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MOST CIRCUIT COURTS VIEW MACEVOY RULE AS HARSH

You never give me your money
You only give me your funny paper.
--- The Beatles

1. INTRODUCTION

The Miller Act (Act)[2] provides that, "[a] person having a direct contractual relationship with a subcontractor but no contractual relationship, express or implied, with the contractor furnishing the payment bond may bring a civil action on the payment bond . . . ."[3] In the same section, the Act defines a subcontractor as a *person who performed labor* ***or*** *furnished material.*[4] Additionally, the right to sue on a payment bond is granted by the Act to "*every* person that has furnished labor *or* material."[5] The Act's anti-waiver provision is also stated in the disjunctive, making no difference whether the person furnished labor or material for the project.[6] A payment bond furnished under the Act is "for the protection of *all* persons supplying labor and material in carrying out the work provided for in the contract."[7] So, not only is the plain wording of the Act a comprehensive granting of protection to broad classes of beneficiaries, the courts also construe it liberally to achieve its purpose.[8] Congress was motivated to enact the Heard Act and then the Miller Act to override the barriers to payment to subcontractors and suppliers that had been erected by the states. However, the seventy-three year old Supreme Court opinion in *MacEvoy v. United States* shrinks the class of covered beneficiaries to only persons furnishing labor and materials to another subcontractor or general contractor who is also furnishing labor and materials.[9] The circuit courts have recognized the harsh results of the *MacEvoy* Rule and have written exceptions to the Rule.

The primary issue in the circuit cases following *MacEvoy* is whether a third-tier subcontractor may become a statutory "subcontractor" so that the subcontractor enjoys beneficiary status under a payment bond posted by the general contractor. While the Supreme Court maintained its restrictive reading of the Miller Act in *MacEvoy*, as restated in *Bateson v. United States*,[10] most circuits have left open a small gateway to achieve bond coverage for a hapless third-tier subcontractor.

2. THE REMOTENESS ISSUE

The *MacEvoy* Rule restricts the outer limits of bond coverage to only those who qualify as a technical "subcontractor" because, in the Court's view, a prime contractor should not have to provide payment bond protection to "unknown" subcontractors or suppliers too remote to be anticipated. For example, an unpaid supply house providing nails or screws taken from general inventory and sold to a framer or mason might be too remote for the prime contractor to monitor. The reason supporting this reduced outer limit is based upon the Supreme Court's belief that a prime contractor cannot protect itself from remote materialmen or laborers furnishing to subcontractors and so is thus unable to anticipate the increased risk to bond coverage. The Supreme Court opinion exclaims: "Imposing wholesale liability on payment bonds. . . is to create a precarious and perilous risk on the prime contractor and his surety."[11]

But the current industry practice actually belies this notion. Every prime contractor obtains quotes from its subcontractors and suppliers in order to assemble its bid to the owner. The labor and material needs of a project and their cost are thus symmetrically prescribed by the bid and resulting prime contract. Moreover, the prime contractor gathers pay applications from subcontractors and their suppliers to generate each monthly pay application, which the prime contractor then submits to the owner. As the project progresses and each milestone is reached, the prime contractor knows precisely what subcontractor and supplier helped bring the project out of the ground and what costs were incurred.

Indeed, AIA prime contracts *require* the prime

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2. The Heard Act was passed by Congress in 1894 but repealed in 1935 and the Miller Act placed in its stead. See 40 U.S.C. § 3131 (2012).
3. *Id.* § 3133(b)(2).
4. *See id.* § 3133(a).
5. *Id.* § 3133(b)(1) (emphasis added).
6. *See id.* § 3133(c)(3).
7. *Id.* § 3131(b)(1) (emphasis added).
8. *See* MacEvoy Co. v. United States, 322 U.S. 102, 107 (1944); *see also* Hill v. American Surety, 200 U.S. 197 (1906).
9. *See MacEvoy Co.*, 322 U.S. 102.
10. 434 U.S. 586 (1978).
11. *MacEvoy Co.*, 322 U.S. at 106, 111.

contractor to disclose the names and the work each subcontractor and supplier will be furnishing.

