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THE GOVERNMENT'S ABUSE OF DISCRETION FOR FAILING TO PROPERLY TERMINATE

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Introduction

On occasion, the surety finds itself in the position whereby a principal has allegedly defaulted in its performance of work, and the surety is then called upon to complete performance. In this scenario, the surety aggressively investigates the propriety of the termination, and reaches into its arsenal of defenses to either overturn the default; discharge, at least a portion, of its obligations; or mitigate its damages. This paper explores the antithesis of the problem sureties more frequently encounter: instead of considering whether the principal was unfairly terminated, the analysis here explores why the principal, if indeed defaulting in performance, was not terminated earlier.

In the construction context, the Government will most assuredly counter this attack with the Default clause, and the arguments usually employed by the surety or principal, such as the drastic nature of a default termination, the Government's ability to use reasonable discretion, and the FAR factors applicable in a default analysis. This paper addresses the sufficiency and completeness of these arguments, and the surety's right to recover for failure to timely terminate the principal.

I. The Impairment of Suretyship Doctrine

The impairment of suretyship doctrine provides the basis for a surety's claim against the Government for failure to promptly terminate the principal. In this regard, the surety may assert that the Government, in failing to timely terminate the principal, has further depleted the contract balances and has placed the surety at greater risk for additional potential liability (for example, the surety's risk may have increased due to defects in the work or the principal's failure to advance the work).

The "impairment of suretyship" doctrine discharges a surety from its obligation to perform whenever the obligee increases the surety's risk of loss without the surety's consent. This doctrine is set forth in the Restatement (Third) of Suretyship & Guaranty §§ 37-44 (1996), which explains that when an obligee acts to increase the surety's risks by increasing its potential cost of performance or decreasing its ability to have its principal meet their obligations, the surety is entitled to relief. Restatement § 37 a.

The impairment doctrine presents a unique approach to surety claims because it is much broader and more malleable than other bond defenses. The advantages of asserting the impairment doctrine include: (i) notice to the obligee is not necessarily required; (ii) a showing of material breach or material deviation is not necessarily required; and (iii) the doctrine provides for expanded remedial options, including the potential for a complete discharge.

In public contract cases, the Government does not ordinarily owe an equitable duty of care to the surety without the surety's notification of a contractor's potential default. See

Firemen's Fund Ins. Co. v. United States, 909 F.2d 495 (Fed. Cir. 1990). Conversely, an impairment claim can hinge on an obligee's contractual failing, increasing the surety's risk, and does not require notice of any kind. See Nat'l Surety Corp. v. United States, 118 F.3d 1542 (Fed. Cir. 1997). This application to public construction cases marks a fundamental change from previous case law, which held that the government's duty to the surety was only triggered by the surety's notice to the government of a contractor's potential default.

Additionally, because the doctrine applies any time the obligee increases the surety's risk of loss, an impairment claim eliminates the necessity of proving a material breach or material alteration of a contract or bond provision. In this regard, the restatement has adopted a two-prong approach in determining the extent of the breach and the resulting relief. First, where the obligee fundamentally alters the risk to the surety or the nature of the bargain, the surety may obtain a complete discharge from any unperformed duties. RESTATEMENT § 37(2)(b). Second, and more commonly, under the impairment doctrine a surety could require strict compliance with contract or bond terms and a failure to adhere to even the slightest term could discharge the surety to the amount that the alteration effected the suretyship status (*pro tanto*). Accordingly, the surety has a lesser burden of proof than under ordinary bond or contract defenses and may be discharged from performance after simply showing that the obligee increased the surety's risk beyond that for which it contracted.

Although the Restatement identifies numerous instances where an obligee's conduct gives rise to impairment, the prevailing application of the doctrine in the construction setting has been in the context of the premature release of funds. These cases are premised upon the surety's right to contract balances and the resulting impairment through the depletion of those funds. Notwithstanding, the RESTATEMENT permits expansion to virtually any situation in which the obligee increases the surety's risk. Therefore, the doctrine's potential application is seemingly greater than has been evaluated by the courts and may apply in a much broader context, including the obligee's failure to promptly terminate the contractor.

