

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

**NECESSITY FOR DEFAULT DECLARATION AND OTHER
CONDITIONS PRECEDENT TO INVOKE SURETY'S
OBLIGATIONS UNDER PERFORMANCE BOND**

PRESENTED BY:

**THOMAS L. SELDEN, ESQUIRE
STARNES & ATCHISON LLP**
Seventh Floor, 100 Brookwood Place
Birmingham, Alabama, 35259-8512
(205) 868-6000

INTRODUCTION

When does the surety have an affirmative obligation to the obligee/owner to undertake to discharge its performance bond obligations? What must the obligee do to compel the surety's intervention and involvement? Are communications from the obligee expressing frustration and dissatisfaction with the principal's performance, or even threatening to default or formally terminate the principal's contract, sufficient to trigger the surety's obligations? Or is something more required to force the surety's hand?

Thanks to the wording of certain standardized performance bond forms, along with the Fifth Circuit Court of Appeals' decision in L&A Contracting Co. v. Southern Concrete Serv., Inc., 17 F.3d 106 (5th Cir. 1994), some of these questions have become easier to answer. The A312 performance bond promulgated by the American Institute of Architects ("AIA"), for instance, sets forth specific requirements concerning notice to cure, default of the principal and termination of the contract with which the obligee must generally comply to impose liability on the surety under the bond. As shown below, however, some resourceful obligees have developed arguments in an effort to circumvent certain of these conditions (often after the fact) which, in some instances, has caused confusion as to when the surety's obligations arise.

I. Performance Bond Forms

Determining whether the surety has a duty to perform requires a close reading of the language of the bond. Typically, the bond will set forth the conditions of the surety's obligation, as well as the surety's performance options, in the event of the principal's default. Two of the most widely utilized standard performance bond forms on private construction projects¹ are the AIA A311 (1970) bond and the AIA A312 (1984) bond.

The A311 bond requires that the surety perform "whenever [the principal] shall be, and declared by [the obligee] to be in default under the contract, the [the obligee] having performed [obligee's] obligations thereunder" Thus, the three (3) conditions to the surety's obligations under the A311 bond are (1) a default by the principal; (2) a declaration of default by the obligee; and (3) performance or lack of breach of the contract by the obligee. If each of these three conditions has been met, the surety is obligated to perform. The surety's performance options upon a proper default, however, are narrowly described. Unlike the A312 bond discussed below, the A311 bond states only that surety may "remedy the default" or complete the project upon default of its principal.

¹Public works projects, including Federal and State projects, are regulated by statute. The surety's liability on public projects is likewise defined and controlled by statute. Bond language which attempts to limit the surety's liability or expand performance options beyond what is permitted by the terms of the governing statute will not be enforced. See, e.g., City of Marshall v. American General Ins. Co., 623 S.W.2d 445 (Tex. Ct. App. 1981); Fenetz v. Stine, 407 So. 2d 1381 (La. Ct. App. 1981); Universal Elec. Constr. Co. v. Robbins, 239 Ala. 105, 194 So.194 (1940). Bond language, on the other hand, which is more expansive than that required by the controlling statute typically will be held to be binding upon the surety. See, e.g., Water Works, Gas & Sewer Bd. v. P.A. Buchanan Contracting Co., 318 So. 2d 267 (Ala. 1975); South Carolina Pub. Serv. Comm'n v. Colonial Constr. Co., 266 S.E. 2d 76 (S.C. 1980); Wal-Board Supply Co. v. Daniels, 629 S.W.2d 686 (Tenn. Ct. App. 1981); Valliant v. Dept. of Transp., 437 So. 2d 845 (La. 1983); Florida Keys Community College v. Insurance Co. of N. America, 456 So. 2d 1250 (Fla. Dist. Ct. App. 1984).

The A312 performance bond form (specimen copy attached) describes with more particularity both the default procedure and the surety's performance options upon default. Paragraph 3 of the A312 bond states as follows:

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 ... to discuss methods of performing the Construction Contract. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract, but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default; and

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

3.3 The Owner has agreed 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 in accordance with the terms of the contract with the Owner.

