Chapter 1—The Contract Bond Surety’s Common Law Right to Equitable Subrogation—The Basics

Samuel J. Arena, Jr., Lee A. Rosengard, David E. Somers, III and Alex L. Rubenstein

Introduction .................................................................................................................. 1

I. The Nature and Scope of Equitable Subrogation .............................................. 2
   A. The Historical Basis for the Surety’s Subrogation Rights .................. 2
   B. The Essential Elements of Subrogation .............................................. 5
   C. The Rights to Which the Surety Is Subrogated .............................. 8
      1. Rights of the Obligee .............................................................. 9
      2. Rights of the Principal ......................................................... 11
      3. Rights of Third Party Claimants ........................................... 13
   D. The Equitable Basis for the Surety’s Subrogation Rights .......... 14
   E. The Differences Between Suretyship and Insurance ................. 15

II. A Review and Comparison of the Surety’s Rights ...................................... 17
   A. The Surety’s Equitable Rights Under Common Law .................. 17
      1. Exoneration and Quia Timet ............................................... 17
      2. Indemnity and Reimbursement ........................................... 19
      3. Subrogation ........................................................................... 21
      4. Contribution .............................................................................. 21
   B. The Surety’s Contractual Rights Under the Indemnity Agreement ........................................ 22
      1. The Indemnity Provision (“Contractual Reimbursement”) ................ 22
      2. The Collateral Deposit Provision (Contractual “Exoneration”) .................... 24
3. The Assignment Provision .................................................................. 26
4. The Trust Fund Provision .................................................................. 27
C. A Comparison of the Surety’s Subrogation Rights to the Surety’s Other Equitable Rights and Its Contract Rights .......... 28
   1. The Surety’s Subrogation Rights as Compared to the Surety’s Other Equitable Rights .............................................. 28
   2. The Surety’s Subrogation Rights as Compared to the Surety’s Contract Law Rights .................................................. 29

III. The Factors and Issues Affecting the Surety’s Subrogation Rights ........................................................................... 33
   A. The Necessity of the Principal’s Default—The Surety’s Subrogation Rights Arise Upon the Principal’s Default .......... 34
   B. The Necessity of the Surety’s Performance ............................................. 35
   C. The Surety’s Performance or Payment Must Be Made in the Discharge of a Legal Obligation ....................... 41
   D. The “Relation Back” and “No Debt Due” Concepts ......................... 42
      1. The “Relation Back” Concept .............................................. 42
      2. The “No Debt Due” Concept .............................................. 44

IV. Definitions and Distinctions—The Performance Bond Surety and the Payment Bond Surety ............................................... 45
   A. The Definition of the Performance Bond Surety ......................... 45
   B. The Definition of the Payment Bond Surety .................................. 46
   C. Differing Subrogation Rights for the Performance Bond Surety and the Payment Bond Surety—Case Law ..................... 47
   D. Differing Subrogation Rights for the Performance Bond Surety and the Payment Bond Surety—Restatement Law ...... 51

V. Definitions and Distinctions—The Type of the Remaining Bonded Contract Funds ................................................................. 52
   A. Types of Remaining Bonded Contract Funds .............................. 52
   B. Should There Be a Distinction Between the Types of the Remaining Bonded Contract Funds for the Purposes of Subrogation? ................................................................. 55
VI. Damages—The Elements and Measure of the Surety’s Claim for Damages When the Surety Exercises Its Subrogation Rights ................................................................. 55

Conclusion ........................................................................................................... 57

Chapter 2—The Treatment of the Fundamental Principles of the Surety’s Subrogation Rights in the Restatement of the Law

T. Scott Leo

Introduction .......................................................................................................... 59

I. Restatements of the Law .................................................................................. 61

II. The Restatement of Suretyship & Guaranty ..................................................... 62
   A. The Impact of Commercial Guaranty Practice on the Restatement of Suretyship Project ................................................................. 63
   B. The Participation of Surety Industry Attorneys and Company Representatives and Members of the FSLC as Advisers .................................................. 63

III. The Preparation of the Restatement of Suretyship ..................................... 65

IV. Subrogation and the Right of Return Performance ................................... 68
   A. The Terminology of the Restatement of Suretyship ................................. 71
   B. The Progression of the Restatement of Suretyship Provisions Addressing the Surety’s Subrogation Rights ............................ 73
   C. The Surety’s Right of Return Performance Under Section 31 of the Restatement of Suretyship .................................................. 78
   D. The Obligee Cannot Setoff to the Detriment of the Surety’s Right to Return Performance ......................................................... 81