A. The Surety's Right to Contract Balances

The courts that have analyzed the impairment doctrine's application in the construction surety context have done so in actions involving a premature release of funds or failure to comply with a condition precedent to payment. See Nat'l Sur. Corp. v. United States, 118 F.3d 1542 (Fed. Cir. 1997) (the government failed to obtain a required arrow diagram before payment); Capital Indemnity Corp. v. Price Municipal Corp., 2002 WL 818064 (E.D. Utah, Apr. 25, 2002) (the city failed to obtain the surety's consent before payment). In a default termination context, these cases lend support to the argument that the obligee, by failing to terminate the principal contractor promptly and therefore failing to properly protect the contract balances for the performing surety, has impaired the surety's rights. Under suretyship law, contract funds maintained by the obligee are considered security or "collateral" from which the surety can recover to pay losses that it may incur should the principal default in performance. Transamerica Premier Ins. Co. v. United States, 32 Fed. Cl. 308, 313 (Ct. Cl. 1994); Home Indem. Co. v. United States, 376 F.2d 890 (Ct. Cl. 1967). The government's duty to the surety and the contract balances was

analyzed in Transmission Premier Ins. Co., supra. According to Transamerica:

> As holder of the contract funds, suretyship law requires the Government to use "reasonable care in the custody and preservation of collateral in its possession." Restatement (Third) of Suretyship § 38 cmt. e (Tent. Draft No. 2, April, 1993). Thus, the Government, although not in privity with the surety, does have 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. And that obligation 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.

Id. at 313-14 (emphasis added).

One example of a premature payment case in the federal government context is presented by United Pacific Insurance Co. v. United States, 16 Cl. Ct. 555 (1989). In United Pacific, a surety brought suit against the government on an emergency power system contract for making a progress payment to a defaulting contractor before properly inspecting materials delivered to the site. Id. at 556. When the contractor failed to pay its subcontractors, the surety stepped in and paid them, then went after the government for the erroneous payment. The Claims Court held that by not going beyond a simple initial inspection, the government "utterly failed" to protect the surety's interests. See id. at 558. While not using the term "impairment," the court held that by failing to fulfill a condition precedent to payment, i.e. the inspection, the government increased the surety's risk of loss by reducing the amount of contract funds available to pay the subcontractors. Consequently, the surety was entitled to recover its losses as measured by the overpayment.

The reduction of contract balances is particularly prejudicial to the surety because it increases the surety's risk of loss if called upon to perform, reduces the amount of contract funds remaining, and diminishes the contractor's incentive to complete the contract or pay its outstanding debts. See National Surety, 118 F.3d at 1548.

These cases recognize the surety's interest to contract funds and the "impairment" to the surety where these funds are released early or where the obligee fails to adhere to a condition precedent for payment. Likewise, in a default situation, the obligee's failure to promptly consider the principal obligor's default in performance and continued payment of contract proceeds, notwithstanding such default, can be argued as an impairment of suretyship.

B. Maladministration of the Termination Process

In the default context, sureties should recognize the impairment doctrine's expansive application to situations not only involving the depletion of contract funds, but also where an obligee exercises discretion when administering the contract in a manner that increases the surety's risk of loss. Specifically, the doctrine would be applicable where an obligee fails to promptly terminate a defaulting contractor. Although not identifying the sureties' position as an "impairment of suretyship claim," analogous cases, decided before the RESTATEMENT was modified, apply the same principals as, and confirm the applicability of, the impairment doctrine for failure to timely terminate a defaulting contractor.

