

**TWENTIETH ANNUAL
NORTHEAST SURETY AND FIDELITY
CLAIMS CONFERENCE**

SEPTEMBER 24th and 25th, 2009

**THE COMPLETION OPTIONS AFFORDED TO A SURETY
UNDER VARYING PERFORMANCE BOND FORMS - RIGHTS
TO COMPLETE AND NOT TO COMPLETE**

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INTRODUCTION

The traditional performance bond was remarkably terse regarding a surety's rights and obligations in the event of its principal's default, typically setting out defeasance language such as the following:

If the principal faithfully performs and fulfills all of the undertakings, covenants, terms, conditions and agreements of the contract and any extensions thereto, this obligation shall be void; otherwise to remain in full force and effect.¹

Common law precedents regarding the surety's rights and obligations filled in the gaps. In many contexts, these precedents afforded the surety rights in the event of a claim to arrange completion of the project (whether by takeover, financing the principal, or tender), deny the claim, or pay the obligee for its completion costs in excess of the contract balance.²

A surety's right to complete a bonded project in the event of a default can offer significant advantages to the surety in terms of managing and reducing completion costs, resolving back charges from the obligee and payment bond claims at fair amounts, and preserving evidence relating to affirmative claims. This paper will address to what extent the surety retains the right to complete under the various performance bond forms most commonly in use today, including but not limited to the AIA A311 and the A312 bond forms.

A surety's common law right to reimburse the obligee for its losses in lieu of completing a project may also be a valuable option for a surety. There are numerous circumstances under which a surety may not want to complete the bonded work, including if:

- There are serious questions as to whether the obligee is in default of the bonded contract;
- The obligee is clearly in default and there are serious questions as to whether the default is or is not material;
- The obligee is uncooperative;
- There are serious unresolved design issues;
- The principal's subcontractors are hostile or uncooperative;
- The surety is unable to locate contractors or key subcontractors having the necessary expertise and availability to complete the work at a fair price;
- The surety determines that its only viable completion option is a tender, but the obligee refuses to accept a tender;
- The surety is prepared to take over the project but the obligee refuses to sign a takeover agreement;

¹ Bonds that define the surety's performance obligations using this kind of language will be referred to herein as "Defeasance Bonds."

² See, e.g., *United States v. Seaboard Surety Co.*, 817 F.2d 956 (2d Cir. 1987); *Granite Computer Leasing Corp. v. The Travelers Indemnity Co.*, 894 F.2d 547 (2d Cir. 1990); *In re Technology for Energy Corp.*, 123 B.R. 979, 982-3 (Bkrcty. D.Tenn. 1991).

- The obligee takes an unreasonable position regarding the amount of the contract balance and/or refuses to make the contract balance available in a fair amount to defer completion costs; and/or
- The obligee can likely complete the bonded contract for at or near the amount of the undisbursed contract balance.

This paper will explore to what extent the bond forms that are most commonly used today, particularly the AIA A311 and the AIA A312, preserve the surety's right to pay damages to an obligee in lieu of completing the bonded obligation ("buy out"). This paper will also address examples of manuscripted bond forms that may limit the surety's ability to refuse an obligee's demand that the surety complete. It is particularly important that a surety understand to what extent it has the right to deny an obligee's demand that the surety complete, since refusing to complete if completion is contractually mandated can expose the surety to bad faith liability and consequential damages.³

Notwithstanding whether or not a bond form can be construed to require a surety to complete on demand, the surety should maintain the right under all commonly used bond forms to refuse to perform if it reasonably concludes that the obligee is in breach of the conditions prerequisite to the surety's obligations under the bond or is otherwise in material breach of the owner's obligations under the bonded contract.⁴

ANALYSIS

I. WHETHER THE SURETY CAN REFUSE AN OBLIGEE'S DEMAND THAT THE SURETY COMPLETE THE BONDED PROJECT?

A. "Completion Bonds"

Certain performance bonds may severely restrict the surety's performance options. One such manuscripted bond reads, in pertinent part, as follows:

NOW THEREFORE, the condition of this obligation is such that if the said Principal shall well and faithfully perform all the terms and conditions of the bonded contract..., and shall indemnify and save harmless the said City as therein stipulated, then this obligation shall be of no effect; otherwise it shall remain in full force and virtue.

