Annual Survey of Fidelity and Surety Law, 1999 — Part I

This roundup of recent cases covers public and private construction bonds, fidelity and financial institution bonds, and sureties' remedies

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I. PUBLIC CONSTRUCTION BONDS

A. Bonds under Federal Laws

1. Substantive

Federal Prompt Payment Act permits recovery of penalties and attorney's fees in Miller Act claims.

In a Miller Act claim before a federal district court in Louisiana, the plaintiff has sought penalties and attorney's fees. The defendant prime contractor and its surety filed a motion for partial summary judgment on that claim. The motion was denied, the court holding that the 1998 amendments to the Prompt Payment Act (31 U.S.C. § 3905(j)) effectively terminated previous holdings that penalties and attorney's fees were not covered by the Miller Act.

The succinct opinion goes on to say: "Congress may have indeed 'entrenched' itself into the field of federal project contracting and subcontracting to the extent that all state law regarding the matter is now preempted. That being said, Congress may 'taketh' from litigants, but it may also 'giveth.'" *Cal's A/C & Electric v. Famous Construction Group.*[1]

Full recovery of delay damages allowed even though prime contractor only party responsible for delays.

In another Miller Act case related to the construction and remodeling of Air National Guard buildings in St. Louis, the prime contractor failed properly to issue revised construction schedules, causing substantial delay damages to its electrical subcontractor. A federal district court in Missouri found that the government and

1. 34 F.Supp.2d 104 (W.D. La. 1999).

the prime contractor shared responsibility for the delays but awarded the subcontractor damages compensating it in full for the delays.

On appeal, the prime contractors and its surety argued that they were only partially at fault for the damages and that their responsibility should be limited. The Eighth Circuit found that other circuits had allowed full recovery and followed the reasoning of those cases. As a side issue, the court refused to allow recovery of damages for lost profits, holding that a separate breach of contract claim under state law would be necessary to apply for such relief. *Consolidated Electrical & Mechanicals v. Biggs General Contracting.*[2]

2. Procedural

Non-arbitrable Miller Act claims stayed pending arbitration of separate equitable claims.

In *Tanner v. Daco Construction Inc.*,[3] the subcontract sued on provided for arbitration but specifically excluded from arbitration any claim under the Miller Act. When a controversy arose, the federal district court for Oklahoma found that separate equitable claims asserted by the subcontractor were subject to arbitration but held that it would be "grossly inefficient" to have the parties arbitrate and litigate at the same time. Consequently, it stayed the Miller Act case until the arbitration had been concluded.

B. STATE AND LOCAL BONDS

1. Substantive

Interest on claim under bond due from date of default to date of notice of default.

In a claim under the Massachusetts payment bond statute, the surety filed an answer admitting liability and tendered the amount of the claim. The subcontractor-claimant argued that he was entitled to interest from the date of default. The surety said that it should have to pay only from the date it was notified of the default.

The Massachusetts Appeals Court stated that it had been long settled in that state that in the absence of a provision in the bond to the contrary, it was up to a compensated surety to keep itself informed of any defaults. Interest was awarded from the date of the default. The court went on to affirm judgment for attorney's fees in addition to interest. *John W. Egan Co. v. Major Construction Management Co.*[4]

Obligation of bond does not cover claim for extra interest rate, late penalties and attorney's fees.

In a Wyoming case, the prime contractor and its surety conceded that it owed the claim of a supplier to a subcontractor. In addition, the supplier claimed interest at the rate of 2 percent per month, more than the statutory rate, along with late penalties and attorney's fees.

Noting that the general contract and the bond did not include any obligation to pay such fees, the Wyoming Supreme Court refused to authorize them. In doing so, it declined to follow the precedent of the federal Miller Act, notwithstanding that the Wyoming statute was based on that act. *Vaughn Excavating and Construction v. P.S. Cook Co.*[5]

Acquisition of supplies by state not covered by bond.

