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**CHANGE ORDERS AND THE PENAL SUM OF THE
PERFORMANCE BOND**

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Change Orders and the Penal Sum of the Performance Bond

Sureties are occasionally faced with the question of whether the penal sums of their performance bonds fluctuate as the underlying contract price increases or decreases due to change orders. The immediate inclination may be to assume that contract price changes have a direct impact on the penal sum of a bond. After all, was not the penal sum of the bond originally based upon the contract price or a percentage thereof? And does not the bond obligee argue that it paid additional bond premium to the principal in additive change orders? However, unless the language of the bond unambiguously allows for a bond penal sum increase as a result of additive change orders or the surety executes a new bond or a rider to the original bond, the penal sum of the bond remains constant despite changes to the underlying contract price.^a

In the AIA Document A311 Performance Bond, the penal sum of the bond and its effect are stated as follows:

Principal . . . and . . . Surety . . . are held and firmly bound unto . . . [the] Obligee . . . in the amount of _____ Dollars. . . . Surety may promptly remedy the default [of its Principal], or shall promptly 1) Complete the Contract in accordance with its terms and conditions, or 2) Obtain a bid or bids for completing the Contract . . . or . . . arrange for a contract between . . . [the completion bidder and the Obligee], and make available as Work progresses . . . sufficient funds to pay the cost of completion less the balance of the contract price; **but not exceeding . . . the amount set forth in the first paragraph hereof.** (emphasis added.)^b

In the AIA Document A312 Performance Bond, after citing the bond “Amount” in the preamble language of the bond, the limitation of the Surety’s liability is stated as follows:

To the limit of the amount of this Bond, but subject to commitment by the Owner of the Balance of the Contract Price to mitigation of costs and damages on the Construction Contract, the Surety is obligated without duplication for [three classifications of costs and expenses including but not limited to additional legal, design professional and delay damages]. (emphasis added.)^c

There are numerous cases that hold that a surety’s liability is limited by the penal sum of

^a For ease of discussion, this paper will address additive change orders and their effect on the bond penal sum. It is assumed that deductive change orders would follow the same reasoning.

^b AIA Document A311 (1970). Note, however, that there have been occasions where a surety has been adjudged liable for costs and damages in excess of the penal sum of its bond to cover interest, attorneys’ fees and punitive/exemplary damages.

^c AIA Document A312 (1984).

the bond.^d These cases, however, do not address the issue of whether the limitation of a surety's exposure increases or decreases as change orders to the underlying contract are executed. The natural tendency is to assume that the penal sum of a bond increases as change orders increase the price of the underlying contract. First, the underlying contract is typically incorporated by reference into the bond and made a part thereof. Furthermore, the surety usually waives notice of any changes, alterations, additions, and other modifications of the contract incorporated by reference into the bond and may even consent to changes in the language of the bond. Lastly, the surety customarily charges an additional premium to its principal at the end of a project when the contract price increases during the project due to change orders. (Conversely, a surety may refund some premium to the principal in cases where deductive change orders reduce the contract price.)^e The principal may even break down its change order price to the obligee to include a provision for the increased bond price (usually 1% of the change order price).

Nevertheless, the penal sum bond exposure of a surety should not be confused by issues relating to the calculation of the bond premium. Bond premiums are calculated based on the price of a contract, not the penal sum of a bond. The penal sum of a bond is often the same as the underlying contract price, but it can also be a percentage of the contract price (e.g. 50%). Even where the penal sum of a bond is less than the contract price, the premium charged for the bond is based upon the price of the contract. The reason for this is because the premium is a reflection of the risk assumed by the surety in issuing a bond on behalf of the principal. As the contract price increases, the potential for exposure to loss by the surety increases and the surety should be compensated for this additional exposure to loss by charging additional premium. Stated another way, as the contract price increases and/or the principal's time of performance is extended, there is an increased risk of a claim being made against the bond. Even though the limit of the surety's liability

^d E.g., See Board of County Supervisors of Prince William County v. Sie-Gray Developers, Inc., 34 S.E.2d 542, 546 (Va. 1985) (damage recovery of an obligee is limited to the reasonable costs of completion, not to exceed the face amount of the bond); Iowa State Commerce Commission v. IGF Insurance Co., 309 N.W.2d 445 (Ia. 1981) (surety is usually only liable to proper claimants up to the face amount of the bond); Marshall Contractors, Inc. v. Peerless Insurance Co., 827 F. Supp. 91, 94 (D.R.I. 1993) (the balance of the subcontract price is credited against the cost of completing the work and the surety's liability is limited to the amount of the bond); Morse/Diesel, Inc. v. Trinity Industries, Inc., 875 F.Supp. 165, 176 (S.D.N.Y. 1994) (surety's liability capped at the amount of its bond).

