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THE SURETY UPDATE

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I. MILLER ACT CASES

A. NOTICE

The Miller Act contains strict notice requirements for materialmen and sub-subcontractors that have no contractual relationship with the general contractor furnishing the Miller Act bond. 40 U.S.C.A. § 270b(a). The pertinent language of § 270b(a) is as follows:

> any person having direct contractual relationship with a subcontractor but no contractual relationship express or implied with the contractor furnishing said payment bond shall have a right of action upon the said payment bond upon giving written notice to said contractor within 90 days from the date on which such person did or performed the last of the labor or furnished or supplied the last of material for which such claim is made, stating with substantial accuracy the amount claimed and the name of the party to whom the material was furnished or supplied or for whom the labor was done or performed. Such notice shall be served by mailing the same by registered mail, postage prepaid, in an envelope addressed to the contractor at any place he maintains an office or conducts his business, or his residence, or in any manner in which the United States Marshall of the district in which the public improvement is situated is authorized by law to serve summons.

Despite the Miller Act's seemingly rigid notice requirements, federal courts have historically been liberal in construing § 270b(a) and, in some cases, have ignored its requirements altogether in order to carry out the remedial purposes of the Act. *See e.g., Fleisher Engineering & Const. Co. v. U.S. f/u/b/o Hallenbeck*, 311 U.S. 15, 18, 61 S.Ct. 81, 83, 85 L.Ed. 12 (1940) (written notice sufficient despite not being sent via registered mail as the statute provides); *Coffee v. U.S. f/u/b/o Gordon*, 157 F.2d 968, 969 (5th Cir. 1946) (a writing shown to a general contractor in the course of discussions served as adequate notice under the Miller Act). In some instances, courts have even deviated from the requirement that notice be given in writing. *See e.g., U.S. f/u/b/o Consol. Elec. Distributors, Inc. v. Altech, Inc.*, 929 F.2d 1089, 1092 (5th Cir. 1991) (the "only reasonable inference" from a meeting was that the subcontractor sought payment from the general contractor).

1. Content of Notice

In 1996, the Eleventh Circuit took a step towards stricter construction of the Miller Act notice requirements in *Maccaferri Gabions, Inc. v. Dynateria, Inc.*, 91 F.3d 1431 (11th Cir. 1996) *cert. den. Maccaferri Gabions, Inc. v. Wilkinson & Jenkins Const. Co., Inc.*, ____U.S.____, 117 S.Ct. 1430, 137 L.Ed.2d 539 (1997). In *Maccaferri*, a materialman sought recovery under the Miller Act despite its failure to comply with the strict notice requirements of § 270b(a). The materialman pointed to three occurrences during the statutory period that it claimed put the general contractor on notice of its claim -- (1) the materialman copied the general contractor on a demand letter it had made to the delinquent subcontractor; (2) the materialman claimed that the joint check arrangement it had with the general contractor and the subcontractor also constituted sufficient statutory notice; and (3) the materialman suggested that the general contractor's

preparation of its monthly payment estimates where it took into account the materialman's invoices somehow constituted sufficient Miller Act notice.

The Eleventh Circuit denied the materialman recovery under the bond, finding that it had failed to supply sufficient notice. The court, distinguishing a body of case law that had developed over the past 50 years liberally construing § 270b(a), wrote:

> Although courts have been somewhat lenient about enforcing the Act's requirements concerning the method by which such notice is given . . . they have interpreted more rigidly the Act's requirements for the content of that notice . . . .

Id. at 1437 (citations omitted). The court found it crucial that the notice state a claim directly against the general contractor, that the claim state with some specificity the amount due and that the claim specify the subcontractor allegedly in arrears. None of the instances to which the materialman pointed provided sufficient notice to the general contractor that the materialman was asserting a claim *directly against it*.

In another recent decision, *U.S. f/u/b/o Waterworks Supply Corp. v. George Hyman Const. Co.*, 131 F.3d 28 (1st Cir. 1997), however, the First Circuit Court refused to follow the *Maccaferri* decision. In *Waterworks*, like *Maccaferri*, a materialman brought a claim against a Miller Act bond, where it had failed to comply with the strict notice requirements of § 270b(a). The materialman also pointed to several occurrences during the statutory period which it claimed provided the general contract sufficient notice of its claim -- 1) the materialman's credit manager had made several phone calls to the general contractor during the notice period; 2) the materialman emphasized that it had copied the general contractor on the demand letter it had sent to the delinquent subcontractor; and 3) the general contractor sent a letter to the materialman indicating that it would not pay any claims until it had a clear picture of its options.

The First Circuit Court reached the opposite result from the *Maccaferri* court, finding that the materialman had satisfied the Miller Act's notice requirements. The Court found that the materialman's demand upon its subcontractor, unlike the demand letter in *Maccaferri,* exhibited that other copies had been sent to the general contractor's three sureties, and therefore the general contractor "could have had no illusion that it was not being asked to pay." *Id.* at 33.

