SECTION 2

CONTRACTOR LICENSING, QUALIFICATION, AND BOND REQUIREMENTS

A. LICENSING AND PREQUALIFICATION OF CONTRACTORS

1. Licensing and Prequalification Requirements

Where eligibility requirements are imposed on bidders by state law, they generally involve compliance with contractor licensing and prequalification rules.[1] Many states have requirements that all bidders must be licensed by the state and prequalified by the contracting agency as a condition to submission of a bid and award of a contract. These requirements have a direct relationship to determination of the lowest responsible bid. Application of these rules may vary depending on whether state or federal funding is involved. Licensing and prequalification requirements may apply to subcontractors as well as prime contractors.[2]

a. Public Policy Concerning Qualification of Bidders

Contractor qualification requirements are an important part of how transportation agencies carry out their statutory obligations to award construction contracts to the "lowest responsible bidder" in competitive bidding.[3] The term "lowest responsible bidder" means the bidder whose price is the lowest and whose offer adequately demonstrates the quality, fitness, and capacity to perform the work.[4] Determination of bidder qualifications and responsibility is largely a judgmental process.[5] Thus, the contracting officer's determination of responsibility is reviewed only for arbitrary and capricious action.[6]

Cases provide varying definitions of responsibility. One definition is "the bidder's apparent ability and capacity to perform the contract's requirements."[7] Another states that responsibility addresses "performance, capability of bidder including financial resources, experience, management, past performance, place of performance, and integrity."[8] Responsibility is considered to be a qualitative term, and includes trustworthiness, quality, fitness, and capacity to perform the contract satisfactorily.[9] Another court has allowed the consideration of financial ability, skill, integrity, business judgment, experience, reputation, and quality of previous work on public contracts.[10]

States may also define responsibility by statute. Oregon's public works statute provides that in determining if a prospective bidder has met the standards of responsibility, the public contracting agency shall consider whether a prospective bidder has:

> (i) Available the appropriate financial, material, equipment, facility and personnel resources and expertise, or ability to obtain the resources and expertise, necessary to indicate the capability of the prospective bidder to meet all contractual responsibilities;
>
> (ii) A satisfactory record of performance. The public contracting agency shall document the record of performance of a prospective bidder if the public contracting agency finds the prospective bidder not to be responsible under this sub-subparagraph;
>
> (iii) A satisfactory record of integrity. The public contracting agency shall document the record of integrity of a prospective bidder if the public contracting agency finds the prospective bidder not to be responsible under this sub-subparagraph;
>
> (iv) Qualified legally to contract with the public contracting agency; and
>
> (v) Supplied all necessary information in connection with the inquiry concerning responsibility. If a prospective bidder fails to promptly supply information requested by the public contracting agency concerning responsibility, the public contracting agency shall base the determination of responsibility upon any available information, or may find the prospective bidder not to be responsible[.][11]

Determination of these qualifications must be made by the contracting officer on a case-by-case basis. Historically, contracting officers have resorted to four basic methods, or combinations of methods, in carrying out this function. The earliest practice relied on the contracting officer's acknowledged authority to reject any (or all) bids if he or she deems it to be in the public in-

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[1] Portions of this section are derived from *Licensing and Qualification of Bidders* by Dr. Ross D. Netherton, published by the Transportation Research Board in 1976 and included in the first edition of SELECTED STUDIES IN HIGHWAY LAW.

[2] *See* 30 DEL. CODE §§ 2502 (1997); PG Constr. Co. v. George & Lynch, Inc., 834 F. Supp. 645 (D. Del. 1997).

[3] At least one court has held that even in the absence of a statutory requirement for doing so, public policy and economical conduct of government business require that contracts be awarded to the lowest responsible bidder. City of Phila. v. Com., Dep't of Envtl. Resources, 133 Pa. Commw. 565 577 A.2d 225, 228 (1990).

[4] *See* 30 ILL. COMP. STAT. 500/1-15.80 (2001) for a statutory definition of responsible bidder.

[5] W. Va. Medical Institute v. W. Va. Public Employees Ins. Bd., 180 W. Va. 697 379 S.E.2d 501, 503–04 (1989) (statute requiring award to lowest responsible bidder required subjective evaluation of quality, service, and compatibility with other programs in addition to price).

[6] *See, e.g.*, Advance Tank and Constr. Co. v. Arab Works, 910 F.2d 761, 765 (11th Cir. 1990) (applying Alabama law); State of Nev., State Purchasing Div. v. George's Equip. Co., 105 Nev. 798, 783 P.2d 949, 954 (1989); Grand Canyon Pipelines, Inc. v. City of Tempe, 816 P.2d 247, 250 (Ariz. 1991) (agency's decision regarding a determination of responsibility must not be arbitrary).

[7] Applications Research Corp. v. Naval Air Dev. Center, 752 F. Supp. 660, 682 (E.D. Pa. 1990).

[8] Bean Dredging Corp. v. United States, 22 Cl. Ct. 519, 522 (1991).

[9] Stacy and Witbec, Inc. v. City and County of S. F., 44 Cal. Rptr. 2d 472, 483, 36 Cal. App. 4th 1074, *modified on denial of rehearing, review denied* (1995).

[10] La. Associated General Contractors, Inc. v. Calcasieu Parish Sch. Bd., 586 So. 2d 1354, 1363 (1991).

[11] OR. REV. STAT. § 279.029(6)(a)(B) (2002).

terest to do so. Under this authority, a bidder's qualifications may be investigated and evaluated to the extent necessary. Courts have generally upheld the authority of contracting officers to investigate prospective contractors. They have also upheld the substantive determination of the administrative agency in the absence of any evidence of fraud, collusion, bad faith, or arbitrary and capricious conduct.[12]

A second method relies on the requirement that contractors must furnish performance bonds and other security for the protection of the general public and of individuals dealing with the contractors. Its rationale is that if a contractor can furnish the necessary bonds and sureties, the contracting officer may rely on the surety's investigation to verify the contractor's fitness.

A third method includes requirements that persons desiring to engage in general construction contracting or any of the various specialized branches of contracting must first obtain a license for this purpose. Licensing procedures normally call for a duly authorized public agency to examine the applicant and determine whether it is competent in its knowledge of engineering, construction, business administration, and laws applying to contracting, and has a good business reputation.[13] The contracting officer may wish to rely on this license, reasoning that if an applicant is considered "responsible" enough to obtain a contractor's license, it is responsible enough to bid on and receive the award of a public works contract.

Because both surety bonding and licensing have their limitations, a fourth method—prequalification—is widely used by states to evaluate contractors' qualifications. Under this procedure, contractors wishing to bid on public works contracts must previously be determined by the contracting agency to be qualified for the category of work involved and for undertaking a project of the size advertised.

Each of these four methods, or any combination of them, may serve as the basis for a valid administrative determination that a particular low bidder is also the lowest responsible bidder. The choice of method to be used may be made by the legislature, or may be delegated to the governing body or chief administrative officer of the contracting agency.

Procedures for evaluating contractors' qualifications serve three major public interests, namely preventing or minimizing adverse consequences of contractor default or delay; maximizing the benefits of the competitive bidding system; and improving the quality of public construction work.

i. Prevention of Contractor Default or Delay.—Legislatures have sought to protect public investments in public works by requiring suretyship and indemnification provisions in all public works contracts. However, these efforts may not be enough to cover the costs that the public must bear. Bonding requirements generally protect public agencies from loss of funds invested directly in costs of preparation and construction of a project. But the indirect costs of the agency's added overhead expense and the public's added period of inconvenience cannot be recovered from the contractor's surety.

To some extent, public works agencies can minimize risks that contractors will overextend themselves by subdividing large contracts into segments, no one of which is likely to overtax the contractor to which it is awarded. However, in such situations a default or inexcusable delay inevitably affects not only the contractor directly involved, but also other contractors whose work schedules are planned with reference to the schedules of that contractor.

Public safety is also an important reason for insisting that construction contractors be qualified to perform according to contract standards and schedules. Moral, legal, and professional obligations call for transportation construction programs to provide safe and convenient facilities for public travel. Court decisions and statutes have eliminated or restricted some states' sovereign immunity from suits based on defects in design and workmanship. At the same time, statutory standards for safe working conditions in federal law apply to contractors on state construction projects using federal funds, and similar state laws apply to state-funded projects. Thus, competence to adhere to standards that protect the safety of the traveling public and of workers employed in construction activity is an important aspect of contractor qualification.

ii. Improvement of Competitive Bidding.—The competitive bidding system is intended to secure the highest quality work for the least cost. But it can do this only if individual bidders realistically analyze the requirements of a construction plan and make their proposals fully responsive to these requirements and to prevailing market conditions.

Reliance on market forces alone to eliminate those contractors who engage in irresponsible bidding is not practical. Mandatory qualification procedures are viewed by all segments of the construction industry as a means by which responsible contractors can promote the stability of the bidding process by assuring that bids will maintain a realistic relationship to sound engineering practices and market conditions.

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[12] Marvec Constr. Co. v. Township of Belleville, 254 N.J. Super. 282 603 A.2d 184, 187 (1992); City of Cape Coral v. Water Services of America, Inc., 567 So. 2d 510, 513, *review denied*, 577 So. 2d 1330 (Fla. App. 2 Dist. 1990); Tasco Dev. & Building Corp. v. Long, 212 Tenn. 96, 368 S.W.2d 65 (1963).

[13] *See, e.g.,* IDAHO CODE § 54-1910(a) (2001).

iii. Improvement of the Quality of Public Construction.—Early proponents of contractor licensing and prequalification systems argued that such a system would result in higher quality highway construction. Contractors would be required to submit to examination of their qualifications prior to announcement of contracts. Also, the system included classification of contractors for certain types of work that they had demonstrated the ability to handle. Bidding would then be confined to those contractors whose competence was established.[14]

New or out-of-state contractors interested in doing work for transportation agencies may be allowed to bid only on small and less complex projects until they acquire the experience and financial resources to assure successful performance on larger projects. However, most states allow contractors wide latitude in the types of contracting work for which they may qualify. States assign capacity ratings to contractors according to fixed formulas that are applied uniformly to all applicants.

b. The Legal Basis of Contractor Qualification Systems

Many states require that persons engaging in general or specialized engineering or construction work must obtain licenses based on satisfactory demonstration of their professional competence. In addition, contractors intending to compete for public contracts for highway construction must, in most states, establish their qualifications for performing such work prior to being allowed to file their bids. In states that do not require prequalification, contractors who are low bidders on public projects must be certified as responsible and qualified to receive the contract award under a "postqualification" procedure. In both pre- and postqualification, the applicant is required to submit records of finances, management, and past relevant experience. Qualification is then based on a rating derived from evaluation of this evidence.

> A distinction must be made between the mechanism of licensing and the various forms of bidder qualification. Licensing is required to authorize individuals or corporations to engage in the business of construction contracting within a particular state. In contrast, prequalification and postqualification are methods of establishing a bidder's eligibility to bid on a public contract managed by a particular public agency, or to receive a particular contract as a result of competitive bidding. Licensing of contractors and certification under various qualification procedures must also be distinguished from that form of licensing that is in the nature of an occupational or privilege tax, which is chiefly for the production of tax revenue.[15]

i. Limits On State Police Power Applied To Contractor Qualification.—As in the regulation of businesses, trades, and occupations generally, the authority for licensing and qualification of contractors dealing with the public is based on the state's police power. The states must, however, respect the supremacy of federal law where it applies, and refrain from imposing any limitations on Interstate commerce. Accordingly, federal regulations applying to federally-assisted highway projects declare that state procedures for qualification of contractors will not be approved by the Federal Highway Administrator if in his or her judgment they may operate to restrict competitive bidding.[16] In addition to respecting the supremacy of federal laws, state contractor qualification requirements must avoid unfair discrimination among contractors, and must employ standards that are reasonably related to the legitimate objectives of the law.

Much of the early concern over possible discrimination is reflected in two Pennsylvania cases—*Harris v. Philadelphia*[17] in 1930 and *Corcoran v. Philadelphia* in 1950.[18] Both were taxpayers' suits to enjoin the application of municipal ordinances requiring prequalification of bidders on city public works projects. In *Harris*, the prequalification procedure was declared to be discriminatory; in *Corcoran*, the ordinance was sustained.

In *Harris*, the prequalification questionnaires were filed with the head of the municipal department that would supervise the performance of the contract, and if he was satisfied the prospective bidder's name was placed on a "white list" of "responsible bidders" entitled to submit bids without further inquiry. Others who were rejected by the department head were entitled to appeal his decision to a special board. In enjoining enforcement of this ordinance, the Supreme Court of Pennsylvania declared:

> It is obvious that, even if this plan is, in some respects, an advance on the previous method, it nevertheless opens wide the door to possible favoritism. The awarding director can place upon the white list the name of any intending bidder whom he chooses to approve, however irresponsible in fact, and that decision is not reviewable. On the other hand, he may compel all bidders, who are not favorites of his, to go to the expense of an appeal to the board, which will have before it only the answers to the questionnaire by those the awarding director has excluded from bidding, with no way of knowing whether or not their plant, equipment, experience and financial standing are superior or inferior to those of the bidders whose names the director has placed on the white list.[19]

Suggesting a way out of this danger, the court stated that prequalification might not be objectionable if all bidders' questionnaires were submitted to an independent committee having the expertise to properly analyze the evidence and advise on the classification and quali-

[14] *See* NETHERTON, *supra* note 1, at 1047.

[15] *See, e.g.*, WASH. REV. CODE § 18.27.030 (1999, 2003 Supp.)

[16] 23 C.F.R. § 635.110(b) (Apr. 2002).

[17] 299 Pa. 473, 149 A.722 (1930).

[18] 363 Pa. 606, 70 A.2d 621 (1950).

[19] 149 A. at 723–24.

fications of the applicants. It insisted, however, that all bidders must be treated equally in order to comply with the law.

Twenty years later, the Pennsylvania Supreme Court was asked to pass on another ordinance by which Philadelphia sought to require prequalification of bidders on municipal contracts.[20] The court held that the city's prequalification requirements were entirely reasonable, and were applicable to all potential bidders without discrimination. Moreover, the court found no fault with the manner in which the system had been applied to the project advertised in this instance, and denied plaintiff's charge that the city had circumscribed the advertised project in such a way as to place it outside the scope of the work classification for which the plaintiff was certified.

c. Qualification of Contractors on Federal-Aid Highway Projects

A policy of protecting and encouraging competitive bidding for contracts to construct federal-aid highways is reflected in federal statutes and FHWA regulations. The basic mandate is the statutory requirement that federal-aid highway projects shall be performed by contracts awarded through competitive bidding, unless the Secretary of Transportation makes an affirmative finding that some other method better serves the public interest. Contracts shall be awarded only on the basis of the "lowest responsive bid submitted by a bidder meeting established criteria of responsibility."[21] At the same time, the statute states:

> No requirement or obligation shall be imposed as a condition precedent to the award of a contract to such bidder for a project, or to the Secretary's concurrence in the award of a contract to such bidder, unless such requirement or obligation is otherwise lawful and is specifically set forth in the advertised specifications.[22]

The FHWA regulations require federal approval of any state prequalification requirements that will be applied in a federal-aid project.[23] The regulations further provide that there shall be no approval of qualification procedures that operate to restrict competition or prevent submission or consideration of bids by any responsible contractor.[24] "No contractor shall be required by law, regulation, or practice to obtain a license" before it may submit in a federal-aid project bid or have that bid considered.[25] As a result, some states exempt federally-funded transportation construction contracts from their state licensing requirement.[26] However, this prohibition does not prevent states from requiring the successful bidder to obtain a business or professional license upon the award of a contract.[27] This rule is based in part on the constitutional doctrine that states may not subject nonresident contractors to requirements that impede their bidding and so create a barrier to Interstate commerce. However, it also reflects the practical consideration that licensing serves no purpose in the bidding phase of a public works project. Federal regulations permit states to apply this requirement to both resident and nonresident contractors bidding on federal-aid highway projects.[28]

Federal regulations also require that states must allow sufficient time between the call for bids and the opening of bids.[29] This allows all potential bidders an opportunity to be prequalified after a full and appropriate evaluation of the contractor's experience, personnel, equipment, financial resources, and performance record.

In recognition of federal regulations designed to foster competition, and of the fact that contractors on federal-aid highway construction projects are everywhere subject to prequalification or postqualification requirements, states may accord special status to federal-aid highway contracts under their licensing laws. Idaho's Public Works Contractors License Act, for example, states:

> It shall be unlawful for any person to engage in the business or act in the capacity of a public works contractor within the state without first obtaining and having a license. . . . No contractor shall be required to have a license under this act in order to submit a bid or proposal for contracts for public works financed in whole or in part by federal aid funds, but at or prior to the award and execution of any such contract by the state of Idaho, or any other contracting authority mentioned in this act, the successful bidder shall secure a license as provided in this act.[30]

Although federal policy thus encourages the fullest possible competition for federal-aid contracts and prohibits states from imposing licensing or prequalification requirements that might serve to exclude responsible contractors from out of state, federal policy also expects contractors on federal-aid projects to be responsible firms and seeks to keep federal-aid funding from going to non-responsible firms that have engaged in serious criminal conduct or other non-responsible actions.[31]

[20] 70 A.2d at 623.

[21] 23 U.S.C. § 112 (2001).

[22] 23 U.S.C. § 112(b)(1) (2001).

[23] 23 C.F.R. § 635.110(a) (Apr. 1, 2002).

[24] *Id.*

[25] 23 C.F.R. § 635.110(c).

[26] MISS. CODE § 31-3-1(c) (2000).

[27] 23 C.F.R. § 635.110(c); *see also* 29 DEL. CODE § 6923(d) (contractor is required to have Delaware business license prior to execution of public works contract); Thompson Elects. Co. v. Easter Owens/Integrated Systems, Inc., 702 N.E.2d 1016, 1020, 301 Ill. App. 3d 203, 234 Ill. Dec. 362 (Ill. App. 1998) (county did not abuse its discretion in accepting lowest bid even though bidder was not licensed in the state; decision was based on bidder's experience, its prequalification approval, and the fact that the bid specifications did not require a license prior to contract execution).

[28] 23 C.F.R. § 635.110(a) (Apr. 1, 2002).

[29] 23 C.F.R. § 635.110(c) (Apr. 1, 2002).

[30] IDAHO CODE § 54-1902 (2000, 2002 Supp.).

[31] This portion of this volume is drawn from a publication prepared by the authors of the 2011 update to this current

Accordingly, the qualification of contractors for federal-aid highway projects is subject to federal legislation and to federal regulations revised significantly in 2008, which concern the suspension and debarment of contractors and subcontractors from federal-aid transportation projects by the USDOT, as discussed in Section 2(B)(1) of this volume.[32]

The enactment of the ARRA,[33] and the Fraud Enforcement and Recovery Act of 2009 (FERA),[34] has had a significant impact in this area. ARRA provided approximately $50 billion in funding for transportation capital projects, as part of a broader $500-billion economic stimulus package, and provided certain safeguards to protect that funding as described below. In addition to amending the Federal False Claims Act, FERA strengthened certain other safeguards in federal law, and provided $245 million in additional funding to support investigative and enforcement efforts.

ARRA established a Recovery Accountability and Transparency Board to oversee the use of federal stimulus funding. It reviews and audits ARRA-funded programs and projects, refers potential abuses to the Inspectors General of USDOT and other federal agencies for investigation, and offers recommendations to agencies, the President and Congress on measures to prevent waste, fraud, and abuse. ARRA also provides whistleblower protection for employees of state and local governments and contractors.

The enactment of ARRA and FERA also led the USDOT Office of Inspector General (OIG) to conduct a further review of USDOT's suspension and debarment program beyond the revisions to that program made by the rulemaking in 2008. In May 2009, OIG issued an ARRA Advisory concerning the suspension and debarment program,[35] and in January 2010 OIG issued a more detailed audit report on that program.[36] These reviews considered ways to strengthen the program's effectiveness, as discussed further in Section 2(B)(1) of this volume.

While state DOTs operate under their own state statutory authority to award state contracts, the award of a federal-aid highway or bridge contract requires FHWA concurrence in order to maintain continued eligibility for the federal-aid funding for such a contract. If a state DOT selects a contractor for a federal-aid contract who has been suspended or debarred by USDOT, the state DOT may not be able to obtain FHWA concurrence in the award of the contract or if it obtains such concurrence without FHWA officials being aware of the involvement of a suspended or debarred firm, it may later face FHWA withdrawal of federal-aid funding after the project is already underway. This gives state DOT officials strong reasons for ensuring that their state processes for contractor qualification take USDOT suspensions and debarments into account.

The USDOT OIG has played, and continues to play, an important role in the implementation of other fraud-prevention measures under ARRA and FERA. The OIG works with FHWA, other USDOT units, and with state and local stakeholders to combat fraud, waste, and abuse affecting federal-aid highway and bridge programs. The OIG is mandated by law to conduct audits and investigations to prevent and detect waste, fraud, and abuse affecting USDOT programs.[37] USDOT's Inspector General is one of the members of the Federal Recovery Accountability and Transparency Board established pursuant to ARRA.[38] The USDOT OIG has also been strengthened by FERA, which significantly strengthened the Federal False Claims Act (FCA) and also gave federal investigators and prosecutors "significant new criminal and civil tools to assist in holding accountable those who have committed financial fraud."[39]

Acting in coordination with FHWA and other agencies as appropriate, the USDOT OIG embarked on a series of initiatives flowing from ARRA and FERA. The OIG's goals focused on maintaining oversight over USDOT's implementation of ARRA programs, including new tracking and reporting requirements; conducting proactive and reactive grant fraud investigations involving ARRA-funded programs and projects; conducting investigations of collusive price fixing, of false

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volume; ERIC KERNESS & PETER SHAWHAN, IDENTIFICATION, PREVENTION, AND REMEDIES FOR FALSE CLAIMS IN HIGHWAY IMPROVEMENT CONTRACTING (NCHRP Legal Research Digest 55, Transportation Research Board, 2011); available at http://onlinepubs.trb.org/onlinepubs/nchrp/nchrp_lrd_55.pdf, last accessed on Nov. 26, 2011.

[32] *See* 31 U.S.C. § 6101 Note; *see also* 73 Fed. Reg. 24,139 (May 2, 2008), repealing 49 C.F.R. pt. 29 and adopting a new 2 C.F.R. pt. 1200.

[33] American Recovery and Reinvestment Act of 2008, Pub. L. No. 111-5, 123 Stat. 115 (2009).

[34] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, 123 Stat 1617 (2009) (FERA); text available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ21/pdf/PLAW-111publ21.pdf (last accessed July 26, 2012).

[35] USDOT OIG, Advisory No. AA-2009-01, ARRA Advisory–DOT's Suspension and Debarment Program, May 18, 2009, available at http://www.oig.dot.gov/sites/dot/files/pdfdocs/Final_DOT_ARRA_Advisory_05-18-09_.pdf (last accessed on July 26, 2012).

[36] *See* USDOT OIG Report No. ZA-2010-034, *Final Report on the Department of Transportation's Suspension and Debarment Program*, Jan. 7, 2010, available at http://www.oig.dot.gov/library-item/5255 (last accessed on June 11, 2010).

[37] Inspector Generals Act of 1978 as amended by the Inspector General Reform Act of 2008, Pub. L. No. 110-409, 122 Stat. 4302 (2008); available at http://www.ignet.gov/pande/leg/pl110-409.htm (last accessed June 12, 2010).

[38] *See* The Recovery Accountability and Transparency Board, http://www.recovery.gov/About/board/Pages/TheBoard.aspx and related links (last accessed on June 11, 2010).

[39] Press Release, White House Office of Communications, Statement of the President, May 20, 2009; available at http://www.whitehouse.gov/the-press-office/reforms-american-homeowners-and-consumers-president-obama-signs-helping-families-sa (last accessed June 12, 2010).

claims involving labor and materials, and of bribery of public officials; and promoting joint efforts with USDOT units and state and local stakeholders to combat fraud, waste, and abuse.[40]

The OIG also conducted fraud prevention awareness training and other outreach activities to inform USDOT staff, state DOTs, and others at all levels of government about how to recognize, prevent, and report suspected fraud.[41] The USDOT OIG has, among other things, prepared a training video on False Statements and Claims to provide government officials and members of the public with an understanding of common fraud schemes and to strengthen collaborative efforts aimed at prevention and detection of such schemes. This video is potentially useful for any federal, state, or municipal transportation officials.[42] As of January 31, 2010, the OIG had provided 168 training sessions for more than 11,000 individuals nationwide, including officials from FHWA regional offices, state DOTs, and other public agencies. As of January 31, 2010, OIG had also received 184 complaints and accepted 16 for prosecution.[43] The OIG continues to monitor fraudulent schemes in the contracting process and to issue audit reports concerning various administrative practices, develop work plans, and conduct outreach to various state DOTs and public authorities.[44]

In addition, the USDOT OIG, the Federal Recovery Accountability and Transparency Board, the Antitrust Division of the U.S. Department of Justice (DOJ), and the U.S. Government Accountability Office (GAO) have undertaken initiatives to combat waste, fraud, and abuse potentially affecting federal-aid highway and bridge projects following the enactment of ARRA and FERA. Such measures go beyond the scope of a discussion of qualification of bidders for federal-aid contracts, but are discussed in other publications.[45]

Beyond the statutory safeguards provided by ARRA and FERA and agency initiatives undertaken pursuant to them, the FARs were amended in 2008 to add new requirements for contractors and consultants dealing with federal agencies.[46] *It should be noted that the 2008 FAR amendments apply only to direct contracting by federal agencies, and do not apply to grant recipients. Thus, they do not apply to federally-funded state highway contracts on federal-aid projects.* They are instructive, however, with regard to ethics and disclosure requirements which the DOJ and Congress consider necessary to protect federal contracting from fraud.

The impetus for the FAR amendments came both from DOJ and from enactment of federal legislation, the Close the Contractor Fraud Loophole Act.[47] The 2008 FCA amendments require that every covered federal contractor adopt a written Code of Business Ethics and Awareness within 30 days after receiving the award of a federal agency contract and make that Code available to each of their employees. The 2008 FCA amendments also require that every contractor receiving a federal agency contract of more than $5 million, and major subcontractors on such contracts, make timely disclosure to the agency OIG, in connection with the award, performance, or closeout of a government contract by the contractor or subcontractor, whenever the contractor has credible evidence that a principal, employee, agent, or subcontractor has committed a violation of federal criminal law involving fraud, conflict of interest, bribery or gratuity, criminal or civil violation of the FCA, or receipt of a significant overpayment on the contract. The disclosure requirement includes an ongoing obligation to disclose any newly discovered information up to 3 years after the closeout of the contract. Note that a conviction, indictment, investigation, or conclusive proof is not required to trigger the disclosure requirement. The firm merely has to have "credible evidence" indicating that an associated person or firm has committed criminal conduct.[48] Under the 2008 FCA amendments, failure to make such mandatory disclosures contitutes grounds for federal suspension and/or debarment.

2. Prequalification of Contractors for Performance-Based Construction

The traditional process of developing and performing highway and bridge projects is usually conceived of as having three main phases. A state or municipal DOT or other public owner identifies a need for a transportation project, obtains public funding for the project, and conducts a planning and environmental review process,

[40] *See* the USDOT OIG's Strategic Plan dated Sept. 2009, available at http://www.oig.dot.gov/sites/dot/files/OIG_Strategic_Plan_2009_508.pdf (last accessed June 10, 2010).

[41] *See, e.g.*, http://www.oig.dot.gov/oig-recovery-training (last accessed on June 10, 2010), including a detailed USDOT OIG PowerPoint training presentation, Fraud Awareness and Prevention, available at http://www.oig.dot.gov/sites/dot/files/Website_2009_ARRA_OIG_General_Presentation.pdf (last accessed on June 10, 2010).

[42] USDOT OIG, False Statements and Claims Video, available at http://www.preventtransportationfraud.org/false statementvideo.html (last accessed on June 22, 2010).

[43] *See* USDOT OIG Recovery Act Monthly Report for January 2010, available online at http://www.oig.dot.gov/sites/dot/files/DOT%20OIG%20Monthly%20Report%20Num%2011%20January%202010%2002-05-10.pdf.

[44] *Id.* The USDOT OIG and the American Association of State Highway and Transportation Officials (AASHTO) held a Sixth Annual National Fraud Awareness Conference on Transportation Infrastructure Programs in Arlington, Va., from July 26 through 29, 2010; for further information, see http://www.preventtransportationfraud.org/ (last accessed on June 22, 2010).

[45] *See* KERNESS & SHAWHAN, *supra* note 31.

[46] 48 C.F.R. § 52.203.13

[47] Pub. L. No. 110-252, tit. VI, ch. 1, 122 Stat. 2323 (2008).

[48] 48 C.F.R. §§ 3.1003, 9.406-2(b)(vi), 9.407-2(a)(8), and 52.203.13.

which identifies a preferred alternative approach to the project. The DOT then either assigns in-house engineering staff, or retains an engineering firm as a consultant, to prepare detailed engineering designs for the project, with the personnel preparing, reviewing, and approving the engineering design for the project having to meet state licensing requirements for the practice of engineering as a profession. Finally, when the engineering plans are complete and funding is in place, the DOT lets a construction contract to the lowest responsible bidder, with bidders either being reviewed in advance before being allowed to bid (prequalification) or being reviewed after bidding and rejected only if they are determined non-responsible (postqualification). The DOT then inspects the construction work on an ongoing basis, either through in-house construction inspectors or construction inspection consultants, to assure that the contractor complies with the minimum quality standards established by the DOT's standard specifications.

While the traditional system has advantages, it also has disadvantages that become increasingly evident over time. It is relatively slow to deliver a completed project, because no construction work can be undertaken until all engineering design work has been completed. It does not, for example, allow for fast-tracking projects by allowing construction to begin while later stages of the project are still being designed. It does little, if anything, to foster teamwork between designers and construction contractors, because they are generally entirely separate businesses engaged in different lines of work and performing their respective functions at different times during the life cycle of a project.

One consequence of this is that design engineers often fail to obtain sufficient information about constructability issues from interacting with contractors who have field experience. As a result, some designers may on occasion produce designs that look good on paper and in theory, but prove to be more difficult, time-consuming, and expensive than necessary for contractors to build in the field.

Another consequence of this is that, if contractors encounter unanticipated site conditions, advanced deterioration of existing structures, or constructability problems, construction work may need to stop for weeks at a time while a team of design engineers, who had previously completed their work designing the project and had moved on to other things, are reassembled in order to analyze the problem and design a solution, with the public forced to cope with traffic congestion, the parties potentially incurring financial losses, and the DOT facing a number of dissatisfied parties in the meantime.

In addition, the authors note that although the prequalification and postqualification systems may weed out firms that have been convicted of criminal conduct or lack sufficient financial capacity or technical capability to perform the project, they do little beyond that to improve the quality of construction beyond meeting the specifications set by owners. Aside from contracts that may include incentive/disincentive clauses, cost-plus-time bidding, or quality incentives, they do little to identify or reward construction contractors who demonstrate quality in performance by building projects on time, within budget, safely, and with a cooperative attitude toward the public owner and members of the public affected by the project. If anything, the traditional prequalification and postqualification systems may involve a risk of generating perverse incentives, in which firms could gain cost advantages by cutting corners on quality of materials and equipment, employing inexperienced personnel willing to work for lower wages, not meeting contract specifications, and disregarding construction safety practices, and use cost advantages obtained through such practices to underbid higher-quality construction firms. Such contractors might increase administrative costs for public owners by requiring closer supervision through construction inspection. There might also be a risk that the projects built by such contractors might have higher maintenance costs following completion as problems resulting from inferior work practices develop over time.

The current trend toward innovative forms of project management, such as design-build (DB) and construction manager at risk (CMR), basically represents efforts to devise structural solutions to some of these difficulties. Both DB and CMR are intended to allow for fast-tracking of projects by allowing construction to begin while the design of later stages of the projects is still underway. Both DB and CMR are intended to provide for closer cooperation and teamwork between design engineers and construction contractors, so that project designs take constructability considerations into account and engineers remain part of the project team and available on an ongoing basis to help devise prompt solutions to unanticipated problems encountered by construction contractors in the field, thus minimizing construction downtime and project delays. Both DB and CMR are, in theory at least, also intended to help DOTs and other public owners reduce administrative costs by having DB or CMR firms take on greater responsibility for quality control and warranty commitments so that DOTs can reduce costs associated with construction inspection.

Unless DOTs and other public owners can select DB or CMR firms with an established record of proven performance and high quality, however, the DB and CMR approaches involve increased risks. If a DOT entrusts quality-control functions to a DB or CMR firm and reduces or eliminates construction inspection efforts in reliance upon expectations of quality, and if the DB or CMR firm abuses that trust, then both the DOT and the traveling public may face consequences in terms of poor-quality transportation facilities, growing maintenance problems, and lack of adequate means to hold contractors accountable for dealing with postconstruction problems. The traditional prequalification and postqualification approaches do not focus on selecting contractors who deliver the highest-quality results.

Solving such problems necessarily involves developing a system for evaluation and selection of contractors that identifies and places a value on contractors capable

of performing quality work without constant and close supervision, and capable of performing a project on time, within budget, and with minimal delays resulting from problems encountered in the field. This type of system will involve ongoing evaluation and rating of the quality of contractors' work over time, and will factor the rated quality of contractors' performance into the weighting of bids or the evaluation of proposals submitted through a competitive RFP process. Such a system can no longer continue to rely on the existing postqualification or prequalification systems without significant change.

The Transportation Research Board (TRB) and NCHRP have devoted attention to this issue. In 2009, TRB published a synthesis, *Performance-Based Construction Contractor Prequalification*,[49] which evaluates this issue through a detailed examination of contractor prequalification policies and procedures, contractor performance evaluations, barriers to implementation, and prequalification case studies, and offers both conclusions and recommendations for further research. It focuses on identifying contractor performance-based prequalification practices based on construction quality, timely performance, safety record, and other criteria, with an effort to identify systems that effectively furnish incentives for good contractor performance.[50] The study indicates that two guiding principles for evaluating such systems is whether such systems add value to projects by reducing performance risk and whether the elements of such systems are justifiable and defensible.[51]

The study defines performance-based prequalification as:

> A set of practices and backup documents that must be followed by a construction contractor to qualify to submit a bid on a construction project based on quality, past performance, safety, specialized technical capability, project-specific work experience, key personnel, and other factors. This information may be provided on a project-by-project basis or on a specified periodic basis.

