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**THE SURETY ANALYST'S PROCEDURAL CHECKLIST  
FOLLOWING A DEFAULT TERMINATION**

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## **THE SURETY ANALYST'S PROCEDURAL CHECKLIST FOLLOWING A DEFAULT TERMINATION**

### **I. INTRODUCTION**

A surety which issues a performance bond suffers its greatest liability exposure upon receiving notice of its principal's termination for default. At that time, the surety must quickly review and analyze its position prior to taking any action. In this regard, the surety must insure that it: (i) properly protects its rights; (ii) preserves any of its possible defenses; and (iii) reviews its options for limiting any potential liability.

Initially, the surety should review the Owner/Obligee's actions specifically to determine the propriety of the default termination, and whether the Owner satisfied any conditions precedent under the performance bond. This evaluation is necessary to determine whether the surety can assert that its bond obligations have been discharged, thereby precluding any action by the surety under the performance bond.

In the event the surety elects to proceed, the surety must then formulate its completion strategy to preserve any defenses it may later assert on behalf of the principal or on its own behalf. This includes the preparation and execution of a takeover agreement which will protect the surety's rights and assure the surety standing to assert claims. Moreover, the surety must insure it has obtained the cooperation of, or preserved the proper authority from, its principal to later challenge the propriety of the default and to assert the claims of its principal. The surety should obtain a valid assignment from its principal, to which the Owner/Obligee is a party.

Finally, the surety should examine any mitigation doctrines that may limit its liability in the event the default is considered proper.

### **II. THE OWNER'S/OBLIGEE'S ACTIONS AND THE SURETY'S OBLIGATIONS**

#### **The Propriety of the Default**

The Owner carries a heavy burden in proving that its default termination was proper. Lisbon Contractors v. U.S., 828 F.2d 759 (Fed. Cir. 1987). Consistently, in evaluating the propriety of a default termination, courts consider that "default terminations -- as a species of forfeiture -- are strictly construed," and therefore, the Government/Owner must "turn square corners" in order to prevail when invoking this harsh sanction. DeVito v. U.S., 413 F.2d 1147 (Ct. Cl. 1969); Delfour, Inc., VABCA No. 2049, 89-1 BCA ¶ 21,394 (1988).

For the surety, the analysis of the propriety of the default is necessary so that the surety may determine its strategy to proceed. In this regard, the surety must investigate and decide whether (a) its principal's actions constituted a breach of contract, (b) any breach of contract by its principal was sufficiently material to warrant a termination for default, and (c) whether the Government/Owner has satisfied its obligations under the

Contract. If the Owner has failed to satisfy its obligations, the default may be considered improper.

#### **A. Material Breach**

A performance bond surety cannot be held liable for the default of its principal where the Government/Owner materially breaches the contract. See Nexus Const. Co., ASBCA No. 31070, 91-3 BCA ¶ 24,303 (1991). For example, federal courts will not affirm the default termination of a construction contract where the Government materially breaches its payment obligation to the principal. Significant in this regard, the U.S. Armed Services Board of Contract Appeals has held that the Government's failure to make adequate payments to a contractor constituted a material breach of the contract that excused further performance of work by the contractor. Id., see also Wolfe Const. Co., ENGBCA Nos. 3607, 3608, 3609, 84-3 BCA ¶ 17,701 (1984).

In addition to breaching a construction contract by failing to make adequate payments to a contractor, the Government's issuance of defective contract specifications has also been held to constitute a material breach releasing a surety from liability. See Pilcher, Livingston & Wallace, Inc., ASBCA No.13391, 70-1 BCA ¶ 8,331 (1970). Likewise, courts and boards will not affirm the Government's termination of a contract for default where the Government fundamentally changes the nature the contract work. See U.S. Fidelity & Guaranty Co. v. U.S., 298 F.2d 365 (D.C. App. 1924). Although a surety that issues a bond on a contract containing a "Changes" clause impliedly consents to subsequent changes made within the scope of the contract, the surety is released from its obligations where the underlying contract is fundamentally altered. See Massachusetts Bonding & Ins. Co. v. John R. Thompson Co., 88 F.2d 825 (8<sup>th</sup> Cir. 1937). (See also FAR).

Principals and their sureties have utilized the "fundamental change" or "cardinal change" defense to defeat default termination decisions in numerous different cases. For example, in one case, the court ruled that a surety was relieved of its performance bond obligations on a subcontract for the construction of a building where the principal entered into a subsequent agreement to perform more than twice the construction work anticipated by the original subcontract. Employers Ins. of Wausau v. Const. Management Engrs. of Florida, Inc., 377 S.E.2d 119 (S.C. App. 1989). Similarly, the U.S. Court of Appeals for the Eighth Circuit has held that a prime contractor's change to a bonded excavation subcontract exceeds the scope of the subcontract where the change significantly increases the volume of contract work performed and triples the cost of the subcontract. Peter Kiewit Sons' Co. v. Summit Constr. Co., 422 F.2d 242 (8<sup>th</sup> Cir. 1969).

