

**THE GOOD THE BAD AND THE UGLY:
RECENT DEVELOPMENTS IN SURETY LAW**

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I. CONDITIONS PRECEDENT

Performance bonds contain express conditions precedent that the obligee must comply with to obtain performance or recovery from the surety. Recent decisions focus on the facts in determining whether to hold the surety liable, with some contradictions between jurisdictions on how definitive the obligee (owner) must be in declaring the bonded contractor in default.

A. Hunt Constr. Group, Inc. v. National Wrecking Corp., 2009 WL 4110379 (D.C. Cir. Nov. 29, 2009)

Near the end of project performance, the Contractor recognized that a subcontractor's delays were imperiling completion by the contractually required date. The Contractor incurred additional expenses to mitigate the impact of the subcontractor's default. After completion, the Contractor sued the subcontractor and its performance bond sureties for breach, seeking recovery of costs associated with delay. The court found that notice to the sureties of the subcontractor's default was a condition precedent to recovery under the performance bond and that the Contractor's failure to give notice of such default until after completion barred recovery under the bonds.

B. United States Fire Ins. Co. v. United States, 78 Fed. Cl. 308 (Fed. Cl. 2007)

After the government terminated the contractor and made demand upon the surety to perform, the surety entered into a takeover agreement with the government and completed the contract. Thereafter, the surety sued the government, asserting that the government's payments to the contractor while the contractor was in default resulted in significant overpayments for incomplete and defective work, and eroded the contract balance available to the surety to complete the bonded work. The court rejected the surety's claim, finding that the failure of the surety to put the government on notice to withhold progress payments from the contractor precluded its recovery on an equitable subrogation claim based on the government's alleged improper progress payments.

C. Colorado Structures, Inc. v. Insurance Co. of the West, 167 P.3d 1125 (Wash. 2007)

A surety was held liable under its performance bond even though the obligee never terminated the bonded subcontract or gave the surety notice of default. The court found that the bond's requirements related to default were merely "options" that the obligee

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could employ if it terminated the bonded contract, and providing the surety written notice that it had supplemented the bonded contractor's work because of performance inadequacies was sufficient to trigger liability.

D. **Dooley & Mack Constructors, Inc. v. Developers Sur. & Indem. Co.**, 972 So.2d 893 (Fla. Dist. Ct. App. 2007)

The appellate court overturned a ruling in favor of the surety and found that the surety was liable for the obligee's costs of completing the bonded work, even though the obligee completed the principal's work without notifying the surety of default or giving the surety an opportunity to perform. The appellate court noted that, based on the bond alone, the surety would not be legally obligated where the obligee usurped the surety's right to perform following default. Relying on the incorporated bonded contract, however, which gave the obligee broad rights to complete the work as it deemed necessary, the court found that the obligee's actions in completing the work prior to notifying the surety was permissible and did not discharge the surety.

E. **Current Builders of Fla., Inc. v. First Sealord Sur., Inc.**, 984 So.2d 526 (Fla. Dist. Ct. App. 2008)

The surety was held not liable to the obligee for the bonded subcontractor's default because the obligee waived the default by allowing the bonded subcontractor to continue performing after notice of default was provided. Even after the obligee terminated the bonded subcontractor and gave proper notice, the obligee's failure to subsequently tender to the surety the balance of the subcontract defeated its claim for the costs of excess procurement against the surety.

F. **Hunt Constr. Group, Inc. v. National Wrecking Corp.**, 542 F.Supp.2d 87 (D.D.C. 2008)

Rejecting the reasoning of *Colorado Structures*, the court found that the obligee's "termination" of the bonded contractor months after the contractor had finished its work did not trigger the surety's obligation to perform. The court found that declaration of default was necessary, and where an obligee fails to notify the surety of default and to provide the surety an opportunity to perform, the preclusion of the surety's rights results in a discharge.

