Differing Rights and Obligations

Navigating Surety Claims on a Federal Project

By Heather F. Shore and Diane Hastings Lewis

The surety's challenge is to act quickly with minimal information while uncovering the status of project work, avoiding liability for improper claims, and protecting its rights to recover its losses to the greatest extent possible.

Federal construction projects, for which the Miller Act requires bonding, represent a significant portion of bonded projects across the country. To the outsider, a federal project may appear to have a lot in common with a private bonded project; however, if a surety is required to perform on a federal project, the surety's rights and obligations often differ significantly from those on a private project.

Default and Takeover

By the time a surety is first notified of its principal's default on a federal construction project and is called upon to perform under its bonds, numerous problems probably already exist, such as non-performance by the principal, delayed performance, non-conforming work, and unpaid subcontractors, laborers, and suppliers. A surety called upon to perform under a bond must quickly get up to speed on the status of the project and perform and fulfill all undertakings, covenants, terms, conditions, and agreements of the contract between the government and the principal. A surety must inspect all project documents, perform an accounting of payments made by the government and payments made to and claims by subcontractors and suppliers, and assess the current physical status of the work on site. After thoroughly investigating, a surety is ready to deal with all of the important issues necessary to completing the project successfully.

To facilitate a surety's performance, the government and a surety often execute a "takeover agreement," which sets forth the rights and the expectations of both parties relative to the surety's completion of a project. This takeover agreement constitutes a contract between a surety and the government, and the surety must have one if the surety needs to bring a Contract Disputes Act claim against the government for issues related to performing on a project.

The Federal Acquisition Regulations (FAR) enumerate mandatory requirements for a government takeover agreement with a surety. 48 C.F.R. §49.404(e). Specifically, a takeover agreement between a surety and the government may prioritize the surety's right to payment from the defaulting

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principal's assets, must require the surety to complete the work set forth in the contract, and must require the government to pay the surety's costs up to the unpaid balance of the contract price, subject to certain setoff rights of the government, and a reservation of rights for the government concerning liquidated damages. A surety should consider pressing for the government to make the takeover agreement a tripartite agreement to include the surety, the government, and the defaulting contractor as authorized by 48 C.F.R. §49.404(d) to avoid challenges to claims related to events occurring before the takeover agreement became effective. This benefit must be weighed against the risk that the defaulting contractor may make negotiations more difficult.

A takeover agreement should also incorporate all contract documents, including drawings, the schedule of values, all submitted and approved pay estimates as of the date of the takeover agreement, and any documents that relate to defects in the work or previous government complaints regarding non-compliance with contract provisions. Finally, the completion agreement between a surety and a completing contractor should also be attached so that all parties are aware of the terms and conditions to which the completing contractor is bound. The government has an interest in assuring that a completing contractor is held to the same terms, conditions, and standards as a defaulted prime contractor.

The FAR that apply to takeover agreements contain some provisions contrary to standard surety principles. These provisions have not been extensively litigated, so it is important for sureties to be aware of these FAR to navigate them accordingly. Notably, §49.404(e)(3) places an assignee bank ahead of a surety with respect to the unpaid contract balance. Such an arrangement directly conflicts with well-established law, which provides that a surety's subrogation claim takes precedence over any claim of the defaulting contractor and thus is ahead of the contractor's assignees. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S. Ct. 232, 9 L. Ed. 2d 190 (1962) (citing *Henningsen v. United States Fid. & Guar. Co.*, 208 U.S. 404, 28 S. Ct. 389, 52 L. Ed. 547 (1908)). Moreover, §49.404(e)(4) conditions surety reimbursement for completion of contract work on (1) the agreement of the government, the surety, and the defaulting contractor; (2) the determination of the Comptroller General identifying the payee and the amount; or (3) a court order. This requirement could quickly escalate a surety's costs if it must seek a court order to secure payment because the government and defaulting contractor will not agree to permit the surety to receive payment.

Once a takeover agreement is in place, the government and a surety should meet with the completing contractor for a pre-construction conference to identify known and potential problems that may impede project completion or drive up the costs of completion. A surety will then authorize the completing contractor to proceed with the work. A surety's first order of business is to (1) prepare, certify, and submit the principal's last payment application if this did not previously occur, and (2) follow up with the government for payment of any previously submitted payment applications.

