

**NINTH ANNUAL
NORTHEAST SURETY AND FIDELITY CLAIMS
CONFERENCE
OCTOBER 22 - 23, 1998**

**THE SURETY'S USE OF PROMPT PAYMENT STATUTES
TO OBTAIN CONTROL OF CONTRACT FUNDS**

PRESENTED BY:

**CYNTHIA E. RODGERS-WAIRE
WHITEFORD, TAYLOR & PRESTON L.L.P.**
Seven Saint Paul Street
Baltimore, Maryland 21202-1626
(410) 347-8700
FAX (410) 347-9412

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I. INTRODUCTION

At last year's Northeast Surety & Fidelity Claims Conference, Barney Reinert and Joe Krutzsch, presented a paper entitled, "A Survey: State Prompt Payment Acts and the Surety." The paper and its appendix reviewed various states' prompt payment statutes and explored the surety's obligations and rights under two different circumstances:

The surety's liability for interest, penalties and/or attorneys' fees arising from a subcontractor's or supplier's claim against a principal's bond; and

1. The surety's right to make a prompt payment claim against the obligee, either under an assignment or by its subrogation rights, if the obligee has failed to promptly pay the principal.

The Reinert/Krutzsch paper reviewed the common provisions of prompt payment statutes, including their scope and applicability, the time limits for payment, the rights to interest and attorneys' fees, and the surety's defenses.

This paper will address another facet of prompt payment statutes, one that may be overlooked: the affirmative use of federal and state prompt payment statutes by a surety to protect its claim to the bonded contract funds when the surety's principal has failed to pay its subcontractors and suppliers, but is still performing the contract, and the surety has duly given notice to the obligee of the principal's failure. Consider the following scenario commonly faced by sureties: During the course of performance of a federal construction project and, prior to contract completion, the surety receives various payment bond claims from its principal's subcontractors and suppliers. The surety makes inquiry with the principal regarding the claims, and the principal requests the surety not to pay because the claims are disputed. The claimants contend there are no disputes and demand immediate payment from the surety. During its continuing investigation, the surety's apprehension heightens because, although the principal's defenses to the claims are colorable, the surety fears that the defenses are not well documented and not strong enough to succeed in subsequent litigation brought by the unpaid claimant or claimants. In addition, the surety begins to receive payment bond claims on other projects it has bonded for the principal and complaints about the principal's performance. In other words, the surety finds itself in the classic situation in which the surety believes the principal is sliding down the tubes but the surety has not yet paid any claims.

In these circumstances, the surety's primary interest is to protect the remaining contract funds. The surety believes that any future progress payments to the principal would only result in further misdirection by the principal as its financial condition worsens. In addition, the surety has a legitimate concern that these are the funds that it will have to mitigate its losses if (or more likely when) it pays payment and performance bond claims. Both the principal and the federal government obligee/owner may, and frequently do, have different and competing interests in the remaining contract funds. The principal may need the contract funds to pay its employees and keep its business operating. The government's main goal is to get its project completed without a default termination. The government's contracting officer

recognizes that the principal is likely financing the project through the use of progress payments. Although the contracting officer is concerned about unpaid subcontractors and suppliers, the contracting officer's primary concern is contract completion because the contracting officer knows that he or she can ultimately look to the surety for payment on these claims.

How can the surety convince the government's contracting officer that future progress payments must be withheld from the principal? This paper will explore in detail the federal prompt payment statute, found at 31 U.S.C. § 3901 *et seq.*, the accompanying regulations found in the Federal Acquisition Regulations (commonly known as the FARs), and caselaw addressing the surety's rights to progress payments when the contractor is still performing but the surety has notified the government's contracting officer of the principal's failure to pay its subcontractors and suppliers on a federal project.¹

II. PERTINENT FEDERAL LAW

A. The Federal Prompt Payment Act

The federal Prompt Payment Act ("PPA"), 31 U.S.C. §§ 3901 *et seq.*, was enacted in 1982 as a mechanism to compel the federal government and its various agencies to make timely payments to contractors.² Section 3903 of the PPA and its accompanying regulations require the government to make payments to its contractors within thirty (30) days after receipt of a proper invoice for the amount due, unless the contract between the federal government and the contractor provides for a different payment schedule. Section 3902 imposes an interest penalty on the government for late payments. In 1988, the PPA was amended (the "1988 Amendment") to clarify that the interest penalty provisions apply to partial or periodic payments such as progress payments on government construction contracts.³

