SURETY TODAY PRESENTATION

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SURETY CASE LAW UPDATE – WHAT WE HAVE FOUND INTERESTING OVER THE PAST NINE MONTHS

Mike: Hello everyone and welcome to this edition of Surety Today. I am joined today by George Bachrach, a man who needs no introduction, so he won't get any. Surety Today is designed, as you know, to keep the busy surety claims professional up to date and informed on surety issues. Our topic today is: *Surety Case Law Update - What We Have Found Interesting Over The Past Nine Months.* We did this case law update as our initial presentation of Surety Today back in May of 2016. What we have done is sort of the same thing. We've gone back through the SFAA case blurbs that have come out periodically since May 2016, so from May until January, we went through all of those case blurbs and picked out a few cases that we wanted to discuss today. So, without further delay, I will turn it over to George.

Maschmeyer Concrete Co. of Fl. v. American Southern Ins. Co., 2016 U.S. Dist. LEXIS 90119 (M.D. Fla. July 12, 2016)
Renewed Bond Issues

George: In choosing the cases to discuss, one of the issues that we have struggled with is whether to address or discuss cases where the litigated problem arises at the surety underwriting level.

Most surety claims arise at the obligee and principal and the principal and payment bond claimant levels - the obligee claims that the principal is in default, the principal claims that the obligee is in default, and the principal, the surety and the payment bond claimant dispute who is liable for what and the amount of the damages.

Other surety claims arise when the surety seeks to assert its rights - its indemnity and subrogation rights, among others. But – sometimes – the surety claims representative is faced with resolving a problem resulting from a form of "surety underwriting self-inflicted wound."

There are a number of examples in recently reported cases – some of which we see many times and others which are more unique. For example:

1. Cases involving forged indemnitor signatures on indemnity agreements; or

2. Cases involving "misnaming" the principal, either in the indemnity agreement or in the bonds.

3. There have been several recent cases concerning the proper execution of the indemnity agreement by LLC indemnitors – who is the proper managing member to execute the indemnity agreement on behalf of the LLC and what are the ramifications if the surety doesn't get the right person or entity to execute the indemnity agreement?

Furthermore, there is a recent case where the surety underwriters failed to renew a license bond, which may potentially result in the surety's liability and damages to the principal, or at least that is what has been alleged.

When these kinds of cases arise, the claims representative is usually stuck with pretty "hard facts" that can't be changed or modified, and the only question is whether the surety has any legal liability, loses its rights of indemnity or subrogation, or faces other exposure.

The case that I will talk about is when the surety bonds Year 2 of a 5 year contract, and then faces exposure to liability for the three future years that the surety thought that it did not bond. The case is *Maschmeyer Concrete Co. of Fl. v. American Southern Ins. Co.*, 2016 U.S. Dist. LEXIS 90119 (M.D. Fla. July 12, 2016) and we will send the case's citation to you after the presentation.

Facts

1. The Surety bonded Year 2 of a 5 year contract (another surety bonded Year 1 and did not renew its bond):

a. The total contract for the remaining four years = $600,000.

b. The Year 2 bond penal sum: $150,000, or 1/4th of $600,000 of the remaining four years.

c. The Year 2 bond incorporated by reference the applicable state bond statute "provisions and limitations" and the original Year 1 contract provisions.

d. Specifically, the Year 2 bond stated that the term of the bond is for the period of one year, from 12/1/12 to 11/30/13, "regardless of contract language to the contrary."

2. What happened was that the obligee and the principal renewed the contract in Year 3 [12/1/13 to 11/30/14] and in Year 4 [12/1/14 to 11/30/15]. The opinion does not say whether the Year 2 bond was extended or renewed, too, or whether the language in the Year 2 bond with the term limitation was amended for the Year 3 dates or the Year 4 dates. I will have to assume that the answer is NO. The only thing mentioned in the case is that the principal said in the Year 3 renewal acceptance that it would send the bond to the obligee at the appropriate time.

