SCRIBBLES SQUIBS #45 (March 15, 2016)***

IS A PUBLIC OWNER LIABLE FOR ACCEPTING A BOGUS PAYMENT BOND?

By Attorney Jonathan Sauer

I. INTRODUCTION.

First and second tier material suppliers and subcontractors on Massachusetts public projects have an ability and right to collect all of their rightful claims from the general contractor's payment bond for public work, including having the surety pay their reasonable attorneys' fees. This kind of payment security simply doesn't exist in private work.

But, such payment bonds are obtained by and accepted by public owners, who will be looking at such bonds well before any claimant will. Typically, before a subcontractor even *asks* to see the payment bond, its performance is substantially complete and it may be owed a great deal of money.

What happens to such possible payment bond claims when the payment bond accepted by the public owner from the general contractor turns out to be bogus? Does that mean such payment bond claims simply vanish, simply the tough luck of material suppliers and subcontractors who performed their work counting on its existence should payments not be made by their contracting parties? Or, does it mean that the public owner – who otherwise has no legal obligation to directly pay material suppliers and subcontractors from its own funds – now has an obligation to pay such claims itself? In other words, does the public owner become the *de facto* surety as the result of its carelessness in not performing sufficient due diligence relative to the surety on the payment bond presented?

In the case under review, there were claims by four claimants on a University of Massachusetts Lowell public project. The Defendants are the University of Massachusetts (UMASS) and University of Massachusetts Lowell (UMASS Lowell). In February, 2012, UMASS Lowell accepted the general contractor bid of KGCI, Inc. for an on campus renovation project. KGCI, Inc. executed a payment bond upon which First Mountain Bancorp. (Surety) was the surety. The claimants claim in their complaint that they were never paid by KGCI, Inc. and previously filed suit against the payment bond only to find out that Surety was not a licensed surety in Massachusetts and was, in fact, a false business entity without any assets.*** Judgments were entered in favor of the claimants against Surety and, in some of the cases, against KGCI, which judgments in the aggregate exceeded $500,000. Neither KGCI nor Surety responded to such judgments or made any payment on account of such judgments. This led to the plaintiffs filing an action against the University of Massachusetts, which had neglected to

verify the acceptability and worth of Surety. The case was before the Court on the Defendants' Motion to Dismiss the Complaint.

The superior court's decision on the Defendants' Motion to Dismiss the Plaintiffs' complaint in the case of Kapiloff's Glass, Inc. v. University of Massachusetts addresses these issues. If you would like to see a copy of the entire decision, send us an email and we will forward it to you.

II. DETERMINING IF A PAYMENT BOND AN OWNER MIGHT ACCEPT OR UPON WHICH CLAIM MAY BE MADE IS FROM A VALID SURETY AND IS A VALID BOND.

We are discussing in this *Squib* 'contract bonds'. Contract bonds are performance and payment bonds issued for a particular construction project. Although I have seen situations where only a performance bond was issued for a particular project, in the vast majority of cases, one does not exist without the other, contract bonds invariably being both payment *and* performance bonds.

As a point of information, there are all kinds of 'bonds' that are not contract bonds. Examples include, without limitation, court bonds, miscellaneous bonds, contractor licensing bonds, probate bonds, appeal bonds and fidelity bonds, which are actually a form of insurance and are not even a surety product.

Initially, Massachusetts has specific legal requirements for the registration of insurance companies. A list of whether or not an insurance company you have an interest in is registered in Massachusetts can be obtained at http://www.mass.gov/ocabr/licensee/license-types/insurance/insurance-companies/massachusetts-licensed-insurance-companies.html.

Most sureties which write contract bonds sell half or more than half of their bonds with regard to public projects. Because of this fact, the majority of *legitimate* contract bond sureties will be registered with the Federal government, which is far and away the largest public owner in the United States. Registered and approved sureties are listed in a certain federal document known as the 'Circular 570', the so-called 'Treasury List', being a list generated by the Treasury Department of the Federal government. This is a list of sureties who are acceptable to the federal government to issue contract bonds on federal public projects. Quite simply, the majority of all legitimate sureties will want to be on the list. And, since all of the sureties on this list are essentially prequalified by the federal government, one can believe that such companies are legitimate companies, at least at the time of their registration. This list can be found at https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570.htm.