Notwithstanding this primary purpose, the 1988 Amendment of the PPA contains important new provisions of which a Miller Act surety should be aware. The new provisions are intended to give subcontractors the same rights to timely payments from the principal contractor as the principal contractor has against the federal government. More importantly, from the surety's perspective, the PPA Amendment requires the principal contractor to certify to the federal government that the contractor is in compliance with the PPA with respect to previously paid progress payments and that it intends to comply with the PPA upon receipt of the payment for which it is now applying.⁴ Violations of the PPA certification trigger possible criminal penalties. The PPA, as amended, states in pertinent part:

¹ Although this paper focuses exclusively on federal government contracts and projects, the same analysis may be used for state, local and private contracts in those states with similar prompt payment statutes.

² The legislative history indicates that the PPA was enacted to "provide incentives for the Federal Government to pay its bills on time." H.R. Rep. No. 461, 97th Cong., 2d Sess. 1, reprinted in 1982 U.S. Code Cong. & Admin. News 111. In enacting the PPA, Congress recognized that the cost savings recognized by the federal government through untimely payments could be outweighed in other ways: "[The Government's] reputation as a slow payer discourages businesses from bidding for government contracts. The Government consequently is deprived of the innovation and lower prices that result from vigorous competitive bidding." *Id.*

³ See *Reddick & Sons of Gouverneur, Inc. v. United States*, 31 Fed. Cl. 558 (1994) (granting summary judgment in favor of the contractor on the issue of whether the untimely payment penalty provisions of the PPA, as enacted in 1982, applied to construction progress payments).

⁴ See 31 U.S.C. §§ 3903(b) and 3905(a).

A payment request may not be approved under subsection (a)(6)(A) of this section unless the application for such payment includes --

* * *

(B) a certification by the prime contractor, to the best of the contractor's knowledge and belief that --

(i) the amounts requested are only for performance in accordance with the specifications, terms and conditions of the contract;

(ii) payments to subcontractors and suppliers have been made from previous payments received under the contract, and timely payments will be made from the proceeds of the payment covered by the certification, in accordance with their subcontract agreements and the requirements of this chapter; and

(iii) the application does not include any amounts which the prime contractor intends to withhold or retain from a subcontractor or supplier in accordance with the terms and conditions of their subcontract.

31 U.S.C. § 3903(b)(1)(emphasis added).

The PPA now provides some assurance to the surety that the contract funds will be used to pay the principal contractor's subcontractors and suppliers to whom the surety is ultimately liable under its payment bond. This does not mean that the principal contractor and its surety are left without leverage in paying subcontractors and suppliers when defective workmanship or materials are uncovered after the principal contractor has received its progress payment. As set forth in the PPA, any payment made by the government to the principal contractor for defective work (or work that fails to conform to the terms of the contract) is considered an "unearned amount."⁵ In such cases, the principal contractor may withhold payment to the subcontractor or supplier without violating its PPA certifications, but only if the principal contractor takes the following steps: first, it must notify the government about the dispute; and second, it must pay the government interest on the "unearned amount" that it did not pay to the subcontractor or supplier. The interest continues to accrue until the defective work is corrected or until the date the principal contractor submits a subsequent certified payment application to the government that contains a reduction for the "unearned amount."⁶

B. The Federal Acquisition Regulations
1. Regulations related to the PPA.

FAR 2.232-5 describes in detail the information that a principal contractor must submit with each payment application. Specifically, the regulation requires the principal contractor

⁵ 31 U.S.C. § 3905(a) and 48 C.F.R. 52.232-27(e).

⁶ Id.

to include “[a] listing of the amount included for work performed by each subcontractor under the contract” and “[a] listing of the amounts previously paid to each such subcontractor under the contract.”

FAR 2.232-5(c) also contains the specific language to be used for the contractor’s certification, which must be attached to each payment application:

I hereby certify, to the best of my knowledge and belief,
that--

(1) The amounts requested are only for performance in accordance with the specifications, terms, and conditions of the contract;

(2) Payments to subcontractors and suppliers have been made from previous payments received under the contract, and timely payments will be made from the proceeds of the payment covered by this certification, in accordance with subcontract agreements and the requirements of chapter 39 of Title 31, United States Code;

(3) This request for progress payments does not include any amounts which the prime contractor intends to withhold or retain from a subcontractor or supplier in accordance with the terms and conditions of the subcontract; and

(4) This certification is not to be construed as final acceptance of a subcontractor’s performance.

