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Workshop C

***MANAGING PERFORMANCE BOND
DEFAULT RISK***

Presented by

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Tuesday, November 9, 1:30–3:00 p.m. and 3:30–5:00 p.m.

Workshop C

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Mr. Patin is presenting Workshop C, "Managing Performance Bond Default Risk," on Tuesday afternoon. He leads Washington, D.C.-based Spriggs & Hollingsworth's prominent construction practice and has an extensive nonconstruction government contracts practice. While Mr. Patin's legal profession has involved traditional construction and government contract disputes, he has developed a specialized expertise in various aspects of construction law including builders risk and liability insurance disputes, bid protests, bond claims, jury trials, and complex litigation involving fiduciary duty claims.

Mr. Patin's teaching and writing efforts keep him current on changing case law developments. He represents the owner of one of the largest construction projects in the United States (the Central Artery Tunnel in Boston), some of the largest general contractors and subcontractors in the country, and many smaller general contractors and subcontractors who have become devoted clients over several decades. He has several litigation achievements involving contractors issues to his credit.

Mr. Patin earned a bachelor of arts degree with highest honors from the University of Wisconsin—River Falls in 1976 and a Juris Doctor from George Washington University National Law Center in 1979.

Notes

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MANAGING PERFORMANCE BOND DEFAULT RISK

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MANAGING PERFORMANCE BOND DEFAULT RISK

Introduction and Overview

Managing the risk of a general contractor or a subcontractor performance default requires an understanding of (1) how the rights and obligations of the parties are defined by the contracts and bonds involved, and (2) how the courts interpret those rights and obligations. The performance bond surety will be able to raise the same defenses as the general contractor would raise in litigation with an owner, or as a subcontractor would raise in litigation with the general contractor. Thus, before an obligee¹ on a bond decides to declare a default and call upon the performance bond surety to perform, it must make sure that (1) the breach of contract is material enough to justify declaring a default, and (2) that the default has procedurally been implemented according to the terms of the contract. In addition, proper notice and any other procedural requirements of the performance bond must be followed.

This session will analyze the legal and practical issues that arise in managing performance default risks and an obligee's rights and obligations in making demands upon the performance bond surety.

Default Clauses

Whether the obligee on the performance bond is an owner or a general contractor, the first step in managing the risk of a default is to draft a default clause that maximizes the obligee's right to terminate the principal and the remedies available in the event of a default. In addition, the obligee wants to limit its exposure in the event subsequent litigation determines that the default was improper.

Owner Default Clauses

The terms and conditions of public construction contracts are not subject to negotiation since they contain standard clauses in solicitation packages subject to public procurement procedures. The standard federal construction default clause is found at FAR 52.249-10 and states:

Default (Fixed-Price Construction) (Apr 1984)

- (a) If the Contractor refuses or fails to prosecute the work or any separable part, with the diligence that will insure its completion within the time specified in this contract including any extension, or fails to complete the work within this time, the Government may, by written notice to the Contractor, terminate the right to proceed with the work (or the separable part of the work) that has been delayed. In this event, the Government may take over the work and complete it by contract or otherwise, and may take possession of and use any materials, appliances, and plant on the work site necessary for completing the work. The Contractor and its sureties shall be liable for any damage to the Government resulting from the Contractor's refusal or failure to complete the work within the specified time, whether or not the Contractor's right to proceed with the work is terminated. This liability includes any increased costs incurred by the Government in completing the work.
- (b) The Contractor's right to proceed shall not be terminated nor the Contractor charged with damages under this clause, if —

¹In the prime contract performance bond context, the owner is the obligee on the bond and the prime contractor is the principal. In the subcontract performance bond context, the prime contractor is the obligee and the subcontractor is the principal.

- (1) The delay in completing the work arises from unforeseeable causes beyond the control and without the fault or negligence of the Contractor. Examples of such causes include —
 - (i) Acts of God or of the public enemy,
 - (ii) Acts of the Government in either its sovereign or contractual capacity,
 - (iii) Acts of another Contractor in the performance of a contract with the Government,
 - (iv) Fires,
 - (v) Floods,
 - (vi) Epidemics,
 - (vii) Quarantine restrictions,
 - (viii) Strikes,
 - (ix) Freight embargoes,
 - (x) Unusually severe weather, or
 - (xi) Delays of subcontractors or suppliers at any tier arising from unforeseeable causes beyond the control and without the fault or negligence of both the Contractor and the subcontractors or suppliers; and
- (2) The Contractor, within 10 days from the beginning of any delay (unless extended by the Contracting Officer), notifies the Contracting Officer in writing of the causes of delay. The Contracting Officer shall ascertain the facts and the extent of delay. If, in the judgment of the Contracting Officer, the findings of fact warrant such action, the time for completing the work shall be extended. The findings of the Contracting Officer shall be final and conclusive on the parties, but subject to appeal under the Disputes clause.
- (c) If, after termination of the Contractor's right to proceed, it is determined that the Contractor was not in default, or that the delay was excusable, the rights and obligations of the parties will be the same as if the termination had been issued for the convenience of the Government.
- (d) The rights and remedies of the Government in this clause are in addition to any other rights and remedies provided by law or under this contract.

[Emphasis added]

Note that under ¶ (c) if the default termination is later declared improper, the default termination is converted to a termination for convenience. This language is essential protection for limiting the owner's liability for consequential damages due to an improper default. A contractor may not recover lost profits or consequential damages from the government under a termination for convenience. *Manloading & Mgmt. Assocs. v. U.S.*, 461 F.2d 1299, 1303 (Ct. Cl. 1972).

The Standard AIA A201 (1997) default clause states the following grounds for termination:

14.2.1 The Owner may terminate the Contract if the Contractor:

- .1 persistently or repeatedly refuses or fails to supply enough properly skilled workers or proper materials;
- .2 fails to make payment to Subcontractors for materials or labor in accordance with the respective agreements between the Contractor and the Subcontractors;
- .3 persistently disregards laws, ordinances, or rules, regulations or orders of a public authority having jurisdiction; or
- .4 otherwise is guilty of substantial breach of a provision of the Contract Documents.

These provisions are identical to the 1987 version of A201. Unlike the federal clause there is no conversion to a termination for convenience language if a termination for cause is later found to be improper. Thus, a contractor may recover consequential damages under the AIA clause for an improper default termination. *See, e.g., Blaine Economic Development Authority v. Royal Elec. Co., 520 N.W. 2d 473 (Minn. Ct. App. 1994).*

Subcontract Default Clauses

There is quite a variety in subcontract default clauses. While they are theoretically subject to negotiation, a subcontractor's ability to "negotiate" the terms of the general contractor's subcontract form is generally limited and dependent upon how much leverage the subcontractor has with the general contractor. The standard AIA subcontract default clause A401 (1997) states at 7.2.1:

7.2 TERMINATION BY THE CONTRACTOR

7.2.1 If the Subcontractor persistently or repeatedly fails or neglects or carry out the Work in accordance with the Subcontract Documents or otherwise to perform in accordance with this Subcontract and fails within seven days after receipt of written notice to commence and continue correction of such default or neglect with diligence and promptness, the Contractor may, after seven days following receipt by the Subcontractor of an additional written notice and without prejudice to any other remedy the Contractor may have, terminate the Subcontract and finish the Subcontractor's work by whatever method the Contractor may deem expedient. If the unpaid balance of the Subcontract Sum exceeds the expense or finishing the Subcontractor's work, and other damages incurred by the Contractor and not expressly waived, such excess shall be paid to the Subcontractor. If such expense and damages exceed such unpaid balance, the Subcontractor shall pay the difference to the Contractor.

