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THE ROLE OF THE SURETY ON A TROUBLED PROJECT

"*I was gratified to be able to answer promptly – I said I didn't know*"
~ Mark Twain

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I. INTRODUCTION

In order for the commercial bond surety to attain a profitable scenario on any given project, three things need to occur. First, the surety embarks upon a thorough underwriting review of its principal to verify itself of the contractor's character, capacity, and credit. Second, having furnished performance and payment bonds, the surety's principal performs well for the obligee by completing the project and paying its downstream suppliers. Third, because of the principal's stellar performance, no one calls upon the bonds or makes claims and the surety is simply forgotten. These three events, albeit simplistic, afford the surety the ability to make a profit from the bond premiums collected from the principal. The principal then moves on to bid on other bonded work, and continues to purchase bonds. This is not an unrealistic scenario, it is reported that 2005-2008 were the most profitable years in the history of the construction business – and for sureties as well.[1]

Compare the rosy setting scripted above with the current state of the construction industry. The industry itself has almost shrunk in half – from being a $1.2 trillion industry in 2006 to a $760 billion industry in 2011. The exorbitant number of bidders pursuing a smaller amount of work results in competition that forces margins into negative territory. Exacerbating matters, contractors are also more likely to accept one-sided, onerous contract language with the economic indicators such as they are.

According to a recent ENR report, surety companies have reported an increase in contractor failure in 2011, concentrated mostly in the small to middle markets. The losses are expected to continue through 2011 and into 2012. In addition, the construction industry as a

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[1] 2011 Surety Market Report, Engineering News Record, S10, June 27, 2011 (www.enr.construction.com/resources/special)

whole has an unemployment rate of 17.8%, nearly double the national average.[2] In these times, the tipping point for many contractors currently is the tendency to overextend already strained balance sheets, just to get more work to keep afloat.

With that backdrop, we begin with an overview of the surety's role on a troubled project. At its core, a performance bond assures that if a contractor fails, despite the surety's stringent prequalification, the surety completes the project or pays for completion of the project up to the sum of the penal bond. A payment bond assures that certain subcontractors, labor, and suppliers will be paid. A common perception held by some in the industry is that sureties as a whole would rather litigate with claimants instead of paying valid bond claims. However, according to the Surety & Fidelity Association of America (SFAA), sureties have paid out more than $10.4 billion on contract bond claims since 1995.[3]

II. CONTRACTOR DEFAULT

On any troubled construction project, there are the inevitable warning signs that a default is forthcoming. But what are some of the common precipitous indicators that a principal may be defaulting? The SFAA has reviewed 86 claims associated with contractor failure and has identified the top five factors related to contractor failure:

- Accounting and financial issues – these situations include inadequate cost and project management systems; estimating or procurement problems; lack of adequate insurance; improper accounting practices.

- Management issues, which include personnel and performance – 36% of the cases reviewed had performance issues as a factor that impacted the contractor's default. These issues usually involve inexperience with a new scope or types of work; personnel not having adequate training or experience; insufficient personnel.

[2] *Id*.
[3] Surety Bonds at Work, Surety & Fidelity Association of America (SFAA).

- Unrealistic growth – 37% of cases reviewed involved "unrealistic growth" as playing a factor in their default status. This typically includes a change in the type of work performed; expanding into a new geographic area; rapid or over-expansion; or a significant increase in the dollar-value and size of the projects being awarded.

- Character issues – these involve scenarios when a contractor retires, dies or sells the company, which changes the leadership and focus of the company; or a failure of a management transition plan to ensure continuity in the event of a death or disability.

If the contractor defaults and the owner elects to terminate the contract and seek performance from the surety, the owner must ensure compliance with both the contract and bond procedural requirements to trigger the liability of the surety. Deciding to terminate a contractor for default is a very serious decision fraught with exposure for the owner. The reason why is because the law does not favor "forfeiture," and courts expect that parties who have entered into contracts will be permitted to fulfill their obligations. Therefore, owners should view termination for default as a remedy of last resort. If the owner elects to implement that remedy, then it must ensure that it has complied with all procedural requirements to effect the termination.

