

**FOURTEENTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
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RECENT DEVELOPMENTS IN SURETY LAW

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This paper is presented to briefly highlight some of the significant surety law issues that have arisen in reported federal and state court cases decided during 2002. It would be

impossible to discuss each and every 2002 case that involved surety law issues, and the paper does not pretend to do so. For the sake of clarity, this paper is divided into four sections – Federal Contracts, State Law Contracts, Surety’s Rights, and Procedure.

I. FEDERAL CONTRACTS

A. Completing Surety’s Claim Against Government

Firemen’s Fund Ins. Co. v. Secretary of Navy, 313 F.3d 1344 (Fed Cir. 2002).

The United States Navy entered into a contract in 1988 with Summit General Contracting Corp. (“Summit”) to construct a building. Firemen’s Fund was the surety and provided performance and payment bonds. The government terminated the contract for default on January 16, 1990, after Summit failed to complete the contract by the scheduled date. Demand was made upon the surety.

On April 17, 1990, the government and Firemen’s Fund entered into a takeover agreement under which Firemen’s Fund agreed to complete the contract. Summit was not a party to the takeover agreement.

Firemen’s Fund submitted a claim to the contracting officer seeking an adjustment of liquidated damages based upon delays and performance costs by the government, both before and after the takeover agreement. The contracting officer denied all claims, and Firemen’s Fund appealed to the Board of Contract Appeals. The board dismissed the claims that arose before the takeover agreement on a procedural motion. Because Firemen’s Fund was not a “contractor” under the Contract Disputes Act, it had no standing to invoke the act to assert those claims and the board thus lacked jurisdiction. The board ruled that Summit’s assignment of its claims to Firemen’s Fund in the general indemnity agreement was not enforceable under the Anti-Assignment Act, and further rejected Firemen’s Fund’s claim of equitable subrogation, finding the doctrine to be inapplicable. Firemen’s Fund appealed.

The United States Court of Appeals for the Federal Circuit turned its attention first to the effect of the Anti-Assignment Act. The applicable statute governing the assignability of federal contracts is the Assignment of Contracts Act, 41 U.S.C. §15 (hereinafter “The Act”). The Act prohibits “transfers” of government contracts and was designed to protect the government from conflicting claimants in multiple liability. *Martin v. National Surety Co.*, 300 US 588 (1937). Its sister act, the Assignment of Claims Act, 31 U.S.C. §3727 prohibits the assignment of claims except under certain circumstances. The case law interpreting both acts is identical, and both contain an exception for assignment of contracts/claims to financial institutions to give contracting parties the financial freedom to attain financing. *General Casualty Co. of America v. Second National Bank of Houston*, 178 F.2d 679 (5th Cir. 1949).

Courts have held that a surety does not qualify as a lending institution so the exception does not apply. *Id.* In examining this issue, the Court of Appeal noted this jurisprudence and correctly cited it as binding precedent.

The Court of Appeal noted, without much discussion, that the assignment was contained in the general indemnity agreement which was not referenced in the takeover agreement

between Firemen's Fund and the government. Though not explicitly set forth, this probably was raised in the context of case law holding that the government can choose to recognize an assignment. *Tufco Corp. v. United States*, 614 F.2d 740 (Ct. Cl. 1980). By failing to include an acknowledgment of assignment in the takeover agreement, the surety failed to obtain the government's consent.

Firemen's Fund also attempted to avoid the Anti-Assignment Act by invoking its rights of equitable subrogation. Firemen's Fund argued that as a surety that had taken over performance of a government contract, it could assert a claim against the government under that contract in a capacity as "contractor" under the Contract Disputes Act. This argument was also rejected by the Court of Appeal. The court found that the surety's equitable subrogation rights did not make it a "party" to any contract with the government prior to the takeover agreement it had with the government. As a result, the Board of Contract Appeals had no jurisdiction to hear the equitable subrogation claims. In short, the court held that equitable subrogation claims are not barred by the Anti-Assignment Act, but that the Board of Contract Appeals had no jurisdiction to hear such claims. Accordingly, it affirmed the decision of the Board dismissing the pre-takeover contract claims.

B. Pay If Paid Clauses

United States for the Use and Benefit of Walton Technology, Inc. v. West Star Engineering, Inc., 290 F.3d 1199 (9th Cir. 2002).

The United States Navy entered into a contract with West Star Engineering, Inc. to repaint navy hammerhead crane No. 28 in Bremerton Washington. In compliance with the Miller Act, West Star obtained a payment bond from Reliance Insurance Company. West Star's subcontracted with Walton to rent a fabric and frame shroud called the "sale system" to cover the crane as the work proceeded. The agreement between West Star and Walton was set forth in a purchase order with an addendum.

The parties had a falling out and within six months, Walton filed suit in federal court alleging that West Star had breached the agreement by failing to make timely payments. West Star and Walton thereupon entered into settlement negotiations. While those negotiations were pending, the sale system was damaged in a series of incidents, and West Star's corporate parent presented a damage claim to its insurer.

On January 13, 1997, Walton and West Star executed a settlement agreement modification which provided the continuation of the rental period for the sale system, and the settlement of all existing disputes and lawsuits, including the breach of contract claim. West Star paid Walton the sum of \$62,000.00 in full settlement of all disputes and lawsuits existing at the time and in full payment of monthly rental for the sale system through January 31, 1997. Finally, the settlement agreement provided that, although the rental of the sale system would continue, future payment of rental fees would be subject to the following provision:

...further payment to Walton for ... rental shall only be made when and if paid by the Navy and only to the extent paid by the Navy....

