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A SURETY'S WINNING STRATEGIES TO BEAT A DEFAULT TERMINATION

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I. INTRODUCTION

Upon receiving notice of its principal's termination for default on a construction project, a performance bond surety is immediately thrust into a quandary where legal rights and liabilities can become hopelessly intertwined. A thorough understanding of the surety's possible defenses to the default termination as well as options for limiting its liability in the event of a proper default termination are necessary before a winning strategy can come into focus.

More precisely, before deciding how to proceed in the event of a default termination, the performance bond surety must embark upon the process of evaluating the propriety of the Government's actions. The surety must quickly investigate and decide: 1) whether its principal's actions constituted a breach of the contract, 2) whether any breach of contract by its principal was sufficiently material to warrant a termination for default[1], and 3) whether the surety can otherwise assert any viable defenses to the obligee's termination. Simultaneously, the surety must assess its overall financial exposure and devise a cogent mitigation of damages strategy.

This paper sets forth a checklist of defenses that a surety should consider in deciding whether to contest a default termination. Furthermore, this paper will discuss mitigation doctrines which will assist sureties in limiting their liability when a default termination cannot be effectively challenged. Specifically, Section II of this paper will summarize the high burden that the Government must meet to prevail in a default termination proceeding. Section III of this paper will analyze case law discussing defenses generally applicable to default termination decisions. Section IV of this paper will discuss defenses that are uniquely suited to specific types of default terminations. Section V will examine case law and regulations relating to mitigation principles which may be applied by a surety in limiting its liability after its principal has been properly terminated for default. Section VI of this paper provides a summary checklist of defenses and mitigation doctrines the surety must consider to readily distinguish between its rights and liabilities following a default termination so that the surety may develop a winning strategy for meeting its obligation by the most cost-effective means.[2]

II. LEGAL STANDARDS GOVERNING DEFAULT TERMINATION

In disputes arising from a default termination, the Government carries the burden of proving that its default termination was proper.[3] The Government must exercise its right to terminate

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[1] See J.D. Hedin Constr. Co. v. United States, 408 F.2d 424, 431 (Ct. Cl. 1969)(ruling that a contracting officer must not terminate a contractor for default where the contractor experiences the types of minor deficiencies that are common on every construction project).

[2] For ease of reference and in recognition of the ample use of Federal Government contract case law herein, the obligee/owner is often referred to as the Government. Nonetheless, the general defenses and mitigation doctrines presented are oftentimes applicable in local government and private contract scenarios. Accordingly, the controlling law of the applicable jurisdiction should be examined to ascertain the extent to which a particular doctrine has been adopted.

[3] See Lisbon Contractors v. United States, 828 F.2d 759 (Fed. Cir. 1987); Executive Elevator Service, Inc., VABCA No. 2152R, 87-3 BCA ¶20,083 (1987).

a contract for default prudently because the sanction has the "drastic consequence" of leaving the contractor without further compensation.[4] Therefore, courts evaluating the propriety of default terminations are guided by the fundamental proposition that "[d]efault terminations - - as a species of forfeiture - - are strictly construed," and that the Government must therefore "turn square corners" in order to prevail when invoking this harsh sanction.[5] Consistently, default terminations will be enforced only to the extent they comport with fundamental notions of equity and good conscience.[6]

III. GENERAL DEFAULT TERMINATION DEFENSES

Under a performance bond, a surety's liability is coextensive with that of its principal.[7] Consequently, in contesting a default termination, a surety benefits from all defenses that its principal retains against the Government.[8] Regardless of the factual setting giving rise to a default termination of a construction contract, a surety can likely reverse a default termination decision[9] where it proves that: 1) the Government "abused its discretion" in terminating a contract for default, 2) the Government materially breached a contract, 3) the Government failed to implement notice procedures properly when defaulting the principal, or 4) its principal substantially performed the contract prior to the default termination.[10]

A. Abuse of Discretion

The Government cannot reflexively terminate a contractor for default because it is bound by common law to exercise discretion in deciding whether or not the drastic sanction of default is proper. Moreover, the Government's contracting officer is constrained in the exercise of its discretion by express regulatory parameters. Consequently, looking behind the Government's decision process often yields a basis for a successful challenge to a default termination.

Under established precedent, a contracting officer must exercise "discretion" in deciding whether to terminate the contract of a defaulted contractor.[11] An "arbitrary and capricious"

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[4] Schlesinger v. United States, 390 F.2d 702, 709 (Ct. Cl. 1968); see also, J.D. Hedin Constr. Co. v. United States, 408 F.2d 424, 431 (1969).

[5] DeVito v. United States, 188 Ct. Cl. 979,413 F.2d 1147, 1153 (1969); Delfour, Inc., VABCA No. 2049, 89-1 BCA ¶ 21,394 at 107,855 (1988).

[6] See Mountain State Constr. Co., Inc., ENGBCA No. 3549, 76-2 BCA ¶ 12,197 at 58,725 (1976).

[7] See A. Stearns, Law of Suretyship § 7.1 (5th ed. 1951); 72 C.J.S. Principal and Suretyship § 92 (1951).

[8] See id.

[9] Under the Federal Government contract case law, a court will convert an improper default termination into a termination for convenience. See Lisbon Contractors, Inc. v. United States, 828 F.2d 759, 767 (Fed. Cir. 1987); Quality Environ Sys., Inc. v. United States, 7 Cl. Ct. 428, 432 (1985).

[10] Given the myriad factual possibilities giving rise to a termination for default, it is beyond the scope of this paper to provide an exhaustive discussion of all defenses to Government default termination decisions. However, the defenses discussed in this section constitute the most commonly used and effective general defenses to default termination decisions.

[11] See Schlesinger v. United States, 390 F.2d 702, 707 (Cl. Ct. 1968).

decision to terminate a contractor for default does not constitute a discretionary act and, therefore, will be reversed.[12] In Schlesinger v. United States, the United States Claims Court emphasized that default termination clauses permit, but do not require, the Government to terminate a contract when a contractor is in default.[13]

Applying the above principle, the Schlesinger court held that the default termination at issue constituted an abuse of discretion, even though the contractor was technically in default, because the contracting officer based his decision on a recommendation from a Congressional Oversight Subcommittee rather than on his own independent judgment.[14] The Schlesinger court, however, failed to clarify what constraints were to be applied to the contracting officer's decision.