G. **Developers Sur. & Indem. Co. v. Dismal River Club, LLC**, 2008 WL 2223872 (D.Neb. May 22, 2008)

The court in Dismal River strictly interpreted an AIA A312 bond, holding the obligee had failed to comply with the mandatory conditions precedent necessary to hold the surety liable for default. Namely, the obligee's failure to declare a default by the principal, terminate the principal's right to complete and agreeing to pay to the surety the contract balance were all viewed as non-compliances with the conditions of the bond. In the absence of compliance with the bond, the surety was not liable to the obligee.

II. DAMAGES RECOVERABLE FROM SURETY

Damages recoverable from the surety on its bonds generally include any damages that are recoverable under the bonded contract, including unpaid contract balances, delay damages, interest and attorney's fees. Several new cases follow this general principle.

A. Lexicon, Inc. v. Safeco Ins. Co. of Am., 436 F.3d 662 (6th Cir. 2006).

In a claim filed against a payment bond by a sub-subcontractor for "delay and impact claims," the court found that, in general, claims for labor and material costs caused by delay may be recoverable if permitted under the bonded contract or the bond. Claims for non-labor or material related delays are not, however, recoverable under the bond.

B. First Nat'l Ins. Co. v. Cam Painting, Inc., 173 Cal. App. 4th 1355 (2009)

Where the same surety bonded the contractor and subcontractor on a public works project, a supplier's payment claim against the subcontractor was covered by the bond issued to the subcontractor, and the surety could not seek indemnity from both the contractor and subcontractor. Where, as here, the contractor prevailed against a subcontractor on a defective workmanship claim, and the subcontract contained an attorney's fee provision, the subcontractor and its surety were jointly liable to the contractor for attorney's fees.

III. LIMITATIONS ON CLAIMS AGAINST SURETIES

Payment bond claims against sureties are subject to a number of distinct defenses, including unique defenses available only to the surety, such as limitations found in applicable statutes or the bond and contractual definitions of who qualifies as a claimant, and other defenses emanating from the principal, such as pay-when-paid clauses or set-off. Courts typically construe the Federal Miller Act or state Little Miller Acts liberally in favor of affording claimants the right to pursue an action for payment. In several recent decisions, the court more often than not found that the surety could not rely upon the limitations periods, the claimant's standing or contract defenses to bar a payment bond claim.

A. Contractual and Statutory Limitations

1. Evco Sound & Elecs., Inc. v. Seaboard Sur. Co., 2009 WL 4124432 (Idaho. Nov. 27, 2009)

Limitations periods within which sub-subcontractor was required to provide notice to the general contractor of its claim under the payment bond and to file suit began to run when the sub-subcontractor provided training sessions, installed part of a television system, and completed as-built drawings, all of which were done as part of the original sub-subcontract scope. The sub-subcontractor, as prevailing party on appeal, was entitled to appellate attorney fees under the Public Contracts Bond Act.

2. **Paradigm Contract Mgmt. Co. v. St. Paul Fire & Marine Ins. Co.**, 979 A.2d 1041 (Conn. 2009)

Subcontractor was not entitled to bring common law action on bond issued pursuant to a statute that required state contractor to make payment to subcontractor within 30 days.

3. **Arch Ins. Co. v. Precision Stone, Inc.**, 584 F.3d 33 (2d. Cir. 2009)

District court did not clearly err in determining that claimant's action was timely under a bond's one-year limitations period, and the general contractor's full cost to complete a portion of the contracted work that had not been completed by subcontractor was irrelevant to the subcontractor's damages award.

4. **J.C. Gibson Plastering Co., Inc. v. XL Specialty Ins. Co.**, 521 F.Supp.2d 1326 (M.D. Fla. 2007), *vacated by* 2009 WL 2710316 (M.D. Fla. Aug. 26, 2009).

