

## **PENNSYLVANIA SUPREME COURT AFFIRMS THAT A RELEASE OF THE PRINCIPAL ALSO RELEASES THE SURETY**

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The Pennsylvania Supreme Court has offered assurance to sureties in regard to the effect of a release of their principal. In its recent decision, *Kiski Area School District v. Mid-State Surety Corporation*, 2008 WL 5244817 (Pa. 2008), the Court reaffirmed the longstanding principle in Pennsylvania that the release of a principal also releases its surety.

This case arose from an alleged failure to satisfactorily complete a construction contract. The Kiski Area School District contracted with Lanmark, Inc. to perform construction and renovation services for the Allegheny-Hyde Park Elementary School in Allegheny Township, Westmoreland County, Pennsylvania. Mid-State provided a performance bond for the project, naming Lanmark as the principal and the school district as the obligee.

In the event of a delay in completing the work, the contract between the school district and Lanmark required Lanmark to pay the school district liquidated damages. In the event of a default by Lanmark, Mid-State's bond provided that Mid-State would assume responsibility to complete Lanmark's work, and would be entitled to be paid any remaining contract balance owed by the school district.

The school district ultimately became dissatisfied with Lanmark's work, declared Lanmark to be in default, withheld final payment, and demanded that Mid-State assume responsibility for the remaining work. However, the school district never paid Mid-State the remaining contract balance.

Two lawsuits arose from this dispute. Lanmark first sued the school district for payment of the outstanding contract balance. The school district then filed a separate suit against Lanmark. Mid-State was named a party to both cases, having been joined as an additional defendant in the first matter and sued as an original defendant in the second.

The school district and Lanmark reached a settlement agreement in the first matter, which they placed on the record at a hearing before a judge. The terms of the agreement provided that the school district would pay

Lanmark \$430,000, and the parties would release each other "for any and all claims that Lanmark and/or the Kiski Area school district has, have had, or may in the future have against each other, known or unknown, arising out of or relating to the construction contract dated February 27th, 1997, regarding the Allegheny/Hyde elementary school. . . ." In the negotiations leading up to the settlement agreement, neither party mentioned Mid-State.

After the settlement hearing, Lanmark and Mid-State requested that the release include language that provided that the school district also released its claims against Mid-State. The school district refused to include this language in the release, arguing that it had reserved its rights against Mid-State. The parties could not agree on language pertaining to Mid-State, and the school district and Lanmark ultimately executed a release that mirrored the release placed on the record at the settlement hearing. The release did not mention any release of, or reservation of rights against, Mid-State. In fact, the release mentioned nothing at all about Mid-State.

Following the execution of the release, Mid-State filed a motion for summary judgment in the second action, arguing that the release had discharged Mid-State and that the school district's final payment to Lanmark barred any claim on the bond. The trial court agreed and granted Mid-State's motion. On appeal, however, the Superior Court reversed, and held that summary judgment was improper because a reservation of rights could be inferred by the school district's statements that it would not release Mid-State. The Pennsylvania Supreme Court granted the surety's petition for allowance of appeal.

To determine whether the release of Lanmark released Mid-State, the Supreme Court first examined the nature of the surety relationship. At the heart of a surety relationship is the guarantee that if a principal, like Lanmark, defaults on a contract, then the obligee, like the school district, is entitled to performance by the principal's surety. In other words, the surety stands in the shoes of the principal. Pennsylvania courts have long recognized this principle. Pennsylvania courts have also recognized that the existence of a surety relationship does

not entitle an obligee to more than one full performance, and that an obligee cannot demand performance by the surety if the principal has fully performed.

In the *Kiski* case, however, the Court was faced with an alleged partial performance of a contract by the principal. The Court recognized that where a principal only partially performs on a contract, the obligee may release the principal from its remaining performance. Generally, such a release of the principal also releases the surety, however, the Court recognized two exceptions to this rule: 1) where a surety consents to its own on-going liability, despite the release of its principal; or 2) where the obligee expressly reserves its rights against the surety.

The Court found neither exception to be present in the *Kiski* case. It was undisputed that Mid-State had not consented to its on-going liability. Moreover, it was clear that the release executed by the school district and Lanmark made no mention of any reservation of rights against Mid-State. The Court held, based on its prior opinion in *Keystone Bank v. Flooring Specialists, Inc.*, 513 Pa. 103, 518 A.2d 1179 (1986), that any reservation of rights against a surety on a performance bond must be clearly and expressly stated in the language of the release of the principal. In affirming the “bright-line rule” of *Keystone Bank*, the Supreme Court rejected arguments advanced by the school district that the court should employ a “totality of the circumstances” analysis, and consider evidence beyond the language of the release itself, to determine whether the principal’s release was intended to also discharge the surety. The school district’s argument was based on §39(b)(ii) of the *Restatement (Third) of Suretyship & Guaranty* (1996), which suggests that a reservation of rights may be inferred from the “language or circumstances of the release” (emphasis added). The Court reasoned that this was not a situation where the release contained an ambiguous term that needed to be clarified through an examination of extrinsic evidence, and that instead the “bright-line rule” would apply. Moreover, the Court noted that §39(c) of the *Restatement* makes clear that there can be no reservation of rights against the surety in certain circumstances, and that specifically in §39(c)(iii) the *Restatement* states that there can be no reservation where the owner releases the contractor from performance. In such a circumstance, regardless of any attempt to reserve rights, the surety is discharged. The Court held that §39(c)(iii) applied squarely to the facts of the case.

The Court also found compelling the fact that the school district essentially paid Lanmark the remaining amount due on the contract and agreed that Lanmark would have no continuing obligations under the contract.

It emphasized that the school district was entitled only to a single performance, by either Lanmark or Mid-State. Moreover, because Mid-State, as surety, stood in the shoes of Lanmark, as principal, it had no greater obligation to the school district than Lanmark.

Ultimately, the Court held that the school district’s complete release of any future performance by Lanmark fully discharged Mid-State from any obligation under its bond. This decision is a stark reminder to obligees to include clear and expressive language in a release of a principal if they wish to reserve their rights against the surety. It also offers reassurance to sureties that they continue to stand in the shoes of their principals, and that they can be discharged, as a matter of law, if their principal is released under certain circumstances, regardless of the intent of the obligee. The Pennsylvania Supreme Court is not yet inclined to force the surety to bite off more than their principals have chewed.

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