SURETY TODAY PRESENTATION
Given by
Michael A. Stover and Gerard P. Sunderland
Wright, Constable & Skeen, LLP
Baltimore, MD
July 11, 2016

THE SURETY AND THE FEDERAL GOVERNMENT

Mike: Our topic today is *The Surety and the Federal Government - How the Surety Can Use the FAR's, the Lumbermen's Decision and Other Cases to its Advantage.* This is the first installment, we hope, in a number of installments under this general topic of The Surety and the Federal Government. We want to get to a number of issues. Today, Jerry is going to be doing the presentation. Ordinarily, at least in the past, we have been going back and forth between myself and either Cindy or George, but Jerry is going to cover this topic himself. He has spoken about it several times, he has written about it several times, and I think he just has a huge wealth of knowledge on it. First he's going to look at two cases, *National Surety* and *Lumbermens* and talk about how to reconcile these two conflicting cases and talk about how a surety claims handler can use those cases in the federal government context. Then he will focus on the Federal Prompt Pay Act and how the claims handler can use the provisions of that statute and the provisions of the corresponding FAR regulations to its advantage when dealing with claims. So with that said, I will turn it over to Jerry to give the presentation.

Jerry: Okay, I'm looking at an attempt by actual people in the field to try to protect the surety's rights to contract funds, primarily in a payment bond situation where there are numerous iterations of this problem, but today I really want to look at the situation of protecting the contract funds where there are payment bond claims. There are two major cases on this issue. The first case is called *National Surety Corporation v. U.S.*, 118 F.3d 1542 (Fed. Cir. 1997). In that particular contract scenario, the contract required the principal and general contractor to submit a specific form of CPM schedule. It was called an arrow diagram. I have no idea what an arrow diagram is, but the contract said you must submit this document and retainage could not be released until the government received that particular CPM schedule. In *National Surety*, the government released the retainage without obtaining the arrow diagram, the principal defaulted, and the surety filed suit against the government for the premature release of the retainer. The surety recovered in Court of Federal Claims and the surety prevailed on appeal to the Federal Circuit.

Now you would think this is a pure litigation attorney talking, but what's important is it was a two to one decision by the Federal Circuit, and the Chief Judge of the Federal Circuit dissented. The government argued, and it goes back 50 years, that the

government has no duty to a surety to protect the contract funds unless and until the surety notifies the government. In fact, a number of the cases say that there must be a "notice of default" to the government, which, based on my experience many years ago, I was always hesitant as a surety in-house attorney to say "gee whiz, my principal's in default" but some of the cases use that precise word. In holding for the surety, the *National Surety* court said that the government had no discretion to deviate from a specific mandatory contract term to the detriment of the surety. In this case, it was a mandatory required term where there is no discretion and you shall not release the retainage until you get this diagram. The government released the retainage; the surety won to the extent of that retainage.

Mike: The Court did talk about how the government can modify the contract, but it has to follow specific procedures to do that. It has to get the signed documentation in place in order for the government to modify a contract. If it doesn't do that, what the *National Surety* court is saying is that you just can't ignore the federal law and do the work however you want to.

Jerry: This is a non-discretionary term. As Mike pointed out, it is very important. The next big case is *Lumbermens*. Also important about this is the two to one decision by the Federal Circuit. Under the federal rules, a three-judge panel cannot overrule another three-judge panel, so *National Surety* is still good law. *Lumbermens* is still good law. It's a technicality, but it's important. You can find *Lumbermens* at 654 F.3d 1305 (Fed. Cir. 2011). If I don't bore you too much, you will find a very detailed discussion of this case in a paper I wrote for the Surety Claims Institute in 2012. If you have any member in your company who is a member of the SCI, all you have to do is use your member organization and all of our papers are word searchable since 1995. I gave a fair amount of discussion on this case. I had a very hard time trying to rationalize these two cases.

The government in *Lumbermens*, quite frankly in my opinion, did what the government ultimately does; they didn't give a damn about how much work was completed, they just kept paying and paying to keep the contractor going. The contractor ultimately fell on its face and notified the government that it had defaulted and could not complete the contract. Basically, 12% of the work had been finished and 44% of the contract funds had been paid. The surety argued that there were multiple violations of the FAR regarding payment. If you go back and look at each and every one of the FARs mentioned in the *Lumbermens'* opinion, they are all discretionary. The contracting officer has discretion to see if the payments are up to date. They were all discretionary, unlike *National Surety*.

The lawyer who handled this through the Department of Justice in my opinion, is a very, very smart lawyer. He spoke at Pearlman a number of years ago. Simply because I'm crazy, I asked him to go into a room with me and he and I spent 45 minutes arguing about this case. He finally made a point that all of the cases involving the surety's right

to contract funds are based upon notice. I said "gee whiz, there was no notice in *National Surety*" and he said that the court in *Lumbermens* said gee whiz they found notice upon default, but upon default is too late. He said, well, gee whiz, notice is what's important. In the *Lumbermens* case, the surety did not give notice, and therefore, the government had no duty to withhold the contract funds.