3. SECTION TWO PROVISO

Nevertheless, whether or not "remoteness" is a valid basis for a modern analysis of the prime contractor's risk, the Supreme Court relied primarily on a statutory proviso in Section Two to hold that the Miller Act provided bond coverage to only the first two tiers in the construction chain of contract. That "proviso" was found in Title 40 § 270(b)(a), but was deleted in the 2002 version of the Miller Act found in Title 40 § 3133(b)(2), which now merely states the notice deadline for bond claims.

Recognizing the harsh impact on third-tier subcontractors, some circuit courts pre-*Bateson* fashioned "functional" or "substantive" tests to fashion a broader definition of what a "subcontractor" is on a case-by-case basis, whereas the Supreme Court in *MacEvoy* used a "technical meaning" to reach its restricted definition.

Thirty-four years later, *Bateson* specifically resolved conflicting holdings on the liberalized method of determining who is a subcontractor among the First, Fourth, Fifth, and Ninth Circuit Courts.[12] However, the issue in *Bateson* was not about a subcontractor furnishing labor or material to construct a project; rather, a subcontractor's employees sued to recover union dues wrongfully withheld. In his dissent, Justice Stevens doubted that the Congressional Committee testimony upon which the majority relied bore serious scrutiny; moreover, his dissent pointedly observed that the states' Little Miller statutes granted broader application to bond claimants than *MacEvoy* allowed.[13]

The Texas Little Miller Act (the McGregor Act) is an example of broader bond coverage whereby a subcontractor is simply defined as someone providing "labor or material" to a prime contractor or a subcontractor.[14] There is no limitation on which tier the subcontractor or supplier occupies.

Since *Bateson*, except for the more generous Ninth Circuit, about half of the circuit courts appear to have reluctantly allowed only the contractual "sham" exception as a way for a third-tier subcontractor to obtain classification as a statutory subcontractor.

4. THE CIRCUIT DECISIONS

(a) The Ninth Circuit and its Thirteen Conveyor Factors

The Ninth Circuit in *Conveyor Rental and Sales Co. v. Aetna Casualty and Surety Co.* observed thirteen factors to determine whether a party is a mere material supplier or a covered subcontractor.[15] The Court employed a "balancing test" by weighing the thirteen factors to determine whether a party was a subcontractor or fell into a lower, unprotected tier. In particular, the following factors weigh in favor of a subcontractor relationship: (1) the product supplied is custom fabricated; (2) the product supplied is a complex integrated system; (3) a close financial interrelationship exists between the companies; (4) a continuing relationship exists with the prime contractor as evidenced by the requirement of shop drawing approval by prime contractor or the requirement that the supplier's representative be on the job site; (5) the supplier is required to perform on site; (6) there is a contract for labor in addition to materials; (7) the term "subcontractor" is used in the agreement; (8) the materials supplied do not come from existing inventory; (9) the supplier's contract constitutes a substantial portion of the prime contract; (10) the supplier is required to furnish *all* the material of a particular type; (11) the supplier is required to post a performance bond; (12) there is a back charge for the cost of correcting supplier's mistakes; and (13) there is system of progressive or proportionate fee payment. Probably the most important factor is the first one: whether the material was custom fabricated. If the material was specified and had to be manufactured and sized to meet those specifications, then those materials are not off-the-shelf inventory and are more likely to elevate the provider to true subcontractor status. However, material specifications must still be more than "merely descriptive" and must be for "highly intricate customized fabrication" so that the finished materials are "unique" such as may be part of a complex integrated system.[16] This factor echoes the eighth factor requiring that the furnished materials not come from existing inventory. The fourth factor considers whether the general contractor met directly with the subcontractor to furnish specialized materials as well as provide requisite expertise, then such a relationship could merit bond coverage. The fifth factor weighs whether the

12. *See Bateson*, 434 U.S. 586.
13. *Id.* at 602–04 (Stevens, J., dissenting).
14. TEX. GOV'T CODE ANN.§ 2253.001(9) (2012); *see also* GOV'T § 2253.021(c).
15. Conveyor Rental & Sales Co. v. Aetna Cas. & Sur. Co., 981 F.2d 448, 450–52 (9th Cir. 1992).
16. *Id.* at 452.

subcontractor performed on site and coordinated with the general contractor's engineers to supervise performance. The tenth factor is whether the subcontractor furnished all or substantially all of the scope of the prime contractor's work for the project. Thus, an examination of the proportionate responsibility for performing the project as a whole could be persuasive, except that the percentage of the prime contract varies widely among the reported opinions.

