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Properly defining “payment bond claimant” is critical to defeat obligee claims.

Stemming the Flow of Obligee Payment Bond Claims

Although claims against sureties by a named obligee on construction bonds have traditionally been restricted to claims against the performance bond, increasingly, obligees have asserted payment bond claims, usually in

an effort to bolster their total anticipated recovery from sureties beyond the penal sum of a performance bond. These payment bond claims have not been well-received by sureties or the courts because the rationale for requiring both a performance bond and a payment bond on each project, instead of a general purpose project bond, is that the two types of bonds serve different purposes. A performance bond assures an obligee, either a project owner, if the bonded contractor is the general contractor, or a general or prime contractor, if the bonded contractor is a subcontractor, that the scope of work will be completed in the event the bonded contractor defaults, or alternatively, the cost of performing the work will be paid. On the other hand, a payment bond offers no assurance of completion; it only guarantees payment to those providing labor and material to the bonded contractor that they will be paid in the event the bonded contractor fails to pay them. *See generally*, 17 Am. Jur. 2d, *Contractor's Bonds* §1; Couch on

Insurance §163:10. This article will examine the various legal theories underlying payment bond claims asserted by obligees, the causes of this trend of multiple bond claims, the case law that has developed concerning these claims, and how sureties can defend against dual bond claims.

The Trend of Dual Bond Claims by an Obligee

In a typical case in which an obligee brings suit against a surety under both performance and payment bonds, the bonded contractor is in default, and the obligee has either taken over the bonded contractor's work, or has at least supplemented the bonded contractor's work and paid for labor and materials to complete the bonded contract work in excess of the penal sum of the performance bond, as well as any retained contract funds. Realizing that a traditional performance bond claim against their sureties will leave obligees without full recovery, and that separate recovery from defaulted contractors is improbable, obligees have advanced several arguments to justify payment bond claims against sureties. The primary argument used to support making such a claim is that since an obligee has paid for labor and material used to complete the bonded con-



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tractor's work, it has become a "claimant" under the terms of the payment bond and may recover any expended funds for labor, materials or equipment to complete the bonded contract under the payment bond. Sometimes an obligee hinges its argument that it is a proper claimant on the language of the documents incorporated into the bond, such as the subcontract or the prime

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contract. Obligees usually incorporate allegations in payment bond claims that might give rise to separate subrogation and/or unjust enrichment claims. Other obligees have argued that as they are named as the party to whom the payment bond runs, the assurances provided by the payment bond should be available to them to the extent that they have paid or have become obligated to pay costs for labor and material to complete the bonded contract work.

The Evolution of Case Law on Payment Bond Claims by Obligees

Most courts that have considered dual bond claims filed by obligees have had little trouble recognizing that the "payment bond claim" was nothing more than an attempt to recover from a surety on the payment bond what should only be properly classified as recoverable under a performance bond claim. Recognizing that bond claims, as all other contractual claims, should be governed by

the intent of the parties to the agreement, in each decision in which courts have had to decide whether an obligee could recover under a payment bond as well as a performance bond, the courts have focused on the definition of a payment bond claimant as set forth in the bond. Since the bond's language is determinative of this issue, rather than the nature of the bond against which the claim is made, obligees have found a multitude of ways to maintain that they are a proper payment bond claimant.

The Nebraska Supreme Court was squarely presented with the issue of whether an obligee can properly assert a payment bond claim in addition to its performance bond claim in *Cagle v. Sammons*, 198 Neb. 595, 254 N.W.2d 398 (1977). In that case, the plaintiff general contractor brought suit against its subcontractor and the subcontractor's surety claiming that (1) the subcontractor had failed to perform a substantial part of the work required by the subcontract, and (2) the obligee, in paying for the labor and materials used to complete the bonded contract work, became a payment bond claimant as that term was defined in the payment bond for "costs and expenses for labor and material, which Plaintiff has paid, or become obligated to pay." *Id.* at 597, 254 N.W.2d at 401. The bond, which was titled "Subcontract Labor and Material Bond," defined a bond claimant as "one having a direct contract with the Principal for labor, material, or both, used or reasonably required for use in the performance of the contract." *Id.* at 598, 254 N.W.2d at 402. Although the plaintiff/obligee in *Cagle* acknowledged that it did not have a direct contract to provide labor or materials to its subcontractor/ principal under the bond, the obligee argued that the language of the bond incorporated the subcontract, which, in turn contained a provision allowing the obligee to take over the subcontract, complete the work, and charge the cost to its subcontractor, the bond's principal. The obligee contended that once it had taken over and paid for the bonded work, the obligee had a right to collect from the principal directly, and therefore, it could assert a payment bond claim. Rejecting that argument, the Nebraska Supreme Court found that the surety had bound itself only to persons or entities having a direct contract with its principal to provide labor and materials,

