition of the "Surety's Losses" covers every payment that the surety may make, including but not limited to performance and payment bond payments and the surety's advances or loans to the principal and/or the Special Account.

E. Taxes on the Principal's Labor

1. Generally - When the surety initiates some form of funds control, whether joint control with the principal or some other surety control over the principal's use of the bonded contract funds, including under a financing agreement, the surety may become directly liable for the principal's withholding taxes as a result of the surety's control over the payment of the wages of the principal's laborers. The Internal Revenue Code (the "Tax Code") creates potential tax liability for the surety under three sections – 26 U.S.C. §§ 3401, 6672 and 3505.

2. Section 3401 [26 U.S.C. § 3401] - Under Section 3401 of the Tax Code, the surety may be liable for withholding taxes as the "employer" when it exercises control over the payment of wages to the principal's employees. The term "employer" is defined in section 3401(d) as follows:

> Employer.—For purposes of this chapter, the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person except that— (1) if the person for whom the individual

> performs or performed the services does not have control of the payment of the wages for such services [then] the term "employer" ... means the person having control of the payment of such wages.

26 U.S.C. § 3401(d)(1).[46]

If the surety is found to be an "employer": (a) first, the surety may be liable for both the employees' share of the amounts of withholding taxes that were required to be deducted and paid to the IRS AND the employers' share of those taxes; and (b) second, as an "employer," the surety may be liable for penalties for the "employer's" failure to file quarterly tax returns and failure to deposit the withholding taxes with the IRS.

3. Section 6672 [26 U.S.C. § 6672] - Under Section 6672, the surety's control over the bonded contract funds may make the surety personally liable for the payment of the tax and a penalty equal to the amount of the taxes that were to be withheld by the principal. There are two elements to a claim for individual liability under Section 6672. First, the individual against whom the penalty has been assessed must be a person responsible for collecting and paying the tax. Second, the "responsible person" must "willfully" fail to pay to the government the amount of taxes otherwise due.[47] "Responsible person" is one who is "required to collect, truthfully account for, and pay over any" payroll taxes. It has been held that responsible persons may include "employees, stockholders, sureties, lenders and others outside the formal corporate organization." Thus, the crucial inquiry is whether the individual had the effective power to pay the taxes.[48] "Willfulness" under the statute "requires a voluntary, conscious, and intentional act, but not a bad motive or evil intent." Willfulness is normally established by evidence that the responsible person paid other creditors with knowledge that withholding taxes owed to the United States were in arrears at the time. "Willfully" can be found if the person recklessly disregarded a known or obvious risk that trust funds would not be paid over to the United States.[49]

It is important to note that the failure to make withholding tax payments is not willful if the responsible person does not have unencumbered funds with which to make the payments. "Unencumbered" can appropriately be defined as funds which are available to the taxpayer for use in its discretion. Where the taxpayer's discretion in the use of funds is subject to restrictions imposed by a legal obligation that is superior to any interest claimed by the IRS, the funds are regarded as encumbered if those restrictions preclude the taxpayer from using the funds to pay the taxes.[50] The reality is that where the surety is exercising funds control over the bonded contract funds to reduce its bond losses, whether it is financing the principal or not, it may be deemed to be a "responsible person." Furthermore, under the loose definition of "willful," the surety preferring to pay other creditors and not pay the withholding taxes to the IRS will face tax liability to the IRS for those withholding taxes. Bottom line is pay the tax if you are controlling the funds.

[46] *Otte v. United States*, 419 U.S. 43, 51 (1974); *Reliance Ins. Co. v. United States*, No. 97-803-HA, 1998 WL 718177, at *4 (D. Or. July 17, 1998); *Century Ind. Co. v. Riddell*, 317 F.2d 681 (9th Cir. 1963).

[47] *Fid. & Cas. Co. of N.Y. v. United States*, 490 F.2d 960, 964 (Ct. Cl. 1974).

[48] *Verret v. United States*, 542 F. Supp. 2d 526, 534 (E.D. Tex. 2008), *aff'd*, 312 F. App'x 615 (5th Cir. 2009); *Roth v. United States*, 779 F.2d 1567 (11th Cir. 1986); *Howard v. United States*, 711 F.2d 729 (5th Cir. 1983).

