CHAPTER 32 PERFORMANCE BONDS

CHAPTER 32 Roger P. Sauer

Gregory S. Arnold

§32.01 Introduction
§32.02 The Insurance Misconception
§32.03 Construction Framework
§32.04 Surety's Rights and Obligations
- **[A] Before Default of Its Principal**
- **[B] Declaration of Default**
- **[C] Notice to Surety**
  - **[1] Notices in Supplementation Cases**
- **[D] Duty to Investigate**
- **[E] Options on Default**
  - **[1] Buying Back the Bond**
  - **[2] Financing the Principal**
  - **[3] Takeover Agreement**
  - **[4] Tendering a New Contractor**
  - **[5] Do-Nothing Option**
  - **[6] Deny the Claim**
- **[F] What the Performance Bond Covers**
  - **[1] Cost of Completing the Construction Contract**
  - **[2] Defective and/or Deteriorated Work**
    - **[a] Performance Guarantees**
  - **[3] Delay and Liquidated Damages**
  - **[4] Consequential Damages**
  - **[5] Claims by Others**
  - **[6] The Penal Sum as a Limit of Coverage**
- **[G] Suretyship Defenses**
  - **[1] Material Alteration**
  - **[2] Improper Payment**
  - **[3] Defective Work**
  - **[4] Statute of Limitations**
  - **[5] Fraud or Misrepresentation**
    - **[a] By Principal**
    - **[b] By Obligee**
  - **[6] Change of the Obligee or Principal**
- **[H] Surety's Remedies**

§32.05 Conclusion

§32.01 INTRODUCTION

A surety is one who is answerable for the debt, default, or miscarriage of another. This concept is hardly new. In fact, one of the earliest references to a surety appears in the story of Joseph in the Book of Genesis. After Joseph was sold by his brothers as a slave and then rose to prominence in Egypt, his father, Jacob, sent his other sons to Egypt in search of food. When the brothers arrived, they did not recognize him, but Joseph recognized his brothers and asked for his younger brother, Benjamin, whom Jacob did not send. The brothers returned to Jacob and explained that Joseph wanted to see all the brothers, including Benjamin. After losing Joseph, Jacob was concerned that a similar fate could befall Benjamin if he made the journey to Egypt. The oldest brother, Judah, eliminated his father's concern and became the first surety. Specifically, Judah stated: “I will be surety for him; of my hand shall thou require him; if I bring him not unto thee and set him before thee, then let me bear the blame for ever.”[1] Other Biblical references to suretyship, however, come with grave warnings. For example, one famous warning is: “He that is surety for a stranger shall smart for it; and he that hateth suretyship is sure.”[2]

Suretyship was a common part of the ancient economies. The first recorded suretyship is a tablet, from the Library of Sargon I, King of Accad and Sumer (circa 2750 B.C.). The tablet describes an agreement between a farmer who entered the king's army and a second farmer who agreed to cultivate the soldier's farm and return half the produce to the soldier. The tablet further states that the lessee's performance was guaranteed by a merchant from Accad.[3] Consequently, this surety was motivated by profit as opposed to love or affection.

In modern day construction, although some antiquated language survives, the concept of suretyship takes the form of a written performance bond. In fact, construction bonds play a unique and critical role in both public and private construction projects. In the ordinary course, a contractor enters into a contract with an owner for a particular construction project. The owner, in turn, may require the contractor to provide both a performance bond and a payment bond. On private construction projects, the owner decides if it wishes to incur the expense of a bond. On public projects, the requirements for surety bonds, and many times the exact terms of the bonds, are dictated by statute. Although the contractor purchases the bond, the cost is factored into the bid price. As a result, the owner indirectly absorbs the cost of the bond. On some projects, the contractor in turn may also require that its major subcontractors and suppliers obtain performance bonds naming the contractor as the obligee.

A performance bond is unique because it is a tri-party contract or agreement between the owner or “obligee,” the contractor or “principal,” and the surety. A performance bond is designed to protect the owner from a contractor's failure to complete the work. If the principal or contractor discharges its duties and completes the project, the surety is also discharged because the obligee or owner is entitled to only one aggregate performance.[4] If the principal, however, defaults on the underlying contract, the surety has a contractual obligation regarding the completion of the project. The scope of the surety's obligation, as well as any defenses it may possess, are fact specific and invariably depend on the language of the bond.

In 1996, the *Restatement (Third) of Suretyship and Guaranty* was published. The *Third Restatement* constitutes a reformation of the *Restatement of Security* to make the law of suretyship more accessible.

---

[1]*Genesis* 43:9.

[2]*Proverbs* 11:15.

[3]Morgan, The History and Economics of Suretyship, 12 Cornell L.Q. 153 (1926). For a review of the development of the law of suretyship from ancient times through the modern performance bonds, see William H. Woods, *Historical Development of Suretyship from Prehistoric Custom to a Century's Experience With the Compensated Corporate Surety, in* The Law of Suretyship (Edward G. Gallagher 2d ed., ABA 2000).

[4]Restatement (Third) of Suretyship and Guaranty §19(a) (1996); *In re* Teerlink Ranch, Ltd., 886 F.2d 1233 (9th Cir. 1989).

Also, since the *Restatement of Security* was published more than 45 years ago, the *Third Restatement* also takes account of the changes in the law. The Restatement has also adopted a new vocabulary. The contractor who has the direct contractual relationship to the owner is called the "principal obligor" since it has the principal obligation on the underlying construction contract, while the surety is identified as the "secondary obligor."[5]

While there are many general rules of "suretyship," a performance bond remains a written contract. Therefore, although certain bonds are widely used, such as the A311 and A312 bonds promulgated by the American Institute of Architects, when confronted with a performance bond issue, the critical first step is to read the bond carefully because the full extent of the parties' rights, liabilities, and defenses are determined by the four corners of a particular bond. As a result, regardless of any general rules of suretyship outlined in this chapter or in any other treatise, the starting point must be the precise terms of the bond.[6] Fundamentally, it boils down to the written agreement to which the parties bound themselves. In other words, contract interpretation. Everything else is secondary.

In one form or another, performance bonds have been around since ancient times. As a result, the judicial decisions interpreting performance bonds are generally based on sound and long-tested principles. Because the cost and pace of large construction projects, both public and private, are increasing, it is no wonder that performance bonds have and will continue to generate a great deal of litigation. Although those handling performance bond issues have a well-developed body of both case law and excellent secondary resources available, the area that has generated the most uncertainty, and at times conflicting decisions, is the surety's exposure to extracontractual damages.[7] Once a claim is filed, the surety finds itself in the middle, with the owner or obligee on one side, and its principal and its indemnitors on the other. As a result, sureties face extracontractual damages from both sides. *Cates Construction, Inc. v. Talbott Partners, Inc.* was a significant case decided by the California Supreme Court, which denied a claim for extracontractual damages against a surety.[8]

As the cost and pace of large public and private construction projects are increasing, performance bonds have and will continue to generate a great deal of litigation. In addition to a well-developed body of state and federal case law, there are many secondary sources available to help address the myriad issues that confront owners, contractors, and sureties when performance bond claims are asserted.[9]

§32.02 THE INSURANCE MISCONCEPTION

Before examining what a surety bond is, it is important to define what it is not. A common and unfortunate misconception is to equate surety bonds with insurance policies. Sureties base their risk calculations on having rights and remedies that are unique to their status as sureties. Because some courts

---

[5]Restatement (Third) of Suretyship and Guaranty §1 cmt. (d) (1995).

[6]*See* The Law of Suretyship (Edward G. Gallagher 2d ed., ABA 2000); Bond Default Manual (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox, eds., 4th ed. ABA 2015); The Most Important Questions a Surety Can Ask about Performance Bonds (Stephen J. Strawbridge & Lawrence Lerner ed., ABA 1997); Managing and Litigating the Complex Surety Case (Philip L. Brunet ed., ABA 1998). The authors have drawn considerable information from the efforts of these earlier works addressing the rights under performance bonds.

[7]*See* The Law of Suretyship (Edward G. Gallagher, ed., 2d ed. 2000); The Law of Performance Bonds (Lawrence R. Molemann & John T. Harris, eds., 1999).

[8]Cates Constr., Inc. v. Talbot Partners, Inc., 980 P.2d 407 (Cal. 1999).

[9]*See* The Law of Suretyship (Edward G. Gallagher, ed., 2d ed. ABA 2000); The Law of Performance Bonds (Lawrence R. Molemann, Matthew M. Horowitz & Kevin L. Lybeck, eds., 2d ed. ABA 2009); Bond Default Manual (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox, eds., 4th ed. ABA 2015).

equate construction surety bonds with insurance policies, at the critical times when sureties seek to assert those rights, sureties often find they are stripped of their special status and relegated to the more limited defenses and remedies of liability insurers.[10]

Although most performance bonds are issued by companies that have the term "insurance" in their names, a surety bond is not insurance and must not be analyzed under a traditional liability insurance framework. There are four fundamental differences between insurance and suretyship. First, the surety obligation or bond is a three-party agreement between the principal, obligor, and surety, while an insurance contract is an agreement between an insurer and its insured or beneficiary. Second, the surety does not anticipate any losses. If a surety pays a claim, it has a common-law right of indemnification. As added protection, a surety almost universally requires its principal to execute a broad indemnification agreement in connection with any bonds issued by the surety. As a result, sureties also have an express contractual right of indemnification by which they shift any ultimate cost or loss back to their principals. Insurers, by contrast, expect losses from fortuitous events over which there is no immediate control. After all, protection against losses caused by accidents and unforeseen events is why people obtain insurance in the first place. Third, sureties differ from insurers in the manner in which premiums are calculated. Unlike liability "premiums," bond "premiums" are not designed to create a pool of available reserves to draw upon when losses occur. Rather, the principal controls the risk of loss itself through its performance. Actually, the premium for a surety bond is similar to a service charge or fee that is in large part based on the economic and business strengths of the principal. Liability insurers, however, calculate their premiums over many policies using actuarial tables and loss experience data.[11]

The fourth and perhaps greatest difference between a surety and an insurer lies in the rights and remedies available in the event of a claim. With insurance, the insurer's rights and defenses are limited. If a claim asserted by an injured third party falls within the coverage provided by the insurance policy, the insurer must ordinarily pay the claim and absorb the loss. Although it may cancel its insured's coverage, it generally cannot look to shift the cost of that claim to its insured. Because a surety does not anticipate any losses, when confronted with a claim, a surety uniquely has a variety of rights and defenses it may assert against an obligee, and through common-law and contractual indemnification may also shift the cost of any claims or losses to its principal.

That said, considerable litigation has arisen over the status of bonds as within the inclusion of both statutory remedies and common law doctrines for the assertion of bad faith claims, exemplary damages, the imposition of attorneys' fees and like forms of recovery that go beyond providing funds for the completion of a construction contract and the payment of those who put value, either in labor or materials, into the project. On these complex issues, it is simply impossible to generalize. The outcome of every case will depend upon its own facts, the skills of legal practitioners, and the legal idiosyncrasies of the jurisdiction in which the controversy has arisen.[12]

---

[10]10 Williston on Contracts §1213, at 708 (3d ed. 1967). For a discussion of the critical differences between a "surety" and an "insurer," see Great Am. Ins. Co. v. North Austin Mun. Util. Dist. No. 1, 908 S.W.2d 415 (Tex. 1995). *See also* Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407 (Cal. 1999), for a detailed discussion of the critical difference between performance bonds and traditional liability insurance policies.

[11]William H. Woods, *supra*, note 3.

[12]*See* Olympic S.S. Co. v. Centennial Ins. Co., 811 P.2d 673 (1991) ("an award of fees is required in any legal action where the insurer compels the insured to assume the burden of legal action, to obtain the full benefit of his insurance contract"); Dadelin Depot, Inc. v. St. Paul Fire and Marine Ins. Co., 945 So. 2d 1216 (Fla. 2006); Berlin Steel Constr. Co. v. Trataros Constr., Inc., 2007 WL 2482521 (Ct. Sup. Aug. 17, 2007); The Boldt Co. v. Thomason Elec., Inc., No. 6:07-CV-00697 (S.C. Sept. 17, 2007); King Cnty. v. Vinci Constr. Grands Projets/Parsons RCI/Frontier-Kemper, 2017 Wash. LEXIS 743 (Wash. Sup. Ct. July 6, 2017) ("the rule in Olympic Steamship applies to performance bonds in the surety context.

§32.03 CONSTRUCTION FRAMEWORK

Surety bonds are used on construction projects to shift the risk of the contractor's nonperformance from the owner/obligee to the surety. The two main construction bonds are performance bonds and payment bonds. The performance bond is designed solely for the benefit of the owner or obligee. The performance bond has a penal sum. The penal sum is the face amount of the bond. In general, the penal sum is equal to the total amount of the construction contract. The bond protects the owner from the contractor's inability or refusal to complete the project. If the contractor satisfactorily performs the obligations of the underlying construction contract, there can be no claim against the surety. If, however, the contractor fails to perform and the obligee makes a demand against the performance bond, the surety's rights, duties, and obligations are triggered. Since the bond provides the surety with certain rights and defenses, the surety generally has several options when called on to perform. A payment bond is designed to protect subcontractors and suppliers that provide labor and material to a project against nonpayment by the bonded contractor, and further protects the owner against potential mechanics' liens.[13]

The use of performance bonds is optional on private construction projects. When the owner is a federal, state, or local governmental body, whether a performance bond is required is ordinarily dictated by statute. On federal government projects, before any contract is awarded for any construction, alteration, or repair of any public building, the Miller Act requires the contractor post a performance bond.[14] Because the Miller Act performance bond only protects the federal government from the contractor's failure to complete the work, the statute also requires a contractor to post a payment bond for the protection of subcontractors and suppliers.[15] Furthermore, there are standard payment and performance bonds that have been adopted by the federal government.

Following the lead of the federal government, many states have enacted what are known as "little Miller Acts." As this title suggests, the little Miller Acts statutes are designed to protect state and local governmental units on construction projects. Moreover, as under the Miller Act, the bond form required on state and local governmental projects generally is not negotiated. Rather, the enabling statute ordinarily establishes the exact text of the bond that the surety issues. Even though many state Miller Act follow the federal Miller Act and the federal case law, one must carefully read the appropriate state statute as well as the judicial interpretations because the scope of each bond's coverage differs from state to state.

Although the Miller Acts and many other state statutes mandate a separate performance bond and payment bond for each project, some states allow what is known as a combined bond. A combined bond permits a general contractor to obtain a single bond with a stated penal sum for the joint benefit of both the owner and subcontractors.[16] A combined bond with a single penal sum, however, may not provide either the owner or subcontractors or suppliers with the same protection as separate performance and payment bonds. In the event of a claim, if the total cost to complete the project plus the cost of unpaid subcontractors and suppliers exceeds the bond's penal sum, a combined bond will be inadequate. Under these circumstances, subcontractors and suppliers are forced to compete with the project owner for the financial protection provided by the bond. With a single bond, subcontractors and suppliers must carefully review the particular state's priority rules because often the owners will have statutory priority. As a result, while a combined bond may provide adequate protection for owners, it may afford subcontractors

---

Although a statutory fee provision exists for public works contracts…it is not the exclusive fee remedy available").

[13]*See* Chapter 33.

[14]40 U.S.C. §1331(b)(1).

[15]40 U.S.C. §1331(b)(2).

