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**NAMED OBLIGEE'S RIGHTS UNDER THE PAYMENT BOND
(ARE THERE ANY?);**

**RIGHTS AND LIMITATIONS ON THE OBLIGEE'S RIGHTS ON
EXHAUSTION OF PERFORMANCE BOND PENALTIES**

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INTRODUCTION

Nothing would seem clearer in the law of suretyship than that the limit of the surety's liability is the penal sum of the bond¹. In the last forty years, however, a considerable number of case law decisions have been handed down by the courts which indicate some slippage away from this bedrock principle. This paper examines the decisions our research has found wherein the penal sums of the bonds sued upon were inadequate to satisfy the claim(s) asserted against them, and attempts to categorize them by identifying the characteristic situations in which such potentially erosive attacks on the bond penal sum may be made.

I. PAYMENT BONDS

Because, simply, they seem easier to handle, we will deal first with the cases in which it was a labor and material payment bond which was inadequate to satisfy claims for labor and materials which had arisen on a bonded construction project .

A. THE FEDERAL CASES: KALADY AND THE CASES IN ITS WAKE: RESORTING TO THE PERFORMANCE BOND WHEN THE PAYMENT BOND PENAL SUM IS INSUFFICIENT TO PAY ALL CLAIMS FOR LABOR AND MATERIAL.

Apparently, the first breach of the bedrock principle that the labor and material payment bond penal sum is the limit of the surety's liability for labor and material is *United States v. Kalady Construction Company*.² In that case the payment bond penalty had been exhausted. The plaintiffs, unpaid laborers who were employees of the bonded Miller Act contractor, claimed, and Judge Robson ruled, that the performance bond, which incorporated the underlying contract, was breached by the nonpayment of compensation as specified in the contract. The Court held "since there has been an exhaustion of the resources under the payment bond, these claimants should have recourse against the performance bond. Their claims fall within the obligations specified in the contract covered by the performance bond. Any other conclusion would not be granting the bonds given under the Act, and the Act the "highly remedial" interpretation Congress is said to have intended. It would be making the "two-halves"--the two bonds--less than the whole bond it had been under the Heard Act"³.

One year later in *Sun Insurance Co. of New York v. Diversified Engineers, Inc.*,⁴ an interpleader case in which the payment bond was insufficient to satisfy all labor and material claims the court refused to follow *Kalady* calling into question Judge Robson's reliance on the two cases cited in *Kalady*. Those cases, *American Cas. Co. of Reading, Pa. v. Brezina Construction Co.*⁵ and *Glens Falls Indemnity Indemnity Company v. United States of America, etc.*⁶, did not involve Miller Act bonds, but rather involved subcontractor performance bonds sued upon by the prime contractors/named obligees of such bonds for indemnity for materials furnished to the subcontractors for which both the subcontractor and the prime contractor were liable. The *Diversified Engineers* Court cited several additional cases not in agreement in the thrust of their holdings with *Kalady*,

¹ *Pennsylvania Fire Ins. Co. v. American Airlines, Inc.* 180 F.Supp. 239 (E.D. N.Y. 1960) ; *Sternberg Co. v. State Nat. Bank of Texarkana* 69 F.2d 759 (5 Cir. 1934)

² 227 F.Supp. 1017 (N.D. Ill. 1964)

³ *Id.* At p. 1021

⁴ 240 F.Supp. 606 (D. Montana 1965)

⁵ 295 F.2d 603 (8 Cir. 1961)

⁶ 229 F.2nd 370 (9 Cir. 1955)

among them, *Seaboard Surety Co. v. Standard Acc. Ins. Co.*⁷, *St. Paul Mercury Indem. Co. v. Wright Contracting, Inc.*,⁸ *U. S. to Use of Stallings v. Starr*,⁹ and *U. S. for Use of Gibson v. Harman*¹⁰.

In 1970, in *U.S. for Use and Benefit of James E. Simon v. Ardelt-Horn Constr. Co.*¹¹, again a Miller Act payment bond was insufficient to satisfy all claims for labor and material and, again, recovery was attempted on the performance bond. The district court which won *per curiam* affirmance in the Court of Appeals,¹² found no "clear hint at an intent that the materialmen would have rights under [the] performance bond."¹³ In affirming the Eighth Circuit said "We agree with the view of the trial court that the Miller Act by its clear language, which is fully supported by the legislative history, provides for a payment bond for protection of those providing labor and material on government projects and a performance bond for the protection of the United States, and that no basis exists for plaintiff's claim as a third party beneficiary of the performance bond." *U.S. Fidelity and Guaranty Co. v. A&A Machine Shop, Inc.*¹⁴ which followed *Ardelt-Horn* distinguished *Kalady* factually because, first of all, of a the specific covenant in the bonded contract calling for payment of laborers and, secondly, the performance bond language conditioned upon fulfillment of all contractual covenants and also because the *Ardelt-Horn* rationale "much more closely effects the public policies sought to be furthered by the Miller Act."¹⁵

