CHAPTER 1

INVESTIGATION AND MANAGEMENT OF CLAIMS

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Introduction

In the opening chapter of the original edition of this book, Phil Bruner, one of the national deans of both construction and surety law, began with the simple declarative statement: "Construction suretyship is among the most complex of all fields of law."[1] He elaborated on that concept in his next sentence, which was clearly stated, easy to understand, grammatically perfect, and forty lines long.

That two-sentence, three-page paragraph is itself a metaphor for the surety industry. The proper handling of a complex surety claim requires a very high level of attention to detail in order to deal with any number of disparate, competing interests. Successfully litigating that same claim to an acceptable conclusion requires the ability to take that complexity and to unify it into a single narrative with no more than two or three themes. In a word, this is hard. It requires a focus on detail while avoiding the trap of being driven only by the details. To borrow from the worn saying, one must see the forest and the trees, and that must be done while fighting the raging fire that threatens to immolate everything.

Complex construction surety claims arise from the partial or complete collapse of sophisticated organizations. This collapse occurs amidst ongoing projects involving numerous parties, large sums of money at risk, and high stakes time pressure. Generally, the surety gets involved late in the process after numerous opportunities to avoid disaster have been squandered by one side or the other, after all good will has been replaced by hard-bitten animosity, and after the universal lubricant of construction projects—money—has ceased to flow. The surety's involvement on the claim side most often comes when the

1. Philip L. Bruner, *Ch. 1, Strategic "Generalship" of the Complex Construction Surety Case*, *in* MANAGING AND LITIGATING THE COMPLEX SURETY CASE 1, 1 (Philip L. Bruner ed., 1st ed. 1998).

principal is defaulted on its contract, the obligee makes claim on the bond, and the surety must respond. The surety is called upon to do this with virtually no knowledge of the current facts regarding the viability of the bonded principal, the status of the project(s), or even the nature of the disputes, let alone who bears responsibility.

The difficulty presented by this lack of information is compounded by the competing interests that have to be acknowledged by the surety. The surety has a contractual obligation under its bond to the obligee. Furthermore, in most states, the law imposes on the surety a good faith duty to the obligee to properly adjust the claim. However, the bonded contractor, who is obligated to indemnify the surety, has a legitimate interest in having its defenses considered as well. And, of course, the surety has a serious and valid interest in protecting its fisc from illegitimate claims.

In short, at the very outset of the claim the surety has three separate interests to consider: the validity of the claims and defenses of the obligee, the validity of the claims and defenses of the bonded principal, and the existence and validity of the surety's own separate claims and defenses. But the surety receives the claim in the midst of competing recriminations. Both sides contend that the other is in breach, each contests its own responsibility. The surety presented with a new claim is walking into a savage factual and legal crossfire, often already involving lawyers and always with litigation looming on the horizon. Properly managing the claim starts with a neutral investigation.

I. The Surety's Investigation

The surety's investigation typically begins in an office complex hundreds of miles from the job site. A notice of some sort is received: it might be an actual termination; it might be a notice of intent to terminate; it might be little more than a complaint. Whatever it is, it is routed to a claim handler, often an in-house attorney, who specializes in dealing with such defaults. More often than not, that person was unaware of the existence of the project and perhaps even the existence of the bonded contractor prior to receiving the notice. Initial inquiries must be made. These start with a simple question: Is this a claim on the bond?

A. Has a Claim Been Made?

Every construction project has its problems, including technical, financial, and personnel conflicts. Plans change, hidden conditions are encountered, and the weather prevents work. In short, construction projects are fraught with disputes, minor and major. Not every problem that arises on a project, however, triggers the surety's obligation. The mere fact that the obligee makes a claim against a bond does not necessarily trigger the surety's obligation to perform. Almost invariably, more will be required before the surety's obligation is invoked. Depending on the bond form and the jurisdiction, in order to trigger the surety's obligation, the obligee may be required to terminate the principal or the obligee may be required to make a demand upon the surety to perform.

Upon receiving a notice of some sort, the surety will want to determine whether notice of an actual claim has been given. Some notices are patently insufficient and are couched as a notice to the surety that the obligee is unhappy with the principal for various reasons, specified or not in the notice, but coupled with no request for action or intervention. In such cases, in order to avoid misunderstandings or a later recasting of events, it is wise to respond with an acknowledgement of the communication. This acknowledgement should contain an affirmative statement by the surety that the obligee is not making a claim on the bond and that it expects no action from the surety at that time. On the other hand, if the notice clearly evidences an expectation of action on the surety's part, the surety will want to look further into the matter.

1. Verify the Bond

The first order of business will be to verify that the bond was actually issued and reported.[2] While rare, counterfeit bonds are not

2. Surety bonds are typically issued by bonding agents. The underwriters often will establish the parameters under which bonds for a certain principal can be issued, and the agent is then given a limited power of attorney to issue bonds on the company's behalf. The agent issues the bonds, attaches the power of attorney, collects the premium, and reports the issuance of the bond to the company. Unreported bonds can be indicative of a very serious problem and require immediate attention.

unheard of.[3] If the company does not have a record of the bond being issued, immediate action to clarify the situation will be necessary. Denying coverage on the basis of not having issued the bond, if not true, will present serious issues under the bad faith statutes of most jurisdictions even though it was a good faith mistake.[4] But a failure to advise the obligee of the issue in a timely manner could give rise to claims as well—claims that could be time-consuming and expensive to defeat.[5]

2. Review the Bond's Terms

Assuming that the bond was issued by the surety, which usually will be the case, the next step is to review the bond. Suretyship is a contractual

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3. *See*, *e.g.*, United States v. Stern, 13 F.3d 489 (1st Cir. 1994) (appellate review of criminal prosecutions for issuance of counterfeit bonds). A surety will not be bound by a counterfeit bond, although it may be bound by an unauthorized bond issued by a surety broker with a valid power of attorney. Herbert Constr. Co. v. Cont'l Ins. Co., 931 F.2d 989, 997-98 (2d Cir. 1991) (general contractor sued surety on subcontractor's payment and performance bonds; the appellate court held that fact issues surrounding the agent's apparent authority to execute the subcontractor bonds, including power of attorney issues, precluded summary judgment); Mfrs. Cas. Ins. Co. v. Martin-Lebreton Ins. Agency, 144 F. Supp. 515, 517 (E.D. La. 1956), *rev'd*, 242 F.2d 951 (5th Cir. 1957); *see also* Great Am. Ins. Co. v. Gen. Builders, Inc., 934 P.2d 227, 261-62 (Nev. 1997) (parties stipulated that surety bonds were unauthorized, but the surety had earlier provided the involved agent with the surety's seal and unconditional power of attorney; the court found that the surety had clothed the agent with apparent authority, rendering the surety liable to the principal for breach of contract damages flowing from the obligee's declination of a construction contract bid award to the principal subsequent to the surety's revocation of the bonds).
4. *See generally* 14 STEVEN PLITT ET AL., COUCH ON INSURANCE § 207.37 (3d ed. 2017).
5. N. Am. Specialty Ins. Co. v. Emp'rs Reinsurance Corp., 857 So. 2d 606, 609-10 (La. Ct. App. 2003) (after learning of issuance of unauthorized bonds, surety accepted premiums thereon, amounting to tacit ratification of the unauthorized actions; the court faulted the surety for failing to take proactive steps to renounce the unauthorized bonds); *Herbert Constr. Co.*, 931 F.2d at 997-98; *see also* Insco Ins. Servs., Inc. v. Fed. Ins. Co., No. 15-1702, 2016 WL 7486284 (C.D. Cal. July 12, 2016).

obligation; in the first instance, it is governed by the terms of the bond that the surety issued and the obligee accepted. A thorough review of the bond and contract documents is crucial. Initially, the surety will review the bond to determine the named parties and those that may assert claims against the bond. Rights may be afforded to other parties through dual obligee riders, or the surety may be faced with claims by parties that may not be covered by the bond.[6] The right to claim on the bond is critical; the surety will want to clarify this issue as soon as possible. Also of importance in this initial review is the penal sum of the bond, the description of what contract is covered by the bond, what event(s) may trigger the surety's liability, and what options are available to the surety in responding to a claim.

There are a myriad of different bond forms in use, and even manuscripted bonds are encountered occasionally. The bond may contain conditions precedent that the obligee must honor in order to trigger the surety's obligation.[7] The bond may grant the surety great latitude in responding to the default and mitigating its loss, or it may leave the surety with no options other than to deny the claim or write a check. The terms of the bond inform the surety of its rights and obligations under that bond.

Additionally, the surety has to be aware of the statutory framework in which the bond was given, particularly if the obligee is a public entity. Most jurisdictions have minimum requirements for public bonds.[8] These requirements are defined by statute.[9] Generally, when the language in the bond purports to limit the surety's liability or expand its performance options beyond what is permitted by the express terms of the statute, the statute will control, although this is not always the case.[10] Depending on

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6. *See* Travelers Cas. & Sur. Co. of Am. v. Univ. Facilities, Inc., No. 10-1682, 2011 U.S. Dist. LEXIS 44411, at *5 (E.D. La. Apr. 25, 2011).
7. *See infra* Section II.C.1.
8. *See* 4A PHILIP L. BRUNER & PATRICK J. O'CONNOR, BRUNER & O'CONNOR ON CONSTRUCTION LAW §§ 12:5-12:6 (2016) (giving an historical background to public contract bond statutes in the United States).
9. *See* United States *ex rel.* Hill v. Am. Sur. Co. of N.Y., 200 U.S. 197, 200 (1906); Maricopa Turf, Inc. v. Sunmaster, Inc., 842 P.2d 1370, 1372 (Ariz. Ct. App. 1992).
10. *See Hill*, 200 U.S. at 204-05; *see also* Fla. Keys Cmty. Coll. v. Ins. Co. of N. Am., 456 So. 2d 1250, 1252-53 (Fla. Dist. Ct. App. 1984); Fenetz v.

the jurisdiction, extraneous provisions in the bond may be read out of the bond as a matter of law.[11]

3. Triggering the Surety's Obligation

The issue at this point in time is to ensure that the surety's obligation may have arisen and, by that same token, that its right to act has been validly triggered. If the bond requires a default termination of the principal to trigger the surety's responsibility and no such termination has occurred, then the principal and the obligee still have a valid contract between them. A typical performance bond generally predicates the surety's liability to respond upon a clause that states:

> . . . whenever principal shall be, and shall be declared by obligee to be in default under the subcontract, the obligee having performed obligee's obligations thereunder. . . .[12]

Such a clause recognizes that the surety is secondarily liable to the obligee and cannot be expected to intervene and act until the principal, who is primarily liable, is no longer permitted to perform. The surety who acts too aggressively in this circumstance runs the risk of a claim

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Stine, 407 So. 2d 1381, 1385 (La. Ct. App. 1981); City of Marshall v. Am. Gen. Ins. Co., 623 S.W.2d 445, 446 (Tex. App. 1981).