[16]*See, e.g.*, Wash. Rev. Code Ann. §39.08.010 (West 1997); Ala. Code §39-1-1 (1997); Ill. Comp. Ann. Stat. ch. 30, §550/1 (West 1998); Fla. Stat. Ann.§255.05 (1997).

and suppliers little protection.[17]

§32.04 SURETY'S RIGHTS AND OBLIGATIONS

[A] Before Default of Its Principal

Upon executing a performance bond, the surety's liability is secondary and contingent. This means that the contractor or principal has both the primary liability and obligation to fully discharge its contractual obligations (hence the *Restatement's* designation of "principal obligor"). In other words, although the surety faces a potential claim because it issued the bond (*i.e.*, it is the "secondary obligor"), the contractor must perform the work. Two critical points flow from this. First, the principal has the right to be free from interference from the surety in prosecuting the work. The corollary is that unless and until the owner properly issues a declaration of default in strict compliance with the terms of the bond and contract, the surety's contingent rights in the project have not vested.[18]

It may represent sound business practice for a surety to monitor its principal's work. Sureties however, frequently do not have either the expertise or the resources to actively monitor each project of every principal. Moreover, even if a surety monitors a project, the surety must not interfere or meddle in the affairs of its principal. As a result, the surety must allow the contractor to prosecute the contract work as the latter sees fit. This includes the principal's right to resolve disputes with the obligee. As is common on all construction projects, disputes or disagreements often develop between the owner and contractor regarding the progress of the work, the scope of change orders, and a variety of other items. Even though the surety may be aware of these disputes or disagreements, however, they do not provide the surety with the unilateral right to intervene on the side of either the contractor or the owner. Rather, these issues must be resolved between the owner and the contractor. In fact, if the surety interferes in its principal's business before a declaration of default, the surety faces a potential suit by its principal that it tortiously interfered with its principal's contract.[19] To the extent bonded projects have been assigned to the surety, and by virtue of the tripartite surety relationship, a surety can argue that the surety cannot interfere with its own contract.[20]

Consequently, prior to a default, a surety generally does not have a unilateral right to be involved in the project.[21] Rather, the surety's involvement in a construction project is ordinarily triggered only upon the obligee's decision to issue a declaration of default. In some circumstances, however, the indemnification agreement may provide the surety with some limited rights before the declaration of default. Moreover, some bonds specifically require the involvement of the surety before a formal default. For example, the AIA Document A312 Performance Bond provides that upon proper notification from the obligee, the surety is contractually obligated to attend meetings with the owner and contractor even though a formal default has not occurred.[22]

---

[17]Mayor & City Council of Baltimore v. Fidelity & Deposit Co., 386 A.2d 749 (Md. Ct. App. 1978).

[18]*But see* §32.04[C].

[19]Gerstner Elec. Inc. v. American Ins. Co., 520 F.2d 790 (8th Cir. 1975).

[20]Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454 (Cal. 1994).

[21]Granite Computer Leasing Corp. v. Travelers Indem. Co., 894 F.2d 547 (2d Cir. 1989).

[22]AIA Doc. A312, Performance Bond (2010). The 2010 revisions to the 1984 version adds language clarifying that the owner's failure to comply with the notice requirements of Section 3.1 does not release the surety from its obligations under the bond except to the extent the surety demonstrates actual prejudice. The new form shortens the notice period for surety default under the bond from 15 days to 7 days. The penal limit of the bond does not apply if the surety elects to undertake and complete the contract itself. The A-312-2010 Payment Bond increased the period of time in which a surety must answer a payment bond claim from 45 to 60 days and, now, a failure of a surety to answer or make a

Even where the bond does not obligate the surety to attend meetings, some sureties attend pre-default meetings called by the obligee. Generally, an obligee may look to meet with the surety and contractor with the hope of preventing what the obligee perceives as a troubled project from becoming one in which the principal is default terminated. If the surety attends these meetings, it must be careful not to jeopardize or undermine its principal's position. The cautious and smart surety will support its principal in a bona fide dispute with the owner to avoid a potential tortious interference claim by its principal.[23] As a result, although an obligee may complain to the surety about the contractor's alleged shortcomings and deficiencies, these complaints ordinarily are not sufficient to trigger a formal response by the surety.

[B] Declaration of Default

Since the surety has no obligation to perform until its principal has been defaulted, the declaration of default is obviously a watershed event.[24] Because the declaration of default usually has a substantial financial impact on the surety, principal, and obligee, oftentimes contentious litigation follows. For the obligee, a wrongful or improper declaration of default is a double-edged sword. On the one side, if the owner wrongfully terminates the contract, it is liable to the principal for the resulting damages. On the other side, a wrongful termination also relieves the surety's performance bond obligations.[25] Consequently, and not surprisingly, owners oftentimes approach a potential default with great trepidation.

Determining when the surety is obligated to perform is, of course, defined by the terms of the particular bond. For example, under the AIA Document A311 bond, the surety's performance bond obligations are triggered "whenever [the principal] shall be, and declared by [the obligee] to be in default under the Contract, the [obligee] having performed, [its] obligations thereunder." Consequently, the three preconditions to the surety's liability under the A311 bond are (1) the default by the principal; (2) the obligee's declaration of default; and (3) last, that the obligee itself has not breached the contract. While the obligee's duty to terminate the principal's right to complete the work is implicit under the A311 bond, it is specifically stated in the AIA Document A312 bond. With an A312 bond, the surety is not obligated to perform unless the obligee has notified both the contractor and the surety in writing that the owner is "considering declaring a contractor default," has "declared a contractor default, and formally terminated the contractor's right to complete the contract," and "has agreed to pay the balance of the contract price to the surety," and last, is itself not in default.[26]

Although the declaration of default is the event that triggers the surety's liability, for the obligee determining what constitutes a "default" is not as straightforward as it may appear. Despite the fact that many contracts contain specific default termination provisions, the trigger for a declaration of default remains somewhat elusive. For example, a standard termination clause contained in the AIA Document A201 General Conditions gives the owner the right to terminate the contract if the contractor:

---

payment in the time period specified is not a waiver of the surety's and contractor's defenses to the claim. Rather, the claimant may now be entitled to attorneys' fees.

[23]*See also* Restatement (Second) of Torts §§766, 766A (1979).

[24]Not all bonds, however, require the owner to issue a Declaration of Default before the surety is obligated to perform. For example, the New York City Department of Design and Construction Standard Bond Form in part states: "The Surety (Sureties), for value received, hereby stipulates and agrees, if requested to do so by the City, to fully perform and complete the Work to be performed under the Contract pursuant to the terms, conditions and covenants thereof, if the City determines the Principal for any cause, has failed or neglected to fully perform and complete such work."

[25]Cuddy Mountain Concrete v. Citadel Constr., 520 N.W.2d 473 (Minn. Ct. App. 1994).

[26]AIA Doc. A311, Performance Bond (2010); AIA Doc. A312, Performance Bond, paras. 3.1, 3.2, 3.3. *See also* Philip L. Bruner, et al., *The Surety's Analysis of Investigative Results: "To Perform or Not to Perform—That Is the Question," in* Bond Default Manual (Duncan L. Clore, Richard E. Towle & Michael J. Sugar ed., 3d ed. 2005).

1. persistently or repeatedly refuses to supply enough properly skilled workers or proper materials;
2. fails to make payment to subcontractors for materials or labor in accordance with the respective agreements between the contractor and the subcontractors;
3. persistently disregards laws, ordinances, or rules, regulations, or orders of a public authority having jurisdiction; or
4. otherwise is guilty of substantial breach of a provision of the contract documents.[27]

Implicit in this definition is a recognition that the contractor's breach or series of breaches must be material for the obligee to lawfully default the contractor.

In addition to a specific termination clause, in determining whether the breach or series of breaches is sufficiently material justifying a default, owners can look to §241 of the *Restatement (Second) of Contracts*. Although this is a fact-specific inquiry not susceptible to a precise and universal definition, the *Restatement* identifies five "circumstances that are significant" in determining whether the breach is "material." These are:

(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;

(b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;

(c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;

(d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;

(e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.[28]

The requirement that the contractor's breach or series of breaches be material is especially significant with a construction contract. On virtually every construction project, there inevitably occur any number of arguable "breaches," ranging from delayed performance to a failure to pay subcontractors or suppliers in a timely manner, and everything in between. For the owner, however, not every "breach" is sufficiently material to justify defaulting the contractor.

The Fifth Circuit Court of Appeals, in what has become the leading opinion on point, addressed this critical issue in *L&A Contracting Co. v. Southern Concrete Services Inc.*[29] In *L&A*, the obligee alleged that the contractor failed to timely perform its obligations under the contract and also had committed additional other "breaches." These ultimately culminated in a letter by the owner requesting "that the Bonding Company take the necessary steps to fulfill the contract to prevent further delays and costs to the [owner]." The surety did not respond. Litigation followed. In distinguishing between "breach" and "default," the court stated:

> Although the terms "breach" and "default" are sometimes used interchangeably, their meanings are distinct in construction suretyship law. Not every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it. To constitute legal default, there must be a (1) material breach or series of material breaches (2) of such magnitude that the obligee is justified in

[27] AIA Doc. A201, General Conditions of the Contract for Construction, subpara. 14.2.1 (1997).
[28] Restatement (Second) of Contracts §241 (1981).
[29] 17 F.3d 106 (5th Cir. 1994).

terminating the contract.[30]

After concluding that only material breaches are sufficient to justify terminating the contract and defaulting the principal, the *L&A* court also addressed the mechanics of and specificity required for a declaration of default.

The Fifth Circuit then rejected the owner's argument that its letter requesting the surety to step in and prevent additional delays constituted a "declaration of default." The court summarized the reasons, stating that:

> [S]erious legal consequences attend a "declaration of default," particularly in cases such as this case involving multi-million-dollar construction projects. Before a declaration of default, sureties face possible tort liability for meddling in the affairs of their principals. After a declaration of default, the relationship changes dramatically, and the surety owes immediate duties to the obligee. Given the consequences that follow a declaration of default, it is vital that the declaration be made in terms sufficiently clear, direct, and unequivocal to inform the surety that the principal has defaulted on its obligations and the surety must immediately commence performing under the terms of its bond.[31]

Thus, a declaration of default must be distinguished from the normal course of correspondence that may flow from an owner or obligee complaining about progress or other problems on a construction project. Consequently, since the court concluded that the owner's letter did not constitute a clear and unambiguous declaration of default, there was never a formal demand against the surety; hence, the award against the surety was vacated.[32] The award against the contractor, however, was affirmed.

The declaration of default continues to be a flashpoint in performance bond disputes. Since performance bonds are contracts, the need for a formal declaration of default is determined by the specific language of the performance bond and the construction contract between the obligee and the principal. Where the bond contains a specific requirement for a "declaration of default," it is generally enforced. Therefore, if the bond specifically requires a "declaration of default" and the owner fails to declare it in a sufficiently clear, direct, and unequivocal manner, the surety will not be liable.

For example, in *Elm Haven Construction Limited Partnership v. Neri Construction LLC*,[33] a general contractor who was an obligee sued a surety that had issued a performance and payment bond on behalf of a subcontractor, claiming that the surety breached its obligations under both bonds. The surety was granted summary judgment because the general contractor failed to comply with the terms of the performance bond that specifically required a declaration of default. Relying upon *L&A Contracting Co. v. Southern Concrete Services, Inc.*,[34] the court found that the series of letters sent by the general contractor to the surety do not contain an unequivocal declaration of default thereby triggering the surety's

---

[30]*Id.* at 110 (citations omitted).

[31]*Id.* at 111 (citations omitted).

[32]*Id. See also* Balfour Beatty Constr. v. Colonial Ornamental Iron, 986 F. Supp. 82 (D. Conn. 1997), where the court granted the surety's motion for summary judgment as a result of the failure to issue a declaration of default. The court relied on *L & A Contracting v. Southern Concrete Services* and concluded that letters to the surety that only mentioned delays were insufficient as a matter of law to institute a formal declaration of default. Significantly, the court also found that as a result of the failure to provide the declaration of default, the surety was denied "the opportunity to exercise any of its options under the bond." *Id.* at 86.

[33]376 F.3d 96 (2d Cir. 2004).

[34]17 F.3d 106 (5th Cir. 1994). *See* §§32.04[B] and [C].

liability under the bond. Ultimately, the obligee in fact satisfied the bond's requirement for a proper declaration of default. By then, however, the obligee had already hired a completion contractor. The court found that surety was discharged because the obligee's decision to hire a replacement contractor denied the surety the opportunity to perform its obligations under the bond. The court also found that since the general contractor did not meet the definition of a "claimant," it could not invoke the payment bond.[35]

In addition to a declaration of default clause, some bonds delineate specific options available for a surety to discharge its obligations under a performance bond once a default is properly declared. Since a performance bond is a contract, an obligee's failure to permit a surety to exercise one of the options in the bond in responding to a default may also discharge a surety. In *St. Paul Fire & Marine Insurance Company v. City of Green River Wyoming*,[36] the surety responded to the default and agreed to take over the project and complete the work using employees of the defaulted principal. This was an option delineated in the bond. The owner objected and refused to permit the surety to proceed with the work using employees of the defaulted principal. The court found that by prohibiting the surety from exercising its rights under the bond to complete the work in the most cost efficient manner, the owner materially breached the bond, thereby discharging the surety. *See also Seaboard Surety Co. v. Town of Greenfield*,[37] where a public owner sent a performance bond surety a series of letters indicating that it was contemplating a declaration of default. Ultimately, the owner declared a default and the surety began its investigation and negotiating the terms of a possible takeover agreement with the obligee. The obligee was dissatisfied with the surety's proposed completion contractor, and without providing the surety the 15-day cure period in the bond, defaulted the surety and immediately hired a contractor to complete the work. The court found that the surety was discharged because obligee's conduct denied the surety the 15-day period during which it may attempt to cure the alleged breach prior to default and thus minimize its economic exposure.

The requirement for a formal declaration of default as a condition precedent for a suit against a surety, however, is not absolute. Rather, since a bond is a contract, courts that examine these issues start with the language in the bond. In a recent case, a court found that although an American Institute of Architects (AIA Doc. No. 311, Performance Bond), references a declaration of default, it does not require a formal declaration of default as a condition precedent to instituting legal action on the bond.[38]

[C] Notice to Surety

At common law, an obligee was not required to notify the surety if its principal was defaulted. Many modern bonds include a specific notice provision requiring timely notification of a default. In fact, this requirement was added to the bond to avoid the common-law rule that the surety is not entitled to notification when its performance is due.[39] In one case, for example, the surety was discharged because of the obligee's failure to provide the surety with notice of the default and the opportunity to respond as mandated by the bond before the obligee completed the project with its own contractor. The court reasoned that the obligee's conduct stripped the surety of its contractual right to limit its liability by selecting another contractor to complete the work. This court found that the obligee's conduct constituted

---

[35] *See also* Bank of Brewton, Inc. v. International Fid. Ins. Co., 827 So. 2d 747 (Ala. 2002).

[36] 93 F. Supp. 2d 1170 (D. Wyo. 2000).

[37] 370 F.3d 215 (1st Cir. 2004).

[38] Walter Concrete Constr. Corp. v. Lederle Labs., 99 N.Y. 2d 603 (Ct. App. 2003). *See also* Gloucester City Bd. of Educ. v. American Arbitration Ass'n, 333 N. J. Super. 511 (App. Div. 2000) (interpreting a New Jersey statutory bond required on public projects); Colorado Structures, Inc. v. Insurance Co. of the West, 106 P.3d 815 (Wash. App.), *cert. granted*, 126 P.3d 1279 (2005).

