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REVISITING THE SURETY'S FINANCING OPTION WHEN THE BOND DOES NOT EXPRESSLY PROVIDE FOR PERFORMANCE

PRESENTED BY:

VIVIAN KATSANTONIS, ESQUIRE
CHRISTOPHER J. BRASCO, ESQUIRE
CHRISTOPHER M. ANZIDEI, ESQUIRE
CHRISTOPHER M. HARRIS, ESQUIRE
ELIZABETH G. DORFMAN, ESQUIRE
WATT, TIEDER, HOFFAR & FITZGERALD, LLP
8405 Greensboro Drive, Suite 100
McLean, VA 22102
(703) 749-1000

I. INTRODUCTION

A performance bond surety faces potential liability whenever one of its bond principals fails to perform the bonded construction contract. The surety's obligations generally arise when the bond obligee declares the principal to be in default and terminates the principal's right to complete the contract. Upon such a default termination, the surety must generally select a course of action in order to discharge its bond obligations. Because the surety's decision will often have serious financial and other consequences, it is imperative that the surety understands and carefully considers the full range of its performance options.

While some bond forms, such as the popular A312 bond form published by the American Institute of Architects ("AIA"), expressly delineate the performance options available to the surety upon the default termination of its principal, other commonly used bond forms do not enumerate specific options. There is a prevailing belief that the surety, at minimum, has a right to complete the work upon the default termination of its principal even where a performance bond does not set forth specific performance options. Notwithstanding, some courts have failed to recognize and enforce such a right to perform. Thus, in a handful of cases involving bonds that did not expressly provide the surety with the right to complete the contract (and, in at least one case where the bond did), courts have held that, upon a default termination, the bond obligee may complete the work and then charge the surety for any completion costs in excess of the contract balance.

In light of such rulings, which can obviously have grave and inequitable consequences upon the surety, performance bond sureties may wish to reconsider the financing option as a preemptive means of avoiding a default termination. The surety may want to finance its principal if it appears that the principal may default particularly where (i) the performance bond does not expressly provide the surety with a right to complete; and/or (ii) the bond incorporates an underlying contract that provides the obligee with a right to complete.

The financing option can be attractive in that it allows the surety to retain control of the project, which could otherwise be lost through a default termination, and to minimize potential losses. This option is also attractive in that, at least in some jurisdictions, a financing surety is treated as a performing surety for purposes of equitable subrogation and, therefore enjoys the same valuable priority rights to unpaid contract balances. A performance bond surety on a public project, however, will want to carefully consider the potential impact of the doctrine of sovereign immunity prior to electing to finance the principal.

II. DISCUSSION

A. Recent Court Decisions Have Eroded a Surety's Rights to Complete the Project Where the Bond Does not Expressly Provide the Surety With Such Rights

At common law, the performance bond surety has traditionally been afforded a panoply of performance rights and options upon the default termination of its principal, including the right to step in and complete performance, even under a bond that does not enumerate specific options. Notwithstanding, several recent court decisions are eroding, or at least threatening to erode, this panoply of performance rights and options, including in particular the surety's option to complete performance. For example, some courts have recently enforced an obligee's contractual right to complete performance over the surety's competing claim for the right to complete. In such cases, courts have further required the surety to pay the obligee its excess completion costs and legal fees associated with the obligee's enforcement of its contract rights.

1. Courts Have Traditionally Upheld the Surety's Right to Complete the Contract Upon a Default Termination

Historically, the courts have consistently enforced the performance bond surety's right to protect itself and mitigate damages by selecting a method for completing the performance of the underlying contract after a default termination.[1] For example, in construing and enforcing Miller Act bonds, which do not delineate specific performance options, courts have generally acknowledged and enforced the surety's traditional rights either to complete the principal's work itself or to pay for completion by the obligee. 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).

Courts have similarly construed the surety's performance options broadly in cases involving private, common-law bonds that do not specifically enumerate a set of performance rights and options. 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) (rejecting argument that performance bond's lack of express performance options rendered the bond a

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[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.

