SURETY TODAY PRESENTATION
Given by
Michael A. Stover and George J. Bachrach
Wright, Constable & Skeen, LLP
Baltimore, MD
April 10, 2017

The Reach of the Surety's Subrogation Rights Beyond the Bonded Contract Funds

Our topic today is the Reach of the Surety's Subrogation Rights Beyond the Contract Funds. This is the flip side of our presentation last month, which focused on the limitations of the surety's subrogation rights. Today, we will focus on how far those surety subrogation rights can go.

INTRODUCTION

George: Normally, the surety's subrogation rights are asserted against the bonded contract funds from the contract that the surety bonded with the principal for an obligee. By obtaining the bonded contract funds, the surety may reduce its bond losses.

In the Surety Today presentation on March 13, we addressed some limitations on the surety's subrogation rights to the bonded contract funds when competing with the obligee, the principal's subcontractors and suppliers, the bank, taxing authorities and others. In discussing today's Surety Today topic about the reach of the surety's subrogation rights beyond the bonded contract funds to protect and reimburse the surety, we need to again review the four essential elements required for the surety to assert its subrogation rights:

1. An obligation of the principal to the obligee – which is the bonded contract;
2. The failure of the principal to perform that obligation – namely, the principal's default;
3. Rights in the obligee arising from the principal's default and failure to perform – the obligee's common law rights and the obligee's rights under the bonded contract when the principal defaults; and
4. The performance by the surety, pursuant to its suretyship obligations, of the obligation which the principal failed to perform – the suretyship obligations being the surety's obligations under the bonds.

The focus today is in Element No. 3 – the obligee's common law rights and contractual rights, as well as the common law and contractual rights of the principal and the principal's subcontractors and suppliers, all of which may arise as a result of the principal's default and failure to perform the bonded contract. Those rights may stretch, or reach, further than just the obligee's and the others' rights to the bonded contract funds, and may include their rights to other property to which the surety may assert its subrogation rights.

<u>NOTE</u>: All of the issues that we will address today are discussed in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS (George J. Bachrach, James D. Ferrucci & Dennis J. Bartlett eds, Am. Bar Ass'n, 2013) (the "Subrogation Book"). We recommend that you refer to the Subrogation Book for more details about the issues that we will cover today and review the various case citations.

<u>Common Obligee Doctrine</u>

Our first <u>reach</u> is known as the Common Obligee Doctrine.

The <u>target</u> of the surety's assertion of its subrogation rights under the "Common Obligee Doctrine" is not the bonded contract funds on a project that the surety bonded when the principal defaults under its bonded contract with the obligee. Rather, the <u>target</u> is contract funds that the obligee is holding that it may owe the principal on a totally unrelated contract, whether that unrelated contract was bonded by the surety, some other surety, or not bonded at all. Namely, the surety is seeking to assert its subrogation rights to the obligee's setoff rights.

This subject is addressed in Chapter 14 of the Subrogation Book, where the surety's assertion of its subrogation rights to an obligee's setoff rights may reduce the surety's loss on a bonded contract because the surety's subrogation rights may <u>reach</u> to the contract funds from a contract that is totally unrelated to the bonded contract on which the principal was in default and the surety incurred its loss.

The easiest way to present this issue is with an example.

1. First, assume that the principal and the obligee entered into two separate contracts referred to as Contract 1 and Contract 2 (and no surety is involved in either Contract 1 or Contract 2).
2. Second, also assume that the principal fully performed Contract 1 and is owed $100,000, but the principal defaulted under Contract 2, which caused to the obligee to sustain a loss in relation to Contract 2 of $200,000.
3. Under those circumstances, the obligee would possess the common law and, perhaps, a contractual right to set off any funds in its possession that would otherwise be owed to the principal under Contract 1 (the $100,000) to reduce the obligee's $200,000 loss under Contract 2. The result would be that the obligee has a net $100,000 loss on Contract 2.
4. Now, assume that Contract 2 was bonded by the surety and, following the principal's default under Contract 2, the obligee has paid the surety the remaining bonded contract funds from Contract 2.
5. As a result, the surety, and not the obligee, has incurred the $200,000 in losses (the surety's performance and/or payment bond losses) by completing Contract 2 following the principal's default. In essence, the surety's $200,000 in bond losses prevented the obligee from sustaining its own $200,000 loss in relation to Contract 2.

