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INTRODUCTION

Over the last year, the surety law decisions have produced a little something for everyone. We have chosen to present just a few of the highlights. The cases have been separated by the topical areas of Equitable Subrogation, Fees, Proper Parties, Bad Faith, Conditions Precedent, and Miscellaneous areas of interest; Miller Act and state law cases are interspersed throughout.

I. Equitable Subrogation

The Delaware Chancery Court provided an excellent summary and review of the time-honored rights of the surety to contract funds in Travelers Cas. & Surety Co. of Am. v. Colonial Sch. Dist., 2001 WL 287482 (Del. Ch. Mar. 16, 2001). In Travelers, the contractor-principal fell behind in his payments to subcontractors on non-bonded projects, and executed promissory notes to the subs which were the subject of collection efforts. Ultimately, the subcontractors attached contract balances retained by two owners on projects bonded by Travelers. The attachments were received by the owners before the principal defaulted on the bonded jobs. After the default, Travelers undertook to complete the project and to pay claims of the subcontractors and suppliers. The owners, faced with competing claims to the contract funds, elected to retain the contract balances; Travelers then filed an action to enforce its priority to the contract funds.

Travelers moved for summary judgment, seeking a declaration that it was entitled to the funds because of: (1) its equitable subrogation rights; (2) its contract rights; and (3) general equitable principles. The owners and the non-bonded subs opposed Travelers' arguments on several grounds. First, while acknowledging that the surety was entitled to assert rights of equitable subrogation, they argued that Travelers' rights did not mature, and could not be asserted, at the earliest, prior to the contractor's default, and at the latest, at the time of completion of the project. Because the attachments were filed before default and completion of the project, their claims to the funds should enjoy priority. The defendants also opposed Travelers' arguments that the funds were held by the owner as a constructive trustee, and contended that to the extent any constructive trusts existed, they should encompass only a portion of the funds needed to pay subcontractors and material suppliers who submitted proper claims. The defendants disputed Travelers' contract claims, arguing that Travelers' rights to reimbursement from contract funds following performance did not amount to an enforceable contract claim to the disputed funds. Last, the defendants argued that the equities principles of "fundamental fairness" favored their position, contending that Travelers "assumed the risks" of its principal's financial condition, that Travelers should have exercised more diligence by investigating this condition prior to default, and that Travelers should have exercised its rights earlier.

The Court found in favor of the surety as to all theories and claims, and rejected each and every one of the defendants' arguments. Concerning the equitable subrogation rights, the Court confirmed that Travelers' rights were established when the bonds were issued, and not at any later date, so that the date of default or date of completion of the contract by the surety were irrelevant. The Court reaffirmed the basic proposition that a surety's equitable subrogation rights are superior to claims of general creditors, the contractor, the contractor's

receiver or trustee, and any assignee of the funds. The Court rejected the notion that a surety's performance must be complete before its claims to the funds would mature. Accordingly, the Court concluded that the attachments of the non-bonded subcontractors were unenforceable, inasmuch as the fund to which they purportedly "attached" was not the property of the general contractor, but rather belonged to the surety.

Concerning the contract claim, the Court had no difficulty concluding that Travelers had an independent and superior claim to the funds based upon the bond language and the language of the contract which was incorporated by the performance bond. Finally, the Court rejected the claimants' "fairness" argument, noting that both the owner and the non-bonded subs chose to do business with the general contractor, and to the extent any of the parties "assumed the risks" of the contractor's insolvency, Travelers was no more culpable than the owner and subcontractors.