11. *See* Water Works, Gas & Sewer Bd., Inc. v. P.A. Buchanan Contracting Co., 318 So. 2d 267, 269 (Ala. 1975); Paul Schoonover, Inc. v. Ram Constr., Inc., 630 P.2d 27, 29-30 (Ariz. 1981); Valliant v. Dep't of Transp. & Dev., 437 So. 2d 845, 848 (La. 1983); Nelson Roofing Co. v. United Pac. Ins. Co., 245 N.W.2d 866, 868 (Minn. 1976); S.C. Pub. Serv. Comm'n v. Colonial Constr. Co., 266 S.E.2d 76, 78 (S.C. 1980); City of San Antonio v. Argonaut Ins. Co., 644 S.W.2d 90, 91-92 (Tex. App. 1982).
12. This language is found in both the AIA A311 Performance Bond and the AIA A312 Performance Bond.

from the principal of tortious interference with contractual relations.[13] It is still the principal's contract.[14]

In this same vein, sureties receive many communications from obligees which do not rise to the level of a claim on the bond. It is not uncommon, for instance, to receive notices that the principal is behind schedule or is not properly manning the job. These notices often are intended to bring pressure to bear on the principal through the surety. What is really desired by the obligee is improved performance by the principal, not overt intervention by the surety. While the surety may not be legally required to respond to such notices, it is good practice on the part of the surety to acknowledge the communication and to confirm that no claim has been made on the bond and no action is expected of the surety at that time.

B. Commencing the Investigation

Having determined that a *prima facie* claim has been made, the surety must first place the default in context. This starts with understanding who the participants are and obtaining as much background information as possible. For the surety claim professional, commencing an investigation in the midst of a construction project with looming deadlines and contractors arguing with each other can be a daunting task. It will be for the surety claim professional to seek some semblance of order amidst the chaos, to ascertain as much of the present facts as possible, to predict future risk, and, ultimately, to make a decision that does not compound the problems.

With that in mind, the surety's first obligation upon receiving a performance bond claim is to commence an investigation of the claim in

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13. *See* Windowmaster Corp. v. Morse/Diesel, Inc., 722 F. Supp. 1532, 1534-35 (N.D. Ill. 1988). Of course, defenses exist in favor of the surety upon the assertion of such causes. The terms of the indemnity agreement are particularly relevant in this context. *See*, *e.g.,* Gene F. Zipperle, Jr., *Rights to Contract Funds: Counterclaims for Tortious Interference with a Contract*, 51 FOR THE DEF. 32 (D.R.I. 2009).
14. However, a proper claim on the surety's bond in the absence of a default termination should trigger the surety's right to exoneration under the law or deposit of collateral under the indemnity agreement. A default under the indemnity agreement will give the surety a wide range of options in dealing with the principal and any other indemnitors.

order to determine the most appropriate response. The manner and timing of the surety's investigation is driven by the context and facts and is likely subject to state laws and regulations.[15]

The surety has an obvious and justifiable responsibility to protect itself from unnecessary loss. It needs to investigate and determine which options it will pursue. In many states, the relationship between the surety and the obligee is governed by what is commonly referred to as the "implied covenant of good faith and fair dealing," which the surety satisfies by acting reasonably in response to a claim by its obligee.[16] It is commonly recognized that once a claim arises, the surety has a duty to independently investigate the claim.[17]

At this stage, there are three major sources of information available to the surety: its own underwriters, the obligee, and the principal.

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15. *See, e.g.,* ALASKA STAT. § 21.36.125 (2015); ARIZ. REV. STAT. § 20-461 (2015); ARK. CODE ANN. § 23-66-206 (2015); CAL. INS. CODE § 790.03(H) (Deering 2015); COLO. REV. STAT. § 10-3-1104(1)(H) (2015); DEL. CODE ANN. Tit. 18, § 2304(16) (2015); FLA. STAT. § 626.9541(1)(I) (2015); GA. CODE ANN. § 33-6-33 to 33-6-36 (2015); HAW. REV. STAT. ANN. § 431:13-103(A)(11) (2015); IDAHO CODE § 41-1329 (2015); 215 ILL. COMP. STAT. 5/154.6 (2015); IND. CODE ANN. § 27-4-1-4.5 (2015); IOWA CODE § 507b.4(9) (2015); KAN. STAT. ANN. § 40-2404(9) (2015); KY. REV. STAT. ANN. § 304.12-230 (2015); ME. REV. STAT. ANN. Tit. 24-A, § 2164-D (2015); MASS. GEN. LAWS Ch. 176d, § 3(9) (2015); MICH. COMP. LAWS § 500.2026 (2015); MINN. STAT. §§ 72a.20(12), 72a.201(4) (2015); MONT. CODE ANN. § 33-18-201 (2015); NEB. REV. STAT. § 44-1540 (2015); NEV. REV. STAT. § 686a.310 (2015); N.H. REV. STAT. ANN. § 417:4(XV) (2015); N.J. REV. STAT. ANN. § 17:29b-4(9) (West 2015); N.M. STAT. ANN. § 59A-16-20 (2015); N.Y. INS. LAW § 2601 (Consol. 2015); N.C. GEN. STAT. § 58-63-15(11) (2015); N.D. CENT. CODE § 26.1-04-03(9) (2015); OR. REV. STAT. § 746.230 (2015); 40 PA. CONS. STAT. § 1171.5(A)(10) (2015); S.C. CODE ANN. § 38-59-20 (2015); S.D. CODIFIED LAWS § 58-33-67 (Thompson West, 2018); TENN. CODE ANN. § 56-8-104(8) (2015); UTAH CODE ANN. § 31A-26-303 (2015); VA. CODE ANN. § 38.2-510 (2015); W. VA. CODE § 33-11-4(9) (2015); WYO. STAT. ANN. § 26-13-124 (2015).
16. *See*, *e.g.*, Loyal Order of Moose Lodge 1392 v. Int'l Fid. Ins. Co., 797 P.2d 622, 626 (Alaska 1990).
17. *See*, *e.g.*, Dodge v. Fid. & Deposit Co. of Md., 778 P.2d 1240, 1243 (Ariz. 1989); *see also* United States *ex rel.* Custom Grading, Inc. v. Great Am. Ins. Co., 952 F. Supp. 2d 1259, 1265-66 (D.N.M. 2013) (reasoning that the surety has the duty to act in good faith with regard to the obligee).

1. The Underwriting File

The surety may be aware of problems the principal is experiencing before the obligee provides a formal declaration of default to the surety. It is not uncommon for the obligee to copy the surety on correspondence in which the obligee is alleging a material breach of the bonded contract or is threatening to terminate the principal, giving a preview of a future performance bond claim. This pre-claim correspondence generally is not a claim per se and does not trigger any duties by the surety to investigate. Nevertheless, the surety claims professional should review the contents of the surety's file at the commencement of any investigation.

Basic information as to the principal should be within the surety's own underwriting file, including the financial strength of the principal to deal with the problem, the nature and depth of its experience on similar projects, and who its key people are. The underwriting file typically contains a copy of the bond and documents leading to the issuance of the bond, a general overview of the principal's operations and financial condition (at least at the time the bonds were written), the principal's other bonded projects, and the resources and assets the principal has available for use in the completion of the bonded work. This information will help the surety determine coverage limitations, timing requirements, whether its principal has encountered a single difficult project, or whether it has more extensive operational problems.

The underwriter responsible for the account can give valuable insight into the company, and often has some knowledge of the nature of the project and other participants. Similarly, brokers can be a source of information, but their neutrality is suspect, as they often have business and personal interests in favor of the principal prevailing in the dispute.

2. Information from the Obligee

As a general rule, however, the details regarding troubled projects can only be obtained from the participants themselves. The surety's investigation into a performance claim typically begins with a written acknowledgement to the obligee of receipt of the claim and a request for pertinent documents relating to the project. This response is the first step not only in obtaining information, but also in establishing the role of the surety. The Restatement of Law defines suretyship as a "financial accommodation," and, at its core, suretyship is a guarantee of a debt that may or may not exist. However, most obligees view the surety more as a

fire department arriving on the scene to suppress an inferno. They are incredulous when, rather than immediately engaging, the fire chief asks: "So, what caused this fire?" The very act of commencing an investigation places the obligee on notice that an investigation will be necessary and that favorable action on the part of the surety is not a foregone conclusion. Hopefully, it also conveys that the claim is being treated seriously.

