

**EIGHTH ANNUAL  
NORTHEAST SURETY AND FIDELITY CLAIMS  
CONFERENCE  
NOVEMBER 6<sup>TH</sup> - 7<sup>TH</sup>, 1997**

***PERILS AND PITFALLS IN PAYMENT BOND CLAIMS  
A DISCUSSION OF UNUSUAL CASE LAW***

**PRESENTED BY:**

**MICHAEL A. STOVER, ESQ.**  
Whiteford, Taylor & Preston  
7 St. Paul Suite 1400  
Baltimore, MD 21202

## PERILS AND PITFALLS IN PAYMENT BOND CLAIMS A Discussion of Unusual Case Law

Michael A. Stover, Esquire

Surprising results; cases with, shall we say, *peculiar* reasoning; and just plain bad law are lurking in the law of payment bonds. We have all run into them from time to time, when some enterprising claimant's counsel dredges up some theory and throws it at you in the heat of battle. These *unusual* cases await the unwary claims professional as a peril or pitfall in the otherwise seemingly mundane practice of handling payment bond claims. It is the purpose of this paper to discuss some of the more unusual opinions, procedures and circumstances, of which claims professionals and practitioners may face and should be aware, to avoid unanticipated liability.

The law concerning payment bonds is for the most part statutorily derived, and as such, is generally straight forward. Issues such as who may make claims, notice requirements, what claims are covered and the time periods when suit must be filed, are all fairly well established in most jurisdictions. Of course, these statutory schemes cannot address the myriad of issues which arise in practice, nor can they insure consistency of results in the variety of factual settings which arise. Still, the statutory nature of payment bond claims lends to an air of certainty, that perhaps is misplaced. There are numerous decisions across the country which seem to fly in the face of conventional wisdom and generally accepted payment bond principles.

For example, surety companies are generally secure in the knowledge that absent bad faith, the penal sum of the payment bond will be the limit of the surety's liability. However, in some instances the courts have gone beyond the penal sum of the bond and extended the surety's liability. Similarly, it is generally recognized that performance bonds and payment bonds are separate obligations covering separate claims. Yet, some courts have allowed payment bond claims to be made against performance bonds. Indeed, in some instances, a surety may actually want to have its payment bond considered as a performance bond. Further, it is generally recognized that the surety's right of equitable subrogation entitles it to the remaining contract balances on a project upon default of the principal. However, in some instances, the courts allow payment bond claimants to take priority over the surety, even in circumstances where the payment bond claim would be barred under the Miller Act. Finally, it is believed, as a general matter, that if the payment bond claimant fails to timely assert its claim under the Miller Act, the claim will be barred. However, some routine actions by the surety can result in the surety being estopped from asserting the statute of limitations as a defense.

Clearly, there are circumstances that may arise in the context of the typical payment bond claims practice that merit extra thought and care for the surety to avoid unexpected liability. This paper will explore some of those circumstances.

**A. When The Penal Sum Of The Payment Bond May Not Be The Limit Of Liability.**

As a general rule, absent bad faith, the surety's liability is limited to the penal sum of the payment bond.<sup>1</sup> However, in certain circumstances, the stated penal sum of the bond may not be the limit of the surety's liability.

In United States ex rel. Howard P. Foley Co. v. Home Indem. Co.,<sup>2</sup> the court, in a Miller Act case, held that when a surety pays in full some payment bond claims and later seeks to interplead the remaining amount of the bond, the surety is liable for the pro rata amount found to be due in the litigation, *even if this amount exceeds the penal sum of the bond.*<sup>3</sup> In Foley, the surety, Home Indemnity Company, issued a payment bond on behalf of the principal in the amount of \$398,655.00, which was later increased to \$418,326.06. The surety paid \$324,810.35 in payment bond claims without contest, leaving only \$93,515.71 of the penal sum of the bond remaining. There were three other payment bond claims asserted that were contested, which totaled \$225,000.00.<sup>4</sup> The surety moved to interplead the three remaining claims for a prorated distribution of the remaining amount of the bond.

In a two page opinion, relying only on Sternberg Co., Inc. v. State Nat. Bank of Texarkana,<sup>5</sup> the Foley Court held that:

all claims, paid and unpaid will be added together and a pro rata rate of distribution will be determined. Judgment will then be entered in the three pending cases based on that determination even though the total amount to be paid will exceed the penal limit of the bond.<sup>6</sup>

The court, in reaching its decision, provided the following example to clarify its opinion:

---

<sup>1</sup> See Transamerica Premier Ins. Co. v. Ober, 894 F. Supp. 471, 474, n. 4 (D. Me. 1995); Pennsylvania Fire Ins. Co. v. American Airlines, Inc., 180 F. Supp. 239, 241 (E.D. N.Y. 1960); Mid-State Precast Systems Inc. v. Corbetta Construction Co., 608 N.Y.S.2d 546 (App. Div. 3d. Dept. 1994); Aetna Cas. & Surety Co. v. Buck, 594 So.2d 280 (Fla. 1992); and Long v. City of Midway, 311 S.E.2d 508 (Ga. 1983).

<sup>2</sup> 256 F. Supp. 943 (M.D. Fla. 1966).

<sup>3</sup> Id. at 944.

<sup>4</sup> It is not clear from the Foley case if the contested claims were in existence and known to the surety at the time the uncontested claims were paid. As will be discussed this fact may have some bearing on the scope of the Foley opinion.

<sup>5</sup> 69 F.2d 759 (5th Cir. 1934).

<sup>6</sup> Id. at 944.

For example, if the bond limit was \$100,000.00 and the bonding company had voluntarily paid \$80,000.00 in valid claims against the bond and then an additional \$70,000.00 in valid claims were proved through litigation, then each claimant would be entitled to recover against the bonding company only two-thirds of its claim. The fact that the company had already paid some claimants more than two-thirds of their claims prior to finally knowing their full liability on the bond would not alter the liability to pay the remaining claimants two-thirds of their claims even though such payments would cause a pay out in excess of the bond limit. In the hypothetical, the surety would have to pay out \$46,666.60 on the remaining claims which added to the \$80,000.00 voluntarily paid out would total \$126,666.60 or \$26,666.60 more than the bond limits.<sup>7</sup>

By relying exclusively on Sternberg, the Foley Court has rendered its decision inherently suspect, since Sternberg was decided in 1934, under the then applicable Heard Act. Foley, on the otherhand, was decided in 1966, under the Miller Act. In 1935, Congress enacted the Miller Act, which repealed and replaced the Heard Act.<sup>8</sup>

Upon review of the Heard Act, it is apparent that it differs significantly from the Miller Act, particularly with respect to the procedures for recovery under the bond. The Heard Act provided for two methods of recovery against the surety. The first, by intervening in a suit brought by the United States against the surety. The second, by filing suit in the name of the United States, if no suit had been filed by the government within six months of completion of the project. Only one suit against the surety could be maintained and all claimants were required to join in that action to recover against the bond. The Act also provided direction for the surety in the event that the penal sum of the bond was insufficient to cover all of the claims asserted. The Act stated:

If the recovery on the bond should be inadequate to pay the amounts found due to all of said creditors, judgment shall be given to each creditor pro rata of the amount of recovery. The surety on said bond may pay into court, for distribution among said claimants and creditors, the full amount of the sureties' liability, to wit, the penalty named in the bond, less any amount which said surety may have had to pay to the United States by reason of the execution of said bond, and upon so doing the surety will be relieved from further liability.<sup>9</sup>

---

<sup>7</sup> Id.