Endorsing prior rulings out of Maryland and Virginia, a Florida federal district court found that where the payment bond contained a provision requiring the surety to respond to the claim within 45 days after receipt of the claim, paying or making arrangements to pay the undisputed amount and advising of any defenses to the disputed portion, the surety's failure to respond within the time period waived the surety's right to challenge the claim. The court rejected the surety's argument that the 45 day period began running upon receipt of a completed, sworn proof of claim form. Similarly, the court rejected the surety's contention that its letters sent to the claimant within 45 days of notice of the claim satisfied the A312 bond requirements because the letters did not identify the undisputed amount or set forth the basis for disputing the claim. More than two years after this decision was rendered, the order was vacated at the request of the parties. Interestingly, the court noted that as a result of the vacating of the order, the decision shall not be cited as precedent in any other proceedings.

B. Identification of Claimant

1. **The Boldt Co. v. Thomason Electrical Co.**, No. 6:07-cv-00697-GRA, slip op. (Sep. 27, 2007)

Obligee's payment bond claims failed because language of payment bond required a payment bond claimant to have a "direct contract" with the principal for labor or materials.

2. **Preussag Int'l Steel Corp. v. March Westin Co.**, 655 S.E.2d 494 (W. Va. 2007)

Ignoring the traditional "tier" considerations utilized to determine whether a party may pursue a claim under a public works payment bond, the Court found that a steel company

that custom-fabricated and assembled the steel for a building is a “Subcontractor” under the terms of the Miller Act rather than a supplier because of its substantial and important relationship with the prime contractor. Hence, the company that supplied the steel fabricator with raw steel is covered under the public works payment bond.

3. **United States *ex rel.* E&H Steel Corp. v. C. Pyramid Enter., Inc.**, 509 F.3d 184 (3d Cir. 2007)

A company who supplied steel for a project was deemed a subcontractor rather than a supplier because it had a substantial and important relationship with the prime contractor and performed important functions on the project.

C. Other Surety Defenses to Payment Bond Claims

1. **United States *ex rel.* McKenney’s Inc. v. Government Technical Servs., LLC**, 531 F.Supp.2d 1375 (N.D. Ga. 2008)

The surety defended a subcontractor’s claim under the Miller Act by relying upon the pay-when-paid clause in the subcontract. The Court rejected the defense, holding that allowing the contract language to trump a federal remedy available under the Miller Act conflicted with the intent of the Act and was, therefore, unenforceable.

2. **United States *ex rel.* Acoustical Concepts, Inc. v. Travelers Cas. & Sur. Co. of Am.**, 635 F.Supp.2d 434 (E.D. Va. 2009)

A carpentry subcontractor who successfully completed separate subcontracts on two federal projects for the general contractor sued the general contractor’s sureties to collect the contract balance on those two subcontracts. The sureties filed for summary judgment, asserting no payment was due on either federal subcontract because of a large set-off asserted by the general contractor on a separate, unrelated non-federal project subcontract. The court granted the plaintiff subcontractor summary judgment, finding that the sureties were not entitled to rely upon the broad set-off provisions in the federal subcontracts because doing so would operate to frustrate the intent and purpose of the Miller Act of ensuring prompt payment to subcontractors for their work on federal projects.

IV. SURETY’S RIGHTS TO SETTLE ITS PRINCIPAL’S CLAIMS

Typical indemnity agreements permit the surety broad discretion to settle affirmative claims, but allow the indemnitors to forestall such action where they timely object and tender collateral sufficient to cover the claim and anticipated defense costs. Several recent cases have reinforced the surety’s right to settle its principal’s affirmative claims where the indemnitors either did not give notice of their desire to challenge the claim or post the collateral.

