TWELFTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS CONFERENCE

THE SURETY UPDATE

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I. Federal Miller Act Cases

A. Notice Provisions

In the last two updates we proudly announced the further tightening of the Miller Act notice requirements with the Eleventh Circuit's decision in the *Maccaferri Gabions, Inc. v. Dynateria, Inc.*, 91 F.3d 1431 (11th Cir. 1996) *cert. denied* 117 S.Ct. 1430 (1997). Unfortunately for those bonding projects in the Seventh Circuit, your elation will be substantially muted.

The Miller Act requires that a sub-subcontractor's notice of nonpayment contain three pieces of information: (1) notice must be given within 90 days of the sub-subcontractor's last work; (2) the notice must state with substantial accuracy the amount claimed; and (3) the notice must include "the name of the party to whom the material was furnished or supplied, or for whom the labor was done or performed." 40 U.S.C. § 270b(a). The majority of circuit courts, including the *Maccaferri* court, have held that a fourth factor – explicit demand for payment from the general contractor – is implicit in section 270b(a), and is therefore required in a notice in order to comply with the Act.

For a short period of time, it looked as though courts in the Seventh Circuit might follow the majority rule and require that a sub-subcontractor's Miller Act notice also contain an explicit demand for payment from the general contractor. In *United States ex rel. N. E. W. Interstate Concrete, Inc.*, 93 F. Supp.2d 974 (S.D. Ind. 2000), the district court not only required that the notice contain explicit demand for payment, but also applied a "reasonable contractor" test to that demand. The district court held that the demand for payment from the general contractor must be such that a reasonable contractor would be prompted to withhold payment from a subcontractor after receiving such notice.

Like the majority of federal cases coming before it, the *N.E.W. Interstate* case would have created one more obstacle in a sub-subcontractors road to recovery from the Miller Act surety. However, in its very recent and unfortunately well-crafted decision, the Seventh Circuit impliedly overruled the *N.E.W. Interstate* case and, in doing so, refused to join five other circuit courts,[1] which had held that a sub-subcontractor's Miller Act notice must contain explicit demand for payment from the general contractor. *United States ex rel. S & G Excavating, Inc. v. Seaboard Surety Co.,* 236 F.3d 883 (7th Cir 2001). Instead, the Seventh Circuit sided with the Tenth Circuit, the only other circuit court to hold that the Miller Act contains no implicit fourth requirement.

The Tenth Circuit's decision, *McWaters & Bartlett v. United States ex rel. Wilson,* 272 F.2d 291 (10th Cir. 1959), which the Seventh Circuit followed, is the oldest circuit court case in which the issue was considered. After it was decided, *McWaters* was followed by the five circuit court cases cited in Footnote 1, *supra*, spanning the next forty years, all of

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[1] See *United States ex rel. Water Works Supply Corp. v. George Hyman Construction Co.*, 131 F.3d 28, 32-33 (1st Cir. 1997); *Maccaferri Gabions, Inc. v. Dynateria, Inc.*, 91 F.3d 141, 1437 (11th Cir. 1996); *United States ex rel. Blue Circle West, Inc. v. Tucson Mechanical Contracting, Inc.*, 921 F.2d 911, 914-15 (9th Cir. 1990); *United States ex rel. Jinks Lumber Co. v. Federal Insurance Co.*, 452 F.2d 485, 487-88 (5th Cir. 1971); *United States ex rel. Charles R. Joyce & Son, Inc. v. F.A. Baehner, Inc.*, 326 F.2d 556, 558 (2d Cir. 1964).

which directly conflict with *McWaters.* The Seventh Circuit's decision to break from this swelling modern trend thus makes its decision all the more poignant.

Sureties can only hope that the Seventh Circuit's reasoning in *S & G* does not catch on in those circuits yet to consider the issue. Due to the sharp division among the circuits, this is an issue that may someday be brought to the United States Supreme Court for resolution.

B. Limitation Provisions

1. Corrective Work Falls Outside the Scope of 270b(b)

The Miller Act requires that suits to recover against the payment bond be filed no more than "one year after the date on which the last of the labor was performed or material was supplied…." 40 U.S.C. §270b(b). Federal courts recently handed down two decisions interpreting section 270b(b) that should be very encouraging to sureties.

In *United States v. International Fidelity Ins. Co.*, 200 F.3d 456 (6th Cir. 2000), the Sixth Circuit joined the majority of circuit courts that have held that remedial or corrective work, or inspection of work already completed, falls outside the meaning of the term "labor" in section 270b(b). Under *International Fidelity,* the trier of fact in a Miller Act case in the Sixth Circuit will now be required to apply a bright line test to determine whether the work was performed as a part of the original contract or, to the contrary, for the purpose of correcting defects or making repairs following inspection of the project.

