inSights

Summer 2011

Welcome

Dear Clients and Friends,

We are pleased to provide you with the Summer 2011 installment of Reinert Weishaar & Associates, P.C.'s newsletter. This issue is dedicated to analyzing two cases of interest for sureties doing business in Missouri, as well as to providing you with an update of what's new with Reinert Weishaar & Associates.

Subject to the unpredictable developments in the law, we try to tailor each issue to achieve maximum relevancy to our diverse cliental. In other words, Construction and Surety Law are traditionally our core business, we place a special emphasis on following the evolution of this area of the law but strive to dedicate some issues of our newsletter to topics of interest to other client groups.

We hope that you will enjoy our Summer 2011 Newsletter and would be grateful for any feedback you can give us.

Regards,

Reinert Weishaar & Associates, P.C.

Yorkville

By: Christopher A. Michener

An unpaid subcontractor lacks standing to sue on a subdivision bond, even where that bond provides that one of the events of the principal's default is that the subdivision "improvements have been or are likely to be the subject of liens or other claims by contractors, subcontractors, or third parties," according to a recent holding by an Illinois federal court.

In City of Yorkville for the Use and Benefit of Pirtano Construction Co. v. Ocean Atlantic Service Corp., 2010 U.S. Dist. LEXIS 87461 (N.D.Ill.), Ocean Atlantic, owner and developer of the Westbury East Village subdivision, was required by city ordinance to obtain subdivision bonds "to assure the satisfactory installation of required improvements." American Southern Insurance Company issued the necessary irrevocable bonds in 2006, naming Ocean Atlantic as principal and the City of Yorkville as obligee.

By the summer of 2009, Ocean Atlantic advised the City to make claim on the bonds as five mechanic's liens totaling $2.8 million were presently on file and Ocean Atlantic would be unable to pay those claims or complete the project. The City submitted its claim to the surety.

Three of the unpaid contractors which had already filed mechanic's liens filed suit against the surety on the bonds. The three cases were removed and consolidated. In each, the contractor sued as a "use plaintiff" through the City, the named obligee on the bonds. American Southern moved to dismiss the consolidated cases claiming that the contractors lacked standing to sue on the bonds.

In addressing the motion to dismiss, the court first noted that the language of the bonds indicated no express intention to benefit third parties, and that under Illinois law in such cases the implication of such intent "must be so strong as to be practically an express declaration." The court then addressed and distinguished three cases relied on by the plaintiffs in which unnamed third-party lower tier contractors were held to be beneficiaries of contracts or bonds.

In *Avco Delta Corp. Canada Ltd. V. United States*,[1] the Seventh Circuit Court of Appeals held that subcontractors were intended beneficiaries of retainage provisions contained in the prime contract. However, in that case the retainage provision required the prime contractor to provide a sworn statement that its job creditors had been paid. The court construed this as an expressed intention of the contracting parties to "substantially" benefit the prime contractor's job creditors. The City of Yorkville court found no such promise made by Ocean Atlantic.

The court next addressed *East Peoria Community High School District 309 v. Grand Stage Lighting Co.*[2], an Illinois state appellate court case in which the public entity school district failed to require of the general contractor a payment bond as mandated by the Illinois public works "Bond Act." In that case, the court held that the Bond Act was applicable and its terms, including third-party rights, were to be read into the contract between the District and the general contractor. However, that court also found an intent to confer third-party rights contained in several provisions of the prime contract in which the general contractor promised to promptly pay subcontractors upon receipt of contract funds and to submit to the District satisfactory evidence that all indebtedness had been paid before receiving final payment. The City of Yorkville court, while noting that the East Peoria decision was based primarily on its holding concerning the Bond Act, also noted that the contract which should have been bonded in that case contained promises by the general contractor to pay its job creditors. No such promises were made by Ocean Atlantic to the City of Yorkville or to American Southern.

Finally, the court addressed Neenah *Foundry Co. v. National Surety Corp.*,[3] an Illinois appellate court case in which what appeared on its face to be strictly a performance bond was construed to include payment obligations. As in the other two cases, the Neenah court looked to the underlying contract and determined that the contractor had promised that all claims would be paid. Again, this promise, as part of the contract bonded by the surety, was held to be intended to benefit third party subcontractors and suppliers. The City of Yorkville court distinguished the case on the same grounds as the other two cases, in finding that Ocean City had not made similar promises in an underlying contract.

The holding of City of Yorkville is that absent clear intent manifested by the express terms of the bond itself, or at least reference to an underlying contract in which the principal promises payment to job creditors, a subdivision bond is a performance bond only and only the named obligee has standing to claim against it. In reaching its conclusion, the court appeared to rely solely on its application of the law of third-party beneficiary rights in a contract.