(Name)

(Title)

(Date)

Without a signed certification from the principal contractor, the federal government will not issue a progress payment to the contractor. This offers the surety some degree of protection from a principal contractor that intends to use progress payments for purposes other than payment of its subcontractors and suppliers. However, this does not mean that government will undertake, nor does it have any statutory or contractual duty to undertake, any independent investigation to verify the accuracy of the principal contractor’s certifications before issuing a progress payment. As a result, it falls upon the surety to notify the federal government contracting officer when it has received notice or claims from unpaid subcontractors and suppliers and to request that the contracting officer investigate the veracity of the principal contractor’s past PPA certifications and withhold future payments until any

questions about the veracity of the past PPA certifications has been resolved.

2. Other Relevant Regulations.

Sometimes a principal determines that it is best for it to notify the surety of its financial problems or other difficulties and obtain the surety's assistance in completing the project with as minimal a loss as possible. In such a case, in consideration for the surety's assistance, the surety should require that the principal submit a writing to the federal government contracting officer directing the government to send all future contract payments to the surety. However, there are many times when a principal contractor will choose, for any number of reasons, not to cooperate with its surety. In these cases, the principal contractor will no doubt resist and object to the surety's efforts to block release of the contract funds, which may be the contractor's only source of revenue. Under these circumstances, the principal contractor will make every effort to convince the contracting officer that the government cannot withhold progress payments as long as the contractor is performing under the terms of the contract.

The principal contractor appears to have strong support for its argument. FAR 28.106-7 states the following:

(a) During contract performance, agencies shall not withhold payments due contractors or assignees because subcontractors or suppliers have not been paid.

(b) If, after completion of the contract work, the Government receives written notice from the surety regarding the contractor's failure to meet its obligation to its subcontractors or suppliers, the contracting officer shall withhold final payment. However, the surety must agree to hold the Government harmless from any liability resulting from withholding the final payment. The contracting officer will authorize final payment upon agreement between the contractor and surety or upon a judicial determination of the rights of the parties.

At first glance, this regulation appears to imperil the surety's chances of convincing the government to withhold future progress payments. It offers an easy solution to the contracting officer who wants to continue making payments so that the contractor completes the work. However, as the cases discussed in greater detail below demonstrate, all is not lost for the surety.

III. FEDERAL CASE LAW TO THE RESCUE ? - BALBOA AND ITS PROGENY

A. The Federal Government's Equitable Obligations to the Surety

1. General Obligations with Respect to Progress Payments.

Although there is no contractual privity between the federal government and the surety, the government has an equitable obligation that it owes to the surety. Further, the government cannot escape this equitable obligation under the guise of sovereign immunity. The government's actions in entering into a construction contract involve proprietary, not sovereign, functions. As the Court of Federal Claims stated in Transamerica Premier Insurance Company v. United States,⁷ the government has "an obligation, consistent with its own business needs, to avoid actions that impair the surety's interest in the contract collateral, i.e., the contract proceeds on hand payable for work done." As a result, it has a duty not to act negligently and cause loss to third parties such as the surety.⁸

As a result of this equitable obligation, the federal government agency holding unpaid progress payments cannot pursue its interest in completing the construction project while disregarding the surety that has issued payment and performance bonds for the project. As the Court of Claims stated in Argonaut Ins. Co. v. United States:⁹

During the performance of the contract, the Government has a duty to exercise its discretion responsibly and to consider the surety's interest in conjunction with other problems encountered in the administration of the contract.

This is because the surety "does not contract to assume the risks of unreasonable conduct by a contracting officer which results in a loss to the government"¹⁰ (which loss, absent some standard, would ultimately be paid by the surety pursuant to its bond obligations.)

Prior to the case of Balboa Insurance Company v. United States,¹¹ sureties' efforts to seek damages from the federal government for progress payments improperly paid to defaulting contractors were unsuccessful. In rejecting the surety's argument in Argonaut Ins. Co., supra., the Court of Claims stated:

During performance, the Government's role is substantially different from that of a mere stakeholder of a final contract payment. The defendant has an important interest in the timely and efficient completion of the contract work. In furtherance of this interest, the Government contracts for a broad range of rights which are designed to promote continuation of the contract work. These provisions give the Government considerable discretion and flexibility in administering the contract. Public policy supports this flexibility in light of the various unforeseen circumstances which

⁷ 32 Fed. Cl. 308, 313 (1994).