The *International Fidelity* case is an important decision for sureties. Although the Sixth Circuit joined the majority of circuits, including the Third, Fourth, Eighth, Ninth and Tenth Circuits in adopting the bright line test, no circuit court had adopted the test within approximately the last 20 years, and the test had recently come under considerable fire from lower courts. In this respect, the *International Fidelity* case is a clear-cut victory for the industry.

Similarly, in *United States ex rel. Mid-West Painting, Inc. v. Hartford Accident and Indem. Co.*, 99-1308-JTM, 2000 WL 1072296 (D. Kan. July 14, 2000), the district court found that a suit which was filed more than one year after the date of inspection, but less than one year after the date of additional repainting and touch-up work, fell outside the scope of the Miller Act's one year limitations period.

2. Unfavorable Contract Construction

The First and Fourth Circuits have not been quite as kind to sureties in recent decisions concerning Miller Act limitations defenses. The First Circuit recently shot down a crafty surety's limitations defense. In *GE Supply v. C & G Enterprises., Inc.*, 212 F.3d 14 (1st Cir. 2000), the subcontractor sued for nonpayment and mistakenly attached an affiliate's invoice to its complaint as the contract upon which it based its suit. The terms and conditions of the affiliate's invoices stated that each delivery was a separate and independent contract. The surety argued that the brunt of the subcontractor's claim was barred by the Miller Act one-year statute of limitations because the subcontractor sought

recovery on separate and independent contracts, which were primarily completed outside the one-year limitations period.

The district court denied the surety's motion for summary judgment and the circuit court affirmed. The circuit court based its holding on the language of the Miller Act, which provides in relevant part that the statute of limitations runs "from the day on which the last of . . . [the] material was supplied." The court reasoned that the limitations period should run only once for each supplier, and the suppliers should not be required to bring multiple suits to recover payment for materials supplied for a single project. In other words, the circuit court refused to allow the language of the subcontract (in this case an invoice) to overcome the language of the Miller Act.

The Fourth Circuit in an unpublished opinion recently unraveled a summary judgment a surety had obtained in the district court. In *D'Elegance Mgmt. Ltd. v. Universal Sur. of Am.*, 2000 WL 1224164 (4th Cir. Aug. 29 2000), a subcontractor sued on two payment bonds for projects in two separate counties in North Carolina, Penders County and New Hanover County. A prime contract covered the work in both counties, but it was unclear whether the bonds in dispute covered the separate projects or the contract as a whole. The subcontractor had completed its work in Penders County more than one year before filing suit, but less than one year from completion in New Hanover County. The district court found that the scope of the bonds was ambiguous and thus considered extrinsic evidence as to the intended scope. The court then granted the surety's motion for summary judgment. The court found that both of the bonds simply covered the project in Penders County, where the subcontractor had completed its work more than one year before filing suit, and thus the subcontractor's claim was barred by the Miller Act statute of limitations.

The Fourth Circuit reversed. The circuit court found that the first of the two payment bonds contained a contract number and date references, which made it clear that the first bond was intended to cover *the prime contract as a whole – covering the work in both counties.* Because the last work on the New Hanover County portion of the project had been performed within a year of its filing suit, the subcontractor's payment bond claim remained viable against the first payment bond.

Sureties and practitioners alike would be wise to keep *D'Elegance* in mind when drafting limiting language in payment and performance bonds. Assuming the merits of the surety's position in *D'Elegance,* this surety simply failed to limit the scope of its payment bond exposure with proper references in the bond, and, by failing to doing so, the surety undercut a solid payment bond defense.

C. Hunting Down the Blue Fox – Sovereign Immunity & Equitable Subrogation

In 1999 the United States Supreme Court issued an opinion involving sovereign immunity that many, including the Justice Department, believe may interfere with a surety's equitable subrogation rights.

In *Dept. of Army v. Blue Fox, Inc.*, 119 S. Ct. 697 (1999), the court held that the United States' sovereign immunity precludes a subcontractor from suing the United States directly to recover contract funds. In *Blue Fox,* a subcontractor notified the Government that the general contractor had not paid it for its work. Ignoring the notice, the Government paid the general contractor, which, in turn refused to pay the subcontractor. The subcontractor sued the Government directly, arguing that it had perfected an equitable lien in the contract funds that were once in the government's possession. The subcontractor argued that the trial court had jurisdiction to enforce the subcontractor's equitable lien based upon the waiver of sovereign immunity clause in section 702 of the Administrative Procedures Act. Section 702 provides that parties may sue the United States directly when seeking equitable relief, as opposed to money damages.[2]

The trial court disagreed with the subcontractor's theory. However, the Ninth Circuit, interpreting cases relating to a surety's equitable subrogation rights, held that the subcontractor was indeed entitled to an equitable lien in the funds "wrongfully" paid out to the general contractor.