Moreover, the court looked past the *content* versus *method* distinction the *Maccaferri* court had emphasized. Rather than focusing on the content of the communications from the materialman to the general contractor, the court focused on the general contractor's letter to the materialman, which appeared to respond to what it must have believed was a request for payment by the materialman. The *Waterworks* and *Maccaferri* decisions leave a great deal of uncertainty concerning future judicial interpretation of the Miller Act notice requirements.

2. Timing of Notice.

In *American Builders & Contractors Supply Co., Inc. v. Bradley Const. Co.*, 960 F.Supp. 145 (N.D. Ill. 1997), the court recently examined the "trigger date" for the notice period within which a sub-subcontractor or materialman must give notice to a general contractor of a claim against the bond. In *A, B & C*, a materialman shipped a subcontractor materials on four separate occasions and sent the subcontractor invoices corresponding with each of the shipments. The subcontractor paid for the last shipment but left the former three invoices unpaid. The materialman sent a bond notice within 90 days of furnishing its last materials but approximately 130 days from the date of the last *unpaid* shipment to the subcontractor.

After the materialman filed suit against the bond, the surety moved to dismiss, arguing that it had not received notice within the 90 day notice period. In opposition, the materialman argued that the notice began to run from the last date it furnished materials to the subcontractor, regardless of whether the subcontractor paid for those materials.

The court granted the surety's motion to dismiss. The court found that although the Miller Act should receive liberal construction to effectuate its "protective purposes", this liberality does not extend to the notice provision of the Act. The court, examining the plain language of § 270b, found that the trigger date for (1) notice of nonpayment and (2) the filing of the lawsuit are different under the statute. Under § 270b(b), a lawsuit must be commenced "after the expiration of one year after the date *on which the last of the . . . material was supplied* . . . ." 40 U.S.C. § 270b(b) (emphasis added). Whereas, § 270b(a) requires that notice be furnished "within 90 days from the date on which such person . . . furnished or supplied the last of the materials *for which said claim is made*." 40 U.S.C. § 270b(a) (emphasis added). The court found that the separate treatment of these dates within the statute was significant to show that Congress intended for this difference to have meaning. The materialman's failure to serve notice within 90 days of the last unpaid shipment barred its bond claim.

B. ATTORNEY FEES

The Miller Act does not provide for the recovery of attorney fees. Further, in *F.D. Rich Co. v. Industrial Lumber Co.*, 417 U.S. 116, 126, 94 S.Ct. 2157, 2163, 40 L.Ed. 70 (1974), the Supreme Court held that attorney fees are not permitted in Miller Act cases unless a statute or enforceable contract term provides for such fees. *See also U.S. f/u/b/o Ben. of Howell Crane Service v. U.S. Fidelity & Guar. Co.*, 861 F.2d 110, 112 (5th Cir. 1988) ("[A]ttorney's fees are not generally available in a Miller Act suit even when state law provides for such an award"). Interestingly, in some recent decisions, federal courts have broadened the *F.D. Rich* holding to allow for an award of attorney fees against a surety based upon an attorney fee provisions contained in the contract between a sub-subcontractor or materialman and the subcontractor *to which the surety was not a named party*. *See e.g. U.S. f/u/b/o Maddux Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 86 F.3d 332 (4th Cir. 1996) (the court allowed the attorney fees and interest against the surety on the ground that these were "sums justly due" under § 270b(a)); *U.S. f/u/b/o Big 4 Rents, Inc. v. Ogamba*, 1997 U.S.Dist. Lexis 10455 (N.D.Ca. 1997) (default judgment included the award of attorney fees where fees were provided for in the subcontract).

Also of interest, in *Towerridge, Inc. v. T. A. O., Inc.*, 111 F.3d 758 (10th Cir. 1997), the Tenth Circuit explored the parameters of the "bad faith" exception to the American Rule regarding attorney fees, which permits an award of attorney fees in cases where a party has acted in bad

faith. While the court recognized its "inherent power to sanction conduct that abuses the judicial process," it refused to award attorney fees based solely upon *prelitigation* conduct, and thus refused to create an additional basis for attorney fees in Miller Act cases.

C. EFFECT OF IDIQ CONTRACT ON SURETY'S MILLER ACT LIABILITY

In *U.S. f/u/b/o B & M Roofing of Colorado, Inc. v. AKM Associates, Inc.*, 961 F.Supp. 1441 (D.Co. 1997), a surety filed a motion for summary judgment asking the district court to determine the limit of its liability. The contract involved was an indefinite delivery and indefinite quantity ("IDIQ") contract[1] for roofing repairs at the U.S. Air Force Academy. At the outset of the contract, the surety provided a payment bond with the penal sum of $100,000. During the first year of the contract, several delivery orders were placed and the value of the work under the contract exceeded $1,000,000. Materialmen filed Miller Act claims exceeding $100,000, and the surety argued that its liability was limited to the $100,000 penal sum of its bond. The materialman argued that the surety was liable for all of the unpaid materials and labor supplied.