⁸ *Id.* at 316.

⁹ 434 F.2d 1362, 1368 (Ct. Cl. 1970).

¹⁰ Ohio Casualty Insurance Company v. United States, 12 Cl. Ct. 590, 591 (1987).

¹¹ 775 F.2d 1158 (Fed. Cir. 1985).

may hinder performance.¹²

Several years later, the same court stated: “so long as there is no showing of bad faith or an abuse of discretion, the decision of a Government contracting officer that a progress payment to a financially strapped contractor should not be withheld will be accorded deference by this court and the surety’s burden of proving the contrary is high.”¹³

2. The Balboa Case.

In 1985, the Federal Circuit Court of Appeals decided Balboa Insurance Co. v. United States.¹⁴ In Balboa, the surety on a Miller Act project sued the federal government for recovery of a progress payment that the surety asserted had been improperly paid to the contractor by the government after the surety had notified the government that the contractor was in default. Six days before the government paid the progress payment to the contractor, the surety, by letter, notified the government that the contractor would not be able to fulfill its payment and performance obligations, and demanded that no further payments be released to the contractor without the surety’s consent. Despite this notice, the government paid the progress payment to the contractor. Four months after the payment to the contractor, the government terminated the contract. Pursuant to its payment bond obligations, the surety made payments to subcontractors and suppliers in excess of the amount of the progress payment that had been paid to the contractor.

After addressing the threshold issue of whether the court had jurisdiction over the surety’s action (and finding that it did), the court turned to the issue of whether the government acted properly when it released the progress payment to the contractor. The surety asserted that the government either did not exercise discretion or acted unreasonably in paying the progress payment to the contractor. While recognizing the difference between the government’s role before and after completion of performance of the contract, as described in Argonaut Insurance Co. v. United States and United States Fidelity & Guaranty Co. v. United States, the court also recognized that the government must make an investigation to determine whether the contractor can complete the job when it has been notified by the surety that the contractor has defaulted in its obligations.¹⁵

The court went on to list eight factors that it considered to be important in determining whether the government had exercised reasonable discretion in disbursing the contract funds to someone other than the surety, as set forth below:¹⁶

¹² 434 F.2d at 1367-68. Where the project is fully complete and the government is a mere stakeholder with regard to the remaining contract funds, the result is different. See, e.g., Great American Ins. Co. v. United States, 492 F.2d 821 (Ct. Cl. 1974); Home Indemnity Co. v. United States, 376 F.2d 890 (Ct. Cl. 1967); Newark Ins. Co. v. United States, 169 F. Supp. 955 (1959).

¹³ United States Fidelity & Guaranty Co. v. United States, 676 F.2d 622, 628 (Ct. Cl. 1982).

¹⁴ 775 F.2d 1158 (Fed. Cir. 1985),

¹⁵ Id. at 1164 (citing Fireman’s Fund Insurance Co., 362 F. Supp. 842, 848 (D. Kan. 1973)).

¹⁶ 775 F.2d at 1164-65. In its opinion, the court provides the full citations for the cases listed with shortened references in the eight factors. The full citations for those cases are as follows: United States Fidelity & Guaranty Co. v. United States, 676 F.2d 662 (Ct. Cl. 1982); Royal Indemnity Co. v. United States, 529 F.2d 1312 (Ct. Cl. 1976); United States Fidelity & Guaranty Co. v. United States, 475 F.2d 1377 (Ct. Cl. 1973); Argonaut Insurance Co. v. United States, 434 F.2d 1362 (Ct. Cl. 1970); and Fireman’s Fund Insurance Co. v. United States, 362 F. Supp. 842 (D. Kan. 1973).

(1) Attempts by the Government after notification by the surety, to determine that the contractor had the capacity and intent to complete the job. United States Fidelity & Guaranty Co. v. United States, 676 F.2d at 631; Royal Indemnity Co., 529 F.2d at 1321; Argonaut Insurance Co., 434 F.2d at 1366, 1369; Firemen's Fund Insurance Co., 362 F. Supp. at 848.

(2) Percentage of contract performance completed at the time of notification by the surety. United States Fidelity & Guaranty Co. v. United States, 676 F.2d at 631; United States Fidelity, 475 F.2d at 1385; Argonaut Insurance Co., 434 F.2d at 1366.