There is also a termination for convenience clause at Article 7.2.2 which allows termination for convenience of the subcontract if the owner terminates the prime contract for the owner's convenience. There is no conversion to a convenience termination language in the event a default is improperly declared. Thus, the AIA subcontract form puts the general contractor at risk for lost profits and consequential damages if the default is declared improper.

Many subcontract forms used by general contractors are much more comprehensive in protecting the general contractor's rights than the AIA form. One subcontract form provides the following:

Default. Should subcontractor at any time:

- (a) fail to supply the labor, materials, equipment, supervision and other things required of it in sufficient quantities and of sufficient quality to perform the Work with skill, conformity, promptness and diligence required hereunder,
- (b) cause stoppage or delay of or interference with the Project work,
- (c) become insolvent, or
- (d) fail in the performance or observance of any of the covenants, conditions, or other terms of this Subcontract,

then in any such event, each of which shall constitute a default hereunder by Subcontractor,

Contractor shall, after giving Subcontractor notice of default and forty-eight (48) hours within which to cure, have the right to exercise any one or more of the following remedies:

- (i) require that Subcontractor utilize, at its own expense, overtime labor (including Saturday and Sunday work) and additional shifts as necessary to overcome the consequence of any delay attributable to Subcontractor's default;
- (ii) remedy the default by whatever means Contractor may deem necessary or appropriate, including, but not limited to, correcting, furnishing, performing or otherwise completing the Work, or any part thereof, by itself or through others (utilizing where appropriate any materials and equipment previously purchased for that purpose by Subcontractor) and deducting the cost thereof (plus an allowance for administrative burden equal to fifteen percent (15%) of such costs) from any monies due or to become due to Subcontractor hereunder;
- (iii) terminate Subcontractor's performance under this Subcontract, without thereby waiving or releasing any rights or remedies against Subcontractor or its sureties, and by itself or through others take possession of the Work, and all materials, equipment, facilities, plant, tools, scaffolds and appliances of Subcontractor relating to the Work, for the purposes of completing the Work and securing to Contractor the payment of its costs (plus an allowance for administrative burden equal to fifteen percent (15%) of such costs) and other damages under the Subcontract and for the breach thereof, it being intended that Contractor shall, for the stated purposes, be the assignee of and have a security interest in the property described above to the extent located on the Project site (and Contractor may at any time file this Subcontract as a financing statement under applicable law); and
- (iv) recover from Subcontractor all losses, damages, penalties and fines, whether actual or liquidated, direct or consequential, and all reasonable attorney's fees suffered or incurred by Contractor by reason of or as a result of Subcontractor's default.

The foregoing remedies shall be considered separate and cumulative and shall be in addition to every other remedy given hereunder or under the Contract Documents, or now or hereafter existing at law or in equity.

After completion of the Work by the exercise of anyone or more of the above remedies and acceptance of the Work by Architect and payment therefor by Owner, Contractor shall promptly pay Subcontractor any balance of the Price. In the event a termination of Subcontractor's performance under this Subcontract for default is subsequently determined by a court of competent jurisdiction to be unjustified, then such termination shall be deemed to have been a termination by Contractor without cause under the provisions of Article 9, Termination and the compensation due Subcontractor, if any, shall be determined accordingly. [emphasis added]

Article 9 of this subcontract form provides:

Termination. If the Contract is terminated, this Subcontract may be thereupon likewise terminated, and compensation to Subcontractor shall be made or claimed on the same basis as that provided for in the Contract or Contract Documents.

In addition to the provisions for termination specified above and under Article 23, Default, Contractor may terminate all or any portion of the Work of this Subcontract, without cause, by issuing written notice of such intention to Subcontractor. In such event, Subcontractor shall be paid, subject to the appropriate provisions of this Subcontract relating to progress and final payments, the value of the Work performed up to the date of termination less previous payments plus an equitable disposition of materials in progress and the reasonable cost of demobilization. Under no circumstances, however, shall Contractor be liable for anticipated profits on work not performed or materials and equipment not delivered and incorporated in the Work.

This subcontractor form gives the contractor the right to perform a portion of the subcontractor's work after giving notice of the default, without terminating the subcontract, which provides the general contractor great flexibility in supplementing the subcontractor's forces and then collecting any costs in excess of the subcontract value against the surety. Article 9 of this subcontract form provides protection against lost profits and consequential damages in the event a court later determines that the default was improper.

There Must Be a Material Breach to Justify The Default

Generally, courts view default terminations as a drastic remedy that should not be casually utilized. They are treated as a legal forfeiture not favored under the law. Thus, a breach of contract must be material to justify a default termination. Restatement (Second) of Contracts § 237 (1981). A default termination is a "drastic sanction which should be imposed (or sustained) only for good grounds and on solid evidence." *J.D. Hedin Const. Co. v. U.S.*, 408 F.2d 424, 431 (Ct. Cl. 1969) (citation omitted). *See also, Wells Benz, Inc. v. U.S. ex rel. Mercury Elec. Co.*, 333 F.2d 89, 92 (9th Cir. 1964):

[C]onsistent with the rule governing contracts generally, a building contract may not be repudiated or unilaterally terminated by one party simply because the other is in default; rather, the party may treat his own obligation at an end only if the other's breach is so gross that the very object of the contract is defeated.

See also Sweet on Construction Industry Contracts: Major AIA Documents, Vol. II at p. 650 (4th ed. 1999):

In our view, the AIA documents demonstrate that the AIA considers termination a last drastic step, a step to be taken only under extraordinary circumstances.

Many bonds and subcontract forms require a "default" to be declared. Thus, one needs to read the contract or bonds in question to see if these documents define a "default." Many times they do not. When they do not, the parties and the court must attempt to give the word "default" meaning. The results are

similar to the above referenced cases equating a material breach to a "default." See, e.g., *Siegfried Const. Inc. v. Gulf Ins. Co.*, 203 F.3d 822, *3 (4th Cir. 2000) (unpublished) (interpreting Virginia law):

To determine whether there was a proper declaration of default, we must first define a "default," a term that neither the bond nor the subcontract specifically explicate. In general, a default is defined as "the omission or failure to perform a legal or contractual duty." Black's Law Dictionary 417 (6th ed. 1990). According to the Virginia Supreme Court, a "building contractor defaults in the performance of his contract if he furnishes defective materials or workmanship." *Clevert v. Jeff W. Soden, Inc.*, 400 S.E.2d 181, 183 (Va. 1991). Stated another way, "a builder's breach in the performance of his contract, i.e., a defective performance, also would be a 'default' in that contract." *Id.* The subcontract before us, though not specifically defining default, describes a "failure to perform" as follows: failure to provide skilled workers and quality materials; failure to complete work on time, causing delays for Siegfried or other subcontractors; or any other action indicating an inability or unwillingness to perform. "When contract terms are clear and unambiguous, the words used by the parties must be given their plain and ordinary meanings." *Gordonsville Energy v. Virginia Elec. & Power Co.*, 512 S.E.2d 811, 817 (Va. 1999).