....

In the event that the bonded contract is abandoned by the contractor or is terminated by the City, under the provisions thereof, said surety hereby further agrees that it shall, if requested in writing by the City, take such action as is necessary to complete such agreement.

³ *Continental Realty Corp. v. Crevolin*, 380 F.Supp. 246 (D.W.V. 1974); *In re Technology*, 123 B.R. 979 (Bkrcty E.D.Tenn. 1991); *Miracle Mile Shopping Center v. National Union Indemnity Co.*, 299 F.2d 780 (7th Cir. 1962); *Spancrete Northeast, Inc. v. Travelers Indemnity Co.*, 477 N.Y.S.2d 502 (App.Div. 1984)

⁴ See *Roel Partnership v. Amwest Surety Insurance Co.*, 685 N.Y.S.2d 832 (App.Div. 1999)

This bond form does not expressly condition the surety's liability on the obligee's compliance with its obligations under the bonded contract. Nonetheless, it can fairly be maintained that a material breach of the bonded contract by the obligee is an implied surety defense. Assuming that all conditions prerequisite to surety performance are satisfied, this bond form may mandate completion on the part of the surety at the obligee's demand. Assuming that this is the case, the bond form is not entirely clear as to whether a tender or a timely monetary payment would satisfy the surety's obligation to complete.

The bond language addressed by the court in *Continental Realty Corp. v. Crevolin* ("*Crevolin*")⁵ appears to limit but not negate the surety's option to buy out its performance obligation. The bond imposed a fifteen day deadline on the surety in the event of its principal's default to take over the bonded contract. If the surety failed to take over within this period, the bond required the surety and obligee to re-bid the outstanding work and the surety was required to pay the obligee its excess completion costs within fifteen days after the amount of the lowest responsible bid had been determined. The surety in *Crevolin* did not comply with either of the fifteen day deadlines, arguing that it was not obligated to do so because the obligee had materially breached its obligations under the bonded contract. The court rejected the claim of obligee breach, declared the surety in breach of its obligations under the bond, and found the surety liable for consequential damages purportedly incurred by the obligee as a result of the surety's failure to complete and delay in making payment, including sums in excess of the penal sum.⁶

Though the bond in *Crevolin* did not require that the surety complete under all circumstances, the decision in *Crevolin* poses the dilemma that confronts a surety where its principal has been terminated, there are serious questions as to which party under the bonded contract is in default, there are compelling reasons why completing the work is financially disadvantageous, but the bond language narrows the surety's common law right to fashion a buy out. The surety should be able to argue under any bond form that it has been released as a result of a material breach of the bonded contract by the obligee regardless of whether or not the bond incorporates express condition precedent language. However, if a court finds that a surety is incorrect in its allegation of an obligee breach, the surety can be exposed under these kinds of "completion bonds" to potentially substantial and open ended awards of consequential damages. To the extent that a surety is confronted by a bond that seems to require that it complete the bonded obligation in the event of its principal's termination and the surety determines that it would be more advantageous to negotiate a buy out rather than complete, it may be advantageous for the surety to attempt to negotiate a financial settlement at an early point in time.

B. AIA A312 Performance Bond

The A312 performance bond specifically incorporates a surety's common law right to buy out its performance obligations in the event of its principal's termination:

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:

⁵ 380 F.Supp. 246 (D.W.V. 1974).

⁶ See also *Miracle Mile Shopping Center v National Union Indemnity Co.*, 299 F.2d 780 (7th Cir. 1962).

....

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 practical after the amount is determined, tender payment thereof to the Owner; or
- .2 Deny liability in whole or part and notify the Owner citing reasons therefore.

Two caveats to this buyout option should be noted. If the surety itself completes the bonded contract, its exposure is limited under Paragraph 6 of the A312 to its completion costs net of the undisbursed contract balance which may be adjusted by liquidated or actual damages caused by the principal's delay in completing, and additional costs (legal, design professional and delay) resulting from the principal's default and/or the surety's actions or failures to act. Where the surety opts to buy out its obligations, the A312 bond does not protect the surety from other kinds of consequential damages.