V. Suretyship Defenses and the Scope of the Surety’s Subrogation Rights .......... 85
   A. Impairment of Suretyship Status ............................................................... 86
Chapter 3—The Parties’ Rights to Which the Contract Bond Surety Is Subrogated

Brett D. Divers and Brandon J. Held

Introduction ............................................................................................. 93

I. Rights of the Obligee ................................................................................ 97
   A. The Obligee’s Claims Against the Principal ........................................... 98
      1. The Obligee’s Claims Under the Bonded Contract ......................... 99
         a. Bonded Contract Funds .......................................................... 99
         b. Other Contract Rights .......................................................... 101
      2. The Obligee’s Common Law Setoff Rights ...................................... 101
   B. The Obligee’s Claims Against Third Parties ..................................... 103
      1. The Obligee’s Claims Against Design Professionals ..................... 105
      2. The Obligee’s Claims Against Assignees/Lenders ....................... 105
      3. The Obligee’s Claims Against Other Third Parties ....................... 107

II. Rights of Subcontractor and Supplier Claimants (Third-Party Beneficiaries Under the Payment Bond) ............................................. 107
   A. The Claimants’ Claims Against the Obligee ...................................... 108
      1. Contract Rights ........................................................................... 109
      2. Statutory Rights ........................................................................... 109
         a. Mechanic’s Lien or Other Lien Rights ...................................... 109
         b. Trust Fund Rights .................................................................. 111
         c. Stop Notice/Withheld and Direct Payment Rights ............... 112
         d. Other Statutory Rights ......................................................... 113
      3. Common Law Rights .................................................................. 114
   B. The Claimants’ Claims Against the Principal ................................... 115
      1. Contract Rights ........................................................................... 116
      2. Statutory Trust Fund Rights ....................................................... 116
      3. Common Law Rights .................................................................. 118

Conclusion .................................................................................................. 90
4. Payment Bond Rights ................................................................. 119
C. The Claimants’ Claims Against Third Parties ......................... 119
  1. The Claimants’ Claims Against Assignees/Lenders ........ 120
  2. The Claimants’ Claims Against Other Third Parties .......... 121

III. Rights of the Principal .................................................................... 123
  A. The Principal’s Claims Against the Obligee ......................... 125
     1. Contract Rights ............................................................. 125
     2. Statutory Rights ......................................................... 131
     3. Common Law Rights ................................................. 132
  B. The Principal’s Claims Against Other Parties ......................... 132
     1. The Principal’s Claims Against Design Professionals .... 133
     2. The Principal’s Claims Against Assignees/Lenders ....... 134
     3. The Principal’s Claims Against Subcontractors and Suppliers ......................... 135
     4. The Principal’s Claims Against Other Third Parties .......... 136

Conclusion ............................................................................................ 137

Appendix to Chapter 3 .......................................................................... 139

Chapter 4—The Necessity of the Principal’s Default
Carol Z. Smith

Introduction ............................................................................................. 175

I. What Is a Default and When Does It Occur? ......................... 177
  A. What Are the Sources of the Principal’s
     Obligations to the Obligee? ............................................. 178
     1. The Bonded Contract ................................................. 178
     2. The Performance and Payment Bonds ...................... 180
  B. When Does the Principal’s Failure to Perform Its
     Contractual Obligations Constitute a Default? ............. 181
     1. Default and the Material Breach Doctrine ................. 182
     2. Actual Default ......................................................... 184
     3. Excused Default ....................................................... 185
C. When Does the Principal’s Default Support the Surety’s Assertion of the Surety’s Subrogation Rights?......................... 187
   1. The Principal’s Failure to Complete the Bonded Contract Work ....................................................... 188
   2. The Principal’s Failure to Pay Subcontractors and Suppliers ............................................. 189
   3. The Principal’s Need for the Surety’s Financial Assistance ........................................................... 192
D. How Is the Date of Default Determined? ................................ 195

II. The Government’s Discretion and Rights With Respect to Ignoring Certain of the Principal’s Defaults ......................... 198

Conclusion ............................................................................................ 201

Chapter 5—The Necessity of the Surety’s Performance
David W. Slaughter

Introduction ........................................................................................... 203

I. Performance as a Condition of the Surety’s Assertion of Its Subrogation Rights ............................................... 207