Siegfried's [contractor] uncontradicted evidence indicates that the workers Jennifer [subcontractor] provided were too few and without adequate supervision, that workmanship was substandard, and that Jennifer's deficiencies were causing delays in construction. Viewing this series of failings in a light most favorable to Siegfried, Jennifer's failure to perform was defective, material, and "defeated an essential purpose of the contract." *Horton v. Horton*, 487 S.E.2d 200, 204 (Va. 1997); see also *RW Power Partners v. Virginia Elec. & Power Co.*, 899 F. Supp. 1490, 1496 (E.D. Va. 1995) (stating that under Virginia law a material breach deprives the party of an expected benefit and "goes to the root of the contract") (internal quotation marks omitted). As the provisions of the subcontract and the performance bond must be read together, see *New Amsterdam Cas. Co. v. Moretrench Corp.*, 35 S.E.2d 74, 77 (Va. 1945), we conclude that the evidence presented during Siegfried's case in chief demonstrates that Jennifer was in default.

Another federal court addressed the definition of default as follows:

A contractual term is ambiguous if it is reasonably subject to more than one meaning [footnote omitted.] Although the bond does not define the terms "declare" or "default", we consider the term "declared in default" unambiguous; the definition L & A offers is unreasonable. The only authority L & A offers for its view is *Webster's Ninth New Collegiate Dictionary*. *Webster's* defines "declare" as "to make clear; to make known formally or explicitly; to make evident; to state emphatically" and "default" as "to fail to fulfill a contract, agreement, or duty". Therefore, L & A concludes, any communication that "[made] it clear that [Southern] failed to fulfill a contract or duty" constituted a legal declaration of default.

Three factors counsel rejection of L & A's popular dictionary authority. First, L & A's proffered definition misapprehends the legal nature of the "default" that is required before the obligee's claim against the surety matures. Although the terms "breach" and "default" are sometimes used interchangeably,² their meanings are distinct in construction suretyship law. Not every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it. To constitute a legal default, there must be a (1) material breach or series of material breaches (2) of such magnitude that the obligee is justified in terminating the contract [footnote omitted.]. Usually the principal is unable to complete the project, leaving termination of the contract the obligee's only option [footnote omitted.]The definition of "default" implicit in L & A's dictio-

²See, e.g., Black's Law Dictionary 417 (6th ed. 1990), including "the omission or failure to perform a legal or contractual duty" among the definitions of "default".

nary analogy impermissibly blurs the distinct concepts of “breach” and “default” [footnote omitted.]

L&A Contracting Co. v. Southern Concrete Services, Inc., 17 F.3d 106, 110 (5th Cir. 1994).

Thus, a fundamental risk management issue is to make sure that the default is substantively valid and is supported by solid evidence. A performance bond surety has no obligation under the bond if the default is invalid.

The Default Must Follow The Procedures Set Forth In the Contract

Similarly, if the default clause at issue calls for notice and/or opportunities to cure, the party declaring the default should carefully follow those procedures. The surety may rely upon a failure to follow the default procedures in the underlying contract to defend against the performance bond claim. In *Dragon Construction v. Parkway Bank & Trust*, 678 N.E.2d 55 (Ill. App. 1997), the court absolved the contractor’s surety of liability under the performance bond because the owner failed to provide the contractor and the contractor’s surety seven-days’ notice prior to terminating the contractor’s performance. The performance bond incorporated the construction contract, which required the seven days’ written notice to both the contractor and the surety. The owner’s failure to provide such notice rendered the bond “null and void.” *Dragon Construction*, 678 N.E.2d at 58.

Likewise, in *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003), the court held that the owner had not satisfied certain conditions precedent to surety liability, including notice to the contractor of the impending default. The performance bond incorporated the construction contract, which required the owner to give the contractor and the contractor’s surety seven days’ written notice prior to terminating the contractor’s performance. The court found that the owner had failed to give the required notice and explained why such a failure prejudices, and ultimately discharges, the surety:

Here, however, USF&G is not claiming discharge simply because it, as surety, did not have notice of contractor default as required by the Bond, but rather because San-Gra -- the *principal* -- was not notified as required by the Bond and the Construction Contract. Moreover, the seven-day notice requirement in the Construction Contract exists precisely to provide the surety an opportunity to protect itself against loss by participating in the selection of the successor contractor to ensure that the lowest bidder is hired and damages mitigated.

Enterprise Capital, 284 F. Supp. 2d at 177. See also *Blaine Economic Development Authority v. Royal Elec. Co.*, 520 N.W. 2d 473 (Minn. 1994) (owner’s termination of contractor was improper when owner failed to give contractor seven days’ written notice, which was an express condition of owner’s right to terminate contract).

The defaulting party also needs to be sure that it complies with any requirement that the architect certify that there is sufficient cause to terminate the contractor or subcontractor. (See, e.g., A201-1997, subparagraph 14.2.2). When a contract requires architect certification, the failure of the owner or general contractor to secure one may invalidate the default. In *Oden Constr. Co. v. Helton*, 65 So.2d 442 (Miss. 1953), for example, the Supreme Court of Mississippi held that the project architect’s letter, which was critical of the subcontractor’s work, did not constitute an architect certification in compliance with the contract. The architect’s letter was critical of the subcontractor’s performance and insisted that the “some definite action be taken,” but it did not reference an architect certification in support of termination, nor did the letter indicate that one particular act or omission by the subcontractor was sufficient to terminate his contract. *Oden Constr.*, 65 So.2d at 445.

Declaration of Default to Surety

When the bond requires that a declaration of default be provided to the surety, the obligee must clearly follow the bond's terms to trigger the surety's obligations. One subcontract performance bond form provides that:

Whenever subcontractor shall be, and declared by or through General Contractor to be, in default under the subcontract, the General Contractor having substantially performed General Contractor's obligations thereunder, the Surety may promptly, within the time permitted Subcontractor under the Subcontract, remedy the default or shall promptly . . .

Sending the surety a letter complaining of performance without declaring a default will not be sufficient to trigger the surety's obligation to perform under the bond. *L&A Contracting Co. v. Southern Concrete Servs., Inc.*, 17 F.3d 106 (5th Cir. 1994) (none of letters sent used word "default"); *Balfour Beatty Constr. Co. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997) (complaining letters did not declare default).