(3) Efforts of the Government to determine the progress made on the contract after notice by the surety. United States Fidelity & Guaranty Co. v. United States, 676 F.2d at 631; Royal Indemnity Co., 529 F.2d at 1320-21. See United States Fidelity, 475 F.2d at 1385.

(4) Whether the contract was subsequently completed by the contractor (not conclusive, but relevant to show the reasonableness of the contracting officer's determination of the progress on the project). See Argonaut Insurance Co., 434 F.2d at 1369.

(5) Whether the payments to the contractor subsequently reached the subcontractors and materialmen (this goes to the equitable obligation of the Government to subcontractors and others to see that they will be paid; also, because the surety is liable to the subcontractors, any money that reaches them furthers the objectives of the surety as well as those of the Government). United States Fidelity, 475 F.2d at 1385; Argonaut Insurance Co., 434 F.2d at 1369.

(6) Whether the Government contracting agency had notice of problems with the contractor's performance previous to the surety's notification of default to the Government. United States Fidelity, 475 F.2d at 1385.

(7) Whether the Government's action violates one of its own statutes or regulations. United States Fidelity & Guaranty Co. v. United States, 676 F.2d at 630.

(8) Evidence that the contract could or could not be completed as quickly or cheaply by a successor contractor. United States Fidelity & Guaranty Co. v. United States, 676 F.2d at 631; Royal Indemnity Co., 529 F.2d at 1321; Argonaut Insurance Co., 434

F.2d at 1369.

In reversing the decision of the Claims Court, which had granted summary judgment in favor of the government, the Federal Circuit Court of Appeals held that the Claims Court had failed to consider or evaluate the surety's evidence addressing some or all of the eight factors listed above, which had been presented by the surety in opposition to the government's summary judgment motion. In addition, the appellate court held that the Claims Court had improperly found that the surety had to submit proof of deliberate or fraudulent conduct on the part of the government. The court stated:

Proof of "deliberate or fraudulent conduct" is only one way of demonstrating abuse of discretion and is required only when allegations of bad faith have been asserted. See United States Fidelity & Guaranty Co. v. United States, 676 F.2d at 629. Proof of such conduct is not required to prove arbitrary or capricious action or abuse of discretion on the part of the Government.¹⁷

As a result, the case was remanded for further proceedings to determine whether the government's payment of the progress payment "was a reasonable exercise of the discretion conferred on the contracting agency by the terms of the contract and the applicable law and regulations."¹⁸

3. Post-Balboa Decisions.

The surety's claim of abuse of discretion by the government in distributing progress payments to a defaulting contractor and the use of the eight Balboa factors has only arisen in a handful of published cases.¹⁹ It is rare in a Balboa-type case that there are no genuine issues of material fact between the government and the surety. As a result, most of the published post-Balboa decisions are denials of summary judgment motions.²⁰

In United Pacific Insurance Company v. United States,²¹ the issue before the court was whether the government had abused its discretion in issuing a progress payment during the course of a construction contract. The court found that the contractor had made false statements to the government about the degree of completion and was not paying its bills to subcontractors and suppliers. Nevertheless, the government continued to make progress payments during the course of construction without making any investigation and despite the surety's objection. The court reviewed in detail the eight factors identified in Balboa and found

¹⁷ 775 F.2d at 1165.

¹⁸ Id. After the remand, the parties settled prior to a decision on the merits.

¹⁹ There are a number of other contexts in which the Balboa criteria are analyzed by the courts to determine whether the government has abused its discretion so as to relieve the surety of liability. These include: 1) the failure of the government to timely default the contractor, as in Ohio Casualty Insurance Company v. United States, 12 Cl. Ct. 590 (1987); and 2) overpayment caused by failure to withhold retainage, as in United Pacific Insurance Company v. United States, 16 Cl. Ct. 555 (1989); National Surety Corp. v. United States, 31 Fed. Cl. 565 (1994); Fireman's Fund Ins. Co. v. United States, 909 F.2d 495 (Fed. Cir. 1990).

²⁰ See United States Fidelity & Guaranty Co. v. United States, 16 Cl. Ct. 541 (1989) (payment made to defaulting contractor's assignee) and Integon Indemnity Corp. v. United States, 12 Cl. Ct. 115 (1987) (payment made to the defaulting contractor).