In a suit under the Illinois Public Construction Bond Act, a claim was made by the supplier of paint to the state's procurement services division. The Illinois Appellate Court noted that the plaintiffs wanted to interpret the term "public work" so broadly as to encompass virtually any state contract. It declined to do so and held that the bond did not cover the claim. *Chemco Industries v. Employer's Mutual Casualty Co.*[6]

2. 167 F.3d 432 (8th Cir. 1999).
3. 38 F.Supp.2d 1299 (N.D. Okla. 1999).
4. 709 N.E.2d 66 (Mass.App. 1999).
5. 981 P.2d 485 (Wyo. 1999).
6. 708 N.E.2d 66 (Ill.App. 1999).

2. Procedural

Bid bond for 5 percent rather than 10 percent was a material variance allowing the city to reject a bid.

The City of Champaign, Illinois, issued a request for bids that contained a condition that bids be accompanied by a 10 percent bid bond. The low bid was made by a contractor that submitted only a 5 percent bid bond. The city held a pre-award meeting and awarded the contract to the next low bidder, which indeed had provided a 10 percent bid bond.

The Illinois Appellate Court concluded that the city had discretion to act in the manner it did and affirmed the lower court decision. *Bodine Electric v. City of Champaign.*[7]

County liable to claimant where it excused failure to require bond by declaration of emergency after the contract was awarded.

In a case similar to *Bodine*, the Oregon intermediate appellate court had to deal with a somewhat more complicated set of facts. A county housing authority had excused the contractor from furnishing a bond as required by the county's first solicitation for bids. It was authorized to do so if it issued a declaration of emergency.

It turned out, however, that the declaration of emergency did not take place until after the contract had been awarded. In accordance with state procedures, that late declaration was not sufficient to immunize the county from liability for a claim by the subcontractor. *Plant Electric Supply v. JC Northwest.*[8]

II. PRIVATE CONSTRUCTION BONDS

A. Liability of Surety

In event of principal's bankruptcy, automatic stay of 11 U.S.C. § 362(a) does not stay actions against surety. Automatic stay has no effect on declaration of default by obligee of principal's performance, as surety's obligations are determined not by termination of contractual rights of its principal but rather by declaration of default by obligee.

In *Am-Haul Carting Inc. v. Contractors Casualty and Surety Co.*,[9] the surety provided a payment and performance bond pursuant to the Miller Act for a subcontractor on a government job. The findings of the court are equally applicable to an action involving a private construction bond.

In May 1997, the subcontractor filed a Chapter 11 bankruptcy petition but did not notify the general contractor of its action at any time. In September 1997, the general contractor declared the subcontractor to be in default and terminated the subcontractor's contract. A copy of the default letter was sent to the surety with a cover letter notifying the surety that the general contractor expected the surety to fulfill its obligations under the performance bond.

As a defense, the surety argued that the letter from the general contractor violated the automatic stay provisions of the Bankruptcy Code. The U.S. District Court for the Southern District of New York rejected this contention. First, the court held that the provisions of the automatic stay protected only the debtor, property of the debtor, or property of the state, and not non-debtor parties or their property. Therefore, the stay did not apply to actions against guarantors or sureties. The court cited *Advanced Ribbons and Office Products Inc.* for this position.[10]

The court went on to hold that even if the Bankruptcy Code voided the termination of the contract, this would have no impact on the surety's obligations, since

7. 711 N.E.2d 471 (Ill.App. 1999).
8. 976 P.2d 1186 (Or.App. 1999).
9. 33 F.Supp.2d 235 (S.D. N.Y. 1998).
10. 125 B.R. 259, 263 (9th Cir. Bankr. 1991).

the declaration of default, not the termination of the contract, that triggered the surety's obligations under its bond.

The Court also rejected the surety's argument that there had been a material alteration to the contract by virtue of a change order.

B. Extra Contractual Liability of Surety

After declaration of default, surety did not act in bad faith by negotiating cancellation agreement in which surety would share in recovery from principal.

In *Revenue Markets Inc. v. Amwest Surety Insurance Co.*,[11] the principal under a payment and performance bond sued its surety for breach of the indemnity contract. The complaint also included a claim for breach of an implied duty of good faith and fair dealing in connection on the basis of allegations that the surety (1) the surety shared confidential information about the principal with obligee; (2) liquidated the principal's $300,000 letter of credit; (3) cooperated with the obligee in litigation between obligee and principal by providing witnesses and other aid; (4) did not disclose to the principal its negotiations with the obligee regarding a bond settlement agreement; and (5) in the bond settlement agreement, was entitled to share in recovery by the obligee against the principal. The surety counterclaimed for indemnification and for exoneration.