The Supreme Court reversed, distinguishing the line of cases upon which the Ninth Circuit had relied. The Court used some unfortunate language, which the Justice Department now suggests places a surety's right of equitable subrogation in jeopardy. The Court wrote:

> Respondent contends that in several cases examining a surety's right of equitable subrogation this Court suggested that subcontractors and suppliers seek compensation directly against the government…. None of the cases relied upon by respondent involved a question of sovereign immunity, and, in fact, none involved a subcontractor directly asserting a claim against the Government. Instead, these cases dealt with disputes between private parties over priority to funds... They do not in any way disturb the established rule that, unless waived by Congress, sovereign immunity bars subcontractors *and other creditors* from enforcing liens on government property for funds to recoup their losses. (citations omitted) (emphasis added).

With this language, the Justice Department argues that the Supreme Court has invited the United States to assert its right of sovereign immunity in defense of sureties' claims of equitable subrogation. This invitation is apparently based upon the phrase "and other creditors," coupled with the Court's suggestion that its prior equitable subrogation opinions did not address any sovereign immunity arguments.

To date, no appellate court has decided the effect of the *Blue Fox* decision on a surety's equitable subrogation rights to federal contract balances. However, a case that is currently on appeal will hopefully provide some guidance, if not answers, to these issues.

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[2] For a more detailed discussion of the *Blue Fox* decision and its impact on sureties, *See* Marilyn Klingler, *The Surety's Rights of Equitable Subrogation Versus the U.S. Government's Right to Sovereign Immunity*, Tort and Insurance Law Journal, Vol. 36, No. 1 Fall 2000.

In 1999, the U. S. Court of Federal Claims ruled that *Blue Fox* did not negatively affect a surety's equitable subrogation rights. *Insurance Co. of the West v. United States*, No. 00-5039 (Fed Cir. Filed Dec. 14, 1999). However, the court certified the following controlling question of law for interlocutory appeal:

> Whether, as recognized by the Federal Circuit in *Balboa*, the United States has waived sovereign immunity for the equitable subrogation claims of a surety against the United States, in light of the Supreme Court's recent holding in *Blue Fox*, and if not, whether jurisdiction for such a claim can be predicated on a surety's status as a third party beneficiary.

On January 11, 2000, the Federal Circuit Court of Appeals granted the United States permission to appeal. *Insurance Co. of the West v. United States*, 230 F.3d 1378, 2000 WL 123380 (Fed. Cir. 2000) (unpublished disposition). As of the writing of this update, the Federal Circuit has not ruled on the appeal.

Obviously it is very encouraging that the U.S. Court of Federal Claims did not find the Justice Department's sovereign immunity argument compelling, and hopefully the Federal Circuit will reject that argument as well. Nonetheless, sureties would be well advised to keep an eye on the *Insurance Co. of the West* case, which should be decided soon. Because the Justice Department's argument arises from a Supreme Court decision, it is entirely possible, if not likely, that the High Court will ultimately settle the issue.

D. Take-Over Agreements With the Federal Government

The *Home Assurance Co. v. United States*, 46 Fed. Cl. 160 (2000) case makes clear the need for a prompt and appropriately worded take-over agreement with the Federal Government in the event of a principal's default. In *Home Assurance,* the surety gave notice to the Federal Government, as project owner, that its principal, the contractor on a Government project had defaulted and the surety would be required to complete the project. The surety instructed the Government that it should make future payments to a bank account established by the surety for completion of the project. The surety failed, however, to require the execution of an appropriate take-over agreement.

After the surety's notice, the Government mistakenly made two payments directly to the contractor. The surety sued the federal government for the total amount paid to the contractor after notice. The Court of Federal Claims held that absent a take-over agreement between the Government and the surety, the surety may be entitled to its right of equitable subrogation, but was not entitled to make a claim against the Government for the payments made directly to the contractor, even after notice from the surety to pay it.

E. Bad Faith Delay

Sureties must continue to be mindful of the Prompt Payment Act, 39 U.S.C. §3901 *et seq.*

In *United States ex rel. Don Siegel Constr. Co., Inc. v. Atul Constr. Co.*, 85 F.Supp.2d 414 (D.N.J. 2000), a subcontractor sued a surety, in part for the surety's alleged

bad faith delay in responding to the subcontractor's payment bond claim. When the surety moved to dismiss the claim, the court considered whether the subcontractor was entitled to bring such a claim in a Miller Act case. The court determined that the question was answered by the Prompt Payment Act, which allows subcontractors on federal projects to sue for attorney's fees and penalties for nonpayment or late payment on payment bonds, *provided that state law allows such fees or penalty claims.* The court*,* however, was unable to locate any New Jersey state law addressing the subject. The court therefore simply *predicted* how the New Jersey Supreme Court would handle the issue, and held that the New Jersey Supreme Court would recognize a bad faith claim against a surety under its own state law. The subcontractor's claim survived dismissal.