The surety's equitable subrogation right to unpaid contract funds was also at issue in United States Fidelity & Guar. Co. v. APAC-Kansas, Inc., 151 F. Supp. 2d 1297 (D. Kan. 2001). There, the surety claimed its interest in contract balances and retainages owed to its principal and interpleaded by the obligee with the Court was superior to that of an assignee of a perfected secured party in the principal's accounts receivable. The Court agreed, although the surety had not perfected its rights under the Uniform Commercial Code (UCC). The Court's decision was based upon the surety's right of equitable subrogation which arises by operation of law and is not dependent upon any filing under the UCC, and further, according to the Court, gives the surety priority regardless of the date of issuance of its bonds. Citing a number of cases, the Court concluded that "[n]otwithstanding the chronology of execution of the surety bonds in relation to a bank's security interest in a contractor's accounts, upon default, the surety 'steps into the shoes' of the owner, while the bank's rights do not attach until the funds reach the contractor, giving priority to the surety." Id. at 1301.

Another case discussing the doctrine of equitable subrogation is In re Cone Constructors, Inc., 265 B.R. 302 (Bankr. M.D. Fla. 2001). In Cone, the dispute concerning priority to contract funds was between the surety which paid multiple payment bond claims following its principal's default and subsequent bankruptcy and the trustee of the principal's Chapter 7 bankruptcy estate. Relying upon Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962) and decisions from bankruptcy courts in Florida and elsewhere, the Court found that the surety, by virtue of the discharge of its bond obligations prior to its principal's bankruptcy, possessed a right of equitable subrogation to the remaining contract funds which was superior to that of the bankruptcy trustee. Where, as in Cone, the principal defaults and the surety steps into the principal's shoes by performing under the bond before the bankruptcy filing, the contract proceeds never actually become property of the debtor's estate, and therefore, the trustee has no right to the funds. In such instances, the surety should prevail, whether it pays claims or completes a project, or both, to the extent of its loss under the bonds.

In In re Steve A. Clapper & Assoc. of FL, 265 B.R. 460 (Bankr. M.D. Fla. 2001), the payment and performance bond surety of a debtor contracting business filed an action in the bankruptcy, requesting that the Bankruptcy Court compel the Trustee to turn over funds which it averred were not property of the estate. The funds were contract payments on two separate projects which had been earned and demanded while the debtor was still in Chapter 11,

before the case was converted to a Chapter 7, and before the owners had declared it in default of the projects. However, the funds were ultimately paid in to the Trustee after the Chapter 7 conversion. Meanwhile, upon default, the surety had paid substantial amounts for outstanding debts to the various subcontractors and suppliers, which far exceeded the amount of the disputed funds paid to the Trustee. The surety argued that the indemnity agreement made all funds payable to the debtor on the projects trust funds for the benefit of the surety. However, the Trustee argued, and the Court found, that because the debtor was not in default when the contract payments were earned and requested, the funds paid to the Trustee were fully earned by the debtor and constituted property of the estate under 11 U.S.C. §541(a), so that the surety's subrogation rights did not attach.[1]

In East Quincy Servs. Dist. v. General Accident Ins. Co. of Am., 88 Cal. App. 4th 239 (Cal. App. 2001), the Court held that, under California law, contract funds, otherwise available to the surety upon default of the principal, could be withheld to pay penalties for wage and overtime violations committed by the principal prior to default. The surety argued that once it undertook its principal's obligations under the contract, it was subrogated to the rights of the obligee that imposed the penalties and, therefore, should be able to set off its completion costs against any remaining contract funds. The Court rejected this argument and held that the surety assumed the defaulting contractors' obligations which included liability to the obligee for wages and overtime violations. The Court further held that the withheld funds were forfeited as soon as the violations occurred and, therefore, were no longer part of the contract balance.

II. **Fees**

The rights of an owner/obligee to recover attorneys' fees against the surety were the subject of a decision by the U. S. District Court for the Eastern District of Pennsylvania in North Am. Specialty Ins. Co. v. Chichester Sch. Dist., 158 F. Supp. 2d 468 (E.D. Pa. 2001). The Chichester case involved a school project. After default was declared and the contract terminated, the surety and the obligee were unable to agree on a method of completion, and the owner declined to execute a takeover agreement proposed by the surety. Nonetheless, the surety undertook to complete, using the services of an independent completing contractor. After completion and occupancy of the facility, the obligee raised numerous issues concerning the quality of construction and compliance with the plans and specifications; citing these problems, the owner refused to pay the contract funds to the surety.