Most commercially available bond forms are conditioned upon the owner's faithful performance of its contractual duties. Therefore, the owner should commence its analysis by assessing whether it has taken any actions that could be deemed to be a breach of the contract. In other words, the owner cannot seek performance from the surety if the owner is the party who first breached the contract. Typical areas of concern for the owner to evaluate its compliance with the contract include confirming: (a) prompt and proper payments to the contractor; (b) the sufficiency of the plans and specifications; (c) appropriate owner response to contractor claims and proposed change order requests which assert significant impacts to either or both time and cost of the work; and (d) involvement of or creation by the owner of situations or conditions creating cardinal changes to the performance of the work.

If the owner is comfortable that its own actions in administering the contract are in substantial compliance with the contract, then the owner must examine the actions of the contractor and comply with the default and termination provisions of the contract, including giving proper notices and opportunity to cure, if required by the contract. These actions should be taken in careful coordination with the terms of the bond. For example, the American Institute of Architects (AIA) A312 Performance Bond provides detailed provisions for implementing default and triggering action by the surety.

One of these conditions is that the owner give notice of its intent to declare a default, request a meeting with the contractor and surety and provide an opportunity for the contractor (perhaps with the aid of the surety) to cure the breach. Note that this is language that is also typically included in the default and/or termination provisions of the contract between the owner and the contractor.

III. FORMAL DECLARATION OF DEFAULT

The three industry groups whose bond forms are utilized with the most frequency include the American Institute of Architects (AIA), the Engineers Joint Contract Documents Committee (EJCDC), and ConsensusDOCS. The AIA form documents are the most prevalent forms in the industry, and the forms have undergone a number of revisions since being first issued. Regarding performance bonds, the AIA A311 was issued in 1970. The AIA A312 payment and performance bonds were issued in 1984 and were recently revised in 2010. Under the A311 performance bond, there is a split of authority as to whether the bond entitles the surety to notice of the principal's default as a condition precedent to its liability on the bond. Some cases have held that a performance bond surety is entitled to take certain actions under the bond. Without notice to the surety, there can be no liability.[4]

The most commonly used version of the AIA forms is the 1984 AIA A312 performance bond form, which provides a detailed procedure to be followed to invoke performance by the surety. In contrast to the split over interpretation of the default language of the A311 performance bond, courts have universally agreed that the notice requirement and other provisions of paragraph 3 of the bond are conditions precedent to the surety's obligation to perform under paragraph 4.[5] As noted above, a condition precedent to declaring a default by the owner is the request for a meeting between the owner, contractor and surety in an event to avert default. The owner is then required to wait 20 days after that meeting before declaring a default. The A312 bond then sets forth the surety's options upon default.

Paragraph 3 of the A312 bond form sets forth the owner's obligations for triggering the surety's obligations under the Bond, stating:

> If there is no Owner Default, the Surety's obligation under this Bond shall arise after:
>
> 3.1 The Owner has notified the Contractor and the Surety 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

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4 *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106 (5th Cir. 1994); *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*, 376 F.3d 96 (2d Cir. 2004); *Hunt Const. Group v. Nat'l Wrecking Corp*., 587 F.3d 1119 (D.C. Cir. 2009); but see, *Walter Concrete Constr. Corp. v. Lederle Labs.*, 99 N.Y.2d 603, 788 N.E.2d 609, 758 N.Y.S.2d 260 (N.Y. 2003).

5 *120 Greenwich Dev. Assoc., LLC v. Reliance Ins. Co.*, 2004 WL 1277998 (S.D.N.Y. June 4, 2004); *Bank of Brewton, Inc. v. Int'l Fid. Ins. Co.*, 827 So. 2d 747 (Ala. 2002); *St. Paul Fire & Marine Ins. Co. v. VDE Corp.*, 603 F.3d 119 (1st Cir. 2010).

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.

Under the AIA A312-1984, the owner must: (1) not be in default of its own contractual obligations; (2) give written notice to the contractor and surety of its intent to declare a default and request a meeting to occur within 15 days of the notice; (3) provide an opportunity to cure; (4) declare a default and terminate the contract no earlier than 20 days from the first written notice; and (5) agree to pay to the surety the balance of the contract price. These obligations are in addition to whatever notice and termination provisions are contained in the construction contract. Note that while the notices may be combined if consistent, if the contract has additional notice requirements, the owner must comply with them.