A. **Liberty Mut. Ins. Co. v. Northeast Concrete Prods., LLC**, 756 N.W.2d 93 (Minn. App. 2008)

Following a declaration of default, the surety took over performance of the project from its principal. The obligee subsequently initiated arbitration against the principal and surety, seeking recovery of losses and delays associated with the default. Despite efforts to reach a three way settlement, the surety ultimately settled only with the obligee and then pursued indemnity from its principal. The principal asserted that the surety acted in bad faith when it took over the project because it acted only to preserve a business relationship with the obligee and, further, that it acted in bad faith when it settled with the obligee. The court rejected the principal's arguments, finding as a matter of fact that the surety claims representative was not aware of his company's relationship with the obligee prior to settlement and, in any event, the surety was obligated by contract to take over following default. As for the settlement, the court found that the surety advised the principal of bilateral discussions following the failure of the three-way settlement discussions and that the surety's later efforts to advise of the continuing negotiations, coupled with the lack of any objection by the principal, defeated the argument of bad faith.

B. **RLI Ins. Co. v. Indian River Sch. Dist.**, 556 F.Supp.2d 356 (D. Del. 2008)

Performance bond surety could not maintain negligent misrepresentation claim against architect who certified improper progress payments for contractor because of the economic loss doctrine. Where, as here, the damages are purely economic, and there is no privity of contract, no action in tort lies.

C. **Wilkinson Industr., Inc. v. Taylor's Industr. Servs., LLC**, 2008 WL 1766762 (D.Neb. Apr. 14, 2008)

Over the objections of the principal and the indemnitors, the Court enforced a settlement agreement between the surety and the obligee resolving the principal's claims against the obligee. In supporting the surety's right to settle the claims, the court rejected the principal's claim that the surety waived its right to enforce the terms of the indemnity agreement, which permitted the surety to settle claims unless the principal or indemnitors gave notice that the claim should be defended and posted sufficient collateral to cover the claim. Not only did the indemnitors fail to post any collateral, but the court found that even though the surety litigated the case for a year and half, there was no evidence that the surety clearly and unequivocally waived its right to demand collateral.

V. **THE SURETY AND ARBITRATION**

Typically courts will not compel sureties to arbitrate unless they are direct signatories to a contract containing an arbitration provision. Two new cases address the concept that third parties, such as sureties or subcontractors, to a contract containing an arbitration provision cannot be compelled to arbitrate.

- A. **United States ex rel. Lighting & Power Servs., Inc. v. Interface Constr. Corp.**, 553 F.3d 1150 (8th Cir. 2009).

Under Missouri law, a sub-subcontractor need not arbitrate its Miller Act claim, where the sub-subcontract does not contain an arbitration agreement but the subcontract does.

- B. **Liberty Mut. Ins. Co. v. Mandaree Pub. Sch. Dist. #36**, 503 F.3d 709 (8th Cir. 2007)

An obligee was not permitted to enforce its contractual right to arbitrate against the surety where the bond did not contain an arbitration provision even though the bonded contract between the surety's principal and the obligee did contain an arbitration provision.

VI. DEFECTIVE CONSTRUCTION CLAIMS AND THE SURETY

- A. **Continental Cas. Co. v. Ryan Inc. Eastern**, 974 So.2d 368 (Fla. 2008)

Performance bond surety, who settled claim against its principal and then sued the principal's liability insurer for wrongful denial of coverage, is not entitled to statutory attorney's fees from the insurer.

VII. EFFECT ON SURETY OF SETTLEMENT BETWEEN PRINCIPAL AND OWNER

In a recent case, a Pennsylvania court enforced the long-standing rule that, in any release of a principal, a reservation of rights against the surety must be expressly stated in the release. Silence in the release will discharge the surety along with the principal.

- A. **Kiski Area Sch. Dist. v. Mid-State Sur. Corp.**, 967 A.2d 368 (Pa. 2008)

Owner argued that the Court should adopt a "totality of the circumstances" test for determining whether the release of a general contractor discharged its performance bond surety. The Court rejected the owner's argument and instead adopted the bright-line rule that any reservation of rights against a performance bond surety must be expressly stated in the language of the release of the contractor. Therefore, the owner's settlement with a contractor, even though silent as to the release of the contractor's surety, discharged the surety as well.