Thus, the surety's obligation to perform under the A312 bond arises only after (1) the owner has notified the surety and its principal of its intent to declare a default and has requested a meeting with the surety and the principal in an effort to avoid a default; (2) the obligee has, in fact, declared the principal to be in default and has formally terminated the principal's right to complete the contract (such a declaration may occur no later than twenty days after the notice and request for a meeting);² (3) the obligee has agreed to pay the balance of the contract proceeds to the surety in the event the surety undertakes to complete the contract; and (4) the obligee itself is not in default or otherwise in material breach of its obligations under the contract. Only if each of these conditions has been met is the surety liable to the obligee under the A312 performance bond. See generally Ray H. Britt, *The New AIA Performance and Payment Bond Forms—What they Mean to the Surety, Owner and Subcontractor, in Trouble Areas in Construction* 1,10 (ABA Forum Committee on the Construction Industry and Fidelity and Surety Law Committee of Tort and Insurance Practice Section, 1985).

As indicated above, the remedial options available to the surety upon default of its principal are broader under the A312 performance bond. The surety may (1) utilize the principal, with the obligee's consent, to complete the project; (2) undertake to complete the project itself; (3) procure a qualified contractor to complete the work under contract with the

²In terminating the contractor's right to complete the contract, the obligee must act in accordance with the contract provisions governing termination of the contract.

owner; (4) waive its right to complete the project and tender to the obligee the amount of money for which it may be liable; or (5) deny liability in whole or in part and notify the obligee of the reasons for the denial of liability.

II. Case Law

For the most part, courts have sided with the surety over the past few years relative to notice, default and termination issues. As shown below, however, some courts have strayed unnecessarily from the bond language and controlling authority, often making life difficult for the surety.

A. The Good

The leading case discussing the default procedures under an AIA performance bond is L&A Contracting Co. v. Southern Concrete Serv., Inc., 17 F.3d 106 (5th Cir. 1994). There, the Fifth Circuit Court of Appeals reversed a judgment against the performance bond surety of a subcontractor because the contractor, as obligee, did not properly declare the subcontractor to be in default as required by the terms of the performance bond.

L&A Contracting involved an action for breach of contract by L&A Contracting Company (“L&A”), the general contractor on a bridge project in Apalachicola, Florida, against its subcontractor, Southern Concrete Services, Inc. (“Southern”), and the subcontractor’s surety, Fidelity and Deposit Company of Maryland (“F&D”). Under the subcontract, Southern agreed to furnish concrete for the project, but “breached the subcontract in numerous . . . particulars,” *id.* at 108, by failing to provide sufficient concrete to L&A on a timely basis and committing various other breaches. Although L&A repeatedly complained to Southern about its late deliveries and the inferior quality of concrete furnished on the project, and although the complaints were often reduced to writing in letters to Southern and copied to the surety (including one letter in which L&A requested “that the Bonding Company take the necessary steps to fulfill this contract to prevent any further delays and costs to L&A.” *Id.* at 108), L&A did not at any time refuse to accept Southern’s performance, and Southern eventually was allowed to complete its work under the subcontract. Following a six-day trial, the District Court, after offsetting amounts it determined were owed on Southern’s counterclaim, awarded \$642,269.00 in damages to L&A.

On appeal, the Fifth Circuit Court of Appeals reversed the entry of judgment against Fidelity & Deposit on the grounds that L&A had not properly declared Southern to be in default or fulfilled other preconditions to Southern’s liability under the performance bond. The Court affirmed the judgment against Southern.

The subcontract performance bond issued by F&D provided that F&D would become liable to take certain actions “[w]henver principal shall be, and shall be declared by obligee to be in default under the subcontract, the obligee having performed obligee’s obligations thereunder.” *Id.* at 109 n.6. Based upon the performance bond language, the Court concluded that F&D would be liable for Southern’s breach only if two (2) conditions existed: (1) Southern must, in fact, have been *in default* of its obligations under the subcontract; and (2) L&A must have *declared* Southern to be in default. *Id.* at 109.