However, another factor appears to have influenced the court's analysis. As it distinguished the cases relied on by plaintiffs, the court made a point of noting in each that the unpaid job creditors lacked resort to a mechanic's lien action. The "use" plaintiffs in City of Yorkville, by contrast, not only could avail themselves of such rights, but in fact had already filed their liens. Additionally, the plaintiffs' lack of standing did not affect the City's rights to make claim on the bonds, and there was no indication that the City would not recover against American Southern and use the funds to pay the plaintiffs' claims. These factors may have played a role in the court's construction of the intent of the bonds, as it is arguable that in none of the cases addressed were the promises made by the surety or prime contractor truly "intended" to benefit third parties.

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[1] 484 F.2d 692 (7th Cir. 1972).

[2] 601 N.E.2d 972 (Ill.App. 1992).

[3] 197 N.E.2d 744 (Ill.App. 1964).

Surety Beware

Missouri Courts May no Longer Enforce Notice Provisions Contained in Contractors' Bonds in Many Cases

By: Boris A. Kaupp

Enforcement of Payment Bond Notice Requirements and Claims for Payment Asserted Against a Performance Bond - A Recent Opinion by the Missouri Court of Appeals Contains two Separate Holdings Which are Problematic for Sureties

In the case of *Greg Thomas et al. v. A.G. Electrical, Inc. et al., 304 S.W.3d 179 (Mo.App.E.D. 2009)*, the general contractor on a public works construction project applied for and its surety issued both a payment bond and a performance bond on the project. An electrical subcontractor on the project failed to pay its workers the prevailing rate of pay for their work. The workers made alternative claims on both the payment and the performance bond by letter more than one and a half years after they last furnished labor on the project. The surety filed a Motion to Dismiss for failure to state a claim, arguing that (1) its performance bond was only to ensure the successful completion of the project and did not secure payment of prevailing wages and (2) its payment bond required claimants to provide notice of their claims within 90 days of last furnishing labor or materials on the project. The Court of Appeals reversed and remanded. In doing so, the Court held that the Prevailing Wage Act mandated that all contractors' bonds issued on a project, including performance bonds, guarantee the payment of the prevailing wage. In regard to the surety's argument that the workers' payment bond claim was tardy, the Court held that a notice-of-claim provision in a payment bond on a public-works project should not be strictly construed, and that liability under a payment the bond cannot be avoided absent a showing of prejudice.

1. The Problem with the Court's Ruling Regarding the Payment Bond

The 90-day notice provision found in the payment bond here at issue[4] is modeled after the notice provision in the Miller Act for claimants not having a direct contractual relationship with the prime contractor. See 40 U.S.C. 3133 (b) (2).[5] In the Miller Act, the notice provision is intended to establish a date on which it is safe for the contractor to release payment to its subcontractors, thereby protecting both the contractor and the surety from having to pay twice for work performed by entities which may be unknown to the contractor. The same rationale applied to the Greg Thomas matter as well: the payment bond, pursuant to which both the surety and its principal, the general contractor, undertook to be liable for any unpaid labor or materials provided pursuant to the principal's contract with the Owner, provided a date certain on which the general contractor could release payment to subcontractors such as the electrical subcontractor who employed the claimants without facing liability on the bond or through any indemnity claim by the surety.

The Greg Thomas Court appears to have looked at the notice provision simply in terms of an arbitrarily imposed condition to reduce the surety's exposure. This is suggested by the fact that the Court, in refusing to strictly enforce the provision, likened it to notice provisions commonly found in insurance policies. When such provisions are challenged in legal proceedings, insurers often use the argument that the insurer needs to have timely notice of the insurance claim in order to be able to properly investigate it. Missouri courts, taking the insurers by their word, have held that such notice provisions should not be enforced where the insurer has failed to show that the belated notice of the claim has in fact prevented a full and proper investigation of the claim. See for example *Carroll v. MIRMA, 181 S.W.3d 123 (Mo.App.W.D. 2005)*. The Greg Thomas Court, cited a number of court decisions across the nation in which notice provisions were not enforced absent prejudice to the insurance company, all of which dealt with insurance policies and not with bonds. Further, the Court, in relying

on the case law pertaining to the enforcement of notice provisions in insurance policies, specifically mentioned that the surety in the case at bar had maintained that the purpose of the notice provision was to afford the surety the opportunity to investigate the payment bond claim.