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) (recognizing surety's option either to take over 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) (holding that a non-specific performance bond guarantees that if contractor defaults, the surety can complete the contract or pay the full amount of its obligation).

2. Under Recent Decisions, a Surety May Lose its Right to Complete the Project Where the Bond Form is Silent and/or the Underlying Contract Gives the Obligee the Right to Complete

Notwithstanding any prevailing view that performance bonds, even if non-specific as to performance options, provide the surety with the right and option to complete the contract following a default by its principal, a few courts have recently held that a surety may be foreclosed from taking control of the completion effort. These cases typically involve both (i) a performance bond that does not specifically provide the surety with a right to complete the contract upon the principal's default; and (ii) an underlying contract that provides the obligee with the right to complete the work upon such a default. Of course, the latter instrument is often expressly incorporated into the performance bond. Faced with competing claims regarding the right to complete, some courts have begun to side with the obligee, enforcing the obligee's right to complete and allowing it to recover its excess completion costs from the surety.

For example, in Dooley and Mack Constructors, Inc. v. Developers Surety and Indemnity Company, 972 So.2d 893 (Fla. Dist. Ct. App. 2007), a general contractor/obligee, Dooley, prevailed in a suit for recovery of its own post-termination completion costs against the surety of the terminated subcontractor, even though Dooley had failed to provide the surety with prior notice and an opportunity to perform the completion work.

The surety had issued a performance bond on behalf of a subcontractor in furtherance of a masonry subcontract on a community college construction project. The subcontractor abandoned the job prior to completion of the subcontract. Dooley arranged for completion of the subcontract work without providing formal notice to the surety and then attempted to recover its associated completion costs from the surety. The surety initially prevailed on a summary judgment motion on the grounds that Dooley's failure to provide notice and an opportunity to cure resulted in a discharge of its bond obligations. In the cited opinion, however, the appellate court reversed the summary judgment order based on certain language contained in the subcontract.

The performance bond provided, in pertinent part, that if the subcontractor was in default and Dooley declared the subcontractor to be in default, then the surety, "may promptly remedy the default," among its other options. The subcontract, which was expressly incorporated into the bond, provided that, if in Dooley's opinion, the subcontractor fell behind in progressing the work, Dooley could take such steps as Dooley deemed necessary to improve the rate of progress, including an express right to

"declare the Subcontract breached and take charge of and complete performance of the WORK with such persons, firms or corporations as [Dooley] shall deem necessary." The subcontract further provided that the subcontractor and its surety would be liable for all associated losses, damages and expenses, including attorney's fees.

In reversing the summary judgment order, the appellate court essentially held that the subcontract language providing the obligee with a right to takeover and complete the subcontract trumped the performance bond language providing the surety with the right to remedy its principal's default. The court determined that because the bond incorporated the terms of the subcontract, Dooley had the option to either complete the work itself and recover its losses from the surety or call upon the surety to complete the subcontract work. Accordingly, the court concluded that the surety was liable for the obligee's completion costs notwithstanding Dooley's failure to provide the surety with notice or an opportunity to complete.[2]

A federal court in California recently reached a consistent result in a case involving similar bond and contract language. Specifically, in Fru-Con Construction Corporation v. Sacramento Municipal Utility District, 2008 WL 877970 (E.D. Cal. Mar. 28, 2008), the court rejected the performance bond surety's argument that it was discharged from any bond liability, as a matter of law, by the obligee's hiring of a replacement contractor one business day after terminating the bond principal, without notifying the surety. As in the Dooley case, the bond provided the surety with a right to promptly remedy the default, and the underlying contract provided the obligee with a right to take over and complete the work. The court held that, under the performance bond and in light of the plain terms of the bonded contract, the obligee "did not per se violate the terms of the performance bond by hiring another contractor to complete the work upon [the principal]'s termination."[3]

