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**“ANOTHER BARGAINING CHIP AND DEFENSE FOR
THE SURETY: THE PUBLIC OWNER'S FAILURE TO
DISCLOSE TO THE SURETY THAT THE
CONTRACTOR HAS COMMITTED A BID MISTAKE”**

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I. Introduction

The courts are more often than not embracing the requirement of full disclosure in many commercial and consumer settings. For example, many state courts now require residential home sellers to disclose to potential purchasers any information the seller may have that materially affects the value or marketability of the real property being sold. **See Johnson v. Davis, 480 So.2d 625 (Fla. 1985).**

This same principle of "full disclosure" should also hold true for obligees obtaining contract surety bonds.

The original **Restatement of Security § 124** applied such a rule of full disclosure to sureties under certain circumstances:

(1) Where **before** the surety has undertaken its obligation, the creditor [obligee] knows facts unknown to the surety that materially increase the risk beyond that which the creditor has reason to believe the surety intends to assume, and the creditor also has reason to believe that these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety, **failure to notify the surety of such facts is a defense to the surety.** (Emphasis added).

An example of a factual situation contemplated by **Restatement of Security § 124** involves a public owner accepting the surety's performance and payment bonds where the public owner has knowledge that the surety's proposed principal/contractor has made a bid mistake. If a public owner knows or has reason to believe that the lowest responsible bidder has made a bid mistake, then the owner should be required to inform the proposed surety of this highly relevant information before the surety issues its bonds. The owner should not be permitted to later say "Gotcha" to the Surety and profit from an overly advantageous contract price for the proposed construction project.

This article will address the nondisclosure issue in this context: Whether a public owner, prior to the surety issuing its performance and payment bonds for a construction project, has any obligation to the surety to disclose or inform the surety that the lowest responsible bidder/contractor has committed a bid mistake.

To better illustrate this issue, the following fact pattern, taken from an actual contract surety dispute, will be utilized.

II. Case Summary

In April of 1993, a troubled marine contractor, Have-No-Barge Marine Contracting, Inc. ("No Barge"), defaulted on its public works construction contract with Metropolitan Dolfan County, Florida ("Dolfan County"). Dolfan County notified No Barge's surety, Substandard Surety & Fidelity ("Substandard Surety"), of No Barge's default and termination and demanded that Substandard Surety complete the contract. Upon investigating this performance claim, Substandard Surety declined Dolfan County's claim. A lawsuit resulted.

The following facts are the basis of this dispute.

Dolphin County is located in South Florida on a large body of water called Big Blue Bay. Big Blue Bay is bounded on the West by a large mainland city and on the East by barrier islands. During the real estate boom years of Dolphin County, real estate developers developed and built on the barrier islands. To build up the barrier islands above sea level elevations, real estate developers dredged many parts of Big Blue Bay, producing fill to be placed on the barrier islands. These dredging operations left large depressions in Big Blue Bay. Over time, these manmade depressions altered Big Blue Bay's marine-life habitat.

In the early 1990's, Dolphin County received grant monies from the State and Federal governments for an experimental construction project, The Dolphin County Dredged Area Restoration Project, also known as "Project Seaweed" for short. The purpose of Project Seaweed was to restore one of several manmade depressions in Big Blue Bay to its original natural condition by utilizing "spoil" material dredged from Cruise Ship Channel. The "spoil" material, consisting of large pieces of rock excavated from a dredging operation to deepen Cruise Ship Channel, was to be transported to the selected manmade depression in Big Blue Bay. After the "spoil" material was placed in the manmade depression, sand was to be layered over the "spoil" material to prevent contamination of the Bay. Seaweed was then planted to hold the sand in place and restore the bay bottom.

In early 1992, after Dolphin County had obtained its funding commitments and the project's contract documents were finalized, Dolphin County advertised Project Seaweed for public bidding. A number of marine contracting firms responded, including a small marine contractor, No Barge. On July 8, 1992, No Barge submitted its bid in the amount of \$340,714.00 in response to Dolphin County's solicitation.