Under the Common Obligee Doctrine, the surety may assert its subrogation rights to the obligee's setoff rights against the principal relative to the contract funds that would otherwise be owed by the obligee to the principal under Contract 1 (the $100,000). The surety would be entitled to recover those $100,000 in contract funds that would otherwise be owed to the principal under Contract 1 (regardless of whether it was bonded by the surety) to reduce the surety's $200,000 in losses under Contract 2, leaving the surety with a net loss of $100,000 on Contract 2. Therefore, the surety would be in the same position as the obligee if there were no surety bonds on Contract 2 – each would have a net loss of $100,000 on Contract 2.

Why can this occur? The reason is that upon the principal's default and failure to perform under the bonded contract, the obligee has rights – common law and contractual rights, including its setoff rights. In reviewing what is stated above, <u>if neither of the contracts are bonded</u>, and the obligee owes $100,000 in contract funds to the principal on Contract 1, but the obligee has incurred $200,000 in losses due to the principal's default and failure to perform on Contract 2, the obligee is not legally required to pay the principal what may be owed under Contract 1. The obligee may set off against its $200,000 in losses on Contract 2 by NOT paying the principal $100,000 on Contract 1 and using the Contract 1 contract funds to reduce the obligee's losses on Contract 2 by $100,000, from $200,000 to a net loss of $100,000 on Contract 2.

When the surety is involved by issuing bonds for Contract 2, and pays the losses of $200,000 on Contract 2, it is subrogated to all of the obligee's common law and contractual rights, including the obligee's set off rights. As a result, if the obligee owes the principal $100,000 in contract funds on Contract 1, and could exercise its common law and contractual set off rights against the Contract 1 contract funds due to the obligee's $200,000 in losses on Contract 2, the surety may, by asserting its subrogation rights to the obligee's common law and contractual set off rights, obtain those $100,000 in contract funds from Contract 1.

There are some bumps in this <u>reach</u>.

1. First, for set off rights to work, the obligee must be the same entity that contracted with the principal for both Contract 1 and Contract 2.
2. Second, the obligee must be a stakeholder for the Contract 1 contract funds and not have any other independent rights to the Contract 1 contract funds, such as obligee losses due to the principal's default on separate Contracts 3, 4 and 5, none of which were bonded by the surety and on which the obligee has incurred losses. Namely, the obligee gets to make itself whole first before the surety has rights to the excess $100,000 in Contract 1 contract funds.
3. Third, if another surety bonded Contract 1 and had losses, its rights to the $100,000 in contract funds from Contract 1 would prevail over the set off claims of the surety which bonded only Contract 2.
4. Fourth, under state law, the principal's subcontractors and suppliers on Contract 1 may have trust fund or other rights to the $100,000 in contract funds on Contract 1 that may prevail over the set off claims of the surety which bonded Contract 2.

But, there are some gold mines in this <u>reach</u>, too. For example:

1. There are cases which have held that an obligee that has notice of the surety's assertion of is subrogation rights to the obligee's set off rights and then the obligee wrongfully pays the Contract 1 contract funds to another entity – such as the principal, a bank or others

claiming through the principal – then the obligee may have to pay the surety, too, and the obligee ends up paying twice.

2. There is a recent case where a bank asserted that its security interest in the Contract 1 contract funds and the surety asserted its subrogation rights to those Contract 1 contract funds under the Common Obligee Doctrine, and the surety won. The reasoning: the principal was not due the Contract 1 contract funds because of the obligee's ability to assert its set off rights, and, therefore, there was no debt due from the obligee to the principal on Contract 1 to which the bank's security interest could attach.

3. Under the same reasoning, the surety should prevail against the rights of the principal/debtor or the principal's trustee in bankruptcy – there is no debt due and the surety has better rights to the Contract 1 contract funds than the debtor's unsecured creditors in the bankruptcy case.

There are nuances to the Common Obligee Doctrine that are addressed in Chapter 14 of the Subrogation Book. The basis for the surety's assertion of its subrogation rights is equitable, and the surety will not prevail if the result is not fair and equitable.