It would go beyond the scope of the current volume to discuss in detail the research findings and syntheses of practice offered in the study. For state and municipal DOT officials responsible for efforts to develop improved project delivery systems for the future, careful and thorough consideration of this study and its findings would appear to be warranted. A few of the study's conclusions may be summarized briefly, however.

a. Dependence Upon Selection of Well-Qualified Contractors

The authors of *NCHRP Synthesis 390* recommend that highway construction agencies begin the process of transitioning to performance-based prequalification rather than continuing to rely on existing administrative prequalification or postqualification systems. They take the view that the bonding of construction contractors is associated more with administrative prequalification than with performance-based prequalification, and question what value performance-bonding adds to construction projects. They recommend that DOTs simplify the performance-based prequalification process, focusing on major rather than minor performance evaluation criteria, and seek to develop nationwide standardization of the information required by DOTs for performance-based prequalification. They suggest that both bidding and bonding capacity could be adjusted through a performance-based prequalification system, with performance-bonding requirements lowered for contractors with proven track records of high-quality performance. They suggest the use of a three-tier performance-based prequalification system, with the first tier including evaluation of the contractor's bonding capacity, the second tier involving a contractor performance-evaluation system based on specified factors, and the third tier involving project-specific prequalification of contractors for selected projects, in which agencies concluded that this would add value to the contractor-selection process for a given project.[52]

b. Contractor Prequalification Policies and Procedures

The authors of the NCHRP study examined state DOT approaches to contractor prequalification policies and procedures.[53] The authors found that 35 state DOTs had prequalification requirements. Of those, 29 required prequalification for all projects, and 6 required it only for selected projects. In addition, 21 applied the same prequalification criteria to all projects, whereas 14 applied prequalification criteria, which differed according to the monetary size, technical complexity, delivery method, technical content, or other characteristics of the contracts involved. Those figures changed somewhat when the prequalification requirements were performance-based. Of the states having performance-based prequalification procedures, 7 required prequalification for all projects while 11 required it for selected projects only. Four applied the same prequalification criteria to all projects, while 9 applied criteria that differed depending on the characteristics of the projects and contracts involved.[54] Analyzing the various prequalification forms in use by state DOTs, the authors of the NCHRP study identified 10 factors, falling into

[49] Douglas D. Gransberg and Caleb Riemer, *Performance-Based Construction Contractor Prequalification, A Synthesis of Highway Practice,* NCHRP Synthesis 390, TRB, The National Academies, Washington, D.C., 2009; available at http://onlinepubs.trb.org/onlinepubs/nchrp/nchrp_syn_390.pdf, last accessed on January 3, 2012.

[50] *Id.* at 3.

[51] *Id.* at 5.

[52] *Id.* at 54 to 60.

[53] *Id.* at Chapter Two, pp. 15 et seq.

[54] *Id.* at 16-17; see esp. table 5 and figures 6 and 7.

three broad categories, included in the majority of such forms. These were:[55]

- Financial criteria—type of business (publicly or privately owned), and financial statement.
- Managerial criteria—key personnel experience, major convictions for bidding or contract crimes or fraud, business connections, and any prior project defaults or other failures.
- Performance criteria—work classifications, construction experience, major project experience, and available equipment.

More than half of the state DOTs using performance-based prequalification procedures focused on eight particular criteria when making their prequalification determinations. The three most frequently cited factors were major project experience, technical ability, and past illegal behavior. The other five common factors included key personnel experience, available equipment, quality and workmanship, managerial ability, and financial capability.[56]

c. Contractor Performance Evaluations vs. Bonding and Bonding Capacity

Going beyond general prequalification criteria, the authors of the NCHRP study examined more closely what things state DOTs considered important in establishing credible contractor performance evaluation processes, and what particular criteria agencies focused on in rating contractor performance. The study found that, to establish credible processes, agencies focused on assuring the accuracy, fairness, and consistency of evaluations of contractor performance, and on establishing a retention period for such evaluations that was sufficiently long to be useful, but that still allowed marginal contractors who worked on improving their performance to have the opportunity for such improvements to be reflected in their current evaluations.[57] The study's authors reviewed the factors considered by agencies in rating performance, and identified 17 factors typically considered by the state evaluation systems. The 10 factors most frequently used by DOTs in such evaluations were:[58]

- Timely project completion.
- Coordination and cooperation with the agency.
- Timely and complete submittals of documentation.
- Environmental compliance.
- Conformance with contract documents.
- QA program effectiveness.
- Proper maintenance and protection of traffic.
- Safety program effectiveness.
- Impacts to the traveling public.
- DBE utilization.

[55] *Id.* at 17–19.

[56] *Id.* at 21–23; see esp. figure 12.

[57] *Id.* at 26–28.

[58] *Id.* at 29–30, see esp. figure 19.

Additional factors often considered in performance evaluations included coordination and cooperation with property owners, level of effort displayed on the job, coordination and cooperation with third-party stakeholders, timely punchlist completion; mitigation of time overruns, mitigation of cost overruns, and responsiveness to warranty call-backs.

d. State DOT Experiences

To consider how difficult it might be for state DOTs or other agencies to implement performance-based prequalification and how performance-based prequalification was working out in actual practice for those agencies that had already implemented it, the authors of the NCHRP study considered actual and potential barriers to implementation[59] and selected three agencies for case studies. [60] Of barriers to implementation, those considered to have the greatest significance included ensuring that agency evaluators were qualified, assuring that agency rules governing the process were transparent and logical, the potential impact of agency performance ratings on contractors' bonding capacity, and the legal implications of performance evaluations. A variety of other barriers were, however, also noted by state DOTs and contractors, and discussed by the authors of the study.[61] In selecting agencies for case studies, the authors sought agencies that had adopted objective contractor performance evaluation systems that supported their prequalification processes in a meaningful way and had adopted specific processes that not only used the performance evaluation output to reward contractors with a good record, but also encouraged contractors with a poor record to improve. Based on these considerations, the authors chose Michigan DOT, FDOT, and the Ontario Ministry of Transportation for case studies. Although these agencies' procedures and experiences varied somewhat, the case studies revealed that all three agencies included consideration of the following factors in their systems:[62]

- Contractors' financial capability.
- Contractors' calculated capacity factors from their financials.
- Detailed financial analyses.
- Contractors' equipment and plant resources.
- Performance evaluations.
- Past project experience.

Those interested in a closer examination of how these three agencies approached evaluating the performance of contractors, and what experiences they had in doing so, will find detailed case study evaluations of each in the NCHRP study.[63]

[59] *Id.* at ch. 4, at 37–40.

[60] *Id.* at ch. 5, at 41–53.

[61] *Id.* at 37–40.

[62] *Id.* at 41–43.

[63] *Id.* at 43–44 (Michigan DOT), 44–48 (Florida DOT), and 48–51 (Ontario MOT).

3. State Laws and Regulations Relating to Licensing of Public Works Contractors

By requiring persons who engage in public works construction to first obtain a license for this business, public agencies have an opportunity to screen applicants to assure that they have professional competence and other characteristics that favor high standards of workmanship and business integrity. Generally, these laws are completely separate in their operation from highway agencies' contractor qualification procedures, but in several states the licensing of contractors operates as part of the qualification process. A listing of state contractor licensing laws is included in Appendix D.

Some states' statutes make the undertaking or overseeing of construction work in violation of a contractor's licensing law a misdemeanor.[64] Penalties for such violations generally consist of fines, although some states specifically authorize injunctions to restrain unlicensed persons from engaging in public works contracting.[65]

Contractor licensing laws and rules are necessary parts of the public's defense against unreliable, fraudulent, and incompetent work.[66] Accomplishment of this objective has been held to require that the regulatory penalties apply as consistently to licensed contractors who undertake work beyond the scope of their licenses as to those who are unlicensed for any type of construction work.[67] Conditions of the license must be met regardless of any inconsistent arrangements made between private parties, even though the convenience of the construction process may be served by them.[68] While recognizing that strict adherence to licensing requirements limits the flexibility often desired by contractors to improvise responses to unforeseen construction problems, courts are very reluctant to relax compliance standards.[69]

Although licensing laws may provide that intentional failure to comply is punishable as a misdemeanor, a parallel deterrent is the doctrine that courts will not enforce claims of contractors who do not comply with licensing laws.[70] This rule may be applied to defeat the entire contract as being illegal where entered into by an unlicensed contractor.[71] It may also be applied to limit the right of recovery by a licensed contractor to the dollar limit of the work that the license authorizes it to undertake. Application of contractor licensing laws to bar an unlicensed contractor's action against a state has been held not to constitute a taking of property without due process of law.[72] The failure of the contractor to obtain the required license prior to the start of the work cannot be cured; a subsequently obtained license does not validate the contract.[73] However, where an individual corporate officer was licensed, even if the corporation was not, a state court did enforce the contract rather than create a windfall to the owner for the completed but uncompensated work.[74] Most states require that the contractor be licensed at the time of contract execution, but do not require that it be licensed at the time of bid submission, opening, or award.[75]

Parties may choose to voluntarily comply with the terms of a contract with an unlicensed contractor. A court may enforce an arbitration award in favor of an unlicensed contractor.[76] Also, an unlicensed contractor may be able to recover actual documented expenses in a court of equity, upon a showing of clear and convincing proof of those expenses, even though the court will not allow recovery in quantum meruit.[77]

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[64] IDAHO CODE § 54-1920 (2000; 2002 Supp.), FLA. STAT. 489.127(2) (2001).

[65] State v. Summerlot, 711 So. 2d 589, 592 (Fla. App. 1998) (contractor was criminally liable for contracting without a license).

[66] Northwest Cascade Constr. Inc. v. Custom Component Structures, 8 Wash. App. 581, 508 P.2d 623, 626 (1973), *modified*, 83 Wash. 2d 453, 519 P.2d 1 (1974); Scientific Cages, Inc. v. Banks, 81 Cal. App. 3d 885, 146 Cal. Rptr. 780, 781 (1978).

[67] Alan S. Meade Assoc. v. McGarry, 315 S.E.2d 69, 71–72 (N.C. App. 1984).

[68] Hagberg v. John Bailey Contractor, 435 So. 2d 580 (La. App. 1983) (where a contractor who was duly licensed to do business in his own name undertook to assist a street paving contractor by acting under the latter's name, court held that he acted as an unlicensed contractor, because the licensing law required him to do business only under the name by which he was licensed).

[69] Scientific Cages, Inc. v. Banks, 81 Cal. App. 3d 885, 146 Cal. Rptr. 780, 781 (1975).

[70] Brady v. Fulghum, 308 S.E.2d 327, 330 (N.C. 1983); White v. Miller, 718 So. 2d 88 (Ala. App. 1998) (unlicensed contractor could not recover under contract or quasi-contract, nor could it file a mechanics lien for work that required a contractor's license because contracts entered into by unlicensed contractor, whether express and implied, are void); Fisher Mechanical Corp. v. Gateway Demolition Corp., 669 N.Y.S.2d 347, 247 A.D. 2d 579 (N.Y. App. 1998) (an unlicensed plumbing subcontractor could not recover in breach of contract action against general contractor on transit project even though the general contractor knew that the subcontractor was not licensed); Cevern, Inc. v. Ferbish, 666 A.2d 17, 22 (D.C. App. 1995) (no recovery in quantum meruit for unlicensed contractor); *see also* FLA. STAT. § 489.128 (2001).

[71] *See* White v. Miller, 718 So. 2d 88 (Ala. App. 1998).

[72] Cameron v. State, 15 Wash. App. 250, 548 P.2d 555, 557 (1976) (contractor sought recovery of bid bond and cost of parking lot construction).

[73] Jenco v. Signature Homes, Inc., 468 S.E.2d 533 (N.C. 1996).

[74] Berkman v. Foley, 709 So. 2d 628 (Fla. App. 1998).

[75] Thompson Elects. Co. v. Easter Owens/Integrated Systems, Inc., 301 Ill. App. 3d 203, 234 Ill. Dec. 362, 702 N.E.2d 1016 (1998).

[76] Davidson v. Hensen, 135 Wash. 2d 112, 954 P.2d 1327, 1331 (1998).

[77] Roberts v. Houston, 970 S.W.2d 488 (Tenn. App. 1997); *see also* Covern, Inc. v. Forbish, 666 A.2d 17 (D.C. App. 1995) (no recovery in quantum meruit even where contractor had complied with all licensing requirements except paying for the license).

With only a few exceptions, contractor license fees are set at levels needed to defray, at least in part, the expenses of administering the regulatory features of the law.[78] Principles of tax equity apply, and have been tested in cases where licensees pay differing rates according to classifications described in the law. Delaware's law provides that nonresident contractors must pay fees for each job performed, while resident contractors pay only a single annual license fee. A court held that this rate structure was not unconstitutional, despite the fact that nonresidents might pay considerably more fees annually than residents would.[79]

a. Comparison of State Legislation

The structure and much of the content of state laws for licensing of public works contractors reflect general agreement on what these laws should try to accomplish, and how this can best be done. A comparative summary of these laws is given in Appendix C.

Some state legislatures have chosen to establish special bodies or boards to administer licensing requirements, and have delegated to them substantial rule-making authority for working out procedures and standards to assure that applicants have professional competence and other requisites. The separate status of these boards provides a degree of independence, which is considered important for impartial processing of license applications and administering disciplinary actions. As a result, little or no suggestion of favoritism or abuse of discretion in the issuance of licenses has occurred in the history of these laws. Coupled with provisions for formal review and appeal to the courts when rulings of the board are disputed, these laws have not been challenged on the constitutional sufficiency of their structure.[80]

b. Scope of the Licensing Requirement

Statutory definitions of contracting agree in substance that a contractor is one who, for a fixed fee, commission, or other form of compensation except wages, undertakes, oversees, or bids to undertake the construction, alteration, repair, improvement, removal, or demolition of a building, highway, bridge, road, street, railroad, or other structure.[81] The licensing requirement may be limited to instances of this activity where the monetary value of the contract exceeds a stated minimum figure.[82]

A number of other exemptions also appear in state contractor licensing laws. Typically, no contractor's license is required for the following:

- Public utilities engaged in construction, repair, or alteration of their own facilities.[83]
- Duly licensed engineers and architects acting solely in their professional capacity.[84]
- Persons engaged in building, altering, or repairing residential structures on their own property.[85]
- Construction, alteration, or repair of structures on land owned by the federal government.[86]
- Installation of products that are not actually fabricated into and become permanent parts of a structure.[87]
- Mowing and litter removal on highways.[88]

Judicial interpretation has also refined the legislative definition of the scope of these laws. Thus, where a person furnished equipment and labor on a day-to-day basis for construction of an industrial structure, he was not regarded as a contractor under the state's licensing act.[89] In the court's view, the statute's purpose was to insure the quality of contractors' work. For the license requirement to apply to a contractor, its role in a project must be a substantial one, both in terms of its size and its influence on the work performed.[90] Also, where the two entities that made up a joint venture were each licensed, no separate license was needed for the joint venture.[91]

Consistent with their purpose to protect the public against unreliable, incompetent, or fraudulent construction practices generally, statutes requiring licensing of construction contractors describe the objects of their regulation in broad and inclusive terms. As a result, much of the litigation involving these laws is concerned with interpreting statutory definitions of the term "contractor." This has called for making distinctions between contractors and their employees. It also requires distinctions between general contractors and others performing the functions of subcontractors, ma-

[78] *See* Lite House, Inc. v. North River Ins. Co., 471 S.E.2d 166 (S.C. 1996) (license bond was intended to apply toward health and safety concerns and not to cover supplier for nonpayment of materials).

[79] American Paving Co. v. Director of Revenue, 377 A.2d 379 (Del. Super. 1977).

[80] *See* NETHERTON, *supra* note 1, at 1057.

[81] *See, e.g.*, FLA. STAT. § 489.105(3) (2001).

[82] *See* IDAHO CODE § 54-1903(i) (2000).

[83] Westinghouse Elec. Corp. v. Rhodes, 97 Ariz. 81, 397 P.2d 61 (1964).

[84] FLA. STAT. § 489.103(11) (2001).

[85] *But see* City of Seattle v. State of Wash., 965 P.2d 619, 136 Wash. 2d 693 (1998) (city program that used unemployed homeless adults to upgrade lighting fixtures in low income housing units violated state requirement for electrical contractor's license).

[86] IDAHO CODE § 54-1903(f) (2000).

[87] IDAHO CODE § 54-1903(d) (2000).

[88] Clancy's Lawn Care and Landscaping v. Miss. State Board of Contractors, 707 So. 2d 1080 (Miss. 1997).

[89] Messina v. Koch Indus., 267 So. 2d 221*, writ issued*, 263 La. 620, 268 So. 2d 678 (1972).

[90] *See* Vallejo Dev. Co. v. Beck Dev. Co., 24 Cal. App. 4th 929 (Cal. App. 1994) (execution of contract and exercising administrative and oversight functions is acting in the capacity of a contractor, thus licensing requirement applied); Interstate Commercial Building Services, Inc. v. Bank of America, 23 F. Supp. 2d 1166 (D. Nev. 1998).

[91] J. Caldarera & Co. v. Hospital Service District, 707 So. 2d 1023 (La. App. 1998).

terial men, lessors of equipment, and fabricators of manufactured products used as fixtures.[92]

In their interpretation of contractor licensing laws, the courts have distinguished between contractors and their employees according to the extent to which they share in 1) determining the nature of the work to be done, 2) deciding on methods to be used, and 3) supervising the work. Therefore, in considering whether one who furnished a backhoe and operator must obtain a contractor's license, the court was persuaded he should not, because he was told by others where to dig, when to come to work, and what degree of care was needed, and the work was supervised by representatives of other contractors at the work site.[93]

In contrast, where one has control over the manner in which details of the work are accomplished, purchases materials and equipment, hires labor, and supervises the construction process, one is subject to the licensing requirement. This is true notwithstanding that he or she is called an employee, and that the employer makes suggestions as to these matters and coordinates various parts of the total project.[94]

Where decision-making authority is divided, or is exercised jointly, the criterion of control must be applied cautiously. Even when the decisions of one are limited chiefly to accepting construction plans and specifications that another has been hired to prepare and supervise, both may be regarded as general contractors so as to require them to obtain licenses.[95]

By the same criterion of control, one who undertakes to supply labor and materials to a general contractor may also be treated as a contractor. Where an entity was engaged in supplying temporary laborers to licensed contractors, retaining all payroll functions and ability to determine wages, that company was subject to contractor licensing requirements.[96] In another case, Arkansas' contractor licensing law was applied to a materials and labor subcontractor on the grounds that it had agreed to 1) do work to the owner's satisfaction, 2) indemnify the owner and general contractor for any claim resulting from the subcontractor's fault, 3) do work according to the owner's plans and specifications and be responsible for work and materials, and 4) restore damaged work.[97]

Where employee status is not at issue, liability under construction contractor licensing laws may turn on how directly and substantially one's work contributes to the construction process and project result. One who merely supplies goods for others to install, or whose products are not permanently attached to a structure, has regularly been held not to be a contractor within the terms of the licensing law. The same applies to lessors of construction equipment.

The distinction between contractors and manufacturers of fabricated items used in highway construction or operations has been presented in various situations involving on-site assembly and installation of fixtures. The California court's approach to this problem is illustrated in *Walker v. Thornsberry*, where a general contractor purchased prefabricated metal restrooms from a manufacturer, to be delivered to the construction site and bolted to a concrete foundation furnished for them by the purchaser.[98] Plumbing, electrical hook-ups, roofing, and painting were to be done by the general contractor or other subcontractors. On these facts, the court held that the manufacturer was not engaged in construction that required obtaining a contractor's license. Its contribution to the finished construction project was "at most minor and incidental," and not sufficient to make the items installed a fixed part of the structure being built.

The test used by the California court in *Walker v. Thornsberry* may have different results in other circumstances. For example, where a sprinkler system and mounting for a sign were buried in the ground, and there was excavation and construction of concrete dugouts, the court held that these actions constituted construction within the purview of the contractor licensing law.[99]

Painting must always be considered carefully according to its particular circumstances. Often it is entirely incidental to the construction process, where in other cases it adds something necessary to the structure. Moreover, painters frequently have almost complete control over the way their work is done. In such cases, painters may be considered contractors for licensing purposes.[100]

Contractor licensing laws may restrict their scope only to certain types of construction contracting. In the case of a contract to excavate and dispose of earth and rock, and to reclaim land at a sanitary landfill site, an Idaho court applying the state's licensing statute held that the work could be regarded as public works construction within the purview of the statute, even though no structures were involved in the project.[101]

[92] *See* Farwest Steel Corp. v. Mainline Metal Works, Inc., 48 Wash. App. 719, 741 P.2d 58, 60, *review denied*, 109 Wash. 2d 1009 (1987) ("subcontractor" is one who takes from the prime contractor a specific part of the work, distinguished from materialman).

[93] Dahl-Beck Electric Co. v. Rogge, 275 Cal. App. 2d 893, 80 Cal. Rptr. 440 (1969).

[94] Campbell v. Smith, 68 N.M. 373, 362 P.2d 523 (1961).

[95] Harrell v. Clarke, 325 S.E.2d 33 (N.C. App. 1985).

[96] Personnel Temp. Services v. W. Va. Division of Labor, Contractor Licensing Bd., 197 W. Va. 149, 475 S.E.2d 149, 153–54, 197 W. Va. 149 (W. Va. 1996).

[97] Bird v. Pan Western Corp, 261 Ark. 56, 546 S.W.2d 417 (1977).

[98] 97 Cal. App. 3d 842, 158 Cal. Rptr. 862 (1979).

[99] E.A. Davis Co. v. Richards, 120 Cal. App. 2d 238, 260 P.2d 805 (1953).

[100] 19 A.L.R. 3d 1407, 1418

[101] McKay Constr. Co. v. Ada County Bd. of County Comm'rs, 99 Idaho 235, 580 P.2d 412 (1978).

c. Examinations and Criteria for Licensing

State contractor licensing laws generally require applicants to submit statements regarding their qualifications with their license applications. Thereafter, applicants may be required to take oral and/or written examinations, or submit to a background investigation by the licensing board, in order to fully establish compliance with licensing criteria.

Statements of criteria for licensing vary considerably in their details. Essentially they focus on the question of whether a contractor appears to have the ability to make practical applications of its knowledge of general contracting, and whether it has a good reputation for conducting business. Technical competence as a contractor must be shown in such matters as ability to read plans and specifications, estimate costs, and apply construction methods. Professionalism generally is also tested by reference to an applicant's knowledge of construction ethics and of the state's laws and regulations relating to construction, health, safety and liens, and the applicant's record in the business community.[102]

d. Impact of Licensing on the Design-Build Method of Contracting

When state licensing of contractors developed, the DBB or "lowest responsible bidder" method of contracting was the main, and indeed almost the only, method of public works contracting. As newer approaches to contracting have developed, such as the DB and CMR approaches, it has become apparent both that the state licensing process was not, in general, set up to accommodate DB or CMR contracting; and that the different approaches to licensing taken by different states have varying impacts on attempts to pursue DB or CMR contracting in different states.

Although it is now several years old, one of the best considerations of this issue is a legal memorandum, available online, prepared by two partners in a law firm with a significant practice in the area of infrastructure.[103] The article points out that before deciding how to organize a DB contractor to perform work in a particular state, it is first necessary to evaluate state licensing laws and any DB specific laws in that state. All 50 states and the District of Columbia require professional licenses for the performance of architectural or engineering (A/E) services, but the states' approaches to such regulation vary considerably. Beyond pointing out the ways in which differing statutory provisions can require those organizing DB firms to take different approaches, the memorandum provides a state-by-state survey of relevant statutes in all 50 states plus the District of Columbia, as those statutes stood when the memorandum was prepared, together with an assessment of how each state's laws affect the structure of DB entities. The memorandum also includes a page of summary observations on special issues relating to DB firms.

4. State Practice Regarding Prequalification of Bidders

The process and standards for a state's contractor qualification system may not be fully set forth in its statutes. Some of the law relating to prequalification is in the form of administrative regulations and the related policy directives of the state transportation agency's governing body.[104] See Appendix E for statutes and regulations relating to qualification of bidders for state transportation agencies.

The question of whether specific enabling legislation is necessary to authorize and guide such administrative action arose relatively early in the history of prequalification. Generally this was satisfactorily resolved by reference to the language of the state transportation agency's authority for awarding construction contracts. There was considerable support for the view that the power to impose prequalification requirements may be implied in performing the statutory duty to select the lowest responsible bidder.[105]

However, the earliest court decisions on prequalification dealt with this matter in a way that inspired most public officials to desire some statutory authority for their system even though it might not be absolutely necessary. Statutory authority for a local school board to require prequalification was at issue in *J. Weinstein Building Corp. v. Scoville*.[106] On its own resolution, the board required prospective bidders on its construction contracts to submit evidence of their qualifications before receiving copies of the project plans. The only state statute involved required that the contract be awarded to "the lowest responsible bidder furnishing security as required by the board." The court held that this did not authorize the prequalification requirement, saying that it required legislative authority.[107]

The critical issue for legislation is that it provide all the elements that courts have suggested are essential to assure fairness among bidders and promote competition. In this regard, seven main elements comprise the

[102] *See, e.g.,* IDAHO CODE § 54-1910 (2000, 2002 Supp.).

[103] Nancy C. Smith & Linda N. Cunningham, Memorandum, Impact of Licensing Rules on Legal Structure of D-B Contractors, Nossaman Guthner Knox & Elliott LLP, Apr. 11, 2005; available at http://nossaman.com/impact-licensing-rules-legal-structure-db-contractors, last accessed on Nov. 26, 2011.

[104] Pursuant to the requirements of the Administrative Procedure Act (APA) in most states, prequalification requirements are rules of general applications that should be adopted in compliance with the APA, rather than being merely included in standard specifications or statements of agency policy. *See* Department of Transp., State of Fla. v. Blackhawk Quarry of Florida, Inc., 528 So. 2d 447, *review denied*, 536 So. 2d 243 (1988), for a discussion of what type of procedure must be adopted as a rule under the APA rather than included as a contract specification that is not subject to the APA's procedures.

[105] *See* Netherton, *supra* note 1, at 1050, 1055.

[106] 254 N.Y.S. 384, 388, 141 Misc. 902 (Sup. Ct. 1931).

[107] *Id*.

prequalification systems that typically apply to the states' transportation construction contracts.

1. Authority for establishment of prequalification requirements.
2. Definition of the scope of application of the requirements.
3. Designation of the agency responsible for certifying contractor qualification.
4. Description of the evidence of qualification to be submitted to the certifying agency, and procedure therefor.
5. Description of the criteria for evaluating contractor qualification.
6. Establishment of a system of classification for contractors, and methods for rating contractor qualifications.
7. Establishment of bases for revocation or disqualification of contractors' certification, and procedures for review or appeal of such actions.

a. Designation of Responsible Agency

Except where it is part of licensing public contractors, prequalification for highway construction contracts is the responsibility of the state agency that awards those contracts. In those states that combine prequalification with licensing, the licensing agency examines and certifies bidder applicants for the particular classes of work and assigns the capacity ratings it deems them qualified for.

In the majority of states, enabling statutes provide merely that the prequalifying agency shall be the state transportation agency. Taken literally, this may be open to the objection that possible favoritism may exist because the contract-awarding agency is in a position to control who may bid. Therefore, the regulations governing prequalification may specify that certification shall be by or on the recommendation of a separate committee or board appointed for this purpose by the chief administrative officer or governing body of the highway agency. Judicial approval of the use of these advisory bodies to evaluate contractor qualifications has encouraged the adoption of this approach as an alternative to spelling out standards and procedures in excessive detail in enabling legislation.[108]

b. Scope of Requirements

Where limits are placed on the requirements for prequalification of contractors, they generally are stated in terms of minimum amounts of the contracts involved. Also, the prequalification requirement may be impliedly removed for emergency construction work where that work is statutorily exempt from competitive bidding.

Previous qualification in another state generally is considered in evaluating an applicant's experience and past record of performance, but with the single exception of the District of Columbia, out-of-state qualification is not accepted as an alternative to compliance with prequalification requirements.[109]

State laws and policies on prequalification of subcontractors vary. Those that favor subcontractor prequalification point out that the need to assure competency and responsibility in construction work is as great in regard to subcontractors as for prime contractors.[110] One benefit is that prequalification of subcontractors may assist prime contractors in locating potential subcontractors whose work record and financial condition have been documented and evaluated by the agency. Also, where specialty work is contracted for separately, the same specialty contractor may bid as a prime contractor on one project and appear as a subcontractor in another.

These benefits have a practical price for the public works agency that must process the additional volume of subcontractor applications, annual reports, and other paperwork. Specialty contractors include a high proportion of small businesses, of which a certain number may have only minimal experience and capitalization. Transportation agencies may conclude that they cannot effectively monitor the number or range of specialty businesses that may wish to be prequalified, and may prefer instead to let the public interest be protected by the diligence of the prime contractor, backed up by its surety bonding company, each of which has a direct interest in seeing that the contract is performed satisfactorily.

Administration of prequalification programs, regardless of their scope, needs good working definitions of subcontractors for the variety of situations in which it may be necessary to distinguish them from other parties in the construction process. The distinction between subcontractors and employees is one that must be made frequently. This was an issue in *Ro-Med Construction Company v. Clyde M. Bartly Co*. [111] Under Pennsylvania's regulations, contractors on state highway projects were required to use only subcontractors currently prequalified and classified by the DOT. The subcontractor had arranged to have its payroll carried by the prime contractor, and its key personnel listed with nonexistent job titles on the prime contractor's employee list. The genuineness of this apparent employee relationship was further brought into question by evidence of how labor actually was hired and supervised for the project in question. The court concluded that the doubtful employee-subcontractor relations precluded sum-

[108] *See* Harris v. City of Phila., 299 Pa. 473, 149 A. 722 (1930).

[109] While acknowledging savings of time and effort in processing certifications, the Department of Transportation noted that if certification by one state must be accepted by others on full faith and credit, it would be possible for fronts and firms of marginal eligibility to seek certification in states with the least effective programs for screening out ineligible businesses. This type of "forum-shopping" is not consistent with the objectives of the program. *See* 49 C.F.R. §§ 23.51, 23.53, and comments in 48 F.R. 33440 (July 21, 1983).

[110] *See* 30 DEL. CODE ANN. §§ 2502(a) (2001); PG Constr. Co. v. George & Lynch, Inc., 834 F. Supp. 645 (D. Del. 1993).

[111] 411 A.2d 790 (Pa. Super. 1979).

mary judgment on the legality of the contract under the department's prequalification regulations.

Distinctions may also have to be made between subcontractors and fabricators or suppliers of materials and structural units at work sites. Such cases generally turn on whether the party in question performs a substantial part of the contract as a "distinct part of the work" in such a way that it does not contemplate merely furnishing materials or supplying personal service.[112]

When legislation specifies standards to be applied in prequalification, strict construction of the statutory language may limit what a contracting agency can do to modify or change its procedures. Even where emergencies occur, courts are wary of allowing any administrative modification of standards or procedures that may exceed delegated authority. This was the result where the WSDOT attempted to direct the manner in which temporary measures would be taken while a major bridge was being replaced, and included this in the standards for prequalification of bidders on the project.[113] WSDOT decided that a temporary floating structure should be installed to allow traffic operations to be maintained on a state highway while a permanent bridge for the highway was being built at a nearby location. WSDOT had had success with the design and methods used by a particular contractor, and when it published its notice for bids, it modified its usual prequalification criteria to require bidders to show "necessary experience, organization and technical qualifications to design and construct floating structures," and to provide "evidence of previous successful use…of the proposed floating bridge configuration."[114] The proposed configuration, as set forth in the bid specifications, essentially described the methods used by a particular contractor who had done previous work on floating bridges. Under the published criteria, that contractor was the only one qualified to bid, and other interested bidders appealed WSDOT's denial of their prequalification.

The court viewed WSDOT's action as inconsistent with the policy that public contracts must be awarded through competitive bidding. The court held that this policy already was limited by the prequalification standards contained in the state law, and that any attempt to introduce further limitations administratively must be solidly based on legislative authority.[115] Admittedly, this put WSDOT in a difficult position, since its need to replace a major bridge destroyed by storm was both critical and immediate. Under the circumstances, WSDOT concluded that it did not have time to prepare a detailed bridge design and perform the customary engineering analysis before putting it into operational use. Therefore, it selected a solution that already had been demonstrated as safe for public use, and made the previous successful use of that design a requirement for prequalification of bidders. Notwithstanding this rationale, the court held that WSDOT lacked statutory authority to include an additional prequalification requirement, noting that "[b]y choosing to eliminate competent bidders at the prequalification stage, the salutory effect of truly competitive bidding was lost."[116]

c. Evidence of Qualification

Current practice has achieved a substantial degree of standardization regarding the types of evidence contractors must submit to show their qualifications, and the format for their presentation. This result is due mainly to early efforts of the American Association of State Highway and Transportation Officials (AASHTO) and the Associated General Contractors (AGC) to develop uniform definitions for the items of information that were considered to be the minimum necessary to permit reliable contractor prequalification.[117] While most states adhere to a standard request for financial information and history of other projects, some states do have additional information requirements.

Practice varies regarding the necessity for an applicant's financial statement to be prepared by a certified public accountant. Regardless of this requirement, the evidence submitted by an applicant to document its qualifications is subject to verification by the state.[118] However, the agency is not necessarily required to do its own investigation of the contractor's financial status if its submission is incomplete.[119]

Contractor prequalification statements, questionnaires, and related documents may be treated as confidential information by the state officials who receive and handle such documents, so long as disclosure is not required under public disclosure laws.[120]

Once they are determined to be prequalified bidders by the highway agency, contractors are periodically required to give evidence of their continuing eligibility for this status. Generally, this is done annually by submitting information on work performed during the previous year, an updated financial statement, and a description of current personnel and equipment. In addition, transportation agency regulations customarily require prequalified contractors to promptly notify the agency of any significant changes in their circumstances that might affect their capacity to perform work

[112] *See*, *e.g.*, Druml Co. v. Knapp, 6 Wis. 2d 418, 94 N.W.2d 615 (1959).