In August of 1992, Hurricane Andy devastated the Dolphin County area. This delayed the start of Project Seaweed. Also, as a result of Hurricane Andy, No Barge had difficulties hiring a marine barge and tugboat subcontractor. All of the marine barge and tug boat operators were busy performing lucrative post-hurricane salvage work, raising and transporting sunken boats and yachts.

Notwithstanding the effects of Hurricane Andy, Dolphin County awarded No Barge the contract for this project in October of 1992. On October 12, 1992, Substandard Surety issued its Florida Statute § 255.05 public works bond on behalf of No Barge on Project Seaweed. The named obligee under the bond was Dolphin County. The penal sum of the bond was \$340,714.00, the amount of No Barge's bid.

The Project Seaweed general contract required No Barge to transport and place dredged "spoil" material from Cruise Ship Channel into one of the manmade depressions located several miles north on Big Blue Bay. No Barge contracted to cover the "spoil" material with expensive Aragonite sand. After placing the Aragonite sand, No Barge was required to plant seaweed in the special sand. The contract contemplated that No Barge's work would be performed in 90 days.

In late March of 1993, another severe storm, called the "No-Name Storm", hit Big Blue Bay while No Barge was attempting to perform its contract with Dolphin County.

Ultimately, No Barge was unable to complete its work in a timely or workmanlike fashion. In April of 1993, Dolphin County defaulted and terminated No Barge. Dolphin County sent a copy of the default/termination notice to Substandard Surety and demanded that Substandard Surety complete the project.

Upon receipt of the default termination notice, Substandard Surety secured the assistance of several construction consultants who then investigated No Barge's default.

Substandard Surety's investigation revealed, among other things, that the engineering firm for Project Seaweed had prepared a pre-bid Engineer's Estimate for the project. The Engineer's Pre-Bid Estimate was for \$450,000.00. Substandard Surety then did an analysis of the bid spread between No Barge's bid and the other higher bidders. Its analysis not only showed that No Barge's bid was substantially lower than the project engineer's own estimate but also much lower than all of the other bids submitted. Substandard Surety concluded that Dolfan County had to have known that a bid mistake had occurred.

Substandard Surety also interviewed its principal's President, Noah Boatman, and learned that before accepting No Barge's Bid, Dolfan County's construction management department, on several occasions, had called Noah Boatman, questioning Mr. Boatman about his bid and asking if he had made a bid mistake. Substandard Surety was never made aware of Dolfan County's concerns and inquiries about No Barge's bid.

Upon completing Substandard Surety's post-default investigation, Substandard Surety notified Dolfan County that Substandard Surety was rescinding and canceling its \$255.05 public works bond. Substandard Surety asserted that Dolfan County failed to notify Substandard Surety of the significant bidding process discrepancies before Substandard Surety issued its bond on behalf of No Barge. In the event of litigation, Substandard Surety had also obtained several cost-to-complete estimates from several of the other bidders on the project.

In August of 1993, Dolfan County relet this job through the public bidding process. The project was later completed.

Ultimately, Dolfan County filed suit against Substandard Surety for breach of the performance portion of the \$ 255.05 bond. Dolfan County asserted that No Barge's default had caused Dolfan County to suffer significant damages in excess of Substandard Surety's bond penal sum. Dolfan County also sought prejudgment interest at 12 % per annum, attorneys' fees and taxable costs.

Substandard Surety counterclaimed against Dolfan County for rescission and cancellation of the bond and for restitution arising from Substandard Surety's payment of payment bond claims presented by "innocent" third parties to this construction project.

After requiring Substandard Surety to amend its counterclaim against Dolfan County, the trial court denied Dolfan County's Motion for Judgment on the Pleadings.

Upon the trial court denying Dolfan County's motion, the parties submitted the matter to an early mediation. Later in this article the results of the meditation will be discussed.

