

**TWELFTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
CONFERENCE**

**THE UNCOOPERATIVE OWNER:
THE SURETY'S DEFENSES WHEN THE OWNER
UNILATERALLY COMPLETES, OVERPAYS
OR OTHERWISE MISBEHAVES**

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There is a parable which aptly sums up the relationship between the surety and the owner on many defaulted projects. In the story, a scorpion and a frog meet on the bank of a stream and the scorpion asks the frog to carry him across the stream on his back. The frog warily inquires, "If I do, how do I know you won't sting me?" The scorpion replies, "Because if I do, I will die too." The frog agrees to ferry the scorpion across, but midstream, the scorpion stings the frog. The frog feels the onset of paralysis and starts to sink. Knowing they both will drown, the frog asks, "Why?" Replies the scorpion, "It's my nature."

There are numerous ways in which an owner can "sting" the surety. This paper examines potential defenses of the surety to remove the venom from that "sting."

I. THE AXMAN: CORRECTIVE WORK WHICH DIFFERS FROM THE ORIGINAL SPECIFICATIONS.

When negotiating the takeover of a defaulted contract by the surety, or when unilaterally arranging for completion of a defaulted contract, an owner may attempt to contract for work which is different from that specified in the contract. Under a dated Supreme Court decision, a surety may avoid liability for the costs of the "gold-plated" completion project.

A. *Axman.*

In the seminal case of United States v. Axman, 234 U.S. 36, 34 S.Ct. 736 (1914), the United States Supreme Court held that a defaulted contractor is not liable for completion costs in excess of the original contract unless the relet contract is the same as the original contract. Axman involved a contract between Axman and the government for dredging in a bay. During performance of the contract, Axman requested authorization to dump spoil in a location other than that specified in the contract. Permission was refused. Following Axman's default, the government relet the contract and permitted the relet contractor to dump spoil in the location requested by and refused to Axman.

On appeal, the Court characterized the issue as follows:

It is thus apparent that the real question in this case is whether the contract relet for the completion of the work under paragraph 4 of the original contract was a contract for work for which Axman was bound and which he had failed to carry out, or whether it was a different contract and therefore one for which Axman and his surety cannot be held and which cannot be used for the measure of recovery for breach of the original contract.

Finding that the relet contract differed from the original contract, the Court affirmed the lower courts' rulings dismissing the government's claims. Apparently, the government did not put on evidence of damages independent of the relet price. The Court did not remand the case to give the government a chance to introduce further evidence.

Accordingly, Axman created an evidentiary rule which bars the use of the completion price as evidence of damages when the terms of the completion contract vary from the terms of the bonded contract. Application of the evidentiary rule resulted in the dismissal of the obligee's claim for failure to prove damages.

B. Dulling the *Axman's* Blade.

Courts have been reluctant to strictly follow the holding of Axman, and have found ways to ameliorate or avoid its application.

1. Limiting *Axman* to Material Alterations.

Not every deviation from the original contract will justify application of the Axman exclusionary rule. Rather, the deviation must be "substantial" or "material." See CJP Contractors, Inc. v. United States, 45 Fed. Cl. 343 (1999), in which the court noted that the government was not entitled to costs arising from re-procurement specifications which contained material changes from the original contract; Schwartz v. United States, 65 F.Supp. 391 (Ct. Cl. 1946), in which the court held that the owner could not recover the difference in cost between the original contract and the relet contract where the owner specified a system which materially differed from the system specified in the original contract.

Similarly, in Southern Surety Co. v. American Const. Co., 36 S.W.2d 212, 215 (Tex.App. 1931), the court held that Axman only applies where the completion contract "differ[s] in substantial respects from" the bonded contract. See also Seaboard Lumber Co. v. United States, 45 Fed.Cl. 404 (1999); American Surety Co. of New York v. United States, 317 F.2d 652, 657 (8th Cir. 1963) (holding that a reduction in the number of items ordered and a change in delivery terms did not constitute a material change, and upholding the use of the relet contract price as the measure of damages).