Consistently, in the controversial Colorado Structures, Inc. v. Insurance Company of the West, 167 P.3d 1125 (Wash. 2007) decision, the Supreme Court of Washington held that the obligee on a standard AIA A311 performance bond was entitled to recover its completion costs and related attorney's fees from the surety, following the default of its bond principal, notwithstanding that the obligee had never

[2] Notably, a thorough dissenting opinion included with this decision, which was decided by a two to one majority, recognized that the contract provisions relied upon by the majority are common and have not traditionally been construed so as to undercut bond language as the proper measure of the surety's obligation. Moreover, the United States District Court for the Southern District of Florida recently declined to follow the majority opinion in Dooley, adopting instead the reasoning supplied in its dissenting opinion. CC-Aventura, Inc. v. Weitz Co., 2008 WL 2937856 *7 (S.D. Fla. July 14, 2008). Thus, the CC-Aventura court held that the surety was discharged by the general contractor's failure to comply with the bond's notice requirements, notwithstanding a provision in the subcontract that ostensibly gave the general contractor a right to complete the work in the event of a subcontractor default.

[3] Significantly, the court stopped short of adjudging the surety liable for the obligee's completion costs in this case, holding that a material issue of fact existed regarding whether the obligee, in hiring the replacement contractor without notice to the surety, had breached the implied duty of good faith and fair dealing. By ruling that the obligee was required to exercise discretion regarding its completion rights in good faith, the court at least gave some force to the bond language regarding the surety's completion rights.

formally declared a default by the principal.[4] The A311 bond form expressly provides the surety with the right to promptly remedy a default by the principal following a proper termination. The obligee never terminated the bonded subcontract, however, but instead "supplemented" the principal's work and then claimed its excess supplementation costs against the performance bond. While unclear from the decision, it is reasonable to assume that the contract gave the obligee the right to supplement the principal's work where the principal fell behind schedule. The court clearly enforced the obligee's right to complete the work through supplementation effectively defeating the express completion rights afforded to the surety in the A311 bond.

As the foregoing cases demonstrate, even where a performance bond provides the surety with an option to remedy its principal's default, courts may enforce the completion rights afforded to the obligee by the bonded contract to the exclusion of any completion rights afforded to the surety in its performance bond. Thus, if the underlying contract provides the obligee with the right to complete the work, at the surety's expense, the surety may lose the right to retain control of the completion of the work and the corresponding ability to protect itself by minimizing costs and damages. In the wake of these recent decisions, sureties should re-evaluate the financing option.

B. The Financing Option as a Means of Retaining Control over Completion Methods and Costs

When confronted with a possible contractor default, the surety must consider a number of options for discharging its bond obligations and completing the bonded work. In light of the recent decisions that are undermining the surety's right to take over and complete upon the principal's default, the surety should at least consider the option of financing its principal as a preventive measure whenever there is a potential for default. The financing option is attractive for a number of reasons. First, it is an effective means of retaining control over completion methods and costs, including the avoidance of unnecessary mobilization and reprocurement costs. It can also be an effective means of establishing priority rights to unpaid contract balances under the doctrine of equitable subrogation. Additionally, it is an attractive option to the principal and surety alike in that it avoids the undesirable consequences, tangible or otherwise, that inherently accompany a default termination.

Notwithstanding, there are substantial risks associated with the financing option, which may include the refusal of a particular jurisdiction to recognize the financing surety's equitable subrogation rights and/or the right of a financing surety to assert claims against the government. Thus, a financing surety must carefully implement a

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[4] As noted in a subsequent decision by the United States District Court for the District of Columbia, the formal declaration of a default by the principal has long been recognized as a fundamental condition precedent to surety liability under a standard AIA A311 performance bond. Hunt Constr. Group, Inc. v. Nat. Wrecking Corp., 542 F. Supp. 2d 87 (D.D.C. 2008). Thus, the Hunt Construction court respectfully rejected the reasoning in Colorado Structures, holding that the latter opinion "failed to appreciate the inter-relationships among the subparagraphs" of the bond and enforcing the bond's notice provisions.

strategy that will ensure that it can recoup its expenditures from any unpaid contract funds and/or preserve its rights to assert claims against a government obligee.

