SEVENTH ANNUAL
NORTHEAST SURETY & FIDELITY CLAIMS CONFERENCE
OCTOBER 24-24, 1996

WHEN IS A BOND PAYMENT CLAIMANT NOT A CLAIMANT? (PAYMENT CLAIMS BY CLAIMANTS RELATED TO THE BOND PRINCIPAL)

PRESENTED BY:

MICHAEL T. TROCKE AND DANIEL G. MUSCA
SHUMAKER, LOOP & KENDRICK
101 EAST KENNEDY BOULEVARD
SUITE 2800
TAMPA, FLORIDA 33602

WHEN IS A BOND PAYMENT CLAIMANT NOT A CLAIMANT?
(PAYMENT CLAIMS BY CLAIMANTS RELATED TO THE BOND PRINCIPAL)

A. The Problem.

A bonded general contractor occasionally will subcontract a portion of its work to a wholly-owned or related entity. In such cases, if the general contractor defaults on its payment obligations, the payment bond surety usually will not face a claim by the affiliated company for payment for work performed on the project because the surety hopefully, in most cases, will have personal guarantees from the general contractor's key officers and/or shareholders, pursuant to a General Indemnity Agreement, indemnifying the surety for any losses it may sustain. In other words, the principal shareholders of the affiliated company have no incentive to collect against the surety because any money their company receives will be paid back out of their personal pockets.

Occasionally, however, the surety may not have such personal guarantees or the personal indemnitors might be judgment proof and the affiliate entity might be owned by a spouse, relative or close friend.

Relatively few court decisions have addressed this situation (most likely because of the tenacity on the part of sureties in requesting and obtaining personal guarantees in connection with the issuance of their bonds), but the courts which have been presented with this and similar scenarios not unexpectedly have reached inconsistent results in order to allegedly work equity, which generally means that the surety loses. In order to work their "equity", courts have pierced the corporate veil between affiliates, found the affiliates to be "joint venturers" unable to recover on statutory grounds and/or have found fraudulent or collusive conduct on the part of the affiliated companies. The surety can attempt to cobble a defense from the relatively sparse case law wherein an affiliate is denied recovery based on the argument that surety bonds are not intended to compensate an affiliate of the bonded principal.

B. Disregarding the Corporate Structure (Piercing the Veil).

1. General Principles.

The principle of disregarding the separate existence of related multiple corporate entities is generally referred to as "piercing the corporate veil." Alternatively, courts may disregard the separate corporate structures on the basis that the related entities are "alter egos" of each other or that one corporation is a "mere instrumentality" of the other. The end result is the same: one corporation's liabilities are treated as both corporations' liabilities. Piercing the corporate veil usually occurs in parent and subsidiary situations, but may also occur with horizontally related corporations.[1]
As a general rule, courts are reluctant to disregard the corporate structure absent some evidence of fraud, or gross injustice. Courts have identified the following factors as

[1] M Corp. v. Oberer Dev. Corp., 631 F.2d 536 (7th Cir. 1980); Cabalceta v. Standard Fruit Co., 883 F.2d 1553 (11th Cir. 1989).

grounds for piercing the corporate veil in the context of a parent and its subsidiary where there is no clear-cut fraud or illegality:

(I) the parent owns all or a majority of the capital stock of the subsidiary,
(ii) the parent and the subsidiary have common directors or officers,
(iii) the parent finances the subsidiary,
(iv) the parent subscribes to all of the capital stock of the subsidiary or otherwise causes its incorporation,
(v) the subsidiary has grossly inadequate capital,
(vi) the parent pays the salaries or expenses or losses of the subsidiary,
(vii) the subsidiary has substantially no business except with the parent and no assets except those conveyed to it by the parent,
(viii) in the corporate records of the parent, and in the statements of its officers, `the subsidiary' is referred to as a department or subdivision,
(ix) the directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent, and
(x) the formal legal requirements of the subsidiary as a separate and independent entity are not observed.[2]

No one of such factors in and of itself is determinative.[3]

It has also been said that the corporate fiction will not be recognized where one corporation is so organized and controlled and its business conducted in such a manner as to make it a mere agency, instrumentality, adjunct or alter ego of another corporation.[4]

In a nutshell, where from a preponderance of the facts and circumstances it appears that the relationship between a parent and its subsidiary is so intimate, the parent's control is so dominating, and the business and assets of the two are so intermingled, that treatment of each entity as distinct would result in injustice to third persons, courts will look beyond the legal fiction of separate entity and will treat the two entities as justice requires.[5] Courts may, however, refuse to pierce the corporate veil in cases

---

[2] Fish v. East, 114 F.2d 177 (10th Cir. 1940); Intern. U., United Auto., Etc. v. Cardwell Mfg. Co., 416 F. Supp. 1267 (D. Kan. 1976).