The dispute was the subject of a bench trial which resulted in an award to the surety in the amount of $407,801.44, and an award to the obligee on its counterclaim in the amount of $166,524.63. The obligee then made a supplemental claim for attorneys' fees. The owner/obligee made two arguments: first, it claimed it was due fees under the terms of the contract, which listed "attorneys' fees" among the recoverable expenses which the contractor would owe if it defaulted. Interestingly, however, this argument was rejected; the Court,

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[1] Warning: Westlaw reported incorrectly that this decision was *reversed in part, and vacated in part*, in an unreported, unpublished opinion by the Eleventh Circuit Court of Appeals in Heidkamp v. Kelly, 273 F.3d 1112 (11th Cir. 2001). Actually, as accurately reported by Lexis, as of this date, there is no subsequent history for this opinion.

applying Pennsylvania law, decided that the performance bond, not the underlying contract, would govern and control the surety's liability, and rejected the owner's claims for fees under the contract.

The surety's victory celebration, however, was short-lived. Under the bond language, the owner's claim was deemed meritorious. The surety argued that it should not be responsible for attorneys' fees under the bond because: (1) the owner breached its duties and responsibilities with respect to payment of the contract balance; and (2) attorneys' fees should be recoverable only if the surety breached its obligations under the bonds. The Court rejected both arguments, finding that since the owner had established its entitlement to recovery of some funds under its counterclaim, it was also entitled to "reasonable attorneys' fees" resulting from the default. A separate evidentiary hearing was ordered to determine the final amount.

In United States, ex rel. Great Wall Constr., Inc. v. Mattie & O'Brien Mechanical Contracting Co., 2001 WL 127663(D. Me. Feb. 14, 2001), a case brought by a Miller Act payment bond claimant, the Court dismissed claims for attorneys' fees, interest and treble damages, all of which were based on state law claims separate and apart from the Miller Act claim. The plaintiff, a subcontractor to the Miller Act surety's principal, sued the principal and surety for amounts due for work performed on the bonded project. In addition to its claim under the Miller Act, the plaintiff brought claims under Maine's unfair settlement practices law and unfair trade practices law. Under the state law counts of its Complaint, the plaintiff did not seek any substantive relief, but rather sought only attorney's fees, interest and treble damages. Citing the United States Supreme Court's decision in F. D. Rich Co. v. United States, ex rel. Industrial Lumber Co., 417 US 116 (1974), the Court held that state law or policy does not determine whether an award of attorney's fees is proper under the Miller Act and that adding state penalties to the Miller Act claim would improperly expand the Miller Act claim.

An owner's claim for delay damages, liquidated damages and attorneys' fees was rejected by the Commonwealth Court of Pennsylvania in Downingtown Area Sch. Dist. v. International Fidelity Ins. Co., 769 A. 2d 560 (Pa. Cmmw Ct. 2001), where the performance bond's express language limited the surety's liability to completion costs. The underlying contract provided that the principal would be liable for liquidated damages for delay plus any other consequential losses that the owner might incur due to the delay. Although the performance bond incorporated the contract by reference, it also allowed the surety, upon default by the principal, to pay "the cost of completion less the balance of the contract price. . . ." Because the performance bond did not further obligate the surety to compensate the owner for claims it may have against the principal under the contract, the surety's liability was limited to the cost of completing the contract.