1. Establishing Rights to Contract Balances and a Path to Assert Claims through the Financing Option

A well conceived financing strategy must consider both the contractual and equitable means for protecting the surety's interests. Contractually, a performance bond surety can best establish and preserve its rights to recover unpaid contract balances and to assert claims against the obligee by including such rights in a negotiated takeover agreement with the owner. The execution of a takeover agreement may be a particularly attractive option where public contracts are involved in that it can help overcome potential obstacles raised by anti-assignment legislation and sovereign immunity. A takeover agreement is generally only appropriate after a default termination has occurred, however, and thus is typically not an available option to a financing surety. Thus, a financing surety may only be able to preserve its rights, via contract, by negotiating and executing a pre-termination financing agreement with the obligee. For various reasons, however, the surety may encounter difficulty in negotiating such an agreement with the obligee. Nonetheless, the surety should, at minimum, ensure that a formal financing agreement is in place with its principal that clearly establishes that the surety is advancing funds for the completion of the work.

Alternatively, the financing surety may be able to rely on its equitable rights to recover monies expended and to assert claims against the obligee. In this regard, performance bond sureties commonly rely upon the doctrine of equitable subrogation as an avenue for asserting such rights and claims. Under the doctrine of equitable subrogation, a surety that is compelled to discharge an obligation on behalf of its principal is generally entitled to assert all of the rights and claims of both the principal, whose debts were paid, and of those entities who received such payments, including the obligee. In the latter instance, the performing surety takes a priority right to unpaid contract balances because, by satisfying the principal's obligations, the surety has conferred a benefit upon the obligee, by insuring completion of the work and relieving the obligee of the burden of procuring completion on its own. Accordingly, the performing surety is subrogated to both the rights of the principal and the obligee.

By discharging such debts, the surety is generally entitled to recoup its expenditures from unpaid contract balances and takes a priority right to such funds that is superior to competing claims by, among others, the obligee, subcontractors and suppliers, and the principal's assignees. In order to ensure maximum recovery, it is critical that the surety understands the full breadth of the surety's subrogation rights and the identification of the parties whose rights have been subrogated, as well as any potential impediments to recovery, such as, in the case of a public owner, the doctrine of sovereign immunity. Accordingly, when considering whether to finance its principal, a surety must consider the corresponding impact of the financing option upon the surety's equitable subrogation rights.

It is well-established in the law of suretyship, particularly in the realm of federal government contracts cases, that where a surety has provided financing to its bond principal in furtherance of completion of the contract work, the so-called "financing surety" is treated as a "performing surety" for purposes of equitable subrogation. See Aetna Cas. & Sur. Co. v. United States, 845 F.2d 971, 975 (Fed. Cir. 1988); see also Great American Ins. Co. v. United States, 481 F.2d 1298, 1308 (Ct. Cl. 1973) (holding that a surety's act of financing its principal constitutes a fulfillment of its performance bond obligation).

For example, in Aetna Casualty and Surety Company v. United States, 845 F.2d 971 (Fed. Cir. 1988), the surety attempted to recover contract balances from the federal government after the surety had advanced funds to its bonded contractor in order to enable the financially burdened contractor to complete its work on three construction contracts with the government. When the government refused to remit the remaining contract balances to the surety, the surety filed suit against the government. The government argued that the surety's mere provision of funding to the contractor was tantamount to a discharge of the surety's payment bond obligations but was insufficient to afford it the more expansive equitable subrogation rights of a performing surety.