Moreover, the Government/Owner's failure to issue proper time extensions will also preclude a termination for default where the basis for default is the failure to timely perform. In the Government contract context, the Federal Acquisitions Regulations ("FAR") and the Contract plainly require that the contracting officer consider any extensions to which the contractor may be entitled before terminating the contract for default. The Default clause incorporated into Government contracts, FAR 52.249-10, provides as follows:

If the Contractor refuses or fails to prosecute the work or any separable part, with diligence that will ensure its completion

within the time specified in this contract including any extensions, or fails to complete the work within this time, the Government may, by written notice to the Contractor, terminate the right to proceed with the work (or any separable part of the work) that has been delayed.

(emphasis added).

Thus, in determining whether to terminate a contract for failure to make progress towards completion, the Government is required by the Default clause to consider appropriate time extensions due the Contractor. See J.D. Hedin Construction Co. v. United States, 408 F.2d 424, 432 (Ct. Cl. 1969) (even where government contract does not include convenience-termination clause, “the court has ruled that there is a breach of contract where a default-termination for alleged untimely performance fails to take into account time-extensions due the contractor for unforeseeable delays if such an extension would have taken the contractor out of default”); Ballenger Corp., DOTCAB Nos. 74-32, et al., 84-1 BCA ¶ 16,973 (1984) (finding the termination for default improper where the Government failed to demonstrate that at the time of termination, the contractor was failing to prosecute the work with such diligence as would insure its completion within the time specified or any properly considered extensions); Pilcher, Inc., ASBCA No. 13391, 70-1 BCA ¶ 8,331 (1970) (converting termination for default into termination for convenience where contractor was entitled to have the completion date extended because of extra work for which no time extensions had been granted and defective contract specifications).

Moreover, the FAR expressly requires the Government to examine the causes of delay before defaulting. FAR 52.249-10 provides that the contract may not be terminated if the failure to prosecute the work arises from causes beyond the control and without the fault of the contractor, such as when the delays in performance were caused by the Government. Additionally, FAR 49.402-3(f) provides that the Government, in making a decision to default terminate a contractor, must consider, among other things:

...  
(2) [t]he specific failure of the contractor and the excuses for the failure.

Accordingly, as a matter of law the Government must take into account any time extensions due to the contractor as a result of Government delays, before determining to terminate a contract for default. If the contractor is due valid time extensions for which the Government/Owner has failed to issue or consider, then the default will be considered improper.

Thus, to the extent the surety’s investigation reveals the Government’s/Owner’s material breach of any of its obligations, the surety will likely benefit from a “material breach” defense warranting a conversion of the default termination to a termination for convenience.

## **B. The Conditions Precedent**

The surety must also evaluate whether the Owner/Obligee satisfied the conditions precedent under the contract, bond or by regulation in terminating the principal for default. The surety may assert defenses based on the obligee's failure to comply with the procedural requirements for defaulting a contract. For example, an obligee's failure to provide a contractor with notice of default or with an opportunity to "cure" a default may render a subsequent default termination improper.

In many instances, the performance bond itself establishes conditions precedent that must be satisfied prior to triggering the surety's obligations. These requirements exist to insure that the surety is properly protected from excess liability, and that the surety is given the opportunity to most effectively respond to any obligation it may have. In the event the Owner/Obligee fails to satisfy these conditions precedent, the surety's obligations may be discharged.

Specifically, for example, the Performance Bond may contain the following conditions by which the Owner/Obligee is required to comply prior to any action by the Surety or the assertion of any liability against the Surety:

- (1) That there is no Owner Default;
- (2) The Owner has notified the Contractor and the Surety that the Owner is considering declaring a Contractor default and has requested and attempted to arrange a conference with the Contractor and the Surety to be held not later than a specific number of days after receipt of such notice to discuss methods of performing the Construction Contract;
- (3) The Owner cannot declare a Contractor Default and formally terminate the Contractor's right to complete the contract earlier than a specific number of days after the Contractor and the Surety have received notice; and
- (4) The Owner has agreed to pay the Balance of the Contract Price to the Surety in accordance with the terms of the Construction Contract or to a contractor selected to perform the Construction Contract in accordance with the terms of the contract with the Owner.