2. Reduction of Damages Rather than Exclusion of Completion Price.

In Seaboard Lumber Co. v. United States, 45 Fed.Cl. 404 (1999), the court denied a motion for summary judgment filed by the owner based on factual issues regarding the materiality of changes in the relet contract. The court indicated that it may be appropriate to merely reduce damages rather than relieve the contractor from liability for the excess cost of the relet contract where the changes were not “substantial.” The court noted:

A trial must be held to determine whether the changes were sufficiently substantial and material to relieve plaintiffs of liability under *Axman* or whether it may be appropriate to reduce damages due to the changes and to what degree.

Id., at 410. See also Manke Lumber Co. v. United States, 44 Fed.Cl. 219, 228 (1999).

Similarly, in Doehler Metal Furniture Co. v. United States, 149 F.2d 130, 135 (2nd Cir. 1945), the court distinguished the situation where the work or goods under the contract are changed from the mere addition of a term to the contract. The court held that where the work or goods under the contract are changed, the relet contract price cannot be used as a measure of damages. However, where a term is added and the additional cost of that term can be ascertained, the cost of the relet contract (less the cost of the added term) can be used as evidence of damages. The court illustrated the distinction as follows:

. . . when the government, in a purported reletting, contracts for work or goods substantially different from that covered by the original contract . . . the government cannot recover under the reletting provision for the reason that, the two contracts being incommensurable, the price named in the second contract “cannot be used for the measure of recovery for breach of the original contract.” The attempted comparison is then like one between pigs and apples. But where the goods to be delivered under the two contracts are precisely the same and the only difference is an added item of obligation which enhances the cost in an ascertainable amount, the comparison, once the cost of that item is deducted from the price in the second contract, is unimpeachable. Consider, for instance, a contract for Idaho potatoes to be delivered at St. Louis followed by a relet contract, at a greater price, which requires delivery at Cleveland, where part of the increase in price can be shown to be due to additional transportation charges.

Id. The court remanded the case for trial on the issue of whether the additional cost of a liquidated damages clause not contained in the original contract could be ascertained, and whether the clause accounted for the entire increase in the cost of the relet contract.

____ See also United States v. Warsaw Elevator Co., 213 F.2d 517, 519 (2nd Cir. 1954), in which the court followed Doehler, and opined that the complete discharge rule is inequitable.

3. Remanding for Additional Evidence of Damages.

While recognizing the same principals announced in Axman, some courts have refused to impose the harsh penalty of dismissal of the owner's claim for failure to prove damages.

An illustrative case is the Louisiana Supreme Court's holding in State v. Smith, 119 So. 56 (La. 1928). In Smith, the state sought to recover costs incurred in connection with a relet contract for the construction of a highway embankment after the contractor was defaulted and the surety refused to takeover, asserting that the default was improper. The relet contract altered terms relating to the borrow pit which resulted in a higher completion cost. The Court rejected the surety's assertion that the reletting of a contract under terms different from the former contract in and of itself discharges the surety. However, the Court held that the new contract could not form the basis of the state's damages calculation. Id., at 62. Rather, independent proof of the loss must be shown. The Court noted that "the changed condition or new term may have the effect of virtually discharging the principal and surety, by rendering proof of the amount of loss impossible." Id. Since the substance of the work remained the same, however, the Court remanded the case to provide the state with an opportunity to introduce other evidence of its loss. Id., at 63. Axman was not cited by the Court.

____ See also Central Louisiana Electric v. Giant Enterprises, 371 So.2d 641, 652 (La.App 3rd Cir. 1979) (holding that where relet contract materially differed from original contract, relet price could not form the basis for damages; but remanding to permit plaintiff to introduce other proof of loss).

4. Axman Distinguished Based on Contract Terms.

____ In United States v. Elliot, 149 F.Supp. 52 (E.D. Mich. 1957), aff'd 261 F.2d 835 (6th Cir. 1958), the court distinguished Axman based on a contract provision which the court interpreted as allowing the contracting officer to relet the contract under terms which differed from the original contract in the event the original contract was terminated. Elliot involved a contract to procure truck axles and propellor shafts for the government. The contractor defaulted and the government procured the items from another source at a cost in excess of the contract price. The contractor sought to avoid

liability for the excess cost, asserting that the government required in the relet contract that the equipment must be located in the United States and available for inspection. The original contract did not contain this provision, which the government admitted enhanced the price under the relet contract. The court rejected the contractor's defense, finding that the original contract contemplated a deviation in contract terms. The contract provided that in the event of termination, the government:

may procure, upon such terms and in such manner as the Contracting Officer may deem appropriate, supplies or services similar to those so terminated.

