(IN)EQUITABLE SUBROGATION: THE FEDERAL CIRCUIT'S IRRATIONAL AND UNWORKABLE PROGRESS PAYMENT FRAMEWORK IN *BALBOA*

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ABSTRACT

American taxpayers spend more than $100 billion per year on federal construction projects. Yet massive construction delays, huge budget overruns, and unorganized contractors increase the cost of construction for the federal government. Passed in 1935, the Miller Act attempted to protect the federal government in the event that the contractor defaulted or was unable to complete the project. By requiring contractors to enlist third party "sureties" as guarantors on projects, the Miller Act provides the government with the assurance that another party will step in to complete projects if need be. Contractors are typically paid via periodic progress payments, with monthly invoices paid for work completed. If a contractor defaults, forcing a surety to take over on the project, the doctrine of equitable subrogation entitles the surety to all remaining progress payments due to the contractor. Fearing that default may be imminent and eager to receive any payments it can, a surety may be inclined to warn the federal government of imminent contractor default, at the same time that the contractor assures the federal government that it can perform. A series of Federal Circuit cases allows the surety to sue the federal government to recover progress payments that were already made to the contractor, even though those payments were made prior to the contractor defaulting, in accordance with federal regulations.

Given an opportunity to reduce this risk of double payment, the Federal Circuit instead created an incoherent and unworkable progress-payment framework in Balboa Insurance Co. v. United States*, complicating a government official's regulatory mandate to provide progress payments to contractors. The court misinterpreted a*

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standard that is normally extremely deferential to the federal government, and created a complex eight-factor behemoth that unreasonably burdens the federal government. This Note proposes new regulations to replace Balboa*, which focuses on whether the federal government received reasonable assurances from the contractor that it would complete performance.*

INTRODUCTION

In an era of contentious budget cuts,[1] appropriations for many federal programs have been slashed.[2] Yet for federal construction contractors, business is booming. Last year, American taxpayers spent more than $123 billion on federal construction projects.[3] Recent projects include massive undertakings such as building a permanent home for the Department of Homeland Security costing a total of $4.5 billion,[4] expanding Washington D.C.'s public transportation system with $975 million in federal funds,[5] and constructing a new nuclear waste facility with a $7.7 billion price tag.[6]

To minimize delays and cost overruns that can plague construction projects, the federal government has enacted statutes and promulgated regulations that help protect the government during complex and

1. *See, e.g.*, Jonathan Weisman, *House Republicans Propose Budget with Deep Cuts*, N.Y. TIMES (Mar. 17, 2015), http://www.nytimes.com/2015/03/18/us/politics/house-republican-budget-overhauls-medicare-and-repeals-the-health-law.html [https://perma.cc/9CDT-P4KN] (describing Democrats' negative reaction to a recent Republican budget proposal that would reduce spending by $5.5 trillion over 10 years).

2. *See* OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2016 BUDGET OF THE U.S. GOVERNMENT, 87–88 (2005) (listing $3.358 billion in discretionary cuts and $69.491 billion in mandatory cuts in the fiscal year 2016 budget).

3. *See AGC Summary of Federal Construction Accounts ($ in Millions) FY 2017 Budget*, ASSOCIATED GEN. CONTRACTORS OF AM., https://www.agc.org/sites/default/files/Federal%20Construction%20Accounts_FY%2017_budgetfinal.pdf [https://perma.cc/Z4KC-LURC] (listing fiscal year 2016 appropriations for construction accounts at $123.929 billion).

4. *Oversight of the DHS Headquarters Project at St. Elizabeths: Impact on the Taxpayer Before the Subcommittee on Oversight and Management Efficiency of the H. Comm. on Homeland Security*, 113th Cong. 26 (2014) (statement of Norman Dong, Chairman, Public Building Service, General Services Administration).

5. Press Release, Wash. Metro Transp. Auth., Metro Launches Silver Line, Largest Expansion of Region's Rail System in More than Two Decades (July 25, 2015), http://www.wmata.com/about_metro/news/PressReleaseDetail.cfm?ReleaseID=5749 [https://perma.cc/M5NK-JJ5J].

6. U.S. GOV'T ACCOUNTING OFFICE, GAO-14-231, PLUTONIUM DISPOSITION PROGRAM: DOE NEEDS TO ANALYZE THE ROOT CAUSES OF COST INCREASES AND DEVELOP BETTER COST ESTIMATES 28 (2014), http://www.gao.gov/assets/670/660927.pdf [https://perma.cc/X347-ELPJ].

costly projects. Among them, the Miller Act,[7] enacted in 1935, relies on an ancient commercial technique[8] to mitigate the risk of a contractor failing to perform.[9] It requires any contractor undertaking a federal project to secure bonds from a "surety" to guarantee performance.[10] A surety is a third-party insurer who agrees to take responsibility for the contractor's contractual obligations if the contractor fails to perform.[11] A bond is a contractual agreement between the contractor and the surety; thus, the federal government does not contract directly with the surety.[12] The surety charges the contractor a fee, called a "premium," for its bond services, adjusted for the surety's risk assessment of the project.[13] These bonds protect the federal government by requiring the surety to complete performance if the prime contractor defaults.[14] A prime contractor "defaults" when it materially breaches the contract by, for example, falling far behind schedule or going out of business entirely.[15] When the project goes awry, the surety must step in and finish performance by finding a new contractor.

In addition to requiring a contractor to secure surety bonds on a project, the federal government also protects itself by paying for construction work in installments, rather than in a lump sum. These periodic payments, called progress payments, provide the contractor

7. Miller Act, 40 U.S.C. §§ 3131–3133 (2012).

8. *See* HAMMURABI, THE COMPLETE CODE OF HAMMURABI § 23 (H.-Dieter Viel trans., LINCOM Europa ed. 2005) (c. 1772 B.C.E.) ("If a criminal has not been caught, the injured man shall declare in the presence of god what he has lost and the citizens of the state or the leader of the province where the crime was committed shall repay to him anything he has lost.").

9. *See* 40 U.S.C. § 3131(b)(1) (requiring contractors to secure a performance bond "for the protection of the Government").

10. *Id.* § 3131(b)(1)–(2) (requiring contractors to secure both payment and performance bonds).

11. *See* Anthony N. Palladino & Anna P. Clarke, *The Recognition of Sureties' Rights Under Government Contracts*, 25 TORT & INS. L.J. 637, 645 (1990) (noting that the performance bond "ensur[es] that [the government] will receive a completed project at the price set forth in the underlying contract").

12. *See* Shwarz v. United States, 35 Ct. Cl. 303, 309 (1900) (noting that there is a "want of privity" between the surety and the United States); Palladino & Clarke, *supra* note 11, at 637 (describing the "lack of privity" between sureties and the federal government).

13. *See* RESTATEMENT OF THE LAW OF SEC. § 82 cmt. i (AM. LAW INST. 1941) (describing a "compensated surety" as a surety that receives a premium based on a "computation of risks on an actuarial basis").

14. *See* James F. Nagle & Johnathan A. DeMella, *A Primer on Prime Contractor-Subcontractor Disputes Under Federal Contracts*, PROCUREMENT LAW., Winter 2011, at 12, 15 ("[A] performance bond is issued to protect the government . . . .").

15. Richard S. Wisner & James A. Knox, Jr., *The ABCs of Contractors' Surety Bonds*, 82 ILL. B.J. 244, 246 (1994).

with enough capital to continue working on the project, while incentivizing the contractor to remain on schedule.[16] The Federal Acquisition Regulations (FAR) require a government contracting officer to make prompt progress payments after receiving a contractor's invoice for work completed.[17] For instance, when the prime contractor properly submits a monthly invoice for pouring concrete, wiring a building for electricity, and installing plumbing, the government official must certify a payment within fourteen days for the work completed.[18] If the government official chooses to withhold a progress payment from a contractor, the agency might be violating the FAR and might also have materially breached the contract.[19]

When prime contractors encounter problems on the jobsite, there can be significant payment complications. If the contractor defaults and the surety is required to step in and complete the project, the doctrine of equitable subrogation allows the surety to "stand[] in the shoes" of the contractor[20] and receive all future progress payments.[21] But even *before* a contractor defaults, a surety can claim that default is imminent and demand that the government send the progress payment to the surety, rather than the contractor. In that scenario, a low-level government official[22] is placed in the precarious position of assessing whether the contractor is capable of finishing the project. If the government official determines that default is not imminent, he or she

16. T. Scott Leo, *The Financing Surety and the Chapter 11 Principal*, 26 TORT & INS. L.J. 45, 56 n.38 (1990) (noting that progress payments provide contractors with the "working capital" to fund overhead costs).

17. FAR 32.904 (2013) ("The due date for making progress payments based on contracting officer approval of the estimated amount and value of work or services performed, including payments for reaching milestones in any project, is 14 days after the designated billing office receives a proper payment request.").

18. *See id.* (establishing the fourteen-day deadline).

19. *See* Johnson v. All-State Constr., Inc. 329 F.3d 848, 851 (Fed. Cir. 2003) (noting that the issue was whether the Navy's withholding of a percent of the earned progress payments operated "as a breach of contract"); C.S. Maravilla & David Schneider, *The Government's Non-Bankruptcy Rights for Debt Collection*, 23 FED. CIR. B.J. 267, 274–75 (2013) (describing several cases in which the government official's decision to withhold progress payments was deemed a material breach).