[113] Manson Constr. and Eng'g Co. v. State, 24 Wash. App. 185, 600 P.2d 643 (1979).

[114] 600 P.2d at 645.

[115] *Id*. at 646.

[116] 600 P.2d at 647.

[117] *See* NETHERTON, *supra* note 1.

[118] Dep't of Labor and Indus. v. Union Paving & Constr. Co., 168 N.J. Super. 19, 401 A.2d 698 (1979).

[119] Kimmel v. Lower Paxton Township, 633 A.2d 1271 (Pa. Commw. 1993) (contractor's failure to include "assets page" was legally disqualifying error that could not be cured after bid opening).

[120] For example, Washington's Public Disclosure Act specifically exempts financial records submitted to the Department of Transportation for the purpose of prequalification. WASH. REV. CODE 42.17.310(1)(m).

for which they have been prequalified. This requirement may be in general terms, or it may be particularized by referring to information called for in the agency's prequalification questionnaire.[121]

Where joint venture bids are planned, the general rule is that all the joint venturers must be prequalified separately, although the combined current capacity of all may be used to determine whether the joint bid will be accepted and considered.[122] In this matter the desires of the joint venturers regarding the percentage of a contract to be charged to the capacity of each of the parties are normally carried out in determining qualification. On the other hand, where two or more firms under the same ownership are combined for purposes of bidding, they are treated as a single entity for qualification and bidding.

The possibility that information obtained and relied on for prequalification of bidders may have secondary legal significance was raised in a Michigan court in *E.F. Solomon v. Department of State Highways and Transportation*.[123] This suit sought to recover liquidated damages withheld from a prime contractor for a work delay resulting from the insolvency of a subcontractor during the course of construction. Under the department's regulations, subcontractors as well as prime contractors were required to be prequalified and to submit evidence of their ability to carry out the work. The prime contractor had selected a paving subcontractor from the department's list of prequalified bidders.

Referring to these prequalification procedures, the plaintiff argued that a warranty of accuracy accompanied prequalification approval and listing by the department, and the plaintiff had reasonably relied on this implied warranty to his detriment. The plaintiff cited cases in which contractor claims were allowed because of reliance on erroneous information supplied by the agency.

While the court might have distinguished these cases, because in each case the state knew the unreliability of the information given to its contractor, it elected instead to meet the issue of an implied warranty of accuracy squarely. It stated that prequalification procedures were "simply a mechanism by which defendant determined who would be allowed to bid on state highway projects," and emphasized that recovery of claims based on misrepresentation of information generally depended on the state having previous knowledge of the prequalified bidders' erroneous character, or else having failed to take appropriate precautions that would have revealed the error in time to avoid it or the consequences of relying on it. The court also cited the state constitutional prohibition against using the credit of the state as a guarantee or surety in favor of a private individual and declared that the contractor's attempt to find an implied warranty of accuracy in the prequalification process would accomplish precisely what the constitution prohibited.

d. Classification of Contractors

The certifying agency generally has a twofold responsibility. First, it must determine what type of construction work each particular contractor is qualified to perform. Second, it must assign to the contractor a maximum limit on the amount of work it has the apparent capacity to perform successfully at one time. The former is generally referred to as a contractor's "classification," and the latter as its "rating." Customarily, the prequalification statute or regulations establish a list of classes of work, and instruct applicants to indicate those classes for which they wish to be certified.

The validity of classification lists, whether statutory or administrative, is likely to depend on their having a reasonably close relationship to the way the transportation agency organizes and advertises work to be performed through contract. Classification lists vary in detail, but generally reflect agreement on certain broad categories of construction, such as excavation and grading, paving, structures, and specialty work of all types. Classification systems that use these categories are readily defensible against possible charges that the certifying agency may arbitrarily and unfairly exclude contractors from bidding on work they desire. Among the categories of work listed, valid distinctions generally can be made on the basis of the types and amounts of equipment needed, the amount of working capital involved in acquiring and processing materials, technical and managerial skills, and organization required. In addition, contractors are not restricted from requesting that they be qualified for new classes of work.

e. Contractor Capacity Ratings

Certification of a contractor's eligibility to bid on public construction work normally includes an evaluation of its capacity to perform such work, and designation of its maximum limit in terms of the total dollar amount of work that the contractor may have underway for the contracting agency at any one time. Capacity ratings are individual, and are based on analysis of the contractor's disclosures regarding its current financial circumstances and other business information. Review of state laws and practices reveals several approaches to this analysis.

In some states, the entire function of rating contractors' capacity is treated as a matter of judgment by the contracting agency. Evaluation of contractors' capacity is based on statements of financial resources, experience, and organization. But inevitably, heavy reliance is placed on the contractor's record of past performance with the agency, and on the safeguard that it must furnish various bonds to indemnify the agency for any default in performance.

A contrasting practice is illustrated in those states where legislation or administrative regulations set forth mandatory formulas for establishing maximum capacity ratings for prospective bidders. Coupled with standard

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[121] E. Smalis Painting Co. v. Commonwealth, Dep't of Transp., 452 A.2d 601 (Pa. Commw. 1982).

[122] *See* OHIO REV. CODE § 5525.03.

[123] 131 Mich. App. 479, 345 N.W.2d 717 (1984).

definitions and uniform accounting procedures, these formulas promote systematic, uniform comparison of contractors' financial resources and other performance factors with a minimum of personal judgment by the rating officer.

Most states determine capacity ratings in a two-stage process. Typically, an applicant contractor's financial resources are initially rated to reflect its presumed ability to finance the construction work called for. Adoption of uniform accounting definitions and procedures permit formulas for financial ratings to become quite precise. But regardless of form, ratings are designed to measure financial responsibility by standards that have practical acceptance in the market place, where the contractor must compete for labor, materials, and technical skill.

Once financial resources are rated, an applicant's maximum capacity rating is established by evaluating its financial condition in conjunction with other relevant factors: (1) the types and amounts of equipment available, (2) the background of key personnel and structure of the organization, (3) previous experience, and (4) record of performance. Application of these factors to the applicant's current financial base may be through use of a multiplier number, or a percentage of a hypothetical perfect standard. Selection of a multiplier or other modifying factor may be based almost entirely on the judgment of the certifying officer, or upon judgment channeled to a prescribed set of factors.[124]

f. Rating First-Time Bidders and Out-of-State Contractors

Because the rating systems described above cannot entirely avoid using judgment based on an applicant's past performance, special problems arise in the evaluation of the capacity of new businesses bidding for the first time and of contractors whose base of operations and work record are outside the state. Because neither type of contractor has established any record of performance with the certifying agency, they may be given ratings of limited capacity until they demonstrate the capacity and reliability of their work.

In the case of out-of-state contractors, the normal practice is to relate their rating to their previous out-of-state experience. For example, the policy of the WSDOT is to award out-of-state contractors an initial prequalification rating of 2.5 times the highest value of the work the contractor has completed within that work class during the past 3 years.[125]

Where the state does not have a formula for rating out-of-state contractors and first time bidders, it must rely on administrative judgment based on information obtained from other agencies. These may be found objectionable because they depend so largely on judgment rather than on objective methods of measuring capacity and competency. Agency judgments may restrict competition or deal unequally with segments of the construction contracting industry. There is no history of litigation challenging these limitations on bidding capacity, and the apparent acceptance of prequalification practice under these rating formulas is largely attributable to a combination of careful initial handling of applications and effective use of administrative appeal procedures in the resolution of disputed ratings.

g. Conclusiveness of Prequalification

Courts are divided on the question of whether an agency may give further consideration to a prequalified contractor's responsibility when it submits a bid. The Alabama Supreme Court has held that the fact that a contractor is prequalified does not necessarily represent a finding of responsibility when a bid is submitted.[126] An Indiana appellate court has held that a bidder is a "responsible bidder" if it is capable of performing the contract fully, has integrity and reliability, and is qualified under the Indiana statute.[127]

5. State Practice Regarding Postqualification of Bidders

The practices of Minnesota, New York, and Rhode Island are based on a policy that favors examining a bidder's competence, financial responsibility, and other qualifications only if it is the low bidder on a public works contract. The proponents of this practice argue that it serves the general objective of encouraging as many contractors as possible to bid on a given project, and assures that the lowest responsible and competent bidder is awarded the contract. They assert that postqualification is more advantageous because it renders judgment on contractor capacity as near to the award of the contract as possible. Events can and do sometimes change a bidder's qualifications within a short time. If an apparent low bidder is postqualified, the most recent developments and current circumstances may be considered, and will assure the best evaluation. Also, for smaller agencies that do less construction, it may be more efficient to evaluate only the low bidder rather than all potential bidders.

Prequalification systems recognize the necessity of evaluating bidders in the light of their current circumstances and prospects. In many states prequalification procedures provide for updating information filed earlier. Advocates of postqualification point to this, however, as a case of duplicating the effort of both the bidder and the contracting agency.

In a New Jersey case, the court considered whether the New Jersey Highway Authority had discretion to use a postqualification process in a contract for towing services on state highways. In *Sevell's Auto Body Company, Inc. v. New Jersey Highway Authority,* [128] the

[124] *See* NETHERTON, *supra* note 1.

[125] WASH. ADMIN. CODE § 469-16-120(5).

[126] Crest Constr. Corp. v. Shelby County Bd. of Educ., 612 So. 2d 425 (Ala. 1992) (citing ALA. CODE § 41-16-50).

[127] Koester Contracting, Inc. v. Board of Comm'rs of Warrick County, 619 N.E.2d 587 (Ind. App. 1993) (citing A.I.C. 36-1-12-4(b)(8)).

[128] 703 A.2d 948 (N.J. Super. 1997).

state sought to enter into a contract for towing services on state highways. The provision in the specifications allowing postqualification of bidders was challenged. The court held that the specification did not conflict with the principle that a bidder may not agree to supply an essential element of its bid after bids are opened. Bidders were required to meet detailed standards on the bid submission date, and were required to submit with their bids a certification stating that they were in full compliance with those standards as of that date.

After low bidders for each zone were identified, they were asked to submit evidence of qualification. The court held that the agency's decision to use this method was an appropriate exercise of its discretion, in that it sought to minimize the administrative burden for itself and bidders while at the same time assuring that all bidders were competing on an equal basis.

6. Disadvantages Faced by Postqualification States

While postqualification provides for open access to participation in competitive bidding by the largest possible selection of firms and avoids the necessity of investigating the responsibility of construction firms unless and until a firm is the lowest bidder for a government construction contract, this approach to determining contractor responsibility also involves some significant potential disadvantages for the state DOTs or other public owners involved.

The postqualification approach appears to be implicitly based on the assumption that the need for competition, considerations of justice, and other factors involving the public interest require that agencies open contract lettings to the broadest possible group of potential bidders and give any firm consideration on a *de novo* basis any time it submits a low bid, even if it has significant legal, financial, or other responsibility problems.

A criminal conviction, for example, does not automatically dictate that a contractor must be found nonresponsible. Bidders for contracts, even those whose records include a criminal conviction, are entitled to due process before a DOT in a postqualification state determines whether to accept or reject their low bid. The state DOT may be able to resolve concerns about a firm's responsibility by imposing conditions on a contract award, such as requirements that all convicted officers or directors place their stock in a blind trust and remove themselves from management of the company, or that the company retain at its own expense an IPSIG or Monitor to prevent or deter any further misconduct. In addition, the public agency in its discretion, after giving due consideration to a conviction, may award the contract for other specific reasons. Various state DOTs have had experience, and some successes, with this approach.

There are, however, some significant potential disadvantages to this postqualification system. State DOTs operating solely under "lowest responsible bidder" contract award statutes, without the benefit of prequalification authority, cannot automatically comply with USDOT suspensions and debarments, even for firms that have been indicted or convicted for serious criminal offenses directly involving government contracting, and even when the state DOT concludes that the nature and severity of the criminal conduct, and the degree of moral turpitude involved, would make any award to such a firm against the public interest. Instead, each time they let contracts, they must receive and open bids from such firms, make an initial announcement that such a contractor is the apparent low bidder for a government construction contract, and then afford the contractor notice and an opportunity to be heard on the issue of whether the contractor is "responsible" within the meaning of the state's "lowest responsible bidder" statute. To comport with constitutional due process requirements, a federal debarment cannot be considered to be conclusive and automatically dispositive evidence in such a matter; it must be treated as merely evidence to be considered in the application of state law. On federal-aid projects, this forces the state DOT to go beyond merely reciting a prior history of a criminal conviction and federal debarment and build an administrative record that will withstand state judicial review before rejecting the bidder as non-responsible; or, in the alternative, face the near certainty that FHWA will withdraw the federal-aid funding from the project if the state fails to find the low bidder non-responsible and reject the firm's bid in favor of another firm that has submitted a higher bid.

The issue is not simply that state DOTs or other public owners lacking debarment authority must handle such a situation on a case-by-case basis. Even a firm from which a state DOT has previously rejected bids as nonresponsible can continue to bid on further projects. This gives nonresponsible contractors and their attorneys multiple ongoing opportunities to change organizational arrangements, to test and challenge the state DOT's stated rationale for finding the firm nonresponsible, and then to initiate legal proceedings in an effort to persuade not just the state DOT, but the state courts reviewing their actions, that the state DOT lacks sufficient evidence in the record to justify depriving contractors of major contracts. Aside from the risk of losing a court ruling in such a case, state DOTs or other public owners engaged in such litigation face a considerable administrative burden in working with their litigation attorneys to justify their decisions in court repeatedly on an ongoing basis.

7. Subcontractor Responsibility, State Review, and Approval of Subcontractors

State transportation agencies focus significant attention on contractor qualification, capacity, and responsibility. Attention should also be focused on subcontractors. Federal regulations (23 C.F.R. § 635.116) require that before any contract work is to be performed under a subcontract, it must be authorized in writing by the state highway agency. The regulations also mandate that the state highway agency assure that each subcontract contains all the pertinent provisions and require-

ments for the prime contract, such as the form FHWA-1273. Other regulations (23 C.F.R. 625.116 (a)) specify that not less than 30 percent of the total original contract must be performed by the prime contractor, exclusive of identified specialty items. Aside from these provisions, there are no regulations (aside from DBE regulations) that relate to subcontractor approval.

Disclosure of subcontractor approval often occurs after the contract has been signed and awarded. However, the Oregon Department of Transportation requires that the name of the subcontractor be disclosed within 2 working hours after the advertised bid closing time. Failure to submit the form by the disclosure deadline will result in a nonresponsive bid which will not be considered for award.[129]

Our research has found no uniform state subcontractor approval process. Each state adheres to its own individual statutory requirements and state processes.

Many states, prior to approving the prime contractor's request to subcontract, review the Excluded Parties List maintained by GSA to determine whether the proposed subcontractor is federally debarred or under suspension so as to avoid jeopardizing federal funding for the project. Some state agencies require the subcontractor to be prequalified using their state's prequalification process, while postqualification states review their internal records to ascertain if there is a cause for any concern. One postqualification state agency, NYSDOT, will check the GSA's Exluded Parties List and will also review corporate status, debarment, and willful violation lists maintained by the New York State Department of Labor and records of Occupational Safety and Health Administration (OSHA) violations. In addition, NYSDOT ascertains if the subcontractor resides in a discriminatory jurisdiction, which may require additional approvals. Further, NYSDOT will also review its own internal list of firms with known responsibility issues to determine whether there is any cause for concern. If the review raises any concerns, the contractor and the proposed subcontractor will be informed and given an opportunity to address and respond to these concerns and issues prior to NYSDOT's determining whether to approve or disapprove the request for permission to subcontract.

B. SUSPENSION AND DEBARMENT OF CONSTRUCTION CONTRACTORS; LICENSE REVOCATION; DISQUALIFICATION

1. USDOT Suspension and Debarment from Federal-Aid Programs

In reviewing potential contract awards and/or subcontractor approvals on federal-aid highway and bridge projects, state DOT officials must determine whether the apparent low bidder, chosen RFP responder, or proposed subcontractor is subject to a USDOT suspension or debarment from participation in federal-aid construction programs. Since USDOT suspensions and debarments have uniform nationwide application, USDOT suspensions and debarments have much broader impacts on firms that engage in business in more than one state than on any license revocation, disqualification, revocation of prequalification, or suspension or debarment actions undertaken by the officials of any individual state.

a. USDOT Suspension and Debarment Regulations: 2 C.F.R. Part 1200

USDOT undertakes the suspension or debarment of contractors, subcontractors, and other firms from federal-aid construction programs pursuant to USDOT's debarment regulations. USDOT has had suspension and debarment regulations in effect since 1984.[130] Since 2008, these have been codified as 2 C.F.R. Part 1200.[131]

USDOT does not suspend or debar contractors in a vacuum. Federal suspensions and debarments are subject to Executive Order 12549 of 1986 and Executive Order 12689 of 1989 and also to regulations of OMB, 2 C.F.R. Part 180. USDOT has adopted the OMB regulations, 2 C.F.R. Part 180 Subparts A through I as the USDOT policies and procedures governing USDOT suspensions and debarments.[132] USDOT suspensions and debarments apply to all contracts and subcontracts, regardless of tier, funded by USDOT and expected to equal or exceed $25,000 and also to all contracts governed by 2 C.F.R. §180.220(b) of the OMB regulations.[133] The USDOT regulations apply not only to contractors and subcontractors, but also to any participant in a covered transaction as defined by the OMB regulations, apparently including state DOT officials involved in the funding, award, and administration of federal-aid state contracts.[134]

The USDOT regulations require state DOTs, prime contractors, and subcontractors to pass the USDOT suspension and debarment requirements down to all contractors, subcontractors, and lower-tier subcontractors, by including in all contracts and subcontracts provisions requiring such participants to comply with 2 C.F.R. Part 180 Subpart C, and requiring such participants to include a similar term or condition in lower-tier covered transactions.[135]

It may be possible for a state DOT that is so inclined to obtain from USDOT an exception permitting an excluded contractor or subcontractor to participate in a

[129] OAR § 279C.370, First Tier Subcontractor Disclosure.

[130] *See* former 49 C.F.R. pt. 29, adopted in 1984; 49 Fed. Reg. 15,197 (Apr. 18, 1984).

[131] *See* 2 C.F.R. pt. 1200. For statutory authority, see 31 U.S.C. § 6101 Note, Pub. L. No. 103-355 § 2455, 108 Stat. 3243, 3327 (1994). For rulemaking adopting 2 C.F.R. pt. 1200 and repealing former 49 C.F.R. pt. 29, *see* 73 Fed. Reg. 24139 (May 2, 2008).

[132] 2 C.F.R. §§ 1200.10 and 1200.30.

[133] 2 C.F.R. § 1200.220.

[134] 2 C.F.R. § 1200.20.

[135] See 2 C.F.R. §§ 180.435, 1200.332, and 1200.437.

particular federal-aid project. The USDOT regulations authorize such exceptions to be granted by the heads of USDOT's various operating administrations, which include FHWA, and other persons to whom the heads of such operating administrations may delegate such authority.[136] As a practical matter, any state DOT seeking such an exception will probably need to do so not only through the appropriate FHWA Division Office, but also through those officials of the USDOT Office of Inspector General (OIG) handling FHWA matters.

b. Issues Addressed During 2008 Rulemaking

During 2008, USDOT undertook a rulemaking to repeal and replace its former 49 C.F.R. Part 29 suspension and debarment regulations with the current 2 C.F.R. Part 1200 suspension and debarment regulations.[137] In the course of doing so, USDOT addressed a variety of specific issues. These issues included, among other things, a government-wide federal initiative to consolidate all federal agencies' formerly separate suspension and debarment regulations into 2 C.F.R.; the adoption of OMB's regulations, 2 C.F.R. Part 180, as governing the policies and procedures to be followed in suspension and debarment proceedings; the availability of a procedure for seeking exceptions from USDOT; the applicability of USDOT's suspension and debarment requirements to all subcontracts, regardless of tier, over $25,000; the responsibility of all participants, including state DOTs, prime contractors, and subcontractors, to notify lower-tier participants of USDOT's suspension and debarment requirements; and the responsibility of state DOTs to inform prime contractors of the requirements of 2 C.F.R. §180.435.

c. Implementation Issues [138]

Any state DOT attempt to award a federal-aid contract to a firm under USDOT suspension or debarment, absent the grant of an FHWA exception expressly authorizing such an action, would involve substantial risks. FHWA could not only withhold the FHWA consent required to award such a contract, but it could also withdraw federal-aid funding from a project even if such funding had previously been approved. Even were such a situation not to come to FHWA's attention until after a state DOT had awarded the contract and the contractor had already commenced work, FHWA could retroactively withdraw all remaining federal-aid funding for the project and potentially seek to recover any federal-aid funds previously paid out under the contract, leaving both the state DOT and the contractor without the federal funding necessary to pay for any work already performed or to continue the project.

USDOT and FHWA take the suspension and debarment program quite seriously, and this program has received concerted attention from USDOT and FHWA management in recent years. The enactment of ARRA[139] and FERA[140] led the USDOT OIG to conduct a further review of USDOT's suspension and debarment program, beyond the revisions to that program made by the rulemaking in 2008. In May 2009, OIG issued an ARRA Advisory concerning the suspension and debarment program,[141] and in January 2010 OIG issued a more detailed audit report on that program.[142] These reviews considered ways to strengthen the program's effectiveness.

OIG's May 18, 2009, ARRA Advisory concerning the suspension and debarment program noted deficiencies that could leave USDOT potentially vulnerable to doing business with irresponsible businesses and individuals.[143] This Advisory noted a lack of adherence to USDOT policy time frames and a lack of oversight. OIG's more detailed audit report, issued in 2010, focused on increased risks that USDOT and other agencies might award contracts and grants to parties that USDOT would ultimately suspend and debar and on other weaknesses in USDOT's policies and procedures and internal controls.[144]

The 2010 audit report referred, for example, to a case in which the Commonwealth of Kentucky had awarded a $24-million contract in ARRA funds to a company that could have been suspended based upon indictments under USDOT's policy and Code of Federal Regulations. FHWA commented that the available evidence was not legally sufficient. The report and the authors noted that the FHWA's Chief Counsel had cited recent action to improve the processing of suspension and debarment cases, which included developing an action plan and dedication of more staff to this effort, steps to expedite cases, and efforts to reduce the backlog to meet the 45-day contract award time period.[145]

2. State Suspension and Debarment

Where prequalification statutes permit consideration of factors bearing on bidder responsibility as well as ability and capacity, prequalification and debarment

[136] 2 C.F.R. § 1200.137.

[137] 73 Fed. Reg. 24,139 (May 2, 2008).

[138] FHWA memorandum, Relocation and Amendment of Nonprocurement Suspension/Debarment Regulations, June 12, 2008, http://www.fhwa.dot.gov/construction/contracts/080612.pdf.

[139] American Recovery and Reinvestment Act of 2008, Pub. L. No. 111-5, 123 Stat. 115 (2009).

[140] FERA, Pub. L. No. 111-21, 123 Stat 1617 (2009); text available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ21/pdf/PLAW-111publ21.pdf (last accessed June 12, 2010).

[141] USDOT OIG, *supra* note 35.

[142] *See* USDOT OIG Report No. ZA-2010-034, *Final Report on the Department of Transportation's Suspension and Debarment Program*, Jan. 7, 2010, available at http://www.oig.dot.gov/library-item/5255 (last accessed on June 11, 2010).

[143] USDOT OIG, *supra* note 35.

[144] *See* USDOT OIG, *supra* note 36.

[145] *Id.*; and address of Tom Holian, FHWA Chief Counsel, to TRB Annual Meeting, Jan. 12, 2010.

tend to be used as complementary processes. Contractors' efforts to assert a right to do business with public agencies have succeeded in some states, and have resulted in some procedural limits on agency discretion in debarment actions.[146]

Legislative authority for prequalification of bidders normally includes authority for the certifying agency to suspend or revoke a contractor's certification for various enumerated causes and "for other good cause."[147] Consistent with their basic approach to review of administrative actions, courts generally are not inclined to second-guess the decision of an executive agency on its merits in the absence of a showing of fraud, bad faith, or arbitrary action. Yet because prequalification directly affects the right to have one's bid considered for a contract award, disciplinary action that results in suspension or revocation of a bidder's eligibility is taken seriously by all interested parties. Recognizing that the right to engage in business has important economic consequences, courts have insisted that disciplinary actions against qualified bidders must be handled in accordance with rules that assure fairness and equal treatment. Actions must be taken in strict compliance with applicable statutes and administrative regulations.

This is illustrated in *White Construction Company, Inc. v. Division of Administration, State Department of Transportation*.[148] In that case the prequalifying agency notified a contractor of its temporary suspension by letter from the agency's Director of Road Operations, citing apparent failures to follow certain procedures on the work site and relying on statutory authority to suspend for good cause. In an action for mandamus to restore the contractor's bidding status, the Florida Supreme Court found that the agency's intended suspension was not effective because it was not issued by the Secretary of Transportation, as required by the statute.[149]

The court in *White Construction Company* made it clear that where prequalification authority is conferred by statute, and the certifying agency promulgates rules, the agency must fully comply with those rules.[150] Similarly, contractors must comply with these rules in order to protect their rights. For example, failure to make timely application for administrative review of a suspension order has resulted in a holding that the right to such a hearing was waived.[151] Likewise, a contractor was found to have not timely filed exceptions to the administrative law judge's decision where it mailed them on the last day of the applicable time period.[152]

a. Failure to Update Prequalification Records

Agencies may require the contractor to update or supplement its prequalification questionnaire or to notify the agency of significant changes in its status. For either type of requirement, however, interpretations of their scope differ. This is illustrated in *E. Smalis Painting Company v. Commonwealth, Department of Transportation.*[153] Department prequalification regulations required contractors to submit a statement of any felony convictions of its directors, principal officers, or key personnel, and also to notify the department of any changes in that information. Based on these requirements, and acting on information from a local prosecuting attorney's office that the petitioner's president had been convicted of a felony and was awaiting sentencing, the department suspended the contractor.

In contesting the suspension, the petitioner argued that the duty to submit a report of the conviction did not arise until sentencing was completed. The court disagreed. While conceding that the term "conviction" had both a popular usage and a technical usage, and that the technical usage should be used unless it would defeat the apparent intent of the law, the court felt that in this instance "conviction" was to be understood as meaning a verdict of guilty or a plea of guilty.[154]

b. Debarment for Failure to Pay Prevailing Wages

In the mid-1930s, the Davis-Bacon Act was amended to provide that where a firm was found to have disregarded its obligation to pay prevailing wages to employees, no contract would be awarded to that firm for 3 years from the date of publication of the list containing the name of the firm.[155] Several courts have held that failure to pay prevailing wages is grounds for debarment. In *Electrical Contractors v. Tianti*, the contractor was debarred for 3 years for failure to pay prevailing wages, even though the failure was found to be negligent rather than intentional.[156] In other cases, the violation of the prevailing wage requirement was found to be willful and therefore a basis for debarment.[157] In considering a claim that the bidder had violated overtime provisions, however, a court found that where the

[146] Sameena, Inc. v. United States Air Force, 147 F.3d 1148 (9th Cir. 1998) (contractor was entitled to notice and a hearing before being debarred).

[147] *See, e.g.,* Lawrence Aviation Indus. v. Reich, 28 F. Supp. 2d 728 (E.D. N.Y. 1998) (failure to promptly pay award of backpay and prejudgment interest to victims of sexual discrimination in hiring was grounds for debarment).

[148] 281 So. 2d 194 (Fla. 1973).

[149] 281 So. 2d at 197.

[150] 281 So. 2d at 197.

[151] Dickerson, Inc. v. Rose, 398 So. 2d 922 (Fla. App. 1981); Latrobe Road Constr. Inc. v. Com. Dep't of Transp., 107 Pa. Commw. 54, 527 A.2d 214, *appeal denied*, 536 A.2d 1335 (1987) (failure to raise issue of whether prequalification provisions violated due process was waived when not raised before agency review board).

[152] State Board of Registration v. Brinker, 948 P.2d 96 (Colo. App. 1997).

[153] 452 A.2d 601 (Pa. Commw. 1982).

[154] *Id*. at 602.

[155] 40 U.S.C.A. § 3144 (6 (2003); 29 C.F.R. pt. 5 (2000)).

[156] 613 A.2d 281, 223 Conn. 573 (1992).

[157] Hull Corp. v. Hartnett, 568 N.Y.S.2d 884, 77 N.Y.2d 475, 571 N.E.2d 54 (1991).

violation was not willful it did not render the contractor ineligible to bid.[158]

In *Copper Plumbing & Heating Company v. Campbell*, the Secretary of Labor's power to debar for wage law violations was challenged.[159] The court found that the regulations were not "penal" in nature and were necessary for effectuating compliance with and furtherance of the public policy represented by the labor acts. *Janik Paving & Construction v. Brock* also discussed the power of the Secretary of Labor to debar and cause such debarment to be listed with the Comptroller General.[160]

c. Other Grounds for Suspension and Debarment

Several other statutory grounds for debarments relating to misconduct, such as bribery of public officials, fraud in the procurement of public contracts, or violation of the Buy America Act, were enacted at the federal and state levels starting in the 1930s and continuing up to the present.[161] Additional statutes did not specify suspension or debarment for violation, but such powers were found to be inherent within the powers to establish a program or the regulations to effectuate a program. For example, *L.P. Stewart & Bro., Inc. v. Bowles* dealt with presidential power under the Second War Powers Act.[162] The court determined that the President had the power to allocate materials or facilities, of which requirements for national defense created a shortage, in such manner, upon such conditions, and to such extent as he deemed necessary or appropriate in the public interest. This included the power to issue suspension orders against those who did not comply with the program.

i. Antitrust.—If the contractor has been found to have violated the antitrust laws, a suspension or debarment proceeding may be undertaken at the federal level and possibly at the state level. However, the following situations may result in nonresponsibility determinations prior to the actual suspension or debarment:

1. The antitrust matter predated the practice of having suspension or debarment proceedings at the federal level following conviction for antitrust violations;
2. There is or was insufficient evidence for criminal conviction, but there is sufficient evidence to find a contractor to be "nonresponsible";
3. The prosecutors strike a deal with the contractor, in exchange for plea bargaining or testimony, that suspension or debarment will not take place at the federal level;
4. The contractor is named as an unindicted coconspirator and there is no recovery for antitrust based on a civil action;
5. An antitrust indictment has been rendered against the contractor;
6. Principals of a firm were convicted of antitrust violations while they were with another firm and no suspension or debarment proceeding was undertaken against those principals on an individual basis;[163]
7. The parent or the holding company of the contractor has been found guilty of antitrust violations somewhere else in the country.[164]

ii. Collusive Bidding.—Public policy favoring award of public contracts through competitive bidding serves the interest of the contracting agency by assuring that it obtains needed goods and services at fair prices, and serves the interest of contractors by assuring that all bidders will have equal opportunity to bid and receive equal treatment in consideration of their proposals. This policy is implicit in statutes and regulations directing that competitive bidding be used, and is explicitly implemented in legislation prohibiting fraud and combinations in restraint of trade and competition. All these interests are endangered when there is collusion among bidders to submit noncompetitive or rigged proposals, or otherwise restrict competition and thereafter conceal the fact that such an unfair advantage exists.

Collusion of this sort may take the form of agreements among bidders to submit proposals that are artificially high, or to submit identical bids, or for some bidders to withhold or withdraw their bids in favor of others. The damaging effects of contractor combinations may sometimes be less direct and obvious.

Instances of unpermitted collusion in bidding are usually thought of in terms of restricting competition by secret arrangements among bidders. However, the issue may arise through arrangements between contractors and public agencies. Collusive contracting was charged where a municipality leased a parking lot from an attorney who did work for the city, where it obtained insurance from a company in which the mayor owned stock and was employed, and where it deposited funds in banks where city officials served as director. Under these circumstances, it was held that the purchase of insurance from a company employing the mayor was the only act that violated the state's competitive bidding requirement. The other actions were held to not constitute prohibited forms of collusion in public bidding.[165]

Where there is evidence of a conspiracy to subvert a statutory requirement for award to the lowest responsible bidder through competitive bidding, the criminal nature and consequences of the conspiracy cannot be

[158] Hull-Hazard, Inc. v. Roberts, 517 N.Y.S.2d 824, 129 A.D. 2d 348, *aff'd*, 532 N.Y.S.2d 748, 72 N.Y.2d 900, 528 N.E.2d 1221(1988).

[159] 290 F.2d 368 (D.C. Cir. 1961).

[160] 828 F.2d 84 (2d Cir. 1987).

[161] *See, e.g.,* 41 U.S.C. § 106.

[162] 322 U.S. 398, 64 S. Ct. 1097, 88 L. Ed. 1350 (1944).

[163] State of N.Y. v. Hendrickson Bros., 840 F.2d 1065 (2d Cir. 1988), *cert. denied*, 488 U.S. 848, 102 L. Ed. 2d 101, 109 S. Ct. 129 (1988).

[164] *See* HARP, *supra* note 1, at 1124-N-22, 23.

[165] McCloud v. City of Cadiz, 548 S.W.2d 158 (Ky. App. 1977).

avoided by reliance on the contracting authority's statutory right to reject any or all bids "if it is in the public interest to do so."[166]

iii. Improper or Unethical Conduct.—In connection with the DBE program, many situations arise where the contractor has transactions with a DBE firm that is later decertified or otherwise loses its status for fraud or illegal conduct. Some states have tried to undertake corrective action against the contractors who have transacted business with these DBE firms by finding the contractor "nonresponsible," entering into corrective action agreements, or attempting to suspend or debar the contractor. Such situations include:

1. The contractor has set up a DBE firm with which it deals exclusively (a front for the contractor).
2. The contractor has dealt with a DBE that it should reasonably know is a front based on the manner in which the DBE conducts its business.
3. The contractor has dealt with a DBE that it should reasonably know is not rendering a "commercially useful purpose."
4. The contractor has performed the DBE's work and given the DBE a percentage of the contract price.