<sup>8</sup> See 40 U.S.C. §270 (1986), Repealed, Aug. 24, 1935, c.642, §5, 49 Stat. 794, and 40 U.S.C. §270a (1986)

<sup>9</sup> See Appendix A.

The Miller Act contains no language regarding pro rata recovery for claims in excess of the penal sum of the bond, nor does it provide for impleading the penal sum of the bond.<sup>10</sup> Further there is no requirement that there be only one suit against the surety.<sup>11</sup> The differences between the two Acts, calls into question the soundness of the Foley Court's decision, given that it was decided under the Miller Act, with its reasoning apparently based on the Heard Act.

In Sternberg, various claims against the bond were settled prior to any litigation being filed. Additional claims against the bond were later brought in a suit involving the surety. Ultimately, after computing the pro rata share of the claimants in the litigation, taking into account the claims which had already been settled, the \$11,600 penal sum of the bond was exceeded by \$2,400.00.<sup>12</sup> By paying some claims before the filing of suit and impleading the remainder of the bond after suit had been filed, the surety lost the protection provided under the Act.<sup>13</sup> This result was compelled by the language of the Heard Act.

Aside from the suspect support for its decision, the Foley Court's holding presents a number of practical problems, not the least of which is the scope of its application. Under a broad reading of Foley, it could be argued that the surety risks liability in excess of the penal sum of the bond whenever it pays any payment bond claims before the full extent of its liability has been determined; even if the surety pays in good faith, without knowledge of any additional claims. A more narrow reading of the case, would suggest that it should apply only in a situation where the total known claims exceed the penal sum of the bond, and the surety knowingly elects to pay some claims in full while disputing others. In such a situation, the surety is in effect using the penal sum of the bond as a sword, depriving the disputed claimants of an opportunity to recover on a pro rata basis with the other claimants if they prevail in the dispute.<sup>14</sup>

Unfortunately, the timing of when the uncontested claims were paid, in relation to when the contested claims became known to the surety is not clear from the Foley opinion. Thus, we do not know if the Court intended to hold the surety liable in excess of the penal sum of the bond, simply because with hindsight the surety failed to pay claims on a pro rata basis or

---

<sup>10</sup> See 40 U.S.C. §270a (1986).

<sup>11</sup> Id.

<sup>12</sup> The focus of the Sternberg case was on the issue of whether the claims which had been compromised and settled prior to the litigation should be considered in computing the pro rata share of the claimants in the litigation. The Court held that it was proper to consider all of the claims in determining the pro rata distribution, even if the claims were not filed in the litigation.

<sup>13</sup> See e.g. Commonwealth v. City Trust Safe Deposit and Surety Company, 73 A. 425 (Pa. 1909).

<sup>14</sup> Id.

whether the Court reached its decision because the surety elected to pay some claims in full while ignoring the potential rights of other known claimants.

A second problem with the Foley opinion is that it ignores the reality of the claims process. Claims professionals are pressed to pay payment bond claims as promptly as possible. Often, by the time the surety becomes involved, it has been several months since the subcontractors and suppliers have been paid. Thus, prompt payment of these claimants is often necessary just to keep them on the job and to avoid delaying the project. However, despite the need for prompt action, obtaining accurate information from the principal in a timely fashion may be difficult or even impossible. Thus, the surety is often forced to act on known payment bond claims, without knowing what other claims may be lurking out there.

Moreover, contrary to the purpose of the Miller Act, the Foley analysis would seem to foster litigation, in that it requires the surety to interplead the penal sum of the bond as a precautionary measure to protect itself from later unknown claims that may exceed the penal sum of the bond. Such a policy forces delay in payment to the subcontractors and may cause delay in the project, perhaps placing the surety at risk on the performance bond.

The Foley decision has received little or no attention from other courts. However, whether the decision represents good law or bad, the fact remains that it has not been overturned. The uncertainty surrounding the Foley opinion illustrates the need to approach payment bond claims with caution. It is of course always advisable to get as much information as possible before paying claims. As quickly as possible, the claims professional must assess the likely number and amount of claims that may be presented. If it appears that the amount of the claims may exceed the penal sum of the bond, even if some of the claims are disputed, the prudent course would be to implead the penal sum before paying any claims.

The difficulty arises where sufficient information regarding potential claims is not readily available, as is often the case. In such a situation, if factors are present which would suggest significant potential liability, the prudent course may still be to implead the bond. By doing so, the surety can “buy” itself some time and force the other claimants to assert their claims. If delay threatens to impact the project, the surety is still in a position to negotiate a resolution or perhaps satisfy such claims under its performance bond. This scenario may be preferable to risking liability in excess of the penal sum of the bond, especially if the amount of that liability is unknown, but potentially large.

There are other circumstances where the surety may face liability in excess of the penal sum of the bond. In United States ex rel. B&M Roofing of Colorado, Inc. v. AKM Associates, Inc.,<sup>15</sup> the surety, Amwest Surety Insurance Company, bonded an indefinite delivery, indefinite quantity (“IDIQ”) contract for roofing repairs at the United States Air Force Academy (“Academy”). The contract was for one year, with options for additional years, and the contract

---

<sup>15</sup> 961 F. Supp. 1441 (D. Colo 1997).

guaranteed orders of at least \$200,000.00 with an upper limit of \$9 Million. At the beginning of the project, the surety provided a Miller Act payment bond with a \$100,000.00 penal sum. During the course of the first year of the contract, the Academy placed several orders for repair work totaling approximately \$1 Million. The Academy also exercised its option to extend the contract. A “consent of surety” form was sent to Amwest regarding the extension of the contract; however, it was never signed.

While Amwest did not expressly consent to bond the option year, it did request a status report from the Academy during the option year; based upon that report, Amwest billed the principal for additional premiums in light of the increased contract price. Shortly thereafter, the principal fell behind schedule in the work and fell behind in its payments to subcontractors and material suppliers. Eventually, the Academy terminated the contract during the option year.

The subcontractors argued that Amwest was liable for all unpaid materials and labor supplied under the terms of the contract and under the equitable doctrine of *quantum meruit*. Such liability would exceed the penal sum of the bond. Amwest contended that its liability was limited to the penal sum of the bond and that it did not agree to bond the extended option period. Cross motions for summary judgment were filed.