The court denied the surety's motion, finding that its liability was commensurate with the total amount of the labor and materials supplied. The court looked to the language of the contract in determining the extent of the surety's liability. Despite the fact that the contract did not specifically address the surety's liability,[2] the court found that an IDIQ contract automatically increases the bonding liability when additional materials or labor is supplied.[3]

D. MILLER ACT JURISDICTION

In *U.S. v. Suffolk Const. Co., Inc.*, 1996 W.L. 391875 (S.D.N.Y. 1996), a private association of graduates from the United States Military Academy entered into a contract for the construction of a private alumni building on leased public land on the West Point campus. After not receiving payment, one of the sub-subcontractors brought a Miller Act claim. The district court found that because the construction of the alumni building was not contracted for by the United States, the project did not fall within Miller Act jurisdiction, even though the project itself may have been carried out for public purposes, was funded by public revenues and was located on public property.

E. WAIVER OF SUBCONTRACTOR'S MILLER ACT CLAIMS.

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[1] An IDIQ contract has an escalating contract price -- as delivery orders are placed, the value of the contract rises.

[2] The court construed the term "bidder" to refer to both the principal and the surety.

[3] The surety advanced additional arguments that are worth noting. The IDIQ contract was for a one-year period, subject to options for additional years. The academy sought to exercise its option after the first year, and sent the surety a consent to surety form, which the surety never returned. The surety, nonetheless, asked for status reports and billed and received additional premiums during the second year based on the increased contract amount. The court found that an issue of disputed material fact remained concerning whether the surety intended to provide additional coverage. The court, however, allowed that even if the surety's liability was limited to the first year of the contract, the materialman could recover against the surety under a quantum meruit theory.

In *U.S. f/u/b/o Trans Coastal Roofing Co., Inc. v. David Borland, Inc.*, 922 F. Supp. 597 (S.D. Fla. 1996), a general contractor moved to dismiss a subcontractor's Miller Act claim, arguing that under the language of the subcontract agreement, the subcontractor's Miller Act claim had been waived. The court found that a subcontractor's Miller Act rights may be waived, "where the subcontract contains a provision making the disputes clause of the primary contract expressly applicable to the subcontract, and where the subcontract contains an express waiver of the subcontractor's Miller Act remedy." *Id.* at 598 (citation omitted) The court found that both the conditions were met, and dismissed the subcontractor's claim.

F. SUBCONTRACTOR ENTITLED TO DAMAGES SUSTAINED AFTER THE INSTITUTION OF LAWSUIT

In *U.S. f/u/b/o McAmis Indust. of Oregon, Inc. v. M. Cutter Co.*, 130 F.3d 440 (9th Cir. 1997), a subcontractor brought a Miller Act claim against the general contractor for sums due for use of its two barges. The suit was filed April 10, 1995, but the barges were not actually returned until June 29, 1995. The district court awarded the subcontractor not only the amounts due on April 10, 1995, but also the sum due for the rent of the barges through June 29, 1995. The general contractor contended that under § 270b, a claim may only be brought for the amount "unpaid at the time of institution of such suit" and thus damages should not be awarded for the period between April 10th and June 29th.

The Ninth Circuit affirmed the district court, pointing to the language of § 270b that allows a Miller Act suit to be prosecuted "to final execution and judgment for the sum or sums *justly due.*" 40 U.S.C. § 270b (emphasis added) The court found "it would be entirely contrary to the purpose of the Miller Act and the spirit of the federal rules to hold that the plaintiff should have filed a new suit to obtain the money that by June 29 was due it." *Id.* at 441.

II. SURETY LIABILITY

A. BAD FAITH

Bad faith litigation against sureties continues to be an active field. The Colorado Supreme Court, in an *en banc* decision in *Transamerica Premiere Ins. Co. v. Brighton School Dist.*, 940 P.2d 348 (Colo. 1997), extended the scope of bad faith claims to commercial sureties. Colorado state courts had previously only recognized a bad faith cause of action for liability insurance. In reaching its decision, the Colorado Supreme Court specifically rejected the surety's argument that suretyship is distinct from insurance, adding one more nail to the coffin of that aging surety argument. If there was any silver lining to this otherwise dark cloud, it was that the bad faith award was only $10,000.00. (See the cases that follow).

Proving again that "hard facts make bad law," or otherwise stated "sureties really ought to settle bad cases," is the case of *Great American Ins. Co. v. General Builders, Inc.*, 934 P.2d 257 (Nev. 1997). In this case, a contractor obtained a bond through an agent for the surety. The agent had been furnished with bond forms, seals for the surety, and powers of attorney. Unknown to the contractor, and apparently forgotten by the agent was a requirement in the agency contract with the surety that the surety have prior approval rights before any bond could be issued. This,

of course, did not happen. As soon as the surety learned that the bond had been issued, a "senior bond claim lawyer" with the surety informed the contractor and the obligee that the bond was revoked. This, in turn, caused the contractor to lose the project as well as develop hard feelings towards the surety. To make a hard case even harder, discovery revealed that the "senior bond claim lawyer" who issued the revocation of the bond did so in spite of an internal memorandum he received from one of the lawyers under his supervision, counseling that the agent certainly had apparent authority to issue the bond and that the surety would be liable to the contractor. For reasons not revealed in the opinion, the surety decided to take this case to trial. A compensatory damages award of $1 million and a punitive damages award of $2 million were returned by the jury. On appeal, the Nevada Supreme Court affirmed the compensatory award, finding a wealth of support for the surety's bad faith. Somewhat unexpectedly, however, the Supreme Court reversed the award of punitive damages based upon the peculiarities of Nevada law which require the finding of a fiduciary relationship between surety and principal in order to sustain punitive damages.