[39] L&A Contracting v. Southern Concrete Servs., 17 F.3d 106, 111 (5th Cir. 1994).

a material breach that rendered the surety's bonds null and void.[40] In cases where bonds do not contain an explicit notice provision, courts imply a duty to provide notice. A surety is generally entitled to relief only if it can demonstrate that the failure to provide notice resulted in increased damages or other substantial prejudice.[41]

Sometimes, however, the delay in the failure to notify the surety can be so gross that a court will exonerate the surety even in the absence of a demonstration of prejudice. Just such a situation arose in a case in the Eastern District of Virginia where the bond required immediate notice of default, but for some reason, the obligee waited nearly a year before notifying the surety. While holding that such a requirement mandated notification of the bonding company within a "reasonable" time, the court nonetheless granted the surety summary judgment, finding that while prejudice had been shown, this would not be necessary for dismissal.[42]

In contrast to the foregoing, a 2007 opinion by the Washington Supreme Court takes an approach to this issue that is basically unique in the reported case law.[43] The court essentially bifurcated the performance bond, an A311 form document, into two sections, one dealing with language of conditions, and the other dealing with language of promissory undertakings. Provisions in the bond calling for various steps to be taken in the event of default were deemed to be options that the obligee could pursue, but not such as to waive the prefatory condition of the bond remaining in force and effect unless the principal were to faithfully perform its obligations. Without declaring a default, the obligee

---

[40]Dragon Constr., Inc. v. Parkway Bank & Trust, 287 Ill. App. 3d 29 (1997); *see also* 120 Greenwich Dev. Assoc., LLC v. Reliance Ins. Co., 2004 WL 1277998 (S.D.N.Y. June 8, 2004) (failure to provide notice to surety of default pursuant to the terms of bond discharged the surety of all obligations under bond); Seaboard Sur. Co. v. Town of Greenfield, 370 F.3d 215 (1st Cir. 2004) (After terminating the contractor for default, the town and the surety actively negotiated for the surety to complete the contract until the town broke off the discussions and hired another contractor. The town argued that the surety breached its bond by not performing quickly enough, but the court, in a 2-1 decision, held that the terms of the bond required the town to give the surety 15 days' notice and an opportunity to cure the alleged default, and that the town breached the bond by not giving the surety this notice.); *See also* Milton Reg'l Sewer Auth. v. Travelers Cas. & Sur. Co. of Am., No. 4-13-cv-2786, 2014 U.S. Dist. LEXIS 85557 (M.D. Pa. June 24, 2014) (court found that despite a myriad of letters sent by the public owner, it had not complied with conditions of the bond, requiring a meeting with the surety and providing the contractor an opportunity to cure); *but see* AgGrow Oils, LLC v. National Union Fire Ins. Co. of Pittsburgh, Pa., 420 F.3d 751 (8th Cir. 2005) (Under North Dakota law, surety waived compliance with default notice provisions to invoking performance bond when it declared that its contractor had completed construction project and that it would decline to complete project, thereby rendering further actions by owner to invoke bond a useless formality.).

[41]*See* Blackhawk Heating & Plumbing v. Seaboard Sur. Co., 534 F. Supp. 309, 316–18 (N.D. Ill. 1982) (finding that notice was an implied condition and a surety must have an opportunity to remedy the default or minimize damages and "that if the failure to give notice results in increased damages which could have been avoided if the surety had been notified, then the failure to give the notice bars recovery of the increase in damages…and [the surety] shall have the burden of proving that it has been prejudiced [by the] failure [of the obligee] to give notice"); Town of Clarkstown v. North River Ins. Co., 803 F. Supp. 827, 829 (S.D.N.Y. 1992) (implying a timely notice requirement in subdivision bonds); Conesco Indus. v. Conforti & Eisele Inc., 627 F.2d 312 (D.C. Cir. 1980); 1199 Housing Corp. v. International Fid. Ins. Co., 788 N.Y.S.2d 88 (N.Y.A.D. 2005) (Surety's failure to plead breach of notice requirement with specificity and particularity (as was required in New York) resulted in loss of this defense for surety.).

[42]New Viasys Holdings, LLC v. Hanover Ins. Co., 2007 WL 783179 (E.D. Va. 2007) (a bond titled Supply Bond, which the court analyzed to determine whether it was a performance bond or an indemnity bond, and decided it was an indemnity bond, despite its title).

[43]Colorado Structures, Inc. v. Insurance Co. of the West, 167 P.3d 1125 (Wash. 2007).

"supplemented" the contractor's forces, and the court held the surety to be nonetheless liable for these charges.

However, *Solai Cameron, Inc. v. Plainfield Community Consolidated School District No. 202*,[44] took a more orthodox route. Although the prime contractor obligee had corresponded with its subcontractor's surety prior to defaulting the sub, it delayed notifying the surety of default and hired a replacement before terminating the principal. The surety was granted summary judgment based upon the obligee's failure to allow the surety to exercise its completion options under paragraph 4 of the AIA bonds.

[1] Notices in Supplementation Cases

The approach taken in the Washington case involved an obligee's election to supplement the principal's forces, rather than to default. In such a situation, it would be illogical to both default and supplement, because an obligee cannot supplement a contract that has been defaulted. In such a situation, an obligee's notice to a surety that it is supplementing the principal's forces, with a request for some acknowledgment from the surety, or some involvement to mitigate losses, is sufficient.

[D] Duty to Investigate

Various difficulties and complexities arise for a performance bond surety once the obligee issues a declaration of default because it triggers the surety's bond obligations. If the principal contests the default, the surety finds itself in a difficult position. In fact, the surety is squarely in the middle, with the principal and obligee tugging in opposite directions with very different expectations from the surety. The obligee will claim that because the default was proper and justified, the surety must immediately honor its bond obligations and compete the project. Aware of its exposure under the indemnification agreement with the surety, the principal will insist that its surety support its position that the default was improper and, furthermore, that because of the obligee's breach of the construction contract, the obligee is not entitled to the surety's performance. Added to the mix is the surety's parochial desire to minimize its own costs. The default situation is made even more complex because, in addition to defenses of its principal, the surety also has many unique defenses based on its status as surety.

An often cited case from the Court of Appeals for the District of Columbia equates the ordinary circumstances of a large construction project with the entropy of a battlefield.[45] While it is certainly

---

[44] 871 N.E.2d 944 (Ill. App. 2007).

[45] Blake Constr. Co. v. C.J. Coakley Co., 431 A.2d 569 (D.C. 1981). There, the court stated:

> [E]xcept in the middle of a battlefield, nowhere must men coordinate the movement of other men and all materials in the midst of such chaos and with such limited certainty of present facts and future occurrences as in a huge construction project such as the building of this $100 million hospital. Even the most painstaking planning frequently turns out to be mere conjecture and accommodation to changes must necessarily be of the rough, quick and ad hoc sort, analogous to ever-changing commands on the battlefield. Further, it is a difficult task for a court to be able to examine testimony and evidence in the quiet of a courtroom several years later concerning such confusion and then extract from them a determination of precisely when the disorder and constant readjustment, which is to be expected by any subcontractor on a job site, become so extreme, so debilitating and so unreasonable as to constitute a breach of contract between a contractor and a subcontractor. This was the formidable

difficult for a trial judge to determine if a construction contract was breached, even with the benefit of expert testimony and hindsight, parties to a problem-ridden construction project are afforded neither hindsight nor time. Rather, they are often forced to make quick decisions based on less-than-complete information in an effort to prosecute the work, which may be behind schedule or on the threshold of unfavorable weather.

After the obligee takes the initial step of defaulting the principal, the ball drops in the surety's court. One of the first issues confronting a performance bond surety is whether it must investigate the project following the default. In general, a performance bond surety is obligated to conduct an investigation of a default claim quickly. This investigation should include possible claims by the obligee against the principal and vice versa, as well as any claims involving the principal and third parties. Essentially, the investigation should seek to determine whether the default termination was proper and what options the surety may have available in determining how and whether to cure the default while minimizing the surety's own costs.

Before responding to the obligee's declaration of default, the surety's investigation does not need to be a searching inquiry into every possible issue. Rather, the benchmark used by courts in evaluating the adequacy of a surety's investigation is whether it was "reasonable" under the circumstances.[46] Not surprisingly, the decisions do not offer nor could they contain a precise definition of what a reasonable investigation would encompass in all cases. Rather, it is a fact-sensitive inquiry measured against the unique facts and circumstances of each particular case. For although a surety is required to conduct a reasonable investigation in response to a performance bond claim, this does not require the surety "to create the plaintiff's claims."[47]

The critical issue confronting a performance bond surety regarding the scope of its investigation is the threat of a bad-faith claim. A performance bond surety faces this threat from the obligee, from its principal and indemnitors, and from materialmen and suppliers on a payment bond. Whether a performance bond surety faces potential bad-faith liability depends upon the law of the particular jurisdiction. In general, in jurisdictions that blur or have eliminated the distinction between traditional liability insurance and suretyship through either case law or statutes that subject sureties to unfair claims practices applicable to liability insurers, sureties may be subject to bad-faith claims. Moreover, a bad-faith claim may also lie in jurisdictions that impose a duty of good faith and fair dealing in all contracts.[48]

In a significant decision, the California Supreme Court reversed a $15 million judgment against a surety for breach of an implied covenant of good faith and fair dealing concluding that tort recovery is not appropriate for a claim on a performance bond. Rather, a performance bond surety's liability will be governed by contract theories, not tort theories.[49] Once, however, the surety conducts an investigation,

---

undertaking faced by the trial judge in the instant case.

Id. at 575.

[46]Loyal Order of Moose Lodge 1392 v. International Fid. Ins. Co., 797 P.2d 622, 628 (Alaska 1990) ("failure by a surety minimally to investigate its principal's alleged default may constitute bad faith if that investigation would confirm the obligee's allegations in material part").

[47]Farmers Union Cent. Exch. v. Reliance Ins. Co., 675 F. Supp. 1534, 1542 (D.N.D. 1987).

[48]*See, e.g.*, Sons of Thunder Inc. v. Borden, Inc., 148 N.J. 396 (1997).

[49]Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407 (Cal. Sup. 1999) (*see* note 76, *infra*). *See also Bell BCI Co. v. HRGM Corp.*, 276 F. Supp. 2d 462 (D. Md. 2003) (finding that as a matter of law a surety is not liable in tort damages to an obligee for a breach of good faith and fair dealing); *Norwood Co. v. RLI Ins. Co.*, 2002 WL 485694 (E.D. Pa. 2002) (finding that the obligee may not assert a bad faith claim against a surety under Pennsylvania law); *Masterclean Inc. v. Star Ins. Co.*, 556 S.E.2d 371 (S.C. 2001) (finding that the principal may not sue a surety in tort for a bad faith refusal to pay a first-party claim); Cates Constr. Inc. v. Talbot Partners, 62 Cal. Rptr. 2d 548, 552 (Ct. App. 1997) (surety's bad faith was

even if limited, and determines that a genuine dispute exists as to its principal's liability, the surety has satisfied its duty to investigate and is not required to look any further.[50]

In addition to potential bad-faith claims by an obligee, the surety faces similar claims from the principal and its indemnitors. Cases on point generally involve allegations that the surety paid claims without conducting a sufficient investigation. The principal and indemnitors will contend that the surety's payment to either the obligee or the laborers or materialmen was improper. Although allegations of bad faith may be couched in terms of an affirmative claim, they generally amount to a defense that as a result of the surety's "bad faith" in failing to investigate properly, the surety is not entitled to enforce its indemnification agreement against the principal. In cases where the surety paid claims without conducting an adequate investigation or acted unreasonably, the surety was denied indemnification and thus absorbed the loss.[51]

The settlement of claims over a principal's objection is a flashpoint where the interests of the principal and surety conflict. In one case, a surety was entitled to indemnification even though it settled bond claims despite its principal's claims of a valid defense. Under that indemnification agreement, the surety had the right to settle all claims unless the principal requested that the surety litigate the claim and posted collateral with the surety to secure the amount of a possible judgment and the litigation expenses. There, although the principal requested the surety to litigate the claims, the principal failed to post the necessary collateral. Essentially the principal was litigating its claims with the obligee with the surety's money. As a result of the principal's failure to post the necessary collateral, the surety settled the claim and was entitled to indemnification. The only restriction upon the surety's right to settle claims was that the surety must act in "good faith."[52]

In some cases, although the jurisdiction may not impose a common-law or statutory good-faith requirement on a surety, if the indemnification agreement requires the surety to act in good faith, this could constitute a valid defense to a surety's claim for indemnification. In one recent case, a court found that under the indemnity agreement, the surety's good faith in setting claims was a condition precedent to

---

based on two interrelated acts: Without conducting any investigation, the surety received an assignment of its principal's mechanic's lien, and then prosecuted its right under the lien); Transamerica Premier Ins. Co. v. Brighton Sch. Dist., 940 P.2d 348 (Colo. 1997) (finding a surely liable for a bad faith breach of the performance bond claim for failing to timely respond to the obligee's default termination of the principal). *See also* United States *ex rel.* Don Siegel Constr. Co., Inc. v. Atul Constr. Co., 85 F. Supp. 2d 414 (D.N.J. 2000) (finding that New Jersey would extend same rationale that permitted bad faith claims against insurers for failing to settle claims to sureties on Miller Act payment bond claims); International Fid. Ins. Co. v. DelMaura Sys. Corp., 2001 WL 541469 (Del. Super. 2001), *appeal denied*, 782 A.2d 264 (finding that a performance bond surety may be subject to a bad faith claim by an obligee).

[50]Brinderson Newberg v. Pacific Erectors, 971 F.2d 272, 282 (9th Cir. 1992) ("A court can conclude as a matter of law that an insurer's denial of a claim is not unreasonable, even if a court concludes the claim is payable under the policy terms, so long as there existed a genuine issue as to the insurer's liability.…[O]nce [the surety] understood [its principal's] interpretation of the contract and a genuine dispute over liability existed, [the surety] was under no further duty to investigate [the obligee's] claim on the bond.").

[51]St. Paul Fire & Marine Ins. Co. v. Pepsico, Inc., 160 F.R.D. 464, 466 (S.D.N.Y. 1995) (holding that the surety was not entitled to indemnification because it had "blindly paid on bonds without investigating or defending claims…[and it] did not act reasonably"); Windowmaster Corp. v. Morse/Diesel, Inc., 722 F. Supp. 1532 (N.D. Ill. 1988) (holding that whether the surety acted in good faith in settling claims with the obligee created an issue of material fact regarding a surety's claim for indemnification).

[52]GAIC v. Merritt-Meridian Constr. Corp., 975 F. Supp. 511 (S.D.N.Y. 1997).

its right to indemnification.[53]

Sureties continue to confront bad faith and extra contractual claims. These claims are being asserted on three separate fronts: by obligees or owners on performance bonds, by laborers and materialmen in payment bonds, and by principals and indemnitors in indemnity suits. Whether a surety is actually subject to bad faith or extra contractual claims depends on the specific jurisdiction.