^e A surety company's pricing of contract surety bonds is based on its bond rate structure that is typically based upon the rules and rate guidelines promulgated by the Surety Association of America ("SAA"). The SAA's Rate Manual regarding the pricing of contract surety bonds reads as follows:

The contract price on which premium is computed means the whole sum of money or other reimbursement which has passed from the owner to the contractor when final settlement between the two has been made (excluding any bonus for "time", [sic] and not deducting any penalty for "time"), or the entire dollar value of work for which the contractor is responsible, whichever is higher. If this sum is different from the original estimate, premium must be adjusted accordingly; either by refund of part of the original premium by the surety if the original estimate was larger than the actual contract price; or by payment of additional premium by the contractor if the original estimate was smaller than the actual contract price.

Surety Association of America, Rate Manual of Fidelity, Forgery and Surety Bonds, page C-7 (Revised July 15, 1977).

remains constant, its potential exposure to and risk of loss is heightened when a higher priced contract is extended over a longer period of time than was originally planned. The surety is entitled to additional premium because it is placed at a greater risk of loss in these circumstances.

Although the bond follows the contract and often incorporates the underlying contract into the bond by reference, the bond has its own terms and conditions independent from the contract. One of these independent terms and conditions is the penal sum limit of the bond. The seminal case that discusses the difference between the penal sum of the performance bond and the increases in the underlying contract price is In re Technology for Energy.^f (“Technology.”) Bechtel Engineering Co. (“Bechtel”) and Public Service Electric & Gas Co. (“Public Service”) entered into two purchase orders with Technology for Energy Corp. (“TEC”) in which TEC agreed to build a radiation monitoring system for a nuclear power plant that Bechtel and Public Service were building in New Jersey. American Insurance Company (i.e. Fireman’s Fund Insurance Co.) issued a combination payment and performance bond for each of the two purchase orders. The penal sums of both bonds totaled approximately \$3,800,000. Change orders to the purchase orders increased the combined contract prices to approximately \$6,900,000. The bonds waived notice of changes in the contracts and provided that changes would not release American Insurance from liability under the bonds. Such a significant contract price increase raises the cardinal change issue which was addressed but not resolved in the Technology case.

Using the Statute of Frauds as the primary basis for its reasoning, the court wrote an eloquent opinion in holding that the penal sums of the surety’s bonds did not increase despite increases in the underlying contract prices. An example of a Statute of Frauds provision can be found in Connecticut General Statutes §52-550 (a) which states that:

No civil action may be maintained in the following cases unless the agreement, or a memorandum of the agreement, is made in writing and signed by the party, or the agent of the party, to be charged . . . (2) against any person upon a special promise to answer for the debt, default or miscarriage of another . . .

Basically, the Statute of Frauds requires there to be a written instrument before a promise by one party to answer for the debt, default or miscarriage of another can be enforced. As an extension of this reasoning, the Statute of Frauds further requires that any material change to the written instrument must also be in writing. The Technology court found that the dollar limit of the surety’s liability was a key part of the surety’s promise and that any increase in that limit would be a material change in the bond. Therefore, the Statute of Frauds requires an additional writing signed by the surety as a prerequisite to an increase in the penal sum of the bond. This additional writing can be in the form of a new bond or a rider to the existing bond signed by the surety. An exception to this requirement is if the surety alters the bond form to allow the penal sum of the bond to increase automatically with contract changes.⁹ If the bond were thus modified, it would unambiguously state that

^f 140 B.R. 214 (Bkrcty.E.D.Tenn. 1992).

⁹ An example of such bond language is the following: “If the contract price increases by the issuance of change orders, the amount specified in this bond shall increase by the same amount.”

the penal sum of the bond increases as the contract price increases due to change orders. Otherwise, the penal sum change must be in writing.