On appeal from the lower court's decision in favor of the government, the United States Court of Appeals for the Federal Circuit held that, by financing the contractor's completion of the work, the surety did, in fact, attain the status of a performing surety and was therefore entitled, under equitable subrogation, to recover the amounts it had expended. The court essentially determined that the surety's provision of financing was made in satisfaction of its performance bond obligations. The court ruled further that, in order to attain the status of a performing surety, the surety was not required to assume primary responsibility for the work, under a takeover agreement or otherwise, and that no formal default termination was necessary. Additionally, the court held that the fact that the original contracts had not been fully performed did not alter the analysis. Rather, it was sufficient that the surety had elected to advance the completion of the work by funding its financially incapable principal.

The Aetna decision further demonstrates that courts may consider a number of factors in determining whether a surety that has made payments in connection with a bonded project has acted as a "performing surety," under its performance bond rather than under its payment bond. In this regard, the existence of a formal financing agreement or other evidence indicating that the contractor was financially unable to complete the work may be helpful in establishing that the surety's payments were made in furtherance of its performance bond obligation. Payments made directly to subcontractors, by comparison, are more likely to be construed as a discharge of the surety's payment bond obligations, although Aetna and other case law instructs that this is not necessarily a completely dispositive factor. Ultimately, the determination hinges on whether the surety's payments were made to advance the completion of the work. Assuming the surety can demonstrate that its financing payments were made to facilitate completion of the work, the surety will likely be able to enforce its equitable

subrogation rights, as though it were a performing surety, in an independent action against the owner.

In Great American Insurance Co. v. United States, 481 F.2d 1298 (Ct. Cl. 1973), the United States Court of Claims upheld the surety's right to the contract balances as a result of financing a project to completion. There, the surety issued payment and performance bonds on behalf of a joint venture contractor, for the construction of a levee for the Department of the Interior. During contract performance, the contractor notified the surety that it could not complete the contract work and acknowledged that it was in default. As a result, the surety financed the contractor's completion of the project and in furtherance of this effort, the contractor and surety executed a loan agreement established a joint account. The surety filed suit after the Government refused to pay over the contract balances. In resolving the issue of entitlement to the remaining contract balances, the court reasoned that by advancing money to the contractor, the surety became equitably subrogated to the contractor's rights to the contract balances. The court further reasoned that neither a formal declaration of the contractor's default, nor notice to the Government of the surety's intention to finance the contractor, was necessary for the surety to prevail on its claim to the contract balance. The court concluded that all that was necessary for the surety to prevail was that the contractor be in default as a matter of fact and that as a result, the surety had become obligated under the performance bond. The court ultimately held that the remaining contract balances must be paid to the surety.

The Aetna and Great American cases make clear that, as a matter of federal government contracts law, a financing surety will generally be afforded performing surety status, including all corresponding inherent equitable subrogation rights. As these cases instruct, in order to maximize recovery rights, a surety that elects to finance its principal should structure its financing in such a way that its payments are clearly characterized as being made in furtherance of its obligations under its performance bond. In this regard, the execution of a financing agreement clearly establishing the nature and purpose of the financing is preferable.

While the rule in the federal government contracts context is fairly clear, most states have not expressly ruled on the precise issue of whether a financing surety may be treated as a performing surety. A jurisdiction's recognition and adherence to the fundamental principles served by the doctrine of equitable subrogation, however, provides strong support for such treatment. Accordingly, when considering the financing option, the surety must evaluate the applicable jurisdiction's enforcement of the doctrine of equitable subrogation.

2. The Impact of State Sovereign Immunity Statutes on the Surety's Equitable Rights

While the surety may be able to bring its equitable claims against the federal government and in certain circumstances, against a state and/or its agencies, the surety on a state project must be aware of the possibility that its equitable claims may be barred by that state's sovereign immunity doctrine. Indeed, several courts have held that absent a direct contract with the state, a surety may be barred from bringing its equitable claims against the state. See, e.g., Federal Deposit Ins. Corp. v. Peabody, N.E., Inc., 680 A.2d 1321 (Conn. 1996). While the sovereign immunity doctrine is sufficiently developed in some states to give clear guidance to sureties in this regard,[5] the potential impacts and effect of the doctrine in other states is more difficult to discern. Thus, when the surety is considering its options upon a probable contractor default, the surety must carefully analyze the applicable jurisdiction's statutory and common law to determine the extent to which that state has waived sovereign immunity.