III. Issues Raised By No Barge's Involuntary Termination:

- A. Whether, under the facts of this case, Dolfan County had an affirmative duty to inform Substandard Surety that Substandard Surety's proposed principal, No Barge, had made a bid mistake.**

B. Whether Substandard Surety was entitled to seek rescission and cancellation of its bond, and restitution for those monies Substandard Surety paid out to defend and resolve claims under the payment side of the public works bond.

IV. Discussion of Issues:

A. Under the facts of this case, Dolfan County had an affirmative duty to inform Substandard Surety that Substandard Surety's proposed principal, No Barge, had made a bid mistake.

Case law interpreting suretyship principles support the proposition that certain nondisclosures by an obligee, whether intentional or negligent, are deemed to constitute material misrepresentations to the surety thereby discharging or making voidable the surety's obligation. St. Paul Fire & Marine Company v. Commodity Credit Corporation, 646 F.2d 1064 (5th Cir. 1981); Rachman Bag Company v. Liberty Mutual Ins. Co., 905 F.Supp. 95 (E.D.N.Y. 1995); Camp v. First Federal S & L, 299 Ark. 455, 772 S.W. 2d 602 (1989); Sumitomo Bank of California v. Iwasaki, 70 Cal.2d 81, 447 P.2d 956, 73 Cal.Rptr. 564 (1968); Lambert v. Heaton, 134 So.2d 536 (Fla. 1st DCA 1961); General Crushed Stone Company v. State of New York, 46 Misc.2d 266, 259 N.Y.S.2d 757 (Sup. Ct., Albany County 1963); First National Bank and Trust Co. of Racine v. Notte, 97 Wis.2d 207, 293 N.W.2d 530 (1980); See also Williston on Contracts, Third Edition § 1249.

In the case, St. Paul Fire & Marine Company v. Commodity Credit Corporation, 646 F.2d 1064 (5th Cir. 1981), two compensated sureties, St. Paul Fire & Marine Insurance Company (St. Paul) and Boston Insurance Company (Boston), sued Commodity Credit Corporation "CCC" seeking a declaration of no liability on three bonds assuring United Farmers Marketing Association ("UFMA") of its obligations under a 1963 Cotton Cooperative Loan Agreement executed between UFMA and CCC. St. Paul and Boston were the sureties on the three bonds; UFMA, a Texas agricultural cooperative, was the principal; and CCC was the obligee. CCC counterclaimed for \$265,000.00, the aggregate face amount of the three bonds, charging that UFMA's failure to redeem 3,421 bales of cotton, released to UFMA under trust receipts, was a breach of the 1963 Cotton Cooperative Loan Agreement. The trial court ruled that CCC should take nothing on its counterclaim and granted the sureties their requested declaratory relief, that the sureties be discharged of their surety bond obligations. After reviewing the complicated facts leading up to this case, the United States Court of Appeals, Fifth Circuit, held that the sureties were not liable under the bonds and affirmed the trial court's judgment in favor of the sureties. In so ruling, the Fifth Circuit recognized:

...[that] the suretyship bond is fragile, easily broken by the conduct of the creditor. The validity of the contract may be vitiated **ab initio** by the creditor's actions during its creation. A creditor who, during negotiations, actively and fraudulently conceals pertinent facts cannot then turn to the surety for reimbursement. **[Citations not quoted]** Similarly, the surety has a defense to liability if, before the obligation is undertaken, the creditor knew of facts unknown to the surety and which he had reason to believe were not known to the surety, the facts materially increased the obligor's risk and the creditor had adequate time to disclose them but failed in his responsibility. **Restatement of Security § 124 (1941).**