3. Needless to say, the payment bond claimant filed its claim for work performed partially from 4/29/14 (in Year 3) to 1/30/15 (in Year 4). The principal filed bankruptcy in Year 4. So, the claim comes in to the surety and the surety's defense is that it executed a Year 2 bond with its limited term duration for Year 2 only, with certain specific dates, and it did not cover the work performed by the claimant in Year 3 or Year 4.

Court's Holding

The Court held that the Surety was liable under the Year 2 bond for the Year 3 and Year 4 claims. The reason was because the state's bond statute was changed on October 1, 2012, JUST BEFORE the Surety's execution of the Year 2 bond in December of 2012, to provide that any provision in a statutory bond which limits or expands the effective duration of the statutory bond is unenforceable. The court stated that the change in the bond statute occurred prior to the Surety's execution of the Year 2 bond and "was presumably known" to the Surety. Therefore, the Year 2 bond duration was extended to cover the full term of the single five year contract when that contract was renewed for Year 3 and Year 4. As a result, the one year duration in the Year 2 bond was unenforceable and the Surety was liable to the claimant for its Year 3 and Year 4 claims.

Comments

Now the question is – is this an "underwriter self-inflicted wound" when the statute was changed on October 1, 2012 and the Year 2 bond was to be in effect starting on December 1, 2012? – two months later. My response is maybe yes or maybe no. But, it is certainly a warning to sureties that multiple year and renewable contracts have red flags all over them and have to be watched closely. This occurs both as to the duration of the contracts – from Time A to Time B – and also for those contracts where the principal's scope of work is partly bonded and partly non-bonded, such as the surety bonds the principal's demolition work but not the rest of the principal's work on the project, which is a case that Mike Stover had and won for the surety.

You may want to talk to your underwriters and point out the potholes in providing such bonds under the above circumstances in order to avoid writing and charging a premium for one year for a $150,000 bond that may later be found to cover $600,000 in exposure over four years, not one year.

***Tri-State Electric v. Western Surety Company*, 2017 WL 123426 (1/11/17 D. Idaho)**
"No Damage For Delay Clause"

Mike: Thank you George. The first case that I would like to discuss explores the issue of waiver under the Miller Act. In *Tri-State Electric v. Western Surety Company*, 2017 WL 123426 (1/11/17 D. Idaho), the Court addressed a sub-subcontractor's claim for delay damages against a Miller Act payment bond. The Project involved an electrical system upgrade at the Boise, Idaho Veterans Administration Medical Center. The General Contractor was Sygnos, Inc. and it was bonded by Western Surety. Sygnos entered into a subcontract with Apex Enterprises to replace certain electrical switchgear and Apex in turn entered into a Sub-Subcontract with Tri-State Electric to perform part of the Subcontract work. The Project experienced significant delays and a wide variety of disputes arose between the parties, but the dispute I would like to focus on for the purpose of this discussion relates to a damage limitation argument that was asserted by Western.

In response to the claims of Tri-State, Western pointed to a provision in the Apex/Tri-State Sub-Subcontract commonly referred to as a "No Damage for Delay Clause" which provided that:

> The Contractor shall not be liable to the Subcontractor for any damages or additional compensation as a consequence of delays caused by others unless the Contractor has first recovered for such damages on behalf of the Subcontractor. ... The Subcontractor's sole and exclusive remedy for delay shall be an extension in the time for performance of the Subcontractor's work.

That is a standard provision you see in subcontracts and typically they are upheld, while there are some jurisdictions that don't enforce such provisions and some that do. In response to Western's arguments, Tri-State asserted that the damage limitations provisions were impermissible waivers under the Miller Act and such provisions were therefore void. Now the waiver that they are referring to was recently add to the Miller Act. In 1999 Congress amended the Miller Act to include a provision specifying the requirements for a valid waiver of Miller Act rights. The provision at 40 U.S.C. §3133(c) provides:

> A waiver of the right to bring a civil action on a payment bond required under this subchapter is void unless the waiver is:
>
> (1) In writing
> (2) Signed by the person whose right is waived and
> (3) Executed after the person whose right is waived has furnished labor or material for use in the performance of the contract.