Walton furnished the sale system for West Star's use through the end of 1997, but made no further rental payments. Instead, rental invoices were sent to the insurer for payment. The insurer actually reimbursed West Star in full for all sums that West Star claimed it owed to Walton, including the rentals. These funds did not find their way to Walton.

As a result, Walton filed a Miller Act suit against West Star and its surety, Reliance. Astonishingly, the Ninth Circuit affirmed the district court's dismissal of Walton's unjust enrichment and conversion claims against West Star, but found Reliance liable under the Miller Act.

Reliance quite properly argued that the "pay when and if paid" clause in the settlement agreement had not been satisfied, as West Star was never paid by the Navy. Accordingly, Reliance argued that there are no "sums justly due" for which Walton is entitled to recover under the Miller Act. Reliance pointed out that as surety, its liability was co-extensive with that of its principal. The court found that in the context of Miller Act cases, it was necessary to look beyond the principal's contractual liability, to the Miller Act itself to define the limits of liability. Ignoring the fundamental premise that a surety guarantees another's debt, the court held that the subcontractor's right of recovery on a Miller Act payment bond accrues ninety days after the subcontractor completes its work not "when and if" the prime contractor is paid by the government. The court found that the "when and if paid" clause did not constitute a valid waiver of Walton's Miller Act rights.

Judge Trott's dissent cogently describes the problem:

This case stands for the peculiar proposition that a Miller Act surety is liable to the subcontractor on a Miller Act payment bond even though the bonded principal owes nothing to that subcontractor. Although Judge Paez makes a good case for this result, the holding here appears to stand the general rule of suretyship law on its head. It is a cardinal rule of the surety/principal relationship that a surety occupies the shoes of its principal and "may avail himself of any defense" available to the principal other than those that are purely personal, such as bankruptcy or infancy....

Here it is as clear as the difference between chalk and cheese that West Star is not liable to Walton for the dispute itself. Why? Because Walton expressly agreed for good and sufficient consideration – \$62,000.00 – in a written and signed settlement and release agreement that "any further payment to Walton for the framing and fabric rental shall only be made when and if paid by the Navy and only to the extent paid by the Navy."

II. STATE LAW CONTRACTS

A. Liability for Tax Debt of Principal

Island Insurance Company Limited v. Hawaiian Foliage and Landscape, Inc., 288 F.3d 1161 (9th Cir. 2002).

Oahu Construction Co. (“Oahu”) contracted with the city and county of Honolulu to build a golf course. The landscaping work was subcontracted by Oahu to Hawaiian Foliage and Landscape, Inc. (“Hawaiian”). Hawaiian obtained a subcontractor performance and payment bond from Island Insurance Co. (“Island”). Hawaiian defaulted on the subcontract, and Island paid a number of Hawaiian’s obligations. Island refused, however, as surety, to pay Hawaiian’s tax debt to the United States and to Hawaii. Instead, it sought a declaratory judgment holding it not liable for such taxes. The governments filed counter claims, and the surety moved for summary judgment. The district court granted the surety’s motion, holding that these debts were not within the scope of the surety’s obligation. The Ninth Circuit reversed.

Ignoring for the moment the fact that neither the United States nor the State of Hawaii were obligees under the bond, the Ninth Circuit decided to analyze the surety’s obligation. It started with the subcontractor, which mentioned taxes in two places. The first sentence of Article One of the subcontract states:

Subcontractor agrees to pay in full for all labor, materials, equipment, supplies, superintendents, insurance, *taxes* and other items used in, upon, or for the work called for in this agreement.

Article 14 of the subcontract states:

Subcontractor agrees to pay any and all *taxes* and contributions for unemployment insurance, old age retirement benefits and life pensions and annuities which may now or hereafter be imposed by the United States or any state or local government upon any wages, salary or remuneration.... and save Oahu harmless from the payment of any and all such *taxes* and contributions or penalties.

The court found it “apparent” from these two passages that the subcontract required the subcontractor to pay its payroll taxes.

The court then turned its attention to the bond. The bond stated:

Now, therefore, if the said principal shall duly and truly perform and complete said subcontract and pay for all materials used in the performance of same and shall hold the said obligee free and harmless from and against all claims for any and all labor and materials used in the performance of said subcontract ... then this obligation shall be null and void

The court found that the bond lists three conditions in parallel, the breach of any of which would create an obligation on the part of the surety, and that the first of these conditions was the performance of the subcontract. As the bond incorporated the entire subcontract, the payment of federal and state taxes was one of the bond's conditions for discharge. In the words of the court, "the subcontractor was bound to pay its taxes, the surety insured the subcontractor's obligations under the subcontract, and so the surety is now bound to pay the taxes the subcontractor defaulted upon." Having reached this conclusion, the court was no longer troubled by the fact that the governmental entities were not obligees on the bond. "Once we accept that the surety was bound to cover the subcontractor's tax obligations, it follows that the federal and state governments are intended beneficiaries of the surety contract." Accordingly, they had the right to force the surety to pay these taxes.

In a strong dissent, Judge O'Scannlain noted that the only identified and intended beneficiary of the bond was Oahu. It further noted that the purpose of bond was to protect Oahu from subcontractor default. The subcontract required Hawaiian to "save Oahu harmless from the payment of any and all taxes," and the dissent correctly found that this was the scope of Island's obligation. In conclusion, the dissent stated:

"Here, the majority interpretation is inequitable and unusual, and it certainly does not describe a contract into which reasonable men and women would likely enter."