The B&M Roofing Court held that because of the unique nature of IDIQ contracts, the surety’s liability was not limited to the stated penal sum of the bond. The Court ruled that Amwest would be liable for labor and materials supplied in amounts in excess of the penal sum of the bond, up to 40% of the total contract price, assuming<sup>16</sup> the contract price was between \$1 Million and \$5 Million.<sup>17</sup> With respect to the option year, while finding that Amwest’s actions in charging additional premiums and requesting status reports were inconsistent with an intent to limit exposure to just the first year of the contract, the Court held that there was a dispute of fact preventing summary judgment on the issue.<sup>18</sup> Finally, the B&M Roofing Court also held that the subcontractors were entitled to recover from the surety for the value of their services and supplies under *quantum meruit*, irrespective of whether they can collect under the contract.<sup>19</sup>

The Court’s analysis on the penal sum issue seems to be premised on a “loose” construction of the principal’s contract to avoid the requirements of the Federal Acquisition

---

<sup>16</sup> Given the procedural posture of the case, the exact contract amount had not been established, thus, the Court was forced to “assume” the contract price based upon the positions being argued between the parties.

<sup>17</sup> Id. at 1444-45.

<sup>18</sup> The principal/obligee contract provided that in the event the contract option was exercised, the principal had 45 days to provide bonding for the option year. The principal did not provide new bonds.

<sup>19</sup> Id. at 1445.

Regulations. Under FAR 28.102-2 (c)(2), regarding indefinite quantity contracts, the contracting officer is to treat the contract price as the price payable for the specified minimum quantity when determining the penal sum of the bond. This provision further provides that “[w]hen the minimum quantity is exceeded, subparagraphs (a)(2) and (b)(2) above apply.” FAR 28.102 (b)(2)<sup>20</sup> relates to payment bonds and provides “[i]f the original contract price is \$5 Million or less, the Government may require additional protection if the contract price is increased. The penal amount of the total protection as revised shall meet the requirement of subparagraph (1) immediately above.”<sup>21</sup> FAR 28.102-2 (b)(3) provides the procedure to be followed if the Government decides to require additional protection:

The Government shall secure additional protection by directing the contractor to increase the penal sum of the existing bond or to obtain an additional bond.

While the Court’s reasoning is not clearly set forth on this issue, it appears that the B&M Roofing Court determined that the language of the contract placed Amwest on notice that it would be required to “automatically” increase the bonding liability when additional materials and labor were supplied. The contract provision upon which the Court based its reasoning states that the bidder

should consider the cumulative effects of Delivery Orders (DO) placed against this contract . . . in determining total bonding liability and costs.<sup>22</sup>

The Court apparently was of the opinion that this contract provision, *in advance*, placed Amwest on notice that additional protection would be required each time the contract price increased. Several policy reasons were cited by the Court to support its interpretation of the effect of the contract language.<sup>23</sup> However, these policy reasons do not explain the fact that the contract provision cited by the court is not a clear directive to automatically increase the penal sum of the bond as would be required by the FAR. The FAR provisions regarding increases in IDIQ contract bond protection are discretionary as to whether additional bonding protection will be required. The Government *may* require additional protection. Because the FAR provisions are discretionary, the surety is not required by the FAR to automatically assume that additional protection will be required. Accordingly, the surety should be entitled

---

<sup>20</sup> FAR 28.102-2(a)(2) relates solely to performance bonds.

<sup>21</sup> Subparagraph (1) provides “The penal amount of payment bonds shall equal - (i) 50 percent of the contract price if the contract price is not more than \$1 million; (ii) 40 percent of the contract price if the contract price is more than \$1 million but not more than \$5 million; or (iii) \$2 1/2 million if the contract price is more than \$5 million.

<sup>22</sup> United States ex rel. B&M Roofing, Inc., 961 F. Supp. at 1444.

<sup>23</sup> The policy reasons were: (1) efficiency, there is no need for the Academy to require additional bonding protection each time the contract price increases; (2) forces the parties best able to monitor the contract’s value to ensure that the bonds are sufficient to protect materialmen; (3) provides protection for the suppliers at all times with no gaps, which is in harmony with the purpose of the Miller Act. Id. at 1444.

to rely on the issuance of a “directive” if the penal sum of the bond is to be increased.<sup>24</sup> The contract language cited by the Court does not provide a *directive*, nor does it clearly signal an intent to modify the FAR requirements.

Moreover, the Court’s analysis seems to be based upon a degree of participation and involvement with the bidding and contracting process by the surety, which in practice is rarely present. The Court placed a great deal of emphasis on the notion that the surety had “knowledge” of the fact that the contract was an IDIQ contract. This knowledge appears to have been inferred from the fact that the contract identified itself as an IDIQ contract. However, underwriters typically do not review the principal’s contracts prior to or as a condition of issuing bonds. Thus, any presumption of the surety’s knowledge of the contract language is overstated. Further, the Court held that the contract’s reference to “bidder,” referred to both the contractor and the surety “because the bidding process is a joint effort between principal and surety.”<sup>25</sup> Typically, with the issuance of payment bonds and performance bonds, the surety is not involved at all in the bidding phase, unless the contract is unusual in some significant respect. Thus, unless there were facts present which were not discussed in the Court’s opinion, the Court’s finding that the bidding process is a “joint effort” is not accurate in light of the surety industry practice. Given the strained contract construction employed by the Court and the faulty premise regarding the surety’s knowledge, it can be effectively argued that the B&M Roofing case may have been improperly decided.

However, regardless of whether the B&M Roofing case was properly decided, it still demonstrates the fact that simple reliance upon the penal sum stated in the bond for limitation of the surety’s liability may not be sufficient to protect the surety and its reinsurers. Courts are increasingly willing to engage in legal gymnastics to extend the liability of a surety to cover an “innocent” supplier or subcontractor. The surety claims professional must be aware of the particular type of contract and even certain activities taken by underwriting, which can expose the surety to liability in excess of the penal sum of the bond or for extended coverage periods. For example, the B&M Roofing Court noted as significant such common and routine activities as the fact that a report was requested during the option year and that additional premiums were charged by the surety. The Court appeared to be of the opinion that these actions on the part of the surety may have been enough to overcome the fact that the surety had not expressly consented to bond the option year.<sup>26</sup> Clearly, potential unexpected liability in excess

---

<sup>24</sup> This is particularly true in this circumstance inasmuch as Amwest’s Treasury bonding limit with the government was insufficient to cover the potential upper limit of the contract. See 59 *Fed. Reg.* 34145 (1994) (*Listing of Companies Holding Certificates of Authority as Acceptable Sureties on Federal Bonds and as Acceptable Reinsuring Companies*). Thus, Amwest and the Academy could not have agreed to an “automatic” fluctuating bonding arrangement, because Amwest was prohibited from bonding any amount of the contract above its Treasury limit of \$2.85 Million in 1994, the date of the contract.

