

**TWENTIETH ANNUAL
NORTHEAST SURETY AND FIDELITY
CLAIMS CONFERENCE**

SEPTEMBER 24th and 25th, 2009

**STRATEGIES FOR PREPARING AND PURSUING AN
EFFECTIVE CLAIM FOR OVERPAYMENT**

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INTRODUCTION

An owner/obligee's failure to preserve the value of the collateral which secures the surety's obligation, may lead to a claim for overpayment by the surety. In this regard, the surety considers the contract funds on projects for which the surety has provided a performance bond to be collateral for performance of the work. Upon an event of default, the contract balances are to be provided to the surety for the completion of the work. Alternatively, the contract balances should be considered as an offset to any claim by the owner/obligee for the costs of completion. To the extent the collateral is improperly or prematurely depleted, the surety may assert a claim for overpayment and impairment of the surety's collateral. Relatedly, the owner/obligee's failure to adhere to the payment requirements of the contract may also serve as a basis for the surety's overpayment claim and a discharge argument. This paper will address the nature of the surety's overpayment claim and provide strategies and considerations related to the pursuit of an effective claim.

The surety may wish to assert an overpayment claim or defense if it discovers, upon investigation of a default and/or termination, that the bond obligee has overpaid the principal on the underlying contract. In this instance, the surety may wish to investigate and pursue an overpayment claim (or assert overpayment as a defense) against the obligee. Typically, overpayments occur when the obligee issues payment to the principal for incomplete or defective work. Both the overpayment claim and defense are premised upon the fundamental surety defenses of material alteration of the surety's underlying obligation and correspondingly, impairment of the surety's collateral. These fundamental principle are based upon the surety's rights pursuant to The RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY §§ 41-42. Specifically, to the extent that the obligee's overpayments materially alter the surety's agreed upon risk, or impair the value of the surety's collateral, the surety may be entitled to a pro tanto or complete discharge. Thus, an effective overpayment claim or defense can be a powerful tool at the surety's disposal in responding to a default termination.

In asserting an overpayment claim or defense, the surety must consider whether and to what extent overpayment is available as a claim or defense based upon the guiding contractual provisions and relevant statutory or common law, and the elements of proof required to establish such a claim or defense. Strategically, the surety should also evaluate when and how it wishes to assert the claim. For example, the surety may wish to raise the claim prior to, and as part of, any takeover agreement; or instead, assert the overpayment claim as a defense to a bond demand or as part of a completion claim.

This briefing addresses the nature of the surety's overpayment claim, the evidentiary requirements in establishing such claim, and additional considerations in effectively asserting an overpayment claim or defense.

DISCUSSION

I. **Asserting a Claim for Overpayment**

In order to set forth a successful overpayment claim or defense, the surety must be mindful of the evidentiary burden it must satisfy in a subject jurisdiction. A prudent analysis of the availability of an overpayment claim or defense includes consideration of the sources of applicable law, including the bond, the contract and any relevant statutory or common law. Additionally, presuming that the surety can establish the obligee's overpayment, the surety must consider to what extent will the obligee's acts give rise to the surety's complete or partial discharge from bond liability. Courts have discharged the surety from its bonded obligation under a theory of material breach of the underlying contract and in circumstances amounting to impairment of the surety's right to contract balances as collateral against loss. Finally, the surety must assess whether it will be sufficient to prove a material alteration to the underlying contract to effect discharge, or whether the surety must make an additional showing of prejudice or injury as a result of the alteration.

A. Basis for Overpayment Claim

As an initial matter, the surety must review the relevant documents and applicable law to assess the availability of an overpayment claim or defense. In this regard, the surety should carefully examine the contract's payment terms and inspection requirements. For example, if the obligee, is required to inspect the work prior to certifying the work for payment and the obligee ultimately pays for defective or incomplete work, the obligee has breached its contractual duties and possibly materially altered the contract, resulting in the surety's discharge. See United Pacific Ins. Co. v. United States, 16 Cl. Ct. 555 (Cl Ct. 1989); U.R.S. Co. v. Gulfport-Biloxi Reg'l Airport. Auth., 544 So.2d 824 (Miss. 1989); Transamerica Ins. Co. v. City of Kennewick, 785 F.2d 660 (9th Cir. 1986).