The burden is on the obligee to show a prima facie claim. In some states, the threshold to trigger the surety's obligation will not arise until the obligee provides documentation sufficient to support a prima facie case.[18] As one court stated, the surety's duty to investigate the facts does not mean the surety has a duty to "create the claim."[19] In other words, it is not the surety's burden to substantiate mere allegations. Every claimant has a responsibility to document its claim (i.e., submit a proof of claim) before a duty to corroborate the accuracy of a properly documented claim arises.[20] After receiving a mere notice of a claim, it would be advisable for the surety to acknowledge it, request further documentation to substantiate the claim, and continue to reserve rights and defenses. By doing so, the surety properly shifts the burden of substantiating the claim back to the claimant or obligee. Until the claim is documented, further corroboration is not required although may be desirable from the surety's standpoint.[21]

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18. *Compare* GA. CODE ANN. § 10-7-30 (2017), *and* Doss & Assocs. v. First Am. Title Ins. Co., 325 Ga. App. 448 (2017) (holding the insurer was not in bad faith as a matter of law because the insured's demand letter did not substantiate the claim with the "critical facts pertaining to its loss"), *with* CAL. CODE REGS. tit. 10, § 2695.5(h) (2015) (requiring the surety within 15 days upon receiving a notice of claim to provide necessary claim forms, instructions, and reasonable assistance except in cases when the first notice of the claim the insurer receives is a notice of legal action), *and id.* § 2695.5(a) (requiring an acknowledgment of a notice of claim immediately and in no event later than 15 days).
19. Farmer's Union Cent. Exch., Inc. v. Reliance Ins. Co., 675 F. Supp. 1534, 1542 (D.N.D. 1987).
20. *Id*.
21. *But see* CAL. CODE REGS. tit. 10, § 2695.10(b)-(c) (2015) (Providing that following receipt of a Proof of Claim, the surety has 60 days in which to "accept or deny the claim, in whole or in part, and affirm or deny liability." After a proof of claim is submitted, if the surety cannot decide within 60 days whether to "accept or deny the claim," it must keep the

Immediately upon receiving a claim from the obligee, the surety should generally request documentation from the obligee in support of its claim. Even if documentation sufficient to establish a prima facie case has been provided, the surety likely will need additional documentation in order to fully investigate the claim. As a practical matter, in addition to specific document requests, the surety also should make a continuing request for additional information as it becomes available, especially if the project is incomplete at the time of claimed default.

It bears noting here that the obligee has an affirmative obligation to cooperate with the surety's investigation.[22] After the surety's right to investigate arises, the obligee must afford the surety the opportunity to investigate the performance bond claim in order for the surety to determine its preferred performance option.[23] As such, the right to investigate is related to the right of the surety to mitigate its damages. To the extent the surety's mitigation efforts are resisted by an uncooperative obligee, the surety may be entitled to a discharge.

It is in the surety's interest to understand the obligee's perspective regarding the status of the bonded project and the reasons the obligee defaulted or terminated the principal. In many contexts, the surety will attempt to speak or meet with the obligee or its representatives as soon as practicable after the declaration of default for a detailed explanation of the obligee's alleged problems with the principal and the work that remains incomplete.

The parties may attempt to meet at the project site so that they can simultaneously review and document the work at issue. The surety should request that the obligee provide copies of all relevant project documents, including complete contract documents, payment

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claimant apprised of the need for additional time to decide, the reasons for it, what additional information may be needed, and how long it might take to consider the claim. Thereafter, the claimant must be kept apprised every 30 days.).

22. *See* Hunt Constr. Grp., Inc. v. Nat'l Wrecking Corp., 542 F. Supp. 2d 87, 94-96 (D.D.C. 2008) (endorsing an AIA A311 Performance Bond surety's right to investigate and reasoning that the obligee must cooperate with that investigation, by noting that the obligee in that case "[after failing to timely declare a default] sat on its hands and failed to assist the Sureties in their legitimate investigation").

23. *See* Solai & Cameron, Inc. v. Plainfield Cmty. Consol. Sch. Dist., 871 N.E.2d 944, 956-57 (Ill. App. Ct. 2007).

applications received and checks issued, meeting minutes, significant correspondence, and project work schedules. The types of documents requested can be limited or expanded, depending upon the issues raised by the obligee and the principal.

The potential for environmental liability should be noted either from an inspection of the work site or an examination of the scope of work, such as asbestos abatement, demolition work, or lead paint abatement. Such environmental exposure under CERCLA[24] or state laws may significantly affect whether the surety will take over, tender, or even finance the principal.[25]

In reviewing the status of the construction, the architect may be helpful in identifying the remaining scope of work, the quality of the work in place, as well as preliminary estimates of the cost to complete. If the surety is contemplating keeping the principal on the project, the surety's decision may be influenced by the architect or design professional's opinions regarding the technical ability and qualifications of the principal's work force.

3. Information from the Principal

At the same time that it sends a request to the obligee for documentation, the surety should send the obligee's notice of claim to the bonded principal and request comment on the claim and pertinent documents. The purpose of the notice to the principal is to obtain information relating to any defenses that the principal may have to the claim, as the surety has the right at law to assert any defenses that its principal may have.[26] Again, this not only is the first step in obtaining information, it

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24. Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601-9675 (2018).
25. *See* William F. Ryan & Robert M. Wright, *Hazardous Waste Liability and the Surety*, 25 TORT & INS. L.J. 663 (1990); Robert M. Wright & William F. Ryan, *Hazardous Waste Liability and the Surety Revisited*, 30 TORT & INS. L.J. 739 (1995); *see also* William Piper, *Environmental Risk Management on Construction Projects: A Surety's Perspective, Environmental Construction: Market or Minefield?* (unpublished paper submitted at the ABA Forum on the Construction Industry/TIPS Fidelity & Surety Law Committee program on Jan. 27, 1994, at the 1994 annual Mid-Winter Meeting).
26. *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136 (1962); *In re* Dutcher Constr. Corp., 378 F.2d 866, 869-70 (2d Cir. 1967).

also conveys to the principal that its surety takes its bond obligations seriously and will not be a puppet of the principal.

Assuming that the principal maintained job records, the surety will want to examine these. Documents to be obtained include complete contract documents that govern the construction, including a full copy of the contract, change orders, pending change orders, construction change directives, general and special conditions, specifications, and drawings; copies of all progress estimates and/or pay applications; a list of all subcontracts and purchase orders for suppliers as well as copies of the subcontracts and purchase orders; accounts payable and accounts receivable ledgers; all communications with the architect, especially those relating to RFIs and changes; job correspondence and the original bid estimate file.

These documents are best obtained through a personal visit to the principal's office. At that time, the surety can request a meeting with the principal's project management personnel, among others, to hear the principal's responses to the obligee's specific allegations. The surety may inquire as to any problems that the principal has had with the obligee over payment, problems with an obligee-supplied design, approval of change orders, granting of time extensions, and obligee interference. The surety typically will gather information regarding the principal's other projects, both bonded and non-bonded, in order to evaluate the principal's overall status and the possibility of completing the bonded work by retaining the defaulted principal.

By asking that the principal respond and document its position, the surety also takes an important step toward preserving evidence that it may eventually need to evaluate a bond claim. Often, the principal will offer conflicting information, color its story differently, or even ignore the surety and the problem. During this phase, the manner in which the principal responds and the extent to which the principal can support its position may tell the surety a lot about the veracity of the obligee and the principal, the merits of any claim or defense, and the principal's ability to continue managing the project. Even if the principal appears to be right, lack of substantiation may affect the surety's ultimate evaluation and decision if it appears the principal is not in a position to prove the point should the matter lead to litigation.

Occasionally, the surety will encounter an uncooperative principal. Most indemnity agreements require the principal to cooperate with the surety, and many specifically require the principal to provide any

documents or information requested by the surety. An uncooperative principal should be reminded of its duties under the applicable indemnity agreement and that the failure to honor its obligations to the surety may operate to the detriment of the principal and its indemnitors. At a minimum, an uncooperative principal will complicate the surety's handling of bond claims.[27]

At this initial stage of information gathering, the best the surety can hope for is a rough understanding of the parameters of the dispute and the issues between the parties. Construction projects are incredibly complex and do not lend themselves to quick analysis. Rather than attempting to render a snap (and potentially ill-informed) decision as to whether its principal has defaulted or not, the surety's first objective must be to see if there is any common ground between the parties and whether the catastrophe looming over everyone can be averted. That usually calls for an in-person meeting.

C. Meeting with the Obligee

It is advisable, and very common, for the surety to meet with the obligee and the principal early in the investigation, generally within a few days of receiving the claim. The AIA A312 bond form requires this and the meetings are often referred to in the industry as a "312 Meeting" even when an unrelated bond form is at issue.[28] This meeting is critical. In cases where there are serious, legitimate disputes between the parties, this meeting often is the last best chance to avoid litigation.

At this stage of the investigation, however, the surety must be prepared to be met with impossible expectations. The obligee is convinced of the righteousness of its position, often has demonized the bonded principal, and expects that any fair-minded person would immediately see the truth of the situation. Any delay on the part of the surety in accepting that position often is seen by the obligee as evidence

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27. *See, e.g.,* Mountbatten Sur. Co. v. Szabo Contracting, Inc., 812 N.E.2d 90, 97-100 (Ill. App. Ct. 2004) (explaining how the indemnitors created multiple legal impediments for surety in a protracted dispute over indemnity).
28. The AIA A312-2010 Performance Bond and AIA A312-1984 Performance Bond specifically provide for a conference between the obligee, principal, and surety to discuss the obligee's intent to declare the principal in default.

of collusion with the principal or as a wrong-headed desire to avoid paying the claim at any cost. The bonded principal, on the other hand, is equally convinced of the righteousness of its position; it often is in denial and has no real idea how dire its situation is. The principal often fails or refuses to recognize the real risk to the surety, and it is unable to understand why the surety does not simply back the principal's position and get out of the way.

In short, each side believes it is correct. The room is hostile and a great deal of this hostility, by dint of transference, is directed at the surety, whom neither side trusts. If the obligee conflates the surety with the principal, it will not accept any suggestion from the surety that there may be fault on all sides, and the obligee will not be open to any possible resolution that does not involve the surety simply shouldering full responsibility for remedying the debacle. If the principal sees the surety as its auxiliary, it will view any openness to the obligee's point of view as betrayal.

