SURETY TODAY PRESENTATION

Given by
Michael A. Stover and George J. Bachrach
Wright, Constable & Skeen, LLP
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The Limitations on the Surety's Subrogation Rights

Our topic today is the Limitations on the Surety's Subrogation Rights, and basically, we're going to be talking about areas where the surety's subrogation rights come up a little short. We are all fortunate today to be joined by Mr. Subrogation, George Bachrach, and I'm going to turn the presentation over to George.

George: Good afternoon. All of the issues that we're going to discuss today are treated in a subrogation book called THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS (George J. Bachrach, James D. Ferrucci & Dennis J. Bartlett eds, Am. Bar Ass'n, 2013). If you need to refer to anything to supplement what we say, that is a primary source you can look to. Before we talk about the limitations of the surety's subrogation rights, we wanted to give you a little introduction on the surety's subrogation rights themselves.

Subrogation Generally

At common law, the surety has a number of equitable rights that it may enforce, including its rights of exoneration and *quia timet*, indemnity and reimbursement, subrogation and contribution. While the surety may assert these common-law rights, many of them have become contractual rights, either under a written indemnity agreement, as in the case of exoneration, *quia timet*, and indemnity and reimbursement, or a written co-surety agreement in the case of the sureties' contribution rights among each other. But, the surety's common-law right of subrogation remains equitable in nature and does not exist in contract form.

There are four essential elements required for the surety to assert its subrogation rights. The first is an obligation of the principal to the obligee, which is the bonded contract. The second is the failure of the principal to perform that obligation, which is the principal's default. The third are the rights of the obligee arising from the principal's default and failure to perform. The obligee's rights are under the bonded contract when the principal defaults, and include the obligee's right to withhold payment of the bonded contract funds until the principal cures any defaults. The fourth and last element is the performance by the surety pursuant to its suretyship obligations of the obligation for which the principal defaulted on and failed to perform. The suretyship obligation is the surety's obligation under its bonds.

When these four elements exist, the surety is subrogated to the rights of the obligee, the principal and third-party claimants, namely the principal's subcontractors and suppliers. The Subrogation Book in Chapter 3 lists all of the rights of the obligee, the principal and the third-party claimants to which a surety may be subrogated.

While all four elements that form the basis of the surety's subrogation rights are based upon and defined by contract rights, namely the obligations of the obligee and principal under the bonded contract, the principal's default under the bonded contract, the obligee's rights upon the principal's default, and the surety's obligations to the obligee under the bonds, the ultimate reason for the surety's subrogation rights is equitable in nature. The fundamental equity in permitting the surety to assert its subrogation rights is that a surety is a party that is secondarily liable for an obligation, not primarily liable, and the surety should not, in fairness, suffer a loss that was caused by other parties. "Subrogation is a rule that the law adopts to compel the eventual satisfaction of an obligation by the one who ought to pay it." When the surety performs its obligations under the bonds for the benefit of the obligee, it is equitable for the obligee to be required to pay the bonded contract funds to the surety. The surety's assertion of its subrogation rights allows the surety to "stand in the shoes" of all of the parties to accomplish this equitable result.

The surety's subrogation rights are very powerful with respect to the surety's rights to the bonded contract funds. However, because they are grounded or based in equity, there are times when other competing parties have better rights than the surety has under its subrogation rights.

This presentation will address some of those times when the surety may not prevail and may not be equitably entitled to the bonded contract funds over the claims of other parties. This discussion does not mean that the surety must give up and not assert its subrogation rights to the bonded contract funds. Rather, some courts have ruled in favor of other parties based upon that court's understanding of what is equitable and whether the surety's subrogation rights should prevail. Mike and I will address four of those instances.

The Surety is Competing with the Obligee for the Bonded Contract funds

The first instance is when the surety is competing with the obligee for the bonded contract funds. When the surety performs the principal's defaulted bonded contract under the performance bond, the bonded contract funds are usually paid directly to the surety for its performance or to a completion contractor for its performance regardless of the performance option that is undertaken, whether it is a takeover, a surety financing, a tender, or an obligee completion using its own completion contractor.

When a surety performs under the payment bond by paying the principal's subcontractors and suppliers due to the principal's default in making such payments, and that default is a default under the principal's bonded contract with the obligee, some obligees attempt to set off the bonded contract funds that they would otherwise owe to the surety performing under the payment bond to pay other non-bonded obligations that the principal owes to the obligee.