When its principal defaults on payment and/or performance obligations, the surety is left to pick up the pieces, and must do so with some immediacy. Unfortunately, an insolvent principal is not typically forthcoming with the information a surety will need to properly evaluate its payment and performance obligations. The *Don Siegel* case is an unfortunate reminder of what can happen if the surety is not vigilant in this area.

F. Jurisdiction

In *United States ex rel. Frances McCollum v. Dawnco Constr.,* R. No. Civ-98-2826, 2000 W.L. 288107 (ED Pa. March 16, 2000), the district court found it had no jurisdiction under the Miller Act to consider a case where the bond was issued in connection with the construction of a state housing authority complex. The court found that Miller Act jurisdiction only exists for claims related to "public work or public building of the United States." The United States' involvement in the housing authority project only amounted to partial funding, and not ownership or control. This decision may provide useful fodder to Miller Act sureties seeking to dispense with claims with suspect jurisdictional bases.

II. STATE LAW CASES

A. Surety's Equitable Subrogation (and Bankruptcy) Rights

At last years conference, we suggested that the Sixth Circuit had put to rest the "earned" vs. "unearned" progress payment distinction that had eviscerated the surety's equitable subrogation rights in some bankruptcy contexts. Hopefully, we didn't speak too soon.

Most sureties are now aware of three district courts cases in the Sixth Circuit, *In re Glover Constr. Co. Inc.*, 30 B.R. 873 (Bankr. W.D. Ky. 1993); *In re Universal Builders, Inc.*, 53 B.R. 1993 (Bankr. M.D. Tenn. 1985); and *In re Wm. Cargill Contractors, Inc.*, 203 B.R. 644 (Bankr. S.D. Ohio 1996), which together, frame-out what has become known as the *Glover* doctrine. Under the *Glover* doctrine, progress payments that are allegedly "earned" by the bonded contractor prior to bankruptcy,[3] are considered property of the Chapter 11 bankruptcy estate and are not subject to the surety's equitable subrogation claim. This rule is grounded in the theory that, given the importance of the progress payments to a bankruptcy reorganization, a debtor can apparently (and absurdly) "earn" a progress

[3] i.e. where the defaulted principal/contractor has completed some portion of the bonded project, submitted a pay application and the owner has certified the work as complete.

payment, regardless of whether it has paid its subcontractors and suppliers for the work performed. In *Glover* and its progeny, the district courts distinguish *Pearlman v. Reliance* 371 U.S. 132 (1962), limiting the application of its holding to contract retainage. Unfortunately, Chapter 11 debtors-in-possession and Chapter 7 trustees have used the *Glover* doctrine as leverage with varying degrees of success in contests with sureties over contract balances around the country.

Sureties hoped that with *Kentucky Central Ins. Corp. v. Brown (In re: Larbar Corp.)*, 177 F.3d 439 (6th Cir. 1999), the Sixth Circuit had undercut the *Glover* doctrine. In *Larbar,* the Court considered whether a surety was entitled to outstanding contract balances and profits on several public projects in various stages of completion in a Chapter 7 bankruptcy case. The surety was forced to step in and fulfill its payment and performance obligations on the projects. The court did not dissect the issue with a scalpel, instead it used a mallet. In ruling in favor of the surety's rights to all funds, the court wrote, "[t]he law is clear that a surety under these circumstances has a right to the payments due to the contractor *to the extent of full reimbursement*." The Court did not stop to consider whether progress payments on the various jobs were "earned" or "unearned".

With *Larbar*, we believed that the Sixth Circuit had put to rest the argument that progress payments, as opposed to retainage, can somehow be considered earned and therefore part of the debtor's bankruptcy estate. Unfortunately, last year in an unpublished and perhaps somewhat schizophrenic decision, the Sixth Circuit may have breathed new life into the *Glover* doctrine.

In *In re Hughes-Bechtol, Inc.*, No. 98-4257/98-4309, 2000 WL 1091509 (6th Cir. 2000), the Sixth Circuit considered what effect a cash collateral order would have on a bank and a surety's competing claims to pre- and post-petition contract proceeds. After the bankruptcy court ruled in favor of the bank, the district court reversed, only to have the Sixth Circuit then reverse its decision.

The Sixth Circuit construed the cash collateral order (to which all the parties, including the surety, apparently consented) as a contract among the parties. The Sixth Circuit then interpreted the language of the order to give the bank a priority interest to all the contract proceeds. This outcome alone seemed to have little impact on sureties' equitable subrogation rights. However, by pushing the issue, the surety may have backed into some bad law.