Id., at 56 [Emphasis in original]. The court found that this language contemplated some variation from the original contract and vested broad discretion in the contracting officer to relet the contract. The court concluded that absent an abuse of discretion, the contractor was liable for the relet cost.

A similar result was reached in Consolidated Airborne Systems, Inc. v. United States, 348 F.2d 941 (Ct. Cl.1965), under an identical contract provision. The Consolidated court, however, held that the defaulted contractor could escape liability for the excess cost if it could show both that the change resulted in an unreasonable increase in expense and the amount by which the excess costs were increased by the unreasonable expense. Id., at 948.

D. Using *Axman* to Avoid paying for the Gilded Project.

While most courts have not been willing to strictly apply the rule of Axman, the case remains a useful tool for avoiding payment for items added to a completion contract. However, it is likely that relief under an Axman argument will depend on the materiality of the change from the original contract.

II. WAIVER BASED ON FAILURE TO PROVIDE SURETY WITH AN OPPORTUNITY TO COMPLETE.

The obligee further acts at his peril when he unilaterally completes a project, or takes steps which deprive the surety of its option to complete.

A. The Surety's Option to Complete.

AIA Form A312 (1984) provides the surety with the following options upon the default of the principal:

1. Arrange for completion by the contractor, with the owner's consent;

2. Takeover and complete the contract;
3. Tender a bonded completion contractor acceptable to the owner; or
4. Refuse to complete and either (a) tender the estimated completion cost plus other damages recoverable under the bond to the owner; or (b) deny liability.

See § 4.

When a performance bond provides the surety with the option of completing the contract, the surety has the right to minimize its liability by completing the contract. St. Paul Fire & Marine Ins. Co. v. City of Green River, 93 F.Supp.2d 1170 (D. Wyo. 2000). Action by an obligee which deprives the surety of its ability to protect itself pursuant to performance options under the bond constitutes a material breach and nullifies the bond. Id.; Balfour Beatty Constr. v. Colonial Ornamental Iron Works, Inc., 986 F.Supp 82, 86 (D.Conn. 1997) (addressing the obligee's failure to provide the surety with notice of the principal's default); Insurance Co. of North America v. Metropolitan Dade County, 705 So.2d 33 (Fla.App 3rd Dist. 1997); Dragon Const., Inc. v. Parkway Bank & Trust, 678 N.E.2d 55 (Ill.App 1st Dist. 1997).

B. Breaching The Bond: Actions Which Prejudice The Surety's Right to Complete.

There are several cases which recognize that an action by the obligee which deprives the surety of its option to complete is a material breach of the bond which discharges the surety from liability under the bond.

In City of Green River, supra, 93 F.Supp.2d at 1177-78, the surety offered to complete the contract using the defaulted contractor's forces. The owner found the use of the contractor's forces unacceptable and refused to permit the surety to complete the project. The surety filed a declaratory judgment action seeking a declaration that the owner had breached the bond, thus exonerating the surety from any further obligation under the bond. The owner asserted various counterclaims.

The court held that the surety had the right to complete the project under the terms of the bond, which tracked the language of AIA form A312 (1984). The court further noted that when a surety agrees to takeover a project, the surety has "the freedom to assemble the project team of its choosing." Id., at 1177. The court therefore concluded that the owner breached the bond when it refused to permit the surety to complete. The court further found that the breach was material, and discharged the surety from any further obligation under the bond. The court reasoned:

The effect of the [owner'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 the 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.

