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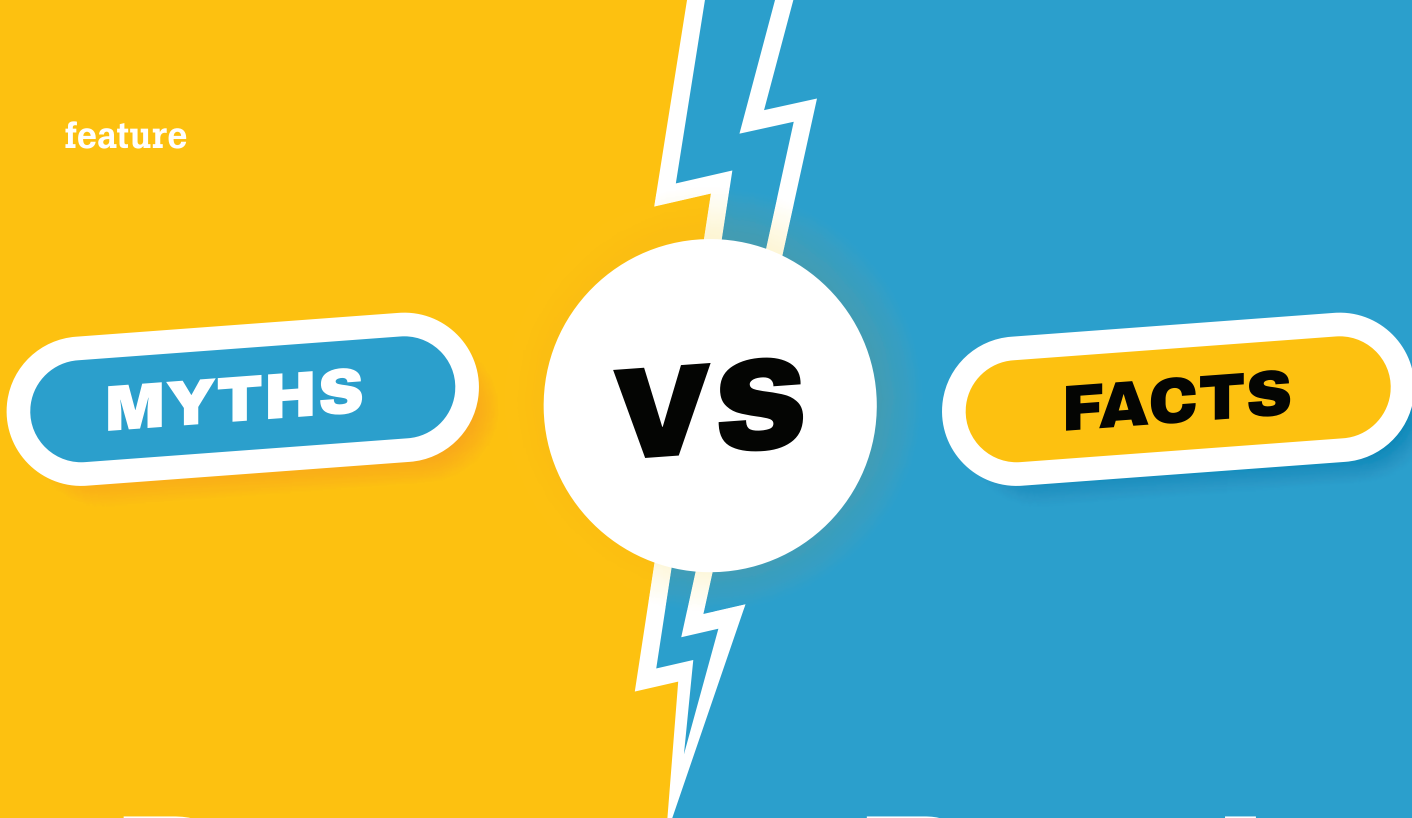

Payment Bond MythBusters

These widely understood "rules" are anything but.

BY DAVID A. HARRIS

THERE ARE ALL sorts of rules and concepts that sureties, contractors, and bond producers just *know* to be true about payment bonds and that have become imbedded as immutable rules. As it turns out, many of the supposed hard-and-fast rules have exceptions and subtleties. In these cases, the rules are not rules at all—but simply myths.

Exposing these payment bond myths leads to a better collective understanding of when our understanding of the rules needs to be modified to account for exceptions and when the rules may be flatly wrong and need to be busted once and for all.

Myth 1:
"The liability of a surety on a payment bond is coextensive with the principal's liability."

