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**A PRIMER FOR THE SURETY'S HANDLING OF  
PERFORMANCE BOND CLAIMS**

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## PREFACE

### A PRIMER FOR THE SURETY'S HANDLING OF PERFORMANCE BOND CLAIMS

The attached paper, authored by George J. Bachrach of Whiteford, Taylor & Preston, LLP, Baltimore, Maryland, was first published for and presented at the October, 2007 Fall Meeting program of the American Bar Association Forum on the Construction Industry entitled "Another Perfect Storm." The paper was part of Plenary 8 of the program entitled "Shipwrecked: Dealing With Construction Contract Defaults in the Real World." Based upon the program's nautical theme, the actual paper title was "*The Surety's Performance Bond Lifeboat: Bailing Out and/or Salvaging Someone Else's Wreck.*" For the purposes of the 2008 Northeast Surety and Fidelity Claims Conference, we have mercifully re-titled the paper to "*A Primer for the Surety's Handling of Performance Bond Claims.*"

The goal of the paper presented at the 2007 Fall Meeting of the Forum on the Construction Industry was to educate the audience - primarily made up of owners, contractors, subcontractors, architects, engineers and the occasional surety, and their representatives, including inside and outside counsel, accountants and consultants - about the surety's perspective and actions when dealing with construction contract defaults and claims against the surety's performance bonds in the real world. It provides an overview of the surety claims process when there are disputes on a bonded construction project by starting with the underwriting process, then proceeding to the claims investigation and the analysis of the surety's rights and defenses, and ultimately describing the surety's obligations and options under its performance bond. As such, the paper is truly a resource providing access to other materials that address these issues from the surety's perspective, including books, articles, papers and cases.

Because of its original purpose and audience, this paper may not provide much in the way of new information or insights for the experienced surety claims representative and/or outside counsel. However, it does accomplish two significant goals: (1) it presents the substantive issues that a surety must address when dealing with construction contract defaults and claims against performance bonds in an organized and logical manner; and (2) it provides an enormous number of the citations to secondary sources that deal in-depth with the substance of the issues discussed in the paper. Therefore, as a reference and resource tool, this paper is invaluable.

The paper serves as the background support for the 2008 Northeast Surety and Fidelity Claims Conference presentation by Kenneth M. Givens, Jr. of Arch Insurance Company and Michael A. Stover of Whiteford, Taylor & Preston, LLP. Because the paper is a reference and resource work, Mr. Givens and Mr. Stover have chosen to ignore the paper for the purposes of their program presentation entitled "**Hot Topics for the Performance Bond Surety**" in order to address several issues that are of primary interest to surety practitioners, including issues that have arisen since the original paper was prepared.

We hope that you find the attached paper to be a valuable reference and resource tool, both now and in the future.

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## **A PRIMER FOR THE SURETY'S HANDLING OF PERFORMANCE BOND CLAIMS**

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When a construction project gets to the point where the owner, the general contractor and/or the subcontractor contemplate a default and/or termination of the construction contract or subcontract with another party, many issues arise, including the default events and material breaches that may justify the termination of the construction contract, the non-breaching party's alternatives and options short of a termination for default, and what occurs when there is a termination for default (remedies and damages). These issues, and many more, affect the surety that executes a performance bond and a payment bond for its defaulted principal on a particular construction project.<sup>1</sup>

After a brief discussion concerning the background of surety bonds, this paper will be divided into three major sections concerning the surety's immediate role when there is an alleged and/or actual default and/or termination of the principal's construction contract. Those sections include the following:

1. The surety's duty to investigate the obligee's claim that the principal is in default under the construction contract such that the obligee has the right to terminate the principal's construction contract;
2. The surety's right to determine if there are any defenses to the obligee's claim against the surety's performance bond; and
3. The surety's obligation, whether or not there are any defenses to the obligee's claim, to determine the surety's options under the performance bond and how best to exercise those options.

There are other less immediate but still very important issues for the surety, including the surety's ultimate liability under the performance bond, the surety's rights to the contract funds from the defaulted construction contract, the surety's indemnity rights against and reimbursement rights from its principal and indemnitors under the indemnity agreement, the surety's rights against third parties, and others, which will be discussed more generally and briefly at the end of this paper.

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<sup>1</sup> Sureties write performance and payment bonds on behalf of their general contractor customers, as principals, to the owners, as obligees, and on behalf of their subcontractor customers, as principals, to the general contractors, as obligees. There are some major differences between the circumstances when an owner default terminates a general contractor and makes a claim against the surety's performance bond and when a general contractor default terminates a subcontractor and makes a claim against the surety's subcontractor performance bond. To eliminate what might create some confusion, this paper will always address the owner (or general contractor) as the "obligee" under the performance bond and the general contractor (or subcontractor) as the "principal" under the performance bond, as appropriate. In the instances when this paper may make specific points and observations about the general contractor and subcontractor relationship, the general contractor, as "obligee," and the subcontractor, as "principal," will be specifically identified.

The goal of this paper is to provide a practical research tool and resource for owners, architects, engineers, general contractors, subcontractors, sureties, and others involved in the construction process and industry, and their counsel, by accumulating in one place a summary and description of the surety's duties, rights and obligations when an obligee makes a claim against a surety's performance bond as a result of the obligee's default and/or termination of the principal's construction contract.

## **I. INTRODUCTION -- SOME BACKGROUND ON SURETY BONDS<sup>2</sup>**

Performance and payment bonds are not insurance. Rather, suretyship is a credit transaction.<sup>3</sup> In underwriting bonds for its principal, the surety does not look at an actuarial analysis for assessing its risk of loss as an insurer would do. Rather, the surety looks at other factors, including the three "C's" of contract surety underwriting -- the principal's cash, capacity and character. The three "C's" evolve into three questions. Does the principal have the financial wherewithal, or cash, to continue the performance of the work and the payment of the bills of the laborers, subcontractors and suppliers on the construction project? Does the principal have the capacity to perform the work (the necessary manpower, both in quality and quantity; the technical ability and construction expertise to timely and correctly perform and complete the work; and the home office expertise, including accounting expertise, record keeping and other backup services, to ensure that the principal's progress in performing the work can be accurately measured and computed)? Does the principal have the character (the honesty, integrity, trustworthiness and commitment to complete the work on the construction contract) that is critical to the success of both the construction project and the principal and surety relationship?

The surety also makes other judgments in determining whether to write bonds for the principal. The principal's expertise in the kind or type of work to be performed; the location of the construction project; the total amount of the principal's work program that is outstanding; the scope of work, contract price and time of completion (duration) of the particular construction contract, especially in light of the prior construction contracts the surety has bonded for the principal; the added complexity that various contract and performance bond terms and requirements may add to the scope and performance of the work (including design-build, performance-based specifications, "onerous" bond provisions and others); and other

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<sup>2</sup> Stewart R. Duke & Mary Jeanne Anderson, *How Contract Surety Bonds Are Underwritten*, in THE LAW OF SURETYSHIP, 2D ED. 49-61 (Edward G. Gallagher, ed. 2000); Lynn M. Schubert, *Why Obligees Buy Bonds*, in THE LAW OF SURETYSHIP, 2D ED. 41-47 (Edward G. Gallagher, ed. 2000); Roger P. Sauer, *Creation of the Relationship*, in THE LAW OF PERFORMANCE BONDS 1-17 (Lawrence R. Moelmann & John T. Harris, eds. 2000); and Marilyn Klinger, *A Toast - To the Underwriters: The Underwriting Process and Salvage by the Surety*, in SALVAGE BY THE SURETY 63-92 (George J. Bachrach, ed. 1998).

<sup>3</sup> "A surety, by providing bonds to its principal, is, in reality, providing the surety's credit to the principal in order for the principal to enter into a contract with the obligee. In banking parlance, the surety's bonding of its principal creates a "credit facility" where the surety, for a fee, extends its credit to the principal. The surety expects to incur no loss as a result of that extension of credit. The surety's extension of credit is done with the understanding, whether under common law or through a written agreement such as an agreement of indemnity, that the principal, and any third-party indemnitors, will reimburse the surety in the event that the surety incurs a loss under the bonds it executes for the principal." George J. Bachrach, *The Surety's Rights to Obtain Salvage - Exoneration, Reimbursement, Subrogation and Contribution*, in SALVAGE BY THE SURETY 1 (George J. Bachrach, ed. 1998).

factors weigh heavily on the surety's decision to write the performance and payment bonds for a particular construction project.

Practically every performance bond is different from every other performance bond.<sup>4</sup> Both the principal and the surety execute the performance bond in favor of the obligee.<sup>5</sup> Normally, the principal and the surety are jointly liable under the performance bond so long as any applicable conditions precedent are met.

In summary, the universe of obligees requests bonds from the principal and the surety in order to assure themselves that the construction contract will be performed and completed for the agreed upon consideration. In the vast majority of cases, the obligee procures the bonds from the principal and the surety, sticks them in the file, and never looks at them again. However, when the obligee alleges that the principal is in default and advances toward a termination of the principal's construction contract, the bonds may become the performance life boat for the obligee that wants the surety to bail out and/or salvage what the obligee considers to be the principal's wreck of the construction project.

## **II. THE SURETY'S DUTY TO INVESTIGATE**

### **A. Why the Surety has a Duty to Investigate<sup>6</sup>**

In any construction project, the principal and the surety have a whole set of legal, contractual, equitable and statutory obligations to many parties that are not shared by the obligee. The obligee looks to the obligations of the principal to complete the performance of the work under the construction contract and to the obligations of the surety to guarantee that performance. However, the principal and the surety may have obligations to the principal's laborers, subcontractors and suppliers on the construction project and the lower-tier entities that have contractual relationships with those subcontractors and suppliers. Furthermore, the principal, third-party individual and corporate indemnitors, and the surety may have a contractual relationship in the form of an indemnity agreement to support the surety's execution of the bonds. Finally, there are other relevant third parties, such as banks, taxing

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<sup>4</sup> There are many basic types of performance bonds, including but not limited to standard form private performance bonds, statutorily required performance bonds, indemnity bonds, manuscript bonds, completion bonds, and others that an obligee may request or require and a principal and a surety may execute. The various types of performance bonds are discussed in Philip L. Bruner, Patrick J. O'Connor, Jr. & Tracey L. Haley, *The Surety's Analysis of Investigative Results: "To Perform or Not to Perform - That is the Question,"* in BOND DEFAULT MANUAL, 3D ED. 87-93 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005). Occasionally, the "standard" performance bond may become a "manuscript" performance bond that shifts the "normal construction risks and liabilities" in some fashion such that it may become "onerous" to one party (usually the surety) or another. Steven D. Nelson, "Onerous" Bond Forms - A Look at Departures from Standard Performance and Payment Bond Provisions (unpublished paper submitted at the ABA Forum on the Construction Industry/TIPS Fidelity & Surety Law Committee annual midwinter meeting on January 29, 2004).

<sup>5</sup> There are times when there are "dual obligees" on the performance bond. Frequently, the obligee may be the owner of the construction project and the dual obligee is the owner's financing lender. Another dual obligee situation may be the obligee general contractor and the dual obligee owner on a subcontractor performance bond. See Section V., note 91, *infra*.

<sup>6</sup> Once a claim arises, the surety has a duty to independently investigate the claim. *Dodge v. Fid. & Deposit Co. of Md.*, 778 P.2d 1240 (Ariz. 1989), but not to substantiate or create a claim, *Farmer's Union Cent. Exch., Inc. v. Reliance Ins. Co.*, 675 F. Supp. 1534 (D.N.D. 1987).

authorities, judgment creditors and other entities that may have an interest in the principal's performance of the work (and collection of the contract funds).<sup>7</sup> Regardless of the outstanding disputes, the surety must investigate the facts before it may arrive at any conclusions and decisions.

When a default and/or termination either is imminent or has occurred, the surety has to determine whether there are any defenses to the obligee's claim and the various facts necessary in order for the surety to determine its options. There may be conflicts in the various obligations of the principal and the surety to the obligee and others. Those conflicts may escalate when the obligee and the principal are in dispute about whether there is, in fact, a default, and who is in default, thereby placing the surety in the "classic dilemma."<sup>8</sup> Why does a surety have a duty to investigate? It is because the surety has many parties that it has to answer to as it attempts to learn the facts about the situation and make its decisions.

## **B. When Does the Surety Investigate**

Many performance bond forms set conditions precedent for when a surety must perform its obligations under the performance bond. As will be seen later in this paper, the obligee's failure to meet those conditions precedent may result in a surety being released and discharged from its obligations under the performance bond. However, there are few, if any, performance bonds that describe when a surety must begin its investigation<sup>9</sup> into an impending obligee default and/or termination of the principal.<sup>10</sup>

For example, the AIA Document A311 Performance Bond (1970) provides that:

Whenever Contractor shall be, and declared by Owner to be in default under the Contract, the Owner having performed Owner's obligations thereunder, the Surety may . . .

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<sup>7</sup> For a concise yet compelling discussion of the astounding myriad and variety of legal and other relationships on a construction project, see Philip L. Bruner & Tracey L. Haley, *Strategic "Generalship" of the Complex Construction Suretyship Case*, in *MANAGING AND LITIGATING THE COMPLEX SURETY CASE*, 2D ED. 1-9 (Philip L. Bruner & Tracey L. Haley, eds. 2007).

<sup>8</sup> The "classic dilemma" for a surety is when both the obligee and the principal are adamant that their positions are correct, with the obligee declaring the principal to be in default under the construction contract and asserting a claim against the surety under the performance bond and the principal claiming that the default was wrongful such that the obligee is in breach of contract and the surety has no obligation to perform. See Marilyn Klinger, James P. Diwik & Kevin L. Lybeck, *Contract Performance Bonds*, in *THE LAW OF SURETYSHIP*, 2D ED. 94-96 (Edward G. Gallagher, ed. 2000); John W. Hinchey, *Surety's Performance Over Protest of Principal: Considerations and Risks*, 22 *TORT & INS. L.J.* 133 (1986).

<sup>9</sup> See AIA A312 Performance Bond, paragraph 4.4.1, for the only reference in that performance bond to a surety's "investigation".

<sup>10</sup> While the "when" of a surety's investigation may be unknown and/or unsettled, the right of a surety to perform an investigation is not. See *Seaboard Sur. Co. v. Town of Greenfield*, 266 F. Supp. 2d 189, 194 (D. Mass. 2003), *aff'd*, 370 F.3d 215 (1<sup>st</sup> Cir. 2004) ("courts have deemed that it is commercially reasonable to allow the sureties time to investigate the circumstances surrounding a default termination of a contractor before selecting from the various performance options available to them.").

take certain actions, and the performance bond then outlines various options for the surety. This language sets three conditions precedent before the obligee has rights against the surety under the performance bond -- the principal is in default, the principal is declared by the obligee to be in default, and the obligee has performed its obligations under the contract.<sup>11</sup> One unanswered question is when the surety's duty to investigate arises under this performance bond.