[49] *Verret v. United States*, 542 F. Supp. 2d at 538–39.

[50] *In re Premo*, 116 B.R. 515, 534–35 (Bankr. E.D. Mich. 1990); *Huizinga v. United States*, 68 F.3d 139, 145 (6th Cir. 1995); *Bell v. United States*, 355 F.3d 387, 396 (6th Cir. 2004).

4. Section 3505 [26 U.S.C. § 3505] - Section 3505(b) provides for personal liability if a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required under the Tax Code, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. The liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose. There are two elements which must be satisfied. First, the surety must supply funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer. Second the surety must have actual notice or knowledge that such employer does not intend to or will not be able to make timely payment or deposits of the withholding taxes. In most instances involving sureties who elect to finance their principals, there will usually be little doubt that some or all of the funds being advanced by the sureties to the principals will be used for payroll in some form or another. While there is no requirement of control, the surety must have "actual knowledge" that the taxes are not being paid in order for liability to be imposed under Section 3505(b).[51]

Section 6323(i)(1) provides that an organization shall be deemed for purposes of a particular transaction to have actual notice or knowledge of any fact from the time such fact is brought to the attention of the individual conducting such transaction, and in any event from the time such fact would have been brought to such individual's attention if the organization had exercised "due diligence." Due diligence is exercised if reasonable routines for communicating significant information to the person conducting the transaction are maintained and there was reasonable compliance with the routine.[52] At the time the tax payments are paid by the surety and the principal, the surety must file quarterly Form 941 with the Internal Revenue Service.

In summary, the takeaway from this part of the article is that when the surety takes some kind of control over the principal's receipt and use of the bonded contract funds, whether the surety is financing the principal or not, the surety must withhold and pay the payroll taxes to the IRS and report those amounts as required by the IRS.

F. Sale of the Principal's and/or the Indemnitors' Collateral Security

In the event that the principal and/or the indemnitors provide collateral security to the surety, the financing agreement must provide a mechanism for the sale of that collateral and use of the proceeds by the surety.

[51] Of course, the surety has liability for certain taxes under its bonds issued under the Miller Act. *See* 40 U.S.C.A. § 3131(c)(1)("Every performance bond required under this section specifically shall provide coverage for taxes the Government imposes which are collected, deducted, or withheld from wages the contractor pays in carrying out the contract with respect to which the bond is furnished.)

[52] *United States v. Metro Const. Co., Inc.*, 439 F.Supp. 308 (C.D. Ca. 1977).

G. The Surety's Right to Repayment and Reimbursement

The financing agreement and the Indemnity Agreement describe the principal's and the indemnitors' indemnity and reimbursement obligations to the surety to repay and reimburse the Surety's Losses. However, there may be a question as to whether the use of the funds in the Special Account to pay the principal's overhead and general operating and administrative expenses (the "Principal's Overhead") is an element of the Surety's Losses for which the surety not only has a right to repayment and reimbursement, but also a subrogation right against the bonded contract funds for each of the bonded contracts. The financing surety is a performing surety and has the right to assert the subrogation rights of a performing surety. To the extent that the surety has paid payment bond claims of the principal's subcontractors, suppliers and laborers on the bonded projects, the payment bond surety has the right to assert the subrogation rights of a payment bond surety. Therefore, all of the surety's payments to fulfill its performance and payment bond obligations on the bonded contracts, whether they were paid directly by the surety or whether they were paid through the surety's advances and loans to the Special Account, allow the surety to assert its subrogation rights to the bonded contract funds for each of the bonded contracts.

An accounting system must be established and maintained from the first day of surety financing of the principal in order to account for the use of the bonded contract funds and the surety's advances and loans to the Special Account. The surety must maintain a trail for all of the transactions from the Special Account, whether the funds are coming in or going out of the Special Account, in the event there are any questions in the future concerning the allocation of those funds among the bonded contracts. Regardless of the method of the allocation of the principal's overhead to one or more of the bonded contracts, there are two rules that must be followed: (a) some allocation of the principal's overhead must be made to each of the bonded contracts to fairly attribute the cost of the performance of the completion of the work to the bonded contracts; and (b) whatever method of allocation is chosen, it should be reasonably representative of the economics of the principal's business over the period of time that the surety finances the principal, whether one method of allocation is used or many methods are used.