In such instances, the language of the Performance Bond unambiguously sets forth the conditions which the Owner/Obligee must satisfy before the surety is required to perform under the Performance Bond.<sup>1</sup>

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<sup>1</sup>Courts cannot ignore the plain language and intent of the contracting parties. United States Plywood Corporation v. Continental Casualty Co., 157 A.2d 286 (D.C. App. 1960). "Contracts in writing, if in unambiguous terms, must be permitted to speak for themselves, and cannot by the courts, at the instance of one of the parties, be altered or contradicted by parol evidence, unless in case of fraud or mutual mistake of facts; that this principle is applicable to cases of insurance contracts as fully as to contracts on other subjects..." Northern Assur. Co. v. Grand View Building Ass'n, 183 U.S. 308, 22 S. Ct. 133, 147, 46 L.Ed. 213 (1902).

Courts have consistently held that requirements similar to those set forth above are conditions precedent to a surety's liability under the Performance Bond. See Odegard v. General Casualty & Surety Co., 44 F.2d 31, 34 (8<sup>th</sup> Cir. 1930); National Surety Co. v. Long, 125 F. 887, 888 (8<sup>th</sup> Cir. 1903); Boston Mutual Life Insurance Co. v. Fireman's Fund Ins. Co., 613 F. Supp. 1090 (D.Mass. 1985); United States Plywood Corporation v. Continental Casualty Co., 157 A.2d 286 (D.C. App. 1960); Gilmour v. Standard Surety & Casualty Co. of New York, 97 N.E. 673 (Mass. 1935); Knight & Jillson Co. v. Castle, 87 N.E. 976 (Ind. 1909).

Failure to satisfy a condition precedent of a bond relieves the surety of any duty to takeover and complete or fund completion of the contract work. See National Surety Co. v. Long, 125 F. 887, 888 (8<sup>th</sup> Cir. 1903); United States Plywood Corporation v. Continental Casualty Co., 157 A.2d 286 (D.C. App. 1960); Knight & Jillson Co. v. Castle, 87 N.E. 976 (Ind. 1909). In National Surety, the bond required immediate notice to the surety of the principal's default. The Court held that mailing notice eleven (11) days after the default did not satisfy the notice condition of the bond and the surety was discharged from its obligations under the bond as a result of the obligee's failure to comply with the condition precedent of the bond to provide notice of the principal's default.

Similarly, Courts have consistently held that an obligee's action that deprives a surety of its ability to protect itself pursuant to performance options granted under a Performance Bond constitutes a material breach, which renders the bond null and void. See L & A Contracting Co. v. Southern Concrete Serv., Inc., 17 F.3d 106, 111(5<sup>th</sup> Cir. 1994); Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc., 986 F. Supp. 82, 86 (D. Conn. 1997); Insurance Co. v. Metropolitan Dade County, 705 So.2d 33, 334-35 (Fla. Dist. Ct. App. 1997); Dragon Constr., Inc. v. Parkway Bank & Trust, 678 N.E.2d 55, 58 (Ill. App. Ct. 1997). In Balfour, 986 F. Supp. at 84, the performance bond provided that when the obligee declared a principal default, the surety could remedy the default, or, after reasonable notice to the surety, the obligee could arrange to remedy the default at the surety's expense. The obligee in Balfour failed to notify the surety of the default, allowed the principal to complete the work in an untimely fashion, and then sought recovery from the surety. Id. at 85-86. Because the obligee's actions "deni[ed] the [surety] the opportunity to exercise any of its options under the performance bond," the obligee could not recover under the performance bond. Id. at 86.

It is notable, however, that some Courts have held that an obligee's failure to comply with a condition precedent under the bond will totally discharge the surety only if the surety can prove it was prejudiced or damaged. R.C. Walters Co., Inc. v. DeBower, 216 N.W.2d 515, 547 (Neb. 1979); Haddock Construction Co. v. Wilber, 169 P.2d 599, 604 (Ore. 1946).

Thus, where the surety is deprived of its right to cure or minimize its liability under the Performance Bond, and where the Owner/Obligee fails to satisfy these conditions precedent, the surety's obligations under the bond may be discharged.

## **V. HOW TO PROCEED – THE TAKEOVER AGREEMENT**

In the event the surety elects to proceed and complete performance on behalf of its principal pursuant to the performance bond, the surety must formulate its completion strategy to preserve any defenses it may later assert on behalf of the principal or on its own behalf. Fundamental to this strategy is the execution of a proper takeover agreement which will preserve the surety's rights and insure that the surety maintains standing to assert claims.

Typically, a surety which performs its obligations under the performance bond is equitably subrogated to the rights of both the principal and the owner/obligee. Accordingly, the surety is entitled to recover from any remaining contract proceeds the costs it has incurred for completion of the work without setoff from any competing claim. Aetna Cas. & Surety Co. v. United States, 845 F.2d 971, 974 (Fed. Cir. 1988). A performing surety attains this superior status by equitably subrogating itself to the Government/Owner's rights in the Contract funds. Pearlman v. Reliance Ins. Co., 471 U.S. 132, 138 (1962); Aetna Cas. & Surety Co., 845 F.2d at 974. This equitable right is premised on the fact that the surety relieved the Government of its obligations to complete performance.