II. The Definition of Performance............................................................. 208

III. The Surety’s Performance Must Be Made in Discharge of a Legal Obligation .................................................... 210

IV. Performance and the Type of the Surety’s Obligation............................................................... 216
   A. The Surety’s Performance Under the Performance Bond...... 216
      1. The Surety’s Payment to the Obligee ........................................... 217
      2. The Surety’s Takeover and Completion or Tendered Completion ............................................. 219
      3. The Surety’s Financial Assistance to the Principal’s Performance ........................................ 221
Contents

B. The Surety’s “Performance” Under the Payment Bond........... 225
C. Other Surety Performance or Substitutes for Performance..... 232

V. How Much Performance Is Enough Performance? ....................... 237
   A. The General Rule of Full Performance and
      Payment and Exceptions to the Rule ................................. 238
   B. Full Performance and Partial Payment ................................. 243
   C. Partial Performance and Full Payment ............................... 250
   D. Partial Performance and Partial Payment .......................... 253
   E. No Performance or Payment .............................................. 254

VI. When is “Everything” Not “Enough”? ........................................... 256
   A. Full Performance of All Performance Bond
      Obligations May Not Be Enough ....................................... 257
   B. Full Performance of All Payment Bond
      Obligations May Not Be Enough ....................................... 259

VII. The Timing of Performance ...................................................... 261

Conclusion ..................................................................................... 263

Chapter 6—The Necessity of Notice to the Obligee or Third Parties
Joel M. Long

Introduction ..................................................................................... 265

I. Whether Notice Is Required ..................................................... 266

II. Requirements for Effective Notice .......................................... 266
   A. Timing of the Notice ......................................................... 267
      1. General Rule ............................................................... 267
      2. Other Timing Considerations ....................................... 267
   B. Form and Content of the Notice ....................................... 269
   C. Sender of the Notice ....................................................... 271
      1. Surety ...................................................................... 271
      2. Principal ................................................................. 272
The Contract Bond Surety’s Subrogation Rights

3. Other Parties ........................................................................ 273
4. Obligee Exception ................................................................ 274
D. Recipient of the Notice .................................................... 274
  1. Obligee in Possession of the Bonded Contract Funds .......... 275
  2. Other Potentially Interested Parties .................................. 275
     a. Principal ..................................................................... 275
     b. Principal’s Subcontractors and Suppliers ...................... 276
     c. Principal’s Assignees ............................................... 276
     d. Principal’s Creditors ............................................... 277
     e. Parties in the Principal’s Bankruptcy ......................... 277
     f. The IRS .................................................................. 278
  3. Authority to Accept Notice ............................................. 278

III. Effect of the Surety’s Notice .................................................. 279
   A. In General ...................................................................... 279
   B. Before Completion of the Bonded Project ....................... 279
   C. After Completion of the Bonded Project ......................... 283

IV. Exceptions to Notice Requirements ........................................ 284

V. Development of the Applicable Law ........................................ 287

Conclusion .................................................................................. 287

Chapter 7—The Surety v. The Obligee
Thomas J. Vollbrecht

Introduction ............................................................................ 289

I. The Obligee’s Role and Other Key Factors That Impact the Surety v. The Obligee Contest for the Bonded Contract Funds .................................................... 290
   A. The Obligee’s Role ...................................................... 291
   B. Bonded Contract Funds Status – Who Holds the Bonded Contract Funds ......................... 292
II. The Surety v. The Obligee for the Bonded Contract Funds ........... 294
   A. The Performance Bond Surety v. The Obligee for the Bonded Contract Funds ......................................................... 295
      1. Progress Payments .............................................................. 297
      2. Retainage ............................................................................ 299
      3. The Principal’s Claims, Extras, Bonuses and Other Bonded Contract Funds ......................................................... 300
      4. The Obligee’s Setoff Rights and Claims Under the Bonded Contract ......................................................... 301
      5. The Obligee’s Improper or Wrongful Payments ........... 301
      6. Impairment of Collateral by the Obligee ................................ 305
   B. The Payment Bond Surety v. The Obligee for the Bonded Contract Funds .............................................................. 305
      1. Progress Payments .............................................................. 306
         a. The Obligee as Stakeholder with No Further Claim against the Progress Payments ............................................. 308
         b. The Obligee as Interested Party Seeking Further Performance on the Bonded Contract ............. 309
      2. Retainage ............................................................................ 311
      3. The Principal’s Claims, Extras, Bonuses and Other Bonded Contract Funds ......................................................... 313
      4. Impairment of Collateral by the Obligee ............................ 313