In discussing the “default” requirement, the Court noted that while the terms “breach” and “default” are sometimes used interchangeably, their meanings are distinct in suretyship law. *Id.* at 110. According to the Court, not every deviation from or breach of a construction contract will constitute a default sufficient to justify the surety’s involvement. Instead, “[t]o constitute a legal default, there must be a (1) material breach or series of material breaches³ (2) of such magnitude that the obligee is justified in terminating the contract.” *Id.* Although the Court concluded Southern had breached the subcontract in various particulars as noted previously, the Court did not reach the question of whether there was a material breach or series of material breaches by the subcontractor sufficient to constitute an actual default under the contract.

The Court next turned to the “default declaration” requirement, holding that, given the serious consequences that attend a “declaration of default,” it is critical that the declaration be made in terms sufficient to clearly inform the surety that the principal has defaulted and the surety must immediately act in the performance of its obligations under the bond. *Id.* at 111.

A declaration of default sufficient to invoke the surety’s obligations under the bond must be made in clear, direct, and unequivocal language. The declaration must inform the surety that the principal has committed a material breach or series of material breaches of the subcontract, that the obligee regards the subcontract as terminated, and that the surety must immediately commence performing under the terms of its bond.

Id. Absent such a declaration, sureties face potential tort liability for “meddling in the affairs of their principals.” *Id.* As a result, observed the Court, “[i]t is not asking too much of obligees to require that when they wish to give up on a principal and look to the surety for satisfaction, rather than merely to urge the principal to what they hope will be better performance, they must say so *to the surety* in clear, unequivocal terms.” *Id.* at 111 n.18 (emphasis original). Upon a proper declaration of default, the relationship between the parties fundamentally changes, and the surety owes “immediate duties” to the obligee. *Id.* at 111. Because L&A did not properly declare Southern to be in default, the Court concluded that L&A had failed to prove a necessary precondition to F&D’s liability under the performance bond, and rendered judgment for F&D.

Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc., 986 F.Supp. 82 (D. Conn. 1997) is another favorable case for the surety. There, under facts remarkably similar to L&A Contracting, a general contractor sued a subcontractor and its surety for delay and related damages arising from the construction of a railway bridge in Connecticut. As in L&A Contracting, the performance bond required that the contractor declare the principal to be in default. The surety argued that the contractor had not met the conditions to the surety’s

³Non-material breaches including “ordinary items of uncompleted or non-conforming work, endemic to every construction project,” which typically are corrected as punchlist or warranty work. See Philip L. Bruner, et al. *The Surety’s Analysis of Investigative Results: “To Perform or Not to Perform—That is the Question,”* in Bond Default Manual 57, 69 (Duncan L. Clore ed., 2d edition, 1995); Miree Painting Co. v. Woodward Constr. & Design, Inc., 627 So. 2d 389 (Ala. Civ. App. 1992), rev’d on other grounds, 627 So. 2d 393 (Ala. 1993).

liability under the bond and moved for summary judgment. The contractor, in response, maintained that two letters provided to the surety gave sufficient notice that the contractor considered the subcontractor to be in default. The Court, relying on L&A Contracting, disagreed with the contractor and granted the surety's motion for summary judgment.

The court concludes that the plaintiff did not declare the principal to be in default. The fact remains that the letters, which only mention [the subcontractor's] delay in performance, did not provide sufficient notification to the defendant that the principal was in default. As a result, the plaintiff failed to meet a necessary condition for [the surety's] liability under the bond and the defendant's motion for summary judgment is granted.

Id. at 85.