<sup>25</sup> United States ex rel. B&M Roofing, Inc., 961 F. Supp. at 1444, n.3.

<sup>26</sup> In doing so the Court distinguished the present case from United States ex rel. Modern Elec. Inc. v. Ideal Elec. Sec. Co., 868 F. Supp. 10 (D.D.C. 1994), *rev’d on other grounds*, 81 F.3d 240 (D.C. Cir. 1996), where the surety took no such actions.

of the penal sum can spring upon the unwary claims professional, even from the most innocuous actions.

**B. When The Performance Bond May Be Treated As A Payment Bond And When The Surety May Want To Treat Its Payment Bond As A Performance Bond.**

Closely aligned to the issue of when liability may exceed the penal sum of the payment bond, is the circumstance where the payment bond claimant is permitted to make a payment bond claim against the *performance bond*. By giving access to the performance bond for such claims, the courts have effectively enlarged the payment bond liability.

Several courts have taken the position that material and service providers, whose full claim would otherwise be barred by the penal sum of the payment bond, may nevertheless recover under the performance bond.<sup>27</sup> In Kalady, the United States District Court for the Northern District of Illinois allowed the salaries of four laborers to be recovered under the performance bond. The court concluded that the Miller Act must be read liberally and that the incorporation by reference language of the performance bond covered the contractual obligation of the principal to perform the contract in strict accordance with certain labor standards. The labor standards in turn required payment of the laborers.<sup>28</sup> According to the Court, since part of the performance required under the contract included compliance with labor standards and the principal had failed to comply with that requirement, the laborers claims fell within the obligations covered by the performance bond.<sup>29</sup>

In Pitt General, the United States District Court for the Eastern District of Tennessee permitted recovery by a payment bond claimant against the principal's performance bond. The subcontractor was owed over \$46,000.00 for labor and materials; however, the penal sum of the payment bond was only \$21,210.95. The Pitt General Court approached the issue of recovery under the performance bond from a somewhat different perspective than the Kalady court. The contract between Pitt General and the United States required that Pitt General submit a certification stating that it will make payments to its suppliers and subcontractors out of the final payment of the contract as a condition to receiving the final payment from the government.

---

<sup>27</sup> United States ex rel. Hines Lumber Company v. Kalady Construction Co., 227 F. Supp. 1017 (N.D. Ill. 1964) and United States ex rel. Blount Fabricators, Inc. v. Pitt General Contractors, Inc., 769 F. Supp. 1016 (E.D. Tenn. 1991).

<sup>28</sup> Id. at 1020-21.

<sup>29</sup> Id.

The “critical question” under the court’s analysis was whether the surety, by issuance of the performance bond, was guaranteeing the principal’s promise to the United States to pay subcontractors and suppliers, thereby creating intended third party beneficiaries. As third party beneficiaries of the surety’s guarantee of the promise to pay the subcontractors and suppliers, those subcontractors would be entitled to enforce the promise against the performance bond. The Pitt General Court ruled that the surety had guaranteed the promise and that in so doing it created third party beneficiary rights in the subcontractors and suppliers, which could be enforced against the performance bond.<sup>30</sup> It is important to note that several courts have taken the opposite position on this issue, holding that the payment bond claims may not be asserted against the performance bond.<sup>31</sup> However, these courts employ the same third party beneficiary analysis, with the outcome seeming to turn on the particular facts of the case. Thus, it is important for the surety to be cognizant of the principal’s contract with the obligee, because the terms of that contract may extend the liability of the surety for payment bond claims.

In certain circumstances, however, the surety may want to have the discharge of its obligations under a payment bond treated as performance under the performance bond. Whether the surety has performed under a performance bond or a payment bond may be determinative of whether the surety will have a superior or inferior priority as against a tax lien owed by the principal to the obligee.<sup>32</sup> Thus, in this context the surety may want to argue that payments made to payment bond claimants were actually made pursuant to its performance bond. In this regard the foregoing analysis may prove beneficial for the surety. In addition, the United States Court of Appeals for the Federal Circuit has addressed this issue in Aetna Casualty and Surety Company v. United States.<sup>33</sup> The Court in Aetna reversed the United States Claims Court and held that the surety’s payments to subcontractors and suppliers were made under its performance bond and that the surety had a right to contest the payment of contract funds to the Internal Revenue Service.<sup>34</sup> In Aetna, the principal experienced difficulty in completing performance on several projects for the Naval Facilities Engineering Command (“NAVFAC”). As a result, the surety funded the principal’s operations relating to the projects under a formal financing agreement. The agreement provided that the financing would be limited to those funds which the surety would be obligated to provide under its payment bonds

---

<sup>30</sup> Id.

<sup>31</sup> See Transamerica Premier Ins. Co. v. Ober, 894 F. Supp. 471 (D. Me. 1995); United States ex rel. Simon v. Ardelt-Horn Construction Co., 446 F.2d 820-821 (8th Cir. 1971), *cert. denied*, 404 U.S. 1060 (1972); United States Fidelity and Guaranty Co. v. A&A Machine Shop, Inc., 330 F. Supp. 1403 (S.D. Tex. 1971); and Sun Insurance Company v. Diversified Engineers, Inc., 240 F. Supp. 606 (D. Mont. 1965).

<sup>32</sup> See George J. Bachrach and John V. Burch, *The Surety’s Subrogation Rights, in The Law of Suretyship* (Edward G. Gallagher, ed. 1993), p. 26-12 - 14, 26-18 - 20.

<sup>33</sup> 845 F.2d 971 (Fed. Cir. 1988).

<sup>34</sup> Id. at 976.

and that the surety was not assuming the responsibility for ultimate completion of the work on the projects. The agreement also recognized that the principal was unable to complete the project and that it was requesting the surety's assistance in completing the contracts.

After several months of financing, the principal informed the surety that it was able to complete the projects without further funding of its operations. The surety stopped making direct payments to the principal, however, it continued to make payments directly to the subcontractors and suppliers. A few months later the principal fell behind schedule and NAVFAC terminated the principal, took beneficial occupancy and issued deductive change orders for work that had not been completely finished. Subsequently, over the surety's objections, NAVFAC released some of the contract retainage to the IRS for taxes owed by the principal.

The Aetna Court, noting the distinctions between performance bonds and payment bonds and the rights which arise under each, stated:

A surety that pays on a performance bond in order to complete the subject contract has priority over the United States to the retainages in its hands. A surety that pays on its payment bond, however, does not have priority when the United States is asserting a tax or other obligation owed by the prime contractor.<sup>35</sup>

The Court held that "whether a surety is a performing or paying surety must be determined by an objective analysis of all the facts and circumstances of the particular case."<sup>36</sup> The Court noted that neither a formal termination of the contract by the government nor execution of a take-over agreement by the surety is necessary in order for the surety to qualify as a performing surety.<sup>37</sup> Indeed, the surety may satisfy its performance obligations by funding an insolvent contractor to complete performance.