In order to overcome this situation, the surety first must psychologically separate itself from its principal. The surety has two objectives in that initial meeting. The first objective is to act as an ad hoc mediator in order to see if the default can be avoided. The second objective is to get the information it needs to assess its exposure, its responsibility, and its best response if the default cannot be remedied. To do either of these things effectively, the surety must establish itself as an independent actor. Doing this serves three purposes. First, it facilitates the flow of information from both sides. Second, it places the surety in a position to act as an intermediary to help the parties to step back from the brink. Third, it blunts later claims in litigation that the surety intentionally favored one side or the other.

At the meeting itself, the surety should convey to the parties the risks and costs of a failure to resolve the dispute and continue with the project. Time is always of the essence on construction projects, and many times a frank and honest discussion of the significant time needed to complete the surety's investigation and to replace the contractor, if appropriate, is enough to cause an obligee to reconsider its options. At the same time, the surety should assess for itself whether, in its opinion, the contractual relationship between the obligee and the principal has become so toxic that attempts to bridge the divide are futile. In such situations, even if the parties do agree to lift the default, it is likely that a subsequent default

will follow, at which point job conditions will have deteriorated even further and the surety's position may be worse.

If in fact the parties are able to agree on a way forward that either avoids a default or lifts one that has been imposed, the surety as a matter of good practice should confirm in writing that is the case and that the obligee is not expecting action on the part of the surety. If no agreement to remedy the default has been reached, the surety must decide upon its formal response to the claim.

II. Analyzing Performance Bond Exposure

The surety's options when responding to a default have been the subject of many books and publications.[29] Surety practitioners think in terms of tender, takeover, and financing, all of which will be discussed at more length later in this chapter. However, the initial question that must be answered by the surety is whether the claim should be denied outright, accepted, or conditionally accepted with a reservation of rights. At this stage of the process, the surety will have a general idea of the nature of the project and its stage of completion, the scope of the dispute, the relevant issues between the parties, and some understanding of the financial viability of the principal. Making the decision as to the best response to the obligee's claim requires significant analysis, which in turn depends on an adequate base of information. At this point, a full investigation and analysis is required.

This investigation necessarily will be multi-faceted, and the surety will need to assemble a team. Assuming that the principal asserts defenses that are not specious, these too will need to be analyzed. To the extent these defenses involve technical issues and the surety does not have in-house expertise, a construction consultant with pertinent expertise will be required to advise on the technical issues underlying the default. If the default turns on a failure to meet the construction schedule, as it often does, expertise in analyzing impact claims is needed. If the defense turns on impossibility or impracticability of performance, subject matter expertise in that area of work will be necessary. Additionally, outside counsel may be required to the extent that contractual and legal

29. *See generally* BOND DEFAULT MANUAL (Michael F. Pipkin et al. eds., 4th ed. 2015); THE SURETY'S INDEMNITY AGREEMENT: LAW & PRACTICE (Marilyn Klinger et al. eds., 2d ed. 2008).

defenses are in play, and accounting support may be required to establish the financial status of the job, including contract balances and payables.

A. Was There a Material Breach?

There are several broad issues that must be considered in the investigation. These include whether there was a material breach of the bonded contract by the principal, whether the obligee itself is in breach, and whether the surety has its own independent surety defenses.

1. Breach vs. Default

Sureties often receive notices that a bonded principal is in breach of the contract when there has been no default. Depending on the law of the jurisdiction and on the language of the bond, this may not be enough to trigger the surety's obligation to perform under its performance bond. Generally, there must be a "default" by the bonded principal. Although the terms "breach" and "default" are sometimes used interchangeably, their meanings are distinct.[30] Not every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it. To constitute a default, there must be a material breach or series of breaches of such magnitude that the obligee is justified in terminating the contract.[31]

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30. L & A Contracting Co. v. S. Concrete Servs., 17 F.3d 106, 110 (5th Cir. 1994).

31. *See* 4A BRUNER & O'CONNOR, *supra* note 8, §§ 18:1-18:31; *see also* Bat Masonry Co. v. Pike-Paschen Joint Venture III, 842 F. Supp. 174, 182 (D. Md. 1993) ("[T]here is a range of reasonably expected adverse conditions in the performance of a construction contract within which there is no breach."); St. Paul Fire & Marine Ins. Co. v. City of Green River, 93 F. Supp. 2d 1170, 1178 (D. Wyo. 2000), *aff'd*, 6 F. App'x 828 (10th Cir. 2001) ("A material breach occurs where the covenant not performed is of such importance that the contract would not have been made without it."). In *Blake Construction Co.*, 431 A.2d 569 (D.C. 1981), the court stated:

> It is well-established that there are certain implicit duties between the contracting parties, particularly the duty not to prevent performance by the other party. In the case of construction contracts, courts have construed those mutual duties in light of the prevailing practices of the trade and out of

Whether a default termination is required in order to trigger the surety's obligation depends on the language of the bond. Under the AIA A312-2010 Performance Bond, the surety's obligation to perform does not arise until after (1) the obligee has declared the principal to be in default and has terminated the principal's rights under the bonded contract; (2) the obligee has agreed to pay the remaining bonded contract funds to the surety; and (3) the obligee is not itself in default of its obligations under the bonded contract.[32] These express conditions precedent to the surety's liability are routinely enforced.[33]

The AIA A312-1984 Performance Bond, which is still widely used in the construction industry, additionally requires the obligee to notify the surety and its principal of its intent to declare a default.[34] The AIA A312 Performance Bond expressly states that the obligee has a legal obligation to terminate the principal's rights under the bonded contract before calling upon the surety. Under Section 5 of the AIA A312-2010 Performance Bond, the surety has five options once the surety's obligation arises: (1) to arrange for the principal, with consent of the obligee, to complete the bonded contract; (2) to undertake to complete the bonded contract itself; (3) to arrange for another contractor to complete the bonded contract; (4) to tender to the obligee an amount of

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> deference to the inherent uncertainties of the timing and conditions of the actual performance. However, there is a point at which a contracting party exceeds the necessary latitude of discretionary action, even in construction contracts.

Id. at 576-77.

32. U.S. Fid. & Guar. Co. v. Braspecto Oil Servs. Co., 369 F.3d 34, 53 (2d Cir. 2004).

33. RKI Constr., LLC v. WDF, Inc., 14-1803, 2017 WL 1232441 (E.D.N.Y. Apr. 3, 2017); Stonington Water St. Assoc., LLC v. Hodess Bldg. Co., 792 F. Supp. 2d 253, 263 (D. Conn. 2011); 4A BRUNER & O'CONNOR, *supra* note 8, § 12:36; Archstone v. Tocci Bldg. Corp. of N.J., Inc., 990 N.Y.S.2d 44, 45 (N.Y. App. Div. 2014).

34. This requirement has been defanged in the 2010 version of the bond. Under Section 4 of the AIA A312-2010 Performance Bond, failure to comply with this provision "shall not constitute a failure to comply with a condition precedent to the Surety's obligations, or release the Surety from its obligations, except to the extent the Surety demonstrates actual prejudice."

money sufficient to satisfy the surety's obligations; or (5) to deny liability to the obligee in whole or in part.[35]

In contrast, the AIA A311 Performance Bond requires only "default" by the principal, but termination may be required as well.[36] In *L & A Contracting Co. v. Southern Concrete Services, Inc.*, Judge Wisdom, writing for the Fifth Circuit, construed liability under the AIA A311 Performance Bond to be triggered upon a "material breach or a series of breaches of such magnitude that the obligee is justified in terminating the contract."[37] Not all courts agree, however, reasoning that the AIA 311 bond by its terms requires only a default, not a termination.[38]

Obviously, in determining whether there is a default sufficient to trigger the surety's obligation, the language of the bonded contract must also be considered. The contract likely will set forth the grounds and procedures for contract termination. The contract might set forth specific remedies for material breaches in lieu of termination.[39] But beyond the

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35. The analogous provision in the AIA A312-1984 Performance Bond is contained in Paragraph 4.
36. 17 F.3d 106, 110 (5th Cir. 1994); *cf.* Dcc Constructors, Inc. v. Randall Mech., Inc., 791 So. 2d 575, 577 (Fla. Dist. Ct. App. 2000) (distinguishing *L & A Contracting* as not requiring termination before triggering the surety's bond obligations because of the principal's abandonment of the subcontract); McClain v. Kimbrough Constr. Co., Inc., 806 S.W.2d 194, 198 (Tenn. Ct. App. 1990) (reasoning that the obligee had an implied obligation to give the principal a cure notice).
37. 17 F.3d at 110.
38. *See, e.g.,* Siegfried Constr., Inc. v. Gulf Ins. Co., No. 98-2808, 2000 U.S. App. LEXIS 1304, at *13-14 (4th Cir. Feb. 2, 2000) (holding that the obligee had properly declared a default, but rejecting *L & A Contracting* by ruling that the bond's language did not require termination); Dooley & Mack Constructors, Inc. v. Developers Sur. & Indem. Co., 972 So. 2d 893, 899 (Fla. Dist. Ct. App. 2007) (holding the bond's declaration of default provision was trumped by the subcontract provision, which permitted the obligee to cure the principal's default itself without notice to the surety and at the surety's expense); *Dcc Constructors, Inc.*, 791 So. 2d at 577 (concluding that the declaration of default, without a termination, was sufficient to trigger surety's liability given the subcontract's extensive reference to what constituted a default, and that termination was just one option provided to the obligee by the subcontract).
39. *See* United States v. Utah Constr. & Mining Co., 384 U.S. 394, 405 (1966) ("When the contract makes provision for equitable adjustment of

express terms of the contract are other implied obligations.[40] The materiality of any breach has to be considered in the context of ordinary construction industry customs and practices,[41] which recognize that items of uncompleted and nonconforming work, endemic to every construction project and routinely completed or corrected later in the construction process as "punch list" items or "warranty" work, rarely constitute material breaches.[42] Similarly, delay to construction activities not on the "critical path" or not performed under a contract when "time is of the essence" may, under certain circumstances, not constitute a material

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particular claims, such claims may be regarded as converted from breach of contract claims to claims for relief under the contract."); Mellon Stuart Constr., Inc. v. Metro. Water Reclamation Dist. of Chi., No. 94 C 1915, 1995 WL 124133, at *4 (N.D. Ill. Mar. 20, 1995) (finding that contract payment provisions for extra work constituted an acknowledgement that the possibilities of delays and increased costs were contemplated at the outset of the contract and barred the contractor from terminating the contract). A liquidated damages clause expressly stated to be an exclusive remedy for delay has been held to preclude termination for that reason. *See* St. Paul Fire & Marine Ins. Co. v. City of Green River, 93 F. Supp. 2d 1170, 1175 (D. Wyo. 2000), *aff'd*, 6 F. App'x 828 (10th Cir. 2001):

> [T]he performance bond explicitly states that [the surety] is liable for liquidated damages caused by [the principal's] delay. No doubt [the surety] would be in breach of the performance bond if the project was not completed on the construction deadline . . . The performance bond's express contemplation of a tardy completion by the surety due to contractor delays, manifested by its provision of liquidated damages for contractor delays, runs contrary to the notion that the [obligee] could terminate [the surety] if it exceeded the completion deadline.

