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Opportunity Lost: Federal Circuit Declines Reconsideration of Surety's ASBCA Rights

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The Contract Disputes Act (CDA) limits appeal rights to the Armed Services Board of Contract Appeals (ASBCA) to entities that contract directly with the federal government. Performing sureties on those same projects cannot assert claims to the ASBCA, except for those claims that arise after a takeover agreement creates the direct contract the CDA requires. In this case, *Guarantee Co. of North America, USA v. Ikhana, LLC*,[1] two justices of the United States Court of Appeals for the Federal Circuit invited the court to reconsider the issue, including a review of precedent, legislative history, and fundamental principles of suretyship and contract law that support an extension of those rights to the surety. The subsequent petition for a rehearing was recently denied, dashing the hopes of the surety industry for a necessary change.[2]

The matter stems from a 2013 federal construction contract between contractor Ikhana, LLC and the U.S. Army Corps of Engineers (the Corps) for work at the Pentagon. Guarantee Company of North America (GCNA) provided the Miller Act performance and payment bonds, with Ikhana executing a general indemnity agreement assigning its contract rights to GCNA in the event of its default or payment by GCNA. Problems arose, the project was delayed, and Ikhana submitted claims for additional costs and time to the

CONTINUED ON PAGE 3

NO STATUS QUO: Surety's Reservation of Rights Fails to Preserve It's Subrogation Claims in Bankruptcy

BRIAN M. STREICHER

Under the Bankruptcy Code, a surety must fully discharge its obligation under a performance bond for its subrogation rights to succeed as against a competing secured creditor. In addition, a surety's reservation of rights will not preserve subrogation rights that have been extinguished by the subrogor. This was the holding of the United States District Court for the District of Delaware in the case of *Insurance Company of the State of Pennsylvania v. Giuliano (In re LTC Holdings, Inc.)*,[1] sitting in its appellate capacity over a summary judgment decision of the Bankruptcy Court.

In *Giuliano*, the surety had bonded two government contracts for the Department of Defense (DOD). The principal later defaulted and the surety took over completion of the contracts under the performance bond. The principal filed for Chapter 7 bankruptcy relief, and among the creditors making claims were the surety, the principal's bank (which was secured by a UCC lien), and the United States government, which held claims against the principal for breaches of the DOD contracts.

Though the claims of the bank, the surety, and the government totaled a nine-figure sum, one of the principal's only assets for distribution to creditors was a $5 million tax refund. The government initially withheld the tax refund from the Chapter 7 trustee, asserting its right to set off the tax refund against its claims against the principal. Eventually, however, the trustee and the government agreed that the government would surrender the tax refund to the trustee, to be placed in escrow, in exchange for a release of the principal's counterclaims against the government.

As a part of the proceedings, the surety insisted on language added to the settlement order stating that nothing therein:

> ...shall waive, estop or otherwise limit the rights of any party...claiming an interest in the [t]ax [r]efund and the parties reserve any and all rights and arguments they had regarding the ownership of or ...interest in [t]ax [r]efund (sic) prior to the entry of this [o]rder.

In subsequent adversary proceedings, the surety asserted rights to the tax refund based upon its subrogation rights to the obligee-government's setoff claims. The bank argued that under Section 509 of the Bankruptcy Code, a surety's partial subrogation rights (limited to the extent of payment) are subordinated to those of competing secured creditors until such time as the surety fully performs under the bond. Because the settlement agreement was entered and approved by the Bankruptcy Court before the surety had completed the DOD contracts, the bank had priority, it said. Moreover, since the surety's subrogation rights remained only partial, the surety was bound by the

CONTINUED ON PAGE 2

IN THIS ISSUE

Sub Gets No Termination Penalty or Expectation Damages from Miller Act Surety When Performance Incomplete

MATTHEW D. HOLMES

A recent Oklahoma federal district court rejected a subcontractor-claimant's efforts to recover its entire remaining contract balance from the Miller Act surety where it had only completed a portion of the work. In *Maguire-O'Hara Constr., Inc. v Cool Roofing Systems*, the court confirmed that the surety's liability is limited to costs actually expended by the subcontractor in performance of the federal contract work in cases where the subcontract work is not complete.[1]

In the case, subcontractor Maguire contracted with Cool Roofing Systems on a federal construction project at Tinker Air Force Base for an agreed price of $2.9 million. The surety, Philadelphia Indemnity Insurance Company, provided the required Miller Act payment bond. Maguire performed some work on the project and invoiced Cool Roofing for over $600,000, but was paid only $285,000. Sometime thereafter, Cool Roofing terminated Maguire's subcontract "for convenience" and required Maguire to halt construction. Under that termination provision, Cool Roofing was obligated to pay Maguire the entire remaining subcontract balance. The surety called it a "termination penalty."