What does it take for a surety to get onto this list? As stated by the Treasury Department on its website at https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/background.htm:

> "Companies' applications are reviewed thoroughly to ensure that financially sound companies receive Treasury recognition. It's the responsibility of the Fiscal Service to continually review and monitor the financial status of companies to be approved in all of the 3 categories listed above. Companies in categories 1 & 2 are published in the Circular 570 list of acceptable surety companies every July 1, in the Federal Register."

So, since Massachusetts-registered contract bond sureties and the Federal government's approved contract bond sureties are on one or two lists that are readily available and can be quickly checked without even having to speak to a human being, it is a matter of no difficulty to ascertain whether or not a particular contract bond is from a legitimate company because it is almost unimaginable that a legitimate contract surety will not be on one or both of these lists.

Irrespective of who performs it, this may be one of the easiest 'due diligence' searches that can ever be made!

III. PRINCIPLES OF LAW HELPFUL IN UNDERSTANDING THE DECISION IN THIS CASE.

There are **three** of them.

The **first** is that the decision under review concerned a ruling by the Court on the Defendants' motion to dismiss the complaint for failure to state a claim, described as follows:

1. RULE 12 (b)(6) MOTIONS.

The first one is from Rule 12 (b) (6) of the Massachusetts Rules of Civil Procedure (the Rules.)

This is a method by which a defendant can test the legal sufficiency of a plaintiff's complaint, usually made at the very beginning of the case and often before an answer is filed. In fact, defendants are *encouraged* by the Rules to assert such claims before they even answer the complaint and, generally speaking, an answer to a complaint is otherwise due within 20 days of service of the complaint upon a defendant by the sheriff. Filing a motion to dismiss puts this 20 day period of time into a holding pattern until it has been decided.

There are a number of different kinds of motions to dismiss. This *specific* ground for dismissing a complaint is when the defendant claims that the plaintiff's complaint 'fails to state a claim upon which relief can be granted'. It is not at all a test of the sufficiency of the facts or of the evidence or of the believability of the testimony of the witnesses. It's simply a challenge to the legal sufficiency of the claim asserted in the complaint. When successful, the complaint itself doesn't state a legal claim or the complaint itself demonstrates that there is a fatal deficiency in the claim as alleged. For example, for a payment bond claim the complaint may make sufficient allegations which make it clear that a condition precedent, such as the giving of

notice, has not been complied with. The complaint might indicate that the claim has been made after the statute of limitations for making such a claim has expired, which is typically one year on public payment bond claims, state and federal.

Parenthetically,****another form of challenge to the sufficiency of a complaint is by a motion for summary judgment. A motion for summary judgment, however, involves a discussion of the facts and of the evidence and which will be supported by sworn, factual affidavits. This is, generally speaking, not filed until fairly late in the case, usually after there has been an opportunity to conduct 'discovery' of the other party's facts, witnesses and documents. Usually, such a motion is not filed during the first two years of a construction case in the superior court.

It is important to understand that when a defendant's motion to dismiss is denied, this doesn't mean that the plaintiff has necessarily won its case or *will* win its case. The *only* thing it means is that, for now, this specific case can continue further. Unless that plaintiff's claim is successfully challenged and defeated through a motion for summary judgment, the case will proceed to trial where either a judge or a jury will issue a definitive statement of the parties' rights.

So, within the context of the decision in *this* case, the fact that the Court denied the Defendants' motion to dismiss does not mean that it has been established as a principle of law that a payment bond claimant under these circumstances is necessarily entitled to be paid its claims from the public owner's funds.

For this case, this decision is 'interlocutory', meaning that it isn't a final decision. In addition, and, generally speaking, only decisions by Massachusetts' appellate courts hold precedential weight. In other words, it is only the decisions in appellate cases which can be cited in *other* cases as legal authority. Superior court decisions are not generally recognized as establishing precedent to be applied to other, future cases. Principally, it is only the decisions of the Appeals Court and of the Supreme Judicial Court, Massachusetts' highest court, which are precedent with regard to other cases.

Within the state district court system – the district court being an inferior court to the superior court, handling smaller cases – there is an Appellate Division of the District Court. The two higher appellate courts don't seem to reference these decisions when they are deciding a point of law as frequently as they reference their own decisions. The decisions of the Appellate Division themselves can be appealed under certain circumstances to the Massachusetts Appeals Court, so that they may not be final.