H. The Surety's Right to Stop Financing and to Take Over the Work on the Bonded Projects

If during the surety's financing of the principal the surety determines that one or more of the bonded contracts should be performed and completed by some other manner or method, including by a new completion contractor that is not the principal, the surety has the right and authority to act in its sole option and discretion and in its own best interests to make that decision and use one or more of the Voluntary Letters of Default and Termination.

I. Additional Consideration to the Surety

1. The Surety's Release Through the Date of the Execution of the Agreement – As additional consideration for the surety's execution of the Agreement and providing financing to the principal, the surety must receive a general release from the principal and the indemnitors for any causes of action or claims that they may have or may

allege that they may have against the surety arising prior to and up through the date of the execution of the Agreement.

2. Waiver of Jury Trial Rights – Out of an abundance of caution, the surety should require that the principal and the indemnitors waive any right to a trial by jury in any action that may be brought against the surety based upon, arising out of, relating to or in any way connected with the indemnity agreement, the bonds or the financing agreement. The waiver of jury trial must be irrevocable, continue after the execution of the financing agreement, and should not be affected by any modifications or amendments to the financing agreement.

J. Termination

The surety must have the unfettered right and ability to terminate the financing agreement at its sole option and discretion for whatever reason and/or due to the circumstances that arise in the future. The surety must be able to control the bonded contract funds as a means to ensure that the bonded contract funds are used to pay bills on the bonded contracts, and also to be repaid for the surety's losses. Thus, the financing arrangement must be in place at the surety's discretion. The financing agreement must have a repayment agreement between the principal and the indemnitors and the surety.

K. Bankruptcy Provisions

1. Bonded Contract Funds - The principal and the indemnitors must acknowledge and agree that the bonded contract funds and any other funds and monies in the Special Account, including the bonded contract funds and the surety's advances and loans to the Special Account, are the surety's property in which the surety has absolute ownership rights pursuant to the Agreement, the indemnity agreement, its trust fund rights, its subrogation rights, and all of the surety's other contractual, statutory, legal and equitable rights. Furthermore, if the principal/debtor later claims that the surety's property is not the surety's property, but is the principal/debtor's property instead, the principal/debtor agrees that: (a) the "surety's property" is subject to the surety's various rights and interests; and (b) certain terms and provisions in the Agreement are the sole and only means and methods to adequately protect the surety for the principal/debtor's use of the "surety's property" during the principal/debtor's bankruptcy proceeding if the bankruptcy court authorizes the principal/debtor to use the "surety's property."

2. Assumption/Rejection of the Bonded Contracts - The financing agreement must provide for the manner and method of the principal/debtor's right to assume, assume and assign, or reject any of the bonded contracts. Standards of proof for the principal/debtor to meet in the event that the principal/debtor wishes to assume or assume and assign any of the bonded contracts without the surety's consent, including the principal/debtor's proof of the benefit of its performance of the bonded contracts to the principal/debtor's bankruptcy estate, the definition of a default under the bonded contracts, the requirement to cure any bonded contract defaults, and the burden of proof that the principal/debtor must meet to show that it has provided the surety with adequate assurance of the future performance of the work on the bonded contracts.[53]

[53] *In re* CM Systems, Inc., 64 B.R. 363, 364 (Bankr. M.D. Fla. 1986).

3. The Surety's Relief from the Automatic Stay - If the principal/debtor is unable to show the bankruptcy court that it can perform one or more of the bonded contracts, or that the principal/debtor's performance of one or more of the bonded contracts either will not benefit the principal/debtor's bankruptcy estate or is not necessary for an effective reorganization of the principal/debtor, the surety will be entitled to seek relief from the automatic stay in order to exercise its rights against the principal/debtor under the financing agreement or the indemnity agreement. The financing agreement should obtain the principal and indemnitor's consent to relief from the automatic stay as a means of potentially avoiding the cost and expense of a contested motion to lift stay. However, there are issues concerning whether a party may waive the protections of the automatic stay in an agreement prior to the party's filing of a bankruptcy proceeding and the effect of any such attempted waiver.[54] Partial waivers of certain Bankruptcy Code provisions have received a mixed response.[55] Bankruptcy courts are split on whether to enforce a waiver of the automatic stay.[56]