The FARs provide at 28.106.5, 28.107.3, if I can read my handwriting, 28.107.7 that the government shall not withhold payment because subs and suppliers have not been paid. Once the jobs have been finished, then the government may withhold. Now that doesn't make sense and does not compare to all the cases over the past 40 years that have said the government pays after the surety notices the government to be liable. Now the *Firemen's Fund of Newark* case and the *Balboa* case, you have a *Transamerica* case; there are numerous cases, so here's what I'm going to suggest that you may try to do. Again, there is no law precisely on the point; I've used this twice and it's worked.

Think about this. You're sitting at your desk and you have an account that from time to time you get a payment bond claim or from time to time you get a complaint about the principal from the owner. From time to time you get that. No big deal, we all have seen that and it's always resolved. But then, all of a sudden, and this is primarily a federal contractor, you start getting what you perceive to be an increased claim volume. You write to your principal and the principal and/or lawyer responds to you and says gee whiz, we don't owe this money…..they haven't done this; they haven't done that; they haven't done whatever. All of us, and I can say I've seen it, see that all of the time and what do you do? You don't want to jump in and start paying claims because you have a principal which facially is very solid, raises good revenue, and your underwriters and major agent say gee whiz you can't agitate these people because they're good. But you're starting to get nervous.

Here's a practical suggestion using *Lumbermens* and *National Surety* and of course, the Prompt Pay Act. The Prompt Pay Act in FARs is found a 32.905, 52.232.5 and 52.232.7. These FARs are implementation of the federal statute. In essence, the federal government is required to make payment upon receipt of a proper invoice within X number of days. In my opinion, the federal government ignores it, and what I'm talking about now, most general contractors ignore it. The general contractor is required by FARs and the statute, if it submits a payment, say for $100,000 and it includes a request that $10,000 is to be paid for mechanical. Think about it, $100,000 for the contractor's own work and $10,000 for mechanical/electrical. It then says gee whiz, we have a fight with the mechanical and electrical; they're late, they haven't done X, they haven't performed and they have not done Y. They tell you surety claims professional, were not paying because of this. That's fine. Under a Prompt Pay Act, there is nothing to prohibit the general from withholding money, but, at the next payment request, the contractor is required to tell the government that it has withheld that amount of money and it is also required to reduce its pay request by that amount. In other words, again,

$100,000 and $10,000. Next month, $100,000 of its work, it is required to reduce its pay request to $90,000 to allow the government to withhold the money for the sub. It is also required to give a written notice to the contracting officer that the money has been withheld.

Based on my experience, and I don't know about you, but I guarantee you 95% of the jumbo contractors don't pay attention, don't agree with it and ignore it. But as a claims handler, think about this….you have these claims and the principal says you have defenses. What is wrong with your writing a letter to the principal saying "okay, we understand you have these claims and defenses; send us your pay requests, your prompt pay certification and by the way, send us notice to the contracting officer that you have withheld the money and you're going to reduce the pay request next time." I guarantee, based on my experience, 98% of the time, the general contractor is scratching his head and saying, oh, we have not done it. You may get ignored, you may not get any response. Depending on how concerned you are, you can then say to the principal or its attorney, "gee whiz, we've got this little piece of paper called a general agreement of indemnity, this says we have access to the books and records, we want these requests. Okay, if it's big enough, we'll send a consultant down, and by the way, you, your spouse or significant other, are required to pay us for this." I guarantee you again you will get no response. Then what's wrong with you writing a letter to the contracting officer? You don't have to say the contract is in default, which are some of the magic words. You say to the contracting officer, here's the notices of claim we have received. Our principal says it has defenses. We've asked for the prompt pay certification. We hereby demand and require you, the contracting officer, to enforce the specific terms and provisions of the contract. We expect you to demand their prompt pay certificates. If they have not withheld money, say to the government, if you pay them without them withholding appropriate amount of money, you have prejudiced our rights and discharged us to the extent of these payments.

I think I can rationalize both *National Surety* and *Lumbermens*. The Prompt Pay Act is a mandatory contract term. The government has no ability to digress from this term. They must pay unless they get the appropriate prompt pay certification. You say, government, you have not received them, if you pay, you pay us twice. I know my time today is short. I will tell you very quickly, there is a two-edged sword to this. It's what's called the False Claims Act. I only know of three cases involving a surety in the United States under False Claims Act. One I cannot discuss because it's actively in litigation in Federal Court in Washington. Hopefully, we're going to get a decision soon. If so, I will share it. But, the two cases are really crazy. One is where an agent and the contractor got together and agreed to split premiums on excess costs. They both lost money and went to jail. The other one, which is goofy in my opinion, is where the general contractor submitted a request for equitable adjustment and included bond premium. The court, threw their multi-million dollar claim out, because it was for bond premiums not paid, if they used the word "estimated" it would be fine.

