

**SOUTHERN SURETY AND FIDELITY CLAIMS
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**PERFORMANCE BOND DECLARED NULL AND VOID!
SURETY'S DEFENSE ARISING FROM OBLIGEE'S
FAILURE TO ALLOW SURETY TO EXERCISE
PERFORMANCE BOND OPTIONS**

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A. Introduction

The Introductory Note to Title B, Suretyship Defenses, under Topic 3, in Chapter 3 of the Restatement of Suretyship and Guaranty Third (1996), states:

"There is probably no area of suretyship law in which there is less consensus than the law of suretyship defenses. Rules vary from jurisdiction to jurisdiction, from context to context, from common law to the Uniform Commercial Code."

That comment is particularly accurate where the surety asks the court to be discharged from its performance bond liability because the obligee failed to declare the principal in default and serve timely notice upon the surety of its default termination of the principal. This paper will explore the viability of the defense as a means of obtaining a complete discharge of the performance bond surety.¹ We will examine the early treatment of the defense and the recent cases which appear to depart from the general rule. Finally, we will attempt to reconcile the recent decisions with what otherwise appears to be the prevailing authority on this subject.

B. Early Treatment of the Defense

The decisions generally recognize that surety's liability should not be increased by reason of any action or inaction by the obligee that materially breaches the expressed or implied duties under its contract with the principal and/or the bond instrument. Therefore, the surety must plead and prove that the obligee did not declare the principal in default or otherwise give timely notice of the principal's default termination, and that such failure is deemed material and results in economic prejudice so as to entitle surety to a full or partial discharge to the extent of the increased loss. The variations in the results of the cases are primarily based upon how the courts interpret and apply the facts rather than the law of the case.

A historical review of the decisions involving the rights of surety to be discharged under those circumstances reflects a transition from a more strict interpretation of the duties that the obligee and surety had to each other. Traditionally, the cases held that absent express language in the contract or bond that notice of default be given to surety, the obligee had no affirmative duty to advise surety of the principal's default termination.² The rationale given for those rulings is that surety had an independent duty to monitor the work of the principal and, therefore, had no right to rely upon the obligee's failure to give notice as a defense to the claim.³ Conversely, there are decisions finding for surety where the obligee did not comply with the notice requirements, even though such requirements, by today's standards, are not considered as conditions precedent to surety's liability.⁴

A more realistic approach is taken by the courts in recent cases which hold that even in the absence of a written provision in the contract or bond documents, the obligee still has an implied duty to give surety timely notice that the principal has been declared in default to allow surety the right to exercise its options under the bond to mitigate its loss.⁵ There is no discernable difference in the decisions where there are no notice provisions in the contract or bond and those where notice is specifically included. The cases appear to be uniformly consistent with the rationale of the new Restatement which essentially allows for the discharge of surety's liability to the extent that its loss is increased by the obligee's action, but still requires a showing of prejudice.

With certain exceptions⁷, there are no cases which have awarded a total or partial discharge of surety's liability where the obligee failed to give timely notice when such conduct was not construed either as a failure of a condition precedent or a material breach. Although acknowledging that surety may have been denied the right to mitigate its loss, the courts have found a number of reasons that precluded such reduction. Among those reasons are that: no economic prejudice was shown;⁸ surety had prior knowledge of the problems on the project;⁹ the late notice did not prejudice surety;¹⁰ the delay for which the obligee was claiming compensation was caused by the principal¹¹ or that surety would not have been able to correct the problems if timely or earlier notice had been given.¹²

It is axiomatic that courts abhor forfeitures. Thus, often the clear language of the bond has been ignored or misconstrued resulting in a finding that the untimely notice of default had to be supported by a showing of prejudice to award surety a total discharge or partial discharge.¹³ There are several older cases, however, in which the lateness of notice was considered so unreasonable that surety was completely discharged without proof of prejudice, where the notice provisions do not conform to the "condition precedent language."¹⁴

C. Recent Treatment of the Defense

There are four recent decisions which depart from the general rule requiring the surety to prove economic prejudice arising from the obligee's failure or delay in notifying surety of the principal's default. Those decisions involved either AIA Form 311 performance bonds or bond forms containing language substantially similar to the AIA Form 311 performance bond.¹⁵ Each court found that the obligee's failure to follow the bond's notice requirements¹⁶ stripped the surety of its performance bond options and deprived the surety of its bargained for right to mitigate its liability. Consequently, each court held that the surety was completely discharged by the obligee's failure to give notice.¹⁷