In the Florida appellate case, **Lambert v. Heaton, 134 So.2d 536 (Fla. 1st DCA 1961)**, a creditor obtained a summary final judgment in an action at law against a surety, United Bonding Insurance Company, and its principal, a promissory note debtor. The surety had issued a performance bond guaranteeing payment of a promissory note executed by the promissory note debtor in favor of the plaintiff creditor. Upon being granted final summary judgment, the plaintiff creditor attempted to execute the judgment against both the surety and the promissory note debtor. In response, the surety filed a motion to stay execution of plaintiff's judgment, asserting that the plaintiff creditor had exacted usurious interest under the promissory note in an amount constituting a crime under Florida Statutes and that the surety did not have any knowledge or notice of the usurious nature of the loan transaction it had bonded. The trial court agreed with the surety, staying execution of the plaintiff creditor's judgment. The plaintiff creditor appealed to the District Court of Appeal of Florida, First District, which affirmed the lower court's decision. In ruling in favor of the surety, the Florida Appellate Court stated:

[I]t is the rule that if with the knowledge or assent of the creditor any material part of the transaction between the creditor and his debtor is misrepresented to the surety, the misrepresentation being such that but for the same having taken place either the suretyship would have not been entered into at all, or, being entered into, the extent of the surety's liability might thereby be increased, the surety so given is void at law, on the ground of fraud. **Stone v. Compton(1838), 5 Bing. (NC) 141, 132 Eng.Rep. 1059.** And if facts material to the surety are concealed by the obligee when it is his duty to disclose them, his motive in concealing is immaterial.

In the California Supreme Court case, **Sumitomo Bank of California v. Iwasaki, 70 Cal.2d 81, 447 P.2d 956, 73 Cal.Rptr. 564 (1968)**, the plaintiff bank brought an action on a "Continuing Guaranty" agreement which provided that a private surety had guaranteed all present and future indebtedness of two borrowers to the extent of \$5000.00 plus interest. Plaintiff bank sought recovery of those amounts owed by the two borrowers on three different loans, one of which plaintiff bank made several months after the private surety executed the "Continuing Guaranty". The trial court entered judgment in favor of plaintiff bank on the first two loans but discharged the private surety as to the third loan. The trial court held the private surety was discharged from liability on the third loan because the plaintiff bank failed to disclose to the private surety that the two borrowers required the third loan to pay their federal taxes. The Plaintiff bank appealed. The California Supreme Court specifically adopted **Restatement of Security § 124** holding that a creditor owes a duty to the surety to disclose facts known by the creditor if the creditor has reason to believe that those facts materially increase the risk beyond that which the surety intended to assume and that those facts are unknown to the surety. **But see, Institutional & Supermarket Equip. v. C & S, 609 So.2d 69 (Fla. 4th DCA 1992)**, where the Florida Fourth District Court of Appeals, addressing facts dissimilar to **Iwasaki**, refused to apply **Restatement of Security § 124** and **Iwasaki** to a continuing guaranty containing a waiver of any notice of dishonor or of any matter coming to light **after** the guaranty was issued.

Restatement Third, Suretyship and Guaranty § 12, is derived primarily from the old **Restatement of Security § 124 (1)**, and further underscores the rule that a surety's obligation is voidable due to an obligee's misrepresentation:

(3) Subject to subsections (4) and (5), if, before the secondary [surety] obligation becomes binding, the obligee:

- (a) knows facts unknown to the secondary obligor [surety] that materially increase the risk beyond that which the obligee has reason to believe the secondary obligor [surety] intends to assume; and
- (b) has reason to believe that these facts are unknown to the secondary obligor [surety]; and
- (c) has a reasonable opportunity to communicate them to the secondary obligor [surety];

the obligee's nondisclosure of these facts to a secondary obligor [surety] constitutes a material misrepresentation.

(4) For purposes of subsection (3), whether the obligee has reason to believe that (i) facts unknown to the secondary obligor [surety] materially increase the risk beyond that which the secondary obligor [surety] intends to assume and (ii) such facts are unknown to the secondary obligor [surety], shall be determined in light of the obligee's reasonable beliefs as to:

- (a) the nature of the secondary obligor's [surety's] relationship to the principal obligor [principal];
- (b) the nature of the secondary obligor's [surety's] business; and
- (c) the secondary obligor's [surety's] ability to obtain knowledge of such facts independently in the exercise of ordinary care.