[E] Options on Default

Following a declaration of default, many obligees are either surprised or disappointed that the surety does not march in the very next day with its own construction forces and complete the work. Rather, at the conclusion of its investigation of the entire project, the surety generally has five very diverse options when called upon to perform. These include (1) buying back the bond; (2) financing the principal; (3) taking over and completing the project; (4) tendering a new contractor to the obligee; or (5) simply allowing the obligee to complete the work. Some bonds specifically delineate or limit the surety's options on a default.[54] Where the bond does not specifically list the surety's options, the surety and obligee must

---

[53]Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276 (Tex. 1998) (under Texas common law, a surety does not owe its principal a duty of "good faith." The indemnity agreement at issue, however, required the surety to exercise good faith in settling claims. The court concluded that the "good-faith" requirement is a condition precedent to the surety's right of recovery under its indemnification agreement. Since the court found that there was evidence that the surety did not act with good faith, the surety was denied indemnification.); Shannon R. Ginn Constr. Co. v. Reliance Ins. Co., 51 F. Supp. 2d 1347 (S.D. Fla. 1999).

[54]For example, under the AIA Document A312 Bond, when the owner has satisfied the conditions of paragraph 3, the surety shall promptly and at the surety's expense take one of the following actions:

> 4.1 Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract; or
>
> 4.2 Undertake to perform and complete the Construction Contract itself, through its agents or through independent contractors; or
>
> 4.3 Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and the contractor selected with the Owner's concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages as described in Paragraph 6 in excess of the Balance of the Contract Price incurred by the Owner resulting from the Contractor's default; or
>
> 4.4 Waive its right to perform and complete, arrange for completion or obtain a new contractor and with reasonable promptness under the circumstances.
>
> After investigation, determine the amount for which it may be liable to Owner and, as soon as practicable after the amount is determined, tender payment therefor to the Owner; or
>
> Deny liability in whole or in part and notify the Owner citing reasons therefor.

negotiate a mutually agreeable option, often with a reservation of rights so that any claims may be resolved at a later date without delaying the completion of the project. Whatever option is ultimately selected, the surety's primary goal is to fulfill its bond obligation at the lowest cost, while the obligee is looking to have its project completed as quickly as possible.[55]

[1] Buying Back the Bond

Here, the surety seeks to obtain a full release from the obligee by purchasing back its performance bond by paying a sum to the obligee up to the bond's penal limit. This option is best suited for a default that has occurred in the early stage of construction, and the surety's estimated cost to complete either approaches or exceeds the bond's penal limit. The advantage to the surety of this approach is that even though it may incur a substantial loss, the surety can fix its liability at an amount equal to or less than the bond's penal sum. Although this option may provide the obligee with a substantial cash infusion at a critical juncture, it still may not be willing simply to release the surety. After all, the project still must be completed, and with the surety off the hook, the obligee no longer has recourse to a third-party “deep pocket” to complete the work.

The primary risk to the surety using this approach is a potential claim by the principal and the indemnitors that the payment was either excessive or otherwise inappropriate. If a court sustains the principal's and indemnitors' position, this will either reduce or totally eliminate the surety's right to indemnification. One way to avoid this risk is to obtain the principal's and indemnitors' consent to buy back the bond before the agreement with the obligee is finalized. Another way is to include language in the indemnity agreement about the surety's right to exercise this option. Under any circumstances, it would be prudent to put the principal and indemnitors on notice of the agreement.

[2] Financing the Principal

Another option for the surety is to finance its principal.[56] Whether the financing takes the form of a direct loan to the principal or the surety's guarantying bank loans, the goal remains the same—namely, providing sufficient financial assistance to enable the principal to complete the bonded project or projects as quickly and economically as possible. Financing is a risky option for the surety, however. A surety generally considers financing as its best option when the majority of the work has been completed, the obligee is satisfied with the quality and pace of the principal's work, and the surety believes the principal's default resulted from temporary cash flow problems. Under these circumstances, the surety gambles that a quick and short-term capital infusion will enable the principal to proceed with the bonded project rather than risk default solely for want of adequate working capital.

Sureties also consider financing in less than ideal situations. These situations arise where financing the troubled principal would nonetheless be the surety's best option for completing the project at the lowest cost. For example, even if the principal is not a perfect candidate for financing, the surety may have little choice if the work is highly specialized, such as a complex process plant, or where the work is in a remote location, or where the contract provides for substantial liquidated damages and the project will lose time in the transition to a replacement contractor. In each of these circumstances, although the principal's problems may be more than merely the need of short-term capital infusion, financing the

---

[55]For an overview of the surety's performance bond options, see Marilyn Klinger, James Diwik & Kevin L. Lybeck, *The Contract Performance Bonds, in* The Law of Suretyship (Edward G. Gallagher 2d ed., ABA 2000).

[56]For a more in-depth discussion of this option, as well as some standard clauses to include in a financing agreement, see George J. Bachrach, Michael A. Stover & Shane C. Mecham, *Financing the Principal, in* Bond Default Manual (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox, eds., 4th ed. ABA 2015).

principal may still represent the surety's least costly option for completing the project as quickly as possible.

Prior to deciding to finance the principal, the surety must conduct a thorough investigation because if the surety decides to finance, the surety will then be pumping its money directly into its principal's business. The surety's investigation addresses four main points. First, the surety must know how much it will ultimately cost. This includes not only how much it will cost to complete the bonded project but also the amount of cash the principal needs to meet its current expenses, including paying subcontractors and suppliers as well as general overhead expenses. The surety will also want to know what collateral the principal and its indemnitors may have to secure the surety's financing. Second, the surety must evaluate whether the principal and the indemnitors are sufficiently honest, trustworthy, and committed to completing the project. This is critical because once the surety decides to finance the principal, the surety is, in effect, in business with its principal. Third, the surety must decide if the principal has the technical ability to complete the work. Does it have the necessary manpower and expertise, both in the field and the home office, and does it have the ability to supervise and manage subcontractors and suppliers? Fourth, the surety must also conduct a general investigation into the reasons for the default and the current status of the work so as to minimize future expenses.

In addition to the direct dollar costs of financing the principal, the surety also incurs additional costs in monitoring the ongoing project. Because the surety will now be directly contributing its money to the principal and the project, a surety will generally monitor the project to see where and how its money is being spent. Although a surety may employ its own personnel for this purpose, more often than not a surety will engage an engineer or construction accountant to monitor the principal and the project. The degree and cost of these services vary with the facts and circumstances of each case, but the surety's goal remains the same: to ensure that its money is efficiently spent on completing the bonded work at the lowest cost. Of course, this monitoring effort also increases the surety's costs.

Although financing has certain benefits to the surety of allowing the work to proceed quickly, it does have substantial risks. The greatest risk arises from the fact that funds expended by the surety financing the principal do not reduce the bond's penal limit. As a result, the surety's performance bond exposure remains the same. Thus, financing could result in an ultimate loss to the surety in excess of the bond's penal sum because even after the surety has spent a large sum of money by financing its principal, the principal may nonetheless be defaulted, and the surety will then confront a performance bond demand by the obligee. Under these circumstances, the amount spent on financing the principal, plus the amount of the ultimate performance bond claim, may very well exceed the bond's penal sum. To avoid this predicament, before agreeing to finance its principal, the surety should seek the obligee's written consent that the amount contributed by the surety for financing reduces the bond's penal limit dollar for dollar. An obligee, however, may have very little incentive to enter such an agreement other than the enhanced prospect of completing the project on or near schedule.

In addition to the risk that the damages may exceed the bond's penal limit, the surety also faces claims by third-party creditors of the principal, and claims by the principal itself when the surety decides to finance its principal. In this situation, creditors may assert what has been described as an "alter ego" claim. For example, in *James E. McFadden v. Baltimore Contractors, Inc.*,[57] the surety entered into a financing arrangement with its principal. The plaintiff, a subcontractor on a nonbonded job, sued the surety, claiming that through the financing agreement the surety exercised total control over the principal so that the principal became an instrument of the surety. The court rejected this argument and found that the surety "did not take absolute control of [the principal], but rather that it took steps to minimize its risks as a major creditor of [the principal]."[58]

---

[57]609 F. Supp. 1102, 1105 (E.D. Pa. 1985).

[58]*Id.* at 1104–05 (providing useful guidance on the steps a surety can take in preparing a financing agreement to avoid an alter ego claim).

In addition to claims by third parties, principals and indemnitors have also asserted claims against sureties following unsuccessful financing arrangements. A typical theory is that through the financing agreement the surety so thoroughly dominated the principal's business management that the surety caused the principal's business to fail. One of the leading cases on this issue is *Lambert v. Maryland Casualty Co.*[59] Lambert was a large road contractor that began experiencing severe cash flow problems. Lambert looked to both its surety and its bank for money. The surety agreed to provide the requested funding and entered into a financing agreement with Lambert. Ultimately, Lambert's condition deteriorated, and the surety pulled the funding. Lambert filed for bankruptcy, and litigation followed. The Louisiana Supreme Court concluded that the surety's good-faith duties did not require it to support its principal "by the advancing of additional funds or by continuing to forebear in the exercise of its rights, contracted at arms length, for its own protection against further liability and loss as surety, guarantor, and creditor."[60] Furthermore, the court stated that the surety had a "legitimate and serious interest in the exercise of its legal rights reasonably believing that the corporation could not meet its obligations under the contracts and that continued financial support of the corporation would not prevent or reduce the ultimate loss to either the [principal] or surety."[61] Essentially the court found that when the principal's position became hopeless, the surety was not required to throw good money after bad in a futile effort to keep a sinking ship afloat. So, prior to entering a financing arrangement with its principal, the surety must be careful to avoid "dominating" its principal. Also, the financing agreement should vest the surety with the unilateral right to cut off the funding. This may help the surety avoid a claim that its decision to stop funding was a breach of the financing agreement or of a possible fiduciary duty.

Unintended consequences can also creep in as a result of financing. A North Carolina Federal court case illustrated a clash among sureties, where a bonding company that chose to finance brought suit against two of its principal's other bonding companies, alleging that they had been unjustly enriched as a result of the first surety's willingness to step up to the plate and provide actual money to keep the principal afloat. This claim got nowhere. For while the court agreed that the unrelated sureties had benefited from the financing, it nonetheless found significant that they had not induced the relationship and were at most incidental beneficiaries of action taken by the first surety to secure and advance its own business interests.[62]

[3] Takeover Agreement

Another option for the surety is to enter into a formal takeover agreement with the obligee.[63] Under this approach, the surety and obligee sign a formal agreement wherein the surety agrees to take over and complete the project either through a completion contractor or through a construction manager. This option is most attractive when the project is in an advanced state of completion, and completion by the principal is no longer an option. In this setting, the surety first enters into an agreement with the obligee to complete the remaining work. The surety then enters into a completion contract that includes all outstanding work with another contractor. In an effort to protect itself, the surety may require the completion contractor to obtain its own payment and performance bonds in the amount of the completion

---

[59]418 So. 2d 553 (La. 1982).

[60]*Id.* at 561.

[61]*Id.*

[62]Fireman's Fund Ins. Co. v. Safeco Ins. Co. of Am., 2007 WL 4233317 (W.D.N.C. 9/28/2007).

[63]For a more detailed discussion of the use of and some standard clauses in a takeover agreement, see Gregory L. Daily &Todd C. Kazlow, *Takeover and Completion, in* Bond Default Manual (Duncan L. Clore, Richard E. Towle & Michael J. Sugar ed., 3d ed. 2005); and for guidance on avoiding Claims Court jurisdiction preclusive issues with respect to the administrative requirements of the Contract Disputes Act, despite a takeover agreement, see Lumbermens Mut. Cas. Co. v. United States, 654 F.3d 1305 (Fed. Cir. 2011).

contract. It may also require the new completion contractor to obtain a “dual obligee” performance bond listing both the owner and the original surety as co-obligees.

The primary advantage for a surety in entering a takeover agreement is that it puts the surety in a better position to control the costs of completing the work. Moreover, through a takeover agreement, the surety can usually obtain some concessions from the obligee. Although obligees generally are not required to enter into takeover agreements, they often do so. In negotiating takeover agreements, sureties can seek to cap their liabilities to the penal sum of the bond. In drafting the takeover agreement, the surety will want to be clear as to whether pre-default costs paid by the surety post-default can be charged against the penal sum.[64] With careful drafting, the surety can maintain the cap on the penal sum for its own breaches.[65] Most obligees that will enter a takeover agreement will not accept any limit on the surety's liability short of the bond's penal limit. Oftentimes, however, by the time the takeover agreement is signed, either the project has passed its completion date and the obligee has the right to assess liquidated damages, or there is not sufficient time to complete the remaining work by the original completion date. As a result, through a takeover agreement, the surety can get the owner to waive liquidated damages for the principal's delay and establish a new completion date. This can be a substantial concession.

The greatest risk confronting a surety when entering a takeover agreement is that its liability is no longer capped by the bond. Rather, once it decides to complete the project, the surety becomes responsible to complete the work even if the cost exceeds the bond's penal sum. Through an adequate investigation, however, a surety can minimize this risk. Among the items the surety must consider are the following: the difficulty of the work, whether the project is well run, how responsible and responsive is the obligee, the prospect of numerous change orders, how well the plans and specifications are drawn, the quality of the work in place, and how far out is the project completion date. Quality information on these items will assist the surety in determining whether there are any hidden risks at the project and in making an intelligent choice whether to take over the contract.

Another flash point can be a claim by the obligee that rights and defenses are impliedly waived when the surety takes over the project, unless these are reserved in the takeover agreement (and even sometimes when they are). That argument failed in a federal court case involving a school district in Westchester County, New York. The court refused to find any such waiver and allowed the bonding company to defend the owner's counterclaims on the basis that termination was wrongful because substantial competition of the project had already been reached.[66]

[4] Tendering a New Contractor

Another option for the surety is tendering a new contractor. Under this approach, the surety investigates the current status of the work. At the conclusion of the investigation, the surety then solicits bids from new contractors to complete the remaining work. After selecting the lowest responsible bidder, the surety then tenders the new contractor to the obligee with a new bond from another surety. The surety also tenders the difference between the completion contract price and the remaining contract funds up to the penal limit of its bond. Unlike the takeover-and-completion option, when tendering a new contractor with a new bond, the surety also receives a release of its liability on the existing performance bond from the obligee. This option is accomplished with a contract between the surety and obligee. Sometimes obligees are unwilling to agree to the tender option unless it involves an agreement signed by the obligee, surety, and new contractor. The three-way tender agreement is becoming more common.

---

[64]Allegheny Cas. Co. v. Archer Western/Demaria Joint Venture, No. 8:13-cv-128, 2014 U.S. Dist. LEXIS 116621 (M.D. Fla. Aug. 21, 2013).

[65]Deluxe Bldg. Sys. v. Constructamax, Inc., No. 2:06-cv-02996, 2013 U.S. Dist. LEXIS 126464 (D.N.J. Sept. 5, 2013).

[66]Travelers Cas. & Sur. Co. v. White Plains Pub. Sch., 2007 WL 935612 (S.D.N.Y. 2007).

This method is best suited for projects where the default occurred in the early stages of a project. The advantage to tendering a new contractor is that once the surety receives the release from the obligee, it has discharged its bond obligations and its costs are fixed. The surety can then close its file on that bond.

This option also has certain disadvantages. First, preparing the bid documents to obtain a completion contractor is both time consuming and expensive, and some obligees may grow impatient with what they perceive as the surety's delay in completing the work. As a result, an obligee may begin to complete the work and later sue the surety for breaching its agreement. Moreover, if the jurisdiction permits, the suit will undoubtedly include a bad-faith claim. Tendering also results in increased costs because the completion contractor is assuming full responsibility for completing the work. Accordingly, whether stated or not, the completion contractor's price will generally include a contingency fee for latent defects and other unknown cost factors that are inherent in stepping into a partially completed project. Generally, the more work completed, the greater the chances are that the new contractor will encounter latent defects it will be assuming the responsibility to correct.