III. The Surety v. The Obligee and the Obligee’s Setoff Rights ........ 314
   A. The Performance Bond Surety v. The Obligee ........................ 314
   B. The Payment Bond Surety v. The Obligee ......................... 315

Conclusion ............................................................................................ 316
Chapter 8—The Surety v. The Principal
Jay M. Mann

Introduction ........................................................................................... 319
I. Performance Bond Surety v. Principal ........................................... 320
II. Payment Bond Surety v. Principal ................................................. 325
III. The Surety’s Subrogation Rights to Principal’s
    Assets Other than the Bonded Contract Funds ................................ 328
Conclusion ........................................................................................... 329

Chapter 9—The Surety v. Third Party Beneficiaries Under the
Surety’s Payment Bonds (Payment Bond Claimants)
Lawrence Lerner

Introduction ........................................................................................... 331
I. Performance Bond Surety v. Claimants ............................................ 333
   A. Types of Bonded Contract Funds ........................................... 334
      1. Progress Payments – (earned and paid; earned and unpaid) .... 334
      2. Retainage ............................................................................ 336
      3. Other Monies Due (bonded contract funds
         yet to be earned, extras, additional work
         modifications, change orders, claims) ......................... 337
      4. Exceptions ........................................................................ 337
   II. Payment Bond Surety v. Claimants ............................................ 338
      A. Types of Bonded Contract Funds ........................................ 339
         1. Progress Payments – (earned and paid; earned and unpaid) 339
         2. Retainage ........................................................................ 343
3. Other Monies Due (bonded contract funds yet to be earned, extras, additional work, modifications, change orders, claims) ................................ 344
  B. Mixed Treatment of Untimely Claims by Claimants .......... 345
  C. Impairment of Surety’s Subrogation Rights .................. 347
  D. Equitable Pro-Rata Distribution to Payment Bond Surety ................................................................. 348

III. Performance and Payment Bond Surety v. Claimants.............. 348
  A. Types of Bonded Contract Funds .................................. 348
    1. Progress Payments – (earned and paid; earned and unpaid) .............................................................. 348
    2. Retainage ............................................................................. 349
    3. Other Monies Due (bonded contract funds yet to be earned, extras, additional work, modifications, change orders, claims) ................................ 350
  B. Combination Performance and Payment Bonds ............... 350

IV. Disputed Areas and Concerns for the Payment Bond Surety ................................................................. 351
  A. The Surety Exhausts the Penal Sum of the Payment Bond and Not All of the Claims Against the Payment Bond are Paid................................. 351
  B. The Payment Bond Surety Competes for a Principal’s Bankruptcy Estate Distribution With Untimely Claimants Against the Payment Bond ........................................ 354
  C. The Surety is Treated as a Volunteer for Purposes of Asserting the Surety’s Subrogation Rights for Paying Untimely Claims Against the Payment Bond .............. 356

V. The Governmental Obligee May Be Directly Liable to the Claimants for its Failure to Obtain a Statutory Payment Bond................................................................. 357

Conclusion ............................................................................................ 359
Chapter 10—The Surety v. The Assignee/Lender

Steven H. Rittmaster

Introduction..............................................................................................................363

I. The Rights of the Assignee/Lender Under the UCC .......................366
   A. Perfection of the Bank’s Rights ....................................................367
      1. How the Bank Perfects its Lien ........................................367
      2. The Effect of the Bank’s Perfection .................................368
   B. The Parties’ Rights to the Bonded Contract Funds ...............369
      1. The Bank has Rights to the Bonded Contract Funds
         Only if the Principal has Rights to the
         Bonded Contract Funds .....................................................369
      2. The “No Debt Due” Theory ..............................................370
      3. The Performing Surety’s Rights to the Bonded
         Contract Funds are Typically Superior to the
         Bank’s Claim to the Bonded Contract Funds .............372
   C. Statutory (Trust Fund) Rights that Affect the Principal’s
      Rights to the Bonded Contract Funds ................................372
   D. The Bank’s Rights to the Principal’s Personal Property ....373