[3] Bendix Home Systems, Inc. v. Hurston Enter., Inc., 566 F.2d 1039 (5th Cir. 1978).

[4] 18 C.J.S. Corporations § 1 et seq., pp. 366 ff.

[5] Intern. U., United Auto., Etc. v. Cardwell Mfg. Co., 416 F. Supp. 1267 (D. Kan. 1976); DeWitt Truck Brokers v. W. Ray Flemming Fruit Co., 540 F.2d 681 (4th Cir. 1976).

where two corporations act as alter egos if such piercing will not prevent fraud, injustice or wrong.[6]

2. Piercing the Corporate Veil in the Surety Bond Context.

Courts have shown greater than normal willingness to pierce the corporate veil in cases involving actions against sureties. Sureties have long been given the "red-headed stepchild treatment" under the law,[7] and courts have felt at liberty to stretch traditional legal concepts to impose liability on the surety. Such cases, which have disregarded the separate corporate structures of entities in order to find sureties liable, may also be used to the advantage of the surety in cases where entities which are related to the bonded principal are filing claims against a surety's bond. The surety will argue that the separate corporate structures of the principal and the claimant should be disregarded. Since the principal has no right to recover against the bond, neither does the affiliated corporation.

The overwhelming majority of cases which have disregarded a corporation's separate status when surety bond payments are at stake involve bonds issued in accordance with the Miller Act.[8] The Miller Act governs surety bonds issued in connection with federal construction projects, and most states' statutes have "little Miller Acts" requiring surety bonds for public works.

In situations where a surety bond's coverage is limited to subcontractors directly contracting with the general contractor, sub-subcontractors frequently argue that the related subcontractor was the "alter ego" of the general contractor or that the subcontractor was a mere "instrumentality" of the general contractor. If this argument prevails, then the sub-subcontractors will be deemed to have contracted directly with the general contractor and can thus recover against the surety bond. Courts have been very sympathetic toward such arguments, particularly where there appeared to be some intent on the part of the general contractor and the subcontractor in question to

---

[6] McCulloch Gas Tran. v. Kansas-Nebraska Natural Gas, 768 F.2d 1199 (10th Cir. 1985).

[7] "[A] corporate surety in business for profit is not a favorite of the law and surety contracts ... are to be liberally construed in favor of laborers and materialmen." Miller v. Commercial Electric Construction, Inc., 223 Pa. Super. 216, 297 A.2d 487 (1972); United States Fidelity & Guaranty Co. v. United States, 191 U.S. 416, 24 S. Ct. 142, 48 L. Ed. 242 (1903) (a bond underwritten by a corporation which has undertaken for a profit to ensure the obligee against a failure of performance on the part of the principal obligor should be liberally interpreted in favor of the obligee).

[8] 40 U.S.C. § 270a et seq.

structure the subcontracting of a project in a manner which would limit the scope of the surety's liability.[9]

The case law involving the piercing of the corporate veil is extremely fact-intensive. The following cases attempt to identify the most important factors relied upon by courts in determining whether to disregard the separate existence of one or more corporations acting in concert.

A recent case, Ragan v. Tri-County Excavating, Inc.,[10] involved a union's claim that a family-run subcontractor was the alter ego of a general contractor and thus the union could make a claim for unpaid pension fund obligations and union dues against the general contractor's surety without filing a notice of the claim within the ninety-day notice period set forth in the surety bond. The court weighed the general contractor's argument that corporate formalities were scrupulously maintained throughout the subcontractor's twenty-three-year existence and there was no evidence of commingling of funds, against evidence that (i) family members made up the shareholders, officers and directors of both corporations, (ii) the subcontractor owned no equipment of its own, (iii) the subcontractor never paid a dividend, (iv) the subcontractor was grossly undercapitalized for the work it had contracted to perform, (v) the general contractor treated an employee of the subcontractor as its own employee, and (vi) the president of the subcontractor was unable to answer questions concerning the routine affairs of the corporation.[11] Furthermore, the prudent surety had obtained an indemnification provision from the subcontractor which effectively precluded the subcontractor from making a claim against the bond.[12] The court found the above factors as evidence that the separate corporate existence of the subcontractor was a mere sham[13] and adopted what it referred to as a flexible standard of piercing the corporate veil. No finding of fraud or illegality was required; but instead, the corporate veil would be pierced whenever necessary to avoid injustice.[14]