For another example, the AIA Document A312 Performance Bond (1984), paragraph 3, provides that, if there is no Owner Default,<sup>12</sup> the surety's obligation arises after the obligee complies with the performance bond's conditions precedent:<sup>13</sup>

3.1 The Owner has notified the Contractor and the Surety at its address described in Paragraph 10 below that the Owner is considering declaring a Contractor Default<sup>14</sup> and has requested and attempted to arrange a conference with the Contractor and the Surety to be held not later than fifteen days after receipt of such notice to discuss methods of performing the Construction Contract. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract,<sup>15</sup> but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default; and

3.2 The Owner has declared a Contractor Default and formally terminated the Contractor's right to complete the contract. Such Contractor Default shall not be declared earlier than twenty days after the Contractor and the Surety has received notice as provided in Subparagraph 3.1; and

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<sup>11</sup> See Section III. B. 2., *infra*.

<sup>12</sup> The AIA Document A312 Performance Bond (1984) defines Owner Default as:

12.4 Owner Default: Failure of the Owner, which has neither been remedied nor waived, to pay the Contractor as required by the Construction Contract or to perform and complete or comply with the other terms thereof.

<sup>13</sup> See Section III. B. 2., *infra*.

<sup>14</sup> The AIA Document A312 Performance Bond (1984) defines Contractor Default as:

12.3 Contractor Default: Failure of the Contractor, which has neither been remedied nor waived, to perform or otherwise to comply with the terms of the Construction Contract.

<sup>15</sup> The AIA Document A312 Performance Bond (1984) defines the Construction Contract as:

12.2 Construction Contract: The agreement between the Owner and the Contractor identified on the signature page, including all Contract Documents and changes thereto.

3.3 The Owner has agreed to pay the Balance of the Contract Price<sup>16</sup> to the Surety in accordance with the terms of the Construction Contract or to a contractor selected to perform the Construction Contract in accordance with the terms of the contract with the Owner.

Arguably, the surety may begin its investigation prior to the date set for the conference required under paragraph 3.1 of this performance bond. However, there is a large difference between a surety's investigation of whether, as the obligee alleges, the principal is in default under the construction contract, especially when the principal disputes that it is in default, and a surety's investigation after the obligee's termination of the principal's construction contract in order to determine and/or exercise the surety's options under the performance bond.

Neither the AIA Document A311 Performance Bond nor the AIA Document A312 Performance Bond provides some defined time when the surety has a duty to investigate. Some obligees routinely and regularly claim that the principal is in default during the course of construction for minor, not so minor and/or more material breaches of the construction contract, and send notices to the surety of these alleged breaches and defaults on a frequent basis, usually as a copy of a letter directed to the principal. Do such notices trigger the surety's duty to investigate? Different sureties take different positions on whether the surety has a duty to investigate prior to the obligee's complying with the performance bond's conditions precedent, thereby triggering the surety's performance obligations under the performance bond. It is beyond the scope of this paper to delve deeply into when the surety must commence its duty to investigate. Other commentators have written extensively on the surety's duty to investigate and when that occurs in conjunction with the acts and events triggering the surety's performance obligations under the performance bond.<sup>17</sup>

### **C. The Who, What and How of the Surety's Investigation**

There is a difference in the who, what and how of a surety's investigation when the situation is whether the principal is in default under the construction contract (and whether the surety may have the obligation to perform under its performance bond) as compared with the situation when the principal is actually in default and the obligee has terminated the principal's construction contract, with the surety investigating its performance obligations and

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<sup>16</sup> The AIA Document A312 Performance Bond (1984) defines the Balance of the Contract Price as:

12.1 Balance of the Contract Price: The total amount payable by the Owner to the Contractor under the Construction Contract after all proper adjustments have been made, including allowance to the Contractor of any amounts received or to be received by the Owner in settlement of insurance or other claims for damages to which the Contractor is entitled, reduced by all valid and proper payments made to or on behalf of the Contractor under the Construction Contract.

<sup>17</sup> William S. Piper & Carl C. Coe, Jr., *The Surety's Investigation*, in BOND DEFAULT MANUAL, 3D ED. 43-60 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005) (which focuses on the objectives of the investigation, the responsibility to investigate, the information required to make appropriate decisions, the significance of such information, and the source from which such information is obtainable); Marilyn Klinger, James P. Diwik & Kevin L. Lybeck, *Contract Performance Bonds*, in THE LAW OF SURETYSHIP, 2D ED. 96-98 (Edward G. Gallagher, ed. 2000); Ray H. Britt, *The Surety's Investigation*, 17 FORUM 1151 (1982).

options under the performance bond. However, for this paper, I will treat the who, what and how of the surety's investigation in one place.

When the surety investigates a performance bond claim, the commentators have described a number of sources for the facts, information and documents that a surety may require.<sup>18</sup> The sources and kinds of information that the surety may seek during its investigation generally include the following:

1. A review of the surety's underwriting files and documents to support the bonds themselves, including a thorough review of the actual performance and payment bonds, the construction contract, the bidders on the project and the bid spreads, any job status inquiries, and all other documents.

2. A review of the principal's books and records for the construction contract, including a complete set of the contract documents, change orders, pending change orders, general and special conditions, specifications and drawings; copies of all progress estimates and/or payment applications; lists of all subcontracts and purchase orders, and, if appropriate, copies of those documents; all accounts payable and accounts receivable; the bid estimate file; and job correspondence.

3. A review of the obligee's books and records for all of the construction contract documents, including the plans and specifications, all change orders (approved, pending and denied) and backcharges, job minutes, progress reports and punchlists; copies of all progress estimates and/or payment applications; job schedules; any lists of notices from the principal, subcontractors and suppliers of nonpayment; and all job correspondence between the obligee and the principal. Very importantly, the obligee must provide the surety with fully executed copies of the performance and payment bond.<sup>19</sup>

4. The surety may comply with and want to visit the bonded project site(s) to determine the state of the completion of the performance of the work and inventory any materials stored on the premises for use in the performance of the work. The surety may also want to review the project schedule(s) that may be located at the project site(s).

5. Assuming that the surety has received payment bond claims from the principal's subcontractors and suppliers on the bonded contract(s), the surety will investigate the factual basis for and resolve those claims in compliance with the terms of the relevant payment bond(s).

#### **D. The Surety's Analysis of its Investigation**

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<sup>18</sup> William S. Piper & Carl C. Coe, Jr., *The Surety's Investigation*, in BOND DEFAULT MANUAL, 3D ED. 54-57 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005); Marilyn Klinger, James P. Diwik & Kevin L. Lybeck, *Contract Performance Bonds*, in THE LAW OF SURETYSHIP, 2D ED. 96-98 (Edward G. Gallagher, ed. 2000); Ray H. Britt, *The Surety's Investigation*, 17 FORUM 1151 (1982).

<sup>19</sup> Most surety underwriting and financial files do not contain a copy of the fully executed performance and payment bonds. The bond agent usually executes the bonds on behalf of the surety and sends the bonds to the principal to execute and then to deliver the fully executed bonds to the obligee with an executed copy of the construction contract. As a result, the obligee is frequently the only party that has a fully executed copy of the final performance and payment bonds.

There is never enough time for a surety to complete a full investigation before it may be required to make a decision on whether and/or how to perform under the surety's performance bond. A surety's investigation reviews many issues, including the following:

1. Why the performance bond claim arose.
2. Whether the obligee's termination of the principal for default is proper and justified under the construction contract<sup>20</sup> and whether the obligee has complied with any conditions precedent under the performance bond such that the surety is obligated to perform under the performance bond.<sup>21</sup>
3. Whether the surety may assert any of the principal's defenses (see Section III. A. below) or assert its own surety defenses (see Section III. B. below) to the obligee's performance bond claim.
4. How the surety may comply with and fulfill its performance bond obligations and its options under the performance bond while controlling and/or mitigating its loss exposure (see Section IV. below).
5. How the surety may recover its losses through indemnity, salvage, subrogation or other means (see Section VI. A., B. and C. below).

At some point, promptly after its analysis of its investigation, a surety will make a decision. The basis for the surety's decision and the consequences of that decision are the subject of Sections III. and IV. below.

### **III. THE SURETY'S RIGHTS AND DEFENSES**

In a default and/or termination scenario, it is rare that a surety may fully perform the definitive detailed investigation that it would like before it must determine what steps to take. The critical documents to review are the performance bond and the construction contract as they set out the rights and obligations of the three parties -- the obligee, the principal and the surety. Once the investigation is as complete as possible under the various time constraints, the surety must analyze its rights, which include possible defenses to the obligee's claims against the performance bond, and its options going forward, whether they are spelled out specifically within the performance bond or not.

#### **A. The Surety's Assertion of the Principal's Defenses**

Many performance bonds require not only that the principal be in default and/or declared by the obligee to be in default under the construction contract, but also that the obligee must have performed the obligee's obligations under the construction contract. That is true under both the AIA Document A311 Performance Bond ("the Owner having performed

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<sup>20</sup> The primary issue for the surety's initial investigation is whether the obligee is justified in terminating the principal's construction contract for default and the factual and legal basis that may constitute and support a justified contract termination. See note 24, *infra*.

<sup>21</sup> See Section III. B. 1. and 2., *infra*.

Owner's obligations" under the construction contract) and the AIA Document A312 Performance Bond ("[i]f there is no Owner Default," which is defined in paragraph 12.4 of the AIA Document A312 Performance Bond as the "[f]ailure of the Owner, which has neither been remedied nor waived, to pay the Contractor as required by the Construction Contract or to perform and complete or comply with the other terms thereof"). If the obligee is in default under the construction contract, the principal may have a defense to the obligee's termination of the principal's construction contract, and the surety may assert the principal's defenses when the obligee makes a claim against the performance bond.<sup>22</sup>

Listed below are a number of the principal's defenses that the surety may assert. During the surety's investigation and analysis, there may be other defenses that the principal may assert that the surety may discover. There are a number of books, articles and papers that discuss the surety's assertion of the principal's defenses against an obligee's performance bond claim, and some of the most relevant and helpful are listed in the footnote below.<sup>23</sup>

1. The obligee's wrongful termination of the principal's construction contract.<sup>24</sup>

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<sup>22</sup> The principal's performance or lack of performance of all of the material obligations under the construction contract may affect the surety's assertion of the principal's defenses. For example, the principal may have an implied duty to seek clarification of patently ambiguous design documents, an implied warranty of workmanship, an implied duty of cooperation, an implied product warranty of merchantability and fitness of purpose, an implied duty to warn, a duty to perform a site inspection and/or an obligation to give timely claim notice and submissions in order to fully comply with the terms of the construction contract. See Philip L. Bruner & Tracey L. Haley, *Strategic "Generalship" of the Complex Construction Suretyship Case*, in *MANAGING AND LITIGATING THE COMPLEX SURETY CASE*, 2D ED. 54-63 (Philip L. Bruner & Tracey L. Haley, eds. 2007).

<sup>23</sup> Philip L. Bruner & Tracey L. Haley, *Strategic "Generalship" of the Complex Construction Suretyship Case*, in *MANAGING AND LITIGATING THE COMPLEX SURETY CASE*, 2D ED. (Philip L. Bruner & Tracey L. Haley, eds. 2007) (hereinafter "Bruner - Complex"); Philip L. Bruner, Patrick J. O'Connor, Jr. & Tracey L. Haley, *The Surety's Analysis of Investigative Results: "To Perform or Not to Perform - That is the Question,"* in *BOND DEFAULT MANUAL*, 3D ED. (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005) (hereinafter "Bruner - Bond Default"); M. Michael Egan & Marla Eastwood, *Discharge of the Performance Bond Surety*, in *THE LAW OF SURETYSHIP*, 2D ED. (Edward G. Gallagher, ed. 2000) (hereinafter "Egan - Suretyship"); Julia Blackwell Gelinis, *Defenses Available to the Surety*, in *THE LAW OF PERFORMANCE BONDS* (Lawrence R. Moelmann & John T. Harris, eds. 2000) (hereinafter "Gelinis - Performance Bond").

<sup>24</sup> An obligee's wrongful termination of the principal's construction contract is itself a breach of that construction contract that relieves the principal from its obligations under the construction contract and the principal and the surety from their liability under the performance bond. During its investigation, the surety will attempt to determine what constitutes default under the principal's construction contract and whether the obligee's termination of the principal for default is proper and justified, or whether the obligee wrongfully terminated the principal's construction contract. There are a number of facts and factors that are relevant for the issue of a wrongful termination, including the importance of a good faith motive for the obligee's termination, the importance of a proper cure notice, and/or the obligee's waiver of its right to terminate the principal for default. See Bruner - Complex, pp. 16-28; Bruner - Bond Default, pp. 93-112. Furthermore:

The obligee's termination of the principal under the termination clause of a bonded contract can be upheld only if the obligee sustains its burden of proof that (1) the principal materially and inexcusably breached its contract, (2) the principal's breaches were not induced or preceded by the obligee's own supervening material breaches of contract, such as nonpayment, maladministration of the construction process, or refusal to grant proper time extensions or other recognized "contract defenses," (3) the obligee's termination was not improperly motivated or conceived in bad faith and was made independently and with the exercise of discretion by its representative having

2. The obligee's failure to pay the contract funds.<sup>25</sup>

Obviously, if the obligee wrongfully fails to pay the principal the contract funds, the principal may have a defense as a result of the obligee's material breach of the construction contract.

3. The obligee's duties incident to the project's design.

If the obligee fails to fulfill its duties incident to the design of the project, including but not limited to the obligee's failure to provide plans and specifications that are free from defects, the principal may be discharged from its performance under the construction contract. The obligee's duties include the following:<sup>26</sup>

- a. The obligee's implied warranty of design adequacy (including the "government contractor" defense<sup>27</sup>).
- b. The obligee's implied warranty of commercial availability of specified construction materials.
- c. The obligee's implied duty of disclosure.
- d. The blending of design and performance specifications.
- e. The obligee's approval of the principal's work plan.
- f. The obligee's implied warranty of design versus the principal's warranty of materials.
- g. The obligee's responsibility for latent ambiguities in its design.

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authority to terminate the contract, (4) the principal was given ample notice of deficiencies so as to understand what needed to be "cured," and (5) the obligee properly followed its contractually-specified termination procedure.

Bruner - Bond Default, p. 104; see also Bruner - Complex, pp. 20-21; Gelinas - Performance Bond, pp. 205-06. The obligee's wrongful termination of the principal's construction contract may lead to the obligee's release and discharge of the surety's principal and the surety and/or the obligee's failure to comply with the performance bond's conditions precedent requiring the surety to perform. See Section III. B. 1. and 2., *infra*.

<sup>25</sup> Bruner - Complex, pp. 46-47; Bruner - Bond Default, pp. 128-29; Egan - Suretyship, pp. 138-39; T. Scott Leo & B. Scott Douglass, *The Obligee's Duties to Provide Plans and Specifications, Make Payment, and Process Change Orders* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997).

<sup>26</sup> Bruner - Complex, pp. 34-42; Bruner - Bond Default, pp. 117-25; Gelinas - Performance Bond, pp. 202-03; T. Scott Leo & B. Scott Douglass, *The Obligee's Duties to Provide Plans and Specifications, Make Payment, and Process Change Orders* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997).