B. Creation of Trust Fund by Surety

In *Eastern Steel Constructors, Inc. v. St. Paul Mercury Insurance Co.*, Nos. 972, 973, 989, 1003, 1037 WDA 2001 (Pa. Super. Ct. 8/2/2002) (unpublished opinion) ("*Eastern Steel*"), the Pennsylvania Superior Court addressed several issues of interest to sureties. Of particular note, the court held that the creation by the principal and the surety of a joint trust account was a fraudulent transfer rendering the surety liable to a subcontractor for breach of trust.

Whipple-Allen, as contractor, entered into a contract with Barton Mallow Company for the construction of a building for the St. Vincent Health Center ("Project"). St. Paul Mercury Insurance Co. ("St. Paul") issued, among other bonds naming Whipple-Allen as principal, a payment bond ("Bond") in connection with the Project. Whipple-Allen subcontracted a portion of the work to Eastern Steel Contractors, Inc. ("Eastern Steel").

Eastern Steel completed its work on the Project and sought payment in the amount of \$38,799.72, representing retainage and additional work. Whipple-Allen failed to pay Eastern Steel, and Eastern Steel filed a demand for arbitration against Whipple-Allen, claiming damages for "retainage, anticipated net income, delay damages, unpaid extra work, interest, legal fees, expert witness fees and office/staff costs." While the arbitration was pending, Eastern Steel notified St. Paul of a claim for \$40,456.62 for retainage and additional work. The arbitrators awarded Eastern Steel a lump sum of \$220,533.72, which was subsequently increased to include post-judgment attorneys' fees and interest.

Whipple-Allen's financial condition continued to deteriorate during and following the pendency of the arbitration. Whipple-Allen and St. Paul began discussing plans to permit

Whipple-Allen, with St. Paul's assistance, to complete the various projects bonded by St. Paul, and, shortly after the judgment confirming the arbitration award was entered, Whipple-Allen and St. Paul created a joint trust account ("Trust Account").

After the arbitration award was confirmed, Eastern Steel sent a claim to St. Paul for \$220,533.72, the full amount of the arbitration award. St. Paul refused to pay this amount, and Eastern Steel then filed suit against St. Paul. Shortly thereafter, Eastern Steel sent a summary of its damages to St. Paul. St. Paul then tendered a check in the amount of \$38,799.72, the original amount claimed by Eastern Steel, but Eastern Steel rejected the tender offer.

At the close of the trial, the jury awarded Eastern Steel \$146,069.00 for labor and \$38,799.93 for retainage (for a total of \$183,868.93). The jury additionally found that the Trust Account was created for an illegal purpose and that St. Paul's conduct in creating the Trust Account was "outrageous"; therefore, St. Paul was held liable for "breach of trust" under the Pennsylvania Fraudulent Transfer Act, 12 Pa. C.S.A. § 5104 (Transfers Fraudulent as to Present and Future Creditors). The jury awarded an additional \$260,000.00 in punitive damages.

Both Eastern Steel and St. Paul appealed. On appeal, Eastern Steel argued that several aspects of the trial court's ruling were erroneous. Specifically, Eastern Steel argued that St. Paul had acted in bad faith under 42 Pa. C.S.A. § 8371 (Actions on Insurance Policies); that the full amount of the arbitration award against Whipple-Allen should have been binding on St. Paul; that St. Paul should have been found liable for prejudgment interest and attorneys' fees; and that, under a constructive trust theory, St. Paul should have been found liable for the full \$220,533.72 awarded by the arbitrator, as opposed to the \$183,868.93 awarded by the jury. St. Paul, on the other hand, argued that it should not have been found liable for breach of trust; that it should not have been liable for punitive damages; and that it should not have been found liable for any sum in excess of \$38,799.93 because such claims were not properly asserted and because such sums were not covered under the Bond. The *Eastern Steel* court affirmed the trial court on all issues.

Bad Faith. Eastern Steel first asserted that the trial court should not have dismissed its claims against St. Paul under 42 Pa. C.S.A. § 8371 (Actions on Insurance Policies), under which the court may award extraordinary damages when an insurer has acted in bad faith. The court first noted that no Pennsylvania appellate court has considered the question of whether a surety contract is an "insurance policy" within the meaning of the statute. However, the *Eastern Steel* court relied on a recent decision of the United States District Court for the Eastern District of Pennsylvania, *Superior Precast, Inc. v. Safeco Insurance Company of America*, 71 F. Supp. 2d 438 (E.D. Pa. 1999), in which the court held that because there was no direct contractual relationship between the surety and the claimant, such as is found between an insured and an insurer, the extraordinary damages available under Section 8371 were not "logically consistent." The *Eastern Steel* court thus upheld the trial court's refusal to entertain Eastern Steel's claims under Section 8371.

Enforceability of Arbitration Award. Eastern Steel next asserted that the federal court judgment confirming the arbitration award as to Whipple-Allen should have been binding in its entirety on St. Paul. The Bond provided that St. Paul would pay for "labor, materials and equipment." According to the court, because the lump sum arbitration award satisfied Eastern

Steel's claims for "contract damages, retainage, payment for extra work, interest, attorneys' fees and costs," some of which are obviously not "labor, materials and equipment," the arbitration award could not be used to establish St. Paul's liability. The court further noted that the arbitration provision in the subcontract was not enforceable as to St. Paul because it was not a party to that agreement.¹

Eastern Steel additionally complained that the court limited its constructive trust remedy by holding St. Paul liable for only \$183,868.93, rather than the full amount of \$220,533.72 for which Whipple-Allen was found liable. Again, the court reiterated that St. Paul could only be held liable for damages which were covered under the language of the Bond, *i.e.*, "labor, materials and equipment."