There are literally scores of cases stating that liability of the surety is coextensive with the liability of its principal. And many bonds begin by stating that the surety and principal are jointly liable to the obligee. However, this concept is often abused by payment bond claimants to hold the surety liable for more than what the bond covers. Just as there are cases reciting this "rule," there are any number of instances where it is inapplicable.

For example, if a general contractor terminates a subcontractor, but the termination is wrongful, the subcontractor may recover its lost profits for the work not yet performed. However, even though the general contractor may be liable for those damages, the surety may not be liable under a payment bond that defines coverage as "labor and material delivered or installed on the project."

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Myth 2:
"A subcontract provision can waive bond claims."

Federal courts have consistently held that the Miller Act is to be liberally construed. Exactly how does that play out with a claim that a payment bond subcontractor has waived contractual rights?

The Miller Act states that a clause in a subcontract waiving a right to the payment bond is void unless the waiver is executed after the labor and material have been furnished. See 40 U.S.C. § 3133(c). Many states similarly prohibit the waiver of payment bond claims prior to performance of the work. This non-waiver rule is broader than may be thought. It has been extended beyond the straightforward notion that a subcontractor or supplier does not waive its rights under a bond even if its contract says bond claims are waived.

In one case the general contractor had a strong no-damage-for-delay clause with the subcontractor. When the subcontractor made a claim for delays, the surety invoked the subcontract clause as a defense. The court held that the clause was not enforceable because it amounted to a waiver of the claim. See *U.S.* ex rel. *McCullough Plumbing, Inc. v. Halbert Construction Co.*, No. 17-CV-803-CAB-WVG, 2018 WL 6601844 (S.D. Cal. 2018).

Myth 3:
"Delivery of materials to the project is required."

One of the rules that is often believed to apply in all circumstances is that materials must be delivered to the bonded project for there to be a valid claim on the payment bond. However, courts have found an exception to this rule where the supplier had a reasonable, good faith belief that materials were intended for the bonded project. See, for example, *TDS Construction, Inc. v. Burke*, 206 Ga. App. 223, 425 S.E.2d 359 (1992).

Federal court cases analyzing claims made under the Miller Act have also found that a reasonable, good faith belief that the subcontractor intended the material for the job is enough to trigger coverage. See *U.S.* ex rel. *Pomona Tile Mfg. Co. v. Kelly*, 456 F.2d 148 (9th Cir. 1972); *U.S.* ex rel. *Carlson v. W.R. Taylor Co.*, 414 F.2d 431 (5th Cir. 1969) ("re-reiterate that neither delivery of materials to nor use by the contractor is necessary in order . . . to recover"); *U.S.* ex rel. *Color Craft Corp. v. Dickstein*, 157 F. Supp. 126 (E.D.N.C. 1957).

As always, it is important to read the bond. Many payment bonds require a lienable claim as a precondition to payment, and most lien statutes require delivery of the materials to the project.

Myth 4:
"The owner may not assert a claim on the payment bond."

The question of whether an owner is a claimant under a payment bond depends on the language used in the bond. The AIA-312 payment bond, for both the 1984 and the 2010 version, explicitly gives the owner rights under the payment bond. The 2010 AIA-312 provides that the surety's obligation to the owner is to defend claims, demands, liens, and suit against the owner or the owner's property by those seeking payment for labor and materials.

Of course, this can lead to the anomalous situation of having claims by the owner under both the performance bond and the payment bond. Contractors are generally required to keep a project lien free, and a failure to do so can trigger a performance bond claim. The result is that liens and payment bond claims can trigger surety exposure under both the payment bond and the performance bond.

Myth 5:
"Lost profits are not recoverable."

Many believe that lost profits are not recoverable under a payment bond. Can a subcontractor's claim be denied where the underlying contract provides for payment of profits?

Suppose, for example, a subcontract says the contractor would advance money for labor costs for day-to-day expenses, and the balance owed to the subcontractor is to be paid out of profits. In this scenario the subcontractor would be entitled to recover its operational expenses. Whether or not it could recover its claim to a share of the profit would depend on whether the general contractor was profitable. If the job were indeed profitable, the subcontractor could recover. See, for example, *U.S.* ex rel. *Harrington v. Trione*, 97 F. Supp. 522 (D. Col. 1951).

Lost profits, particularly on a delay claim, are generally not recoverable. There are instances based on the language of the bonded subcontract where lost profits may be recoverable. In a case in which the subcontractor was entitled to be paid a share of profits, and the job was indeed profitable, the subcontractor could recover. See *U.S.* ex rel. *Woodington Electric Co., Inc. v. United Pacific Insurance Co.,* 545 F.2d 1381 (4th Cir. 1976). The court held that, where a subcontract includes a profit-sharing provision, "[a] surety is liable for the subcontract price, unless it was fixed by collusion, fraud or overreaching."