Here is an example. Let's say that the bonded contract is for $1,000,000. The principal has been paid $800,000. The principal completes the performance of the work on the bonded project and there remains $200,000 to be paid. The surety pays $400,000 in payment bond claims to the principal's subcontractors and suppliers and makes a claim for the remaining balance of the bonded contract funds of $200,000. However, the obligee has other claims against

the principal arising out of other obligations from the principal. It could be amounts owed by the principal to the obligee on another non-bonded contract or other unsatisfied debts in excess of $200,000, or it could be the obligee as a taxing authority, whether federal, state or local, and is owed taxes in excess of $200,000 from the principal.

As a result, the obligee sets off – or literally takes or steals – the $200,000 of remaining bonded contract funds to pay off the other principal debts or obligations to the obligee, despite the fact that the surety has performed under the payment bond and incurred losses of $400,000. You have to remember that the surety executed a $1,000,000 performance bond and a $1,000,000 payment bond on the bonded project under the expectation that the obligee would pay that amount to either the principal for its performance of the work or the principal's payment of its subcontractors and suppliers that provided work or materials on the bonded project. Or, the obligee could pay the surety those bonded contract funds if the surety performed in the event that the principal defaulted in its performance of the work or its payment of the subcontractors and suppliers.

In the *Munsey Trust* case, a 1947 US Supreme Court decision, the principal completed the performance of the work but failed to pay its subcontractors and suppliers. The surety paid those amounts to the payment bond claimants and made a claim for the remaining bonded contract funds. Using the numbers that I just gave to you as an example, the Supreme Court held that the obligee could set off against the $200,000 in bonded contract funds for the principal's other obligations to the obligee. In that case, it was a debt on another non-bonded contract. The obligee did not have to pay the $200,000 to the surety that had paid $400,000 in claims to the payment bond claimants. The surety lost despite asserting its subrogation rights to the rights of the obligee and the payment bond claimants to the remaining bonded contract funds.

The result in *Munsey Trust*, as found in many cases that have been decided since then, has been to suggest that there is a distinction between the subrogation rights of a surety performing under its performance bond and the subrogation rights of a surety performing under its payment bond.

Almost 50 years later, the correct result was set out in the RESTATEMENT OF SURETYSHIP, Section 31, which is thoroughly analyzed in the Subrogation Book both in Scott Leo's Chapter 2 and in other places.

Under <u>both</u> the performance bond and the payment bond, the surety's performance and payment satisfies the defaulting principal's obligations to the obligee under the bonded contract and the bonds; namely, the surety performs the work and pays for the payment of the principal's subcontractors and suppliers. It is the <u>OBLIGEE</u> that is the one that requires the principal to pay its subcontractors and suppliers under the terms of the bonded contract AND the <u>OBLIGEE</u> is the one that obtains the promise of the principal and the surety under the payment bond that the principal's subcontractors and suppliers will be paid. When the surety cures the principal's defaults by paying the principal's subcontractors and suppliers under the payment bond, the surety is subrogated to the rights of the obligee to the remaining bonded contract funds.

Section 31 of the RESTATEMENT OF SURETYSHIP describes the surety's subrogation rights as the "surety's right of return performance." The surety performs the principal's defaulted obligations to the obligee under its bonds, and the surety is entitled to the obligee's return performance, which is payment to the surety of the remaining bonded contract funds regardless of whether the surety's performance is under the performance bond or the payment bond or both. Under Section 31 of the RESTATEMENT OF SURETYSHIP, the obligee may not set off an unrelated obligation against the bonded contract funds when the surety is entitled to return performance.

In summary, despite the problems that *Munsey Trust* has generated over the years in forcing courts to distinguish the surety's subrogation rights depending upon whether the surety is performing its performance or payment bond obligations, there are good legal and equitable grounds to argue that *Munsey Trust* is wrong, and that the obligee, whether it is an owner or general contractor, has no right to set off other obligations owed to them by the principal against the bonded contract funds that the surety is claiming under its subrogation rights.

The Surety's Subrogation Rights and the Discretion of the Federal Government

Mike: Let's spend a few minutes talking about a situation where the federal government is holding the funds.