(b) Third Circuit

The Third Circuit applies a strictly structural method to determine the statutory definition of subcontractor, rather than a functional examination.[17] That is to say, the Court examined the formal chain of contract. The Court left available to subcontractors, however, leeway to show that the upstream chain of contract contained an illusory contract or sham relationship.[18]

(c) Fourth Circuit

Likewise, the Fourth Circuit adopted a "formal approach" and rejected a "functional" definition of subcontractor; further, it required a third-tier subcontractor to plead and prove the rigorous "pierce the corporate veil" standard to come within the sham exception.[19] The Court observed that the pre-*Bateson* cases were more lenient, including the Supreme Court's holding in *F.D. Rich Co. v. United States*,[20] which adopted a "functional" rather than a technical definition of subcontractor. However, the Fourth Circuit no longer will focus on "the substantiality and importance of the entity's relationship with the prime contractor."[21]

(d) Fifth Circuit

MacEvoy has been relied upon by the Fifth Circuit to insulate prime contractors and their sureties from "unlimited" liability under a payment bond.[22] The Fifth Circuit, as expected, has rigidly adhered to the *MacEvoy* Rule.

(e) Tenth Circuit

The Tenth Circuit held that the pre-*Bateson* cases focused on the scope of the contractual duties in order to determine whether a subcontractor is a statutory "subcontractor."

The Tenth Circuit had earlier found that a party was a subcontractor even where there were fewer than the full thirteen Ninth Circuit "conveyer factors."[23] In *J.W. Cooper Construction Co. v. Public Housing Administration*, the subcontractor provided cabinets for a project, provided shop drawings for those cabinets, and went to the site to obtain measurements for the cabinets.[24] Thus, the Court qualified Cooper as a statutory subcontractor.

The Tenth Circuit conceded it is now unclear that its focus on "substance and intent" to determine subcontractor status[25] is still proper after *Bateson* because that opinion forbade a functional analysis. The Tenth Circuit chose to follow the majority of the circuits writing on the issue by allowing the sham exception.[26]

5. CONCLUSION

Unless the third-tier subcontractor is able to prove a sham relationship in the upstream chain of contract, all the circuits writing on the issue, except the Ninth Circuit and perhaps the Tenth Circuit, have closed the door on unpaid third-tier subcontractors' attempt to use any functional or substantive approach to define statutory subcontractor. In conclusion, unpaid third-tier subcontractors and their vendors, who are a significant part of the construction of federal facilities, may only get relief to broaden Miller Act bond coverage in the halls of Congress—an unlikely prospect indeed.

17. *See* K&M Corp. v. A&M Gregos, Inc., 607 F.2d 44 (3d Cir. 1979).
18. *Id.* at 48.
19. *See* Global Bldg. Supply, Inc. v. WNH Ltd. P'ship, 995 F.2d 515, 518 (4th Cir. 1993).
20. Rich v. United States, 417 U.S. 116 (1974).
21. *Global Bldg. Supply, Inc.*, 995 F.2d at 518.
22. *See* Gulf States Enters., Inc. v R.R. Tway, Inc., 938 F.2d 583 (5th Cir. 1991); Gold Bond Bldg. Prods. v. Blake Constr. v. Fed. Ins. Co., 820 F.2d 139 (5th Cir. 1987).
23. J.W. Cooper Constr. Co. v. Pub. Hous. Admin., 390 F.2d 175 (10th Cir. 1968).
24. *Id.*
25. Such as in its own prior ruling in Glens Falls v. Newton, 388 F.2d 66 (10th Cir. 1967).
26. *See* O.L.S., Inc. v. Southwind Constr. Servs., 510 F. App'x 688 (10th Cir. 2013).