Last, but not least, Transamerica Insurance got clobbered in a recent bad faith case in California. In *Cates Const. Inc. v. Talbot Partners*, 62 Cal.Rptr.2d 548 (App. Ct. Cal. 1997), *app. dis.* 948 P.2d 409 (Cal. 1997),[4] Transamerica, as surety, issued payment and performance bonds for a commercial project on which its principal was the prime contractor. After a dispute between the principal and obligee, the principal walked off the job, filed a substantial mechanic's lien, and promptly went out of business. After an investigation, the details of which were not reported, Transamerica took an assignment of its principal's mechanic lien claim, and instituted a lawsuit to foreclose the lien against the obligee. After some delay, Transamerica also began the process of completing the project. There was apparently evidence that its efforts were slow and half-hearted. Several months later, the obligee's bank foreclosed on the project. Litigation quickly followed. In addition to breach of contract counts, the obligee brought a bad faith claim against Transamerica couched in terms of a tortious breach of the implied covenant of good faith and fair dealing.

The trial judge initially ruled against Transamerica on the bad faith claim as it relates to compensatory damages. The court found that Transamerica had breached its obligations by conducting an inadequate investigation and failing to promptly complete the contract. The court made an award of compensatory damages of $3 million against the principal and surety. That, unfortunately, was just the beginning. A jury then tried the issue of punitive damages and found against the surety in the amount of $28 million. While the appellate court later reduced the punitive damages award to $15 million, this was small solace for the surety. It is noteworthy that this case and the Nevada decision discussed immediately above involved the same causes of action (tortious breach of the implied covenant of good faith and fair dealing), yet on seemingly worse facts, the Nevada court reversed the punitive damages award against the surety.

B. OTHER

On balance, the surety industry at least held its own in deflecting other claims of liability. In a pair of similar, but unrelated cases, sureties played to a draw on the issue of disclosure, but

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[4] Pursuant to Rules 976, 977 and 979, California Rules of Court, this case may not be cited.

both cases seem to be correctly decided. In *Guarantee Co. of North America v. City of Cleveland*, 1997 W.L. 614406 (N.D. Ohio 1997), the surety bonded the prime contractor on a public works job. Within a very short period after commencing performance, it was apparent to all - owner, subs, surety, and probably the principal itself - that the principal was hopelessly lost in trying to complete the project. The city terminated the contractor, and the surety completed the work. At the conclusion of the job, the city withheld $3 million from the surety because, among other things, it failed to inform the city that the contractor did not have the requisite "skill, ability, equipment, manpower, or financial wherewithal" to perform the work.

The surety filed a motion for summary judgment, claiming that it had no duty to disclose any information concerning the competency or financial circumstances of its principal. The court analyzed the issue on traditional principles of misrepresentation and concealment. The court concluded that the surety's obligations did not go beyond the explicit terms of its bond. Thus, no duty to inform the obligee of the principal's financial condition arose. In its analysis, the court also observed:

> Since the obligee [city] contracts initially with the principal, it often does so following an investigation. In the course of that investigation it may discover information regarding the principal which tends to affect the surety's risk and which is kept from the surety's attention. In these situations, the general rule . . . is that the obligee is under no duty to disclose this information. We can perceive no reason why a different rule should be imposed where the surety possesses information accessible to, and indirectly known by, the obligee.

The language quoted immediately above proved to be prophetic in the case of *Concrete Tie of San Diego v. Liberty Const.*, 107 F.3d 1368 (9th Cir. 1997). There, the surety was on the other side of the fence. It claimed that the Small Business Loan Administration, which was financing the surety's principal, had a duty to advise the surety of adverse financial information concerning the principal, and further had a duty to disclose that the principal was not sufficiently competent to perform the work on the bonded project. The 9th Circuit, likewise, found no such duty to disclose and dismissed the surety's claims.

In a recent decision by the Florida Supreme Court, in *Federal Ins. Co. v. Southwest Florida Retirement Center, Inc.*, 1998 W.L. 54694 (Fla. 1998), the nagging subject of the surety's liability for latent defects was again addressed. The surety naturally took the position that it could not be liable for latent defects. The surety relied upon the *American Home Assur. Co. v. Larkin General Hospital, Ltd.*, 593 So.2d 195 (Fla. 1992) case, in which the Florida Supreme Court held that a surety could not be liable for delay damages due to the contractor's default unless the bond specifically provided coverage for delay damages. The Supreme Court rejected this argument, specifically declining to extend *Larkin* beyond claims for delay damages. Rather, the court looked at the language of the bond and found:

> that [the surety's] promise that the project would be completed according to the terms and conditions of the construction contract means that [the surety] would be liable for defective work performed by the general contractor upon the general contractor's default. This

liability is not dependent upon whether the defect was discovered before or after substantial completion.