There is some precedent for a contrary result where the underlying contract and/or the owner's solicitation documents arguably place the surety on notice that the penal sum of its bond is meant to increase with contract price increases. A surety may find itself subject to an increased penal sum bond risk in such instances, particularly where a court finds that the surety's actions are not consistent with limiting its bond liability. In United States ex rel. B & M Roofing v. AKM Associates, Inc.^h ("B & M Roofing"), the Court denied Amwest's Summary Judgment Motion regarding the limitation of its bond liability and found that it could be liable for payment bond claims in excess of the penal sum of Amwest's bond. The B & M Roofing case involved an indefinite delivery, indefinite quantity ("IDIQ") contract for roofing repairs at the US Air Force Academy in Colorado. Amwest produced a Miller Act performance bond for its principal contractor, AKM Associates, Inc. ("AKM"), with a penal sum in the amount of \$200,000.00 and a payment bond with a penal sum in the amount of \$100,000.00. AKM's contract was for a one-year period from March 1994, subject to options for additional years, and covering a guaranteed amount of work between a minimum of \$200,000.00 and maximum of \$9,000,000.00.

During the first year of the contract, the value of AKM's contract exceeded \$1,000,000. Amwest billed and was paid premium for its bond from AKM for the first year. The Air Force Academy then sent Amwest a notice of its exercise of the first year option and a Consent of Surety form. Although the contract work proceeded, Amwest never returned the Consent of Surety form. Nevertheless, Amwest issued and received a bond status inquiry regarding the performance of the contract from the Air Force Academy and billed AKM for additional premium during the first option year. Ultimately, the Government terminated AKM for default under the contract and Amwest faced claims in excess of its \$100,000.00 payment bond. Amwest filed a Summary Judgment Motion claiming that its payment bond exposure covered only the first contract year and that its liability under the bond was capped at \$100,000.00.

The court stated that Amwest's liability had to be determined by reading not only the bond, but the terms of the contract, the Miller Act, and any applicable regulations. In analyzing the operative contract, the court found that Amwest and AKM were both put on notice that the contract was an IDIQ contract. Furthermore, the court found that the "BONDS" paragraph of the contract warned that the "bidder" should consider the cumulative effect of delivery orders under the contract in determining total bonding liability and costs. Interestingly, the court found that the term "bidder" applied to both AKM and Amwest because "the bidding process is a joint effort between principal and surety."ⁱ The court also found that the contract also unambiguously instructed AKM and Amwest that the total bonding liability would be calculated by adding the total value of the delivery orders to be placed. Although the court's finding was based at least in part on the fact that the contract at issue was an IDIQ contract, the determinative factor in swaying the court's opinion in holding Amwest liable for an amount in excess of the penal sum of its bond was the

^h 961 F. Supp. 1441 (D. Colo. 1997).

ⁱ 961 F. Supp. at 1444, footnote 3.

language of the CONTRACT. The court believed that the contract involved in the case clearly obligated AKM and Amwest to determine their own total bonding liability. Therefore, the court reasoned, that Amwest was placed on notice of and acknowledged its liability in excess of the face amount of its bond.

The court further reasoned that its holding that Amwest could be held liable for claims in excess of the penal sum of the payment bond, pending sufficient proof at trial, was consistent with public policy and the law. As to public policy, the court stated that automatic increases in bond liability when additional material or labor is supplied in IDIQ contracts is justified because it: 1) is efficient (it obviates the need for the Government to require additional bonding protection each time supplies are furnished); 2) forces the parties that are best able to monitor the progress of the contract (the principal and surety) to ensure that materialmen continue to get protection; and 3) protects material and labor suppliers at all times without there being a risk of gaps. As to the law, the court merely stated that its finding was in harmony with the universally accepted purpose of the Miller Act (to protect suppliers of labor and materials) and the Federal Acquisition Regulations (the "FAR"). The court provided no analysis as to how its public policy arguments squared with the rigid requirements of the Statute of Frauds. Furthermore, the court failed to provide analysis of its findings in light of the long-standing principle of suretyship that a surety's liability is limited to the penal sum of its bond.

Regarding the court's reference to the FAR, the operative section of the FAR that related to the penal sum of payment bonds in existence at the time that the AKM contract with the government was executed and Amwest's bond was issued read as follows:

If the original contract price is \$5 million or less, the Government **may** require additional protection if the contract price is increased. The penal amount of the total protection as revised **shall** meet the requirement of subparagraph (1) immediately above.¹ (emphasis added).