20. Joseph C. Kovars & Jay Bernstein, *When the Shoes Don't Fit: Defenses of the Principal that Are Unavailable to the Surety*, 29 CONSTRUCTION L. 24, 24 (2009).

21. *See* RESTATEMENT (THIRD) OF SURETYSHIP AND GUAR. § 27(1) (AM. LAW INST. 1996) ("Upon total satisfaction of the underlying obligation, the secondary obligor is subrogated to all rights of the obligee with respect to the underlying obligation to the extent that performance of the secondary obligation contributed to the satisfaction.").

22. *See* Harold J. Krent, *Reconceptualizing Sovereign Immunity*, 45 VAND. L. REV. 1529, 1567 (1992) (noting that contracting officers with the power to terminate a contract may be at a "low level").

will likely abide by the FAR and continue to make progress payments to the contractor per the terms of the contract. But if the contractor subsequently defaults, the government is vulnerable to a lawsuit from the surety to recover the contested progress payment that was already sent to the contractor. This equitable basis for recovery, recognized by the Court of Federal Claims,[23] adds insult to injury by potentially forcing the federal government to pay twice for work performed, without the possibility of the government being made whole by the defaulted contractor.

In *Balboa Insurance Co. v. United States*,[24] the Federal Circuit outlined a complicated framework to assess whether a government official appropriately exercised his or her discretion in disbursing a progress payment to the contractor. The framework has become entrenched in construction law over the last thirty years. Supposedly embodying the extremely deferential "arbitrary, capricious, [or] an abuse of discretion" standard from the Administrative Procedure Act (APA),[25] the court relied on a jumbled array of Court of Federal Claims cases to synthesize an eight-factor behemoth.[26] If the court applies this test and concludes that the government official did not exercise reasonable discretion when it paid the contractor, the

23. *See, e.g.*, U.S. Fid. & Guar. Co. v. United States, 676 F.2d 622, 629 (Ct. Cl. 1982); Royal Indem. Co. v. United States, 529 F.2d 1312, 1321 (Ct. Cl. 1976); Argonaut Ins. Co. v. United States, 434 F.2d 1362, 1369 (Ct. Cl. 1970).

24. Balboa Ins. Co. v. United States, 775 F.2d 1158 (Fed. Cir. 1985).

25. 5 U.S.C. § 706(2)(A) (2012); *see Balboa*, 775 F.2d at 1164 (stating that the factors are "important in determining whether the Government has exercised reasonable discretion in distributing funds")

26. *Balboa*, 775 F.2d at 1164–65. The eight Balboa factors are as follows:

> (1) Attempts by the federal government after notification by the surety, to determine that the contractor had the capacity and intent to complete the job.
>
> (2) Percentage of contract performance completed at the time of notification by the surety.
>
> (3) Efforts of the [Federal] Government to determine the progress made on the contract after notice by the surety.
>
> (4) Whether the contract was subsequently completed by the contractor . . . .
>
> (5) Whether the payments to the contractor subsequently reached the subcontractors and [suppliers] . . . .
>
> (6) Whether the [federal] agency had notice of problems with the contractor's performance before the surety's notification of default . . . .
>
> (7) Whether the [Federal] Government's action violates one of its own statutes or regulations.
>
> (8) Evidence that the contract could or could not be completed as quickly or cheaply by a successor contractor.

Id. (citations omitted).

government must pay the surety the disputed progress payment that was already sent to the contractor in good faith.[27]

While "reasonable discretion" is seemingly very deferential to the government officer, the long-entrenched *Balboa* framework is fundamentally flawed, and those flaws come at the government's expense. *Balboa*'s progress-payment framework is irrational and unworkable, and it undermines the purpose of the Miller Act requiring sureties. Several *Balboa* factors are at odds with the federal regulations covering government-funded construction, and the court did not provide a mechanism for weighing one factor against any other. The *Balboa* framework is also troubling because of the informational disparity between the surety and the government official: the surety is in the better position to assess the contractor's risk of default and price that risk into the bond premium, yet the framework inefficiently places the onus for assessing that risk on the government official. Moreover, the *Balboa* factors are costly to litigate, leading the federal government to settle lawsuits that may lack merit. Ironically, this complex framework—which emerged from legislation designed to protect the federal government—may force the federal government to pay twice for work.[28]

While frequent delays and cost overruns have led many to criticize the federal acquisition program,[29] this troublesome Federal Circuit case law has presented a structural impediment to righting the ship. Until corrected, the progress-payment framework puts government officials in a catch-22 situation that will continue to exacerbate delays and cost overruns on federal projects.

This Note argues that the eight *Balboa* factors ought to be replaced. Prior to the surety notifying the government of the contractor's risk of default, the government official should have

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27. *Id.* at 1160 ("Balboa asserted that it should have received the fifth payment check and, when the Government denied liability, sought recovery of that amount in the U.S. Claims Court."); *see also* United Pac. Ins. Co. v. United States, 16 Cl. Ct. 555, 558–61 (1989) (applying the *Balboa* factors to progress payment litigation); Ohio Cas. Ins. Co. v. United States, 12 Cl. Ct. 590, 594–96 (1987) (applying the *Balboa* factors to progress payment litigation).

28. *Balboa*, 775 F.2d at 1158 (noting that the surety sought to recover progress payments that were already paid to the prime contractor).

29. *See* Shelley Roberts Econom, *Confronting the Looming Crisis in the Federal Acquisition Workforce*, 35 PUB. CONT. L.J. 171, 185 (2006) (noting that Department of Defense contracting guidelines can create schedule delays and increased costs); Bob Davis, *Feds' Procurement Shortcomings a Threat to Industry*, FCW (Jan. 5, 2015), https://fcw.com/articles/2015/01/05/federal-procurement-shortcomings.aspx [https://perma.cc/QB59-SKS2] (noting that the lack of government procurement officers contributes to delays on projects).

unlimited discretion to make progress payments for work completed, absent a showing of fraud. If the surety notifies the government that default is imminent, the government official should be required to exercise due diligence and seek out reasonable assurances that the contractor can complete performance. The precise contours of the due-diligence standard should be defined through FAR administrative rulemaking, rather than the irrational and unworkable framework created by the Federal Circuit in *Balboa*.

Part I provides background information on sureties and the doctrine of equitable subrogation in Miller Act construction projects. Part II analyzes the *Balboa* factors, highlighting their irrational features and the problems with their application. Part III recommends that *Balboa*'s framework be eliminated in favor of FAR rulemaking that would simply require a government official to receive assurances from the contractor when the surety warns of potential default. This Note then briefly concludes.

I. BACKGROUND

A. *History of Sureties*

The modern construction surety industry earns profits of more than $1 billion annually,[30] yet surety agreements began as an ancient and simple means of guaranteeing contractual performance. The first surviving record of a surety agreement dates from 2750 B.C.E., when a Mesopotamian tablet chronicled the plight of a farmer drafted into the king's army.[31] Unable to tend to his fields while serving in the army, the man enlisted the aid of another farmer to cultivate his land in his absence, in exchange for splitting the profits.[32] A local merchant served as the agreement's surety by guaranteeing that the second farmer would take care of the land.[33] Surety agreements were codified by law in Hammurabi's Code in a peculiar passage protecting citizens from robbery.[34] Section 23 of the Code required the state to indemnify a

30. AON RISK SOLUTIONS, SURETY MARKET 2014 OUTLOOK 1 (2014), http://www.aon.com/attachments/risk-services/2014-Surety-Market-Update-Final.pdf [https://perma.cc/9PJ9-6ML4].

31. JEFFREY S. RUSSELL, SURETY BONDS FOR CONSTRUCTION CONTRACTS 9 (2000).

32. *Id.*

33. *Id.*

34. *See supra* note 8.

robbery victim if the thief was never captured.[35] In effect, the state served as the surety of the escaped robber by guaranteeing payment to the victim. In the ancient world, surety agreements were usually based on familial or community relationships,[36] as discussed in the Bible and Apocrypha[37] and embraced by the Roman Empire.[38]

By the time of the Magna Carta, sureties were recognized as an important tool for facilitating commercial ventures without a banking industry.[39] The importation of English common-law principles made lawsuits involving surety relationships common in the early United States.[40] In 1865, the Fidelity Insurance Company became the first surety company in the United States,[41] which signaled the replacement of "personal, uncompensated" sureties with corporate firms.[42]

Less than three decades after the first American surety company was formed, Congress passed the Heard Act,[43] which required any person who contracted for the construction of a public building or public work to secure a bond from a surety company, guaranteeing that the laborers and subcontractors would be paid in the event of

35. *Id.*; *see* FINANCIAL INSTITUTION BONDS 3 (Duncan L. Clore ed., 2d ed. 1998) (noting that in effect, "the city and governor served as the surety for the 'infidelity' of the robber who got away").

36. David C. Olson, *Magna Carta Viewed as Embodiment of Commerce*, TORTSOURCE, Winter 2015, at 1, 6 (2015) (contrasting the modern commercial form of suretyship with ancient sureties based on familial relationships).

37. According to the Apocrypha,

> An honest man is surety for his neighbour; but he that is impudent will forsake him. Forget not the friendship of thy surety, for he hath given his life for thee. A sinner will overthrow the good estate of his surety: And he that is of an unthankful mind will leave him that delivered him. Suretiship [sic] hath undone many of good estate, and shaken them as a wave of the sea: and he that undertaketh and followeth other men's business for gain shall fall into suits.