I understand that this sounds like a lot of court work, a source of infinite, never-ending income to lawyers. My Bentley dealer would not disagree. But, these various procedures are in place to protect the rights of litigants in case some judge along the way makes a serious, prejudicial error. This opportunity for a further review is something almost totally lacking in arbitration cases where, generally speaking, there are *no* rights of appeal, not even *once,* unless

the party seeking to overturn an arbitrator's decision can produce a picture of the arbitrator on one of the lawyers' boats!

2. **MGL C. 149, S. 29 – MASSACHUSETTS' PUBLIC PAYMENT BOND STATUTE.**

Within the federal statutes for the protection of material suppliers and subcontractors on federal public projects is a requirement for the general contractor to supply for most projects payment bonds. Informally, this statute is referred to as 'The Miller Act'. This has caused the majority of states to adopt 'little Miller acts' for the protection of material suppliers and subcontractors on their state and municipal work.

MGL C. 149, s. 29 is the Massachusetts 'little Miller Act', which is the **second** thing to know to best understand this decision. Here are some of the basic requirements of this statute:

> "**Officers or agents** contracting in behalf of the commonwealth or in behalf of any county, city, town, district or other political subdivision of the commonwealth or other public instrumentality for the construction, reconstruction, alteration, remodeling, repair or demolition of public buildings or other public works when the amount of the contract is more than $25,000 shall obtain security by bond in an amount not less than one half of the total contract price, for payment by the contractor and subcontractors for labor performed or furnished and materials used or employed therein . . ." (Emphasis added)

The payment bond is a form of security for first and second tier material suppliers and subcontractors to get paid, particularly necessary when the upstream contract party – the first tier subcontractor or the general contractor – does not want to pay or, worse, has an inability to pay, something, unfortunately, not uncommon in our uncertain economic times.

These bonds can be nothing short of the difference between economic life or economic death for material suppliers and subcontractors. When Modern Continental filed bankruptcy in June of 2008 – this company being, at one time, one of the largest general contractors in the United States, employing four thousand workers on its direct payroll during the time of the Big Dig – a lot of material suppliers and subcontractors were left in the economic lurch. Bankruptcy rules require a 'debtor' – one is not supposed to use the word '*bankrupt*' because that might seem to be a word expressing a value judgment, unnecessarily pejorative in nature – to list in one of its schedules its twenty largest unsecured creditors.

My recollection of reading Modern Continental's list is that most of them – possibly, *all* of them – had claims in the millions of dollars. And, we know the answer to the question of how many material suppliers and subcontractors are likely to survive when just *one* account owes them something in the millions of dollars for which they can't get paid. The answer to that would be hardly any.

Instructive as to the necessity of and as to the sheer power of payment bonds, for one of my mechanical subcontractors working on Modern Continental projects I was able to recover one and one-half million dollars from the surety. Without that payment bond, this subcontractor would have been completely out of luck for, under most forms of bankruptcy, trade debt receives either nothing or next to nothing from the distribution of the assets from a bankrupt estate.

And, such bond claims have other benefits. Along with most other forms of contract claims, successful claimants receive interest at the rate of 12% simple interest per year from the 'date of breach' until a judgment issues. That is a gargantuan amount of interest, especially in a day where banks attempt to induce depositors to invest in certificates of deposit where the interest rate offered is less than one percent.

Since most payment bond claims in the superior court take five years to come to trial, that can mean that those material suppliers and subcontractors who have to go through the entire trial process – which only happens in about one percent of all civil actions – can get 60% interest automatically added on to the amount of the judgment they are awarded.

A great benefit to successful payment bond claimants under C. 149, s. 29 is that they are entitled to an award of their reasonable attorneys' fees when they win. Those familiar with earlier *Squibs* know that in Massachusetts successful plaintiffs awarded judgments are only entitled to an attorneys' fee award, believe it or not, in the amount of two dollars and fifty-cents!*****

3**. MGL C. 149, s. 29D.**

The **third** thing important to know to best understand this decision is to be familiar with MGL C. 149, s. 29D:

"Every bid bond, every performance bond and every payment bond issued for any construction work in the commonwealth **shall** be the bond of a surety company organized

> pursuant to section 105 of chapter 175 or of a surety company authorized to do business in the commonwealth under the provisions of section 106 of said chapter 175 and be approved by the U.S. Department of Treasury and are acceptable as sureties and reinsurers on federal bonds under Title 31 of the United States Code, sections 9304 to 9308." (Emphasis added)

There are a variety of Massachusetts judicial decisions defining the meaning of the word 'shall' for purposes of statutory construction.