Over a decade after its decision in Schlesinger, the United States Court of Claims further addressed the level of discretion that must be exercised in deciding whether to terminate a contractor for default.[15] In United States Fidelity and Guaranty Co., the Court of Claims held that, in evaluating whether a contracting officer's decision in administering a contract is arbitrary and capricious, a court should review whether: 1) there is evidence of subjective bad faith on the part of the contracting officer, 2) the default termination decision is supported by a reasonable contractual basis, 3) the contracting officer is afforded a significant amount of discretion in carrying out his duties, and 4) the contracting officer violated a statute or regulation.[16]

In the years following the United States Fidelity and Guaranty decision, the courts and boards continued to review the Government's default termination decisions to ensure that the Government was appropriately exercising its discretion as measured by applicable law and regulations. For example, in Darwin Constr. Co. v. United States, the United States Court of Appeals for the Federal Circuit found that a Navy contracting officer abused his discretion in default terminating a contract for improvements to a Navy Machinery Facility where the contractor's work was progressing behind schedule due to the late delivery of equipment, that the lack of progress did not interfere with the Navy's use of the Machinery Facility, and that the contractor was willing and able to complete the improvement work.[17] In so holding, the Darwin court's reasoning paralleled the standards set forth in Section 49.402-3(f) of the Federal Acquisition Regulations (the "FAR").[18]

Significantly, FAR Section 49.402-3(f) provides:

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[12] See id.; see also Darwin Constr. Co. v. United States, 811 F.2d 593, 595 (Fed. Cir. 1987).

[13] See id.

[14] See id. at 706-08.

[15] See United States Fidelity and Guaranty Co. v. United States, 676 F.2d 622, 630 (Ct. Cl. 1982).

[16] See id.

[17] Darwin Constr. Co., 811 F.2d at 594-96.

[18] See id.

> The contracting officer shall consider the following factors in determining whether to terminate a contract for default (emphasis added):
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> 1) The terms of the contract and the applicable laws and regulations.
> 2) The specific failure of the contractor and the excuses for the failure.
> 3) The availability of the supplies or services from other sources.
> 4) The urgency of the need for the supplies or services and the period of time required to obtain them from other sources, as compared with the time delivery could be obtained from the delinquent contractor.
> 5) The degree of essentiality of the contractor in the Government acquisition program and the effect of a termination for default upon the contractor's capability as a supplier under other contracts.
> 6) The effect of a termination for default on the ability of the contractor to liquidate guaranteed loans, progress payments or advance payments.
> 7) Any other pertinent facts and circumstances.

Applying these procedural requirements, in Lisbon Contractors, Inc. v. United States,[19] the Court of Appeals for the Federal Circuit held that, before terminating a contract for default, a contracting officer must analyze whether the defaulted contractor can complete the contract more expeditiously than a follow-on contractor. It must, however, be noted that despite the mandatory language of the FAR provision, a contracting officer's failure to make a specific finding on any particular factor will not, by itself, render a default termination improper. For instance, in DCX, Inc. v. Perry,[20] the Court of Appeals for the Federal Circuit noted that consideration of the factors listed in FAR § 49.402-(3)(a) are not prerequisites for a valid default termination but further emphasized that evidence which demonstrates that a contracting officer did not comply with the FAR in issuing a default termination is probative of the fact that the officer abused his discretion.

While the above decisions and the FAR make clear that a contracting officer's discretion is restricted in considering a default termination, a recent decision by the Court of Appeals for the Federal Circuit may somewhat limit the scope of the "abuse of discretion" defense.[21] In McDonnell Douglas Corp. v. United States, a Navy Contracting Officer default terminated a contract for the construction of an A-12 Avenger stealth aircraft after the contractor admitted

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19 Lisbon Contractors, Inc. v. United States, 828 F.2d 759, 767 (Fed. Cir. 1987).

20 DXC, Inc. v. Perry, 79 F.3d 132, 135 (Fed. Cir. 1996).

21 See McDonnell Douglas Corp. v. United States, 182 F.3d 1319 (Fed. Cir. 1999).

that it could not meet either the contract's delivery schedule or required specifications.[22] Subsequently, the contractor challenged the Navy's default termination in the Court of Federal Claims. Applying Schlesinger, the trial court held that the contracting officer failed to exercise reasonable discretion in terminating the contract because, the court reasoned, the contracting officer terminated the contract at the direction of the Secretary of Defense.[23]

On appeal, the Court of Appeals reversed the Court of Federal Claims finding that the default was per se improper due to the contracting officer's deference to the direction of the Secretary of Defense.[24] In so holding, the Court of Appeals applied a narrow reading of Schlesinger by reasoning that "Schlesinger and its progeny stand for the proposition that a termination for default that is unrelated to contract performance is arbitrary and capricious, and thus an abuse of the contracting officer's discretion."[25] However, unlike Schlesinger, the Appellate Court emphasized that, in this case, the contracting officer had examined contract performance and had found that the contractor was incapable of meeting contract delivery dates, unable to comply with contract specifications, and likely incapable of ever completing the aircraft.[26] Accordingly, the Court of Appeals concluded that the contracting officer had not, per se, abused his discretion in reaching its decision to default terminate.[27] After concluding that the Government had not abused its discretion, the Court of Appeals remanded the case back to the trial court for a determination of whether the default was improper for other reasons.[28]

The McDonnell Douglas Court applied a discretion test which mandated that a sufficient "nexus" exist between a contracting officer's decision to terminate a contract for default and the contractor's performance of the contract.[29] In so holding, the Court disregarded other improper factors influencing the Government's termination decision. Consequently, McDonnell Douglas suggests that the broader interpretation of Schlesinger and its progeny, namely, that improper influence alone will result in a finding of an abuse of discretion, will be rejected by the courts and boards considering this question.

B. Material Breach

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22 See id. at 3.