In 1974, the Eighth Circuit reaffirmed *Ardelt-Horn*, holding in *United States for Use and Benefit of Warren v. Kimrey*¹⁶ that "[the] performance bond here involved as written unambiguously makes the Government the sole obligee and contains no provision for the protection of building or materialmen,"¹⁷

The issue does not come up again until 1991 in *U.S. for Use and Benefit of Blount Fabricators, Inc. v. Pitt General Contractors*¹⁸ where a subcontractor faced with an insufficient labor and material payment bond penal sum to satisfy its claim successfully argued that it was a third-party beneficiary of the prime contract which was incorporated into the performance bond by virtue of language in it that the prime contractor either had or would pay it subcontractors and suppliers out of the contract proceeds.

The final case, *Transamerica Premier Ins. Co. v. Ober*¹⁹ recited the foregoing history of the cases, and rejected the applicability of the third-party beneficiary status to the unpaid subcontractors and material suppliers advancing claims against the Miller Act performance bond when the payment bond penal sum was insufficient to satisfy such claims. It was argued that the Prompt Payment Act²⁰ was included among the covenants of the contract incorporated into the performance bond. The court

⁷ 277 N.Y. 429, 14 N.E.2d 778, 117 ALR 658

⁸ 250 F.2d 758 (4 Cir. 1958)

⁹ 20 F.2d 803 (4 Cir. 1927)

¹⁰ 192 F.2d 999 (4 Cir. 1951)

¹¹ 446 F.2d 820 (8 Cir. 1971), cert. den. 404 U.S. 1060, 92 S.Ct. 740, 30 L. Ed 2d 747 (1972)

¹² 446 F.2d 820 (8 Cir. 1971), cert. den. 404 U.S. 1060, 92 S.Ct. 740, 30 L. Ed 2d 747 (1972)

¹³ at p. 257 of 316 F.Supp

¹⁴ 330 F. Supp. 1403 (S.D. Tex. 1971)

¹⁵ id. at 1405-6

¹⁶ 489 F.2d 339 (8 Cir. 1974)

¹⁷ Id. At 343

¹⁸ 769 F. Supp. 1016 (E.D. Tenn. 1991)

¹⁹ 894 F. Supp. 471 (D. Me. 1995)

²⁰ 31 U.S.C. 390 et seq.

rejected the argument saying it "would be even more circuitous than that in *Kalady* * * * to permit a recovery under the performance bond at complete odds with the language of the Miller Act, * * *".²¹

B. BE CAREFUL IN HANDLING LABOR AND MATERIAL PAYMENT BOND CLAIMS IF INTERPLEADER IS IN THE OFFING.

A number of the cases previously cited are interpleader cases.²² In those cases the surety interpleaded the insufficient penal sum of the payment bond in an effort to limit its liability to that amount. The first of those cases, *Sternberg Co.*, is the progenitor of what has become an unfortunate rule the effect of which, was/is to increase what the surety had/has to pay out in those cases above. In other words, in a developing situation where a surety is faced with some initial claims which it chooses to settle, it does so at its own risk and cannot simply take credit against the bond penalty for what it has paid out and seek pro-ration of the balance of the bond penal sum when additional claims exceeding the bond penal sum come to light. The pro-ration will still be of the total bond penalty against the total claim amounts. In *Sternberg* about 85% had been paid on the claims settled. By the Court's pro-ration, only about 52% would have been paid. That difference meant the surety took about a \$3,500.00 hit in excess of the bond penalty. The *Sternberg* rule was followed in *United States v. Home Indemnity Company*²³ and appears to be the law.

C. THE STATE CASES

Our research has brought to light no state court cases involving payment bonds, the penal sums of which had been exhausted, with payment bond claimants then asserting that nevertheless they were entitled to be paid out of the payment bond or alternatively under the performance bond. There are many cases representing attempts, in the absence of a labor and material payment bond altogether, laborers and materialmen may have a right to recover as third party beneficiaries of the performance bond by; virtue of incorporated contract terms.²⁴

II. PERFORMANCE BONDS

A. THE FEDERAL CASES

*Bill Curphy Co. v. Elliott*²⁵ is the earliest federal case yielded by our research in which a concerted effort was made by a named bond obligee to recover more than the penal sum of the performance bond which it held out of that bond. The subcontract performance bond language set out in the opinion appears to be essentially the AIA 311 bond language. The prime contractor/obligee argued that this language placed no dollar limit upon the absolute duty of the surety to complete the contract unless the surety obtained bids, which it did not do. The court turned back the argument saying no recovery could be had beyond the penal sum of the bond from either the principal on the surety, on the default of either of them, in any circumstances, citing many cases.