The biggest obstacle to tendering is the obligee's refusal to consent.[67] First, although the obligee is obtaining a new bond from a new surety, most obligees are hesitant about releasing the original surety. Second, public owners are subject to public bidding statutes. Consequently, there is a concern that soliciting a completion contractor may violate the public bidding laws. As a result, public owners prefer the option of a takeover agreement where, although a completion contractor is hired, the original surety remains liable.

[5] Do-Nothing Option

The last option for the surety is to allow the obligee to complete the project and then pay the difference between the total adjusted contract balance and the cost to complete the outstanding work. In other words, the surety simply does nothing, waits until the dust settles and the obligee makes a demand for payment. The surety's payment, however, should not exceed the bond's penal sum. The advantage for the surety with the “do-nothing option” is that, although the surety bears the ultimate financial responsibility for completing the work, the surety avoids becoming the party primarily responsible for completing the work.

There are, however, two substantial risks. First, by allowing the obligee to complete the work, the surety has absolutely no control over costs. As a result, once the obligee presents the surety with the bill for completing the work, the surety may be in a difficult position to argue that the costs to complete were unreasonable or too high. The other pitfall to this approach is the potential for a bad-faith claim by the obligee based on the surety's decision to do nothing and leave the effort of completion to the obligee.

Any surety contemplating the do-nothing approach must carefully review the bond and applicable law to ensure that it is not breaching any obligation under the bond. For example, in *Continental Realty Corp. v. Andrew J. Crevolin Co.*,[68] the surety was found liable for damages over and above the penal sum of the bond as a result of its decision to do nothing. There, the bond required the surety to either take over and complete the project, or pay the obligee the reasonable cost of completion. Doing nothing, however, was not an option.

Under the AIA Document A312 bond, the surety essentially has a “do-nothing” type option. This option however, is not absolute. In other words, although the surety has the specific right not to complete the work, the surety cannot simply disappear. Rather, the A312 bond requires the surety to conduct an investigation, “deny liability in whole or in part and notify the Owner citing reasons therefor.”[69]

[67]AIA Document A312 requires the owner's consent before tendering.
[68]380 F. Supp. 246 (S.D.W. Va. 1974).
[69]AIA Doc. A312 subpara. 4.4.2.

Consequently, although the surety is not required to step in and complete the project, the surety must tell the owner why it does not recognize an obligation to perform under the bond.

[6] Deny the Claim

As cautioned above, the surety may have an obligation to deny a claim, rather than do nothing in response to a performance bond claim. This requires skill to avoid increasing liability of the surety beyond the penal sum. In responding to a claim on an AIA 312 performance bond form, a surety should consider whether the language in Paragraph 6 limiting the surety's liability to the penal sum applies when the surety rejects the claim under Paragraph 4.4.[70]

[F] What the Performance Bond Covers

[1] Cost of Completing the Construction Contract

This is the most obvious expenditure that a performance bond may cover. In fact, some have argued that the cost to complete should be the only subject of the bond's protection.[71] This is the purpose of the performance bond. Should the principal default, the surety, but for its own insolvency, provides a source certain of funding so that the obligee may be placed in as good a position as it would have occupied had the principal not defaulted.[72] Although, as noted above, the surety has several options regarding the precise way in which the funding will be provided, the end result ought to remain the same: guarantying performance at the contract price for the obligee.

This can be illustrated through some simple arithmetic. Assume that the principal enters into a contract with the bond obligee to build a project for one million dollars. After $500,000 has been paid by the obligee, the principal defaults because difficulties encountered at another job site have drained its working capital. It will in fact take $500,000 to complete the balance of the project. Coincidentally, the surety secures a relet contractor who agrees to finish the job for just this amount. Hence, although the surety "fronts" the money to the relet contractor, it is ultimately reimbursed by the owner with the $500,000 of unpaid contract funds.

Of course, rarely is the situation as uncomplicated as the one just outlined, and rare indeed is the default where a surety sustains no loss. In fact, in such a situation, the incentive of the principal to remain at the job site and complete the work with its own forces would be quite high. That is because, by definition, the cost to complete the project will not exceed the contract balance and will, presumably, even afford the principal some profit.

A number of factors can go toward escalating the cost to complete that will exceed the contract balance still retained by the owner and, ultimately, cause the completing surety to sustain a loss. In the first place, either through ineptitude or a desire to keep cash flow moving at a potential risk to profit, the principal may have underbid the contract.[73] This discrepancy will manifest itself through a shortfall of revenues to costs during the completion phase. Second, the principal may have distorted the cost to

---

[70]Northline Excavating, Inc. v. County of Livingston, 839 N.W.2d 693 (Mich. Ct. App. 2013) (this risk can be avoided where the bond clearly limits exposure to its penal sum, the state's common law recognizes the limit of the penal sum, and the lack of any conflicting language that would expand the surety's exposure beyond the penal sum).

[71]*See, e.g.*, Marshall Contractors v. Incorporated Peerless Ins. Co., 827 F. Supp. 91 (D.R.I. 1993).

[72]*See* Trainor v. Aetna Cas. & Sur. Co., 290 U.S. 47 (1933).

[73]In a competitive bidding situation, should the principal's number be at sufficient variance from those of its competitors, a surety may argue that the bid was accepted by the owner/obligee in bad faith and thus seek a discharge of its bond. The same might be true of grotesque front-end loading.

revenue ratio by "front-end loading" its requests for progress payments. This proverbial robbing of Peter to pay Paul in the early stages of performance will also manifest itself in enhanced completion costs at the back end of the job. Third, the costs for labor and materials can sometimes escalate dramatically during the ongoing prosecution of the work. Finally, when sureties hire completion or "takeover" contractors, contingencies for encountering and dealing with unknown and unknowable latent defects are usually built into fixed-price quotations.[74] In actual experience, all of these things are much more the norm rather than the exception, and any of them will lead toward a completion cost that will exceed the contract balance. The surety will have to make up the shortfall out of its own resources.

[2] Defective and/or Deteriorated Work

The principal's ultimate default is rarely an abrupt black-and-white type of occurrence. Instead, the pattern is more typically one of a gradual erosion of the contractor's finances, resources, capacity, and control, with their attendant, cumulative impact on the quality of the finished product. Few construction projects resemble an assembly line where the forces of production can effectively be turned on and off. Instead, a close monitoring of the precision of the effort is more often than not necessary to make certain that standards of quality are met.

A contractor in financial difficulty frequently loses these controls. Key supervisory people may leave or in any event have their loyalty or diligence compromised if payrolls are missed. Suppliers may impose more demanding terms of payment or suspend shipments. Corner cutting, in some form, is the almost inevitable result.

The consequence of any or all of the above is likely to be defective work. This concept covers a broad spectrum of conditions, from what is nonconforming, but acceptable, to that which is grossly improper or even dangerous. Perhaps understandably, when a default occurs, owners have a tendency to take a "fine-toothed-comb" approach in searching for defective work. Generally, it will be the owner's expectation that the surety will have to bear the costs of correcting any of this defective work, a cost that will presumably manifest itself in the enhanced price of its relet contractor and almost certainly add to the surety's loss. Generally, sureties have been held liable for these increased costs, particularly when defects are latent[75]—that is to say, when they would not have been detected in the course of a reasonably diligent prior inspection.[76]

It is also rare for sureties to take control of the project immediately following the events giving rise to default. In the first place, disputes between contractors and owners that give rise to termination scenarios are often evolutionary rather than revolutionary, and problems that will have to be rectified may have arisen far in advance of the actual termination date.[77] A common situation is where the surety's principal will contest the propriety and efficacy of its termination and protest any action by the surety that is in concert with the owner. Although this may compel the surety to investigate, investigations can be time consuming. Finally, the very nature of the work itself, particularly when exposure to the elements is a potential source of concern, may itself lead to enhanced completion costs. These, too, may enhance the surety's loss.

Courts have created exceptions, however, in the case of so-called "completion" bonds. Where roof

---

[74]Of course, the surety has the option of hiring its relet contractor on a time and material basis, but in such a situation, the contractor has very little incentive to work quickly and efficiently and in so doing, minimize the surety's loss in the completion phase.

[75]American Sur. Co. v. United States, 317 F.2d 652 (8th Cir. 1963); Miracle Mile Shopping Ctr. v. National Union Indem. Co., 299 F.2d 780 (7th Cir. 1962).

[76]See below as to the existence of a defense on the part of the surety where grossly defective work has been paid for.

[77]To the extent that this may give rise to a defense on the part of the surety, see §32.04[G] below.

leaks in the project developed three years after the building was finished and occupied, and where the bond was conditioned on completion of the project, no recovery was allowed. The court found such a latent defect to be beyond the scope of the performance bond.[78]

[a] *Performance Guarantees*

In *AgGrow Oils, LLC v. National Union Fire Insurance Co. of Pittsburgh, Pa.*,[79] the court found that the performance bond covered the contractor's failure to meet the contract's performance standards. The performance bond covered a design and build contract for an oil seed processing plant. The contract included certain performance guarantees using extracting equipment from agreed upon manufacturers. After the contractor completed the work, the plant underperformed and did not meet the specified performance guarantees. The owner sued the contractor, the surety, and the equipment manufacturers. The court found the bond covered the cost of the corrective work, lost revenue, and lost profits. In reaching its conclusion, the court rejected the surety's argument that since the project achieved substantial completion, the surety's bond obligations were discharged.

[3] Delay and Liquidated Damages

Conceptually, altering the time that a project takes to complete is contractually distinguishable from the status of being complete. As a consequence, some have argued that although a performance bond may provide a source of funds to enable completion of the contract in the first place, it ought not to provide recompense for damages stemming from a lack of timely performance.[80]

However, because in the commercial world time is money and vice versa, construction contracts rarely lack a “time of the essence” clause. One effect of such a provision is to make the time of performance by the principal as cardinal an element of its agreement with the owner as the act of performing itself. Because most bonds contain language incorporating the underlying contract and effectively making it a part of the bond, timely performance by the principal becomes simply another element of performance, for which the bond provides protection. In such circumstances, sureties have been held liable for delay damages as well as sums figured in liquidated damages provisions that act as stipulated amounts for the types of economic harms that may arise from delay.[81]

[4] Consequential Damages

Consequential damages are really just a more expansive form of time-oriented-delay type of damages. As a general rule, it can be said that the bond looks to the contract for a definition of harms that will be covered. This is so, among other reasons, because a performance bond invariably incorporates the text of the bonded contract into the bond itself. As a general rule of contract law, those damages will be allowed that were reasonably foreseeable as a consequence of breach at the time the contract was entered into. This follows the rule set down long ago by the English courts in the seminal case of *Hadley v.*

---

[78]Independence Sch. Dist. No. 74 v. Shurtleff-Gahareh, Inc., 2007 WL 2248159 (E.D. Okla. 8/2/0007).

[79]276 F. Supp. 2d 999 (D.N.D. 2003).

[80]*See* General Ins. Co. v. Hercules Constr. Co., 385 F.2d 13 (8th Cir. 1967).

[81]*See* Southern Roofing & Petroleum Co. v. Aetna Ins. Co., 293 F. Supp. 725 (E.D. Tenn. 1968). *Cf.* American Home Assurance Co. v. Larkin Gen. Hosp., 593 So. 2d 195 (Fla. 1992); Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407 (Cal. 1999). JMR Constr. Corp. v. Environmental Assessment and Remediation Mgmt., Inc., 198 Cal. Rptr. 3d 47 (Cal. Ct. App. 2015) (general contractor as obligee against drywall subcontractor's performance bond recovered damages that included delay damages for concurrent delays pursuant to a modified total cost calculation).

Baxendale.[82]

Depending upon the particular setting of the project involved, the applicability of the *Hadley v. Baxendale* approach can vary markedly. For example, many public works projects offer little guidance in terms of judging adverse economic consequences that flow in the wake of breach by the contractor. For example, how does one measure the cost to the municipality of the library that does not open on time or the bridge that can only handle six lanes of traffic, rather than eight, because of necessary corrective work before the job can be considered done? It could probably be said that it is for precisely these reasons that governmental contracts almost invariably contain liquidated damages clauses.

However, just the opposite is likely to be true in a commercial setting. People undertake commercial building projects for profit, and if something goes wrong with the project, whether it is structural, time oriented, or both, that profit tends to be adversely affected. The hotel with the leaky roof can mean empty rooms on the top floor. When completion of a process plant is delayed, the product cannot get to market. As one might imagine, mixed results have obtained in terms of permitting the recovery of consequential damages.[83]

[5] Claims by Others

When it rains, it pours. This adage can usually be applied to the morass in which the failed bonded contractor finds itself. In addition to defaulting on its duties to the obligee, more often than not, the principal will encounter difficulties on other fronts as well. Typically, the contractor on the way down will be delinquent in its obligations to everyone, including the government. Moreover, because it may have lost some of the control it once held over its organizational forces, the contractor may have run into difficulties with others on the job site, too. If anything, default and the subsequent emergence of the surety may induce a kind of feeding frenzy where a host of putative claimants will attempt to get their proverbial piece of the pie.

In the main, these efforts have proved legally ineffective. Among other reasons to defeat such claims, the general thinking is that availability of the penal sum of the bond, intended as it is to provide funds for completion of the project, may be compromised if those other than the owner/obligee are permitted to recover under it. Hence, in the following situations, those other than the named obligee were not allowed to recover: another prime contractor at the project,[84] personal injury claimants,[85] and adjacent property owners.[86]

However, this prohibition is hardly absolute. Some claimants have argued that they were specifically intended to be third-party beneficiaries of the contract between the principal and owner, performance of which was conditionally insured by the bond. In such a situation, it is reasoned that performance of an obligation to a third-party beneficiary is tantamount to any other kind of performance of the contract, including tasks that will directly benefit only the obligee. In such circumstances, courts have equated payments to third parties as classical "performance" of the bonded contract and hence within the scope of

---

[82]9 Ex. 341, 156 Eng. Rep. 145 (1854). *See* Restatement (Second) of Contracts §351 (1981); *see* SP No. 54 Limited P'ship v. Fidelity and Deposit Co. of Maryland, 2005 WL 3555836 (Fla. App.) (court held that surety owed no general duty of care to owner with respect to its issuance of performance bonds to contractor for work on owner's projects and, thus, could not be held liable to owner for gross negligence or negligent misrepresentation; surety's only duty was to fulfill its express obligations under the bonds, and owner had no right to rely on the competency of surety's underwriting.).

[83]Hunt v. Bankers & Shippers Inc. Co., 423 N.Y.S.2d 718 (App. Div. 4th Dep't 1979) (loss of rents allowed as a measure of damages).

[84]MGM Constr. v. Education Facilities, Auth., 220 N.J. Super. 483, 532 A.2d 764 (Law Div. 1987).

[85]Foshee v. Daoust Constr. Co., 185 F.2d 23 (7th Cir. 1950).

[86]Tri-State Ins. Co. v. United States, 340 F.2d 542 (8th Cir. 1965).

the performance bond.