Ecclesiasticus 29:14–19 (King James); *see also Hebrews* 7:22 (King James) ("By so much was Jesus made a surety of a better testament.").

38. *See* Wisner & Knox, *supra* note 15, at 244 ("A requirement for a Roman gateway project in 106 B.C. was that 'whoever shall be awarded the contract shall furnish bondsmen secured by real estate to the satisfaction of the magistrates.'" (quoting J. Harry Cross, *Suretyship Is Not Insurance*, 30 INS. COUNS. J. 235, 235 (1963))).

39. Olson, *supra* note 36, at 6.

40. *Id.* (citing Ford v. Keith, 1 Mass. 139 (1804); Vance v. Lancaster, 4 Tenn. 130 (1816)).

41. Willis D. Morgan, *The History and Economics of Suretyship*, 12 CORNELL L.Q. 487, 487 (1927) (noting that Fidelity Insurance Company was the first surety company to operate in North America).

42. Olson, *supra* note 36, at 6.

43. Heard Act of 1894, ch. 280, 28 Stat. 278, *repealed by* Miller Act, ch. 642, 49 Stat. 793, 794 (1935) (current version at 40 U.S.C. §§ 3131–3133 (2012)).

contractor default.[44] The Miller Act replaced the Heard Act in 1935 and created the modern construction surety framework.[45]

B. Sureties' Purpose and Function

Although sureties exist in different forms,[46] the central tenet of surety agreements is consistent throughout: the surety has a contractual obligation to satisfy the debtor's promise if the debtor defaults.[47] A surety agreement contemplates three parties: the principal (debtor), the surety, and the obligee. The principal is the person who owes the obligation, the surety provides the guarantee, and the obligee owns the obligation.[48] The obligee is not a contractual party to the surety agreement, however.[49] The obligee is merely the beneficiary of the agreement, while the surety agreement binds the principal and the surety.[50]

The guarantee that the surety furnishes is called a bond.[51] Generally, a surety receives some sort of payment from the principal in exchange for agreeing to satisfy the principal's obligation to the obligee.[52] A surety typically uses a percentage of the project's total price as a guideline for setting the premium amount, but also considers a risk assessment of the contractor's ability to complete the project.[53]

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44. Jack E. Kerrigan & David C. Harris, *The Preemption Debate: What Is the Scope of the Miller Act Remedial Scheme?*, ARMY LAW., Dec. 1998, at 1, 2 (comparing the bond that protected suppliers to a state's mechanics' lien).

45. *See infra* Part I.C.

46. Suzanne Wilhelm, *Taking Suretyship Seriously*, 18 OKLA. CITY U. L. REV. 87, 88 (1993) (listing the uses of sureties, ranging from securing a corporation's commercial loan to securing a spouse's line of credit).

47. *See id.* at 88–89 ("But regardless of the form of the underlying business relationship between the creditor and debtor, and regardless of the form that the suretyship takes, it is the surety's obligation to satisfy the debtor's promise in the event of the debtor's default.").

48. Philip G. Alber, *Making Sense out of Performance and Payment Bonds*, 71 MICH. B.J. 1020, 1020 (1992).

49. Randall S. Udelman, Comment, *Surety Contractors: Are Sureties Becoming General Liability Insurers?*, 22 ARIZ. ST. L.J. 469, 484 (1990) (noting that only the principal and the obligee are parties to the underlying construction project).

50. Amfac Mortgage Corp. v. Arizona Mall, 583 F.2d 426, 435 (9th Cir. 1978); Udelman, *supra* note 49, at 470 n.8 (citing United States v. Tilleraas, 709 F.2d 1088, 1091 (6th Cir. 1983)).

51. *Id.* at 469.

52. Alber, *supra* note 48, at 1020.

53. *See* RESTATEMENT OF THE LAW OF SEC. § 82 cmt. i (AM. LAW INST. 1941) (defining a "compensated surety" as a surety that receives a premium based on a "computation of risks on an actuarial basis"); *The Consumer's Total Guide to Surety Bonds*, SURETYBONDS.COM, https://www.suretybonds.com/edu/guide.html [https://perma.cc/WE2M-CVY5] ("The bond type - including its amount, term and contractual risk - determines the complexity of the underwriting

If the principal fails to perform its obligation, the obligee can call on the surety to step in and perform, per the terms of the bond.[54] In the context of federal construction projects, the contractor is the principal and the federal government is the obligee. If the contractor stops paying its subcontractors or abandons the jobsite, the federal government can require the surety to carry out an action, per the terms of the bond.[55]

The action the surety must take is based on the guarantee made in the bond. Sureties offer two types of bonds, one that primarily protects the investments of the project's subcontractors and suppliers, and another that protects the federal government's interest in the project's timely completion. The first type of bond, called a "payment bond," is triggered when the contractor is unable to pay its subcontractors and laborers on a project.[56] The surety steps in to pay the contractor's bills, "protecti[ng] . . . all persons supplying labor and material in carrying out the work provided for in the contract."[57] In contrast, a "performance bond" protects the federal government if the prime contractor defaults.[58] A prime contractor defaults when it materially breaches the terms of the construction contract.[59] Examples of contractor default include falling significantly behind schedule on a time-sensitive project and walking off the site because the contractor could not afford to pay its subcontractors.

If the contractor defaults, the performance bond "ensur[es] that the [g]overnment will receive a completed project at the price set forth in the underlying contract."[60] If the performance bond is triggered, the surety is responsible for finding a new contractor and ensuring that the project is completed at no additional cost to the government.

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process. The applicant's credentials - including credit scores, past work history, references and professional reputation - indicates a principal's financial credibility.").

54. SURETYBONDS.COM, *supra* note 53 ("[Surety bonds] guarantee that people do their jobs . . . . If the principal fails to fulfill the bond's obligations . . . . the surety will provide compensation up to the bond amount.").

55. *See* Nat'l Sur. Corp. v. United States, 118 F.3d 1542, 1544 (Fed. Cir. 1997) (noting that the contractor abandoned the jobsite so the surety completed construction "in accordance with its performance bond").

56. Nagle & DeMella, *supra* note 14, at 15 (noting that payment bonds protect a subcontractor if it was not paid by the contractor).

57. 40 U.S.C. § 3131(b)(2) (2012).

58. Nagle & DeMella, *supra* note 14, at 15.

59. Wisner & Knox, *supra* note 15, at 246.

60. Palladino & Clarke, *supra* note 11, at 645.

Sureties are critical to the success of federal construction projects. Contractor default is rampant, with tens of thousands of construction firms going out of business annually.[61] Construction projects tend to be large in scale and take place over many months or years, increasing the risk of problems along the way.[62] Without performance bonds, the government could face significant expense and hardship as it scrambled to find a new contractor after the original contractor defaulted.[63] The federal government would need to assess the work remaining on the project, open a bidding process to select a new contractor, and negotiate terms with the replacement contractor.[64]

Moreover, without sureties, the federal government would struggle to meet its statutory obligations under the Small Business Act of 1953,[65] which requires agencies to award a "fair proportion" of all government contracts—including those for construction projects—to small businesses.[66] Without the protection of a surety, the federal government would be less inclined to hire small-business contractors for fear that smaller firms would be more likely to go out of business, obligating the government to develop a contingency plan for an incomplete project. Performance bonds provide the federal government with the security that critical construction projects will be completed according to schedule, regardless of the size of the contractor.

While the surety must step in and complete the project under a performance bond if the contractor defaults, it does not surrender all

61. SURETY INFO. OFFICE, WHY DO CONTRACTORS FAIL? (2014), http://c.ymcdn.com/sites/www.surety.org/resource/resmgr/LearnAboutSurety/Why_Do_Contractors_Fail.pdf [https://perma.cc/L4ND-744X] (citing a 2014 BizMiner study that found that of the 986,057 contractors in business in 2011, only 735,160 were still in business two years later).

62. T. Scott Leo, *The Construction Contract Surety and Some Suretyship Defenses*, 34 WM. & MARY L. REV. 1225, 1226, 1228 (1993) (noting that even simple construction projects require financing expertise, entail significant transactional costs, and are "risky" ventures).

63. *Id.* at 1226 (noting that if a contractor defaults, there could be "substantial" transaction costs, including finding a replacement contractor, assessing the remaining work, and negotiating the contract for completing the project).

64. *Id.*

65. Small Business Act of 1953, Pub. L. No. 83-163, 67 Stat. 232 (current version at 15 U.S.C. §§ 631–657 (2012)); *see also* FAR 19.202-1 (2015) (describing the accommodations that a contracting officer should make to "encourage" small-business participation in federal contracts).

66. 15 U.S.C. § 631(a) (describing one of the purposes of the Small Business Act as "insur[ing] that a fair proportion of the total purchases and contracts or subcontracts for property and services for the Government (including but not limited to contracts or subcontracts for maintenance, repair, and construction) [are] placed with small business enterprises"). The Small Business Act set an annual goal of awarding 23 percent of prime contract dollars to small businesses. *Id.* § 644(g)(1)(A)(1).

hope of compensation when it does. The surety may seek whatever future payments the prime contractor was due on the project as compensation for completing the job,[67] in addition to whatever premium the contractor paid the surety up front to secure the bond agreement.[68] As will be discussed in Part I.D, when a prime contractor defaults, the surety "stands in the shoes" of the principal[69] and is entitled to receive the scheduled progress payments.