The Supreme Court of New Jersey in In re Estate of Lash, 776 A.2d 765 (N.J. 2001) held the surety liable for attorney's fees incurred in proceeding on an administrator's bond. There, the administrator of an estate misappropriated and converted estate funds to his own use. The estate later sought to recover the full penal sum of the bond, plus attorney's fees, interest and costs. The Supreme Court held that the estate was entitled to recover the fees incurred in pursuing recovery against the surety. In so doing, the Court applied a rule of tort

law to hold the surety liable: If as a result of a tort, a victim has to sue a third party, the victim may recover the expenses of that suit from the tortfeasor as an element of consequential damages. Given that the administrator's tortious breach of fiduciary duties caused the estate to sue the administrator's surety, the administrator was liable for the estate's attorney's fees in that action. Further, because the surety's liability is coextensive with that of its principal, the Court reasoned the surety should also be liable for such fees, even though the bond was silent concerning the recoverability of fees. Otherwise, according to the Court, an estate will not be made whole for an administrator's conversion of estate assets or breach of fiduciary duties. The good news is that the Court limited the surety's liability for interest to simple interest from the dates of the defalcations, as opposed to an "investment market rate" interest as requested by the estate.

III. Proper Parties

The Seventh Circuit Court of Appeals issued an unusual decision in U.S ex rel. Aldridge Elec. Co. v. Pickus Constr. and Equip. Co., 249 F.3d 664 (7th Cir. 2001). In Aldridge, the general contractor hired an electrical subcontractor to perform work at a Naval Training Center in Illinois. Both were bonded on the project in accordance with the Miller Act. Before the electrical work was completed, the subcontractor defaulted. Its surety hired another subcontractor to finish the project. Although the general contractor paid the surety the entire sum owed to the defaulted subcontractor, the surety and replacement subcontractor sued for extra expenses associated with the general contractor's project delay. After a bench trial, the district court found that the general contractor was not liable for any additional funds above what it had negotiated originally with the subcontractor. On appeal, the Seventh Circuit curiously focused mainly on the fact that the replacement subcontractor, who had been fully compensated by the defaulted subcontractor's surety, was not a proper party in the action. The Court criticized the district court for permitting the replacement subcontractor to remain in the case, for concentrating primarily on the replacement subcontractor in its findings of facts and for stopping the trial without hearing the defendants' case. The Court ultimately reversed and ordered a new trial before a different judge to determine what claims the defaulted subcontractor's surety had against the general contractor due to the project delay.

The United States District Court for the Southern District of New York also uncovered an improper party in Tri-State Employment Serv. v. The Mount Batten Surety Co., 2001 WL 487423 (S.D.N.Y. May 7, 2001). In Tri-State an employee leasing company sued a Labor and Material Payment Bond surety for breach of payment bonds, and seeking the amount due for "labor and material" allegedly provided to the principal in connection with the project. The Court recounted the language of the payment bonds, which defined labor and materials as including, "that part of water, gas, power, light, heat, oil, gasoline, telephone service or rental of equipment directly applicable to the contract." The Court also recognized that it could find no authority concerning whether an employee leasing company was a proper claimant under a labor and materials surety bond. It ultimately concluded that the employee leasing company's payroll and human resources services did not fall within the definition of "labor and materials" under the bonds, and granted summary judgment to the surety.

In Tri-State Ins. Co. v. Soderstrom's Sales & Serv., Inc., 2001 WL 316149 (Minn. Ct. App. April 3, 2001), the Court held that private citizens are entitled to recover under Minnesota

statutory bond which septic tank inspectors are required to hold. The bond states that the surety is "bound to the Commissioner of the Minnesota Pollution Control Agency - State of Minnesota and any other persons aggrieved by reason of the principal's failure to perform . . . all contracts entered into." The stated purpose of the statute is "to prevent, reduce, and eliminate water pollution and to provide for the preservation of water resources." The surety contended that, based upon the broad public purpose, the bond's coverage cannot apply to wholly private claims. Suggesting that to construe the bond in the manner proposed by the surety would ignore its stated terms, the Court held that private citizens may properly recover under the statutory bond.

