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A SURETY'S INHERENT RIGHT TO PERFORM

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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.

Even when AIA-style bond forms are utilized, however, courts are still often faced with the dilemma of reconciling the surety's performance rights with any express completion rights that may belong to the obligee under the terms of the bonded contract. In such instances, courts seem to parse the language of both the bond and the contract in light of the project-specific context to determine whether these apparent conflicting rights can be reconciled. When faced with such a circumstance, a surety would be well served by making sure that the

judge understands the purpose of a performance bond and the theoretical basis for a surety's completion rights—mainly, that the surety should be entitled to mitigate its losses.

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 & O'Connor 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 to "assure that the government has a completed project for the agreed contract price."); *New Amsterdam Cas. 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); *School Bd. of Escambia County v. TIG Premier Ins. Co.*, 110 F. Supp. 2d 1351, 1354 (N.D. Fla. 2000) (holding that a surety's performance bond obligations were discharged by the obligee's failure to provide the required notice and thereby deprived the surety of its right to mitigate damages); *Tishman Westside Constr. LLC v. ASF Glass, Inc.*, 33 A.D.3d 539, 540 (N.Y. App. Div. 2006) (holding that surety was discharged because obligee failed to provide an opportunity for the surety to exercise its options under the bond). 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); *Island Co. v. Hawaiian Foliage & Landscape, Inc.*, 288 F.3d 1161, 1170 (9th Cir. 2002); *Aetna Cas. & Sur. 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. Fid. & Deposit Co. of Md.*, 94 F.2d 632, 635 (D.C. Cir. 1937); *ZP No. 54 Ltd. P'ship. v. Fid. & Deposit Co. of Md.*, 917 So.2d 368, 373 (Fla. Dist. Ct. App. 2005). Illustrating the surety's broad rights to take over the work, 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., *Bd. of County Supervisors of County of Henrico v. Ins. Co. of N. 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 take over and perform the contract or pay the damages caused by the principal's breach); *Standard*

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.

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). There are numerous cases involving AIA-style bonds where sureties have been discharged where the obligee 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. See *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). This principle should apply with equal force even where the bond does not expressly codify the surety's specific performance options. 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 & O'Connor 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.

Interplay of Surety's Performance Options with Contract Clauses that Allow the Obligees to Complete the Terminated Work

The inherent tension between a surety's performance rights and an obligee's desire to complete the terminated work as expeditiously as possible becomes manifest where the obligee asserts a competing right to complete the work based upon express language in the contract (typically found in the default clause). The default clause in many subcontracts, for example, provides that the general contractor shall have the rights (i) to supplement the work of a non-performing subcontractor and (ii) to correct defective work, after a short notice period. Two recent cases analyzed whether such provisions effect a surety's ability to assert its express performance rights under the AIA-A312 Bond, with one court deciding in favor of the surety and the other in favor of the obligee. Compare *Solai & Cameron, Inc. v. Plainfield Comm. Consol. Sch. Dist. No. 202*, --- N.E.2d ---, 2007 WL 2027732 (Ill. Ct. App. July 10, 2007) (finding that surety's express performance options defeated competing contractual right to complete by obligee) with *Commercial Cas. Ins. Co. of Ga. v. Maritime Trade Ctr. Builders*, 572 S.E.2d 319, 320-21 (Ga. App. 2002) (reaching contrary result). Both courts acknowledged that the bond and the underlying contract must be read together as one instrument, and each decision turned on the parsing of the specific contractual and bond language within the specific factual context in an attempt to reconcile the conflicting terms.

The court in *Solai* affirmed summary judgment in the surety's favor, finding that the surety was discharged because the general contractor had replaced the bonded subcontractor without first providing proper notice to the surety under Paragraph 3.2 of the A312 Bond and agreeing to pay the Contract Balance under Paragraph 3.3. The obligee had asserted that its actions were proper under the subcontract, which provided that, after the issuance of a required three-day written notice letter, "[i]f ... subcontractor continues to fail in properly executing his responsibilities, the General Contractor shall have the right to properly complete this subcontract with its own or other forces. All costs for the General Contractor to then complete this subcontract shall be charged to this subcontractor." *Id.* at *1.

