ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of --	)	
	)	
United Pacific Insurance Company	)	ASBCA No. 52419
	)	
Under Contract No. F28609-95-C-0037	)	

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MAJ Brian G. Koza, USAF
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Trial Attorneys

OPINION BY ADMINISTRATIVE JUDGE DICUS
ON RESPONDENT'S MOTION TO DISMISS THE APPEAL IN PART

This appeal was taken from a contracting officer's decision denying the claim of appellant, a surety which completed performance under a takeover agreement. Respondent seeks dismissal of so much of appellant's claim as arose before the takeover agreement. Respondent's motion is premised on appellant's alleged lack of standing. We grant the motion.

FINDINGS OF FACT

The following findings are for the sole purpose of resolving the motion.

1. Contract No. F28609-95-C-0037, for repair of the POL secondary containment system at McGuire Air Force Base, New Jersey, was awarded to Castle Abatement Corporation (Castle) on 28 September 1995. The contract included a repair portion with a fixed-price of $1,957,630 and a portion for removal and disposal of various materials with an estimated price of $354,737, for a total contract price of $2,312,267 (R4, tab 1). United Pacific Insurance Company (United or appellant) provided a performance bond in the amount of $2,312,267 and a payment bond in the amount of $1,156,134. The bonds were dated 28 September 1995. (R4, tab 1g).

2. The contract incorporated by reference the following clauses: FAR 52.232-23 ASSIGNMENT OF CLAIMS (JAN 1986); FAR 52.233-1 DISPUTES (DEC 1991);

FAR 52.236-2 DIFFERING SITE CONDITIONS (APR 1984); and FAR 52.243-4 CHANGES (AUG 1987).

3. The contract required removal and disposal of contaminated hazardous and non-hazardous soil, contaminated debris, hazardous waste sludge, and wastewater. The specification at 01040, 102 G provides:

> G. 1. The site has historically and is presently used for the storage and transferring of virgin petroleum based materials. Therefore, the potential exists that soil and ground water contaminated with virgin petroleum products will be encountered. The Contractor shall be prepared to manage, but not remediate, virgin petroleum contaminated soil and ground water in accordance with the New Jersey Department of Environmental Protection and Energy (NJDEPE) and federal requirements.
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> 2. If so directed by the Contracting Officer, the Contractor will provide workers who meet the training requirements of the OSHA Hazardous Waste Operations and Emergency Response Standard (29 CFR 1910.120). As a minimum, this requires workers who have participated in a suitable training program and participate in a medical surveillance program.
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> 3. The presence and extent of petroleum contaminated material cannot be quantified at this time. This information is provided so the Contractor can make appropriate preparations. The Contractor shall prepare their bid for clean site conditions, but must have the capabilities to meet the requirements of this section with minimal interruptions to schedules. Any work performed beyond preparation activities specified in these documents will be considered out of scope work and the Contractor will be reimbursed in accordance with the Contract Documents.

(R4, tab 1)

4. By letter of 17 June 1997 sent to United "c/o Reliance National," Castle sought financial assistance from United, stating that if assistance was not forthcoming performance would be abandoned (R4, tab 7). Thereafter, Castle sent a 15 July 1997 letter

to all its employees on the contract informing them that its bonding company had not provided financial assistance and that all operations had been suspended (R4, tab 8). On that same date a Show Cause Notice was sent to Castle by respondent (R4, tab 9). Effective 21 July 1997 the contract was terminated for default (R4, tab 1f). There is no evidence that Castle appealed or otherwise contested the default termination.

5. United and respondent entered into a takeover agreement, to which Castle was not a party, on 5 August 1997. That agreement incorporated all the provisions of the contract. It further stated that under the performance bond United was willing to "cause the CONTRACT to be completed in accordance with the provisions of this AGREEMENT, provided that in so doing it will receive the contract balance as hereinafter set forth." The contract balance for the fixed price portion of the contract was $998,863.64. The estimated contract balance for the estimated quantity portion of the contract was $55,271. It named as completion contractor Latimer & Associates (Latimer). Paragraph 10 of the agreement reserved United's rights as follows:

> 10. SURETY expressly reserves all prior rights, including but not limited to overpayment by the Government to the Contractor, equitable liens and rights to subrogation that would be the United States', the laborers' or materialmen's or the contractor's under the CONTRACT or at law or equity, as well as its own rights dating back to the execution of the performance and payment bonds, including, but not limited to those rights and remedies that may accrue during the completion of the CONTRACT. No waiver of such rights is agreed to or implied or intended regardless of any provisions of this TAKEOVER AGREEMENT to the contrary. Any disagreement between the GOVERNMENT and SURETY shall be considered a dispute within the Disputes Clause contained within the CONTRACT and SURETY shall be entitled to exercise such rights as are afforded by the Disputes Clause and the Contract Disputes Act of 1978, as amended.

(R4, tab 1g)

6. The following modifications altered the fixed-price contract balance as set out below:

Modification No. P00008	$ 47,437.00
Modification No. P00010	26,597.00
Modification No. P00011	(313,014.00)
Total	($238,980.00)

Thus, the parties agreed to a contract balance of $759,883.64 ($998,863.64-$238,980.00). (R4, tabs 1h, 1j, 1k) According to United, it has been paid $713,595.27, leaving a contract balance due of $46,288.37 (complaint, ¶¶ 40-44).

7. United filed a certified claim dated 23 October 1998 in the total amount of $1,759,966.82, as follows:

1. Excess Superintendence	$ 180,000.00
2. Safety Office	$ 5,000.00
3. Contaminated Soil	$ 700,743.36
4. Delay Costs	$ 566,502.72
5. Pre-Cast Walls	$ 109,440.00
6. Footing Washout	$ 3,023.00
7. Concrete Cure	$ 11,420.00
8. Health and Safety Plan	$ 28,212.74
9. Grade Elevation Change	$ 125,625.00
10. Pump Station 5	$ 30,000.00
TOTAL OF CLAIMS:	$1,759,966.82

(Claim, R4, vol. 2 at 00009)

8. In an undated contracting officer's decision the claim was granted in the aggregate amount of $1,431.16 and otherwise denied (R4, tab 11). United appealed that decision in an 11 October 1999 letter which notes the date of the contracting officer's decision as 20 July 1999. There is no evidence that Castle sponsored the appeal, and we find Castle did not sponsor the appeal.

9. In its complaint appellant alleges four counts, as follows:

Counts I and II - Equitable Adjustment/ Cardinal Change -	$1,437,407.10
Count III - Specific Enforcement of Settlement -	214,745.00
Count IV - Contract Balance -	46,288.37
Total	$1,698,440.47

The majority of United's claim arose during Castle's performance (complaint).

10. Appellant has submitted exhibits which appear to document respondent's knowledge of contamination at McGuire (exs. A-D). One of the exhibits refers to a "gross under estimation [sic] of hauling hazardous soil in the spec" and expresses the belief that Castle would prevail in litigation if Castle were to be terminated for default (ex. C). According to appellant, respondent intentionally withheld information about the contamination.

DECISION

Respondent's motion seeks dismissal of so much of appellant's claim as arose during Castle's performance. Respondent argues that appellant lacks standing. Appellant argues there are four bases for standing: Government fraud and misrepresentation led appellant to issue bonds when it would not have done so had the Government disclosed the facts; equitable subrogation; *pro tanto* discharge; and an assignment under the takeover agreement.

The Contract Disputes Act (CDA), 41 U.S.C. §§ 601-613, as amended, defines a contractor as "a party to a Government contract other than the Government." 41 U.S.C. § 601. Only a contractor may bring an appeal to the Board. *Admiralty Construction, Inc. by National American Insurance Co. v. Dalton,* 156 F.3d 1217, 1220 (Fed. Cir. 1998). Moreover, Board jurisdiction on behalf of a surety is not obtained through the provisions of an indemnity agreement between the surety and a contractor. *Id.* at 1222. Appellant became a CDA contractor upon execution of the takeover agreement, and there are portions of appellant's claim that arose during performance of the takeover agreement over which we have jurisdiction. Respondent does not challenge those aspects of the appeal. In this regard, we do not purport in this opinion to identify with specificity which portions arose during the takeover agreement, except to note the 5 August 1997 date of the takeover agreement.

