



Performance Bonds: Default, Defenses & Discharge

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In the present economy, performance bonds are often important for construction projects, for several reasons:

- 1) Although Construction Manager/contractor defaults have always been of concern (public agencies routinely require bonds), such defaults have increased recently with the worsening economy;
- 2) Owners, developers, sureties, Construction Managers, and contractors need to protect their interests; and
- 3) Such bonds enhance the viability of construction projects generally. It is always important to make sureties as secure as possible, or else they won't issue bonds, thereby drying up what little construction is in—or about to enter—the pipeline.

There are several basic concepts in the performance bond context. First, the relationship here is tripartite, not the normal one-on-one contractual relationship. The three parties are (i) the Construction Manager or contractor (in many forms referred to as the “Principal”), (ii) the surety, and (iii) the project owner (in many forms referred to as the “Obligee”). Each side's rights are interdependent, but the surety is a powerless bystander for most of a project. The latter is injected into the process only when the project owner has formally declared a default.

Declaration of Default—the Surety's Options

Prior to the owner's formal declaration of default, there is no legal basis for the surety to take any action vis-à-vis the owner or the Construction Manager/contractor. Once the owner has formally issued its declaration holding the Construction Manager/contractor in default, the surety has five options:

- 1) fund the principal to completion;
- 2) perform the work itself by retaining a completion contractor and overseeing that contractor's work;
- 3) tender a completion contractor and then walking away;
- 4) tender payment to the owner up to the penal sum of the bond, less amounts previously paid, or
- 5) do nothing and interpose all defenses against the owner's default.

Surety's Defenses to Owners' Claims on the Bond

Once an owner has declared the Construction Manager/contractor to be in default, several defenses are available to the surety, including those that the Construction Manager/contractor may have had, unless waived, vis-à-vis the owner, e.g., non-payment, obstruction of construction activities, or other such claims.

In essence, the surety will argue that the owner had no right to default the Construction Manager/contractor. In addition, the surety may have its own defenses, separate and apart from those of the Construction Manager/contractor, bases on which it can claim that it was discharged from its obligations under the bond by virtue of improper conduct on the part of the owner vis-à-vis the Construction Manager.

Whether to pursue the Construction Manager/contractor's defenses can be an unenviable choice for the surety. If the surety sides with its principal (i.e., the Construction Manager/contractor), it risks a claim from the owner of bad faith disclaimer of liability or breach of its obligations under the bond. On the other hand, if the surety sides with the owner and admits that the owner's default determination

was justified, then the Construction Manager/contractor may claim that that determination was unjustified. The CM or contractor can then use that claim to avoid its indemnification obligations under the general agreement of indemnity it would have executed to obtain the bond in the first place, arguing that the surety was acting as a “volunteer.” One possible solution to this difficult choice is for the surety to apply to a court for a declaratory judgment adjudicating the rights and obligations of the respective parties.

The surety has a duty to investigate the owner's demand on the bond, both in order to decide how best to pursue its defenses and to meet its good faith obligations under the bond. It should employ consultants or otherwise learn of problems; not just problems related to the actual construction but also other issues such as unpaid taxes, payroll taxes, etc.—in short, all of the possible claims that might be made against the bond.

In addition, the contractor's should also investigate the Construction Manager/contractor's claims against parties other than the owner, e.g., subcontractors or other prime contractors, claims that the surety could pursue by way of subrogation. After investigation, the surety must then decide which side to support, owner or Construction Manager/contractor, or whether to complete its principal's work under a reservation of rights.

Distinct Defenses Available to the Surety

There are also several defenses unique to the surety. The surety could argue that certain owner acts have relieved or discharged the surety from its obligations under the bond. Among the bases for such a discharge are any of the following:

- 1) owner's relinquishment of its security, including overpayment to the Construction Manager/contractor;
- 2) material alteration of bonded contract;
- 3) misrepresentation, concealment or fraud; and
- 4) owner's release of the Construction Manager/contractor.

The overpayment defense is perhaps the most common. The concept is that the surety has relied on the owner compliance with contract terms, including the requirement that the owner make timely payments to the Construction Manager/contractor, but not overpay. That is, the contract balance/retainage acts as security for the surety, not just for the owner. For example, if the owner were to pay its Construction Manager/contractor 80 percent of the GMP or lump sum for only 40 percent completed work, the surety will have lost

collateral valued at 40 percent of the GMP/lump sum. This is not a theoretical concern, as owners often advance funds to their Construction Managers/contractors. Therefore, it is important for the owner and Construction Manager/contractor to obtain consent of surety for each such advance. Whether an advance is in fact a violation of the bond sufficient to discharge the surety is a fact-specific determination, where the legal standard is whether the owner has used reasonable prudence and has a good faith reasonable basis for making the payment. The surety must also affirmatively demonstrate that the owner's payment created actual harm to the surety.



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The barriers to a complete discharge are many. The burden is on the surety to demonstrate both the fact of overpayment and the harm created thereby. But even where the surety is able to meet both of these criteria regarding an overpayment, it will only gain a so-called *pro tanto* discharge, that is, a discharge limited to the extent of the overpayment.

Another defense is that there were material alterations to the bonded agreement, both in terms of contract terms, e.g., extensions of time, failure to give notice, and drastically changing the scope of the work to be performed. According to the case law, examples of material alterations include

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changing the project from building a warehouse to building a hospital, imposing an inordinate number of change orders (although there is no absolute standard as to the number or even the dollar amount of change orders necessary to qualify), a material change in allocation of revenues, and failure to obtain lien waivers.

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Among the examples of non-material alterations are changing a building’s height, changing the location of the building, adding an additional floor, adding a basement, and failure of the owner to obtain builder’s risk insurance from the contractor. In analyzing each situation, the court will not permit ex post facto perspective—that is, the situation must be viewed from perspective of the time when the bond was issued.

Owner’s Claims Against the Surety

Just as the surety may maintain its principal’s claims against the owner, the owner may likewise maintain against the surety its (the owner’s) claims against the principal, the Construction Manager/contractor. Among the claims that the owner may assert are those for incomplete or defective work (but the owner has a duty to mitigate these claims), unexcused delays, including liquidated damages (which the surety may in turn pursue against its principal’s lower tier trade contractors/subcontractors). If the agreement does not provide for liquidated damages, the owner may pursue a claim against the surety for its actual delay damages, assuming the terms of the bond permit direct plus consequential damages. The owner may also pursue other claims it might have against its Construction Manager/contractor, such as breach of warranty or latent defects, even if the bond form does not explicitly so permit.




Conclusion

While in many instances, certain technical defenses might appear to let a surety disclaim coverage or be discharged, such a result will not always obtain. Key to any such determination will be whether the surety can sustain its burden of proof both as to the defense itself and also that the event giving rise to that defense caused actual prejudice to the surety, something that usually cannot be shown.

Where the surety’s defenses are not permitted and liability is assessed against it, however, the ultimate liability will likely rest not with the surety but with the principals of the Construction Manager/contractor for which it has issued the bond, as they will have issued the general agreement of indemnity for the bond, which usually includes a personal guarantee. In that sense liability will come full circle and ultimately fall on the defaulted Construction Manager/contractor, or at least its principals. As a result, corporate insolvency/bankruptcy will not help the Construction Manager/contractor.

The key factor in seeing that the performance bond process is handled properly, as is often the case for construction projects, is close project monitoring—of claims, change orders, time requests and extensions, and like matters—together with providing proper notice thereof, and especially obtaining consent of surety for these various items. Such monitoring and notice will help all parties see that the inevitable project difficulties and obstructions are handled as effectively and painlessly as possible. **CM**

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