Among the types of misconduct to which federal debarment regulations apply are fraud, deceit, or other actions indicating serious lack of business integrity or honesty with respect to the eligibility of firms to participate in the DBE, WBE, or MBE programs. For example, a firm may be suspended or debarred if it acts as or knowingly makes use of a "front" company (i.e., a firm that is not really owned and controlled by minority or disadvantaged individuals or women, but poses as such to participate as a DBE in a federally assisted contract). Even in the absence of a specific false statement that would subject a party to criminal liability under 18 U.S.C. § 1001 (the federal "false statements" statute), a firm that acts as or uses a front may justifiably be viewed by acting so as to indicate a serious lack of business integrity or honesty.[167]

USDOT's DBE regulations indicate that DBE violations may result in USDOT suspension and debarment proceedings, or in a referral to the U.S. Department of Justice for a criminal investigation.[168] When the DBE rules were rewritten in 1999, the provisions for possible suspension and debarment were retained.[169]

Violations may also result in potential criminal action and/or debarment by the state involved. However, if the violation pertains to the federal DBE program, it is more likely to involve only a federal debarment unless the state has by statute also adopted or duplicated the federal program. To the extent that DBE violations also transgress state criminal statutes, independent or concurrent remedies could exist.

d. Right to Due Process in the Suspension, Debarment, or Disqualification Process

The law does not recognize that a contractor has a legally protected right to bid and be awarded a public contract merely because its qualifications as a potential bidder have been certified. However, revocation of a certificate of qualification is in the nature of a license revocation and is subject to due process requirements.[170] Thus, a certificate holder is entitled to notice and a hearing at which its representatives may explain or rebut the evidence giving rise to the agency's action.

Because the bidding and award process is based entirely on statutory authority, departmental administrative proceedings leading to suspension or debarment must adhere strictly to statutory requirements. Thus, statutes have been construed to require that contractors may be disqualified for unintentional violations of the law as well as for intentional actions.[171] Also, jurisdiction and authority for debarment by a contracting agency has had to be specifically authorized in applicable statutes.[172] Administrative proceedings must include the keeping of records showing that all jurisdictional elements of the case were addressed and sustained by factual findings developed in accordance with statutes and regulations.[173]

Under USDOT's new regulations, 2 C.F.R. Part 1200, suspension and debarment of highway construction contractors and subcontractors on federal projects are governed by the Governmentwide Debarment and Suspension (Nonprocurement) process, adopted in accordance with the rule-making provisions of the federal Administrative Procedure Act.[174] With respect to debarments, suspensions, or disqualifications at the federal level, when the appropriate processes provided for within the rules are followed, due process challenges to

[166] Commonwealth v. Gill, 5 Mass. App. 337, 363 N.E.2d 267 (1977).

[167] 50 F.R. 18493 (May 1, 1985).

[168] *Id*.

[169] 49 C.F.R. § 26.107 (2000).

[170] Capeletti Bros. v. State Dep't of Transp., 362 So. 2d 346 (Fla. App. 1978) (delinquency on prior state contract); North Central Util. v. Walker Community Water Systems, Inc., 437 So. 2d 922 (La. App. 1983) (failure to comply with public bid law); Seacoast Constr. Corp. v. Lockport Urban Renewal Agency, 339 N.Y.S.2d 188 (1972) (lack of qualification and experience record); Couch Constr. Co. v. Dep't of Transp., 361 So. 2d 172 (Fla. App. 1978) (failure to attend pre-bid conference).

[171] Dep't of Labor and Indus., Div. of Workplace Standards v. Union Paving and Constr. Co., 168 N.J. Super. 19, 401 A.2d 698 (1979) (repeated violations of prevailing wage laws).

[172] Dep't of Labor v. Berlanti, 196 N.J. Super. 122, 481 A.2d 830 (1984).

[173] Dep't of Labor v. Berlanti, 196 N.J. Super. 122, 481 A.2d 830 (1984); Seacoast Contr. Corp. v. Lockport Urban Renewal Agency, 339 N.Y.S.2d 188 (1972); Dep't of Labor and Indus., Div. of Workplace Standards v. Union Paving and Constr. Co., 168 N.J. Super. 19, 401 A.2d 698 (1979); Capeletti Bros. v. State Dep't of Transp., 362 So. 2d 346 (Fla. App. 1978).

[174] 5 U.S.C. § 700 *et seq.*

the validity of such actions have relatively little chance of succeeding.

The USDOT's suspensions or debarments of highway construction contractors undertaken pursuant to 2 C.F.R. Part 1200 are serious actions. In order to be eligible to receive federal aid for transportation projects, the states must abide by the federal actions or lose the federal aid.[175] In addition, consistent action by the states complements and effectuates the federal action. Federal suspension or debarment regulations also require that the General Services Administration (GSA) "shall compile, maintain, and distribute a list of all persons who have been debarred, suspended, or voluntarily excluded by agencies under Executive Order 12549 and these regulations, and those who have been determined to be ineligible."[176]

However, state action of suspension or debarment cannot be undertaken by relying solely on federal suspension or debarment when states are administering projects with federal-aid, as doing so would violate the contractor's right to a hearing before the state agency. State agencies should not use the Federal Government's consolidated lists of suspensions, debarments, or disqualifications without considering the matter at the state level in an appropriate due process fashion. A violation of the contractor's rights may be found where one agency uses a clearinghouse or consolidated list of agency determinations to take a new adverse action against the contractor or subcontractor, without giving the contractor any hearing or opportunity to rebut. Unless there are clear statutory authorizations that permit or authorize the list to be used to suspend, debar, or disqualify a contractor or subcontractor, clearinghouse lists should be used only to alert governmental agencies at the state level that there is some question of the contractor's or subcontractor's status. There must then be a review that complies with due process before a deprivation of rights takes place.

i. De Facto Debarment.—When responsibility determinations are made in case-by-case reviews, contractors have claimed that they were subjected to de facto debarment. However, the courts have upheld determinations of nonresponsibility even where such decisions were repeated several times based on the same facts, as long as an opportunity was given to the contractor each time to show corrective action. This issue was addressed in *Callanan Industries v. White*, [177] where the court stated:

> The ability of the Department to reject bids of irresponsible bidders is not frustrated by its inability to debar future bids. Once the Department finds a bidder to be irresponsible for a particular reason, assuming that such a finding was not arbitrary or capricious, it could proceed to reject each of that bidder's future bids, in effect creating the sort of debarment accomplished in the instant case. However, this would force the Department to consider anew the bidder's responsibility upon each bid and presumably, change its position when and if the bidder remedies the cause of the finding of irresponsibility.

ii. Compliance with Rule-Making.—Callanan addressed both the authorization to debar or suspend at the state level and the requirements of a rule-making process under a state Administrative Procedure Act. The New York State Department of Transportation was concerned about Callanan's business relationship with two DBE firms. These firms, one of which Callanan had established, were found to be frauds and guilty of misconduct in the DBE program and were decertified. The next time Callanan was the lower bidder, the Department challenged the firm's honesty, integrity, good faith, and fair dealings and indicated that the firm should show good cause why the award should be made to it for that project. The Department also declared its intention to suspend or debar the firm for up to 3 years for its past conduct. The Department set forth in its Manual of Administrative Procedures (MAP), a copy of which was given to Callanan with the notice, the notice requirements and the criteria that should be applied in any suspension or debarment decision. The MAP also established a Contract Review Unit (CRU) to effectuate the MAP process relative to contract awards and approvals. Prior to the meeting between the CRU and Callanan, the firm submitted the apparent low bid on another project and that too was reviewed by the CRU.

At the meeting, Callanan's attorney did not address the contractor's misconduct but, instead, challenged the authority of the CRU. After the meeting, the CRU determined on January 3, 1986, that Callanan should be debarred from receiving awards of future projects and from participating as a subcontractor, supplier, or provider of labor on future contracts for a period of 30 months.[178]

The MAP was not promulgated as a rule under the State Administrative Procedure Act. The Department considered the procedures to be internal guidelines to assist the CRU's decision-making process. The procedures did not dictate a particular result, but rather set out what should be considered by the CRU. The Department also did not have express legislative authority to suspend or debar contractors, but assumed it had such power from the legislative direction to award contracts only to the lowest responsible contractor as would best promote the public interest.[179]

The court considered the main issue to be "whether the Department had the authority to provide for a means of debarring or suspending bidders on the ground of irresponsibility."[180]

[175] *See* Required Contract Provisions, Federal-Aid Construction Contracts, Form FHWA-1273 Part XI, Certification Regarding Debarment, Suspension, Ineligibility and Voluntary Exclusion (modified June 22, 1999).

[176] 49 C.F.R. § 29.500 (2001).

[177] 118 A.D. 2d 167, 503 N.Y.S.2d 930, 933, *motion to modify denied*, 123 A.D. 2d 462, 506 N.Y.S.2D 287, *appeal denied*, 69 N.Y.2d 601 (1987).

[178] *Id.* 503 N.Y.S.2d at 932.

[179] *Id*.

[180] *Id*.

> [T]he authority given the Department with regard to awarding of contracts is in terms of rejecting or accepting bids. Certainly, the Department can and should consider past conduct by a bidder in making its decision as to whether the bidder on a particular contract is responsible…
>
> However, in no statute has the Legislature granted the Department the authority to commence any sort of proceeding for the purpose of punishing an irresponsible bidder or debarring such a bidder from submitting bids in the future.
>
> The power to investigate violations of a statute and to punish violators is a significant power and is penal in nature.[181]

The court found that debarment was a punishment and, therefore, must be based on specific and express legislative terms with appropriate procedural safeguards before debarment can be undertaken. The court also concluded, "Nor can the power to debar bidders be necessarily implied from the authority to reject bids made by irresponsible bidders."[182]

The court also held that the debarment provisions were invalid because they were not adopted pursuant to the state Administrative Procedure Act. Where an administrator is undertaking some action relative to suspension, debarment, or disqualification of a contractor, the right affected will be deemed to be either a "property right" or a "liberty right," or both. Therefore, the process must be subjected to appropriate rule-making.[183] Where the rules have been properly adopted, the suspension or debarment will be upheld if it is supported by substantial evidence.[184]

Due process requirements relative to suspension, debarment, or disqualification of highway construction contractors at both the federal and state levels are now well established. The deprivation of a right, even on a temporary basis, must meet the constitutional requirement of notice and a meaningful opportunity to respond before the deprivation takes effect. At a minimum, this involves the right to be informed of the nature of the charges and of the relevant supporting evidence. In determining the adequacy of the deprivation procedures, there must be consideration of the government's interest in imposing the deprivation, the private interests of those affected by the deprivation, the risk of erroneous deprivations through the challenged procedures, and the probable value of additional or substitute procedural safeguards.

Some cases state that depending on the circumstances and the interests at stake, an evidentiary hearing may be required before a legitimate entitlement may be terminated or suspended.[185] In more recent cases, the Supreme Court has held that procedures will be sufficient, even though they provide for less than a full evidentiary hearing, as long as they do provide for some kind of a hearing or meeting that ensures an effective initial check against mistaken decisions before the deprivation occurs, in addition to a prompt opportunity for complete administrative and possibly judicial review after the deprivation.[186]

Brock v. Roadway Express[187] brought much of the prior law on the requirements of due process in connection with deprivation of a right into focus. That case involved the temporary reinstatement with back pay of a truck driver who claimed that he was discharged in retaliation for complaining about safety violations. The Secretary of Transportation, pursuant to Section 405 of the Surface Transportation Assistance Act of 1982, ordered the reinstatement of the truck driver with back pay pending a final determination on his complaint.[188] The central issue of the case was whether the Secretary of Transportation had provided Roadway appropriate due process when the driver's reinstatement and back pay were imposed on Roadway by the Secretary. Roadway was notified of the driver's charge and given an opportunity to meet with personnel in the Secretary's office, and was permitted to submit statements. However, it was not permitted access to the relevant evidence supporting the driver's complaint or to other information on which the reinstatement order was based. The Supreme Court stated:

> We conclude that minimum due process for the employer in this context requires notice of the employee's allegations, notice of the substance of the relevant supporting evidence, an opportunity to submit a written response, and an opportunity to meet with the investigator and present statements from rebuttal witnesses. The presentation of the employer's witnesses need not be formal, and cross-examination of the employee's witnesses need not be afforded at this stage of the proceeding.[189]

Due process thus does not require a full evidentiary hearing prior to invoking a deprivation, provided there is an adequate post-determination hearing at a meaningful time intended to resolve the disputes. Further, due process requires access to information upon which the deprivation of rights order was based.

The result in *Callanan Industries v. City of Schenectady* is consistent.[190] In that case, Callanan Industries had submitted the low bid, but the City of Schenectady awarded the contract to the second bidder,

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[181] *Id.* at 932, 933.

[182] *Id.*

[183] *Id.* at 933, 934.

[184] Adonizio Brothers v. Pa. Dep't of Transp., Bd. of Review, 529 A.2d 59 (1987).

[185] *See, e.g.*, Goldberg v. Kelly, 397 U.S. 254, 90 S. Ct. 1011, 25 L. Ed. 2d 287 (1970).

[186] *See, e.g.*, Cleveland Board of Educ. v. Loudermill, 470 U.S. 532, 105 S. Ct. 1487, 84 L. Ed. 2d 494 (1985) (public employee had property right in continued employment, was entitled to notice and opportunity for pre-termination hearing); O'Hare Truck Service v. Northlake, 518 U.S. 712, 116 S. Ct. 2353, 135 L. Ed. 2d 874 (1996) (public contractor entitled to same property right as public employee in continued performance of contract).

[187] 481 U.S. 252, 107 S. Ct. 1740, 95 L. Ed. 2d 239 (1987).

[188] *Id.* at 256.

[189] *Id.* at 264.

[190] 116 A.D. 2d 883, 498 N.Y.S.2d 490 (1986).

who was determined to be the lowest responsible bidder. Prior to the award, Callanan discussed its past performance with City officials in view of the City's claim that in the prior year a rehabilitation contract had been performed by Callanan in a seriously deficient manner, and further that the corrections by Callanan were unsatisfactory to the City officials. Callanan claimed that the City's failure to provide it with a hearing prior to the rejection of the bid denied it due process. The court determined that Callanan's informal conferences with the City Council and other City officials as well as judicial review satisfied Callanan's due process rights.

This issue was also considered in *Inglewood Los Angeles County Civic Center Authority v. Superior Court of Los Angeles County*, in which the award was made to the second lower bidder on the basis of qualifications, but where the low bidder was not found to be nonresponsible.[191] The court found in that case that due process required giving the low bidder the evidence reflecting on its responsibility and affording it the opportunity to rebut adverse evidence and present evidence that it was qualified to perform the contract.

In *DeFoe Corporation v. Larocca*, the New York State Department of Transportation had rejected all bids for a project due to bidding irregularities.[192] In the second bidding for the project, the joint venture of Schiavone and North Star Contracting Company was the apparent low bidder. Schiavone had been part of a different joint venture that had been the apparent low bidder the first time the project had been advertised. Between the time of the first bid and the second bid, several officials in the Schiavone firm were indicted for MBE fraud. Because of the indictment, as well as the possible inability of the top officials of the corporation to perform the project while defending against the criminal charges, the Department found the Schiavone firm to be nonresponsible and awarded to the second low bidder.[193]

Prior to the second bid letting on that project, the Schiavone firm was also the apparent low bidder on another large project in New York City, but was found to be nonresponsible for the same reasons given above. The matters were considered together in the State's Appellate Division in *Schiavone Construction v. Larocca*.[194] Upholding the State's decision, the Appellate Division made several important points relative to due process. First, it noted that Schiavone did not acquire a property right to the contracts.[195] Second, however, the court held that since the refusal to award the contracts to Schiavone "had a drastic effect upon their ability to carry on their business," Schiavone had a "cognizable liberty interest."[196] Lastly, the court noted that

> [T]he procedures afforded petitioners [Schiavone and the joint venture of Schiavone and North Star] were adequate. Due process is flexible and is determined by a weighing of the interests at stake, the risk of erroneous deprivation, the probable value of additional safeguards and the cost of substitute procedures. In cases such as the one at bar, a formal trial-type hearing is not necessary. Here, petitioners were given notice of the [Contract Review] Unit's concern over their responsibility and the reasons for that concern. Petitioners were afforded an opportunity to rebut the charges both in writing and at informal hearings. They were informed of the reasons for denial of their contract bids and were afforded this review pursuant to CPLR article 78. We find that these procedures were adequate under the circumstances of this case.[197]

Whether the contractor succeeds in challenging a suspension or debarment might depend upon whether it asserts a property or a liberty interest in its ability to bid on public contracts. *Polyvend, Inc. v. Puckorius* demonstrates what a difficult time a contractor can have when it asserts a denial of due process in connection with a property interest.[198] In that case, a license plate manufacturer had its bid for a license plate contract rejected pursuant to a state statute, which prohibited award of a government contract to a person or business that had been involved in the bribery of a state official or employee. The Circuit Court granted the state summary judgment. The Appellate Court reversed with a finding that the state statute was unconstitutional on due process grounds. The Supreme Court of Illinois reversed and decided in the state's favor. Polyvend had had the contract for the 3 prior years. The conviction for bribery occurred in 1974. The state statute concerning bribery became effective in 1977. The court found that Polyvend did not have a legitimate claim of entitlement to a future state contract. The case review was centered on a "property right" in the future state contract and no such property right was found.[199]

Another issue is the length of time prior to the post-determination hearing. The time given to rebut a proposed action is set at 30 days by the Governmentwide Debarment and Suspension (Nonprocurement) process.[200] This procedure gives the contractor 30 days after receipt of notice to submit "in person, in writing, or through a representative, information and argument in opposition to the proposed debarment." The debarring official then has 45 days after submission of the relevant information to render a determination.[201]

The Governmentwide Debarment and Suspension (Nonprocurement) process recognizes that suspension is

[191] 103 Cal. Rptr. 689, 500 P.2d 601 (1972).

[192] 488 N.Y.S.2d 532, 128 Misc. 2d 39 (1984), *aff'd*, 489 N.Y.S.2d 1017, 110 A.D. 2d 965 (1985).

[193] Schiavone Constr. v. Larocca, 503 N.Y.S.2d 196, 197, 117 A.D. 2d 440 (1986).

[194] *Id*.

[195] *Id.* 503 N.Y.S.2d at 197.

[196] *Id*. at 197–98.

[197] *Id*. at 198 (citations omitted).

[198] 77 Ill. 2d 287, 32 Ill. Dec. 872, 395 N.E.2d 1376 (1979), *appeal dismissed*, 444 U.S. 1062 (1980).

[199] *Id.* 395 N.E.2d at 1379.

[200] 49 C.F.R. § 29.313(a) (Oct. 1, 2001).

[201] 49 C.F.R. § 29.314(a) (2001).

a serious action to be imposed only when there exists adequate evidence of one or more of the causes set out in the regulations, and immediate action is necessary to protect the public interest.[202] The regulations provide that a contractor may be suspended upon adequate evidence to suspect the commission of an offense listed in 49 C.F.R. § 29.305(a) or a cause for debarment under 49 C.F.R. § 29.305 may exist. The regulations further provide that, "Indictment shall constitute adequate evidence for purposes of suspension actions."[203]

3. Established Time Periods Versus Flexible Time Periods for Suspensions, Debarments, or Disqualifications

When a statute directs suspension, debarment, or disqualification for a prescribed period of time upon a finding of violation of a governmental program, there is little discretion that has to be exercised by the governmental administrator relative to the length of time suspension, debarment, or disqualification is to be effective. The administrator's real function in those circumstances is to see that the determination of the violation is consistent with due process requirements. The courts, therefore, will examine such a statutorily mandated period to determine whether or not it is "penal or punitive" in nature versus being a period of ineligibility that is necessary and appropriate to protect a legitimate government interest.

In the flexible time situation, those statutes that provide that the suspension, debarment, or disqualification may be determined to be up to a certain maximum period of time leave considerable discretion in the administrator's hands to pattern the length of any suspension, debarment, or disqualification to the particular circumstances that exist relative to the violation, the contractor's or subcontractor's particular situation, and any governmental needs or objectives relative to the program. The most serious aspects that the courts will look at in flexible time matters are whether the period of ineligibility is established on an ad hoc basis, whether there is similar treatment of contractors under similar circumstances, as well as whether the length of the suspension, debarment, or disqualification is justified by the facts that are established by the administrative record.

Consistency of the administrator's handling of similar situations will be very important relative to any court challenge. Further, the court will apply a standard of "abuse of discretion" or "arbitrary and capricious" to its review of the period of the suspension, debarment, or disqualification. An administrator who blindly applies the maximum ineligibility period in each and every case may be found to have abused his or her discretion, because the legislative direction is to "determine" an appropriate length of time for the ineligibility, not to exceed the statutory maximum limit. The administrator is required to use discretion in fixing the period.

[202] 49 C.F.R. pt. 29.

[203] 49 C.F.R. § 29.405(b) (2001).

4. License Revocation

Because a contracting license represents a valuable business interest, it cannot lightly be withdrawn once it has been issued.[204] One protection against arbitrary action by a licensing agency in most states is the inclusion in the licensing laws of the acts or circumstances that may be cause for suspension or revocation.[205] A second protection against arbitrary or unfair suspension or revocation is the existence of mandatory statutory procedures that apply whenever such actions are taken. In general, these require notice of the charges involved, a hearing with opportunity to explain and clear the charges, and a right of judicial review in the event the licensee disputes the licensing agency's ruling.

Suspension or revocation of a contractor's license for cause is a form of disciplinary action administered by the licensing agency. As such, imposition of this penalty has no effect on the contractor's civil liability, even where its failure to adhere to a statutory duty or to follow specifications provides the cause for revocation. The conditions upon which a license is granted are imposed for protection of the public, and are enforced solely through the administrative action of suspending or revoking the license. No civil cause of action by one who suffers injury arises from the licensing agency's action. Similarly, revocation of a contractor's license because of bankruptcy does not have any effect on the collection of claims.[206] Nor does revocation because of a contractor's violation of a labor law give rise to any claim by the employees involved.[207]

Because severe sanctions and penalties may be involved in the disciplinary provisions of contractor licensing laws, courts have been reluctant to construe these laws more broadly than necessary to achieve the statutory purpose.[208] This policy is regularly tested in determinations of whether a contractor's actions or omissions bring its conduct within any of the statutory grounds for suspension or revocation of its contractor's license. Judicial interpretations of contractor licensing laws have refined the list of the leading causes of disciplinary action.

[204] Portions of this section are derived from *License and Qualification of Bidders* by Dr. Ross D. Netherton, and from *Suspension, Debarment, and Disqualification of Highway Construction Contractors* by Darrell W. Harp, published by the Transportation Research Board in 1976 and included in the first edition of SELECTED STUDIES IN HIGHWAY LAW.

[205] A summary of state statutes regarding grounds for contractor license revocation is found in App. C.

[206] Tracy v. Contractor's State License Board, 63 Cal. 2d 598, 407 P.2d 865, 47 Cal. Rptr. 561 (1965).

[207] Lee Moor Contracting Co. v. Hardwicke, 56 Ariz. 149, 106 P.2d 332 (1940).

[208] Peck v. Ives, 84 N.M. 62, 499 P.2d 684 (1972).

Whether specifically required by statute or not, fairness requires that disciplinary action by a licensing agency be based on a hearing, with opportunity for the licensee to explain or contradict the evidence being considered. Normally, such a hearing is held prior to issuing any suspension order so that premature or unwarranted penalties may be avoided. Statutory procedures may, however, provide that where public health or safety justifies it, a temporary suspension order may be issued prior to holding a hearing on the matter.[209]

Where statutory lists of grounds for disciplinary action specify that misconduct must be willful, this intent is an essential element of proof. However, intent may be inferred from the nature of the act.[210]

Closely related to these cases are others involving the adequacy of performance regarding project plans, specifications, and estimates, or other conditions of work.[211] A case-by-case approach to disciplinary action on these grounds is necessary because of the wide variety of conditions involved, including the use of performance specifications and the use of change orders during the progress of work. In practice, construction rarely can be performed without some deviation from the original plans and specifications, and determination of whether deviations reach a point of violating the licensing standard requires consideration of all the circumstances.

In this process, the courts have developed and applied the doctrine of substantial performance by the contractor. As described by the court that adopted this doctrine in California, the guiding principle is that

> [T]here is substantial performance where the variance from the specifications of the contract does not impair the building or structure as a whole, and where after it is erected the building is actually used for the intended purpose, or where the defects can be remedied without great expenditure and without material damage to other parts of the structure, but that the defects must not run through the whole work so that the object of the owner to have the work done in a particular way is not accomplished, or be sure that a new contract is not substituted for the original one, nor be so substantial as not to be capable of a remedy, and the allowance out of the contract price will not give the owner essentially what he contracted for.[212]

A certain amount of leeway has been allowed in holding contractors to the requirement that a valid license must be maintained at all times when their work is in progress. Thus, where a contractor's license expired after 90 percent of a project had been completed, and the remaining work was actually completed under the supervision of licensed professional personnel, the court held that the contractor was in substantial compliance with the licensing law.[213] In contrast, where a contractor's license expired while work was in progress, but the licensee failed to act promptly to renew it or have a licensed manager supervise the remaining work, the court held that was not in substantial compliance with the licensing law.[214] In another case, the contractor was entitled to maintain a claim against the state even though it had not complied with the requirements of a nonresident contractors' registration statute, where the contractor had obtained the required performance bonds that covered payment of state and local taxes and the contractor had substantially completed the registration process prior to completing the project.[215] A low bidder with a class A license but no class B license satisfied the license requirement for the project where the agency had delayed its opinion calling for a class B license for the project.[216]

Courts have been less inclined to apply doctrines of forgiveness where violation of licensing standards appeared to be deliberate or willful. Deliberate action has been found in cases of alleged diversion of funds given to contractors for specific construction work, or misrepresentation of information in license applications or business dealings, or failure to pay bills for labor or materials.[217]

Diversion of funds advanced to assist commencement of construction or other purposes is treated seriously by all licensing agencies. New Mexico's contractor licensing law, which makes diversion of funds a cause for revocation, has been described as "imposing a fiduciary duty upon contractors who have been advanced money pursuant to construction contracts.[218]

Among the causes for disciplinary action listed in typical contractor licensing laws, one of the most difficult to apply is the rule that contractors must perform construction in a workmanlike manner, in accordance with the plans and specifications and reasonably within the agreed or estimated costs. Standards for workmanship may be provided specifically either in the contract plans and specifications, or in a trade or industry code

[209] State ex rel. Perry v. Miller, 300 S.E.2d 622 (W. Va. 1983).

[210] Bailey-Sperber, Inc. v. Yosemite Inc. Co. 64 Cal. App. 3d 725, 134 Cal. Rptr. 740 (1976) (court rejected the argument that the willfulness of the action must be proved under the California statute).

[211] J.W. Hancock Enterprises v. Ariz. State Registrar of Contractors, 142 Ariz. 400, 690 P.2d 119 (1984); Mickelson Concrete Co. v. Contractors State License Board, 95 Cal. App. 3d 631, 157 Cal. Rptr. 96 (1979).

[212] Tolstoy Constr. Co. v. Minter, 78 Cal. App. 3d 665, 143 Cal. Rptr. 570, 573–74 (1978) (citing Thomas Haverty Co. v. Jones, 185 Cal. 285, 197 P. 105 (1921)); *see also* First Charter Land Corp. v. Middle Atlantic Dredging Co., 218 Va. 304, 237 S.E.2d 145 (1977).

[213] Barrett, Robert & Wood, Inc. v. Armi, 296 S.E.2d 10 (N.C. App. 1982).

[214] Brown v. Solano County Business Dev., Inc., 92 Cal. App. 3d 192, 154 Cal. Rptr. 700 (1979).

[215] Dep't of Transp., State of Ga. v. Moseman Constr. Co., 260 Ga. 369, 393 S.E.2d 258 (1990).

[216] City of Phoenix v. Superior Court, 909 P.2d 502 (Ariz. App. 1995).

[217] Fillmore Products, Inc. v. Western States Paving, Inc., 561 P.2d 687 (Utah 1977).

[218] In re Romero, 535 F.2d 618, 621 (10th Cir. 1976).

applicable to the work in question. Where these sources do not furnish suitable guidance for disciplinary action, licensing agencies and courts have defined "workmanlike manner" as doing the work in an ordinarily skilled manner, as a skilled worker should do it by reference to established usage and accepted industry practices prevailing where the work is performed.[219]

Where the licensing statutes require that failure to follow plans and specifications must be willful or deliberate, evidence of intent may be inferred from the conduct of the parties. Thus, where willful departure from workmanlike standards was charged, the decision of the licensing agency to discipline the contractor was upheld when it was shown that the contractor failed to install an acceptable slab of concrete, and then represented that he could correct the defect by a "pour-over" technique, which only made matters worse. [220] The court found that this "indicates a purposeful departure from accepted trade standards which may be properly characterized as 'willful.'"

The contractor's failure to perform work within the contract price or cost estimate is often associated with failing to follow plans and specifications. Cost overruns are sometimes listed among statutory reasons for license revocation. They may also be associated with incompetent or negligent performance, which are also well-recognized grounds for revocation or suspension. In addition, courts regularly apply an indirect penalty in some instances of cost overrun, by limiting contractor recovery to the dollar ceiling of its license.[221]

Although contractors are not often disciplined because of assisting in the evasion of licensing laws, this possibility is illustrated where a contractor permits its license to be used by unlicensed contractors on a project in which it does not actively participate.[222]

5. Disqualification or Rejection of a Bid Proposal

Loss of eligibility to bid on transportation construction projects may result from various causes set forth in state laws or regulations relating to licensing, prequalification, and conflict of interest.[223] Suspensions or other forms of withdrawal of eligibility are based entirely on statutory or administrative authority and procedures. They are construed strictly, as they are considered regulatory in nature.

Also, disqualification of one or more major contractors may have the practical result of significantly reducing the number of contractors capable of performing certain types of construction, and thus may reduce competition.

Procedures for judicial review of administrative actions denying prequalification or disqualifying certified bidders are essential features of the states' licensing and prequalification systems. Courts have been divided on whether the interest acquired by a low bidder is a constitutionally protected property interest or a liberty interest.[224] However, courts finding either basis for a constitutional right have held that the contractor is entitled to the protections of procedural due process before the bidder can be disqualified on the grounds that it is not responsible.

There are three types of adverse actions: (1) denial of an application for prequalification, or for a change in classification or rating; (2) disqualification of a bidder or rejection of its bid on a particular project; and (3) suspension or revocation of a prequalification certificate for cause.

The statutes and regulations governing prequalification procedures do not make clear distinctions between the bases for these three types of actions. Thus, a finding of "inadequate" financial resources or equipment, or "unsuitable" experience, may be specified as grounds for denial of an initial application, and may also sustain the refusal to consider a contractor's bid in the event that the decisive information on these matters comes to the contracting agency's attention prior to the actual award of a contract. For example, a firm's filing for Chapter Eleven reorganization in bankruptcy was a rational basis for making a determination of lack of responsibility, since financial stability is a factor in contractor responsibility.[225]

Similarly, lack of satisfactory progress or performance on a previous construction job may be cited as grounds for disqualifying a bidder from consideration

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[219] J.W. Hancock Enterprises v. Ariz. State Registrar of Contractors, 142 Ariz. 400, 690 P.2d 119 (1984).

[220] Mickelson Concrete Co. v. Contractors State License Board, 95 Cal. App. 3d 631, 157 Cal. Rptr. 96 (1979).

[221] *Compare* Alan S. Mead & Assoc. v. McGarry, 315 S.E.2d 69 (N.C. App. 1984) (recovery allowed up to license limit) *with* Martin v. Mitchell Cement Contracting Co., 74 Cal. App. 3d 15, 140 Cal. Rptr. 424 (1977) (recovery allowed beyond license limit).

[222] Moore v. Fla. Constr. Industry Licensing Bd., 356 So. 2d 19 (Fla. App. 1978).

[223] A summary of state statutes indicating grounds for disqualification, suspension, and debarment is found in App. F.

[224] *See* Pataula Elec. Membership Corp. v. Whitworth, 951 F.2d 1238 (11th Cir. 1992) (holding that under Georgia law a bidder may have a property interest in the award of a public contract); LaCorte Electrical Const. and Maintenance, Inc. v. County of Rensselaer, 574 N.Y.S.2d 647 (1991) (low bidder does not have a property right in the award of the contract, but has a liberty interest that requires procedural due process if the low bidder's bid is to be rejected); Triad Resources and Systems Holdings, Inc. v. Parish of Lafourche, 577 So. 2d 86 (La. App. 1990) (lowest responsive bidder has protected interest in award of contract requiring procedural due process before the bidder may be disqualified as not responsible).

[225] Adelaide Envtl. Health Assocs. v. New York State Office of General Services, 669 N.Y.S.2d 975, 248 A.D. 2d 861 (1998). Note that New York uses a post qualification system; however, this rule should apply regardless of when the responsibility determination is made. *See also* Lewis v. State Dep't of Business and Professional Regulation, 711 So. 2d 573 (Fla. App. 1998) (failure to satisfy civil judgment was grounds for license revocation even though contractor had filed for bankruptcy; however, evidence that the debt had been discharged in bankruptcy would allow contractor license to be reinstated).

for another contract.[226] This mixture is illustrated by the standard specification for issuance of a proposal by the Connecticut Department of Transportation:

The Commissioner reserves the right to disqualify or refuse to issue a proposal form to any individual, partnership, firm or corporation for reasons including, but not limited to any of the following:

1. For having defaulted on a previous contract.
2. For having failed, without acceptable justification, to complete a contract within the contract period.
3. For having failed to prosecute work in accordance with contract requirements.
4. For having performed contract work in an unsatisfactory manner.
5. For having failed to prosecute work continuously diligently and cooperatively in an orderly sequence.
6. For having failed to file with the Department a recent sworn statement on the form furnished by the Department fully outlining the capital, equipment, work on hand and experience of the bidder; such statement to be valid, must be on file with the Department at least 20 calendar days before application for a proposal form is made.
7. For filing a sworn statement with the Department which, in the Commissioner's judgment, indicates that the bidder does not have the required experience in the class of work to be bid on, does not have the proper labor and equipment to prosecute the work within the time allowed, or does not have sufficient capital and liquid assets to finance the work.[227]

A number of states specifically provide for suspensions or revocations of prequalification classifications or ratings, and have set forth the grounds required in their regulations. Pennsylvania's regulations illustrate this type of provision in requiring the preparation of a "past performance report" to be used in prequalification and responsibility determinations:

> The past performance report shall include evaluation of a contractor's attitude and cooperation, equipment, organization and management, scheduling and work performance. Poor or unsatisfactory ratings for specific work classifications shall constitute justification for revoking classifications previously granted. A contractor who has an overall unsatisfactory rating on performance reports will not be prequalified.[228]

Less specific, but apparently sufficient, is Kentucky's regulation.