A surety functions as a hybrid of a banking firm and a traditional insurance firm.[70] Some commentators have compared sureties to banks,[71] analogizing a bond to a conditional letter of credit or loan. This is because, in the event of contractor default, the surety would complete the project but seek compensation from the contractor.[72] In other words, the terms of the bond may require the defaulting contractor to fully compensate the surety for completing the project.

While comparing surety agreements to letters of credit is apt on its face, the practical effect of a contractor's default belies that analogy. When a contractor defaults, it is often because the contractor has gone out of business.[73] A surety cannot hope to recover blood from a stone. If a contractor goes out of business and has no ability to pay the surety, the surety is only compensated by the progress payments sent by the federal government and may suffer a financial loss on the project. In that respect, a surety functions more as an insurer, prepared to take a possible loss on a project. As with standard insurance, the principal must pay a premium to secure the surety's bond. Moreover, like an

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67. *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132, 139 (1962) (noting that when the surety steps in and performs, it has a subrogation right to the remaining contract funds).

68. *See* Alber, *supra* note 48, at 1020 (noting that the surety receives a premium payment in exchange for agreeing to serve as the surety).

69. Kovars & Bernstein, *supra* note 20, at 24.

70. Nat'l Shawmut Bank of Bos. v. New Amsterdam Cas. Co., 411 F.2d 843, 845 (1st Cir. 1969) ("Neither is the business one of ordinary financing, for while the surety extends its credit to the owner . . . this is a credit that may either never have to be drawn upon or, if it is drawn upon at all, will in all likelihood be overdrawn."); *see* B.C. Hart, *Bad Faith Litigation Against Sureties*, 24 TORT & INS. L.J. 18, 19–20 (1988) (noting that the core relationships among parties to a surety agreement are different from relationships in typical insurance agreements).

71. *See* Wisner & Knox, *supra* note 15, at 244 (comparing a surety to a banker who "will make a loan only if satisfied that the borrower is creditworthy").

72. Alber, *supra* note 48, at 1020–21.

73. *See* Donavan Bezer, *The Inadequacy of Surety Bid Bonds in Public Construction Contracting*, 40 PUB. CONT. L.J. 87, 130 (2010) (noting that contractors are often judgment proof, and that without a surety bond, a project owner would be left to sue a "bankrupt contractor that has defaulted on its contractual obligations").

insurer, a surety's financial obligation is triggered by a specific event—in the surety's case, the prime contractor's default.[74]

C. Miller Act Sureties

Surety agreements have been a cornerstone of federal construction projects since 1894 when Congress passed the Heard Act.[75] Prior to the enactment of the Heard Act, a subcontractor or supplier could not collect outstanding debts from a contractor because "a lien cannot attach to government property."[76] The Heard Act required the contractor to secure a bond on the project.[77] The bond created a civil right of action against the prime contractor and the surety for unpaid labor and supplies, and it also enabled the federal government to require performance by the surety upon the contractor's default.[78]

In 1935, in an effort to strengthen the bond framework[79] and subcontractor remedies provided by the Heard Act, Congress passed the Miller Act.[80] The Miller Act differentiated between payment and performance bonds, and required the prime contractor to secure both.[81] The Miller Act applied to a broad range of federal projects, affecting all contracts "for the construction, alteration, or repair of any public building or public work of the United States"[82] whose cost exceeded $20,000 (later amended to $100,000).[83] While ordinarily the federal government enjoys sovereign immunity, the Tucker Act, enacted in 1887, provides the Court of Federal Claims with jurisdiction

74. Wisner & Knox, *supra* note 15, at 246.

75. Heard Act of 1894, ch. 280, 28 Stat. 278, *repealed by* Miller Act, Pub. L. No. 74-321, § 5, 49 Stat. 793, 794 (1935).

76. *See* J.W. Bateson Co. v. U.S. *ex rel.* Bd. of Tr. Nat'l Automatic Sprinkler Indus. Pension Fund, 434 U.S. 586, 589 (1978) (quoting F.D. Rich Co. v. United States *ex rel.* Indus. Lumber Co., 417 U.S. 116, 122 (1974)).

77. Note, *Reconsideration of Subrogative Rights of the Miller Act Payment Bond Surety*, 71 YALE L.J. 1274, 1277 n.18 (1962) (noting that the Heard Act required a single bond that included both payment and performance of the project).

78. *Id.*

79. H.R. REP. NO. 74-1263, at 1 (1935) (discussing the single bond framework from the Heard Act, which created "considerable complaint[s]" from subcontractors who sought to collect money due to them).

80. Miller Act, Pub. L. No. 74-321, § 1, 49 Stat. 793, 794 (1935) (current version at 40 U.S.C. § 3131 (2012)).

81. *Id.* (requiring contractors to secure both payment and performance bonds).

82. *Id.*

83. Pub. L. No. 103-355, 108 Stat. 3341 (1994) (codified as amended at 40 U.S.C. § 270) (current version at 40 U.S.C. § 3131).

to hear a suit brought by a contractor or a surety against the federal government when there is a contract dispute.[84]

D. Progress Payments and the Doctrine of Equitable Subrogation

Given the risk that problems could arise during performance, contractors on government construction projects are not typically paid in a full lump sum. However, many contractors could not complete massive, multi-million-dollar construction projects without revenue during performance.[85] Small-business contractors in particular would struggle to complete a project without consistent cash flow, reducing competition during the government bidding process because "only the largest and most fluid businesses would be financially able to invest their own capital or arrange for private financing."[86]

Thus, as a result of the federal government's desire to encourage accountability on the jobsite and promote small-business contractors,[87] contractors receive progress payments. Progress payments are periodic payments for work completed,[88] and are generally made month-by-month. Progress payments encourage contractors to perform work promptly and to specification, because the contractor's payment will be tied to accurate completion of the project. The government official who manages the particular construction project certifies progress payments and sends payments to the contractor.[89] For instance, if a contractor paves cement and installs roofing at a military base, it will submit an invoice for the value of work completed and supplies used in that month to an Army officer at the base. Federal regulations require

84. Tucker Act, 28 U.S.C. § 1491 (2012); *see* Ins. Co. of the W. v. United States, 243 F.3d 1367, 1375 (Fed. Cir. 2001) ("[A]fter stepping into the shoes of a . . . contractor, [the surety] may rely on the waiver of sovereign immunity in the Tucker Act . . . .").

85. *See* Fireman's Fund Ins. Co. v. United States, 362 F. Supp. 842, 846 (D. Kan. 1973) ("It is common knowledge that contractors rely upon contract proceeds administered through progress payments to properly finance the contract.").

86. Paul Maurice Meador, *Financing Government Contracts with Progress Payments*, 18 A.F. L. REV. 1, 2 (1976).

87. *Id.* at 2–4 (noting that promoting small business contractors is a goal of federal procurement policy and that progress payments help facilitate that goal).

88. Depending on the type of project, progress payments may take the form of payment for costs incurred during the specified period, or as a percent of the total contract. *See* FAR 32.102(b), (e) (2015) (comparing progress payments made based on costs with progress payments made based on percent of project completed).

89. *See id.* at 1.602-2 (describing the job duties of a contracting officer as "ensuring performance of all necessary actions for effective contracting, ensuring compliance with the terms of the contract, and safeguarding the interests of the United States in its contractual relationships").

that once the federal agency overseeing the work receives a proper invoice from the contractor for work completed, the agency must submit a payment to the prime contractor.[90] Because the federal government has no contractual relationship with the suppliers or subcontractors, the prime contractor receives the full progress payment and allocates the funds to its suppliers and subcontractors.[91]

If the contractor's work is advancing by the terms of the contract, all payments are made to the contractor and there is little need for the surety. The trouble arises when the surety believes the prime contractor is struggling to perform. When contractors are involved in multiple projects at once, their finances can become strained if they use revenue from one project to finance another project, possibly leaving subcontractors and suppliers waiting for payment.[92] In more serious cases of financial turmoil, the contractor may pack up and walk off the job site, signaling that the firm does not intend to complete the project.[93] If either of these problems occurs, a subcontractor may contact the surety and complain that the prime contractor is failing to perform adequately.

When the contractor has defaulted, the surety naturally seeks to mitigate its potential loss on the project. The doctrine of equitable subrogation provides the surety with a remedy, entitling the surety to all future progress payments that would ordinarily go to the (defaulted) prime contractor. Rooted neither in statute nor in contract language,[94]

90. *See id.* at 32.904 (2013) ("The due date for making progress payments based on contracting officer approval of the estimated amount and value of work or services performed, including payments for reaching milestones in any project, is 14 days after the designated billing office receives a proper payment request.").

91. *See id.* at 32.112-1 (describing subcontractor payment as the contractor's responsibility).

92. *See* Scott Wolfe, Jr., *Getting Paid in the Construction Industry: A War Between Policy, Contract, and Tempers*, ZLIEN: CONSTRUCTION PAYMENT BLOG (Mar. 19, 2013), http://www.zlien.com/articles/getting-paid-in-the-construction-industry-a-war-between-policy-contract-and-tempers [https://perma.cc/6BC2-2GTG] (noting that the uncertainty in construction projects encourages some contractors to apply money from one project to another project, or "robbing Peter to pay Paul").