The Court denied Western Surety's motion for summary judgment based on the "No Damage for Delay Clause" finding that such provision violated the Miller Act waiver prohibition and was void because the damage limitation provision was entered into before any work was performed. The Court found that the "No Damage for Delay Clause" effectively amounted to a waiver of the claimant's rights to bring an action on the payment bond.

A good argument can be made that the Court got this one wrong. Let's look at some basics:

- The Miller Act provides for the recovery of "sums that are justly due."
- In general, the surety's liability on a payment bond is defined by the liability of the underlying contract – thus, it has been held that the surety on a Miller Act payment bond is liable only to the extent that the general contractor would be liable
- For this reason, the surety may avail itself of the contract defenses available to the bonded principal
- The well recognized purpose of the Miller Act is to ensure that subcontractors are promptly paid for their work on federal construction projects.

Other Courts that have addressed the "No Damage for Delay Clause" have made the distinction between clauses that affect the timing of recovery with clauses that affect the measure of recovery. These Courts have held that "No Damage for Delay clauses" only affect the measure of recovery and not the timing and as such are not contradictory to the Miller Act and are valid and enforceable provisions.

See: *U.S. ex rel. Kogok Corp. v. Travelers Cas. & Surety Co. of America*, 55 F. Supp. 3d 852, 860 (N.D. W. Va. 2014); *Morganti Nat'l, Inc. v. Petri Mech. Co., Inc.,* 2004 WL 1091743 (D. Conn. May 13, 2004)*; Chasney & Co. v. Hartford Acc. & Indemn.,* 2015 WL 3887792 (D. Md. June 22, 2015).

> The Court in *Morganti* observed that "[t]he "no damages for delay" clause, is one that affects the measure of damages, *i.e*., whether there is any liability for monetary damages. It simply delineates the extent of the general contractor's liability or, in the context of the Miller Act, what sums are "justly due" to the subcontractor. Accordingly, the "no damages for delay" clause just as much defines the liability of [surety] as it does the liability of [the bonded principal], and so, both parties are entitled to raise this clause in their defense.

In contrast if you have for example a "pay if paid provision" that has been held by numerous courts to affect the timing of payment and is therefore not enforceable under the Miller Act as an impermissible waiver. There are also cases out there holding that contract provisions which purport to bind the claimant to the dispute resolution process of the bonded principal also can constitute an impermissible waiver.

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

***Kimball Construction Co. v. XL Specialty Insurance Company*, 2016 U.S. Dist. LEXIS 143793 (D. Md. October 18, 2016) Preferences – Payment Bond Claims**

George: My next case is *Kimball Construction Co. v. XL Specialty Insurance Company*, 2016 U.S. Dist. LEXIS 143793 (D. Md. October 18, 2016). This case discusses a preference action in the principal's bankruptcy case.

The Problem

1. The facts were that less than 90 days before the principal filed its bankruptcy, the principal paid a subcontractor $100,000.

2. After the principal filed the bankruptcy case, the Surety paid the subcontractor an additional $200,000 under the payment bond, and obtained a full, executed release – and that's the important fact here.

3. Twelve months later, the principal's trustee filed a preference complaint against the subcontractor for the $100,000 that was paid pre-petition, and there was no defense to the preference payment action (it is not in the ordinary course of business, not for new value, no trust fund provision – there were no defenses).

4. So, the subcontractor sued the Surety for the $100,000 it had to legally turn over to the Trustee as a preference.

5. <u>The question is</u>: who wins – the Surety because of the full release, or the subcontractor because it has not been paid in full for its work despite the release?

<u>Initial Comments</u>

These are tough cases. They usually come up under one of two situations: (a) first, as this one, as a result of the subcontractor signing a full release of its claims against the Surety and the payment bond; or (b) second, when the applicable statute of limitations for a claim against the payment bond has expired at the time of the filing of the preference complaint.

Sometimes sureties make a policy decision to pay these claims regardless of the limitations or release defenses, and I've been on that side of the fence.

Sometimes the payment may have to be made in order for the surety to successfully assert its subrogation rights to the bonded contract funds; namely, if a subcontractor hasn't been paid, the surety may not have subrogation rights.