In public contracts in particular, the government is provided seemingly broad discretion to manage the contract to meet its interests in the project. See Argonaut Ins. Co. v. United States, 193 Ct. Cl. 483, 495 (1970). However, the government must take into account the interests of the surety while wielding such discretion. See Ohio Cas. Ins. Co. v. United States, 12 Cl. Ct. 590, 591 (1987) ("the surety does not contract to assume the risks of unreasonable conduct by a contracting officer. . ."). And an abuse of discretion, which increases the surety's risk, could discharge the surety's obligations under a performance bond. See id. at 592.

In Argonaut, the surety claimed the government increased its risk by failing to terminate a defaulting contractor in a timely manner. See Argonaut, 193 Ct. Cl. at 490. The Court of Claims held that even if there were grounds for terminating, the decision whether to terminate was discretionary, and where performance charts showed that the contractor's progress was satisfactory, the government did not abuse its discretion by not terminating the contractor. See id. at 495. In its decision, the court analyzed the government's discretion provided in the contract and held that the government's refusal to terminate the contractor was well within the range of discretion conferred on the contracting agency by the terms of the contract and the applicable regulations. See id. at 496.

When faced with a similar challenge seventeen years later, the court held that a contracting officer's abuse of discretion could discharge a surety from its obligations. See Ohio Casualty 12 Cl. Ct. at 591 (1987). In Ohio Casualty, the court reviewed the actions of a U.S. Navy contractor to build five steel buildings. After numerous delays by the contractor, and several warnings from the surety concerning the contractor's potential default, the Navy failed to terminate the contract. The court held that the government's failure to terminate the contract after clear evidence of the contractor's incompetence was an abuse of discretion impairing the surety's rights. See id. at 594. Thus, although Argonaut and Ohio Casualty precede the Restatement and the impairment of suretyship doctrine, the fundamental principles applied in these cases are the same as, and support, those of the impairment doctrine. Accordingly, under Ohio Casualty and subsequent cases such as United Pacific (discussed supra), a surety could potentially claim impairment where an obligee fails to timely terminate a faltering contractor. See United Pacific, 16 Cl. Ct. 555 (1989) (defining the discretion permitted by a contracting officer).

II. Alternative Grounds to Terminate Beyond the Default Provision

In asserting its defenses to an impairment claim for failure to promptly terminate the contractor, the Government obligee will likely attempt to justify its actions under the prevailing Federal Acquisitions Regulations (FAR) provisions for default. However, the FARs also provide alternative bases to the obligee to terminate the contract, such as violations of the Davis Bacon Act or compliance with Payrolls and Basic Records requirements. Accordingly, the surety may argue that the obligee should have implemented these provisions to terminate the contractor, and protect the surety's rights.

Alternatively, the surety need not await the application of the grounds set forth in the FAR as a basis for termination of the principal. Rather, the commission of fraud by the contractor during performance of the contract is a separate basis for termination.

A. FAR Provisions That Allow the Government to Default Terminate a Construction Contract

Unlike most types of Government contracts which allow the Government to justify a default termination based on any material breach of the contract by the contractor, there are only limited grounds available to the Government to default terminate a construction-related contract. See e.g. Brandywine Prosthetic-Orthotic Service,. Ltd., VABCA 3441, 93-1 BCA ¶ 25,250; Engineering Tech. Consultants, S.A., ASBCA 43454, 94-1 BCA ¶ 26,586. Generally, a construction contract may only be default terminated if the contractor breaches a clause that specifically grants the Government the right to terminate.

Of course, the primary clause used to justify a default termination of a construction contract is the standard Default clause, FAR 52.249-10. This clause allows the Government to issue a default termination "[i]f the Contractor refuses or fails to prosecute the work or any separable part, with the diligence that will insure its completion within the time specified in the contract." FAR 52.249-10. This clause not only allows the Government to terminate the contract if the work progresses past the contract completion date, but it also give the Government the right to terminate before the contract completion date if it becomes apparent that the contractor will not be able to complete the work in time. FAR 52.249-10; Engineering Tech. Consultants, S.A., ASBCA 43454, 94-1 BCA ¶ 26,586.

he corollary to the Default clause is the Schedules for Construction Contracts clause, FAR 52.236-15, which gives the Government the right to demand that the contractor accelerate work that is behind schedule. Under the Schedules for Construction Contracts clause, the Government is authorized to default terminate a contract if the contractor fails to comply with the Government's acceleration directives and, as a consequence, it becomes evident that the contract cannot be completed on time.