In reaching the conclusion that Aetna had performed under the performance bond, the court found the fact that Aetna was funding the principal, as well as the manner and nature of the payments being made, to be determinative.<sup>38</sup> The fact that the contract was not actually "completed" by the principal or the surety was not significant. The Court found

---

<sup>35</sup> Id. at 974, *quoting*, United States Fidelity Guaranty Co. v. United States, 475 F.2d 1377, 1383 (Ct. Cl. 1973).

<sup>36</sup> Id. at 975.

<sup>37</sup> Id.

<sup>38</sup> The Aetna Court found significant the fact that Aetna made most of its payments directly to the principal and that the payments exceeded the penal sum of the payment bond. The Court reasoned, if Aetna had been paying on its payment bond it would have made such payments directly to the subcontractors and suppliers and it would have ceased making such payments at the penal sum of the bond. Id. at 976.

that NAVFAC elected to accept the work by taking beneficial occupancy and issuing a deductive change order.<sup>39</sup>

While blurring the lines between payment bonds and performance bonds as a matter of policy may not be advantageous for the surety in the long run, in some circumstances it may be a necessary evil.

### **C. When The Payment Bond Claimant Has Priority Over The Surety In Recovering Contract Balances Or Assets Of The Principal.**

Few rights of the surety have been better defined or more widely recognized than the surety's right to equitable subrogation. Subrogation in general has been defined as:

. . . a creature of equity resting on principles of natural justice whereby a new creditor is substituted for an old creditor and acquires all the rights of the original creditor. Such doctrine has been held to mean placing one in the shoes of another, invested with all the rights of the latter, after the involuntary payment of debt or claim.<sup>40</sup>

In the context of surety law, it was observed long ago that "the rule . . . is undoubted, and it is founded upon the plainest principles of natural reason and justice, that a surety paying off a debt shall stand in the place of the creditor, and have all the rights which he has, for the purpose of obtaining reimbursement."<sup>41</sup> In more recent times, the Supreme Court referred to the surety's right of equitable subrogation as being "deeply imbedded in our commercial practices, our economy, and our law . . ."<sup>42</sup>

The surety's right of equitable subrogation will arise from the discharge of its obligations under a payment bond or performance bond. While the surety's priority to contract balances or the assets of the principal is generally thought to be superior to most other claimants, including some federal tax liens, the relative strength of the surety's equitable subrogation rights versus other claimants depends in large measure upon the rights to which the surety becomes subrogated.<sup>43</sup> If the surety steps in and completes a project after default by the principal, the surety becomes subrogated to the various rights of the obligee and the principal.

---

<sup>39</sup> Id.

<sup>40</sup> 11 *Appleman, Insurance Law and Practice* §6505, p. 444 (1981).

<sup>41</sup> Hodgson v. Shaw, 3 Mylne & K. 183, 190 (1834).

<sup>42</sup> Pearlman v. Reliance Insurance Company, 371 U.S. 132, 140 (1962).

<sup>43</sup> See George J. Bachrach and John V. Burch, *The Surety's Subrogation Rights, in The Law of Suretyship* (Edward G. Gallagher, ed. 1993), p. 26-1.

If the surety pays subcontractors and suppliers under the payment bond, after the principal's failure to do so, the surety becomes subrogated to the various rights of the payment bond claimants and the principal.<sup>44</sup> Accordingly, with respect to the priority of the surety's equitable subrogation rights, the subrogation rights arising out of the discharge of obligations under a performance bond are significantly different from the rights arising out of a payment bond.

In the context of payment bonds, despite the fact that a surety may pay the full penal sum of its bond, if the payment bond claims exceed the penal amount of the bond, the surety will not be able to assert its equitable subrogation rights as a priority over the unsatisfied payment bond claimants.<sup>45</sup>

In American Surety Co. of New York v. Westinghouse Electric Mfg. Co.,<sup>46</sup> the United States Supreme Court (Cardozo, J.) addressed a circumstance where the surety paid the full extent of the penal sum of the payment bond, however, the sum was not sufficient to fully satisfy the payment bond claims asserted. Westinghouse involved a contract for the drilling of a well. Under the contract, the government was required to retain 10 percent of the contract price until final completion. The contractor finished the work required by the contract, however it did not pay all of the suppliers and laborers. The surety paid the penal sum of the payment bond into court, but it was not sufficient to satisfy the claims. The principal went into bankruptcy and the contract retainage was paid by the government to the bankruptcy trustee. Thereafter, the payment bond claimants and the surety filed competing claims based in equity to recover the 10 percent retainage from the principal's trustee.

The Court held that the surety could not compete for the retainage with the payment bond claimants.<sup>47</sup> The Court 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. This is the rule where the right to a dividend has its basis in the principle of equitable subrogation. 'A surety liable only for part of the debt does not become

---

<sup>44</sup> Active Fire Sprinkler Corp. v. United States Postal Service, 811 F.2d 747, 755 (2nd Cir. 1987).

<sup>45</sup> United States v. TAC Construction Co., Inc., 760 F. Supp. 590, 593-94 (S.D. Miss. 1991); Active Fire Sprinkler Corp. v. United States Postal Service, 811 F.2d 747, 756 (2nd Cir. 1987); North Denver Bank v. United States, 432 F.2d 466 (Ct. Cl. 1970); United States Fidelity & Guaranty Co. v. United States, 475 F.2d 1377, 1381 (1973); American Surety Co. of New York v. Sampsell, 148 F.2d 986, 987 (9th Cir. 1945) and American Surety Co. of New York v. Westinghouse Electric Mfg. Co., 296 U.S. 133 (1935).

<sup>46</sup> 296 U.S. 133 (1935).

<sup>47</sup> Id. at 137.

subrogated to collateral or to remedies available to the creditor unless he pays the whole debt or it is otherwise satisfied.”<sup>48</sup>

The Court reasoned that where the bond is issued pursuant to a statute, equity would not allow the statutory security to be reduced indirectly by permitting the surety to recover ahead of the class which the bond was to protect.<sup>49</sup> Thus, despite the fact that the surety pays the limit of its liability under the payment bond, its right of equitable subrogation will not be perfected in any of the contract retainage or balances, unless all of the claimants have been paid in full.

The foregoing principle has been taken a step further and applied to circumstances where the payment bond claimant competing with the surety for priority has failed to timely assert its claim against the bond. In American Surety Co. of New York v. Sampsell,<sup>50</sup> the United States Supreme Court (Black, J.) held, in a bankruptcy context, that payment bond claimants who were not paid in full had priority over the surety who paid the penal sum of its payment bond, even though the claimants had failed to comply with the applicable state statute for recovery under the payment bond.<sup>51</sup> The claimant at issue in Sampsell failed to file a lien claim and failed to provide timely notice to the surety regarding its claims, as required by statute. The surety argued that such claims were extinguished under state law prior to the bankruptcy proceedings, and therefore they should not be accorded priority ahead of the surety. Noting that bankruptcy law not state law controlled the issue of the distribution of the principal’s assets in bankruptcy,<sup>52</sup> the Court reasoned that but for the insolvency and

---

<sup>48</sup> Id., quoting United States v. National Surety Co., 254 U.S. 73, 76 (1920)

<sup>49</sup> Id. at 139.