Sometimes, the release:

a. Does not include a release of possible preference actions and the subcontractor maintains the right to seek additional claims if it subsequently faces preferential payment exposure; or

b. Refers to specific invoices to be paid and the preference action is for prior invoices that are not listed in or part of the release.

Furthermore, even if there is no post-petition payment by the surety or release by the payment bond claimant, Section 70 of the RESTATEMENT OF SURETYSHIP provides that the surety's payment bond obligation revives when the claimant paid by the principal within 90 days before the bankruptcy case is then sued for receiving a preferential payment.

In the *Kimball* and *XL Surety* case:

1. The subcontractor lost BIG TIME because when it attempted to assert its claims against the Surety while facing almost $600,000 in preferential payments, the court found that the executed release of all claims against the Surety was clear, straightforward, "plain and unambiguous."

2. The Court stated that even though the Trustee filed the preference action AFTER the release was executed, the subcontractor signed the release over four months AFTER the principal's bankruptcy case was filed. Therefore, the subcontractor was on "clear notice" of the principal's bankruptcy filing and the possible filing of a preference complaint for the $100,000 payment.

3. So, the release was found to be valid and applicable with respect to the bond claims the subcontractor asserted after the release was executed arising from the pre-petition preferential payments.

Ramifications

One of the ramifications of this case is that the Court's ruling was legally correct, very harsh, and may eventually result in NO subcontractor or supplier ever signing a Surety's release of claims without a reservation of rights to assert another claim in the event of a Trustee filing of a preference action, or, when the release is specifically related to particular invoices, that the release won't apply to other invoices that are subject to the preferential complaint.

Remember, there is a reason why the claimant is seeking payment from the surety under the payment bond – namely, because it is not getting paid by the principal. Frequently, that is the result of the principal having no money to pay the claim because it is insolvent and about to file for bankruptcy.

To paraphrase Section 70 of the RESTATEMENT OF SURETYSHIP: When the principal performs by paying the claimant and thereby discharges the surety from its obligations to perform under the payment bond, and later the claimant, under a legal duty, must repay the money to the principal's trustee as a preference, the surety's obligations under the payment bond revive and the claimant may make a resulting claim against the payment bond.

We, as outside counsel, always want to win the case on behalf of our surety clients, but in this instance, the battle was won, but ultimately the war may end with a revised release that does not allow the surety to prevail when the claimant must return a bankruptcy preference payment to the trustee. Ultimately, I am not sure that this would be the wrong result.

***International Fidelity Insurance Company v. Americaribe-Moriarity, JV*,**
192 F. Supp.3d 1326 (S.D. Fla. 6/22/2016)
Compliance with the Bond and Right to Supplement

Mike: Thank you George.

The next case that I would like to discuss is *International Fidelity Insurance Company v. Americaribe-Moriarity, JV*, 192 F. Supp.3d 1326 (S.D. Fla. 6/22/2016). This is out of the Southern District of Florida. The case involves the discharge of the surety as a result of the Obligee's failure to comply with the AIA A312 Performance Bond conditions precedence. The case also addresses the interplay between the surety's rights under the performance bond and the obligee's right to supplement and perform the work for the defaulting principal. In

IFIC/Americaribe, the surety instituted the action with a declaratory judgment suit seeking a ruling that it was discharged because the Obligee failed to satisfy the conditions precedent in the bond. Of course, the Obligee asserted a counterclaim contending that IFIC breached the bond by failing to cure the default or arrange for performance. Both parties later then moved for summary judgment.

The JV was the general contractor and IFIC bonded the subcontractor – Certified Pool Mechanics or "CPM". CPM was contracted to perform pool work on the project. The facts with respect to notice are as follows, and I will just read through quickly some of the various notices that took place so you can get a sense of the discharge offense that was occurring here:

July 15, 2015 – the JV sent a letter to CPM notifying that it was in default and they gave then three days of cure.

August 17, about a month later, the JV sent a letter to IFIC and CPM advising of delays, poor workmanship and making a demand for an A312 conference.

August 20, three days, later, IFIC responded advising that it was investigating, requesting additional documents and information and advising the JV not to complete the work without IFIC's prior consent.

September 2, the parties held the A312 conference.