Breach of Trust. St. Paul also argued that the trial court should not have found it liable for breach of trust under the Pennsylvania Fraudulent Transfer Act, 12 Pa. C.S.A. § 5104 (Transfers Fraudulent as to Present and Future Creditors). Section 5104(a) provides, in pertinent part: "A transfer made . . . is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer . . . with actual intent to hinder, delay or defraud any creditor of the debtor. . . ." The statute also sets forth the following eleven nonexclusive factors to consider in determining actual intent:

- (1) the transfer or obligation was to an insider;
- (2) the debtor retained possession or control of the property transferred after the transfer;
- (3) the transfer or obligation was disclosed or concealed;
- (4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
- (5) the transfer was of substantially all the debtor's assets;
- (6) the debtor absconded;
- (7) the debtor removed or concealed assets;
- (8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
- (9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

¹ *Eastern Steel*, at 6 (quoting *Cumberland-Perry Area Vocational-Technical School Authority v. Bogar & Bink*, 396 A.2d 433, 435 (Pa. Super. Ct. 1978); see also *Juniata Valley Bank v. Martin Oil Co.*, 736 A.2d 650 (Pa. Super. Ct. 1999)).

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.²

Applying these factors, the court found that the jury could have concluded that the creation of the Trust Account was a fraudulent transfer. In support of its conclusion, the court noted that the Trust Account was created only after the federal judgment in favor of Eastern Steel had been entered and that Whipple-Allen's financial difficulties made payment of subcontractors and suppliers on the various projects bonded by St. Paul unlikely. The court additionally found several pieces of St. Paul correspondence particularly damning. For example, in a letter to Whipple-Allen's president, counsel for St. Paul expressed concern over Eastern Steel's ability to levy on Whipple-Allen's bank accounts, equipment, and receivables. In a second letter, counsel for St. Paul explained the need for the Trust Account as follows:

[I]t would be useful if the funds were trust funds and if St. Paul had advanced funds on each of those contracts in the amount of any remaining contract balances, so that it could argue that it has a priority claim to those contract funds ahead of Eastern Steel. . . . The argument is, of course, subject to the counter argument that funds advanced are not payments under the payment bond. But, at least it's an argument **The issue is the protection of those funds from claims by Eastern . . . and the characterization of those funds as trust funds** never coming into the possession of Whipple-Allen. . . .

The court thus concluded that the creation of the Trust Account was a breach of trust and a fraudulent transfer under Section 5104.

Punitive Damages. St. Paul also asserted that punitive damages were not proper because it should not have been held liable for breach of trust, because St. Paul did not commit any tort, and because St. Paul's conduct was neither willful nor malicious. According to the court, "[t]he purpose of punitive damages is to punish outrageous and egregious conduct done in a reckless disregard of another's rights; it serves a deterrence as well as a punishment function. Therefore, . . . a court may award punitive damages only if an actor's conduct was malicious, wanton, willful, oppressive, or exhibited a reckless indifference to the rights of others. . . . Conversely, punitive damages may not be awarded for misconduct which

² 12 Pa. C.S.A. § 5104(b).

constitutes ordinary negligence such as inadvertence, mistake and errors of judgment.”³ Finding that St. Paul was liable for breach of trust under Section 5104 and that it thus had indeed committed a tort, the court concluded that punitive damages were warranted. In addition, quoting St. Paul’s counsel (“The issue is the protection of those funds from claims by Eastern . . . and the characterization of those funds as trust funds never coming into the possession of Whipple-Allen.”), the court found that St. Paul’s conduct was both willful and malicious, rendering punitive damages appropriate.

Conclusion. The *Eastern Steel* decision places tort liability on the surety for exercising a common protective strategy. When the principal on several bonded projects experiences financial difficulty, the surety is faced with losses on every side—it often must finance the contractor to insure completion of the projects or take over the projects itself, and it must insure that suppliers and subcontractors who have valid claims under the bonds are paid. If contract funds remain outstanding, the surety obviously desires that such funds be used to minimize its losses. To protect the funds from depletion by the principal, it is not unusual for the surety, before financing the contractor’s operations, to insist that remaining contract balances be placed in a joint trust account. Generally, these funds are then used to pay subcontractors and suppliers on the projects. This appears to be the exact scenario which occurred in *Eastern Steel*.

The *Eastern Steel* court apparently found that the placement of the contract funds in the Trust Account was a fraudulent transfer because one of the surety’s reasons for creating the Trust Account was to protect the funds from recovery by Eastern Steel. However, St. Paul did not attempt to deny all recovery to Eastern Steel. It tendered the amount to which it believed Eastern Steel was entitled under the Bond. Further, the surety’s desire that the contract funds be viewed as trust funds which had never come into Whipple-Allen’s hands is a purely legal argument, and one which has often been raised successfully by sureties. To find that St. Paul acted willfully and maliciously in considering that argument is unwarranted, and the court’s award of punitive damages against St. Paul for its counsel’s legal strategizing is untenable.