Generally, a surety and the government will review the existing contract schedule of values as well as the percentage of completion approved by the government and compare it to the schedule at the time of the principal's default or termination. The schedule of values, together with the most current pay estimate, is typically given to prospective completing contractors for their use in preparing bids for completion of work. Although problems with the schedule of values or the percentage of completion approved and paid for by the government often surface during the bidding process when contractors discover inconsistencies in the schedules, some problems remain latent until much later. Overpayments due to front-end loading or the misstatement of line item values by an original contractor can be difficult to uncover. This is particularly true when a completing contractor is pressured to bid low and to begin work quickly or when the schedule of values contains large line items for work measured in units that are hard to ascertain, such as excavation, cut and fill, blasting, rock removal, or concrete. These are the types of problems that a surety will need to address soon after coming in on a government project.

Pitfalls of Front-End Loading, Overpayments, and Claim Certification

Completing the construction work on a defaulted project is only the beginning of a surety's work because the project finances will almost certainly be a mess. Payments made by the government to its contractors are governed by the FAR, which require monthly progress payments based on 80 percent of the cost to perform the work, with the remaining 20 percent held as retainage. 48 C.F.R. §52.232-1, *et seq.* The customary progress payment rate for contracts with small business concerns is 85 percent. The payments may be made at more frequent intervals and advance payments may be allowed if approved by the contracting officer.

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Federal construction contracts require a contractor to provide an itemization of the total contract price and the amount requested in each category of work to verify the amount of the payment requested. 48 C.F.R. §52.232-5(b). This schedule of values will also contain details of the work to give the government a basis for keeping track of proper progress payments during the progression of a project. It is the contracting officer's responsibility to review the work that has been completed and the

accompanying progress payment request and to determine how much to pay. The contracting officer has broad discretion in this regard.

Although the schedule of values is designed to prevent advance payments, it can be distorted if it does not correctly distribute the actual costs between the categories of contract work. For example,

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by placing a nominal or reduced price on some portions of the work and inflated prices on other categories, a contractor can distort the schedule and, therefore, the payment process. Advance payments may only be made under certain specific circumstances and with adequate security. 41 U.S.C. §4503. A schedule of values that requests the government to pay more than the value of work actually completed distorts the payment process and is referred to as "front-end loading." Mathematical imbalance and front-end loading are not entirely unusual and do not necessarily result in a prohibited advance payment. These issues become legitimate concerns when a contractor might not finish a project. Front-end loading and a mathematically unbalanced bid are not problematic unless the bid line items are "materially unbalanced." A bid is materially unbalanced only if it poses an "unacceptable risk to the government." *J & D Maint. & Servs. v. United States*, 45 Fed. Cl. 532, 536-37 (Fed. Cl. 1999). A materially unbalanced bid creates risk to a surety because it is likely to increase the loss that the surety will incur on a project if the principal fails to complete the bonded work.

A surety taking over a project may also discover that a defaulting principal has billed and received contract funds in excess of the work performed or completed, thereby overbilling the project. Overbilling can occur in several different forms. For example, overbilling could occur if the government advanced funds to assist a cash-strapped principal, if the principal billed the government for more work than it completed, or if the government failed to withhold the retainage mandated by a contract. Overbilling can reduce a principal's incentive to finish its work on a project, and it reduces the contract balance available to a surety for the completion of a project. While a surety theoretically should not be liable for the government's improper payment for work that was not actually performed by a principal, it is difficult for a surety to succeed in asserting the "overpayment defense" on a public project.

In evaluating a surety's assertion of the overpayment defense, courts consider whether there has been a "material departure from contractual provisions related to the security of retained funds" before it will entertain releasing a surety from liability under a bond. *RLI Ins. Co. v. Indian River Sch. Dist.*, 556 F. Supp. 2d 356, 363 (D. Del. 2008). Notably, the government's actions in making the overpayments are reviewed for abuse of discretion, which requires a surety to prove more than simple misconduct. *Cincinnati Ins. Co. v. United States*, 71 Fed. Cl. 544, 547 (Fed. Cl. 2006). In some situations, it might be difficult for the government to identify overbilled line items; however, sometimes overpayments could have been avoided by simple observation of the work or stricter adherence to the contract.

Sometimes, the government will overpay a contractor before a surety takes over the project, which reduces the remaining contract balance available to the surety to offset its losses in completing that project. In these situations, a surety may have a difficult time obtaining relief from the government. For example, in *Lumbermens Mut. Cas. Co. v. United States*, 654 F.3d 1305 (Fed. Cir. 2011), at the time of the prime contractor's default, the government had paid the contractor 40 percent of the contract balance, yet only 12 percent of the work had been performed. After completing the project under a takeover agreement, the surety sued the government, claiming equitable subrogation under the theory that the government improperly increased the surety's losses by overpaying the principal contractor. The court rejected the surety's equitable subrogation claim because the government made the objectionable overpayments to the contractor before it received notice from the surety.