23 See id. at 4.

24 See id. at 10.

25 Id. at 11.

26 See id. at 8-9.

27 See id.

28 See id. at 9-10.

29 See id. at 6.

A performance bond surety on a Government contract cannot be held liable for the default of its principal where the Government materially breaches the contract.[30] For example, federal courts will not affirm the default termination of a construction contract where the owner materially breaches its payment obligation to the principal.[31] Significant in this regard, in Nexus Constr. Co., the Armed Services Board of Contract Appeals held that the Government's failure to make adequate payments to a contractor constituted a material breach of the contract which excused further performance of work by the contractor.[32] Similarly, in Roel Partnership v. Amwest Surety Ins. Co.,[33] the court held that an owner's failure to pay a contractor two thirds of the progress payments due released the contractor's surety from liability under a performance bond.

In addition to breaching a construction contract materially by failing to make adequate payments to a contractor, the Government's issuance of defective contract specifications has also been held to constitute a material breach releasing a surety from liability.[34]

Likewise, courts and boards will not affirm the Government's termination of a contract for default where the Government fundamentally changes the nature of contract work.[35] Although a surety that issues a bond on a contract containing a "changes clause" impliedly consents to subsequent changes made within the scope of the contract, the surety is released from its obligations where the underlying contract is fundamentally modified by the owner.[36]

Principals and their sureties have utilized the "fundamental change" or "cardinal change" defense to defeat default termination decisions in numerous different cases. For example, in Employers Ins. Of Wasau v. Construction Management Eng'rs. Inc.,[37] the court ruled that a surety was relieved of its performance bond obligations on a subcontract for the construction of a building where the principal entered into a subsequent agreement to perform more than twice the construction work that was anticipated by the original subcontract. Similarly, in Peter Kiewit Sons' Co. v. Summit Constr.,[38] the Court of Appeals for the Eighth Circuit held that the

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[30] See Nexus Constr. Co., ASBCA No. 31070, 91-3 BCA ¶ 24,303 (1991). The surety's liability under a performance bond is coextensive with its principal. See Stearns, supra note 7.

[31] See id.

[32] See id.; see also, Wolfe Constr. Co., ENGBCA Nos. 3607, 3608, 3609, 84-3 BCA ¶ 17,701 (1984).

[33] See 685 N.Y. S.2d 832 (N.Y.A.D. 1999).

[34] See Pilcher, Inc., ASBCA No. 13391, 70-1 BCA ¶ 8,331 (1970); see generally Ballenger Corp., DOT CAB Nos. 74-32 et al., 84-1 BCA ¶ 16,973 (1984)(ruling that a termination for default was improper where a contractor was entitled to time extensions sufficient to excuse delays in contract performance).

[35] See United States Fidelity and Guaranty Co. v. United States, 298 F.365, 368 (D.C. Cir. 1924).

[36] See Massachusetts Bonding & Ins. Co. v. John R. Thompson Co., 88 F.2d 825,829 (8th Cir. 1937).

[37] See 377 S.E.2d 119, 122 (S.C. Ct. App. 1989). Material alterations in a bonded contract have similarly resulted in a discharge of surety liability where the owner changed the height of a building. See Barrett-Hicks Co. v. Glas, 99 P.856 (Cal. App. 1908); Lamson v. Maryland Cas. Co., 194 N.W. 70 (Iowa 1923).

[38] See 422 F.2d 242, 255 (8th Cir. 1969)

prime contractor's change to a bonded excavation subcontract exceeded the scope of the subcontract where the changes significantly increased the volume of contract work performed and tripled the cost of the subcontract.

C. Substantial Performance

Numerous state and federal courts have ruled that where a bonded contract is substantially complete, a material breach of the contract is not possible. Accordingly, the owner of the construction project is not permitted to default terminate the contract.[39]

D. Inadequate Notice

The surety may also assert defenses to a default termination based on the obligee's failure to comply with the procedural requirements for defaulting a contract. For example, an obligee's failure to provide a contractor with notice of default or with an opportunity to "cure" a default will likely render any subsequent default improper where such procedures are required by contract, bond or regulation.

Depending on the type of contract in question, the Government's failure to provide a contractor with notice of default before terminating a contract for default may render the termination invalid. For example, the Government is required to provide a contractor with notice of default and with an opportunity to cure a default in all Government supply contracts and non-construction service contracts.[40] Consequently, if the Government terminates a contractor for default on a general service or supply contract without affording the contractor an opportunity to cure its default, the termination for default will be converted into a termination for convenience.[41] In contrast with supply and general service contracts, fixed-price construction contracts do not require the Government to provide a contractor with an opportunity to cure its default on a contract.[42] However, the general FAR provisions governing default termination procedure instruct that, before terminating a contract for default, a contracting officer should provide the contractor with an opportunity to "show cause" as to why the contract should not be terminated.[43] As a result, many Government construction contracts commonly afford a contractor the right to receive a cure notice before a contract is default terminated.

Failure to provide notice to the surety may also relieve the surety from its obligations under the bond. For example, the Illinois Court of Appeals recently ruled a surety was

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[39] See Worthington Corp. v. Consolidated Aluminum Corp., 544 F.2d 227, 230-31 (5th Cir. 1976); Husar Indus., Inc. v. A. Huber & Sons, Inc., 674 S.W. 2d 565 (Mo. Ct. App. 1984); Dittmer v. Nokleberg, 219 N.W. 2d 201, 206 (N.D. 1974). Relatedly, courts typically hold that bonded construction work is complete where the object constructed can be utilized for its intended purposes. See, e.g., Dittmer, 219 N.W.2d at 206.

[40] See FAR §52.249-8(a)(2).

[41] See Kisco Co. v. United States, 610 F.2d 742, 752 (Ct. Cl. 1979); Composite Laminators, Inc. v. United States, 27 Fed. Cl. 310, 322 (1992).

[42] See FAR §52.249-10(a).