However, <u>what you need to take away from the presentation of this issue</u> – the surety's assertion of its subrogation rights to the obligee's common law and contractual set off rights – is to continually remember that the Contract 2 which the surety bonded may not be the only contract between the obligee and the principal, and that there may be Contract 1, or Contract 3 or Contract 4, contract funds that may be available for the surety to obtain for reimbursement and the reduction of the surety's Contract 2 bond losses.

THE SURETY'S SUBROGATION RIGHTS AGAINST THIRD PARTIES

Insurance Coverages

Mike: On most construction projects there are numerous types of insurance policies that provide coverage for various project related losses/damages. Typical insurance coverages include: Builders' Risk, Commercial General Liability (CGL), Design Liability, Owner's and Contractor's Protective Liability Insurance, Subcontractor's Default Insurance, Excess Insurance, Wrap-Up Insurance and others. If the surety performs and satisfies the requirements for subrogation it may be subrogated to the benefits of the various insurance policies that may be applicable to the project.

As a small example, I just wrapped up a case for a surety where the owner sued the surety and the principal and the principal promptly went into bankruptcy. We filed a third party claim against the principal's subcontractor and they filed a fourth party claim against the sub-subcontractor. On behalf of the surety we then asserted a claim against the principal's CGL carrier. Ultimately, a settlement was reached with the owner for $100,000. The fourth party paid $35,000, the third party paid $35,000, the surety paid $15,000 and the CGL carrier paid $15,000. Insurance coverage can come in handy.

One must keep in mind that when the Surety exercises its subrogation rights against third parties like insurance companies, such rights will be no greater than the rights of the party to whose shoes the Surety is stepping into. Therefore, the Surety's subrogation rights will be subject to applicable policy defenses such as expiration of coverage, exclusions, or failure to provide timely notice of the claim. It should also be noted that the surety's rights against the insurer are generally only for the insured's losses paid by the surety and not any and all losses incurred by the surety.

When you are investigating a claim one thing to consider is inquiring about all available insurance coverage.

Claims Against Design Professionals

Design professionals, such as architects and engineers, have extensive involvement in nearly every aspect of a construction project and are typically retained by the project owner. When the obligee is the owner and asserts a claim against the performance bond, the design professional may have been responsible for some, or even all, of the surety's losses. That responsibility may arise from deficient plans or specifications; the failure to properly review the work; the wrongful certification of payments for the work; or other negligent acts. Under such circumstances, the surety may want to assert the design professional's wrongful conduct as a defense to the obligee's performance bond claim or as a basis for recovering the surety's performance bond losses.

When the surety has satisfied claims for which the design professional was responsible and otherwise met the requirements of subrogation, the surety may assert its subrogation rights to the rights of the obligee against the design professional for the design professional's deficient performance as a way of achieving reimbursement for the surety's losses.

In the absence of subrogation the surety would typically not be able to assert a claim directly against a design professional on a project because of the operation of the doctrine of privity, unless you are in a jurisdiction that has abolished privity. The doctrine of privity holds that a design professional does not owe a duty to a party unless the party and the design professional are in direct contractual privity. The doctrine of subrogation gets the surety around privity because the surety is subrogated to the rights of the party who has directly contracted with the design professional and the surety stands in the shoes of that party and can assert the rights that that party has against the design professional.

In *Acuity, A Mutual Insurance Company v. McGhee Engineering, Inc.*, 297 S.W.3d 718 (Tenn. Ct. App. 2008) the court analyzed the surety's right to assert claims against design engineers based upon the surety's right to equitable subrogation. *Acuity* involved the construction of tunnels and water intake pipes underneath the embankment of the Cumberland River. The engineer was required under its contract with the obligee to review the principal's work while it was on-going. During construction, the principal refused to extend the tunnels beyond the embankment by the distance required in the drawings. The engineer did not raise an objection. When a subcontractor attempted to excavate into the embankment in order to connect with the tunnels, the embankment began to fail. The engineers inspected the embankment and only recommended that tarps be placed on the embankment instead of considering other stabilization measures. When the embankment completely collapsed shortly thereafter, the principal could no longer complete the bonded project. The obligee declared a default and asserted a performance bond claim against the surety.