If the owner complies with Paragraph 3 of the A312 bond, Paragraph 4 of the A312 Bond sets forth the surety's options as to how it may carry out its obligations under the Bond:

When the Owner has satisfied the conditions of Paragraph 3, the Surety shall promptly and at the Surety's expense take one of the following actions:

4.1 Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract; or

> 4.2 Undertake to perform and complete the Construction Contract itself, through its agents or through independent contractors; or
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> 4.3 Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and the contractor selected with the Owner's concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages as described in Paragraph 6 in excess of the Balance of the Contract Price incurred by the Owner resulting from the Contractor's default; or
>
> 4.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances:
>
> .1 After investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, tender payment therefor to the Owner; or
>
> .2 Deny liability in whole or in part and notify the Owner citing reasons therefor.

The owner must permit the surety the opportunity to exercise one of these options, which, as discussed below, usually entails an investigation by the surety.

The 2010 amendments to the A312 bond have eliminated the requirement that the owner request a meeting before declaring a default – although it created in the surety the right to request a meeting if the owner does not. Moreover, the 2010 amendments to the A312 bond eliminated the 20-day waiting period required following the meeting before termination can be implemented. These changes were intended to provide owners with more flexibility in situations where it is clear the contractor cannot cure, and the meeting and waiting period act only to delay the inevitable.

The EJCDC and new ConsensusDOCS standard contract bond forms contain similar requirements to the AIA A312-1984 performance bond form. The EJCDC C-610 performance bond form requires the owner to formally terminate the contractor's right to proceed in addition to declaring a default. The ConsensusDOCS 260 performance bond, although a more concise form than the A312, shares many similar requirements with the AIA form, with one key difference. The ConsensusDOCS form does not require a meeting before a default may be declared.

IV. TRIGGER OF SURETY INVESTIGATION

Whether the claim originates from a performance bond obligee or payment bond claimant, the investigation is typically the surety's first action once it has been placed on notice of an alleged default or been advised of a pending action. The surety's investigation typically involves the following steps: (1) reviewing the contract documents; (2) interviewing both obligee and principal; (3) using outside consultants, outside counsel, or in-house engineers to assess and evaluate the status of the project from the most objective and impartial view. If the investigation reveals that the contractor is not in default, the surety company is not obligated to perform.

A thorough investigation also yields whether any factual or legal defenses exist that cancel its obligation. As an initial matter, there are scenarios under which the obligee making the claim is different from the entity listed on the face of the bond. Additionally, the principal may have undergone a complete change in management and now no longer resembles the bonded principal. These issues may reduce or eliminate the surety's obligation to provide coverage under the bond.

The investigation also includes an immediate review of the remaining uncompleted bonded jobs, a compilation of all unpaid subcontractors and suppliers and the amount owed to each. The surety determines what receiveables are due and to be earned, together with the retainages being withheld. Such a task is not easy when the communication flow is hampered with a struggling or defaulted principal, whose project records are incomplete. Sureties typically obtain the following from both claimant and principal to ascertain accuracy of records: contract documents; job schedules; photographs; substantial and final completion certificates; substantiation of the claim; correspondence; applications for payment; notice of breach or default; statement of account; punchlists; estimates of the remaining work; accounts payable and receiveable.[6]

The above description of the investigative process, however, assumes that the surety has ample time to perform its review. It is not uncommon for sureties to have a multitude of factors affecting their investigation period, such as, seasonal conditions shutting down the project; numerous scope disputes; subcontractors threatening to abandon; and/or accruing liquidated damages. Worse, the surety may be dealing with an uncooperative obligee or principal, the surety may face documents that are incomplete, vague, or ambiguous. Any of these issues may accelerate or compress the time in which the surety has to truly define the scope of work.

e. What is the Scope of the Bonded Obligation?