[43] See FAR §49.402-3(e)(1).

discharged from its obligations under a performance bond where the terms of the bond required the owner of a construction project to give the surety seven days notice of its principal's default and where the owner defaulted the surety's principal without providing the surety with such notice.[44] The Illinois Court of Appeals reasoned that the owner's failure to afford the surety adequate notice of default constituted a material breach of the bond because the surety was not given an opportunity to mitigate its liability.[45] Accordingly, the court concluded that the surety's bonds were invalid.[46]

IV. DEFENSES TO SPECIFIC TYPES OF DEFAULT TERMINATION

Although default termination defenses such as "abuse of discretion," "material breach'" "substantial performance," and "inadequate notice" will likely apply across a broad range of factual settings, many other defenses to a default termination decision will prove particularly useful in cases where the Government defaults a contractor for a specific set of reasons. This section will examine viable defenses to default decisions where the Government terminates a contract for 1) failure to make progress in the contract work, 2) anticipatory repudiation, and 3) defective work.

A. Default for Failure to Make Progress

1. Waiver

The Government's right to terminate a contract for default may be waived when the Government encourages a contractor to complete work after the contract completion date has passed and the Government fails to set a new completion date.[47] Specifically, the Government waives its right to terminate a contract for default if : 1) the Government fails to terminate a contract within a reasonable time after default under circumstances indicating forbearance, and 2) a contractor relies on the Government's failure to terminate the contract and continues performance with the Government's express or implied consent.[48] If the Government fails to set a new prospective completion date, the contractor will not be found guilty of failing to make progress as there is no enforceable schedule by which to measure such progress.[49]

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[44] See Dragon Constr. Inc. v. Parkway Bank & Trust, 678 N.E. 2d 55 (Ill. App. Ct. 1997).

[45] See id. at 58.

[46] See id.

[47] See Sun Cal, Inc. v. United States, 21 Cl. Ct. 31 (1990) ; Milo Werner Co., IBCA No. 1202-7-78, 82-1 BCA ¶15,698 (1982). See also Martin J. Simko Constr., Inc. v. United States, 11 Cl. Ct. 257 (1986), vacated, 852 F. 2d 540 (Fed. Cir. 1988) (Government waived its right to terminate a construction contractor for default when it encouraged the contractor to continue its performance beyond an extended completion date without establishing a new date).

[48] See DeVito v. United States, 413 F.2d 1147, 1154 (Ct. Cl. 1969).

[49] See Electronics of Austin, ASBCA No. 24912, 86-3 BCA 119,307 (1986).

The logic underlying these decisions is that the Government's conduct demonstrates that time was not of the essence in such contracts.[50] Where the Government fails to set a new completion date, it necessarily follows that the contractor cannot possibly "fail to progress" the work because contract time is no longer of the essence. Succinctly presenting the rationale underlying the waiver rule, the Armed Services Board of Contract Appeals in Electronics of Austin stated:

> Without a binding performance schedule [the contractor] could not be in default of meeting such non-existent schedule. [It] could not be guilty of failing to deliver items or to perform services within a specified time when there was no such specified time. Likewise [it] could not be guilty of failing to progress toward an enforceable schedule in the absence of such a schedule. Under such circumstances we hold that [the contractor] was not in default, that Navy lacked the right to terminate for default; and that the default termination was improper.[51]

Accordingly, once the Government has waived the performance schedule, a contract cannot be terminated for default if no new schedule is set.[52]

2. Reasonable Likelihood of Completion Defense

In cases where the Government default terminates a contractor for failure to make adequate progress on project work, the Government must support its decision with evidence showing that the contractor had no reasonable likelihood of completing contract work by the required completion date.[53] For example, in American Sheet Metal Corp., the Government default terminated a roofing contract after concluding that the contractor was incapable of completing its work by the contract completion date.[54] Significantly, the Government based its termination decision on the roofer's established rate of production on the contract.[55] Notwithstanding the Government's showing, the board ruled that the termination was improper because the Government failed to consider whether the contractor could have completed the contract on time under an accelerated work schedule.[56]

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[50] See DeVito v. United States, 188 Ct. Cl. 979, 413 F.2d 1147 (1969).

[51] Electronics of Austin, ASBCA No. 24912, 86-3 BCA 119,307 (1986).

[52] See SIPCO Services & Marine, Inc. v. United States, 41 Fed. Cl. 196, 218-19 (1998); Motorola Computer Systems, Inc., ASBCA No. 26794, 87-3 BCA ¶20,032 (1987). Notably, even in the absence of a Government waiver, an inordinate Government-caused completion delay may constitute a "cardinal change" allowing the surety to avoid performance bond liability. See State v. Preferred Accident Ins. Co., 149 So.2d 632, 647 (La. App. 1963).

[53] See American Sheet Metal Corp. v. General Services Admin., GSBCA No. 14066 (March 31, 1999).

[54] See id.

[55] See id.

[56] See id.

Likewise, in Monaco Enterp. v. United States,[57] the Court of Appeals for the Federal Circuit converted a default termination of a contractor, who was in technical default on its contract, into a termination for convenience where the Government based its termination decision solely on its determination that the contractor could not complete work within the time specified in the contract. In so holding, the Federal Circuit reasoned that further factual findings were essential when default terminating a contract prior to the scheduled completion date:

> Particularly where a contractor is terminated in advance of the contract performance date, the contracting officer must not only have solid evidence that timely performance is beyond the contractor's reach but also that the contractor could not complete the work. . . If the contractor intends and is able to continue performance, albeit untimely, the penalty of delay damages is available and should be considered as an alternative to the penalty of termination for default (emphasis added).[58]

The Federal Circuit further emphasized that the Government did not comply with FAR regulations because the Government failed to demonstrate that the contractor was unable or unwilling to perform, that the work was urgently needed, or that a substitute contractor was likely to complete the project more expeditiously than the contractor.[59] Accordingly, the Court of Appeals concluded that the Government's termination decision was improper.[60]

B. Default for Anticipatory Repudiation

When considering its possible defenses to a default termination, a surety must be mindful that the Government bears a heavy burden in justifying its actions on the basis of a principal's repudiation of a contract. To sustain a default for anticipatory repudiation, the Government must prove that the principal definitely and unequivocally manifested an intent not to render the promised performance.[61] Accordingly, the Government must show that the principal expressed a "positive, unconditional, and unequivocal declaration of fixed purpose not to perform the contract in any event or at any time."[62]