Upon completion of the bonded project, the surety asserted claims against the engineer. The trial court granted summary judgment against the surety's claims. The Tennessee Appellate Court reversed and ruled that equitable subrogation is based upon the principle that "substantial justice should be attained, regardless of form" and that "its basis is the doing of complete, essential, and perfect justice between all the parties." Applying those principles, the court found that the engineer breached duties owed to the obligee, which caused the surety to incur additional losses under the performance bond. Therefore, equity and justice permitted the surety to assert its subrogation rights to the rights of the obligee and recover losses caused by the engineers.

<u>The Surety's Subrogation Rights to the Principal's Setoff Rights</u>

George: Not only may a surety assert its subrogation rights to the obligee's set off rights, but the surety may also assert its subrogation rights to <u>reach</u> the set off rights of others either to obtain reimbursement or to compel the principal and others, such as the obligee and/or the principal's subcontractors and suppliers, to exercise their own set off rights to reduce their claims against the surety and reduce the surety's liability and loss.

The right to compel certain parties to exercise their respective set off rights primarily arises when the principal is insolvent and unable to reimburse the surety for its bond losses. Again, an example helps:

1. The principal is insolvent, and perhaps in bankruptcy.
2. A payment bond claimant asserts a claim against the surety's payment bond for $10,000.
3. However, the payment bond claimant owes $6,000 to the principal on an unrelated debt or obligation.
4. The surety may assert its subrogation rights to either:
   a. Compel the principal to exercise its set off rights against the amount owed by the claimant to the principal of $6,000, reducing the surety's liability to $4,000; or
   b. Compel the claimant to exercise its set off rights against the principal for the $6,000 the claimant owes to the principal, reducing the surety's liability to $4,000.

Either way, the result is the same. What is avoided in either result is that the surety is not forced to pay the $10,000 to the claimant and see the $6,000 due from the claimant to the principal be paid to the principal and disappear, or be paid to the principal's trustee and distributed to the principal/debtor's other creditors (or to pay the trustee and its counsel). To deny the surety's subrogation rights to compel the parties to exercise their set off rights would enhance or "unjustly enrich" the principal's bankruptcy estate by $6,000 at the surety's sole expense due to its $10,000 payment to the claimant.

The same surety subrogation right to compel the principal and a payment bond claimant to set off their mutual obligations for the benefit of the surety to reduce the surety's loss extends to the surety's right to compel a performance bond obligee to exercise its similar set off rights.

Like in the Common Obligee Doctrine, <u>there are some nuances to these surety subrogation rights</u> that are addressed in Chapter 14 of the Subrogation Book. For example, the surety may not be able to assert the surety's subrogation rights to compel another entity to exercise its set off rights when:

1. The principal is solvent and otherwise able to pay the surety's losses; or
2. The surety has other collateral (such as the proceeds of a letter of credit) to reduce its losses.

In the latter instance, the equitable basis for allowing a surety to compel an insolvent principal to exercise its setoff rights does not exist while the surety possesses collateral securing the principal's performance of the bonded obligation. The debtor's bankruptcy estate is not "unjustly enriched" until the surety has exhausted any collateral it possesses in relation to the bonded obligation.

In summary, just as in the Common Obligee Doctrine, one should be aware that the prospects for a surety to reduce its loss may come from asserting its subrogation rights to compel others to exercise their set off rights.

THE SURETY'S SUBROGATION RIGHTS TO THE OBLIGEE'S RIGHTS TO INVENTORY AND MATERIALS PURCHASED FOR THE BONDED PROJECT

Mike: If the Surety is subrogated to the rights of the Owner, the Surety can assert the Owner's rights to inventory and materials purchased for the bonded project if such inventory and materials are still in the possession of the Principal. For example, let's assume that the Surety bonded the flooring subcontractor on a project and as is typical in the industry the flooring subcontractor purchased the materials in advance of when the materials were actually needed to ensure availability and avoid long lead times on materials and then stored those materials in its warehouse. The Principal flooring contractor then goes into bankruptcy. The Trustee and/or secured lender may seek to assert interests in the materials held in the warehouse. The secured lender could seek to have the automatic stay lifted so that it can sell the Principal's inventory or the Trustee may seek to sell the inventory under 11 USC §363. If the General Contractor and/or the Owner have paid for those stored materials then a variety of arguments may be asserted to block the Trustee and Secured Lender from selling off the materials; and the subrogated Surety, standing in the shoes of the Owner, can assert those arguments to preserve and protect the materials and avoid paying multiple times for such materials. Those arguments include:

1. That the materials are no longer property of the estate because title has passed from the Principal to the GC or Owner
    a. At the time of the filing of the bankruptcy, Section 541 of the Bankruptcy Code creates an estate of all property in which the debtor has an interest, but if title has passed to the flooring materials in the debtor's warehouse prior to bankruptcy then the debtor does not have an interest in such materials and they are not property of the bankruptcy estate.
        i. Title can pass in such materials in a variety of ways:
            1. Through the language of the underlying bonded contract to which the principal is a party; or
            2. Through a bill of sale which may have been executed for the materials upon the principal's receipt of payment; or

3. Through the operation of law under the UCC when such materials have been segregated and identified to the project.

2. If title has passed, the materials are not subject to the security interest of the lender when such purchase was by a good faith purchaser for value

3. Other arguments such as constructive trust and bailment may also be asserted to establish that the debtor only has a possessory interest and not an ownership interest.

THE SURETY'S SUBROGATION RIGHTS TO THE PAYMENT BOND CLAIMANT'S MECHANICS' LIEN RIGHTS

Everyone no doubt has some familiarity with mechanic's lien rights. Mechanic's liens are statutory rights that apply to unpaid contractors, subcontractors and possibly suppliers on private projects. Mechanic's lien statutes typically allow a party that has performed work for or about a building to place a lien on the property if the party is not paid. Such lien rights do not apply to property of the federal, state or local governments. The question is - if the Surety performs by paying a subcontractor and supplier who has mechanic's lien rights can the surety be subrogated to those mechanic's lien rights?

The Court in *Golden Eagle Ins. Co. v. First Nationwide Fin. Corp.*, 26 Cal. App. 4th 160, 163–64, 31 Cal. Rptr. 2d 815, 817 (1994) addressed this very issue under California law. In *Golden Eagle* the general contractor was hired by the property owner to construct the "infrastructure" of a residential planned unit development – the roads, curbs, gutters, sidewalks, etc. The GC obtained bonds from Golden Eagle Insurance Company and subcontracted the grading work to a subcontractor. The grading subcontractor performed substantial grading on the property but was not paid by the GC or the property owner. The owner also had not paid the GC. The grading subcontractor initiated a mechanics' lien action against the property. Thereafter, the Surety paid the claim of the grading subcontractor and substituted itself as the plaintiff in the mechanics lien action.

The trial court in the mechanics lien action granted summary judgment against the surety. The appellate court reversed and held that if the surety can satisfy all of the requirements of subrogation then it could be subrogated to the mechanic's lien rights of a subcontractor. The court noted however, that because of the equitable nature of subrogation if the owner has fully satisfied its contractual obligations to pay for the work in question then the owner has committed no wrong and permitting subrogation would inequitably subject the owner to double payment in order to free their property of the lien against it. If the owner has breached a contractual obligation to pay the GC for the work, the owner would not be an "innocent" party. Under those circumstances, permitting the surety to enforce the mechanics' lien to the extent of the outstanding balance that remains due from the owner for the performance of the underlying work would to that extent provide the surety with repayment to which it is entitled, and would work no injustice to the rights of the property owner.

The Surety's Subrogation Rights to the Rights of Certain Priority Creditors in the Principal's Bankruptcy Case under Section 507(d) of the Bankruptcy Code

George: Unless the surety has collateral – a lien on the debtor's property, a letter of credit or its proceeds, or the surety's subrogation rights to some contract funds – the surety's losses under its bonds normally result in the surety having an unsecured claim against the debtor and the property to the debtor's bankruptcy estate. In Section 507 of the Bankruptcy Code, the statute sets out which claims have priority, and the order of priority, to distributions from the property of the debtor's bankruptcy estate.

However, Section 507(d) specifically states that an entity, such as a surety, that is subrogated to the rights of the holder of a claim that has priority under Section 507 "is not subrogated to the right of the holder of such claim" to any priorities that such a claim may have.