Additionally, careful consideration must be given to the payment terms of the contract, and the discretion, if any, afforded to the owner/obligee. To the extent the payment terms are unambiguous and precise, the surety will have a powerful arsenal to assert an overpayment claim. For example, the contract (often incorporated into the bond), may contain provisions, such as (i) only allowing for release of 80% of the schedule of values price for a certain item of work until the work is fully complete; (ii) only allowing for payment of materials after delivery to site; and (iii) only allowing for payment of 90% of the contract value, with the balance being retained until final completion. A breach of any of these contractual provisions will lend strong support to an overpayment claim. Conversely, contractual terms that provide more latitude or discretion to the owner/obligee, may limit the claim.

Further, the bond terms must also be considered. Often, the bond incorporates the contract which may be used as a basis for requiring the obligee's adherence to certain contractual requirements, including the payment terms.

While the terms of the contract, bond, or applicable statutes may support a surety's overpayment claim or defense, these sources may also preclude such claims. In this regard, the surety must analyze whether the terms of the bond or contract expressly or impliedly waive an overpayment claim or defense. See Aniero Concrete Co., Inc. v. New York City Constr. Auth., No. 94-9111, 1998 WL 148324 (S.D.N.Y. Mar. 30 1998) (holding that surety waived its right to assert an overpayment defense because the terms of the performance bond specifically provided that the surety would not be relieved of its obligations even in the event payments were made before the contractually required time for payment. Reliance Ins. Co. v. United States, 27 Fed. Cl. 815, 826 (Fed. Cl. 1993) (stating that surety has heavy burden to prove government acted arbitrarily or capriciously by making progress payments to contractor where the contract vests contracting officer with discretion to make sure payments).¹

B. Establishing a Claim or Overpayment

In establishing the obligee's overpayment claim, the surety must determine how to present its claim, and to what extent will the obligee's acts give rise to the surety's complete or partial discharge from bond liability. Courts have discharged the surety from its bonded obligation, either in part or in full, under the theories that the obligee's overpayments constitute a material alteration of the underlying contract, and that such payments amount to an impairment of the surety's right to contract balances as collateral against loss. Additionally, while some courts only require a showing of material alteration of the underlying contract to discharge the surety, other jurisdictions require the added showing of prejudice or injury to the surety. Thus, when considering the feasibility of an overpayment claim or defense, the surety must carefully evaluate the status of the law in the subject jurisdiction.

1. Impairment of Collateral

Typically, the surety's overpayment claim or defense is based upon the theory that an obligee's overpayment of the bonded principal impairs the surety's collateral. The RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY provides that impairment of the surety's collateral by an obligee discharges the surety's obligation. Specifically, section 42, Impairment of Collateral provides, in pertinent part,

(1) If the underlying obligation is secured by a security interest in collateral and the obligee impairs the value of that interest, the secondary obligation is discharged to the extent that such impairment would otherwise increase the difference between the maximum amount recoverable by the

¹ But see American Insurance Company v. United States, 62 Fed. Cl. 151, 157 (2004) ("[V]arious cases suggest that if the [Government] abused its discretion in making progress payments that too could be viewed as an impairment of plaintiff's suretyship and give rise to damages." (citing Nat'l Sur. v. United States, 118 F.3d 1542, 1546 (Fed.Cir.1997); U.S. Fid. & Guar. Co. v. United States, 475 F.2d 1377, 1384 (1973); and Argonaut Ins. Co. v. United States, 193 Ct.Cl. 483, 434 F.2d 1362, 1368 (1970)).

secondary obligor pursuant to its subrogation rights...and the value of the secondary obligor's interest in the collateral.