A failure to provide the surety notice of the default will excuse the surety's obligation to perform. Prejudice to the surety may be presumed. *School Bd. of Escambia County v. TIG Premier Ins. Co.*, 110 F. Supp. 2d 1351 (N.D. Fla. 2000) (prejudice to surety is presumed and surety not liable when performance bond required owner to declare contractor in default and owner failed to give surety notice within a reasonable time after the owner discovered contractor's breach and cured it); *St. Paul Fire & Marine Ins. Co. v. City of Green River, Wyo.*, 93 F. Supp. 2d 1170, 1178 (D. Wyo. 2000), *aff'd* 2001 WL 369831 (10th Cir. 2001) (surety discharged from performance bond obligations when owner refused to allow surety to complete project because surety forecast project completion beyond contract completion date and proposed to use defaulting contractor's personnel for completion); *Ins. Co. of N. America v. Metro. Dade County*, 705 So.2d 33 (Fla. 3 DCA 1997) (surety relieved of liability when owner's failure to notify surety of contractor's breach until after discovery and remediation of defective work denied surety its contractual right to minimize damages); *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55, 58 (Ill. App. Ct. 1997) (surety discharged and performance bond rendered null and void when owner's failure to give surety contractual seven-day notice prior to termination of contractor stripped surety of right to minimize its liability).

The court in *Elm Haven Constr. Ltd. Partnership v. Neri Constr. LLC*, 281 F. Supp. 2d 406 (D. Conn. 2003) reviewed several letters from the general contractor to the subcontractor and the subcontractor's performance surety and determined that none satisfied the condition that the subcontractor be declared in default. The court agreed with the L&A decision in ruling that the term "declare in default" in the performance bond was not ambiguous:

In considering the word "default," the [Fifth Circuit in L&A] reasoned, and we agree, that its meaning is distinct insofar as it relates to construction suretyship law. The court observed that "[n]ot every breach of a construction contract constitutes a default sufficient to require a surety to step in and remedy it." A legal default requires a material breach or series of material breaches such that the obligee is justified in terminating the contract. A material breach on the part of the principal, is not enough, however, it only justifies the obligee's actions in the next step of the process which is a declaration of default. This is the sequence of events that must take place pursuant to the performance bond because it provides that the surety's obligations are triggered only after the principal is in default of its obligations and the obligee declares such default.

Elm Haven, 281 F. Supp. 2d at 412 (emphasis added; internal citations omitted).

Under the AIA performance bond form, A312, a surety's obligations do not arise until after the bond obligee performs a series of somewhat cumbersome procedures. First, the obligee must issue written

notice to the contractor and the surety that it is considering declaring a "Contractor Default"³ and that it has requested and attempted to arrange a conference with the contractor and the surety to discuss methods of performing the balance of the bonded contract. Second, the obligee must declare a Contractor Default and formally terminate the contractor's right to complete the contract. Importantly, the obligee may not declare the Contractor Default until 20 days after the contractor and surety received the required notice described in the first step. Third, the obligee must agree to pay the "Balance of the Contract Price"⁴ to the surety or to a contractor selected to perform the balance of the work.

Is Termination Required Before A Surety's Liability Is Triggered?

There has been a debate in the industry and case law over whether an obligee must terminate the principal's right to performance before the performance bond surety's obligations are triggered. One obvious first step in answering this question is to examine the performance bond language. For example, AIA Document 312 states that the surety obligation arises after:

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

The federal performance bond form does not require a termination. See FAR 53.301-25, Standard Form 25. Note that the federal default clause states that the surety is liable "whether or not the Contractor's right to proceed with the work is terminated." FAR 52.249-10(a). One rather persuasive argument has been that if the surety requires a termination before it is obligated to act then it should require it in the language of the bond form.

Most subcontractor bond forms require a declaration of default and do not specifically require a termination. For example, one form states:

Whenever Subcontractor shall be, and declared by or through General Contractor to be, in default under the Subcontract, the General Contractor having substantially performed General Contractor's obligations thereunder, the Surety may promptly, within the time permitted Subcontractor under the Subcontract, remedy the default. . . .

The surety industry relies heavily upon the decision in *L&A Contracting Co. v. Southern Concrete Servs., Inc.*, 17 F.3d 106 (5th Cir. 1994) for its position that a subcontract performance bond surety's obligation is not triggered until the bonded contract is terminated. In this case, the contractor sent the surety letters complaining about the subcontractor's performance. None of the letters declared a default. The court could have relied upon that fact alone to find for the surety. However, it went on to state that:

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. at 111 (emphasis added).

³AIA document A312 defines "Contractor Default" in Article 12.3 as the "[f]ailure of the Contractor, which has neither been remedied nor waived, to perform or otherwise to comply with the terms of the Construction Contract."

⁴AIA document A312 defines "Balance of the Contract Price" in Article 12.1 as "[t]he total amount payable by the Owner to the Contractor under the Construction Contract after all proper adjustments have been made, including allowance to the Contractor of any amounts received or to be received by the Owner in settlement of insurance or other claims for damages to which the Contractor is entitled, reduced by all valid and proper payments made to or on behalf of the Contractor under the Construction Contract."

While some cases refer to the termination language in L&A, they actually hold that there was not a proper declaration of default. They do not hold that the subcontract must be terminated. For example, in *Balfour Beatty Construction v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997), the court considered whether a general contractor was required to declare the subcontractor in default to recover damages from the subcontractor's surety. The court determined that letters from the general contractor to the surety complaining about the subcontractor's failure to deliver materials in a timely manner were not sufficient to constitute a declaration of default. Although the court did not specifically hold that termination of the subcontractor's performance was required to hold the surety liable, the court cited the L&A decision favorably, noting that "[t]he facts of L&A are strikingly similar," that the "private performance bonds had identical express conditions," and "[i]n both cases, ... the principal was never declared in default, nor was the contract with the principal terminated." *Balfour Beatty Construction*, 986 F. Supp. at 85 (emphasis added).

L&A interpreted Florida law. However, the court never cited a Florida case for its ruling on termination being required. A subsequent Florida Court of Appeals decision has rejected the termination requirement of L&A, thus undermining the precedential authority of L&A, since the federal court must interpret state law - not make it. *DCC Constructors, Inc. v. Randall Mechanical, Inc.*, 791 So.2d 575 (Fla. 5th DCA 2001), at 577:

American Alliance relies upon *L & A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106 (5th Cir. 1994) to support its argument that termination of the subcontract was necessary before it was required to perform under its bond. However, *L & A Contracting* is distinguishable. The Fifth Circuit held that there was need for a clear, direct declaration of default by the general contractor in order to inform the surety that its principal is in material breach of its obligations under the subcontract. In that case, the general contractor gave multiple notices to the subcontractor and surety of the subcontractor's repetitive defaults and after each notice, the subcontractor would cure the default. The decision, while indicating that a legal default exists when a material breach is committed of such seriousness that it would justify termination of a subcontract, does not hold that liability under a performance bond only occurs when the general contractor actually terminates the subcontract. In the instant case and unlike the facts in *L & A Contracting*, DCC repeatedly notified both Randall and American Alliance in writing that Randall was in default, that Randall had failed to cure the default, and that it would look to the performance bond for recompense. Randall never attempted to cure the default. Additionally, the evidence in the instant case indicates that Randall did not fulfill its obligations under the subcontract; the subcontractor in *L & A Contracting* eventually satisfied its obligations and the action was for damages incurred because of the delay in performance.