<sup>50</sup> 148 F.2d 986 (9th Cir. 1945).

<sup>51</sup> Id. at 573.

<sup>52</sup> It is not clear from the Sampsell decision to what extent bankruptcy law, as set forth in the Bankruptcy Act of 1898, as amended, controlled the Court’s ruling. Although the Court stated that bankruptcy law not state law controlled the distribution of assets, the Court cited to no Bankruptcy Act provisions. The Court did refer to a “well-established rule under federal bankruptcy law,” however, the Court referenced Westinghouse. The Westinghouse Court decided the distribution of the bankrupt’s assets under equitable principles, noting:

[I]liability to pay was ended, but equities growing out of the suretyship relation survived in undiminished force. Acquittance under the bond did not leave the surety at liberty to prove against the assets of the insolvent principal on equal terms with the materialmen, still less to go ahead of them. The settled principles of the law of suretyship forbid that competition.

Under the provisions of the Bankruptcy Act a similar result would have been reached. Section 57(i) of the Act provided:

Whenever a creditor whose claim against a bankrupt estate is secured, in whole or in part, by the individual undertaking of a person, fails to prove and file that claim, that person may do so in the creditor’s name, and he shall be subrogated to the rights of the creditor, whether the claim has

bankruptcy of the principal, the laborers and materialmen would have been able to recover from the principal, no matter what their rights against the surety might have been.<sup>53</sup> Consequently the Court held “the surety should not by claiming under subrogation or indemnity for money paid to some of the creditors for whose benefit the bond was intended, be allowed to reduce the share of the bankrupt’s assets due to other creditors whom the bond also was intended to protect from insolvency.”<sup>54</sup>

In addressing the surety’s argument that the claimants who had not complied with the state statute were no longer “covered by the bond”, the Sampsell Court analogized their position with the claimants in Westinghouse, noting that those creditors were certainly no more protected by that bond after the surety had paid out the full amount, than the claimant here after the time for notifying the surety had expired.<sup>55</sup>

The principle has also been applied in a non-bankruptcy setting with the same result. In Active Fire Sprinkler Corp. v. United States Postal Service,<sup>56</sup> the Second Circuit was faced with competing claims to contract balances from sureties and an unpaid subcontractor. The subcontractor, Active Fire Sprinkler Corp. (“Active”), failed to timely assert its claim against the bond. The payment bond claims that were asserted exceeded the \$2.5 Million penal sum of the bond, which was paid into court in an interpleader action. The principal assigned all of its rights under the USPS contract to the sureties after it completed the project. Active attempted to intervene in the interpleader action; however, the District Court denied its motion because its claim was untimely. Active then filed an equitable lien action directly against the USPS to recover the remaining contract balances which were owed to Active by the principal under the contract.<sup>57</sup> At the time the lien action was filed, the USPS was holding approximately

---

been filed by the creditor or by him in the creditor’s name, to the extent that he discharges the undertaking except that in absence of an agreement to the contrary, he shall not be entitled to any dividend until the amount paid to the creditor on the undertaking plus the dividends paid to the creditor from the bankrupt estate on the claim equal the amount of the entire claim of the creditor. Any excess received by the creditor shall be held by him in trust for such person.

To the extent that the Westinghouse and Sampsell cases were decided under bankruptcy law, their rulings will still have effect today in light of the current provisions of the Bankruptcy Code. See 11 U.S.C. §509-510. In addition, as the Active Fire Sprinkler Corp., case demonstrates, non-bankruptcy cases reach the same result.

<sup>53</sup> Id.

<sup>54</sup> Id. at 573-74.

<sup>55</sup> Id. at 573.

<sup>56</sup> 811 F.2d 747 (2nd Cir. 1987).

<sup>57</sup> By enacting the Postal Reorganization Act (“PRA”), Congress has waived sovereign immunity as to the USPS. Active Fire Sprinkler Corp., 811 F.2d at 752. The PRA provides that the USPS shall have the power “to sue and be sued in its official name.” See 39 U.S.C. §401 (1982). The Active Court noted that such language has been held to constitute a broad waiver of sovereign immunity. Id. at 752, *citing* Franchise Tax Board v. USPS, 467 U.S.

\$900,000.00 in contract balances. While the lien action was pending, the USPS paid out the contract balance, with the bulk (\$857,779.00) of the money being paid to the sureties and a smaller amount being paid to other subcontractors. Active amended its complaint to include the principal, and the sureties moved to intervene in the lien action asserting that they were entitled to the remaining contract balances.

Cross Motions for Summary Judgment were filed by all parties. The USPS, the principal and the sureties argued that Active could not assert an equitable lien against the USPS because Active had failed to timely pursue its remedies against the bond. In addition, they also argued that the sureties, as subrogees to the subcontractors who had been paid and as assignees of the principal, had superior rights to the contract balances. The District Court granted the sureties' motion for summary judgment and dismissed the lien action. The Second Circuit reversed the District Court's ruling.

On appeal, Active argued that its equitable interest in the contract balance was superior to the sureties', and that the sureties and the USPS should be held liable to Active for its share of the contract balance that was held by the USPS at the time of the filing of Active's suit. In reaching its decision, the Second Circuit first held that the Miller Act was not an exclusive remedy as to the USPS, since sovereign immunity had been waived.<sup>58</sup> The Court distinguished a long line of cases characterizing the Miller Act as the only remedy available to subcontractors on government projects by noting that none of the cases involved government agencies where sovereign immunity had been waived.<sup>59</sup> Absent sovereign immunity, subcontractors have a well recognized equitable interest in contract balances owed by a building owner to a general contractor.<sup>60</sup> With respect to the competing claims between the sureties and Active, the Court framed the relevant inquiry as "to determine whether the

---

512, 517-18, 520 (1984).

<sup>58</sup> *Id.* at 754.

<sup>59</sup> Arvanis v. Noslo Eng'g Consultants, Inc., 739 F.2d 1287 (7th Cir. 1984) (per curiam), *cert. denied*, 469 U.S. 1191 (1985); United States for the use of Aetna Drywall Contractors, Inc. v. Aetna Casualty & Sur. Co., 725 F.2d 650 (11th Cir. 1984) (per curiam); Warrior Constructors, Inc. v. Harders, Inc., 387 F.2d 727 (5th Cir. 1967); United States for the use of B's Co. v. Cleveland Elec. Co., 373 F.2d 585 (4th Cir. 1967); Fanderlik-Locke Co. v. United States, 285 F.2d 939 (10th Cir. 1960), *cert. denied*, 365 U.S. 860 (1961); United States for the use of Industrial Contractors Corp. v. William Clairmont, Inc., 341 F.Supp. 940 (D.Neb. 1972); Fett Roofing & Sheet Metal Co. v. Seaboard Sur. Co., 294 F.Supp. 112 (E.D.Va. 1968); United States for the use of Brown Bros. Grading Co. v. F.D. Rich Co., 285 F.Supp. 572 (D.S.C. 1968).