²¹ See p. 480 of 894 F.Supp.

²² *Transamerica Premier Ins. Co. v. Ober*; *Sun Insurance Company of N.Y. v. Diversified Engineers, Inc.*; *Pennsylvania Fire Ins. Co. v. American Airlines, Inc.*; *Sternberg Co. v. State Nat. Bank of Texarkana*

²³ 265 F.Supp. 943 (M.D. Fla. 1966)

²⁴ E.g. *Neenah Foundry Company v. National Surety Corporation*, 197 N.E.2d 747, Ill. App.2d 427 (Il. App. 1st Dist. 1964); *LaSalle Iron Works, Inc. v. Lagen*, 410 S.W.2d 87 (Mo. 1966); *Ill-Mo Contractors, Inc. v. Aalcan Demolition and Contracting Co., Inc.*, 431 S.W.2d 165 (Mo. 1968); *Wilbur Waggoner Equipment Rental and Excavating Company, Inc. v. Bumiller*, 542 S.W.2d 32 (Ct. App. Mo. 1976); *Ceco Corp. v. Plaza Point, Inc.*, 573 S.W.2d 92 (Ct. App. Mo. 1978); *Stahlhut v. Sirloin Stockade, Inc.*, 568 S.W.2d 269 (Ct. App. Mo. 1978); *Kansas City N.O. Nelson Co. v. Mid-Western Constr. Company of Missouri, Inc.*, 782 S.W.2d 672 (Ct. App. Mo. 1989)

²⁵ 207 F.2d 103 (5 Cir. 1953)

In 1962, the *Miracle Mile Shopping Cente v. National Union Indem. Co.*,²⁶ case came before the Seventh Circuit United States Court of Appeals. It must be mentioned because it is erroneously cited in later cases for allowing recovery in excess of the penal sum of the bond. In actual fact, the Court was extremely careful repeatedly to limit the surety's liability to the penal sum of the bond. While not precisely an AIA 311 form, the bond language, in effect, is similar to the AIA 311 bond language. The Court found the "primary obligation" of the bond to be, on the part of the surety, to pay the penal sum "should the contractor's default damage the owner to that extent."²⁷ The options to "take over" and complete the contract or to pay in cash the reasonable cost to complete as determined by obtaining three bids established minimums of liability of which the surety might avail itself if it chose to pursue one or the other such option. Failing choosing one of those options, the surety is bound by its primary obligation "to make good all losses occasioned by the contractors' default, limited, of course, to the penal sum of the bond."²⁸ The Court allowed recovery of the costs of completion at the date of contract breach, nothing more. It was less, but not much less than the bond penal sum. This clearly is not a case of an "in excess of the bond penal sum" result.

In 1974, the notorious *Continental Realty Corp. v. Andrew J. Crevolin Co.*²⁹ case was decided. The reported opinion in this case attempts to paint a picture of egregious wrong-doing by the surety. With the hyperbolic statements made by the Court in its opinion, the non-sequiturs expressed, the extreme vexation with the surety expressed by the Court, the purported statements of applicable law without citation of authority, or with inapposite citations, this opinion should not carry much weight. Yet, because of the enormously dramatic impact of the case, in large part because it involved millions of dollars both of bond penalty and moneys in excess of the bond penalty, the case gets more attention, perhaps, than it deserves. It is, at best, a poor decision and a poorly reasoned one.

In this case, the Court held the surety liable for approximately, as we calculate it, \$7,760,000.00 on a performance bond with a penal sum of \$4,050,754.00, with about \$7,050,000.00 of that being excess project completion costs and the rest being for miscellaneous items of expense, such as interest, maintenance costs and the like. The Court justified its judgment citing the *Miracle Mile Shopping Center* case saying that the surety in addition to the principal, had breached the bond and was therefore liable for all of the damages flowing from the breach without regard to the bond penalty.

B. THE STATE CASES INVOLVING IN EXCESS OF PERFORMANCE BOND PENAL SUMS CLAIMS AND AWARDS.

Just as there are but a few federal cases wherein claims were pressed or damage awards were made in excess of the sued upon performance bond penal sums, so also our research has yielded only a few state court cases.