One noteworthy case in which a court rejected a surety's equitable claims on sovereign immunity grounds is XL Specialty Insurance Company v. Commonwealth of Virginia, Department of Transportation, 624 S.E.2d 658 (Va. App. 2006). There, the court rejected the performance bond surety's attempt to assert the claims of its principal, which were premised upon the surety's equitable subrogation rights, directly against the Commonwealth. The court first determined that the Commonwealth's statutory waiver of sovereign immunity for contract claims was limited to claims by parties having direct contractual relationships with the Commonwealth. Based on this principle, the Court concluded that, because XL Specialty's equitable subrogation claims were not based upon a direct contract with the Commonwealth, the surety was precluded from asserting such claims against the Commonwealth.[6]

XL Specialty had argued that its claims should not be barred by sovereign immunity in that: (i) the tripartite relationship between the Commonwealth, XL Specialty and the bonded principal created an express contract between XL Specialty and the Commonwealth; and (ii) by completing the project, XL Specialty became equitably subrogated to the contractual rights of its principal, including its right to bring suit on its contract claims directly against the Commonwealth.

In analyzing the surety's arguments, the court examined a number of cases discussing the nature of sovereign immunity protections in Virginia and concluded that any waiver of sovereign immunity must be strictly construed. Based upon a prior ruling

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[5] In Arkansas, for example, it is clear from its own constitutional law that a surety may not name the State as a defendant under any circumstances. Ark. Const. of 1874, art. V § 20.

[6] Notably, the surety and the Commonwealth had executed a takeover agreement, which the court acknowledged would constitute a direct contract with the Commonwealth, thus waiving the state's immunity protection. The surety had not initially included a count for breach of the takeover agreement in its complaint, however, and therefore the court refused to consider the agreement in its analysis. The court subsequently permitted the surety to amend its complaint to include a claim for breach of the takeover agreement.

by the Supreme Court of Virginia in a remand opinion in the same case, the lower court reaffirmed that the tripartite relationship did not create a direct contractual relationship with the Commonwealth, and that, therefore, claims premised upon a tripartite theory did not fall within the ambit of the narrowly construed waiver of sovereign immunity statute. The court similarly rejected the surety's claims based on equitable subrogation, holding that the surety's equitable rights also did not satisfy the direct contract requirement of the waiver of sovereign immunity statute. Accordingly, the court rejected XL Specialty's arguments and dismissed its claims against the Commonwealth.

XL Specialty makes clear that the existence of a direct contract with a state, at least in some jurisdictions, is essential to establishing a claim within the confines of a state's waiver of sovereign immunity. In such jurisdictions, the surety's traditional resor to the doctrine of equitable subrogation may not provide a basis for overcoming the sovereign immunity doctrine. Therefore, the financing surety must carefully analyze the requirements for asserting contract claims against a state owner, and in particular, the laws defining the outer limits of the state's wavier of sovereign immunity.

III. CONCLUSION

In selecting a course of action upon a probable contractor default, a surety may wish to reconsider the financing option as a preemptive means of avoiding a default termination. Especially in light of recent court decisions that erode, or threaten to erode, the surety's notice and/or performance rights, financing may be a worthwhile option for maintaining control over completion methods and project costs. While a financing surety may enjoy the same equitable rights as a performing surety in the federal context and certain other jurisdictions, the financing surety may encounter obstacles in asserting the claims of its principal in other jurisdictions. For example, the surety on a public project for a state is cautioned to explore the sovereign immunity doctrine of the applicable jurisdiction, which may bar the surety's equitable claims against that state. Therefore, the surety must carefully consider the law of the jurisdiction where it must bring its claims in determining the feasibility and benefits of the financing option.