<sup>27</sup> Bruner - Complex, pp. 36-37 and its footnotes 103-05; Bruner - Bond Default, pp. 119-20.

4. The obligee's implied duty of cooperation.<sup>28</sup>
5. The impossibility or impracticality of the performance of the work.<sup>29</sup>
6. The obligee's failure to properly administer the construction contract (including the obligee's lack of response to requests for information and proposed change orders and other failures to act timely).<sup>30</sup>
7. The obligee's failure to provide the principal with an opportunity to cure the default.<sup>31</sup>
8. The obligee's implied waiver of contract requirements.<sup>32</sup>
9. The obligee's insistence upon strict compliance in the face of economic waste, and hypertechnical inspection.<sup>33</sup>
10. The obligee's release and settlement of claims against the principal.<sup>34</sup>
11. The principal's setoffs and/or counterclaims.<sup>35</sup>

## **B. The Surety's Assertion of its Own Defenses**

Along with the defenses of its principal, the surety may assert its own defenses to an obligee's performance bond claim. Listed below are a number of the surety's defenses to an obligee's performance bond claim after the default and termination of the principal on the construction contract, with citations to the books, articles and papers that discuss the surety's defenses against an obligee's performance bond claim.

<sup>28</sup> Bruner - Complex, pp. 42-44; Bruner - Bond Default, pp. 125-26.

<sup>29</sup> Bruner - Complex, p. 50; Bruner - Bond Default, p. 132; Gelinas - Performance Bond, pp. 204-05; RESTATEMENT (2D) OF THE LAW OF CONTRACTS § 261 (1981).

<sup>30</sup> Bruner - Complex, pp. 45-49; Bruner - Bond Default, pp. 127-32; Egan - Suretyship, pp. 138-39; Gelinas - Performance Bond, p. 203; T. Scott Leo & B. Scott Douglass, *The Obligee's Duties to Provide Plans and Specifications, Make Payment, and Process Change Orders* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997).

<sup>31</sup> Bruner - Complex, pp. 23-27; Bruner - Bond Default, pp. 107-10; Gelinas - Performance Bond, pp. 206-07.

<sup>32</sup> Bruner - Complex, pp. 50-51; Bruner - Bond Default, p. 133; see BRUNER & O'CONNOR ON CONSTRUCTION LAW, § 18:17-18:20.

<sup>33</sup> Bruner - Complex, pp. 51-52; Bruner - Bond Default, pp. 133-34.

<sup>34</sup> Bruner - Complex, pp. 53-54; Bruner - Bond Default, pp. 135-36; Gelinas - Performance Bond, pp. 219-20; RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 39 (1996).

<sup>35</sup> Gelinas - Performance Bond, p. 207.

1. The release and/or discharge of the surety's principal (including but not limited to the obligee's wrongful termination of the principal's construction contract).<sup>36</sup>

2. The obligee's failure to provide notice to the surety and/or to comply with the performance bond's conditions precedent requiring the surety to perform (including the obligee's failure to allow the surety to have the opportunity to exercise and/or perform its options under the performance bond).

During the surety's investigation and analysis, the surety attempts to determine from the facts gathered and its legal review what constitutes a principal's alleged construction contract default so that an obligee may require the surety to perform its obligations under the performance bond.<sup>37</sup> In making its analysis, the surety will review the distinction between a breach of contract and a default,<sup>38</sup> what is a material breach of contract,<sup>39</sup> whether the construction contract provisions defining a "default" or an "event of default" are the exclusive

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<sup>36</sup> See Section III. A. 1. and note 24, *supra*; RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 39 (1996) (the obligee's release of the principal from its duties and obligations pursuant to the underlying construction contract releases the surety's obligations under the bond).

<sup>37</sup> Philip L. Bruner & Tracey L. Haley, *Strategic "Generalship" of the Complex Construction Suretyship Case*, in *MANAGING AND LITIGATING THE COMPLEX SURETY CASE*, 2D ED. 16-28 (Philip L. Bruner & Tracey L. Haley, eds. 2007); Philip L. Bruner, Patrick J. O'Connor, Jr. & Tracey L. Haley, *The Surety's Analysis of Investigative Results: "To Perform or Not to Perform - That is the Question,"* in *BOND DEFAULT MANUAL*, 3D ED. 93-112 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005); Benjamin D. Lentz, *Default, Notice of Default, Impact Upon Surety's Obligations Where Notice is Not Given*, in *THE LAW OF PERFORMANCE BONDS* pp. 19-35 (Lawrence R. Moelmann & John T. Harris, eds. 2000); see also note 24, *supra*, for a discussion concerning the obligee's wrongful termination of the principal's construction contract.

<sup>38</sup> In *L&A Contracting Company v. Southern Concrete Services, Inc.*, 17 F.3d 106, 110 (5<sup>th</sup> Cir. 1994), the court articulated the distinction between a breach and a default as follows:

Although the terms breach and default are sometimes used interchangeably, their meanings are distinct in construction suretyship law. Not every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it. To constitute a legal default, there must be (1) material breach or series of material breaches (2) of such magnitude that the obligee is justified in terminating the contract. Usually the principal is unable to complete the project, leaving termination of the contract the obligee's only option.

<sup>39</sup> While there are a number of definitions in the case law of "materiality" or "material breach," the RESTATEMENT (2D) OF CONTRACTS § 241 provides:

1. The extent to which the injured party will be deprived of the benefit which he reasonably expected;
2. The extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
3. The extent to which the party failing to perform (or failing to offer to perform) will suffer forfeiture;
4. The likelihood that the party failing to perform (or failing to offer to perform) will cure his failure, taking account of all of the circumstances including any reasonable assurances; and
5. The extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

grounds for determining the principal's default, or whether there are other grounds,<sup>40</sup> and the obligee's potential waiver of the principal's default.<sup>41</sup>

In addition, many courts have found that the surety may be entitled to a notice<sup>42</sup> from the obligee of the obligee's declaration of the principal's default.<sup>43</sup> Some courts have found differently and concluded that such an obligee notice to the surety is unnecessary.<sup>44</sup> There may be consequences to the obligee if the required notice of its declaration of a principal's default is not provided to the surety. If the notice to the surety is a condition precedent for the surety to perform its obligations under the performance bond, the surety may be released from all of its liability to the obligee under the performance bond because of the obligee's failure to

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<sup>40</sup> The question is whether the default provisions in a construction contract are "exclusive" or "non-exclusive." Specifically, if the construction contract default provision is silent on whether it is exclusive or not, may the obligee assert a basis or ground for default that is not described in the construction contract? In *Olin Corporation v. Central Industries, Inc.*, 576 F.2d 642 (5<sup>th</sup> Cir. 1978), the court noted the split in authority between (1) what the court referred to as the "Corbin view" [6 Richard Corbin *Contracts* § 1266 at 64 (1962)], namely that "where such a termination provision is included in a contract, it constitutes the exclusive means of terminating the contract, and (2) what the court referred to as the "Williston view" [Samuel Williston, *Williston on Contracts*, § 842, note 1 at 165 (3d ed. 1959)], namely that "[U]nless a contract provision for termination for breach is in terms exclusive (citation omitted), it is a cumulative remedy and does not bar the ordinary remedy of termination for a 'breach which is material, or which goes to the root of the matter or essence of the contract.'"

<sup>41</sup> Even if the obligee has grounds for asserting that the principal is in default under the construction contract, the obligee may waive, by its actions or words, the right to declare the principal in default. See Bruner - Complex, pp. 50-51; Bruner - Bond Default, p. 133.

<sup>42</sup> Numerous cases have held that the notice to the surety must be stated in clear, direct, definite, explicit, unambiguous and unequivocal language. See *Seaboard Sur. Co. v. Town of Greenfield*, 266 F. Supp. 2d 189 (D. Mass. 2003), *aff'd*, 370 F.3d 215, 223 (1<sup>st</sup> Cir. 2004) [citing *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106, 111 (5<sup>th</sup> Cir. 1994) ("A declaration of default sufficient to invoke the surety's obligations under the bond must be made in clear, direct, and unequivocal language. The declaration must inform the surety that the principal has committed a material breach or series of material breaches of the subcontract, that the obligee regards the subcontract as terminated, and that the surety must immediately commence performing under the terms of its bond."); *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC.*, 281 F. Supp. 2d 406 (D. Conn. 2003), *aff'd*, 376 F.3d 96 (2d Cir. 2004); and *Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82, 86 (D. Conn. 1997)]; *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003).

<sup>43</sup> A number of cases hold that the surety is entitled to the obligee's notice of a declaration of a principal's default either under the performance bond or under the construction contract. *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106 (5<sup>th</sup> Cir. 1994) (the court found that the performance bond required a formal declaration of default as a condition precedent to the surety's liability. The court held that the obligee's failure to send the surety any notice of default resulted in a complete discharge of the surety's performance bond obligations); *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55 (Ill. App. Ct. 1997) (the court held that a performance bond was null and void when the obligee failed to provide seven days' notice to the surety and the principal as required, not under the performance bond, but under the general conditions of the construction contract that was incorporated into the performance bond); *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003); *Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997).

<sup>44</sup> *Siegfried Construction, Inc. v. Gulf Insurance Company*, 203 F.3d 822 (4<sup>th</sup> Cir. 2000) (where no formal declaration of default or termination of the construction contract was required under Virginia law to trigger a surety's performance bond obligations); *Walter Concrete Constr. Corp. v. Lederle Lab.*, 788 N.E.2d 609, 610 (N.Y. 2003) ("Notwithstanding [the surety's] contrary claim, the AIA-311 performance bond contains no explicit provision requiring a notice of default as a condition precedent to any legal action on the bond . . . Unlike the AIA-312 bond, another industry standardized bond, an action on the AIA-311 bond is not tied to a declaration of default, the principal's cessation of work or the surety's refusal to perform under the bond."); *Winston Corporation v. Continental Casualty Co.*, 361 F. Supp. 1023, *rev'd*, 508 F.2d 1298 (6<sup>th</sup> Cir. 1975).

provide the surety with such notice.<sup>45</sup> In other cases, however, the obligee's failure to provide such notice to the surety may only reduce the surety's liability under the performance bond to the extent that the surety has been prejudiced or harmed as a result of not receiving the obligee's notice of the declaration of the principal's default.<sup>46</sup>

Finally, whether or not the obligee has provided the surety with notice of the obligee's declaration of the principal's default under the construction contract, if the obligee takes actions that deny the surety the ability to exercise its rights to perform under the performance bond, the surety may be released and discharged from any liability to the obligee under the performance bond.<sup>47</sup>

3. The principal's substantial performance of the construction contract.<sup>48</sup>
4. The obligee's actions that are prejudicial to the surety.

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<sup>45</sup> *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106 (5<sup>th</sup> Cir. 1994); *Balfour Beatty Construction, Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997); *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55 (Ill. App. Ct. 1997); *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*, 281 F. Supp. 2d 406 (D. Conn. 2003), *aff'd*, 376 F.3d 96 (2d Cir. 2004); *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003); *The School Board of Escambia County, Florida v. TIG Premier Insurance Company* 110 F. Supp. 2d 1351 (N.D. Fla. 2000); *153 Hudson Dev., LLC v. DiNunno*, 778 N.Y.S.2d 482 (App. Div. 2004); *120 Greenwich Dev. Assocs., LLC v. Reliance Ins. Co.*, No. 01 Civ. 8219 (PKL), 2004 WL 1277998 (S.D.N.Y. June 10, 2004); *St. Paul Fire and Marine Ins. Co. v. City of Green River, Wyoming*, 93 F. Supp. 2d 1170 (D. Wyo. 2000), *aff'd*, 6 F. Appx. 828 (10<sup>th</sup> Cir. 2001); *Seaboard Sur. Co. v. Town of Greenfield*, 266 F. Supp. 2d 189 (D. Mass. 2003), *aff'd*, 370 F.3d 215 (1<sup>st</sup> Cir. 2004).

<sup>46</sup> *Winston Corporation v. Continental Casualty Co.*, 361 F. Supp. 1023, *rev'd*, 508 F.2d 1298 (6<sup>th</sup> Cir. 1975) (the court found that the failure to give a seven-day notice required by the general conditions of the contract was an insubstantial breach that might permit the surety to a discharge to the extent of the harm, but would not justify a complete discharge of the surety's obligations); *Blackhawk Heating & Plumbing Co. v. Seaboard Surety Co.*, 534 F. Supp. 309 (N.D. Ill. 1982) (a failure by the obligee to give notice of a declaration of default might result in a *pro tanto* rather than complete discharge of the surety's obligations under the performance bond); *Plowden & Roberts, Inc. v. Conway*, 192 So.2d 528, 533 (Fla. Dist. Ct. App. 1966) (the "surety's liability is merely reduced by any harm which it suffered by the fact that it was not accorded its rights to remedy the default."); *Continental Bank & Trust Co. v. American Bonding Co.*, 605 F.2d 1049 (8<sup>th</sup> Cir. 1979).

<sup>47</sup> *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*, 281 F. Supp. 2d 406 (D. Conn. 2003), *aff'd*, 376 F.3d 96 (2d Cir. 2004); *Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997); *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003); *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55 (Ill. App. Ct. 1997); *Insurance Company of North America v. Metropolitan Dade County*, 705 So. 2d 33, 35 (Fla. Dist. Ct. App. 1977) (the court noted that the obligee's failure to comply with the terms of INA's bond notice provisions, "stripped the surety of its bargained for right and relieved the surety of its liability."); *St. Paul Fire and Marine Ins. Co. v. City of Green River, Wyoming*, 93 F. Supp. 2d 1170 (D. Wyo. 2000), *aff'd*, 6 F. Appx. 828 (10<sup>th</sup> Cir. 2001) ["[t]he effect of the [obligee's] termination of [the surety] was to divest [the surety] of its ability to minimize its liability by selecting the lowest cost option and by 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," citing *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106, 111 (5<sup>th</sup> Cir. 1994); *Balfour Beatty Construction, Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82, 86 (D. Conn. 1997); *Insurance Company of North America v. Metropolitan Dade County*, 705 So.2d 33, 34-35 (Fla. Dist. Ct. App. 1977); and *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55, 58 (Ill. App. Ct. 1997). 93 F. Supp. 2d at 1178.].

<sup>48</sup> Bruner - Complex, pp. 30-33; Bruner - Bond Default, pp. 113-17; see *Bank of Brewton, Inc. v. Int'l Fid. Ins. Co.*, 827 So. 2d 747, 753 (Ala. 2002) ("[The surety's] obligations to [the obligee] concluded upon completion of the project.").