In Therm-Air Manufacturing Co., Inc.,[63] the contractor began experiencing financial difficulties purportedly because the Government owed it money on a claim for equitable adjustment. The contractor wrote the Government and advised that "we have been

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57 See 907 F.2d 159 (Fed. Cir. 1990)

58 Id.

59 See id.; see also FAR § 49.402-3(f).

60 See id.

61 See Milo Werner Co., IBCA No. 1202-78, 82-1 BCA ¶15,698 (1982)

62 Id. at 77,641, citing Dingley v. Oler, 117 U.S. 490, 503 (1886).

63 See NASA BCA Nos.180-2, 1280-21, 82-2 BCA ¶15,881 (1982).

forced to suspend manufacturing operations at this facility."[64] The Government terminated the contractor for default stating that the contractor failed to timely complete the work and had repudiated the contract. The Board concluded that the contractor's "suspension" of work was not a definite and unconditional statement that performance would not take place.[65] Further, the Board concluded that even though "Appellant disabled itself from performance since its president had resigned, the production manager had left, its vice-president was on extended vacation, it could not meet the payroll and virtually the entire direct labor force had been laid off" there was no unequivocal finding that the contractor did not have the ability to perform.[66] Moreover, the Board concluded that the suspension letter was not a clear and unmistakable admission that the Appellant had a critical and irreversible financial problem and that it would not be able to resume manufacturing operations even if it received an immediate and substantial cash infusion.[67] Nonetheless, the Board held that insolvency is not in itself a breach for which to justify a default action.[68] Accordingly, the Board found that the contractor did not repudiate the contract but was actively trying to solve its financial problem so it could resume its manufacturing operations. Thus, the default termination was converted to a termination for the convenience of the Government.[69]

Similarly, in Milo Werner Co.,[70] the Board found that the Government waived its right to terminate a construction contract for default. The Government argued that the contractor had repudiated the contract by abandoning its work.[71] The week prior to the termination, the contractor decided to cease work until it could make arrangements for additional funding.[72] The Board concluded that there was no evidence of either abandonment or anticipatory repudiation by the contractor.[73] The Board noted that, at most, the record showed that the contractor had temporarily discontinued performance.[74] Additionally, there was also no evidence that additional funds were impossible to obtain.[75] Thus, there existed no

[64] See id. at 78,763.

[65] See id. at 78,767.

[66] See id.

[67] See id. at 78,768.

[68] See id.; but see Hubsch Industrieanlagen Spezialbu v. United States, 116 F.3d 1497, 1497 (Fed. Cir. 1997)(finding an anticipatory repudiation where a contractor asserted that it could not complete a construction project without additional time and funds and where the Government had determined that the contractor was either unwilling or unable to complete the project).

[69] See id.

[70] IBCA No. 1202-7-78 82-1 BCA ¶15,698 (1982),

[71] See id.

[72] See id.

[73] See id. at 77,641.

[74] See id.

[75] See id.

abandonment or anticipatory repudiation and the default termination was converted to one for the convenience of the Government.[76]

C. Default for Defective Work

In many jurisdictions, a surety may assert an affirmative defense of waiver to a default based on defective work in cases where an owner accepts such work before default terminating the contract.[77] The Government may "constructively waive" the right to require a contractor's compliance with contract specifications where the Government administers the contract "in such a way as to give a reasonably intelligent and alert opposite party the impression that a contract requirement has been suspended or waived."[78] In order to prove that the Government has constructively waived specifications in a contract, a plaintiff must establish that: 1) the Government had notice that the contractor's work differed from contract requirements, 2) the Government's action or inaction indicated that the contractor's non-conformance with contract specifications was acceptable, 3) the contractor relied on the Government's action or inaction, and 4) it would be unfair to permit the Government to retract the waiver.[79]

V. DEFENSES LIMITING LIABILITY FOR PRINCIPAL'S DEFAULT

Even in instances where the obligee's default termination is proper, the surety maintains an arsenal of potential defenses which may significantly limit its liability under the bond.

A. Impairment of Suretyship

In addition to the many principal-based defenses that a surety may raise in a default termination proceeding, the surety may further assert several independent defenses which arise from the nature of its performance bond obligation. Under established precedent, where an obligee to a bond increases a surety's exposure to risk without the surety's consent, the surety is discharged from its bond obligations "pro tanto," which means to the extent it is injured by the modification.[80] This surety defense is best presented under the impairment of suretyship doctrine. The impairment of suretyship doctrine applies where an obligee alters a surety's risks under a bond and, therefore, gives rise to a concomitant discharge in the surety's obligation.[81] An act that increases a surety's risk of loss by increasing its cost of performance constitutes an impairment of suretyship status.[82]

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76 See id.

77 See Murphy v. State expel Jackson School Twp., 168 N.E. 875 (Ind. App. 1929).

78 Gresham & Co. v. United States, 470 F. 2d 542, 555 (Ct. Cl. 1972).

79 See Hannon Elec. Co. v. United States, 31 Fed. Cl. 135, 147 (1994).

80 See National Surety Corp. v. United States, 118 F.3d 1542,1544 (Fed. Cir. 1997).

81 See Restatement (Third) of Suretyship and Guaranty §37 (1996) [hereinafter Restatement (3d)].

82 See id.

Section 37 of the Restatement (3d) sets forth two general instances where an obligee's conduct gives rise to an impairment of suretyship status defense. First, Section 37 notes that an obligee impairs a surety's status where the obligee modifies the risks imposed on the surety by fundamentally altering the obligee's contract with the principal.[83] Second, Section 37 provides that an obligee impairs a surety's status where the obligee limits the surety's recourse against its principal.[84] The Restatement further clarifies that an act or omission by an obligee impairs a surety's recourse where, for example, an obligee's action or inaction reduces the value of a surety's collateral in an underlying obligation or limits a surety's right of subrogation.[85] In fact, in the explanatory notes, the drafters of the Restatement specifically provide that an obligee's improper management of unpaid funds on a construction contract constitutes an impairment of collateral.[86]