The *Eastern Steel* decision is unreported and may not, with some very limited exceptions, be cited in support of or against an argument before the courts. However, it demonstrates the dangers which beset the construction surety. There is a delicate balance between the surety’s rights and the rights of claimants under the bond, and the big bad surety must be wary lest its legal strategizing be misconstrued as an unforgivable infringement of the rights of the little fish.

C. Bad Faith Claim by Principal

Master Clean v. Star Insurance Company, 556 S.E. 2d 371 (S.C. 2001).

³ *Eastern Steel*, at 14-15 (quoting *Hall v. Jackson*, 788 A.2d 390, 403 (Pa. Super. Ct. 2001)).

In this case, the University of South Carolina contracted with Master Clean to remove asbestos from one of its buildings. Master Clean obtained a performance bond from Star Insurance Company to insure performance. The University notified Star of Master Clean's default and made a claim on the bond. Star concluded that Master Clean defaulted on the contract, but refrained from deciding the claim pending negotiations with the University. The University hired a replacement contractor to complete the project.

Thereafter, the South Carolina Chief Procurement Officer issued a ruling in May 1996 finding Master Clean in default and ordering it to pay \$1 million in damages. All parties entered a negotiated settlement for \$900,000.00 with Star liable for \$100,000.00 and Master Clean paying the difference. Master Clean brought suit against Star claiming that Star should have mitigated the damages by performing its bond obligations and that its failure to take over the project entitled Master Clean to damages in tort. The Supreme Court of South Carolina rejected that argument, finding a principal cannot sue a surety for bad faith.

Master Clean argued that sureties are insurers, and a performance bond is insurance. Accordingly, Master Clean argued that it should be allowed to sue in tort for Star's bad faith refusal to pay insurance benefits on a first party claim. The court held that the fact of regulation of sureties under the insurance code did not render sureties subject to bad faith actions, as insurers would be. The court found that a bad faith tort action arises from the common law due to the special characteristics of the insurance relationship, not simply because it is a regulated industry.

The court also noted the lack of any public policy reasons for extending bad faith claims to encamp a suretyship. The court noted that unlike insurance, which is obtained for protection against calamity, bonds are obtained merely for the economic advantage of competing for a contract.

D. Equitable Subrogation

Federal Insurance Co. v. Maine Yankee Atomic Power Co., 183 F.Supp.2d 76 (D. Maine 2001).

Federal agreed that Maine Yankee contracted with Stone and Webster Engineering Corporation ("SWEC") to decommission a nuclear power plant over a five and ½ year period. In accordance with the contract, SWEC obtained a payment and performance bond from Federal Insurance. Maine Yankee declared a formal default by SWEC, based in part on SWEC's insolvency. Maine Yankee thereafter negotiated an Interim Service Agreement with SWEC, by which SWEC would continue to work on the project on a cost basis, but Maine Yankee would pay subcontractors and suppliers directly. Federal signed the agreement, but expressly preserved its rights under the performance bond. However, there was no reference to Federal's payment bond.

The court held that Maine Yankee decommissioned the project and pursued a formal claim against Federal for the full amount of the performance bond. Federal rejected Maine Yankee's claim due to Maine Yankee's failure to ever notify Federal of SWEC's default. Maine Yankee filed suit against Federal, seeking restitution under an unjust enrichment theory for money it paid to subcontractors and suppliers under the payment bond. In addition, Maine

Yankee alleged statutory unfair claims settlement practice based on Federal's rejection of claims made under the performance bond.

Maine Yankee did not have the right to recover contractually under the payment bond; Maine Yankee did not pay subcontractors and suppliers as volunteers, as would preclude restitution under unjust enrichment theory; the Interim Service Agreement between Maine Yankee and SWEC did not preclude recovery on unjust enrichment theory; and Maine Unfair Claims Settlement Practices Act did not apply to Maine Yankee's claims under performance bond.

Maine Yankee did not have the right to recover contractually under the payment bond since generally claimants under payment bonds are subcontractors and suppliers. In addition, Maine Yankee could not recover under the payment bond since Maine Yankee's decision to pay subcontractors and suppliers under the Interim Service Agreement did not constitute default by Federal.

Maine Yankee was not precluded from recovering under the theory of unjust enrichment. The court concluded that Maine Yankee satisfied all three elements of unjust enrichment since Federal was saved the burden of paying certain claims. Federal knew under the terms of the Interim Service Agreement that Maine Yankee would pay subcontractors and suppliers, and Federal was the party obliged to pay subcontractors and suppliers in the event of SWEC's default. Noting that even though Maine law precludes recovery under unjust enrichment if there is a contractual relationship or if the payments are made voluntarily, the court determined that the Interim Service Agreement created a contractual relationship between the parties, but was not extended to the payment bond issues. Therefore, the court held that Maine Yankee could proceed on its claim of equitable subrogation for payments made to subcontractors and suppliers.

Finally, Maine's Unfair Claims Settlement Practices Act did not apply to Maine Yankee's claims under performance bond. The court noted that even if the Unfair Claims Act applied to claims under the performance bond, Maine Yankee could not establish knowing misrepresentation in denial of claims since Federal was not provided with notice of the principal's default.

E. Liability for Interest

In the Matter of Conservatorship of Huerta, 41 P.3d 814 (Kan. 2002).

In six cases, a successor conservator brought an action against the principal and the surety as a result of the principal's conversion or theft of funds. In each case, the probate court found that the principals had converted assets and subsequently entered judgment against them and their sureties for the amount of the loss, plus interest and fees. In all but one case, the judgment exceeded the limit of liability, or penal sum of the bond.