September 15, IFIC sent another letter advising that it was continuing its investigation, noting some issues that it had discovered with respect to the schedule, asking for additional informatin and once again advising the JV that any attempt to complete the work without IFIC's consent would be a violation of the bond.

September 16 (One day later), the JV obtained a proposal from another subcontractor to complete CPM's work.

September 17, (Next day), the JV and the new subcontractor set a tentative start date for work which was to be 9/21.

September 21 the JV sent a letter to CPM and IFIC declaring a default, terminating CPM and demanding that IFIC perform.

September 22 the JV sent a letter advising IFIC that it intended to subcontract with the new subcontractor and

September 23, the subcontractor began performing the work.

The JV made some later attempts to provide additional notices, but the Court held that under such facts the JV failed to give proper and timely notice to IFIC as required by the Performance Bond, failed to allow IFIC reasonable time to select a performance option and failed to give IFIC the additional seven days notice required under the Performance Bond. The Court noted that coordinating with the replacement contractor before meeting the requirements of the bond was a clear breach of the bond.

I think everyone would agree that IFIC was given the "bum's rush" here, but the JV argued that under the terms of the subcontract with CPM, which was incorporated into the bond by reference, the JV was entitled to employ other contractors to complete the work upon the default of CPM and that its actions were in compliance with the Subcontract.

In addressing this argument, the Court held that the Performance Bond and the Subcontract must be read together "harmoniously" in order to give effect to all terms and provisions of both contracts. The Court noted that where the JV was required to give notice under both the Performance Bond and the Subcontract before it could undertake completion efforts, the surety was entitled to reasonable notice and was entitled to exercise its rights under the Performance Bond.

The Court observed that the bond and the subcontract were not inconsistent, one did not modify or overrule the other. In concluding, the Court stated "[a]lthough the [JV] may have had a right under the subcontract to hire a replacement subcontractor to complete the subcontract, it did not have the right to do so without first allowing IFIC an opportunity to exercise its rights under the Performance Bond."

To address the interplay between the subcontract provisions and the performance bond provisions, the Court essentially reverted to the time honored rules of contract construction. Thus, it is a generally accepted rule that when provisions of a contract appear to be in conflict, the court should attempt to reconcile those provisions, if possible. An interpretation of a contract which gives a reasonable, lawful and effective meaning to all of the terms is preferred to an interpretation which leaves a part unreasonable, unlawful or with no effect.

How this interpretation of the performance bond and subcontract will play out in a given jurisdiction will depend in part on how that jurisdiction applies the incorporation by reference. In some jurisdictions when a document is incorporated by reference the two documents become as one and it is as if the surety is a party to the subcontract. In other jurisdictions, the incorporation by reference is more limited. So, that's going to be an issue when you're looking at this question of how do you determine whether the obligee can just supplement and complete work or whether they've got to comply with the bond terms. In addition, the terms of the bond and the subcontract will also figure heavily in the Court's analysis, in particular the existence of notice provisions in both the bond and subcontract must be present.

Finally, as a practice pointer, the IFIC folks really did a good job in their communication, reminding the obligee that you can't just jump off here and start completing the work, we've got rights under the bond and to do that, you're going to be in violation of the bond and they did that in several of the communications, and I think that was an important factor as well and something that everybody should try to emulate, particularly when you've got that A312 bond form.

Those are the cases that we found interesting. There were actually quite a few more, as you might imagine. We looked through a lot of blubs and what we decided was that some of those cases can be pulled together to create their own separate presentation, so that's what we will be doing in the future.

WRAP UP

The next edition of Surety Today will be on Monday, March 13 at 12:30 ET. The topic will be "The Limitations of the Surety's Subrogation Rights." George and I will talk about how far you can go with subrogation and where are the limitations on that; where does it run out. So, we will get into that. Quick rundown of surety events:

- February 15, the PSCA Luncheon will be held in Philadelphia. David Krebs will be the speaker there
- February 16, the Atlantic Surety Claims Association will have its luncheon
- March 2, the Chicago Surety Claims will its luncheon
- March 15, the PSCA will have another luncheon with Phil Alber speaking