We conclude that the trial court erred by entering summary judgment after concluding that DCC had to first terminate Randall before American Alliance's obligations arose. The judgment is vacated and the cause is remanded for further proceedings consistent with this decision. [emphasis added]

Another federal appeals court has disagreed with the logic of L&A, with some rather compelling logic. *Siegfried Constr., Inc. v. Gulf Ins. Co.*, 203 F.2d 822, *4-5 (4th Cir. 2000) (unpublished):

Gulf further argues that Siegfried had to actually terminate Jennifer to declare default. Though other courts have required obligees to terminate a subcontractor to invoke a surety's obligations, see *L & A Contracting Co. v. Southern Concrete Servs., Inc.*, 17 F.3d 106, 111 (5th Cir. 1994); *Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82, 85-86 (D. Conn. 1997), Virginia law does not counsel this result. Had the parties intended that Siegfried actually terminate Jennifer before making a claim on the bond, "such a provision would surely, in clear language, have been inserted in the bond." *Phoenix Ins. Co. v. Lester Bros., Inc.*, 127 S.E.2d 432, 436 (Va. 1962). Were the court to read such a requirement into the bond, we would

be drafting rather than enforcing the bond as written. See *D.C. McClain, Inc.*, 452 S.E.2d at 662 (stating that courts must enforce contracts as written).

Moreover, equating termination with default could effect a major change in the construction industry in Virginia. When the general contractor notices deficiencies in a subcontractor's work, generally all parties benefit if the subcontractor remains on the job. This common practice keeps the subcontractor working and permits the correction of problems and mistakes. The actual termination of a subcontractor is disruptive to the entire construction process because it adds to delays and expenses as new subcontractors must be found and retained, often at higher rates because of the premium paid for availability.

Similarly, Gulf contends that its involvement in the construction of the Sleep Inn -- absent Jennifer's termination--could have resulted in Jennifer bringing a suit for tortious interference with contractual relations. We find this to be an unlikely result. Considering that Siegfried arranged for the correction and completion of Jennifer's work, it is unclear how Gulf would have been faced with a suit for tortious interference had it simply paid the claim. Likewise, Gulf's exercise of other options under the bond, such as arranging for the completion of Jennifer's work, could not have been the cause of a breach of the subcontract or Jennifer's termination. Jennifer's failure to perform prior to the declaration of default would be considered the cause of a breach or termination. Even assuming Gulf's fear has some merit, the danger arises from the wording of Gulf's own bond. If Gulf believes termination is necessary to avoid a tortious interference suit, the better course would be to add this requirement to its performance bond. As the bond currently reads, the obligee is simply required to declare default, not terminate the principal.

Notices to Surety During Performance of Material Changes to the Contract

Most bond forms waive notice of changes or time extensions. However, an obligee does not have a free hand in making fundamental changes to the underlying contract which may prejudice the surety's rights. Therefore, it is always prudent to notify the surety of major scope changes. In addition, it is a good practice to notify the surety of major significant time extensions, subcontractor or supplier payment defaults, or changes in payment terms. By providing such notices, an obligee lowers its risk that the surety will claim it has been discharged in whole or in part if there is a fundamental change in the underlying contract bonded and it has not been provided notice thereof.

Under federal law, the owner has no obligation to terminate a contractor's performance before substantial completion upon receiving notices from the surety that the contractor is in default. The owner has great discretion to allow the contractor to continue performance without risking discharge of the surety. *Balboa Ins. Co. v. U.S.*, 775 F.2d 1158 (Fed. Cir 1985). Eight factors need to be reviewed to determine whether the federal owner exercised reasonable discretion in continuing to pay the contractor as it continued to struggle with performance:

- 1) Attempts by the Government after notification by the surety, to determine that the contractor had the capacity and intent to do the job.
- 2) Percentage of contract performance completed at the time of notification by the surety.
- 3) Efforts of the Government to determine the progress made on the contract after notice by the surety.
- 4) Whether the contract was subsequently completed by the contractor (not conclusive, but relevant to show the reasonableness of the contracting officer's determination of the progress on the project).

- 5) Whether the payments to the contractor subsequently reached the subcontractors and materialmen (this goes to the equitable obligation of the Government to subcontractors and others to see that they are paid; also, because the surety is liable to the subcontractors, any money that reaches them furthers the objective of the surety as well as those of the Government).
- 6) Whether the government contracting agency had notice of problems with the contractor's performance previous to the surety's notification of default to the government.
- 7) Whether the Government's action violates one of its own statutes or regulations.
- 8) Evidence that the contract could or could not be completed as quickly or cheaply by a successor contractor.

However, that discretion does not apply if the federal owner knowingly made progress payments for work not performed. *United Pac. Ins. Co. v. U.S.*, 16 Cl. Ct. 555 (1989). In *Ohio Cas. Ins. Co. v. U.S.*, 12 Cl. Ct. 590 (1987), the surety was discharged when it was obvious to the owner that the contractor lacked the capacity and intent to perform, and when the contractor spent twice the contract time to complete less than one-half the work.

Material departures from payment terms may discharge the surety. In one case, a subcontractor surety was discharged when a contractor made advance payments to the subcontractor to pay for a second crew, without the architect's approval. A separate showing of prejudice was not required. *Southwood Builders, Inc. v. Peerless Ins. Co.*, 366 S.E.2d 104 (Va. 1988). However, in *Ramada Dev. Co. v., U.S. Fid. & Guar. Co.*, 626 F.2d 517 (6th Cir. 1980) advance payments to the subcontractor did not discharge the surety absent a showing of prejudice. Advance payments alone do not automatically demonstrate that a surety is prejudiced. See also *Transamerica Ins. Co. v. City of Kennewick*, 785 F.2d 660 (9th Cir. 1986) (if the issue is one of overpayment of contract sums, the surety may be discharged only if it proves that it suffered an injury and/or the funds were not used to complete the project).

Damages Recoverable Against A Performance Bond Surety

Obviously, completion costs are recoverable against a surety. *Louise Caroline Nursing Home, Inc. v. Dix Constr. Corp.*, 285 N.E.2d 904 (Mass. 1972) (surety was to pay reasonable cost of completing the contract and repairing defective work; "benefit of the bargain" losses were not permitted). In one case, damages were awarded the owner against the contractor and surety for the difference between the actual construction cost incurred and the agreed maximum price of a cost-plus contract. *Robinhorne Constr. Corp. v. Snyder*, 251 N.E.2d 641 (Ill. App. Ct. 1969), aff'd, 265 N.E.2d 670 (Ill. 1971).

As with any damages claim, there is a duty to mitigate one's damages. Thus, the completion costs must be reasonable and timely procured. Nor can an obligee recover damages against a surety outside the scope of the original contract as modified.

Most courts will allow the recovery of liquidated or actual damages against a performance bond surety. In one case, a surety was liable for liquidated damages where the contractor's delays caused completion after the scheduled date. *U.S. v. Doby*, 201 F.2d 800 (9th Cir. 1952) (where surety had no notice of Government's intention to claim liquidated damages and evidence failed to show prejudice to surety the surety remained responsible for acts of its principal); *Turk v. United States Fidelity & Guar Co.*, 197 N.E. 765 (Ill. 1935) (surety's liability co-extensive with that of the contractor including liquidated damages); *Mason v. City of Albertville*, 158 So.2d 924 (Ala. 1963) (liquidated damages for 381 days of overrun in completing contract was loss covered by performance bond).