[6] The Penal Sum as a Limit of Coverage

Every performance bond contains a penal sum. As a general rule, this will be the face amount of the contract, but this need not be the case. In theory, a penal sum equal to the full amount of the contract price ought to be more than sufficient to cover the consequences of default. For example, even if the principal never started the project, theoretically an amount that would be equal to double the contract price would be available for completion, including not only the face amount of the performance bond but also the completely unpaid contract balance. The bidding mistakes of the principal would have to be serious indeed (in excess of 100%) to imperil the penal sum as a claim. Moreover, as the contract work progresses, while the contract funds are being drawn down and thus by definition will be unavailable to spend on completion should the principal default, work is being done as well. The value of the completed work will naturally mitigate the exposure of the surety.

Of course, the possibility exists that because of latent defective work, perhaps coupled with underbidding practices on the part of the contractor, it may actually cost more money to correct and complete the contractor's failed effort than the full amount of the contract price to begin with, even when counting on contract funds as yet unpaid to the principal. In such circumstances, however, the surety should not expect to pay or be liable for more than the penal sum of the bond. After all, were this not so, there would be little point in having a penal sum to begin with.

All of these considerations change when the surety, after default, takes over for its principal and effectively becomes the contractor on the job. The surety now becomes wedded to the work and hence obligated to complete the physical performance of the contract, whatever the cost may be.[87] To avoid this exposure, some sureties attempt to negotiate takeover agreements that expressly limit their monetary exposure even though they assume control of the work. While such a step may have some efficacy, it is hardly ironclad.[88] In such a situation, an owner may argue that the surety or its forces acted negligently in completing the work—that is to say, that the surety's own carelessness or improper activities actually aggravated the cost to complete the job properly. It would no longer be a matter of rectifying what the principal either had or hadn't done. An owner would seek to impose liability on the surety for its own errors, as opposed to its liability to perform corrective work to cure the errors of its principal.[89]

Some case law exists holding that a surety has an independent duty in a performance bond to come forward and complete its principal's contract itself. Where the surety fails to do so and the owner, now put to the expense of completing itself, incurs costs in excess of the penal sum, the surety has been held responsible.[90]

Generally, a performance bond surety's liability is capped at the penal sum of the bond. However, in *David Boland, Inc. v. Trans Coastal Roofing Co.*,[91] in answering a certified question from the United States Court of Appeals for the Eleventh Circuit, the Florida Supreme Court found a performance bond

---

[87]*See* United States v. Seaboard Sur. Co., 817 F.2d 956 (2d Cir. 1987). *See also* Village of Fox Lake v. Aetna Cas. & Sur. Co., 534 N.E.2d 133 (Ill. App. Ct. 1989) (where a "reservation of rights" was not enforced).

[88]*See* Employers Mut. Cas. Co. v. United Fire & Cas. Co., 682 N.W.2d 452, 456–58 (Iowa App. 2004) (By taking over the contract as part of a settlement agreement, the surety effectively waived its protections under the terms of the bond, including the penal sum, and agreed to be bound as the principal. The original subcontract and penal sum were in the amount of $147,864, but the work agreed to under the settlement agreement ultimately exposed the surety to $847,390 worth of repair costs.).

[89]*See* Continental Realty Corp. v. Andrew J. Crevolin Co., 380 F. Supp. 246 (S.D.W. Va. 1974).

[90]However, this is a distinctly minority (and heavily criticized) view.

[91]851 So. 2d 724 (Fla. 2003).

surety an "insurer" for purposes of the Florida statute that permitted a prevailing party to recover attorneys' fees, and that those fees are recoverable even though the fees exceeded the performance bond's penal sum. Consequently, the claimant not only recovered on its $31,654 disputed work claim, but also received attorneys' fees of $276,950, even though the penal sum of the performance bond was only $167,800.

[G] Suretyship Defenses

Following the obligee's declaration of default, part of the surety's investigation will include possible defenses to the claim by the obligee. The surety, however, has two different types of defenses. First, to the extent its principal has a defense to the performance of its duty, the surety also has that defense. If the obligee breached the agreement relieving the principal's performance, the surety is likewise relieved. Second, the surety also possesses defenses against the obligee based on its unique status as surety. The surety's defenses can arise in three ways. These are (1) the obligee's impairment of the surety's rights against the principal; (2) modification of the underlying contract; and (3) the conduct of the obligee.[92]

The primary purpose of the performance bond is that in the event of the principal's default, the obligee can look to the surety for the performance to which it is entitled. The performance bond, however, does not guarantee an obligee performance to which it is not entitled. In other words, if the principal has valid defenses to the obligee's demand for performance of the underlying contract, the surety is likewise entitled to assert those very same defenses.[93] These defenses focus primarily on the obligee's actions, or lack thereof, while the principal was attempting to perform. Among the more common contractor defenses are the obligee's termination was improper; the obligee issued the declaration of default in bad faith; the obligee failed to issue a proper cure notice; the contractor substantially performed its obligation; the obligee breached express or implied duties regarding the project design; the owner improperly exercised its duty of cooperation; the owner was responsible for differing site conditions; the owner failed to properly administer the contract; and issues of impossibility or impracticality of performance that would relieve the contractor of its duty to perform.[94]

In addition to the defenses of its principal, the surety also has a number of "surety defenses." Defining the parameters of the surety defenses is not easy. In fact, there is "probably no area of suretyship law in which there is less consensus than the law of suretyship defenses."[95] Although the following defenses are generally available to a surety, it is still critical to read the bond carefully. After all, since the bond is a written contract, the surety may choose to waive any of its defenses either in the text of the bond or otherwise.[96]

The extent to which a "defense" discharges a surety has changed. At common law, sureties were favored. As a result, any modification of the underlying contract, no matter how insignificant or immaterial, discharged the surety. While these strict rules may have been acceptable for a surety whose motivation was friendship or affection, they sometimes provided a financial windfall for a compensated surety. Since compensated sureties were obtaining discharges because of immaterial changes or modifications to the underlying obligations, two things happened. First, courts began finding that sureties were entitled to only a *pro tanto* discharge—that is, a discharge to the extent the surety suffered tangible harm by the change or modification. Second, performance bonds were revised to specifically include what

---

[92]*See* Restatement (Third) of Suretyship and Guaranty §§37-48 (1996).

[93]*Id.* at §33.

[94]*Strategic "Generalship" of the Complex Construction Surety Case, in* Managing and Litigating the Complex Surety Case (Philip L. Bruner ed., ABA 1998) (providing an excellent overview of defenses of the principal to performance of the underlying obligation).

[95]Restatement (Third) of Suretyship and Guaranty, Title B, Surety Defenses, Introductory Note.

[96]Restatement (Third) of Suretyship and Guaranty §48, Waiver of Suretyship Defenses, Consent (1).

now has become almost standard waiver clauses for certain types of modifications.[97] Sureties also now include language in their general indemnity agreements consenting to changes.[98]

At common law, any extension of the time for performance also provided a discharge to the surety. The modern rule is that this extension does not release the surety. Moreover, many bond forms contain an express waiver of this traditional defense. For example, the A311 bond states, "The surety hereby waives notice of any alternations or extensions of time made by the owner."[99] Consequently, an extension of the time for completion of the contract hardly ever provides a defense to the surety.

[1] Material Alteration

Many bonds explicitly permit the obligee to make changes to the scope of work in the underlying obligation. Also, virtually all construction contracts are incorporated into the performance bond, and the contracts almost universally allow changes in the work. In fact, changes in construction are so commonplace that basically all construction contracts contain specific clauses or provisions that lay out the mechanism for the owner to request additional or "change order" work. For example, the AIA Document A201 General Conditions explicitly state that changes in the work will not invalidate the contract.[100] Therefore, since changes or modifications in the underlying obligation are specifically authorized, they do not invalidate the contract or discharge the principal, nor do such changes discharge the surety.[101] But this principle is not absolute, and even in situations where the obligee has the contractual right to make changes in the plans and specifications, there are limitations. This limitation is known as a "cardinal change," often times referred to as a material alteration or material modification.

A cardinal change is a change comprising such a material modification of the underlying contract that it imposes risks on the surety that are fundamentally different from those present in the initial contract. In other words, a surety is discharged when the modification or change is one that the parties could not have reasonably anticipated as being within the scope of the underlying obligation. Furthermore, a series of modifications, no one of which is sufficiently fundamental but that in the aggregate represent a

---

[97]*See*, *e.g*., Federal Form 25 Performance Bond ("The above obligation is void if the Principal…(2) Performs and fulfills all the undertakings, covenants, terms, conditions, and agreements of any and all duly authorized conditions, and agreements of the contract during the original term of the contract and any extensions thereof that are granted by the Government, with or without notice of the Surety(ies) and during the life of any guarantee required under the contract,…").

[98]At least one surety has the following language in its general indemnity agreement: "The Surety is authorized and empowered, without notice to or knowledge of the Indemnitors to assent to any change whatsoever in the Bonds, and/or any contracts referred to in the Bonds, and/or in the general conditions, plans and/or specifications accompanying said contracts, including, but not limited to, any change in the time for the completion of said contracts and to payments or advances thereunder before the same may be due, and to assent to or take any assignment or assignments, to execute or consent to the execution of any continuations, extensions or renewals of the Bonds and to execute any substitute or substitutes therefor, with the same or different conditions, provisions and obligees and with the same or larger or smaller penalties, it being expressly understood and agreed that the Indemnitors shall remain bound under the terms of this Agreement even though any such assent by the Surety does or might substantially increase the liability of said Indemnitors."

[99]AIA Doc. A311 (1970).

[100]AIA Doc. A201 art. 7 (1997).

[101]*See Centex Constr. v. Acstar Ins. Co.*, 448 F. Supp. 2d 697, 701 (E.D. Va. 2006) (citing language from the bond and holding against the surety, "Any increase in the Subcontract amount shall automatically result in a corresponding increase in the penal amount of the bond without notice to or consent from the Surety, such notice and consent hereby being waived") (The court found "…that the escalation provision is unambiguous." Id, at 207).

fundamental change, will likewise discharge the surety.[102]

Determining whether a change is truly "cardinal," thereby discharging the surety, is a fact-sensitive inquiry based on the unique circumstances in each case. Generally, a cardinal change can take one of two forms.[103] The first one, far more common, is a material change in the scope of work.[104] To give an exaggerated example, adding a nuclear power station to a contract for a bus garage would constitute a cardinal change. Also, a change that dramatically increases the cost of the underlying contract will constitute a cardinal change.[105] The second circumstance where a cardinal change arises has been described as the "scope of completion" test. Under this test, a cardinal change occurs when a change would circumvent the competitive bidding process by adopting drastic modifications beyond the original scope of the contract.[106]

[2] Improper Payment

The owner's improper payment or release of contract funds also provides a defense for the surety to an obligee's performance bond demand. Most construction contracts contain specific payment clauses that generally permit periodic payments by the obligee to the contractor. The contractor, typically on a monthly basis, submits a requisition for payment for work performed the previous month. The owner's obligation or duty to pay the contractor is generally triggered by a certification by the architect that the work listed in the pay requisition has been satisfactorily performed. Contracts further permit the owner to withhold a certain amount from the periodic payments. This is known as "retainage." Retainage is ordinarily paid by the owner to the contractor when the project is completed or reaches substantial completion.

This method of payment provides both an incentive to the contractor and protection for the obligee and surety. The quicker the contractor completes the work, the quicker it earns its money. Thus, the contractor has the incentive to prosecute the work because it is not entitled to any payment until work is performed and accepted by the obligee. The obligee is protected because it is only required to pay for the work as it is completed. This protects the surety commensurately because, upon default of the contractor, the surety is entitled to the remaining contract funds. Therefore, once a demand is made upon the surety, the surety looks to the contract balances to defray the cost for completing the work. When, however, the owner releases contract funds before they are due, the surety has a defense. The scope of this defense differs.

Traditionally, an improper or premature payment of contract funds discharged the surety. This was so

---

[102]Restatement (Third) of Suretyship and Guaranty §41 cmt. (e).

[103]*See* Bruner, *supra* note 94.

[104]*See Hancock Electronics Corp. v. WMATA*, 81 F.3d 451, 454 (4th Cir. 1996) (a non-surety case holding that "[a] cardinal change occurs…when the government demands a contractual alteration 'so drastic that it effectively requires the contractor to perform duties materially different from those originally bargained for'"). (Citations omitted.)

[105]*See Liquidation of Union Indem. Ins. Co. v. Superintendent of Ins.*, 632 N.Y.S.2d 788, 789 (App. Div. 1st Dep't 1995) (holding that two change orders that nearly doubled the value of the underlying contract without the surety's consent constituted a material alteration as a matter of law).

[106]*See* Cray Research Inc. v. Department of Navy, 556 F. Supp. 201, 203 (D.D.C. 1982) (stating that "[t]he 'cardinal change' doctrine prevents government agencies from circumventing the competitive procurement process by adopting drastic modifications beyond the original scope of a contract. The basic standard is whether the modified contract calls for essentially the same performance as that required by the contract when originally awarded so that the modification does not materially change the field of competition.").

without a showing of prejudice by the surety.[107] The modern trend, however, is that an improper payment by the owner does not provide an absolute discharge to the surety. Rather, the surety is discharged only to the extent it has been prejudiced by the overpayment. Under these circumstances, the surety has a *pro tanto* discharge to the extent of the improper payment.[108]

Merely because the contractor received a payment before it was due does not automatically constitute an "overpayment" defense for a surety. Rather, in determining whether the surety was prejudiced by the premature release of contract funds, some courts look to whether the release of the funds resulted in an increased risk to the surety. The inquiry here focuses on what the principal did with the money. If the money was dissipated and spent on items not related to the contract, the surety's risk obviously increased, and the surety is entitled to a *pro tanto* discharge.

Where, however, the principal pumps the prematurely released funds into the project by paying for labor or material on the project, the surety is not entitled to any discharge. The rationale for denying the surety any discharge under these circumstances is that although the obligee may have departed from the terms of the contract's payment clause because the funds were used by the contractor to prosecute the work, the surety has not been prejudiced. Thus, it is reasonable that since the money was used to advance the work, it benefited the surety because the money expended reduced the surety's liability.[109]

In addition to assessing how the principal used the money, some courts also examine the obligee's conduct in making the payment. These decisions recognize that a construction payment requisition is just an estimate of the work completed in that particular pay period and that evaluating a pay requisition is not an exact science; rather, it is an estimate of the amount and value of the work performed. In these circumstances, the courts look to whether the payment was made in good faith. If an overpayment was made on a good-faith but incorrect assessment of the work completed, the surety generally is not discharged. In one case, a municipal owner asserted the good-faith defense to a claim by the surety by arguing it relied upon its engineer's assessment of the work. The court found the good-faith defense inapplicable because the owner relied on certifications negligently made by its own employee as opposed

---

[107]*See* Southwood Builders, Inc. v. Peerless Ins. Co., 366 S.E.2d 104, 108 (Va. 1998) (finding "[a] separate showing of prejudice to the surety is unnecessary because a material deviation, in itself, establishes prejudice.…[T]he material deviation is established by proof that the subcontractor was paid money before it was due and without approval by the architects.…[S]uch a procedure diminishes funds that should have been available to the surety in case of default.").

[108]Restatement (Third) of Suretyship and Guaranty:

> §42. Impairment of Collateral
>
> (1) If the underlying obligation is secured by a security interest in collateral and the obligee impairs the value of that interest, the secondary obligation is discharged to the extent that such impairment would otherwise increase the difference between the maximum amount recoverable by the secondary obligor pursuant to its subrogation rights (§§27-31) and the value of the secondary obligor's interest in the collateral.