The Courts have not disputed the surety's right to assert claims for contract balances. See Hartford Fire Ins. Co. v. United States, 40 Fed. Cl. 520, 522 (1998); Westech Corp. v. United States, 20 Cl. Ct. 745, 749 (1996). However, the issue of standing has been asserted where the surety seeks to assert claims related to the principal's performance of work prior to the default. The breadth of rights attainable under equitable subrogation will be discussed in more detail below. Notwithstanding the rights of equitable subrogation, however, a surety can secure its rights contractually by executing a formal, written takeover agreement. As such, the surety can secure its rights to assert all claims, including those of its principal, without regard that the Government will somehow attempt to challenge the surety's standing.

### **A. Takeover Agreement**

A surety can obtain rights to assert claims by executing a formal, written takeover agreement. See Travelers Indem. Co. v. United States, 16 Cl. Ct. 142, 153 (1988). Pursuant to a takeover agreement, the surety enters into a contract with the Government/Owner and agrees to complete the work. The effect of a takeover agreement is to place the surety in the shoes of the original contractor, with the surety assuming all of the rights and obligations under the contractor's contract. See Carchia v. United States, 485 F.2d. 622, 628-30 (Ct. Cl. 1973). Thus, a takeover contract allows the surety standing to sue the Government directly under the Contract Disputes Act ("CDA"). See Westech Corp. v. United States, 20 Cl. Ct. 745, 749 (1990); Travelers Indem. Co., 16 Cl. Ct. at 153. For example, a takeover agreement would allow the surety to sue the Government/Owner: (1) to challenge the propriety of the Government's/Owner's prior actions, including the decision to terminate for default, see Intercargo Ins. Co. v. United States, 41 Fed. Cl. 449, 460 (1998); (2) to recover for delay and acceleration damages, see Westech Corp., 20 Cl. Ct. at 749-50; (3) to recover for changes, see Universal Surety Co. v. United States, 10 Cl. Ct. 794, 800 (1986); and (4) to recover for extra work under the original contract, see Carchia v. United States, 485 F.2d. 622, 628 (Ct. Cl. 1973).

It should be noted that entering into a takeover agreement may expose the surety to additional liability. For instance, the surety is subject to the completion contractor's claims for additional costs incurred during the performance of the project, which the surety must pass through to the Owner. The surety may reduce this risk by including a contractual provision that the completion contractor's relief is contingent upon the Owner's payment to the surety and that all remedies must be pursued against the Owner. Moreover, by entering a takeover agreement, the surety, in most instances, is bound to complete the contract and can no longer limit its liability to the penal sum of the performance bond. Consequently, the surety's decision to enter into a takeover agreement must include, among other things, consideration of the benefit in retaining and maintaining, in its own name, the right to assert claims against the Government/Owner, and the increased liability by contracting with the Government/Owner.

## **B. Recent Decisions of the ASBCA Regarding Takeover Agreements**

In the Federal Court of Claims, where the takeover agreement between the surety and the Government specifically incorporates and binds the parties to the terms of the original contract, the surety is entitled to pursue claims arising under the original contract. See Travelers Indemnity Co. v. United States, 16 Cl. Ct. 142, 154 (1988); St. Paul Fire & Marine Ins. Co., et al v. United States, 1994 WL 87440, \*9 (Fed. Cl. 1994).

Recently, however, a disturbing trend has developed in the Armed Services Board of Contract Appeals ("ASBCA" or the "Board") that needs to be considered in drafting and executing a takeover agreement. The ASBCA has held, based upon the express terms of certain takeover agreements, that a surety cannot assert the claims of its principal that arose prior to the date of the surety's execution of a takeover agreement absent specific language in the agreement allowing the surety to do so. This decision appears to contradict decisions from the Court of Federal Claims ("COFC"). Because appeals from agency decisions can be taken to either the ASBCA or the COFC, set forth below are recommended actions to incorporate into any takeover agreement to ensure the viability of the surety's claims.

### **1. Decisions from the ASBCA**

In February 2001, the ASBCA issued its decision in Appeal of United Pacific Insurance Company, ASBCA No. 52419 (Feb. 7, 2001), dismissing portions of the surety's appeal for claims that arose prior to the takeover agreement based on the Board's finding that the surety lacked standing to assert its principal's claims.<sup>2</sup> The facts in United Pacific are familiar to any surety whose principal has been terminated for default. United issued payment and performance bonds to the Federal Government for Castle Abatement Corporation's ("Castle") repair of a containment system on an Air Force base. Castle allegedly defaulted on the contract and United entered into a takeover agreement with the Air Force that incorporated all the provisions of the Castle Contract. Castle was not a party to the takeover agreement.

