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## *Fidelity and Surety*

### In This Issue

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### The IADC

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## **Which Comes First, the Arbitration or the Lawsuit?**

***By Roger Sauer, Phil Allogramento and Charles Herman***

Arbitration, mediation and other types of ADR are becoming the focal point of construction litigation in order to not only cut costs but to move matters along more quickly and help clear the over crowded dockets of our courts. Most construction contracts contain a mandatory arbitration clause. In a recent United States District Court decision, the Court granted a stay requested of the related litigation pending arbitration, thereby reinforcing the effect of the arbitration clause.

The Court stated the position that any doubts concerning scope of arbitrable issues under Federal Arbitration Act should be resolved in favor of arbitration. It also took the position from cited cases, that since the contract contained a mandatory arbitration clause, the stay of the pending Miller Act action was required under the Federal Arbitration Act.

There are certain situations when a subcontractor decides to bring a Miller Act action against the surety to make the surety perform on the bond. It is customary for the principal to provide an indemnification to the surety. Thus the principal may be at risk if and when a surety is asked to perform on a bond and the surety then looks to the principal pursuant to the indemnification the principal provided the surety. Because the principal has the right to protect its interests, it is allowed to intervene provided it can demonstrate that it (1) submitted a timely motion; (2) it has a direct and substantial interest in the property or transaction; (3) it proves that its interest would be impaired if not for the intervention; and (4) it establishes that the interest is inadequately represented by the existing parties.

*An example of such a case involves The United States of America for the use and benefit of MPA Construction, Inc. v. XL Specialty Insurance Co., No. CIV.A.DKC 2004-1681.*

The parties involved in the construction project are the federal government's National Institute for Health ("NIH"), the project owner; Movant Jowett, Inc. ("Jowett"), the prime contractor; MPA Construction ("MPA"), a subcontractor on the project; and XL Specialty Insurance Co. ("XL"), the surety.

In this particular matter, the construction project involved the construction of a fire station in Bethesda, Maryland. The prime contract was valued in excess of \$100,000. Because the construction was for a federal building and the prime contract was in excess of \$100,000, the requirements of section 3131 (b) of the Miller Act are applicable. As required, Jowett did obtain a payment bond from XL, an authorized payment bond surety.

Jowett entered into a contract with MPA in June 2002 to install drywall and ceilings at the facility as evidenced by the subcontract agreement the parties executed. As is customary, the subcontract contained a mandatory arbitration clause (Article 12), which stated, "*all disputes between Contractor and Subcontractor... shall be resolved by arbitration...*"

MPA submitted invoices to Jowett for the work it had performed, but Jowett did not pay MPA in full for the work it had performed.

In July 2003, NIH terminated Jowett, but did not provide a reason as to why it chose to terminate the contract. At the time of termination, NIH sought a "termination for convenience" settlement with Jowett. MPA believed that it had successfully completed its work on the project and it also believed that Jowett had received all the payments from NIH for MPA's work. Jowett on the other hand

asserted that MPA's work was defective and that it may have been part or all of the cause for the termination. Jowett also contended that it had not received all monies due from NIH for MPA's work. As a result of the dispute, and as was its right under the Miller Act<sup>1</sup>, MPA made a demand of XL for XL to perform on the payment bond.

Jowett now seeks to intervene, asserting that, if the Court finds the surety liable than the surety will seek indemnification from Jowett for the amount of the judgment. Jowett also moves for a stay to this action pending arbitration between MPA and Jowett pursuant to the mandatory arbitration clause.

The Court granted the stay, stating that one of the primary reasons why federal law favors arbitration is to resolve cases more quickly and efficiently. "Federal law evinces a clear preference for arbitration over litigation for private dispute resolution" and "arbitration provides a speedier and less costly method of dispute resolution than does litigation, while relieving congested court dockets." The Court went on to say that arbitration relieves the undue delay experienced in much litigation. This is a major endorsement of the ADR process.

Additionally, the Court in *MPA Construction* spent a good deal of time reviewing how other courts had addressed the stay of Miller Act bond actions pending arbitration in light of the Federal Arbitration Act. The Court found an almost universal acceptance that Miller Act claims should be stayed pending arbitration of the underlying contract.<sup>2</sup>

Contractors must bargain for the right and ability to arbitrate with a subcontractor. Absent compelling countervailing circumstances, a subcontractor should not be able to end run or negate those negotiated terms. Let it be remembered, that the primary obligation secured by a bond is between the contractor and the subcontractor on the underlying contract. The reason for the existence of a bond in the first

place is the Miller Act (because one cannot just place liens on federal property). Payment bonds are merely a credit instrument, the sole purpose of which is to provide payments for monies due from underlying contract funds. Because of the universality of indemnity agreements, if the claim against the surety went first, the indemnity agreement would bind the principal to the result and render moot the ability to arbitrate.

When drafting contracts for your clients you should make certain that you include the mandatory arbitration clause [all disputes between the Contractor .....shall be resolved by arbitration in accordance with the rules of the American Arbitration Association] adding JAMS or any other recognized organization familiar with construction...]. This give the parties the flexibility of reviewing the rules of each organization and making the decision as to which best meets the needs of the parties.

### Endnotes

1. MPA was able to bring a civil action against the payment bond because it had not been paid in full within 90 days of the work it performed.
2. See, e.g., U.S. ex. rel. Tanner v. Daco Constr., Inc., 38 F.Supp.2d 1299 (N.D. Okla. 1999); U.S. ex. rel. Newton v. Neumann Caribbean Intern., Ltd., 750 F.2d 1422 (9<sup>th</sup> Cir. 1985); U.S. ex. rel. Portland Constr. Co. v. Weiss Pollution Control Corp., 532 F.2d 1009 (5<sup>th</sup> Cir. 1976); U.S. ex. rel. Capolino Sons v. Electronic & Missile Facilities, Inc., 364 F.2d 705 (2<sup>nd</sup> Cir), cert. dismissed, 385 U.S. 924 (1966). But see, U.S. ex. rel. Pensacola Constr. Co. v. St. Paul Fire and Marine Ins. Co., 705 F. Supp. 306 (W.D.La. 1988).