(2) Impairing the value of the security interest in collateral includes:

(c) failure to perform a duty to preserve the value of collateral owed to the principal obligor or the secondary obligor.

RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 42. Thus, if the obligee fails to preserve the value of the surety's collateral, the surety may be discharged by the amount that the alteration effected the suretyship status. The surety may argue that by overpaying the bonded principal, the obligee improperly dissipated the contract balance required to be available for the surety's use in the event of default, resulting in an impairment of suretyship; and, depending upon the jurisdiction, a complete or partial discharge of the surety's obligations. See Blackfeet Tribe of the Blackfeet Indian Reservation v. Blaze Constr., Inc., 108 F. Supp.2d 1122 (D. Mont. 2000) (holding that an obligee's overpayment impaired the surety's security interest and the obligee improperly acted without due care to preservation of the surety's collateral); Transamerica Ins. Co. v. City of Kennewick, 785 F.2d 660 (9th Cir. 1986) (holding that certain pre-payments by the obligee impaired the surety's security interest in collateral and resulted in a pro tanto discharge of the surety's obligations). Therefore, in establishing an overpayment claim, the surety may argue that it must be discharged on the basis that the obligee's actions improperly impaired the value of the surety's collateral.

Notably, an "impairment" argument, does not necessarily require a showing of material breach. Rather any breach of a contractual obligation, here payment, may result in an impairment claim. Under the RESTATEMENT approach, the surety may potentially bring an impairment claim without having to prove a material breach or alteration of the underlying contract by the obligee. See Nat'l Sur. Corp. v. United States, 118 F.3d 1542 (Fed. Cir. 1997) (holding that government's actions in departing from contract's payment terms impaired the surety's collateral and resulted in discharge); Capital Indemnity Corporation v. Price Municipal Corporation, No. 2:99CV0141, 2002 WL 818064 (D. Utah Apr. 25, 2002).

For example, in Capital Indemnity Corporation, the surety brought suit against a municipality for releasing contract funds to the contractor without first obtaining the surety's consent as required by the contract. Specifically, the contract stated that the principal's final payment application must include the surety's consent for payment and required the city's engineer to review the application to ensure that it included all appropriate documentation. The city did not obtain the surety's consent prior to issuing final payment. Relying on the impairment doctrine, the court held that by paying the contractor without the surety's consent, the city "clearly increased [the surety's] risk of loss" and impaired "[the surety's] ability to make the contractor pay its subcontractors." *Id.* at *4. Thus, the court ultimately determined that the increased risk imposed on the

surety by the obligee, and not necessarily the magnitude of the breach, resulted in the obligee's liability.

Similarly, in National Surety, supra, the court held that the government's failure to abide by the express terms of the contract governing retainage impaired the surety and required the surety's discharge to the extent of its injury. Id. at 1547-48. While the court did not state that the government's actions constituted a material breach of the contract, it held that the government's departure from the terms of the contract constituted an impairment of the surety's collateral. Id. Thus, the court's holding in National Surety demonstrates that even in the absence of a material breach of the underlying contract, a strict compliance rule could be established warranting a discharge, at least partial (or pro tanto), of the surety's obligations whenever an obligee increases the surety's risk by failing to abide by even the less significant contract terms.

2. Material Alteration

In asserting its overpayment claim or defense, the surety may also present its claim by asserting that the obligee's overpayment constitutes a material alteration of the surety's obligation. The RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY expressly provides that material changes to the underlying contract that fundamentally alter the agreed-upon risk assumed by the surety result in discharge of the surety's bonded obligation.

Specifically, section 41, Modification of Underlying Obligation, provides, in pertinent part,

If the principal obligor and the obligee agree to a modification. . . of the principal obligor's duties pursuant to the underlying obligation:

(b) the secondary obligor is discharged from any unperformed duties pursuant to the secondary obligation:

(i) if the modification creates a substituted contract or imposes risks on the secondary obligor fundamentally different from those imposed pursuant to the transaction prior to the modification. . .

RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 41.

