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TAKEOVER CHALLENGES UNDER THE MILLER ACT

When the principal ceases to perform on a Federal contract, is defaulted, and the demand is made upon the surety, challenges in working out a takeover agreement with the Government begin. This paper will briefly touch on some of the issues dealing with this situation. Keep in mind that we are assuming the default was validly declared and that there is a demand that the surety immediately step in. The Bond Default Manual, (4th ed. 2015) provides a terrific array of detailed insight, forms and suggestions, and is a terrifically valuable resource. This paper will simply touch on some of the issues that crop up.

Federal Acquisition Requirements. In dealing with default and takeover issues, keep in mind the detailed provisions of the Federal Acquisition Regulations. Part 49 is titled “Termination of Contracts” and sets out the rules the Federal Government must follow. FAR 49.401, et seq., states the right to terminate and the effect of termination, and FAR 49.404 addresses surety takeover agreements.

Some contracting officers are sticklers with following the FAR’s requirements, others are ignorant of them, and some will simply ignore them. But it is important for the surety claims representative to be thoroughly familiar with those guidelines. While at times they seem to be an obstacle, sometimes they are a big help in getting thru the process of default and takeover.

Contracting Officers. Ironically one of the challenges dealing with a contractor default and takeover is the wide variation in the views and experience levels of the contracting officers. A surprising number have never been through the process, and can be incredibly timid and bureaucratic about taking any action. On the other hand, some contracting officers are incredibly strong willed and have very specific ideas of what must be done, how it should be done, and insist on it being done their way. In many instances one of the best things to do is to find the government attorney who will be providing legal advice to the contracting officer and get them to provide reasonable and timely legal advice on going through the process. One of the other challenges in dealing with contracting officers is that they will very often corral a large committee to deal with the surety. This gaggle of folks on the government side may have conflicting views, different views, or indifferent views. Sometimes the contracting officer insists that they participate in in every decision and discussion with the surety, yet they are sometimes difficult to corral, causing the contracting officer to delay making any decision or resolving any of the critical issues on the default and takeover that inevitably come up. The time that lapses while the contracting officer makes up his or her mind and works out issues with the surety can have an adverse impact on the ultimate completion of the project. The contracting officer may claim that liquidated damages continue to run, prices may rise, and bidders that the surety might look to might get cold feet or no longer be available to do the work.

Necessity of a Default. In order for the surety to enter into a takeover agreement, there must be a default. A default is a necessary ingredient whether this default comes because the Government has declared a default or whether it is voluntary. See Restatement of Suretyship and Guaranty, 3rd Ed., § 27, District of Columbia v. Aetna Insurance Co., 462 A.2d 428 (D.C. 1983). If the principal is not terminated, the surety could be considered to be a volunteer.
When the contracting officer issues a notice of termination, they are required to notify the surety. FAR 49.102. While the FAR's permit the surety to continue to perform in lieu of termination or for a default, FAR 49.402-4, it would be dangerous to do so without the concurrence of the principal. Moreover, a surety takeover agreement requires a termination for default. FAR 49.404. Performance without a termination may create more issues for the surety than it cures.

In an indemnity action if the surety were found to have satisfied an obligation without a duty or without being compelled to pay, it is a volunteer. Spencer Law of Suretyship, § 138. Moreover, if there is no default, the principal is of course, entitled to be paid contract funds. Further, if a default is not declared, a bankruptcy filing will trigger the automatic stay, which bars a termination of the contract by the government, causing the parties to sit and wait for a court ruling.

Sometimes contracting officers seem to believe that merely writing a letter to the surety demanding it attend a meeting and stating that the contractor is not performing is sufficient to trigger the surety’s obligations to step in and take over the project. This means that the surety simply has to impress upon the contracting office the notion that a default must be declared in order for the surety to have any obligation.

**Tender vs. Takeover.** Sureties will very often prefer to tender a completion contractor to the Government rather than entering into a takeover agreement. The FARs do not mention a tender agreement, and there is no reference in these administrative regulations to either permitting a tender or instructing the contracting officer as to what to do. However, some contracting officers are willing to enter into a tender agreement. One of the primary problems are delays in the contracting officer making a decision on a surety’s offer of tender. Ultimately, they may reject the tender offer and demand a takeover. Again, this lapse of time, uncertainty and accruing liquidated damages can create problems.