So, my scenario, think about this, and you have to factor this into your judgment and your policy decision: if the principal has been submitting pay requests without withholding properly, have they committed a False Claims Act violation which can subject them to sanctions. I've seen one case where the bonded principal did everything. They completed the job, the government got exactly what it wanted; but they submitted pay requests that were not quite accurate. I think there were 12 of them. The government and the court said okay, government is whole but you're going to pay a $10,000 fine for each false certificate of payment. Now that's $120,000. Big contractors can afford it but if you're working with a medium size contractor, that can be a death sentence. I'm not saying it will happen; I'm not saying the government will pursue it, but I think I should mention it because I will also say from my perspective if you all were around in the early 80's and remember the cottage industry of asbestos cases, I'm seeing a cottage industry coming of lawyers in small firms marketing themselves to take a Prompt Pay False Claims Act case for 10% and will pay all expenses.

I hope I didn't go too fast but I would like in the future to take the *Indiana Lumbermens* case and utilize that to discuss what the Miller Act performance bond really is and how to use it to defend, which we all have seen, threats of debarment. By the way, you are talking to an individual who was an in-house lawyer for F&D when *Bristol Steel* came about. It was not my case initially. I was called into the president's office when F&D was debarred as public record, along with its co-sureties by Penn Dot, and I was told okay get us back in business in 90 days. Simple thing…..write a check. Then the president said, oh no, Jerry, you have to pay the money in 90 days and make sure we get it back. Easy job. Thanks for your attention, I hope this will help you.

Mike: We still have some time. Let's talk about the issue in *Lumbermens* where the court said that the surety's impairment defense could not be raised as an affirmative claim, but it did say it could be raised as a defense.

Jerry: I deliberately did not get into that because that's the performance bond side. We are all claims professionals. I personally don't think a *quia timet* or what they said was an overpayment defense is an affirmative cause of action, but essentially it was a discharge of suretyship argument. We lawyers try to make a discharge of suretyship argument and affirmative claim. I've never seen a discharge of suretyship as an affirmative claim entitled to damages.

Mike: In the federal courts. In state courts, the cases are there.

Jerry: I've never seen it in federal court and I think it was pled a little bit incorrectly.

Mike: But the court said you could still use it as a defense. In other words, the court in the *Lumbermens* case said that the surety could elect not to pay under the bond, and instead could raise the defense of discharge based on overpayment.

Jerry: That is a very, very interesting topic. As far as I can determine, there is only one case in the United States that defines what a Miller Act bond may be. It's a case that goes back 30 plus years. It's called the *Trinity Universal* case out of the 5th Circuit best known for establishing a performance bond surety's, subrogation rights for contract funds is superior as performance bond surety to the IRS. In that opinion, and again, I think it's the only opinion in the country; the 5th Circuit said the Miller Act bond is an indemnity bond and as Mike points out, *Lumbermens* agreed to that. It's an indemnity bond, you don't have to undertake completion and quite frankly, I've seen a trend, especially one particular government agency that I won't mention, but they tend to wear very dark blue suits and a lot of their officers come from Annapolis. Take a guess who it is, who are now taking the position that we will not enter into a takeover agreement unless the surety waives its penal sum. I can make a very good scenario in *Lumbermens* to say okay guys in blue, shovel it, we're going to tender, we're going to write you a check, assert our defenses, and gee whiz if you complain to the Department of the Treasury, here's the case that says we have a defense, and we're entitled to assert that defense.

Mike: Thank you, Jerry for that. Before we get into the question and answer period, I just want to remind everyone that the next edition of Surety Today will be Monday, August 8 at 12:30 EST, using the same call in number, code and pin. The topic will be "The Surety and the Uniform Commercial Code" and I will be joined by Professor Lisa Sparks, our very own professor. She's of counsel here and a fulltime professor at the University of Baltimore School of Law and she teaches the UCC. So, she's going to be joining us next month to talk about the UCC.

Now for a quick rundown of upcoming events in the surety world: on August 18 will be the Atlanta Surety Claims Association meeting. I'm not aware of anything else in July or August. Then in September, we get pretty busy

- September 7 – 9: Pearlman conference in Seattle, WA. Jerry will be there.
- September 14: Philadelphia Surety Claims Association lunch in Philly.
- September 21 – 23: Northeast Surety Claims Conference in Atlantic City. I hope to see everybody there. Wright Constable is a co-sponsor of that conference.

I want to thank everyone for calling in and we hope you will join us again on August 8.