Consistently, in keeping with the RESTATEMENT, courts have discharged a surety's bonded obligation where the obligee materially alters the underlying contract without the surety's consent. For example, in Southwood Builders, Inc. v. Peerless Ins. Co., 366 S.E.2d 104 (Va. 1988), the court discharged the surety's obligations under a performance bond based upon early, improper payments made to a subcontractor. There, Southwood Builders contracted with the Board of Supervisors of Gloucester County to build an office building. The contractor subsequently subcontracted with

United Drywall & Plastering Company to provide the drywall and metal stud partitions for the office building. Peerless Insurance Company provided the performance bond for United. A few months after work began, the contractor and the subcontractor entered into an agreement wherein the subcontractor agreed to add another work crew to the project and the contractor agreed to pay for the crew and additional materials to facilitate completion of the project. The agreement provided that any monies paid for additional crews and materials would be deducted from the subcontractor's progress payments. None of the parties apprised the surety of the agreement until the subcontractor was declared to be in default several months later. Following the default, the surety determined that the contractor paid for materials that were not actually delivered to the site in contravention of the Contract requirements.

The contractor subsequently filed a claim with the surety for the additional labor and material costs incurred in prosecuting the work. The trial court rejected the contractor's claim under the performance bond in that the contractor's actions, in executing the agreement with the subcontractor and making substantial payments to the subcontractor before such payments were due, constituted a material change to the surety's obligations, resulting in the surety's discharge from liability. More specifically, the court held that before an obligee can recover under a bond, the obligee must show that it has performed the conditions set forth in the bond. In this regard, the court reasoned that making substantial payments to the subcontractor before such payments are due constitutes a variation in the terms of the contract that will discharge the surety from its obligations to the obligee. Id. at 108. The court further held that a separate showing of prejudice to the surety is unnecessary because a material deviation in itself establishes sufficient prejudice. Id. The Supreme Court of Virginia affirmed the trial court's ruling.

Similarly, in Continental Ins. Co. v. City of Virginia Beach, 908 F. Supp. 341 (E.D. Va. 1995), the District Court for the Eastern District of Virginia awarded the surety its excess costs to complete as a result of the owner's overpayments to the principal based upon the existence of a material alteration of the underlying contract. In Continental, the City of Virginia Beach contracted with Utility Builders for the construction of new sewer and water lines. Continental Insurance Company as surety, provided the performance and payment bonds on the project. After the owner declared the contractor to be in default, the surety discovered that the owner had not conducted proper inspections before making progress payments, as the contract required. By making progress payments to the contractor, the owner implied that it had completed the required inspections. At the time of default, the owner had paid the contractor approximately 80% of the contract price. The surety hired a new contractor to finish the project, and filed suit against the owner for the amount the surety paid to the completion contractor in excess of the original contract price. In asserting its overpayment claim, the surety argued that the owner's overpayments to its principal constituted a material alteration of the contract, thus discharging the surety from its bonded obligation. The Court held that the overpayments were a material alteration to the contract and discharged the surety from its obligations. Id. at 348.

3. Prejudice or Injury

Certain jurisdictions require, in addition to proving the existence of a material alteration to the underlying contract that the surety establish that such alterations resulted in prejudice or injury to the surety. See United States v. Reliance Ins. Co., 799 F.2d 1382 (9th Cir. 1986) (releasing surety from its bonded obligation where contract modifications resulted in prejudice to the surety); Ramada Dev. Co. v. United States Fid. & Guar. Co., 626 F.2d 517 (6th Cir. 1980) (reversing district court's pro tanto discharge of surety where surety was not injured or otherwise prejudiced by overpayments); Mergentime Corporation v. Washington Metropolitan Areas Transit Authority, 775 F. Supp 14 (D. D.C. 1991).