II. The Surety’s Use of its Subrogation Rights to Claim Priority ......374
   A. The Surety’s Subrogation Rights Generally .........................374
      1. A Surety’s Subrogation Rights Typically
         Trump a Bank’s UCC Rights ........................................375
      2. The Bank’s Continuing Attacks on the Surety’s
         Subrogation Rights to the Bonded Contract Funds ....377
   B. The Surety’s Subrogation Rights are Not
      A Security Interest Requiring Perfection ..........................379
   C. The Surety Does Not Waive its Subrogation
      Rights Even if it Perfects a Security Interest ...................382
   D. Even if the Bank’s Loan Proceeds are Used to Fund
      the Bonded Project, the Performance Bond Surety’s
      Subrogation Rights to the Unpaid Bonded
      Contract Funds are Superior .........................................382
   E. The Surety is Subrogated to the Obligee’s Rights ..............383
Contents

F. The Surety’s Subrogation Rights Relate Back to the Date of the Bonds .......................................................... 383
G. The Surety’s Rights to Payments Sent to the Bank ................. 384
H. The Bank is Deemed on Notice of the Surety’s Subrogation Rights .................................................................. 385
I. The General Rule Affording Priority to the Surety’s Subrogation Rights to the Bonded Contract Funds ............. 386

III. The Performance and Payment Bond Surety v. The Assignee/Lender ................................................................. 387
A. Progress Payments (Earned by the Principal and Paid by the Obligee)................................................................. 389
1. Whether the Surety May Recover the Bonded Contract Funds Paid by the Obligee and Deposited with the Principal’s Bank Prior to the Principal’s Default and/or Prior to the Bank Receiving Notice or Having Knowledge that the Principal Has Failed to Pay its Subcontractors and/or Suppliers on the Bonded Project......................................... 389
   a. The Bank’s Knowledge of the Principal’s Financial Distress ................................................................. 390
   b. The Bank’s Knowledge of the Surety’s Subrogation Rights to the Bonded Contract Funds ...... 391
   c. Actual Knowledge and Notice ...................................... 392
   d. Constructive Knowledge and Notice ............................. 393
2. Identification and Tracing Issues—Did the Deposit Come from the Bonded Contract Funds, Which then Caused the Principal’s Failure to Pay its Subcontractors and/or Suppliers on the Bonded Project?.......................... 394
   a. In Unique Circumstances, Equitable Principles May Allow a Bank to Prevail in a Contest for Bonded Contract Funds Over the Surety’s Subrogation Rights .............................................. 395
   b. Absent These Exceptions, a Bank Loan Provided for a Specific Construction Project Does Not Entitle the Bank to Higher Priority ............................................................... 396
c. If the Surety Acts as a Volunteer, that May Also Allow the Bank to Prevail in the Contest for Bonded Contract Funds ................................................................. 397

3. The Effect of the Surety’s Subrogation Rights to any Trust Fund Rights for the Benefit of the Subcontractors and/or Suppliers and the Effect of the Trust Fund on the Bank v. the Bank’s Asserted Right to Setoff the Deposited Bonded Contract Funds Against the Principal’s Obligations to the Bank, Whether Related to the Loan of Money or Unrelated Debts (Equipment Loans, etc.) .................................................................................. 398
   a. How Trust Funds are Created (by Statute or Contract) ........................................ 398
   b. The Effect of the Existence of a Trust in the Competition between the Surety and the Bank for the Bonded Contract Funds .................................................. 399

B. Progress Payments (Earned but Unpaid and Unearned Progress Payments) .................................................. 401
   1. The Obligee’s Right to Withhold the Bonded Contract Funds ................................ 401
   2. The Equitable Lien Theory ..................................................................................... 403
   3. The Surety v. The Assignee Priority Disputes when the Principal is in Bankruptcy .............................................................. 404
   4. In Summary, the Surety’s Subrogation Rights Generally Prevail Over the Assignee’s Claims to Bonded Contract Funds when the Obligee is Holding the Bonded Contract Funds .................................................. 405

C. Retainage .................................................................................................................. 405

D. The Surety’s Subrogation Rights as Affected by the Assignment of Claims Act ............................................................. 408
   1. How the Assignment of Claims Act Works ............................................................ 409
   2. Impacts on the Surety when there has been an Assignment to a Bank of the Bonded Contract Funds Under the Assignment of Claim Act ........................................... 410
   3. Effect of No Notice to the Surety of the Assignment to the Bank .................................................. 411
4. Recovery of Payments Erroneously Made to the Bank After the Principal’s Default ............... 412
5. An Assignment Under the Assignment of Claims Act Does Not itself Override the Surety’s Subrogation Rights to the Bonded Contract Funds ........................................... 412

Conclusion ........................................................................................................... 413

Appendix to Chapter 10 .................................................................................... 415