Because the minimum value of the AKM contract was \$200,000.00, the requirements of FAR 28.102-2(b)(2) applied. The court then concluded that the only requirement placed on the acquisition of additional bonding protection was that the penal sum of the bond had to be in accordance with FAR 28.102(b)(1) wherein the regulation dictated that the penal sum of the bond had to be a strict percentage of the contract price. The court thus used this interpretation of the FAR to find that AKM and Amwest had notice that the penal sum of the bond would increase with contract price increases.

Inexplicably, however, the court failed to review and analyze other significant language in the FAR that, if adhered to, should have led the court to a different result. FAR 28.102-2(b)(3) provided the following:

¹ FAR 28.102-2(b)(2) [48 CFR Ch. 1. FAR 28.102-2(b)(2)]. When determining the penal sum of payment bonds for IDIQ contracts, FAR 28.102-2(c)(2) provided that "the contracting officer shall consider the contract price to be the price payable for the specified minimum quantity. When the minimum quantity is exceeded, subparagraphs (a)(2) and (b)(2) above apply." Whereas subparagraph (b)(2) related to the penal sum of the payment bond, subparagraph (a)(2) related to the penal sum of the performance bond.

The Government shall secure additional protection by directing the contractor to increase the penal sum of the existing bond or to obtain an additional bond.^k

By reading all of the applicable provisions together, it is clear that rather than the penal sum of the bond on contracts, including IDIQ contracts, automatically increasing as contract quantities increase, there must be some affirmative action taken by the government and then the bonded contractor to provide additional protection under the bond, either through increasing the penal sum of the existing bond or providing an additional bond. If one of those actions had been taken, then the requirements of both the FAR and the Statute of Frauds would have been met.

Furthermore, the court did not analyze the language on the underlying contract incorporated by reference into the bond in light of the language on the face of the bond instrument itself on which the penal sum exposure of Amwest was explicitly expressed. Clearly, the language of the underlying contract giving notice to the “bidder” (the term of which was found by the court to include Amwest) indicating that adding delivery orders to the contract would increase the “bidder’s” bond liability was inconsistent with the Surety’s penal sum bond exposure on the face of the bond. At best, this inconsistency created an ambiguity as to what exposure the Surety obligated itself. Due to the law’s historically rigid application of the requirements of the Statute of Frauds, one would expect that a court would not find a Surety liable for an obligation that is ambiguously defined and not in a writing signed by the Surety. However, the B & M Roofing court did not even address this issue in reaching its decision.

In light of the foregoing failings of the court’s analysis in the B & M Roofing case, the opinion should have questionable precedential value.

In Certified/LVI Environmental Services, Inc. v. PI Construction Corp.^l (“Certified/LVI”), the court distinguished the B & M Roofing decision while finding that the sureties involved in the case did not obligate themselves beyond the penal sums of their respective bonds. Like the contract in the B & M Roofing case, the Certified/LVI case involved an IDIQ contract. PI Construction Corp. contracted with the United States Government to perform certain construction activities, including demolition and abatement work at Kelly Air Force Base in San Antonio, Texas. The contract was for a minimum of \$150,000.00 and a maximum of \$5,000,000.00. The duration of the contract was one year with two additional option years. Ranger Insurance Company provided a payment bond for PI Construction Corp. in the amount of \$75,000.00 for the first year of the contract and Acstar Insurance Company

^k 48 CFR Ch. 1, FAR 28.102-2(b)(3). This was the reading of the applicable FAR clause at the time AKM entered into its contract with the Government. Interestingly, the B & M Roofing court referred to the FAR clauses as revised in 1996--the year before its opinion but two years after AKM’s contract was executed. The 1996 version of FAR 28.102-2(b)(3) read slightly different from the earlier version:

The Government shall secure additional protection by directing the contractor to increase the penal sum of the existing bond or to obtain an additional bond or to furnish additional alternative payment protection.

^l 2003 U.S. Dist. LEXIS 18057 (W.D. Tex., Sept 18, 2003).

provided a \$75,000.00 payment bond to PI for the second year of the contract. Ultimately, the sureties faced claims from subcontractors of PI Construction in excess of the penal sums of the payment bonds.