The principal entered into a contract for the construction of a highway toll collection system with the obligee. In June 1995, the obligee declared the principal to be in default on its construction contract and terminated the principal. In response, the principal filed suit against the obligee seeking damages in excess of $3.5 million. At the time of the declaration of default, there were approximately $700,000 in payment bond claims made against the principal and surety from various unpaid suppliers and subcontractors.

After the principal was declared in default, the surety retained an expert to act as consultant on behalf of the surety to review the situation between the obligee and the principal. During the review, the surety requested the principal to provide certain confidential information to the expert to aid in its investigation. In connection with providing that information, the principal and the expert entered into a nondisclosure agreement, to which the surety was not a party.

While the litigation between the principal and obligee was pending, the surety negotiated a settlement with the obligee wherein the surety agreed to pay the obligee up to $1 million for the cost of using a substitute contractor in exchange for a termination of surety's obligations and liabilities to the obligee under its payment and performance bond. In addition, the bond cancellation agreement provided that the surety would provide information and assistance to the obligee in connection with the litigation between the obligee and the principal. Finally, the bond cancellation agreement provided for the surety to share in one quarter of any monies recovered by the obligee against the principal.

Prior to paying any money in connection with the settlement, the surety liquidated a $300,000 letter of credit that had been provided by the principal as collateral security under the general indemnity agreement. In December 1996, the litigation between the obligee and the principal came to a close, and the principal was awarded $3.5 million in damages.

Carefully analyzing the terms and conditions of the indemnity agreement between the surety and the principal, the U.S. District Court for the Southern District of Florida found that the surety had done nothing that would constitute a breach of that agreement and that the surety had not acted in bad faith. To the contrary, the Court concluded that the indemnity agreement specifically provided that the surety could take the actions it did in resolving

11. 35 F.Supp.2d 899 (S.D. Fla. 1998).

the claim against the payment and performance bond.

The court found no basis in Florida law to recognize the existence of a fiduciary duty between the surety and its principal, stating that "what now appears ex-post as opportunistic behavior on the part of [the surety] was, at the time of [principal's] default, the prudent actions of a commercial actor defending its interest within the confines of its contractual obligations."

The court granted summary judgment for the surety for indemnification for all loss and expenses, and it also granted the surety exoneration for all future costs and expenses in connection with the issuance of the payment and performance bond.

C. Miscellaneous

Under New Jersey law, unique characteristics of suretyship remains intact, courts resisting temptation to blur distinction between contracts of suretyship, guarantee, and indemnity.

In *Cruz-Mendez v. ISU/Insurance Services*,[12] the Supreme Court of New Jersey interpreted the state's statutory provisions[13] requiring the issuance of a bond in connection with public fireworks display. While the technical issues regarding the statutory interpretation are not relevant outside of New Jersey, the general statements of the law by the court show that New Jersey continues to recognize the unique characteristics of suretyship and rejects the temptation to blur the distinction between contracts of suretyship, guarantee, and indemnity.

The court cited with approval Section 51 of the Restatement (Third) of Suretyship and Guarantee, which states:

> A traditional suretyship contract involves three parties: an obligee who is owed a debt or duty; a primary obligor who is responsible for the payment of the debt or performance of the duty; and a secondary obligor, or surety who agrees to answer for the primary obligor's debt or duty. An obligee may bypass the primary obligor and enforce the obligation directly against the surety.

The court ruled that despite the commercial liability language of the policy before it, given the language of the statute, the fireworks insuring agreement was in fact a suretyship agreement, and an injured party had a right of direct action against the surety.

D. Liability of Surety

Where a surety assumes responsibility as completing contractor and a subsequent dispute arises, surety may enforce arbitration provision in principal's contract.

In *Buck Run Baptist Church v. Cumberland Surety Insurance Co.*,[14] an obligee entered into a standard AIA contract with a principal for the construction of a new worship center and educational building for a church in rural Franklin County, Kentucky. The agreement provided that all controversies or claims arising out from contract or from any breach of it would be subject to binding arbitration. At the same time, the surety issued a payment and performance bond providing that the contract between the principal and the obligee was made a part of the bond, the same as though it was set forth therein.