IV. **Bad Faith**

In Continental Cas. Co. v. Paredes, 2000 WL 12903 (N.D. Tex. 2000), *aff'd*, 250 F.3d 743 (5th Cir. 2001), the surety filed suit seeking enforcement of the indemnity agreement and reimbursement from the individual defendants for losses it incurred from completing a project of the defendants' bankrupt contracting business. After the project owner had declared the contractors in default, the surety stepped in and negotiated a settlement with the owner, tendering a completion contractor and making substantial payments to the owner and unpaid suppliers. The surety then demanded that the defendants indemnify it for the losses it had incurred in accordance with the indemnity agreement, but the defendants refused. The United States District Court for the Northern District of Texas applied Texas law and upheld the indemnity agreement, granting the plaintiff's motion for summary judgment. It determined that the surety had an unqualified contractual right to settle the claim without a judicial determination of liability and the principal defendants were bound to reimburse the surety for amounts paid in settlement. Moreover, the Court recognized that since the indemnity agreement did not contain a "good faith" provision, and neither Texas law nor the Fifth Circuit has found any special relationship between a surety and its indemnitors, the defendants' claims of bad faith were invalid.

In Frontier Ins. Co. v. International, Inc., 124 F. Supp. 2d 1211 (N.D. Ala. 2000), the Court granted the surety's motion for summary judgment in an indemnification action with respect to amounts paid under two payment bonds issued on separate bonded projects. The Court noted that, absent a showing of fraud or a lack of good faith in the payment of claims which, in the suretyship context, "carries an implication of a dishonest purpose, a conscious doing of wrong, a breach of a duty through motives of self-interest or ill-will," id. at 1214, the surety is entitled to reimbursement from its indemnitors. Specifically, the Court rejected the indemnitors' contentions that alleged overpayments to payment bond claimants or purported inadequate investigation of claims by the surety constitutes bad faith. Citing various cases, the Court held that alleged excessive payments, negligence, bad judgment, and indeed, even gross negligence, do not rise to the level of bad faith. Moreover, actual liability under the bonds is not a prerequisite to the surety's right to reimbursement, so long as the surety has made payments under the good faith belief it was required to so pay.

The Superior Court of Delaware in International Fidelity Ins. Co. v. Delmarva Sys. Corp., 2001 WL 541469 (Del. Super. Ct. May 9, 2001), opined that a bad faith failure to respond to an obligee's performance bond claim could give rise to a tort action against a surety under Delaware law. In that case, the bonded contractor abandoned performance at the work site

and the obligee made a claim against the surety under the performance bond. The surety subsequently filed a declaratory judgment action regarding its rights and obligations under the bond, and the obligee counterclaimed for breach of performance obligations and bad faith.

The surety moved to dismiss the bad faith claim, which the Court denied. In so doing, the Court analyzed various cases from across the country which have considered the existence of bad faith claims in the surety context and concluded that the more compelling holdings were those in which the courts have recognized such claims. The Court found persuasive that the Delaware Code included sureties in the definition of "insurer," and further reasoned that because the Delaware Supreme Court had upheld bad faith claims in the first-party insurance context, bad faith claims against sureties should also be recognized.

V. Conditions Precedent

In Bank of Brewton, Inc. v. International Fidelity Ins. Co., 2002 WL 227934 (Ala. Feb. 15, 2002), the Supreme Court of Alabama upheld the entry of summary judgment in favor of the surety in an action by the Bank of Brewton, as obligee, under an AIA A312 performance bond. There, over a course of some ten months, the Bank copied, or wrote directly to the surety, a number of letters in which the Bank repeatedly complained and expressed dissatisfaction over the bonded contractor's work. The contractor, however, was never terminated, and the surety denied the contractor was in default or had materially breached the contract, or that the obligee had ever properly declared the contractor to be in default as required by paragraph 3 of the bond. The Supreme Court agreed that the obligee had failed to comply with the requisites set forth in paragraph 3 of the A312 bond, all of which are conditions precedent to the surety's obligations under the bond. Although the obligee made "many threats to declare a contractor default," id. at 18, there never was a default declaration in "clear, direct, and unequivocal language," id. at 17 *quoting* L&A Contracting Co. v. Southern Concrete Servs., Inc., 17 F.3d 106, 111 (5th Cir. 1994), sufficient to invoke the surety's obligations. Such a declaration "must inform the surety that the principal has committed a material breach or series of material breaches of the subcontract, and that the obligee regards the subcontract as terminated, and that the surety must immediately commence performing under the terms of its bond." Id. at 17-18, *quoting* L&A Contracting Co., 17 F.3d at 111. Because the Bank's efforts fell short of the requirements of the bond, the Court determined that the lower court properly granted summary judgment in favor of the surety.