Maguire brought suit against Cool Roofing and the surety for its entire unpaid contract balance of $2.7 million or, alternatively, about $360,000 for unpaid performance on the subcontract and nearly $650,000 in lost expected profits. The surety moved for Judgment on the Pleadings pursuant to FRCP 12(c), dismissing the claims for the unearned subcontract balance and for lost profits. Cool Roofing failed to defend the action. The court agreed with the surety and dismissed those claims.

In evaluating the surety's motion, the court relied on two lines of Miller Act cases. The first line of cases arises when a contractor terminates or breaches its contract with a subcontractor. In that event, the Miller Act operates similarly to a lien under state law, and a subcontractor cannot recover other breach of contract or expectation damages from the surety. The second line of cases occurs when a subcontractor fully performs its contractual obligations but the contractor fails to pay. Where the subcontract has been fully performed, the surety is obligated to pay "the compensation to which the parties have agreed" even though the amount exceeds the cost of labor, material, and overhead actually expended. The key distinction between the two lines of cases is whether the subcontractor completed its performance. Citing to the Miller Act the court observed:

> [T]he Act ensures payment to subcontractors for completed, unpaid work, but not for uncompleted unpaid work due to a principal's [the contractor's] breach of contract.

Maguire argued unsuccessfully that the situation somehow fit into the second line of cases, despite its partial performance, and that the surety was obligated to pay the compensation to which the parties (Maguire and Cool Roofing) agreed. The court noted, however, that Maguire failed "to cite one case where a subcontractor collects the unpaid, uncompleted amount of a contract secured by a public works statute." The court explained that the Miller Act and the prevailing case law indicate that:

> …a Miller Act payment bond surety is not obligated to remit the value of the remaining unpaid balance – on a federal project covered by the Miller Act – to the subcontractor when the work under contract is incomplete.

The opinion does not directly address Maguire's $360,000 claim for unpaid performed work, but a later decision on a motion *in limine*[2] shows that the surety disputes it. There, the court ruled that despite Cool Roofing's failure to appear, no judgment was entered so as to preclude the surety from asserting Cool Roofing's defenses to the claim. The case is a good reminder to sureties that desperate (or greedy) subcontractors continue to test the system and require sureties to defend such cases to enforce their rights. E&D

1 2020 US Dist. LEXIS 177598*, 5:19-cv-705-R (W.D. Okla. September 28, 2020).

2 2020 U.S. Dist. LEXIS 207161* (W.D. Okla. Nov. 5, 2020).

CONTINUED "NO STATUS QUO: SURETY'S RESERVATION OF RIGHTS FAILS TO PRESERVE SURETY'S SUBROGATION RIGHTS IN BANKRUPTCY"

government's release of its setoff rights in the tax return under the settlement agreement, and the surety's derivative subrogation rights were extinguished by the release.

The Bankruptcy Court, at summary judgment, and the District Court on appeal, agreed with the bank. Put simply, the bank's secured claim took priority, and the bank was entitled to receive the entire proceeds of the tax return. The surety's argument that the reservation of rights preserved its government-derived setoff claims against the tax return, and thus prevented this result, was rejected. In interpreting the settlement agreement, the court held that the government's release of its setoff rights in the tax refund was a material quid-pro-quo for the principal-contractor's release of its counterclaims against the government. The surety's reservation of rights, the court held, cannot be interpreted to prevent the very result that the settlement order approved. The parties consummated the settlement pursuant to a final order, the court noted, and exchanged releases.

Giuliano presents a teachable moment for sureties and their counsel. Obviously, the surety should always try to maximize its security against the principal through UCC liens or mortgages as applicable, so that it need not rely solely on setoff rights through subrogation. The surety also needs to understand the subordination consequences of Section 509 where the surety's performance obligations have not been fully discharged. Finally, any release of rights to which the surety may become subrogated must be closely examined. The *Giuliano* court reiterated that the surety had every opportunity to appreciate and adequately address the impacts of the government's release of its claims, whether through an adversary proceeding or otherwise. Be aware that a reservation of rights may not properly preserve the status quo where rights of subrogation are involved. E&D

1 2020 U.S. Dist. LEXIS 170790*, 19-CA-327 (D. Del. Sep. 17, 2020).

CONTINUED "OPPORTUNITY LOST: FEDERAL CIRCUIT COURT OF APPEALS DECLINES RECONSIDERATION OF SURETY'S ASBCA RIGHTS"

contracting officer. The Corps declared Ikhana in default, terminated the contract without issuing a final decision on the claims, and asserted its performance bond rights. Ikhana appealed the termination decision and its cost claims to the ASBCA.

To meet its performance obligations, GCNA negotiated a resolution in which the Corps contracted with a new company to complete the work. Under the resulting settlement agreement, the Corps used the remaining contract funds (to which GCNA was entitled under the assignments and equitable subrogation principles) to pay the new contractor. GCNA agreed to dismiss Ikhana's pre-existing claims before the Board based upon its right to settle those claims under the indemnity agreement. But Ikhana refused to dismiss its Board claims.