The surety not only attempts to uncover factual and legal defenses in the investigation phase, the surety also seeks to examine the contract documents to attempt to define the remaining scope of work. After establishing the base scope of bonded work, sureties must attempt to

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[6] Bond Default Manual, William S. Piper and Kenneth M. Givens, Jr., (Duncan L. Clore 2d ed., 1995).

deciper what inevitable changes occurred on the project. Changes are an anticipated part of the construction process, and because of that reality, most bonds waive notice to the surety of changes to the contract. However, the surety does not necessarily consent to all changes.[7] The surety should attempt to obtain a written representation from the owner that they have provided all executed copies of change orders. This allows the surety to determine whether a material alteration occurred on the project through the change order process and/or assists the surety in defining remaining scope of work.

f. What is the Contract Price?

The amount of the remaining contract balance will almost certainly be impacted by the owner's default termination of the contractor. The amount of the contract price may have already been reduced before a demand is made upon the surety to perform under its performance bond. For instance, the owner may have supplemented the work by the owner's own forces or by those of another contractor; in either event the owner will seek a deduction to the contract price. In addition, the contractor's failure to pay subcontractors and suppliers may affect the amount of the contract price, as will the owner's previous withheld payments from the contractor. Sureties must also determine whether any joint checks were issued, which causes the contract balance to fall, but also simultaneously reduces the sureties exposure under its payment bond. As the surety performs, it is entitled to payment (directly or to others) of the remaining contract balance. This absolute right to the contract balance is established in the Performance

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[7] Generally, a "consent to changes" provision in a bond does not include material, unforeseeable changes. *See e.g.*, *Roberts v. Sec. Trust & Sav. Bank*, 196 Cal. 557, 567 (1925); *Barrett-Hicks Co. v. Glas*, 9 Cal. App. 491 (1908); *Hocehvar v. Maryland Casualty Co*., 114 F.2d 948, 952 (6th Cir. 1940); *Phoenix Indem. Co. v. Nicholas*, 121 F. Supp. 168, 171 (N.D. Cal. 1954).

Bond itself (AIA A312). However, there are also other contractual,[8] statutory, legal and equitable[9] grounds upon which the surety's right to the contract price is absolute, such as the general agreement of indemnity between the surety and its principal. The key to navigating the contract balance issue is establishing the claimed offsets, delay damages, backcharges, liquidated damages, or other deducts that the owner is asserting and negotiating those items.

g. What is the Time to Complete?

In the initial stages of taking over the construction contract, the surety must familiarize itself with the project and the project requirements so that it can determine how much time remains under the bonded contract for the completion of the work. This phase is typically accompanied by thoroughly reviewing all the contract documents. Just like the contract balance is affected by many events, so too, the calculation of the time remaining to complete the project can be difficult to ascertain. The surety may be in the position of having to educate itself and negotiate a request for time extension based on adverse weather conditions, change orders, errors and omissions in the plans, or other grounds for excusable delays. For non-excusable delays, the surety is in the position of negotiating for a waiver of assessed liquidated damages when it enters into the takeover agreement, or at least evaluating its exposure to them when determining the remaining contract balance.

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[8] *See generally* The Surety's Indemnity Agreement – Law & Practice, 2d Ed (M. Klinger & G. Bachrach, eds. 2008).

[9] *See generally* George Bachrach & John Burch, The Surety's Subrogation Rights, The Law of Suretyship, 2d Ed. 419-53 (Edward G. Gallagher, ed. 2000).

h. When is the Time to Respond?

The terms of the bond control the time in which the surety has to respond to any claim. Under the terms of most bonds, the surety must act in good faith in responding to bond claims. Good faith is generally construed to mean that the surety "reasonably" investigated the claims. However, for payment bond claims, most attendees are familiar with the line of cases from 2006 – 2008, which narrowly construed the provisions of the standard form A312 bond as barring a surety from raising any defenses after a 45-day period. *National Union Fire Insurance Co. of Pittsburgh, Pa. v. David A. Bramble, Inc.*, 879 A.2d 101 (Md. 2005); *Casey Industrial, Inc. v. Seaboard Surety Co.*, 2006 WL 3299932 (E.D. Va.)[10]