Second, Paragraph 4.4 obligates the surety to act with "reasonable promptness" to estimate the likely completion costs and tender to the obligee the amount of the estimate. Arguably, the A312 bond does not permit the Surety to delay all payments to the obligee until the work is completed and the price is fixed. Query whether the A312 would allow the surety to promptly make periodic partial payments to the owner as costs are incurred so that the surety is not at risk of paying in excess of the completion costs that are actually incurred? In contrast, it can be argued under a Defeasance Bond that a surety opting for a buy out may be able to delay making payment until the final cost is fixed or at least may make periodic payments to avoid the risk of an overpayment.

C. AIA A311 Performance Bond

The operative language under the AIA A311 performance bond is as follows:

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 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 condition, 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... sufficient funds to pay the cost of completion less the balance of the contract price....

In *National Union Fire Insurance Co. v. Fortune Construction Co* ("Fortune"),⁷ the court addressed the question of whether or not the A311 bond preserves a surety's buyout option. The surety in *Fortune* financed its principal for a limited period, paid payment bond claims,

⁷ 320 F.3d 1260 (11th Cir. 2003).

refused the obligee's request to complete after it ceased financing, and then refused a damages demand from the obligee on the basis that the undisbursed contract balance was in excess of the obligee's completion costs. The obligee claimed that it had the right to set off the undisbursed contract balance against "unbonded" debts owed to it by the principal. In determining that the obligee could properly set off debts unrelated to the bonded project, the court held that the surety was in breach of its obligations under the A311 by refusing to complete upon demand of the obligee. The court acknowledged a surety's buy out right under a defeasance or indemnity bond. However, the court ruled that under an A311 bond, the surety's options were limited to financing the principal to complete, completing the work itself either with or without a completion contractor, or tendering a completion contractor.⁸ In reaching this decision, the Fortune Court relied heavily on commentary from *Bruner & O'Connor on Construction Law* which does not specifically address the A311 bond and is not necessarily applicable to the text of the A311 bond.

In contrast, the federal district court in *Balfour Beatty Construction, Inc. v. Colonial Ornamental Iron Works, Inc. ("Balfour Beatty")*⁹ noted in dicta that the language similar to that in the A311 bond preserves all of the surety's common law completion rights including its buyout option.

Assuming that a surety asserts a buy out right under an A311 bond and refuses to itself complete, it may be prudent for the surety to offer to either promptly negotiate a final buyout number or pay the obligee's excess construction costs as these become due in the absence of closure on a final buy out number in order to obviate or mitigate exposure to consequential damages in the event that a court was to opt for the holding in *Fortune* in lieu of the dicta in *Balfour Beatty*.

D. AIA A311 Subcontractor Performance Bond

The operative language under the AIA A311 subcontractor performance bond is as follows:

1. Whenever Principal shall and is declared by certified mail notice to the Surety to be, in default under the subcontract, the Obligee having performed its obligations thereunder,
 - a. Surety may promptly remedy the default subject to the provision of paragraph 1.(c) herein, or;
 - b. Obligee after reasonable notice to the Surety may, or Surety upon demand of the Obligee may, arrange for the performance of the Principal's obligations under the subcontract subject to the provisions of paragraph 1.(c) herein;
 - c. The balance of the contract price, as defined herein, shall be credited against the reasonable cost of completing the subcontract....

The Court in *Fortune* held that the surety had the right under the subcontractor

⁸ 320 F.3d at 1272-74. See also *Cooper Industries, Inc., v. Tarmac Roofing Systems, Inc.*, 276 F.3d 704 (5th Cir. 2002).

⁹ 986 F.Supp. 82 (D.Conn. 1997)

bond to use its principal to complete or to complete itself at the request of the contractor, but that the bond did not afford the surety the right to compel the obligee to accept a buy out.¹⁰ Again, this holding is seemingly at odds with the district court's dicta in *Balfour Beatty* recognizing a surety's right to a buy out under an A311 contractor's bond.¹¹

In sum, a surety must carefully examine the operative performance bond form to determine whether its common law buy out right has or has not been preserved.