[109]*See* Ramada Dev. Co. v. USF&G, 626 F.2d 517, 522 (6th Cir. 1980); Mergentime Corp. v. Washington Metro Area Transit Auth., 775 F. Supp. 14, 19 (D.D.C. 1991) ("In other words, a material modification to a contract is not the same as a modification that materially increases the surety's risk."); Honolulu Roofing Co. v. Felix, 49 Haw. 578, 604, 426 P.2d 298, 316 (1967) ("An immaterial deviation from the terms of the contract in the matter of making payments will not release the surety on the bond." (quoting Hustace v. Davis, 23 Haw. 606, 612 (1917)).

to an independent engineer. As a result, the surety was entitled to a *pro tanto* discharge.[110]

[3] Defective Work

In addition to situations where payments have been prematurely released for work not yet completed, a defense for the surety is likewise triggered if the obligee pays for patently defective work. Under these circumstances, to the extent the surety can demonstrate it was prejudiced, it can obtain a discharge because the obligee's improper release of contract funds increased the surety's risks. If the obligee has issued payments based on its reasonable reliance on pay requisitions approved by the architect, some courts have found that the surety's claim is not against the obligee but rather against the design professional.[111] Under many construction contracts, however, the design professional is an agent of the obligee. Therefore, the acts of the design professional in negligently approving defective work should be chargeable against the obligee, thereby reducing the surety's liability to the extent its risk increased as a result of the improper payment.[112]

[4] Statute of Limitations

Just as the failure to file a lawsuit within the time provided by the applicable statute of repose provides an absolute defense for any party, a surety likewise enjoys an absolute statute of limitations defense. Determining the appropriate limitations period is a coefficient of various factors, including the type of performance bond, statutory or private, the event that triggers the statute to begin to run, and the type of claim, such as a failure to perform the underlying obligation or a breach of a warranty obligation. Again, it is critical to read the bond because many bonds contain a specific suit limitations clause.[113]

Although private parties are generally free to provide their own limitations period for bringing suit, that freedom is not itself without limitation. Rather, courts generally permit private parties to agree on a limitations period shorter than that authorized by statute, as long as the period is reasonable. Some states, however, have a statutory prohibition preventing parties from agreeing to a period of time shorter than a statutory minimum time.[114] Under those circumstances, a party's freedom to contract has been trumped by the statute, and the statutory minimum limitations period controls. Parties, however, are generally permitted to expand the time within which to bring suit.

Most performance bonds contain a limitations period for bringing suit. For example, the AIA Document A311 bond requires that the suit must be filed within two years from the date final payment was due.[115] Consequently, on an A311 bond, the limitations period begins to run once the final payment

---

[110] *See* Transamerica Ins. Co. v. City of Kennewick, 785 F.2d 660 (9th Cir. 1986).

[111] *See* City of Houma v. Municipal & Indus. Pipe Serv., Inc., 884 F.2d 886 (5th Cir. 1989).

[112] *See* Transamerica Ins. Co. v. Housing Auth., 669 S.W.2d 818 (Tex. App. 1984).

[113] *See* Snapping Shoals Elec. Membership Corp. v. RLI Ins. Co., 2005 WL 3434803 (N.D. Ga.) (Where bond incorporated a specific bond expiration date in the underlying contract, the fact that the owner unilaterally agreed to extend completion date for the contractor did not also extend the bond expiration date. This holding relied in part upon a Georgia law that dictated that "surety's liability will not be extended by implication or interpretation.").

[114] *See* Safeway Stores, Inc. v. Certainteed Corp., 687 S.W.2d 22 (Tex. App. 1984); GBMC LLC v. ProSet Sys. Inc., 2013 WL 1629162 (N.D. Fla. 2013); Stellar J. Corp. v. Argonaut Ins. Co., No. 3:12-cv-05982, 2014 U.S. Dist. LEXIS 53015 (W.D. Wash. Apr. 16, 2014) (under Washington law, any provision limiting the applicable statute of limitations period to less than one year is void. Because the bond required suit within one year from the delivery of materials, the court held that the provision was void. The bond title was "Supply Bond," but the language of the bond and a Dual Obligee Rider had a striking resemblance to a performance bond).

[115] AIA Doc. A311.

becomes due. This two-year limitations period has been upheld even where the owner did not discover a latent defect until after the two years had passed since the date of the final payment.[116] The same result obtained when seven years after occupancy of a hotel, the owners sued a construction manager and the latter brought claim against the sureties of subcontractors whose work was supposedly at fault.[117] The AIA Document A312 bond requires that the suit be filed within two years after contractor default, or within two years after the surety refuses or fails to perform its obligations under the bond, whichever occurs first. Occasionally a court will have a departure from the expected, allowing a shorter limitations period than otherwise provided by statute. One court enforced a suit limitation in a public contract performance bond requiring suit to be brought within two years following final payment under the contract, and found that final payment as defined in the contract was made despite the fact 1% of the contract amount had been withheld by the City. The bond also states that if the bond's suit limitations period is void or prohibited, then the minimum period of limitations available to sureties as a defense in the jurisdiction of the suit shall be applicable to bar any action.[118] The pendency of a surety's declaratory judgment suit, may not toll this limitations period.[119]

On public works projects, the bond is almost always authorized by statute. In these circumstances, the bond usually incorporates the statute by which it was authorized. Consequently, if there is a conflict between a limitations period established in the bond and statute, the terms of the statute will control if the bond contains language purporting to provide less than the statutorily mandated protection.[120]

In some jurisdictions, the limitations period for bringing a claim against the surety is longer than that for bringing a claim against the contractor. This creates an anomaly because under strict surety principles, the surety's liability is coextensive with that of its principal. Therefore, if the time to file suit against the principal has expired, the surety should concurrently be able to assert that same defense. In fact, the *Restatement (Third) of Suretyship and Guaranty* provides that if the obligee fails to pursue the surety within the limitations period for an action against the principal, the surety may be discharged.[121]

Predictably, where there is a difference in the statute of limitations period for suits against the principal and surety, there is no hard and fast rule. In some cases, sureties have successfully asserted their principal's statute of limitations defense.[122] Under circumstances where there is a specific statute of limitations applicable to sureties, the surety is subject to suit even if the statute has run against its

---

[116]*See* Yeshiva Univ. v. Fidelity & Deposit Co. of Md., 116 A.D.2d 49, 500 N.Y.S.2d 24 (1st Dep't 1986).

[117]La Liberte, LLC v. Keating Bldg. Corp., 2007 WL 4323687 (E.D. Pa. Dec. 11, 2007).

[118]City of Yonkers v. 58A TVD Indus., Ltd., 981 N.Y.S.2d 736 (App. Div. 2014).

[119]Peekskill City Sch. Dist. v. Colonial Sur. Co., 6 F. Supp. 3d 372 (S.D.N.Y. Mar. 18, 2014).

[120]*See, e.g.*, Wichita Sheetmetal Supply, Inc. v. Dahstrom & Ferrell Constr. Co., 792 P.2d 1043 (Kan. 1990).

[121]Restatement (Third) of Suretyship and Guaranty §43, Delay in Enforcement: Running of Statute of Limitations as to Underlying Obligation. Under this section, the discharge of the surety based on the running of the statute of limitations for actions against the principal is governed by §39, Release of the Underlying Obligation; *see also* Nacimiento Water Co., Inc. v. International Fid. Ins. Co., 2015 WL 4554288 (C.D. Cal. July 28, 2015) (in a subdivision performance bond case, applying California Code of Civil Procedure section 359.5, a court held that "the expiration of the statute of limitations with respect to the obligations of the principal, other than the obligations of the principal under the bond, shall also bar an action against the principal or surety under the bond.").

[122]*See* County of Hudson v. Terminal Constr. Co., 154 N.J. Super. 264, 381 A.2d 355 (App. Div. 1977) (rejecting the obligee's argument that the statute was tolled because the claim involved a latent defect).

principal.[123] Sureties can address the risk of this anomaly in its indemnity agreements. For actions upon a liability created by statute, some courts might apply a shorter statute of limitations to the surety than that which is applicable to the principal. This can be the situation with subdivision performance bonds, because such bonds are statutorily required.[124]

[5] Fraud or Misrepresentation

[a] By Principal

Fraud or misrepresentation committed by the principal in procuring the bond will almost never discharge the surety's duty to the obligee. In these circumstances, although the principal may have committed fraud, the obligee is viewed as an innocent third party and is ordinarily entitled to the bond's protection.[1] As a result, unless the obligee is somehow involved in the principal's fraud, the surety is generally not discharged. Of course, the surety may have an independent cause of action in tort against the principal for any misrepresentations upon which the surety can prove justifiable reliance, in addition to its claims under the indemnification agreement.

[b] By Obligee

Where, however, the obligee either participates in a fraud or withholds information that would be material to the surety in determining whether to underwrite the risk, the surety can obtain a discharge. The *Restatement's* approach to fraudulent or material misrepresentation by the obligee is both technical and specific.[125] Under the *Restatement*, the surety is discharged when the following requirements are met: (1) the misrepresentation must be either fraudulent or material; (2) the misrepresentation must have induced the surety to issue the bonds; and (3) the surety must have reasonably relied on the representation.[126]

Discovered instances of an obligee's making either a fraudulent or material misrepresentation are rare. Examples include misrepresentations of financial strength of the principal to the surety. For example, where the obligee was aware that the principal was in dire financial straits and in default in some other obligation and concealed or withheld this information from the surety, the surety has obtained a discharged.[127] Other examples are where obligee misrepresents to surety the full scope of a construction project,[2] and where an obligee fails to disclose to the surety a secret collateral agreement.[3]

---

[123]*See* Regents of the Univ. of Cal. v. Hartford Accident & Indem. Co., 147 Cal. Rptr. 486, 581 P.2d 197 (1978).

[124]For example, *see* California Code of Civil Procedure section 338(a), a three-year statute of limitations for actions "upon a liability created by statute." Otherwise, the applicable statute of limitations is four years, the usual statute of limitations for written contract actions, under California Code of Civil Procedure section 337.

[1] Chrysler Corp. v. Hanover Ins. Co., 350 F.2d 652 (7th Cir. 1965) (applying Indiana law).

[125]Restatement (Third) of Suretyship and Guaranty §12. See also a similar rule in 10 Samuel Williston & Walter H.E. Jaeger, WILLISTON ON CONTRACTS § 1249 (3d ed. 1967).

[126]*Id.* cmt. (a).

[127]*See* St. Paul Fire & Marine Ins. v. Commodity Credit Corp., 646 F.2d 1064 (5th Cir 1981).

[2] Employers Ins. of Wausau v. Constr. Mgmt. Engineers of Fla., Inc., 377 S.E.2d 119 (S.C. Ct. App. 1989). *See* also The Law of Performance Bonds, 2nd Ed., (2009), *supra,* at 18.

[3] Harris & Harris Constr. Co. v. Crain & Denbo, Inc., 123 S.E.2d 590 (N.C. 1962) (holding that the obligee had no duty to disclose alleged collateral agreement with the principal because it had not in fact been agreed to) (conversely, obligee does have this duty if in fact obligee and principal had agreed to a secret collateral agreement). For recission in general based upon misrepresentation or concealment by

Other cases permit the surety to maintain a defense based on the obligee's concealment. These courts place the burden squarely on the surety by requiring it to ask the right questions. In other words, the surety must demonstrate its diligence by seeking the information it deems material. This requires a showing that, before issuing the bond, the surety initiated contact with the obligee regarding the circumstances that form the basis of the fraudulent misrepresentation defense.[128] If, however, the surety did not undertake to obtain such information, it is difficult indeed to claim it relied on a misstatement by the obligee.

Fraud by obligee can also include concealment from the surety that a contractor bonded by the surety is not licensed as a contractor, and where obligee has reason to believe surety is not aware of the fact.[4] Where an obligee solicits a signature on a contract by a contractor that the obligee knows is not licensed as a contractor in the state of the project, and where obligee has reason to believe the surety is unaware of such lack of license, a surety can elect to consider its bond void *ab initio*. Such fraud can occur at any time during a project, and need not be in the category of fraud in the inducement. Where a court finds that a bond was procured by fraud, that finding would only invalidate the bond, not the underlying contract between obligee and principal.[5]

[6] Change of the Obligee or Principal

Absent a specific prohibition against an assignment, the obligee's assignment of its rights in the underlying contract does not release the surety.[129] When the obligee changes, although the surety and principal owe a duty to a new party, the scope of that duty as defined by the underlying obligation or contract remains the same. Consequently, since the surety's risk remains the same, it cannot obtain a discharge because the surety is unable to demonstrate prejudice.[130]

Changes in the principal, however, are more problematic for the surety. If the principal merely changes form—for example, from corporation to partnership—this generally will not discharge the surety as long as the change does not increase the risk to the surety. After all, a surety issues its bond solely on the economic strength of its principal, and as long as the change in the form of ownership does not change

---

obligee, *see* Clarke, Bogda M.B., Ferrucci, James D. & Shahinian, Armen, *Fraud and Inducement as a Defense to Fidelity and Surety Claims*, 42 TORT & INS. LAW J.181 (Fall 2006).

[128]*See* Rachman Bag Co. v. Liberty Mut. Ins. Co., 46 F.3d 230, 235 (2d Cir. 1995) (finding a jury question regarding the circumstances surrounding whether an "obligee's failure to come forward with information it knows to be material [constitutes] fraud." The court further noted that "the policy behind surety bonds is not to protect a surety from its own laziness or poorly considered decision.…sureties must usually take the initiation and inquire about information they deem important."). *See also* Pinkerton Laws Inc. v. Marco Constr. Inc., 485 S.E.2d 797 (Ga. Ct. App. 1997) (prior to issuing the bond the surety was advised by the obligee that work in the field had not yet began. In actuality, however, work was well under way, and the obligee was already threatening to default the principal); Ground Improvement Techniques, Inc. v. Merchants Bonding Co., 63 F. Supp. 2d 1272 (D. Colo. 1999).

[4] See, e.g., *Bryan Builders Supply v. Midyette*, 162 S.E.2d 507, 512, 274 N.C. 264 (N.C. 1968) ("Owners, being a member of the class for whose protection G.S. 87-1 et seq. was enacted, and not being *in pari delicto* with (contractor) Bryan, were entitled to maintain an action for Bryan's breach of contract.") (Conversely, when an owner <u>is</u> *in pari delicto* with the contractor, it is not entitled to maintain an action, and the surety can elect to void its performance bond).

[5] Allied World Ins. Co. v. New Paradigm Prop. Mgmt., FN 7, LLC (E.D. Cal. 2017).

[129]*See* Hunters Pointe Partners Ltd. P'ship v. USF&G, 442 N.W.2d 778, 779–80 (Mich. Ct. App. 1989); *see also* Citibank v. Grupo Cupey, Inc., 382 F.3d 29, 32 (1st Cir. 2004) (holding that assignee had no right of action under performance bond that limited surety's liability to original named beneficiaries).

[130]*See* Leila Hosp. & Ctr. v. Xonics Med. Sys., 948 F.2d 271 (6th Cir. 1991).

the level of risk, the surety is not discharged. Once again, this defense requires a close examination of the facts and circumstances of each case because a change in the principal can form the basis of a defense for the surety when the change results in prejudice to the surety, such as a diminished financial capacity.[131]

A closely related issue is the impact upon the surety of the obligee's release of the principal. Traditionally, if the obligee released the principal, the surety was discharged.[132] Under the *Restatement*, however, the defense has been limited. The critical inquiry focuses on the intent of the obligee in releasing the principal, and the extent to which the surety was prejudiced. Where the obligee did not intend to release the surety, the release of the principal does not discharge the surety.[133] Where the obligee did not intend to release the surety in releasing the principal, but the obligee increased the surety's risk, the surety is discharged to the extent of the increase in risk.