There is one exception to the rule that the Government may not terminate a contractor based on the above FAR provisions unless there is a determination that the contractor simply cannot complete the work in the remaining time allotted. The Government can terminate even if there is sufficient time remaining to complete the work if there is an anticipatory repudiation of the contract by the contractor. Milo Werner Co.,

IBCA 1202-7-78, 82-1 BCA ¶ 15,698. An anticipatory repudiation occurs when the contractor's conduct manifests a "positive, unconditional, and unequivocal declaration of fixed purpose not to perform the contract in any event or at any time." Id. Under these circumstances, the Government may terminate the contract immediately without going through the meaningless exercise of waiting until it is clear that the contractor could no longer complete the work on time. Id.

In addition to the Default clause, there are a number of other FAR provisions that specifically grant the Government the authority to default terminate the contractor upon breach. For example, the Inspection of Construction clause, FAR 52.246-12, allows the Government to default terminate a contract if the contractor fails to promptly replace or correct rejected work. The Contract Termination – Debarment clause, FAR 52.222-12, permits the Government to default terminate a contractor for violating certain FAR clauses such as the Davis-Bacon Act (FAR 52.222-6), Compliance with Copeland Act Requirements (FAR 52.222-10), Contract Work Hours and Safety Standards Act – Overtime Compensation (FAR 52.222-4) and Payrolls and Basic Records (FAR 52.222-8). At least one Board has found, however, that the contractor must be given the opportunity to mitigate or rectify the violations prior to being terminated under the Contract Termination – Debarment clause. Herman B. Taylor Constr. Co., GSBCA 12961, 95-1 BCA ¶ 27,572 recon. den. 95-2 BCA ¶ 27,723.

Other clauses that allow the Government to default terminate the contract (depending on the nature of the breach) include: FAR 52.203-3 (Gratuities), FAR 52.203-10 (Price or Fee Adjustment for Illegal or Improper Activity), FAR 52.228-1 (Bid Guarantee), FAR 52.209-5 (Certification Regarding Debarment, Suspension, Proposed Debarment, and Other Responsibility Matters), FAR 52.222-26 (Equal Opportunity), and FAR 52.223-6 (Drug-Free Work Place).

B. Fraud As a Ground For Default Termination

Although the Contractor's untimely performance and breach provide a basis for default termination, the surety may be in a position where the principal is not late in performance, but nonetheless is impeding progress or otherwise impairing the surety rights. An example is where the principal fails to apply contract funds to the payment of subcontractors or fails to further progress the work. In this case, the surety need not idly stand by, but rather can assert fraud as grounds for the obligee's prompt termination of the principal.

Courts have held that in addition to the grounds for default termination provided in the FAR, the commission of fraud by the contractor during performance of the contract is grounds for default termination. Joseph Morton Co. v. United States, 757 F.2d 1273 (Fed. Cir. 1985) ("A contractor which engages in fraud in its dealings with the Government on a contract has committed a material breach justifying a termination of the entire contract for default"); see also Daff v. United States, 31 Fed. Cl. 682 (1994) ("[f]raud taints everything it touches … Consequently, proof of fraud by clear and convincing evidence is a ground for default termination"). The severity of the fraud does not seem to be an issue as courts

have rejected contractor defenses based on the insignificance of the fraudulent activity. Joseph Morton, 757 F.2d at 1279 (court refuses to perform a balancing test to compare the fraudulent act with the amount of fraud free work noting that "there is support for the argument that any fraud warrants termination for default as a matter of law"). In order to justify a default termination based on fraud, however, the Government must be able to prove the fraudulent activity with clear and convincing evidence. Daff, 31 Fed. Cl. at 688.