Id., at 1178 (citations omitted). The court did note that where the surety does not takeover the project, it cannot force the owner to complete with the contractor where the bond requires the owner's consent to use this option. Id., at 1177.¹

In Dragon Const., Inc. v. Parkway Bank & Trust, 678 N.E.2d 55 (Ill.App 1st Dist. 1997), the owner contracted with a completion contractor four days before giving the surety notice of the principal's default. The owner then sought to recover the cost of completion from the surety. The trial court, on summary judgment, found that the bond was nullified (1) by the owner's failure to properly and promptly notify the surety of the principal's termination, and (2) by the owner's contracting with a completion contractor prior to giving the surety notice of the principal's termination. On appeal, the owner argued, in part, that the surety failed to timely respond to the late notice (almost three months elapsed between the late notice and the first response from the surety to the owner), therefore, the late notice should not nullify the bond. The appellate court rejected this argument, noting that the only relevant fact was the owner's failure to provide the notice required by the contract, and before hiring a completing contractor.

Like the court in City of Green River, the court noted that the surety had a right to participate in the selection of a completion contractor, and the owner's failure to advise the surety of the termination before replacing the principal "stripped [the surety] of its contractual right to minimize its liability under the performance bond by ensuring that the lowest responsible bidder was selected to complete the job." Id., at 58. The court concluded that this act was a material breach of contract which rendered the bond null and void.² See also Insurance Co. of North America, *supra*, 705 So.2d at 35, following Dragon; but see American Surety Co. of New York v. United States, 317 F.2d 652 (8th Cir. 1963) (holding that where neither the bond nor the contract required notice

¹ At the time of the writing of this paper, the case was on appeal to the Tenth Circuit.

² The appellate court did not directly address the waiver argument because the owner failed to plead waiver as an affirmative defense. However, early in the opinion the court noted that the slow response by the surety to the late notice was irrelevant to the case.

of default, the owner could contract for completion of the contract, at the surety's expense, without notice to the surety).

C. Right to Complete Under a Statutory Bond.

Where a statutory bond is involved, reference must be made to the underlying statute, which is deemed in many states to govern the terms of the bond without regard to the bond's printed language. If the underlying statute does not give the surety the right to complete, the owner may be able to limit the surety's options.

III. LIQUIDATED DAMAGE CLAIMS:³

_____ Related issues arise where the obligee runs up liquidated damages. An obligee, for whatever reason, may delay defaulting a principal until the contract time has expired (despite lack of progress by the principal) or until significant liquidated damages have accrued. In other cases, the obligee may permit the principal to complete, even though contract time has long elapsed. Invariably, the obligee will then look to the surety for payment of liquidated damages which may have been avoided had the obligee timely defaulted the principal.

General principals of mitigation provide a defense to claims of the obligee who allows the principal to rack up liquidated damages. The surety can assert that the owner failed to mitigate loss by calling in the surety at a time when liquidated damages could have been avoided or minimized. See Blackhawk Heating & Plumbing Co., Inc. v. Seaboard Surety Co., 534 F.Supp 309 (N.D. Ill. 1982).

Blackhawk involved a subcontract bond which did not require the contractor to give the surety notice of the bonded subcontractor's default. The subcontractor failed to provide fixtures which met specifications, and the project was delayed. Nevertheless, the contractor continued to work with the subcontractor for fifteen months and did not notify the surety of the delay. The contractor thereafter asserted a substantial claim against the surety for delay damages. The surety asserted that the contractor waived its right to delay damages by failing to give the surety an opportunity to remedy the problem causing the delay. The court agreed, holding that to the extent the surety could have remedied the delay and thereby avoided additional costs, the surety was not liable for delay damages. However, the court held that to the extent action by the surety could not have avoided the delay, the contractor was entitled to damages. Id., at 315.

_____ See also Continental Bank & Trust Co. v. American Bonding Co., 605 F.2d 1049, 1057 n. 17 (8th Cir. 1979), wherein the court noted that "the obligee may not delay

³ This paper does not address the issue of whether delay damages are recoverable under a surety bond. See L&A Contracting Co. v. Southern Concrete Services, 17 F.3d 106 (5th Cir. 1994).

before notifying the surety and then insist that the measure of the surety's liability includes escalated costs arising in the interim between default and demand."

AIA form A312 (1984) supports a defense to liquidated damages where the owner fails to default the principal. § 6 of the bond form provides, in pertinent part, that "[a]fter 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 . . . the Surety is obligated without duplication for . . . Liquidated damages." Subparagraphs 4.1, 4.2, 4.3 provide for the surety financing the principal, taking over the project and tendering a completion contractor, respectively. Therefore, an argument can be made that if there is no default, the surety is not liable for liquidated damages.

