

SEVENTEENTH ANNUAL NORTHEAST SURETY AND FIDELITY CLAIMS CONFERENCE

SEPTEMBER 21st and 22nd, 2006

**PROTECT YOUR TAKEOVER RIGHTS
OR BE TAKEN OVER**

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Introduction

A surety that has issued a performance bond for a construction contract may become liable under the bond when the principal fails to fully and correctly perform the underlying contract between the principal and the obligee/owner ("owner"). Typically, a surety's obligations under a performance bond are triggered when the owner declares the principal to be in default or terminates the principal's contract for default. After receiving notice of its principal's default, the surety generally is entitled to a reasonable period in which to investigate the circumstances surrounding the propriety of the default and to choose a course of action in performing its bond obligations. Of course, if the surety believes that the obligee has acted improperly, it may elect to deny liability and not perform under the performance bond or else it may choose to perform under a reservation of rights.

In either case, once the surety elects to perform, it must initially determine the best performance option given the circumstances and available options. Some bonds, such as the familiar AIA-A312, expressly delineate the performance options available to the Surety, thereby restricting the surety's options to those set forth in the plain terms of the bond form. Other bonds, such as the SF-25 Miller Act bond and other similar common-law bonds utilized on many private or local government projects, do not explicitly identify any specific performance options for the surety. These bonds merely bind the surety to fully perform the obligations undertaken by the principal in its contract with the obligee. In such instances, the applicable common law generally defines the surety's rights and obligations upon default of the principal, although, in the case of Miller Act bonds and many other bonds utilized by public entities, the applicable regulations often provide further guidance regarding the surety's performance obligations.

With the AIA-style bonds attaining more popularity, some owners have labored under the mistaken impression that—in derogation of the surety's common-law rights and

obligations—they can terminate the principal's contract and complete the work in any manner that they see fit, unless the bond explicitly sets forth the surety's performance options. Of course, such owners still expect the surety to pay the bills even though the surety was given no opportunity to perform its bond obligations, no control over any aspect of the completion, and no opportunity to mitigate its damages.

Owners who take such positions demonstrate a misunderstanding of the long-standing principles of suretyship, including the surety's most basic rights and obligations under the common law. The common law of suretyship obligates the performance bond surety to complete the obligations of its principal, preserving the surety's right to choose from among the full panoply of performance options in discharging its obligations. The more recent bonds that expressly delineate the surety's performance options, such as the AIA-style bonds, merely codify the common law and often serve to restrict the surety's performance options. This paper addresses the surety's completion rights in detail and concludes with several practical recommendations for sureties seeking to preserve their inherent common-law rights.

Obligee's Right to the Benefit of Its Bargain and the Surety's Right to Mitigate Damages

A performance bond is a three-party agreement whereby a surety assures the principal's performance of an underlying agreement between the principal and the obligee. In issuing the performance bond, the surety pledges to complete the principal's obligations in accordance with the underlying bonded contract in the event that the principal fails to do so. Because the driving purpose behind the use of performance bonds has been simply to assure obligees that they will receive the performance that they bargained for, courts interpreting sureties common-law rights have acknowledged the rights of sureties to choose their means and methods so long as the obligee was made whole. See 4 Bruner and O'Conner on Construction Law § 12:77 ("The [surety's] performance options were perceived as the specific 'means and methods' to be implemented by the surety in satisfying its bond obligations . . .");

see also *Morrison Assurance Co., Inc. v. United States*, 3 Cl. Ct. 626 (1983) ("Performance bond protects the [obligee] by making sure that it is not left with a partially completed project . . ."); *Trinity Universal Ins. v. United States*, 382 F.2d 317 (5th Cir 1967) (The purpose of a performance bond is "assure that the government has a completed project for the agreed contract price."); *New Amsterdam Casualty Co. v. Moretrench Corp.*, 35 S.E.2d 74 (Va. 1945) (Performance bond surety is liable for completing work that principal contractor agreed to perform.).