and not to those that provided material and labor to persons other than the principal to complete the bonded work. In reaching its decision, the Nebraska Supreme Court was persuaded by *Standard Accident Ins. Co. of Detroit v. Rose*, 314 Ky. 233, 234 S.W.2d 728 (1950), interpreting a payment bond that included the same definition of "payment bond claimant" as the definition involved in *Cagle*.

The Second District Appellate Court of Illinois considered this issue in *Board of Education v. Hartford Accident & Indemnity Co.*, 152 Ill. App. 3d 745, 504 N.E.2d 1000 (1987). In that case, the obligee was a board of education, which brought suit against the surety of a contractor that had constructed pool facilities at a high school. The obligee sought damages under both the performance and payment bonds issued by the surety. The plaintiff/obligee argued that incorporation of the relevant Illinois statute on bonds for public work converted the payment bond into an additional performance guarantee, or alternatively, that the obligee was an intended third-party beneficiary to the payment bond.

The court rejected both arguments. The court found that incorporation of the statutory language into the bond did nothing to change the nature of the payment bond's obligations or to justify reading additional performance guarantees into the bond. Addressing whether the obligee was an intended third-party beneficiary, the court found that any benefit to the obligee through the payment bond was incidental and limited to preventing liens from being filed on the project. Therefore, the third-party beneficiary claim was without merit. *Id.* at 753, 504 N.E.2d at 1005. As in the *Cagle* and *Rose* decisions, the court reviewed the definition of claimant in the payment bond at issue, which also required a "direct contract." Based on that definition, the court held that as this obligee did not have a direct contract to provide labor or materials, or both, to the principal, the obligee could not assert a payment bond claim. *Id.*

The following year the Virginia Supreme Court weighed in on this issue in *Southwood Builders v. Peerless Ins. Co.*, 235 Va. 164, 366 S.E.2d 104 (1988). In that case, after it became obvious that the bonded principal would not be able to complete the subcontract work in a timely manner, the

obligee requested that the principal supplement its forces on the project by adding an additional crew. When the principal could not add an additional crew, rather than terminating the principal, the obligee proposed that if the principal would add another crew, the obligee would pay for that crew and deduct those costs from the remaining subcontract amount. After the obligee had advanced the principal more than \$11,000, the principal defaulted on the project, and the obligee completed the remaining subcontract work.

The obligee filed suit against the subcontractor's surety, asserting both a claim for the full penal limit of the performance bond, as well as an additional sum as a payment bond claim. The court found that the obligee could not recover on either claim. The court reasoned that the performance claim was barred because the obligee had paid substantial contract sums before they were due and failed to maintain an adequate retainage for the subcontract work, thereby substantially increasing the surety's risk under the bond and relieving it of its performance bond obligations. *Id.* at 170, 366 S.E.2d at 108. Although the court held that the obligee's payment bond claim was untimely under the applicable Virginia statute, the court noted that a timely claim under the payment bond could not be read to include work finished by the entity hired by the obligee to complete the subcontractor's work. The court also rejected the obligee's payment bond claim because it concerned payments that the obligee had made to the principal directly, finding that because the obligee had no contractual obligation to provide labor to the principal, and the payments by the obligee to the principal were extended as loans, creating a credit relationship, rather than a payment bond claim. *Id.* at 172, 366 S.E.2d at 109.