Id. at 1175.

40. *See* 3 BRUNER & O'CONNOR, *supra* note 8, §§ 9:64-9:103.
41. *See* Carter v. Krueger, 916 S.W.2d 932, 935 (Tenn. Ct. App. 1995) ("[I]n the absence of express plans and specifications, the standard of workmanship prevailing in the area coupled with conformity to the applicable codes . . . is the standard by which the [principal's] performance is to be tested.").
42. *See* Miree Painting Co. v. Woodward Constr. & Design, Inc., 627 So. 2d 389, 393 (Ala. Civ. App. 1992), *rev'd on other grounds*, 627 So. 2d 389 (Ala. 1993).

breach.[43] For this analysis, expert engineering consulting support may be necessary.

2. Termination Clause of the Bonded Contract

Construction contracts typically contain a termination clause that defines the grounds and procedures for termination. The surety should review both the contract and the course of dealings between the parties to determine that the contract requirements for termination have been met and that the termination is procedurally proper on that basis as well.

3. Substantial Completion

The obligee's right to terminate the principal for default is not absolute. The obligee may not terminate the bonded contract for default if the contract has been substantially performed.[44] Substantial performance of a construction contract is typically defined as that degree of performance which provides the obligee with construction suitable for the purpose for which it is intended.[45] In essence, substantial performance means that the

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43. *See* 5 BRUNER & O'CONNOR, *supra* note 8, §§ 15:17-15:136.

44. *See* Bank of Brewton, Inc. v. Int'l Fid. Ins. Co., 827 So. 2d 747, 753 (Ala. 2002) ("The clear intent of the [AIA A312] performance bond, taken as a whole, is for [the surety] to serve as an insurer for the *completion* of the project as a whole. The project architect certified the project as substantially complete . . . . [The surety's] obligations to [the obligee] concluded upon completion of the project.") (emphasis in original). The term "substantial performance" is used interchangeably with the term "substantial completion." *See* Worthington Corp. v. Consol. Aluminum Corp., 544 F.2d 227, 230-31 (5th Cir. 1976); Blinderman Constr. Co. v. United States, 39 Fed. Cl. 529, 571 (1997), *aff'd*, 178 F.3d 1307 (Fed. Cir. 1998) ("Substantial completion, commonly known as substantial performance, is a legal standard of contractual performance applied most frequently in cases involving construction contracting."); Husar Indus. Inc. v. A.G. Huber & Sons, Inc., 674 S.W.2d 565, 572-73 (Mo. Ct. App. 1984).

45. *See* 3, 4A & 5 BRUNER & O'CONNOR, *supra* note 8, §§ 8:23, 12:44, 18:12; *see also* O & M Constr., Inc. v. Div. of Admin., 576 So. 2d 1030, 1035 (La. Ct. App. 1991) ("Substantial performance . . . means that the construction is fit for the purpose intended . . . ."); *Husar*, 674 S.W.2d at 573 ("[A] building is substantially complete when it has reached the state in its construction so that it can be put to the use for which it was

principal has completed its work to such an extent that it cannot be said to have materially breached the contract.

In view of the judicial dislike for the forfeiture aspects of default terminations,[46] courts frequently have rejected obligee allegations of material breaches in the face of substantial performance.[47] Absent a material breach of contract, the principal may not be terminated for default and thereby deprived of its contract price. Failure of the principal to complete any work remaining after substantial completion of the contract only allows the obligee to utilize any retained contract funds to complete the remaining work if the principal fails to do so.[48]

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intended."); Dittmer v. Nokleberg, 219 N.W.2d 201, 206 (N.D. 1974) ("[T]here is substantial performance . . . when all the essentials necessary to the full accomplishment of the [building's intended] purposes . . . are performed.").

46. *See* H.L.C. & Assoc. Constr. Co. v. United States, 176 Ct. Cl. 285, 309 (1966) ("The essence of the doctrine [of substantial performance] is to prevent forfeiture, and the test for forfeiture usually is that the owner's requirement, if followed, would amount to economic waste.").

47. *See* Interstate Gen. Gov't Contractors, Inc. v. United States, 40 Fed. Cl. 585, 607-08 (1998) (setting aside a default termination because the system was functioning and "the only items left to perform were punch list items and debugging"); Cont'l Ill. Nat'l Bank & Tr. Co. v. United States, 121 Ct. Cl. 203, 244 (1952) (concluding that minor punch list items did not prevent substantial completion); Campagna v. Smallwood, 428 So. 2d 1343, 1348 (La. Ct. App. 1983) ("[S]ubstantial performance by a contractor is readily found, despite the existence of a large number of defects in both material and workmanship, unless the structure is totally unfit for the purpose for which it was originally intended."); Quinn Bros., Inc. v. Whitehouse, 737 A.2d 1127, 1130 (N.H. 1999) (holding that the existence of punch list items did not justify termination); *see also* 3 BRUNER & O'CONNOR, *supra* note 8, § 8:37.

48. *See* E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS § 8.12 (2d ed. 1998) ("[I]f a builder can meet the test of substantial performance, the builder can recover on the contract the full price, less any damages to which the owner is entitled because of the breach."); *see also* Am. Cont'l Life Ins. Co. v. Ranier Constr. Co., 607 P.2d 372, 378 (Ariz. 1980) (Struck Meyer, J., dissenting).

B. Was the Obligee in Breach?

Suretyship is an ancient form of security, and one of the fundamental rights of the surety stretches back to Roman law; namely the ability to assert any defense that the principal might have to the obligation.[49] The surety, upon termination, steps into the shoes of its principal under the bonded contract and is entitled to assert against the obligee any defenses against liability arising out of or related to the contract.[50] The surety, therefore, must analyze the terms of the bonded contract and the facts surrounding the contract to determine whether the obligee and principal each have performed their respective material obligations. Some of the events in the construction process that may constitute a material breach by the obligee include non-payment, breach of design duties, differing site conditions, failure to administer the contract, and impossibility of performance.

1. Non-Payment

Payment disputes between obligees and principals are extremely common in surety cases. Almost invariably the obligee contends that the percentage of completion on pay applications is overstated; the principal contends that it has not been paid for contract work performed and for legitimate extra work. This issue requires close attention by the surety. First, the contract balances are the surety's collateral and a critical source of loss mitigation. Second, the failure by the obligee to pay according to the terms of the contract can be an absolute defense to performance by the principal.[51] However, this again is dependent on the terms of the contract. In cases of dispute over extra work, some contracts require the principal to perform the work without payment and to submit a claim.[52]

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49. Max Radin, *Fundamental Concepts of the Roman Law*, 13 CAL. L. REV. 34, 39 (1924).
50. *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132, 140-41 (1962); *In re* Dutcher Constr. Corp., 378 F.2d 866, 870-71 (2d Cir. 1967).
51. 3, 4A & 5 BRUNER & O'CONNOR, *supra* note 8, §§ 8:17, 12.59, 18.26; *see also* T. Scott Leo et al., *The Obligee's Duties To Provide Plans and Specifications, Make Payment, and Process Change Orders*, 32 TORT & INS. L.J. 961 (1997).
52. *See*, *e.g.*, AIA A201-2007 General Conditions of the Contract for Construction at pp. 28, 46 §§ 7.3, 15.1; 1 BRUNER & O'CONNOR, *supra* note 8, § 4:7; *see also*, *e.g.*, William Ziegler & Son v. Chi. Nw. Dev. Co.,

2. Design Issues

The owner who contracts with a builder to construct a project according to plans and specifications issued by the owner to that builder warrants the adequacy of the design. This implied warranty flows down from the contractor to its subcontractors, even if the contractor simply passed on the design information received from the owner.[53] This rule of law has two separate components. First, the owner is responsible for the increased costs suffered both by itself and by the contractor in connection with conflicts and inadequacies in plans. Second, the contractor who builds in accordance with plans and specifications is not responsible for defects that are a consequence of that design. This is commonly known as the *Spearin* defense and is universally applied.[54]

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389 N.E.2d 195, 199 (Ill. App. Ct. 1979). In *William Ziegler & Son*, the court stated:

> Where the written contract contains no provision as to authorization for such extras, or how or when they shall be paid for, an oral request by one party for such extra work to be performed and its performance by the other party, does not add to or alter the basic contract between the parties, as to its essential terms. While the extras merit reasonably prompt payment after they have been performed, we cannot say that reasonably prompt payment of invoices within the written original contract, accompanied by a failure to promptly acknowledge and pay for invoices submitted for work which was not provided for in the original contract, and for which there is no written authorization, can invalidate the whole contract and place the contractor in a position to repudiate the entire contract and demand damages for its breach. *William Ziegler & Son*, 389 N.E. 2d at 199.

53. *See* APAC Carolina, Inc. v. Town of Allendale, 41 F.3d 157, 164 (4th Cir. 1994).