In *Amerson v. Christman*, 68 Cal. Rptr. 378 (Ct. App. 1968), the court, in deciding whether the surety should be liable for delay damages, noted the general rule that a surety's liability is co-extensive with

its principal. The construction contract was incorporated into the bond by reference. Under the bond the surety was obligated either to complete the contract or to make available “sufficient funds to pay the cost of completion less the balance of the contract price; but not exceeding, including other costs and damages for which the surety may be liable hereunder the amount set forth above.” The court ruled “that a fair reading of the terms of the bond indicates an intent to reimburse [the owner] for damages consequentially caused by the contractor’s breach and ensuing construction delays.” *Id.* at 388. Consequential damages, including lost rental value, were recovered by the owner from the surety, but not exceeding the penal amount specified in the bond. *Id.*

In another case, damages were awarded because of delay for lost profits in *Burnett & Doty Dev. Co. v. C.S. Phillips*, 148 Cal. Rptr. 569 (Ct. App. 1978). In this case a contractor’s breach forced discontinuance of the owner’s business. The parties should have realized that loss of profits would be a foreseeable result of extensive delay. *Id.* at 572. See also *Prudence Co. v. Fid. & Deposit Co.*, 297 U.S. 198 (1936) (where the Supreme Court permitted as damages on a bond the cost of completion, the cost of correcting defective work, and delay damages, including reasonable rental value); *Costanza v. Cannata*, 36 So.2d 627 (La. 1948) (where a surety knew of a contractor’s performance delays and was notified of its defective work, the surety was liable for damages due to loss of use and increased cost of completion for failure to rectify the contractor’s performance); *Hemenway Co., Inc. v. Bartex, Inc.*, 373 So.2d 1356 (La. Ct. App. 1979) (surety and contractor liable for consequential damages including rental costs for another building used by the owner during period of contractor’s delay); *Boussier Medical Properties v. Abbott & Williams Constr. Co.*, 557 So.2d 1131 (La. Ct. App. 2 Cir. 1990) (lost rents recoverable due to delay in completion). See also *Cates Construction, Inc. v. Talbot Partners*, 86 Cal. Rptr. 2d 855 (1999) (bond and contract read together allowed the recovery of delay damages from surety).

However, other cases deny the recovery of delay damages against a performance bond surety unless the bond expressly provides for such damages. *L&A Contracting Co. v. S. Concrete Servs., Inc.*, 17 F.3d 106, 112-13 (5th Cir. 1994) (citing *American Home Assurance Co. v. Larkin Gen. Hosp.*, 593 So.2d 195 (Fla. 1992)).

Consequential damages may be denied where: (1) they were not foreseeable; (2) the surety bond or contract expressly disclaims liability for consequential damages, and (3) the damages are not a reasonably ascertainable result of the breach in question.

Cost of correcting the contractor’s defective work is recoverable under a performance bond. *Sorenson v. Ewing*, 448 P.2d 110 (Ariz. Ct. App. 1968); *Congregation of St. Peter’s Roman Catholic Church v. Simon*, 497 So.2d 409 (La. Ct. App. 1986) (surety liable for subcontractor’s defective installation work); *Haywood County Consol. School Sys. v. U.S. Fid. & Guar. Co.*, 257 S.E.2d 670 (N.C. 1979); *J & J Elec., Inc. v. Gilbert H. Moen Co.*, 516 P.2d 217 (Wash. Ct. App. 1973). See also *Lake View Trust & Sav. Bank v. Fillmore Constr. Co.*, 393 N.E.2d 714 (Ill. App. Ct. 1979) (surety had obligation to provide corrections).

Attorneys’ fees can be recovered as damages only when authorized by contract, bond language, statute, or because of the surety’s bad faith in litigation. *Union Indem. Co. v. Vetter*, 40 F.2d 606 (5th Cir. 1930) (bond was not within Florida statute permitting attorneys’ fees for contract of insurance). In *Robinhorne Constr Corp. v. Snyder*, 251 N.E.2d 641 (Ill. App. Ct. 1969), the bond required the surety to indemnify the owner for all costs and fees incurred in suits against the obligee. The court held that such a requirement entitled the owner to litigation expenses, accountant, architect, and attorneys’ fees. *Id.* at 646. See also *U.S. ex rel. Maddux Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 86 F.3d 332 (4th Cir. 1996) (where contract between claimant and principal provides for recovery of attorneys’ fees, claimant may recover fees from surety under payment bond); *Mason v. City of Albertville*, 158 So.2d 924 (Ala. 1963) (contract provided that all legal fees expended incident to collecting losses suffered under the bond were recoverable against the performance bond, and the bond incorporated the contract, surety was assessed attorneys’ fees following the owner’s suit for liquidated damages under the bond).

In *Barr/Nelson, Inc. v. Tonto's, Inc.*, 336 N.W.2d 46 (Minn. 1983), the AIA performance bond made no provision for recovery of attorneys' fees and no statutory authority was applicable; therefore, recovery was denied. See also *Federal Sur. Co. v. Basin Constr. Co.*, 5 P.2d 775 (Mont. 1931) (attorneys' fees held not recoverable under bond language indemnifying obligee for all loss or damage arising from the principal's failure to perform).

In *United States Fidelity & Guaranty Co. v. Braspetro Oil Servs., Co.*, 2004 WL 1119583 (2d. Cir. May 20, 2004) the court held that attorneys' fees were not recoverable where the bond stated that the sureties were liable for "[A]dditional legal . . . costs resulting from the contractor's default." The court distinguished legal costs from attorneys' fees and held that it was not clear that the term "legal costs" in the bond required the surety to pay attorneys' fees.

Attorneys' fees may also be recovered based on the surety's bad faith conduct in litigation. In *Insurance Co. of North America v. Allgood Elec. Co., Inc.*, 494 S.E.2d 728 (Ga. Ct. App. 1997), the court held that a subcontractor could recover attorneys' fees where the surety "engaged in 'wanton and excessive indulgence in litigation' by refusing, in bad faith, to investigate, negotiate or discuss any claim, set-off or defense with [the subcontractor]."

Dealing With The Surety

A surety owes a duty to an owner to investigate in good faith a default termination. If it fails to do so it may be liable for bad faith claims. *Loyal Order of Moose Lodge v. Int'l Fid. Ins. Co.*, 797 P.2d 622, 628 (Alaska 1990); *Dodge v. Fid. & Deposit Co. of Md.*, 778 P.2d 1240 (Ariz. 1989).

Conversely, some states impose a duty upon the surety to investigate the contractor's (or subcontractor's) contention that it was improperly default terminated. *City of Portland v. G.D. Ward & Assocs., Inc.*, 750 P.2d 171, 175 (Or. Ct. App. 1988). In *Brindersen-Newberg Joint Venture v. Pac. Erectors, Inc.*, 971 F.2d 272 (9th Cir. 1992), the performance bond surety was not guilty of bad faith, even though a minimal investigation took place, since a *bona fide* dispute existed between the owner and contractor.

Since a surety's best defense against a bad faith claim is a thorough investigation, an obligee on a performance bond should anticipate a thorough investigation before any definitive action is taken by the surety. The following factors will significantly affect the speed and conclusions reached by the surety in an investigation of a prime contractor's default and a demand on a performance bond:

- A. Cooperation of owner in providing access to project records.
- B. Cooperation of contractor in providing access to records, subcontractors, and status of payments.
- C. Cooperation of owner's design professionals in providing documents and information.
- D. Status of work, size and complexity of project.
- E. Existence of claims between owner and contractor.