II. WHETHER THE SURETY HAS THE RIGHT TO COMPLETE UPON ITS PRINCIPAL'S TERMINATION?

A. Defeasance Bonds

As noted *supra*, the common law construing defeasance bonds typically afforded a surety the right to complete the bonded work in the event of the termination of its principal.¹²

B. "Completion Bonds"

Bonds that appear to obligate the surety to complete the bonded obligation may or may not afford the surety a right to complete. Of the two bonds discussed *supra* in connection with "Completion Bonds," one obligates the surety to complete only if requested in writing by the obligee. Whether that bond also affords a surety the right to complete depends on whether or not a court would construe the bond in light of the common law interpretations afforded to defeasance bonds. In contrast, the bond addressed by the court in *Crevolin* appears to expressly afford to the surety the right to complete so long as the surety exercised that option within fifteen days of a claim received on the bond.¹³

C. AIA 312 Performance Bond

The A312 bond specifically affords the surety an opportunity to complete the bonded obligation in the event of its principal's termination:

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 the 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 contract for performance and completion of the Construction Contract,

¹⁰ 320 F.3d at 1273.

¹¹ 986 F.Supp. 82.

¹² See cases cited at footnote 2, *supra*.

¹³ 380 F.Supp. 246.

arrange for a contract to be prepared for execution by the Owner and the contractor selected with the Owner's concurrence...and pay to the Owner the amount of damages...in excess of the Balance of the Contract Price incurred by the Owner resulting from the Contractor's default....

The Courts have held that the obligee must afford the surety a right to complete under the A312 bond, this obligation is a condition prerequisite to the surety's liability, and the failure on the part of the obligee to afford this opportunity constitutes a complete defense to the surety.¹⁴

D. AIA A311 Contractor's Bond

The case law is split as to whether the A311 performance bond affords a surety the right to prompt notice of the principal's termination by the obligee and an opportunity to complete the bonded work. Some courts have held that the obligee must afford the surety a right to complete under the A311 bond, this obligation is a condition prerequisite to the surety's liability, and the failure on the part of the obligee to afford this opportunity constitutes a complete defense to the surety.¹⁵ These cases reference the surety's common law right to complete, as well as the unfairness that would be imposed on a surety if an obligee could complete and then make demand on the surety without affording the surety an opportunity to mitigate its damages or even an opportunity to investigate the obligee's alleged completion costs as these were being incurred.¹⁶

Other cases hold that prior notice and an opportunity to complete are not conditions precedent under the A311 bond and that the A311 allows the obligee to terminate a principal, complete the bonded work, and then provide the surety with notice of the termination and a demand for recovery.¹⁷ These cases rely on a very literal and hyper-technical interpretation of the text of the A311 bond divorced from any notions of fairness or custom, pointing out that the bond does not incorporate the express condition precedent language of the A312 bond regarding the surety's right to complete and/or holding there are no conditions precedent in the A311 that run in favor of the surety.¹⁸

¹⁴ *Seaboard Surety Co. v. Town of Greenfield*, 370 F.3d 215 (1st Cir. 2004); *St. Paul Fire & Marine Insurance Co. v. City of Green River*, 93 F.Supp. 2d 1170 (D.Wy. 2000), *aff'd*, 6 Fed. Appx. 828 (10th Cir. 2001); *Solai & Cameron, Inc v. Plainfield County Consolidated School Dist.*, 871 N.E.2d 944 (Ill. App. Ct. 2007). Though one court has expressed a contrary view, its decision is not well reasoned and has not been followed by other courts. See *Kilpatrick Brothers Painting v. Chippewa Hills School Dist.*, 2006 WL 664210 (Mich.Ct.App. 2006).

¹⁵ See *Hunt Construction Group, Inc. v. National Wrecking Corp.*, *supra*, 542 F.Supp.2d 87; *CC-Aventura, Inc. v. The Weitz Co.*, 2008 WL 2937856 (S.D.Fla. 2008); *INA v. Metropolitan Dade County*, 705 So.2d 33 (Fla. Dist. Ct. 1997); *Balfour Beatty Construction, Inc. v. Colonial Ornamental Iron Works, Inc.*, *supra*, 986 F.Supp. 82.