Notably, if the facts of a particular case do not fall squarely within the categories presented, the impairment of suretyship doctrine may still apply. In defining what precise acts constitute an impairment of recourse and, hence, an impairment of suretyship status, the drafters of the Restatement recognized the futility in attempting to itemize all acts covered by the doctrine.[87] Consequently, the Restatement instructs that it is imperative to scrutinize <u>the result</u> of an obligee's action, and not the action itself, in determining whether or not an obligee's conduct in a given case constitutes an actionable defense of surety discharge:

> [A]cts of the obligee may impair . . . the [surety's] right of restitution or subrogation <u>in ways that do not fit precisely within one of these categories</u>. <u>Nonetheless, it is the fact of such impairment, and not the particular act bringing it about, that gives rise to the [surety's] loss and resulting discharge. Accordingly, this section provides that any act resulting in such impairment gives rise to the concomitant discharge of the [surety]</u> (emphasis added).[88]

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[83] <u>See</u> <u>id.</u>

[84] <u>See</u> <u>id.</u>

[85] The Restatement sets forth additional actions by the obligee which may result in an impairment of a surety's recourse.

[86] <u>See</u> Restatement (3d) §42, illus. 3 (1996); <u>see</u> <u>also</u> <u>U.S. Continental Casualty Co.</u>, 512 F.2d 475 (5th Cir. 1975)(releasing a performance bond surety from its bond obligations to the extent the surety was injured by the Governments improper disbursement of contract funds after terminating the surety's principal for default).

In assessing its mitigation options, the surety must also be mindful that in instances of overpayment, a surety can seek recompense under a theory of Government abuse of discretion. <u>Ransom v. United States</u>, 900 F.2d 242 (Fed. Cir. 1990). The application of the abuse of discretion doctrine, however, depends on the surety's forwarding of notice to the Government of its principal's default in its obligation prior to the release of funds. Significantly, the impairment of suretyship doctrine <u>does</u> <u>not</u> require the surety's provision of notice to the Government prior to the release of payment.

[87] <u>See</u> Restatement (3d) §44 cmt. a. (1996).

[88] <u>Id.</u>

Notwithstanding the Third Restatement's recent adoption in 1996, the Court of Appeals for the Federal Circuit has already affirmed the Restatement's authority in disputes arising out of performance bonds on Government Contracts.[89] In National Surety Corp., the Court of Appeals for the Federal Circuit held that the Government was liable to National Surety Corporation ("National"), a surety which completed work on a construction project after its principal's default, for damages resulting from the Government's premature payment of contract retainage to National's principal.[90] In reaching its holding, the Court of Appeals affirmed the Restatement's observation that the "impairment of Suretyship" cases can not be neatly categorized. Specifically, the Court enlisted both a "modification of contract" rationale and an "impairment or recourse" analysis in arriving at its holding.[91] In concluding that the Government breached its duty "to consider the surety's interests in conjunction with other problems encountered in the administration of the contract," the Court emphasized that the Government had impaired the value of National's collateral and had, thereby, improperly limited National's subrogation rights.[92]

B. The Avoidable Consequence Doctrine

An alternative theory allowing a surety to protect its financial position in the completion of a bonded contract is the avoidable consequences doctrine. Under the avoidable consequences doctrine, a nonbreaching party on a contract must take reasonable steps to avoid incurring damages as a result of a contract breach and may not recover damages which could have been avoided by reasonable precautionary action on its part.[93]

The mitigation principle espoused in the avoidable consequences doctrine is uniformly applied through Government contract common law.[94] The Government possesses a duty under the FAR and under Government contract common law to either terminate a defaulting contractor or to secure performance of the contractor in an expeditious manner. Subpart 11.502 (c) of the FAR clearly delineates a contracting officer's duty to minimize the costly consequences of a liquidated damages clause in a breached Government contract before the contract has been terminated:

> The contracting officer shall take all reasonable steps to mitigate liquidated damages. If a liquidated damages clause is included in a contract and a basis for termination for default exists, the contracting officer should take appropriate action expeditiously to obtain performance by the contractor or to terminate the contract . . . Efficient

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[89] See National Surety Corp. v. United States, 118 F.3d 1542, 1544 (Fed. Cir. 1997).

[90] See id. at 1547.

[91] See id. at 1545-47; see also United States v. Duby, 201 F.2d 800 (9th Cir. 1952)(holding that where the obligee overpaid the surety's defaulted principal for work performed on a contract, the surety was released from its bond obligations pro tanto); Mergentine Corp. v. Washington M.T.A., 775 F.Supp 14 (D.D.C. 1991).

[92] See id. at 1546.

[93] See Cates v. Morgan Portable Bldg. Corp., 780 F.2d 683, 688 (7th Cir. 1985); see also Restatement (Second) Contracts §350.

[94] See Northeastern Penn. Shippers Co-Op Ass'n v. United States, 32 Fed Cl. 72, 78 (1994).

> administration of contracts containing a liquidated damages clause is imperative to prevent undue loss to defaulting contractors and to protect the interests of the Government (emphasis added).[95]

Applying this principle, the Armed Services Board of Contract Appeals has repeatedly ruled that the Government is not permitted to recover liquidated damages for its own delay in reprocuring a contract.[96]

C. Liquidated Damages Defenses: Contract Without Government Supervision

A liquidated damages clause in a Government contract is enforceable where the clause constitutes a reasonable estimation of the damages that the Government is likely to incur in the event the contract is breached.[97] Conversely, a liquidated damages clause that does not stipulate damages based on a reasonable estimate of actual losses is unenforceable, because such a change only functions to penalize a contractor for untimely performance.[98] Accordingly, the enforceability of a liquidated damages clause often depends upon whether or not the clause constitutes a penalty for delayed contract performance.