In a helpful case, in *City of Independence f/u/b/o Briggs v. Kerr Const. Paving Co.*, 957 S.W. 2d 315 (Mo. Ct. App. 1997), a Missouri court affirmed the general rule that the payment bond surety's liability is generally co-extensive with that of its principal. Nevertheless, the court recognized that not every liability of the principal is necessarily transferred to the surety. In particular, where penalties were assessed against the contractor for its failure to abide by the Missouri prompt payment statute, the court found that the surety was not liable for these penalties because neither its bond nor the Little Miller Act which governed the project placed a requirement on the surety that it abide by the prompt payment statute.

Finally, in a case closely watched by all surety practitioners, the court in *Dysart Corp. v. Seaboard Surety Co.*, 688 A.2d 306 (Conn. 1977) served up an aperitif for the surety. In that case, a bonded subcontractor issued payroll checks to its employees. The employees cashed the checks at Tara Pub, a local wateringhole that catered to only the most discriminating of customers. After accumulating quite a number of these checks, the pub owner learned to his great consternation that the subcontractor's bank refused to honor them. The Tara Pub then filed a payment bond claim against the surety claiming that it was a proper payment bond claimant on two grounds - first, it was an assignee of the laborers, and second, it was a holder in due course of the paychecks. The court rejected these arguments, finding that when the laborers cashed their checks at the Tara Pub, there was no intention that they also assign their rights against the payment bond as well. Further, the court found that the status of holder in due course, which certainly existed, only entitled the holder to avoid certain defenses, and did not affirmatively give it payment bond claimant rights. Salude and happy days!

III. SURETY PREEMPTION

A. FEDERAL PREEMPTION

1. Under ERISA

A hot topic over the last year has continued to be whether state "prevailing wage" laws are preempted by the Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. §1001, *et seq.* Prevailing wage laws typically require contractors on state public works projects to pay wages and fringe benefits not less than those prevailing in the locality in which the work is to be performed. In the event that contractors violate this law, a payment bond claim may arise.

One of the defenses contractors and sureties have attempted to assert in response to these claims is the unenforceability of the state prevailing wage law because it has been preempted by ERISA. Success on this defense has eluded the sureties. In an uninterrupted wave of decisions over the past year, from the highest Court in the land on down, the ERISA preemption defense has been rejected. While each case has involved an analysis of the particular state act in issue, the result has been the same. *See California Div. of Labor Standards Enforcement v. Dillingham Const. ___ U. S. ____,* 117 S. Ct. 832, 136 L. Ed. 2d 791 (1997) (California prevailing wage law); *Associated Builders & Contractors v. Perry,* 115 F. 3d 386 (6th

Cir. 1997) (Michigan prevailing wage act); *Burgio and Campofelice v. New York State Dept. of Labor*, 107 F. 3d 1000 (2d Cir. 1997) (New York prevailing wage law); *Board of Trustees of Operating Engineers Local 825 v. L.B.S. Const. Co.,* 691 A. 2d 339 (NJ 1997), (New Jersey prevailing wage law); *Carpenters Local 261 Health and Welfare Fund v. National Union Fire Ins. of Pittsburgh*, 686 A. 2d 1373 (Com. Ct. Pa. 1996) (Pennsylvania prevailing wage law); and *Ironworkers Dist. Council v. Woodland Park Zoo Planning & Development*. 942 P.2d 1054 (App. Ct. Wash. 1997) (Washington prevailing wage law).

While some form of ERISA preemption may be found in an appropriate case, in view of the great weight of unfavorable precedence on this issue, it will be difficult for a surety to prevail on anything less than a clear conflict between the prevailing wage law and a material provision of ERISA.

2. Other

In a more "surety friendly" venue, a surety found success in arguing against federal preemption. In *American Manufacturers Mutual Ins. Co. v. Irvin,* Civil Action No. CV595-86, pending in the United States District Court for the Southern District of Georgia (order dated April 9, 1997), a surety litigated the validity of a bond it provided for the benefit of a livestock company pursuant to the Packers and Stockyards Act, 7 U.S.C. §181 *et seq.* The surety argued that it was entitled to invalidate the bond it issued pursuant to this federal act because of fraud. Specifically, after claims were made against the bond, the surety discovered that the signatures of several of the individual indemnitors had been forged. Under Georgia state law, this provided the surety with the basis for invalidating the bond *ab initio*. Needless to say, the hog farmers who had made the claims were not pleased with this position, and argued that the federal act providing for the bond "trumped" the state law. After a thorough analysis of the issue, the court concluded that no federal preemption was involved, and that the surety's motion for summary judgment was granted.