A prerequisite to the surety's successful assertion of its subrogation rights against the federal government is the requirement that the surety provide notice to the government. The surety must notify the federal government that the principal has failed to fulfill its contractual obligations and is in default and that the surety is entitled to the remaining bonded contract funds.

The surety will generally not be able to recover the federal government's payments made prior to the surety providing that notice. The surety's rights will also depend on the sufficiency of the notice as well. The notice must provide "some evidence or indication of the principal's default." A notice that contains a mere implied assignment of rights or simply requests that the federal government make payments to the surety rather than to the principal is generally going to be held to be insufficient.

Assuming that proper notice has been given, the extent of the federal government's obligation to withhold the bonded contract funds after receiving the surety's notice depends on whether the federal government is acting as a mere "stakeholder" of the bonded contract funds or whether it continues to have an interest in the bonded contract funds to complete the project.

Following the completion of a bonded project, the government obligee acts as a stakeholder for the remaining bonded contract funds. However, during the performance of the bonded contract, the government obligee has an "important interest in the timely and efficient completion of the contract work." This interest of the government gives rise to a potential limitation on the surety's subrogation rights.

If the federal government is acting as a stakeholder, after it receives proper notice from the surety it must withhold the bonded contract funds or risk having to make a double payment. Moreover, as a mere stakeholder if the federal government is faced with competing claimants to the bonded contract funds, it should not decide on its own who has the superior right, but instead should seek relief in court.

If the project is ongoing, the federal government continues to have an interest in the bonded contract funds, and as a result the federal government is not automatically required to discontinue making progress payments upon receipt of the surety's notice. Rather, the courts recognize that the federal government has an interest in the principal completing the construction contract and, as such, the federal government has broad discretion and flexibility in determining whether to withhold the progress payments for the benefit of the surety or to pay the progress payments to the principal to continue the performance of the construction contract. The government's discretion includes whether to default and terminate the principal and the government's use and disbursement of the progress payments.

Notwithstanding this discretion given to the federal government, when the surety has provided notice to the government that the principal is in default, the government does have a "duty to exercise its discretion responsibly and to consider the surety's interest in conjunction with other problems encountered in the administration of the contract." The federal government must take reasonable steps to determine whether the principal has "the capacity and intention" to complete its obligations under the construction contract. The exercise of this discretion was commented on in the case of *Balboa Ins. Co. v. United States*, 775 F.2d 1158 (Fed. Cir. 1985). In that case, the court listed eight factors as important in determining whether a government obligee has exercised reasonable discretion in distributing the bonded contract funds. Those factors are:

(1) attempts by the government obligee, after notification by the surety, to determine whether the principal had the capacity and intent to complete the bonded contract;
(2) percentage of bonded contract performance completed at the time of notification by the surety;
(3) efforts by the government obligee to determine bonded contract performance after notification by the surety;
(4) whether the bonded contract was subsequently completed by the principal;
(5) whether payments of bonded contract funds subsequently reached the principal's subcontractors and suppliers;
(6) whether the government obligee had notice of the principal's performance problems prior to notification by the surety;
(7) whether the government obligee's actions violate its own statutes or regulations; and
(8) evidence that the bonded contract could or could not have been completed as quickly or cheaply by a successor contractor.

The federal government may be held liable to the surety for wrongful payment if the government's payment was made after receiving the surety's notice and the payment was found to be "arbitrary or capricious" an "abuse of discretion," or was a "deliberate and fraudulent" act

(bad faith). The surety's burden of establishing that the government has abused its discretion is a very high standard.

<u>The Surety' Subrogation Rights and the Principal's Unpaid Subcontractors and Suppliers</u>

I'd like to talk a few minutes about what is performance? George mentioned earlier that one of the requirements for subrogation is performance. Most courts require that upon the principal's default, the surety must perform pursuant to its bond obligations to remedy the principal's default before any subrogation rights can arise. The extent of the surety's "performance" that is necessary will be determined by the surety's undertaking as set forth in the bond as well as in the scope of the underlying contract.

The question becomes how much performance by the Surety is required to give rise to the surety's subrogation rights? Most courts considering the question hold to the view that the surety must "fully perform" to support the surety's assertion of its subrogation rights to the bonded contract funds. The next question then is - what exactly constitutes "full performance?" Under the RESTATEMENT OF SURETYSHIP, the surety may only assert its subrogation rights upon the "total satisfaction of the underlying obligation." RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. § 27(1) (1996). Thus, most courts have adopted the view that full performance has been achieved when the claims of the obligee and the third-party claimants under the payment bond are fully satisfied.