[H] Surety's Remedies

Although a surety does not anticipate any losses in connection with the issuance of its bonds, losses do occur. Perhaps one of the surety's most powerful tools is its equitable right of subrogation. According to *Black's Law Dictionary*, subrogation is "(t)he substitution of one party for another whose debt the party pays, entitling the paying party to rights, remedies, or securities that would otherwise belong to the debtor."[134] Subrogation simply means substitution of one party for another; that is, one person is allowed to stand in the shoes of another and assert that person's rights against the defendant. Factually, the case arises because, for some justifiable reason, the subrogation plaintiff has paid a debt owed by the defendant.[135] Accordingly, the surety becomes subrogated not only to the rights of the principal on whose behalf it expended funds but also to the rights of the obligee and other claimants it has paid.

When the surety is called on to perform or pay money on either a performance or payment bond claim, the surety acquires various rights and remedies against other parties. The most common formulation of the surety's right of subrogation was articulated in the landmark Supreme Court decision of *Pearlman v. Reliance Insurance Co.*[136] In *Pearlman*, the Supreme Court stated: "[A] surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed."[137] What this means is that upon paying a lawful claim against its principal, the surety is subrogated to its principal's rights and also to the rights of the party it paid. The most significant right for the subrogated surety is its right to the remaining contract funds. As a result, subrogation provides substantial protection to the surety because in the event of a demand upon the surety, the surety can look to the remaining contract funds to offset any claims or losses the surety incurs in completing the work.[138]

---

[131]*See* 95 Lorimer LLC v. Insurance Co. of the State of Pennsylvania, 6 Misc. 3d 500 (N.Y. Sup. Ct. 2004) (During the course of a demolition project, without notice to the surety, the owners of the principal set up a new legal entity and the obligee accepted the new entity as its contractor and paid for the work. A dispute arose as to performance and the owner called upon the performance bond. The New York court held that the substitution of a new principal was a material and substantial change to the bonded obligation and the surety was discharged.).

[132]*See* Restatement (Third) of Suretyship and Guaranty §39, Release of Underlying Obligation, cmt. (d).

[133]*Id.* illus. 3, 4.

[134]Black's Law Dictionary 1563 (9th ed. 2009).

[135]*Id.* at 1564.

[136]371 U.S. 132 (1962).

[137]*Id.* at 137.

[138]In addition to the right to the contract funds, the Restatement (Third) of Suretyship and Guaranty §28, Rights Obtained Through Subrogation, states:

a. To the extent that the secondary obligor is subrogated to the rights of the obligee, the secondary

Although subrogation is deeply rooted in our jurisprudence and is a doctrine of "pure unmixed equity having its foundation in the principles of natural justice,"[139] and is wholly independent of statutory or contract law, it is not an absolute trump card for the surety to place it ahead of other creditors of its principal. After all, defaults are frequently complex, and the defaulted contractor usually faces claims not only by the surety and obligee, but by other creditors as well.

If the surety incurs a performance bond loss, it generally has absolute priority to the contract funds. A surety that incurs a payment bond loss is, however, not entitled to absolute priority. Rather, the surety and other creditors, including banks, secured lenders, the Internal Revenue Service, or some state tax authority, subcontractors, suppliers, and/or a bankruptcy trustee may also assert a claim against the contract funds. Because contract funds in the hands of the owner may be the only assets arguably remaining to the principal, other creditors should not be expected to concede defeat and acknowledge under *Pearlman* that the surety has absolute priority to the contract funds. Rather, these creditors generally fight aggressively to assert their right to the contract funds. Although *Pearlman* is still good law, the surety does not always prevail.

Not surprisingly, the decisions vary from jurisdiction to jurisdiction, and some compelling themes are evident in several recent decisions. For some courts, priority for the remaining contract funds is solely a function of the rights in the owner/principal contract and the indemnity agreement. These courts also look to classify the funds held by the owner as either "retainage," "progress payment," or "final requisition." Other courts focus on priorities and rights confirmed under state statutory law. Still other courts seem to apply *Pearlman's* equitable doctrine and seek to protect the surety that has performed and paid either performance or payment bond claims.[140]

---

obligor may enforce, for its benefit, the rights of the obligee as though the underlying obligation had not been satisfied:

b. against the principal obligor pursuant to the underlying obligations;

c. against any other secondary obligor for the same underlying obligation, unless the other secondary obligor is a sub-surety for the subrogated secondary obligor;

d. against any interest in property securing either the obligation of the principal obligor or that of any other secondary obligor against whom the rights of the obligee may be enforced; and

e. against any other persons whose conduct has made them liable to the obligee with respect to the default on the underlying obligation.

f. Recovery under this section is limited as follows:

g. the total recovery of the secondary obligor pursuant to subsection (1) may not exceed the secondary obligor's cost of performance of the secondary obligation;

h. the enforcement of the obligee's rights against a co-surety, and against any interest in property securing performance of the obligation of a co-surety, is limited to the amount that will satisfy the co-surety's duty of contribution (§55).

[139]Prairie State Nat'l Bank of Chicago v. United States, 164 U.S. 227, 231 (1896) (quoting Gladsen v. Brown, Speer, Eq., 37, 41 (Johnson, Ch.)).

[140]*See In re* Construction Alternative, 2 F.3d 670 (6th Cir. 1993); *In re* Capital Indem. Corp., 41 F.3d 320 (7th Cir. 1994); Universal Bonding v. Gittens & Sprinkle Enters., 960 F.3d 73 (3d Cir. 1994); *In re* Structures, Inc., 27 F.3d 73 (3d Cir. 1994); *In re* Comcraft, 206 B.R. 551 (D. Or. 1997); *In re* Alcon Demolition, 204 B.R. 440 (D.N.J. 1997). *But cf.* Nova Cas. Co. v. New York City Hous. Auth., No. 602527-208, 212 N.Y. Misc. LEXIS 55668 (Sup. Ct. Dec. 14, 2012), distinguishing performance and payment bond situations and giving the surety greater priority in the former. The surety's claim for subrogation is equitable in nature and continues to be a significant remedy for a surety. Recently, in

A recent opinion from the Fourth Circuit is instructive in the seemingly endless battle over contract funds between bankruptcy trustees and bonding companies. When given the opportunity, the court refused to hold that section 541 of the Bankruptcy Code legislatively overruled *Pearlman* by expanding the definition of "property of the estate" in the Bankruptcy Code. The opinion expressly negates any suggestion that *Pearlman* is no longer good law.[141]

Claims of equitable subrogation to a contract balance can also place under scrutiny claims to set-off by the obligee. As a rule, the performance bond's surety's right to the contract balance has been found to be superior to such competing claims. Typical is *Hanover Insurance Co. v. Blueridge General Inc.*[142] In that case, Blueridge, the obligee, had two contracts with Hanover's principal, Thayer Masonry, one of which was bonded and the other one was not. Both contracts contained a clause that permitted the GC to withhold from sums due on one contract offsets that had arisen on the other. However, its effort to do this in a way that would reduce the performing surety's entitlement on the bonded contract was not allowed. Hanover was allowed to recover free from the offset. These concepts were taken one step further in *Hartford Fire Insurance Co. v. United States*,[143] where the completing surety, Hartford, claimed that its rights of equitable subrogation had been prejudiced by the government disbursing funds to the bonded contractor on a second, unbonded job, rather than using these to offset the size of the loss on the first project. Reasoning that the surety succeeded to the rights of both principal and obligee, the Court of Claims reasoned that were the surety's claim to fail, the result would encourage sureties not to undertake the completion on their own, leaving the governmental obligee to proceed on its own and, itself, invoke available contract offsets. As a result, it held that the surety's claim of prejudice was justifiable.[144]

In addition to the surety's equitable right of subrogation, sureties have common-law rights of *quia timet* and exoneration and indemnification. *Quia timet* is a common-law bill in equity. On a construction project, a surety may seek quia timet relief if it has reasonable grounds to anticipate that its rights are being compromised. This can take many forms, including circumstances where the principal is diverting proceeds from the bonded contract. Exoneration is "the removal of a burden, charge, responsibility or duty—particularly the act of relieving a person or estate from a charge or liability by casting the same upon another person or estate."[145] On a construction project, exoneration takes two forms. First, the surety has the right to require that contract proceeds be used to pay obligations of the principal that, if unpaid, would become an obligation of the surety. Second, after there has been a demand made on the surety, either a performance bond claim by the obligee or a payment bond claim by materialmen or suppliers, the

---

Department of Army v. Blue Fox, Inc., 525 U.S. 225 (1999), the U.S. Supreme Court held that federal courts did not have jurisdiction over a claim by a subcontractor asserting an equitable lien on funds held by the Army. Although the Blue Fox decision was limited to the issue of whether district courts have jurisdiction over a subcontractor's claims for an equitable lien on contract funds held by the federal government, the question has arisen as to whether the Blue Fox decision upsets the long-standing recognition of the surety's equitable right of subrogation. Blue Fox, however, should be limited to the facts of its case and should not be interpreted to overrule the long-standing equitable subrogation cases involving sureties.

Another troubling case is *M.E.S., Inc. & Travelers Cas. & Sur. Co. of Am. v. United States*, 104 Fed. Cl. 620 (2012), holding that the surety was not an equitable subrogee because it did not complete the project, although it had paid the government an agreed amount to settle a performance bond claim, and holding that the court had no jurisdiction under the Tucker Act to determine if the surety may recover from the government.

[141]Grochal v. Ocean Tech. Servs. Corp., 476 F.3d 238 (4th Cir. 2007).

[142]2013 WL 4590568 (E.D. Va. 2013).

[143]108 Fed. Cl. 525 (2012).

[144]108 Fed. Cl. at 532–34.

[145]Black's Law Dictionary 576 (6th ed. 1990).

surety can require that the principal pay the debt.[146]

In addition to these firmly rooted common-law rights, sureties also are entitled to indemnification. Here, a surety is entitled to common-law indemnification from its principal if the surety sustains a loss based on its principal's failure to perform. In addition to common-law indemnification, sureties also seek specific contractual protection. Prior to executing performance and payment bonds, sureties generally require that the contractor execute a rather broad and sweeping indemnification agreement. This indemnification agreement is usually signed not only by the contracting entity but also personally by its owners. As a result, this provides additional protection for the surety in the event of a claim.[147]

For a detailed discussion of a surety's subrogation rights, *see Insurance Company of the West v. United States.*[148] The decision also contains a fairly comprehensive review of the leading Supreme Court decisions on the surety's subrogation rights.

Contractual indemnity agreements that sureties require their principals to sign customarily contain provisions providing for an automatic assignment of the principal's claims on a project in the event of a breach of the indemnity agreement. Because construction projects gone bad typically support the adage that "when it rains, it pours," a breach of the indemnity agreement, or at the very least an alleged breach of it, will more likely than not be in the picture. In such circumstances, sureties are understandably quite prepared to take command of a principal's claims, particularly when such action may be the only practical way to mitigate a loss caused by the principal. Courts ordinarily enforce such provisions, even to the point of granting summary judgments to the bonding company.[149] In such circumstances, it is imperative that the settling party require the surety to document its authority to settle the principal's claim.

Sureties have also been successful in mitigating their losses on construction projects by pursuing claims against third parties. In the main, such actions have grown out of claiming subrogation rights from owners/obligees to whom payment has been made. Often, such claims will be against design professionals and related consultants for the certification of defective work. In such situations, the doctrines of equitable subrogation to the rights of others and privity of contract as a bar to relief

---

[146]For a discussion of these issues, see Jay M. Mann, *Exoneration and Quia Timet, in* The Law of Suretyship (Edward G. Gallagher ed., 2d ed. ABA 2000). *See also* Hudson Ins. Co. v. Simmons Constr., LLC, CV-12-0407 (PHX-DGC), 2012 WL 5381457, at *3 (D. Ariz. Nov. 2, 2012), where the court granted the surety's motion for summary judgment on a demand for $3,900,000 of collateral, finding "that the GIA is enforceable under Ninth Circuit law and that Defendants are in breach of that agreement. Plaintiff has established a reserve of $3,900,000 and has deemed that same amount necessary to protect it from any loss, cost, or expense. Plaintiff need not wait until ultimate resolution of the indemnity claims to demand collateral, so long as that collateral is not dispersed until indemnifiable claims are determined and the remainder, if any, is returned to Defendants." Accordingly, the court granted plaintiff's motion for partial summary judgment." Ninth Circuit courts favor summary judgment as a remedy to enforce the indemnity agreement, and will apply Rule 65, Fed. R. Civ. P rather than the common law doctrine of *quia timet*. The same courts routinely issue orders for prohibitory injunctions to maintain the *status quo*, such as freezing assets, but find that mandatory injunctions, such as collateral orders, are "particularly disfavored." *See* Travelers Cas. & Sur. *Co.* of Am. v. W.P. Rowland Constructors Corp., CV-12-00390 (PHX-FJM), 2012 WL 1718630, at *2 (D. Ariz. May 15, 2012). The court held that, under Ninth Circuit authorities, economic injury by itself "does not support a finding of irreparable harm, because such injury can be remedied by a damage award." (*Id*. at *3).

[147]*See* Chapter 34.

[148]55 Fed. Cl. 529 (2003).

[149]Liberty Mut. Ins. Co. v. Aventura Eng'g & Constr. Corp., 534 F. Supp. 2d 1290 (S.D. Fla. 2008).

frequently clash, and courts have gone both ways on these issues.[150] Claims against lending institutions have also been brought as alleged aiders and abettors of defunct principals, but these are frequently difficult cases to bring home.[151] An infrequently used, yet successful, recovery method is to pursue recovery of surety losses and expenses under the principal's commercial general liability policies, or under the incidental contractual liability coverage where that coverage exists.[152]

§32.05 CONCLUSION

Certainly, Judah could not have anticipated the development of modern day performance bonds when he agreed to be surety for Benjamin's journey into Egypt. The issues facing the obligee, principal, and surety when a default occurs are usually complex. In examining these issues, the starting point must be the bond. After all, the bond is the contract to which the parties have bound themselves. After that, there is a considerable body of case law and numerous secondary sources that will help guide parties through the many issues.

---

[150]Carolina Cas. Co. v. R.L. Brown & Assocs., Inc., 2006 WL 2842733 (N.D. Ga. Sept. 29, 2006); Lyndon Prop. Ins. Co. v. Duke Levy & Assoc. LLC, 475 F.3d 268 (5th Cir. 2007); American Mfrs. Mut. Ins. Co. v. Payton Lane Nursing Home, Inc., 2007 WL 674691 (E.D.N.Y. Feb. 28, 2007).

[151]Fidelity and Guar. Ins. Underwriters, Inc. v. Wells Fargo Bank, N.A., 2006 WL 870683 (S.D. Tex. Mar. 31, 2006); United States Sur. Co. v. KeyCorp., 2007 WL 2331942 (N.D. Ohio Aug. 13, 2007).

[152]*See* Merrick Constr. v. Hartford Fire Ins. Co., 449 So. 2d 85 (La. Ct. App. 1st Cir. 1984), Spirco Envtl. v. American Int'l Specialty Lines, 555 F.3d 637 (8th Cir. 2009). *See also* CGL Builders' Risk Monograph, American Bar Association, 2004, pp. 43–44, Gregory S. Arnold, contributing writer.