---

[9] See Continental Casualty Co. v. United States, 308 F.2d 846 (5th Cir. 1962) (general contractor's use of wholly-owned subcontractor deemed to be a sham for purposes of determining whether the general contractor had notice of a sub-subcontractor's claim, and thus the sub-subcontractor could recover on a Miller Act surety bond).

[10] 62 F.3d 501 (3d Cir. 1995).

[11] Id., 62 F.3d at 506.

[12] Id., 62 F.3d at 507.

[13] Id., 62 F.3d at 609.

[14] Id., 62 F.3d at 508.

A somewhat similar set of facts was presented in American Casualty Co. of Reading, Pa. v. Assiran,[15] in which the court held that a related corporation could not collect under a Miller Act bond. The contractor principal named under the bond had as its president and sole shareholder the same individual who owned a sole proprietorship subcontractor and another subcontractor corporation, both of which subcontractors attempted to recover against the surety bond. The court denied recovery, stating that the purpose of the bond was "to protect suppliers of labor and materials who are not part of `the family' of the principal and who are, as it were, strangers dealing without opportunity for knowledge of the principal's resources and without a common commitment in joint ventures."[16]

The Ragan and American Casualty decisions demonstrate that sureties need not rely solely on traditional piercing the corporate veil concepts in denying recovery to subsidiaries of, or companies related to, the bond principal. Although the foregoing two decisions utilize the legal theory of piercing the corporate veil, the holdings appear to be more policy driven than based upon the multifactored analysis typically seen in piercing the corporate veil cases.

In Lezzer Cash & Carry, Inc. v. Aetna Insurance Company,[17] in order to qualify for coverage under a Miller Act surety bond, a sub-subcontractor argued that it had a direct contractual relationship with a general contractor of a construction project, by virtue of the fact that the sub-subcontractor had contracted with a subcontractor which shared the same office and telephone with the general contractor. The court rejected this argument, and refused to disregard the individual corporate status of the two corporations noting that there was no evidence of common ownership or interlocking boards of the two corporations, nor was there evidence of fraud, injustice, illegality or wrongdoing.

Different terminology was employed in Fine v. Travelers Indemnity Co.,[18] where the court "telescoped" the corporate relationship between a sub-subcontractor and a subcontractor in order to allow claimants against the sub-subcontractor to recover on a surety bond. In the Fine case, the general contractor and the subcontractor were controlled by one individual, there was no written contract between the general contractor and the subcontractor, and the subcontractor had no money or risk in the contract. Furthermore, the related subcontractor was not truly acting as a subcontractor, but was merely taking a percentage on work which was farmed out to the sub-subcontractors. Such factors led the court to conclude that the corporate separateness of each entity should be disregarded.

---

[15] 289 F. Supp. 645 (D. Mass. 1968).

[16] Id., 289 F. Supp. at 646.

[17] 371 Pa. Super. 137, 537 A.2d 857 (1988).

[18] 233 F. Supp. 672 (W.D. Mo. 1964).

A similar scenario was presented in John A. Hall Construction Co. v. Boone & Darr, Inc.,[19] in which a surety bond's terms required that notice of claims be received by the general contractor within a certain time period. A sub-subcontractor successfully argued that it had a direct contractual relationship with the general contractor (and thus the general contractor had notice of the sub-subcontractor's claim) because the wholly-owned subcontractor was merely a shell of the general contractor. The court focused on the facts that the two corporations had the same officers, there was a unique back charge arrangement which did not reflect arms' length dealings between the general contractor and the subcontractor, and the general contractor did not require the subcontractor to obtain a performance bond.