V. PERFORMANCE BOND SURETY'S DEFENSES

Once the investigation is as complete as possible under the various time constraints, the surety must analyze its rights, including the possible defenses to the obligee's claims against the performance bond, and its options going forward.

a. The Surety's Assertion of the Principal's Defenses[11]

As noted above, many performance bonds require not only that the principal be in default and/or declared by the obligee to be in default under the construction contract, but also that the obligee must have performed the obligee's obligations under the construction contract.[12] If the obligee is in default under the construction contract, the principal may have a defense to the

[10] Phillip L. Bruner and Patrick J. O'Connor, Bruner and O'Connor on Construction Law, BOCL § 8:176.
[11] Bond Default Maunal, Duncan L. Clore, (3rd Ed. 2005); George J. Bachrach, A Primer for the Surety's Handling of Performance Bond Claims, 19th Annual Northeast Surety and Fidelity Claims Conference, (September 2008).
[12] That is true under both the AIA Document A311 Performance Bond ("the Owner having performed Owner's obligations" under the construction contract) and the AIA Document A312 Performance Bond ("[i]f there is no Owner Default," which is defined in paragraph 12.4 of the AIA Document A312 Performance Bond as the "[f]ailure of the Owner, which has neither been remedied nor waived, to pay the Contractor as required by the Construction Contract or to perform and complete or comply with the other terms thereof").

obligee's termination of the principal's construction contract, and the surety may assert the principal's defenses when the obligee makes a claim against the performance bond.

- The obligee's wrongful termination of the principal's construction contract.

- The obligee's failure to pay the contract funds.

- The obligee's duties incident to the project's design.

  - The obligee's implied warranty of design adequacy (including the "government contractor" defense).
  - The obligee's implied warranty of commercial availability of specified construction materials.
  - The obligee's implied duty of disclosure.
  - The blending of design and performance specifications.
  - The obligee's approval of the principal's work plan.
  - The obligee's implied warranty of design versus the principal's warranty of materials.
  - The obligee's responsibility for latent ambiguities in its design.

- The obligee's implied duty of cooperation.

- The impossibility or impracticality of the performance of the work.

- The obligee's failure to properly administer the construction contract (including the obligee's lack of response to requests for information and proposed change orders and other failures to act timely).

- The obligee's failure to provide the principal with an opportunity to cure the default.

- The obligee's implied waiver of contract requirements.

- The obligee's insistence upon strict compliance in the face of economic waste, and hypertechnical inspection.

- The obligee's release and settlement of claims against the principal.

- The principal's setoffs and/or counterclaims.

b. The Surety's Assertion of its Own Defenses[13]

Along with the defenses of its principal, the surety may assert its own defenses to an obligee's performance bond claim. Listed below are a number of the surety's defenses to an obligee's performance bond claim after the default and termination of the principal on the construction contract:

- The release and/or discharge of the surety's principal (including but not limited to the obligee's wrongful termination of the principal's construction contract).

- The obligee's failure to provide notice to the surety and/or to comply with the performance bond's conditions precedent requiring the surety to perform (including the obligee's failure to allow the surety to have the opportunity to exercise and/or perform its options under the performance bond).

- The principal's substantial performance of the construction contract.

- The obligee's actions that are prejudicial to the surety.
  - Material alterations to the construction contract (cardinal changes).
  - Overpayments or improper payments - impairment or release of collateral (the bonded contract funds).
  - Extensions of time.
  - The failure to give timely notice and/or to timely default and terminate the principal.
  - The obligee's failure to mitigate its damages.
  - Other obligee actions, including changes in the obligee or the principal.

- Contractual and statutory limitations.

- The obligee's lack of good faith (concealment, non-disclosure and/or misrepresentation of facts).

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13 George J. Bachrach, A Primer for the Surety's Handling of Performance Bond Claims, 19th Annual Northeast Surety and Fidelity Claims Conference, (September 2008).

e. Financing the Bond Principal

Project completion is the primary goal of all participants. To that end, providing liquidity to one's principal to keep them afloat arguably may provide the shortest path in reaching completion. Surety companies may provide financial assistance directly to a bonded contractor, which enables the contractor to continue its work program, pay subcontractors and suppliers, and keep the project moving forward. This assistance may be provided at the contractor's request without the involvement of the project owner and may occur without formal declaration of default. In addition to providing direct financing, when the surety becomes aware of a contractor's financial difficulties, it may guarantee a line of bank credit. This assures a steady flow of materials to the work site and payments to subcontractors. Another way to assist the principal, the professional expertise of the surety company and surety bond producer can minimize problems and losses on a project. Many sureties employ professional engineers, accountants and other technical staff or advisors that can help a contractor succeed.