In Louisiana, a provision of the Public Works Act enacted solely for state Department of Transportation and Development projects also supports an argument that a default is necessary to trigger liability for liquidated damages and places a thirty day notice requirement on the LADOTD. La. R.S. 48:255.2 provides, in pertinent part:

Within thirty days after default by a contractor on a public works project, the department shall notify the surety company with whom the contractor acquired a performance bond. Such notification shall be in writing by certified mail or overnight delivery. Within forty-five days of receipt of such notification, the surety company shall present to the department either a plan to assume performance on the contract and procure completion of the project, or provide the public entity in writing with a reasonable response for the contractor's alleged default. **If no plan is presented by the surety company, and the public entity completes the project, the surety company shall then be responsible for payment to the public entity** of the costs of completion of the project and **stipulated damages** assessed by the public entity up to the total amount of the bond purchased by the contractor.

[Emphasis added]. There is no case law interpreting R.S. 48:255.1.

A default could place the owner in a Catch-22, depending on contract language, as the Supreme Court has interpreted certain contract language as providing that an owner cannot recover liquidated damages when the contractor is defaulted. United States v. American Surety, 322 U.S. 96 (1944).

IV. OVERPAYMENT/ RELEASE OF RETAINAGE

When a performance claim is asserted against a surety, the surety will invariably look to the contract balances as a first source for minimizing loss.⁴ In fact, AIA form A312 (1984) recognizes that for the surety's obligation under the bond to arise, the owner must agree "to pay the Balance of the Contract Price to the Surety in accordance with the terms of the Construction Contract or to a contractor selected to perform the Construction Contract." § 3.3.

The issue which has plagued the courts is the proper remedy when the owner pays for work not performed, or releases retainage and later claims under the bond. The positions taken by courts range from a discharge of the surety without a showing of material prejudice to discharge to the extent that material prejudice is shown.

A. Discharge without a showing of prejudice.

In Southwood Builders, Inc. v. Peerless Ins. Co., 366 S.E.2d 104 (Va. 1988), the court held that the surety was discharged from its performance bond obligations where the contractor gave the principal, a subcontractor, advances and made payment without the architect approval called for in the subcontract. The court held that the surety need only show a material deviation from the contract, and that a showing of prejudice was not necessary because "a material deviation in itself, establishes sufficient prejudice." Id., at 108. The court noted that payment of substantial sums before they were due and without architect approval was a variation in the terms of the contract which discharged the surety from its obligations to the obligee. The court articulated a sound policy reason for its decision, noting that poor payment procedure by the obligee both "diminishes funds that should have been available to the surety in case of default" and "undermines the inducement of the contractor to finish the work on schedule." Id., at 108.

The court did examine the amount of overpayment in determining that there was a material deviation. The court noted that the overpayment exceeded \$31,000.00 where the contract price was \$79,500.00. Thus, the court left open the possibility that overpayments which represent a smaller percentage of the contract price would not be deemed a material deviation.

B. Discharge to the Extent Prejudice is Shown/*Pro Tanto* Discharge.

The automatic discharge rule of Southwood Builders was softened in Continental Ins. Co. v. City of Virginia Beach, 908 F.Supp. 341 (E.D. Va. 1995), a case which involved a contract for the construction of sewer and water lines. The principal

⁴ Overpayment issues arising in federal contracts are not addressed in this paper.

submitted monthly payment applications to the owner based on the number of feet of pipe and manholes installed. Payment applications were approved by the owner's inspector without inspecting or testing the work billed. After receiving over seventy five percent of the contract funds, the principal filed for bankruptcy and was defaulted. The surety arranged completion of the project under a tri-party agreement. During completion, testing revealed over \$300,000.00 in defective work. The surety then sued the owner, arguing that the owner's payment for defective work was a material variation from the contract which released the bond.