A significant policy rationale behind the surety's right to take over the defaulted principal's work is the surety's right to mitigate damages resulting from the default. Numerous court decisions have highlighted the surety's right to mitigate damages in cases in which the surety's rights under a performance bond have been at issue. In a significant recent case, *St. Paul Fire & Marine Ins. v. City of Green River*, 93 F.Supp.2d 1170 (D. Wy. 2000), the obligee refused to allow the surety to complete a project on which the contractor had defaulted on the grounds that: (1) the surety was going to use the defaulted principal's employees and (2) the surety's estimated completion date exceeded the completion date called for by the original contract. Although the performance bond involved was an AIA A-312 bond, the court's decision addresses the surety's general right to mitigate damages. In granting the surety a discharge of further duties under the performance bond the Court stated:

The effect of the Board's termination of [the surety] was to divest [the surety] of its ability to minimize its liability by selecting the lowest cost option and directing the construction or participating in the contractor selection process. Courts have consistently held that an obligee's action that deprives a surety of its ability to protect itself pursuant to performance options granted under a performance bond constitutes a material breach, which renders the bond null and void.

St. Paul Fire & Marine Ins., 93 F.Supp.2d at 1178.

In another significant case, *Dragon Constr., Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55 (Ill. App. Ct. 1997), the owner on a construction project terminated the contractor for lack of

progress without providing notice to the surety. The owner then unilaterally hired a replacement contractor with no input from the surety. The court held that the surety was discharged from any obligations under the performance bond because the owner's actions in replacing the contractor without notice to the surety stripped the surety of its right to limit its liability through involvement in the termination and hiring of a successor contractor. *Id.* at 58; *see also Seaboard Sur. Co. v. Town of Greenfield*, 266 F.Supp.2d 189 (D. Mass. 2003) (Upon the obligee's notice of default, the performance bond surety is allowed a reasonable amount of time to investigate the circumstances before selecting from the available performance options). These decisions demonstrate that while the obligee has the right to receive the benefit of its bargain under a performance bond, the surety has a coequal right to limit its liability in discharging its obligation to make the obligee whole.

Surety's Common Law Right to Choose to Either Complete Performance or Finance the Obligee's Completion

In enforcing the performance bond surety's right to mitigate damages, courts have consistently acknowledged in a variety of circumstances that the surety has the right to choose its method of performance in the event of the principal's default. In Miller Act cases, courts have construed the non-specific performance bond language as reserving the surety's traditional rights to complete the principal's work itself or to pay for completion by the obligee.¹ *See, e.g., Granite Computer Leasing Corp. v. Travelers Indem. Co.*, 894 F.2d 547, 551 (2d Cir. 1990); *Aetna Cas. & Surety Co. v. United States*, 845 F.2d 971, 975 (Fed. Cir. 1988); *Morrison Assurance Co., Inc. v. United States*, 3 Cl. Ct. 626, 632 (1983); *Trinity Univ. Ins. Co. v. United States*, 382 F.2d 317, 321 (5th Cir. 1967); *Morgenthau v. Fidelity & Deposit Co. of Maryland*, 94 F.2d 632, 635 (D.C. Cir. 1937). Illustrating the surety's broad rights to takeover the work,

¹ Of course, the surety choosing to complete performance itself may generally effect its obligation by several different methods including: (1) literally completing the work itself, (2) entering into a completion agreement with a replacement contractor to complete the work, (3) financing the defaulted principal or (4) hiring employees of the defaulted principal to complete the contract.

the *Aetna* court observed that “a performing surety may satisfy its obligations in various ways . . . the surety may formally take over the project and contract for its completion, or it may allow the project to be defaulted and let the government complete or contract for the completion of the project, in which case the surety is responsible for costs in excess of the contract price. A performing surety may also satisfy its obligation by providing funds to an insolvent contractor to complete performance.” 845 F.2d at 975.