With respect to the pre-takeover agreement portions of this appeal, Castle was the contractor in privity with the Government and has the preeminent right to assert claims arising from its performance and appeal any contracting officer's decision denying its claims. Castle is not a party here. Claims which it could have brought without jurisdictional challenge have been brought by United without Castle's sponsorship (finding 8). In dealing with the assertion of those claims and the filing of this appeal by United, a party not in privity with the Government until the takeover agreement, we must look to the exceptions carved out for sureties if we are to find standing and take jurisdiction.

Respondent's Alleged Fraud and Misrepresentation

Appellant alleges that it was misled into issuing the performance and payment bonds here by respondent's fraud and misrepresentation. Specifically, appellant maintains that respondent knew of "severe and pervasive contamination that was never remediated, [despite which] the Government required and accepted a bid for the project as a 'clean site' and feigned ignorance as United Pacific bonded the project . . ." (emphasis in original) (app. br. at 7). Although it is incumbent upon a surety to inquire about information it deems important, a surety may be relieved of its obligation under a bond when there has been fraudulent concealment by the obligee. *United States v. Martinez,* 151 F.3d 68, 73 (2d Cir. 1998) *cert. denied,* 526 U.S. 1020 (1999); *Rachman Bag Co. v. Liberty Mutual*

Insurance Co., 46 F.3d 230, 235 (2d Cir. 1995). Fraudulent concealment has been explained as follows:

> Traditionally, the failure to disclose information to a surety constitutes fraudulent concealment when: (1) the information materially increases the surety's risk compared to the risk that the obligee has reason to believe the surety intends to assume; (2) the obligee knows that the surety does not know the information; and (3) the obligee has an opportunity to communicate the information to the surety. *See* Restatement (Third) of Suretyship and Guaranty § 12(3) (1995) ("Restatement (Third)"); *see also Rachman*, 46 F.3d at 235.
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> . . . .
>
> The Restatement (Third) provides that the traditional elements of fraudulent concealment are not, in themselves, grounds for voiding a suretyship contract. Section 12(3) of the Restatement (Third) explains that if a surety demonstrates the three traditional elements of fraudulent concealment, the obligee's actions constitute only a *material misrepresentation*, which is not an independent ground for voiding the contract. Under Section 12(1) of the Restatement (Third), a surety's obligations are voidable only if it was *justified in relying* on the material misrepresentation. Thus, under the Restatement (Third), a surety's obligations are voidable for fraudulent concealment only if the surety was reasonably justified in relying on the non-existence of the information that the obligee failed to disclose. *See* Restatement (Third) § 12(3),(1).
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> . . . .
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> The materiality inquiry, however, should not focus simply on what the *surety* considered material when he signed the contract. Rather, the inquiry is whether the undisclosed fact materially increased the risk that the obligee had reason to believe the surety would be unwilling to undertake. In short, the standard focuses on the obligee's reasonable perception of the risk the surety is willing to undertake. *See* Restatement (Third) § 12(3) cmt.

United States v. Martinez, supra at 73-74.

In this instance, the contract contained a Differing Site Conditions clause (finding 2) through which Castle and appellant were provided, and agreed to, a specific remedy for conditions at variance with those in the contract. In addition, the contract here was for removal and disposal of contaminants and the very section of the specification relied on by appellant, in our view, alerted bidders to the potential for greater quantity of contaminants and agreed to pay for such "out of scope" work (finding 3). We find the contract addressed the subject matter of contamination, thereby alerting Castle and appellant to its presence, and adequately provided a specific remedy if the information proved inaccurate. Appellant's risk was not, therefore, materially increased.