> Upon receipt of information or evidence that a holder of a certificate of eligibility has failed to perform satisfactorily or adhere to the laws, regulations administrative or specifications applicable to a contract or a subcontract, the department [of highways] may take action to suspend or revoke the certificate of eligibility or reduce the maximum eligibility amount.[229]

Contractors who are dissatisfied with rulings of certifying officials can, by timely request, have the ruling reconsidered by those officials or by the higher administrative authority that has ultimate responsibility for the prequalification process. In some states contractors enjoy a right to judicial review on the merits.[230] Some courts, however, have refused to examine the issue of disqualification in the context of a bid protest challenging the award of the contract.[231]

Administrative reviews of contractor classifications and ratings for possible reconsideration or revision are usually informal. They are directed entirely to reexamination of the grounds for the disputed action cited in the prequalifying agency's letter of notification to the contractor. These proceedings, however, give the applicant an opportunity to submit further evidence in support of its qualifications. Where prequalification boards or committees make the initial determination of classifications and ratings, requests for review may go to the director of the transportation department or to the state transportation commission.[232] A New York court held that before a bidder may be designated as not responsible, it must be notified of the agency's reasons for its finding of nonresponsibility and must be given an opportunity to appear before the agency and present information or evidence to rebut the agency's finding.[233]

The actions of boards of review and other reviewing authorities are generally declared to be final by the laws or regulations creating them. However, some states confer on the aggrieved applicant an additional right of judicial review. Massachusetts' statute allows for both administrative review within the agency, and for judicial review of the administrative board's determination.

> Any prospective bidder who is aggrieved by any decision or determination of the prequalification committee or the commissioner which affects his right to bid may file a new application for qualification at any time, or within fifteen days after receiving notice of such decision the applicant may request in writing a hearing before an appeal board to reconsider his application or qualifications.

[226] State, Dep't of Transp. v. Clark Constr. Co., 621 So. 2d 511 (Fla. App. 1993); F.S.A. §§ 339.16, 339.16(1)(b). Such a finding may also sustain the certifying agency's suspension of that contractor's classification and rating for a specified period of time.

[227] *Connecticut Department of Transportation, Standard Specifications for Roads, Bridges, and Incidental Construction*, Form 815, § 1.02.02 (1995).

[228] PA. CODE § 457.10(b) (1999).

[229] 603 KY. ADMIN. RULES 2:015 § 8(1) (Aug. 15, 2000).

[230] *See, e.g.* WASH. REV. STAT. 47.28.070 (denial of prequalification may be appealed within 5 days of determination).

[231] D.A.B. Constructors v. State Dep't of Transp., 656 So. 2d 940, *rehearing denied* (Fla. App. 1995); Sabre Constr. Corp. v. County of Fairfax, 501 S.E.2d 144 (Va. 1998).

[232] *See* HAW. REV. STAT. § 103D-702(a), which allows a bidder an opportunity to be heard before prequalification is denied.

[233] N.Y. State Asphalt Pavement Ass'n v. White, 532 N.Y.S.2d 690, 141 Misc. 2d 28 (1988).

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> Such hearing shall be deemed to be an adjudicatory proceeding, and any bidder or prospective bidder who is aggrieved by the decision of the appeal board shall have a right to judicial review under the applicable provisions of said chapter thirty A.[234]

Ohio's code states that

> Any applicant, other than one who has been debarred, aggrieved by the decision of the director may file a new application at any time for qualification or, within ten days after receiving notification of such decision, the applicant may request, in writing, a reconsideration of the application by a prequalification review board, which the director shall create within the department of transportation with the request for reconsideration, the applicant shall submit additional evidence bearing on the applicant's qualifications. The review board shall consider the matter and either may adhere to or modify the director's previous decision.[235]

Whatever the limits of judicial review prescribed by statute, one court has held that the appellant contractor may not enlarge the scope of that review beyond that created by the statute by alleging facts outside the prequalification process.[236]

6. Criminal Offenses

Most statutes that provide for prequalification of bidders use standards that measure a contractor's ability and capacity to perform contracts in various categories of construction. Typically, financial condition, equipment, experience, and organization are the indicators used to establish eligibility. However, other matters that may affect a contractor's responsibility, such as business honesty and integrity, may also become grounds for rejection of the bid of a properly prequalified low bidder, or may be grounds for suspension or debarment. In practice, it may be difficult to maintain the distinction between prequalification and the determination of a low bidder's responsibility. This is illustrated in a series of cases growing out of New Jersey's landmark decision in *Trap Rock Industries v. Kohl*.[237]

The New Jersey Supreme Court's first decision in *Trap Rock Industries v. Kohl* involved suspension of previously qualified contractors.[238] Indictments had been returned charging criminal offenses by the contractors, and the Commissioner of Transportation ordered suspension of their classification pending final disposition of these charges. No proof of the charges was offered to the Commissioner prior to his order, and the contractors declined an opportunity to present evidence to the Commissioner concerning the matter. The trial court ruled that the suspension was unlawful in the absence of this evidence.[239] The New Jersey Supreme Court reversed the lower court and affirmed the suspension.

The appeal provided an opportunity to discuss two basic issues: (1) the relationship of prequalification actions to the Administrative Procedure Act and (2) the constitutional guarantee of due process of law. In addition to charging that the Commissioner acted without affirmative evidence concerning the truth of the indictments, the contractor claimed that the state's prequalification standards did not specify the misdeeds that would disqualify a bidder. Stressing the legislative mandate that the Commissioner retained the right and duty to reject bidders that were not the lowest responsible bidder, the court declared:

> These cases do not involve the right to engage in business. The contractors are free to do business with anyone willing to deal with them. The question is whether the state must do business with them despite the Commissioner's view that the public interest would be disserved by doing so.[240]

The court continued:

> We find nothing in this statute to evidence a legislative departure from the basic principle that bidding statutes are intended for the benefit of the taxpayer rather than the bidder or prospective bidder. The statute simply provides, so far as feasible, for a determination of qualification before bidding rather than after the bids are in. The opportunity for hearing afforded by this statute merely parallels the right to hearing after the bids are in which the more conventional bidding statutes contemplate. We find no purpose to vest in a preclassified bidder any "right" which derogates the primary right of the state…to do business…with "the lowest responsible bidder."[241]

The court affirmed that the legislative concept of a responsible bidder included moral integrity as much as a capacity to supply labor and materials, and that citizens expected their public officials to do business only with people of integrity, whether as individuals or as officers of corporations. However, important as this element might be in certifying contractor qualifications, neither the prequalification statute nor the Administrative Procedure Act required that the state specify in its rules all the factual patterns constituting actionable lack of moral responsibility. The court found that it was not only infeasible to do so, but that it was more desirable to permit administrative definitions to evolve on a case-by-case basis. For this purpose, the concept of moral responsibility as spelled out in judicial decisions is constitutionally sufficient. The court stressed the distinction between this action of suspension and those involving revocation of a contractor's license to do business, and noted cases where the latter actions were

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[234] MASS. GEN. L. ch. 29, § 8B (West 2001).

[235] OHIO REV. CODE § 5525.07 (2000 Replacement Vol.)

[236] Enertol Power Monitoring Corp. v. State, 108 Or. App. 166, 814 P.2d 556 (1991).

[237] 63 N.J. 1, 304 A.2d 193 (1973).

[238] 59 N.J. 471, 284 A.2d 161 (1971).

[239] Trap Rock Indus. v. Kohl, 115 N.J. Super. 278, 279 A.2d 138, *rev'd*, 59 N.J. 471, 284 A.2d 161 (1971).

[240] 284 A.2d at 164.

[241] 284 A.2d at 166.

properly required to comply with the standards of the Administrative Procedure Act.[242]

A year later, the Department ruled that this suspension also made Trap Rock ineligible to serve as a supplier of materials to a prime contractor whose contract with a local government was funded in any part by the department. Trap Rock argued that prequalification of suppliers was not required by statute, and that to try to do so in all cases would entail great difficulty. The court upheld the suspension, declaring that the contracting agency could not on those accounts "ignore what it learns about those who seek to do business directly with the state."[243]

New Jersey's prequalification statute required applicants to answer a questionnaire regarding financial ability, prior experience, adequacy of plant and equipment, organization, "and such other pertinent and material facts as may be deemed desirable."[244] By its ruling on the suspension of Trap Rock Industries, the New Jersey court raised the question of whether information that customarily is used to determine responsibility and fitness to receive a contract award can also properly be relied on to suspend eligibility to bid on future contracts. The court's decisions affirmed that the Commissioner of Transportation could do this, and could later reinstate the contractor as a qualified bidder when satisfied that the reason for disqualification was removed.

These cases were followed by another that reported the issue of whether the same grounds used to stop work on a project could also sustain a decision to suspend the contractor's eligibility to bid on future contracts with the department.[245] In this instance, the department in effect reversed an earlier decision to reinstate the contractor's eligibility to bid, and imposed a new suspension on the ground that one of the individuals responsible for the earlier corporate criminal acts had not disassociated himself sufficiently from the corporation's management to insulate the corporation from his lack of integrity.

The court found no fault with the department's power to reconsider and modify prior determinations of eligibility when it appeared necessary to protect the public interest, or with the grounds cited to justify suspension of bidding eligibility. But on review of the department's action, the court found that the Commissioner relied on the evidence presented at a prior hearing, and decided to reimpose suspension by applying a contrary and speculative interpretation to the conclusion reached by the previous Commissioner on the same evidence. Warning that "the power to reconsider must be exercised reasonably, with sound discretion reflecting due diligence, and for good and sufficient cause," the appellate court held that, under the circumstances, the department's action was not sustained by the evidence.[246]

7. Responsibility Agreements and IPSIGs or Monitors[247]

a. Use of IPSIGs or Monitors to Protect the Public Trust

Public owners in postqualification states sometimes seek to resolve situations in which low bidders have significant responsibility problems, such as criminal convictions, through developing responsibility agreements that incorporate precautionary elements to prevent recurrence of the conduct that gave rise to such responsibility problems. These may involve the use of IPSIGs, a concept first developed in the New York metropolitan area. An IPSIG, as defined by the International Association of IPSIGs, is an independent, private sector firm with legal, auditing, investigative, management, and loss-prevention skills, employed by an organization to ensure compliance with relevant law and regulations, and to deter, prevent, uncover, and report unethical and illegal conduct by, within and against an organization.[248]

History of IPSIGs.—The IPSIG's role is patterned after the federal inspectors general created by the Inspector General Act of 1978 (IG Act), which assigned inspectors general to each of the federal agencies and tasked them with preventing waste, fraud and abuse.[249] In 1990, the New York State Organized Crime Task Force *Final Report on Corruption and Racketeering in the New York City Construction Industry* raised the idea of adapting the Inspector General concept to government contractors in order to prevent fraud on public construction projects.[250] IPSIGs were later adopted by the New York City School Construction Authority (SCA), established in the wake of that report, for billions of dollars of New York City school construction. "Contrac-

[242] *Id.* at 167. In distinguishing the decision in Gonzalez v. Freeman, 334 F.2d 570 (D.C. Cir. 1964), the court suggested that where a specific act in itself is deemed sufficient to justify the adverse action, it should be specified in the administrative standards.

[243] 305 A.2d at 194.

[244] *Id.* (quoting N.J. STAT. ANN. § 27i7-35.3).

[245] Trap Rock Indus. v. Sagner, 133 N.J. Super. 99, 335 A.2d 574 (1975), *aff'd*, 69 N.J. 599, 355 A.2d 636 (1976).

[246] 335 A.2d at 580. However, this could also have been considered to be an abuse of discretion based on the officer's failure to consider new evidence; generally an officer's failure to exercise his or her discretion at all is an abuse of discretion.

[247] This portion of this volume is drawn from a publication prepared by the authors of the 2011 update to this current volume; KERNESS & SHAWHAN, *supra* note 31.

[248] *See* IAIPSIG Code of Ethics, available at http://www.iaipsig.org/ethics.html (last accessed June 16, 2010).

[249] James B. Jacobs & Ronald Goldstock, *Monitors & IPSIGS: Emergence of a New Criminal Justice Role*, 43 CRIMINAL LAW BULLETIN, No. 2, available at http://www.iaipsig.org/Criminal%20Law%20Bulletin%20-%20James%20Jacobs%20%20Ronald%20Goldstock%20Article.pdf.

[250] RONALD GOLDSTOCK, CORRUPTION AND RACKETEERING IN THE NEW YORK CITY CONSTRUCTION INDUSTRY: FINAL REPORT OF THE NEW YORK STATE ORGANIZED CRIME TASK FORCE (NYU Press, 1991).

tors who faced debarment from government contracts on integrity grounds could nonetheless be awarded contracts it they retained an IPSIG that would report to the SCA..."[251] Other public authorities and New York City agencies adopted the use of IPSIGs thereafter.

Imposing an IPSIG as a Condition for Public Contracts: Use of Monitoring Agreements.—In New York City, when contractors or vendors have been found "non-responsible" for bidding public contracts, individual city agencies have given them an opportunity to demonstrate their restored integrity by negotiating and entering into an compliance agreement providing for an IPSIG, which the subject company retains at its own expense.[252] A standard IPSIG agreement of this type requires the contractor to provide the IPSIG with complete access to its books, records, personnel and operations. The IPSIG maintains a 24-hour hotline used by employees or others to report wrongdoing that affects the contractor. All IPSIG findings are reported directly to the NY City Department of Investigation, which supervises the implementation of the monitoring agreement and works with the IPSIG to develop and implement a strict code of business ethics, as well as a corruption prevention program. In addition, the contractor must agree to have its personnel undergo an ethics training program. Should the contractor default under the monitoring agreement, the City may declare the contractor in default of the agreement.[253]

Example 1: World Trade Center Debris Removal Contract

The changing role of IPSIGs was reflected in the IPSIGs employed on the each of the four no-bid $250-million PANYNJ contacts for removal of debris from the site of the former World Trade Center (WTC) following the 9/11 terrorist attack. Prior to the WTC project, IPSIGs were usually imposed as a condition of doing business in which the company's "responsibility" had already been called into question under a "lowest responsible bidder" letting statute.[254] On the WTC cleanup project, the role of the IPSIG was changed from rehabilitating a "non-responsible" contractor to proactively preventing waste, fraud, and abuse. The IPSIGs monitored the operations of contractors, conducted audits and investigations to ensure compliance with the contracts and applicable laws, performed on-site interviews with subcontractors and suppliers, implemented procedures to ensure that all vendors, suppliers, and subcontractors had the necessary integrity and qualifications, and conducted further on-site investigations as necessary.[255] The results drew praise from participants and outside observers. There were no scandals or charges of significant corruption. A staff report by the House Committee on Management, Integrity, and Oversight of the Committee on Homeland Security concluded that:

> [T]heir deployment (IPSIGs) was an overwhelming success. Private Integrity monitors identified a number of contractors with ties to organized crime which were subsequently removed from the site, found trucks cooping (idling) while on the clock, flagged several attempted frauds that were referred for prosecution, recovered $47 million in over-billing by contractors and subcontractors and saved immeasurable more money by deterring fraud.[256]

Example 2: Port Authority of New York and New Jersey Hub Project

The Port Authority of New York and New Jersey is now requiring the use of IPSIGs in connection with the WTC Transportation Hub project to assist in providing the necessary oversight and monitoring. The purpose of the integrity monitor is to prevent waste, abuse, and/or corruption, detect it, and if detected, to coordinate with the Port Authority Inspector General on the action to be taken. The tasks of the IPSIG include conducting reviews of all existing procedures and processes for fraud, corruption, cost, abuses, safety and environmental risks; implementing corruption prevention programs; reviewing the records of the construction manager and general contractor; monitoring and conducting forensic review of project costs; and providing necessary forensic auditing and investigative services as necessary, as directed by the Port Authority's Inspector General.[257]

Conformance with Sentencing Guidelines.–The Federal Sentencing Guidelines, adopted in November 1991, are indicative of the standards to which business organizations and their officers are now held. One of the guidelines for sentencing provides for the review of steps taken by the organization to ensure that it has an effective program to prevent and detect violations of law.[258] Adoption of a monitor conforms to these requirements.

Similar monitoring programs are part of administrative settlement and compliance agreements negotiated between USDOT and contractors to avoid debarment and suspension as authorized by 2. C.F.R. § 1200.635. Typically these agreements may require the contractor to adopt a code of ethics and corporate compliance pro-

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[251] Jacobs & Goldstock, *supra* note 249, at 223.

[252] Stanley N. Lupkin & Edgar J. Lewandowski, *Independent Private Inspector General: Privately Funded Overseers of the Public Integrity* 10 NY LITIGATOR, Summer 2005, No. 1, at 9; available at http://www.iaipsig.org/nylit-newsl-spring05-lewandowki.pdf (last accessed July 6, 2010).

[253] *Id.* at 9–10.

[254] *Id.* at 9–14.

[255] *Id.* at 12.

[256] Subcommittee on Management, Integration and Oversight of the House Comm. on Homeland Security, Staff. Rep., *An Examination of Federal 9/11 Assistance to New York: Lessons Learned in Preventing Waste, Fraud, Abuse and Lax Management*, Committee Print 109-C, USGPO Document No. 29-452, Aug. 2006; available at http://www.access.gpo.gov/congress/house/cp109-c.pdf (last accessed June 16, 2010).

[257] Port Authority of NY & NJ, Request for Proposals, RFP 9392, Feb. 23, 2006. ch. 2 , Scope of Work, at 7 and Exhibit A, at 2–3.

[258] Neil Getnick & Leslie Ann Skillen, *Structural Reform: The Front Line Fight Against Organized Crime*, 1 NY Litigator, No. 2, Nov. 1995.

gram. They may provide for the company to retain an Independent Monitor to oversee implementation of its Corporate Compliance Program. The Monitor would submit periodic reports directly to FHWA for 3 years regarding the contractor's implementation of measures required by the agreement.

The adoption of monitors can be a useful tool to prevent waste, fraud, and abuse. A key component of a monitor and/or IPSIG arrangement is the requirement that they be truly independent and not subject to control by the contractor they are supposed to be monitoring. Attention should also be focused on the monitor's adherence to a code of ethics to ensure independence and impartiality.

C. SURETY BONDS AND INDEMNIFICATION

1. Introduction

Because public projects are not subject to mechanics or materialmens' liens, public agencies require successful bidders on construction projects to furnish security for satisfactory contract performance.[259] Additional requirements assure that laborers, materialmen, and subcontractors are paid for their goods and services.[260] Others require that taxes and other obligations are paid. Public agencies may also require indemnification for losses incurred because of a contractor's negligence or default. These requirements result in the formation of third-party beneficiary contracts, or suretyships. A summary of state requirements for contractor bonds is found in Appendix F.

Congress addressed this need by enactment of the Miller Act in 1935.[261] The Miller Act requires that before a public works contract utilizing federal funds may be awarded, the contractor must furnish both a payment bond for the benefit of laborers, subcontractors, and materialmen, and a performance bond for the benefit of the United States. States have followed by enacting their own "Little Miller Acts" patterned after the federal statute, and also requiring the provision of payment and performance bonds by public works contractors. The bonds required by both federal and state law customarily are referred to as statutory bonds.

2. Basic Concepts of Suretyship

One of the distinguishing characteristics of suretyship is that it is always collateral to another contract. It is a tripartite agreement in which one party (the surety) agrees to assume liability for the debt or duty of another (the principal) to a third party (the obligee) in the event the principal does not perform its duty under the contract.[262] Under this separate agreement, the surety becomes liable notwithstanding the fact that it has no personal interest in the principal's duty to the obligee, and receives no benefit from it.[263]

Except where they arise by operation of law, suretyships must be created by express agreement of the parties. The agreement must be in writing, as suretyships come within the statute of frauds.[264] Once created, a suretyship remains in effect until terminated, or until the surety is discharged, or until changes in the basic contract by the principal and obligee alter it so substantially that it requires a different performance than was previously contemplated by the surety.

3. Public Policy Regarding Contractors' Bonds

a. Rationale of Contractor Bonds

The requirement for contractors' performance and payment bonds provides a way to protect the public against major deviations in public contract performance. The protection that these bonds offer, however, depends to some extent on the surety's choice among several options open to it in the event the agency terminates a contract for cause. First, the surety may elect to do nothing toward arranging for the completion of the contract and let the agency make arrangements for completing the work. In that event, the surety's liability is limited to the costs of completion less the contract funds held by the agency at the time of termination. Second, the surety may try to have the agency's termination rescinded and finance the contractor in the completion of the work. This course of action is rarely selected, because the fact that there was a termination suggests that the surety may not have found good business reasons for extending financial help earlier when termination might have been avoided. Third, the surety may enter into a takeover agreement with the agency and proceed to complete the contract work. Under such an agreement, the government pays the surety the balance of the contract funds that remain unpaid, and the surety hires another contractor, approved by the agency, to complete the work. If the new contractor's expenses exceed the unspent funds from the original award, the surety may solicit new bids to complete the contract and request the agency to enter into a new contract with the lowest responsible bidder. Again, if the costs of this new arrangement exceed the funds remaining unspent, the surety pays the difference.

From the surety's viewpoint, it is advantageous to cooperate with the agency in arranging for completion of a defaulted contract unless there are serious compli-

[259] Portions of this section are derived from *Indemnification and Suretyship in Highway Construction Contracts* by Dr. Ross D. Netherton, and *Indemnification and Insurance Requirements for Consultants and Contractors on Highway Projects* by Darrell W. Harp, published by the Transportation Research Board and included in the first edition of SELECTED STUDIES IN HIGHWAY LAW.

[260] First National Bank of Paonia v. K.N.J., Inc., 867 P.2d 152, 154 (Colo. App. 1993).

[261] 40 U.S.C. § 3131 *et seq*. (formerly codified at 40 U.S.C. § 270a. et seq.).

[262] 74 AM. JUR. 2D *Suretyship* § 3 (2001).

[263] Miners' & Merchants' Bank v. Gidley, 150 W. Va. 229, 144 S.E.2d 711 (1965).

[264] WIS. STAT. § 241.02(1)(b) (2001).

cating circumstances. Moreover, most sureties will wish to avoid being placed between the government and the "takeover" contractor, and so will prefer to work out a method for creating a new direct contractual relationship between the government and the party who actually performs the completion work.

Statutes and bid specifications that require performance guarantees generally are satisfied by obtaining a surety bond. Whether cash or other assets may be substituted for a surety bond is a matter of state law. Even if allowed under state law, the use of assets other than cash may result in a dispute regarding whether the value of the assets pledged is adequate. The substitution of other security for the customary three-party surety arrangement has been permitted as providing the functional equivalent of a surety and a reliable source of recovery to which the contracting agency had a right of direct recourse in the event of a contractor's default or insolvency. [265]

Requirements for providing payment and performance bonds are creatures of legislation and apply only to the parties and projects covered by the statute. So, where a state university was created in the state constitution and governed by its own board of regents outside the control of the legislature, it was held that its contracting process was not subject to the bonding requirements of statutes regulating other public agencies' contract procedures.[266] Likewise, where a public garage was not built on land owned by the state or a public entity at the time the contract was executed, no bond was required.[267]

Statutes requiring payment and performance bonds will apply only to public projects. Thus, port authority facilities intended to be operated by private enterprise were not "public works" within the meaning of the statute.[268] A similar result was reached in denying the claim of a concrete supplier to the subcontractor of a private telephone company that was replacing sidewalks at the direction of a local government after the company had removed the original sidewalks to install telephone cable.[269]

b. Agency's Duty Regarding Contractor Bonds

An agency's duty with respect to the contractor bond requirement is defined by statute. Generally, prior to contract award, the agency should verify that the agent signing the bond for the surety has authority to do so, and verify that the surety is registered to do business in the state.

Where a statute establishes an explicit duty to see that a bond or equivalent escrow arrangement is furnished for the protection of suppliers of labor or materials who would be entitled to claim a lien except for the public nature of the project, the public agency's failure to require that security may be negligence. Therefore, in *New England Concrete Pipe Corp. v. D/C Systems of New England, Inc.*, a sub-subcontractor was able to recover for materials and labor supplied for a housing project when the state housing finance agency was shown to have breached its duty to see that a payment bond or equivalent escrow was provided.[270] An agency may also be found to have the duty to verify the validity of a bond rather than merely accepting what purports to be a valid bond. Such was the result in a Michigan case in which the agency provided a certified copy of the bond upon the subcontractor's request.[271] The court found that the agency's action had the effect of verifying the bond's validity. The agency would not have had this duty had it not provided a certified copy of the bond; had the subcontractor not requested a copy of the bond, then it would have borne the risk of the bond being invalid.

Another area that an agency should review is whether the surety is registered in the state. If the surety is incorporated under the laws of another state, it must generally obtain official authorization to do business in the state where the contract is let. This authorization generally involves registration with the Secretary of State or other appropriate state official, and

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[265] Cataract Disposal, Inc. v. Town Board of Town of Newfane, 440 N.Y.S.2d 913, 916, 423 N.E.2d 390, 53 N.Y.2d 266 (1981) (cash deposit in lieu of bond); Central Arizona Water & Ditching Co. v. City of Tempe, 680 P.2d 829, 831 (Ariz. App. 1984) (substitute security); *but see* Cataract Disposal, 440 N.Y.S.2d at 917 (dissent arguing that use of a surety relieves the contracting agency of the responsibility for obtaining a substitute if needed to complete performance, and gives the agency the benefit of the surety's independent assessment of the contractor's reliability).

[266] William C. Reichenbach Co. v. State, 94 Mich. App. 323, 288 N.W.2d 622, 628 (1980).

[267] Murnane Assoc. v. Harrison Garage Parking Corp., 659 N.Y.S.2d 665, 239 A.D. 2d 882 (1997).

[268] James J. O'Rourke, Inc. v. Indus. Nat'l Bank of R.I., 478 A.2d 195 (R.I. 1984) (meat processing plant financed with port authority bonds but operated entirely by private industry, construing R. I. GEN. LAWS, § 37-13-14); *see also* Annotating 48 A.L.R. 4th 1163 (1986).

[269] Modern Transit-Mix, Inc. v. Michigan Bell Tel. Co., 130 Mich. App. 300, 343 N.W.2d 14, 15 (1983) (applying MICH. COMP. LAWS ANN., 129.201); *see also* Davidson Pipe Supply Co. v. Wyo. County Indus. Dev. Agency, 624 N.Y.S.2d 92, 94, 85 N.Y.2d 281, 648 N.E.2d 468 (1995) (energy cogeneration plant developed with assistance of industrial development agency not "public improvement" where all risks and benefits were borne by private entity); Consolidated Elec. Supply, Inc. vs. Bishop Contracting Co., 205 Ga. App. 674, 423 S.E.2d 415 (1992) (YWCA building not a public work).

[270] 495 F. Supp. 1334, 1344–45 (D. Mass. 1980); *see also* H-K Contractors, Inc. v. City of Firth, 101 Idaho 224, 611 P.2d 1009, 1010 (1979) (construing IDAHO CODE, § 54-1926, and holding that general time limits for filing claims do not apply to claims based on failure to require payment bond); George Weis Co. v. Dwyer, 867 S.W.2d 520 (Mo. App. 1993); Palm Beach County v. Trinity Indus., 661 So. 2d 942 (Fla. App. 4 Dist. 1995).

[271] Kammer Asphalt Paving Co. v. East Chine Tp. Schools, 443 Mich. 176, 504 N.W.2d 635, 641 (1994).

designation of a resident agent of the corporation with an in-state address for receiving mail and service of process.[272] In some cases, bonds issued by out-of-state sureties must be countersigned by this resident agent, and filed with a copy of the agent's power of attorney.[273] Occasionally state laws require disclosures of other information about the surety or its resident agent.

Explicit provisions that the surety must be approved by the contracting agency before its bond is acceptable are found in several states. However, even where statutes are silent on this matter, state agencies have claimed that such authority is implicit in their legal responsibility for managing public construction contracts with appropriate protection of the public interest. Whether based on explicit or implicit authority, the requirements established by state transportation agencies for federal-aid highway contracts must not be unduly or unfairly restrictive. Federal highway regulations provide that no procedure shall be required by states in connection with federal-aid highway contracts that operate to restrict competitive bidding by discriminating against the purchase of a surety bond or insurance policy from a surety or insurer outside the state and authorized to do business in the state.[274]

Financial responsibility is implicit in the requirement that sureties must be "acceptable" to the contracting agency. Criteria for acceptance by the state may not be fully set forth in statutes or regulations. Such standards are often departmental policy, which may be applied with flexibility and administrative judgment. In some instances, however, minimum standards of financial condition are published by the state's public works agencies. This concern extends beyond the question of a proposed surety's initial financial rating, and prescribes limits on the dollar amount of a surety's bond commitments at a given time.

Other items that should be reviewed include whether the principal contract has been incorporated into the bond by reference; whether the bond sets out the alternatives available to the surety in the event of contractor default; whether it includes a definition of who may claim under the bond and in what time period a claim must be filed; and whether it is signed by individuals authorized to bind the surety.[275]

Under the Miller Act, the agency has a duty to provide a certified copy of the bond and the principal contract to any one who has furnished labor or materials and who submits an affidavit to the agency stating that he or she has not been paid.[276]

[272] *See, e.g.*, WASH. REV. CODE § 23B.15.070 (Supp. 2003).

[273] *See* Shrake Elec., Inc. v. Central Sur. & Ins. Corp., 185 Kan. 230, 342 P.2d 159 (1959) (extent of the authority given by power of attorney).

[274] 23 C.F.R. § 635.110 (2002).

[275] 17 AM. JUR. 2D *Contractors' Bonds* § 3 (1990).

[276] 40 U.S.C. § 3133(a).

c. Development of the Present Suretyship System

In 1894, Congress enacted the Heard Act, which required construction contractors for the federal government to provide a bond "with good and sufficient sureties, [and] with the additional obligation that such contractor or contractors shall promptly make payments to all persons supplying him or them labor and materials in the prosecution of the work provided for in such contract…"[277] However, under the Heard Act it was possible for subcontractors to bring suit before completion of a project and exhaust the resources of a prime contractor and the surety under the bond before the government could move to protect its interest in assuring performance.[278] Congress then amended the law in 1905 to postpone creditors' recourse to the surety bond until the Federal Government had adequate opportunity to enforce its claims.[279] The federal law remained substantially in this form until passage of the Miller Act in 1935.[280] In the Miller Act, Congress directed that the performance and payment features be executed in separate bonds, each with its own rights and rules for recourse to the surety.[281]

During the period before the Miller Act, a number of states passed legislation permitting a mechanic's lien to attach to the funds earned by a public works contractor while recognizing that the public works themselves were immune from levy or attachment under the lien. Generally, however, state legislation for the protection of laborers, materialmen, and subcontractors before 1935 followed the pattern of the Heard Act in requiring contractors to furnish a surety bond conditioned on performance and payment of claims.[282] After passage of the Miller Act, states began to follow the federal model in amending their own bonding statutes.

[277] Act of Aug. 13, 1894, ch. 280, 28 Stat. 278.

[278] United States v. American Sur. Co., 135 F. 78 (1st Cir. 1905); American Sur. Co. v. Lawrenceville Cement Co., 96 F. 25 (C.C.D. Me. 1899); Davidson Bros. Marble Co. v. United States ex rel. Gibson, 213 U.S. 10, 29 S. Ct. 324, 53 L. Ed. 675 (1909) (jurisdictional problems); United States Fidelity & Guar. Co. v. United States for the Benefit of Kenyon, 204 U.S. 349, 27 S. Ct. 381, 51 L. Ed. 516 (1907) (jurisdictional problems).

[279] As amended, the law required creditors to refrain from suit on the bond for 6 months after completion of final settlement, and allowed the United States a priority over other claimants in the distribution of surety funds. Act of Feb. 24, 1905, ch. 778, 33 Stat. 811, 812.

[280] Act of Aug. 24, 1935, ch. 624, 49 Stat. 793 (formerly codified at 40 U.S.C. §§ 270a–270d (1970), now codified at 40 U.S.C. §§ 3131–134 (2003).

[281] NETHERTON, *supra* note 259.

[282] *Id*.