54. *See* United States v. Spearin, 248 U.S. 132, 135 (1918). In *Spearin*, a construction site was flooded by a break in a sewer line constructed in conformance with the government's design documents. The government took the position that the contractor was responsible for the site clean-up because the project had not been completed and accepted and the contract required the contractor to assume responsibility for the site and examine the site and the plans. The contractor showed that it had complied fully with the government's plans and specifications in constructing the broken sewer line. In an opinion written by Justice Brandeis, the court held:

In short, the surety is not liable for problems arising from design when the owner was responsible for that design. This does not hold true in a design-build contract, however, and the surety who bonds such a contract without qualification will be responsible for design errors.[55] Such a bond can turn an unwitting surety into a de facto architectural or engineering malpractice carrier.

3. Cardinal Change

A cardinal change is a truly fundamental change in the nature of a construction contract on the part of the owner without the contractor's consent. The change must be of such a magnitude that it cannot be presumed that the contractor would have agreed to the contract as altered. Such a change discharges the contractor from its obligation to

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> [I]f the contractor is bound to build according to plans and specifications prepared by the owner, the contractor will not be responsible for the consequences of defects in the plans and specifications . . . . [T]he insertion of the articles prescribing the character, dimensions and location of the sewer imported a warranty that, if the specifications were complied with, the sewer would be adequate. This implied warranty is not overcome by the general clauses requiring the contractor, to examine the site, to check the plans, and to assume responsibility for the work until completion and acceptance. The obligation to examine the site did not impose upon him the duty of making a diligent enquiry into the history of the locality with a view to determining, at his peril, whether the sewer specifically prescribed by the Government would prove adequate. The duty to check the plans did not impose the obligation to pass upon their adequacy to accomplish the purpose in view.

Id. at 136; *see also* 3 BRUNER & O'CONNOR, supra note 8, §§ 9:78-9:91; S. Bernstein, Annotation, *Construction Contractor's Liability to Contractee for Defects or Insufficiency of Work Attributable to the Latter's Plans and Specifications*, 6 A.L.R. 3d 1394 (2017) (citing authorities from various jurisdictions which have adopted the implied warranty of design specifications).

55. Nicholson & Loup, Inc. v. Carl E. Woodard, Inc., 596 So. 2d 374, 388-89 (La. Ct. App. 1992).

further perform.[56] Although case law provides some guidance in determining whether a cardinal change has occurred, courts routinely caution that "each case must be analyzed on its own facts and in light of its own circumstances."[57]

There are two distinct tests for cardinal changes. First, a cardinal change is said to occur when the owner affects an alteration of the work so drastic that it effectively requires the contractor to perform duties materially different from those originally bargained for. This expression of the cardinal change doctrine is sometimes referred to as the "scope of the contract" test.[58] Second, in the context of projects awarded through a competitive bidding process, a cardinal change can occur when the contract is modified in such a way so as to materially change the field of competition. This expression of the doctrine is sometimes referred to as the "scope of the competition" test and requires an analysis of the substance of the change rather than its magnitude.[59]

The availability of the cardinal change defense will depend heavily upon the facts and circumstances of the particular case. However, when a cardinal change in the bonded contract is found, both the principal and the surety are discharged from further performance obligations.

4. Differing Site Conditions

Ordinarily, unless expressly disclaimed in the construction contract, the owner will be responsible for non-performance due to hidden conditions at the site that differ materially from those normally encountered or represented in the contract documents. Many construction contracts contain an explicit "differing site conditions" clause under which the owner assumes the risk of such conditions. The purpose of such a clause is to make it unnecessary for contractors to include large contingencies in

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56. *See* O'Brien & Gere Tech. Serv., Inc. v. Fru-Con/Fluor Daniel Joint Venture, 380 F.3d 447, 455-56 (8th Cir. 2004); Airprep Tech., Inc. v. United States, 30 Fed. Cl. 488, 505-06 (1994).
57. *See* Edward R. Marden Corp. v. United States, 442 F.2d 364, 369 (Ct. Cl. 1971); Wunderlich Contracting Co. v. United States, 351 F.2d 956, 966 (Ct. Cl. 1965).
58. *See* Gen. Dynamics Corp. v. United States, 585 F.2d 457, 462 (Ct. Cl. 1978); Aragona Constr. Co. v. United States, 165 Ct. Cl. 382, 391 (1964).
59. *See* Cray Research, Inc. v. Dep't of Navy, 556 F. Supp. 201, 203 (D.D.C. 1982).

their bids to cover the risk of encountering unanticipated adverse subsurface conditions or concealed conditions in existing structures.[60] A surety facing a claim in which its principal met unexpected hidden conditions in prosecuting the job will want to closely examine the contract for such as clause.

5. Failure to Properly Administer the Contract

It is not at all uncommon for a surety to find in its investigation that its principal has been stymied in its performance by a failure of the obligee and its architect to properly administer the contract, including failure to timely process shop drawings, requests for information, and requests for changes. As a result, the contractor has been delayed and disrupted in its prosecution of the work.

American jurisprudence implies an obligation to cooperate in performance of a contract and not to delay, hinder, or interfere with the performance of other parties.[61] In the construction context, it is not uncommon for a court to find that an owner has breached its implied duty of cooperation. Such instances have included the owner's failure to provide timely site access,[62] failure to complete other work necessary to allow the contractor to proceed,[63] and failure to reasonably schedule and coordinate the work.[64]

Hypertechnical inspections can also give rise to a defense. It is improper for the owner to insist that the contractor conform to standards

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60. *See* 3 BRUNER & O'CONNOR, *supra* note 8, §§ 14:1.
61. *See* 3 BRUNER & O'CONNOR, *supra* note 8, § 9:99; *see also* Gulf, Mobile & Ohio R.R. Co. v. Ill. Cent. R.R. Co., 128 F. Supp. 311, 324 (N.D. Ala. 1954) ("A contracting party impliedly obligates himself to cooperate in the performance of his contract and the law will not permit him to take advantage of an obstacle to performance which he has created or which lies within his power to remove.").
62. *See* Capital City Drywall Corp. v. DC Smith Constr. Co., 270 N.W.2d 608, 612 (Iowa 1978); R.G. Pope Constr. Co. v. Guardrail of Roanoke, Inc., 244 S.E.2d 774, 778-79 (Va. 1978); Douglas Nw., Inc. v. Bill O'Brien & Sons Constr. Inc., 828 P.2d 565, 575-76 (Wash. Ct. App. 1992).
63. *See* J.J. Brown Co. v. J.L. Simmons Co., 118 N.E.2d 781, 784-86 (Ill. 1954).
64. *See* Tribble & Sons Co. v. Consol. Servs., Inc., 744 S.W.2d 945, 948-49 (Tex. App. 1987).

more rigorous than those set forth in the plans and specifications. The contractor's failure to comply with such excessive standards cannot serve as a basis for termination of the contract for default. The issue of excessive standards frequently arises when the owner's field inspectors insist that the work meet standards or tests not clearly detailed in the contract.[65]

6. Impossibility of Performance

Construction contracts are sometimes simply impossible or impracticable to complete in strict conformance with their requirements. The doctrines of impossibility and impracticability of performance constitute legal excuses for non-performance.[66] Impossibility excuses contractual non-performance found to be impossible by supervening causes beyond the control of and not foreseeable by either party, such as weather or acts of the government. Impracticability, also called "practical impossibility," excuses non-performance of contracts made impossible "as a practical matter" because they only can be performed at an excessive or unreasonable cost. "Practical impossibility" thus may excuse the non-performance of a contract that is actually possible to perform but commercially impracticable within the basic contract objectives contemplated by the parties.[67] This is not true in all jurisdictions,

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65. *See* 4A BRUNER & O'CONNOR, *supra* note 8, §§ 13:36-13:42; *see also* State v. Buckner Constr. Co., 704 S.W.2d 837 (Tex. App. 1985). In *Buckner Construction Co.*, the state hypertechnically inspected work under a contract for the painting of structural steel on several bridges. Although the specifications required that loose paint be removed by sandblasting, the owner's inspectors insisted upon complete removal of all paint and used non-specified tests to determine compliance. Such non-specified tests included taping adhesive tape to the bridge steel, pulling the tape off, and then insisting that the contractor keep blasting if any flecks of paint were seen on the underside of the tape. At trial, the jury concluded that the owner's hypertechnical inspection constituted a breach of contract and awarded the contractor a "total cost" recovery exceeding by almost three times the original contract price. *Buckner Constr. Co*., 704 S.W.2d at 845-48.
66. *See* 4A BRUNER & O'CONNOR, *supra* note 8, §14:44.
67. *See* Transatlantic Fin. Corp. v. United States, 363 F.2d 312, 315 (D.C. Cir. 1966).

however. Louisiana, for example, has expressly rejected the concept of economic impracticability.[68]

C. Are there Surety Defenses?

Even if the principal has no defense under the contract, this does not mean that the surety is without defenses as well. At this point, a serious analysis of potential surety defenses should be made. This analysis turns in the first instance on the bond and any statute pursuant to which the bond was given, but it also turns on the underlying bonded contract. Remember that the surety's obligations arise from statute or contract or both. Are there conditions precedent in the bond that must be met before claim can be made? Does the bond require termination of the bonded contract? Were these steps followed? Many jurisdictions enforce such conditions,[69] but they can be waived by inaction on the part of the surety.[70]

1. Conditions Precedent in the Bond

The bond may contain an express condition precedent to the surety's obligation to perform. For example, Paragraph 3 of the AIA A312-1984 Performance Bond sets forth several conditions precedent which must be satisfied in order to trigger the surety's obligations under the bond.[71]