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<sup>2</sup>In both of the cases discussed herein, the ASBCA and the Government do not contest that the surety has standing to bring claims that arose during completion pursuant to the takeover agreement.

United filed a certified claim of over \$1 million with the contracting officer (“CO”). The majority of the claim arose during Castle’s performance. The CO denied all but approximately \$1,000 of the claim and United appealed the decision to the ASBCA. After a motion to dismiss was filed by the Government, the Board dismissed the portions of United’s appeal that arose prior to takeover, finding that Castle did not sponsor the appeal. Importantly, the Board held that without an assignment from the principal to the surety to which the Government was a party or some other agreement between all three parties amounting to an assignment, the surety cannot assert the pre-takeover claims of its principal. Specifically, the Board stated that the takeover agreement could not act as a valid assignment of the principal’s pre-takeover claims if the principal was not a party to the takeover agreement. The Board also held that the surety’s claims under the doctrine of equitable subrogation were limited to the unpaid contract balance at the time of termination. The Board declined to extend equitable subrogation to include unliquidated claims for equitable adjustment that arose prior to the surety’s takeover.

The Board stated that it was bound by the prior decision of the ASBCA in Fireman’s Fund Ins. Co., ASBCA No. 50,657, 00-1 BCA ¶ 30,802, *aff’d on reconsid.*, 00-1 BCA ¶ 30,905, *on appeal sub nom.*, Fireman’s Fund Ins. Co. v. Danzig, CAFC No. 00-1420. In a fact pattern almost identical to United Pacific, Fireman’s Fund Insurance Company (“Fireman’s Fund”) issued payment and performance bonds to the Federal Government on behalf of its principal, Summit General Contracting Corp. (“Summit”), for a contract with the United States Navy at Staten Island, New York. The Navy terminated Summit for default and Fireman’s Fund entered a takeover agreement with the Navy that incorporated the terms and conditions of the original Contract between Summit and the Navy. Summit was not a party to the takeover agreement.

Fireman’s Fund submitted a certified claim to the CO that included claims that arose during Summit’s performance on the Contract. The CO denied the claim and Fireman’s Fund appealed to the ASBCA. The Government moved to dismiss those portions of the appeal that arose prior to the execution of the takeover agreement for lack of standing. The Board dismissed Fireman’s Fund’s appeal, holding that neither the general indemnity agreement (“GIA”) nor the takeover agreement served as a valid assignment of Summit’s claims to Fireman’s Fund.

The Board held that the GIA in Fireman’s Fund could not be a valid assignment of Summit’s claims because the Government was not a party to the GIA and there was no evidence that the Government was aware of or consented to the assignment in the GIA. The Board also held that the takeover agreement was not a valid assignment because it did not specifically reference the GIA or any assignment of Summit’s claims to Fireman’s Fund. Finally, the Board concluded that Fireman’s Fund could not seek equitable adjustments to the pre-takeover contract pursuant to the doctrine of equitable subrogation.

As discussed below, the recent decision in Insurance Company of the West, *supra*, may now supersede this line of reasoning, since the case expanded the surety’s rights under the doctrine of equitable subrogation.

## **2. Terms of the Takeover Agreement**

The United Pacific decision is contrary to decisions at the Court of Federal Claims holding that through the execution of a takeover agreement, a surety is entitled to assert the claims of its defaulted principal, including challenging the default termination. See Travelers Indemnity Co. v. United States, 16 Cl.Ct. 142 (1988).

There are a number of steps that the surety may take to address the trend that has appeared in United Pacific and Fireman's Fund. First, the surety should include the principal as a party to the takeover agreement. Pursuant to the Federal Acquisition Regulation ("FAR") 49.404(d), the contracting officer "should consider including in the [takeover] agreement both the surety and the defaulting contractor in order to eliminate any disagreement concerning the contractor's residual rights, including assertions to unpaid prior earnings." Accordingly, the surety should insure that the defaulted principal is a party in the takeover agreement.

Additionally, the surety should specifically incorporate the terms of the GIA into the takeover agreement. The takeover agreement should contain an acknowledgment by the Government/Owner of the terms of the GIA, including the assignment of the principal's claims on the defaulted contract to the surety. The terms should include the Government's recognition of the surety's right to challenge the default termination as well as the surety's right to assert equitable adjustments that arose prior to the takeover agreement. The ASBCA has held that a surety can pursue the claims of its principal where the defaulted principal was included as a party to the takeover agreement and specifically assigned to the surety the right to pursue claims under the defaulted contract. Insurance Company of the West, ASBCA No. 35253, 88-3 BCA ¶ 21,056.