4. Contractor Bonds in State and Federal Construction Contracts

a. Contractor Bond Coverage Under the Miller Act

The Miller Act provides that before the award of any contract exceeding $100,000 and involving construction, repair, or alteration of a public building or public work of the United States, the contractor must furnish (1) a performance bond of sufficient amount to protect the United States Government, and (2) a payment bond "for the protection of all persons supplying labor and material in the prosecution of the work provided for in the contract."[283] This section has been interpreted to limit recovery on a payment bond posted under the act to those materialmen, laborers, and subcontractors who dealt directly with the contractor or a subcontractor. The policy of limiting claimants who can sue under a Miller Act bond is to permit the prime contractor to protect itself by requiring the subcontractors who perform substantial portions of the prime contract to post bonds assuring that their particular materialmen, subcontractors, and laborers will be paid in the event the subcontractor defaults.[284]

The amount of the bond originally varied—one-half the contract price for contracts up to $1 million; 40 percent of the price for contracts from $1 million to $5 million; and a maximum of $2.5 million for contracts in excess of $5 million.[285] The statute was amended in 1999 to require a performance bond in an amount that the contracting officer deems adequate, and a payment bond in the total amount of the contract, unless the contracting officer determines that that amount is impracticable and sets a lesser amount. However, the payment bond may not be less than the performance bond.[286]

In a second section of the Miller Act, Congress specified that suit on the contractor's payment bond may be brought after 90 days following the final performance of labor or supplying of materials.[287] During this 90-day period, any claimant "having direct contractual relationship with a subcontractor but no contractual relationship express or implied with the contractor" who furnished the bond must give written notice of its claim to the contractor.[288] Also, no suit on the payment bond may be commenced by any claimant after the expiration of 1 year after the labor was performed or the materials supplied.[289]

These requirements were intended to strengthen the positions of the protected parties and provide reasonable procedures for exercising their rights. The legislative history of the statute recognized the widening circle of parties necessarily involved in the large, complex, and costly types of construction being undertaken. However, Congress was also sensitive to the inequity of exposing prime contractors and their sureties to "remote and undeterminable liabilities."[290] In turn, the courts approached the questions arising under this act from the standpoint that its remedial character deserved a liberal construction, favoring achievement of Congress's basic objectives. Yet, the rights of claimants under the Act were entirely statutory in their origin, and so could not be expanded beyond the plain meaning of the statute.[291]

b. Little Miller Acts

The Miller Act provided a model for states to enact their own statutes, or "Little Miller Acts," that would cover public works construction that was not covered by federal law.[292] State law establishing requirements for contractors' bonds or other security relating to performance of public construction projects may also be broader in scope than the federal law embodied in the Miller Act. For example, in addition to bonding requirements, state law may require that a certain percentage of the funds owed on the contract be retained by the contracting agency for the benefit of unpaid subcontractors or suppliers.[293] Many of the states' laws on public contractor bonding stem from early efforts to provide laborers and materialmen a form of protection similar to that which mechanic's liens provided in private construction projects.[294] Many states' statutes also include require-

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[283] 40 U.S.C. § 3131(b) (2003).

[284] J.W. Bateson Co. v. U.S. ex rel. Trustees of Nat. Automatic Sprinkler Indus. Pension Fund, 434 U.S. 586 (1978); H.H. Robertson Co. v. Lumberman's Mut. Cas. Co., 94 F.R.D. 578 (W.D. Pa. 1982).

[285] Former 40 U.S.C. §§ 270a (1999) (historical notes).

[286] Construction Industry Payment Protection Act of 1999, Pub. L. 106-49 § 2(a), 113 Stat. 231 (Aug. 17, 1999), codified at 40 U.S.C. § 3131(b) (2003).

[287] 40 U.S.C. § 3133(b)(1) (2003).

[288] 40 U.S.C. § 3133(b)(2) (2003).

[289] 40 U.S.C. § 3133(b)(4) (2003).

[290] Clifford E. MacEvoy v. United States for Use and Benefit of Calvin Tompkins Co., 322 U.S. 102, 110, 646 S. Ct. 890, 88 L. Ed. 1163 (1944).

[291] Thus, the approach to construction of the law has been summed up as follows:

> [Sections 270a-270b…are] remedial in nature and [are] to be liberally construed in order to properly effectuate the congressional intent to protect those who furnish labor or materials for public works, and the strict letter of [such sections] must yield to [their] evident spirit and purpose when this is necessary to give effect to the intent of Congress and to avoid unjust and absurd consequences, [citations omitted] such a salutary policy does not justify ignoring plain words of limitation and imposing wholesale liability on payment bonds.

United States for Use and Benefit of J.A. Edwards & Co. v. Bregman Construction Corp., 172 F. Supp. 517, 522 (E.D.N.Y. 1959); *see also* United States ex rel. Ross v. Somers Constr. Co., 184 F. Supp. 563 (D. Del. 1959).

[292] Norquip Rental Corp. v. Sky Steel Erectors, Inc., 854 P.2d 1185, 1188, 175 Ariz. 199, *review denied* (Ariz. App. 1993).

[293] *See, e.g.,* COLO. REV. STAT. § 38-26-107 (2000).

[294] *See* Western Metal Lath, a Division of Triton Group, Ltd. v. Acoustical and Const. Supply, Inc., 851 P.2d 875, 877 (Colo. 1993).

ments designed to protect the interests of public agencies in a wide range of other matters. These include guarantee of bids, satisfactory performance of contracts, payment of taxes, contribution to workmen's compensation or unemployment funds, performance of maintenance, and issuance of supplies.[295]

The Model Procurement Act also contains a section addressing the requirement of payment and performance bonds.[296] These requirements are similar to the Miller Act requirement for separate payment and performance bonds, but require bond amounts to be 100 percent of the contract price.

c. Statutory Terms and Other Definitions

Much of the Miller Act's annotations interpret the language defining the parties protected and the types of contracts covered. They also discuss what constitutes "labor and materials" supplied "in the prosecution of the work provided for" under a contract. The courts have been asked to clarify the critical dates involved in the 1-year limitation on commencing suit, and the 90-day period for notice of claims, and the sufficiency of the content of the notice. These decisions have also helped shape the meaning of state and local contractor bonding laws or Little Miller Acts that have been patterned after the federal statute.

i. Public Buildings and Public Works.—Because the Miller Act applied to contracts "for the construction, alteration, or repair of any public building or public work of the United States," a threshold question concerned the definition of "public works." In *United States to the Use of Noland Co. v. Irwin*,[297] the Supreme Court gave this phrase a broad scope, consistent with legislative history that contemplated application to public works projects under the contemporaneous National Recovery Act. In contrast to the view that had prevailed under the Heard Act, the Court stated that "the question of title to the buildings or improvements to the land on which they are situated is no longer of primary significance."[298] A more important consideration was whether the structures were constructed for public use and paid for by the Federal Government. Neither was it technically necessary that the contract be made directly with the United States, provided that the work performed was done on behalf of the government under proper authority.[299]

Projects that involve public money but are ultimately privately owned and/or operated buildings also present problems for determining bond requirements under state Little Miller Acts. In Milbrand Co. v. Department of Social Services, [300] a private developer purchased city-owned property under a contract to construct a building in accordance with plans received and approved by the city. The contractor defaulted on payments to a subcontractor, who then sued the city. The court held that the project did not involve a "public building" for which a statutory payment bond was required.[301] A Connecticut court held that whether a project is a "public work" must be determined on a case-by-case basis, and where a building is constructed with public money for private use, the determination depends on the degree of governmental involvement with the project.[302] A Georgia court found that mere receipt of public funds by a private organization did not require application of either the Miller Act or Georgia's Little Miller Act.[303] However, in a case involving construction of both public and nonpublic facilities, the surety was liable to the concrete supplier for concrete used in the nonpublic portion of the project, since the work was completed as part of the covered prime contract.[304]

[295] N.M. STAT. § 13-4-18 (A)(1) (2001) (performance bond); OHIO REV. STAT. § 9.31.1 (2001) (bid security); WIS. STAT. § 779.14(1e)(a) (2001) (including state taxes, workers' compensation, and unemployment insurance).

[296] AMERICAN BAR ASSOCIATION, MODEL PROCUREMENT CODE FOR STATE AND LOCAL GOVERNMENTS § 5-302 (2000).

[297] 316 U.S. 23, 62 S. Ct. 899, 86 L. Ed. 1241 (1942).

[298] 316 U.S. at 29.

[299] United States ex rel. Westinghouse Electric Supply Co. v. National Sur. Corp., 179 F. Supp. 598 (E.D. Pa. 1959).

[300] 117 Mich. App. 437, 324 N.W.2d 41 (1982) (construing MICH. COMP. LAWS, 129.201 (1963)).

[301] 324 N.W.2d at 43; *but see* United States ex rel. Hillsdale Rock Co. v. Cortelyou & Cole, Inc., 581 F.2d 239, 242 (9th Cir. 1978) (payment bond furnished jointly by Stanford University and Atomic Energy Commission). With respect to "public works," see Annotation, 48 A.L.R. 4th 1170.

[302] L. Suzio Concrete Co. v. New Haven Tobacco, Inc., 28 Conn. App. 622, 611 A.2d 921 1992).

[303] Consolidated Elec. Supply, Inc. v. Bishop Contracting Co., 205 Ga. App. 674, 423 S.E.2d 415 (1992) (YWCA received federal funds, but provided no essential government services and was not a governmental agency).

[304] Dixie Bldg. Material Co. v. Liberty Somerset, Inc., 656 So. 2d 1041 (La. App. 4th Cir.) *rehearing denied*, 661 So. 2d 1346 (1995).

ii. Labor Done or Performed.—Many questions regarding the labor covered by the Miller Act payment bonds have involved the requirement that the labor be performed "in the prosecution of the work provided for" in the contract. The language implies that certain services that benefit the contractor are so generalized that they cannot be traced to the contract specifications, and thus are not covered by the bond. However, these limits seldom result in denying a claim because of its remoteness.[305] Claims for work done outside the scope of the contract specifications represent the category most vulnerable to denial, because requirement of their inclusion under the bond would alter the obligation of the surety.[306] Claims for extra work may be allowed where the terms of the bond provide for it and the contractor initially authorizes the work.[307]

Where claims have been made for money withheld from laborers' wages to meet taxes, decisions have varied. Some argue for allowing such claims because the money in question was withheld from laborers' compensation and, in the absence of the withholding directive, would have been paid to the wage earner. Another viewpoint is that that the correct way of looking at the role of the contractor in these circumstances is as a collector of the tax at the point where the laborer receives his or her wages. Wages withheld for taxes generally are not covered by the bond.[308] However, wages withheld to make contributions to union health and welfare funds on behalf of employees are within the bond's coverage.[309]

Applying Iowa's statute, the state court agreed that contributions to health, welfare, and pension funds represented payment for labor or services performed in a construction project, and distinguished those funds from workers' compensation, social security taxes, and board and lodging for employees, which were not in the nature of payment for labor or services.[310]

Federal court decisions on Miller Act bonds have adopted a view that the scope of the phrase "labor and materials" includes those costs that are necessary to provide the products and services or add value to the project of which they are components. Thus, they hold that the statutory coverage of Miller Act bonds does not include attorneys fees, financial charges on overdue accounts, lost profits, cancellation charges, delay damages, escalated material costs, or penalties.[311] State courts have reached the same conclusion under state law regarding personnel administration costs and security interests.[312]

Cases defining "labor in prosecution of the work" as used in the Miller Act have construed the term to include physical work and also activities of architects and other professionals who supervise work done at the project job site. Where the language of the bond is broad enough, it may cover work done by architects outside of the job site.[313] Activities of consulting engineers involving inspection of work being performed by others are within the scope of the statutory coverage.[314] Where professional work does not involve services of a supervisory nature, inspections, job site consultations and job reviews, or similar activities, it is regarded as outside the statutory scope of the bond.[315] In addition, work performed by architects or engineers prior to the con-

[305] *See, e.g.*, Price v. H.L. Coble Constr. Co., 317 F.2d 312, 316 (5th Cir. 1963) (labor furnished for a subcontractor, involving overseeing and expediting construction work, recruiting workmen, making up payrolls, and reporting periodically to the subcontractor held covered by the payment bond).

[306] Sam Macri & Sons, Inc. v. United States for the Use and Benefit of Oaks Constr. Co., 313 F.2d 119, 123–24 (9th Cir. 1963); United States for the Use and Benefit of Warren Painting Co. v. J.C. Boespflug Constr. Co., 325 F.2d 54, 61 (9th Cir. 1963).

[307] Cent. Gulf Elec. Contractor, Inc. v. M. P. Dunesnil Constr. Co., 471 So. 2d 1148 (La. App. 3rd Cir. 1985).

[308] United States v. Seaboard Sur. Co., 201 F. Supp. 630 (N.D. Tex. 1961).

[309] United States for the Benefit of Sherman v. Carter, 353 U.S. 210, 219, 77 S. Ct. 793, 1 L. Ed. 2d 776 (1957).

[310] Dobbs v. Knudson, Inc., 292 N.W.2d 692, 695 (Iowa 1980) (construing IOWA CODE, 573.2 (1976)); *see also* Trustees of Colo. Carpenters & Millwrights Health Bd. Trust Fund v. Pinkard Constr. Co., 199 Colo. 35, 604 P.2d 683, 685 (1979) (construing COLO. REV. STAT. § 38-26-105 (1973)); Trustees, Fla. West Coast Trowel Trades Pension Fund v. Quality Concrete Co., 385 So. 2d 1163 (Fla. App. 1980) (construing Fla. Stat. Ann. § 255.05 (1978)); *see also* Indiana Carpenters Cent. and Western Indiana Pension Fund v. Seaboard Sur. Co., 601 N.E.2d 352, 355–56*, rehearing denied, transfer denied*, 615 N.E.2d 892 (1994); Alibrandi Building Systems, Inc. v. Wm. C. Pahl Constr. Co., 590 N.Y.S.2d 370, 371, 187 A.D. 2d 957 (1992); Puget Sound Elec. Workers Health and Welfare Trust Fund v. Merit Co., 123 Wash. 2d 565, 870 P.2d 960 (1994).

[311] Can-Tex Indus. v. Safeco Ins. Co. of Am., 460 F. Supp. 1022 (W.D. Pa. 1978) (construing PA. STAT., tit. 8, § 193 (1967)); Lite-Air Products, Inc. v. Fidelity & Deposit Co. of Md., 437 F. Supp. 801, 804 (E.D. Pa. 1977); *see also* United States ex rel. Heller Elec. Co. v. William F. Klingsmith, Inc., 670 F.2d 1227 (D.C. Cir. 1982) (Miller Act claim for damages for contractor's delay and loss of anticipated profits); Concrete Structures of the Midwest, Inc. v. Fireman's Ins. Co. of Newark, 790 F.2d 41 (7th Cir. 1986) (claim for lost profits based on common law bond theory denied).

[312] Primo Team, Inc. v. Blake Constr. Co., 4 Cal. Rptr. 2d 701, 3 C.A. 4th 801, *rehearing denied, modified, review denied* (Cal. App. 4th Dist. 1992) (personal administrator not "furnisher of labor"); Union Asphalt, Inc. v. Planet Ins. Co., 27 Cal. Rptr. 2d 371, 21 C.A. 4th 1762 (1994) (holder of security interest not supplier of labor or materials).

[313] Herbert S. Newman and Partners, P.C. v. CFC Constr. Ltd. Partnership, 236 Conn. 750, 674 A.2d 1313 (1996).

[314] *See* United States ex rel. Charles H. Thayer v. Metro Constr. Corp., 330 F. Supp. 386 (E.D. Va. 1971).

[315] United States ex rel. Naberhaus-Burke, Inc. v. Butt & Head, Inc., 535 F. Supp. 1155, 1160 (S.D. Ohio 1982) ("federal case law has adopted an admittedly somewhat narrow definition of the term…covering only skilled professional work which involves actual superintending, supervision or inspection at the jobsite.").

struction contract are not covered by the bond.[316] This narrow interpretation of "labor" in the federal cases contrasts with the argument that the Miller Act should be read to include all professional services under its protection, and that some states have given broader coverage under their analogous mechanics' lien laws.[317]

iii. Material Furnished or Supplied.—Under both federal and state law, the definition of "materials furnished or supplied" includes all types of materials, items, and substances that are incorporated into the public facility, or consumed in its construction.[318] Other things may be included, however, if circumstances show that they were furnished "in the prosecution of the work provided for" in the contract. Materials may be considered to be furnished in the prosecution of the contract work even though they are not deposited at the construction site, or not wholly consumed in the construction work.[319]

State bonding statutes that use the language of the Miller Act (i.e., "furnished labor or materials in the prosecution of the work provided for in such contract") generally are interpreted as imposing on the claimant a burden of showing only that the materials were "furnished" in connection with a particular project, but not that the specific items furnished were actually incorporated into the construction work. While proof of delivery to a job site is an important, and sometimes decisive, factor in proving that goods were "furnished" in connection with a particular project, it is not an absolute requirement or element of proof of the claim.[320] Invoices and sales slips that itemize materials shipped and are adequately dated can meet the claimant's burden of proof.[321]

Where the "materials furnished" are not consumed in the construction process or physically incorporated into the project, their use in the construction process cannot be easily measured.[322] Consequently, recovery for the value of signs and barricades for use during work on drainage structures, wooden forms for concrete pavement, and sheet pilings for lining ditches during excavation operations have been approved only where other rationale for recovery was available.[323]

Contractors, subcontractors, and materialmen in their daily business practices often do not leave clear trails of the movement of labor, materials, and money in their transactions. Proof of problems resulting where contractual transactions are permitted to become casual is illustrated in *Adams v. Magnolia Construction Co.*[324] A general contractor for construction of a municipal sewer system orally arranged with a subcontractor to have the latter furnish "shells" for the structural components needed in the project. The subcontractor obtained the shells from three sources and stockpiled them in the contractor's storage yard, where they were mixed with other shells and used as needed for a series of projects. When a corporate officer of one of the subcontractor's suppliers was unable to testify that any of its company's shells were actually used by the subcontractor in the bonded project, there was no other trail of business records of physical evidence on which to rely, and the supplier's claim was dismissed. In contrast, where purchase orders, invoices, and correspondence between the parties have been available to establish the transfer of materials from supplier to contractor, the claimant can more easily prove their use by the contractor and the payment for them.[325]

Recognizing the reasonable limits to which a supplier can be expected to go in determining what use is made of its materials once they are turned over to another party, courts have accepted proof of delivery to the work site as evidence that the materials were used in the construction.[326] Where a supplier furnished towing services rather than materials, the proof that they were consumed or used in a bonded project was found

[316] Union Asphalt, Inc. v. Planet Ins. Co., 27 Cal. Rptr. 2d 371, 21 C.A. 4th 1762 (Cal. App. 2 Dist. 1994).

[317] *See* Annotation, 3 A.L.R. 3d 573 (1965), 28 A.L.R. 3d 1014 (1969).

[318] Quality Equipment Co. v. Transamerica Ins. Co., 243 Neb. 786, 502 N.W.2d 488, 492 (1993) (state law); Poly-Flex, Inc. v. Cape May County Mun. Utilities Auth., 832 F. Supp. 889, 892 (D. N.J. 1993) (federal law).

[319] Montgomery v. Unity Elec. Co., 155 F. Supp. 179 (D. P.R. 1957); United States ex rel. Purity Paint Products Corp. v. Aetna Cas. & Sur. Co., 56 F. Supp. 431 (D. Conn. 1944); Commercial Standard Ins. Co. v. United States for Use of Crane Co., 213 F.2d 106 (10th Cir. 1954) (recovery allowed under a payment bond for pipe put in inventory to replace that which had been taken out to complete the contract; but recovery denied for stockpiled materials where there was no evidence to show which material actually had been used in the performance of public construction, and which had been used for other contracts); United States for the Benefit and Use of Westinghouse Elec. Supply Co. v. Robbins, 125 F. Supp. 25 (D. Mass. 1954).

[320] City Elec. v. Indus. Indem. Co., 683 P.2d 1053, 1057–58 (Utah 1984).

[321] *Id*. at 1059.

[322] Houston Gen. Ins. Co. v. Maples, 375 So. 2d 1012 (Miss. 1979) (construing MISS. CODE, 31-5-1 (1972)).

[323] Constr. Materials, Inc. v. Am. Fidelity Fire Ins. Co., 383 So. 2d 1291 (La. 1980) *writ granted*, 385 So. 2d 256 (liability based on language of bond broader than statute); Slagle-Johnson Lumber Co. v. Landis Constr. Co., 379 So. 2d 479 (La. 1979) (forms destroyed following use); R.C. Stanhope, Inc. Roanoke Constr. Co., 539 F.2d 992 (4th Cir. 1976) (lost sheet piling treated as rental equipment rather than as material consumed).

[324] 431 So. 2d 38 (La. App. 1983) (applying LA. REV. STAT., § 38:2241); *see also* School Dist. of Springfield R-12 ex rel. Midland Paving Co. v. Transamerica Ins. Co., 633 S.W.2d 238 (Mo. App. 1982) (invoices, weight tickets, account records).

[325] Carr Oil Co. v. Donald G. Lambert Contractor, Inc., 380 So. 2d 157 (La. App. 1979) (petroleum products and fuel delivered to contractor's fuel storage tanks at work site and used there by contractor's road equipment).

[326] Wal-Board Supply Co. v. Daniels, 629 S.W.2d 686 (Tenn. App. 1981); Carr Oil Co. v. Donald G. Lambert Contractor, 380 So. 2d 157 (La. App. 1979).

through matching invoices with the transporter's log book showing the routes used.[327]

In order to recover from the surety, a supplier must show that it delivered materials to the contractor or subcontractor in good faith, that it understood and intended that the materials were to be used in prosecution of the contract work, that the contractor or subcontractor diverted the materials from use in the intended project, and that the supplier did not have knowledge or authorize the diversion.[328] Where materials fabricated for use in a tunnel construction project were delivered to the project site, but thereafter were converted by the contractor to other projects, it was held that the bond covered the converted materials originally intended for incorporation into the tunnel project.[329] In this instance the state's bonding statute required that contractors' payment bonds cover "any material specially fabricated…as a component…so as to be unsuitable for use elsewhere."[330]

A common practice of contractors and subcontractors who must deal regularly with materialmen is to maintain open running accounts for the convenience of their employees to make purchases, as needed, during construction activities. This arrangement, however, increases the need to generate evidence of how the purchased materials were used.[331]

Where goods are rejected as unsuitable after delivery to the construction jobsite, courts have questioned whether the materialman is covered by the payment bond.[332] Holding that the materialman had stated a proper claim under the Miller Act even though it did not allege that its goods were supplied for use in a particular project, the federal court stated that for a materialman to recover under the Miller Act:

> [I]t is necessary only that he show that the materials were supplied in prosecution of the work provided for in the contract, that he has not been paid therefore, that in good faith he had reason to believe that the materials were intended for the specified work, and that he complied with the jurisdictional requirements. It is immaterial to its right of recovery that the materialman deliver the materials to the jobsite or that such materials actually be used in…the work. [333]

iv. Other Items.—In determining the coverage of payment bonds required under the states' Little Miller Acts, various marginal items have been considered by the courts. Where the question is whether particular items are materials or equipment, the nature of the item is a more important indicator than the form of the agreement involved. Thus, scaffolding used by a painting contractor was held to be part of its permanent "plant," or stock of tools, and equipment held on hand to perform its work.[334] Under a statute requiring payment bonds for the protection of "all persons supplying labor and materials" in the prosecution of the work, items such as bulldozers, graders, tractors, trucks, and the like were held not to be "materials" that could be covered by the bond.[335]

The same issue arose where a claimant argued that pumps obtained by rent or purchase for use in constructing a municipal sewer system were "supplies used or consumed" by the contractor. Holding that the costs of renting and purchasing the pumps were not covered by the contractor's payment bond, the Colorado court noted that there was a split of authority on the treatment of tools, equipment, and "plant," but found that the majority did not allow recovery from the surety.[336]

Whether activities conducted away from the construction site can qualify as "work done" in completion of a project was considered where sand for a highway project was taken by dragline from a river and deposited at a loading yard, from which it was hauled by another subcontractor to the site of the road work. When a dragline operator sued to recover from the surety for its services, the court held that the claim was allowed.[337] All links in the transportation chain from a protected materialman to the construction job site are covered by the bond, and so the cost of moving sand from the barges to the loading yard was covered.

Fuel furnished for operating machinery used in construction work on the jobsite generally meets the test of

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[327] Harvey Canal Towing Co. v. Gulf South Dredging Co., 345 So. 2d 567 (La. App. 1977).

[328] Pennex Aluminum Co., A Div. of Metal Exchange Corp. v. International Fidelity Ins. Co., 818 F. Supp. 772, 782–84 (M.D. Pa. 1993) *see also* Solite Masonry Units Corp. v. Piland Constr. Co., 232 S.E.2d 759 (Va. 1977); AMOCO Oil Co. v. Capitol Indemnity Corp., 291 N.W.2d 883, 889–91 (Wis. App. 1980) (supplier should have been aware of diversion because of amount of material ordered).

[329] CC&T Constr. Co. v. Coleman Bros. Corp., 8 Mass. App. 133, 391 N.E.2d 1256, 1259 (1979).

[330] *Id*. (Construing MASS. GEN. L., ch. 149, § 29).

[331] Villa Platte Concrete Service, Inc. v. Western Casualty & Surety Co., 399 So. 2d 1320 (La. App. 1981) (proof insufficient to show that items for which claimant sought recovery actually had been furnished under oral contract between claimant and general contractor); Cedar Vale Co-Op Exchange v. Allen Utilities, Inc., 10 Kan. App. 2d 129, 694 P.2d 903 (1985) (claimant's evidence was insufficient to show that items charged to contractor's account were used in project).

[332] United States ex. rel. Lanahan Lumber Co. v. Spearin, Preston & Burrows, Inc., 496 F. Supp. 816 (M.D. Fla. 1980).

[333] *Id*. at Supp. at 817–18 (quoting United States ex rel. Carlson v. Continental Casualty Co., 414 F.2d 431, 433 (5th Cir. 1969)).

[334] Arthur J. Roberts & Co. v. Delfour, Inc., 14 Mass. App. 931, 436 N.E.2d 1246, 1248 (1982) (construing MASS. GEN. LAWS ANN. ch. 149, § 29).

[335] Valliant v. State, Dep't of Transp. and Dev., 437 So. 2d 845 (La. 1983) (construing LA. REV. STAT. § 38:2241 (1980)); Rish v. Theo Bros. Constr. Co., 269 S.C. 226, 237 S.E.2d 61 (1977) (construing S. C. CODE § 33-224 (1975)).

[336] CPS Distributors, Inc. v. Fed. Ins. Co., 685 P.2d 783, 785 (Colo. App. 1984) (construing COLO. REV. STAT. § 38-26-105 (1982)).

[337] Javeler Constr. Co. v. Fed. Ins. Co., 472 So. 2d 258 (La. 1985) (construing LA. REV. STAT. § 38:2241 (1980)).

necessity.[338] So does fuel used for heating buildings at the jobsite used in performing the work.[339]

The obvious need for moving supplies and materials to the jobsite, sometimes over great distances, and within the jobsite has led to construing transportation as a form of "labor" furnished to the contractor, and therefore covered by payment bonds under the Miller Act and Little Miller Acts.[340].

v. Equipment Rental.—The regular use of rental equipment in public works construction has lead some states to list rental charges as items that are covered by statutory payment bonds. Other states, interpreting variously worded statutes that do not explicitly cover rental of equipment, have held that rental costs are included in the general language and legislative purpose of their laws.[341] In the rationale for permitting claims to recover for use of rented equipment, it is the rental payments, as opposed to the value of the equipment as a capital item, that are "consumed" in the performance of the project. Rental payments represent the increment of the useful life of the equipment that is used up for the benefit of the bonded project. Accordingly, the contract agreement establishing the rental must be a genuine lease rather than a purchase and sale. Whether the agreement is for a lease or a sale must be determined by the facts of each case, and is not solely dependent upon the characterization of the transaction. In a Missouri case, the evidence indicated that the claimant's equipment rental agreement was in fact a lease intended for the security of the seller while the claimant purchased the equipment through a series of monthly payments.[342] In another case, the transaction was considered a rental rather than a sale even though the form was entitled "purchase/rental order," but the information filled in on the form was only the rental rate and not the purchase cost.[343]

In contrast, the federal court in *United States Fidelity and Guaranty Co. v. Thompson-Green Machinery Co.* held that the agreements for rental of heavy construction machinery to a highway contractor were genuine leases and not conditional sales. [344]

> Perhaps the most revealing test is whether the so-called lessee is obligated to accept and pay for the property or is obligated only to return or account for the property according to the terms of the lease from which he may be excused only if he exercises the privilege of purchasing it. If the latter is the case the transaction is a true lease, but if the contract, whatever its form, imposes an absolute obligation to pay for and accept the property and the transferor may require its return only upon default of the transferee, the transaction is a conditional sale… [T]he intent of the parties is controlling and is to be ascertained from the whole transaction, not merely from the language employed.[345]

Essentially the same approach was used where liability for rental was challenged because the equipment was idle for part of the period it was in the lessee's possession. Recognizing that in most construction projects rental equipment is used intermittently, the rented items are considered to be "substantially consumed" on the project during the amount of time they are immediately available to the subcontractor for its use.[346]

Where claims against a contractor for costs of equipment use are based on a conditional sales contract, the claimant cannot have recourse to a Miller Act payment bond. Regarding "rental-purchase" agreements, courts have stated that they will look to the substance rather than the form of these transactions. Thus, where the total rent on equipment substantially equals its purchase price, and a purchase option is exercisable for a nominal sum, the transaction has been held to be a conditional sale.[347] In contrast, where the total rent agreed upon was substantially less than the purchase price of the equipment, and the cost of exercising a purchase option was substantial, the transaction was held to be a rental, and unpaid rental charges were covered by the contractor's payment bond.[348]

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[338] State for Use and Benefit of J.D. Evans Equip. Co. v. Johnson, 83 S.D. 444, 160 N.W.2d 637, 640 (1968) (includes gas and oil); United States for Use of United States Rubber Co. v. Ambursen Dam Co., 3 F. Supp. 548 (N.D. Cal. 1933).

[339] Leo Spear Constr. Co. v. Fidelity and Casualty Co. of New York, 446 F.2d 439, 444 (2d Cir. 1971); United States for Use of Elias Lyman Coal Co. v. United States Fidelity & Guar. Co., 83 Vt. 278, 75 A. 280 (1910).

[340] Standard Accident Ins. Co. v. United States for the Use and Benefit of Powell, 302 U.S. 442, 585 S. Ct. 314, 82 L. Ed. 350 (1938); Conesco Indus. Ltd. v. St. Paul Fire and Marine Ins. Co., 619 N.Y.S.2d 865, 210 A.D. 2d 596, *leave to appeal denied*, 628 N.Y.S.2d 52, 85 N.Y.2d 809, 651 N.E.2d 920 (1995) (freight costs included).

[341] *See, e.g.,* Norquip Rental Corp. v. Sky Steel Erectors, Inc., 854 P.2d 1185, 1190–91 (Ariz. App. 1993); McElhose v. Universal Sur. Co., 182 Neb. 847, 158 N.W.2d 288 (1968).

[342] Public Water Supply Dist. No. 3 of Ray County ex rel. Victor L. Phillips Co. v. Reliance Ins. Co., 705 S.W.2d 190 (Mo. App. 1986) (construing MO. ANN. STAT. 107.170 (1987); rental of excavating machinery paid in five monthly installments with option "guaranteeing" conversion to purchase after 5 months' rental). Regarding distinguishing lease and sale transactions, *see* MO. REV. STAT. 400.1-201(37) (1978) and U.C.C. § 1-201(37); United States ex rel. Eddies Sales & Leasing, Inc. v. Fed. Ins. Co., 634 F.2d 1050, 1052 (10th Cir. 1980) (Miller Act).

[343] Chadwick-BaRoss, Inc. v. T. Buck Constr., 627 A.2d 532 (Me. 1993).

[344] 568 S.W.2d 821 (Tenn. 1978) (construing TENN. CODE ANN. § 54-519 (1978).

[345] 568 S.W.2d at 825.

[346] McGee Steel Co. v. State ex rel. McDonald Indus. Alaska, 723 P.2d 611, 617 (Alaska 1986); John A. Artukovich Sons, Inc. v. Am. Fidelity Fire Ins. Co., 72 Cal. App. 3d 940, 140 Cal. Rptr. 434 (1977).

[347] Oesterreich v. Comm'r Int. Rev., 226 F.2d 798 (9th Cir. 1955).

[348] Kitchen v. Comm'r Int. Rev., 353 F.2d 13 (4th Cir. 1965).

vi. Repairs and Replacement of Parts.—Where claims are based on repairs or replacement of parts in a contractor's equipment, a distinction is made between work needed to maintain the contractor's capital investment in equipment and work needed to replace items worn out in the performance of work. Capital expenditures by the contractor are not covered by payment bonds. Where failure of the equipment during its use requires that it be repaired, the bond under Alaska's Little Miller Act was held to cover repair for incidental damage to the equipment and ordinary wear and tear, but not for repair due to a subcontractor's negligence.[349]

In determining whether repairs and parts replacement must be treated as capital investments, the question of substantial consumption of the repaired or replaced items in the work performed under the contract has been one of the most important tests.[350] It is readily applied to such equipment as tires, batteries, and other automotive accessories that regularly need replacement with wear.[351] However, where the items in question cannot be shown to have been substantially consumed in the contract work, any claim for their repair or replacement is open to the objection that payment will have the effect of adding to the value of the contractor's equipment beyond the needs of the current contract and will be for the benefit of work on other contracts.[352]

Consumption of materials in the course of construction work or integration into the final facility is not questioned in the case of many classes of materials. However, it has presented problems for the state courts in connection with claims based on supplying tires or other equipment not entirely worn out in the work performed. One approach that has received wide acceptance was described by the Pennsylvania court in *Commonwealth to the Use of Walters Tire Service v. National Union Fire Ins. Co.:*[353]

> [T]he proper test to be applied is whether or not in a particular case and bonded project there is a reasonable and good faith expectation by the supplier at the time of delivery that the materials under all the circumstances would be substantially used up in the project under way.[354]

However, a year later the same court had to pass on a claim for replacement of the undercarriage of an item of multi-use equipment. The actual use of the equipment following replacement became the decisive factor. The claim was disallowed when it appeared that following its repair the machinery was used 75 percent of the time on other jobsites.[355] Thus, in practice, the test of reasonableness and good faith is likely to be tempered by reference to whether expectations are validated by actual experience on the jobsite.[356]

"Substantial consumption" is the surest test for distinguishing materials from enhancement of capital investment. However, difficult questions of interpretation have remained in the form of claims based on frustrated expectations of the parties or services performed after the contractor or subcontractor completes work on a contract site. Thus, some courts have focused on the degree of consumption that was expected in connection with a particular job rather than the consumption that actually occurred.[357] Also, the language of the contract may indicate an intent to cover a certain degree of repair or replacement. Where the contract called for rental of equipment at the "net cost" to the subcontractor, the subcontractor was entitled to the cost of repair from the payment bond.[358]

5. Surety Bonds: Legal and Administrative Considerations for State DOTs

Most transporation agencies require performance bonds to secure the performance and completion of their projects. Performance bond forms should be carefully reviewed, kept updated, and list the available options of the surety in event of a default. Most performance bonds incorporate by reference the underlying contract between the principal and the obligee. Further discussion about performance bond provisions is contained in section 7(A)(9) of this volume.