²¹ 16 Cl. Ct. 555 (1989).

that the government “failed to protect not only the interests of the surety, but its own.”²² The court held that the government had abused its discretion and granted the surety’s summary judgment motion.

4. The Surety’s Obligation to Provide Notice to the Federal Government.

It is clear from several post-Balboa cases that the courts will find that the government’s equitable obligations to the surety do not arise unless the surety has given notice to the government of the contractor’s default and the surety’s rights to equitable. In Fireman’s Fund Insurance Company v. United States,²³ the surety fulfilled its payment bond obligations by paying the principal’s unpaid subcontractors and suppliers, but refused to take over the contract after the government subsequently defaulted the principal contractor. In defense of the government’s suit for excess procurement costs, the surety alleged that the government’s premature release of retainage prejudiced the rights of the surety. The facts revealed that the surety had not notified the government of the contractor’s failure to pay its subcontractors and suppliers until five months after the government had released the retainage that the surety claimed. Reversing the lower court ruling in favor of the surety, the Federal Circuit held:

[T]he government as obligee owes no equitable duty to a surety like Fireman’s Fund unless the surety notifies the government that the principal has defaulted under the bond. It is irrelevant whether the surety claims a right to funds during performance of the contract, or after it is completed when the government functions as a “stakeholder” of funds owed but not yet paid. In either event, notice by the surety is essential before any governmental duty exists.²⁴

The Fireman’s Fund decision makes clear that the surety itself must give notice in order to utilize the doctrine of equitable subrogation. In its argument, the surety pointed out, and the court acknowledged, that certain subcontractors and suppliers had informed the government of the contractor’s failure to pay certain bills prior to the release of the retainage. The court found that information concerning nonpayment of subcontractors and suppliers obtained by the government from sources other than the surety was irrelevant, stating that it

does not substitute for notice by the surety and does not trigger the government’s equitable duty to act with reasoned discretion toward it. . . . By definition and agreement the surety protects the

²² Id. at 560.

²³ 909 F.2d 495 (Fed. Cir. 1990).

²⁴ Id. at 498. See also Hartford Fire Ins. v. United States, 40 Fed. Cl. 520 (1998); Reliance Insurance Company v. United States, 27 Fed. Cl. 815, 826 (1993) (“[N]otice by the surety to the government is a necessary first step to trigger the government’s responsibility. Therefore, the eight point test in Balboa should be applied only if notice by the surety is given to the government.”); and Ransom v. United States, 17 Cl. Ct. 263, 272 (1989), aff’d, 900 F.2d 244 (Fed. Cir. 1990) (“[B]efore any obligation arises to withhold or divert funds, the Government must be notified that the sureties believe the contractor is in default and cannot complete the contract. Because there was no notice to the Government in this case before the last progress payment, no obligation arose on the part of the Government to exercise due care on behalf of the sureties in making payments to the contractor.”).

government's interest, not the other way around.

We see no reason to impose on the government a duty toward the surety whenever a subcontractor or supplier complains of late or nonpayment by the contractor. Only the contract should limit the government's flexibility in resolving payment disputes so minor, and perhaps so inevitable, that the surety itself doesn't consider the contractor's role in them a potential default under the bond. Only when the surety may be called upon to perform, that is, only when it may become a party to the bonded contract, should the government owe it any duty. The surety knows best when this may occur; consequently, only notice by the surety triggers the government's equitable duty.²⁵

The government's equitable duty and obligation to the surety to avoid actions that impair the surety's interests in the contract funds "is triggered not only when the Government is informed of the contractor's actual default but also - and perhaps more typically - when the Government receives reasonable warning from the surety of a contractor's threatened default under the bond." Transamerica Insurance Company v. United States.²⁶

B. The Federal Government's Obligation to Comply with Contract Terms

In addition to an abuse of discretion argument, there may be another means by which a surety can recover from the federal government for a progress or other payment released to a contractor after notification to the contracting officer of a default. Standard form construction contracts issued by federal government agencies usually contain numerous provisions related to payment of progress payments, release of retainage, and other issues regarding payment. For reasons unknown, government contracting officers sometimes disregard these provisions and pay contractors more than they have earned under the contract. As result of the improper payments, when the surety ultimately incurs a payment or performance bond loss, there are less (or in some cases, no) remaining contract funds from which to reimburse the surety's losses. Several court decisions have held that the federal government is liable to the surety for the amount of the wrongful payments to the extent of the surety's unreimbursed losses. Although the factual situations differ somewhat from the scenario presented at the beginning of this paper, the same analysis could be used to hold the government liable for releasing progress payments after the surety notified the government that the contractor had submitted false PPA certifications and had breached its obligations by failing to pay subcontractors and suppliers. This is because the PPA certification is part of the contract terms.