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68. *See* Martin Forest Prods. v. Grantadams, 616 So. 2d 251, 254 (La. Ct. App. 1993) ("The fact that compliance with a contract or agreement may be more expensive than originally anticipated is no defense."); Hanover Petroleum Corp. v. Tenneco, Inc., 521 So. 2d 1234, 1240 (La. Ct. App. 1988) (rejecting the common law doctrine of impracticability).
69. L & A Contracting Co. v. S. Concrete Serv., Inc., 17 F.3d 106, 110 (5th Cir. 1994); 4A BRUNER & O'CONNOR, *supra* note 8, § 12:36.
70. AgGrow Oils, L.L.C. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 276 F. Supp. 2d 999, 1017 (D.N.D. 2003), *aff'd*, 420 F.3d 751 (8th Cir. 2005).
71. *See* U.S. Fid. & Guar. Co. v. Braspetro Oil Servs. Co., 369 F.3d 34, 51 (2d Cir. 2004); Seaboard Sur. Co. v. Town of Greenfield, 370 F.3d 215, 217-19 (1st Cir. 2004); Mid-State Sur. Corp. v. Thrasher Eng'g, Inc., 575 F. Supp. 2d 731, 741 (S.D. W. Va. 2008) ("[T]he provisions of paragraph 3 create conditions precedent which must be satisfied by the owner . . . before the surety has any obligation under the Bond."); 120 Greenwich Dev. Assocs., LLC v. Reliance Ins. Co., No. 01 Civ. 8219(PKL), 2004 U.S. Dist. LEXIS 10514, at *34 (S.D.N.Y. June 8, 2004) (holding that the

Paragraph 3.1 of that bond requires notice to the surety and mandates a conference between the obligee, the principal, and the surety prior to declaring a default.[72] Courts have held that the failure of the obligee to comply with that provision discharges the surety.[73] In response to those

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language of Paragraph 3 "creates unambiguous preconditions for triggering [the surety's] obligations under the Bond"); Enter. Capital, Inc. v. San-Gra Corp., 284 F. Supp. 2d 166, 179-81 (D. Mass. 2003) (granting summary judgment to the surety, noting that "other courts have consistently interpreted the language in [Paragraph 3]—'the Surety's obligation under this Bond shall arise after . . .'—to indicate the listing of conditions precedent"); *AgGrow Oils*, 276 F. Supp. 2d at 1017-18; Bank of Brewton, Inc. v. Int'l Fid. Ins. Co., 827 So. 2d 747, 752-54 (Ala. 2002).

72. For reference, Paragraph 3 of the AIA A312-1984 Performance Bond provides:

> If there is no Owner Default, the Surety's obligation shall arise after:
>
> 3.1 The Owner has notified the Contractor and the Surety at its address described in Paragraph 10 below 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 be held not later than fifteen days after receipt of such notice 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.

73. *120 Greenwich Dev. Assoc., LLC*, 2004 U.S. Dist. LEXIS 10514, at *34-36 (holding that notice of default under the AIA A312-1984 Performance Bond is a condition precedent to the surety's liability); Balfour Beatty

cases, Section 4 of the AIA A312-2010 Performance Bond was amended to provide:

> Failure on the part of the Owner to comply with the notice requirement in Section 3.1 shall not constitute a failure to comply with a condition precedent to the Surety's obligations, or release the Surety from its obligations, except to the extent the Surety demonstrates actual prejudice.

As a result, under the 2010 edition of the AIA A312 Performance Bond, the surety now will have to prove actual prejudice stemming from the failure to give notice to achieve a discharge.

A declaration of default is typically also an express condition precedent to the surety's obligations under the bond, and some bonds expressly require a termination of the principal's contract as well.[74] Finally, it is very common for a bond to require an express dedication by the obligee of remaining contract balances to completion of the work.[75]

Even in those instances where the bond is silent, some courts have found implied conditions precedent, based on the surety's historic common law rights. In the seminal case of *L & A Contracting Co. v. Southern Concrete Services, Inc.*, the court emphasized that not every breach of contract is a material default that triggers the surety's liability and obligations under the performance bond. In that case, the court was dealing with an A311 Performance Bond, which predicated the surety's obligation to perform upon the following:

Constr., Inc. v. Colonial Ornamental Iron Works, Inc., 986 F. Supp. 82, 85-86 (D. Conn. 1997) (concluding that the obligee's notice was inadequate to trigger the surety's performance bond obligations); *Bank of Brewton*, 827 So. 2d at 754 (finding that the obligee failed to trigger the surety's performance bond obligations by making mere threats); 153 Hudson Dev., LLC v. DiNunno, 778 N.Y.S.2d 482, 483 (N.Y. App. Div. 2004) ("[The obligee's] failure to comply with the notice provisions of the performance bond issued by [the surety] precludes it from now maintaining this action for damages against the bond's surety. Contrary to [the obligee's] contention that these notice provisions are not conditioned to proceed into recovery against the surety, this bond mandates that pre-default notification be given to the contractor and surety by the owner.").

74. *See*, *e.g.*, AIA A312-2010 at p. 2 § 3.

75. *See*, *e.g.*, *id*. § 3.3.

> Whenever principal shall be, and declared by obligee to be in default under the subcontract, the obligee having performed obligee's obligations thereunder . . . .[76]

Such a clause recognizes that the surety is secondarily liable to the obligee and cannot be expected to intervene and act until the principal, who is primarily liable, is no longer permitted to perform. As the court in *L & A Contracting* wrote:

> 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.[77]

Thus, under the *L & A Contracting* line of cases, as a condition precedent to the surety's obligations under the bond, the principal must not only have defaulted, but also must be terminated, even though the bond does not expressly require this.

There are several cases that run contrary to the rationale of *L & A Contracting* and its progeny, however, and do not require the obligee to terminate the principal as a condition precedent to the surety's performance obligations when this is not expressly required by the bond.[78] Although the weight of authority appears to follow the reasoning

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76. 17 F.3d 106, 109 n.6 (5th Cir. 1994).
77. *Id.* at 111.
78. *See*, *e.g.*, Siegfried Constr., Inc. v. Gulf Ins. Co., No. 98-2808, 2000 WL 1239444, at *4 (4th Cir. 2000) (holding that the obligee had properly declared a default, but rejecting *L & A Contracting* by ruling that the bond's language did not require termination); Dooley & Mack Constructors, Inc. v. Developers Sur. & Indem. Co., 972 So. 2d 893, 899 (Fla. Dist. Ct. App. 2008) (holding the bond's declaration of default provision was trumped by the subcontract provision, which permitted the obligee to cure the principal's default itself without notice to the surety and at the surety's expense); Dcc Constructors, Inc. v. Randall Mech., Inc., 791 So. 2d 575, 577 (Fla. Dist. Ct. App. 2001) (concluding that the declaration of default, without a termination, was sufficient to trigger surety's liability given the subcontract's extensive reference to what

of *L & A Contracting*, the surety should be aware of the law of the state in which the bonded project is located and take that into account when determining whether it is obligated to perform.

2. Contractual Limitations Periods

Most performance bonds contain language specifying the period of time within which the obligee must commence suit against the surety. The AIA A311 Performance Bond requires suit to be instituted before the expiration of two years from the date on which final payment under the contract falls due.[79] The AIA A312 Performance Bond requires suit to be instituted within two years after the principal was defaulted, within two years after the principal ceased working, or within two years of the surety refusing or failing to perform its obligations under the bond, whichever occurs first.[80] The bond's contractual limitation provision/ statutory limitation will often have the effect of cutting off any argument that the surety is liable for latent defects or extended warranty obligations.[81]

A number of states have enacted statutes which nullify a private party's attempts at shortening statutes of limitation.[82] As a consequence, in certain jurisdictions the surety may find that it is unable to rely on its contractual limitation provision.[83] In the absence of a statute specifically invalidating a contractual limitation provision, the clause typically will

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constituted a default, and that termination was just one option provided to the obligee by the subcontract).

79. AIA A311 Performance Bond at p. 2.
80. AIA A312-1984 Performance Bond at p. 3 § 9; AIA A312-2010 Performance Bond at p. 3 § 11.
81. *See* Kiva Constr. & Eng'g, Inc. v. Int'l Fid. Ins. Co., 749 F. Supp. 753, 756 (W.D. La. 1990), *aff'd*, 961 F.2d 213 (5th Cir. 1992); Dist. Sch. Bd. v. Safeco Ins. Co., 434 So. 2d 38, 39 (Fla. Dist. Ct. App. 1983).
82. *See*, *e.g.*, FLA. STAT. § 95.03 (2017); MISS. CODE ANN. § 15-1-5 (2017).
83. *See* Sheehan v. Morris Irrigation, 410 N.W.2d 569, 570-71 (S.D. 1987). Note that South Dakota's law was subsequently changed to reflect the fact that subjecting sureties to long statutes of limitations periods was counterproductive as less bonding credit became available for contractors due to the long exposure times. First Dakota Nat'l Bank v. BancInsure, Inc. (*In re* Certification of a Question of Law), 851 N.W.2d 924, 929-30 (S.D. 2014) (acknowledging the change in the law and the substance of the dissenting opinion in *Sheehan*).

be upheld if the period of time provided is reasonable. As a practical matter, most case law supports the view that a limitation period of twelve months from the accrual of the cause of action on a bond is reasonable.[84] Even limitations periods as short as six months have been upheld.[85]

Performance bonds issued in connection with a public works project are generally governed by the applicable state's public works statute. Most jurisdictions will incorporate the terms and conditions mandated for such bonds by the applicable public works act into statutory bonds.[86] When the terms of the bond conflict with the requirements of the public works statute, the statutory terms will control, assuming the project is determined to be a public work.[87] An exception to this rule occurs when the terms of the bond provide greater protection than the statute. In these cases, the bond generally will be interpreted in accordance with the terms most generous to the obligee.[88]

If the bond does not contain a contractual limitation provision or if that provision is deemed unenforceable under state law, then the state's statute of limitations provision applicable to contract actions will most likely apply. There may be times when the statute of limitations applicable to the surety is longer than that for its principal. In these cases, the surety quite naturally would seek to be relieved of its obligation on the grounds that its liability is no greater than that of its principal and because its principal cannot be found liable to the obligee neither can the

