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THREE TAKEOVER CHALLENGES UNDER THE MILLER ACT

By Jack Burch April 25, 2018

When the principal on a Miller Act project ceases to perform and a demand is made on the surety, the challenges in working out a takeover agreement with the Government begin. In this article we discuss three issues that crop up: 1) the necessity of a declaration of default to the surety's performance, 2) whether a contracting officer has authority to accept a tender agreement, and 3) how to contest a claim for pre-default liquidated damages.

Necessity of a Default

Before the surety's obligations arise under the performance bond, there must be a default and termination. A default is a necessary ingredient whether issued for cause or entered into voluntarily by the principal. *See* Restatement of the Law (3d) of Suretyship and Guaranty, § 27; *District of Columbia v. Aetna Insurance Co.*, 462 A.2d 428 (D.C. 1983).

When the contracting officer issues a notice of termination, he or she is required to notify the surety. FAR 49.102. While the FAR permits the surety to continue to perform in lieu of termination or for a default, FAR 49.402-4, it would be dangerous for the surety do so without the concurrence of the principal. Moreover, a surety takeover agreement requires a termination for default. FAR 49.404. Performance without a termination may create more issues for the surety than it cures.

For instance, in a later indemnity action the surety might not be able to recover for its losses because, without a duty imposed by a default, the surety could be found to have acted as a volunteer. Moreover, if there is no default, the principal is entitled to be paid contract funds. Further, if a default is not declared, a bankruptcy filing will trigger the automatic stay, which bars a termination of the contract by the government, causing the parties to sit and wait for a court ruling.

Sometimes contracting officers seem to believe that merely writing a letter to the surety demanding it attend a meeting and stating that the contractor is not performing is sufficient to trigger the surety's obligations. In such a situation the surety has to impress upon the contracting office the notion that a default must be declared in order for the surety to have any obligation.

Tender vs. Takeover

Sureties typically prefer to tender a completion contractor rather than enter into a takeover agreement.

The FAR does not mention a tender agreement, and there is no reference in these administrative regulations to either permitting a tender or instructing the contracting officer as to what to do. This can create a delay when the surety offers to tender a contractor on a Miller Act project because the contracting officer is forced to make a decision without direct guidance from the FAR. This uncertainty also can contribute to the accruing of liquidated damages. No wonder many sureties are hesitant to offer a tender agreement to resolve a Miller Act performance bond claim.

However, it is not impossible to enter into a tender agreement with the Government on a Miller Act project. The key to having a tender accepted is in convincing the contracting officer that, because the FAR does contemplate completion by another contractor, a tender agreement is an acceptable, and perhaps preferable, solution to remedying the default.

FAR 49.405 states that, if the surety does not arrange for completion, the contracting officer will arrange for completion of the work by awarding a new contract "or any other appropriate contracting method or procedure." Sometimes a contracting officer will consider this authority and accept a tender.

Liquidated Damages

The surety has its hands tied in contesting pre-default liquidated damages because it cannot bring a claim under the Contract Disputes Act and it has no rights to contest liquidated damages through equitable subrogation.

In *Fireman's Fund Ins. Co. v. England*, 313 F.3d 1344 (Fed. Cir. 2002), and *United Pacific Ins. Co. v. Roche*, 380 F.3d 1352 (Fed. Cir. 2004), the court held that, even when the surety entered into a takeover agreement, it did not have the right to assert a claim under the Contract Disputes Act for recovery of liquidated damages assessed prior to the takeover.

And while the surety has rights of equitable subrogation when it completes a project, this does not give a court jurisdiction to hear claims that arose prior to the takeover. In *Lumbermens Mut. Cas. Co. v. U.S.*, 654 F.3d 1305 (Fed. Cir. 2011), the court held that the surety's equitable subrogation rights did not give it standing to challenge pre-default liquidated damages.

Since neither equitable subrogation nor a Contract Disputes Act claim will provide a mechanism to the surety to contest pre-default liquidated damages claims, the net result is that, unless the surety has notified the government to quit making payments prior to default, the surety has no mechanism to challenge pre-default liquidated damages.

The Federal Circuit in *Lumbermens* characterized the surety's claim that the government improperly charged liquidated damages as a claim of impaired surety collateral. But the only way the surety can assert a claim for impairment of surety collateral is to withhold any payment on the performance bond — that is, refuse to perform — and use impairment of suretyship as a defense when sued. The court thus held that the surety had no offensive claim it could assert for pre-default liquidated damages (unless a pre-default demand had been made), but it could use its rights defensively. Telling the surety to deny a Miller Act bond claim and wait to be sued obviously raises the stakes and a host of other issues.

But the surety’s offensive right to challenge liquidated damages if it denies the demand for a takeover may be a basis to have meaningful negotiations with the contracting officer on terms of the takeover agreement to get relief for improperly charged liquidated damages.

Thus, the negotiations on the takeover agreement itself represent the surety’s best shot at dealing with potential liquidated damages that have arisen prior to default. Addressing the basis to challenge liquidated damages and persuading the contracting officer that they should be reduced or waived may be the surety’s only practical mechanism to obtain relief for liquidated damages racked up prior to a takeover.

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