In Ohio Casualty Insurance Company v. United States,²⁷ the surety alleged that the government violated its equitable duty to the surety and abused its discretion in failing to more

²⁵ Id. at 499.

²⁶ 32 Fed. Cl. 308, 313 (1994)

²⁷ 12 Cl. Ct. 590 (1987).

promptly terminate a contractor bonded by the surety. The contractor was allowed nearly three years to only partially complete a job that was supposed to take nine months. Despite this untimely and incomplete performance, the government continued to pay progress payments to the contractor, ultimately paying the contractor in excess of the original contract price. The surety claimed that the government abused its discretion in continuing to make payments to the contractor and in failing to terminate the contractor at an earlier date, thereby violating its equitable obligations to the surety. The court looked at the eight factors cited in Balboa, and finding that the surety had proven most of the criteria in its favor, held that the government abused its discretion. The court found that the evidence “overwhelmingly showed a pattern of unreasonable conduct on the part of those responsible for the administration of the contract” and that “it would be manifestly unjust to make the surety pay for the Navy’s mistake.”²⁸

In National Surety Corp. v. United States,²⁹ the surety incurred losses under its performance bond after the contractor was terminated for default. The surety sought recovery from the government based upon the government’s failure to withhold ten percent retainage. Rather than suing under principles of equitable subrogation, the surety asserted that it was a third party beneficiary of the construction contract.³⁰ The Court of Federal Claims agreed with the surety and granted summary judgment in its favor, finding that an express contract provision required the government to withhold the retainage until a certain condition was met and that the particular condition had never been satisfied by the contractor. Rejecting the government’s argument that it had discretion to release retainage as it saw fit, the court stated: “[T]he scope of the government’s discretion to promote performance depends on the terms the government has contracted for. . . . When the government does agree to limit its discretion, Fireman’s Fund does not support allowing such discretion in breach of the contract.”³¹

In Transamerica Premier Ins. Co. v. United States,³² after the surety had given written notice by letter to the government, the government, at the request of the surety and with the principal contractor’s agreement, executed a unilateral contract modification to change the mailing address for the remaining contract payments from the principal’s office to the surety’s office. When the government erroneously mailed the final contract funds to the principal, the surety sued the government and prevailed.

IV. THE SURETY’S ARGUMENT IN SUPPORT OF ITS REQUEST FOR WITHHOLDING OF CONTRACT FUNDS

As the cliché goes, an ounce of prevention is worth a pound of cure, For the Miller Act surety that has received numerous claims from unpaid subcontractors and suppliers, countered by the principal contractor with dubious and undocumented allegations of disputes, it is important for the surety to prevent the remaining contract funds from being disbursed to

²⁸ Id. at 591.

²⁹ 31 Fed. Cl. 565 (1994).

³⁰ It appears that the surety did not assert a cause of action under the principles of equitable subrogation because it had failed to give notice to the government as required by Fireman’s Fund Ins. Co. v. United States, 909 F.2d 495 (Fed. Cir. 1990).

³¹ 31 Fed. Cl. at 574.

³² 32 Fed. Cl. 308 (1994).

the contractor. Given the apparent financial status of the contractor, these funds are a critical asset and perhaps the only source of future collateral. Once the payments are disbursed, it is unlikely that the surety will be able to recover them from the contractor, absent the successful litigation of a request for a temporary restraining order and/or preliminary injunction. Likewise, the federal government will not agree to pay the funds a second time (to the surety) without costly litigation.

To stand any chance of succeeding in its request for withholding (as well as to preserve its rights to equitable subrogation in the event of later litigation with the federal government), the surety must immediately notify the federal government's contracting officer of the principal's default and request that the government investigate the veracity of the contractor's PPA certifications and its ability to complete the project. Such notice is best accomplished through a written notice to the contracting officer.³³ Apart from the obvious issues of proof, such a writing provides the surety an opportunity to educate the contracting officer and to inform the contracting officer that neither burying his or her head in the sand nor relying on the protections of FAR 28.106-7 will protect the government from paying twice if the progress payments are improperly paid to the contractor.