The Daff case provides an illustration of the Government's right to default terminate a contract for fraud. This case involved a contract for the construction of guided missile parts. Daff, 31 Fed. Cl. at 686. Pursuant to the terms of the contract and the FAR, the contractor was required to establish an inspection system and prepare records evidencing all inspections. Id. at 686-87. When the Government learned that the contractor was forging some of these inspection records, it default terminated the contract without notice. Id. at 687. The Court of Federal Claims found that the contractor made "requests for payment with an intent to deceive the Government into a belief that the contractor had fully complied with the terms of the contract, when in fact it had not." Id. at 689. Thus, because there was clear and convincing evidence of fraud, the Government's decision to default terminate the contract was justified. Id. at 689, 697.

Fraudulent transactions by a contractor that diminish the remaining contract balances are, of course, of special concern to the project surety. This issue arises, for example, where a contractor falsely certifies that it is making progress payments to its subcontractors in order to induce the Government to make payment from the contract balance. If the contractor's fraudulent activity can be shown by clear and convincing evidence, the Government will clearly have an obligation to take the surety's increased risk into consideration when determining whether to default the contractor for fraud. When determining whether there is clear and convincing evidence of this type of fraud, however, it is important to note that at least one court has found that mere fact that the Government was made aware of a payment bond claim is not sufficient evidence to justify a default termination based on the fraudulent submission of payment certifications. International Fidelity Ins. Co. v. United States, 25 Cl. Ct. 469, 479 (1992).

Nonetheless, a finding of a fraudulent act by the contractor will serve as a strong basis to support a surety's claim for impairment where the obligee fails to promptly terminate the contractor.

III. CONSIDERATION OF VOLUNTARY DEFAULT LETTER

Another means by which a surety can seek to protect itself from a principal's floundering performance is by trying to effect a default termination through the use of a voluntary default letter.

As a pre-condition to providing a performance bond on a Government construction contract, a surety may require that the principal contractor provide the surety with an executed voluntary default letter to hold in its files. Probably more often, a surety may require a financially troubled contractor to provide such a voluntary default letter as a prerequisite to entering into a financing arrangement with the contractor. The letter, usually

written on the contractor's letterhead, states something to the effect that the contractor is unable to continue performing the contract due to financial difficulties and that the Government should contact the surety regarding completion and should pay all contract funds to the surety. In providing such a letter, the principal is, in effect, assigning its right to anticipatorily repudiate its contract with the Government to the surety. If the contractor gets into financial difficulty and the surety determines that the contractor's continued performance will lead to increased losses, the surety could theoretically send the letter to the Government, thereby effecting the termination of the contractor. The surety could then take over performance and stop the proverbial bleeding on the project.

While the voluntary default letter may provide the surety with valuable leverage vis-à-vis the contractor, it is not clear whether the Government would be obligated to terminate the contractor upon its receipt of the letter from the surety, especially if the contractor resisted termination and claimed it was able to perform. In most situations, the Government will not have knowledge or be a party to the contractor's assignment of its ability to voluntarily default to the surety. Thus, a threshold question that must be considered is whether the principal's assignment of it's right to voluntarily default to the surety runs afoul of the Anti-Assignment Act. The Anti-Assignment Act, collectively 31 U.S.C. § 3727 and 41 U.S.C. § 15, generally prohibits a party to a Government contact from assigning claims or interests from Government contracts to third parties. Much of the case law interpreting and applying the Anti-Assignment Act focuses on the assignment of claims, rather than the assignment of non-monetary rights under the contract. The cases have not analyzed the interplay between voluntary letters of default and the Anti-Assignment Act. Consequently, while a surety may argue that the voluntary default letter does not violate the Anti-Assignment Act and is thus enforceable, it appears the courts have yet to resolve this question.