In one of the first modern day decisions to provide surety a complete discharge of its performance bond obligations, without requiring the surety to prove prejudice, the United States Court of Appeals for the Fifth Circuit, in L&A Contracting v. Southern Concrete Services,¹⁸ held that an obligee's failure to give the surety notice of the principal's default completely relieved the surety from liability under its performance bond.¹⁹ There, the obligee, L&A Contracting, notified Southern Concrete Services' surety, Fidelity & Deposit Company of Maryland (F&D) of slow delivery rates and the delivery of poor quality concrete. After that initial notice, Southern Concrete's performance improved. L&A Contracting later notified F&D of continuing problems with Southern Concrete's performance but never informed F&D that Southern Concrete was in default of its performance obligations under the subcontract. L&A Concrete allowed Southern Concrete to finish the subcontract work, then sued Southern Concrete and F&D for breach of contract. The court ruled that L&A Contracting failed to prove a "necessary precondition" to F&D's liability under its bond, stating that:

"As a surety, F&D's liability is governed by the terms of its bond with L&A. While Southern is, of course, directly liable for its own breach of contract, the bond in this case imposes liability on F&D for Southern's breach only if two conditions exist. First, Southern must have been in default of its performance obligations under the

subcontract. Second, L&A must have declared Southern to be in default." 17 F.3d at 109. (emphasis added)

The court found that by not declaring a default, L&A Contracting failed to meet one of the conditions precedent to F&D's performance bond liability. F&D was discharged without being required to prove that it had been harmed by the lack of notice.

Three years later, in Balfour Beatty Construction, Inc. v. Colonial Ornamental Iron Works, Inc.,²⁰ the federal district court for Connecticut was confronted with facts strikingly similar to those before the Fifth Circuit in L&A Contracting.²¹

The obligee, Balfour Beatty Construction, Inc. ("Balfour"), entered into a subcontract agreement with the principal Colonial Iron Works ("Colonial"), to provide structural steel for Balfour's prime contract with Metro North Commuter Railroad for the construction of a drawbridge and viaduct in Bridgeport, Connecticut. After Colonial had completed approximately 65% of its subcontract, it furnished Balfour a performance bond issued by National Surety Corporation ("NSC")²². Thereafter, Balfour sent two letters, one to Colonial and the second to NSC's agent, which Balfour contended gave NSC notice that Balfour considered Colonial to be in default.²³ The court, relying on the L&A Contracting decision, found that Balfour's letters, while discussing Colonial's delays in performance, did not provide sufficient notification to NSC that its principal was in default.²⁴ In granting summary judgment for NSC, the court found that:

"... [Balfour] failed to meet a necessary condition for NSC's liability under the bond ... and ... allowed Colonial to complete the project thereby denying [NSC] the opportunity to exercise any of its options under the performance bond." Id. at 5. (emphasis added).²⁵

L&A Contracting and Balfour both involve situations where the surety, though aware of its principal's performance problems and delays on the project, could not exercise any of its options to reduce its potential losses without risking the loss of its indemnity rights, because of the obligee's failure to declare a default.

Another 1997 decision, Insurance Company of North America v. Metropolitan Dade County²⁶ involved a surety that not only received no notice of its principal's default, but had no inkling whatsoever of any performance problems until the obligee filed suit against the principal to recover costs incurred in correcting the principal's allegedly deficient work.

In 1984, Metropolitan Dade County ("the County") contracted with Interamerican Engineers and Constructors Corporation (Interamerican) to perform certain construction work at a municipal airport. Insurance Company of North America (INA) provided a performance bond. Interamerican completed work under the contract in 1986. In 1992, the County discovered defects in roofs constructed by Interamerican when portions of the roofs blew off during Hurricane Andrew. The County repaired the roofs in October 1993 and the County sued Interamerican for breach of contract.

In late October, 1993 INA received a letter from the County advising it of the lawsuit against Interamerican, but that letter neither declared Interamerican in default of the 1984 contract nor

demanded that the surety satisfy its performance bond obligations. In fact, the record reflected that the County never notified INA of its discovery of the roof deficiencies nor did the County make demand on INA to repair the roof deficiencies or give INA the opportunity to exercise any of its performance bond options. In October, 1994, the County obtained a default judgment of \$272,339.00 plus pre-judgment interest against Interamerican. In May, 1996, the County sued INA under its performance bond. The appellate court, in reversing the lower court's entry of summary judgment against INA, found that:

"... [INA] demonstrated that the duties and obligations it had assumed as to the County had not attached to the instant claim because the County had failed to notify the surety of the claim as is clearly outlined in the parties' agreement...