(5) Notwithstanding subsection (3), if the secondary obligor [surety] controls the principal obligor [principal], is controlled by the principal obligor [principal], or is under common control with the principal obligor [principal], nondisclosure to the secondary obligor [surety] by the obligee of facts

- (a) about the principal obligor;
 - (b) known or disclosed to the principal obligor;
- or
- (c) about the underlying obligation that the obligee is under no duty to disclose to the principal obligor

does not constitute a material misrepresentation.

At f. Nondisclosures, Comment on Subsection (3), Restatement Third, Suretyship and Guaranty § 12, the Restatement reporter includes the following illustration:

Illustration:

5. Developer A will enter into a construction contract with contractor C only if C procures payment and performance bonds satisfactory to A. B, who has issued bonds for C in the past, agrees to issue the bonds to A. Unknown to B, C has just suffered a series of business reverses leaving C equitably insolvent. A does not disclose this to B. A is aware of this state of facts, knows that it is unknown to B, and that it increases the risk beyond that which B intends to assume; nonetheless, A fails to disclose it to B despite opportunity to do so. A's nondisclosure is a material misrepresentation.

Under the facts in the No Barge performance bond scenario, there was sufficient evidence to support Substandard Surety's conclusion that Dolfan County, as the owner/obligee, had known that No Barge had made a serious bid mistake.

No Barge's bid proposal of \$340,714.00 included the furnishing of Aragonite sand. However, Substandard Surety's investigation revealed that the project engineer's "original cost estimate" was for \$450,000.00. This \$450,000.00 "original cost estimate" included the furnishing and placement of Aragonite sand at the project site. The project engineers later prepared a revised "original cost estimate" for \$360,000.00. This revised "original cost estimate" for \$360,000.00 excluded the furnishing and placement of Aragonite sand at the project site.

Additionally, Substandard Surety's investigation revealed that all of the other bidders had submitted bids, inclusive of Aragonite sand, which were significantly higher than No Barge's bid. For example, the next lowest bid price, which included Aragonite sand, was 49% higher than No Barge's bid.

Therefore, given the bid spread between No Barge's bid and the other bidders' bids, and given the disparities between No Barge's bid price and Dolfan County's "original cost estimate" of \$450,000.00 which included Aragonite sand and Dolfan County's revised "original cost estimate" of \$360,000.00 which excluded Aragonite sand, there was more than sufficient evidence to support the conclusion that Dolfan County knew that No Barge had made a bid mistake.

Dolfan County also had the opportunity to disclose to Substandard Surety that No Barge had committed a bid mistake before Substandard Surety issued its public works bond for this project. One of Dolfan County's project engineers was present when the bids were opened. He was directly involved in revising the "original cost estimate" from \$450,000.00 with Aragonite sand to \$360,000.00 without Aragonite sand. No Barge's bid proposal of \$340,714.00 stated unequivocally that it included the furnishing of Aragonite sand. However, No Barge's bid proposal was almost \$20,000.00 less than Dolfan County's revised "original cost estimate" which excluded Aragonite sand. A fact finder might certainly conclude that the county engineer's silence at the bid opening conference was an act of concealment.

Also, Substandard Surety's post default interview with its principal's president, Noah Boatman, revealed that before accepting No Barge's Bid, Dolfan County's construction management department, on several occasions, had called Noah Boatman, questioning Mr. Boatman about his bid and asking if he had made a bid mistake.

Notwithstanding all of the above evidence in the No Barge performance bond scenario, Dolfan County never disclosed to Substandard Surety that No Barge had committed a bid mistake before Substandard Surety issued its public works bond for the project. The No Barge performance bond scenario exemplifies the "nondisclosure rule" as a surety defense.