A surety must act carefully and deliberately when investigating. The surety usually hires a consultant to assist its investigation of the project. This investigation will take time and will not be consistent with an owner's desire to immediately replace the defaulted contractor and finish the project. Similarly, if a general contractor wants a subcontractor surety to immediately replace the defaulted subcontractor, time is not working for the general contractor or surety. Thus, it is in the obligee's interest to get the surety involved before the default is declared, so a file has been set up, consultants are hired, and an

investigation is ongoing if the obligees want the surety to expeditiously complete the balance of the work.

One needs to first look at the terms of the performance bond to determine the surety’s options. The standard federal form lists no options. Once the surety’s obligations are triggered under the AIA Document A312, the surety has several options. The surety may: (1) arrange for the defaulted contractor to perform the balance of the bonded contract, but only if the obligee consents; (2) perform the balance of the bonded contract itself; (3) obtain bids or negotiated proposals from qualified contractors acceptable to the obligee for a contract to perform the balance of the bonded contract, arrange for a contract to be prepared for execution by the obligee and the contractor selected with the obligee’s concurrence, which contract is to be secured with payment and performance bonds executed by a qualified surety equivalent to the existing bonds, and pay to the obligee the amount of damages described in Paragraph 6 in excess of the Balance of the Contract Price incurred by the obligee resulting from the contractor’s default;⁵ or (4) waive its right to do any of the three preceding options and (a) determine the amount for which it may be liable to the obligee and tender payment to the obligee or (b) deny liability in whole or in part and notify the obligee of the reasons for the denial. If the surety fails to so proceed with one of these options with “reasonable promptness,” the surety is deemed in default on the bond 15 days after receipt of an additional written notice from the obligee demanding that the surety perform. The obligee is then entitled to enforce any remedy available to the obligee.

The following lists various options a surety generally has in responding to a default by an owner of a general contractor:

1. The surety investigates and determines that the default is improper and does nothing to remedy the alleged default.
2. Preserving its rights, the surety agrees to finance the principal to complete.
3. Preserving its rights, the surety agrees to complete the principal’s contract by (a) hiring a party to manage the subcontractors; (b) hiring a contractor or construction manager to complete.
4. Preserving its rights, the surety enters into a takeover agreement with the owner. This option is usually considered for a federal owner or public owner where the surety desires to protect its rights to prosecute claims against the owner.
5. The surety tenders a bonded completion contractor to complete the work, which enters into a direct contract with the owner. The surety pays any excess procurement costs.
6. The surety pays the penal sum of the bond.
7. The surety does nothing to complete and agrees to negotiate the obligee’s indemnity claim under the bond.

Public and private owners are faced with a daunting task in completing a defaulted contractor’s work when a major portion of the work remains incomplete at the time of default. They are not in the business of building projects. There are many legal and practical hurdles in finding a replacement contractor if the surety refuses or fails to timely complete the work. Similarly, sureties are not in the construction business and have competing legal duties to the obligee and defaulted principal to investigate the

⁵Under Paragraph 6, subject to the penal sum of the bond and the commitment by the obligee to mitigate damages, the surety is obligated to (1) correct defective work and complete unfinished work, (2) pay additional legal, design professional, and delay costs resulting from the default and from the actions or failure to act of the surety, and (3) liquidated damages, or, if there is no provision for liquidated damages under the bonded contract, actual damages, caused by delayed performance or non-performance of the contractor.

merits of a default. The surety also has a daunting task, with many legal and practical hurdles if it chooses to complete the work in some fashion. Thus, it is in both the owner's and surety's interest to cooperate as closely as possible, reserving each party's rights. Otherwise, both the owner and the surety will be spending many unnecessary dollars in the process, with little likelihood that litigation will ever make either party whole.

In one subcontractor performance bond form, the following surety options are listed:

- 1) Complete the subcontract in accordance with its terms and condition, or
- 2) Obtain a bid or bids for completing the subcontract in accordance with its terms and conditions, and upon determination by surety of the lowest responsible bidder acceptable to the general contractor, arrange for a contract between such bidder and general contractor, and made available as work progresses (even though there should be a default or a succession of defaults under the contract or contracts of completion arranged under this paragraph sufficient funds to pay the cost of completion less the balance of the subcontract prices, but not exceeding, including other costs and damages for which surety may be liable hereunder, the amount set forth in the first paragraph hereof. The term "balance of the subcontract price", as used in this paragraph means the total amount payable by general contractors to subcontractor under the subcontract and any amendments thereto, less the amount properly paid general contractor to or for the benefit of subcontractor; and
- 3) indemnify the general contractor against loss, damage or liability resulting from subcontractor's default.

For a general contractor, the options listed above in a contractor default are usually in play for a subcontractor default except for options three and four. Option 7 is by far the more prevalent option in subcontract performance bond claims. It is far easier for a general contractor to move expeditiously to respond to a default and mitigate damages in a subcontractor default situation than for an owner to do so with a general contractor's default. The general contractor intimately knows the status of the subcontractor's work. The contractor is in the daily business of hiring trade subcontractors. It is usually well situated to speedily implement completion of the defaulting subcontractor's work. Usually, a subcontractor's surety cannot act as quickly or as efficiently as the contractor in finding a reasonable completion solution.

Case History

In August 1995, the contractor entered into a contract with the owner to provide remediation construction work at the owner's plant. The contractor and subcontractor entered into a subcontract where subcontractor agreed to install a Leachate Collection and Removal System ("LCS") for \$2.6M. The subcontract required an installation free of defects, which conformed to the requirements of the applicable prime contract Contract Documents.

The subcontract defined the circumstances under which a default may occur. The subcontract provided the contractor may default the subcontractor for:

- failing to supply the sufficient quantity and quality of supervision required to perform the Subcontract work with skill, conformity, promptness and diligence;
- causing stoppage or delay of the project work;
- becoming insolvent; or
- failing to perform or observe any term of the Subcontract;

The subcontractor installed the LCS in 1997 and through the spring of 1998. By letter dated May 4, 1998, the contractor's project manager informed the subcontractor that the subcontractor was in default of its obligations under the subcontract because of (1) notification from several vendors that the subcontractor had outstanding invoices with those vendors that were more than 90 days past due; (2) unsatisfactory progress of the subcontractor's work; and (3) failure to provide supervision of sufficient quality to perform the work. The May 4 letter repeated the use of the word "default" three times:

- The Subject line of the letter read: "*Default* on Subcontract ..."
- The letter referred to "Article 23 entitled Default."
- The letter requested subcontractor advise contractor as to how [subcontractor] intends to remedy the *default* within 48 hours of receipt of the notice.

At the same time, the contractor informed the surety's agent that the subcontractor was in default of its obligations under the subcontract.