Even if the Anti-Assignment Act was held to prohibit a surety from exercising the contractor's right to voluntarily default, the Government can waive the Anti-Assignment Act explicitly by agreeing to accept an assignment from the contractor to the surety. In addition, the Government's course of dealing with the surety in particular situations may constitute a constructive waiver of the Anti-Assignment Act. See Safeco Ins. of America, ASBCA 52107, 03-2 BCA ¶ 32,341; Security Insurance of America, ASBCA 51813, 01-2 BCA § 31,588. As such, if the surety presented the Government with the voluntary termination letter and the Government entered into negotiations with the surety regarding the completion of the project or a takeover agreement prior to terminating the contractor, a tribunal would likely not allow the Government to assert the Anti-Assignment Act in order to avoid honoring the voluntary default letter. See id.

When the surety procures a voluntary default letter from a financially troubled contractor as a prerequisite to entering into a financing arrangement with the contractor, the surety may consider attempting to get the Government to consent to the voluntary default assignment up front. The surety might request the Government to sign a memorandum of understanding acknowledging the arrangement. Leverage to obtain such a concession from the principal at this juncture is obvious. The Government may agree to acknowledge the assignment because the financing would expedite project completion. In addition, if the

contractor experienced further trouble, the surety would presumably terminate the contractor before the contractor's poor performance justified a Government default termination under the FAR, thereby insulating the Government from a claim for improper termination and also overpayment to the principal.

Another potential roadblock to the enforcement of voluntary default letters is a contractor claim that it forwarded the voluntary default letter under duress. Generally, the defense of duress consists of a wrongful act or threat that overcomes the free will of the party. See Rest (2d) Contracts § 175. In the commercial contracting context, duress often involves a party to a contract gaining some advantage by unfairly coercing a party to enter into a contract or to agree to a modification of a contract by threatening to breach the contract or threatening to commit other wrongful acts such as exercising legal rights in an oppressive way. Id. Important to the consideration of any duress argument in this context is whether or not the parties' indemnity agreement commits the surety to provide any particular additional bonding and whether or not the provision of a particular bond(s) can be construed as consideration to support the surety's requirement that a voluntary default letter be provided. Duress may also be a consideration when the surety requires a voluntary default letter before agreeing to a financing arrangement with the contractor. In that situation, the surety should make clear that the financing offered is consideration to support the receipt of the voluntary default letter.

Even if the Government were to validly refuse to honor the voluntary default letter submitted by the surety, it would likely be a Government abuse of discretion not to consider the letter in its decision whether to default terminate the bonded contractor or discontinue the payment of contract funds to the contractor. Courts look to numerous factors in determining whether the Government abused its discretion in continuing to distribute funds to a contractor. See Balboa Ins. Co. v. United States, 775 F.2d 1158 (Fed Cir. 1985). Submission of the letter by the surety would at the very least constitute notification to the Government and trigger a Government duty to investigate the advisability of default termination. Id.

Many sureties in the industry require contractors to give them voluntary default letters at various points in the bonding relationship in order to obtain additional protection. Instances of sureties attempting to enforce these voluntary defaults are apparently few and far between. As a result, there are many questions that remain unanswered regarding the enforceability of voluntary default letters that have the effect of assigning the contractor's right to voluntarily default to the surety.

IV. Conclusion

In situations where the principal contractor is defaulting in performance but the Government obligee fails to promptly terminate the contractor, the surety may assert a claim under the impairment of suretyship doctrine. The basis for the surety's claim is that the Government, in failing to terminate the principal promptly, has further depleted the contract balances and has placed the surety at a greater risk for loss. Accordingly, the surety may argue that the Government abused its discretion.

Additionally, while breach of a FAR clause is typically a requirement for a default termination, the commission of fraud by the contractor during performance of the contract provides a separate basis for termination.

Finally, the surety should consider the procurement and use of a voluntary default letter obtained from the contractor to effectuate a default termination and preserve the surety's rights.