It is well established that if a surety places the government on notice of the principal's default, then the surety can sue the government to recover not only retainage, but also any amounts paid by the government to the principal after the surety has notified the government of the default. *Hartford Fire Ins. Co. v. United States*, 108 Fed. Cl. 525, 528 (Fed. Cl. 2012). Furthermore, once the government has notice of a default, or at the least a risk of default, the government has an obligation to avoid any conduct that materially increases a surety's risk of loss, which includes protecting the remaining contract balance. An egregious failure to do so is known as a "pro tanto discharge" and can result in a complete or partial discharge of a surety's obligations under the theory that the government took improper actions that prejudiced the surety and increased the surety's financial risk. *Lumbermens Mut. Cas. Co.*, 654 F.3d at 1314.

The manner in which a principal billed overhead and profit is also important information for a surety to have when it is deciphering a schedule of values. If a schedule of values does not have a line item dedicated to profit and overhead or general conditions, it is expected that these amounts will be built into the principal's bid elsewhere, because the principal must receive payment for its performance. A principal's allocation of the profits, overhead, and general conditions can become a concern if it is heavily loaded on the front end of the project work so that it could be considered an advance payment. When a principal intentionally misstates the amount of the general conditions, profits, or overhead in a line item designated by the government, or improperly shifts amounts between distinct line items of construction costs, this creates even more problems for a surety. If a surety acting under a takeover agreement prepares, certifies, and submits

pay applications based on the materially unbalanced schedule, or if the surety continues to endorse a previously submitted unbalanced schedule, it could face a claim for misrepresentation.

A surety's potential exposure for preparing, certifying, and submitting a defaulted contractor's pay estimates also is important to consider. To gauge potential exposure properly, a surety must understand its legal status from the perspective of the government and the law. When a surety is called upon to pay the bills of a defaulted government contractor under a payment bond, the surety does not assume the position of general contractor. Rather, a surety is merely performing payment bond obligations, which are governed by the terms and conditions of the bond and the federal Miller Act. A surety's right to recoup its losses arises primarily from the surety's right of equitable subrogation. In general, under the equitable subrogation doctrine, a surety that provides a performance bond and performs its obligations under that bond after a contractor default may step into the shoes of the contractor. A payment bond surety is subrogated to the rights of not only the subcontractors that it pays, but also to the rights of the prime contractor that is in privity with the government, for assuming and paying that contractor's debts. The surety is therefore able to rely on the waiver of sovereign immunity in the Tucker Act, 28 U.S.C. §1491 (2000), to sue the United States for payment. *Commercial Casualty Ins. Co. of GA v. US*, 71 Fed. Cl. 104 (Fed. Cl. 2005).

Dealing with Defective Work and Certifications for Payment

Just as important as monitoring the quantity of work performed by a principal to avoid front-end loading and advanced payments, sureties must also be aware of the quality of work performed by a principal. Subpar or defective work that does not meet the quality standards in the contract may result in additional losses to the surety if the surety has to redo the work. Defective work could also potentially become the basis of a False Claims Act action if there have been certifications to the government that the work complies with the contract.

Problems with quality of work are almost inevitably at issue on a project that has been declared in default. If these problems have been identified by the government before a default, then a surety can gauge the amount of corrective work that will need to be done to ensure the work complies with the contract. Thus, a surety should request that the government inspect the work and identify work that it will not accept so that the surety can incorporate those costs into the completing bid documents. Non-conforming work may also raise False Claims Act implications. The surety cannot request payment for work that it knows does not comply with the contract and should investigate questionably defective work before seeking payment.

False Claim Act implications may also arise with respect to certifications for payment. Indeed, with every request for progress payments, a contractor must certify that "to the best of my knowledge and belief… the amounts requested are only for performance in accordance with the specifications, terms, and conditions of the contract." 48 C.F.R. §52.232.5(c). For example, in *Shaw v. AAA Eng'g & Drafting, Inc.*, 213 F.3d 519, 531 (10th Cir. 2000), a contractor had a fixed-price contract with the government to provide photography services, which included a requirement that the contractor remove trace silver from film processing solution before disposal. Each month, the contractor signed certifications that it had complied with the contract. After it was discovered that the contractor had not complied with the silver recovery requirements, the contractor was found liable under the False Claims Act on the grounds that it falsely signed certifications stating that it had complied with silver recovery requirements in its government contract for photography services when in fact it had not. The court concluded that the contractor's monthly invoices along with its certifications could constitute a knowing presentation of a false claim for payment because the invoices impliedly certified that the contractor's work complied with the contract. Thus, it is imperative that a surety be attuned to the contractual provisions with which it certifies compliance.