In Dragon Constr., Inc. v. Parkway Bank & Trust, 678 N.E.2d 55 (Ill. App. Ct. 1997), the performance bond issued by the surety did not contain default and notice of default provisions. Nonetheless, the Court, relying on the default clause of the underlying contract which the performance bond incorporated by reference, held that the owner's "failure to provide adequate notice of [the contractor's] termination and their hiring of a successor contractor before [the surety] received the late notice stripped [the surety] of its right to limit its liability and constituted a material breach of contract which rendered the surety bonds null and void." Id. at 58. Rather than relying on the "condition" rationale of L&A Contracting, the Dragon Court emphasized the surety's loss of its contractual right to minimize its loss under the performance bond. Similarly, in Insurance Co. of N. America v. Metropolitan Dade County, 705 So. 2d 33 (Fla. Dist. Ct. App. 1997), the Court reversed a judgment in favor of an owner which failed to notify the surety, contrary to the provisions of the performance bond, before certain repair work was undertaken. According to the Court, the owner's actions and conduct "stripped the surety of its bargained for right [to minimize damages] and relieved the surety of its liability for the instant claim." Id. at 35. And in School Bd. of Escambia County, Fla. v. TIG Premier Ins. Co., 110 F.Supp. 2d 1351 (N.D. Fla. 2000), the Court held that the obligee forfeited all rights under a performance bond after it contracted with another party to correct the principal's work prior to giving required notice to the surety. In so holding, the Court rejected the obligee's argument that the surety was required to show it was prejudiced or damaged by the failure to provide notice.

Here, the School Board waited an inordinate amount of time, after the breach was discovered and cured, before providing TIG notice. TIG did not have the opportunity to cure the breach or exercise its rights under the performance bond. In essence, TIG did not have the opportunity to gather the data necessary to demonstrate prejudice. Under these circumstances, prejudice must be presumed.

Id. at 1354.⁴

B. The Bad

Certain courts, in deciding whether notice of a contractor's default must be given as a precondition to recovery against the surety, have employed a prejudice or injury test. According to those courts, absent a showing of prejudice to the surety as a result of the obligee's failure to give notice as required by the performance bond or the underlying contract documents, the surety should not be discharged from its performance obligations.

For instance, in Winston Corp. v. Continental Ins. Co., 508 F.2d 1298 (6th Cir.), cert. denied, 423 U.S. 914 (1975), the Court held that the owner's failure to give advance notice of its actions to the surety as required by the underlying contract did not discharge the surety. There, although the performance bond itself did not include notice requirements, an article of the contract, which was expressly incorporated by the bond, did require the owner to give written notice seven days in advance of taking over the construction. Given that the surety in Winston was kept apprised of the progress of the project and was aware of delays and other difficulties with its principal's work, and because the surety refused to participate in meetings regarding problems with its principal's work, the Court concluded that the owner's failure to give the required notice was an "insubstantial breach" under the circumstances of the case, which did not cause damage or prejudice to the surety. Id. at 1304. The Court, as a result, ruled that the surety should not be released from its obligations and remanded the case for entry of judgment in favor of the owner.

In Blackhawk Heating & Plumbing Co. v. Seaboard Sur. Co., 534 F.Supp. 309 (N.D. Ill. 1982), the Court, while applying the prejudice or injury test, did allow the surety to establish a defense to a claim for delay damages to the extent it could show that the damages would have been reduced had notice to the surety been given. In Blackhawk, the performance bond did not require that the obligee give notice of the principal's default. The surety, nonetheless, argued that an implied condition of the performance bond for recovery of additional costs due to its principal's delay was that the obligee notify the surety of any delays and give the surety the opportunity to remedy such delays. Although declining to release the surety under the circumstances, the Court did agree in part with the surety's position.

To the extent that [the surety] could have remedied the delays, and thereby avoided the additional costs, if it had been given an opportunity to do so, [the surety] is not liable to [the obligee] for such delays. However, to the extent that notice would have been futile, that is if given notice [the surety] could not have remedied the delays, then the failure to give notice is immaterial and [the surety] is liable to [the obligee] for any delays which could not have been avoided by [the surety].

⁴The Court in Balfour, supra, also observed that denying the surety an opportunity to exercise options and to minimize its loss under the performance bond may justify the release of the surety.