It is problematic to apply this rationale to the notice provision in a payment bond such as the one at issue[6] in the Greg Thomas matter as it is arguably prejudicial to the surety and its principal if the notice provision is not enforced as it deprives the principal of any certainty as to when it can "safely" pay its subcontractors.[7] It is for this reason that the notice provision contained in the Miller Act is routinely and strictly enforced. See for example General Electric Company V. Gunnar I. Johnson & Son, Inc., 310 F.2d 899 (8th Cir. 1962); United States ex rel. American Radiator & Standard Sanitary Corp. v. Northwestern Engineering Co., 122 F.2d 600 (8th Cir. 1941); Russell v. Travelers Indemnity Co., 244 F.Supp. 419 (W.D.Mo. 1965). Missouri courts have historically enforced notice requirements such as the one at issue in the Greg Thomas matter as preconditions for bringing a payment bond claim so long as they were found to be "reasonable." Reorganized School Dist. R-3 v. L.D. Compton Const. Co., 483 S.W.2d 674, 676 (Mo.App. 1972); Frank Powell Lumber Co. v. Federal Ins. Co., 817 S.W.2d 648, 652 (Mo.App.S.D. 1991). It remains to be seen whether the Greg Thomas opinion marks the beginning of an era in which Missouri courts no longer enforce notice provisions in bonds consistent with the rationale for including a 90-day notice provision in the Miller Act. In any case, Greg Thomas makes it more difficult for a surety to deny a payment bond claim in Missouri for failure to comply with the bond's notice provision.

2. The Potential Danger of the Court's Ruling Regarding the Performance Bond

The situation of a surety being held liable on its performance bond for unpaid claims by subcontractors and materialmen is not a first in Missouri. This happens from time to time in cases where the performance bond is worded so broadly as to suggest that it is not merely intended to assure the completion of a project but also the payment of those who furnish labor or materials in that endeavor. See *La Salle Iron Works, Inc. v. L. J. Largen, 410 S.W.2d 87 (Mo. 1966).*

The difference with the Greg Thomas case is that the performance bond contained no language suggesting it covered payment bond claims. To the contrary, the court specifically noted the absence of any language dealing with coverage for prevailing wage claims. But it interpreted language then in section 250.290 of the Prevailing Wage Act stating that "[the public body awarding the contract] shall also require in all contractor's bonds that the contractor include such provisions as will guarantee the faithful performance of the prevailing hourly wage clause as provided by contract" to literally mandate, in conjunction with RSMo 107.170, that any and all bonds issued on the project, including performance bonds, cover prevailing wage claims.

While the legislature removed the language in RSMo 250.290 upon which the Court ultimately relied in ruling that the surety's performance bond was to cover the claim for payment of prevailing wages, it must be noted that the decision as a whole indicates a willingness to impose liability for payment claims on a surety's performance bond based on a broad reading of the Public Works Bond Act. Therefore, utmost caution is warranted, specifically in areas where certain claimants (such as laborers subject to the prevailing wage laws) have the benefit of strong public policy backing their claim.

3. What to do?

As far as the enforcement of the notice provision in a payment bond is concerned, it is difficult for a surety to better its position in that it doesn't contract with potential claimants and thus has limited control over its exposure to them. However, it is a good idea to include, with the notice provision, a passage specifically setting out the purpose for the notice provision, which is to avoid prejudice to the surety and its principal by setting a date at which the contractor can safely pay its subs. Also, special attention must be given to the circumstances of the

subcontractor's failure to pay the claim which is now asserted against the payment bond. Where, for example, the subcontractor became insolvent subsequent to the expiration of the notice period applicable to the bond claim, a good argument can be made that the surety would have been successful in corralling its principal to pay the claim, or to obtain collateral security from its principal but for the belated notice, thereby causing prejudice to the surety.

A surety might also consider issuing a combination of payment / performance bonds instead of providing two separate bonds. Such a hybrid bond should contain a notice provision applying to all claims other than a performance claim.

Reinert Weishaar & Associates can help sureties draft these and other provisions designed to effectively limit their exposure in Missouri and Illinois, and to adapt their form bonds to the specific legal landscape of these and other states.

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[4] ... a Claimant having a direct contractual relationship with a subcontractor of the Principal shall have a right of action on this bond only if said Claimant notifies the Surety in writing of its claim within ninety (90) days from the date on which said Claimant did or performed the last labor and/or materials for which the claim is made...

[5] A person having a direct contractual relationship with a subcontractor but no contractual relationship, express or implied, with the contractor furnishing the payment bond may bring a civil action on the payment bond on giving written notice to the contractor within 90 days from the date on which the person did or performed the last of the labor or furnished or supplied the last of the material for which the claim is made.

[6] i.e. one that imposes the notice requirement only for such claimants that have no direct contact to the principal.

[7] This argument of course does not carry much weight were the contractor in fact makes payment before the expiration of 90 days following the last day on which labor or materials were furnished.