The court examined the contract, and determined that the contract language called for inspection of work by the owner before payment. The court held that by failing to inspect the work before payment, the owner materially deviated from the bonded contract and the surety was released from its obligations under the bond to the extent that the surety was prejudiced by the premature payments. Accordingly, the court awarded the surety the costs incurred in correcting the defective work and consulting fees attributable to the correction of the defective work. Id., at 350.

In Mergentine v. Washington Metro. Area Transit Auth., 775 F.Supp. 12 (D.D.C. 1991), the court rejected the Southwood Builders approach and held that the surety is not discharged unless it was prejudiced by the overpayment. The court noted that prepayment of contract funds does not prejudice the surety where the principal uses the funds to keep working on the bonded project. Id., at 23. The court did place the burden on the obligee to show that the surety was not prejudiced by the overpayment. Id., at 21.

____ See also Argonaut Ins. Co. v. Town of Cloverdale, Indiana, 699 F.2d 417 (7th Cir. 1983), where the court questioned an assumption that unauthorized advances increased the risk to the surety.

C. The “Good Faith” Defense to Discharge.

____ In Transamerica Ins. Co. v. Kennewick, 785 F.2d 660, 661 (9th Cir. 1986) (applying Washington law), the court recognized an exception to cases where the surety is discharged based on prepayment of contract funds, where the advance payments were made reasonably and in good faith. The court at times appeared to confuse good faith of the owner with the separate issue of prejudice to the surety, holding that the court should “examine the surety’s prejudice in light of all of the circumstances, especially the reasonableness of the obligee’s behavior and its good faith.” Id., at 662. However, the court held that overpayments based on negligent certifications by an employee of an owner deprive the owner of a good faith defense. The court noted that “before a surety’s obligation will be enforced after an unauthorized alternation of the contract, the obligee must have acted non-negligently.” Id. Accordingly, the court found that the surety was discharged to the extent of overpayments which were negligently

made. See also Blackfeet Tribe Reservation v. Blaze Const., 108 F.Supp.2d 1122, 1137 (D. Mont. 2000).

Some courts have held that a surety is not discharged where a public owner overpays in good faith and in reliance on a certification from the project architect or engineer. These courts have refused to impute any fault on the part of the architect or engineer to the owner. See City of Houma v. Municipal and Industrial Pipe Service, 884 F.2d 886, 891 (5th Cir. 1989); Argonaut Ins. Co. v. Town of Cloverdale, Indiana, 699 F.2d 417, 420 (7th Cir. 1983); American Fire Ins. v. Pavia-Byrne Engineering, 393 So.2d 830, 835 (La.App 2nd Cir. 1981). The surety does, however, have an action in damages against the architect or engineer. City of Houma, *supra*; American Fire, *supra*.

D. Bond Language Waiving Overpayment Defense.

If the bond provides that the surety's obligations under the bond shall not be impaired by prepayments and that the surety waives notice of prepayment, the surety waives any overpayment defense. See United States for the Use and Benefit of H & S Indus. v. Rich, 525 F.2d 760, 771 (7th Cir. 1975).

E. AIA Form 312 (1984).

AIA form 312 handles overpayment issues in its definition of Balance of the Contract Price, which is defined as the total amount payable by the owner to the contractor under the contract (subject to adjustment for change orders and insurance settlements), "reduced by all **valid and proper** payments made to or on behalf of the Contractor." [Emphasis added]. Payments for work which has not been performed or which were not owed are not valid and proper. Therefore, the surety can assert that calculation of the Contract Balance which the owner must pledge to completion of the project should not include overpayments.

F. The "Retainage" Bond.

The Louisiana legislature has created a useful tool for the Louisiana Department of Transportation and Development to release retainage to the contractor and still pursue claims against the surety. La. R.S. 48:256.1 permits the LADOTD to release retained amounts to the contractor if the contractor furnishes a retainage bond. While there are no reported cases interpreting this statute, the LADOTD may assert that the surety waived any overpayment defense by posting a retainage bond. The LADOTD has incorporated the statute into its form performance bond, which underwriters have executed without realizing that the bond permits the release of retainage.

CONCLUSION

The surety does have several defenses when dealing with the uncooperative owner. However, courts have not always embraced the surety and have often ignored and eroded these defenses. Nevertheless, these defenses should be kept in mind when dealing with the uncooperative owner.