Courts have similarly construed the surety’s performance options broadly in cases involving private, common-law bonds. See, e.g., *Board of County Supervisors of County of Henrico v. Insurance Co. of No. Am.*, 494 F.2d 660, 668-69 (4th Cir. 1974) (Court rejected argument that performance bond’s lack of express performance options rendered the bond a penal bond that deprived surety of takeover rights); *Biomass One, L.P. v. S-P Constr.*, 799 P.2d 152, 156-57 (Or. Ct. App. 1990) (In the event of a breach by the principal, the surety can either takeover and perform the contract or pay the damages caused by the principal’s breach); *Standard Accident Ins. Co. v. Rose*, 234 S.W.2d 728, 730 (Ky. Ct. App. 1950) (Performance bond guarantees that if contractor defaults, the surety can complete the contract or pay the full amount of its obligation). Where the obligee has replaced the defaulted principal with another contractor without the surety’s involvement or consent, thereby depriving the surety of its rights to investigate the default and pursue its available performance options, the courts have discharged the surety from its performance bond obligations. *Elm Haven Constr. Ltd v. Neri Constr., LLC*, 376 F.3d 96, 100-01 (2d Cir. 2004); *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp.2d 166, 176-77 (D. Mass 2003); *Seaboard*, 266 F. Supp.2d at 194-95; *Dragon Constr., Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55, 58 (Ill. Ct. App. 1997); cf *County of Henrico*, 494 F.2d 669. In *County of Henrico*, in addition to relying on the material alteration doctrine as the basis for discharging the surety, the Fourth Circuit observed that the surety was not given an opportunity to perform the principal’s obligations after the alleged default

occurred. 494 F.2d at 668-69. The court held that the surety was excused from its performance bond obligations because the obligee arranged for a replacement contractor to perform the bonded reclamation work without involving the surety. Id.

The law of suretyship continues to acknowledge the inherent right of a performance bond surety to mitigate the damages associated with the default of its principal. Courts have preserved this important right by ensuring that sureties are afforded the right to investigate principal defaults and to choose whether to directly take over responsibility for the performance and completion of the principal's work or to finance the obligee's completion of the work. Common-law bonds that lack specific performance options and/or limitations similarly preserve these important surety rights while newer AIA-style bonds have actually served to restrict the surety's performance options. Regardless of the bond form, however, in cases where obligees have interfered with the surety's rights to take over the principal's work, courts have discharged sureties from their performance bond obligations.

Codification and/or Limitation of the Common Law in Bonds with Express Performance Options

Performance bonds that specifically delineate a surety's performance options, such as the AIA-style bonds, are a relatively recent development on the suretyship landscape. See 4 Bruner and O'Conner on Construction Law § 12:77. These bonds do not create or give rise to surety rights and performance options by expressly listing the surety's performance options in the bond. In fact, these bonds serve to either (1) provide procedures for the implementation of the surety's common law rights and obligations or (2) abrogate the surety's common law rights and obligations by restricting the surety's performance options to those expressed in the bond. For example, the AIA-A312 bond generally codifies the common law performance options and mandates procedures that the obligee must follow to trigger the surety's obligation. On the

other hand, the AIA-A311 bond has been held to restrict the surety's common law performance options by requiring the surety to either (1) remedy the principal's default, (2) take over performance itself or (3) tender the lowest bidding completion contractor to the obligee. See *Nat'l Fire Ins. Co. of Hartford v. Fortune Constr. Co.*, 320 F.3d 1260 (11th Cir. 2003) (Due to the restrictive language of the AIA-A311 performance bond, the surety did not have the option to not perform and tender the completion costs to the obligee). In this regard, the AIA-A311 and similar bonds dictate and limit the means and methods available to the surety in discharging its obligation to provide the obligee with the benefit of its bargain. In contrast, common-law bonds that are silent with regard to the surety's performance options leave intact the surety's broad rights to determine its own means and methods of performance by choosing from among its traditional common law performance options.

Conclusion

Despite the recent arguments of some owners, the performance bond surety retains traditional rights and performance options under the common law of suretyship that cannot be abrogated unless expressly done so. Standard Bond forms such as the AIA-type bonds acknowledge and alter these common law rights rather than give birth to surety rights through express language.

It does not escape the authors that most sureties would rather avoid unnecessarily litigating the extent of their common law rights. As such, this paper will close with a few basic suggestions with regard to bond forms: (1) utilize a standard bond form such as the AIA-A312 that expressly provides a wide range of performance options available to the surety;² (2) utilize a customized bond form that specifically preserves the rights and performance options that the surety desires to have available in the event of default; or (3) add a provision to a common law

² Note, however, that the AIA-A312 bond contains language that expressly obligates the surety to pay liquidated damages and attorneys' fees.

bond expressly reserving all rights and performance options available under the applicable common law.