A co-obligee sought to assert a payment bond claim in a Miller Act case in *Trustees of Bricklayers & Allied Craftsmen Local No. 3 v. Reynolds Elec. & Eng'g Co.*, 747 F. Supp. 606 (D. Nev. 1990), which involved an unusually complicated factual scenario. The plaintiff, union trustees, brought an action in state court, which was removed to federal court, against the manager of a Nevada testing site, an entity called Reeco, and the general contractor, to recover pension benefits that a subcontractor had failed

to pay to union workers on the project. In that case, the United States government had contracted with Reeco to manage the test site, and because Reeco was considered an agent of the government for that project, Reeco was named as a co-obligee, along with the United States, on the bonds obtained by the general contractor for the project. Reeco had entered into labor contracts with the union and had hired the general contractor, which in turn hired subcontractors to complete the project work. Although the prime contracts and subcontracts required all contractors to abide by the union contracts entered into by Reeco, one subcontractor failed to remit union pension contributions. After the union obtained a default judgment against that subcontractor in a separate state court action, the union filed claims against Reeco, the general contractor, and the general contractor's surety, seeking to recover the pension funds. Reeco filed cross-claims against the general contractor for indemnity and asserted both performance and payment bond claims against the general contractor's surety.

When addressing whether Reeco, a joint-obligor with the United States, could properly assert its cross-claims, the court relied strictly on the plain language of the Miller Act's definition of a payment bond claimant. The court concluded that the Miller Act did not allow a party named as an obligee under a payment bond to assert a claim under that bond, but rather the limited recourse for an obligee, or co-obligee, was a cause of action under the performance bond. *Id.* at 612.

In *Ayers Enters. Ltd. v. Exterior Designing, Inc.*, 829 F. Supp. 1330, 1333 (N.D. Ga. 1993), the district court, in a diversity action applying Georgia law, concluded that the "obligee, is not a 'person entitled to the protection of the payment bond' within the meaning of [the Georgia Little Miller Act, O.C.G.A.] §36-82-104, and as a result, does not have the right to bring an action on the payment bond." (Georgia Little Miller Act, O.C.G.A. §36-82-104 recodified and incorporated into O.C.G.A. §§36-91-72 and 36-91-73 (2000)). The *Ayers* court was guided by the Georgia Court of Appeals decision in *Fireman's Fund Ins. Co. v. Fischer & Porter Co.*, 143 Ga. App. 533, 535, 239 S.E.2d 174 (1977).

Notwithstanding the great weight of authority favoring a surety in connection with an obligee payment bond claim, a surety remains a prime target for other theories of recovery, as noted in the following case. In another diversity action, *Federal Ins. Co. v. Maine Yankee Atomic Power Co.*, 183 F. Supp. 2d 76 (D. Maine 2001), the obligee acknowledged that case law generally disfavored suits by obligees on a payment bond, so instead, the obligee sought to assert a claim for the payments it had made for labor, supplies and equipment to complete the bonded contract, under theories of unjust enrichment and equitable subrogation. The obligee mingled unjust enrichment and equitable subrogation allegations to state a "payment bond claim" and argued that by paying subcontractors and suppliers itself, rather than insisting that the surety pay these claims directly, the surety had been unjustly enriched. The obligee further asserted that after paying these claims, through necessity rather than as a volunteer, it had stepped into the shoes of the suppliers and contractors that had been paid and should be allowed to assert a claim for those funds under the theory of equitable subrogation. The court did not construe the language of the payment bond, noting that the parties had conceded the payment bond did not apply, but construed instead an Interim Service Agreement (ISA) between the surety and the obligee in which the surety consented to its principal remaining on the project and the obligee paying the principal's subcontractors and suppliers directly. Finding no language that would bar a claim for payments made for material and labor under the separate agreement between the surety and obligee, the court allowed the obligee to maintain its claim against the surety for the monies paid to complete the bonded work.