VIII. INDEMNITY - THE SURETY'S RIGHT TO RECOVER ITS LOSSES

The trend towards protecting the surety's right to recover from its principal under the General Agreement of Indemnity continues. A number of cases have been issued recently upholding the surety's rights to seek posting of collateral by the indemnitors, or recovering from the indemnitors following performance.

- A. **Liberty Mutual Ins. Co. v. Aventura Eng'g Constr. Co.**, 534 F.Supp.2d 1290 (S.D. Fla. 2008).

Performance bond surety may settle its principal's affirmative claims against the owner over the principal's protest:

- Indemnity: Under a performance bond's indemnity provision, a surety may settle the principal's affirmative claims against the owner over the principal's protest, where the principal did not post collateral protecting the surety.
- Bad Faith: A performance bond surety did not act in bad faith where it did not settle with the owner until after it reviewed the principal's records and determined that it had underbid the project and after the principal also failed to post collateral.

- B. **The Plumbing Serv. Co. v. Traveler's Casualty & Surety Co.**, 962 So.2d 1056 (Fla. Dist. Ct. App. 2007).

A sub-subcontractor settled with a payment bond surety, then filed a bad-faith action against the surety. The settlement release only applied to claims that had accrued prior to February 14, 2001. The Court permitted the sub-subcontractor to pursue its action for bad-faith because the claim accrued when the sub-subcontractor filed its notice of violation with the Department of Insurance, a prerequisite for pursuing a bad-faith action under Florida law, which occurred on October 21, 2001.

- C. **Fidelity & Guar. Ins. Co. v. Star Equip. Corp.**, 541 F.3d 1 (1st Cir. 2008).

Under Massachusetts law, a principal that signed a settlement agreement with the owner and performance bond surety cannot then assert surety bad faith as a defense to the surety's indemnity action. The Court held that the level of bad faith necessary to defeat an indemnification claim requires a showing of dishonest purpose or a conscious doing of wrong, and could not occur merely because the surety makes a business decision that disadvantageous the principal. A principal that executes a settlement agreement between the surety and owner cannot, as a matter of law, raise the defense of bad faith.

- D. **Travelers Cas. & Sur. Co. v. Bowman**, 893 N.E.2d 583 (Ill. 2008).

Ten-year statute of limitations for actions on written contracts, not the four-year construction limitations, applies to performance bond surety's express indemnity action against its principal.

- E. **Hartford Cas. Ins. Co. v. Cal-Trans Assoc., Inc.**, 2008 WL 4165483 (D.N.J. Sep. 4, 2008).

Court granted motion for partial summary judgment to require posting of collateral security of \$5.6 million.

- F. **Far West Ins. Co. v. J. Metro Excavating, Inc.**, 2008 WL 859182 (N.D. Ind. Mar. 28, 2008).

The Court ordered the indemintors to post collateral despite the indemnitor's allegations of breaches of the surety's fiduciary duty. Questions concerning the surety's good faith in allowing a claim in the full amount was not deemed relevant to the indemnitor's obligation to post collateral.

- G. **International Fid. Ins. Co. v. Anchor Env'tl., Inc.**, 2008 WL 1931004 (E.D. Pa. May 1, 2008).

Court granted preliminary injunction requiring principal to post collateral. Irreparable harm would occur without the posting of collateral as the surety would then become an unsecured creditor. In addition, the granting of the injunction vindicated the important public interest of ensuring that contractors on public works projects use contract funds to perform the work and pay subcontractors and suppliers. The Court rejected the defendant's argument that irreparable harm would occur if the defendant were required to sell its restaurant in order to satisfy its collateral obligation because the posting of the collateral was already required by the indemnity agreement. The Court made the injunction permanent because the terms of the indemnity agreement remained unchanged and all of the elements were already satisfied for establishing a permanent injunction.