On appeal, the sureties argued that the probate court erred by awarding judgments to the injured wards in excess of the penal sum of the fidelity bonds. The court held that sureties are liable for interest and costs in excess of penal sum of the bonds, and that liability for interest arise on the date of conversion.

The court found Kansas law permits a lower court to impose a judgment of interest against a surety in excess of the penal sum of the bond. In the case of debt under a fidelity bond, interest may be recovered after default in an action against either the principal or the surety, even if it exceeds the penalty. The court reasoned that the penalty of the bond covers the misconduct of the principal, but the interest allowed on the penalty is for the misconduct of the surety for delay of payment. In addition, the court noted that the allowance of reasonable costs and legal expenses does not violate the general rule limiting liability to the penal sum of the bond.

As to the issue of liability of interest arising at the date of conversion, the court declined to accept the sureties argument their liability does not arise at the time of default, but rather at the time demand for payment is made. The court concluded that since the bonds at issue were statutory bonds for conservatorship and not “fidelity bonds”, the general rule of law permitting interest at the time of conversion applies. Accordingly, the judgment of the probate court was affirmed.

F. Professional Employer Organization

Tri-State Employment Services, Inc. v. Mountbatten Surety Co., 295 F.3d 256 (2d Cir. 2002).

Team Star entered into an agreement with O’Ahlborg & Sons, Inc. to perform construction work on a Massachusetts project. Mountbatten, as surety, issued two Labor and Material Bonds to Team Star as principal and O’Ahlborg as obligee.

Tri-State Employment Services, Inc., a Professional Employer Organization (PEO), alleged that it entered into an oral contract to provide Team Star with employee leasing services in connection with the construction project. Tri-State and Team Star executed a Memorandum of Understanding which stated that Tri-State provided labor and payroll services and paid federal, state and local employment taxes on behalf of Team Star. When Team Star failed to make payments on the outstanding invoices, Tri-State filed a proof of claim with Mountbatten under the bond.

Tri-State filed suit against Mountbatten for its refusal to honor Tri-State’s claim. Mountbatten moved for summary judgment, claiming *inter alia*, that Tri-State was not a proper claimant under the bond. The district court held that Tri-State was merely a provider of payroll services to the principal, rather than a provider of “labor and materials” to qualify as a proper claimant under the bond. Tri-State appealed.

On appeal, the Second Circuit noted that in the absence of any applicable case law in New York to conclusively determine the narrow issue of whether a PEO is a proper claimant under a labor and materials surety bond.

The question certified was: In the circumstances presented, is a PEO, under New York law, a proper claimant under a labor and materials surety bond?

The New York Court of Appeals accepted certification September 17, 2002. A decision has not been released.

III. SURETY'S RIGHTS

A. Surety Denied the Right to Tender New Contracts

The School Board of Broward County v. The Great American Insurance Co., 807 So.2d 750 (Fl. 4th Dist. Ct. App. Cir. 2002).

The School Board entered into a written contract with Rockland Construction Company to construct an athletic field and sports complex for a high school located in Broward County. Pursuant to the contract and Fla. Stat. Ann. §255.05(1)(a) (West 1999)⁴, Great American Insurance Company issued a payment and performance bond in the amount of the contract sum of \$1,455,800.00.

Prior to construction, Rockland was declared in default and the School Board made a demand on Great American to complete the project. Great American contracted another contractor, Megan South Construction Co., and offered to "tender" Megan South to enter into a new contract with the School Board. The tender proposed that performance under the new contract would be guaranteed by performance bond issued by a separate bonding company, releasing Great American from its bond. The School Board rejected the offer and demanded Great American "correct" Rockland's default either by "serving as general contractor" or "supervising Megan South's work." Shortly after, the School Board defaulted Great American and awarded the contract to another contractor.

The School Board filed suit against Great American for breach of contract and moved for partial summary judgment on Great American's liability under the bond, arguing that Great American's offer to tender a substitute contractor and release under the bond did not satisfy its obligations to correct Rockland's default. The trial court denied the School Board's motion and granted final summary judgment in favor of Great American. The School Board appealed.

The court held that Great American's tender of new contractor and surety did not correct Rockland's default, and it reversed and remanded. First, the court agreed with the School

⁴ Fl. Stat. Ann. § 255.05(1)(a) provides:

Any person entering into a formal contract with the state or any county, city, or political subdivision thereof, or other public authority, for the construction of a public building, for the prosecution and completion of a public work, or for repairs upon a public building or public work shall be required, before commencing the work or before recommencing the work after a default or abandonment, to execute, deliver to the public owner, and record in the public records of the county where the improvement is located, a payment and performance bond with a surety insurer authorized to do business in this state as surety.

Board's argument that the tender of a new contractor and surety did not "correct" Rockland's default under the bond. Rejecting Great American's interpretation of the bond language, the court found that allowing a substitution of a new contractor and new surety would narrow the scope of coverage under the bond. Since the condition of the bond was Rockland's full performance, if the School Board had accepted Great American's tender, it would have given up its right to enforce Great American obligations under the bond.

Second, the court rejected Great American's argument that any ambiguity in the bond should be construed against the School Board as the drafter. The court concluded that the bond was negotiated between sophisticated parties and Great American was at no disadvantage in dealing with the School Board. Furthermore, Florida's policy favors granting the broadest possible coverage to those intended to be benefitted by protection of the bond. Therefore, if Great American wanted to narrow its obligations after default, it had the burden to include the appropriate language.