- a. Material alterations to the construction contract (cardinal changes).<sup>49</sup>
  - b. Overpayments or improper payments - impairment or release of collateral (the bonded contract funds).<sup>50</sup>
  - c. Extensions of time.<sup>51</sup>
  - d. The failure to give timely notice<sup>52</sup> and/or to timely default and terminate the principal.<sup>53</sup>
  - e. The obligee's failure to mitigate its damages.<sup>54</sup>
  - f. Other obligee actions, including changes in the obligee or the principal.<sup>55</sup>
5. Contractual and statutory limitations.<sup>56</sup>
6. The obligee's lack of good faith (concealment, non-disclosure and/or misrepresentation of facts).<sup>57</sup>

<sup>49</sup> Bruner - Complex, pp. 47-49 & 63-64; Bruner - Bond Default, pp. 129-31 & 137-38; Egan - Suretyship, pp. 128-36; Gelinias - Performance Bond, pp. 210-13; RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 41 (1996).

<sup>50</sup> Bruner - Complex, pp. 67-69; Bruner - Bond Default, pp. 141-43; Egan - Suretyship, pp. 120-28; Gelinias - Performance Bond, pp. 214-15 & 217-19; Randall I. Marmor & Gilbert J. Schroeder, *Overpayment of the Principal as a Defense to the Surety* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997); RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 42 (1996).

<sup>51</sup> Egan - Suretyship, pp. 136-38; Gelinias - Performance Bond, p. 215; James A. Knox, Jr., *The Surety's Extension of Time Defense*, 33 TORT & INS. L.J. 891 (1998); RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 40(b) (1996).

<sup>52</sup> Bruner - Complex, pp. 71-73; Bruner - Bond Default, pp. 144-45; Egan - Suretyship, pp. 136-38; Gelinias - Performance Bond, pp. 207-10.

<sup>53</sup> In *Ohio Casualty Insurance Company v. United States*, 12 Cl. Ct. 590 (1987), the surety alleged that the obligee violated its equitable duty to the surety and abused its discretion in failing to terminate the surety's principal. The court found that the obligee abused its discretion by failing to timely terminate the principal. The court found that the evidence "overwhelmingly showed a pattern of unreasonable conduct on the part of those responsible for the administration of the contract," 12 Cl. Ct. at 591, and that "it would be manifestly unjust to make the surety pay for the Navy's mistake." 12 Cl. Ct. at 591. "The evidence clearly supports a finding that the contractor in this case should have been terminated no later than November of 1981 and that it was an abuse of the contracting officer's discretion to not do so. In so abusing its discretion, the Navy violated an equitable duty it owed to plaintiff [surety]. The evidence also supports a finding that the plaintiff [surety] suffered financial losses of \$592,687.81 as a result of the government's failure to terminate by such date." *Id.*

<sup>54</sup> Gelinias - Performance Bond, p. 214.

<sup>55</sup> Bruner - Complex, pp. 64-67; Bruner - Bond Default, pp. 138-41; Egan - Suretyship, pp. 129-31; Gelinias - Performance Bond, pp. 213 & 216-17.

<sup>56</sup> Bruner - Complex, pp. 73-76; Bruner - Bond Default, pp. 145-48; Egan - Suretyship, pp. 139-43.

#### **IV. THE SURETY'S OBLIGATIONS AND OPTIONS**

In order to adequately discuss the surety's obligations and its options in a performance bond situation, we have to assume that there is a valid obligee default and/or termination of the principal's construction contract such that the surety has no defenses to the performance bond claim and is obligated to perform under the terms of the performance bond. The one caveat to this assumption is that the surety may elect to perform under the performance bond despite the principal's and/or the surety's disputes with the obligee for a myriad of reasons, while reserving all of its and their rights and defenses, including the principal's defenses and the surety's defenses mentioned above.

##### **A. Generally - The Surety's Performance Bond Options**

A frequent reaction of a surety lawyer or in-house surety claims representative when the obligee terminates the principal's construction contract and makes a claim against the surety's performance bond is that the surety has a number of options. The most common surety performance bond options are discussed in this Section IV. of the paper. However, it is important for the surety to complete its investigation of its performance bond obligations and determine its best options. In order to do so, the surety may take the following actions.

1. Read the performance bond.

It is critical for the surety to review the executed performance bond for the construction contract. Both the AIA Document A311 Performance Bond<sup>58</sup> and the AIA

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<sup>57</sup> Bruner - Complex, pp. 76-77 n.243, 246 [see RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 12. See also *Ground Imp. Techniques, Inc. v. Merchants Bonding Co.*, 63 F. Supp. 2d 1272 (D. Colo. 1999) (applying RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY and upholding the surety's right to rescission upon proof that its issuance of a bond to an excavation subcontractor on a Department of Energy environment cleanup project was induced by concealment of material information); see also *Kvaerner Constr., Inc. v. Am. Safety Cas. Ins. Co.*, 847 So. 2d 534 (Fla. Dist. Ct. App. 2003) (upholding a surety's discharge from liability under a subcontractor performance bond, where the contractor obligee had hired the subcontractor knowing that it was not licensed and then had demanded that the surety perform after the county stopped work on the project due to the failure of the subcontractor to be licensed)]; Bruner - Bond Default, pp. 148-49; Egan - Suretyship, pp. 144-45; Gelinas - Performance Bond, pp. 221-22.

<sup>58</sup> The AIA Document A311 Performance Bond provides the following performance options for the surety:

. . . the Surety may promptly remedy the default, 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 in accordance with its terms and conditions, and upon determination by Surety of the lowest responsible bidder, or, if the Owner elects, upon determination by the Owner and the Surety jointly of the lowest responsible bidder, arrange for a contract between such bidder and Owner, and make available as Work progresses (even though there should be a default or a succession of defaults under the contract or contracts of completion arranged under this paragraph) sufficient funds to pay the cost of completion less the balance of the contract price; but not exceeding, including other costs and damages for which the Surety may be liable hereunder, the amount set forth in the first paragraph hereof. The term "balance of the contract price," as used in this paragraph, shall mean the total amount payable

Document A312 Performance Bond<sup>59</sup> provide that the surety may exercise certain performance options. While the obligee and the surety may later negotiate any changes they want to make concerning their respective rights and obligations, if no other agreement can be reached, then the terms of the performance bond will dictate what happens next. There are many types of performance bond forms,<sup>60</sup> and the acronym “RTFB” could not be more accurate when the obligee makes a claim against the surety’s performance bond.

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by Owner to Contractor under the Contract and any amendments thereto, less the amount properly paid by Owner to Contractor.

<sup>59</sup> The AIA Document A312 Performance Bond provides the following performance options for the surety:

4. When the Owner has satisfied the conditions of Paragraph 3, the Surety shall promptly and at the Surety’s expense take one of the following actions:

4.1 Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract; or

4.2 Undertake to perform and complete the Construction Contract itself, through its agents or through independent contractors; or

4.3 Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and the contractor selected with the Owner’s concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages as described in Paragraph 6 in excess of the Balance of the Contract Price incurred by the Owner resulting from the Contractor’s default; or

4.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances:

.1 After investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, tender payment therefor to the Owner; or

.2 Deny liability in whole or in part and notify the Owner citing reasons therefor.

<sup>60</sup> See note 4, *supra*. Under the Miller Act performance bond, the surety’s obligation is void if the principal “performs and fulfills all the undertakings, covenants, terms, conditions, and agreements in the contract.” If the principal fails to perform, the surety is bound “for payment of the penal sum” of the Miller Act performance bond. Nothing is said about and no performance bond options are provided for to describe how the surety is to fulfill its performance obligations under the Miller Act performance bond if the principal fails to fulfill its obligations under the contract with the federal government. Essentially, the Miller Act performance bond is an indemnity bond. See Bruner - Bond Default, pp. 91-92. The Federal Acquisition Regulations, 48 C.F.R. § 49.404, acknowledge that a “surety has certain rights and interests in the completion of the contract work and the application of any undisbursed funds,” and that “the contracting officer must consider carefully the surety’s proposals for completing the contract.” § 49.404(b). Furthermore, the “contracting officer should permit surety offers to complete the contract.” § 49.404(c). “There may be conflicting demands for the defaulting contractor’s assets, including unpaid prior earnings (retained percentages and unpaid progress estimates). Therefore, the surety may include a “takeover” agreement in its proposal, fixing the surety’s rights to payment from those funds. The contracting officer may (but not before the effective date of termination) enter into a written agreement with the surety. § 49.404(d). In reality, the federal government may consider any kind of an agreement with the surety to complete the performance of the work, including a takeover agreement or a tender agreement. Furthermore, a review of the cases involving the federal government shows that the surety’s financing of the principal has been

2. Read the construction contract.

The construction contract is referred to and may be incorporated by reference into the surety's performance bond. Therefore, the provisions of the construction contract may inevitably be read into the performance bond at least to the extent of the major terms concerning the scope of the principal's work, the contract price and the terms of payment. The time of completion, however, may not be binding upon the surety depending upon the circumstances and timing of the obligee's default and termination of the principal.<sup>61</sup> Furthermore, certain provisions, such as an arbitration provision in a construction contract that has been incorporated by reference into the surety's performance bond, may or may not compel the surety to participate in any arbitration between the obligee and the principal.<sup>62</sup>

3. Read any applicable statutes, regulations and/or federal/state law.

Many performance bonds are regulated by statute (either the Federal Miller Act or the various State Little Miller Acts). Numerous cases discuss a surety's liabilities under its statutory performance bond and read the provisions of the statute into the performance bond in order to extend the surety's obligations to those required by statute.<sup>63</sup> Some states, and certainly the federal government,<sup>64</sup> have regulations that are applicable to an obligee's termination of the principal's construction contract and the surety's options under the performance bond. Finally, there are federal and state cases that discuss the particular jurisdiction's applicable law for performance bonds.<sup>65</sup>

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used as a means for the surety's performance of its obligations under the Miller Act performance bond. *Aetna Cas. and Sur. Co. v. United States*, 845 F.2d 971 (Fed. Cir. 1988); *Morrison Assurance Co., Inc. v. United States*, 3 Cl. Ct. 626 (1983); *Great American Ins. Co. v. United States*, 481 F.2d 1298, 1300 n.8 (Ct. Cl. 1973).

For additional secondary materials concerning the federal government as the obligee under the surety's performance bond, see Gerald N. Carozza, Jr. & Cynthia E. Rodgers-Waire, *A Primer on the Tucker Act* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 26, 2008); Donald G. Gavin, Shannon J. Briglia & Mark S. Marino, *Public Works Projects*, in *BOND DEFAULT MANUAL*, 3D ED. 287-311 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005); George J. Bachrach & Robert F. Carney, *The Surety and the United States Court of Federal Claims - Revisited* (unpublished paper submitted at the Tenth Annual Northeast Surety and Fidelity Claims Conference on October 21, 1999); George J. Bachrach & Robert F. Carney, *The Surety and the United States Court of Federal Claims* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 22, 1995); and David D. Crane, *A Critical Examination of the Federal Acquisition Regulations Related to Sureties* (unpublished paper submitted at the ABA annual meeting on August 13, 1991).

<sup>61</sup> See Section IV. A. 5. c., *infra*.

<sup>62</sup> See Section VI. D., *infra*.

<sup>63</sup> Many states have case law that holds that the provisions of the statute are read into a statutory performance bond, that where the performance bond language conflicts with the statutory requirements, it is simply disregarded, but that if the performance bond language affords coverage greater than required by the statute, then the surety's liability will increase beyond that required by the statute. See Bruner - Bond Default, pp. 90-91, nn.5-27.

<sup>64</sup> See note 60, *supra*.

<sup>65</sup> See *PERFORMANCE BOND MANUAL* (Lawrence Lerner & Theodore M. Baum, eds. 2006) for a summary of the law of performance bonds in the 50 states, the District of Columbia, Puerto Rico and all federal jurisdictions. The standard format for the *PERFORMANCE BOND MANUAL* includes such issues as the requirements for the

4. Affirm and protect the penal sum of the performance bond.

Regardless of the terms of the performance bond, the construction contract and the applicable statute and regulations, in exercising any performance bond option, the surety must affirm and protect the penal sum of the performance bond. In choosing its option, the surety must be aware of the risks in each option that it may explore and determine in each situation if any one or more of the options may expose the surety to liability in an amount in excess of the penal sum of the performance bond. In any such factual situation, the surety may well have to discard one or more of its performance bond options when such a risk exists.<sup>66</sup>

5. Understand the three critical performance issues.

Every termination for default that results in the surety's performance under the performance bond has its own set of critical issues. What may be an important issue on one project may not be on another project, and vice versa. However, the issues discussed below are the three critical issues that the surety and the obligee (and/or any prospective completion contractor, if applicable) try to resolve up front (with the exception of when a surety denies liability to an obligee under the performance bond) in any situation when the surety performs under its performance bond.

a. The scope of the remaining work.

The original construction contract normally contains a relatively detailed description of the principal's scope of the work to be performed. Whether the principal is a general contractor on the project (and the scope of the work is building the building or constructing the roadway) or the principal is a subcontractor to the general contractor on the project (putting in the electrical work or plumbing work in the building or striping the roadway), the work to be performed under the construction contract by the surety under its performance bond should be ascertainable. When the obligee terminates the principal for default, the remaining scope of work may become an issue. During construction, the scope of the principal's work may change due to various change orders and other factors. With the exception of the surety's correction of any defective work that the principal may have performed, there may be an issue of whether the obligee expects the surety to perform work in addition to and outside the scope of the principal's original construction contract, all at the surety's cost and expense. The surety, during its investigation of its performance bond options, will attempt to determine the scope of the remaining work to be performed in order to adequately define that remaining scope of work required by its performance bond obligations.

b. The balance of the contract price and payment to the surety.

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performance bond, the damages covered (including the surety's obligations to perform and/or pay and any limitations on damages), the penal sum of the performance bond, the parties covered or not covered (dual obligees, assignees and third-party beneficiaries), notice and/or filing requirements, suit limitations, various procedures, and other matters of interest with respect to performance bonds in each jurisdiction.

<sup>66</sup> While none of the discussions of the various surety performance bond options in Section IV. of this paper go into any great detail concerning the surety's risk of loss in excess of the penal sum of the performance bond, many of the secondary materials cited in the relevant footnotes do address this issue.

Similarly, the balance of the contract price, or the amount of the remaining contract funds, is clearly an issue that must be resolved between the obligee and the surety in order for the surety to determine its ultimate loss. Both the AIA Document A311 Performance Bond and the AIA Document A312 Performance Bond provide that the “balance of the contract price” will be available to the surety that performs under the performance bond. The penal sum of the performance bond is in an amount equal to the original construction contract price, and the surety expects that the remaining contract funds will be used to complete the performance of the project and reduce the surety’s loss. To the extent that the performance of the work costs the surety monies in excess of the remaining balance of the contract price, the surety will fund the excess costs with the expectation that the excess costs will define its ultimate liability under the performance bond.

c. The time of completion.