It might appear that the surety has a weak position to present to the government in requesting that the contracting officer withhold any future contract payments. After all, the courts sometimes distinguish between a payment bond surety and a performance bond surety and find that a surety that has incurred only payment bond losses has lesser rights than a performance bond surety. Moreover, courts also find that payment bond sureties that have not yet paid any losses have no right to seek equitable subrogation, regardless of whether the principal has defaulted and that the surety will eventually incur a loss.

Although no published opinions addressing this issue could be located, it is the opinion of the author that a contractor's violation of the PPA by submitting false certifications clearly falls under the criteria discussed in Balboa and should be used in any argument to the contracting officer that future contract payments should not be released. The surety's notice to the contracting officer that the PPA certifications are false, or at least questionable, provides the contracting officer with knowledge that the payments to the contractor did not subsequently reach subcontractors and suppliers. Although these parties cannot sue the government directly, the government does have an equitable obligation to see that they are paid. In addition, after notice, the government has an equitable obligation to the surety because the surety is ultimately liable to the unpaid subcontractors.

One of the other Balboa criteria is whether the government's action violates one of its own statutes or regulations. The FARs state the government shall not issue progress payments unless there is a PPA certification. The PPA also requires the contractor to notify the government if it is withholding funds from a subcontractor or supplier based upon disputes which relate to quality of work. If the principal withholds payment within the parameters of the

³³ See Klinger, Marilyn, "The Surety's Notice: What Does it Say and Does it Work?", Subrogation Rights of the Contract Bond Surety (George J. Bachrach, ed.), Tort and Insurance Practice Section--American Bar Association (1990).

PPA, the principal is required to reduce its next progress payment by an amount identical to the amount it is withholding from its subcontractors and suppliers and pay interest to the government on the “unearned amount.” In the factual scenario presented at the beginning of this paper, the contractor has failed to comply with the PPA requirements. Because the federal government has been made aware of this non-compliance by the surety, the government is obligated under Balboa to conduct its own investigation. If the government fails to investigate and pays a progress payment knowing that the PPA certification is false, the surety can argue that the government has violated its own statutes and regulations, which are also incorporated into the contract terms, because it is obligated to administer its contract in accordance with the PPA.

V. THE SURETY’S CHECKLIST

First and foremost, the surety must obtain documentation in support of its argument to present to the contracting officer. As soon as the surety receives claims from unpaid subcontractors and suppliers, the surety should ask these parties to provide back-up documentation. This will demonstrate to the contracting officer the amount of the surety’s potential exposure. Information on the dates that work was performed will also provide evidence regarding whether the contractor’s prior PPA certifications were false. The surety should also ask the principal to produce copies of its payment applications, including PPA certifications. The surety is clearly entitled to those documents pursuant to the principal’s common law and contractual indemnity obligations to the surety. If the contractor either refuses to provide documents or PPA certifications, the surety should request this documentation from the government. The surety should also ascertain as soon as possible the amount of remaining contract funds and the status of contract completion. Armed with all of this information, the surety is in a strong position to argue that any release by the government of future contract payments directly to the contractor would be a clear abuse of discretion.

VI. CONCLUSION

A surety with concerns about the abilities of its principal contractor to continue perform and also pay its subcontractors should, in addition to other avenues of investigation, review the principal contractor’s past and pending payment applications. If the surety finds evidence of a false PPA certification, this information should be brought to the attention of the government contracting officer. In light of Balboa, a surety may be able to use the government’s failure to withhold progress payments despite notice of false PPA certifications to recover from the government.

CYNTHIA E. RODGERS-WAIRE

Cynthia E. Rodgers-Waire is an associate with the law firm of Whiteford, Taylor & Preston, L.L.P. She received her B.A. from the University of Virginia in 1989 and her J.D., with honors, from the University of Maryland School of Law in 1992. She is admitted to the Bars of the State of Maryland, the District of Columbia, and the United States District Courts for the District of Maryland and the District of Columbia. Ms. Rodgers-Waire practices in the areas of surety and fidelity law, construction law, bankruptcy, and general litigation. She is a member of the Fidelity & Surety Law Committee, Tort & Insurance Practice Section of the American Bar Association, the Maryland Bar Association, the Bar Association of Baltimore City, and the National Association of Women in Construction.