However, the FAR does contemplate completion by another contractor. FAR 49.405 states that if the surety does not arrange for a completion, the contracting officer will arrange for a completion of the work by awarding a new contract “or any other appropriate contracting method or procedure.” Sometimes a contracting officer will consider that as authority to accept a tender. At other times, the contracting officer may see that as a weapon against the surety, arguing that the surety is simply going to be liable for significant completion costs for a contract arranged by the Government. FAR 49.402-4 establishes a procedure in lieu of termination for default, saying that the contracting officer in lieu of default may permit the surety to continue performance of the contract. However, keep in mind that the surety has no obligation to complete the contract without a default and termination, and a surety’s completion under that scheme might simply be a takeover without a default, which is very problematical for the surety.

**Liquidated Damages.** The takeover agreement represents the surety’s best shot at dealing with potential liquidated damages that have arisen prior to default. Addressing the basis to challenge liquidated damages and persuading the contracting officer that they should be reduced or waived may be the surety’s only practical mechanism to obtain relief for liquidated damages racked up prior to a takeover. The dilemma is that the surety has its hands tied in contesting pre-default L.D.’s because of a lack of a court with jurisdiction to hear such a claim. In *Fireman’s Fund Ins. Co. v. England*, 313 F.3d 1344 (Fed. Cir. 2002), and
*United Pacific Ins. Co. v. Roche*, 380 F.3d 1352 (Fed. Cir. 2004), the court held that even when the surety entered into a takeover agreement, it did not have the right to assert a claim under the Contract Disputes Act for recovery of liquidated damages assessed prior to the takeover.

While the surety has rights of equitable subrogation when it completes a project, this does not give a court jurisdiction to hear claims that arose prior to the takeover. In *Lumbermens Mut. Cas. Co. v. U.S.*, 654 F.3d 1305 (Fed. Cir. 2011), the court held that the surety’s equitable subrogation rights did not give it standing to challenge pre-default liquidated damages. The surety asserted challenges to the assessment of L.D.’s by various theories. Equitable subrogation claims were rejected. The court said that only if the surety notified the Government prior to default giving notice that no further payment should be made to the principal, did the surety have equitable subrogation rights allowing it to challenge any assessment of liquidated damages before the takeover. It also ruled that executing the takeover did not provide a contractual link allowing jurisdiction under the Contract Disputes Act as to pre-default L.D.’s. Neither equitable subrogation nor a CDA claim will provide a mechanism to the surety to pursue these claims. The net result is that unless the surety has notified the government to quit making payments prior to default, the surety has no mechanism to challenge pre-default liquidated damages. The Federal Circuit in *Lumbermens* characterized the surety’s claim that the government improperly charged liquidated damages as a claim of impaired surety collateral. But the only way the surety can assert a claim for impairment of surety collateral is to not make any payment on the performance bond — that is refuse to perform - and use impairment of suretyship as a defense when sued. This court thus held that the surety had no offensive claim it could assert for pre-default liquidated damages (unless a pre-default demand had been made), but it could use its rights defensively. Telling the surety to deny a Miller Act bond claim and wait to be sued obviously raises the stakes and a host of other issues.

But the surety’s offensive right to challenge liquidated damages if it denies the demand to a takeover may be a basis to have meaningful negotiations with the contracting officer on terms of the takeover agreement to get relief for improperly charged L.D.’s.