B. Substandard Surety was entitled to rescission and cancellation of its bond, and restitution for those monies Substandard Surety paid out to defend and resolve claims under the payment side of its public works bond.

Substandard Surety may assert Dolfan County's failure to disclose No Barge's bid mistake as: (1) an affirmative defense seeking discharge under its surety obligations or (2) as an equitable claim for affirmative relief against Dolfan County seeking rescission and cancellation of its public works bond, and seeking restitution for those monies Substandard Surety paid out to defend and resolve claims under the payment side of its public works bond.

Dolfan County's nondisclosure of No Barge's bid mistake not only subjected Substandard Surety to Dolfan County's performance claim, but also exposed Substandard Surety to payment claims of No Barge's subcontractors and materialmen. No Barge's subcontractors and materialmen

would be considered innocent third parties to whom Substandard Surety would still be obligated notwithstanding Dolfan County's nondisclosure.

The fundamental requirements necessary to state a cause of action for rescission or cancellation of a contract are:

- (1) The character or relationship of the parties;
- (2) The making of the contract;
- (3) The existence of **fraud**, mutual mistake, **false representations**, impossibility of performance, or other ground for rescission or cancellation;
- (4) That the party seeking rescission has rescinded the contract and notified the other party to the contract of such rescission.
- (5) If the moving party has received benefits from the contract, he should further allege an offer to restore these benefits to the party furnishing them, if restoration is possible.
- (6) Lastly, the moving party has no adequate remedy at law. **Crown Ice Machine Leas. Co. v. Sam Senter Farms, Inc., 174 So.2d 614 (Fla. 2d DCA 1965).**

By asserting equitable claims against Dolfan County for rescission, cancellation, and restitution, Substandard Surety might have another avenue for being made whole for those monies it expended defending and resolving claims under the payment side of its public works bond issued on behalf of No Barge. Also, Substandard Surety's rescission, cancellation, and restitution claims may work as an additional "bargaining chip" to induce Dolfan County to substantially discount its performance claim against Substandard Surety.

V. Mediation Result:

At the mediation of the No Barge performance bond scenario, Dolfan County and Substandard Surety settled their respective claims. Although Dolfan County's performance claim was in excess of Substandard Surety's bond penal sum, Dolfan County accepted the sum of \$135,000.00 in settlement of its performance claim and waived its other claims for attorneys' fees, prejudgment interest and taxable costs. Rather than submitting this dispute to a judge and a Dolfan County jury for an uncertain resolution, Substandard Surety chose to utilize the results of its post default investigation as a significant "bargaining chip" in its negotiations with the obligee, Dolfan County. The parties' settlement of their respective claims assured a certain result.

VI. Conclusion:

Therefore, in performing its post default investigation, a surety should be cognizant of the rule that a surety's obligation is voidable due to an obligee's nondisclosure or misrepresentation at the time the surety issues its bonds. The discovery of such a nondisclosure or misrepresentation may create an additional "bargaining chip" to be used in the surety's negotiations with the owner/obligee. An undisclosed bid mistake may be one of those factual circumstances giving rise to the surety's assertion of the nondisclosure rule.

Curriculum Vitae Bradford A. Thomas

Bradford Thomas is a shareholder in the Miami, Florida law firm of Kimbrell & Hamann, P.A. He received his undergraduate degree from Ohio Northern University in 1975 and graduated from The University of Miami School of Law, Coral Gables, Florida in 1978. He is admitted to the Florida Bar, the Federal Trial Bar of the United States District Court Southern District of Florida; the United States District Court, Middle District of Florida; Fifth Circuit Court of Appeals; Eleventh Circuit Court of Appeals; and the United States Supreme Court. Mr. Thomas is a member of the ABA's TIPS-Fidelity & Surety Law Committee, ABA's Forum on the Construction Industry, Surety Claims Institute, Southern Surety and Fidelity Claims Association, The American Surety Association and the Defense Research Institute. A majority of his practice is concentrated in the areas of construction, fidelity and surety litigation.