In Mergentime Corporation v. Washington Metropolitan Areas Transit Authority, 775 F. Supp 14 (D. D.C. 1991), for example, the court, while ultimately refusing to rule on the surety's motion for summary judgment, expressly held that the surety would be required at trial to demonstrate that any alleged material changes to the underlying contract resulted in prejudice to the surety's rights. In Mergentime, the Washington Metropolitan Area Transit Authority contracted with Mergentime Corporation and Perini Corporation for the construction of two metro stations in Washington, DC. The Insurance Company of North America provided the performance and payment bonds for both projects. Each contract contained a changes provision that allowed the contracting officer to make certain changes without notifying the surety. The contracts also authorized the owner to make progress payments either monthly, or at intervals approved by the contracting officer. The contract required the owner to retain 10% of the contract price until final completion. During project performance, the owner and the contractor made certain changes to the original contracts, including a term providing for payments to the contractor that exceed the original contract price by about \$6 million. Additionally, the owner also paid \$1 million to the contractor out of the contract retainage before the retainage became due.

In a motion for summary judgment based upon the holding of Southwood Builders, the surety asserted that the material changes to the original contracts, without notice or consent of the surety, released the surety from its obligations. The District Court for the District of Columbia refused to apply the reasoning employed by the court in Southwood Builders and instead relied upon the holding in Reliance Insurance Company v. Colbert, 365 F.2d 530 (D.C. Cir. 1966), wherein the District of Columbia Court of Appeals provided that the proper inquiry to determine whether the surety is discharged from its obligation is not limited to the mere existence of material alterations to the underlying contract but also involves a determination of whether the surety was prejudiced by the changes. Thus, the Court determined that the issue of prejudice must be demonstrated at trial. Notwithstanding, the Court indicated that if the surety could demonstrate at trial that the overpayments were made without a valid factual basis, then the surety may be discharged from its obligation. Id. at 22.

Similarly, in North American Specialty Ins. Co. v. Chichester Sch. Dist., No. 99-2394, 2000 U.S. Dist. LEXIS 10745 (E.D. Pa. July 20, 2000), the District Court required

a showing of prejudice by the surety to warrant discharge. In North American Specialty, the Chichester School District contracted with Craft-Century Construction Inc. for construction of an elementary school. North American Specialty Insurance Company provided the payment and performance bonds for the project. During project performance, the owner paid the contractor's 13th and 14th progress payments with two checks believed not to have cleared. Accordingly, the owner made an additional wire transfer to the contractor to pay the two progress payments. Unbeknownst to the owner, however, the previously issued checks cleared, resulting in an overpayment to the contractor. Because the owner refused to make the 15th progress payment the contractor refused to return the overpayment in its entirety and instead, deducted the 15th progress payment that the owner did not pay. The owner subsequently declared the contractor to be in default.

The surety filed a motion for summary judgment on multiple issues. Specifically regarding the surety's overpayment claim, the Court stated that "[w]here there has been a material departure from contractual provisions relating to payments and the security of retained funds, a compensated surety is discharged from its obligations on the performance bond to the extent that such unauthorized payments result in prejudice or injury." Id. at *37 (citations omitted). The Court held that the owner was negligent in making the overpayment because it should have canceled the checks before making the wire transfer, and the owner's actions amounted to a breach of the contract. Id. at *44. Notwithstanding, the Court further determined that an issue of material fact remained with regard to whether the surety suffered prejudice from the overpayment, and thus summary judgment was not appropriate. Id. at *46.

Significantly, in jurisdictions that require the surety to demonstrate prejudice, courts have generally held that payments for work not actually performed or blatantly defective work are considered prejudicial to the surety. See Transamerica Ins. Co. v. City of Kennewick, 785 F.2d 660, 661 (9th Cir. 1986) (holding that payments by the obligee for installation of materials never installed by the principal prejudiced the surety and resulted in discharge to the extent of the surety's injury); Blackfoot Tribe of the Blackfoot Indian Reservation v. Blaze Constr., Inc., 108 F. Supp.2d 1122 (D. Mont. 2000) (discharging the surety from its obligations because the obligee failed to act with due care in paying for work not performed, which prejudiced the surety by reducing its security and reducing the incentive for the principal to complete the work).