The earliest of these cases is *Fisher v. Fidelity and Deposit Company of Maryland*.³⁰ The case involved a \$14,595.55 performance bond on which the owner-obligee sued and recovered the

²⁶ 299 F.2d 780 (7 Cir. 1962)

²⁷ Id. at 782

²⁸ Id. at 783

²⁹ 380 F.Supp. 246 (S.D. W. Va. 1974)

³⁰ 466 NE 2d 332, 80 Ill. Dec. 880, 125 Ill App. 3d 632 (5th Dist. 1984)

\$14,595.55 bond penal sum plus pre-judgment interest (amount undetermined)³¹, lost rental income of \$21,813.95, \$7,122.29 attorneys fees³², \$5,000.00 vexatious damages and \$25,000.00 punitive damages. The Illinois Appellate Court set aside the award of net rental income lost while the project remained uncompleted and unusable beyond the scheduled completion time³³ citing cases holding that "the extent of the surety's liability was limited to the penal sum [of the performance bond] even when the principal's liability was greater."³⁴

In 1989, the case of *Village of Fox Lake v. Aetna Casualty & Surety* came before the Illinois Appellate Court, Second District. Under the language of the contract and bond, the Court found that Aetna had two alternatives on the contractor being terminated for default: (1) it could "take over and perform the contract" or (2) it could refrain from performing and allow the obligee Village to take over and complete the work. Either way, the Court said, Aetna could be liable for more than the performance bond penal sum. The Court held that Aetna's reservation of rights on taking over to perform the contract did not limit its liability to the bond penalty, nor could it do so, since the contract as bonded required Aetna to take over and perform, or to pay the Village the costs of performance, even if, in either case, such costs exceeded the penal sum of the bond. The court cited the *Fisher* case but impliedly differentiated it upon the basis that different contract terms incorporated into the bond were involved here. The court simply ignored the "primary obligation"³⁵, the *habendum* clause of the bond, which sets out the dollar limit of the liability which the surety undertakes in executing and delivering the bond.

After *Continental Realty and Fox Lake*, sanity is restored somewhat by the decision of the New Jersey Superior Court, Appellate Division, in *Ribeira & Lourenco Concrete Const. v. Jackson Health Care Associates*³⁶. Again we have AIA 311 bond forms. The performance bond penal sum was paid over by the surety to the obligee on the default of the contractor principal. The obligee project owner, still lacking sufficient funds to defray all costs of completion, sued on the payment bond. The Court said, "we are satisfied that [he] has no legal basis for recovery under the payment bond. * * * An obligee is not a claimant as defined in the payment bond. [He] did not have a direct claim for labor and material against * * * the principal, under the payment bond. It is fundamental that a performance bond and a labor and material payment bond are two distinct bonds, each giving rise to different contractual rights and obligations."³⁷ The trial court's summary judgment of dismissal of the obligee's suit on the payment bond was affirmed.

CONCLUSION

The foregoing review of the cases enables us to reach the following conclusions:

- 1_ That bonds have a "penal sum" still means something, still is understood and respected for the most part in the market place and in the law courts.

³¹ We have not concerned ourselves in this paper with awards of interest as it is usually awarded on an independent statutory basis without reference to the bond penal sum.

³² We have not concerned ourselves in this paper with awards of attorneys fees as they are usually awarded on an independent, contractual or statutory basis without reference to the bond penal sum.

³³ The Illinois Appellate Court also set aside the award of punitive damages.

³⁴ See p. 339 of 466 N.E.2d

³⁵ See the *Miracle Mile Shopping Center* case at p. 783 of 299 F.2d

³⁶ 603A.2d 976 (N.J. Super. A.D. 1992)

³⁷ Id. at 979

- 2_ Sureties themselves must be diligent, indeed, aggressive, in pointing out the penal sums of their bonds as the limit of their liability.
- 3_ The main cases allowing recoveries in excess of bond penal sums were not correctly decided nor soundly reasoned: *Kalady* purports to rely on case authorities which in fact do not support the result reached; *Continental Realty* and *Fox Lake* do not take into account the "primary obligation" of the bond contained in the *habendum* clause and the dollar amount limit thereof to which the *Miracle Mile Shopping Center* case (which both cases cite, *Continental Realty* and *Fox Lake*) alludes repeatedly.
- 4_ Sureties must be vigilant in monitoring situations likely to develop into penal sum exposures to avoid having to pay in excess of bond penal sums in interpleader actions and by entering into inadequate reservations of rights and take over agreements. "Eternal vigilance is the price of liberty", of going free without losing your shirt, or paying out in excess of the bond penal sum.