The subrogation theory of recovery was again acknowledged as an appropriate cause of action for a claim that otherwise could not survive strictly as a payment bond claim in *American Cas. Co. of Reading, PA v. D.L. Withers Const., L.C.*, 204 Ariz. 382, 64 P.3d 210 (Ct. App. Div. 1 2003). That case involved a bonded HVAC subcontract. The bonded HVAC subcontractor reached an agreement with the obligee/general contractor that the obligee could



hire another HVAC subcontractor to complete the bonded subcontract work, without giving notice to the surety. The surety later filed a declaratory judgment action, seeking a determination that the obligee would not be a proper payment bond claimant for the payments made to the HVAC subcontractor that would complete the work. The court agreed with the obligee that the language of the bond determined the proper payment bond claimant, rather than the title of the bond, which identified it as either a performance or payment bond. However, the court held that the language of the payment bond in question required that a claimant under that bond have “a direct contract” with the principal. The court reasoned that because the obligee did not have a contract to provide labor or materials to the principal under the bond, there was no authority for the obligee’s position that the payment bond should be construed to provide the obligee with another avenue for recovery against the surety. *Id.* at 384–85, 64 P.2d at 212–13. The court did, however, suggest the obligee could assert a subrogation claim for the payments made to others for labor and material to complete the bonded subcontract. *Id.* at 385, 64 P.2d at 213.

In an unpublished opinion in *The Boldt Co. v. Thomason Electrical Co.*, 6:07-cv-00697-GRA, slip op. (Sept. 27, 2007), the U. S. District Court for South Carolina, in a diversity action applying South Carolina law, found the obligee’s payment bond claims failed because the language of the payment bond required a payment bond claimant to have a “direct contract” with the principal for labor or materials. The court found that the obligee’s attempt to recover funds it had advanced to the principal through a payment bond claim were a loan and not a proper payment bond claim.

Practice Pointers for Defeating an Obligor Payment Bond Claim

As the brief survey provided above indicates, there is no definitive authority that allows an obligee to proceed on a payment bond claim when the definition of a payment bond claimant requires a direct contract with the bonded principal. Although, some courts have suggested that subrogation claims could be in the nature of payment bond claims. See *D.L. Withers, supra*. While it would be logical to assume that given the weight of authority against allowing dual bond claims, obligees would regard payment bond claims as futile, as mentioned earlier, such claims are on the rise, asserted in the hopes of finding a jurisdiction that may favorably consider such a claim in the future. As long as obligees incur expenses in excess of performance bond penal limits to complete a bonded subcontractors’ work, they will continue to be motivated to attempt creative arguments to allow them to expand their claims against sureties.

To defeat obligor payment bond claims, it is critical for sureties to provide in all bonds issued by them a definition of payment bond claimants that require a direct contractual relationship between a principal on the bond and a claimant. In an increasing number of projects, the language of the bonds are dictated by the obligees, requiring underwriters, as well as those defending sureties, to diligently review the language of those bonds. A payment bond must assure only payment of claims by laborers and material suppliers that have contracted with a surety’s principal and never assure payments to complete the scope of the bonded subcontract work.

Also, as courts have indicated their willingness to allow recovery by an obligee on a payment bond, as long as an obligee falls within the definition of claimant under

such a bond, a surety must require approval of any supplemental agreements that would affect the traditional principal-obligor relationship under its bond by the surety before supplemental agreements take effect. To avoid the result in *Maine Yankee Atomic Power Co.*, a surety that is a party to supplemental agreements must specify that to the extent that an agreement cannot be read as consistent with terms of its payment bond, the payment bond language controls. *Maine Yankee Atomic Power Co.*, 183 F. Supp. 2d 76 (D. Maine 2001).

Courts also have indicated their willingness to expand equitable claims, such as subrogation and unjust enrichment claims, to allow an obligee to fully recover its alleged losses. If an obligee directly pays those that contracted with a principal and provided labor or materials to the principal to keep a project on track, subrogation claims against that principal’s surety will most likely be upheld by a court to allow an obligee to recover those funds. Sureties must guard against subrogation claims being expanded to include payment by an obligor of work performed by completion contractors and other work and material not provided directly to the principal; such work is outside the work scope of a bonded contract.

Finally, sureties must vigilantly prevent third-party beneficiary claims from becoming a “back door” payment bond claim. Although an owner or general contractor is always designated as the nominal obligor in a payment bond, other than preventing liens from being filed on the project, there is no intended benefit to an obligor contained in that bond. In a properly managed project, obligor losses should not exceed a performance bond penal limit, and the obligation of a surety should be restricted to that bond. 