Accordingly, the grant of summary judgment entered in favor of Great American was reversed and the case was remanded to enter partial summary judgment in favor of the School Board.

B. Indemnity

Capitol Indemnity Corp. v. Aulakh, 313 F.2d 200 (4th Cir. 2002).

Baljit Aulakh, president and sole shareholder of Superior Management Services, Inc. ("SMS"), and his wife Pavitar, executed an indemnity agreement with Capitol Indemnity Corporation. Capitol issued numerous payment and performance bonds for SMS construction projects. SMS defaulted on a contract with Bolling Air Force Base, wherein Capitol incurred \$92,594 in losses and expenses. Capitol filed an indemnity action, seeking judgment against SMS and the Aulakh's, jointly and severally for the amount of its losses, plus attorney's fees and costs.

Capitol moved for summary judgment on its claims for breach of the indemnity agreement. SMS admitted full liability under the indemnity agreement. However, the Aulakh's argued that the indemnity agreement was unenforceable as to one or both of them because the wife's signature had been secured in violation of the Federal Equal Credit Opportunity Act, as well as Virginia's state equivalent. Appellants argued that because the wife had no involvement with the business, Capitol's requirement that she sign the indemnity agreement constituted credit discrimination.

The district court granted Capitol's summary judgment, holding that neither the federal or state Equal Credit Opportunity Act applied to Capitol's indemnity claim.

In reaching this holding, the Court found that neither the surety bond or the indemnity agreement executed in conjunction with the surety bond qualified as a "credit transaction," within the meaning of either the federal or state act. The Equal Credit Opportunity Act (ECOA) and the Virginia Equal Credit Opportunity Act (VECOA) only govern credit transaction between statutorily-defined credit applicants and creditors. Under both the ECOA and VECOA, the

debtor has the right to defer payment. Since neither the bond nor the indemnity agreement entitles the deferment of payment of any debt or obligation, the protections provided under the state and federal act were inapplicable. Accordingly, the grant of summary judgment in favor of Capitol was affirmed.

IV. PROCEDURES

A. Arbitration

AgGrow Oils, L.L.C. v. National Union Fire Insurance Company of Pittsburgh, PA, 242 F.3d 777 (8th Cir. 2001) (“*AgGrow Oils*”), the Eighth Circuit addressed the issue of whether a surety is bound to arbitrate its surety defenses by virtue of an arbitration clause contained in a construction contract when the bond incorporated the contract by reference. The court held that the surety was not obligated to arbitrate its surety defenses.

Facts and Procedure. AgGrow Oils, L.L.C. (“AgGrow”) entered into a contract with T.E. Ibberson Company (“TEI”) for the construction of a vegetable oil processing plant near Carrington, North Dakota. 242 F.3d at 779. The construction contract contained an arbitration clause, as well as a provision that it should “not be construed to create a contractual relationship of any kind” between anyone other than AgGrow and TEI. *Id.* Ibberson Engineering, a subsidiary of TEI, performed the engineering work on the project, and Anderson International Corporation (“Anderson”) provided the processing equipment. *Id.* National Union Fire Insurance Company (“National Union”) issued a performance bond for the project. *Id.* The bond incorporated by reference the construction contract, but contained a clause to the effect that any suit on the bond could be “instituted in any court of competent jurisdiction.” *Id.*

When the completed plant failed to meet contract specifications, AgGrow filed suit against National Union, Ibberson Engineering, and Anderson, but not TEI. *Id.* at 780. Ibberson Engineering cross claimed against Anderson, and Anderson cross claimed against National Union and Ibberson Engineering. *Id.* Several months after AgGrow’s suit was instituted, TEI filed an arbitration claim against AgGrow, and AgGrow counterclaimed. *Id.* TEI also filed suit against Anderson in the District of Minnesota, which suit was subsequently transferred to the District of North Dakota and consolidated with the instant suit. *Id.*

National Union moved to stay AgGrow’s suit, arguing that AgGrow was obligated to arbitrate its claim under the bond because of the incorporation clause. *Id.* In opposition to the motion, AgGrow argued that it should not be bound by the arbitration agreement because the bond contained no agreement to arbitrate and in fact expressly permitted suit “in any court of competent jurisdiction.” *Id.*

The district court denied National Union’s motion for a mandatory stay, holding that AgGrow’s claim on the bond is not arbitrable because “the bond literally incorporates only AgGrow’s promise to arbitrate with TEI; it does not . . . encompass mandatory arbitration with National.” *Id.* Four months after this ruling, the parties informed the court that Anderson had refused to arbitrate and that no arbitration had been commenced (apparently, the court was

not informed that TEI's arbitration claim was pending). *Id.* The court then denied a discretionary stay. *Id.* National Union filed an interlocutory appeal on the issue of the propriety of the district court's denial of a stay of the proceedings pending resolution of the arbitration between AgGrow and TEI. *Id.*

Mandatory Stay. The Federal Arbitration Act requires a district court to "stay the trial of any action brought 'upon any issue referable to arbitration under an agreement in writing for such arbitration.'" *Id.* (quoting 9 U.S.C. § 3)). However, one may only be required to arbitrate if he has contractually agreed to do so, and state law guides the determination of such contractual issues. *Id.* (citing *AT & T Techs., Inc. v. Communications Workers*, 475 U.S. 643, 648 (1986); *Keymer v. Mgmt. Recruiters Int'l, Inc.*, 169 F.3d 501, 504 (8th Cir. 1999)). The question of whether an issue is arbitrable is for the court, not the arbitrator, to decide. *Id.* (citing *McLaughlin Gormley King Co. v. Terminex Int'l Co.*, 105 F.3d 1192, 1193-94 (8th Cir. 1997)).