To conduct business on federal projects, a surety must be listed on the U.S. Treasury List of Acceptable Sureties. This list, commonly referred as the Treasury List, is also used by some state transportation agencies as a prerequisite for acceptability. The regulations require sureties to honor their bonds promptly, and their

[349] McGee Steel Co. v. State ex rel. McDonald Indus. Alaska, 723 P.2d 611, 617–18 (Alaska 1986) (applying ALASKA STAT. § 36.25.010 (1986)); *see also* Sim's Crane Serv. Inc. v. Reliance Ins. Co., 667 F.2d 30, 32 (11th Cir. 1982) (holding surety not liable for crane damage that exceeded "expected consumption" of equipment and "unduly enlarged" the bond's intended coverage); John A. Artukovich Sons, Inc. v. Am. Fidelity Fire Ins. Co., 72 Cal. App. 3d 940, 140 Cal. Rptr. 434 (1977) (modification of trencher to meet project specifications); Conesco Indus., Ltd. v. St. Paul Fire and Marine Ins. Co., 619 N.Y.S.2d 865, 867, 210 A.D. 2d 596, *leave to appeal denied*, 628 N.Y.S.2d 52, 85 N.Y.2d 809, 651 N.E.2d 920 (1994) (repair costs allowed).

[350] United States for Use and Benefit of J.P. Byrne & Co. v. Fire Ass'n, 260 F.2d 541 (2d Cir. 1958).

[351] United States for Use of United States Rubber Co. v. Ambursen Dam Co., 3 F. Supp. 548 (N.D. Cal. 1933).

[352] United States for Use and Benefit of Wyatt & Kipper Eng'rs, Inc. v. Ramstad Constr. Co., 194 F. Supp. 379 (D. Alaska 1961); Continental Cas. Co. v. Clarence L. Boyd Co., 140 F.2d 115 (10th Cir. 1944).

[353] 434 Pa. 235, 252 A.2d 593 (1969).

[354] 252 A.2d at 595.

[355] County Comm'rs of Tioga County to the Use of L.B. Smith, Inc. v. C. Davis, Inc., 439 Pa. 285, 266 A.2d 749 (1970).

[356] Mountaineer Euclid, Inc. v. Western Cas. & Sur. Co., 19 Ohio App. 2d 185, 250 N.E.2d 768 (1969) (definition of "repair," discussion of whether it includes parts and labor or labor only).

[357] United States for Use and Benefit of Chemetron Corp. v. George A. Fuller Co., 250 F. Supp. 649 (D. Mont. 1965); United States for Use and Benefit of J.P. Byrne & Co. v. Fire Ass'n, 260 F.2d 541 (2d Cir. 1958).

[358] R.J. Russo Trucking and Excavating, Inc. v. Pa. Resource Systems, Inc., 573 N.Y.S.2d 95, 169 A.D. 2d 239 (1991).

failure to do so may result in removal from the Treasury List.[359] Under the regulations, if a federal agency takes the position that the surety's refusal to pay is not based on adequate grounds, it may report the surety to the Treasury Department. This may, after notice and a hearing, result in removal from the Treasury List. In addition, sureties may also be suspended or debarred from government contracting based on "adequate evidence of misconduct." Such misconduct could involve fraud or unsatisfactory performance.[360]

Other states require that sureties have AM Best ratings of A- or better, be authorized to do business in the state, or be approved by the state agency.

6. Enforcement of Payment Bonds

Before a party can recover for payment under the Miller Act, it must prove several elements: that it supplied materials or labor for the work in the contract at issue; that it has not been paid; and that the jurisdictional requirements for timely and adequate notice have been met.[361] However, a threshold question in the enforcement of the remedies provided in the Miller Act concerns the definition of parties eligible to reach the contractor's payment bond. The Miller Act stated that this class consisted of persons who dealt directly with the prime contractor, or who lacked a direct contractual relationship, express or implied, with the prime contractor, but had a direct relationship with one of its subcontractors. There was, however, no statutory definition of a subcontractor.

State statutes vary in the scope of persons who may recover under the payment bond. For example, Kansas's bond statute limits recovery to the same persons eligible under the Miller Act.[362] However, California's statute provides coverage to subcontractors at any tier.[363]

a. Parties Entitled to Claim

The Miller Act allows claims by subcontractors and by those in a contractual relationship with a subcontractor, including materialmen and suppliers of labor. Questions have thus arisen as to who is a subcontractor. The first guidance provided by the Supreme Court on the definition of subcontractor in the Miller Act came in *Clifford E. MacEvoy Co. v. United States for Use and Benefit of Calvin Tompkins Co.*[364] The court held that the term "subcontractor," as used in the Miller Act, was "one who performs for and takes from the prime contractor a specific part of the labor or material requirements of the original contract."[365] The claimant had sold building materials to one who resold them to the prime contractor for use in a federal construction project. The court held that the claimant was merely a supplier to a materialman, and thus too remote from the prime contractor to be eligible to reach the payment bond. The decision appeared to be consistent with the legislative history Congress had provided on this point and reflected the Court's acceptance of Congressional efforts to strike a balance that accommodated the needs of all the interests involved.[366] The Court in particular cited the inability of the prime contractor to protect itself from claims that are too remote.[367]

The contractual basis of the parties' relationship appears to have been given more weight than the function being performed in the construction process. There is an argument that functional analysis may reduce the chance for use of sham subcontractors in order to limit liability on a payment bond. However, the United States Supreme Court has held that Congress imposed a structurally defined limitation on the right to sue on a payment bond, which was not to be overstepped by a functional examination of the relationships of the contracting parties.[368] The necessary contractual basis of a

[359] 31 C.F.R. 223.18(a).

[360] BOND DEFAULT MANUAL 236 (Duncan L. Clore ed., American Bar Association, 2d ed. 1995).

[361] *See, e.g.,* S.T. Bunn Constr. Co. v. Cataphote, Inc., 621 So. 2d 1325 (Ala. Civ. App. 1993).

[362] *See* Vanguard Products Corp. v. American States Ins. Co., 19 Kan. App. 2d 63, 863 P.2d 991 (1993) (applying KAN. STAT. § 60-1111; supplier to subsubcontractor not with scope of coverage of bond).

[363] Union Asphalt, Inc. v. Planet Ins. Co., 27 Cal. Rptr. 2d 371, 21 C.A. 4th 1762 (1994) (applying CAL. CIV. CODE §§ 3110, 3181, 3248(c)).

[364] 322 U.S. 102, 64 S. Ct. 890, 88 L. Ed. 1163 (1944).

[365] 322 U.S. at 109. *See also* Aetna Cas. & Sur. Co. v. United States for Use and Benefit of Gibson Steel Co., 382 F.2d 615 (5th Cir. 1967) (fabricator of steel products who gave the contractor no performance bond, received no progress payments, and whose contract amounted to only 2 percent of the total cost of a project was denied status of subcontractor under the Miller Act); United States for the Use of Wellman Eng'r Co. v. MSI Corp., 350 F.2d 285 (2d Cir. 1965) (firm that supplied hydraulic system for opening and closing roof of missile launcher held status of subcontractor even though it performed no installation work on jobsite); Basich Bros. Constr. Co. v. United States for Use of Turner, 159 F.2d 182 (9th Cir. 1946) (firm that supplied sand and gravel to a location leased by the prime contractor where the materials were further processed and delivered to the jobsite was held to be a subcontractor rather than a materialman; the element of privity was strengthened by the prime contractor's payment of the firm's payroll); Brown & Root, Inc. v. Gifford-Hill & Co., 319 F.2d 65 (5th Cir. 1963); United States for the Use and Benefit of F.E. Robinson Co. v. Alpha-Continental, 273 F. Supp. 758 (E.D. N.C. 1967) (suppliers of labor, although not technically in privity with a prime contractor may be accorded the status of subcontractor); Barton Malow Co. v. Metro. Mfg., Inc., 214 Ga. App. 56, 446 S.E.2d 785 (1994).

[366] One congressional committee's report had stated: "A Sub-subcontractor may avail himself of the protection of the bond by giving notice to the contractor, but that is as far as the bill goes. It is not felt that more remote relationships ought to come within the purview of the bond." H.R. REP. NO. 1263, 74th Cong. 1st Sess. 3 (1935).

[367] 322 U.S. at 110.

[368] J.W. Bateson Co. v. United States ex rel. Bd. of Trustees of Nat. Automatic Sprinkler Indus. Pension Fund, 434 U.S. 586 (1978).

claim is most readily shown by written agreements. However, contracts may be implied from the actions of the parties in the absence of a written agreement.[369]

This is illustrated in *United States ex rel. Parker-Hannifin Corp. v. Lane Construction Co.*[370] The claimant was a manufacturer of hydraulic cylinders for operating the gates of an Army Corps of Engineers dam. It supplied these items to a subcontractor, and later sued on the prime contractor's payment bond when the subcontractor went bankrupt without having paid for the gates. Declaring that no general rule could be devised to dispose of cases of this sort, the court identified the following factors that should be considered in determining whether a claimant should be considered to be a subcontractor or material supplier. The first is the nature of the material or service supplied.[371] For example, fungible goods that are part of general inventory (like sand and gravel), the production of which does not require use of a customized manufacturing process in order to meet the prime contractor's specifications, generally are treated as materials handled by a supplier or broker.

The second factor is whether the claimant had to make shop drawings of the items and supervise their fabrication.[372] Items that are custom-made to specifications set out in the prime contract, by one who is responsible for the design, shop drawings, and fabrication of the items, generally are treated as the work of subcontractors. Custom manufacture by itself is not sufficient to establish subcontractor status, but is a major factor in the test.[373] In *Parker-Hannefin*, the court held that the claimant gate manufacturer qualified as a subcontractor whose work was incorporated into the bonded project, and so was eligible to sue on the project's payment bond.[374]

Interpreting definitions in Little Miller Acts, some states have undertaken a functional relationship test to determine whether a party is a subcontractor or a materialman who is too remote to recover under the bond. Under Arizona's statute, the court held that where a supplier was the "functional equivalent" of a subcontractor, it was entitled to the bond's protection.[375] The court found that the correct test involved an examination of the nature of the dealings between the parties.

Some state courts have given their Little Miller Acts broader coverage based on apparent legislative intent.[376] The same result has been reached by treating material suppliers to sub-subcontractors as third-party beneficiaries, commenting that to hold otherwise would permit contractors and subcontractors to insulate themselves from liability by executing a series of subcontracts for that purpose and thwart the intent of the statute.[377]

The Arizona court set out the following test of subcontractor status: (1) Does the custom in the trade consider the supplier a subcontractor or a materialman? (2) Are the items supplied generally available in the open market or are they "customized"? (3) In determining whether the material is "customized," do the plans and specifications call for a unique product, or are they merely descriptive of what is to be furnished? (4) Does the supplier's performance constitute a substantial and definite delegation of a portion of the performance of the prime contract?[378]

Instances in which a surety takes over the completion of a construction project following default by the project's original prime contractor generally are handled by the surety's engaging another construction company to perform the unfinished work. In such a case, the surety is regarded as stepping into the place of the general contractor and the newly engaged contractor becomes a subcontractor for purposes of determining who is covered by the surety's bond.[379]

The type of material or service supplied is not a reliable basis for determining whether a supplier is a subcontractor. Although suppliers of sand, gravel, and aggregate generally are not considered subcontractors, claims for furnishing these materials occasionally have been allowed on this basis.[380] On the other hand, sup-

[369] United States ex rel. Greenwald Indus. Products Co. v. Barlows Commercial Constr. Co., 567 F. Supp. 464, 466 (D.D.C. 1983) (contractor accepted delivery and used materials supplied by claimant).

[370] 477 F. Supp. 400 (M.D. Pa. 1979).

[371] *Id*. at 411.

[372] *Id*.

[373] *See, e.g.,* LaGrand Steel Products Co. v. A.C.S. Constructors, Inc., 108 Idaho 817, 702 P.2d 855 (Idaho App. 1985) (applying Idaho Code 54-1926) (fabricator was held to be a subcontractor where customized steel plates were a large item in the contract price); Inryco. Inc. v. Eatherley Constr. Co., 793 F.2d 767 (6th Cir. 1986) (fabricator of highway sound barriers manufactured to dealer's specifications, where dealer in turn sold them to a subcontractor, was a supplier to a materialman).

[374] 477 F. Supp. at 412.

[375] Trio Forest Products, Inc. v. FNF Constr., Inc., 182 Ariz. 1, 3, 893 P.2d 1, 3, *reconsideration denied, review denied* (1994).

[376] State ex rel. W.M. Carroll & Co. v. K.L. House Constr. Co., 99 N.M. 186, 656 P.2d 236, 237 (1982) (construing N. M. STAT. ANN., § 13-4-19 (1978)) (statute includes a supplier of any subcontractor, is broader in scope than Miller Act); State ex rel. Certain-Teed Products Corp. v. United Pacific Ins. Co., 389 A.2d 777 (Del. Super. 1978) (construing DEL. CODE, 29-6909 (1978)); Union Asphalt, Inc. v. Planet Ins. Co., 27 Cal. Rptr. 2d 371, 21 C.A. 4th 1762 (1994) (CAL. CIV. CODE §§ 3110, 3181, 3248(c) apply to subcontractors at any tier).

[377] Frost v. Williams Mobile Offices, Inc., 343 S.E.2d 441 (S.C. 1986) (temporary office furnished for staff while military hospital was renovated).

[378] B.J. Cecil Trucking, Inc. v. Tiffany Constr. Co., 123 Ariz. 31, 597 P.2d 184, 187–88 (Ariz. App. 1979) (applying ARIZ. REV. STAT., § 32-1152 (1978)).

[379] H&H Sewer Systems, Inc. v. Ins. Guar. Ass'n, 392 So. 2d 430 (La. 1980).

[380] Standard Accident Ins. Co. v. Basolo, 180 Okla. 261, 68 P.2d 804 (1937) (claimant who supplied sand and gravel for highway construction and delivered it to a location near the jobsite held to be both a subcontractor and materialman); *see also* People for Use and Benefit of Youngs v. United States Fidelity & Guar. Co., 263 Mich. 638, 249 N.W. 20 (1933).

pliers of millwork and hardware items generally have been called contractors, while suppliers of brick, concrete blocks, curbstones, and similar stock items of building supplies have been treated as materialmen. Claims for furnishing fabricated steel items present a range of fact situations that have caused trouble for the courts. Normally the suppliers of these items do not perform any work at the jobsite following delivery, and where they do not, the assignment to them of a materialman's status is understandable. On the other hand, where they perform installation or other services in connection with the construction, their claim to subcontractor status is strengthened.[381]

Viewing the cases as a whole, the results seem to reflect the use of a rather general test that ultimately turns on the degree that the prime contractor shifts or delegates its own responsibility to others. If the responsibility delegated merely entails furnishing or slightly altering standard materials or manufactured items without installing or incorporating them into the construction, the supplier is properly classified as a materialman. But where this responsibility includes installation as well as supply, or involves supplying a custom-built item or a product not generally available, the supplier may be classified as a subcontractor even though its work is performed far from the prime contractor's jobsite.

b. Notification of Claim

i. Time for Providing Notice.—Claimants seeking recourse to a contractor's payment bond under authority of the Miller Act must give written notice of their claim to the contractor within 90 days after the date on which the last labor was performed or the last materials were furnished on which the claim is based. The Miller Act does not address whether notice must be mailed or received within 90 days. However, at least one court has held that notice must be received by the contractor prior to the end of the 90-day period.[382]

State statutes have similar time limitations for filing notice.[383] For example, Florida requires that a claimant have given the contractor notice within 45 days of beginning work on the project that it intends to look to the bond for protection against nonpayment, and must notify the contractor and surety of its claim within 90 days after completing its performance.[384]

Compliance with the requirement for giving timely notice is a jurisdictional requirement for proceeding against the contractor's bond.[385] Where this requirement is in force at the time a contract is awarded and is incorporated by reference into the contract, it applies even though it subsequently is amended or repealed,[386] or a contractor orally undertakes responsibility for a defaulting subcontractor's debts,[387] or fails to object to lack of timely or proper notice of the claim at the commencement of the suit.[388]

A Miller Act claimant may avoid this requirement only by showing that it has entered into a "contractual relationship, express or implied" with the contractor.[389] Such a showing must be unequivocal and must relate to the specific items that comprise the claim. For example, a subcontractor's supplier was excused from giving notice within the statutory period by showing that after the subcontractor's default the contractor executed an agreement to pay the supplier's unpaid balance, and thereafter issued checks made jointly payable to the supplier and subcontractor.[390] In contrast, the claimant was not excused from complying with the notice period where it relied on the contractor's general declaration that it would pay for materials incorporated into the project, despite the fact that the contractor's checks were issued jointly to the supplier and subcontractor.[391] Nor was the necessary contractual relationship present where a claimant relied on its status as a co-prime contractor on the project.[392]

Where a bond provides less stringent notification requirements than what the statute requires, then the terms of the bond will control.[393] However, if the bond

[381] Jesse F. Heard & Sons v. Southwest Steel Prods., 124 So. 2d 211 (La. Ct. App. 1960).

[382] B & R, Inc. v. Donald Lane Constr., 19 F. Supp. 2d 217 (D. Del. 1998).

[383] Sharpe, Inc. v. Neil Spear, Inc., 611 So. 2d 66, *review denied*, 620 So. 2d 761 (Fla. App. 1 Dist. 1992) (applying FLA. STAT. § 255.05).

[384] FLA. STAT. § 255.05.

[385] U.S. Fidelity & Guar. Co. v. Thompson and Green Machinery Co., 568 S.W.2d 821 (Tenn. 1978) (construing TENN. CODE § 54-519 (1975)); Mid-County Rental Service, Inc. v. Miner-Dederick Constr. Corp., 583 S.W.2d 428 (Tex. Civ. App. 1979) (construing TEX. CIV. STAT. art. 5160 (1987)); U.S. Fidelity & Guar. Co. v. Couch, Inc., 472 So. 2d 614 (Ala. 1985) (construing ALA. CODE § 39-1-1 (1975), delaying suit until 45 days after notice to surety and contractor's failure to pay within 45 days).

[386] United Plate Glass Co., Div. of Chromalloy Am. Corp. v. Metal Trim Indus., 505 A.2d 613 (Pa. Super. 1986) (construing 8 PA. STAT. § 194(b)).

[387] Barboza v. Aetna Cas. & Sur. Co., 18 Mass. App. 323, 465 N.E.2d 290, 293 (1984) (construing MASS. GEN. L. ch. 149, § 29).

[388] Travelers Indem. Co. v. Munro Oil & Paint Co., 364 So. 2d 667 (Miss. 1978) (construing MISS. CODE § 31-5-13 (1972)).

[389] 40 U.S.C. § 3133.

[390] United States ex rel. Billows Elec. Supply Co. v. E.J.T. Constr. Co., 517 F. Supp. 1178, 1182–83 (E.D. Pa. 1981).

[391] Noland Co. v. Armco, Inc., 445 A.2d 1079 (Md. App. 1982) (construing MD. CODE, art. 21, § 3-501 (1980)).

[392] Aetna Cas. & Sur. Co. v. Doleac Elec. Co., 471 So. 2d 325 (Miss. 1985) (construing MISS. CODE, § 31-51-1 (1972)); *see also* Fleisher Eng'r & Constr. Co. v. United States for Use and Benefit of George S. Hallenbeck, 311 U.S. 15, 61 S. Ct. 81, 85 L. Ed. 12 (1940); State Roads Comm'n to the Use of Mobil Oil Corp. v. Contee Sand & Gravel Co., 308 F. Supp. 650 (D. Md. 1970).

[393] Trustees for Michigan Laborers' Health Care Fund v. Warranty Builders, Inc., 921 F. Supp. 471, 475–76 (E.D. Mich. 1996), *aff'd*, 137 F.3d 427 (6th Cir. 1998) (applying Michigan Public Works Act, M.C.L.A. § 129.201).

sets more stringent requirements than allowed by the statute, that provision in the bond may be held to be void and the time limits set by statute will control.[394]

If a state has a requirement for recording the bond, then the notice requirement may apply only if the contractor has recorded the bond in the manner required by statute.[395] If the contractor has not recorded the bond where there is such a requirement, a supplier is not bound by the notice and time limitations.[396]

The difficulties of applying the notice rule arise from the variety of business and accounting arrangements under which materials and services are supplied in construction projects. Where a materialman supplies materials on several occasions, each occasion may be treated by the parties as separate orders, a continuing contract, a running open account, or some other type of purchase arrangement. Contracts calling for supply, installation, testing, and training of others in the use of equipment or components may also make it difficult to determine at what point the notice period begins.[397] In contracts requiring a series of steps, some of the steps may be separated by more than 90 days, and recovery for the earlier shipments may be barred.[398] Cautious suppliers who must make a series of deliveries adopt the practice of filing claims within 90 days following each delivery, rather than relying on the argument that the series is integrated or that it is part of an open account transaction.[399]

Where it was necessary to determine the last date on which material was supplied, arguments have been made to adopt the rule of commercial codes that recognize "constructive delivery" of specially manufactured goods to a subcontractor once those goods are segregated and stored by the manufacturer or supplier pending actual delivery to the work site. The Georgia appellate court rejected the analogy to the Uniform Commercial Code, and held that state law contemplated actual delivery of material to the subcontractor rather than constructive delivery.[400]

Where statutory time limits for giving notice of claims start running from the date of final acceptance of a completed project, that date needs to be identified with certainty, generally by execution of a formal certification of acceptance.[401] Where no benchmarks are provided, determination of whether a notice is given within 90 days after completion and acceptance of a project becomes a factual question of when contract performance was actually finished and the completed facility was accepted by word or conduct of the contracting agency.[402]

As a jurisdictional requirement, a timely notification of a claim must be alleged in the claimant's pleadings.[403] Although circumstances may afford a contractor actual notice of a claim in a timely and sufficient manner, statutes based on the Miller Act are strictly construed to require timely written notice.[404] Actual knowledge of an unpaid account or of the presence of the claimant on the project is not sufficient.[405]

iii. Sufficiency of Notice.—The Miller Act specifies that notice to the prime contractor shall state "with substantial accuracy the amount claimed and the name of the party to whom the material was furnished or supplied, or for whom the labor was done or performed."[406] Inevitably, questions have arisen over the status of correspondence where either the intent or the factual accuracy of the contents were not clear. A rule of reason is applied to these cases, based on the underly-

[394] Town of Pineville v. Atkinson/Dyer/Watson Architects, P.A., 114 N.C. App. 497, 442 S.E.2d 73 (1994); Dutchess Quarry & Supply Co. v. Firemen's Ins. Co. of Newark, N.J., 596 N.Y.S.2d 898, 190 A.D. 2d 36 (1993).

[395] *See, e.g.*, Martin Paving Co. v. United Pacific Ins. Co., 646 So. 2d 268 (Fla. App. 5 Dist. 1994) (applying FLA. STAT. § 255.05 (1, 2, 4)).

[396] Martin Paving Co. v. United Pacific Ins. Co., 646 So. 2d 268 (Fla. App. 5 Dist. 1994).

[397] *See, e.g.,* Johnson Serv. Co. v. Transamerica Ins. Co., 349 F. Supp. 1220 (S.D. Tex. 1972), *aff'd*, 485 F.2d 164 (5th Cir. 1973).

[398] United States for Use and Benefit of I. Burack, Inc. v. Sovereign Constr. Co., Ltd., 338 F. Supp. 657 (S.D. N.Y. 1972); United States for Use and Benefit of J.A. Edwards & Co. v. Bregman Constr. Corp., 172 F. Supp. 517 (E.D. N.Y. 1959).

[399] *Compare* Noland Co. v. Allied Contr., Inc. 273 F.2d 917 (4th Cir. 1959) *with* United States for Use and Benefit of J.A. Edwards & Co. v. Peter Reiss Constr. Co., 273 F.2d 880 (2d Cir. 1959), *cert. den.*, 362 U.S. 951, 80 S. Ct. 864, 4 L. Ed. 2d 869 (1960).

[400] F.L. Saino Manufacturing Co. v. Fireman's Fund Insurance Co., 173 Ga. App. 753, 328 S.E.2d 387 (1985).

[401] Maxson Corp. v. Gary King Constr. Co., 363 N.W.2d 901, 902–03 (Minn. App. 1985) (citing Minn. Dep't of Transp. Standard Specifications for Highway Constr. (1978), as incorporated by reference into the contract).

[402] Alexander Constr. Co. v. C&H Contracting, Inc., 354 N.W.2d 535, 538 (Minn. App. 1984) (construing MINN. STAT. 574.31 (1982), streets and sewers); *but see* Honeywell, Inc. v. Jimmie B. Guinn, Inc., 462 So. 2d 145 (La. 1985) (installation of automatic temperature control system held to be necessary to complete the original project); Worcester Air Conditioning Co. v. Commercial Union Ins. Co., 14 Mass. App. 352, 439 N.E.2d 845, 847 (Mass. App. 1982) (installation of additional ducts, done by subcontractor 4 months after punch list was completed and project was accepted, held to be new work under a new contract).

[403] Continental Contractors, Inc. v. Thorup, 578 S.W.2d 864 (Tex. Civ. App. 1979).

[404] Square D Envtl. Corp. v. Aero Mechanical, Inc., 119 Mich. App. 740, 326 N.W.2d 629, 631 (1982) (notice statute required only a following of "specific step-by-step procedures" and should be strictly construed; legislature did not use the term substantial compliance).

[405] Spetz & Berg, Inc. v. Luckie Constr. Co., 353 N.W.2d 233 (Minn. App. 1984) (construing MINN. STAT., § 574.31 (1979)); Barboza v. Aetna Cas. & Sur. Co., 18 Mass. App. 323, 465 N.E.2d 290, 293 (1984) (construing MASS. GEN. L. ch. 149, § 29 (1972)); Posh Constr., Inc. v. Simmons & Greer, Inc., 436 A.2d 1192 (Pa. Super. 1981).

[406] 40 U.S.C. § 3133 (2003).

ing purpose of the notice requirement that the prime contractor should be made aware of the claims of those with whom it has no direct contractual relationship, or presumably, any regular contact during its supervision of the contract work.[407] The essential character of the notice must be a positive presentation of a claim, stated clearly and comprehensively enough for the prime contractor to know its amount, to whom it is owed, and to whom the labor or material was furnished.[408]

Federal courts construing the Miller Act have not insisted on any particular form of notice, but rather have looked to see if the message given to the contractor informed it of the amount owed, the party to which it was owed, the basis of the debt, and if the message actually got to the contractor.[409] The amount claimed need not be stated with absolute precision, but it must be substantially accurate, or else any discrepancies must be explained so as to make the correct amount ascertainable.[410] Also, courts have recognized the practical limits of requiring copies of billing documents, invoices, and orders identifying parts of claims for multiple items of labor and materials where they are to be paid for on a lump sum basis. [411] State statutes may also specify formalities such as making sworn statements or transmitting notice by registered mail.[412] Where statutory language allows it, courts may construe formalities more liberally, in accordance with the statute's remedial nature.[413] Accordingly, where a contractor was in fact informed of a claim, the notice was not invalid because it was sent in advance of the 45-day notice period,[414] or because the notice was sent by regular mail instead of registered mail,[415] or because the wrong contract number was referenced.[416] Similarly, even where the statute required that an affidavit be submitted by the claimant, a document that contained the required information and included a notarized signature of the claimant was held to be sufficient.[417]

The Miller Act previously required the claimant's pre-claim notice to either be served in the same manner as a summons, or sent by registered mail.[418] Amendments to the Miller Act in 1999 allow a claimant to send its pre-claim notice by "any means which provides written, third-party verification of delivery."[419] This allows use of other delivery options such as certified mail or overnight delivery services.

c. Limitation on Suit

The second major procedural requirement that claimants must meet under the Miller Act is the provision that suit against the payment bond must be filed within 1 year of the "date of final settlement" of the contract. As in the application of the requirement for filing notice of claims, the courts have recognized circumstances in which strict compliance with the limitations on filing suit must be relaxed to achieve the broad objective of the law. The strongest cases for allowance of filing after 1 year have involved major repairs or replacements of components of the facilities supplied, so extensive that the earlier installation does not qualify as performance of the supplier's contract obligation.[420] Administrative work, inspections, testing, and correc-

[407] Fleisher Eng'r & Constr. Co. v. United States for Use and Benefit of Hallenbeck, 311 U.S. 15, 61 S. Ct. 81, 85 L. Ed. 12 (1940).

[408] United States for Use and Benefit of J.A. Edwards & Co. v. Thompson Constr. Corp., 273 F.2d 873 (2d Cir. 1959), *cert. denied*, 362 U.S. 951, 80 S. Ct. 864, 4 L. Ed. 2d 869 (1960); *see also* United States for the Use of Old Dominion Iron & Steel Corp. v. Massachusetts Bonding & Ins. Co., 272 F.2d 73 (3d Cir. 1959) (doubtful language); United States for Use and Benefit of Hopper Bros. Quarries v. Peerless Cas. Co., 255 F.2d 137 (8th Cir. 1959); *cert. denied*, 358 U.S. 831, 79 S. Ct. 51, 3 L. Ed. 2d 69 (1958); United States for Use and Benefit of Franklin Paint Co. v. Kagan, 129 F. Supp. 331 (D. Mass. 1955) (accuracy of claim); Dover Elec. Supply Co. v. Leonard Pevar Co., 178 F. Supp. 834 (D. Del. 1959).

[409] United States ex rel. Joseph T. Richardson, Inc. v. EJT Constr. Co., 453 F. Supp. 435 (D. Del. 1978).

[410] United States ex rel. Honeywell, Inc. v. A&L Mechanical Contractors, Inc., 677 F.2d 383 (4th Cir. 1982).

[411] Sims v. William S. Baker, Inc., 568 S.W.2d 725, 730 (Tex. Civ. App. 1978) (construing TEX. ANN. CIV. STAT. art. 5160, sub. B(a)(2) (1978)); *see also* Featherlite Building Products Corp. v. Constructors Unlimited, Inc., 714 S.W.2d 68 (Tex. App. 1986).

[412] Bastianelli v. National Union Fire Ins. Co., 36 Mass. App. Ct. 367, 631 N.E.2d 566, 568 n.4, (1994); San Joaquin Blocklite, Inc. v. Willden, 228 Cal. Rptr. 842 (1986) (notice by first class, certified, or registered mail to contractor, or personal service); Space Building Corp. v. INA, 389 N.E.2d 1054 (Mass. App. 1979) (sworn statement).

[413] Cinder Products Corp. v. Schena Constr. Co., 22 Mass. App. 927, 492 N.E.2d 744 (1986) (citing M.G.L. c. 149 § 29, requiring service by certified or registered mail; failure to use certified or registered mail was not fatal if actual timely notice is proved).

[414] School Board of Palm Beach County v. Vincent J. Fasano, Inc., 417 So. 2d 1063 (Fla. App. 1982).

[415] Vacuum Systems, Inc. v. Washburn, 651 A.2d 377 (Me. 1994); Bob McGaughey Lumber Sales, Inc. v. Lemoine Co., 590 So. 2d 664 (La. App. 3 Cir. 1991); Consolidated Concrete Co. v. Empire West Constr. Co., 596 P.2d 106, 108–09 (Idaho 1979) (construing Idaho Code, § 54-1929 (1979)); *but see* F.L. Saino Mgf. Co. v. Fireman's Fund Ins. Co., 173 Ga. App. 753, 328 S.E.2d 387 (1985) (construing GA. CODE ANN., § 36-82-104(b) (1987) (notice by regular mail is effective when received, while registered mail notice is effective when mailed).

[416] Dixie Bldg. Material Co. v. Liberty Somerset, Inc., 656 So. 2d 1041 (La. App. 4 Cir. 1995).

[417] Acme Brick, a Div. of Justin Industries v. Temple Assocs., 816 S.W.2d 440, *writ denied* (Tex. App. 1991) (McGregor Act requires only substantial compliance).

[418] Former 40 U.S.C. § 270b(a) (1999).

[419] 40 U.S.C. § 3133(b)(2)(A) (2003).