In evaluating whether or not a liquidated damages clause constitutes an unenforceable penalty, courts and boards have applied varying tests. Under the purely prospective test, courts and boards consider the reasonableness of the parties' expectations concerning potential damages at the time of contracting.[99] While the general rule of Federal Government contracts favors a prospective analysis, courts and boards determining the enforceability of liquidated damages provisions have also considered the amount of loss actually sustained on a contract to be an indicator of whether or not a liquidated damages in a contract constituted a penalty at the time the contract was drafted.[100] Relatedly, where a construction contract does not contemplate that the Government will inspect or supervise contract work on a daily basis and where other anticipated, time-related damages have not been itemized in the contract, a liquidated damages provision will be struck as an unenforceable penalty.

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[95] Again, if notice has been provided, the surety can alternatively cast this defense as a Government abuse of discretion. See Ohio Casualty Ins. Co. v. United States, 12 Cl. Ct. 590, 596 (1987). In such cases, the Government is liable to the defaulted contractor's performance bond surety for the additional completion costs that the surety sustains as a result of the Government's delayed termination. Additionally, after a contract is terminated the Government is required to mitigate its damages.

[96] See Arctic Corner, Inc., ASBCA 38075, 94-1 BCA ¶26, 317 (1994); Biehler Painting Co., ASBCA No. 18855, 76-1 BCA ¶11, 729 (1976). Similarly, under Subpart 49.402-6 of the FAR, when services on a contract are not completed after termination of the contract, the Government is obligated to repurchase the services "as soon as practicable." See, e.g., Ross & McDonald Contracting, ASBCA No. 38154, 94-1 BCA ¶26, 316 (1994).

[97] See Garden State Painting Co., ASBCA No. 22, 248, 78-2 BCA ¶13499, 46978 (1978).

[98] See id.

[99] See, e.g., Southwest Eng. v. United States, 341 F.2d 998 (8th Cir. 1965).

[100] See, e.g., Wise v. United States, 249 U.S. 361 (1919).

In Garden State Painting, the contractor ("Garden State") entered into a contract with the Government to paint the interior of a Government arsenal.[101] The painting contract contained a liquidated damages clause that assessed daily damages for each day that Garden State delayed in completing the contract. Following Garden State's delayed completion of its painting work, the Government withheld liquidated damages from its payments under the contract.[102]

Armed Services Procurement Regulations governing Garden State's contract required a liquidated damages clause to be based on the Government's estimated cost of inspection and superintendence for each day of delay in a contract's completion.[103] The regulations further provided that, if the Government anticipated sustaining non-supervisory losses due to a contractor's delay in completing contract work, the Government was required to itemize such losses in a contract's liquidated damages clause.[104] Importantly, the Government did not itemize non-supervisory, prospective, Government delay damages in the contract's liquidated damages clause.[105] Furthermore, the painting contract did not require the Government to either inspect or supervise Garden State's work on a daily basis.[106] Consequently, the Armed Services Board of Contract Appeals held that the liquidated damages clause in the Government's contract with Garden State did not reflect a reasonable forecast of the Government's potential damages under the painting contract.[107] In so holding, the Board reasoned that federal regulations relating to liquidated damages assume that the Government will incur "a daily cost of inspection and superintendence (no emphasis added)" following a breach of a construction contract.[108] Accordingly, the Board ruled that the liquidated damages clause in the painting contract was "logically inapplicable" to Garden State's work and, therefore, constituted an unenforceable penalty.[109]

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[101] Garden State Painting Co., Inc., ASBCA No. 22248, 78-2 BCA ¶13, 499 at 46,978 (1978).

[102] See id. at 46973.

[103] See id. FAR §11.503(b), similarly, provides that a liquidated damages clause in a Government contract should be based on the Government's estimated cost of inspection and superintendence for each day of delay in a contract's completion. Section 11.503(b) further mandates that, whenever the Government anticipates sustaining non-supervisory losses due to a contractor's delay in completing contract work, the Government is required to itemize such losses in a contract's liquidated damages clause.

[104] See id.

[105] See id.

[106] See id. at 46,977.

[107] See id. at 46,978.

[108] Id. at 46,977.

[109] Id. at 46,978; see JEM Dev. Corp., ASBCA No. 42, 645, 92-1 BCA ¶24, 428 at 20,818 (1992) (finding a liquidated damages clause unenforceable where the contract containing the clause only required the Government to inspect the contractor's work on a periodic basis); Engineered Elec., ENGBCA No. 4944, 84-2 BCA ¶ 17, 316 at 100404-06 (1984).

Finally, in defending against the assessment of liquidated damages, a surety should consider whether or not a liquidated damages provision was properly included in a contract. Although the Government is required to insert a liquidated damages clause into all Department of Defense construction contracts exceeding $500,000, except cost-plus-fixed-fee contracts or contracts where the contractor cannot control the pace of the work,[110] the Federal Acquisition Regulations limit the Government's use of liquidated damages clauses in most Government contracts. Specifically, FAR § 11.502 provides that a liquidated damages clause should be inserted in a contract:

> only when both (1) the time of delivery or performance is such an important factor in the award of the contract that the Government may reasonably expect to suffer damage if the delivery or performance is delinquent, and (2) the extent or amount of such damage would be difficult or impossible to ascertain or prove. . . (emphasis added)

VI. THE SURETY'S ARSENAL: DEFENSE CHECKLIST

In assessing its exposure to the Government arising from a default termination of its principal, a performance bond surety on a construction project should review its specific and general defenses as well as its avenues for limiting its potential liability. First, the surety should carefully evaluate the specific bases for the default and should examine whether or not it may overturn the default by advancing specific defenses to the type of default at issue. Second, the surety should assess whether or not it may assert any generally applicable defenses to the default termination. Third, assuming it cannot maintain a viable defense to overturn the default, the surety should examine whether or not it benefits from any mitigation defenses which limit the surety's liability under the performance bond.

A. The Fact Specific Defenses

1. Defeating a Default for Failure to Make Progress

In cases where the Government has default terminated a surety's principal for failure to make progress, the surety should contend, to the extent possible, that the Government has waived its right to impose such a sanction. Specifically, the surety should attempt to develop facts demonstrating that its principal performed work beyond a contract's completion date and that it performed such work in reasonable reliance on the Government's failure to terminate the contract. Moreover, to the extent that it does not benefit from a "waiver" defense, a surety may nonetheless be able to overturn a default termination decision to the extent that the Government fails to prove either that there was "no reasonable likelihood" that a contractor could have accelerated the work and completed the contract by the scheduled date or that the contractor was incapable of completing the contract under any circumstances at any time.