ONE OF THE RULES THAT IS OFTEN BELIEVED TO APPLY IN ALL CIRCUMSTANCES IS THAT MATERIALS MUST BE DELIVERED TO THE BONDED PROJECT FOR THERE TO BE A VALID CLAIM ON THE PAYMENT BOND. HOWEVER, COURTS HAVE FOUND AN EXCEPTION TO THIS RULE.

Myth 6: "Project managers have a claim under a payment bond."

Several Miller Act cases have held that, even if a project manager is on site, unless he/she does some physical labor or might be called upon to do manual labor, he/she has no claim. Determining whether a project manager performs sufficient labor to have a valid payment bond claim requires a case-by-case analysis.

In one case the claimant project manager was an estimator, and he testified that he managed employees, subcontractors, and even did some work such as sanding, patching, and removing light fixtures. The court held that he could recover payment for his onsite work, but he had the burden of producing evidence of how much work he performed, and only that could be recovered. See *U.S.* ex rel. *Olson v. W.H. Cates Construction Co., Inc.*, 972 F.2d 987 (8th Cir. 1992).

In another case a project manager asserted claims because he was on site; determined bid amounts, change orders, and bid proposals; and negotiated contracts. He also said that his labor required him to live on the job site, clean the office and bathrooms, and perform other onsite duties. However, he never performed any physical labor that went toward construction of the project. Under these circumstances, his payment bond claim was denied. See *U.S.* ex rel. *Shannon v. Federal Insurance Co.*, 2006 WL 2349636 (S.D. Miss. 2006).

A final case example involved a claimant who was retained by a subcontractor as a vice president and estimator. The claimant's claimed labor on the project included his role as the on-site representative for the subcontractor, supervising other workers, and lending an "extra hand" with more strenuous tasks such as mixing and pouring concrete. The court determined that the claimant provided labor within the meaning of the applicable Little Miller Act, which it defined to include all work that is "necessary to and forwards" the project secured by the payment bond. His labor in mixing and pouring concrete, as indicated on daily reports, qualified as "labor" under the payment bond. See *Dat Luong v. Western Surety Co.*, 485 P.3d 46, 54 (Alaska 2021).

Myth 7: "If the supplier has gotten paid, or received a check, the claim is not valid."

If the supplier receives a check payable jointly to it and a subcontractor but returns it to the subcontractor without taking its share, some courts hold the supplier cannot later recover from the payment bond. This is generally known as the "joint check rule." It applies when a material supplier endorses the general contractor's check made jointly payable to the supplier and the subcontractor. The rule holds that, if a claimant endorses a joint check without collecting the amount then due from the maker, the claimant is not entitled to assert a payment bond claim.

However, this rule is often not applied on public contracts. Miller Act cases hold that, where the joint check contains no express waiver of Miller Act rights, the supplier has not waived its claims. Simply put, there is no joint check rule under the Miller Act.

The lack of a joint check rule under the Miller Act can lead to some unexpected outcomes. For example, in one case, notwithstanding the fact that the amount due had been paid by the general contractor by joint check to a supplier and subcontractor, and even though the general contractor had no knowledge that payment was then remitted from the supplier to the subcontractor under a retainage agreement, the supplier was nevertheless found to be entitled to recovery under the Miller Act bond. See *U.S.* ex rel. *Marmet Corp. v. Becon Services Corp.*, 794 F. Supp. 428 (D.D.C. 1992).

Bankruptcies can perhaps give rise to the most disturbing example of a subcontractor's having a right to recover under a payment bond even if it has been paid. The Bankruptcy Code creates an action by the trustee for preference claims. A preference action is a claim seeking to recover a payment made by the debtor to a creditor within a specific time prior to a filing of bankruptcy (typically within 90 days of filing, but sometimes within a year after filing). The Bankruptcy Code will allow disgorgement of a payment received by a subcontractor or supplier if the payment is a preference. The surety may then face a claim by the subcontractor that received payment but now has lost a preference action and repaid that amount to the bankruptcy estate.

Closing Thoughts

A very important caveat is in order: whether each of these supposed rules are myths or not depends greatly on the language of the payment bond at issue or the governing statute. How a court might interpret the bond or statute at issue does not necessary align with the hard-and-fast rules sureties, contractors, and bond producers have adopted as true. Exceptions often exist, and sometimes the rules we assume are true are only myths, with limited or no application.

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