93. *See, e.g.*, Ohio Cas. Ins. Co v. United States, 12 Cl. Ct. 590, 593 (1987) (stating that after most of the subcontractors had walked off the job site, "it was obvious to everyone" that the contractor would be unable to complete performance).

94. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136 n.12 (1962) (noting that equitable subrogation "is a creature of equity; is enforced solely for the purpose of accomplishing the ends of substantial justice; and is independent of any contractual relations between the parties" (quoting Memphis & Little Rock R.R. Co. v. Dow, 120 U.S. 287, 301–02 (1887))).

equitable subrogation is a long-standing doctrine[95] that springs from the principle of unjust enrichment.[96] If the government were to demand that the surety discharge the duty of the contractor, yet retain the planned progress payments, the government would be unjustly enriched.[97] As a result, equitable subrogation allows the surety to step into the shoes of the principal (prime contractor), entitling the surety to all the funds the contractor would receive.[98] Upon the surety's successful completion of the project (or plan to successfully complete the project), the surety is entitled to receive the unpaid progress payments that would have gone to the contractor.[99]

When applied as described here, equitable subrogation does not prejudice the federal government's interest in the project because the job will be completed and the government simply pays out the remaining contract funds directly to the surety.[100] When that standard

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95. *See id.* at 136 ("Since there is no statute which expressly declares that a surety does acquire a property interest in a fund like this . . . we must seek an answer in prior judicial decisions.").

96. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 (AM. LAW INST. 2011) ("A person who is unjustly enriched at the expense of another is subject to liability.").

97. RESTATEMENT (THIRD) OF SURETYSHIP & GUAR., § 27 cmt. a (AM. LAW INST. 1996) (describing subrogation as a remedy by which "the property of one person is used to discharge a duty of another . . . under such circumstances that the other will be unjustly enriched by the retention . . . thus conferred, the former is placed in the position of the obligee").

98. Ins. Co. of the W. v. United States, 243 F.3d 1367, 1375 (Fed. Cir. 2001) ("[A]fter stepping into the shoes of a . . . contractor, [the surety] may rely on the waiver of sovereign immunity in the Tucker Act . . . ."). Note that some commentators describe the subrogation right as allowing the contractor to step into the shoes of the *obligee* (the federal government) rather than the principal (contractor). But for the purposes of analyzing progress payments under *Balboa*, it is a semantic distinction without a difference. RESTATEMENT (THIRD) OF SURETYSHIP & GUAR., § 27 cmt. a (AM. LAW INST. 1996) ("In the suretyship context, subrogation provides a secondary obligor who performs the secondary obligation with the obligee's rights with respect to the underlying obligation as though that obligation had not been satisfied.").

99. RESTATEMENT (THIRD) OF SURETYSHIP & GUAR., § 27(1) (AM. LAW INST. 1996) ("Upon total satisfaction of the underlying obligation, the [surety] is subrogated to all rights of the obligee with respect to the underlying obligation to the extent that performance of the secondary obligation contributed to the satisfaction."); *see* Daniel Mungall, Jr., *The Buffeting of the Subrogation Rights of the Construction Contract Bond Surety by* United States v. Munsey Trust Co., 46 INS. COUNS. J., 607, 607 (1979) (noting that the right of equitable subrogation involves four elements: "1. An obligation of the contractor to the owner; 2. The failure of the contractor to perform that obligation; 3. Rights in the owner arising from the contractor's failure to perform; 4. The performance by the surety . . . of the obligation which the contractor has failed to perform").

100. RESTATEMENT (THIRD) OF SURETYSHIP & GUAR., § 27 cmt. a (AM. LAW INST. 1996) ("Since the underlying obligation has been satisfied, no interest of the obligee is prejudiced by permitting the secondary obligor to enforce the obligee's rights, and the resulting benefit to the secondary obligor effectuates the rights of the secondary obligor against the principal obligor.").

version of equitable subrogation occurs, the project can be completed largely on schedule, and litigation between the surety and the federal government is unlikely.

However, many cases of contractor "default" are not so straightforward.[101] Contractor delays on large-scale construction projects are not unusual, and delays do not necessarily signal that the contractor will fail to complete the project.[102] Suppose the surety notifies the government official that it is concerned with subcontractor payment complaints and the project's schedule. The surety is convinced it will eventually need to take over the project, and it seeks to receive payment as soon as possible. The surety requests that the federal government stop sending progress payments to the contractor and begin the process of routing those payments toward the surety. If the contractor has successfully completed 90 percent of the project, with only a few small cosmetic improvements still to come, the government official may plausibly believe that the contractor will get back on schedule and finish the job without incident.[103] Relying on the contractor's assurances that it will complete the job, the government official makes a contractually obligated progress payment to the contractor over the surety's objection. Under the Court of Federal Claims' holding in *Balboa*, if the government official guesses incorrectly and the contractor defaults, the surety may sue the federal government to retroactively recover the recent progress payment that was sent to the contractor.[104] If the federal government loses at trial, it is forced to pay twice for work by issuing a new payment to the surety. The government is unlikely to recover any money from the judgment-proof defaulted contractor.[105] To sue under this theory, the surety must have provided notice to the federal government that the contractor was

101. *See, e.g.*, Balboa Ins. Co. v. United States, 775 F.2d 1158, 1165 (Fed. Cir. 1985) (describing the contract's performance as 91 percent complete and on schedule when the surety first raised concerns).

102. Carl S. Beattie, *Apportioning the Risk of Delay in Construction Projects: A Proposed Alternative to the Inadequate "No Damages for Delay" Clause*, 46 WM. & MARY L. REV. 1857, 1858 (2005); *see also* Sanford M. Fitzsimmons & Abraham Goldfarb, Schweigert *and Delays of Second-Tier Subcontractors*, 11 JAG L. REV. 321, 322 (1969) (noting that the Court of Federal Claims has held that delays that were the fault of a second-tier subcontractor do not constitute default by the contractor).

103. *See, e.g.*, *Balboa*, 775 F.2d at 1165 (describing the project as more than 90 percent complete when the surety complained to the government official).

104. *Id.* at 1162 (noting that the Court of Federal Claims has jurisdiction to hear this type of lawsuit).

105. *See supra* note 73 and accompanying text.

in default "or approaching default,"[106] and that the surety was "invoking its rights to the remaining contract proceeds."[107] Once the surety has provided notice, the government is "convert[ed] . . . into a stakeholder with duties to the surety."[108]

Although it recognized a surety's right to sue to recover allegedly misdirected progress payments, the Court of Federal Claims struggled to articulate a standard by which the government's decisions regarding progress payments would be evaluated.[109] After all, the federal government does not contract with the sureties themselves, and ordinarily a third party's warning or concern does not affect contractual relations between two parties. Furthermore, the federal government is bound by contracts and regulations to make prompt progress payments to its contractors.[110] Moreover, courts have noted that the federal government has a strong interest in the "timely and efficient" completion of construction projects, giving federal government officials "broad discretion and flexibility" in making payments.[111]

Throughout the 1970s, the Court of Federal Claims relied on vague language about duty to guide a fact-based inquiry into the government's decision to issue progress payments.[112] The court held that a government official assumes a "duty to exercise its discretion responsibly and to consider the surety's interest in conjunction with other problems encountered in the administration of the contract" after the surety notifies the government of the risk of default.[113] In 1985, in *Balboa Insurance Co. v. United States*[114] the Federal Circuit attempted to create a more precise framework to assess federal discretion over progress payments.

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106. Colonial Sur. Co. v. United States, 108 Fed. Cl. 622, 634 (2013).

107. Am. Ins. v. United States, 62 Fed. Cl. 151, 155 (2004).

108. *Id.*; *see* Hartford Fire Ins. Co. v. United States, 108 Fed. Cl. 525, 535 (2012) ("[N]otice that the contractor is in default and that the surety is invoking its rights to the remaining contract proceeds converts the government into a stakeholder with duties to the surety.").

109. For examples of this difficulty, see generally U.S. Fid. & Guar. Co. v. United States, 676 F.2d 622, 631 (Ct. Cl. 1982); Royal Indem. Co. v. United States, 529 F.2d 1312, 1321 (Ct. Cl. 1976); U.S. Fid. & Guar. Co. v. United States, 475 F.2d 1377, 1385 (Ct. Cl. 1973); Argonaut Ins. Co. v. United States, 434 F.2d 1362, 1366, 1369 (Ct. Cl. 1970).

110. *See supra* note 90 and accompanying text.

111. *Argonaut Ins. Co.*, 434 F.2d at 1367–68; *U.S. Fid. & Guar. Co.*, 676 F.2d at 628.

112. *See Argonaut Ins. Co.*, 434 F.2d at 1368 (suggesting that the government has a duty to consider the surety's interest during performance of the contract).

113. *Id.*

114. Balboa Ins. Co. v. United States, 775 F.2d 1158 (Fed. Cir. 1985).

II. *BALBOA* AND ITS DEFICIENCIES

Attempting to find an equitable solution to fact-driven progress payment litigation, the Federal Circuit cobbled together a complex, eight-factor framework to assess a government official's decision to pay a contractor over a surety's objection. The *Balboa* framework is irrational and practically unworkable, and it imposes a convoluted and burdensome inquiry on low-level government officials. The Miller Act was designed in large part to protect the federal government from cost increases associated with construction projects,[115] yet ironically the *Balboa* framework that emerged from the statute threatens the federal government with the risk of double payment and imposes a constant litigation risk.