¹⁶ *Id.*

¹⁷ See *Colorado Structures, Inc. v. Insurance Company of the West*, 167 P.3d 1125 (Wash. Sup. Ct. 2007); *Dooley and Mack Constructors, Inc. v. Developers Surety and Indemnity Co.*, 972 So.2d 893 (Fla. Dist. Ct. 2007); *Walter Concrete Construction Corp. v. Lederle Laboratories*, 788 N.E.2d 609 (N.Y. 2003); *Menorah Nursing Home v. Zukov*, 548 N.Y.S.2d 702 (App.Div. 1989).

¹⁸ *Id.*

E. AIA A311 Subcontractor Performance Bond

As noted above, the operative language under the AIA A311 subcontractor performance bond states:

1. Whenever Principal shall and is declared by certified mail notice to the Surety to be, in default under the subcontract, the Obligee having performed its obligations thereunder,
 - a. Surety may promptly remedy the default subject to the provision of paragraph 1.(c) herein, or;
 - b. Obligee after reasonable notice to the Surety may, or Surety upon demand of the Obligee may, arrange for the performance of the Principal's obligations under the subcontract subject to the provisions of paragraph 1.(c) herein;
 - c. The balance of the contract price, as defined herein, shall be credited against the reasonable cost of completing the subcontract....

These terms arguably afford a surety a right in the event of termination of the principal to return the principal to the project and finance the principal to completion.¹⁹ However, the surety is not afforded the right to complete through other means in the event that the obligee chooses to complete itself.²⁰ However, if the obligee chooses to complete, it is obligated by the text of the bond to afford the Surety "reasonable notice" so that the surety can monitor its completion costs. Courts have held that providing a surety with reasonable notice of an obligee's decision to complete is a condition prerequisite to the surety's liability and that the failure to provide such notice affords the surety a complete defense under the bond.²¹

F. Supplanting the Completion Rights Afforded Under the Bond

Assuming a bond that affords a surety the right to complete the bonded work, the question arises as to whether the completion rights afforded to the surety under the bond can be supplanted by the terms of the bonded contract.

The following is a variant of a clause commonly found in many bonded subcontracts:

If the Subcontractor is unable, refuses, or fails to supply enough properly skilled workers, proper materials, or maintain the Schedule of Work, or fails to make prompt payment to its workers, subcontractors or suppliers, or is otherwise guilty of a material breach of a provision of this Subcontract, the Subcontractor shall be deemed in default of this Subcontract Agreement. If the Subcontractor fails to cure the default within one business day of receipt notice of default, the Contractor without prejudice to any other rights or remedies afforded under this Subcontract shall have the right to any or all of the following remedies:

¹⁹ See *Cooper Industries, Inc., v. Tarmac Roofing Systems, Inc.*, *supra*, 276 F.3d at 712.

²⁰ 320 F. 3d at 1273.

²¹ See *Hunt Construction Group, Inc. v. National Wrecking Corp.*, 542 F.Supp.2d 87 (D.D.C. 2008); *CC-Aventura, Inc. v. The Weitz Co.*, 2008 WL 2937856 (S.D.Fla. 2008).

- (a) supply workers, materials, equipment and facilities as the Contractor deems advisable for the completion of the Subcontract Work or any part of that Work and charge the cost to the Subcontractor;
- (b) contract with one or more additional contractors to perform such part of the Subcontract Work as the Contractor determines will provide the most expeditious completion of that Work and charge the cost to the Subcontractor; and/or
- (c) withhold any payments due or to become due to the Subcontractor pending completion of the corrective work in an amount sufficient to cover the Contractor's losses incurred as a result of the Subcontractor's failure to perform.

(hereafter "Supplementation Clause").