Therefore, before pursuing an overpayment claim or defense, the surety is advised to consider each jurisdiction's treatment of the claim, including whether it is sufficient for the surety to demonstrate a material deviation from the underlying contract or whether the surety must make an additional showing of prejudice.

C. Potential Defenses of the Obligee

The surety should be cognizant of potential defenses available to the obligee that may impact the surety's decision in how it wishes to pursue its claim. In analyzing an overpayment claim or defense, the courts, in few instances, have seemingly considered

whether the obligee acted reasonably in its decision to issue payments. Inherent in these cases is a presumption that the obligee is entitled to some discretion in making payments. In these instances, the courts have considered whether the decision to issue additional payments to the principal amounted to business judgment, or if the obligee relied upon the discretion of its construction manager or architect in issuing payments. An awareness of these cases may enable the surety to better shape its claim or defense.

Further, the surety must also consider the courts differing treatment of public versus private obligees.²

1. Business Judgment

When confronted with a claim for overpayment, an obligee may argue that it reasonably exercised its business judgment in paying the bonded principal. For example, an obligee may elect to pre-pay a struggling principal for work not yet performed if the obligee reasonably believes an influx of cash would facilitate completion of the work. See Transamerica Ins. Co. v. City of Kennewick, 785 F.2d 660 (9th Cir. 1986). Here, courts may be reluctant to discharge the surety from its bonded obligation especially if it can be proven that the overpaid amounts were used for work performed on the Project. Implicit, of course, in such analysis, is again the fact that the obligee is entitled to some discretion in making the payments. Notwithstanding, if an obligee asserts business judgment as a defense to overpayment, the surety should nonetheless assert that, regardless of the basis, any deviation from the payment terms of the contract improperly impacts the surety's fundamental rights.

2. Reliance Upon Discretion of Obligee's Agents

Further, the surety should be cognizant of certain case law that provides that to the extent the obligee reasonably relied upon the certifications for payment of an architect or construction manager, as the contract may provide, the court may not recognize the surety's overpayment claim. See RLI Ins. Co. v. Indian River Sch. Dist., et al., 556 F. Supp. 2d 356 (D. Del. 2008).³ Of course such case law and related reasoning is contrary to the legions of cases that prevent the owner/obligee from thwarting its responsibilities by merely contracting away such obligations to a third party. As such, we believe that these decisions are an aberration, but nonetheless a consideration for the surety.

² T. Scott Leo and Michelle L. Killebrew, Asserting the Overpayment Defense and Claim, DRI for the Defense, Fidelity and Surety, March 2009.

³ Importantly, however, the obligee's reasonable reliance upon a design professional does not necessarily prevent the surety from asserting an overpayment claim directly against a design professional who acted negligently in certifying the overpayment. See e.g., Bilt-Rite Contractors, Inc. v. The Architectural Studio, 866 A.2d 270 (Pa. 2005).

3. Status of the Obligee

Generally, courts tend to take a more restrictive view of overpayment claims asserted against a public obligee than a private obligee. In this regard, public or governmental obligees are typically given more discretion or latitude in their decision-making processes and consequently, it may be more difficult for the surety to assert an overpayment claim in this context. See American Ins. Co. v. U.S., 62 Fed. Cl. 151 (Fed. Cl. 2004) (refusing to discharge the surety on the basis of overpayment when a contract provision allowed the government some discretion in making payments, even when such payments exceeded the progress of the work); Reliance Ins. Co. v. United States, 27 Fed. Cl. 815, 826 (Fed. Cl. 1993). It appears that such decisions are based, at least in part, on applicable public regulations providing more discretion to the public entity, and public policy concerns that may impact a court's decision to discharge a surety. Thus, in determining whether to pursue an overpayment claim, the surety should factor in the obligee's status and the potential implications of this status on the surety's claim.