. **B. DISCHARGE OF SURETY'S BOND OBLIGATIONS**

Some helpful cases for sureties in discharging their bond obligations were reported this past year. One of the best was *Dragon Const. v. Parkway Bank & Trust*, 678 N. E. 2d 55 (App. Ct. Ill. 1997), *app. den.* 684 N.E. 2d 1335 (1997). There, the bonded contractor was terminated for failure to provide enough workers to complete the job. The construction contract provided that in order to terminate the contract, the owner had to give both the bonded contractor and the surety seven days prior written notice. This was honored in the case of the contractor, but the surety was not notified until several weeks after the termination. Based on this, the surety denied coverage. The Illinois appellate court agreed, specifically finding that the owner's failure to provide adequate notice of the termination stripped the surety of its right to limit its liability by insuring that the lowest responsible bidder was selected to complete the project. Consequently, the court found this to be a material breach of the contract and rendered the surety bonds "null and void." The opinion indicated no showing of actual prejudice to the surety, but rather presumed it. It is very questionable whether this case would be followed in other, less friendly, jurisdictions.

Another good decision for sureties came out of New York. *Varick Drywall, Inc. v. Aniero*

Concrete Co., Inc., 654 N.Y.S. 2d 815 (Sup. Ct. N.Y. 1997), *app. den.* 686 N.E. 2d 1364 (1997). There, the surety appealed an adverse verdict claiming that it should have been released from its bond obligations because the bonded contractor entered into an agreement to extend the time of payment under its contract without the assent of the surety. The court held that this agreement operated to discharge the surety from its obligations under the payment bond.

Closer to home, in *Pinkerton & Laws, Inc. v. Macro Const., Inc.*, 485 S.E. 2d 797 (Ct. App. Ga. 1997), the surety was permitted to discharge its obligations under the bond because of misrepresentations made to the surety by the obligee before the bond was issued. While it is not entirely clear from the opinion, it is apparent that the obligee gave information to the surety concerning the terms of the contract, presumably material ones, that affected the surety's decision to issue the bond. The obligee claimed that the surety was not entitled to rely on statements made by the obligee and had an independent duty to obtain and review the construction contract it was bonding before it issued the bond. Apparently, the bond was issued without review of the contract by the surety, and at trial the surety put on expert evidence that this was standard practice in the surety industry. This argument was accepted by the court, and the surety was allowed to avoid any obligations under the bond.

C. PAY WHEN PAID CLAUSES

Courts across the country have continued to grapple with the enforceability of "pay when paid" clauses. While the results have varied, there has been little good news for sureties.

Because it has been axiomatic that a surety's liability is co-extensive with that of its principal, sureties have traditionally expected to be able to avail themselves of defenses held by their principal, including the "pay when paid" clause defense. The courts, however, have generally not been so kind.

Striking a blow for subcontractors everywhere, the California Supreme Court in *Wm. R. Clarke Corp. v. Safeco Ins. Co. of America*, 938 P. 2d 372 (Cal. 1997), aligned itself with New York and ruled that "pay when paid" clauses are unenforceable because they are contrary to public policy. The court concluded that to enforce them would "effect an impermissible indirect waiver or forfeiture of the subcontractors' constitutionally protected mechanic's lien rights in the event of non-payment by the owner." As a consequence, the court stated that neither "general contractors or their payment bond sureties" may enforce these clauses.

Because the *Clarke* decision involved a private project, and because the rationale used by the California Supreme Court involved protecting a subcontractor's mechanics lien rights, there was some doubt whether the decision applied to public works projects. One California appellate court, in *Capitol Steel Fabricators, Inc. v. Mega Const. Co.*, 68 Cal. Rptr. 2d 672 (Cal. App. Ct. 1997), quickly removed any lingering doubt in holding that the *Clarke* decision applied with equal force to public works projects.

A somewhat similar decision was reached in *Brown & Kerr, Inc. v. St. Paul Fire and Marine Ins. Co.*, 940 F. Supp. 1245 (N. D. Ill. 1996). There, the federal district court in a similar vein refused to allow a surety to utilize the "pay when paid" defense because to do so "would work a

significant forfeiture of [the subcontractor's] rights under the subcontract and, more importantly, the payment Bond."

The majority of the courts considering this issue have felt less compelled to grab the "moral highground," and instead have relied upon more conventional forms of legal analysis. In *Moore Bros. Const. Co. v. Brown & Root*, 962 F. Supp. 838 (E. D. Va. 1997), the court refused to allow a surety to utilize the "pay when paid" defense, even though the applicable state law allowed a prime contractor to use the defense against its subcontractors. Relying on the Florida Supreme Court's decision in *OBS Co., Inc. v. Pace Const. Corp.*, 558 So. 2d 404 (Fla. 1990), the court found that the payment bond did not contain explicit language granting the surety the benefit of the defenses that its principal had against claims from subcontractors. The court concluded that "[a]bsent such clear language . . . the surety cannot rely on the prime's defenses to payment." Thus, while ruling against the surety, the court did leave the door open for sureties in the future to amend their payment bond forms to incorporate language which would make this defense available to them as well.