A different result was reached in United States v. Farina Construction Corp.,[20] in which the court rejected an attempt by a sub-sub-subcontractor to treat a sub-subcontractor and its parent subcontractor, who was bonded, as alter egos despite the facts that the corporate names were similar, both corporations were located at the same address, certain of the officers were the same individuals and inter-corporate contracts were often not in writing.[21] The court focused upon evidence that each corporation kept separate books and records, each maintained a separate payroll and filed separate tax returns, the corporations had different formation dates, shareholders and bookkeepers, among other factors in determining that the corporations were in fact bona fide separate entities. The sub-sub-subcontractor claimant wished to have the two corporations declared alter egos in order to recover upon a surety bond as a more direct claimant.

In Wyoming Construction Co. v. Western Casualty & S. Co.,[22] a surety which had completed a project under a sub-subcontractor's performance bond, successfully collapsed the corporate structures of a defaulting sub-subcontractor and its parent based upon the parent's domination of the sub-subcontractor. The parent company had acquired the sub-subcontractor, a gypsum supplier, during the project and thereupon directed the sub-subcontractor to supply gypsum solely to the parent, halting performance on the bonded contract. The court noted that a disregard of the corporate entity was appropriate to prevent injustice and that the parent company should be held liable for its role in causing the default on the contract.[23]

When recovery against a surety is at issue, even relatively minor connections between corporations may be grounds for holding that the corporations were alter egos. For

---

[19] 102 Mich. App. 786, 302 N.W.2d 850 (1980).

[20] 261 F.2d 278 (D. Mass. 1966).

[21] Id., 261 F.2d at 280.

[22] 275 F.2d 97 (10th Cir. 1960).

[23] Id., 275 F.2d at 104.

instance, in National Surety Corp. v. United States,[24] the court relied upon evidence that the corporations shared from time to time personnel, equipment, materials and funds and that the two corporations used the same stationary with the name of one company blotted out and the name of the other substituted in its stead. Thus, the general contractor had notice of a sub-subcontractor's claim for purposes of recovery under a Miller Act surety bond.

In sum, a minority of courts which have utilized traditional multifactored analysis, such as Lezzer Cash & Carry and Farina Construction, have typically rejected attempts to collapse the separate corporate existences of affiliated corporations. However, a majority of courts have been more apt to depart from such multifactored analysis where sureties were involved, and have based their decisions more on policy rationales and preventing injustice.

C. **No Recovery by Joint Venturers.**

The Miller Act excludes partners of, or joint venturers with, the general contractor from recovery under a surety bond governed by the Act.[25] State versions of the Miller Act often contain a similar limitation on recovery by partners and joint venturers. Similarly, in the private contact situation, a surety facing a claim by a partner or joint venturer can cite the Miller Act joint venturer cases as authority for the principle that surety bonds are not intended to cover such affiliated entities.

For example, in National State Bank of Newark v. Terminal Const. Corp.,[26] the court stated that the protection afforded to laborers under surety bonds did not extend to joint venturers to whom work was subcontracted. The purpose for obtaining the bond is to protect laborers in the event that the contractor should fail to pay wages, and to extend the protection of the bond to the contractor or one of its principals would mean the surety would, in effect, be a guarantor of the profits or success of the contractor.[27]

---

[24] 378 F.2d 294 (5th Cir. 1967).

[25] 40 U.S.C. §§ 270a.

[26] 217 F. Supp. 341, 361 (D.N.J. 1963).

[27] Id. See also U.S., Etc. Woodington Elec. Co. v. United Pac. Ins., 545 F.2d 1381 (4th Cir. 1976) (subcontractor with share of profits was not a joint venturer and could recover under Miller Act surety bond because subcontractor controlled its performance of work and there was no provision for sharing of losses); Miller v. Commercial Electrical Construction, Inc., 223 Pa. Super. 216, 297 A.2d 487 (1972) (employee could recover his share of profits from construction contract from surety; joint venture defense failed because of lack of joint control); United States v. United States Fidelity & Guaranty Co., 4 F. Supp. 854 (D. Wy. 1933) (sharing of joint checking account and other coordinated activities made two contractors joint venturers barring recovery on Miller Act surety bond). The court in United States Fidelity & Guaranty noted that allowing a joint venturer of a principal contractor to

The court in Theobald-Jansen Electric Co. v. P.H. Meyer Co.,[28] echoed this sentiment in the context of a contractor which had agreed to complete the performance of another contractor's work and thereafter brought a claim against the surety which had given the first contractor performance and payment bonds. If the second contractor could recover from the surety, then "a contractor might agree to pay a brother contractor an unlimited compensation for doing the work the contractor was obligated to do, and by this devious method compel his own surety to pay a fabulous profit not covered by the bond."[29] Clearly, allowing a related subcontractor to recover on the principal's surety bond would create the incentive to inflate profit margins at the subcontractor level, thus ensuring that the shareholders would achieve profits despite any misfortunes the general contractor might suffer in completing the project.[30]