The surety argued that the funds in dispute were not subject to the consent order because the applicable construction contracts gave it a trust interest in the contract proceeds. In rejecting this argument, the circuit court revisited the *Cargill* and *Glover* cases, which sureties had hoped the court had overruled the year before in *Larbar*. Citing *Cargill*, the court reasoned that if a trust had been created, the bankruptcy court had the power to decline to recognize the trust because

> [a]llowing the subcontractors to receive the funds directly by operation of a trust provision in constructions contracts, in absence of a statute so requiring, ... would effectively allow unsecured creditors unjustifiably to be paid even ahead of secured creditors.

The court also cited *Glover*, for the proposition that "[c]ontract proceeds that the debtor ultimately earned by completing performance on the contract are part of the bankrupt estate."

With *Hughes-Bechtol*, it appears as though the "earned" vs. "unearned" progress payment argument may be alive and well in Chapter 11 cases (and maybe even converted Chapter 7 cases). By citing to *Glover*, the Sixth Circuit, at the very least, indicates that the case remains good law in its jurisdiction. Furthermore, although the reference to *Glover* was made in dicta, without more clarification, the Sixth Circuit seems to suggest that a contractor, which defaults by non-payment to its subcontractors, can still "earn" a progress payment. Sureties and their attorneys will thus continue to be faced with this argument in bankruptcy court, perhaps until the Supreme Court adequately clarifies the scope of its *Pearlman* decision.[4]

B. Surety's Indemnity Rights

Fortunately for sureties, courts continue to strike down indemnitors' fraud and bad faith counterclaims and defenses raised in response to surety indemnity actions. Sureties and practitioners alike recognize how difficult it can be to obtain a summary judgment in state court. That is why the court's decision in *American Home Assurance Co. v. Gemma Constr. Co*., 713 N.Y.S.2d 48 (N.Y. App. Div. 2000) is so important.

In *Gemma,* the surety filed suit against both corporate and individual indemnitors. The indemnitors responded with various bad faith and fraud based counterclaims and affirmative defenses, including (1) failure to state a cause of action; (2) neglecting to annex an itemized and sworn statement of loss and expenses; (3) breach by plaintiff of its duty to mitigate losses and perform its contractual obligations in good faith; (4) estoppel arising out of the surety's conduct; (5) gross negligence by the surety in paying claims under the bonds; and (6) unreasonable refusal to allow the principal to substitute another surety on the projects, thereby preventing the contractor from substantially limiting its losses on those jobs and ultimately forcing it out of business. The trial court denied the surety's motion for partial summary judgment and granted the defendants additional time to conduct discovery. However, the Appellate Division unanimously reversed. The appellate court found an utter lack of evidence supporting the indemnitor's "conclusory accusations of bad faith and other purported improprieties," in the face of broad indemnification language in the parties' agreement. The court went on to find that "the fact that defendants [had] not yet been afforded discovery [did] not preclude summary dismissal" of their affirmative defenses and counterclaims. The court took a well-reasoned and very sympathetic view toward the surety, which had completed the bonded projects at "a substantial financial cost." The *American Home* court and other courts continue to cut a clear path to recovery for a surety bringing a breach of indemnity claim.

On a related front, a New Jersey appellate court preserved a surety's indemnity claim in the face of a strong statute of limitations defense. In *First Indemnity of America Ins. Co. v. Kemenash*, 744 A.2d 691 (App. Div. Feb 10, 2000), the surety brought a claim against its indemnitor more than six years after it had entered into a take-over agreement

[4] Resolution perhaps may come if the Court ultimately accepts an appeal in *Insurance Co. of the West,* discussed *supra.*

with the project owner, but within six years after its last payment on the contract to complete the construction project. The trial court entered a partial summary judgment in favor of the surety, finding that its claim was not barred by New Jersey's six-year statute of limitations. The Appellate Division affirmed. The appellate court considered the issue one of first impression and found that the surety's cause of action did not accrue until the loss occurred. The loss did not accrue until the last contractual payment was made.

C. Defenses

1. Statutory Lien Notice Deficiencies

Unlike the Seventh Circuit which has softened the Miller Act notice requirements, Florida state courts continue to strictly apply Florida's lien notice provisions. In *Midtown Enterprises, Inc. v. Contractors, Inc.,* 750 So.2d 683 (Fla. 3d DCA 1999), a subcontractor urged that it had complied with Florida's statutory lien notice (notice of nonpayment) provisions by sending the surety a copy of its letter apprising the owner of the general contractor's nonpayment. The trial court dismissed the subcontractor's bond claim. The Third District Court affirmed the dismissal, finding that the subcontractor's notice failed to provide statutorily required information, including a property description and address, and description of the labor, services or materials allegedly improving the property.

In *Kraemer & Sons, Inc. v. Ashbach Constr. Co.,* 608 N.W.2d (Minn. Ct. App. 2000), the court actually loosely interpreted Minnesota's lien notice provisions to **protect** a surety. The court held that a subcontractor had sufficient information to permit it to provide surety notice of its claim, despite the fact that the surety had listed different addresses for the contractor and itself on separate bond forms. The court held that the subcontractor's failure to provide the proper lien notice barred its claim.