Assuming arguendo, that we had subject matter jurisdiction over the alleged fraud, viewed from the standpoint of an argument that allegations of fraud somehow establish a basis for standing that would not be available for other alleged infractions, appellant's position is even less tenable. We have held that, without an assignment by the contractor to the surety to which the contracting officer consents or some other agreement between the Government, the contractor and the surety amounting to an assignment, a surety lacks standing to pursue pre-takeover agreement claims. *Fireman's Fund Insurance Company*, ASBCA No. 50657, 00-1 BCA ¶ 30,802, *aff'd on recon*., 00-1 BCA ¶ 30,905 on appeal *sub nom. Fireman's Fund Ins. Co. v. Danzig*, CAFC No. 00-1420. Appellant has not produced an assignment to which respondent has consented or an agreement between all three parties regarding the claims at issue over which we can exercise CDA jurisdiction. We cannot, therefore, find that appellant has assumed the mantle of the contractor whose performance it guaranteed for the purpose of pursuing claims that the contractor could have, but has not, pursued. Appellant does not cite, and we have not found, any exception which would bestow standing under the CDA because the claims arose from fraud and misrepresentation. Accordingly, we conclude we cannot take jurisdiction because the claims are based on allegations of fraud and misrepresentation.

Equitable Subrogation

Respondent does not dispute that appellant has the right, under the doctrine of equitable subrogation, to pursue the retained contract balance (resp. mot. at 7). It takes issue with appellant's argument that appellant's equitable subrogation rights extend to claims that existed before the takeover agreement. Appellant relies on *Travelers Indemnity Company v. United States,* 16 Cl. Ct. 142 (1988), to support its position that, as a takeover surety, it has "greater rights" that do not limit it to the contract balance. (App. br. at 11) In that case, the parties entered into a takeover agreement similar to the agreement here. During performance, Travelers discovered what it believed to be a disparity between the work actually completed by the original contractor and the work it had been led by the Government to believe the original contractor had completed. Alleging, *inter alia,* that improper payments were made to the original contractor based on faulty estimates of work completed, Travelers filed an action to recover amounts in excess of the

retained balance. The Court held that Travelers, as a takeover surety whose agreement with the Government incorporated the original contract, could pursue an action for the Government's allegedly wrongful pre-takeover payments based on the incorporation of the original contract into the takeover agreement. *Id.* at 154. We find *Travelers* distinguishable on the facts.

Travelers involves allegedly improper payments to the original contractor, and the allegations of fraud raised in that case related to the surety's inducement to execute the takeover agreement, not, as alleged by the appellant here, to issue the bonds securing payment and performance. Here, as in *Fireman's Fund*, appellant seeks to pursue claims which arose during performance by Castle. In the circumstances, where improper disbursements are not at issue, we are guided by *Fireman's Fund*. We also decline to follow *Travelers* here because we believe that language in *Balboa Insurance Company v. United States*, 775 F.2d 1158 (Fed. Cir. 1985), on which *Travelers* was alternatively based, has been explained away in subsequent decisions by the Federal Circuit. Specifically, in *Travelers* the court stated "This we hold for the additional reason that whereas [sic] here the CAFC has held that 'a surety . . . is as much a party to *the* government contract as the contractor.' *See Balboa*, 775 F.2d at 1160 (emphasis added)." The Federal Circuit has since explained that the dicta in *Balboa* which was relied on in *Travelers* "had nothing to do with the CDA and therefore made no attempt to make sureties eligible to appeal under the Act" but instead, citing *Ransom v. United States*, 900 F.2d 242, 245 (Fed. Cir. 1990), deals with the Government's "stakeholder" status vis-a-vis equitable subrogation. *Admiralty Construction, Inc., supra* at 1221. We understand the reference to "stakeholder" status to address the Government's holding of the contract retainage and amounts, if any, improperly disbursbed after notification of default. Appellant's standing to pursue the contract balance under its equitable subrogation rights is not at issue, but those rights do not extend to the pre-takeover claims in this appeal.

Pro Tanto Discharge

Under the principles of *pro tanto* discharge a surety's obligation is discharged or reduced when a contract is modified, other than by extending the time for payment, without the surety's consent. If the modification materially increases the surety's risk, the surety is discharged. If the modification does not materially increase risk, the surety's obligation is reduced to the extent of the loss suffered from the modification. *National Surety Corporation v. United States*, 118 F.3d 1542 (Fed. Cir. 1997). Citing *Security Insurance Company of Hartford*, ASBCA No. 51759, 00-2 BCA ¶ 31,021, appellant argues "Government's [alleged] fraudulent concealment of the site contamination in the case at bar constitutes a material departure from the contract which increased the surety's risk without its consent." (App. br. at 12) According to appellant, the alleged "material departure" finds a remedy in *pro tanto* discharge. We believe *Security Insurance Company of Hartford* is distinguishable because it deals with allegedly improper progress payments. We have,

nonetheless, considered fully appellant's argument that it is entitled to standing under the rules of *pro tanto* discharge.