Roadblocks to Recovery

Obtaining payment from the government at the conclusion of a federal construction project is governed by a different set of rules than those a surety typically relies on. The Contract Disputes Act (CDA), 41 U.S.C. §7101–7109, governs claims based on government contracts. The CDA requires all claims against the government arising out of a government contract to be in writing and to be submitted to the contracting officer for a decision. A "claim" described in 48

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C.F.R. §52.233-1 has been summarized as "(1) a written demand, (2) seeking, as a matter of right, (3) the payment of money in a sum certain." *Northrop Grumman Computing Sys. Inc. v. United States,* 709 F.3d 1107, 1112 (Fed. Cir. 2013) (citing *Reflectone, Inc. v. Dalton,* 60 F.3d 1572, 1575–76 (Fed. Cir.), *reh'g denied* (Fed. Cir. 1995)). Claims can only be brought by "contractors" that are a party to a federal government contract. 41 U.S.C. §7101(7). Moreover, the Assignments of Claims Act, 31 U.S.C. §3727, and the Assignment of Contracts Act, 41 U.S.C. §15, commonly referred to collectively as the "Anti-Assignment Acts," effectively exclude a surety from pursuing a claim as an equitable subrogee or assignee because both acts withdraw sovereign immunity normally allowed by the Tucker Act. *Ins. Co. of the W. v. United States*, 100 Fed. Cl. 58, 64 (Fed. Cl. 2011).

Once a surety is a party to a takeover agreement, the surety becomes a party in privity with the government with respect

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to claims arising after the execution of the takeover agreement and has standing to maintain actions for breaches of the agreement and any portion of the underlying construction contract that was incorporated into the takeover agreement. The CDA also does not apply to a surety's completing contractor because the completing contractor is not a party to any government contract. So a completing contractor's claims against the government must be brought through the surety.

A takeover agreement does not solve all of a surety's problems asserting a claim under the CDA, however, because a completing surety is not a "contractor" under the CDA with respect to claims that arise from work performed before the execution of a takeover agreement. *United Pacific Insurance. Co. v. Roche*, 380 F.3d 1352 (Fed. Cir. 2004). Equitable subrogation and assignment theories also do not save a surety's pre-takeover agreement claims because the surety was not a party to any contract with the government before the surety executed the agreement. *Fireman's Fund Insurance. Co. v. England*, 313 F.3d 1344 (Fed. Cir. 2002).

Even when a surety is recognized to have standing under the CDA, the surety faces significant disadvantages in asserting the claims of the defaulted principal or the completing contractor. A surety does not manage the day-to-day progression of the work or the collection of costs. With respect to claims belonging to a defaulted principal, a surety may be hindered because the events predicating the claim likely occurred before default and before the surety became involved. Despite these challenges, a surety is bound by the government claim certification requirements.

Specifically, in submitting its written claim in excess of $100,000 to the contracting officer, a surety must certify that (1) the claim is made in good faith; (2) the supporting data are accurate to the best of the surety's knowledge and belief; (3) the amount requested accurately reflects the adjusted amount for which the surety believes the government is liable; and (4) the certifier is duly authorized to certify the claim on behalf of the surety. 41 U.S.C. §7103(b)(1). The individual signing a certification for a surety need only be authorized to bind the surety with respect to the claim. 41 U.S.C. §7103(b)(2). If an individual certifies this claim to the government in the course and scope of his or her employment with the surety, then the individual and the surety could be subject to liability under the False Claims Act. *See U.S. v. Entin*, 750 F. Supp. 512, 519-520 (S.D. Fla. 1990) (citing 31 U.S.C. §§3729–3731). Thus, certification can be a difficult issue for a surety when it did not perform the contract work giving rise to a claim and did not calculate the amounts due.

Certification becomes especially complicated when claims include subcontractors' claims because subcontractors do not have standing to submit their own claims under the CDA. A certifying party does not need to believe a subcontractor's claim to be certain, but the certifying party must believe that there are good grounds for the certified claim. *Trafalgar House Constr., Inc. v. United States,* 73 Fed. Cl. 675, 694 (Fed. Cl. 2006). Notably, a certifying party assumes the liability for fraud. Thus, a surety must certify a claim with a belief that there are "good grounds" for the claim based on the surety's indirect knowledge of the information supporting the claim.

In conclusion, by the time a surety enters the scene of a troubled construction project, it is already at a disadvantage. Something has gone wrong or the surety would not have become involved. The owner, design professionals, defaulting prime contractor, subcontractors, and suppliers are all up to speed on the status of the project, and everyone is probably unhappy. Most parties in this situation expect prompt payment and performance, and the surety's challenge is to act quickly with minimal information while uncovering the status of project work, avoiding liability for improper claims, and protecting its rights to recover its losses to the greatest extent possible. FD