2. Waiver, Release and Judicial Estoppel

The court in *William J. Templemen Co. v. United States Fid. & Guar. Co.*, No. 1-99-3043, 2000 WL 1721062 (Ill. App. Nov. 16, 2000), recently brought to the fore a pitfall sureties often face – the potential of waiving lien notice defenses by failing to modify bond language to correspond with the forum state's lien law requirements. In *William J. Templemen*, the payment bond drafted by the surety contained a notice provision, which required 90 days notice of nonpayment "only if the claimant did not have a direct contract with the general contractor." Illinois' bonding statute, however, did not provide for such a waiver of notice requirement for parties in privity with a general contractor. The surety successfully argued to the trial court that the claimant had failed to meet notice requirements of the Illinois bonding statute. Unfortunately, the surety's victory was short-lived.

The appellate court reversed, holding that language of the payment bond would act as a waiver of the notice requirements of the Illinois bonding statute. The court reasoned that to find otherwise would allow sureties to induce claimants to rely on the language of the bond and then avoid payment by invoking the bond statute. Clearly, this is an instance where a surety failed to redraft the language of its payment bond to conform to the

governing statutes of the forum. The surety's bond form obviously had been used in jurisdictions that did not require notice from those in privity with the general contractor.

Northeast Waste Sys. V. Connecticut Abatement Technologies, Inc., 27 Conn. L. Rptr. 263 (2000), another waiver case of sorts, also illustrates the need to carefully craft bond language for particular jurisdictions. In *Northeast,* a fourth tier subcontractor sued a second tier subcontractor's surety under Connecticut's public works bonding statute. The surety brought what looked like a very strong summary judgment motion, arguing that the bonding statute did not allow a fourth tier subcontractor, who was not in direct privity with the second tier subcontractor, to recover from that second tier subcontractor. The superior court agreed completely with the surety's argument, *but denied the motion anyway because the bond itself authorized payment to "any party" who furnished materials or labor on the project and who had not been paid.* In other words, the court ruled that the language of the surety's bond provided subcontractors and material suppliers a mode of recovery they would not have otherwise had under Connecticut's bonding laws. Needless to say, this surety has preserved a good appellate argument, but this unfortunate outcome could have been avoided with tighter language in the bond!

The Fourth Circuit's decision in *Food Lion, Inc. v. S.L. Nusbaum Ins. Agency, Inc.*, 202 F.2d 223 (4th Cir. 2000), makes clear the benefit of keeping a close eye on your adversaries in any bankruptcy case related, even tangentially, to surety claims. Food Lion engaged a contractor to construct four separate grocery stores. Food Lion required that the contractor post performance bonds. The contractor hired an insurance agent to help it locate a surety that would issue the bonds. When the agent was unable to find a surety to issue the bonds, it contacted a surplus line broker that was soliciting bonds on behalf of an allegedly unlicensed insurance company, American Diversified Insurance Co ("American"). American wrote the bonds for the grocery store project. Unfortunately, before completing the project, the contractor filed bankruptcy, and American failed to fulfill its performance bond obligation, leaving Food Lion with additional costs to complete the grocery store project.

Food Lion eventually sued the insurance agent in federal district court for its role in locating American. Food Lion, however, made a critical error. During the course of the contractor's bankruptcy case, Food Lion agreed to release its claim against the contractor's bankruptcy estate to settle a disputed claim. The district court granted summary judgment in favor of the insurance agent, finding that, by operation of law, Food Lion released its claim against the surety, American, and also released the agent, when it released its claim against the contractor's bankruptcy estate in the related bankruptcy case.

Judicial estoppel arguments like the one raised in *Food Lion* are often successful and often overlooked. Sureties should be sure that any attorney representing them in either federal or state court closely monitors bankruptcy dockets in related cases.

3. "Pay When Paid" Clause Defense

Several jurisdictions in the Southeast have recently upheld the enforceability of "pay when paid" clauses in a general contractor's contract with its subcontractors.

Unfortunately, a surety's right to raise a "pay when paid" defense has recently met with limited success in relevant state and federal courts.

Florida is one of the few jurisdictions to statutorily recognize a surety's right to provide a conditional payment bond on a private construction project, where its principal's contract contains a "pay when paid provision." Section 713.245(1) of the Florida Statutes provides in pertinent part:

> if the contractor's written contractual obligation to pay lienors is expressly conditioned upon and limited to the payments made by the owner to the contractor, the duty of the surety to pay lienors will be coextensive with the duty of the contractor to pay, if the bond contains on the front page, in at least 10-point type, the statement: THIS BOND ONLY COVERS CLAIMS OF SUBCONTRACTORS, SUB-SUBCONTRACTORS, SUPPLIERS, AND LABORERS TO THE EXTENT THE CONTRACTOR HAS BEEN PAID FOR THE LABOR, SERVICES, OR MATERIALS PROVIDED BY SUCH PERSONS. THIS BOND DOES NOT PRECLUDE YOU FROM SERVING A NOTICE TO OWNER OR FILING A CLAIM OF LIEN ON THIS PROJECT.