A. Balboa*'s "Reasonable Discretion" Framework*

In 1979, contractor Chemical Engineers & Constructors, Inc. (CEC) was hired to alter a structure at the Naval Training Center in Orlando, Florida.[116] Balboa Insurance Company served as the project's surety, and CEC provided the government with proof of its payment and performance bonds.[117] In January 1980, CEC was on schedule, had completed 91 percent of the project, and had received four progress payments.[118] In early February, the surety received complaints from subcontractors who said they had not been paid for work performed and that CEC would not be able to fulfill its obligations.[119] When CEC requested its fifth progress payment from the Navy, the surety "demand[ed] that no further contract funds be released without its consent."[120] Notwithstanding the surety's objection, the Navy opted to disburse a progress payment to CEC for work that had been performed.[121] After subcontractors and suppliers complained that they had not been paid for their work,[122] the government terminated CEC for default in June 1980.[123] Balboa stepped in and paid the

115. *See* Palladino & Clarke, *supra* note 11, at 645 (explaining that performance bonds "ensur[e] that the Government will receive a completed project at the price set forth in the underlying contract").

116. *Balboa*, 775 F.2d at 1159.

117. *Id.* at 1159–60.

118. *Id.* at 1160.

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.* at 1162.

123. *Id.* at 1160.

subcontractors and suppliers CEC had failed to pay.[124] Balboa sued the federal government to recover the fifth progress payment made over its objection, arguing that Balboa was forced to make CEC's payments to suppliers.[125]

The Court of Federal Claims awarded summary judgment to the government. The court held that because the project was on schedule when the contested progress payment was made, the government's decision to pay CEC was reasonable as a matter of law.[126] Balboa appealed to the Federal Circuit.

The Federal Circuit first grappled with whether the court had jurisdiction over the surety's suit to recover a misdirected progress payment. The court rejected the federal government's argument that because the government "owe[d] no duty to protect the surety from its principal," the contractor, the government need not consider the surety's interests when making progress payments.[127] Instead, the court relied on the doctrine of equitable subrogation to hold that once a surety notifies the government of possible contractor default, the government "becomes a stakeholder with a duty of acting with reasoned discretion."[128] The court held that in any transaction in which the government is a stakeholder in the surety's interests, the Court of Federal Claims has jurisdiction to hear the surety's claim.[129]

After establishing that the court had jurisdiction, the Federal Circuit addressed the standard of review for assessing the government official's decision. To prevail, the surety would need to establish that the government official's decision was "arbitrary and capricious" and an "abuse of discretion."[130] Traditionally, this standard is extremely

124. *Id.* at 1160 n.1.

125. *Id.* at 1160.

126. *Id.* at 1164.

127. *Id.* at 1160.

128. *Id.* at 1162.

129. *Id.* at 1163.

130. *See id.* at 1164 (finding that "[t]he standard of proof to be applied in a case where an arbitrary and capricious disregard of the surety's interests, and an abuse of discretion, are charged must be, and is, high" (alteration in original) (quoting Royal Indem. Co. v. United States, 529 F.2d 1312, 1320 (Ct. Cl. 1976))). Note that the court in *Balboa* puzzlingly suggested that the surety needs to establish *both* that the decision was "arbitrary and capricious" and that it was an "abuse of discretion," though the APA only requires a showing of one or the other. *Compare id.* (requiring a finding of both arbitrariness and an abuse of discretion for plaintiff surety to prevail), *with* 5 U.S.C. § 706(2)(A) (2012) (permitting courts to set aside an agency's action upon a showing of *either* abuse of discretion *or* arbitrary and capricious action).

deferential and presumes that the government's action is valid.[131] The standard is intended to ensure that the government's process for deciding is "within the bounds of reasoned decision making."[132]

The Federal Circuit outlined eight factors that could be used to assess whether a government official exercised "reasonable discretion" in making a contested payment. Prior to *Balboa*, there was no unified framework to assess the government official's decision. Instead, the Court of Federal Claims had relied on individual factors in a series of one-off cases.[133] Rather than create a framework from scratch, the Federal Circuit in *Balboa* considered many factors that had been used individually in prior cases to synthesize one framework.[134] The eight factors were:

> (1) "Attempts by the Government after notification by the surety, to determine that the contractor had the capacity and intent to complete the job."[135]
>
> (2) "Percentage of contract performance completed at the time of notification by the surety."[136]
>
> (3) "Efforts of the Government to determine the progress made on the contract after notice by the surety."[137]

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131. Charles H. Koch, Jr., *Judicial Review of Administrative Discretion*, 54 GEO. WASH. L. REV. 469, 471 (1986) (describing both the abuse of discretion standard and the arbitrary and capricious standard as "instruct[ing] the court to tolerate a high risk of error and to approach the administrative decision with a restrained critical attitude").

132. Balt. Gas & Elec. Co. v. Natural Res. Def. Council, Inc., 462 U.S. 87, 104 (1983).

133. *See* U.S. Fid. & Guar. Co. v. United States, 676 F.2d 622, 631 (Ct. Cl. 1982) (discussing the importance of the government officer determining that the contractor had the capacity and intent to complete the project); *Royal Indem. Co.*, 529 F.2d at 1321 (discussing the importance of the government officer assessing the progress made on the contract, after notice by the surety); U.S. Fid. & Guar. Co. v. United States, 475 F.2d 1377, 1385 (Ct. Cl. 1973) (discussing whether the progress payment subsequently reached the subcontractors); Argonaut Ins. Co. v. United States, 434 F.2d 1362, 1366, 1369 (Ct. Cl. 1970) (discussing whether the contract was subsequently completed by the contractor); Fireman's Fund Ins. Co. v. United States, 362 F. Supp. 842, 848 (D. Kan. 1973) (discussing the importance of the government officer determining that the contractor had the capacity and intent to complete the project).

134. *Balboa*, 775 F.2d at 1165 ("The Claims Court neither considered nor evaluated Balboa's evidence addressed to the above-enumerated factors.").

135. *Id.* at 1164 (citing *U.S. Fid. & Guar. Co.*, 676 F.2d at 631; *Royal Indem. Co.*, 529 F.2d at 1321; *Argonaut Ins. Co.*, 434 F.2d at 1366, 1369; *Fireman's Fund Ins. Co.*, 362 F. Supp. at 848).

136. *Id.* (citing *U.S. Fid. & Guar. Co.*, 676 F.2d at 631; *U.S. Fid. & Guar. Co.*, 475 F.2d at 1385; *Argonaut Ins. Co.*, 434 F.2d at 1366).

137. *Id.* (citing *U.S. Fid. & Guar. Co.*, 676 F.2d at 631; *Royal Indem. Co.*, 529 F.2d at 1320–21).

(4) "Whether the contract was subsequently completed by the contractor . . . ."[138]

(5) "Whether the payments to the contractor subsequently reached the subcontractors and [suppliers] . . . ."[139]

(6) "Whether the Government contracting agency had notice of problems with the contractor's performance previous to the surety's notification of default to the Government."[140]

(7) "Whether the Government's action violates one of its own statutes or regulations."[141]

(8) "Evidence that the contract could or could not be completed as quickly or cheaply by a successor contractor."[142]

Because there were genuine issues of material fact regarding these eight factors, the case was remanded for further fact-finding, and it appears that the case was settled.[143] Nonetheless, since it was decided, *Balboa*'s framework has been cited in more than one hundred cases.[144]

B. Problems with Balboa*'s Framework*

Although the *Balboa* decision represents a well-intentioned attempt to equitably solve a complex problem, the factors the Federal Circuit approved are plagued with problems. Given the framework's internal contradictions, its lack of clarity about how to weigh factors against each other, and its notable inclusion of irrelevant factors, the

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138. *Id.* at 1164–65 (citing *Argonaut Ins. Co.*, 434 F.2d at 1369).

139. *Id.* at 1165 (citing *U.S. Fid. & Guar. Co.*, 475 F.2d at 1385; *Argonaut Ins. Co.*, 434 F.2d at 1369).

140. *Id.* (citing *U.S. Fid. & Guar. Co.*, 475 F.2d at 1385).

141. *Id.* (citing *U.S. Fid. & Guar. Co.*, 676 F.2d at 630).

142. *Id.* (citing *U.S. Fid. & Guar. Co.*, 676 F.2d at 631; *Royal Indem. Co.*, 529 F.2d at 1321; *Argonaut Ins. Co.*, 434 F.2d at 1369).

143. Diligent searching did not produce any record of *Balboa* on remand, and no later *Balboa*-factor cases mention the *Balboa* trial court assessing the application of the Federal Circuit's factors. *Balboa* was discussed at a surety claims conference in which the speaker said the parties settled. *See* David C. Romm & Robert G. Watt, Surety Recourse Against the Owner for the Non-Performing Principal, or, How to Get Back Those Progress Payments, Northeast Surety & Fidelity Claims Conference 15 (Nov. 7, 1991), http://www.forcon.com/userfiles/file/nesfcc/1991/03.Romm.pdf [https://perma.cc/W9P3-3ERZ] (explaining that *Balboa* "was settled by the parties before a decision on the merits was rendered").