The rationale for the performance requirement is based on the conclusion that the surety is not subrogated to the rights of creditors as long as the creditors retain any interest in those rights. Stated differently, the claimants should not be required to compete with the surety in the enforcement of the claimants' own rights or be otherwise prejudiced by the surety's assertion of its subrogation rights. So let's look at how this issue of full performance can play out with respect to limiting the surety's subrogation rights:

You might think that if the Surety pays the full penal sum of its payment bond that the Surety has fully performed and would be entitled to assert its subrogation rights – you would be wrong.

In *Am. Sur. Co. of N.Y. v. Westinghouse Elec. Mfg. Co.*, 296 U.S. 133, 134, 56 S. Ct. 9, 10, 80 L. Ed. 105 (1935) the Supreme Court addressed the limits of the surety's subrogation rights. In that case, the Principal entered into a contract for drilling a well at the Naval Air Station at Pensacola, Florida. The surety issued the typical Miller Act bond. The Principal finished the work on the project but did not make payment to all of its suppliers and subcontractors. The payment bond claims that were asserted exceeded the penal sum of the payment bond, so the surety paid the penal sum of the payment bond in the court. Thereafter, the unpaid subs and suppliers and the surety asserted competing claims against the retainage held by the government. The surety's claim was based on its equitable right of subrogation. The unpaid subcontractors and suppliers asserted that the total effect of the Miller Act, the contract, and the bond, when read together, was to make the equity of the Surety subordinate to their interests in being fully paid. They contended that an equitable interest, which while not a lien in the strict

sense, should operate with the same effect when competing with the surety's equitable right of subrogation.

The District Court and the U.S. Court of Appeals for the 5th Circuit gave priority in the retainage to the subs and suppliers. The *Westinghouse* Court affirmed and stated:

> A surety who has undertaken to pay the creditors of the principal, though not beyond a stated limit, may not share in the assets of the principal by reason of such payment until the debts thus partially protected have been satisfied in full.

So we see the general rule is that a Surety is not subrogated to the rights of the creditors, nor to the creditors' interests in security, as long as the creditors retain any interest in the right or the security.

There are exceptions to the general rule. One court has noted where the general rule where the Surety has fully performed under its performance bond, but has not fully satisfied all of the claimants under the payment bond, but has paid the penal sum, the payment bond of that surety may have priority over the subs and suppliers by virtue of its performance under the performance bond.

<u>Bankruptcy Application</u>

You might think that that the payment bond surety's subrogation rights have priority over the principal's subcontractors and suppliers who are not paid but whose claims have been barred by the statute of limitations – In the bankruptcy context, you would be wrong. In *Am. Sur. Co. of N.Y. v. Sampsell*, 327 U.S. 269 (1946) the payment bond required claimants to file suit within six months after the principal ceased operations on the work. The surety paid five claims under the bond but did not pay three untimely claims of subcontractors and suppliers. The *Sampsell* court stated that upon bankruptcy of the principal, the surety's claim is subordinated to that of the unpaid subcontractors and suppliers and stated: "[A]s long as there are creditors of the class for whose benefit the original surety bond was written the surety company cannot participate in dividends from the estate until these creditors have been paid in full." *Id.* at 271–72.

So there are circumstances where the surety has appeared to have fully performed, paid its penal sum of the bond, but still subrogation rights have been found to be limited.

<u>The Surety is Competing with the Bank for Earned and Paid Bonded Contract Funds</u>.

George: Another example where the surety's subrogation rights may not be available is when it is dealing with a bank. For the most part, the surety beats the bank.

First, the surety's subrogation rights are not affected or modified by the Uniform Commercial Code. The surety's subrogation rights are not dependent upon an assignment of, a lien on, or any other surety contractual rights to the bonded contract funds. The surety's subrogation rights are not a security interest that requires filing under the UCC to perfect the surety's subrogation rights, whereas, the bank's rights come from an assignment and perfected security interest.