In most situations when the obligee has terminated the principal for default, the time of completion of the original construction contract has either passed or is rapidly approaching. Depending upon the facts and the performance bond option that the surety may exercise, the time of completion issue between the obligee and the surety may become a large dispute. Conceivably, by its failure to terminate the principal for default until the time of completion is close to the end with a lot of work to be performed, the obligee may have waived its right to obtain timely performance of the construction contract.<sup>67</sup> Furthermore, there may be disputes between the obligee and the principal concerning the party or parties who have caused the delays in the time of completion, with the principal contending that it is entitled to additional time for the performance of the construction contract and additional payments for its damages due to the delays caused by others. Finally, depending upon the performance bond option the surety exercises, the surety may be entitled to a reasonable amount of time (and, possibly, a time extension) to perform the work under a takeover agreement or other surety performance bond option.<sup>68</sup>

6. Summary of the surety’s performance bond options.

Generally, the surety may have a number of performance bond options when the obligee terminates the principal’s construction contract, including the options to take over and complete, tender, finance the principal, work with the obligee to complete (and/or “buy back” the performance bond) and/or deny liability under the performance bond.<sup>69</sup> Each of these separate options will be discussed more fully below.<sup>70</sup>

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<sup>67</sup> BRUNER & O’CONNOR ON CONSTRUCTION LAW, § 18:18.

<sup>68</sup> *St. Paul Fire and Marine Ins. Co. v. City of Green River, Wyoming*, 93 F. Supp. 2d 1170 (D. Wyo. 2000), *aff’d*, 6 F. Appx. 828 (10<sup>th</sup> Cir. 2001).

<sup>69</sup> There are a number of books, articles and papers that generally discuss the surety’s performance bond options. The following are relevant and helpful: Marilyn Klinger, James P. Diwik & Kevin L. Lybeck, *Contract Performance Bonds*, in THE LAW OF SURETYSHIP, 2D ED. 83-91 (Edward G. Gallagher, ed. 2000); James J. Mercier & John T. Harris, *Rights of the Surety in Event of Default*, in THE LAW OF PERFORMANCE BONDS 39-59 (Lawrence R. Moelmann & John T. Harris, eds. 2000).

<sup>70</sup> When the principal has been terminated on one construction project, the surety will normally choose its option and stick with it (with the exception possibly being the financing of its principal). When the principal has been terminated from a number of construction contracts, the surety may use a mix of its options, assuming that each of the performance bonds allows various options. For example, the surety may finance the principal’s

## B. The Takeover and Completion Option

Upon the principal's termination for default, the surety may take over the performance of the work and complete the performance of the work using the services of a completion contractor. Frequently, the surety enters into a separate takeover agreement with the obligee that specifies, among other things, the amount of the balance of the contract price, the scope of the work required to complete the performance of the work under the construction contract, and the time of completion. The takeover agreement (and normally the performance bond, too) requires the obligee to dedicate the balance of the contract price to the completion of the construction contract, with the surety agreeing to pay the excess costs of completion up to the penal sum of the performance bond. The surety will then enter into a separate contract with a completion contractor to actually perform the work.

### 1. Prior articles.

There are a number of books, articles and papers that discuss the surety's takeover and completion option, and some of the most relevant and helpful are listed in the footnote below.<sup>71</sup>

### 2. The provisions of the performance bond.

a. Pursuant to the AIA Document A311 Performance Bond, the surety may "[c]omplete the Contract in accordance with its terms and conditions." Allowing the surety to complete the construction contract in accordance with its terms and conditions essentially authorizes the surety's option to take over and complete the performance of the work. The surety expects to be paid the balance of the contract price, with the surety paying any excess costs of completion.

b. Pursuant to the AIA Document A312 Performance Bond, the surety may:

4.2 Undertake to perform and complete the Construction Contract itself, through its agents or through independent contractors . . . .

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completion of one or two of the construction contracts while at the same time either take over and complete or tender a completion contractor on others and work with the obligee (or "buy back" the performance bond) on still other projects. Other than the terms and requirements that may be found in each performance bond, the surety is entitled to mitigate its loss at its discretion and is not required to take only one course of action and use only one option when faced with multiple terminated construction contracts.

<sup>71</sup> Gregory L. Daily & Todd C. Kazlow, *Takeover and Completion*, in BOND DEFAULT MANUAL, 3D ED. 223-41 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005); Bruce C. King, *Takeover and Completion of Bonded Contracts by the Surety*, 27 Brief No. 1, 22 (1997); Gregory S. Arnold, Christopher Morkan & Matthew M. Horowitz, *Issues and Practical Considerations for the Surety in Using Subcontractor Ratification Agreements* (unpublished paper submitted at the Seventeenth Annual Northeast Surety & Fidelity Claims Conference on September 21, 2006); Luther P. Cochrane, *Obligations of Principal's Subcontractors and Suppliers on Default or Takeover by Surety*, 14 FORUM 896 (1979); Michael J. Sugar, Jr., Elizabeth E. Spiker & Richard D. Davis, *Challenges of a Unit Price Contract Re-Let* (unpublished paper submitted at the Fifteenth Annual Northeast Surety & Claims Conference on September 30, 2004).

Paragraph 4.2 recognizes the surety's option to take over and complete the construction contract through the surety's "agents" or through "independent contracts."<sup>72</sup>

3. The documents.

a. The Takeover Agreement between the obligee and the surety.<sup>73</sup>

In order for the surety to takeover and complete the performance of the work under the principal's construction contract, the surety and the obligee may enter into a Takeover Agreement to define their respective rights, duties and obligations. The three major issues that must be dealt with in a Takeover Agreement are the scope of the remaining work to be performed by the surety through its completion contractor, the remaining balance of the contract price and payment (the amount of the original contract price between the obligee and the principal, plus or minus any approved additive or deductive change orders, and minus any payments properly made by the obligee to the principal, all subject to a reservation of rights by the surety to verify the accuracy of the remaining contract funds) and the time of completion.<sup>74</sup> Normally, the original construction contract between the obligee and the principal is incorporated by reference into the Takeover Agreement. In the event that the principal disputes the obligee's termination for default, the Takeover Agreement may have a reservation of rights section to preserve the ability of the principal and/or the surety to contest the obligee's termination of the principal for default and obtain damages for that wrongful termination.

b. The Completion Contract between the surety and the completion contractor.<sup>75</sup>

Because the surety itself will not be performing the work for the obligee under the Takeover Agreement, the surety will "subcontract" that work to a completion contractor. The Completion Contract deals with many of the same issues as the Takeover

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<sup>72</sup> One question with respect to the surety's "agent" or "independent contractor" as its completion contractor is whether the surety may use its principal or the employees and other personnel of its principal to assist in the completion of the construction project. At least one court has held that the surety exercising its rights under paragraph 4.2 of the AIA Document A312 Performance Bond may use the principal's personnel as part of its project team for the completion of the construction project even if the obligee objects. *St. Paul Fire and Marine Ins. Co. v. City of Green River, Wyoming*, 93 F. Supp. 2d 1170 (D. Wyo. 2000), *aff'd*, 6 F. Appx. 828 (10<sup>th</sup> Cir. 2001).

<sup>73</sup> The BOND DEFAULT MANUAL, 3D ED. (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005) contains an Appendix which includes as Exhibits 5.1, 5.2 and 5.3 sample Takeover Agreements, and as Exhibit 5.4, a Completion Agreement with the federal government at pp. 609-28; see also the Takeover Agreement at Exhibit 8.1 on pp. 685-90.

<sup>74</sup> In *St. Paul Fire and Marine Ins. Co. v. City of Green River, Wyoming*, 93 F. Supp. 2d 1170 (D. Wyo. 2000), *aff'd*, 6 F. Appx. 828 (10<sup>th</sup> Cir. 2001), the court found that the obligee was in breach under the AIA Document A312 Performance Bond when it insisted that the surety complete the performance of the work by the original completion date in the construction contract. The surety attempted to exercise its performance rights under paragraph 4.2, and provided the obligee with an alternative completion date for the performance of the work beyond the original completion date. The court found that the surety's obligation to proceed with "reasonable promptness" under paragraph 5 was established.

<sup>75</sup> The BOND DEFAULT MANUAL, 3D ED. (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005) contains an Appendix that includes as Exhibits 5.5 and 5.6 sample Completion Contracts at pp. 629-48.

Agreement, including a definition of the completion contractor's scope of the work, the contract price that the surety will pay the completion contractor to perform the work, and the time for the completion contractor's performance of the work. The Completion Contract is like many other construction contracts with respect to its terms and conditions.

#### 4. The critical issues.

In addition to the issues of the scope of work, the balance of the contract price and payment, and the time of completion, the surety in the Takeover Agreement with the obligee and in the Completion Contract with the completion contractor may deal with other critical issues.

With respect to the Takeover Agreement between the obligee and the surety, the Takeover Agreement may address such issues as the procedures for the discovery and correction of any defective work performed by or the performance of any warranty work required of the terminated principal; the surety's representative on the construction project, including his or her scope of responsibility and extent of authority; the surety's reservation of any rights or claims; the location of any stored materials and the transfer of title to the surety; insurance issues (both prior to the termination and ongoing during the takeover and completion) and others.<sup>76</sup>

The preservation of the penal sum of the performance bond (and the companion payment bond) is the surety's issue, not the obligee's issue. In determining its performance bond options, the surety will zealously guard against making payments that exceed the penal sum of the performance bond. Furthermore, in most Takeover Agreements, the surety requires the obligee to acknowledge that the surety's liability for the excess cost of completion of the performance of the work under the performance bond is limited to the penal sum of the performance bond (with a similar provision concerning the payment bond).<sup>77</sup>

With respect to the Completion Contract between the surety and the completion contractor, in addition to having the completion contractor be bound to the same scope of work, time of performance, and price (including the surety's payment of the completion contractor's excess costs to complete the performance of the work over and above the "balance of the contract price" owed by the obligee to the surety) and payment obligations as the surety is bound to the obligee under the Takeover Agreement, the surety will want the

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<sup>76</sup> See note 73, *supra*, concerning certain form Takeover Agreements.

<sup>77</sup> Tammy Giroux & Morgan W. Streetman, *Limiting the Takeover Surety's Liability to the Bond Penal Sum* (unpublished paper submitted at the Seventeenth Annual Northeast Surety & Fidelity Claims Conference on September 21, 2006). For example, the Takeover Agreement may provide:

The total liability of the Surety under this Takeover Agreement and the Performance Bond for the performance of the work, after the expenditure of the Contract Balance, is limited to and shall not exceed the penal sum of the Performance Bond in the amount of \$\_\_\_\_\_. All payments properly made by the Surety for the performance of the Original Contract shall be credited against the penal sum of the Performance Bond. Nothing in this Agreement constitutes a waiver of such penal sum or an increase in the liability of the Surety under the Performance Bond.

completion contractor's insurance to serve as the surety's insurance for the obligee as well as for the surety under the Completion Contract. Other issues include the requirement of performance and payment bonds from the completion contract to the surety; the resolution of any contract claims, including the prosecution and payment of any pass-through claims to the obligee; the completion contractor's performance of the work to correct any alleged latent defective work performed by the principal and to perform any warranty work required by the scope of work under the construction contract, as well as the surety's payment to the completion contractor, if any, for that work; how any disputes between the surety and the completion contractor are resolved, whether or not they involve the obligee; and others.<sup>78</sup>

5. The surety's takeover under the terms of the performance bond.

At times, an obligee will refuse to enter into a Takeover Agreement with the surety, taking the position that it already has a contract with the surety called a "performance bond" and that it does not need an additional document to have the surety perform under that performance bond. If the terms of the relevant performance bond essentially require the surety to complete the performance of the work in accordance with the terms of the construction contract, the surety may be required to undertake that completion effort as long as it has no other defenses to the obligee's claim against the performance bond. The surety will then contract with a completion contractor to perform the work and will operate under the performance bond and the original construction contract.

Sureties generally prefer to enter into a written Takeover Agreement with the obligee in order to resolve a number of issues (including but not limited to the manner and method of payment, the surety's rights to the contract funds, the resolution of change orders, the correction of the principal's defective work and others) up front that will make the ongoing working relationship between the surety and the obligee easier as the work proceeds. For example, the terminology in the performance bond and the construction contract may become confusing when the principal (the former contractor) is replaced by the surety using the services of its completion contractor.

Notwithstanding the obligee's refusal to execute a Takeover Agreement, the surety needs something in writing that confirms that the surety is taking over the construction contract pursuant to the performance bond. Whether this is a contract modification signed by the obligee (at least to substitute the surety as the "contractor" under the construction contract, and any other such "clarifications") or a detailed letter from the surety to the obligee setting forth the surety's understandings of the takeover arrangement and reserving the surety's rights, such writings at least provide the surety with some confirmation of the obligee's demand and the resulting basis for the surety's actions.

### **C. The Tender Option**

A tender agreement is similar to a takeover agreement, except that the contracting parties are ultimately the obligee and the completion contractor with the support of the surety. Typically, a three-way agreement is reached under which the obligee agrees to allow the completion contractor to complete the performance of the work that was originally required by the terminated principal directly for the obligee for a set contract price. To the

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<sup>78</sup> See note 75, *supra*, concerning certain form Completion Contracts.

extent that the new contract price between the obligee and the completion contractor exceeds the balance of the contract price under the original construction contract between the obligee and the terminated principal, the surety agrees to pay the excess costs of completion to the obligee for its eventual distribution to the completion contractor, either in a lump sum or as the work is performed and completed. The surety should then be released from its performance bond obligations upon payment of the excess costs of completion to the obligee.

1. Prior articles.

There are a number of books, articles and papers that discuss the surety's tender option, and the most relevant and helpful is listed in the footnote below.<sup>79</sup>

2. The provisions of the performance bond.

- a. Pursuant to the AIA Document A311 Performance Bond, the surety may:

- 2) Obtain a bid or bids for completing the Contract in accordance with its terms and conditions, and upon determination by Surety of the lowest responsible bidder, or, if the Owner elects, upon determination by the Owner and the Surety jointly of the lowest responsible bidder, arrange for a contract between such bidder and Owner, and make available as Work progresses (even though there should be a default or a succession of defaults under the contract or contracts of completion arranged under this paragraph) sufficient funds to pay the cost of completion less the balance of the contract price; but not exceeding, including other costs and damages for which the Surety may be liable hereunder, the amount set forth in the first paragraph hereof. The term "balance of the contract price," as used in this paragraph, shall mean the total amount payable by Owner to Contractor under the Contract and any amendments thereto, less the amount properly paid by Owner to Contractor.

This provision provides the surety with a tender option.

- b. Pursuant to the AIA Document A312 Performance Bond, the surety may:

- 4.3 Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and the contractor selected with the Owner's concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and

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<sup>79</sup> E.A. "Seth," Mills, Jr. & Susan M. Moore, *Tender*, in BOND DEFAULT MANUAL, 3D ED. 243-67 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005) and the citations contained therein.

pay to the Owner the amount of damages as described in Paragraph 6 in excess of the Balance of the Contract Price incurred by the Owner resulting from the Contractor's default;

This provision provides the surety with a tender option.