Under these circumstances, we find persuasive Dragon Construction, Inc. v. Parkway Bank & Trust, 287 Ill.App.3d 29,222 Ill.Dec.648, 678 N.E.2d 55 (1997). In Dragon, a similar notice requirement was held to be a crucial and bargained for provision of the surety contract. The failure to notify was held to be a material breach of the parties' agreement, stripping the surety of its contractual right to minimize damages. As in Dragon, [the County's] failure to comply with INA bond's notice provisions stripped [INA] of its bargained for right and relieved [INA] of its liability for the instant claim." Id., at 2-3.

The court reversed the summary judgment in favor of the County without requiring a showing of prejudice and directed the lower court to enter judgment in favor of INA.²⁷

The fourth recent decision in which the surety successfully asserted the notice defense is Dragon Construction, Inc. v. Parkway Bank & Trust.²⁸ In contrast to the L&A Contracting and Balfour decisions, the notice requirement at issue in Dragon was found in the general conditions of the contract which were incorporated by reference into the bond.

In October, 1988, Dragon entered into a contract with the Reicks to build a hardware store in Park Ridge, Illinois. National American Insurance Company (NAIC) provided performance and payment bonds for the project.

The original completion date for the project was April 12, 1989, but that date was extended to July 12, 1989. The store was set to open on September 1, 1989. The procedure for terminating the contract was found in Article 14.2 of the AIA A 201 General Conditions (1987). The Reicks were entitled to terminate Dragon's contract upon the occurrence of certain conditions enumerated in the contract provided that they (1) obtain the architect's certification that just cause existed to justify the termination and (2) give Dragon and NAIC seven days written notice prior to the termination. Dragon fell behind schedule and the Reicks continually requested Dragon to provide more workers. The Reicks never notified NAIC of Dragon's delayed performance. On July 27, 1989, the Reicks terminated Dragon for failure to provide enough workers and for substantial breach of contract. On that date the Reicks also hired Solarcrete to finish Dragon's contract. Solarcrete began work on July 28, 1989. On August 1, 1989, the Reicks sent NAIC notice that "due to intolerable lack of progress and pursuant to the certification of [the architect] ... we have been compelled to replace Dragon." NAIC did not respond to the August 1 notice until October 23, 1989, after the store was completed. On August 24, 1989, Dragon sued the Reicks for breach

of contract and to foreclose its mechanic's lien. Dragon later amended its complaint to seek declaratory judgment as to the parties' rights under NAIC's performance bond. The Reicks filed a cross complaint against Dragon and NAIC for breach of contract seeking damages in the amount of \$224,175.30. The trial court granted Dragon's motion for summary judgment and dismissed the Reicks' cross claim against NAIC, finding that NAIC'S bonds were null and void because the Reicks (1) failed to properly and promptly notify NAIC of Dragon's termination and (2) violated the performance bond and the construction contract by engaging a successor contractor prior to giving NAIC notice of Dragon's termination.

In affirming the granting of summary judgment for the surety, the court held that the failure of the obligee to give the surety the requisite seven-day termination notice²⁹ and the obligee's hiring of a successor contractor without consulting the surety, stripped the surety of its contractual right to limit its liability and constituted a material breach of contract³⁰ which rendered the surety bonds null and void.³¹

Ironically, the surety's failure to respond to the termination notice until after the project was completed may have been the single most important factor in the outcome of the decision. Had the surety investigated the default, solicited bids for completion of Dragon's work and obtained prices comparable to the obligee's actual completion costs, the court may have determined that the obligee's replacement of the principal without informing the surety did not constitute a material breach inasmuch as the surety could not have completed the project for less even if given the opportunity to do so.³²

D. Reconciling The Recent Decisions With The General Rule

One author recently noted that the notice defense is a defense which rarely is meaningful to the performance bond surety: "Absent language in the bond making notice of default a strict condition precedent to bringing suit on the bond, no notice defense will free the compensated surety of its bond obligation."³³ Yet, the L&A Contracting decision and its progeny seem to have revitalized the notice defense for the compensated performance bond surety.³⁴

In none of these decisions did the courts, in finding the surety completely discharged from its performance bond obligations, require surety to prove that it had been prejudiced by the obligee's failure to give notice of the principal's default. But perhaps the rulings in those cases can be reconciled with the rules recently promulgated in The Restatement of Law Third, Suretyship & Guaranty (1996). The courts, expressly in L&A Contracting and Balfour, and perhaps implicitly in INA and Dragon, recognized that had the sureties in those cases performed their obligations prematurely, they would have lost their right as one with "suretyship status" to seek reimbursement from their principals.