144. Balboa Ins. Co. v. United States: Citing References, WESTLAWNEXT, https://1.next.westlaw.com [https://perma.cc/B4GJ-UUB3] (type "775 F.2d 1158" into the search box, click on "Balboa Ins. Co. v. United States" link in search results, scroll over "Citing References" tab and click on "Cases") (listing 128 cases that cite *Balboa*).

standard is irrational for use in resolving surety disputes. Moreover, the framework is unworkable in practice, inefficiently shifting costs to the party with less information and saddling the federal government with the risk of continued litigation. *Balboa*'s progress-payment framework contorts a statute that was designed to protect the government's interests on costly construction projects into a tool to extract double payment from the government for work performed. Thus, *Balboa*'s progress-payment framework is fundamentally flawed.

1. Balboa*'s Framework is Irrational for Resolving Surety Disputes*. First, two of the *Balboa* factors are irrelevant to assessing whether the government official acted with "reasonable discretion" when deciding whether to make the progress payment to the contractor. *Balboa*'s fourth and fifth factors ask whether the project was *subsequently* completed by the original contractor and whether the payments to the contractor *subsequently* reached the subcontractors. The "arbitrary, capricious, [or] an abuse of discretion"[145] standard is designed to assess an agency's decisionmaking *process*.[146] Therefore, the reasonableness of the government's decision can only be logically assessed based on the information the government knew or should have known at the time the payment was made. However, the fourth and fifth *Balboa* factors require the court to engage in a post hoc review, using information that the government official would not, and could not, have had available when the progress payment was made. Determining whether the government's decisionmaking process was reasonable is an independent inquiry from assessing the results of that decision.

Second, the seventh *Balboa* factor asks the court to assess whether the agency's payment decision violates any statute or regulation. On its face, this factor seems reasonable, but it ignores the surety's premise in bringing suit. The FAR requires the federal government to make prompt progress payments to the contractor for work completed.[147] The agency must make the payment within fourteen days of receiving an invoice from the contractor, and there is no exception to this requirement for situations in which the surety requests that the agency

145. 5 U.S.C. § 706(2)(A) (2012).

146. *See* Koch, *supra* note 131, at 508 (noting that the abuse of discretion standard looks only at the "soundness of the discretionary decisionmaking process").

147. FAR 32.904 (2013) ("The due date for making progress payments based on contracting officer approval of the estimated amount and value of work or services performed, including payments for reaching milestones in any project, is 14 days after the designated billing office receives a proper payment request.").

stop payment or redirect the payment toward the surety.[148] Including a factor to assess whether the government official's decision violated regulations is irrational because abiding by the FAR was a necessary precondition to the suit arising. If the agency *had* decided to suspend progress payments for completed work and redirect the payment toward the surety—avoiding a *Balboa* suit entirely—the agency would have violated the FAR. While this factor could be helpful in assessing the agency's compliance with *other* regulations, it seemingly overlooks FAR provisions on progress payments. Compounding this catch-22 situation for government officials is the fact that the *Balboa* court indicated that no one factor is dispositive.[149] *Balboa*'s framework puzzlingly suggests that a court could conclude that the federal government did not exercise "reasonable discretion" in making a progress payment, even though *not* making the progress payment would have violated the FAR.

Finally, the court provided no mechanism to weigh the factors against each other. Instead, the factors were cobbled together from a series of one-off cases with unique facts. Weighing the *Balboa* factors is particularly challenging because the factors vary significantly in their scope. Some factors are quantitative,[150] others involve subjective efforts by the government official,[151] still others involve an objective hindsight test.[152] Relying on *Balboa*, courts have decided cases by vaguely concluding that "the weight" tipped in one party's direction,[153] yet the framework is silent as to which factors are more persuasive. This inhibits government agencies from assessing what "reasonable discretion" entails prior to litigation arising, opening the door for more costly disputes.

The Court of Federal Claims has also reached differing conclusions about whether a *Balboa* analysis is dispositive. Generally, the court has held that *Balboa*'s factors are the dispositive framework for assessing whether a government official exercised reasonable

148. *Id.*

149. Balboa Ins. Co. v. United States, 775 F.2d 1158, 1165 (Fed. Cir. 1985).

150. Factor 2: How significant is it that the project was already 91 percent complete when the surety warned the government of default? *See id.* at 1164.

151. Factor 1: How well did the government attempt to determine if the contractor had the capacity and intent to complete the job? *See id.*

152. Factor 5: Did the payments to the contractor subsequently reach the subcontractors? *See id.* at 1165

153. United Pac. Ins. Co. v. United States, 16 Cl. Ct. 555, 560 (1989) (holding that the weight of the evidence tipped in favor of the plaintiff surety).

discretion.[154] Yet at other times, the court has maintained that the factors "are not in themselves conclusive" and has suggested that even when the weight of the factors "decidedly tip" in favor of the plaintiff surety, there may not have been an abuse of discretion.[155] Given its lack of clarity on how to weigh the factors, and even whether the framework is dispositive, *Balboa* is not a rational standard for assessing progress payments.

2. Balboa*'s Framework is Unworkable in Practice.* *Balboa* also presents a framework that is inefficient and difficult to apply. The *Balboa* framework is inefficient because the surety is in a better position than the federal government to assess the principal's risk of default. Because a surety bases its premium on a risk assessment of the project, it has an incentive to speak with the contractor about its relationships with subcontractors and suppliers prior to reaching a bond agreement.[156] If the surety is concerned that the contractor is unreliable or liable to skip payments to subcontractors, the surety can price that risk into the premium it charges the contractor for its bond services.[157] The surety can rely on its relationship with the contractor and its knowledge of the contractor's relationship with its subcontractors to assess the risk on the project.

In contrast, when awarding a contract, the federal government contracts only with the prime contractor, not its subcontractors.[158] The government official has no direct contact with the project's subcontractors, either before the project begins or during performance.[159] Yet the *Balboa* framework places the onus on the federal government to predict possible subcontractor concerns when

154. *See* Transamerica Premier Ins. Co. v. United States, 32 Fed. Cl. 308, 315 (1994) (describing *Balboa*'s eight factors as the method of "test[ing] the reasonableness" of the government official's decision).

155. *United Pac. Ins. Co.*, 16 Cl. Ct. at 560.

156. *See, e.g.*, *Balboa*, 775 F.2d at 1165 (describing the fifth and sixth factors as requiring the government official to assess subcontractor payment and contractor performance).

157. *See* RESTATEMENT OF THE LAW OF SEC., § 82 cmt. i (AM. LAW INST. 1941) (defining a "compensated surety" as a surety that receives a premium based on a "computation of risks on an actuarial basis").

158. *Balboa*, 775 F.2d at 1160 ("In contrast to a subcontractor, which has no obligations running directly to or from the Government . . . a surety, as bondholder, is as much a party to the Government contract as the contractor." (citation omitted)).

159. *See* Steven W. Feldman, *Get a Grip: How to Handle Government Contracts and Tame the Fury of Federal Forms*, 40 TENN. B.J. 14, 24–25 (2004) (noting that generally speaking, a subcontractor "should expect little involvement" from the federal government in disputes with the prime contractor).

choosing to make progress payments to the prime contractor.[160] Because the federal government has an informational disadvantage in assessing the risk of subcontractor payment problems, the burden should be placed on the surety to price the risk into the premium charged to contractors.

Second, the complexity of the factors puts a government official in a difficult position. The government official in charge of submitting contractor payments is typically a low-level agency official who may be juggling many other projects.[161] The official faces a "task of balancing the Government's interests in proceeding with the contract, against possible harm to the surety."[162] Under *Balboa*, before making a contractually obligated progress payment, the government official must assess not only the status of the project (Factors 2, 6), but also the contractor's mental state (Factor 1), the status of subcontractors with whom the government has no contractual relationship (Factor 5), and also the likelihood that another contractor could replace the current one at below cost (Factor 8), among others. Thus, the "equitable" *Balboa* framework that emerged out of a statute designed in large part to protect the federal government actually imposes significant hardships on those officials.

Moreover, the Miller Act's other goal of protecting subcontractors is not better served by imposing a rigorous test on government officials. A court's assessment of the *Balboa* factors does not affect whether the subcontractors and suppliers receive payment for work performed. The payment bond guarantees that they will be paid. The court's assessment of the *Balboa* factors merely determines whether the surety will be reimbursed for a progress payment the government sent to the contractor prior to default. With or without the government official considering the complex *Balboa* factors, the subcontractors will be paid for their work.

The hardships the *Balboa* framework imposes may also push the government to settle otherwise meritless claims. Weighing the eight

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160. *See Balboa*, 775 F.2d at 1162 (holding that the federal government becomes a "stakeholder" and must choose whether to make further progress payments to the contractor, after the surety notifies the government of potential default).

161. *See* Krent, *supra* note 22, at 1567 (noting that contracting officers with the power to terminate a contract may be at a "low level").