On May 6, 1998, the subcontractor responded to the contractor's letter of default promising to address the three areas in which the contractor declared the subcontractor to be in default. At trial, the contractor's project manager testified, however, that the subcontractor never cured the delay aspect of the default notice. It never cured the insufficient supervision aspect of the default notice. He also testified that the subcontractor was not able to fulfill the promises it made in its May 6, 1998 response to resolve its supplier payment problems. The contractor's project manager also testified that the subcontractor's May 6, 1998 letter did not in itself cure the subcontractor's problems because the contractor had to see if the subcontractor would meet the promises contained in the letter.

After receiving the contractor's May 4, 1998 default letter, and the subcontractor's reply thereto, the surety wrote a May 21, 1998 letter to the subcontractor requesting subcontractor's written position and intentions with respect to [contractor's] claim so that the surety "can respond in kind to the contractor, *as required by law*." The surety, however, never sent any response to contractor. The surety never informed the contractor that the surety concluded that the subcontractor's May 6, 1998 letter "cured" the default.

On May 4, 1998, the contractor also directed the subcontractor to test the LCS to verify that it had been installed and was functioning in accordance with the requirements of the subcontract. This issue had not been raised in the May 4, 1998 default letter. The subcontractor, however, did not perform any testing of the LCS. On July 11, 1998, the owner's consultant in charge of quality assurance/quality control for the project directed the contractor to verify that the LCS lines did not become damaged or clogged before final acceptance of the installation. From July 22 to July 24, the owner's consultant tested the LCS lines for damage and blockages.

Between July 24 and July 27, the owner's consultant issued Notices of Deficiency for the subcontractor's LCS installation, which stated that the pipe verification tests had identified pipe that was partially clogged and/or damaged. On July 27, the contractor informed the subcontractor of the results of the pipe tests and directed the subcontractor to submit a plan for resolving the problems within 48 hours. The subcontractor never submitted any plan for resolving the problems with the pipe installation.

On July 29, 1998, an attorney for the surety hired to protect its interests on the performance bond informed the surety that the pipe installed by the subcontractor for the project had failed. The surety, however, still did not make any attempt to contact the contractor or to participate in the process of determining how to remedy the subcontractor's defective work. The contractor did not know of this communication at the time. It came out during discovery after litigation began.

On August 26, 1998, the owner's representative directed the contractor to repair the blocked LCS lines. Initially, the contractor challenged this directive because the contractor thought the design of the LCS might have caused the blocked lines. The contractor withdrew that challenge after determining that it was the LCS installation, and not the design, that caused the damaged pipe. Moreover, under the subcontract, both subcontractor and contractor were bound by any decisions of the owner concerning the quality of the LCS installation. The subcontractor failed to perform the remedial work.

The contractor worked 80-hour weeks to test and repair the LCS lines and to finish the remaining construction work. The contractor hired subcontractor employees to assist in this effort because the subcontractor was not meeting its payroll obligations.

On September 15, 1998, the contractor informed the surety by letter that it had effectively taken over the subcontractor's work on the project. The contractor referred to its prior May 4, 1998 default letter and informed the surety that a testing program required by the owner had identified damaged or blocked pipe in the lines installed by contractor. The contractor advised the surety that it did not anticipate that the outstanding balance due on the subcontractor's subcontract would cover the cost of finishing subcontractor's work, which could include damage to other parts of the project. The contractor invited the surety to contact the contractor's office with any questions or concerns. During the trial, the surety agreed that the September 15 letter constituted a proper notice of default even though the letter never mentioned the word default.

The LCS repair work continued through October 16, 1998. The contractor had to continue to repair for several additional months the damage caused by digging through the cap work installed over the LCS pipe.

On October 2, 1998, the surety wrote to the contractor acknowledging receipt of the September 15 letter. The surety advised the contractor that its attorney had been authorized to represent the surety's interests in the matter and advised the contractor that it requested the attorney to arrange a meeting with the contractor to determine potential exposure on the bonds the surety issued for the project. The contractor was still repairing the LCS work at this time. In the October 2 letter, the surety did not claim that the May 4 letter sent by subcontractor was not a proper notice of default.

The contractor's project manager met with the surety's attorney in early October. The project manager described the problems the subcontractor was having, including vendors that were still owed money and the repairs being made to the LCS. The surety's attorney asked the project manager to collect the costs of the work and send them to him. He did not tell the project manager that the May 4, 1998 default letter was improper or that subcontractor had cured the default.

On or about February 15, 1999, the contractor, as requested, provided the surety's attorney with a list of the itemized costs incurred by the contractor to repair the LCS, as well as the backup material used to compile the costs. The contractor informed the surety that the contractor claimed these costs against the performance bond issued to the subcontractor. The surety did not respond to contractor's claim and failed to pay the claim.

The contractor filed suit against the subcontractor and the surety on September 10, 1999. Prior to the lawsuit, the surety never told the contractor that the contractor failed to properly declare subcontractor in default under the subcontract, or that the subcontractor cured the May 4, 1998 default. In fact, the surety did not raise the affirmative defense of lack of default notice until January 19, 2001, over two years after it received the September 15, 1998 letter, which the surety conceded was a proper notice of default, and almost one and a half years after the contractor filed the suit.

At the close of the evidence, the jury was asked to decide the following issues:

- 1) [Whether] the subcontractor breached its subcontract with contractor, and
- 2) [Whether] the surety breached its Performance Bond agreement with contractor.

The jury found in favor of contractor on both issues and awarded all of the damages claimed by contractor – \$4.6M. Judgment was entered against subcontractor in this amount plus interest. The contractor stipulated that the maximum judgment, exclusive of interest, against the surety was limited to the penal sum of the bond, \$2.9M.

The following issues arose in this case.

- (1) Was the subcontractor in default?
- (2) Did the contractor declare the subcontractor in default in its May 4, 1998 letter?
- (3) Did the subcontractor's May 6, 1998 letter cure the default?
- (4) What was the significance of the surety's letter to the subcontractor that the surety needed to reply to the contractor's letter? Did it matter if the surety simply stated it was a customary form letter sent?
- (5) Did the contractor have to provide the surety another notice of default after the defective work was uncovered in July of 1998?
- (6) Was the subcontractor in a continuous state of default after May 4, 1998?
- (7) What was the significance of the contractor continuing to deal with the subcontractor from May 4 through July 1998?
- (8) What was the significance of the surety's attorney hiring an attorney in July of 1998 to determine its exposure on the bond and the attorney informing the surety in July of 1998 that the pipe had failed?
- (9) What was the significance of the contractor's default options listed in the subcontract?
- (10) Why didn't the contractor follow up with another letter to the surety immediately after it began the repair work?
- (11) Did the contractor prejudice the surety's rights by not informing the surety until September 15, 1998 that it had taken over the subcontractor's work and had been correcting the subcontractor's defective work?
- (12) Did the surety waive any rights it had to insist on termination as a precondition to the surety's obligation to act by not raising that issue after receiving the contractor's September 15, 1998 letter, and after it sent its attorney to meet with the contractor, and by instructing the contractor to submit its claim?
- (13) What was the significance of the surety not replying to the contractor's February 15, 1999 claim and not taking the position that the notice of default was untimely or improper until two years later?

- (14) Did the contractor have to terminate the subcontractor's right to proceed before the surety's obligations were triggered?
- (15) What could the contractor have done better to protect its rights?
- (16) What could the surety have done better to projects its rights?