Section 22 of the Restatement provides that where the surety is required to perform its obligation due to the principal's default, the surety is entitled to reimbursement from the principal. However, where the surety undertakes performance where its performance obligation has not been triggered, the principal may avoid reimbursement to the surety.³⁵ Furthermore, Section 37 of the Restatement provides:

- (1) If the obligee acts to increase the secondary obligor's risk of loss by increasing

its potential cost of performance or decreasing its potential ability to cause the principal to bear the cost of performance, the secondary obligor is discharged ... An act that increases the secondary obligor's risk of loss by increasing its potential cost of performance or decreasing its potential ability to cause the principal obligor to bear the cost of performance is an impairment of suretyship status ...

(3) If the obligee impairs the secondary obligee's recourse against the principal obligor by:

...
(f) any other act or omission that impairs the principal obligor's duty of performance, the principal obligor's duty to reimburse or the secondary obligor's right of restitution or subrogation; the secondary obligor is discharged from its duties pursuant to the secondary obligation ... in order to prevent the impairment of recourse from causing the secondary obligor a loss."

By failing to give proper notice of the principal's defaults, the obligees in the recent decisions failed to trigger the sureties' performance bond obligations. Had the sureties performed before receiving proper notice of default, they may have lost their right of recourse against their principals. By allowing the principals to continue performance of the contract or by completing the contract without properly calling upon the sureties and giving them an opportunity to exercise their performance bond rights, the obligees impaired the sureties' suretyship status, thus entitling those sureties to a discharge of their performance bond obligations. However, contrary to the rulings in the recent decisions, the Restatement does not provide that a surety is completely discharged once it establishes that its suretyship status has been impaired. Rather, the Restatement adopts the general rule that the surety must still prove loss or prejudice from the obligee's conduct, though certain exceptions are noted.³⁶

Prejudice may be presumed if the surety can demonstrate that the circumstances indicate that the extent of its loss is not "reasonably susceptible of calculation." Under those circumstances, there is a presumption that the surety's loss or prejudice is equivalent to the penal sum of the bond, thus justifying a complete discharge. The burden would then shift to the obligee to rebut the presumption.³⁷

Though the courts in the recent cases did not undertake an analysis of whether the obligees' conduct created a rebuttable presumption of prejudice, perhaps the decisions implicitly recognize that such a presumption arose, given that the sureties were deprived of the opportunity to investigate the circumstances surrounding their principals' alleged "default" and thus could not determine whether their principals were solely responsible for the alleged construction deficiencies; nor was it possible for the sureties to quantify their actual damages. Under circumstances where the surety cannot exercise its rights because its obligations have not been properly triggered and the obligee allows the principal to complete or undertakes completion itself, how can the surety, after the fact, possibly measure the damages caused by the obligee's "impairment of suretyship status?"

Under such circumstances, the rulings in the L&A Contracting decision and its progeny make sense. As the Fifth Circuit observed: "sureties deprived of a rule for notices of default would clearly be reluctant to enter into otherwise profitable contracts."³⁸

E. CONCLUSION:

Certainly the recent decisions are extremely favorable for the surety and must be included in the arsenal of the surety practitioner and claims representative and at least used in negotiating favorable settlements with obligees who may have failed to comply strictly with the notice requirements contained in a performance bond. Obviously, the treatment of the defense will vary depending upon the jurisdiction. In the final analysis, each case must be examined on its own facts. However, if the issue arises in Connecticut, Florida or Illinois, and the performance bond contains a notice requirement, there is now precedent in those jurisdictions for relieving the surety of the burden of proving prejudice and for declaring the performance bond "null and void."³⁹ Whether L&A Contracting and its progeny are considered anomalies, it is abundantly clear that as a result of these decisions, the "notice defense" has become more meaningful to the compensated performance bond surety.