3. The documents.

A Tender Agreement<sup>80</sup> may be a three-party agreement between the obligee, the surety and the completion contractor (although there may be a separate Tender Agreement between the obligee and the surety and a separate Completion Contract between the obligee and the completion contractor, with both documents being executed simultaneously). In a Tender Agreement situation, the surety negotiates what is essentially a direct contract between the obligee and the completion contractor that results in the completion of the work to be performed under the default terminated construction contract. To the extent that the surety must fund the excess costs of completion (over and above the "balance of the contract price"), it may do so on a periodic basis or on a lump-sum basis or other basis, depending upon the negotiations. The surety will also want a release from its performance bond obligation once it has "performed" by tendering a completion contractor to the obligee and paying the excess costs of completion, if any.

4. The critical issues.

The critical issues of the scope of work, the balance of the contract price and the time of completion are always important in any performance bond claim and resolution. However, a fourth issue that is critical to the surety is the release of the surety from all or a portion of its obligations under the performance bond. Unlike the takeover and completion scenario, when the surety remains involved in what is going on during the completion of the performance of the work and, therefore, has some control over its ultimate risks, in the tender option, the surety is relying on the obligee and the completion contractor to complete the performance of the work without the surety's involvement or presence. The surety will seek a release from any further liability under the performance bond when it believes it has paid the obligee a sufficient premium in price to cover whatever the obligee may owe and pay to the completion contractor, including amounts for any unknown events that may occur. The obligee may or may not be willing to provide the surety with such a release, which may go to the heart of the surety's decision on whether to tender a completion contractor to the obligee or maintain control of its risk by taking over the construction project itself and subcontracting directly with the completion contractor.

#### **D. The Financing the Principal Option**

There is an option that a surety may exercise in order to "perform" under its performance bond either prior to or after the obligee's actual default and/or termination of the principal under the construction contract. In the event that a surety learns that its principal is having financial difficulties and may face a default termination situation, a surety may

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<sup>80</sup> The BOND DEFAULT MANUAL, 3D ED. (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005) contains an Appendix that includes Exhibits 6.1 through 6.15, pp. 651-84, that may assist the parties in a Tender Agreement situation.

determine that it is in the best interests of the principal, the obligee, the principal's subcontractors and suppliers and the surety for the surety to finance the principal's completion of the performance of the work required by the construction contract. Surety financing is a mechanism under which the surety may remedy its principal's potential or existing defaults and avoid the obligee's termination of the principal's right to proceed to perform the work under the construction contract. The benefits of a surety financing its principal are that the work continues to be performed on a timely basis because no default or termination is necessary, and, therefore, no delays are caused by the obligee's termination of the principal. Early intervention by a financing surety may preserve the surety's options going forward and provide the surety with better control of the outcome of any claims and potential losses.

The surety's financing may take a number of forms, including direct surety advances to its principal, the surety's guaranty of a bank loan to its principal, "back door financing" and other methods. However, it is clear that a surety financing its principal's completion of the performance of the work may constitute the surety's "performance" under the performance bond.<sup>81</sup>

1. Prior articles.

There are a number of books, articles and papers that discuss the surety's financing of its principal option, and some of the most relevant and helpful are listed in the footnote below.<sup>82</sup>

2. The provisions of the performance bond.

- a. Pursuant to the AIA Document A311 Performance Bond:

. . . the Surety may promptly remedy the default, or shall promptly

- 1) Complete the Contract in accordance with its terms and conditions, . . . .

When a surety is authorized to "promptly remedy the default" and to "[c]omplete the Contract in accordance with its terms and conditions," the surety may accomplish both by financing the principal.

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<sup>81</sup> Francis J. McGrath, George J. Bachrach & Adam Cizek, *The Financing Surety as a Performing Surety - Law and Practice* (unpublished paper submitted at the Fourteenth Annual Northeast Surety & Fidelity Claims Conference on September 18, 2003).

<sup>82</sup> George J. Bachrach & Matthew L. Silverstein, *Financing the Principal*, in BOND DEFAULT MANUAL, 3D ED. 155-221 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005); Francis J. McGrath, George J. Bachrach & Adam Cizek, *The Financing Surety as a Performing Surety - Law and Practice* (unpublished paper submitted at the Fourteenth Annual Northeast Surety & Fidelity Claims Conference on September 18, 2003); T. Scott Leo, *The Financing Surety and the Chapter 11 Principal*, 26 TORT & INS. L.J. 45 (1990); Gilbert J. Schroeder, *Providing Financial Support to the Contractor*, 17 FORUM 1190 (1982); Gilbert J. Schroeder, *Procedures and Instruments Utilized to Protect the Surety Who Finances a Contractor*, 14 FORUM 830 (1979) ("Financing is dangerous.").

b. Pursuant to the AIA Document A312 Performance Bond, the surety may:

4.1 Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract; . . . .<sup>83</sup>

This provision authorizes the surety's financing of its principal to perform and complete the work required under the construction contract with the obligee's consent.

3. The documents.

When the surety makes a decision to finance its principal's completion of the performance of the work, the surety and the principal, and any third-party indemnitors, may execute a Financing and Collateral Agreement or such other agreement and related documents that defines the rights, duties, obligations, mechanisms and procedures for the surety's financing.<sup>84</sup>

4. The critical issues.

There are many critical issues for the surety financing the principal's completion of the performance of the work, which is one very good reason why sureties are disinclined to use the financing option. While the principal may not have sufficient cash to complete the performance of the work, the surety must be assured that the principal is capable of performing the remaining work properly, and without defect, and on a timely basis. Furthermore, the character of the principal and the third-party indemnitors is especially important because the surety is working with them on a daily, weekly and monthly basis to mitigate its and their loss and damage.

## **E. The Completion by the Obligee Option**

Under certain circumstances, and if its actions do not violate the surety's rights under the performance bond and/or risk the release and discharge of the surety's performance bond, the obligee may determine that it will complete the performance of the work of the terminated principal through its own completion contractor, and use the balance of the contract price to fund the completion of the work.<sup>85</sup> Subsequently, if the costs to complete the performance of the work exceed the balance of the contract price, and if the obligee has not

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<sup>83</sup> Paragraph 4.1 of the AIA Document A312 Performance Bond requires the "consent of the Owner" if the surety wants to finance the principal's completion of the construction contract, while paragraph 4.2 does not require the obligee's consent when the surety exercises its right to "[u]ndertake to perform and complete the Construction Contract itself, through its agents or through independent contractors," and those "agents" or "independent contractors" include the principal's employees and other personnel. See *St. Paul Fire and Marine Ins. Co. v. City of Green River, Wyoming*, 93 F. Supp. 2d 1170, 1175-77 (D. Wyo. 2000), *aff'd*, 6 F. Appx. 828 (10<sup>th</sup> Cir. 2001).

<sup>84</sup> The BOND DEFAULT MANUAL, 3D ED. (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005) contains an Appendix that includes Exhibit 4.1, the Financing and Collateral Agreement, along with several other agreements and related documents (Exhibits 4.1.2 through 4.1.7) at pp. 531-604.

<sup>85</sup> When, however, the obligee's actions do violate the surety's rights under the performance bond, the surety may be released and discharged from its obligations under the performance bond. See Section III. B. 2., *supra*.

waived or released its rights against the performance bond, the obligee will make a claim against the surety under the performance bond for the excess costs to complete the performance of the work and any other damages the obligee claims. The surety may consent to the obligee's actions and agree to pay the excess costs of completion, either in whole or in part, depending upon whether or not the surety contends that it is not liable for certain of the alleged excess costs to complete the performance of the work and some or all of the other damages the obligee claims.

A second variation in the obligee completion option is that the obligee and the surety come to some agreement concerning the excess costs to complete the performance of the work, and the surety pays that amount to the obligee in return for a complete release and discharge of the performance bond. This variation is frequently referred to as the "buy back" option and may be used whether or not the estimated excess cost to complete the performance of the work is less than, equal to or greater than the penal sum of the performance bond. The "buy back" option may be attractive to both the obligee, who may need a quick infusion of cash to complete the project, and the surety, because it offers a quick resolution to the problem without exposing the surety to liability in excess of the penal sum of the performance bond.

1. Prior articles.

There are a number of books, articles and papers that discuss the completion by the obligee option, and the most relevant and helpful is listed in the footnote below.<sup>86</sup>

2. The provisions of the performance bond.

- a. The provisions of the AIA Document A311 Performance Bond do not specifically state a completion by the obligee option. However, there is nothing under that performance bond that prohibits the obligee and the surety from agreeing that the obligee may complete the performance of the work under the construction contract and claim the excess costs of completion, if any, under the performance bond.

- b. Pursuant to the AIA Document A312 Performance Bond, the surety may:

- 4.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances:

- .1 After investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, tender payment therefor to the Owner;

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<sup>86</sup> Deborah S. Griffin & Stephen J. Beatty, *Completion by the Bond Oblige*, in BOND DEFAULT MANUAL, 3D ED. 269-86 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005) and the citations contained therein.

This provision provides for an obligee completion option.

3. The documents.

There are a number of documents that may result when an obligee completes the performance of the work through its own completion contractor, primarily depending upon whether and/or when the obligee reaches an agreement with the surety. If the obligee and the surety agree up front that the obligee will complete the performance of the work with its own completion contractor, there may be an agreement (interim, partial or overall) with the surety to fund that completion, either over time as the work progresses or at the end of the project when the final excess cost to complete the performance of the work is known. Under such circumstances, the surety will require a complete release and discharge of its performance bond upon final payment to the obligee of the excess cost of completion and any other agreed upon obligee claims.

If the obligee and the surety agree to the surety's "buying back" of its performance bond, the surety, upon paying the obligee the agreed upon amount, will receive a complete release and discharge of its performance bond and a return of its original performance bond.

If the obligee and the surety cannot reach an agreement resulting in a final payment and the release and discharge of the surety's performance bond, the "last document" may be a complaint in a lawsuit for damages filed by the obligee against the surety under the performance bond (which will generate more documents).

4. The critical issues.

Probably the most critical issue when the obligee completes the performance of the work, with or without the surety's consent, is the parties' mitigation of their damages. Both the obligee and the surety must assess their risks and exposure whether the obligee either unilaterally decides to move forward to complete the construction contract with its own completion contractor and make a claim against the surety's performance bond, or the surety, by its actions and/or pursuant to the terms of the performance bond, allows the obligee to complete the performance of the work on its own.

**F. The Surety's Denial of Liability Under the Performance Bond**

A surety may deny liability under the performance bond for a number of reasons as discussed previously in this paper, including but not limited to the surety's assertion of the principal's defenses (see Section III. A.) and the surety's assertion of its own defenses (see Section III. B.). The prior sections of this paper should be reviewed for the basis of the surety's denial of liability under the performance bond.

1. The provisions of the performance bond.

a. AIA Document A311 Performance Bond.

While the AIA Document A311 Performance Bond does not have a specific provision authorizing a surety to deny liability, it does provide as a condition precedent that the obligee must perform the obligee's obligations under the construction contract ["the

Owner having performed Owner's obligations" (under the Contract)]. If, during its investigation, the surety determines that there are defenses to the obligee's performance bond claim that form the basis for the surety's denial of liability under the performance bond, the surety may take the position that the obligee has not complied with one of the necessary conditions precedent to make a claim against the performance bond.<sup>87</sup>

b. Pursuant to the AIA Document A312 Performance Bond, the surety may:

4.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances:

.2 Deny liability in whole or in part and notify the Owner citing reasons therefor.

Obviously, the AIA Document A312 Performance Bond provides the surety with the option and ability to deny liability under the appropriate circumstances.

To the extent that the surety believes it has defenses to the obligee's claim against the performance bond, and the performance bond does not specifically compel the surety to take one or more specific actions, the surety may deny liability based upon its defenses.

2. The documents.

If the surety denies liability to the obligee under the performance bond, it should notify the obligee of its denial of liability. The AIA Document A312 Performance Bond requires the surety to provide the obligee with its reasons for denying liability.<sup>88</sup> Since it is very conceivable that the obligee will eventually make a claim against whatever performance bond has been executed, the surety may want to carefully set out in as much detail as possible in writing why it is denying liability for the obligee's claim under the performance bond (with the surety's denial letter obviously becoming an exhibit in any future litigation).

3. The critical issues.

The surety's critical issue is whether its analysis of the facts gathered during its investigation and its legal arguments are sufficient to justify the surety's denial of liability to the obligee under the performance bond. Whether the surety is relying on the principal's defenses or surety's defenses, the facts and legal support for the surety's position may well end up in litigation over the obligee's claim against the performance bond.

## **G. The Surety's Failure to Perform Under the Performance Bond**

1. Introduction.

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<sup>87</sup> See Section III. A. and B., including B.2., *supra*.

<sup>88</sup> AIA Document A312 Performance Bond, paragraph 4.4.2.

Other than the surety's denial of liability to the obligee under the performance bond (which is a surety performance option under the AIA Document A312 Performance Bond), it is extremely rare, if ever, that a surety would fail to perform under the relevant performance bond and completely ignore its obligations. If the performance bond is an indemnity bond, the surety is not expected to "perform" until the obligee makes a claim for its damages with the expectation that the surety will reimburse the obligee for any costs incurred over and above the balance of the contract price in performing the remaining work and the obligee's other direct or consequential damages. If the performance bond provides the surety with a number of performance options, then the surety's failure to exercise any one of those options may become the surety's failure to perform under the performance bond.

2. The provisions of the performance bond.

a. AIA Document A311 Performance Bond.

The AIA Document A311 Performance Bond does not address the issue of the surety's failure to perform under the performance bond. If the surety abrogates its performance obligations, the obligee may make a claim against the surety.

b. AIA Document A312 Performance Bond.

The AIA Document A312 Performance Bond sets out five performance bond options for the surety in paragraph 4, and then provides in paragraph 5 for what occurs if the surety does not proceed with "reasonable promptness" as provided in paragraph 4.<sup>89</sup> The obligee, upon providing notice to the surety as required under paragraph 5,<sup>90</sup> may declare the surety in default under the performance bond and may proceed to enforce any remedies available to it.

3. The obligee's claims for the surety's failure to perform.

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<sup>89</sup> The AIA Document A312 Performance Bond, paragraph 5, provides:

If the Surety does not proceed as provided in Paragraph 4 with reasonable promptness, the Surety shall be deemed to be in default on this Bond fifteen days after receipt of an additional written notice from the Owner to the Surety demanding that the Surety perform its obligations under this Bond, and the Owner shall be entitled to enforce any remedy available to the Owner. If the Surety proceeds as provided in Subparagraph 4.4, and the Owner refuses the payment tendered or the Surety has denied liability, in whole or in part, without further notice the Owner shall be entitled to enforce any remedy available to the Owner.

<sup>90</sup> In *Seaboard Sur. Co. v. Town of Greenfield*, 266 F. Supp. 2d 189 (D. Mass. 2003), *aff'd*, 370 F.3d 215 (1<sup>st</sup> Cir. 2004), the court found that the obligee failed to provide the surety with the 15 day notice of default on the bond as required by paragraph 5, and that this constituted a material breach by the obligee, which discharged the surety from any liability under the performance bond as a matter of law. Furthermore, in *St. Paul Fire and Marine Ins. Co. v. City of Green River, Wyoming*, 93 F. Supp. 2d 1170 (D. Wyo. 2000), *aff'd*, 6 F. Appx. 828 (10<sup>th</sup> Cir. 2001), the court held that the obligee's failure to allow the surety to complete the performance of the work under paragraph 4.2 of the AIA Document A312 Performance Bond because the work would not be performed within the time of completion set out in the original contract, but would have been performed with "reasonable promptness" as provided in paragraph 5, resulted in the surety being discharged from its performance bond obligations.