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84. *See* Burlew v. Fid. & Cas. Co., 64 F.2d 976, 977 (6th Cir. 1933); *In re* 1616 Reminc Ltd. P'ship, 14 B.R. 484, 488 (Bankr. E.D. Va. 1981); Meyer v. Bldg. & Realty Serv. Co., 196 N.E. 250, 253-54 (Ind. 1935).
85. Fitger Brewing Co. v. Am. Bonding Co., 149 N.W. 539, 541 (Minn. 1914); Ilse v. Aetna Indem. Co., 125 P. 780, 781 (Wash. 1912).
86. *See* Farm Bureau Mut. Ins. Co. v. Wright, 686 S.W.2d 778, 781 (Ark. 1985); Am. Druggists Ins. v. Thompson Lumber Co., 349 N.W.2d 569, 574-75 (Minn. Ct. App. 1984); Felix Contracting Corp. v. Fed. Ins. Co., 468 N.Y.S.2d 39, 40 (N.Y. App. Div. 1983).
87. *See e.g.*, Renasant Bank v. St. Paul Mercury Ins. Co., 882 F.3d 203, 206 (5th Cir. 2018); State v. Moody, 198 So. 2d 53, 588-89 (Miss. 1967).
88. *See* Am. Cas. Co. v. Irvin, 426 F.2d 647, 650 (5th Cir. 1970); Nelson Roofing & Contracting, Inc. v. C.W. Moore Co., 245 N.W.2d 866, 868 (Minn. 1976); Reliance Ins. Co. v. Trane Co., 184 S.E.2d 817, 818 (Va. 1971). *But see* Transamerica Ins. Co. v. Housing Auth., 669 S.W.2d 818, 822-23 (Tex. App. 1984).

surety.[89] Sureties generally have been able to successfully assert their principal's statute of limitations defenses.[90]

3. Impairment of the Surety's Completion Rights

Depending on the language of the bond, the surety has a right to complete the project to mitigate its loss. If the obligee fails or refuses to give the surety this opportunity, it may result in a discharge of the surety.

a. *Exoneration of the Surety*. In *St. Paul Fire & Marine Insurance Co. v. City of Green River*, the obligee terminated the principal and made a claim against the performance bond.[91] Under the surety's proposed completion compromise, the project would be completed approximately five months after the completion date called for in the original contract. The obligee informed the surety that it considered the proposal an anticipatory breach of the bond. On those grounds, the obligee refused to allow the surety to complete the project. The surety immediately filed suit seeking a declaratory judgment that the obligee's refusal to allow the surety to complete the project was a material breach that exonerated the surety from any further bond liability. The obligee counterclaimed for breach of contract, breach of the covenant of good faith and fair dealing, tortious bad faith, and violation of certain insurance statutes.[92]

The *Green River* court came down squarely in favor of the surety. The court found that the obligee's refusal to allow the surety to complete the project was wrongful and exonerated the surety from any further performance obligations.[93] The obligee takes a significant risk by refusing to allow the surety to perform if the surety's performance plan conforms to the terms of the bond.

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89. *See* State v. Bi-States Constr. Co., Inc., 269 N.W.2d 455, 457-58 (Iowa 1978) (concluding that the statute of limitations ran against the principal, and therefore, the surety also was not liable).
90. *See* Cty. of Hudson v. Terminal Constr. Corp., 381 A.2d 355, 358 (N.J. 1977); *see also* Hous. Auth. v. Hartford Accident & Indem. Co., 954 So. 2d 577, 580-81 (Ala. 2006); George W. Thomas & T. Scott Leo, *Application of Statutes of Limitation Governing Construction Activity to Construction Bond Sureties*, 10 CONSTR. LAW. 1 (1990).
91. St. Paul Fire & Marine Ins. Co. v. City of Green River, 93 F. Supp. 2d 1170, 1179 (D. Wyo. 2000), *aff'd*, 6 F. App'x 828 (10th Cir. 2001).
92. *Id.* at 1173.
93. *Id.* at 1178-1179.

A similar problem arises when the bonded contract contains language that contradicts the performance options of the surety. Some courts have held that the language of the bonded contract supplants the notice and performance-option language in the bond, depriving the surety of its performance options. For example, in *Dooley & Mack Constructors, Inc. v. Developers Surety & Indemnity Co.*, the court reversed a summary judgment ruling in favor of the surety and allowed the general contractor-obligee to complete the subcontractor-principal's work at the surety's expense without a termination and without giving the surety an option to exercise any of its performance options.[94] Because the bond incorporated the bonded contract by reference, the *Dooley & Mack* court determined that the bonded contract's notice provisions trumped the bond's declaration of default terms. Thus, notwithstanding contrary language in the performance bond, the obligee had the right to cure the principal's default itself by completing the work and then holding the surety liable.[95]

Dooley & Mack appears to be an outlier, however. There was a vigorous dissent in *Dooley & Mack* that argued: "The majority . . . seizes upon an obscure provision of the subcontract agreement, not signed by the surety, to afford Dooley & Mack a remedy not contemplated either in the default provision of the subcontract or the bond."[96] The dissent's reasoning was subsequently adopted by *CC-Aventura, Inc. v. Weitz Co.*, in which the court expressly declined to follow the reasoning of *Dooley & Mack.*[97]

In *CC-Aventura*, the court reasoned that an obscure subcontract provision could not override the bond's express language requiring notice be given to the surety.[98] Although the obligee properly declared a default, the court ruled that the obligee had not complied with the additional notice requirements in the bond.[99] The bond provision at issue

94. 972 So. 2d 893, 894-895 (Fla. Dist. Ct. App. 2007).
95. *Id.*
96. *Id.* at 895-96.
97. No. 06-21598-CIV, 2008 WL 2937856, at *7 (S.D. Fla. July 14, 2008), *aff'd*, 492 F. App'x 54 (11th Cir. 2012); Accord Fid. & Deposit Co. of Md. v. Jefferson Cty. Comm'n, 756 F. Supp. 2d 1329, 1338 (N.D. Ala. 2010) (adopting *Dooley & Mack* dissent's reasoning and holding that terms in the bonded contract did not override the bond's express terms).
98. *Id.* at 6-7.
99. *Id.* at 6-8.

required the obligee to provide "reasonable notice" to the surety if the obligee opted to exercise its takeover option.[100] Because the obligee had already hired a completion subcontractor by the time the obligee sent its default letter to the surety, the court ruled that the letter did not constitute "reasonable notice" under the bond.[101] Exonerating the surety, the court rejected the obligee's argument that the subcontract's provisions regarding default and termination, which did not require notice to the surety, overrode the bond's express "reasonable notice" requirement.[102]

In evaluating this defense, though, the surety must move quickly, and resist the temptation to keep all of its options open. The defense of impairment of the surety's completion rights has most often been upheld when the surety immediately denied the claim upon learning of the impairment of its rights. This, of course, is not a legal requirement; it is an issue of credibility.

b. *Hidden Contract Clauses Negating Exoneration*. In evaluating a defense based on an impairment of completion rights, the surety is well advised to carefully review the bonded contract, particularly if it is a subcontract issued by a large general contractor. These contractors are themselves bonded and are intimately familiar with surety defenses. They often have sophisticated in-house construction lawyers who draft their form contracts. Many times, a surety claims professional examining a claim will find that the underwriter has unknowingly bonded a contract that specifically negates specific surety defenses. While the surety is not expressly a party to that subcontract, it has bonded its performance according to its terms, and the bond may incorporate those terms.

This is most commonly seen in the recent supplementation clauses that have been added to subcontracts. Under these clauses, the general contractor can supplement the work force of a non-performing subcontractor rather than issuing a default, and back charge the subcontract balance. The subcontract balance, which otherwise is the surety's collateral, is eroded. Once it is used up, the obligee declares the default and turns over the problem to the surety, many times much worse now than it would have been with an earlier default. These clauses are enforceable and, as a general rule, will not provide the surety with a

100. *Id.*
101. *Id.*
102. *Id.*

defense.[103] At the same time, to the extent that the supplementation exceeds the subcontract balance prior to the declaration of default, an argument can certainly be made that this should give rise to a pro tanto release in the amount of the excess.[104]

There are more extreme clauses than this, however: clauses that waive the surety's rights to notice, to mitigation, and to other basic defenses. The case law on the enforceability of these provisions is undeveloped,[105] but these subcontract clauses bear careful consideration.

4. Overpayment

It is axiomatic that the contract funds are the surety's collateral. When an obligee releases contract funds to the principal which have not been earned, it increases the surety's ultimate loss, as those funds are not available to complete the work. Further, the shortfall, in a sense, is attributable to the negligence of the obligee, and the surety did not bond the obligee.

As a result, improper payment of bonded contract funds by the obligee is a defense that, while rarely allowing the surety to obtain a full discharge, can discharge the surety pro tanto.[106] The obligee's failure to adhere to contractual payment requirements, by making progress

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103. *See, e.g.,* AIA A201-2007 General Conditions of the Contract for Construction at p. 14 § 2.4; Nova Cas. Co. v. Turner Constr. Co., 335 S.W.3d 698, 704-05 (Tex. App. 2011).
104. Shannon J. Briglia & Jarrod Stone, *Ch. 2, Construction Contract Provisions Critical to the Performing Surety: Scope of Work, Contract Price and Time of Completion*, *in* BOND DEFAULT MANUAL 51, 63-66 (Mike F. Pipkin et al. eds., 4th ed. 2015).
105. *Id.*
106. *See* Nat'l Union Indem. Co. v. G. E. Bass & Co., 369 F.2d 75, 77 (5th Cir. 1966) (stating that the "modern rule" allows a surety to be discharged from its performance bond obligations to the extent that it suffers injury as a result of the obligee's overpayments). *But see* Roel P'ship v. Amwest Sur. Ins. Co., 685 N.Y.S.2d 832, 833 (N.Y. App. Div. 1999) (holding that the surety was discharged by the obligee's failure to make progress payment certified by architect); Old Colony Ins. Co. v. City of Quitman, 352 S.W.2d 452, 455-56 (Tex. 1961); Southwood Builders, Inc. v. Peerless Ins. Co., 366 S.E.2d 104, 107 (Va. 1988) (holding that the surety was entitled to a complete discharge as a result of the obligee's overpayments).