Second, the bank has rights to the bonded contract funds, and the bank's security interest only attaches to the bonded contract funds, when the principal has rights to and is entitled to receive the bonded contract funds. If the principal is in default under the bonded contract, then the terms of that contract normally provide that the principal is not entitled to payment from the obligee until the principal has cured the defaults. The principal has not "earned" the bonded contract funds. There is "no debt due" from the obligee to the principal until the principal performs its obligations under the bonded contract, and the principal has not performed when it is in default of its bonded contract obligations to the obligee.

If there is "no debt due" or payment due to the principal from the obligee, then there is nothing to which the bank's security interest may attach. Upon the principal's default and the surety's performance, it is the surety that is entitled to the payment of the bonded contract funds – which is the "return performance" that we talked about previously – and not the principal or the bank that is claiming through the principal pursuant to the bank's security interest. Again, the surety almost always beats the bank.

However, there are times when the obligee pays progress payments to the principal or the bank which have been earned by the principal and paid by the obligee prior to the principal's default under the bonded contract.

When the progress payments are earned by the principal and paid to the bank prior to the principal's default, or if the bank receives payments from the principal without notice or knowledge that the principal has failed to pay its subcontractors and suppliers on the bonded project from the progress payments, the surety has been unable to recover from the bank pursuant to its subrogation rights the payments received by the bank despite the fact that the surety may have subsequent losses under its payment bond. In general, in the absence of knowledge or fraud on the part of the bank, the surety may not use its subrogation rights to obtain progress payments that have already been paid to the bank.

However, banks have been held to be on notice of the surety's subrogation rights as banks are charged with knowledge that many principals are required to provide bonds. When the principal is in default under the bonded contract prior to the payment of the progress payment, and the bank is aware of the principal's default, the surety may be entitled to obtain from the bank the progress payment that was received by the bank.

This issue is fundamentally determined by the circumstances and facts of the case. The Subrogation Book addresses the issues and the factors, and especially what the bank knew about:

1. The principal's financial issues and possible financial distress;
2. The existence of the surety's subrogation rights to the bonded contract funds; and
3. The bank's actual or constructive knowledge or notice of the principal's bonded contract defaults.

The surety's subrogation rights prevail in a fight for the bonded contract funds over the perfected security interest rights of the bank in most instances because there is "no debt due"

from the obligee to the principal which is in default under the terms of the bonded contract. When the principal may be due an earned progress payment, and that payment is paid to the bank, then the bank may prevail under some factual circumstances, but not always.

The Surety' Subrogation Rights and the Internal Revenue Service Right of Levy

Mike: We just have a couple of minutes here. I wanted to talk about a situation where subrogation rights may be impacted when dealing with the Internal Revenue Service.

Of course, the Internal Revenue Code allows the IRS to place a lien on all property and property rights of a delinquent tax payer, and it can do that by asserting a tax lien and recording that tax lien in the appropriate state recording location. The Code, under 26 U.S.C. § 6323(c), talks about the priorities of parties once a tax lien has been filed and recorded, and long story short there is that the sureties have been given a priority under the right circumstances where the surety's subrogation rights will be held to relate back to the date that the bond was issued.

But the question comes up when the IRS can also choose, instead of just filing a tax lien to file a tax levy, and actually attach the property. So the question is what happens there in that circumstance to the surety's subrogation rights and the issue is one of timing. The surety may have subrogation rights and may have priority over the IRS to the funds, but if the surety doesn't assert those rights within nine months of the tax levy being filed, the surety will lose those rights. There is a Supreme Court case that says the exclusive remedy for a third party asserting any rights to property that has been levied by the IRS is to pursue a wrongful levy action under the Internal Revenue Code, and in order to do that, you have a nine-month period limitation.

In *School Board v. J.V. Construction Corp,* 2004 WL 1304058 (S.D. Fla. Apr. 23, 2004) the IRS recorded a tax lien and then levied on the bonded contract funds. A period of 18 months went by and the obligee filed an interpleader action, and then the surety came in and was trying to contest for the funds, and the court held that the surety was barred, even though it may have had superior rights. It didn't assert a wrongful levy within nine months, and therefore, its rights were barred and the IRS prevailed on the funds. So, be careful. You may have better priority through your subrogation rights, but if you don't assert it timely, then you're going to be out of luck if the IRS has issued a levy.

The next edition of Surety Today will be on Monday, April 10 at 12:30 ET. The topic will be the reverse image of this, "The Reach of the Surety's Subrogation Rights Beyond the Bonded Contract Funds." Again, George and I will give that presentation.