The Eighth Circuit characterized the pertinent issue in this case as whether National Union and AgGrow had agreed to arbitrate AgGrow's claim on the bond. *Id.* Applying North Dakota law, the court addressed the question of whether the incorporation provision in the bond was ambiguous. *Id.* at 781. The court analyzed the bond and determined that the incorporation clause clearly "clarified the performance obligations of TEI that National as surety undertook to guarantee." *Id.* at 781. However, the court determined that whether the parties intended the incorporation clause to include the arbitration provisions was a more complex issue. *Id.* Giving weight to the clause in the bond providing for suit in any competent jurisdiction and the provision in the construction contract that the contract should not be construed as creating a contractual relationship between anyone other than TEI and AgGrow, the Eighth Circuit concluded that the contract was ambiguous. *Id.*

When a contract is ambiguous, "the circumstances under which it was made and the matter to which it relates" may be considered to determine the parties' intent. *Id.* (quoting N.D. Cent. Code § 9-07-12). Generally, a performance bond allows an obligee to recover from a surety (or secondary obligor) if the principal (or primary obligor) defaults on its obligation. *Id.* (citing Restatement (Third) of Suretyship and Guaranty § 1 (1996)). In defending a claim, a surety steps into the shoes of the principal and may raise virtually all defenses available to the principal, as well as defenses unique to the surety. *Id.* (citing Restatement (Third) of Suretyship and Guaranty §§ 34, 37-47 (1996)). A surety who has performed its obligation may usually demand reimbursement from the principal. *Id.* (citing Restatement (Third) of Suretyship and Guaranty §§ 22-24 (1996)).

National Union argued that, because its principal TEI could compel arbitration, it also should be able to do so. *Id.* In support of this position, it cited many cases holding that a bond which incorporated the underlying contract also incorporated the arbitration provision. *Id.* at 782 (citing *Commercial Union Ins. Co. v. Gilbane Bldg. Co.*, 992 F.2d 386, 86-89 (1st Cir. 1993); *United States Fid. & Guar. Co. v. West Point Constr. Co.*, 837 F.2d 1507, 1507-08 (11th Cir. 1988); *Exchange Mut. Ins. Co. v. Haskell Co.*, 742 F.2d 274, 275-76 (6th Cir. 1984); *Cianbro Corp. v. Empresa Nacional de Ingenieria y Tecnologia, S.A.*, 697 F. Supp. 15, 19 (D.

Me. 1988); *Firemen's Ins. Co. v. Edgewater Beach Owner's Ass'n*, 1996 WL 509720, at *3 (N.D. Fla. June 25, 1996)).

The Eighth Circuit disagreed with the rationales evinced by these cases because they did not address “the significance of construing the incorporation clause as an express agreement to arbitrate between the obligee and the bonding company.” *Id.* at 782. According to the court, the effects of such an agreement can be “far-reaching.” *Id.* Further, “[w]hether a lawsuit on the bond should be stayed while the obligee and the principal obligor arbitrate is a different question than whether the obligee and the surety have separately agreed to arbitrate any disputes under the bond.” *Id.* at 781-82.

Instead of following the authorities urged by National Union, the court cited with approval *Hartford Accident & Indemnity Co. v. Scarlett Harbor Associates Limited Partnership*, 695 A.2d 153, 156-57 (Md. 1997), and *In re Fidelity & Deposit Co. of Maryland v. Whittemore Contractors Corp.*, 397 N.E.2d 380, 381-83 (N.Y. 1979). *Id.* at 782.

In *Hartford Accident & Indemnity Co.*, the owners of a condominium unit brought suit against a developer and his surety. 695 A.2d at 153-55. The surety bond incorporated by reference the construction contract, which contained an arbitration provision. *Id.* The surety and contractor attempted to force the owner to arbitrate, but the court held that because the owner and surety did not agree to arbitrate, arbitration between them could not be compelled. *Id.* at 157.

Similarly, in *Whittemore Contractors Corp.*, a surety sued to stay arbitration that was filed by a subcontractor. 397 N.E.2d at 381. The subcontract, which contained an arbitration provision, was incorporated into the performance bond. *Id.* The court held that the surety “cannot be held to have agreed to participate in arbitration proceedings with respect to any dispute whatsoever. Certainly there is no language in the performance bond on which to base any argument that it was obligated to submit to disputes arising under its performance bond (as opposed to disputes arising under the subcontract) to resolution by arbitration.” *Id.* at 382.

Applying the holdings of these cases to the instant case, the court concluded that it was “unwilling to construe an incorporation clause whose obvious purpose was to clarify the extent of the surety’s secondary obligation as also reflecting a mutual intent to compel arbitration of all disputes between the surety and the obligee under the bond.” The court thus held that National Union was not entitled to a mandatory stay. 242 F.3d at 782.

Conclusion. Applying North Dakota contract law, the Eighth Circuit considered whether an arbitration agreement contained in a construction contract which has been incorporated by reference into a bond requires the surety and the obligee to arbitrate. The court held that, because there was no express agreement to arbitrate between the surety and the obligee, arbitration was not mandated. However, the court remanded the case to the district court to determine if it should grant a discretionary stay.