The Court in *National Security* looked with favor upon § 37 of RESTATEMENT (THIRD) SURETYSHIP AND GUARANTY (1996) ("the RESTATEMENT") in its discussion of *pro tanto* discharge. *Id.* at 1544. We have examined §§ 37-44 of the RESTATEMENT. Section 37(3)(a)-(e) list specific impairments of suretyship status which do not apply here. However, a "catch-all" provision is found in § 37(3)(f):

> (3) If the obligee [Government] impairs the secondary obligor's [surety's] recourse against the principal obligor [contractor] by:
>
> ….
>
> (f) any other act or omission that impairs the principal obligor's duty of performance, the principal obligor's duty to reimburse, or the secondary obligor's right of restitution or subrogation (§ 44);
>
> the secondary obligor is discharged from its duties pursuant to the secondary obligation to the extent set forth in [§ 44] in order to prevent the impairment of recourse from causing the secondary obligor a loss.

Section 44 provides:

> Other Impairment of Recourse
>
> If otherwise than described in §§ 39-43 the obligee impairs the principal obligor's duty of performance (§ 21), the principal obligor's duty to reimburse (§§ 22-25), or the secondary obligor's right of restitution (§ 26) or subrogation (§§ 27-31), the secondary obligor is discharged from its duties pursuant to the secondary obligation to the extent that such impairment would otherwise cause the secondary obligor a loss.

Paragraph b. of the Comment accompanying § 44 describes the unspecified impairment as "[t]ypically, [involving] an action by the obligee that has the effect of freeing the principal obligor from its duties with respect to any unperformed portion of the underlying obligation." Significantly, neither the Comment nor the accompanying examples describe a contract breach by the obligee or a modification increasing the performance requirements of the underlying contract as among the "other" impairments covered by the section. Moreover, the cases cited in the Reporter's Note as "good examples of the

application of this section," *C.I.T. Corporation v. Anwright Corporation*, 191 Cal. App. 1420 (1987) and *Union Bank v. Max Gradsky*, 265 Cal. App. 40 (1968), both deal with sales of collateral. We also note that the cases construing the surety's rights under the rules of *pro tanto* discharge deal with contract provisions concerning either payments or security. *See, e.g*., *National Surety, supra; United States v. Continental Casualty Co*., 512 F.2d 475 (5th Cir. 1975); *National Union Indemnity Co.v. G.E. Bass and Co*., 369 F.2d 75 (5th Cir. 1966). We conclude the principles of *pro tanto* discharge do not vest in appellant standing to pursue the pre-takeover claims under the CDA.

Assignment

Appellant argues that the takeover agreement amounts to an assignment. Appellant specifically relies on the paragraph 10 reservation of subrogation to the rights of the United States or the contractor (finding 5). According to appellant, it is equitably subrogated to the rights of both. However, as addressed *supra*, equitable subrogation rights are typically limited to claims for the contract balance and, upon proper notice, improper disbursements. *Balboa Insurance Company v. United States, supra.* Moreover, implicit in our *Fireman's Fund* decision is the recognition that the Government, as "stakeholder," may not ignore the rights of the original contractor. We hold that, without participation of the original contractor, the takeover agreement cannot assign the original contractor's claims so as to provide to appellant, with respect to those claims, standing under the CDA.

The motion is granted. We retain jurisdiction of the post-takeover portions of the claims and the equitable subrogation claim for the contract balance.

Dated: 7 February 2001

CARROLL C. DICUS, JR.
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

I concur

MARK N. STEMPLER
Administrative Judge
Acting Chairman
Armed Services Board
of Contract Appeals

EUNICE W. THOMAS
Administrative Judge
Vice Chairman
Armed Services Board
of Contract Appeals

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA No. 52419, Appeal of United Pacific Insurance Company, rendered in conformance with the Board's Charter.

Dated:

EDWARD S. ADAMKEWICZ
Recorder, Armed Services
Board of Contract Appeals