The Fourth District Court of Appeals recently declined to extend the "pay when paid" protection to a surety that had complied with section 712.245(1), where the surety's principal failed to include "pay when paid" clauses in its contract with its subcontractors. *North American Specialty Ins. Co. v. Hughes Supply, Inc.,* 705 So.2d 616 (Fla. 4th DCA 1998). Unfortunately, this case exposes one more area where sureties will have to watch over the shoulders of their principals when writing bonds in Florida.

In the Fourth Circuit, Highlands Insurance Company found itself in the exact opposite situation. In *Moore Bros. Co. v. Brown & Root, Inc.*, 207 F.3d 717 (4th Cir. 2000), Highlands attempted to assert a "pay when paid" defense to a subcontractor's payment bond claim based upon a "pay when paid" provision in its principal's contract with that subcontractor. Highlands failed, however, to include a "pay when paid" condition in its payment bond. Although the State of Virginia recognized a contractor's right to enforce a "pay when paid" clause, the Fourth Circuit predicted that the Virginia Supreme Court would not permit a payment bond surety to raise this defense when it failed to include any similar language in its bond. The court therefore affirmed a summary judgment against Highlands.

4. Improper Venue

Two state appellate courts recently handed down venue decisions relevant to sureties. In *Kerr Constr., Inc. v. Peters Contracting Inc.*, 767 So.2d 610 (Fla. 5th DCA 2000), a subcontractor filed suit against the general contractor in Florida state court, despite a provision of its subcontract requiring that the contract only be enforced in a Kentucky court. The surety moved to dismiss based upon the forum selection clause in the subcontract. The subcontractor argued that section 47.025, Florida Statutes, which became effective on October 1, 1999, vitiated the forum selection provision in the subcontract. Section 47.025 reads:

> [a]ny venue provision in a contract for improvement to real property which requires legal action involving a resident contractor, subcontractor, sub-subcontractor, or materialman . . . to be brought outside this state is void as a matter of public policy. To the extent that venue provision in the contract is void under this section, any legal action arising out of that contract shall be brought only in this state in the county where the defendant resides, where the cause of action accrued, or where the property in litigation is located, unless, after the dispute arises, the parties stipulate to another venue.

The trial court, however, disagreed with the subcontractor's assessment of section 47.025 and dismissed the cause of action shortly after it was filed.

Unfortunately for the surety, the court of appeals reversed, applying Florida law to determine that the subcontractor's forum selection clause was void under section 47.025. The court ruled that, because section 47.025 is procedural in nature and thus did not affect the parties' substantive rights, it could be applied retroactively to defeat the surety's argument.

With the advent of section 47.025, surety's bonding jobs in Florida, must now be conscious of the fact that they may be required to litigate bond claims in Florida, irrespective of the language contained in their bonds or the underlying contracts.

In a North Carolina case, involving a little Miller Act claim, the appellate court handed down a more surety "friendly" venue decision. In *McClure Estimating Co. v. H.G. Reynolds Co.,* 523 S.E.2d 144 (N.C. Ct. App. 1999), a subcontractor attempted to bring a payment bond claim against the surety in the county in which its warehouse was located. North Carolina's little Miller Act contained a venue provision, which required that a payment bond suit be brought in the county where the contract "or any part thereof" was to be performed. The subcontractor argued that venue was proper under this venue provision because it had performed "part" of its contract in the county where its warehouse was located.

The surety moved to dismiss for improper venue, arguing that the language of the venue provision was not subject to the subcontractor's suggested interpretation. The trial court sided with the subcontractor and denied the surety's motion to dismiss. However, the appellate court reversed, finding the subcontractor's interpretation of the venue provision unsupportable. The appellate court based its decision upon federal Miller Act cases, where federal courts had interpreted "any part thereof" to simply apply to construction projects that actually physically span more than one jurisdiction.

5. Discharge

The Montana District Court recently held that an owner's negligent overpayments to the contractor exonerated the surety from liability to the extent it was prejudiced. *Blackfeet Tribe of the Blackfeet Indian Reservation v. Blaze Construction, Inc.*, 108 F.Supp.2d 1122 (D. Mont. 2000). This is a decision that may prove useful to sureties making similar arguments in favor of discharge.