Like the court in B & M Roofing, the Certified/LVI court referred not only to the sureties' bonds but also to the contract and the government's solicitation documents to see whether the language in any of these instruments advised the sureties that they would be liable for claims in excess of the face amount of the bonds. Unlike in B & M Roofing, the Certified/LVI court found that there was no such language in either the bonds or any of the "accompanying and supporting documents" that placed the sureties on notice that they could be liable for amounts greater than the penal sums of their bonds. Therefore, the court limited the sureties' liability to the penal sums of their bonds.^m

Because the Certified/CVI court found no language in the bond, underlying contract, or any other supporting documentation that arguably placed the sureties on notice that they could be liable in excess of the penal sums of their bonds, it did need to analyze the requirements of the FAR and the Statute of Frauds in order to reach its decision. Had the court found that the documentation accompanying the bond had, in fact, placed the sureties on notice of potential liability in excess of the penal sums of their bonds, query whether the court would have reached a finding similar to the holding in B & M Roofing or whether the court would have found that even with such notice the bond penal sum would not increase until the government took affirmative steps to ensure that additional payment protection was provided by the bonded contractor consistent with the requirements of the FAR and the Statute of Frauds.

As a practical note, the issue as to whether or not the penal sum of a performance bond increases with additive change orders to the underlying contract usually arises in one of

^m The Certified/LVI court cited Bill Curphy Co. v. Elliott, 207 F.2d 103 (5th Cir. 1953) for the proposition that the only manner in which the court could resolve the penal sum dispute at issue in the case was by referring to the language contained in the underlying contract that was incorporated by reference into the performance bond. However, the Fifth Circuit in Bill Curphy was interested in the terms of the contract for the purposes of determining the obligations of the Surety on which its liability under the bond would be based. Reference to the incorporated contract was not made by the Fifth Circuit to determine whether or not the penal sum of the Surety's bond increased depending on the Surety's obligations based on the underlying contract. In Bill Curphy, the bond obligee terminated the Surety's principal for default, completed the principal's work and demanded completion cost damages from the Surety in excess of the penal sum of the performance bond. The court wrote:

It is true as appellant contends that the subcontract provided that Elliott [the bond principal] would furnish performance and payment bonds in the amount of 100% of the contract and that the performance bond guaranteed completion of the work to be performed by Elliott under the subcontract. But what appellant apparently overlooks is the fact that the bond only speaks of performance of the contract in expressing the condition upon which the surety's liability is predicated and for the breach of which it would be liable to appellant as obligee. The contract is by reference made a part of the performance bond and accordingly it must be read and construed in connection with that contract. But the obligations of the surety arise out of and are imposed by the bond and can only be measured and determined by the terms of the bond.

207 F.2d at 108. The Bill Curphy case did not involve the impact, if any, of change orders on the penal sum of the performance bond. Rather, the case is useful to apply in cases where a claimant on the Surety's bond tries to argue that the obligations of the contract incorporated by reference into the bond operate to expand the Surety's liability beyond the penal sum of the bond.

two instances. When the surety seeks to negotiate a takeover agreement in anticipation of becoming a takeover and completing surety on a job where its bond principal was terminated for default, the obligee may seek to increase the penal sum limit of the surety's liability in the agreement. In the other typical scenario, an obligee may seek reimbursement from the surety for costs it incurred in completing the defaulted principal's work in excess of contract balances and beyond the penal sum of the surety's bond, particularly where change orders significantly increased the original cost of the principal's work. In both cases, it would be useful for the surety representative to alert the obligee to the Technology case in an effort to dispel any preconceived notions that additive change orders have any impact on the penal sum bond liability of the surety.

Although it is tempting to believe that additive contract change orders increase the penal sum of the bond, it is important to remember that the penal sum of the bond is independent from the underlying contract price and the premium charged by a surety in measuring its risk in producing the bond. Consistent with the Statute of Frauds, unless a surety 1) issues an additional bond for the contract changes; 2) signs a rider to the original bond; or 3) alters the language of the bond to provide for an increased bond penal sum due to contract change orders, fluctuations in the underlying contract price do not affect the penal sum of the bond. However, in some cases where indefinite delivery, indefinite quantity contracts were involved, courts have referred to language in documents other than the bond to see whether the surety obligated itself to liability beyond the penal sum of its bond. Although such contracts are different from the typical construction contract cases involving change orders, one can anticipate savvy counsel seeking to apply the courts' reasoning in IDIQ contracts to the construction change order context. Yet, the Federal Acquisition Regulations in government contract cases and the Statute of Frauds in all contract cases clearly support the contention that a surety's liability under its bond does not increase when change orders increase the original bonded contract price unless the surety obligates itself in writing to the additional exposure.

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