Chapter 11—The Surety v. Trustees/Debtors in Bankruptcy
Chad L. Schexnayder

Introduction ......................................................................................................... 433

I. The Principal in Bankruptcy ........................................................................... 435
   A. The Principal Becomes a Debtor .............................................................. 435
   B. Are the Bankruptcy Trustee and the Debtor Different than the Principal With Respect to the Bonded Contract Funds? .................................................. 437
      1. Different ............................................................................................ 437
      2. The Same ........................................................................................ 438

II. The Bonded Contract Funds Before the Bankruptcy Court ......... 439
   A. The Bankruptcy Estate ............................................................................. 439
   B. What Is in a Name? Labeling the Surety’s Subrogation Rights Before the Bankruptcy Court ........... 442
      1. The “Equitable Lien” Difficulty ......................................................... 444
      2. A Lien in Bankruptcy ........................................................................ 445
      3. Subrogation Rights as an Ownership Interest .................................... 445

III. What Variables Will Impact the Bankruptcy Court’s Determination of the Conflicting Claims of the Surety and the Trustee/DIP to the Bonded Contract Funds? ............. 446
   A. Is the Surety Fulfilling its Performance Bond or Payment Bond Obligations? .................. 448
B. What Is the Nature of the Bonded Contract Funds? ..........449
C. When Did the Default Occur, or When Did
the Surety Pay Losses, in Relation to the Filing
of the Bankruptcy Petition? .....................................................451
D. Is the Bankruptcy Case a Reorganization or a
Liquidation? .............................................................................453

IV. The Trustee’s/DIP’s Use of the Bonded Contract Funds ..........454

V. Concepts Necessary for an Understanding of
Surety Versus Trustee/DIP Priority Disputes to the
Bonded Contract Funds .................................................................457
A. The Bonded Contract Funds Are Held In
“Trust” For the Benefit of Another ..........................................458
1. Statutory Trusts ..................................................................459
2. Trust Fund Provisions in the Indemnity Agreement ...........459
3. Trust Fund Clauses in the Bonded
Construction Contract.................................................................460
B. Unsatisfied Conditions Precedent to the Debtor’s Right
to Payment (the Bonded Contract Funds are “Not Owed”) ....461
C. The Bonded Contract Funds Were Assigned to the
Surety Before the Principal’s Bankruptcy Filing .................462
Conclusion ..................................................................................463

Chapter 12—The Surety v. Other Taxing Authorities and
Governmental Lienors
Matthew M. Horowitz

Introduction ....................................................................................465

I. Priority Disputes Between a Surety’s Subrogation Rights
and Internal Revenue Service Tax Liens ........................................466
A. Whether the Taxpayer/Principal has a Property Right
to the Bonded Contract Funds Purportedly Claimed
or Liened by the IRS........................................................................467
B. The Applicable Criteria for Resolving Priority Disputes
   Between Surety’s Subrogation Rights to the Bonded
   Contract Funds and IRS Tax Liens that have
   Attached to the Bonded Contract Funds ......................... 475
   1. Whether the Relation Back Doctrine is
      Recognized under State Law ........................................ 481
   2. Whether the Relation Back Doctrine is
      Applicable to both Retainage and Progress
      Payments or only to Retainage ..................................... 481
   3. Whether a Surety’s Subrogation Rights Must be
      Perfected Article 9 of the Uniform Commercial Code ...... 483
   4. Whether a Surety can be Subrogated to the Rights
      of the Subcontractor and Supplier Claimants to the
      Bonded Contract Funds if the Claimants did not
      Perfect their Rights against the Bonded Contract
      Funds under Applicable Mechanics Lien
      or Other Lien Statutes ................................................ 484
C. The Implications of the Obligee being Served
   with an IRS Tax Levy ..................................................... 485
   1. Does the Service of a Tax Levy Affect the
      Priority Rules set out in §6323(c)? ............................ 485
   2. Procedures a Surety must follow In Order to Assert
      its Subrogation And Priority Rights to the Bonded
      Contract Funds subject to an IRS Levy ....................... 487

II. Priority Disputes Between a Surety’s Subrogation Rights
    to the Bonded Contract Funds and Other
    Taxing Authorities and/or Government Liens .................. 489

Conclusion ............................................................................ 491
Chapter 13—The Surety v. General Creditors and Judgment Creditors

David C. Olson and Shannah J. Morris

Introduction ........................................................................................... 493