NOTES

1. This paper will not focus on the treatment of the defense in the context of claims under labor and material payment bonds.
2. American Sur. Co. of NY v. U.S., 317 F.2d 652 (8th Cir.1963) Town of Wakefield v. American Surety Co., 95 N.E.350 (Sup.Ct. Mass. 1911).
3. **L. Simpson, Suretyship (1950) at 166-68.**
4. National Surety Co. v. Long, 125 F.887 (8th Cir. 1903).
5. **Blackhawk Heating & Plumbing Co. v. Seaboard Surety Co., 534 F.Supp.309 (7th Cir. 1982).** (The bond did not require the obligee to give notice of the principal's default. The court found that in the absence of a statutory contractual duty to notify surety, such failure results in increased damages which could have been avoided. Such failure bars recovery of the increases in damages. The court found that surety did not suffer a provable loss); **Resolution Trust Corporation v. Gaudet**, 907 F.Supp. 212 (E.D. LA 1995). (This case involved a claim under a financial institution bond which provided for notice at the earliest moment but not to exceed 30 days after discovery of loss. The court held that if timely notice is not an express condition precedent, the insurer had to show that it was sufficiently prejudiced by the late notice. The court found that issues of fact existed even though the proof of claim filed by the claimant was more than two years after the discovery of the loss and denied surety's motion for summary judgment).

Town of Clarksville v. The North River Insurance Co., 803 F Supp.827 (S.D. N.Y. 1992) (The court found that even in the absence of a notice requirement "... the law will imply an obligation that the obligee notify the insurer within a reasonable time of an occurrence or claim within a reasonable time" (at p. 829). The court further went on to state, "The requirement of timely notification is a safety device that ensures that an insurer be put in the best possible position to reduce the cost of the claim. Thus, failure to provide notice should result in a reduction in the sum owed in an amount which would offset the prejudice occurred." The court nevertheless found for the claimant because there was no evidence that the failure to give notice did not result in prejudice to surety).
6. Restatement of § 37 (1). This section clearly reflects that any action or inaction by the obligee which exposes surety to additional losses if provable will to that extent reduce surety's liability.
7. See cases discussed in Section C infra.

8. **Paisner v. Renaud, 149 A.2d 867 (N.H. 1959) (Late notice was not prejudicial, particularly because surety claimed that the need of the requested repair was not by the principal). Bayer & Mignolla v. Deschenes, 205 N.E. 2d 208 (Mass. 1965). (Surety not harmed because principal finished work).**
9. **Ireland's Lumber Yard v. Progressive Contractors, Inc. 122 N.W. 2d 554 (N.D.1963). (Surety had knowledge of default before it received notice from the obligee); Jack v. Craighead Rise Milling Co., 167 F.2d 96, (8th Cir.1948). (Surety had knowledge that the principal was not paying its bills).**
10. **Clarksville N. North River Insurance Co., 803 F.Supp. (S.D.N.Y. 1992) (Surety did not establish that it incurred increased loss because of the late notice).**
11. **Blackhawk Heating & Plumbing Co. v. Seabord Surety Co., 534 F.Supp 309 (7th Cir 1982) (The delay resulting in the damages claimed by the obligee was caused by the principal).**
12. **USF&G v. Orlando Utilities Commission 564 F.Supp.962 (M.D. Fla. 1983) (D.C. FI 1983). Courts concluded that earlier notice of default was excused because surety would not have been able to remedy the problem anyway.**
13. **Insurance Company of Pennsylvania v. Associated International Insurance Co. 922 F.2d 516 (9th Cir. 1991). (The suit involved a claim by a primary carrier against its reinsurer. The court ruled that although the requirement of notice may have been a condition precedent, the reinsurer would have to prove it was prejudiced by the late notice); Babylon Associates v. County of Suffolk, 475 N.Y.S. 2d 869 (1984). (The obligee failed to declare the bond in default which was first disclosed to surety by the obligee in its counterclaim. The court ruled that the reference in the counterclaim satisfied the conditions of the bond); National Gypsum Co. v. Travelers Indemnity Co., 417 So. 2d 254 (Fl.1982) (affirming 394 So.2d 481. Notice was considered a condition precedent by the Appellate Court that raised the presumption of prejudice which discharged surety. While agreeing that the presumption existed, the Supreme Court ruled that it was rebuttable if the claimant showed surety was not actually prejudiced).**
14. **Big Lift Shipping Co. v. Bellefonte Insurance Co. 594 F.Supp 701 (S.D. N.Y. 1984) (An insured brought an action against a marine liability insurer for casualty to an insured vessel. There was a 3 year delay in notifying the carrier. The condition of the policy required such notice to be given as soon as practicable. The court ruled that the established New York law was that compliance with the notes provision was a condition precedent to the insurer's liability and that prejudice need not be shown before it could assert the defense of non compliance. While this appears as a favorable ruling, the New York cases may disagree or distinguish this case). R.C. Walters Co. Inc. v. DeBower, et al. 216 N.W. 2d 515 (Neb.1974) (The bond required a prompt written statement of facts of occurrence be given surety as a condition precedent to recovery); Dockendorf v. Orner 203 N.W. 395 (Neb. 1980). (Action brought against surety on what appears to be a financial guarantee bond. The terms of the bond required that a claim be made within 120 days of the transaction, otherwise surety would not be liable. Timely notice was not given and the court discharged surety because of the claimant's non-compliance).**
15. The AIA A 311 Performance Bond provides in relevant part that:
 "Whenever the Contractor shall be and declared by the Owner to be in default under the Contract, the Owner having performed the 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 conditions, and upon determination by the 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 the Owner and make available as work progresses ... sufficient funds to pay the cost of completion ..."