Subsequent to beginning construction, the obligee terminated the contractor, and the surety retained another contractor to complete the project. A dispute arose between the completing contractor and the obligee, and the church refused to pay the outstanding contract balances. One of the central issues of the case was whether the provisions of the Kentucky statutes are intended to include a performance and payment bonds. The statute exempts from arbitration disputes involving insurance contracts.[15]

The Supreme Court of Kentucky held that the surety had stepped into the shoes

12. 722 A.2d 515 (N.J. 1999).
13. N.J. STAT. ANN. § 21:3-5.
14. 983 S.W.2d 501 (Ky. 1998).
15. KY. REV. STAT. § 417.050.

of its principal and was seeking to enforce the terms of the construction contract. The court went on to state that the dispute in fact did not involve the performance of lack of performance by the surety of its obligations pursuant to the "insuring agreement" in the payment and performance bond, and thus the statute did not apply to sureties.

The court noted that an insurance policy is a contract of indemnity in which an insurer agrees to indemnify the insured for any loss resulting from a specific event, and the insurer undertakes the obligations based on the evaluation of the market-wide risk and losses. By contrast, the court recognized that surety bonds are written based on evaluations of particular contractors and their capacity to perform a given contract. Unlike policies of insurance, compensation for the issuance of surety bonds is based on a fact-specific evaluation of risk involved in each individual case, and "no losses are expected."

The court concluded "a surety's relationship to its principal is more like that of a creditor/debtor than that of traditional insurer/insured."

E. Surety's Liability

Under Massachusetts law, surety's obligation to pay interest begins to accrue from date of default of principal and not from date that surety is notified principal is in default.

In *John W. Egan Inc. v. Major Construction Management Corp.,*[16] the Massachusetts Appeals Court held that a payment bond surety's obligation to pay interest arises from the date of the principal's default and not from the date on which the surety received notice of its principal's default. The obligation of a surety under a payment bond corresponds to that of its principal, the court stated, and the substantial correspondence of the obligation for principal and surety extends to the obligations to pay interest.

The Court concluded that it was long settled in Massachusetts that in the absence of a provision in the bond to the contrary, it is the responsibility of the compensated surety to keep itself informed on any defaults on the part of the principal and that it is not the burden of the creditor to inform and give notice to the surety, citing an 1881 case.[17]

III. FIDELITY AND FINANCIAL INSTITUTION BONDS

A. Employee Dishonesty

Loss resulting from fraudulent floor plan scheme held to be loan loss.

In *First Philson Bank N.A. v. Hartford Fire Insurance Co.,*[18] an employee of an automobile dealer used the dealer's floor plan financing agreement to obtain financing for non-existent automobiles. The bank accused one of its employees of complicity and sought recovery under a standard form financial institution bond. The bank contended that the loss resulted from a check-kiting scheme.

The Pennsylvania intermediate appellate court disagreed, finding that the loss resulted from a loan transaction. The court reasoned that the bank had extended credit to a customer, held a security interest in each automobile in the customer's floor plan and expected advances to be paid in full. That floor plan financing, the court concluded, was a loan transaction, so coverage was not conferred unless the employee received a financial benefit of $2,500, as required by Insuring Agreement A. The court held that the employee did not receive such a benefit.

The bank contended that the employee received a financial benefit from the scheme because it received shares of the bank's stock through an employee stock option plan and received salary increases and bonuses. Insuring Agreement A provided that the $2,500 financial benefit

16. 709 N.E.2d 66 (Mass.App. 1999).
17. Watertown Insuance Co. v. Simmons, 131 Mass. 85, 86 (1881).
18. 727 A.2d 584 (Pa.Super. 1999).

derived by the employee was exclusive of "employee benefits earned in the normal course of employment, including: salaries, commissions, bonuses, promotions, awards, profit sharing or pensions." The court found that the employee earned stock, salary and bonuses in the normal course of business, so they did not constitute a financial benefit as defined by the bond.