Section 507(d) results in two situations, the instances when the surety IS NOT subrogated to the priority rights of a bond claimant and the instances when the surety IS subrogated to the priority rights of a bond claimant.

There are three clear instances when the surety IS NOT subrogated to the priority rights of a bond claimant under Section 507(d):

1. When the payment bond surety pays the wages or salaries of the principal/debtor's laborers or employees that have priority.
2. When the tax bond surety pays a tax that has priority.
3. When the customs/importer bond surety pays a duty arising out of the importation of merchandise that has priority.

The cases provide that the surety could have protected itself by securing collateral before it executed the above bonds, and, therefore, should not get a bump up and priority over other unsecured creditors just because the surety paid an obligation or claim that has a priority under the Bankruptcy Code.

The surety MAY be entitled to reach and obtain priority under Section 507(a)(2) if the surety pays an obligation that is an "administrative expense" under Section 503(b). The "administrative expense" would include the payment of the "actual, necessary costs and expenses of preserving the estate." While this would include "wages, salaries and commissions for services rendered after the commencement of the" bankruptcy case, it would not necessarily include wages and salaries for which a surety is already obligated to pay under a payment bond executed prior to the bankruptcy case petition date.

However, if the bonded contract is assumed by the debtor post-petition, then the debtor's obligations under the bonded contract may rise to the level of an "administrative expense" to the extent that the debtor has to cure any defaults in order to assume the bonded contract [*see* Section 365(b)(1)(A)]. In that situation, the surety that may have paid or may have to pay a claim under the performance or payment bond on a bonded contract that has been assumed by the debtor. The surety may be subrogated to the obligee's or claimant's administrative expense rights.

Again, this is complex stuff that requires piecing together many sections of the Bankruptcy Code to determine whether an obligation that the surety has paid or may pay under a particular bond has a priority as an "administrative expense" to which the surety may assert its subrogation rights in order to obtain a higher priority of distribution from the property of the debtor's bankruptcy estate.

But that possibility should not be ignored.

THE SURETY'S SUBROGATION RIGHTS AND "NULLUM TEMPUS OCCURRIT REGI" (TIME DOES NOT RUN AGAINST THE CROWN)

Mike: Is anyone feeling like a member of the Royal family? If the Surety satisfies the claims of the government and becomes subrogated to the rights of the government, the surety may be able to enforce the rule of "nullum tempus occurrit regi" which means approximately "time does not run against the crown." This common-law rule arises from the doctrine of sovereign immunity and it exempts the government from the operation of statutes of limitations. The doctrine of *nullum tempus* remains in effect in a majority of jurisdictions across the country.

In *Am. Bonding Co. v. National Mechanics' Bank*, 97 Md. 598, 55 A. 395 (1903), the surety issued a public official bond for the clerk of the court. The clerk had multiple bank accounts into which funds belonging to the state were deposited, but the clerk took the interest on those accounts for his own personal use. The state made a claim against the surety under the bond for the misappropriated interest and the surety paid the claim. The principal became insolvent so the surety then went after the bank that paid the interest to the clerk as subrogee of the state. The Maryland Court of Appeals held that a surety, which had paid a judgment owing to the state and thereafter sued a debtor as subrogee of the state, "is entitled to stand in the State's position in reference to its claim against the debtor and enjoy its exemption from the operation of the Statute of Limitations."

A few other courts have applied this holding or recognized that the surety would have the benefit of *nullum tempus* upon subrogation to the government's rights. *U.S. Fid. & Guar. Co. v. Union Bank & Trust Co.*, 228 F. 448, 453 (6th Cir. 1915); *Pond v. Dougherty*, 6 Cal. App. 686, 689–90, 92 P. 1035, 1037 (Cal. Ct. App. 1907) ("appellant is entitled to stand in the state's position in reference to its claim against the appellee, and enjoy its exemption from the operation of the statute of limitations.").

While the surety may stand in the shoes of the government for purposes of subrogation, certain governmental powers do not transfer to the surety. In *In re TriUnion Dev. Corp.*, 314 B.R. 611, 622–23 (Bankr.S.D.Tex. 2004) the court held that the surety was not subrogated to the police powers of the government.