I. Illustrative Case Study – In re ADL Contracting Corp. ......................................................... 497

II. General Creditors ........................................................................... 500
    A. Subcontractors and Suppliers on the Bonded Projects Who Have Not Been Paid Under the Payment Bond ........... 500
    B. Subcontractors, Suppliers and/or Other Entities on the Principal’s Non-Bonded Projects .................................. 501
    C. The Principal’s Overhead and Other General Administrative Creditors Who are Not Covered by the Payment Bond .............................................................. 502
    D. Other Creditors of the Principal Who Do Not Have Claims Against the Surety’s Performance and/or Payment Bonds ................................................................. 504

III. Judgment Creditors ........................................................................ 505
    A. Judgment Creditors Who Have Not Sought To Enforce Their Judgments Through Attachment, Garnishment or Other Means .......................................................... 505
    B. Judgment Creditors Who Have Executed on Their Judgment Against the Bonded Contract Funds .... 507

Conclusion ............................................................................................ 511
Chapter 14—Common Obligee Theory and Other Setoff Rights — The Surety’s Subrogation Rights to the Obligee’s or Principal’s Setoff Rights
Jarrod W. Stone

Introduction ............................................................................................................. 513

I. The Common Obligee Theory Enables the Surety to Assert its Subrogation Rights in Order to Exercise the Obligee’s Setoff Rights Against the Principal to Recover Unrelated Funds the Obligee Owes to the Principal ................................................................. 515
   A. Scenarios in Which the Surety May Attempt to Utilize the Common Obligee Theory to Recover the Other Contract Funds to the Extent of the Surety’s Losses by Asserting its Subrogation Rights to the Obligee’s Setoff Rights Against the Principal .................................................. 515
   B. Cases Allowing the Surety to Recover the Other Contract Funds by Asserting its Subrogation Rights to the Obligee’s Setoff Rights Against the Principal Under the Common Obligee Theory ........................................ 517
   C. Cases Rejecting the Surety’s Attempt To Recover the Other Contract Funds by Asserting its Subrogation Rights to the Obligee’s Setoff Rights Against the Principal Under the Common Obligee Theory ........................................ 524
   D. Recognized Conditions to the Surety’s Ability to Recover the Other Contract Funds by Asserting its Subrogation Rights to the Obligee’s Setoff Rights Against the Principal Under the Common Obligee Theory ........................................ 528
      1. The Surety Must Sustain Losses on a Bonded Contract Under Circumstances Through Which the Surety Becomes Subrogated to the Obligee’s Rights Against the Principal, including the Other Contract Funds ........... 529
2. The Surety Must Continue to Have a Loss on the Bonded Contract After Receiving All of the Bonded Contract Funds ................................................................. 529
3. The Obligee Must Owe the Principal Funds Under a Separate Bonded or Non-Bonded Contract (the Other Contract Funds) ....................................................... 530
4. The Obligee Must Be a Mere Stakeholder With Respect to the Other Contract Funds ........................................ 531
5. The Obligee Must Possess Setoff Rights Against the Principal Relative to the Other Contract Funds .......... 534

II. Equitable Issues and Other Considerations that May Limit the Surety’s Ability to Recover the Other Contract Funds by Asserting its Subrogation Rights to the Obligee’s Setoff Rights Against the Principal Under the Common Obligee Theory .................................................................................. 536
A. The Obligee is a Governmental Entity that Is Asserting a Tax or Other Lien Against the Other Contract Funds .......... 536
B. The Principal Contests the Surety’s Attempt to Recover the Other Contract Funds ...................................................... 536
C. The Principal’s Bankruptcy Trustee or the Principal as Debtor in Possession Claims Entitlement to the Other Contract Funds ......................................................... 538
D. The Principal’s Assignees/Lenders Assert Rights in the Other Contract Funds ............................................................ 539
E. The Other Contract Funds Relate to Contracts that Were Not Bonded By the Surety Asserting the Obligee’s Setoff Rights .......................................................... 541
F. The Principal’s Unpaid Subcontractors and Suppliers Assert Rights in the Other Contract Funds ............................ 542