If the surety fails to perform under the performance bond, the obligee may have claims against the surety's performance bond and may assert those claims for any damages that the obligee may claim or incur (see Section V. *infra*).

## **V. THE SURETY'S LIABILITIES UNDER THE PERFORMANCE BOND**

Regardless of the surety's choice of its performance bond option or options, and assuming that the surety does not have a complete defense to the obligee's performance bond claim (either the principal's defenses or the surety's defenses), the surety may have liability to the obligee under the performance bond. The surety's position is that regardless of the type of the obligee's claims, the surety's liability is capped at the penal sum of the performance bond.

The surety's choice of its performance bond option may totally answer the question of its liability under the performance bond. For example, if the surety tenders a completion contractor to the obligee, if the obligee completes the performance of the work under an agreement with the surety that establishes the obligee's damages for the excess costs of the completion of the performance of the work, or the surety "buys back" its performance bond, the surety will normally receive a release and discharge of any further liability under the performance bond, including a release from any other alleged obligee claims or damages. However, if the surety takes over the completion of the performance of the work or finances its principal to complete the performance of the work, the surety rarely, if ever, obtains such a release and discharge of any other obligee claims against the performance bond.

Most performance bonds provide that only the obligee may make a claim against the surety under the performance bond.<sup>91</sup> However, that has not prevented claims being made against the surety's performance bond by someone other than the obligee, including third-party beneficiary claims (suppliers and subcontractors), co-prime contractor claims, owner claims around a general contractor against a subcontractor's performance bond, adjacent property and/or business owner claims, successor owner claims and personal injury/wrongful death claims (or other claims due to the principal's alleged negligent acts).<sup>92</sup> Other entities claiming through the obligee may make a claim against the surety's performance bond, including the

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<sup>91</sup> Some performance bonds have dual obligee riders. For example, if the obligee is the owner of a private construction project, its construction lender that is providing the obligee with financing for the project may become a dual obligee under the performance bond to give the construction lender a right of recovery against the surety's performance bond. The construction lender's damages against the surety would not include the obligee's financial obligations to the lender under the loan. Rather, the dual obligee bond gives both the obligee and the construction lender a direct cause of action against the performance bond if the principal breaches the construction contract and fails to perform. Most dual obligee riders to performance bonds contain a savings clause in favor of the surety that provides that any default by either of the obligees relieves the surety from its performance obligations. See generally Martha L. Perkins, *The Rights and Obligation of the Surety Under Dual Obligee Bonds* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 23, 2005); Jay M. Mann, *Dual Obligee Bonds - An Overview of the Surety's Liability to Co-Obligees* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 29, 1988); Thomas R. Elliott, Jr., *Dual Obligee Bonds - Some Practical and Legal Considerations*, 11 FORUM 1229 (1976).

<sup>92</sup> Marilyn Klinger, James P. Diwik & Kevin L. Lybeck, *Contract Performance Bonds*, in THE LAW OF SURETYSHIP, 2D ED. 100-05 (Edward G. Gallagher, ed. 2000).

obligee's assignees<sup>93</sup> and other claimants alleging that they are subrogated to the obligee's rights under the surety's performance bond.<sup>94</sup>

## A. The Performance Bond Forms

### 1. AIA Document A311 Performance Bond.

Pursuant to one option under the AIA Document A311 Performance Bond, the surety's liability is capped at the penal sum of the performance bond (with the surety's liability "not exceeding, including other costs and damages for which the Surety may be liable hereunder" - namely the penal sum of the performance bond).<sup>95</sup>

### 2. AIA Document A312 Performance Bond.

The AIA Document A312 Performance Bond provides in paragraph 6:

After the Owner has terminated the Contractor's right to complete the Construction Contract, and if the Surety elects to act under Subparagraph 4.1, 4.2, or 4.3 above, then the responsibilities of the Surety to the Owner shall not be greater than those of the Contractor under the Construction Contract, and the responsibilities of the Owner to the Surety shall not be greater than those of the Owner under the Construction Contract. 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:

6.1 The responsibilities of the Contractor for correction of defective work and completion of the Construction Contract;

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<sup>93</sup> With respect to the issue of whether an assignee of the obligee may assert rights against the performance bond, see Benjamin D. Lentz, *Default, Notice of Default, Impact Upon Surety's Obligations Where Notice is Not Given*, in THE LAW OF PERFORMANCE BONDS 31-35 (Lawrence R. Moelmann & John T. Harris, eds. 2000).

<sup>94</sup> Marilyn Klinger, James P. Diwik & Kevin L. Lybeck, *Contract Performance Bonds*, in THE LAW OF SURETYSHIP, 2D ED. 105-06 (Edward G. Gallagher, ed. 2000); John H. Gregory & Michael Jay Rune, II., *Liability of the Performance Bond Surety (Under Contract of Suretyship)*, in THE LAW OF PERFORMANCE BONDS 37-40 (Lawrence R. Moelmann & John T. Harris, eds. 2000); Kevin L. Lybeck, *The Performance Bond Surety's Potential Liability for Damages Suffered by Someone Other than the Obligee Named in the Bond* (unpublished paper submitted at the ABA annual meeting on August 13, 1991).

<sup>95</sup> However, the AIA Document A311 Performance Bond does place a limitation on who may bring an action under the performance bond as follows:

No right of action shall accrue on this bond to or for the use of any person or corporation other than the Owner named herein or the heirs, executors, administrators or successors of the Owner.

6.2 Additional legal, design professional and delay costs resulting from the Contractor's default, and resulting from the actions or failure to act of the Surety under Paragraph 4; and

6.3 Liquidated damages, or if no liquidated damages are specified in the Construction Contract, actual damages caused by delayed performance or non-performance of the Contractor.

The AIA Document A312 Performance Bond, however, does set some limits on the surety's potential damages other than the limit set by the penal sum of the performance bond.<sup>96</sup>

## **B. The Obligee's Claims for Damages**

There are a number of books, articles and papers that discuss the obligee's claims for damages under the surety's performance bond, and some of the most relevant and helpful are listed in the footnote below.<sup>97</sup> The obligee's success or failure in recovering damages from the surety's performance bond depends on the damages for which the surety has agreed to be responsible as defined by the performance bond and the construction contract, if the construction contract has been incorporated into the performance bond. In the absence of any language limiting the surety's exposure under either the performance bond or the construction contract, the surety's liability is co-extensive with that of its principal; and the surety may be liable to the obligee for certain direct and consequential damages for which the principal is responsible due to the principal's breach of the construction contract. The following are the kinds of claims and damages that obligees have alleged against the surety's performance bond.

1. The principal's incomplete performance.<sup>98</sup>
2. The principal's defective performance (warranty claims and latent defect claims).<sup>99</sup>

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<sup>96</sup> The AIA Document A312 Performance Bond, paragraph 7, provides:

The Surety shall not be liable to the Owner or others for obligations of the Contractor that are unrelated to the Construction Contract, and the Balance of the Contract Price shall not be reduced or set off on account of any such unrelated obligations. No right of action shall accrue on this Bond to any person or entity other than the Owner or its heirs, executors, administrators or successors.

<sup>97</sup> Marilyn Klinger, James P. Diwik & Kevin L. Lybeck, *Contract Performance Bonds*, in *THE LAW OF SURETYSHIP*, 2D ED. 81-118 (Edward G. Gallagher, ed. 2000) (hereinafter "Klinger-Suretyship"); John H. Gregory & Michael Jay Rune, II, *Liability of the Performance Bond Surety (Under Contract of Suretyship)*, in *THE LAW OF PERFORMANCE BONDS* 123-49 (Lawrence R. Moelmann & John T. Harris, eds. 2000) (hereinafter "Gregory - Performance Bonds").

<sup>98</sup> Klinger - Suretyship, pp. 107-08; Gregory - Performance Bonds, p. 133.

<sup>99</sup> Klinger - Suretyship, pp. 107-08 & 115-18; Gregory - Performance Bonds, pp. 141-42; Samuel J. Arena, Jr., *The Performance Bond Surety's Liability for Latent Defect and Warranty Claims* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 24, 1999).

3. The principal's delay.
  - a. Liquidated damages.<sup>100</sup>
  - b. Actual delay damages (financing costs, loss of use damages, overhead and other miscellaneous expenses).<sup>101</sup>
4. The principal's negligence and lack of liability insurance.<sup>102</sup>
5. Design-build contracts.<sup>103</sup>
6. Attorneys' fees.<sup>104</sup>
7. Interest.<sup>105</sup>

### C. Extra-Contractual Damages

If the surety denies liability to the obligee under the performance bond (or if the surety fails to perform under the performance bond), and it is later alleged that the surety was incorrect in its decision, some obligees have contended that the surety may be liable for extra-contractual damages that may exceed the penal sum of the performance bond. Not all courts will expand a breach of contract claim into a tort claim against the surety.<sup>106</sup> Other jurisdictions

<sup>100</sup> Klinger - Suretyship, pp. 108-10; Gregory - Performance Bonds, pp. 136-37; see also Darryl Weissman, *Liability of the Performance Bond Surety for Delay Damages, Consequential Damages and Liquidated Damages* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 24, 1999).

<sup>101</sup> Klinger - Suretyship, pp. 110-12, Gregory - Performance Bonds, pp. 133-35.

<sup>102</sup> Klinger - Suretyship, pp. 114-15; Gregory - Performance Bonds, p. 141.

<sup>103</sup> Gregory - Performance Bonds, pp. 142-45.

<sup>104</sup> Klinger - Suretyship, pp. 112-14; Gregory - Performance Bonds, pp. 145-47.

<sup>105</sup> Klinger - Suretyship, pp. 110-11; Gregory - Performance Bonds, pp. 145-47, 148.

<sup>106</sup> See Bruner - Complex, p. 12, footnote 37, which provides as follows:

See *Bell BCI Co. v. HRGM Corp.*, 276 F. Supp. 2d 462 (D. Md. 2003), in which a subcontractor's performance bond surety refused to perform following default of its subcontractor principal. Rejecting the contractor's claims against the surety for tortious bad faith, the United States District Court for the District of Maryland ruled that a "breach of contract does not, under the circumstances of this case, give rise to a tort action for bad faith." The Court quoted with approval a prior decision of the Maryland Court of Appeals holding as follows:

Maryland does not recognize failure to perform a contract as giving rise to a tort action for bad faith. Indeed, if the [obligee] were successful in its attempt to [plead a failure to perform a contract as a tort action for bad faith], practically every breach of contract would give rise to an action in tort for "bad faith." Every breach of contract could, and probably would, result in claims in both contract and tort. The "bad faith" allegation would likely become "boilerplate" averment

have ruled differently.<sup>107</sup> There are a number of books, articles and papers that discuss the obligee's claim for extra-contractual damages against the surety, and some of the most relevant and helpful are listed in the footnote below.<sup>108</sup>

## **VI. OTHER SURETY ISSUES ARISING FROM A PERFORMANCE BOND CLAIM**

There are a number of other issues that relate to a surety's rights and obligations arising from an obligee's performance bond claim. While it is beyond the scope of this paper to delve into these issues in any great detail, there are a number of books, articles and papers that discuss the issues, and some of the most relevant and helpful will be noted in footnotes below with respect to each issue.

### **A. The Surety's Rights to the Contract Funds**

As discussed above, most performance bonds require the obligee to agree to pay the "balance of the contract price" to the surety as a condition precedent to the surety's performance obligation under the performance bond. The "balance of the contract price" may also include the terminated principal's contract claims that it may have against the obligee, which the obligee may dispute. Regardless of whether the "balance of the contract price" includes the remaining contract funds acknowledged by the obligee (the progress payments, agreed extras and change orders, and retainage) or includes the principal's contract claims that have not been acknowledged or agreed to by the obligee,<sup>109</sup> the surety will claim its rights to all of the remaining contract funds, however characterized, based upon any rights that the surety may have, including its subrogation rights and/or its secured creditor rights.

The surety will make claims to the "balance of the contract price" for all of the bonded contracts. However, the obligee, the principal, and the universe of payment bond claimants, assignee banks and lenders, trustees in bankruptcy and/or debtors-in-possession, taxing authorities and other general creditors of the principal, including judgment creditors, may assert a claim to the contract funds remaining under the construction contract. The surety will

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in every suit for breach of contract. We refuse to employ some supposed "public policy" argument which would obfuscate the distinction between contract and tort by intertwining one with the other. Instead, we hold that a breach of contract does not, under the circumstances of this case, give rise to a tort action for "bad faith."

<sup>107</sup> E.g., *Transamerica Premier Ins. Co. v. Brighton Sch. Dist.* 27J., 940 P.2d 348 (Colo. 1997).

<sup>108</sup> R. Scott Cochrane & Cole S. Kain, *Extra-Contractual Damages*, in BOND DEFAULT MANUAL, 3D ED. 371-92 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005); Thomas J. Casamassima, Mark E. Aronson & Frank E. Marchetti, *Extra-Contractual Damages*, in THE LAW OF SURETYSHIP, 2D ED. 393-418 (Edward G. Gallagher, ed. 2000); Lloyd N. Shields, *Extracontractual Liability of Performance Bond Sureties*, in THE LAW OF PERFORMANCE BONDS 151-77 (Lawrence R. Moelmann & John T. Harris, eds. 2000).

<sup>109</sup> For a detailed discussion of the principal's construction contract claims as a potential source of salvage for the surety, including the surety's recovery rights to its principal's construction claims, the evaluation of the principal's construction claims (establishing the existence and the amount of the loss) and the types of the principal's construction claims (defective plans and specifications, change conditions, delay claims, disruption claims, suspension of work claims, acceleration claims and others), see Patrick J. O'Connor, Jr., *The Principal's Contract Claims as Salvage - A Primer*, in SALVAGE BY THE SURETY 93-199 (George J. Bachrach, ed. 1998).

assert its rights to the remaining contract funds held by the obligee and may have to compete against the other claimants for those contract funds.<sup>110</sup>

## **B. The Surety's Rights Against the Principal and Indemnitors Under the Indemnity Agreement**

Sureties require their principals and third-party indemnitors to execute an indemnity agreement prior to the surety's execution, with the principal, of any performance and payment bonds. The indemnity agreement sets out the principal's and the indemnitor's duties and obligations to the surety and the surety's rights, including enforcement rights, against them under the indemnity agreement. During its investigation of the obligee's performance bond claim, the surety will take steps to preserve, maintain and enforce its rights against the principal and the indemnitors under the indemnity agreement.<sup>111</sup>

## **C. The Surety's Rights Against Third Parties**

In addition to its rights against the obligee, the principal and the indemnitors, the surety may have rights and claims against various third parties whose actions or failure to act may increase the surety's loss. The surety's claims may be against professionals and others who have provided services or materials to the obligee or the principal, including accounting professionals, design professionals (architects and engineers), lending and other financing

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<sup>110</sup> George J. Bachrach & John V. Burch, *The Surety's Subrogation Rights*, in *THE LAW OF SURETYSHIP*, 2D ED. 419-53 (Edward G. Gallagher, ed. 2000); Francis J. McGrath, George J. Bachrach & Adam Cizek, *The Financing Surety as a Performing Surety - Law and Practice* (unpublished paper submitted at the Fourteenth Annual Northeast Surety & Fidelity Claims Conference on September 18, 2003); Edward G. Gallagher, *Entitlement to Contract Proceeds*, in *THE LAW OF PERFORMANCE BONDS* 61-75 (Lawrence R. Moelmann & John T. Harris, eds. 2000); George J. Bachrach & Cynthia E. Rodgers-Waire, *The Surety's Rights to the Contract Funds in the Principal's Chapter 11 Bankruptcy Case*, 35 *TORT & INS. L.J.* 1 (1999); Edward G. Gallagher, *Entitlement to Contract Proceeds*, in *THE LAW OF PAYMENT BONDS* 223-47 (Kevin L. Lybeck & H. Bruce Shreves, eds. 1998); *THE SUBROGATION DATABASE: CASES CONCERNING THE SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY* (George J. Bachrach, ed. 1995).