GCNA sought declaratory judgment from a Virginia federal district court that the indemnity agreement authorized GCNA to intervene and dismiss Ikhana's appeal. That court instead stayed the court action pending the resolution of Ikhana's ASBCA appeal. GCNA moved the Board to intervene and withdraw Ikhana's appeals. The Board denied the motion because GCNA lacked standing under the CDA. GCNA appealed.

The Federal Circuit affirmed the Board's decision. The court reasoned that because GCNA could not have initiated Board appeals in the first instance, it could not supplant Ikhana before the Board to dismiss them. At best, the court noted, only claims arising after the date of the settlement agreement could be determined by the Board. Of course, Ikhana's claims arose prior to the settlement agreement, so GCNA was left without a remedy before the Board, with Ikhana's claims still pending.

In a concurring opinion, the justices urged a review of the cases relied upon by the majority as "wrongly decided" as they "bring government contracting law into conflict with basic principles of suretyship and contract law." In particular, the opinion focused on the legislative history and policy rationales for limiting Board appeal rights to a single contractor as based upon excluding subcontractors without addressing the distinct role and separate rights of the surety in federal construction.

GCNA sought a Federal Circuit rehearing by the initial panel or en banc, and responses by other interested parties were filed, including amicus curiae briefs by The Surety & Fidelity Association of America (SFAA) and the United States. A poll of the active Federal Circuit justices was taken pursuant to the petition and failed, 12 to 4. The four justices in favor of a rehearing dissented, the opinion stating:

> …[u]nder the doctrine of equitable subrogation a surety should be able to step into the shoes of a government contractor in the event of … default under fundamental principles of contract law. As our precedent now erroneously stands, a surety is hindered from playing its necessary role in government contracting—bringing efficient resolution to contract disagreements, assuming financial risk, and ensuring execution of performance—because it lacks the legal rights it needs to ensure speedy dispute resolution.

The dissent found that existing case holdings interpreting the CDA relied upon "erroneous extrapolation of the CDA's legislative history" and expressed grave concern about the implications the impediment of such holdings present to sureties, including higher risks assumed by sureties and higher costs to the government for surety service.

The failure of the Federal Circuit to address this existing gap in surety rights is disappointing. As argued in the SFAA amicus brief, it is undisputed that the surety is entitled to the unpaid contract balance in such cases and, as such, the pre-existing claims are just an argument over the amount of that balance. Here, the real parties in interest settled the matter. As the state of play remains, a defaulted federal contractor can obstruct resolution of disputes and prompt completion of the work by refusing to cooperate in the settlement of preexisting claims. Best practices typically will include the principal-contractor as a signatory to the settlement agreement and, in the case of a federal project, provisions regarding rights and obligations for pre-existing claims. E&D

1 941 F.3d 1140 (Fed. Cir. 2019).

2 959 F.3d 1354 (Fed. Cir. 2020).

John Dreste, right, and Tim Boldt, in background, presented The Salvation Army of Greater Rochester a check for $2,500 on behalf of Ernstrom & Dreste, LLP as a donation to the 2020 Red Kettle Campaign. The event took place on-air during the televised *Salvation Army Red Kettle Telethon* on November 18, 2020 in Rochester, New York.

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Ernstrom & Dreste, LLP also publishes the ContrACT Construction Risk Management Reporter. If you would like to receive that publication as well, please contact Clara Onderdonk at conderdonk@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste, LLP's website (ernstromdreste.com).

FIRM NEWS

John W. Dreste was named the *Best Lawyers® 2021 Litigation – Construction "Lawyer of the Year"* in Rochester, New York.

Todd Braggins attended the Philadelphia Surety Claims Association annual golf outing at Bala Golf Club in Philadelphia on October 26, 2020.

Kevin Peartree was the featured speaker on the ConsensusDocs Master Subcontract Agreement at the AGC Joint Contractors Virtual Conference on November 12, 2020.

John Dreste and Kevin Peartree presented together on the topic of design delegation at the AGC NYS Virtual Construction Industry Conference on December 10, 2020.

Todd Braggins is authoring an article on the topic of the bond producer's role in financing the principal to be published in the National Association of Surety Bond Producers upcoming *Surety Bond Quarterly*.

Brian Streicher, Matt Holmes and Todd Braggins will attend the ABA-TIPS/Fidelity & Surety Law Committee Virtual Mid-Winter Conference February 3-5, 2021. Matt Holmes will present on the topic of bid errors as part of a program entitled *"The Construction Lawyer as Disaster Artist: Strategies for Avoiding Worst-Case Scenarios and Getting Derailed Projects Back on Track."*