In one case, the Court said that: "It is commonly understood that in matters of statutory construction the use of the word "shall" references something which is mandatory as opposed to something which is precatory, usually evidenced by the use of the word "may"."
In another case, the Court said: "Although undoubtedly in some contexts the word shall can be construed as equivalent to may, its usual and correct signification is mandatory." In still another case, the Court said: "It will be noted that "shall," a word of command, is used in the statute."

IV. THE DECISION.

In the instant case, the plaintiffs claimed that the University of Massachusetts had a duty to ensure the legitimacy of Surety's payment bond. The Court said:

> "Although the complaint presents a theory of liability not yet directly addressed by any Massachusetts appellate court, the undersigned (**ED:** this particular **j**udge) concludes that it states a viable claim as a matter of law and should be adjudicated on its merits."

The Plaintiffs claimed that the words 'officer' and 'agent' from MGL C. 149, s. 29 applied to UMASS and UMASS Lowell, the two Defendants in this case. Defendants claimed that neither is an officer or agent of the Commonwealth of Massachusetts and that the sole duty outlined in this statute was for KGCI to supply a payment bond as security for the Project. The Court accepted the Plaintiff's contentions, getting into a technical discussion of the meaning of the words 'officer' and 'agent', which is not necessary to get into for our present purposes.

After doing so, the Court said that the "Defendants' interpretation is neither logical nor in accord with common sense." As part of its analysis, the Court said that KGCI "certainly was not acting on the behalf or for the benefit of Defendants when negotiating the Project. That role was filled by Defendants' employees. . ."

The Court went through a discussion of the history of MGL C. 149, s. 29 since its enactment in 1878. The Court stated that the Commonwealth by these Defendants owes some duty, which is clear by the plain language of this statute and that such an interpretation is in

accord with the history of the statute. Reference was made to a variety of Supreme Judicial Court decisions discussing payment bonds for public projects requiring the Commonwealth to provide a 'sufficient' or 'adequate' payment bond and that "at its core, the law has always protected subcontractors, not the Commonwealth." The Court also referenced various SJC statements in earlier cases to the effect that this statute and its predecessor statutes were intended to protect laborers and materielmen from nonpayment by general contractors and subcontractors and that there have been numerous judicial statements to the effect that this statute should be given a broad and liberal construction to accomplish its intended purpose.

Although not specifically referenced by the Court, as a point of information, the 1972 amendments to MGL C. 149, s. 29 were entitled: "An Act Expediting Payments To General Contractors And To Subcontractors And Improving The Flow Of Funds In The Construction Industry."

The Court also stated in its decision that "there was no party in a better position than Defendants to protect Plaintiffs from KGCI and First Mountain's bond failure in this case" and that "Plaintiff subcontractors did not have access to any payment bond information at the time they accept *(sic)* the Project." The Court also referenced the SJC decision in the seminal case of Manganaro Drywall, Inc. v. White Construction Co. Inc., a case in which I appeared as co-counsel with Sally Corwin before the SJC on behalf of the Plaintiff subcontractor, that C. 149, s. 29 "encourage(s) subcontractors to bid on public works projects and tends to alleviate concerns of subcontractors which might prompt higher bids as a precaution against unreasonable delays in the flow of funds to them." (**ED.** In other words, the payment of materialmen and subcontractors through the mechanism of payment bonds actually meets and fulfills a public purpose.)

The Court denied Defendants' Motion to Dismiss the complaint.

V. CONCLUSION.

As stated in the decision, this is a 'case of first impression' meaning the first time this issue has been presented to a Massachusetts court for decision. Whether or not a rule of law which might survive an appellate challenge will result from this case ultimately to the effect that a public owner has an affirmative obligation to ascertain the validity of contract bonds presented to it remains to be seen. And, even if there is such an obligation, whether or not the public owner *then* becomes the *de facto* payment bond surety in terms of having an obligation to pay such claims *also* remains to be seen.

There seems to be some legitimacy for both contentions. A claimant on a payment bond is stuck with whatever payment bond the owner accepted for a particular project at the very commencement of that public project. There is nothing the material supplier or subcontractor can do in advance of having a claim to make sure for any particular project that there is a legitimate payment bond in place. After all, as discussed above, verifying the legitimacy of any particular surety is as simple as consulting the Massachusetts list of registered insurance companies and the Treasury List and it is the public owner who obtains and accepts such bonds.

It is almost *impossible* to imagine that any particular legitimate surety will not be on one or both of these lists.