Using a similar analysis, the Tennessee Supreme Court in *Koch v. Construction Technology, Inc.*, 924 S.W.2d 68 (Tenn. 1996) concluded that the clause in the prime contract reading "payments . . . shall be due when and as they are received by the contractor . . . " was not sufficiently clear to constitute a condition precedent to payment. As a consequence, the court would not permit the prime contractor or its surety to utilize the clause as a defense to a subcontractor's claim for payment. Again, clearer language in the subcontract, and in the bond, might have changed the result.

Lastly, Colorado courts, for the first time this century, have considered the issue of the enforceability of a "pay when paid" clause. In *Printz Services Corp. v. Main Elec. Ltd.*, 949 P. 2d 77 (Colo. App. Ct. 1997), the court affirmed the enforceability of the clause in question (". . . provided like payments shall have been made by Owner to Contractor.") This language is remarkably similar to the clause involved in *Koch*, *supra*, in which the Tennessee court reached precisely the opposite conclusion. It should be noted that the *Printz* decision did not address the issue of whether a surety could also utilize this defense. Finally, the Colorado Supreme Court has recently granted certiorari in this case, and will therefore present next year's author of the Surety Update an opportunity to tell us what the final word on this issue will be in the State of Colorado.

IV. SUBROGATION AND INDEMNITY

A. EQUITABLE SUBROGATION

1. Bankruptcy and the Surety

With the exception of one aberrant decision, 1997 proved to be another good year for sureties exercising their equitable subrogation rights in the bankruptcy courts. Illustrative of this line of successes is *In re Alcon Demolition, Inc.* 204 B.R. 440 (Bankr.D.N.J. 1997). There the bankruptcy court found that a payment bond surety was equitably subrogated to the proceeds of

an arbitration award its bankrupt principal had obtained against the owner. In reaching this result, the court used some good "sound byte" language that makes it good precedence for future cases. For example, the court stated:

> Nowhere is subrogation more appropriate or common than in the context of suretyship. Indeed, the Supreme Court has noted that 'there are few doctrines better established than that a surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed.' . . . Where a surety performs or pays subcontractors to perform pursuant to a performance and payment bond, it has rights to reimbursement from the remaining contract funds . . . . Thus, a surety has an 'equitable lien' against the identifiable proceeds of the underlying contract . . . . Accordingly, [the surety] has an equitable lien on any funds ultimately determined to be due from [the owner] to [the principal] to the extent of its satisfaction of [the principal's] obligations to materialmen and labors.

Other helpful cases are *In re Comcraft*, 206 B.R. 551 (Bankr.D.Or. 1997) (surety's equitable subrogation rights have priority over those of the principal's secured lender); and *In re Homebuilders, Inc.*, 213 B.R. 475 (Bankr.E.D.Va. 1997) (the bankruptcy court reaffirmed the primacy of the *Pearlman* decision as to the superiority of the surety's rights to contract funds, although in this particular case the surety had not perfected its subrogation rights).

No one wins every battle. In the case of *In re Wm. Cargile Contractor, Inc.*, 203 B.R. 644 (Bankr.S.D.Ohio 1996), the court considered a situation in which the owner of a project was holding funds, presumably contract balances. Apparently, these funds were not retainage as the contract did not have any provision for withholding retainage. The surety for the bankrupt prime contractor had made payments to subcontractors on the contract, and asserted a right to the contract balances. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S. Ct. 232, 9 L. Ed. 2d 190 (1962) was naturally cited as authority. The bankruptcy court, however, decided to confine *Pearlman* to its facts. In *Pearlman*, the surety was equitably subrogated to the retainage held for its principal. Because the contract in this case did not provide for retainage, *Pearlman* was found to be inapplicable. As a result, the surety's claim of priority was denied, and the surety was relegated to presenting a claim as an unsecured creditor in the bankruptcy. Ironically, the name of the bankruptcy judge who did this dastardly deed was "Perlman".

2. State Court Applications of the Doctrine

There are two recent state court actions in which the surety's right of equitable subrogation has been recognized. In *National American Ins. Co. v. Boh Brothers Const. Co.*, 700 So.2d 1363 (Ala. 1997), the Alabama Supreme Court was presented with a situation in which an out-of-state subcontractor performed work on a public works project. The subcontractor failed to pay some of its sub-subcontractors, and as a result the prime contractor's surety paid these claims. Thereafter, the prime contractor asserted on behalf of its subcontractor a claim against the owner for delays and was paid a substantial settlement. The prime contractor, however,

decided to keep the money and not pay it to the subcontractor. It cited as its defense the fact that the subcontractor had failed to qualify to do business in Alabama. This defense carried the day. Nonetheless, the surety made a claim to the funds held by the prime contractor, to the extent of the surety's payment bond payments. The surety won this action on the theory that it did not stand in the shoes of its principal, but rather was subrogated to the rights of the subcontractors and suppliers that it paid under the payment bond.