By contrast, in DCC Constructors, Inc. v. Randall Mechanical, Inc., 791 So. 2d 575 (Fla.Dist.Ct.App. 2001), the Court, in interpreting the language of an AIA A311 performance bond, held that termination of the bonded subcontract was not a condition precedent to the surety's liability under that bond. Although the bond at issue conditioned the surety's obligations upon the principal's default and the obligee's declaration of the principal's default, there was no explicit requirement that the subcontract be terminated to trigger the surety's liability under the bond. The evidence in that case confirmed that the contractor repeatedly notified both the subcontractor and its surety that the subcontractor was in default, and that the contractor properly declared the subcontractor to be in default and indicated an intention to look to the surety to fulfill its obligations under the bond. Such actions, according to the Court, were sufficient to invoke the surety's obligations under the terms of the A311 performance bond. Termination of the subcontract was not required by the bond or the underlying subcontract, which the bond incorporated by reference.

In United States, ex rel. S & G Excavating, Inc. v. Seaboard Surety Co., 236 F. 3d 883 (7th Cir. 2001) the Court considered whether a sub-subcontractor must *expressly* demand payment from the contractor - principal in order to assert a claim against the Miller Act surety. Despite the fact that the sub-subcontractor had filed a Notice of Mechanics Lien in the proper municipal office and mailed a notice of the lien to the contractor, along with an itemized bill revealing exactly what work had been done, what compensation was sought, and the identity of the subcontractor that had hired it, the trial court dismissed the sub-subcontractor's claims because it did not demand *explicitly* that the general contractor pay the amount owed by the subcontractor. The appellate court reversed the trial court's decision and held that the Miller Act requires only three conditions for payment under bond: (1) Notice must be given within ninety (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."

Recognizing that five federal circuits (First, Second, Fifth, Ninth and Eleventh) have required that the notice must inform the contractor, either expressly or by implication, that the subcontractor wants the general contractor to pay the bill, the Court questioned when notice to a contractor stating the amount claimed and the identity of the subcontractor would *not* be an "implied" demand for payment.

The Alabama Supreme Court recently affirmed summary judgment for a subcontractor in an action for the recovery of retainage due under a labor and material payment bond, holding that neither the owner's termination the contract before the subcontractor could complete performance, nor the "pay-when-paid" clause in the subcontract precluded recovery. Federal Ins. Co. v. I. Kruger, Inc., 2002 WL 399039 (Ala. Mar. 15, 2002). In Federal, the Court confirmed that the subcontractor's claim was governed by Alabama's "Little Miller Act", ALA. CODE § 39-1-1 (1975), and rejected the contractor's and surety's arguments that all of the conditions specified in the payment clause of the subcontract had not been met. The Court noted that although the subcontractor had notified the contractor that it was ready to perform the final aspects of the subcontract, the contractor never allowed the subcontractor to complete performance because the owner had prematurely terminated the general contract. The Court determined that because the subcontractor was, through no fault of its own, prevented from completing the requirements of the subcontract, it was excused from further performance and was not prevented from recovering under the payment bond. The Court also rejected the contractor's and surety's arguments that the "pay-when-paid" clause in the subcontract was a condition precedent to the general contractor's payment of the retainage, and instead held that the clause was merely a timing mechanism for final payment under the subcontract. It specifically noted that the subcontractor had never assumed the risk of nonpayment of the retainage by the owner, and that the majority of other jurisdictions construed the "pay-when-paid" clause in a similar fashion. Finally, the Court also affirmed summary judgment against the surety on the alternate ground that the existence of a "pay-when-paid" clause in a subcontract is not a valid defense for a surety to claims made under the payment bond.