16. The notice requirement at issue in Dragon was actually contained in the general conditions of the AIA A201 General Conditions which were incorporated by reference in the AIA A311 performance bond.
17. There are some older cases which held that the obligee's failure to give surety notice of the principal's default completely discharged the surety without requiring a showing of prejudice where the notice requirement was an express condition precedent to surety's liability. Southern Surety Co. v. MacMillan Co., 58 F.2d 541 (10th Cir. 1932) (recognizing the rule but requiring the surety to prove prejudice because the bond language did not clearly make notice a condition precedent). Knight & Jillson Co. v. Castle, 87 N.E. 976 (Sup.Ct. Indiana 1909); National Surety Co. v. Long, 125 F.887 (8th Cir. 1903); United States Fidelity & Guaranty Co. v. Gary, 233 P.731 (Sup.Ct. Okla.1925) Other courts, however, required the compensated surety to prove prejudice resulting from the lack of notice even though the notice requirement was an express condition precedent to surety's liability. See Haddock Constr. Co. v. Wilber, 178 Or.659, 169 P.2d.599 (1946).
18. 17 F.3d 106 (5th Cir.1994).
19. The decision is extremely favorable for the surety as the court recognized that a surety risks losing its right of reimbursement from its principal or being accused of interfering with the underlying contract if it prematurely performs:

"Before a declaration of default, sureties face possible tort liability for meddling in the affairs of their principals. After a declaration of default, the relationship changes dramatically, and the surety owes immediate duties to the obligee. Given the consequences that follow a declaration of default, it is vital that the declaration be made in terms sufficiently clear, direct and unequivocal to inform the surety that the principal has defaulted on its obligations and the surety must immediately commence performing under the terms of its bond. Sureties deprived of a rule for notices of default would clearly be reluctant to enter into otherwise profitable contracts ..." Id. at 110-111 (footnotes omitted).
20. 1997 WL 757549 (D. Conn.).
21. Those facts were arguably more favorable for the surety. In L&A Contracting one of the letters sent to F&D expressly demanded that F&D take over Southern's contract in order to prevent any further delays and costs to L&A Contracting. The Fifth Circuit found that language insufficient to invoke F&D's liability. In Balfour, none of the obligee's letters even suggested that the surety step in and perform the principal's contract.
22. NSC provided the performance bond on August 10, 1995, five days before the delivery completion date contained in the purchase order. Colonial argued that Balfour had demanded that Colonial provide a performance bond in consideration for agreeing to a revised payment and performance schedule. Balfour released \$500,000.00 to Colonial after NSC provided the bond.
23. An August 17, 1995 letter to Colonial provided in relevant part as follows:

"The purchase order required complete delivery by August 15, 1995. This contractual date has not been met. As you are aware, Balfour Beatty Construction, Inc. is and has been ready to receive the material. As you are also aware, Balfour Beatty Construction, Inc. is being delayed in finishing the project as planned. Balfour Beatty Construction, Inc. intends to pursue any and all damages which it incurs as a result of Colonial Iron Works' late performance. Without any manner waiving our ability and intention to deduct from the total Purchase Price all or part of the damages, losses or expenses we incur, if any, resulting from your company's failure to comply with the delivery requirements of the Purchase Order, we agree, subject to the above, to the following payment breakdown contingent upon your company's timely compliance with the performance dates attached hereto."

The court found that neither NSC or its agents had actually received a copy of the August 17, 1995 letter. In fact, neither NSC nor any of its agents received any correspondence or communication from Balfour until NSC

received the following letter from Balfour dated December 19, 1995:

"By letter dated August 10, 1995, you forwarded a Subcontract performance Bond Form A for Colonial Iron Works in the amount of \$2,946,634.00. You signed the bond as attorney in fact on behalf of National Surety Corporation.