Id. at 315. See also Plowden & Roberts, Inc. v. Conway, 192 So. 2d 528 (Fla. Dist. Ct. App. 1966)(wherein Court held that surety's liability is merely reduced by any harm which it has suffered by the fact it was not accorded rights to remedy its principal's default); Continental Bank & Trust Co. v. American Bonding Co., 605 F.2d 1049, 1057 n. 17 (8th Cir. 1979)(even in absence of bond provision requiring notice to the surety upon the principal's default, obligee may not delay before notifying surety and then insist surety should be liable for increased costs arising in interim between default and demand).

C. The Ugly

The most disturbing recent case discussing bond default procedures is Siegfried Constr., Inc. v. Gulf Ins. Co., 2000 WL 123944 (4th Cir. 2000). There, the Court, in applying Virginia law and construing bond language identical to that in L&A Contracting, reversed a lower court's judgment in favor of the surety, holding both that the principal was, in fact, in default and that certain job correspondence and other notices were sufficient to meet the bond's requirements for declaring the principal to be in default. In so ruling, the Court rejected the surety's argument that the obligee under the subcontract performance bond had to formally terminate the principal in order to trigger the surety's liability. Although the Court recognized that some courts, including those in L&A Contracting and Balfour, had imposed a termination requirement, the Siegfried Court declined to do so, reasoning that termination was not required by the performance bond and would be inconsistent with Virginia law and common practice in the construction industry.⁵

In a lengthy opinion, the Court in International Fidelity Ins. Co. v. County of Rockland, 98 F.Supp. 2d 400 (S.D. N.Y. 2000) held that compliance with the requirements of paragraph 3 of the AIA A312 performance bond did not constitute a condition precedent to the surety's liability for delay damages. In that case, the County of Rockland ("the County") entered into a contract with NANCO for the construction of a nursing facility in Pomona, New York. International Fidelity issued an AIA A312 performance bond on behalf of NANCO in favor of the County. After NANCO was unable to complete the contract, the County declared NANCO to be in default, properly terminated the contract in compliance with the bond language and called upon International Fidelity to finish the work. International Fidelity and the County subsequently executed a takeover agreement whereby International Fidelity agreed to complete the project in accordance with the underlying contract documents. International Fidelity also entered into a completion agreement with Hirani Contracting Corporation ("Hirani") who, in turn, also obtained an A312 performance bond from Fidelity and Guaranty Insurance Company ("F&G"), as surety, in favor of International Fidelity, as obligee, to secure completion of the work.

Hirani subsequently declared bankruptcy and ceased work without completing the "punch list" items on the project. Over a long period of time, International Fidelity repeatedly

⁵The Court also disagreed with the lower court's ruling that Siegfried had failed to provide reasonable notice that it was arranging for the completion of the principal's work, as required by the bond following a default declaration. According to the Court, Siegfried's communications provided sufficient information and an adequate time for a response. For these reasons, and because Virginia law has not been overly strict in interpreting notice requirements of construction bonds, the Court concluded that the surety did have reasonable notice that the obligee was arranging for the performance of the principal's obligation.

implored F&G to participate in conferences and otherwise become involved in completing the work on the project. In response to these demands, F&G did nothing. The County eventually terminated International Fidelity, but later allowed International Fidelity to finish the work with yet another contractor. Although the County eventually accepted the project as complete, it subsequently sought damages due to the delay in completing the work. International Fidelity, in turn, asserted claims for indemnification over against F&G relative to the delay claims brought by the County against International Fidelity arising from late completion of the project.

In defense of International Fidelity's claims, F&G argued that completion of all the steps set forth in subparagraphs 3.1 - 3.3 of the A312 performance bond was a condition precedent to the invocation of any of F&G's obligations under the performance bond. Because International Fidelity did not declare Hirani to be in default and formally terminate the contract, F&G insisted it could not be liable to International Fidelity for delay damages. In response, International Fidelity maintained that default declaration and formal termination were not conditions precedent to F&G's obligations to indemnify International Fidelity for the delay damage claims brought by the County. Instead, International Fidelity argued, the default and termination requirements specified in paragraph 3 of the bond only apply where the obligee intends to call upon the surety to undertake the affirmative actions listed in paragraph 4 (i.e., completing the work under the contract or paying the obligee the cost to complete the work), and do not act as a condition precedent to F&G's liability for delay claims or otherwise prevent International Fidelity from bringing a legal action for such claims.