The court in *Solai* acknowledged that it could not reconcile the competing rights of the obligee and the surety when reading the bond and the subcontract together as one instrument. *Id.* at *6. To resolve this conflict, the court examined the unique context of the subcontract negotiations, noting (i) that the subcontract did not explicitly require a bond and (ii) that the effective date of the bond predated the execution of the subcontract. *Id.* at 7. While these considerations may seem arbitrary, the court properly acknowledged the primacy of the surety's performance rights as an outgrowth of its duty to mitigate damages:

A savvy owner should not be allowed to eviscerate a surety's options and protections with language selected later in a subsequent contract with another party. This is especially true when, as here, the language of the subsequent contract has been argued to broaden the authority of [the obligee] and to diminish the right of [the surety] to mitigate the damages. *** We hold the surety's rights arising out of the performance bonds cannot be

diminished by the owner's authority under the terms of the subcontracts that became effective after the performance bonds.

Id. Thus, the court in *Solai* appears to have been swayed by what it perceived as an attempt to "eviscerate" the surety's performance rights in the negotiations of the underlying bonded contract.

The court in *Commercial Casualty*, on the other hand, ruled in favor of the obligee when faced with an express subcontract provision that conflicted with a surety's performance rights under the A312 Bond form. The terms of the underlying subcontract provided that, in the event of the subcontractor's lack of performance, the obligee/general contractor was entitled to supplement the subcontractor's work or replace the subcontractor after providing a 48-hour written notice; this provision also required both the subcontractor and its surety to indemnify the general contractor for its losses arising from any breach by the subcontractor. *Commercial Cas.*, 572 S.E.2d at 321. Construing the surety's bond rights together with the contract, the court held that the surety was not discharged by the general contractor's failure to comply with the bond's specific notice and termination provisions.

The court in *Commercial Casualty* reconciled the conflicting bond and contract terms by distinguishing a breach of contract from a default under the bond. The court reasoned that "[t]he bond itself contains a detailed notice provision in the event of a default, but does not address the contingency of the contractor supplementing the subcontractor's work before it defaults." *Id.* at 322. This reasoning is disingenuous because it appears that the general contractor, for all practical purposes, terminated the subcontractor under the guise of supplementing the work—the general contractor took over the work and installed a new project management team to supervise the field laborers until the work was completed. *Id.* at 321-22. Thus, the court seemingly allowed the obligee to complete the terminated work itself and charge the costs to the surety merely by declaring a "breach" of the subcontract rather than a "default" under the bond.

This case can also be distinguished from *Solai* in that the underlying subcontract explicitly required the surety to indemnify the obligee for all losses arising from any breach of the subcontract. The court, however, did not expressly advance this interpretation as a basis for its decision. Another potentially implicit justification for the court's decision in *Commercial Casualty* is that it does not appear that the surety in that case took any steps to attempt to mitigate its potential bond losses. The court recounted the general contractor's notices to the surety related to the subcontractor's non-performance and the plan to supplement its work, observing that the surety took no action in response to these notices. *Id.* at 321. While not advanced as an explicit justification for its decision, the court may have interpreted the surety's silence after receiving notice of its principal's non-performance as a failure by the surety to mitigate its potential bond losses.

These seemingly contradictory decisions indicate that courts continue to acknowledge a surety's performance options (particularly where these options are explicit under the bond), but struggle to assess liability where the obligee has asserted a competing contractual right to complete the work. Perhaps the lesson to be learned from these decisions is the importance of the equities in cases involving competing assertions of the right to complete the terminated work. The court in *Solai* made explicit its belief that the obligee, as drafter of a subcontract that was executed after the bond's effective date, was attempting to "eviscerate" the surety's

rights to perform the work in order to mitigate its losses. In contrast, the court in *Commercial Casualty* sidestepped the question of whether the subcontractor's breach was a default under the terms of the A312 Bond by finding that the obligee had a right to complete the work under the supplementation clause on a project where the surety failed to respond in any manner to several notices provided by the obligee.

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

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

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Chris Brasco's experience includes all facets of the construction process from contract formation through administration and the disputes process. His legal credentials are complemented by hands-on experience that includes the jobsite administration of a U.S. Corps of Engineer housing project in Germany, which was rescued from imminent default and successfully managed through final completion and large claim recovery. He has a family history in the construction industry, which provides him with a unique perspective and the ability to handle complex issues both at the jobsite and in the courtroom. Chris has represented clients before national and international forums including the International Chamber of Commerce International Court of Arbitration, state courts, boards of contract appeals and in arbitrations and mediations. He is actively involved in several trade associations and regularly lectures on issues of importance to the construction industry.

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- Author: "The Revision Process in Legal Writing: Seeing Better to Write Better," *Volume 8 of Legal Writing: The Journal of the Legal Writing Institute*, Summer 2001.

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