Some of the advantages of financing a contractor include the ability to cure the default and complete the project with a minimum amount of delay. In addition, completion costs are usually reduced in this scenario by obtaining the benefit of original subcontractor prices, and avoiding or minimizing a liquidated damages assessment that the surety may ultimately have to shoulder. The disadvantages are that the costs the surety expends to finance do not reduce the surety's overall liability under the bond and carry the risk that the principal may still default.[14]

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[14] *Public Serv. Elec. & Gas Co. v. Technology for Energy Corp.*, 123 B.R. 979, 982-83 (Bankr. E.D. Tenn. 1991); *see also Aetna Cas. & Sur. Co. v. Butte- Meade Sanitary Water Dist.*, 500 F. Supp. 193, 197 (D.S.D. 1980) (surety "waived its bond limits when it set out to complete the project"); *Bd. of Supervisors of Stafford County v. Safeco Ins. Co. of Am.*, 310 S.E.2d 445, 450 (Va. 1983) (the surety "could either perform at its own expense or pay the cost of

f. Tendering a Replacement Contractor and Negotiating a Takeover Agreement.

In those circumstances when a contractor cannot complete a project, the surety may bring in a replacement contractor to finish the job. In some respects, a true contractor default ostensibly gives the surety fewer options to mull over and removes the risk associated with financing the principal in the hopes that the principal stays afloat and can complete the project. However, the decision to hire a replacement contractor is arguably one of the more burdensome surety options. If the surety elects to come in and takeover a project, a formal takeover agreement will be negotiated with the project owner, clarifying the scope. This option is used when the project is substantially complete or key contractor personnel and subcontractors are crucial to project completion.[15] During these negotiations, the surety will utilize any defenses it discovered during the investigation process when negotiating the takeover agreement with the owner (*i.e.*, overpayments, failure to process changes orders, differing site conditions, delays, impacts and interferences).[16] In addition, the key objectives for the surety in the takeover negotiations are: [17]

- Incorporating the surety's obligations into the agreement;
- Protecting the penal sum of the bond;
- Negotiating concessions on time, scope or claims;
- Preserving rights, defenses and remedies;
- Defining obligations in administration of the remaining work;

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performance up to the face amount of the bonds"); Philip L. Bruner, Patrick J. O'Connor, Jr., and James J. Hartnett, IV, *Bond Default Manual* 115–16 (Duncan L. Clore ed., 2d. ed. 1995)(one of the disadvantages of financing the principal is that "this option … exposes the surety to open-ended liability beyond the penal sum of its bond;" "once a surety agrees to take over the project, its ultimate liability will no longer be limited by the penal sum of its bond").

[15] Robert F. Cushman & Charles A. Meeker, Construction Defaults: Rights, Duties & Liabilities, Performance Bond Surety Options, Section 5.4 (Wiley Construction Law Library1989).

[16] *See generally*, C. Langfitt, B. Lee & R. Nieseley (Performance Options Available to the Surety, Law of Performance Bonds, Ch. 3.

[17] J. Dunn & W. McConnell, Defining the Remaining Scope of Work in the Surety's Investigation of a Performance Bond Claim: Hardly "Elementary", Fidelity & Surety Law Committee, American Bar Association (January 2011 Meeting).

- Correcting deficiencies / non-conforming work;
- Placing risk of “patent” vs. “latent” defects;
- Addressing exclusions to price and scope;
- Addressing future changes;
- Placing risk and burden of prosecuting affirmative claims;
- Addressing issues of state and federal false claims act.