4. Burden of Proof on Bankruptcy Issues - The Bankruptcy Code and case law set certain standards for the burden of proof with respect to relief from the automatic stay of any actions that the surety may take against either the principal/debtor or its property; the principal/debtor's ability and right to use the bonded contract funds; the principal/debtor's obtaining of post-petition financing; and the principal/debtor's right to assume, assume and assign, or reject an executory contract. The financing agreement should place the burden of proof on the principal/debtor before the principal/debtor may obtain certain types of relief from the bankruptcy court.[57] With an agreed upon burden of proof the surety can argue that the bankruptcy provisions in the pre-petition financing agreement with respect to the adequate protection to the surety for both the principal/debtor's use of the bonded contract funds and for the surety's post-petition financing of the principal/debtor set the standards and the burdens of proof that the principal/debtor must meet. The surety can further argue that the financing agreement sets forth certain standards that a principal/debtor must meet before it can assume or assume and assign an executory contract such as a bonded contract.

[54] "It is commonly said that a business may not waive its right to protection under the Bankruptcy Code and that any attempt to do so is void as against public policy." Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 302 (Jan. 1997); *In re Tru Block Concrete Prods., Inc.*, 27 B.R. 486 (Bankr. S.D. 1983); *In re Adana Mortgage Bankers, Inc.*, 12 B.R. 989 (Bankr. N.D. Ga. 1980).

[55] *Id.* at 315.

[56] *See, e.g., In re Alexander SRP Apartments, LLC*, No. 12 20272, 2012 WL 1910088 (Bankr. S.D. Ga. Apr. 20, 2012) (noting that, while pre-petition waivers of the automatic stay are usually not enforced, waivers agreed to during a Chapter 11 proceeding may be enforceable); *In re DB Capital Holdings, LLC*, 454 B.R. 804 (Bankr. D. Colo. 2011); *Farm Credit of Cent. Fla., ACA v. Polk*, 160 B.R. 870 (M.D. Fla. 1993); *In re McBride Estates, Ltd.*, 154 B.R. 339 (Bankr. N.D. Fla. 1993); *In re Hudson Manor Partners, Ltd.*, 28 Collier Bankr. Cas. 2d (MB) 221 (Bankr. N.D. Ga. 1991); *In re Club Tower L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991); *In re Growers Prop. No. 56 Ltd.*, 117 B.R. 1015, 1020 (Bankr. M.D. Fla. 1990); *In re Sky Group, Int'l, Inc.*, 108 B.R. 86 (Bankr. W.D. Pa. 1989); *In re Citadel Prop., Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988); *In re Best Fin. Corp.*, 74 B.R. 243 (Bankr. D. P.R. 1987).

[57] *In re Citadel Prop., Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988); *In re Orange Park S. P'ship.*, 79 B.R. 79 (Bankr. M.D. Fla. 1987) (where stipulation in a pre-petition financing agreement concerning what may constitute adequate protection may be persuasive to a bankruptcy court).

L. Summary

The surety may decide to finance the principal because it believes that financing is the quickest, most efficient and most economical way to get the bonded contracts performed and completed. That belief is predicated upon the surety's investigation and its analysis of the information collected. For the surety to consider financing the principal as a performance bond option, the surety must reach the conclusion that there is nothing wrong with the principal that money cannot cure, and that the capacity, character and collateral of the principal and the indemnitors appear favorable.

The surety should not minimize its substantial financial and management involvement with the principal in an ongoing financing arrangement. From a financial point of view, the surety will frequently pay the principal's debts that are not covered by either the performance or payment bond, including the principal's overhead. From a management point of view, there will be daily and weekly involvement by the surety in the principal's decisions on the bonded contracts. To the extent that consultants, attorneys and accountants are necessary, the surety will incur their costs and expenses in this management function.

Finally, it is critical that the financing agreement between and among the surety, the principal and the indemnitors is clear and unambiguous as to the rights and obligations of the parties. All issues and potential disputes should be discussed and resolved. It is far better to have the negotiations over the financing agreement fall apart at an early stage before the surety commits to financing the principal for any period of time rather than to create and execute a financing agreement that is unclear and ambiguous. The financing agreement should be as detailed as possible, and attempt to resolve anticipated issues as well as those already known and outstanding.