Finally, the surety should obtain a formal Government waiver of the application of the Anti-Assignment Acts, 31 U.S.C. § 3727 and 41 U.S.C. § 15. If the takeover agreement recognizes the surety's right to assert the claims of its principal, however, the Government's explicit acknowledgment of a waiver of the Anti-Assignment Acts may be unnecessary.

In any event, the surety should attempt to expressly set forth its rights in the takeover agreement, thereby preserving its right to assert all of its claims and possible defenses.

### **C. The Expansion of the Surety's Rights under the Doctrine of Equitable Subrogation – *Insurance Company of the West***

While insuring a proper takeover agreement has been executed is the best means by which to secure the surety's rights to assert claims, the recent decision by the United States Court of Appeals for the Federal Circuit in Insurance Company of the West v. United States, 243 F.3d 1367 (Fed. Cir. 2001) has expanded the surety's standing through the doctrine of equitable subrogation.

In its decision in Insurance Co. of the West v. United States, 243 F.3d 1367 (Fed. Cir. 2001) (hereafter ICW), the United States Court of Appeals for the Federal Circuit

("Federal Circuit") determined that the United States has waived sovereign immunity for the equitable subrogation claims of a surety, thereby conferring standing to a surety that has performed its obligations under a performance bond. In ICW, the Court determined that a performing surety is equitably subrogated to all of the claims of its principal. As such, the Government's waiver of sovereign immunity expressly extends to those claims. In ICW, the Government's waiver of sovereign immunity was that expressed in the Tucker Act, 28 U.S.C. § 1491, and the Court concluded that the waiver extended to equitable subrogation claims asserted by the surety of a prime Federal Government contractor. ICW, 243 F.3d 1367, 1375.

The surety, Insurance Company of the West, filed suit in the United States Court of Federal Claims to recover, under the doctrine of equitable subrogation, payments improperly made by the Government to the surety's principal.<sup>3</sup> Relying on dicta in the United States Supreme Court's decision in Dep't of the Army v. Blue Fox, Inc., 525 U.S. 255, 119 S.Ct. 687, 142 L.Ed.2d 718 (1999), the Government moved to dismiss the surety's claims on the grounds that the Government had not waived sovereign immunity for equitable subrogation claims. ICW, 243 F.3d 1367, 1375. The Federal Circuit denied the Motion to Dismiss, holding that the Government had waived sovereign immunity for the equitable subrogation claims of a prime contractor's surety that financed completion of the contract work. Id.

In so holding, the Court of Appeals for the Federal Circuit clarified the fact that a performing surety is equitably subrogated to the rights of its principal, including the right to assert all of its claims.<sup>4</sup> Accordingly, the waiver of sovereign immunity extends to the surety that is equitably subrogated to the rights of the contractor. Id., at 1375. The Court, in following United States v. Aetna Cas. & Surety Co., 338 U.S. 366 (1949), applied "a broader and more generally applicable legal principle: waivers of sovereign immunity applicable to the original claimant are to be construed as extending to those who receive assignments, whether voluntary assignments or assignments by operation of law, where the statutory waiver of sovereign immunity is not expressly limited to waivers for claims asserted by the original claimant." ICW, 243 F. 3d 1367, 1373.<sup>5</sup> Importantly, the Court

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<sup>3</sup> The principal in ICW was never terminated for default and the surety did not execute a takeover agreement with the Government. Id. Instead, the surety performed its bond obligations by financing completion of the Project by its principal.

<sup>4</sup> The performing surety is a surety that either takes over contract performance or finances completion of the defaulted contract. In ICW, the Federal Circuit advised that there are two circumstances in which a surety succeeds to the contractual rights of a contractor against the government: "when the surety takes over contract performance or when it finances completion of the defaulted contract." ICW, 243 F.3d 1367, 1370, citing Admiralty Constr., Inc. v. United States, 156 F.3d 1217, 1222 (Fed. Cir. 1998) and Aetna Casualty and Surety Co. v. United States, 845 F. 2d 971, 975 (Fed. Cir. 1988).