VI. **Miscellaneous**

A. Arbitration

In Employers Ins. of Wausau v. Bright Metal Specialties, Inc., 251 F. 3d 1316 (11th Cir. 2001), the Court held that a Miller Act surety can be compelled to arbitrate a payment bond claim brought by a subcontractor to its principal. After the principal defaulted on the bonded contract, the surety executed a Takeover Agreement with the government whereby the surety assumed all duties and responsibilities of its principal and agreed to complete the project. The surety also entered into a Ratification Agreement with the subcontractor whereby the subcontractor ratified and agreed to complete the subcontract it had entered into with the principal. The subcontract contained an arbitration clause.

The Court held that, by executing the Takeover Agreement, the surety "stepped into the shoes" of its principal and became obligated to any contractual provisions previously negotiated between the principal and its subcontractor. Also, the Court concluded that the Ratification Agreement bound the surety to all provisions of the subcontract, including the arbitration provision. Importantly, the Court further held that the Miller Act does not preclude arbitration under the Federal Arbitration Act where the parties have previously agreed to arbitrate their disputes.

There is a well-reasoned dissent which indicates that the surety should not be bound by the arbitration provision because the only agreement between the surety and the subcontractor is the Ratification Agreement which does not expressly provide that the surety is bound by the terms of the subcontract, but does provide that the subcontractor will look only to the completing contractor for all further payments under the subcontract.

B. Third Party Liability

A 2001 opinion by the First Circuit Court of Appeals concerning the extent of an accountant's liability to third parties has likely attracted special attention considering the recent Arthur Andersen LLP and Enron Corp. debacle. In North Am. Specialty Ins. Co. v. Lapalme, 258 F.3d 35 (1st Cir. 2001), a three-judge panel Court of Appeals affirmed the decision of the United States District Court for the District of Massachusetts, which granted summary judgment to an accounting firm and one of its principals in a suit by a surety for negligent misrepresentation and deceptive trade practices. In Lapalme, the surety's complaint essentially alleged that but for the defendants' omission of information from the principal's annual financial statement concerning the principal's change of ownership, it would not have continued furnishing bonds to the principal, and thus would not have incurred the ensuing losses from the principal's default. The Court of Appeals relied upon Massachusetts law and the Restatement (Second) of Torts § 552 pertaining to a professional's liability to third parties, and held that an accountant was liable for negligent misrepresentation to those third parties who the accountant actually knows would rely upon the supplied information for a specific transaction, or in a transaction that is the same as, or substantially similar to, such transaction. The Court determined that the accountants did not actually know, when they released the financial statement, that the surety would use the statement to write new bonds in the coming year, and that the bonds issued by the surety after the financial statement was released did not constitute transactions that the accountants actually sought to influence, or alternatively,

substantially similar transactions. Finally, the Court found that the accountants' exposure related only to the bonds which had already been issued before the financial statement was released, and upheld summary judgment in favor of the defendants.

C. Statute of Limitations

In United States v. American States Ins. Co., 252 F.3d 1268 (11th Cir. 2001), the Eleventh Circuit Court of Appeals held that the statute of limitations contained in 28 U.S.C.§ 2415(a) barred the federal government's suit against a Miller Act surety for costs of completion. The government had contracted with the principal in 1984 for the renovation of military housing at Eglin Air Force Base, Florida. Pursuant to the Miller Act, the defendant surety had issued a performance bond on behalf of the principal. The government subsequently terminated the principal, but the surety determined the termination was wrongful. The government ultimately employed a replacement contractor, which completed the project in excess of the contract price. In July 1992, the government's contracting officer demanded that the principal and surety reimburse the government for these excess costs, but they refused. In July 1995, the contracting officer issued a final decision demanding the same amount. In November 1999, the government finally sued the surety to recover the excess costs demanded by the contracting officer four years earlier. The district court denied the surety's motion to dismiss on limitations grounds, and entered summary judgment for the government, holding that the surety was bound by the contracting officer's decision.