The original delivery schedule required complete delivery by August 15, 1995. Such date was not met. With consent of surety and without Balfour Beatty Construction, Inc. waiving any rights, the delivery schedule and payment schedule were modified pursuant to certain terms and conditions which are contained in a letter dated August 17, 1995. Such letter was forwarded to Colonial Iron Works with a copy to the surety. Please find enclosed a courtesy copy. Also find enclosed letters dated November 3, November 24 (two letters), December 4 and December 15, 1995 from Balfour Beatty Construction, Inc. to Colonial Iron Works. As may be seen, Colonial Iron Works continues to fail to perform in accordance with its contractual obligations. Balfour Beatty Construction, Inc. intends to pursue any and all damages which it incurs as a result of Colonial Iron Works' failure to perform its obligation in a timely manner, including all remedies against the surety."

24. The court rejected Balfour's argument that NSC had actual notice of Colonial's default on the basis that "the delivery provision set forth in the purchase order was already in breach at the time NSC issued the bond. *Id.* at 4.
25. In their oppositional Memorandum of Law, Balfour's attorneys argued that L&A Contracting is not controlling law on either the adequacy of notice of the principal's default or on whether notice of the principal's default is a condition precedent to surety's liability. Balfour's attorneys cited Morse/Diesel v. Trinity Industries, Inc. 875 F.Supp.165 (S.D.N.Y.1994), (applying New York law); Menorah Nursing Home v. Zukov, 548 N.Y.S. 2d 702 (N.Y. App. Div. 1984) and Babylon Associates v. County of Suffolk, 475 N.Y.S. 2d 869 (N.Y. App. Div.1984) for the proposition that the surety should not be relieved from liability by the obligee's failure to give notice of the principal's default unless the bond contains a provision which expressly requires a notice of default as a condition precedent to any legal action on the bond. Balfour's attorneys also cited Plowden & Roberts, Inc. v. Conway, 192 So. 2d 528 (Fla. 4th DCA 1966) (which would seem to have little weight in light of National Gypsum Co. v. Travelers Indemnity Co., 417 So.2d 254 (Fla. 1982)) and Bayer & Mingolla Construction Co. v. Deschases, 205 NE 2d 208 (Mass.1965) for the proposition that the obligee's failure to give notice and make demand on the surety does not relieve the surety of liability absent the surety proving that it was prejudiced by the obligee's actions. The court apparently did not find those cases persuasive as they are not discussed or cited in the opinion.
26. 1997 WL 667601 (Fla. 3rd DCA).
27. The court also held that the County was not entitled to summary judgment as a matter of law based solely on the default judgment it had obtained against Interamerican. Relying on the Restatement of the Law Third Suretyship and Guaranty §67 (1996), the court observed that a default judgment against the principal is only evidence of a surety's liability. The court reiterated its earlier holding in Heritage Ins. Co. v. Foster Electric, 393 So.2d 28 (Fla.3d DCA 1981) that a default judgment is prima facie evidence of the surety's liability, shifting to the surety the burden to introduce evidence to rebut the liability.
28. 287 Ill.App.3d 29, 222 Ill.Dec.648, 678 N.E.2d 55 (1st Dist.1997).
29. The court erroneously believed that the reason for the seven day notice period was to allow [the surety] to exercise its right under the performance bond to participate in the selection of a successor contractor." The seven days actually provides the principal an opportunity to cure any defaults before the obligee terminates the contract at the end of the period.