<sup>60</sup> *Restatement of Security* § 141 (1941); comment e; see Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404, 410 (1908); Matter of Dutcher Construction Corp., 298 F.2d 655, 658 (2nd Cir. 1962) (*quoting* National Surety Corp. v. United States, 133 F.Supp. 381, 384, 132 Ct.Cl. 724, *cert. denied*, 350 U.S. 902 (1955), *aff'd sub nom.* Pearlman v. Reliance Insurance Co., 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962)).

Sureties' claims supersede the claim of Active, we first must understand the derivation of each party's rights."<sup>61</sup>

The Active Court began its analysis of this issue by observing that "the equitable rights of sureties derive from the equitable rights of the class protected by the bond - in this case, the subcontractors."<sup>62</sup> Those subcontractors' rights have been identified in several Supreme Court cases noted by the Active Court. Thus, in Pearlman, the Supreme Court stated that laborers have the right to be paid out of an unpaid contract balance when an insolvent general contractor fails to pay them.<sup>63</sup> Moreover, the Active Court noted that it has been held that the government has an equitable obligation to ensure the payment of laborers and suppliers on government construction projects.<sup>64</sup> Under the Active Court's reasoning, the surety becomes subrogated to these subcontractor rights. However, the Court continued its analysis by finding that these rights to which the surety is subrogated must be tempered against the general rules of subrogation. One such rule is that the surety is not subrogated to the rights of the subcontractors, including the rights against the contract balances, as long as the subcontractors retain any interest in the right or the security.<sup>65</sup> Inasmuch as Active, a subcontractor was not fully paid, it retained an equitable interest in the contract balances. Accordingly, the Court held "[t]hus, although the Sureties are subrogated to the claims of any subcontractors whose claims they have paid, their claims are inferior to those of any remaining unpaid subcontractors, including Active."<sup>66</sup>

Upon first reading of the Westinghouse, Sampsell and Active decisions it seems as though the wrong result has been reached. However, while the result may seem surprising, if the opinions are analyzed in light of the equitable principles upon which they are based, the results are somewhat more palatable. As noted earlier herein, the nature of the surety's subrogation rights depends upon from where the surety's subrogation rights arise. In the payment bond context, the surety is subrogated to the payment bond claimants. By paying the payment bond claimants, the surety steps into their shoes and acquires their rights. However, when the surety pays the full penal sum of the bond, and that amount is insufficient to cover all of the claims, the surety in actuality has not fully paid the claimants. When the payment bond claims exceed the penal sum of the bond, the claimants share pro rata in the bond proceeds. Therefore, the claimants are not paid in full. The general rule regarding subrogation

---

<sup>61</sup> Id. at 755.

<sup>62</sup> Id.

<sup>63</sup> Id. at 141.

<sup>64</sup> Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404, 410 (1908).

<sup>65</sup> Active, 811 F.2d at 756.

<sup>66</sup> Id.

is that until a claimant is fully paid, subrogation rights do not arise. The surety can not step into the shoes of the claimant until those shoes have been vacated, so to speak. Thus, the surety can not compete against other unpaid payment bond claimants, because it has not fully paid such claimants. Accordingly, the payment bond surety who does not complete the project, must consider the fact that its salvage rights may be significantly impaired if the penal sum of its bond does not fully satisfy the payment bond claimants.

**D. Equitable Estoppel - When The Statute Of Limitations Is Not A Bar To A Payment Bond Claim.**

The Miller Act provides:

Every suit instituted under this section shall be brought in the name of the United States for the use of the person suing, in the United States District Court for any district in which the contract was to be performed and executed and not elsewhere, irrespective of the amount in controversy in such suit, but no such suit shall be commenced after the expiration of one year after the day on which the last of the labor was performed or material was supplied by him.<sup>67</sup>

This provision creates a one year statute of limitations on payment bond claims.<sup>68</sup> Generally, courts will strictly apply the Miller Act limitations period. However, courts also recognize the applicability of the doctrine of equitable estoppel to Miller Act claims. Under this doctrine, ordinary day-to-day claims handling activities of the surety claims professional can have unintended consequences on the payment bond surety's statute of limitations defense. Indeed, even the actions of the principal can result in the loss of an otherwise solid statute of limitations defense to a payment bond claim.

In the context of Miller Act claims, the doctrine has been described as follows:

Estoppel arises where one, by his conduct, lulls another into a false security, and into a position he would not take only because of such conduct. Estoppel, in the event of a disputed claim, arises where one party by his words, acts, and

---

<sup>67</sup> 40 U.S.C §270b (b) (1986).

<sup>68</sup> See United States ex rel. Atlas Erection Co., Inc. v. Continental Casualty Company, 357 F. Supp. 795, 798 (1973); United States ex rel. Nelson v. Reliance Ins. Co., 436 F.2d 1366 (10th Cir. 1971); United States ex rel. Humble Oil & Refining Co. v. Fidelity & Casualty Co. of New York, 402 F.2d 893 (4th Cir. 1968); United States ex rel. E. E. Black, Ltd. v. Price-McNemar Const. Co., 320 F.2d 663 (9th Cir. 1963). A minority of jurisdictions have held that the filing period in the Miller Act is a condition precedent to the institution of a claim and not an ordinary statute of limitations. See United States ex rel. Dover Elevator Co. v. General Ins. Co., 339 F.2d 194 (6th Cir. 1964).

conduct led the other to believe that it would acknowledge and pay the claim, if, after investigation, the claim were found to be just, but when, after the time for suit had passed, breaks off negotiations and denies liability and refuses to pay.<sup>69</sup>

Equitable estoppel typically would not arise unless there was some deception relied upon by the other party to their detriment.<sup>70</sup> However, the modern trend has been to allow the operation of the doctrine without a showing of fraud or deception.<sup>71</sup>

In Humble Oil, the Fourth Circuit held that the surety was estopped from asserting the statute of limitations as a defense against a payment bond claimant under the facts of that case.<sup>72</sup> Humble Oil supplied asphalt and petroleum products to the bonded principal on a highway project. The principal failed to pay Humble Oil for the materials and supplies provided, and approximately 6 months after it last provided materials for the project, Humble Oil gave notice of the nonpayment to the surety, Fidelity & Casualty Co. of New York (“Fidelity”). In the notice of nonpayment, Humble Oil requested that the surety advise as to what information was required to submit a claim. Fidelity responded by requesting a statement of the amount due. In light of the claim, Fidelity asked the principal to communicate directly with the claimant and make arrangements to settle the claim. Humble Oil was advised of this action. Several months later Humble Oil contacted Fidelity again, having been unable to reach the principal. Fidelity advised that it was reviewing the principal’s financial situation and that it would be back in contact at a later time. Having received no update, Humble Oil again contacted Fidelity requesting information on the steps taken to secure payment of its claim. After no response from Fidelity, Humble Oil hired Virginia’s largest law firm to represent its interests.