B. Forgery

Forged incumbency certificates are not instructions or advices within meaning of Insuring Agreement D.

In *First Union Corp. v. United States Fidelity & Guaranty Co.*,[19] a bank incurred a loss of over $35 million as a result of a fraudulent loan scheme perpetrated by a customer posing as an agent of Philip Morris Cos. The wrongdoer persuaded the bank that he was opening a facility for an "offshore" Philip Morris subsidiary. He produced two forged "incumbency certificates," which purported to establish his authority to act on behalf of Philip Morris, but he signed his own name to the promissory note and loan documents.

The bank sought recovery under Insuring Agreement D of a standard Form 24 financial institution bond, which covers loss resulting from the extension of credit on the faith of forged "written instructions or advices" authorizing the transfer or receipt of funds. The trial court granted the insurer's motion for summary judgment, and the Maryland appellate court affirmed.

The court held that the term "instructions or advices" refers principally to commercial paper. The court observed that because the incumbency certificates did not authorize or acknowledge the transfer of money and did not even mention loans, funds or payments, they could not qualify as "instructions or advices" within the meaning of the bond.

C. Securities

Fraudulent incumbency certificates are not "evidences of debt" within meaning of Insuring Agreement E.

In the same case, the bank also sought recovery under Insuring Agreement E, but the appellate court affirmed the trial court's grant of summary judgment in favor of the insurer.

Insuring Agreement E covers loss resulting from an extension of credit on the faith of an original "evidence of debt" that is forged. The court held that the "incumbency certificates" were not "evidence of debt" within the meaning of the bond. The term "evidence of debt," the court ruled, means documents that are the primary indicia of debt, such as promissory notes, and does not include an "incumbency certificate," which simply misrepresents the person's authority to act on behalf of the company.

D. Exclusions

Authorized representative exclusion bars recovery under commercial crime policy covering on-premises and in-transit loss.

In *Stanford University Hospital v. Federal Insurance Co.*,[20] a healthcare provider incurred a loss caused by the dishonesty of several employees, including the president and sole shareholder of its tax service provider, a company known as Hamilton Taft. The trial court held that the loss was covered under the "on-premises" and "in-transit" insuring agreements of the crime policy issued by Federal and granted summary judgment in favor of the insured. The Ninth Circuit reversed.

The policy covered, among other things, "direct losses caused by the actual destruction, disappearance, wrongful abstraction . . . of money and securities within or from the premises . . . [or] outside the premises, while being conveyed by the insured." The policy excluded coverage for loss due to "theft or any other fraudulent, dishonest, or criminal act . . . by any employee, direc-

19. 730 A.2d 499 (Md.App. 1999).
20. 174 F.3d 1077 (9th Cir. 1999).

tor, trustee or authorized representative of the insured whether acting alone or in collusion with others."

Stanford contended that Hamilton Taft was not its authorized representative, but the Ninth Circuit disagreed, finding that Stanford had authorized Hamilton Taft to act as its representative before taxing authorities and that Stanford had filed an Internal Revenue Service form designating Hamilton Taft as its representative. Relying on *Stop & Shop Cos. v. Federal Insurance Co.,*[21] the court held that the term "authorized representative" was not ambiguous and applied to those persons whom the insured authorized to handle the insured's funds. Hamilton Taft was authorized to possess and disburse Stanford's funds, both on the premises of Stanford or in transit, which rendered Hamilton Taft an "authorized representative" within the meaning of the policy exclusionary clause, the court held.

Stanford argued alternatively that even if Hamilton Taft was itself an authorized representative within the meaning of the policy, the employees of Hamilton Taft were not. Stanford contended that the authorized representative exclusion did not apply to the employees because they had diverted funds for personal gain and not for the benefit of Hamilton Taft. Relying on *Federal Deposit Insurance Corp. v. O'Melveny & Meyers,*[22] Stanford argued that under general principles of corporate identity and agency law, the wrongful and self-serving acts of officers cannot be imputed to a corporation.

The court held that officers and employees of "authorized representative" are likewise encompassed by the exclusion. The issue of whether the acts of Hamilton Taft's employees were those of an "authorized representative" under the exclusion, the court held, was different from the issue of whether Hamilton Taft is liable for the wrongful conduct of its employees.