III. Scenarios in Which the Surety is Subrogated to the Principal’s Setoff Rights and/or May Otherwise Compel the Principal and/or the Obligee/Payment Bond Claimant to Exercise Their Respective Setoff Rights to Reduce the Surety’s Liability ................................................................. 543
A. The Surety May Not Be Entitled to Assert the Setoff Rights of a Solvent Principal Over the Principal’s Objections .............................................................. 544
B. The Surety May be Entitled to Exercise the Principal’s Setoff Rights Against an Obligee or Payment Bond Claimant if the Principal and Surety are Named as Defendants in a Single Suit or the Principal Otherwise Consents to the Surety’s Exercise of the Principal’s Setoff Rights ........................................ 545
C. The Surety of an Insolvent Principal May Be Entitled to Compel the Principal and an Obligee/Payment Bond Claimant to Exercise Their Respective Setoff Rights to Reduce the Surety’s Liability if the Surety Does Not Receive Collateral to Secure its Bonded Obligation ........ 546
D. Even if the Principal is Insolvent, a Surety May Not Be Entitled to Compel the Principal or the Obligee to Exercise Their Setoff Rights to Reduce the Surety’s Liability Until the Surety Exhau‌ts Any Collateral It Possesses Relative to the Principal ......................... 555

Conclusion ............................................................................................ 557

Chapter 15—The Surety Subrogation Rights and Claims Against the Federal Government
Omar J. Harb, David J. Krebs and Cynthia E. Rodgers-Waire

Introduction ........................................................................................... 559

I. The Surety’s Disputes with the Federal Government—Jurisdictional Issues ....................................................................................... 560
A. The Tucker Act ................................................................................ 561
   1. Tucker Act Jurisdiction Based Upon an Express Contract ............. 562
   2. Tucker Act Jurisdiction Based Upon an Implied-in-Fact Contract ................................................................. 565
   3. Implied-In-Law Contracts .......................................................... 567
B. The Contract Disputes Act

1. CDA Jurisdiction Arises Only From Appeals of Contracting Officers’ Final Decisions

2. Only “Contractors” May Pursue Claims Under the CDA

3. Certain Claims Brought Under the CDA Must Be Certified

C. The Tucker Act vs. The Contract Disputes Act—Does the Surety Have a Choice?

II. The Use of the Surety’s Subrogation Rights to Establish Tucker Act Jurisdiction

A. Necessity of the Surety’s Performance

B. Necessity of Providing Adequate Notice To The Federal Government

1. The Federal Government as a Stakeholder Relative to the Bonded Contract Funds

2. The Federal Government’s Continuing Interest in the Bonded Contract Funds and the Need to Act With Reasonable Discretion

C. Subrogation Rights Rest Solely With the Surety

III. The Parties’ Rights to Which the Surety Is Subrogated

A. Performance Bond Surety

1. The Surety’s Subrogation Rights to the Principal’s Rights

2. The Surety’s Subrogation Rights to the Federal Government’s Rights

B. Payment Bond Surety

1. The Surety’s Subrogation Rights to the Principal’s Rights

2. The Surety’s Subrogation Rights to the Federal Government’s Rights

3. The Surety’s Subrogation Rights to the Principal’s Subcontractors’ and Suppliers’ Rights
I. Subrogation vs. Assignment ........................................................... 615

II. Claims Against Subcontractors and Material Suppliers .................. 619

III. Claims Against Design Professionals ......................................... 624
    A. Direct Claims Against the Design Professionals ...................... 625
    B. Subrogation Claims Against Design Professionals ................. 626
        1. Equitable Subrogation and Substitution of Parties ............. 626
        2. Superior Equities of the Surety .................................. 630
        3. Exculpatory Clauses ........................................... 632
        4. Losses Sustained by the Obligee ............................... 633
        5. Res Judicata and Collateral Estoppel ............................ 634

IV. Claims Against Lenders and Banks .............................................. 635
    A. Claims Against the Obligee’s Lender .................................. 637
    B. Claims Against the Principal’s Lender ................................. 641
V. Claims Against Defalcating Employees and Other Wrongdoers ................................................................. 645

VI. Claims Against Third Parties for Violations of Trust Fund Rights ......................................................................................................................... 650
   A. Trust Provisions in the Indemnity Agreement ......................................................................................... 650
   B. Trust Fund Statutes ................................................................................................................................. 651

VII. Claims Against the Principal’s Attorneys ....................................................................................... 656

VIII. Insurance Claims ......................................................................................................................... 661

Conclusion .................................................................................................................................................. 662

APPENDIX—FEDERAL AND STATE CASE LIST ................................................................. 663

APPENDIX—BIBLIOGRAPHY OF CONTRACT BOND SURETY SUBROGATION RIGHTS BOOKS, ARTICLES AND PAPERS ............................................. 701