162. U.S. Fid. & Guar. Co. v. United States, 475 F.2d 1377, 1384 (Ct. Cl. 1973).

Balboa factors is extremely fact-intensive.[163] To assess what information the government official had available, the parties would need to engage in extensive discovery to comb through e-mails, minutes from meetings, status updates from jobsites, and complaints from subcontractors. The greater the risk of imposing costly discovery on a party, the greater the risk that the party will be forced to settle a meritless claim.[164] Given the high costs of defending a *Balboa* suit, the federal government may be forced to settle with the surety. Perhaps as a result of the costly nature of litigating a *Balboa* claim, there are only two post-*Balboa* Federal Circuit decisions applying each of the eight factors.[165]

However, the lack of post-*Balboa* decisions does not indicate that the framework is successful. To the contrary, excessive settling not only costs taxpayers money, but it exacerbates the problem by leaving the federal government with little case law demonstrating how to contest the surety's arguments on each of the factors and without data on the government's chances of success at trial. If the complex framework created just results, then its costs to parties attempting to litigate such cases may fairly be judged as reasonable. But when a complicated framework creates serious obstacles to defending lawsuits, forcing the government to settle potentially meritless claims, the framework ought to be eliminated in favor of something simpler.

Moreover, it is unclear precisely how much *Balboa* lawsuits cost taxpayers. The cost of settling is borne by the Department of Justice Judgment Fund,[166] but the Judgment Fund records do not itemize payouts for *Balboa* lawsuits.[167] Tucker Act payouts broadly have totaled more than $448 million since 2002, not including the costs of

163. *See* Hartford Fire Ins. Co. v. United States, 108 Fed. Cl. 525, 537 (2012) (denying the government's motion to dismiss and noting that a *Balboa* analysis is a factual determination that must be assessed at trial).

164. Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 740 (1995).

165. United Pac. Ins. Co. v. United States, 16 Cl. Ct. 555, 558–61 (1989); Ohio Cas. Ins. Co. v. United States, 12 Cl. Ct. 590, 594–96 (1987). Other cases cite *Balboa*, but only these two Federal Circuit cases apply the analysis factor-by-factor.

166. 31 U.S.C. § 1304 (2012) (creating the Judgment Fund to pay court judgments and Department of Justice settlements).

167. *Judgment Fund Payment Search*, U.S. DEP'T OF TREAS., https://jfund.fms.treas.gov/jfrad SearchWeb/JFPymtSearchAction.do [https://perma.cc/22NW-UWZG] (showing a nonitemized list for any suits arising under the Tucker Act, which is the statute that *Balboa* litigants rely on jurisdictionally for the waiver of sovereign immunity).

discovery and Department of Justice attorneys' time.[168] Although it is unclear precisely how much the federal government loses on *Balboa* cases, defending the government's decision in relation to eight vague factors is likely costly. The Miller Act was enacted to protect subcontractors and the federal government, but the complex *Balboa* framework does not advance either goal.

III. REPLACING *BALBOA* WITH A REASONABLE-ASSURANCES STANDARD

The Federal Circuit should eliminate the irrational and unworkable *Balboa* framework in favor of a clearer standard that is easier to administer and provides more certainty. There are two possible contractor-default scenarios, each of which should be treated differently. In the first instance, if a contractor defaults without any forewarning by the surety, the surety must step in and perform per the terms of the bonds. In such cases, the surety should be entitled to all future progress payments owed to the contractor, but it may not recover from the federal government for any payments that were already made to the contractor, absent a showing that the government official made the payment with a fraudulent intent. In other words, unless the government official believes that he or she is authorizing a payment that will not be used to pay for the project's legitimate costs per the contract,[169] a regularly scheduled progress payment to the contractor cannot be challenged when the surety did not provide notice of imminent default.

In the second scenario, if the surety notifies the federal government that it believes contractor default is imminent, the government official must seek reasonable assurances from the contractor that it has the intent and capacity to complete the job. Unlike the *Balboa* framework, which requires the government official to overcome a hindsight test and obtain significant information from

168. *Id.* (selecting the date range of 10/01/2002 through 12/11/2015, clicking "add all" defendant agencies and including "28USC1491-Tucker Act- ClaimsCt" in the "Optional Search Field," lists the total litigation payments as $448,611,876.81).

169. This standard echoes the standard espoused by the Court of Federal Claims at the trial court *Balboa* hearing, which was overturned by the Federal Circuit when it created the eight factors. The trial court held that without "proof of . . . deliberate or fraudulent conduct," the government official's conduct could not be challenged. Balboa Ins. Co. v. United States, 775 F.2d 1158, 1165 (Fed. Cir. 1985). But unlike the prescription recommended in this Note, the trial court held that it was immaterial whether the surety put the government official on notice of the possibility of imminent default. *Id.*

subcontractors, this new framework would enable the federal government to seek assurances from the only party it contracted with: the prime contractor. The government official would lean on the contractor to provide information about the project's status and subcontractor performance. The precise contours of this form of due diligence should be subject to rulemaking and included in the FAR. In order to ensure that the contractor will provide genuine assurances, rather than bluff,[170] the construction contract could contain a penalty clause. The penalty clause would stipulate that if the contractor ultimately defaulted after reassuring the government in light of the surety's warning, the contractor would pay a monetary penalty that it had set aside at the beginning of the project.[171]

This new framework serves several purposes. First, it effectuates one of the Miller Act's primary goals—protecting the federal government's interest in construction projects—without harming the second goal of protecting subcontractors.[172] The Miller Act sought to use sureties as a shield to protect the federal government's interests, but the *Balboa* framework ironically created a sword for sureties to use against the federal government. FAR rulemaking clarifying how the government official can seek reasonable assurances from the contractor, rather than an irrational and complex framework crafted by judges, would reduce the risk of double payments by introducing certainty into the process.

Second, requiring government officials to seek reasonable assurances is a workable alternative to *Balboa*'s contradictory and amorphous eight-factor test. No longer could a court hold that a government official following the FAR failed to exercise "reasonable discretion"; nor would the federal government be unfairly penalized using a hindsight test. Additionally, the federal government would not be pressured into settling potentially meritless claims for fear that litigating an eight-factor test would prove too burdensome.

Moreover, the new standard would take advantage of the surety's informational advantage by triggering due diligence by the government

170. *See* KXMDTV11, *Han Solo All Fine Here*, YOUTUBE (Oct. 29, 2013), https://www.youtube.com/watch?v=KYAbFqkvzQA [https://perma.cc/8ZKU-32EM] (showing a scene from STAR WARS (Lucasfilm Ltd. 1977) in which a disguised Han Solo attempts to reassure a stormtrooper that the situation is under control).

171. The contractor would be required to set aside this penalty amount at the outset of the construction project, ensuring that the penalty will be paid if the contractor defaults after providing assurances to the federal government.

172. *See supra* Part I.B–C.

official when the surety notifies the government that default may be imminent. The surety is in a strong position to predict default problems on a project, and the surety will be rewarded for its efforts to notify the government.

Some may argue that the proposed solution harms sureties by limiting their ability to mitigate losses on a project. It is true that by simplifying the framework, new FAR regulations would likely grant more discretion to government officials. However, the surety already has the ability to price the risk of contractor default into the premium it charges the contractor for its bond services. Because the surety has an ongoing relationship with the contractor and its subcontractors,[173] the surety can base its premium fee on its assessment of the risk of default. In contrast, the federal government's procurement process is geared toward accepting the lowest-priced technically acceptable bid,[174] and the government typically has no relationship with a contractor's subcontractors. Moreover, when the contractor's default was not due to its going out of business, the surety may sue the contractor to recover the contractor's assets per the terms of the bond.

There is also a minimal risk that encouraging the surety to price the risk of default into the bond agreement will raise the cost of contracting for the federal government overall. But bond agreements will only cost the contractor more to the extent that the contractor is a default risk. If a surety is wary of bonding a project for a particular contractor, such that the bond cost would make the contractor's bid on the project higher than that of other contractors, then the contractor would be underbid by competitors. A different contractor with less risk of default could secure a bond at a reasonable price, and would be in a position to submit a lower bid to the federal government. In any event, the potential savings to the federal government—avoiding double payment on massive progress payments[175]—should outweigh the potential for slightly higher bids on projects.

173. *See* Nagle & DeMella, *supra* note 14, at 15 (noting that sureties are active in resolving on-site disputes between the contractor and subcontractor).

174. FAR 15.101-2 (2012) (enabling agencies to use cost as the sole criterion for selecting bids that meet minimum technical specifications).

175. *See, e.g.*, United Pac. Ins. Co. v. United States, 16 Cl. Ct. 555, 556 (1989) (noting that the two disputed payments totaled $486,000).

CONCLUSION

The Miller Act was largely intended to protect the federal government during tremendously costly construction projects, yet the Federal Circuit's *Balboa* framework creates a continual threat of double payment. The "equitable" framework is irrational in the context of surety disputes, and is unworkable in practice. With renewed momentum for modern construction infrastructure,[176] it is time to retire *Balboa*'s cumbersome, thirty-year-old framework. New rulemaking should amend the FAR to clarify that a government official merely must seek reasonable assurances from a contractor when a surety notifies the government that default may be imminent.

176. *Cf.* James Surowiecki, *System Overload*, NEW YORKER (Apr. 18, 2016), http://www.newyorker.com/magazine/2016/04/18/inside-americas-infrastructure-problem [https://perma.cc/4B59-26LH] (suggesting that the large-scale repairs needed in Washington D.C.'s public transportation system could spur a nationwide effort to invest in infrastructure).