**Prevailing Wage Claims.** When entering into a takeover, keep in mind that the surety must comply with all of the underlying requirements in the contract, not just the construction technical specifications. A surety entering into a takeover agreement following its principal’s default will see contract funds set off by the Government for amounts owed by the original contractor under the Davis Bacon Act, 40 U.S.C. § 1341 ("DBA"). There could be wage claims from work done prior to default or under the takeover. In addition subcontractors — both those used by a defaulted principal and by the surety’s completion contractor must meet the requirements of the DBA. If the surety were to not take over the work, when the Government completes the project any DBA claim arising from the principal’s failure to pay statutory amounts will result in a performance bond claim. In *Westchester Fire Ins. Co. v. U.S.*, 52 Fed. Cl. 567 (Ct. Fed. Cl. 2002, the surety did not take over a defaulted contract. The court held the surety was liable for DBA wage violations, and in the process conflated performance and payment bond exposure. The court reasoned that even if the surety were not liable for those claims under its performance bond, it would be liable under its payment bond, with the net result the surety had to pay.
A subcontractor’s performance bond surety may find itself liable for DBA wages even after the project is completed. This is an all too real scenario: After a large project was completed, but the final contract payment was not made, the Government notified the general contractor it was withholding huge sums because of a serious DBA violation by a subcontractor. The general contractor in turn makes a claim against the sub’s performance bond surety. If there is indeed a DBA violation under these circumstances, the subcontractor performance bond surety is liable.

Completion and acceptance with final close out does not bar claims under the DBA. For a full discussion of DBA implications to the surety, see Hitson & Mason, Facing the Department of Labor: a Primer on Prevailing Wage Laws and Their Impact on Sureties, 27th Annual Northeast Surety & Fidelity Claims Conference. While sureties most often think of this exposure as one arising under the payment bond, a DBA violation can in many circumstances trigger performance bond liability.

**Cross-Collateralization.** When taking over and completing one Federal project, if there is another project with funds still due from the Federal Government to the principal, the surety should be able to exercise its right of subrogation on the second project and recover those funds. This can be an important source of recovery. Losses on project A which the surety has to takeover and complete give the surety rights to recover funds owed on project B. **Transamerica Ins. Co. v. U.S.,** 989 F.2d 1188 (1993). It is critically important however to keep in mind that the surety must provide notice to the government on the second, non-defaulted project, that no funds should be paid to the principal, rather they should be paid to the surety. The Government is free to pay the principal unless and until it receives notice on the second project that the surety demands those funds. Even if the takeover agreement has not been entered into, as soon as the surety learns that there are funds on other Federal projects, it should immediately invoke its right of equitable subrogation.

**Disadvantaged Business Enterprise Requirements.** When the surety takes over a project with Disadvantaged Business Enterprise (“DBE”) requirements, it must either comply with those requirements or secure a waiver in a takeover agreement. Of course, the surety may be liable for its principal’s pre-default failure to comply with DBE requirements. However, the surety needs to be fully aware of DBE requirements and sort out precisely how it will deal with those when entering into the takeover.

**Statute of Limitations on Performance Bond Claims.** What happens if the surety on a Miller Act bond refuses to perform? The remedy the Government has in such an event is to reprocure the contract and then sue the surety. It is not terribly surprising to see that there are not many instances in which sureties refuse to perform. However, there is a clear and bright line setting out a statute of limitations on performance bond claims.

The Government must bring an action on a Miller Act bond within six years after the right of action accrues or within one year after the final decision in an applicable administrative proceeding. 28 U.S.C. § 2415.

The Eleventh Circuit enforced this time limit in **U.S. v. American States Ins. Co.,** 252 F.3d 1268 (11th Cir. 2001). In that case the Government terminated the contract, but the surety informed the Government that its termination was wrongful. The contractor and the Government proceeded to litigate the propriety of the termination through the Board of
Contract Appeals, where the termination was found to be proper and affirmed when the contractor appealed to the Federal Circuit. In the meantime while the Contract Disputes Act litigation was ongoing between the contractor and the Government, the contracting officer employed another company to complete the construction project. When the contracting officer issued a final decision demanding payment against the surety, the surety then filed suit in the Claims Court seeking a declaration that the termination was wrong. However, that case was dismissed for a lack of jurisdiction. Then the Government got around to filing an action in the Federal District Court against the surety.

In American States, the Government argued first that it was not subject to the time limits in 28 U.S.C. § 4115, but if it was, that time limit did not begin to run until the contracting officer made his final decision, which was six years less than the time suit was filed. The court recognized that the Miller Act action was essentially a suit on breach of contract, and that at the very latest, by the time the Government had declared default, a replacement contractor had completed the work and demand had been made for excess costs, the clock started on its statute of limitations. The Government tried to argue that the cause of action did not arise until the contracting officer made his final decision, but that was rejected. The court found that the surety's obligation matured when the contractor breached and the Government could sue for the breach.