The surety can contract directly with the completion contractor or arrange for the oblige to enter into a contract with the replacement contractor. The key difference is that the when the surety contracts with the replacement contractor, its liability is not limited by the penal sum of the bond. When the surety arranges for the owner to contract with a new contractor, the surety’s liability is limited to the penal sum of the bond.[18]

By electing this course of action, the surety becomes subrogated to the contract balance retained by the owner. The downside to this option is that a surety must consider the increased costs of subcontractors and material which will be incurred as a result of premiums added to reflect the risk caused by the prior default. Another disadvantage is that the replacement contractor needs time to understand the remaining scope, project requirements, work-in-place, status of inspection and generally become familiar with the project. All of that takes precious time and possibly exacerbates the surety’s exposure to liquidated damages.

g. Denying the Claim or Allowing Obligee to Complete.

Asserting viable defenses the surety may have uncovered during the investigative process as a basis for denying a performance bond claim is another option; but one that likely leads to a litigation posture. To the extent that courts are increasingly reluctant to enforce even the most basic surety legal principles, denying a claim on well-founded surety defenses can even be

[18] International Risk Mangement Institute (IRMI), Performance and Payment Bonds (2002).

fraught with risk. Likewise, doing nothing surely exposes the surety to litigation and possibly a waiver of the penal sum for the surety's failure to do anything at all.[19]

h. Bond "Buy Back"

To the extent a surety views its risk in completing the project on behalf of its principal as a legal quagmire, fraught with unknown risk, the surety may offer to negotiate an amount at which the owner is willing to provide a full release and exonerate the surety.

VII. MILLER ACT BONDS

a. Federal Projects[20]

For federal projects, under the Miller Act, parties that have not been paid in full within 90 days after furnishing their last labor or materials may bring a civil action on the payment bond. However, relief under the Miller Act is limited to a person who "furnished labor or material in carrying out work provided for in a contract for which a payment bond is furnished." The United States Supreme Court has interpreted this to mean that only persons who are in privity with either the prime contractor or a subcontractor to the prime have a right of action on a Miller Act bond. *See J.W. Bateson Co., Inc. v. United States*, 434 U.S. 586 (1978). Thus, subcontractors and suppliers below second-tier status do not have Miller Act protection.

In order to preserve a Miller Act claim, a second-tier subcontractor or supplier first must furnish written notice of its claim to the general contractor within 90 days after furnishing its last labor or materials to the project. The notice must state the amount claimed with substantial accuracy, the name of the party to whom the labor or material was furnished, and it must be

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19 *Continental Realty Corp. v. Andrew J. Crevolin, Co.*, 380 F. Supp. 246 (S.D. W. Va. 1974).
20 International Risk Mangement Institute (IRMI), Performance and Payment Bonds, (2002).

served by any means that provides written, third-party verification of delivery to the general contractor at any place where he maintains an office or conducts business. The purpose of this requirement is to protect the general contractor by notifying it to withhold money from the subcontractor due to the claims of the sub-subcontractor or materialman. For that reason, there is not a similar notice requirement imposed on bond claimants who have contracted with the general contractor.

Waivers of the right to sue on a payment bond under the Miller Act are void unless in writing, signed by the person whose right is waived and specifically and unequivocally waives a Miller Act claim. A demand for arbitration does not result in the waiver of Miller Act remedies. *United States ex rel. Portland Construction Co. v. Weiss Pollution Control Corp.*, 532 F.2d 1009 (5th Cir. 1976).

Contractors can obtain a certified copy of the Miller Act payment bond posted on their project, as well as the contract for which it was given, from the head of the contracting agency or department. The request for such certified copies must include an affidavit that the requesting party has supplied labor or material for work described in the contract and that payment for the work has not been made, or that the requesting party is being sued on the bond.

Payment bond suits must be brought in the name of the United States for the use of the person bringing the action, and must be filed in the United States district court with jurisdiction over the location where the contract was performed, irrespective of the amount in controversy. A suit filed in state court, even if filed timely, does not toll the statute. Even though the state court may have jurisdiction over breach of contract counts in a multiple-count claim, the Miller Act portion of a claim must be filed in federal court.

A suit to enforce a Miller Act bond cannot be filed more than one year after the day on which the claimant last furnished labor or materials to the project. The statute of limitations of 1-year from the date of completion is strictly construed.