In a very detailed opinion, the *Blackfeet Tribe* court chronicled the events that led to the "negligent" overpayments. On a 72-home construction project, the owner disbursed all but $15,000.00 of $5,516,538.00, after only 51 homes were constructed. The uncontroverted testimony of the buildings and utilities chairperson was that he conducted detailed inspections of the work during the duration of the project and was responsible for authorizing payment. The court found that the owner had acted negligently in disbursing the overpayments and the surety's bonded obligation would be discharged *pro tanto.*

The *Cadle Co. v. Arborwood II Nominee Corp.*, 757 A.2d 791 (Md. Ct. App. 2000) decision will have very little practical application to the vast majority of you. However, to the extent any reader of this update is a private surety, i.e. bonding an obligation without compensation, this decision may be of some interest. On certified appeal from the Third Circuit, the court refused to follow the Third Restatement of Suretyship and Guaranty and continued to take the position that when a creditor grants the principal an extension of time for payment, without the consent of *the private surety*, the surety is discharged as a matter of law.

D. Attorneys Fees

Thankfully state courts continue to make it difficult for claimants to recover attorneys fees against sureties, absent clear statutory or contractual entitlement.

In *Sanfelippo Environmental Constr. v. Mews Cos.,* No. 98-2867, 2000 WL 665695 (Wis. Ct. App. May 23, 2000), a general contractor refused to pay a subcontractor for a line item it claimed to have completed itself. The subcontractor sued. At trial, the court determined that the subcontractor had completed 20% of the work on the line item, and the general contractor the other 80%. The trial courts, however, awarded the subcontractor its attorney's fees, finding that the subcontractor was the prevailing party on its claim under the subcontract. The court of appeals reversed and remanded, finding that the term "prevailing party" was ambiguous, and the subcontractor should get its fees only in proportion to its success on the issues in litigation.

In *Gibbs Constr. Co. v. S.L. Page Corp.,* 755 So.2d 787 (Fla. 2^{d} DCA 2000), an action against a surety, the court found that a subcontractor was not entitled to fees, unless its subcontract contained an attorney fee provision, or its subcontract expressly incorporated the general contract (which would obviously need to contain an applicable attorney fee provision). The Florida court apparently found the subcontractor's argument that its subcontract "impliedly" incorporated the general contract as flimsy as a hanging chad.

The Florida Supreme Court also handed down a victory for the handful of you writing automobile dealer surety bonds. Florida's high court has ruled that the Florida Unfair Trade Practices Act, which requires that automobile dealers post a bond to cover "any loss or damage," does not cover attorney's fees. *Hubbel v. Aetna Cas. & Surety Co., 758 So.2d 94 (Fla. 2000)*

The news was not all good. In *L & A Contracting Co. v. Ram Indust. Coatings, Inc.,* No. 99 CA 0354, 2000 WL 829362 (La. App. June 23, 2000), the court of appeals upheld

an attorney fee and cost award which exceeded the penal sum of the bond, where the surety obligated itself in the bond to pay for any loss, damage and expense, including costs and attorneys' fees.

III. THE SURETY'S FEDERAL PRE-EMPTION RIGHT

Although over the last few years federal courts have continued to narrow the scope of the ERISA preemption provisions, ERISA preemption remains a viable argument for the surety in some jurisdictions. In *IBEW Local Union No. 46 v. Trig Elec. Constr.*, 13 P.3d 622 (Wash. 2000) (en banc), a general contractor entered into a contract with the State to build state archives building at a community college. The surety issued a payment bond to protect all workers, mechanics, subcontractors and materialmen on the project. Under provisions of the Washington Public Works Act a union is allowed to collect pension contributions from a general contractor for its subcontractors' workers. In this case, a subcontractor failed to contribute a portion of its workers' wages to a qualified ERISA plan. The union then filed a lien notice against the contractor's bond and brought suit against the surety. The trial court granted a motion for summary judgment in favor of the surety, which was affirmed by the Washington Supreme Court. The high court, however, expanded the trial court's ruling, holding that ERISA pre-empted the Washington Public Works Act, and the union's foreclosure action along with it.[5]

On the opposite coast, the First Circuit was busy reaching a completely contrary conclusion in a similar employee benefits case. In *Carpenters Local Union No. 26 v. United States Fid. & Guar. Co.,* 215 F.3d 136 (1st Cir. 2000), a subcontractor failed to make contributions to a union employee fringe benefits plan in violation of its collective bargaining agreement. The union employees brought a claim against the bond in Massachusetts state court. The surety removed the action to federal district court, arguing that the bond statute upon which the union employees based their claim was preempted by ERISA. The district court denied the union employees' motion for remand.

On appeal, the First Circuit reversed and remanded. The court held that the bond statute did not "relate to" any ERISA plan for its operation. Therefore, ERISA did not preempt the bond statute and the claim was not properly removed to the federal court.

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[5] This decision was made in the face of *Blue Cross and Blue Shield Plans v. Traveler's Ins. Co.*, 514 U.S. 645 (1995) which had narrowed ERISA pre-emption in a similar context.