On appeal, the Eleventh Circuit applied 28 U.S.C.§ 2415(a), which provides that the statute of limitations for every action for money damages brought by the government is six years from the accrual of the cause of action, or one year from a final decision in an administrative proceeding, whichever is later. The Court found that section 2415(a) governed because the decisions of contracting officers are not considered judgments exempted from statutes of limitation, this was not a valid Contract Disputes Act claim, and the lawsuit was essentially a suit for breach of the surety agreement, for which the government was a third party beneficiary. The Court rejected the government's argument that it should be allowed six years from the contracting officer's final decision to sue; it instead held that because the government did not sue within six years from the contracting officer's original demand for reimbursement in July 1992, or within one year from contracting officer's final decision in July 1995, section 2415(a) barred the government's lawsuit. The Court then reversed the district court's summary judgment, and remanded with judgment to be entered in the surety's favor.

D. "Reasonable Promptness"

In St. Paul Fire & Marine Ins. Co. v. City of Green River, Wyo., 93 F. Supp. 2d 1170 (D.Wyo. 2000), the Court held that the performance bond surety would not be in material breach of its obligations if it failed to complete a project by the completion deadline date set forth in the underlying contract. In that case, the owner declared the principal in default, and the surety exercised its option, under the bond, to complete the project. The performance bond required the surety to act with "reasonable promptness." After the surety announced that it anticipated completing the project approximately nine months after the completion deadline of the contract, the owner refused to allow the surety to take any further action to complete the project. The surety filed a declaratory judgment action and moved for summary judgment. The Court held that, although the surety was bound by the "time is of the essence" clause and

completion deadline, and would be liable for liquidated damages caused by the principal's delay, in the accordance with the terms of the bond, it would not be in breach of the performance bond if the project was not completed on the construction deadline, so long as the surety did in fact proceed with reasonable promptness in completing the project. Furthermore, the Court held that the owner's refusal to allow the surety to exercise its right to complete the project was a material breach of the performance bond which discharged the surety of any further obligations under the bond.

E. Bankruptcy

In In re Wright, 266 B.R. 848 (Bankr. E.D. Ark. 2001), the Bankruptcy Court found the Chapter 7 individual debtors' obligation under an indemnity agreement for payment and performance bonds to be nondischargeable. Id. at 852. Previously, after the debtors' contracting business had defaulted on several projects, the surety had been forced to pay all outstanding balances to the laborers and subcontractors. However, when the debtors ultimately filed for Chapter 7 bankruptcy relief, they failed to list the surety as a creditor. Meanwhile, the surety, unaware of the bankruptcy proceeding or the debtors' resulting discharge, sought reimbursement from the debtors under the indemnity agreement. The debtors then reopened their bankruptcy case and sought an adjudication that the surety's debt was already discharged. The Bankruptcy Court found that, pursuant to 11 U.S.C. §523(a)(3), because the debt was neither listed nor scheduled, the debt was not automatically discharged when the case was closed; however, the debtor had the right to reopen the case and seek a determination as to the dischargeability of the unlisted obligation. The Court then determined that the debt was, in fact, non-dischargeable. The Court explained that under 11 U.S.C. §523(a)(4), if a debtor breaches a fiduciary duty by misappropriating trust funds or failing to account for the funds, this constitutes a defalcation for which a debtor cannot be discharged. Fortunately, the indemnity agreement between the parties had contained an express trust provision, which the debtors had effectively breached by spending the funds for other than trust responsibilities; thus, the debt was held to be non-dischargeable.