In the mean time, Fidelity had become increasingly concerned about the principal’s financial condition, and after several audits, a meeting was held between Fidelity and the principal. At this meeting, Fidelity told the principal that it would pay all outstanding bills covered by its bond, including Humble Oil’s claim, if such claims were properly proven by delivery invoices. Fidelity also agreed to meet the principal’s payroll and other bills, as well as pay a salary to the managing owner in exchange for the principal’s agreement to complete several unfinished projects and an assignment of all assets of the owners. The principal told

---

<sup>69</sup> United States ex rel. Nelson, 436 F.2d at 1370.

<sup>70</sup> McWaters & Bartlett v. United States ex rel. Wilson, 272 F.2d 291, 296 (10th Cir. 1959).

<sup>71</sup> United States ex rel. Humble Oil & Refining Co., 402 F.2d at 898.

<sup>72</sup> Id. at 900.

Humble Oil of Fidelity's agreement to pay its claim. Accordingly, Humble Oil forwarded its invoices to the principal prior to the expiration of the statute of limitations. After completing various forms which were later required by Fidelity, Humble Oil was advised that Fidelity was denying the claim because it was barred by the Miller Act statute of limitations. Negotiations followed for several months and suit was eventually filed, more than two years after the date on which Humble Oil last provided materials for the job.

The District Court concluded that Humble Oil could not assert equitable estoppel to avoid the operation of the statute of limitations. The Fourth Circuit reversed. The Court first held that "absence of proof of fraud or deception on the part of Fidelity is not fatal to its being estopped to plead Miller Act limitations where, as we have shown, there has been a representation, reliance, change of position and detriment."<sup>73</sup> The Humble Court next dispatched the argument that estoppel was not appropriate because Fidelity made no promises directly to Humble Oil regarding the payment of its claim. The promise made by Fidelity was to pay "valid" claims and it was made not to Humble Oil, but to its principal. The Court viewed the principal as the agent of Fidelity in light of the fact that Fidelity had effectively assumed control of the principal and had hired its managing owner.<sup>74</sup> Thus, the principal's representation to Humble Oil that Fidelity would pay its claim was binding on Fidelity. Further, the Court determined that under the circumstances, Fidelity should have reasonably anticipated that its promise to pay would be repeated to Humble Oil. The Court stated, "[f]or estoppel, reasonable foreseeability of reliance is sufficient to define the scope of the promise to which the promisor should be held - both with respect to its terms and the promises included therein."<sup>75</sup>

In addition, the Humble Court did not consider the fact that Humble Oil retained an attorney more than 2 months before the statute of limitations had run to be significant.<sup>76</sup> While recognizing that in some circumstances an attorney may not be justified in relying upon representations made to him, such circumstances did not exist in this case. The Court noted that an attorney may be justifiably lulled into a false sense of security as much as a client, and

---

<sup>73</sup> Id. at 898.

<sup>74</sup> Id. at 899.

<sup>75</sup> Id.

<sup>76</sup> Id.

that employment of counsel is only one factor to be considered in determining whether a party in fact reasonably relied upon the representations of another.<sup>77</sup>

The Humble case dramatically illustrates the point that ordinary claims handling practice may deprive the surety of a limitations defense. In this case, the actions of the surety upon which the Court based its opinion were innocuous at best. From an overall perspective, it appears that Fidelity had little direct contact with the claimant and in fact its failure to respond to the claimants inquiries lead the claimant to retain counsel. Nevertheless, the Court found such facts as Fidelity's establishing procedures to verify claims for submission and acknowledgment of debt to be significant, even though the amount of the debt was never agreed upon. Further, Fidelity's promise to its principal to pay valid debts which were properly proven was found by the Court to be a significant factor. These actions, however, are ordinary, routine occurrences in many payment bond claim situations.

The fact that the surety may recognize that some money may be owed to the subcontractor for work performed on the project, does not translate into an agreement by the surety that it will pay and that no suit will therefore be necessary. In the payment bond context, it will frequently be the case that the surety acknowledges that some amount may be owed to a subcontractor; however, genuine and significant disputes may nevertheless exist as to the extent of the debt, which may only be resolvable through litigation. Under the Humble decision, a surety must be very cautious about acknowledging that a debt is owed.

The Court's reliance upon a promise made to the principal to pay properly proven debts covered by its bond ignores the fact that such a promise is nothing more than a recognition of the surety's obligation under the payment bond. A surety is obligated to pay valid claims under the payment bond. Even if one gets past the fact that the promise in this case was not made to the party who later asserted reliance upon it, it is difficult to imagine how a promise to comply with the bond obligation can lead to equitable estoppel.

The teaching of Humble, is two fold. First, by doing away with any requirement for deception or fraud and doing away with even the necessity that direct representations be made, the Humble Court has demonstrated that surety claims professionals must be extremely cautious in negotiations with payment bond claimants if a later statute of limitations defense is to be preserved. Second, the Humble decision underscores the importance of a thorough and specific reservation of rights. When responding to a claim, the surety is well advised to respond with an appropriate reservation of rights letter, which specifically and clearly preserves any rights and defenses relating to notice or suit limitations.<sup>78</sup> While a reservation of rights

---

<sup>77</sup> Id. at 899-900, n.9.

<sup>78</sup> Suggested reservation of rights language: "By this letter [surety] does not waive any of its defenses with respect to your claim and hereby specifically reserves any and all of its defenses, including any time limitations for filing suit or defenses arising from any notice provisions under the bond or from applicable law." Other suggested language: "Please note that this letter is sent to you

letter alone may not prevent the operation of equitable estoppel,<sup>79</sup> it will provide the surety with the best opportunity to avoid the estoppel argument.

## **E. Conclusion**

The potential for unexpected liability abounds in the payment bond context if the surety claims professional is not cognizant of the perils and pitfalls. Ordinary and routine actions can expose the surety to liability in excess of the penal sum of the bond or even operate to deny the surety a defense. By focusing on some of the more typical circumstances, this paper alerts the surety claims professional to the potential hidden liability.

---

for investigatory purposes only. It should not be construed by you or your client as an admission of liability or a promise to pay your client's claim in whole or in part. Our activities are undertaken with a full reservation of rights and defenses under the terms of the bond, the contract and the law, including any defenses related to time or notice limitations. This reservation of rights shall remain in full force and effect unless expressly revoked by the surety in writing."

<sup>79</sup> See United States ex rel. Nelson, 436 F.2d 1366 [despite reservation of rights, subsequent conduct of agent and surety was sufficient to give rise to equitable estoppel].