And, ultimately, if there are such liabilities, it is not hard to imagine that public owners will be looking to insurance agents who write such bonds as impliedly warranting the existence of legitimate, solvent sureties and to design professionals who accept such bonds after performing – or *not* performing – due diligence as possible additional parties to share the cost of paying such claims.

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* A *'squib'* is defined as 'a short humorous or satiric writing or speech'. Wiktionary defines a '*squib'* as: "a short article, often published in journals, that introduces empirical data problematic to linguistic theory or discusses an overlooked theoretical problem. In contrast to a typical linguistic article, a squib need not answer the questions that it poses." ** In case you have ever wondered if there is actually any rhyme or reason as to the frequency of *Squibs,* we write these when we have some downtime or comparative downtime from the practice of law. Our principal job is as working lawyers and we work each and every day at assisting our contractor clients with the various problems they have to deal with.*** Sadly, fraud is not unknown in the surety industry. The vast majority of insurance agents who write surety bonds perform to the highest standards of ethics. But, there have been some insurance agents who have been known to execute 'bottom drawer bonds', meaning they simply would take out a blank bond form from the bottom drawer of their desk, fill it in and submit it to the bond holder (the 'obligee'), obtaining a premium for a bond never reported to or authorized by the surety. (One might describe this as earning a particularly advantageous commission!) It is to deal with this problem that many sureties now have colored and specifically numbered powers of attorney. (This is not unlike some of the changes that have been made to personal checks and to things such as drivers' licenses and credit cards.) The power of attorney is a form which is usually attached to payment bonds and to performance bonds when they are submitted to the oblige, which is supposed to provide some evidence of the fact that the agent signing the bond has some authority from the surety to do so. By having such specific forms of identification which are hard to duplicate, it is believed that this has helped minimize this particular problem. Gallows humor within the surety industry has referenced other such bonds as being executed by the 'Back of the Envelope Bonding Company', meaning a surety whose total assets consist of the cost of having a box of stationary made. For a number of years 'Off-shore sureties' executed bonds which, through a careful reading, indicated that the penal sum (the amount) of the bonds was limited to the collateral posted to get the bond, which was often an unsecured promissory note, something of little or no value to a claimant. 'Personal sureties' – high worth individuals, such as doctors – have been allowed to act as acceptable sureties on various federal projects. Unfortunately, there is more than a little experience of finding when a claim is made that such doctors were either insolvent or were seriously over-subscribed as 'personal sureties'. This very concept exemplifies one of the Republican themes during this election cycle – this *Squib* being

written on ‘Super Tuesday 3’ - of trying to minimize and avoid having unnecessary and unproductive over-regulation. Personal sureties were necessary, according to federal-speak, because some groups had less ability to obtain bonds from legitimate commercial sureties, which require all kinds of supporting financial information from the company seeking bonds and, sometimes, from their owners before such bonds are written. While *possibly* this was a well-intentioned but *liberal* idea – that assuming *any* liberal idea pertaining to commercial issues makes much, if any, sense - in its practice, there proved to be great fraud. **** Once again, that ‘get paid per word’ issue pokes up its ugly head, which arose in our last *Squib*. That’s assuming, however, that the penny per word writer is smart enough to understand the *possibility* that such untold riches can be obtained from the writing game. One who might write for free might generally best be described as an idiot, addlepated or as a low level moron. But, one thinks that there *must* be *some* exceptions!*****The Puritans were among Massachusetts’ earliest settlers. They were known for the practice of frugality, even to the extreme. But, even with an award of the gargantuan sum of $2.50 as an attorney’s fee and employing the greatest possible economies, the actual legal fees a plaintiff *might* incur in pursuing a construction suit through the serpentine wanderings of the superior court process will generally be at least *slightly* more than $2.50. Most construction law firms I am aware of will not handle payment bond suits for $2.50. Most insist on a fee of at least ten dollars and it is rare to get one of the *premier* construction law firms to handle such a case for anything less than fifteen dollars. Ah, the days of economies past! Fifty years ago, ads for White Owl cigars said that they only cost ten cents. When I was a kid, all candy bars other than Mounds’ Bars cost five cents. At today’s prices, one can’t even buy the candy bar *wrapper* for five cents. O’ Goddess of Economy, why have you deprived us of your fickle favors? Indeed, where have all the flowers gone? And, since Mounds Bars used to be made by Peter Paul, one would expect that *they* would know, their being, after all, two-thirds of the group.

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