The Court agreed with International Fidelity, holding that completion of the acts specified in paragraph 3 of the performance bond was not a condition precedent to F&G's liability to International Fidelity for delay claims. Relying on New York law and the language of the performance bond, the Court concluded that the steps set forth in subparagraphs 3.1 - 3.3 of the bond constituted, at best, constructive conditions with which the obligee need only substantially comply to trigger the surety's obligations. *Id.* at 436. Given that International Fidelity "took repeated steps under ¶ 3 to draw F&G into the construction process," *id.* at 438, and because F&G was given "substantial opportunity to protect itself and ameliorate the growing damages," *id.* at 439, but utterly refused to act, the Court could not conclude that International Fidelity failed as a matter of law to substantially comply with the bond's requirements, and denied F&G's motion to dismiss International Fidelity's claims. The good news is that the Court did appear to concede that the obligee generally must comply with the default and termination procedures of paragraph 3 of the A312 bond in order to invoke the surety's performance obligations under paragraph 4 of the bond.

There may be reasons, relating to both the overall wording of the contract and the practicalities of construction projects, why the ¶ 3 steps might generally constitute conditions precedent to enforcement of the affirmative ¶ 4 obligations, but that decision need not be made in this case. Based on the wording of ¶ 3, the structure of the first three paragraphs of the F&G Bond, the logic and logistics of indemnification, and New York precedent, there is no reason to conclude that the steps outlined in ¶ 3 constitute conditions precedent to F&G's liability for indemnification .

Id. at 433.⁶

In Babylon Assoc. v. County of Suffolk, 475 N.Y.S. 2d 869 (N.Y. App. Div. 1984), the performance bond issued by the contractor's sureties on a sewer treatment project expressly required that the obligee declare the contractor to be in default. The obligee, however, never declared the contractor to be in default. Instead, in a subsequent action brought by the contractor to recover damages for extra work and expenses allegedly caused by the obligee's delay and interference, the obligee asserted a counterclaim and impleaded the contractor's sureties to seek a judgment against the sureties for any amounts awarded on the obligee's counterclaim against the contractor. In response to the sureties' argument that the obligee had not declared the contractor to be in default as required by the terms of the performance bond, the Court held that the obligee had satisfied the default provision simply by alleging in its counterclaim that "the Performance Bond [was] in default." Id. at 875.

Clearly, the last three examples are disconcerting to the surety. Unfortunately, it appears that L&A Contracting and its progeny are not the absolute cure-all the surety industry would like them to be and, rest assured, obligees, as well as courts reluctant to find a forfeiture of rights under performance bonds, will encourage a liberal construction of the notice to cure, default, termination and other performance bond requirements in an effort to keep the surety on the hook.

CONCLUSION

Determining whether the performance bond surety has a duty to act in response to the obligee's demands requires a careful review of the bond language. Where the bond imposes conditions to the surety's obligations, the surety should expect and insist upon compliance with such conditions. At least under the A312 performance bond, anything less than a clear and unequivocal declaration of default and termination of the principal's right to complete the contract arguably should discharge the surety from its performance obligations. In close cases, however, the surety should be aware that courts increasingly have strained to hold in the obligees's favor rather than find an outright forfeiture of rights under the performance bond.

⁶But see North American Speciality Ins. Co. v. Chichester Sch. Dis., 2000 WL 1052055 (E.D. Pa. 2000)(wherein Court, in applying Pennsylvania law, held that provisions of paragraph 3 of the A312 performance bond *did* constitute conditions precedent to the surety's obligations. "[I]t appears that the paragraph three obligations act as conditions precedent to the paragraph four obligations of the surety." Id. at 16.)