In support of its conclusions, the court relied on equitable principles of corporate liability and agency theory under California law. The court noted that when necessary to address fraud or prevent injustice, equity will cast aside the legal fiction of independent corporate existence and deal with the corporation and stockholders as identical entities. In this case, the principal wrongdoer was the sole shareholder and director of Hamilton Taft, and Hamilton Taft was merely an instrumentality through which he served his own interests by diverting Stanford's funds. So the wrongdoer's actions should be attributed to Hamilton Taft to avoid the injustice of having Federal pay for his fraudulent acts.

IV. SURETIES' REMEDIES

A. Arbitration

Surety bond not "insurance contract" exempt from arbitration under Kentucky's statutory law. Surety stood in the shoes of principal and thus is entitled to invoke clause in principal's contract.

Buck Run Baptist Church Inc. v. Cumberland Surety Insurance Co. (cited at footnote 14) resulted in an order staying arbitration.

Buck Run had contracted to build a new sanctuary and educational center, the contract providing that claims arising from the contract would be subject to binding arbitration. Concurrently, the surety issued bonds incorporating the contract between Buck Run and the construction company.

After problems arose with the initial contractor, and pursuant to the terms of the bond, Cumberland retained another contractor to complete the project. A dispute arose over the performance by the completing contractor, and Buck Run refused to pay the contract balance. Cumberland made a demand for arbitration and filed a declaratory judgment to compel Buck Run

21. 136 F.3d 71 (1st Cir. 1998). Stop & Shop involved a claim which arose from the same fraudulent scheme by Hamilton Taft employees.

22. 969 F.2d 744 (9th Cir. 1992), *rev'd on other grounds,* 512 U.S.79 (1994).

to arbitrate. Buck Run responded that the dispute with Cumberland was not subject to arbitration because of Kentucky statute that provides that disputes arising from insurance contracts are not subject to arbitration.

The Kentucky Supreme Court held that the surety bond issued by Cumberland was not an "insurance contract" and so was not exempt from arbitration. Because Cumberland's performance bond clearly and specifically incorporated the construction contract, the arbitration provisions, if otherwise enforceable, were binding on Buck Run, the court concluded. In effect, it stated, Cumberland stood in the shoes of the principal, became the contractor on the project and was entitled to enforce the construction contract arbitration agreement.

B. Jurisdiction

Action on guardian's bond is proper only in county where estate is located.

Merchants Bond Co. v. Starkey[23] was an action to review a guardian's management of the estate of an incompetent person. A probate court in Arkansas entered an order forfeiting the bond that had been issued in connection with a second appointment of guardianship in Texas. Merchants Bonding Co., acting as surety in Texas, conditioned that the guardian would properly perform all duties required of her. Merchants appealed the Arkansas probate court's decision.

The Arkansas Supreme Court held that sureties are chargeable only according to the terms of the bond. In this case, nothing in the bond indicated that the parties creating the bond contemplated that the bond would be payable in any state other than Texas. Moreover, according to the laws of Texas, only the court of the county where the bond is filed has jurisdiction over any suit instituted on any bond or obligation of an insurance company licensed in the state. Therefore, the laws of Texas prohibited the enforcement of the bond in Arkansas.

The language of the bond supported this conclusion, the court stated. The bond stated that the guardian and Merchants are "held and firmly bound unto the county judge of El Paso County [Texas], and his successors in office." Moreover, the court recognized that it should read the language of the bond as if the laws of Texas in effect at the time the bond was created were written into it and should not imply any terms not clearly set forth in the bond.

C. General Indemnity Agreement

Wife of owner of corporate principal found not liable on multiple general indemnity agreements where there is accompanying documentation.

National American Insurance Co. v. Hogan[24] demonstrates the maxim of keeping things direct and simple in securing individual liability on a general indemnity agreement.

Brenda Hogan was married to Ben Hogan, who operated Hogan Construction Co. In order to secure surety bonds from National American Insurance Co., the Hogans signed a series of general indemnity agreements. These were obtained through Midwest Indemnity Corp., acting as a managing general agent, with the bonds being written on National's paper. The first agreement was dated May 16, 1988, and was signed by Ben Hogan, individually and as president of the corporation, and by Brenda. It named Midwest as indemnitee. The second agreement, dated October 15, 1991, was signed in blank by the same individuals in the same capacity and showed only the name, "National American Insurance Company." Finally, the third GIA was executed on February 18, 1994, naming National as indemnitee, but was not signed by Brenda.