- **Repair and warranty work.** Neither the mere correction of a defect nor the making of repairs on original work, even when done pursuant to a warranty requirement, count as supplying labor for purposes of determining the claimant's last day of work. *United State f/u/b/o Allsite Contracting LLC v. Hatford Fire Ins. Co.*, 2010 U.S. Dist. LEXIS 128024 (E.D.Va. 2010); *General Insurance Co. of America v. United States ex rel. Audley Moore & Son*, 409 F.2d 1326 (5th Cir. 1969), *cert. denied*, 396 U.S. 902 (1969).

- **Late work or delivery of materials.** Furnishing work under the original contract, even if late, may count as a claimant's last work, provided the work is not unreasonably late or performed only to revive an expired bond claim. *United States ex rel. Lank Woodwork Co., Inc. v. CHS Contractors, Inc.*, 452 F. Supp. 922 (D.D.C. 1978). Contractors often attempt to protect themselves by intentionally delaying the performance of some minor aspect of the original work. While this would be "original work," courts disfavor situations in which the performance of this last part of the work is manipulated in order to come within the filing period.

b. State Miller Acts[21]

Many states, including Virginia, Maryland and the District of Columbia, have adopted a "Little Miller Act" to provide payment bond coverage for subcontractors and suppliers on state

[21] *Id.*

projects. The underlying basis for these acts is the same as the federal Miller Act: public property cannot be liened.

- Virginia Little Miller Act – Exhibit A

The Virginia Little Miller Act is part of the Virginia Procurement Act, Virginia Code Section 2.2-4337 through 4342. The Virginia Little Miller Act is "for the protection of claimants who have and fulfill contracts…to the prime contractor…or to any subcontractor." As such, as with the federal Miller Act, Virginia Little Miller Act protection extends no further than second-tier subcontractors and suppliers. Parties contracting directly with the bond principal — usually the general contractor — are not required to give notice of their bond claim until the suit to enforce. Those parties not contracting with the bond principal must give written notice of their claim to the bond principal within 180 days after the claimant's last work. Claims for retainage are not subject to any time limit on the notice requirement. A bond claim must be enforced within one year after the last day the claimant supplied labor or materials. The enforcement action must be brought in the Circuit Court for the county or city where the project is located.

- Maryland Little Miller Act – Exhibit B

Maryland's Little Miller Act is found in Maryland State Finance and Procurement Code Sections 17-101 through 17-110. Maryland's Little Miller Act requires a contractor to post a payment bond whenever the State or local government awards a construction contract that exceeds $100,000. Maryland's Little Miller Act allows bond claims by any claimant with a direct contractual relationship with a subcontractor or sub-subcontractor to the general contractor. Thus, third-tier subcontractors can file bond claims, which is an enlargement of potential claimants as compared to the federal Miller Act and other Little Miller Acts that only permit claims by first and second-tier subcontractors. All claimants other than those with a contractual relationship with the general contractor must provide written notice to the general contractor within 90 days after the date of last work. A claimant can file suit on the payment bond up until one year after the work is accepted by the owner, which can result in longer periods in which to file suit than under federal or other state Miller Acts. Miller Act bond claims in Maryland strictly comply with one-year statute of limitations to file after date of completion. *US f.b.o. East Coast Contracting Inc v. US Fidelity & Guaranty Company* 133 Fed.Appx. 58, 2005 WL 1248963 (4th Cir. 2005) (visiting site for inspection does not extend deadline from date of completion). Enforcement suits must be brought in the Circuit Court where the prime contract was performed or where the prime contractor has its principal place of business.

- District of Columbia Little Miller Act – Exhibit C

The District of Columbia Little Miller Act is almost identical to the federal Miller Act. The D.C. Little Miller Act is located in D.C. Code § 2-201.01, *et seq*. D.C. typically follow the decisions of federal courts interpreting the Miller Act. The Mayor's office has discretion regarding the requirements of performance and payment bonds for public projects. A suit to enforce a bond claim may be brought in the D.C. Superior Court within one year after the last supply of labor or materials, or in federal court if federal jurisdiction exists.