On the other hand, in St. Paul-Mercury Indemnity Co. v. United States,[31] a subcontractor was able to recover under a Miller Act surety bond despite an agreement between the subcontractor and the general contractor to share in the profits of the project. The court focused on evidence that the general contractor had little control over the subcontractor's performance of the work and the subcontractor did not assume a portion of any losses on the project.[32]

In most situations involving affiliated companies, there will be some aspects of mutual control and profit sharing which can be cited by the surety as evidence that the two companies were "joint venturers" and should be denied recovery under the surety bond.

D. Claims Against Sureties Which are Tainted by Collusion.

Courts have refused to allow claims which, although seemingly valid on their face, are contrary to the purpose behind obtaining the surety bond.
For example, in S.L. Fulghum & Union Indemnity Co. v. State of Florida,[33] a bank took the contractor's contract proceeds from a bonded contract, applied the proceeds to offset other obligations owed by the general contractor to the bank (rather than crediting such proceeds to subcontractors' claims) and advanced additional sums to pay the contractor's unpaid

---

recover for a principal contractor's default against the principal contractor's own surety would open the door to fraud of a serious type. Id., 4 F. Supp. at 855.

[28] 77 F.2d 27 (10th Cir. 1935).

[29] Id., 77 F.2d at 30.

[30] See also United States v. Grubb, 358 F.2d 508, 512 (9th Cir. 1966) (contractor which fully took over a construction project from another contractor became a joint venturer and was thus unable to make a claim against the first contractor's surety).

[31] 238 F.2d 917 (10th Cir. 1956).

[32] Id.

[33] 94 Fla. 274, 114 So. 367 (1927).

subcontractors and in return took back assignments of said subcontractors' rights against the contractor and the surety. Thereafter the bank instituted an action against the surety to recover for the value of the subcontractors' claims it paid and was denied recovery against the bond. The surety and the owner of the property were prejudiced by the bank's actions because neither entity received timely notice that the subcontractors' claims were not being paid. Such activity violated the spirit and purpose of the state statute relating to surety bonds for public projects, which in part was designed to ensure that sureties could take the necessary steps to protect themselves and secure the prompt payment of all claims of laborers.

Similarly, a supplier of materials for a construction project was estopped from filing a claim against a surety bond because of its collusive conduct.[34] The general contractor in the case felt insecure concerning the financial status of one of its subcontractors and required the subcontractor to endorse all payment checks to the subcontractor's supplier. The supplier secretly re-endorsed the checks back to the subcontractor without crediting the subcontractor's account. The court noted that "[d]espite the highly remedial nature of the Miller Act, it was provided for the protection of the `innocent'." The supplier's actions removed it from the class intended to be protected under the Miller Act.[35]

In a somewhat related area of the law, an Illinois court rejected various subcontractors' arguments that the intertwined relationship between an owner of property and a general contractor created an alter ego situation, because the subcontractors were on notice of the allegedly collusive arrangements prior to agreeing to perform the subcontracting services.[36] The court thus held that an anti-mechanic's lien provision in the contract between the general contractor and the owner was valid as against subcontractor claimants.

E. Conclusion.

Although piercing the corporate veil arguments are helpful in a surety's effort to deny recovery to affiliates of the bonded principal, the more effective argument is that such parties should not recover under the bond because the bond was never intended to benefit entities in their position. A better recommended course of action is for sureties to include language in their bonds which specifically excludes affiliates from recovery under the bond.

---

[34] Graybar Electric Co. v. John A. Volpe Construction Co., 387 F.2d 55 (5th Cir. 1967).

[35] See also General Crushed Stone Co. v. State of New York, 19 N.Y.2d 737, 225 N.E.2d 893, 279 N.Y.S.2d 190 (1967) (supplier's fraudulent participation with contractor in diversion of trust funds barred claim against surety).

[36] Ridgeview Construction Co. v. American Nat'l Bank & Trust Co. of Chicago, 205 Ill. App. 3d 1045, 563 N.E.2d 986 (1990).