<sup>5</sup> The Supreme Court in Aetna determined that subrogation was an assignment by operation of law and thus outside the prohibitions of the Anti-Assignment Act. Aetna Casualty & Surety Co., 338 U.S. 366, 376; see also Peerless Ins. Co., ASBCA No. 28887, 88-2 BCA ¶ 20,730 (1988). The three cases on appeal in Aetna were brought by insurers that had paid claims to their insureds as a result of injuries suffered by the insureds at the hands of negligent Federal Government employees. Aetna, 338 U.S. 366, 368-369. By paying the claims, the insurance companies were subrogated to all the rights of the insureds against the Federal Government up to the value of the claims paid, which rights accrued prior to the performance by the surety. Here, Appellants are similarly subrogated to the claims of their principal Martech against the Federal Government, which accrued during

reasoned that the waiver of sovereign immunity applies to the claims to be asserted, not to particular claimants. *Id.*, at 1373-1374. In this regard, the Court cites to express language in both of the Federal Tort Claims Act and the Tucker Act, which provide that the United States waived immunity as to “claims against the United States, for money damages . . .”, Federal Tort Claims Act, 28 U.S.C. § 1346(b), and for “any claims against the United States founded . . . upon any express or implied contract with the United States.” Tucker Act, 28 U.S.C. § 1491(a)(1). Thus, the Court concluded that “[t]he language of both acts contain an unequivocal expression waiving sovereign immunity as to claims, not particular claimants.” *ICW*, 243 F.3d 1367, 1373-1374. (emphasis added). Similarly, the Contract Disputes Act (“CDA”) provides that “[e]ach agency board shall have jurisdiction to decide any appeal from a decision of a contracting officer (i) relative to a contract made by its agency...” 41 U.S.C. § 607 (d) (emphasis supplied). Thus, the CDA also provides that the waiver of sovereign immunity applies to the appeal of a decision on a claim related to a contract with the agency, not to the particular claimant.

Furthermore, the court asserted that neither the constitutional doctrine of sovereign immunity nor the enactment of the sovereign immunity provisions by Congress changed the rule allowing “assignees to step into the shoes of the assignor” *ICW*, 243 F. 3d 1367, 1374, *citing The Federalist No. 81* (Alexander Hamilton). In this regard, the Court stated that ‘the assignee of a claim stepped into the shoes of the assignor for all purposes; ‘an assignment transfers to the assignee the same right held by the assignor, with its advantages and disadvantages”’ *Id.*, *citing* Restatement (Second) of Contracts § 340 cmt. a. (emphasis added). Accordingly, the United States Court of Appeals for the Federal Circuit made it clear that a performing surety steps into the shoes of its principal and is equitably subrogated to all of the rights of its principal and may therefore properly assert any and all claims which the principal could have asserted. *Id.*

Notwithstanding the express conclusions of the Court of Appeals for the Federal Circuit, the Government nonetheless continues to improperly attempt to limit the rights of equitable subrogation to claims arising after the principal’s default termination. In other words, the Government reads into these findings that the subrogee is only subrogated to post-default claims. Such a result is wholly inconsistent with the express ruling in *ICW*. As set forth above, the Government’s waiver of sovereign immunity in the CDA extends to particular “claims,” not claimants: agency boards have jurisdiction to decide “any appeal...relative to a contract made by its agency...” 41 U.S.C. § 607(d). Therefore it would be completely contradictory to conclude that once the surety “stepped into the shoes of the principal” and had the right to assert the principal’s claims, such right would then be limited to only post-default claims. Such a finding is inconsistent with the Court’s ruling and would render *ICW* and the doctrine of equitable subrogation meaningless.

In essence, the Government could escape liability related to claims that accrued prior to the default of the Principal, upon the transfer of “claimants.” This result is nonsensical since the Surety who completes already has standing to assert post-default claims solely by virtue of the execution of a takeover agreement. Such a finding would be in direct contravention of *ICW*, which expressly allows the surety, through the doctrine of

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Martech's performance, up to the value of the Sureties' losses in satisfying the obligations of their principal.

equitable subrogation, to step into the shoes of its principal and assert all of its claims, including those incurred during performance. This conclusion is also consistent with Aetna Casualty & Surety Co., 338 U.S. 366, supra, which the ICW court relied upon, and which provided the insurer with the right to assert its insured's claims for actions occurring prior to the insurer's payment of claims and subrogation to those rights. There has been no express ruling regarding pre-default claims following the ICW decision. Nonetheless, as discussed, it appears that ICW has broadened the surety's rights to assert claims under the doctrine of equitable subrogation.

## **VI. DEFENSES LIMITING LIABILITY – PROPER DEFAULT**

In the event that the owner's/obligee's default is proper, the surety nonetheless maintains an arsenal of potential defenses that may significantly limit its liability. The surety must review and determine these defenses at the outset to insure that it takes no action that would otherwise compromise such defenses.

### **A. Impairment of Suretyship**

Under established precedent, where an obligee to a bond increases a surety's exposure to risk without the surety's consent, the surety is discharged from its bond obligations "pro tanto" – which means to the extent it is injured by the modification. National Surety Corp. v. United States, 118 F.3d 1542 (Fed. Cir. 1997). This surety defense is best understood as a type of "impairment of suretyship" doctrine, which applies where an obligee alters a surety's risks under a bond and, in so doing, gives rise to a concomitant discharge in the surety's obligation. Restatement (Third) of Suretyship and Guaranty § 37 (1996). An act that increases a surety's risk of loss by increasing its cost of performance constitutes an impairment of suretyship status.