II. **Other Considerations**

A. Claim Evaluation and Proof

In effectively asserting its overpayment claim, the surety must consider the types of proof it will need to establish its claim. The surety's analysis should include an examination of the relevant payment records, inspection reports and schedule documents to determine the existence and extent of the obligee's overpayments.

A claim for overpayment can be evaluated in various manners. For example, a claim for overpayment may be based upon: (i) a review of the overall percentage completion of the Project pursuant to the pay applications versus the actual status of completion of the work; (ii) an analysis of a specific item of work and the level of completeness versus payment; (iii) a review of any contractual limitations to payment for certain categories of work and the related payments made; and (iv) an analysis of defective work. A thorough analysis of each of these categories, and the Project documentation readily available in support of such analysis, will determine the strength of the overpayment claim.

In establishing the fact of an overpayment, the surety may wish to enlist the assistance of an expert to compare the percentage of work actually complete versus that for which the obligee paid. Additionally, an expert may assist in itemizing elements of defective work that should have been discovered upon a proper inspection to determine the extent of any overpayment. An overpayment claim or defense is most likely to succeed if the surety can establish, likely through expert testimony, that the obligee issued payment for work the principal never performed or, for patently defective work actually performed by the principal. See Brighton Sch. Dist. 27J v. Transamerica Premier Ins. Co., 923 P.2d 328 (Colo. Ct. App. 1996) (recognizing that overpayment defense would be available if the owner had made payments to the principal for work

not performed or obviously defective work). Additionally, the surety should be forewarned that the more difficult the task of parsing out the alleged overpayments, the more attenuated the overpayment claim, and the less likely the surety will succeed.

B. Timing of Asserting Overpayment Claim

An effective strategy for asserting a claim for overpayment must consider the timing and manner by which the claim should be made. Upon notice of a termination, a surety's investigation will undoubtedly include an analysis of the status of the work, and identification of the scope of work remaining to be performed. At this stage, the surety is best situated to analyze the extent of any overpayment claim. To the extent the surety has determined to complete performance of the work, the surety should insure the maximum funds available, in the form of contract balances, to complete the work. Thus, the surety will be wise to raise the overpayment issue as part of its discussions with the owner/obligee for the takeover of the work. The surety may be successful, depending upon the strength of the overpayment claim, in at least obtaining partial concessions from the obligee, including the immediate infusion of funds. The surety's failure to raise the overpayment claim prior to completion of the work will result in a greater expenditure of funds by the surety at the outset for the completion work, which the surety will then have to pursue, along with any other claims, at the end of the project work.

Further, the surety should include its overpayment claim as a part of the terms of any takeover agreement. If the surety is successful in obtaining concessions from the obligee, those terms may be made part of the takeover agreement. At a minimum, the surety should preserve its overpayment claim and the right to pursue such claim in the takeover agreement.

Alternatively, in the event the surety does not intend to complete the work, the surety may assert the overpayment claim as a defense to a demand by the obligee for completion costs.

C. Principal Considerations

Finally, the surety must also be mindful that in asserting an overpayment claim, such claim may be viewed as somewhat adverse to the previous actions of the principal, including any agreement between the obligee and principal allowing for premature payments. Essentially, the surety is asserting that the principal should not have been paid for various reasons, including for example, that the work had not progressed to the level of compensation, that the contract precludes the payment, or that the work performed was obviously defective. The surety's claim attempts to foist the responsibility for the failure to mitigate losses or protect the collateral back to the owner/obligee, the party in the best position to preserve the collateral. Thus the surety must insure that when asserting such claim, it is consistent with the overall strategy in responding to the bond claim.

CONCLUSION

An overpayment claim or defense is an important tool for the surety's use in preserving and defending its fundamental surety rights to the contract funds. Upon establishing an obligee's overpayment, the surety may assert that the obligee materially altered the risk to the surety and otherwise impaired the surety's collateral. Under these circumstances, the surety will be positioned to claim a complete or partial discharge of its bonded obligations. With careful planning and analysis, the surety can select the best litigation strategy to prepare an effective and powerful overpayment claim or defense.