[420] *Compare* United States for the Use of General Electric Co. v. Gunnar I. Johnson & Son, Inc., 310 F.2d 899 (8th Cir. 1962) *with* United States for Use of McGregor Arch Iron Co. v. Merritt-Chapman & Scott, Corp., 185 F. Supp. 381 (M.D. Pa. 1960).

tive work conducted after delivery do not extend the dates when the limitation period begins to run.[421]

A federal court examined when the statute of limitations begins to run under the Miller Act in *United States v. Fidelity Co. and Deposit of Maryland*.[422] The court compared cases in which the statute was held to begin running at the time of substantial completion, which it found to be the minority view, with those in which the statute began at the time of completion of all of the original requirements of the contract, as opposed to corrections or repairs, which was the majority view.[423] Under the majority view, an uncompleted contract requirement tolls the time for filing, while corrective work does not. Where substantial completion is used as the operative date, the filing period is not extended by insignificant work, even if that work is required under the contract and is not corrective work. The court applied what it called a "middle ground" approach in deciding in favor of allowing a supplier's claim.[424] It did not follow the rule that repair work does not toll the time period, but rather based its decision on the value of the materials involved, the requirements of the original contract, the unexpected nature of the work, and the importance of the materials to the operation of the system.[425]

Once the period of limitation on filing suit begins to run, it is not interrupted or tolled by the occurrence of negotiations between the claimant and the prime contractor over whether the subcontract was duly completed and payment for it was due.[426] Nor is the running of the limitation period changed by amendment of the bond statute to prescribe a different date for its commencement.[427] Where this occurred under Connecticut's Little Miller Act, the court held that the amendment was not retroactive and the provisions of the law in force at the time the claimant's contract was executed were the controlling factor in determining compliance with the filing date.[428]

State bonding statutes with provisions similar to those in the Miller Act prior to 1959 set the time limit for starting suits at 1 year or another specified period after the "final settlement" of the contract.[429] Final acceptance of a project by the public works agency generally is considered as the administrative action constituting final settlement.[430] Exceptions to this rule are recognized, however, where an acceptance is found to be premature because essential work remained to be done after formal acceptance.[431] In order to constitute a final settlement, the public works agency's acceptance must relate to the entire project in order to avoid the risk that the security will be exhausted before the full number of unpaid creditors and their claims are known.[432]

A common practice among agencies contracting for public works construction is to issue a certificate of substantial completion when all work has been performed, inspected, and accepted subject to completion of a "punch list" agreed upon by the parties. In a case under Arizona's Little Miller Act, however, a subcontractor hired to furnish and install an automatic temperature control element of a fire alarm system continued work on punch list items for several months after the certificate of substantial compliance was issued.[433] When a subcontractor later filed suit for unpaid charges, it was held that the period for filing suit started running when the claimant finished work on the punch list. Drawing on federal cases under the Miller Act, the court stated:

> The applicable test asks whether the work was done in furtherance of the original contract, or whether it was for the purpose of correcting defects or making repairs. Work done solely to effect repairs, make corrections or complete final inspection is insufficient to qualify as work pursuant to the original contract and is not considered work per-

[421] Honeywell, Inc. v. Arnold Constr., 134 Ariz. 153, 654 P.2d 301 (1982); 17 AM. JUR. 2D C*ontractors Bonds* § 207 (1990).

[422] 999 F. Supp. 734 (D. N.J. 1998).

[423] *Id.* at 742.

[424] *Id*. at 745.

[425] *Id*.

[426] Visor Builders, Inc. v. Devon E. Trantor, Inc., 470 F. Supp. 911 (M.D. Pa. 1978).

[427] *See* CONN. GEN. STAT. §§ 49-41, 49-42 (1987).

[428] Am. Masons Supply Co. v. F.W. Brown Co., 164 Conn. 219, 384 A.2d 378 (1978); Manganes Printing Co. v. Joseph Bucheit and Sons Co., 601 F. Supp. 776 (D.C. Pa. 1985).

[429] W.B. Headley v. Housing Auth. of Prattville, 347 So. 2d 532 (Ala. Civ. App. 1977); Medical Clinic Bd. of City of Birmingham-Crestwood v. E.E. Smelley, 408 So. 2d 1203 (Ala. 1981); City of San Antonio v. Argonaut Ins. Co., 644 S.W.2d 90 (Tex. App. 1982) ("final completion of contract").

[430] Transamerica Ins. Co. v. Housing Auth. of City of Victoria, 669 S.W.2d 818 (Tex. App. 1984).

[431] Honeywell, Inc. v. Jimmie B. Guinn, Inc., 462 So. 2d 145 (La. 1985); *see also* Cortland Paving Co. v. Capital District Contractors, Ltd., 490 N.Y.S.2d 51 (1985) (parties agreed to reasonable delay to allow contractor to obtain funds from state); Valley Forge Indus., Inc. v. Armand Constr., Inc., 394 A.2d 677 (Pa. Commw. 1978) (correction of defects required substantial repetition of work).

[432] Maurice E. Keating, Inc. v. Township of Southampton, 149 N.J. Super. 118, 373 A.2d 421 (1977); Safeco Ins. Co. of America v. Honeywell, Inc. 639 P.2d 996, 1001–02 (Alaska 1981) (dispute arose over which one of a series of inspections, certifications, notices, and reports constituted "final acceptance;" court ruled that final settlement required a specific administrative act bearing on the completeness of the contract and approving payment; approval of final pay estimates fit criteria of the law and carried out the purpose of the applicable statute, ALASKA STAT. § 36.25.020); Hall v. U.S. Fidelity & Guar. Co., 436 A.2d 863 (Me. 1981) (where sand and gravel were supplied for highway construction, the necessary administrative act that marked the last date of furnishing labor or materials was the highway agency's final determination of the quantities of materials used in the construction project).

[433] Honeywell, Inc. v. Arnold Constr. Co., 134 Ariz. 153, 654 P.2d 301, 304 (1982) (applying ARIZ. REV. STAT. § 34-223 (1987)).

formed or material supplied within the one year statutory limitation.[434]

Bankruptcy of the prime contractor does not toll or extend the running of the time limit for subcontractors to file suit against the surety bond.[435] Nor does the substitution of a new contractor after default by the original prime contractor affect the running of the time limit.[436] However, the surety may extend its liability for claims arising from an abandoned job by making a specific undertaking to do so when it takes over from the defaulting contractor.[437]

Where the provisions of a surety bond regarding the time for starting suit differ from the terms of the bonding statute, the difference may be treated as converting the surety's statutory liability into a common law liability. The effect of such a conversion was explained in the Florida court in *Motor City Electric Co. v. Ohio Casualty Insurance Co*., where a claim for rental of heavy equipment was sustained even though barred by the statutory limit on filing suit.

> [N]ot every bond furnished incident to a public works project falls within the ambit of the statute…courts recognize a distinction between a statutory bond issued in connection with such a project and a common law bond. A bond…will be construed as a common law bond if it is written on a more extended basis than required by Section 255.05, Florida Statutes (1975)… Morover, ambiguities in the form of such a bond must be construed in favor of granting the broadest possible coverage to those intended to be benefited by its protection.[438]

d. Claimant Has Not Been Paid

In addition to showing that labor or materials are furnished for the project in question, it must be shown that the claimant has not been paid for them. Where a public works agency makes progress payments at predetermined intervals, disputes may occur over allocation of those payments to the creditor's accounts. Generally those disputes arise in the absence of instructions by the debtor at the time of payment, leaving it to the creditor's discretion to say how they shall be applied. This discretion, however, is not unlimited. The rule evolved from Miller Act cases is stated in *St. Paul Fire and Marine Insurance Co. v. United States ex rel. Dakota Electric Supply Co.* as follows:

> If a debtor is under a duty to a third person to devote funds paid by him to the discharge of a particular debt, the payment must be so applied if the creditor knows or has reason to know of that duty. This is so despite the debtor's contrary direction.[439]

Federal courts have not imposed a duty on a claimant to inquire about the source of a payment in litigation under the Miller Act. Nor have state courts read this duty into their state bonding laws for public works construction projects.[440] The reluctance to enforce a duty to demand designation of the source and disposition of payments into an open account, or circumstances where the debtor has several project accounts with the creditor, has not prevented courts from rigorous examinations of the parties' transactions and critical appraisal of whether the creditor knew or had reason to know the source of its payment. If the history and circumstances of an unpaid account make prudent in the course of exercising business judgment to inquire about the debtor's sources and expectations of funds, the court may well find there is sufficient knowledge of the "principal source" of the funds to require the creditor to apply the payment to that project account. Therefore, in *School District of Springfield R-12, ex rel. Midland Paving Co.,* the court held that the creditor's failure to apply a partial payment to the bonded project's account was, while not done in bad faith, done "prematurely and without proper precaution."[441]

e. Waiver of Payment Bond Remedies

Prior to the 1999 amendments, the Miller Act did not address whether a potential claimant could waive its payment bond remedies. The amendment allows such a waiver, so long as it is (1) in writing, (2) signed by the potential claimant, and (3) executed after the potential claimant has first furnished labor or material for use in performance of the contract.[442] Thus a subcontractor or materialman could submit a release form with its invoice, so long as it meets these requirements.

7. Enforcement of Performance Bonds

a. Agencies' Remedies

Actions to enforce the obligations of performance bonds are taken at the initiative of the state.[443] They may be brought at any time within the statutes of limitations for actions on written contracts. As a practical matter, however, the state's action of declaring a contractor in default generally is followed by negotiations between the surety and the contracting agency for the purpose of deciding how the contract can be completed by any of the several options open to the parties. Because both the surety and the contracting agency are better off if they complete the contract, recourse to the courts for enforcement of bonds running in favor of the public is relatively rare. More frequently, suits involv-

[434] 654 P.2d at 304 (citations omitted).

[435] Fountain Sand & Gravel Co. v. Chilton Constr. Co., 578 P.2d 664, 665 (Colo. App. 1978).

[436] Adamo Equip. Rental Co. v. Mack Dev. Co., 122 Mich. App. 233, 333 N.W.2d 40, 42 (1982).

[437] Argonaut Ins. Co. v. M&P Equip. Co., 269 Ark. 302, 601 S.W.2d 824 (1980).

[438] 374 So. 2d 1068, 1069 (Fla. App. 1979).

[439] 309 F.2d 22, 25 (8th Cir. 1962).

[440] Trans-American Steel Corp. v. J. Rich Steers, Inc., 670 F.2d 558 (5th Cir. 1982); Geneva Pipe Co. v. S&H Ins. Co., 714 P.2d 648, 651 (Utah 1986) (citing UTAH CODE ANN. § 58A-1a-12 (1985)).

[441] 633 S.W.2d 238, 253 (Mo. App. 1982).

[442] 40 U.S.C. § 3133(c) (2003).

[443] Town of Melville v. Safeco Ins. Co. of America, 651 So. 2d 404, *writ denied*, 654 So. 2d 333 (La. App. 3 Cir. 1995).

ing performance bond obligations arise through the initiative of the surety, who has become subrogated to a claim on monies held by the contracting agency as retainage or as partial payment earned but not yet paid under a contract. A further discussion of agencies' remedies is contained in section 7(a)(9) of this volume.

The determination that a contractor is in default is a matter of judgment by the contracting agency. An act of default by a contractor does not impose upon the contracting agency any duty to declare it in default of its contract if, despite appearances, the agency believes that it will complete the work satisfactorily.[444] Nor may a surety compel the government to shut down a contractor on the basis of information that satisfied the surety that default may be either imminent or inevitable. Although the surety may sincerely wish to conserve the funds remaining in the government's hands so that those funds may be used to complete the defaulted work, the contracting agency is entitled to a reasonable opportunity to investigate the situation thoroughly.

Once a contractor has been declared in default, and its surety has completed the contract, there may be competition for the agency's remaining funds. Differing results have sometimes occurred in federal decisions relating to the Miller Act, and in decisions under state laws. In Miller Act cases where the Federal Government is a claimant (as, for example, where collection of unpaid taxes is sought), it may claim taxes as a setoff against the surety's share of the retained funds. *United States v. Munsey Trust Co.* established the doctrine for federal law on this question, holding that the government was in the same position as a secured creditor, and so entitled to withhold what it owed the contractor until its own claims were satisfied.[445] The surety, subrogated to the contractor's position, is regarded as never having acquired any superior right to the retained funds.

Such a rule had obvious disadvantages for the surety who elected to complete a defaulted contract, for it could never be sure that it could obtain the full amount of the unpaid funds under the original contract. In the surety's view, it was better off to let the agency complete the contract, and let its suretyship liability be limited to the difference, if any, between the contract price and the actual cost of completion.[446] When this matter was carefully considered, however, the *Munsey* doctrine was not extended beyond the setoff of delinquent taxes. In *Massachusetts Bonding & Insurance Company v. New York*, the New York court discussed the position of subrogated sureties:

> It is settled law that a surety which undertakes to complete a construction contract after its principal has defaulted…becomes entitled to payments due the principal….This right to "first" priority attaches not only to moneys due the principal at the time of default, but to so-called "unearned" moneys which arise from the surety's activities in completing the contract after this principals default.[447]

The same rule for priority of claims on unpaid contract funds has been applied where the surety's lien for payment of defaulted debts is subrogated to the contractor's claim on the retained funds. Tax liens in favor of the government have not been given priority over the surety since the latter's equitable right is viewed as arising at the time the surety posted its bond. Subsequent tax liens against the contractor therefore could not reach funds to which the contractor himself had no claim.[448]

Attempts to enforce liability under performance bonds for failure to meet construction contract specifications may be complicated when they are based on discovery of latent defects in materials or workmanship after a project has been completed and accepted. Some state courts have held that statutory bonds do not cover defects that are known or discoverable by reasonable inspection prior to acceptance. The Florida court initially held that as a matter of law a performance bond surety was not liable for construction defects discovered after the project was certified and accepted as substantially complete and the statute of limitations on the bond had run.[449] Subsequent review of this question, however, has resulted in a holding that acceptance and payment do not necessarily constitute a waiver of rights to claim damages or an estoppel to suit against the surety. Thus, if a contracting agency can prove failure to perform the construction according to the contract, and that it was unaware of this failure at the time the project was accepted, and the defects were not apparent by reasonable inspection, the surety's liability is not as a matter of law ended by the project's acceptance.[450]

Where suits against performance bond sureties because of latent defects are permitted, federal courts have allowed recovery of the costs of redoing the defective workmanship and overpayment of the contractor.[451] Liquidated damages owed by a defaulting contractor were recovered from a performance bond where the

[444] United States v. Continental Cas. Co., 346 F. Supp. 1239 (N.D. Ill. 1972).

[445] 332 U.S. 234, 67 S. Ct. 1599, 91 L. Ed. 2022 (1947).

[446] Standard Accident Ins. Co. v. United States, 119 Ct. Cl. 749, 97 F. Supp. 829 (1951) (government was permitted to set off damages to a surety's claim under a performance bond); *see also* Gen. Cas. Co. of America v. United States, 131 Ct. Cl. 818, 127 F. Supp. 805 (1955), *cert. denied*, 349 U.S. 938, 75 S. Ct. 783, 99 L. Ed. 1266 (1955).

[447] 259 F.2d 33, 37 (2d Cir. 1958).

[448] United States Fidelity and Guaranty Co. v. Tribourgh Bridge Auth., 297 N.Y. 31, 74 N.E.2d 226 (1947).

[449] Florida Bd. of Regents v. Fidelity & Deposit Co. of Md., 416 So. 2d 30 (Fla. App. 1982); *see also* Sch. Bd. of Volusia County v. Fidelity Co. of Md., 468 So. 2d 431 (Fla. App. 1985) (construing FLA. STAT. § 95.11(2) (1983)).

[450] School Bd. of Pinellas County v. St. Paul Fire & Marine Ins. Co., 449 So. 2d 872 (Fla. App. 1984), *review denied*, 458 So. 2d 274 (Fla. 1984).

[451] City of New Orleans, et al. v. Vicon, Inc., 529 F. Supp. 1234 (E.D. La. 1982) (defective airport runway construction and overpayment due to fixing weight ticket printer to show greater weight than actually received).

language of the contract providing for those damages was specifically incorporated into the bond by reference.[452] Disputes may occur over whether particular types of costs or losses should be regarded as liquidated within the meaning of the contract, and thus may make interpretation of the scope of the bond more difficult. Relying on federal court applications of the Miller Act, recovery from the surety was allowed for damages due to delay in performance, spoilage of stored materials, replacement of inferior fixtures, and losses due to vandalism, but not for "unabsorbed overhead" or disputed supervisory activities by the contractor.[453]

Suits to recover from performance bonds are subject to estoppel by judgment or res judicata. A valid judgment in a previous action between the same parties on the same claim bars another action on the issues raised in that previous suit, and any others that might have been raised at that time. The same result occurs where estoppel by verdict or collateral estoppel prevents the parties from relitigating an issue that was decided in an earlier proceeding between the same parties but on a different cause of action. Such a situation occurred where a claimant supplied materials to a subcontractor on a housing project and sued for a mechanic's lien on the subcontractor's default of payments.[454] This suit was voluntarily dismissed with prejudice, but subsequently, when the local public housing authority took over the unfinished project, the claimant sued to recover from the payment and performance bond. The Illinois court held that on these facts the claimant had a cause of action on the bond. It stated:

> Under the doctrine of estoppel by verdict, a former judgment barred only those questions actually decided in the prior suit—The scope of the bar is narrower than under the doctrine of estoppel by judgment…If there is any uncertainty…that more than one distinct issue of fact is presented to the court, the estoppel will not be applied, for the reason that the court may have decided upon one of the other issues of fact.[455]

Takeover and completion of a construction project by the surety following the contractor's default places the surety in the position of the contractor in relation to the contracting agency, and so entitles it to all the compensation earned by performance of the contract. Thus, where the contracting agency for a highway construction project objected to releasing funds retained to offset damages due to the contractor's default, the Louisiana court held that the agency's takeover agreement with the surety made the latter eligible for the full amount of the contract price once a satisfactory performance was accepted.[456] In this instance, the state and the federal government had provided the construction funds and had claims against the contractor for funds it had diverted, but these were separate matters that could not be set off against the retainage.

Failure of a subcontractor to perform work for which it earlier received partial payment in advance, and replacement of the subcontractor with another, allows the surety on the performance bond to be subrogated to the contractor's rights and remedies. The subrogated surety, however, is also subject to defenses that may arise from the contractor's action. Thus, where a subcontractor performed sporadically and eventually was replaced, the surety sued to recover the advance partial payment and damages for delay of the project. The subcontractor argued that it was excused because the contractor had subsequently been replaced for its default, and the surety had refused to pay further claims against the contractor thereafter. The Michigan court held, however, that the subcontractor's failure to perform was not excused by the contractor's subsequent default or the surety's refusal to pay the costs of modifying the subcontract.[457]

8. Discharge of Surety Obligations

The surety who has furnished a contractor's performance bond or payment bond is discharged upon the successful completion of the contract. However, questions may arise concerning the time and circumstances for termination of the surety's liability. Orderly termination of a suretyship relating to a public construction project typically involves procedures specified in statutes or regulations that must be strictly complied with.

The varying circumstances of construction contracts and contractors' methods may make it difficult to determine precisely when a contractor has completed the "full and faithful performance" and "prompt payment of all claims" that contractors' bonds generally designate as the condition upon which the surety's obligation will be discharged. Accordingly, it is typical for public construction contracts to stipulate that completion will be shown by official acceptance of the work and issuance of a certificate of acceptance by the engineer or other official representative of the contracting agency. Once issued, the overseeing official's acceptance and certificate are conclusive on the parties for all matters within the certificate's scope and the certifying official's authority. In the absence of fraud, arbitrariness, or such gross mistakes as to imply bad faith, the correctness of the

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[452] Pacific Employers Ins. Co. v. City of Berkeley, 158 Cal. App. 3d 145, 204 Cal. Rptr. 387 (1984).

[453] Hartford Accident and Indem. Co. v. Dist. of Columbia, 441 A.2d 969 (D.C. App. 1982).

[454] Decatur Housing Auth. ex rel. Harlan E. Moore Co. v. Christy-Foltz, Inc., 117 Ill. App. 3d 1077, 454 N.E.2d 379 (1983); *but see* Rawick Mfg. Co. v. Talisman, Inc., 706 S.W.2d 194 (Ark. App. 1986) (claim of materialman for turnkey housing project, arising while construction was privately owned and funded, was not divested when project was taken over by public agency).

[455] Decatur Housing Auth., note 454 *supra*, 454 N.E.2d at 383 (emphasis in original; citations omitted).

[456] Reliance Ins. Co. v. Dep't of Transp. and Dev., Office of Highways, 471 So. 2d 248 (La. App. 1985).

[457] Sentry Ins. v. Lardner Elevator Co., 153 Mich. App. 317, 395 N.W.2d 31, 34–35 (1986).

certification may not be disputed and establishes the time of completion of the construction contract.[458]

Aside from the discharge of sureties by this procedure, state laws recognize certain other situations in which the actions of contracting officers may have the effect of releasing a surety from liability on a contractor's bond, even though such a result is not intended. Suretyship doctrine provides that sureties should be protected in their right to rely on the terms of obligations as originally agreed upon. Therefore, any subsequent agreements between the contracting agency (the obligee) and contractor (the principal) that materially alter the surety's obligation without its consent has the effect of releasing the surety from its obligation, if it chooses to exercise this right by giving reasonable notice to the other parties involved in the contract.

Alteration of the surety's obligation occurs when there is a material change in the terms of the underlying contract, or an action by one of the parties that constitutes a material deviation from the contract terms.[459] Most courts determine the materiality of a deviation by considering whether the surety is prejudiced or injured in any way.[460] Some others, however, have linked materiality to the extent that the contract is altered, or that a new agreement is substituted for the old one.[461]

Premature payment of a contractor or subcontractor by the contracting agency provides an illustration of how alteration of surety obligations may occur. Deciding in favor of allowing premature disbursement of progress payments or retainage funds to authorize release of the surety, state courts have held that these actions destroy the security represented by the continued retention of these funds. Thus they have the effect of reducing the contractor's incentive to complete the work to its last detail.[462] Similar results may follow where the surety can show that the time of performance was changed or a different performance was called for, constituting a material change to which the surety did not consent. Thus, where a contractor and subcontractor, without the surety's knowledge or consent, agreed to reduce the time for completing the performance of the subcontract from 80 to 45 days, the surety objected. Noting that the contract contained a provision for liquidated damages of $100 per day for delays, the surety claimed the change in time for performance increased its risk of liability. The court in this case agreed with the surety, and allowed its release.[463]

The same case-by-case scrutiny of the parties' circumstances and the language of the documents concerned typifies the approach to cases where the specifications for the work are changed. For example, a contracting agency may instruct the contractor to use a type of paving material not listed in the contract specifications. If the change does not alter the essential character of the contract, the surety will remain obligated on its bond, even though it has not consented to the change.[464]

Some standard contract forms for public works construction projects provide that the contractor and contracting agency may make changes during the course of the work without releasing the surety. This language raises the question of whether the courts will uphold public agencies in efforts to hold sureties to obligations that are not fully and finally spelled out when the surety executes its bond. Where the agencies have complied with their own procedures for making authorized changes, the courts generally have denied sureties' request for release. In most instances, this result has been based on the surety's consent to changes that must reasonably be expected in the course of construction work.[465] Indeed, the public interest may be served by allowing some latitude for modification of plans that were based on advance estimates of needs and working conditions.

The extent to which contracts may be altered after they have been executed is, however, always subject to scrutiny if the surety feels that the net effect of a change is to substitute a new and different agreement for the one it undertook to guarantee.[466] In such circumstances, the language of the bond becomes the focal point of inquiry.

Release of a surety because of material alteration of its obligation without its consent depends on the surety's own action in asserting and justifying its demand by showing injury. In connection with this latter requirement, disagreement exists over the extent of injury that must be shown, and over the consequences of the occasional case in which it is shown that the alteration actually benefited the surety.[467] From the surety's viewpoint, however, this burden may become a formidable one, as many of the changes that occur in

[458] State Highway Dep't v. MacDougald Constr. Co., 189 Ga. 490, 6 S.E.2d 570, 137 A.L.R. 520 (1939); Sioux City v. Western Asphalt Paving Corp., 223 Ia. 279, 271 N.W. 624, 109 A.L.R. 608 (1937).

[459] Ferguson Contr. Co. v. Charles E. Story Constr. Co., 417 S.W.2d 228 (Ky. Ct. App. 1967); Gruman v. Sam Breedon Constr. Co., 148 So. 2d 759 (Fla. App. 1963).

[460] 74 AM. JUR. 2D *Suretyship* § 208 (2001).

[461] City of Peekskill v. Continental Ins. Co., 999 F. Supp. 584 (S.D. N.Y. 1998) (issuance of new and materially different site plan approval to new developer after expiration of original plan approval, without surety's knowledge and consent, extinguished surety's obligations under bond).

[462] Gibbs v. Hartford Accident & Indem. Co., 62 So. 2d 599 (Fla. 1952).

[463] Bopst v. Columbia Cas. Co., 37 F. Supp. 32 (D. Md. 1940); *but see* Phoenix Assurance Co. of New York v. City of Buckner, 305 F.2d 54 (8th Cir. 1962) (surety was not prejudiced by extension of time, not released).

[464] State for Use of County Court v. R.M. Hudson Paving & Constr. Co., 91 W. Va. 387, 113 S.E. 251 (1922).

[465] Honolulu Roofing Co. v. Felix, 49 Haw. 578, 426 P.2d 298, 314–15 (1967).

[466] Trinity Universal Ins. Co. v. Gould, 258 F.2d 883 (10th Cir. 1958).

[467] Maryland Cas. Co. v. Eagle River Union Free High School Dist., 188 Wis. 520, 205 N.W. 926 (1925); Village of Canton v. Gobe Indem. Co., 201 820, 195 N.Y.S. 445 (1922).

the course of a construction project cannot conveniently be brought to its prior attention or delayed until submitted for its consent.

Although release of the contractor-principal from liability on the construction contract has the effect of also releasing the contractor's surety from further liability on its performance and payment bonds, this result is permitted only where the contractor's release is full and final. If payment of less than the amount demanded is used to satisfy a claim, that payment must be tendered only on condition that it will be accepted in full payment of that claim. Unless the intent of both the tender and acceptance are clearly shown, the payment cannot extinguish the liability of the principal or its surety.[468]

The fact that a contractor-principal has been paid in full by the contracting agency, and has paid its subcontractors in full, is not a defense against liability to the supplier who has not been paid by the subcontractor. This may occur where the subcontractor becomes bankrupt or abandons the project before it pays its creditors in full,[469] or where the subcontractor had several unpaid accounts with the claimant and failed to specify to which account its payment should be applied.[470]

Liability of a contractor may be extinguished where its contract is determined to be illegal, but the illegality must be of a nature as to make the contract void. Thus, where a contract was not submitted to the Attorney General for approval before being awarded, the court held that the contract was not void and the surety was not discharged.[471]

9. Indemnification for Loss or Liability

In some states, statutory bonding requirements specify that contractors must furnish security to save the contracting agency harmless from costs resulting from specified acts or omissions of the contractor or its employees or subcontractors. These contracts are in the nature of indemnification rather than suretyship. Indemnity differs from suretyship in several essential respects. It is likely to be an original undertaking, whereas suretyship is always accessory to another basic agreement between the principal and obligee of the surety bond. Indemnity is a two-party transaction, whereas suretyship is a tripartite agreement. Indemnity contemplates a duty to make good the losses or costs suffered because of the way the contract was performed when default or negligence occurs. An indemnitor becomes liable when efforts to avoid or recoup losses have been unsuccessful. A surety is directly and immediately liable for the performance of the duty it has undertaken.

The distinction between a contract of indemnity and one of surety was made by the California court in *Leatherby Insurance Company v. City of Tustin*.[472] Here the issuer of a performance bond and payment bond for a street widening project paid five claims against the prime contractor and sought to recover from funds withheld by the contracting agency. The agency refused, citing the provisions of the state Department of Public Works' Standard Specifications, incorporated by reference into the city's contract, that the contractor "shall protect and indemnify [the city] against any claims, and that includes the duty to defend…." But the California court concluded that this incorrectly characterized the position of the surety. It said that execution of the performance and payment bonds created two duties, namely: to assure performance of the contract according to specifications, to the point of stepping into the contractor's place to complete the work if necessary, and to see that all laborers and materialmen were paid if the contractor failed to pay them. These were duties to the contracting agency and to the laborers and materialmen, not to the contractor, and were limited in their extent by the amount of the bond. The language of the state's standard specifications was interpreted as the basis for the requirement that the contractor provide a surety bond to see that the laborers and materialmen were paid.

Where defective workmanship or materials are due to negligence and result in loss to a public agency through tort damages, the agency generally has no chance of being indemnified for those damages by the negligent contractor's performance bond. In Texas, liability on statutory performance bonds was held not to extend to indemnification for tort damages, and would be allowed only where the language of the bond or other agreement was sufficient to turn the statutory bond into a common law bond.[473] In the absence of such language, the Texas court ruled that the bond was entirely a statutory creation for the purpose of assuring the contracting agency that the construction would be done according to plans, specifications, and contract documents, and liability under it was limited to the statute's scope and purpose. A similar restrictive interpretation of the surety's liability applies to one who is not a party to the bond. Where the owner of land adjacent to the site of a water system project filed suit because construction operations caused flooding and loss of business when access was blocked, the court denied the claimant's right to sue, explaining that to allow tort

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[468] Envirex, Inc. v. Cecil M. Garrow Constr., Inc., 473 N.Y.S.2d 63, 99 A.D. 2d 307 (1984).

[469] D.W. Clark Road Equip., Inc. v. Murray Walter, Inc., 469 A.2d 1326 (N.H. 1983); *see also* Naylor Pipe Co. v. Murray Walter, Inc., 421 A.2d 1012 (N.H. 1980); City of Chicago ex rel. Charles Equipment Co. v. U.S. Fidelity & Guar. Co., 142 Ill. App. 3d 621, 491 N.E.2d 1269 (1986).

[470] Trans-American Steel Corp. v. J. Rich Steers, Inc., 670 F.2d 558 (5th Cir. 1982); Sumlin v. Hagan Storm Fence Co., 409 So. 2d 818 (Ala. 1982).

[471] State v. Am. Motorists, Inc. Co., 463 N.E.2d 1142, 1148 (Ind. App. 1984) (statute requiring attorney general's signature on contracts was enacted to protect public funds, therefore could not be invoked by surety to avoid paying under performance bond).

[472] 76 Cal. App. 3d 678, 143 Cal. Rptr. 153 (1977).

[473] City of Marshall v. American General Ins. Co., 623 S.W.2d 445 (Tex. App. 1981) (construing TEX. REV. CIV. STAT. ANN. art. 5160, sub'd. A(a)).

claims to share in the bond might reduce to nothing its ability to perform its function.[474]

In most states, sovereign immunity no longer shields public agencies and officials from suit, particularly with regard to negligence claims. Most states have methods by which claimants can obtain adjudication of claims arising out of public construction work. Accordingly, expansion of the contractor's bond obligation to include indemnification of the contracting agency for damages that it may have to pay because of the contractor's negligence is one way to protect the public.

The same objective is achieved by requiring contractors to carry insurance against various types of third party liability. Requirements concerning insurance coverage of the principal parties involved in a public works construction project are customarily set out in the contract specifications. Typically such an insurance package is comprehensive, including workmen's compensation insurance, public liability for personal injury and property damage, and various special coverages suggested by the type of construction involved. A contractor's failure to provide the required insurance may entitle the owner to common law indemnification.[475]

Beyond the threshold question of why provisions for indemnification are desirable in contractor's bonds, others arise concerning the scope of the obligation required by the statutes. In the language of indemnification law, guaranty against "damage" differs significantly from guaranty against "liability." In the case of the former, the obligation to indemnify cannot be enforced until and unless actual damage is shown to have been sustained by the indemnitee. In the latter case the obligation is enforceable as soon as the indemnitee's legal liability is established.

Enforcement of statutory requirements for indemnification of public works agencies may involve questions of whether enforcement is barred because of the presence of negligence on the part of the indemnitee. Courts have tended to deny the enforceability of indemnity bonds where the indemnitee's own negligence is a factor.[476] Some courts have indicated that active negligence is not necessary, but that an indemnitee may be barred from enforcing an indemnity bond where it merely acquiesced in allowing a dangerous condition on a work site to persist for an unreasonably long period of time, during which a third party suffered injury.[477] In Mississippi, the impropriety of enforcing indemnification for the benefit of one whose own negligence was a cause of its loss is recognized in legislation declaring such agreements contrary to public policy.[478]

The nature of transportation facilities and construction create other factual situations regarding the effects of negligence by employees of subcontractors, materialmen, or other third parties. Contractors view these situations as risks over which they generally have little practical control. Clauses for "holding harmless" are viewed as far too general to enable contractors to measure their risks precisely, or to obtain insurance that fully covers their potential liability. Competitive bidding is likely to reflect errors on the side of overinsurance and indemnity bonding as contractors seek to protect themselves against these risks.

Although not as specific in its reference to the contractor's bond, a Wisconsin statute raises the question of whether suit could be brought under a contractor's performance or payment bond for wrongful application of funds. This statute recites that

> All moneys, bonds or warrants paid or become due to any prime contractor or subcontractor for public improvements are a trust fund only in the hands of the prime contractor or subcontractor and shall not be a trust fund in the hands of any other person. The use of the moneys by the prime contractor or subcontractor for any purpose other than the payment of claims on such public improvement, before the claims have been satisfied, constitutes theft…and is punishable under Section 943.20. This section shall not create a civil cause of action against any person other than the prime contractor or subcontractor to whom such moneys are paid or become due. Until all claims are paid in full, have matured by notice and filing or have expired, such money, bonds and warrants shall not be subject to garnishment, execution, levy or attachment. [479]

Although liability on a subcontractor's bond may be, and usually is, limited by the language of the bond to payment of claims that comply with statutory notice requirements, these requirements can be waived. Thus, where a subcontractor by separate agreement undertook to protect, indemnify, and save the general contractor from "all claims, suits and actions of any kind and description," and the contractor paid several of the subcontractor's unpaid creditors, it was held that the more restrictive liability provided for in the language of the bond was waived.[480]

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[474] Long v. City of Midway, 169 Ga. App. 72, 311 S.E.2d 508 (1983) (construing GA. CODE ANN. § 36-82-104).

[475] Isnardi v. Genovese Drug Stores, Inc., 662 N.Y.S.2d 790, 791, 242 A.D. 2d 672 (1997).

[476] This seems particularly true where the language of the indemnity agreement is broad in describing the obligation. *See, e.g.,* Arnold v. Stupp Corp., 205 So. 2d 797 (La. Ct. App. 1967), *petition for cert. not considered*, 251 La. 936, 207 So. 2d 540 (1968); Kansas City Power & Light Co. v. Federal Constr. Corp., 351 S.W.2d 741 (Mo. 1961); Southern Pacific Co. v. Layman, 173 Ore. 275, 145 P.2d 295 (1944); Kroger Co. v. Giem, 215 Tenn. 459, 387 S.W.2d 620 (1964).

[477] Whirlpool Corp. v. Morse, 222 F. Supp. 645 (D. Minn. 1963).

[478] MISS. CODE § 31-5-41 (2003).

[479] WIS. STAT. § 779.16 (2001).

[480] Miner-Dederick Constr. Co. v. Mid-City Rental Services, Inc., 603 S.W.2d 193 (Tex. 1980).