<sup>111</sup> *THE SURETY'S INDEMNITY AGREEMENT - LAW & PRACTICE*, 2D ED. (Marilyn Klinger, George J. Bachrach & Tracey L. Haley, eds. 2008); Armen Shahinian, Marc Brown & Joseph Monaghan, *Deciding to Litigate: The Surety's Recourse Against Its Principal and Indemnitors*, in *MANAGING AND LITIGATING THE COMPLEX SURETY CASE*, 2D ED. 115-72 (Philip L. Bruner & Tracey L. Haley, eds. 2007); Armen Shahinian, *The General Agreement of Indemnity*, in *THE LAW OF SURETYSHIP*, 2D ED. 487-525 (Edward G. Gallagher, ed. 2000); Jay M. Mann, *Exoneration and Quia Timet*, in *THE LAW OF SURETYSHIP*, 2D ED. 455-85 (Edward G. Gallagher, ed. 2000); G. Steven Ruprecht, *Surety's Rights and Remedies Against Principals and Against Indemnitors Under the General Indemnity Agreement*, in *THE LAW OF PERFORMANCE BONDS* 77-121 (Lawrence R. Moelmann & John T. Harris, eds. 2000); Stephen J. Trecker & Luther S. Ott, *The Agreement of Indemnity - The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims*, in *THE AGREEMENT OF INDEMNITY - PRACTICAL APPLICATIONS BY THE SURETY* 5-92 (George J. Bachrach, ed. 1990) and an unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 27, 1989; Robert L. Lawrence, Robert M. Wright, George J. Bachrach & William M. Dolan, III, *The Agreement of Indemnity - The Surety's Handling of Contract Bond Problems: Enforcement of the Surety's Rights Against the Principal and the Indemnitors Under the Agreement of Indemnity*, in *THE AGREEMENT OF INDEMNITY - PRACTICAL APPLICATIONS BY THE SURETY* 93-172 (George J. Bachrach, ed. 1990) and an unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 27, 1989; Linwood O. Perry, Jr. & Henry J. Wallach, *Salvage - The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity*, in *THE AGREEMENT OF INDEMNITY - PRACTICAL APPLICATIONS BY THE SURETY* 173-221 (George J. Bachrach, ed. 1990) and an unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 27, 1989.

institutions, and the principal's subcontractors and suppliers. Furthermore, the surety may pursue claims under the principal's insurance policies as a source of recovery for its loss. Finally, to the extent that the principal and/or the indemnitors have fraudulently or preferentially transferred their assets to third parties, the surety may take action to recover those assets to reduce the surety's loss. There are a number of books, articles and papers that discuss these issues in more detail.<sup>112</sup>

#### D. Alternative Dispute Resolution and Performance Bond Claims

Some performance bonds provide the location (jurisdiction) where any proceeding may be brought against the surety under the performance bond.<sup>113</sup> Many other performance bonds are silent on the issue. With respect to any alternative dispute resolution proceedings (mediation, arbitration and others), few, if any, performance bonds directly provide for such actions in favor of or against the surety. However, most performance bonds incorporate the construction contract by reference into the performance bond, and many construction contracts have alternative dispute resolution provisions. The question remains: is the surety bound by the alternative dispute resolution provision in the construction contract and required to participate in such a proceeding? There are a number of books, articles and papers that discuss the surety's obligation or lack of obligation to participate in an alternative dispute resolution proceeding between the obligee and the principal under the construction contract.<sup>114</sup>

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<sup>112</sup> Ronald F. Goetsch & Christopher R. Ward, *Deciding to Litigate: The Surety's Recourse Against Third Parties*, in *MANAGING AND LITIGATING THE COMPLEX SURETY CASE*, 2D ED. 173-258 (Philip L. Bruner & Tracey L. Haley, eds. 2007); Patrick J. O'Connor, Jr., *Deciding to Litigate: The Surety's Rights Against Property and Liability Insurers of the Obligee, Principal and Subcontractors*, in *MANAGING AND LITIGATING THE COMPLEX SURETY CASE*, 2D ED. 259-429 (Philip L. Bruner & Tracey L. Haley, eds. 2007); Christopher R. Ward & Mary Jean Pethick, *Considerations With Respect to Insurance Coverage*, in *BOND DEFAULT MANUAL*, 3D ED. 393-430 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005); James D. Ferrucci & Ann Hester, *The Architect as a Source of Salvage* (unpublished paper submitted at the Fifteenth Annual Northeast Surety & Fidelity Claims Conference on September 30, 2004); James D. Ferrucci & Scott D. Baron, *The Surety's Claims Against Third Parties*, in *SALVAGE BY THE SURETY* 209-62 (George J. Bachrach, ed. 1998); Martha Crandall Coleman, *Design Professionals' Liability for Negligent Design and Project Management* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997).

<sup>113</sup> For example, pursuant to the AIA Document A312 Performance Bond, paragraph 9:

Any proceeding, legal or equitable, under this Bond may be instituted in any court of competent jurisdiction in the location in which the work or part of the work is located . . . .

<sup>114</sup> Gregory R. Veal, *Arbitration and the Performance Bond Surety* (unpublished paper submitted at the Surety Claims Institute annual meeting on June 23, 2005); H. Bruce Shreves & Kevin L. Lybeck, *Arbitration of Performance Bond Disputes*, in *THE LAW OF SURETYSHIP*, 2D ED. 375-92 (Edward G. Gallagher, ed. 2000); James D. Ferrucci, *Effect of an Arbitration Provision in the Principal's Contract With the Obligee*, in *THE LAW OF PERFORMANCE BONDS* 249-87 (Lawrence R. Moelmann & John T. Harris, eds. 2000); J. Michael Franks & John W. Heacock, *The Contract Surety's Involvement in and Preclusion by Arbitration Proceedings Involving Its Principal: An Update With Drafting Comments* (unpublished paper submitted at the ABA annual meeting on August 9, 1999); Robert W. Wright, *The Mediation Process* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997); J. Michael Franks & John W. Heacock, *Arbitration and the Contract Surety: Inclusion and Preclusion* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997).

## **E. The Principal's Bankruptcy and its Effects on an Obligee's Performance Bond Claim**

The principal's filing of a bankruptcy proceeding will affect both the obligee's rights under the construction contract and the surety's performance bond and the surety's responses to the obligee's performance bond claim. This complex discussion has been discussed in a number of books, articles and papers<sup>115</sup> and is beyond the scope of this paper.

## **VIII. SUMMARY AND CONCLUSION**

There is no participant in the construction process who is happy when the obligee or the principal believes that the other party has materially breached the construction contract to the extent that they are entitled to terminate the other party for default. Whether or not the construction contract has a surety performance bond, the termination for default will affect everyone coming into contact with the construction project, including specifically the obligee, its lender and other related parties as well as the principal, its subcontractors and suppliers and other related parties. When a surety performance bond is available, it may be called upon for assistance during the storm of broken relationships and expectations. In a very short period of time, the surety is requested to bail out the obligee and/or salvage the wreck of the construction project. There are many issues that must be addressed, whether before, during or after the surety's rescue efforts. Hopefully, this paper will assist the parties to the construction process in successfully navigating through the issues of construction contract defaults and terminations and the surety's responses and actions under the performance bond.

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<sup>115</sup> Robert J. Berens & J. Blake Wilcox, *Deciding to Litigate: Representing the Surety in a Complex Bankruptcy Case*, in *MANAGING AND LITIGATING THE COMPLEX SURETY CASE*, 2D ED. 501-80 (Philip L. Bruner & Tracey L. Haley, eds. 2007); T. Scott Leo & J. Blake Wilcox, *Bankruptcy Considerations and Bond Defaults*, in *BOND DEFAULT MANUAL*, 3D ED. 313-69 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 2005); Chad L. Schexnayder, *Bankruptcy and the Surety*, in *THE LAW OF SURETYSHIP*, 2D ED. 317-73 (Edward G. Gallagher, ed. 2000); Chad L. Schexnayder, *Bankruptcy*, in *THE LAW OF PERFORMANCE BONDS* 289-331 (Lawrence R. Moelmann & John T. Harris, eds. 2000); George J. Bachrach & Cynthia E. Rodgers-Waire, *The Surety's Rights to the Contract Funds in the Principal's Chapter 11 Bankruptcy Case*, 35 *TORT & INS. L.J.* 1 (1999); T. Scott Leo, *The Financing Surety and the Chapter 11 Principal*, 26 *TORT & INS. L.J.* 45 (1990).

## APPENDIX

### **BIBLIOGRAPHY OF FREQUENTLY CITED SECONDARY MATERIALS**

**MANAGING AND LITIGATING THE COMPLEX SURETY CASE, 2D ED.** (Philip L. Bruner and Tracey L. Haley, eds. 2007), TORT TRIAL AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION.

Chapter 1 - *Strategic “Generalship” of the Complex Construction Suretyship Case* by Philip L. Bruner and Tracey L. Haley.

Chapter 3 - *Deciding to Litigate: The Surety’s Recourse Against its Principal and Indemnitors* by Armen Shahinian, Marc Brown and Joseph Monaghan.

Chapter 4 - *Deciding to Litigate: The Surety’s Recourse Against Third Parties* by Ronald F. Goetsch and Christopher R. Ward.

Chapter 5 - *Deciding to Litigate: The Surety’s Rights Against Property and Liability Insurers of the Obligee, Principal, and Subcontractors* by Patrick J. O’Connor, Jr.

**PERFORMANCE BOND MANUAL** (Lawrence Lerner and Theodore M. Baum, eds. 2006), TORT TRIAL AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION. [This book provides a summary of the law of performance bonds in the 50 states, the District of Columbia, Puerto Rico and all federal jurisdictions. The standard format for the PERFORMANCE BOND MANUAL includes such issues as the requirements for the performance bond, the damages covered (including the surety’s obligations to perform and/or pay and any limitations on damages), the penal sum of the performance bond, the parties covered or not covered (dual obligees, assignees and third-party beneficiaries), notice and/or filing requirements, suit limitations, various procedures, and other matters of interest with respect to performance bonds in each jurisdiction.]

**BOND DEFAULT MANUAL, 3D ED.** (Duncan L. Clore, Richard E. Towle and Michael J. Sugar, Jr., eds. 2005), TORT TRIAL AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION.

Chapter 2, Section A - *The Surety’s Investigation* by William S. Piper and Carl C. Coe, Jr.

Chapter 3 - *The Surety’s Analysis of Investigative Results: “To Perform or Not to Perform - That is the Question”* by Philip L. Bruner, Patrick J. O’Connor, Jr. and Tracy L. Haley

Chapter 4 - *Financing the Principal* by George J. Bachrach and Matthew L. Silverstein.

Chapter 5 - *Takeover and Completion* by Gregory L. Daily and Todd C. Kazlow.

Chapter 6 - *Tender* by E.A. “Seth” Mills, Jr. and Susan M. Moore.

Chapter 7 - *Completion by the Bond Obligee* by Deborah S. Griffin and Stephen J. Beatty.

Chapter 8 - *Public Works Projects* by Donald G. Gavin, Shannon J. Briglia and Mark S. Marino.

Chapter 11 - *Considerations With Respect to Insurance Coverage* by Christopher R. Ward and Mary Jean Pethick.

**THE SURETY'S INDEMNITY AGREEMENT - LAW & PRACTICE** (Marilyn Klinger, Gary Judd and George J. Bachrach, eds. 2002), TORT TRIAL AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION.

**THE LAW OF SURETYSHIP, 2D ED.** (Edward G. Gallagher, ed. 2000), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION.

Chapter 6 - *Contract Performance Bonds* by Marilyn Klinger, James P. Diwik and Kevin L. Lybeck.

Chapter 7 - *Discharge of the Performance Bond Surety* by M. Michael Egan and Marla Eastwood.

Chapter 21 - *Arbitration of Performance Bond Disputes* by H. Bruce Shreves and Kevin L. Lybeck.

**THE LAW OF PERFORMANCE BONDS** (Lawrence R. Moelmann and John T. Harris, eds. 2000), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION.

Chapter 2 - *Default, Notice of Default, Impact Upon Surety's Obligations Where Notice is Not Given* by Benjamin D. Lentz.

Chapter 3 - *Rights of Surety in Event of Default* by James J. Mercier and John T. Harris.

Chapter 4 - *Entitlement to Contract Proceeds* by Edward G. Gallagher.

Chapter 6 - *Liability of the Performance Bond Surety (Under Contract of Suretyship)* by John H. Gregory and Michael Jay Rune, II.

Chapter 9 - *Defenses Available to the Surety* by Julia Blackwell Gelinas.

Chapter 11 - *Effect of an Arbitration Provision in the Principal's Contract with the Obligee* by James D. Ferrucci.

**SALVAGE BY THE SURETY** (George J. Bachrach, ed. 1998), TORT AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION.

Chapter 1 - *The Surety's Rights to Obtain Salvage - Exoneration, Reimbursement, Subrogation and Contribution* by George J. Bachrach.

Chapter 3 - *The Principal's Contract Claims as Salvage - A Primer* by Patrick J. O'Connor, Jr.

Chapter 5 - *The Surety's Claims Against Third Parties* by James D. Ferrucci and Scott D. Baron.

### **Author's Note**

Since the publication of the original paper at the October, 2007 Fall Meeting of the American Bar Association Forum on the Construction Industry, the following additional and updated book has been published:

**THE SURETY'S INDEMNITY AGREEMENT - LAW & PRACTICE, 2D ED.** (Marilyn Klinger, George J. Bachrach & Tracey L. Haley, eds. 2008), TORT TRIAL AND INSURANCE PRACTICE SECTION, AMERICAN BAR ASSOCIATION.

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