30. Under the material breach doctrine in Illinois, "a party to a contract is discharged from his duty to perform where there is a material breach of the contract by the other party." Susman v. Cypress Venture, 187 Ill.App.3d 312,316,134 Ill.Dec.901,904,543 N.E.2d 184,187 (1989). A material breach occurs where the covenant not performed is of such importance that the contract would not have been made without it. Haisma v. Edgar, 218 Ill.App. 3d 78,86,161 Ill.Dec.36,41,578 N.E. 2d 163,168 (1991).
31. The court did not address whether the "declaration of default" language in the performance bond constituted a pre-condition to surety's liability. Rather, the court focused its attention on the notice requirement in the general conditions which were incorporated by reference in the bond. In arguing that their failure to give the seven day notice required by the terms of the general conditions of the contract was an insubstantial breach, the Reicks relied upon Winston Corporation v. Continental Casualty Company, 361 F.Supp.1023 reversed 508 F 2d 1298 (6th Cir. 1975). In that case, the court found that an arrangement by which the obligee assumed control of the contract work did not operate to discharge the surety. The failure to provide the requisite seven day notice was an insubstantial breach that would not justify a complete discharge of the surety's obligation but only a discharge to the extent of the damages proved by the surety. The Appellate Court determined that the surety was kept apprised of the problems on the project and therefore necessity of notice as called for by the contract was not material. In reversing, the court stated:
- "Continental kept itself informed of the progress of construction of the nursing home and was aware of the delays and difficulties that finally led to the April 7 agreement. Continental was invited to discuss construction problems with Diversified and Winston several times but declined to attend any meeting, including the one on April 7th."
- The Dragon court, though not citing Winston, apparently distinguished the decision by finding that unlike the surety in Winston, the surety for Dragon did not have an opportunity to exercise its performance bond options.
- The court, however, did not follow its reasoning to its logical conclusion. Though it held the bond to be null and void because of the obligee's failure to give the seven day termination notice required by the terms of the General Conditions of the Contract, it found that the principal was not fully discharged from its performance obligations under the contract.
32. The court's ruling also may have been different had the obligee timely and properly asserted the defense of waiver. The Reicks contended that even if they committed a material breach of contract, NAIC waived its right to deny coverage under the bond because it did not respond to the late notice until after the completion of the project. The court found, however, that the Reicks waived the defense of waiver by never specifically asserting it in the lower court. See Hartford Accident & Indemnity Co. v. D.F. Bast, Inc., 56 Ill.App 3d 960,962,14 Ill.Dec.550,553,372 N.E.2d 829,832 (1978) ("both waiver and estoppel must be specifically pleaded in the initial pleadings).
33. M. Michael Egan Law of Suretyship, Chapter 12 "Discharge of the Performance Bond Surety" (Gallagher ed. 1993).
34. Where notice of claim is a precondition to liability under a payment bond, the defense has received more favorable treatment by the courts. See National Gypsum Co. v. Travelers Indemnity Co., 417 So.2d 254 (Fla.1982) where the Florida Supreme Court held that failure to give surety timely notice of claim under a payment bond, where timely notice was a condition precedent to surety's liability, precludes recovery against the surety, without requiring a showing of prejudice.
35. Restatement §24.
36. Restatement § 49(2).
37. Restatement §49 (3).

38. 17 F.3d at 110.

39. No published opinion has addressed whether an obligee's compliance with the notice requirements found in the AIA 312 performance bond form constitutes a condition precedent to surety's liability under that bond form or whether non-compliance would result in the discharge of surety's performance bond obligations without a showing of prejudice. Unlike the wording of the AIA 311 bond form, the language of the AIA 312 performance bond form expressly conditions surety's performance obligations on the obligee's compliance with certain notice requirements.

Section 3 provides that:

"3 If there is no Owner Default, the Surety's obligation under this Bond shall arise after:

3.1 The Owner has notified the Contractor and the Surety ... that the Owner is considering declaring a Contractor Default and has requested and attempted to arrange a conference with the Contractor and the Surety ...

3.2 The Owner has declared a Contractor Default and formally terminated the Contractor's right to complete the contract ...; and

3.3 The Owner has agreed to pay the Balance of the Contract Price to the Surety ... or to a contractor selected to perform the Construction Contract.

Section 4 of the AIA 312 bond form designates the acts required of the Obligee in Section 3 as "conditions" which must be satisfied before surety is obligated to perform any of the options listed in subsections 4.1 through 4.4.

Our law office recently filed an action for declaratory judgment on behalf of a surety seeking to obtain a complete discharge of its AIA 312 performance bond obligations where the obligee did not satisfy the conditions of section 3. That obligee, similar to the conduct of the obligees in the L&A Contracting and Balfour cases, copied surety with various letters to the principal threatening default for improper and delayed performance, but never "declared a contractor default" nor formally terminated the principal's right to complete the contract. In fact, the principal was allowed to complete the work, but, unbeknownst to the surety, the obligee supplemented the principal's work force and corrected allegedly deficient work. Upon completion of the project, the obligee made demand on surety for excess completion costs and damages (lost rentals, extended overhead, lost tax credits) allegedly caused by the principal's delayed and deficient performance. Though the obligee has not responded to the complaint, we suspect it will argue that, though no formal default was declared, surety was aware of the principal's actual defaults and was not prejudiced by the obligee's conduct. In this situation, it would be impossible for the surety to quantify its damages resulting from the obligee's failure to follow the bond's notice requirements as the surety was never given the opportunity to investigate the alleged construction deficiencies which the obligee completed and paid for six months before making demand on the surety. If the court will not give surety a complete discharge for the obligee's failure to declare a default and failure to allow surety to exercise its performance bond options in order to mitigate its damages, the burden of persuasion should at least shift to the obligee to prove that the surety was not prejudiced by the obligee's conduct.