The *Restatement (Third) of Suretyship and Guaranty* sets forth numerous instances where an obligee's conduct gives rise to an impairment of suretyship status defense. This paper reviews two *Restatement* defenses that are commonly applicable in construction cases – (1) where the obligee modifies the risks imposed on the surety by fundamentally altering the obligee's contract with the principal, and (2) where the obligee limits the surety's recourse against its principal. Id. The *Restatement* further clarifies that an act or omission by an obligee impairs a surety's recourse where, for example, an obligee's action or inaction reduces the value of a surety's collateral in an underlying obligation or limits a surety's right of subrogation. In fact, in the explanatory notes, the drafters of the *Restatement* specifically provide that an obligee's improper management of unpaid funds on a construction contract constitutes an impairment of collateral. Restatement (Third) § 42, illus. 3 (1996); see also U.S. v. Continental Casualty Co., 512 F.2d 475 (5<sup>th</sup> Cir. 1975).

Even if the facts of a particular case do not fall squarely within one of the *Restatement* categories, the impairment of suretyship doctrine may still apply. In defining what precise acts constitute an impairment of recourse and, hence, an impairment of suretyship status, the drafters of the *Restatement* recognized the futility in attempting to itemize all acts covered by the doctrine. Restatement (Third) § 44, cmt. a (1996). Consequently, the *Restatement* instructs that it is imperative to scrutinize the *result* of an

obligee's action and not the action itself, in determining whether or not an obligee's conduct in a given case constitutes an actionable defense for surety discharge.

[A]cts of the obligee may impair. . . the [surety's] right of restitution or subrogation in ways that do not fit precisely within one of these categories. Nonetheless, it is the fact of such impairment, and not the particular act bringing it about, that gives rise to the [surety's] loss and resulting discharge. Accordingly, this section provides that any act resulting in such impairment gives rise to the concomitant discharge of the [surety].

Id.

The U.S. Court of Appeals for the Federal Circuit affirmed the *Restatement's* authority in disputes arising out of performance bonds on Government contracts when it held that the Government was liable to a surety that completed work on a construction project after its principal's default, for damages resulting from the Government's premature payment of contract retainage to the surety's principal. National Security Corp. v. United States, 118 F.3d 1542 (Fed. Cir. 1997). In reaching its decision, the Court of Appeals also affirmed the *Restatement's* observation that the "impairment of suretyship" cases can not be neatly categorized. Specifically, the court enlisted both a "modification of contract" rationale and an "impairment or recourse" analysis in arriving at its holding. In concluding that the Government breached its duty "to consider the surety's interest in conjunction with other problems encountered in the administration of the contract," the court emphasized that the Government had impaired the value of the surety's collateral and had, thereby, improperly limited the surety's subrogation rights. Id.

## **B. The Avoidable Consequences Doctrine**

An alternative theory that allows a surety to protect its financial position in the completion of a bonded contract is the "avoidable consequences" doctrine, under which a nonbreaching party on a contract must take reasonable steps to avoid incurring damages as a result of a contract breach and may not recover damages that could have been avoided by reasonable precautionary action on its part. Cates v. Morgan Portable Bldg. Corp., 780 F.2d 683 (7<sup>th</sup> Cir. 1985); see also Restatement (Second) of Contracts § 350.

The mitigation principle espoused in the avoidable consequences doctrine is uniformly applied throughout Government contract case law. See Northeastern Penn. Shippers Co-op Assn., Inc. v. U.S., 32 Fed. Cl. 72 (1994). Thus, for example, the Government possesses a duty under the FAR and under case law to either terminate a defaulting contractor or to secure performance of the contractor in an expeditious manner. Any failure to do so may prevent the Government from recovering costs as a result of its failure to mitigate damages. See Arctic Corner, Inc., ASBCA No. 38075, 94-1 BCA ¶ 26,317 (1993).

## **VII. CONCLUSION**

Upon receiving notice of its principal's termination for default, a surety must quickly review and analyze its position to determine its proper course of action. Essentially, the surety must insure that it protects its rights and limits its liability exposure. Initially, the surety must determine whether it will perform under its performance bond or whether its bond obligations have been discharged by the owner's/obligee's acts or omissions.

In the event the surety determines to proceed, it must insure it has executed a proper takeover agreement expressly setting forth its rights to later assert claims against the owner/obligee related to the propriety of the default and for any pre-default claims related to its principal's performance of work.

Finally, the surety should determine and implement any mitigation doctrines which may limit its liability.