In another interesting decision, *Bank One v. Highlands Ins. Co.*, 1996 W.L. 656697 (Ct. App. Tex. 1996), the court reached another good result for the surety. There, the surety had provided bonds for a number of projects on which its principal was serving as prime contractor. In addition, there were other unbonded projects on which the principal was also working. Many of the same subcontractors and materialmen were supplying work and materials on both the bonded and unbonded jobs. When the contractor notified the surety that it could no longer complete the work, the surety determined that in order to complete the work as expeditiously as possible, it would have to not only pay the subcontractors and materialmen supplying work and materials to the bonded jobs, but would have to also pay the claims of these same subcontractors and materialmen for the work they were performing on the unbonded projects. It justified these latter payments, asserting that if these subcontractors and materialmen on the unbonded projects were not paid, they would refuse to complete their work on the bonded projects. Later, a dispute arose between the principal's secured lender and the surety over the right to the assets of the principal. The surety claimed that it was equitably subrogated to the assets of the principal, in the full amount of payments made on both the bonded and unbonded projects. The Bank disputed this, contending that the surety had acted as a volunteer to the extent that it made payments on the unbonded projects. The court sided with the surety, finding that the payments had been made in good faith and on a reasonable belief that it was necessary to make the payments on the unbonded projects in order to fulfill the surety's obligations on the bonded projects.

B. SURETY'S INDEMNITY RIGHTS

1. Payments Made in Good Faith

The courts continue to uphold the surety's right to indemnity against its principal for payments made in good faith, although no particularly challenging cases were recently decided. In *Gundle Lining Const. Corp. v. Adams County Asphalt, Inc.*, 85 F.3d 201 (5th Cir. 1996), a payment bond surety sought indemnity against its principal for claims it paid on a project. The principal defended, claiming that the surety's decision to make the payments on the bond was not made in good faith. The only evidence the principal could muster in support of its position was that the surety had originally disputed the payment bond claims, and therefore could not afterwards claim that the payments were made in good faith. The court made short work of this argument finding that there was substantial evidence to support the claims and that the surety made these payments in good faith.

In *General Acc. Ins. Co. of America v. Merritt- Meridian Const. Corp.* 975 F.Supp. 511 (S.D. N.Y. 1997), another desperate attempt of a principal to avoid its legitimate obligations, the "lack of good faith" defense was also raised There, a bonded contractor entered into subcontracts

which provided that final payment was not to be made until the work had been fully accepted and approved by the owner. During the course of the project, the contractor failed to pay subcontractors and suppliers, which the surety was ultimately forced to pay. In the best traditions of suretyship, the surety promptly paid the legitimate claims, even though the owner had not finally accepted all of the work on the project. The principal claimed that the surety had, therefore, prematurely made payments, and in doing so, had acted as a volunteer. Therefore, the surety was entitled to nothing. Again, the court had little difficulty blowing through this argument. The court cited to the indemnity agreement, which gave the surety the right to settle all claims unless the principal (a) requested that the surety litigate, and (b) posted collateral to secure the amount of a possible judgment and the expenses of the litigation. Because the principal failed to post the collateral, the court found that the principal had not availed itself of the contractual right to force the surety to dispute the claim. Further, the court found that the surety had acted in good faith in settling the claims, finding specifically that "[i]t is irrelevant whether [the principal] was actually liable for the payments claimed by the subcontractors or actually defaulted on their contractors with the owners, so long as [the surety] acted in good faith in making the payments and completing the performance under the construction contract."

2. Surety's Attorney Fees Claims

Two recent cases dealt with a principal's challenge to the reasonableness of the amount of attorneys fees a surety could seek against the principal. In the first case, *International Fidelity Ins. Co. v. Jones*, 682 A.2d 263 (Sup. Ct. N.J. 1996), a surety incurred attorneys fees in connection with the defense of claims under a bond. The surety then brought an indemnity action against its principal seeking reimbursement for those fees. The surety argued, apparently seriously, that it was entitled to recover any fees it incurred in good faith, regardless of amount. The courts abruptly rejected this position stating:

> We are of the view that our court should reject the view that under an indemnity agreement the obligor has no defense and that even truly unreasonable payments must be reimbursed as long as they are made in good faith. Failure to oversee the reasonableness of such awards could result in inequities if not promote corruption.

In a similar case, in *Fallon Electric Co. v. The Cincinnati Ins. Co.*, 121 F.3d 125 (3d Cir. 1997), the surety also incurred attorneys fees in the defense of a bond claim. It, thereafter, made a claim against its principal for reimbursement under the indemnity agreement. This particular indemnity agreement provided that any payments made or expenses incurred by the surety "shall be prima facie evidence of . . . the amount of the liability of " the principal. A hearing was held on the attorney fee issue, and the principal contested the amount of the fees arguing that they were unreasonably high. It put on no evidence, however, to demonstrate that the fees were incurred unreasonably, in bad faith or through fraud, or that the surety had acted unreasonably in paying the fees. The trial court accepted the arguments of the principal and substantially reduced the amount of fees awarded to the surety.

On appeal, the Third Circuit reversed, finding that the "prima facie evidence" language in

the indemnity agreement effectively shifted the burden to the principal to prove that the fees were unreasonable. While the court noted that there were other decisions to the contrary, it distinguished those because the indemnity agreements in question did not contain the "prima facie evidence" language.