2. Defeating a Default for Anticipatory Repudiation

[110] DoD FAR § 211.504.

In cases where the Government has concluded that a contractor has repudiated a construction contract and, consequently, default terminates the contractor, the contractor's surety should attentively scrutinize the circumstances of the alleged repudiation. To the extent possible, the surety should argue that its principal did not manifest an "irreversible and unequivocal intent" not to perform the contract "in any event or at any time." If the surety can make this showing, it may likely succeed in reversing the default termination decision.

3. Defeating a Default for Defective Work

In cases where the Government has terminated a contractor for the alleged submission of defective work, the contractor's performance bond surety should determine whether the Government accepted the contractor's work with knowledge of its noncompliance before it terminated the contractor for default. To the extent that it finds that the Government terminated its principal for defective work after knowingly accepting the same, the surety can likely overturn the Government's termination decision. Consistently, to the extent it can show that the Government "constructively waived" contract specifications, a surety can also overturn the default for defective work that relates to the waived specifications.

B. General Defenses

1. Abuse of Discretion

A performance bond surety examining its principal's default termination should emphasize, to the extent possible, that the Government's decision to terminate a contract for default was improper as it was motivated by and premised upon outside factors unrelated to the contractor's performance. Under the McDonell Douglas standard, the surety should attentively review the factual findings underlying a default termination to verify whether a sufficient nexus exists between the contracting officer's decision to terminate the contract and the contractor's performance of the contract. In order to fortify its McDonnell Douglas arguments, a surety should, to the extent possible, develop facts showing that the Government failed to comply with FAR 49.402-3(f) in reaching its termination decision. Finally, the United States Fidelity and Guaranty standard instructs that a surety should attempt to argue that a contracting officer who terminated a contract for default: 1) acted in bad faith; 2) lacked a reasonable basis for its decision; 3) exceeded his authority; and 4) violated a statute or regulation. To the extent that a surety can establish that a contracting officer's default termination decision was unrelated to the contractor's performance failures or inconsistent with the FAR or the United States Fidelity Guaranty standard, the surety may likely establish that the decision constituted an "abuse of discretion," and the default termination must be converted into a termination for convenience.

2. Material Breach

A performance bond surety that has received notice of its principal's default on a construction contract should attempt to develop facts demonstrating that the Government materially breached the underlying contract. For example, the surety should try to establish that the Government issued defective contract specifications or failed to honor its payment obligations under the contract. Moreover, if the Government ordered substantial changes to the contract prior to terminating the contract for default, a surety should consider arguing that

such changes fundamentally altered the contract. To the extent that the surety's investigation reveals the Government's breach of any of the above obligations, the surety can likely benefit from a "material breach" defense warranting a conversion of the Government's default termination to a termination for convenience.

3. Substantial Performance

Upon receipt of notice that its principal has been terminated for default on a construction project, a performance bond surety should consider arguing that the construction project was fit for its intended use or "substantially complete" at the time the Government terminated the contractor. If the surety can make such a showing, it can likely convert the termination for default into a termination for convenience.

4. Inadequate Notice

Under the standard set forth above, upon discovering that its principal's contract has been terminated for default, a performance bond surety should determine whether the contract owner complied with the notice provisions of the FAR, the contract and/or the performance bond agreement. To the extent that a surety finds that a contract owner has breached the notice requirements of the FAR, the contract and/or performance bond, it can likely avoid liability under the performance bond.

C. Liability Limiting Defenses

1. Impairment of Suretyship Status

Under the impairment of suretyship doctrine, a performance bond surety for a defaulted principal may limit its liability under the bond to the extent that the Government paid the surety's principal an excess amount of contract funds during the course of the project. In such cases, a surety should assert that the Government increased the surety's risk under the performance bond by impairing the surety's collateral. If the surety can show that the Government impaired the surety's collateral on the project, a court will likely hold the Government liable to the surety for the injury resulting from the Government's improper payment.

2. Avoidable Consequences

Under the avoidable consequences doctrine, a performance bond surety for a defaulted principal may limit its liability under its bond to the extent that the Government unreasonably delayed in its decision to terminate and reprocure a contract. Consequently, where the Government fails to take reasonable precautions to mitigate the damages flowing from the contractor's breach and withholds liquidated damages, the surety should contend that the Government failed to consider the surety's interests in administering the contract and unreasonably delayed in terminating and reprocuring the contract. To the extent that the surety can make such a showing, the Government is likely to be found liable for the damage that results from the Government's failure to consider the surety's interests.

3. Liquidated Damages Defenses: Contract Not Requiring Supervision

In determining whether liquidated damages may be properly assessed under a contract, a surety should first determine whether timely delivery was an important factor in the contract and whether the Government anticipated difficulty in proving delay damages under the contract. To the extent time is not a critical factor under the contract and delay damages can be proven with little difficulty, a surety may argue that the Government should not have included a liquidated damages clause in the contract. After analyzing whether a liquidated damages clause was properly included in a contract, a surety should further review whether the liquidated damages clause constitutes an unenforceable penalty by determining whether the clause reflects a reasonable estimation of damages at the time the contract was formed, or alternatively, are grossly disproportionate to the actual damages sustained.

Further, a performance bond surety that seeks the remission of liquidated damages should determine whether or not the Government will sustain daily supervisory costs as a result of the principal's breach. In many maintenance contracts, the Government will not incur regular supervisory costs as a result of a contractor's breach. If the surety discovers that the Government did not expect that the principal's breach would cause the Government to incur regular, supervisory costs, the surety should then examine whether or not the liquidated damages clause in the terminated contract itemized the prospective non-supervisory delay damages that the Government anticipated incurring in the event the contract was breached. If the contract failed to make such itemizations, a court will likely hold that the liquidated damages clause in the contract does not constitute a reasonable forecast of damages and is, hence, an unenforceable penalty.