A number of cases have addressed circumstances under which an obligee has made demand on the surety for its excess completion costs after completing some or all of the outstanding bonded work in reliance on a Supplementation Clause and without terminating the principal or providing prior or contemporaneous notice to the surety that the work was being completed by the obligee. In certain of these cases, the courts have denied recovery to the obligee based on its noncompliance with a condition precedent under the bond.²² In these cases, the courts point out that the surety's rights and obligations are determined in the first instance by the terms of its bond and that to the extent of a conflict between the terms of the bond and the terms of the bonded contract, the surety's rights and obligations are necessarily determined by the language in the bond.²³

In other cases, the courts have held that an obligee's exercise of its rights under a Supplementation Clause does not prejudice its rights against a surety even if the bond affords the surety the right to complete.²⁴ Certain of these cases wrongly suggest that the terms of a bond can be modified by the terms of the bonded contract through incorporation of the obligations under the bonded contract into the bond.²⁵ It has also been held that a

²² See *Hunt Construction Group, Inc. v. National Wrecking Corp.*, 542 F.Supp.2d 87 (D.D.C. 2008) (A311 subcontractor bond); *CC-Aventura, Inc. v. The Weitz Co.*, 2008 WL 2937856 (S.D.Fla. 2008) (A311 subcontractor bond); *Solai & Cameron, Inc v. Plainfield County Consolidated School Dist.*, 871 N.E.2d 944 (Ill. App. Ct. 2007) (A312 bond)

²³ *Id.*

²⁴ *United States Fidelity & Guaranty Co. v. Braspetro Oil Services Co.*, 369 F.3d 34, 62-65 (2d Cir. 2004) (A312 bond); *Colorado Structures, Inc. v. Insurance Company of the West*, 167 P.3d 1125 (Wash. Sup. Ct. 2007) ("*Colorado Structures*") (A311 bond); *Commercial Casualty Insurance Co. v. Maritime Trade Center Builders*, 572 S.E.2d 319 (Ga.Ct.App. 2002) (A312 bond) ("*Commercial Casualty*").

²⁵ See *Colorado Structures, supra* and *Commercial Casualty, supra*. For cases holding generally that a surety's liability is determined by the terms of the bond and not necessarily by the scope of the principal's obligations under the bonded contract, see, e.g., *Marshall Contractors, Inc. v. Peerless Insurance Co.*, 827 F.Supp. 91, 93-4 (D.R.I. 1993); *American Home Assurance Co. v. Larkin General Hospital Ltd*, 593 So.2d 195 (Fla. 1992); *Downington Area School Dist. v. International Fidelity Insurance Co.*, 769 A.2d 560 (Pa. Commw. Ct. 2001).

Supplementation Clause is effectively a tool by which an obligee can mitigate damages in the event of a default by the principal and that a performance bond neither obviates an obligee's duty to mitigate nor diminishes its tools available for exercising this duty.²⁶

It is possible based on the facts of at least some of the reported cases to reconcile the conflicting holdings relating to the intersection of an obligee's rights under a Supplementation Clause and a surety's right to complete under a performance bond. It may be that an obligee can exercise its rights under a Supplementation Clause without running afoul of the surety's rights under a performance bond so long as the obligee provides to the surety prompt notice of the supplementation, limits the scope of the supplementation to only what is necessary to obviate significant additional losses, and provides the surety with the opportunity to arrange for completion of the remaining work at the earliest possible time.²⁷ It may be that, at least in certain contexts, limiting an obligee's supplementation rights to this limited scope may prove beneficial to both the obligee and the surety. However, affording an obligee any greater rights to supplement would rewrite the terms of the operative bond and severely and unnecessarily cause the surety prejudice.

CONCLUSION

A surety's right to complete a bonded contract and its right to buy out a bonded obligation are valuable options that were generally made available to sureties under defeasance bonds as construed by the common law. These rights may or may not remain available to a surety depending on the text of the operative performance bond and how that text has been construed in the particular jurisdiction. It therefore is always critical that the surety consult the terms of the bond at the outset of its investigation of a performance bond claim.

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²⁶ *Id.*

²⁷ See *United States Fidelity & Guaranty Co. v. Braspetro Oil Services Co.*, *supra*, 369 F.3d at 62-65.

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