To complicate matters even more, there were three letter agreements that attempted to limit Brenda's liability under the GIAs she executed. Two of them were dated

23. 987 S.W.2d 717 (Ark. 1999).
24. 173 F.3d 1097 8th Cir. 1999).

May 16, 1998, addressed to Midwest and purported to limit her liability to the value of any interest she had or would have in assets owned by Ben Hogan or Hogan Construction Co. The third letter agreement, executed October 15, 1991, was not addressed to anyone, referenced no particular GIA and referred only to American Bonding Co., a concern unrelated to either Midwest or National. However, there was testimony that this particular document was stapled to the October 15, 1991, "blank" GIA.

The Hogans' financial transactions *inter se* were equally complicated. Apparently, Brenda had inherited some money and at various times loaned approximately $155,000 to Hogan Construction Co. However, in return, some land was deeded to Brenda, where the couple lived, and also remitted to her the proceeds of the sale of some other property. Finally, between 1993 and 1996, Ben Hogan repaid his wife approximately $115,000 additionally.

The trial court put to the jury some fairly open-ended interrogatories, and National American's efforts to overturn the verdict on appeal did not succeed. The Eighth Circuit reasoned that there was substantial evidence that the May 16, 1988, general indemnity agreement was valid as between Brenda and National, but also that the accompanying limiting agreement was likewise controlling. The jury also apparently found that any liability assumed by Brenda under the 1988 agreement, as well as that in 1991, was extinguished by National's acceptance of the February 1994 contract that excluded her.

This triggered a discussion of the "substituted contract defense." Under Arkansas law, which controlled, this defense may be raised by a co-obligor to an original contract if the obligee accepts a subsequent agreement signed only by the other obligor as a substitute for the original contract. In addition, acceptance of the notation by express words was deemed not to be necessary; acceptance could be implied from the surrounding facts and circumstances. Similarly, although each of the GIAs provided that a subsequent indemnity agreement would be in addition to and not in lieu of an earlier one, the court found this to be waivable.

Under Arkansas statutory law, an award of attorney's fees was made to the successful indemnitor.

D. Equitable Subrogation

Surety denied right of equitable subrogation where contractor had settled previously with government.

The contract between the principal and the *Intercargo Insurance Co. v. United States*[25] ended almost as soon as it began. The contract was awarded by the Department of the Army in September 1993 for work at Fort Rucker, but by December of that year, the underwriter (not Intercargo) that had been providing the principal's worker's compensation and liability insurance notified that it would cancel effective January of the next year. Although the principal submitted and was paid one progress payment, a cure notice was sent because of the insurance problem, and on February 17, 1994, the contract was terminated. In July, the Army "de-obligated" the remaining contract balance.

A claim was presented by a supplier and Intercargo settled for $150,000. It then filed suit U.S. Court of Federal Claims challenging termination and seeking to convert it into a termination for convenience. The litigation was settled. Next, the surety claimed the government as equitable subrogee for the amount paid in settlement under the payment bond.

The government argued that the court lacked jurisdiction because of the lack of privity of contract between Intercargo and the government. However, the court noted the government's concession that a surety who had paid material suppliers or subcon-

25. 41 Fed.Cl.449 (1998).

tractors indeed had limited rights to sue the government if there were retained contract funds due the contractor. The court also noted that there would be jurisdiction if the government were improperly to pay one other than the surety.

The problem the surety encountered was the early termination of the contact. Finding oft-quoted language in *Pearlman* to be "somewhat ambiguous," the court held that the surety's rights of subrogation would be limited to those it acquired from its principal. It then held that because the government did not hold any fund due and owing the contractor, the principal had no right to contract funds before or after the February 17 termination. Hence, the surety received nothing.

In addition, the court held that Intercargo was barred by settlement of the earlier litigation between the principal and the government from revisiting the issue of converting the termination for default to a termination for convenience.