Chapter 8

Bond Requirements

MARIYLN KLINGER
SHANNON J. BRIGLIA
KEVIN P. GILLILAND
LAUREN P. MCLAUGHLIN

I. Introduction

Construction project owners, particularly public owners, desire performance guarantees and security for their projects to ensure completion of the work and satisfaction of their obligation to taxpayers. From time immemorial, the surety has filled the need for performance guarantees through the provision of surety bonds. As discussed in this chapter, when a contractor defaults on a construction project, the surety is there to remedy the default by completing or arranging for completion of the bonded contract or satisfying the payment obligation of the contractor so that the person who is the beneficiary of the bond will not suffer a loss by virtue of the principal’s default. In recent times, alternative forms of performance security, including the use of letters of credit, parent guarantees, and contractor default insurance, have been employed to varying degrees of success to provide the security desired by project owners.

While many of the same concepts applicable to bonds that are provided for private projects apply to bonds that are issued for public projects, there are a number of unique considerations that apply to public works projects. Most importantly, public owners and contractors and their subcontractors need to be aware of statutory bond requirements that may apply to public projects but do not apply to private projects. These requirements are imposed by “Little Miller Acts,” which are based on (but differ in many specifics) from the federal Miller Act imposing performance and payment bond obligations on contractors. In some jurisdictions, the failure of public owners on state and local projects to obtain from contractors statutorily mandated bonds, especially payment bonds, may afford subcontractors direct claims against the public
entity.\textsuperscript{1} Similarly, the flexibility that exists on private works projects and alternatives to bonds is not typically available in the public works setting. Public owners are circumscribed by legislative authority as to what types and the extent of performance security they can utilize on their projects. This chapter identifies and provides context for the forms of performance security currently deployed in the public sector as well as providing a discussion of the conditions triggering and limiting the performance coverage provided by each form of security.

\textbf{II. Surety Bonds and Bond Alternatives}

\textbf{A. Surety Bonds as a Guarantee of Performance on Public Construction Projects}

Most public construction work in the United States is procured through a competitive bid system where the work is awarded to the lowest priced responsive and responsible bidder. Surety bonds play a crucial role in ensuring that the successful awardee completes the work and satisfies its payment obligations to the laborers and material suppliers who provide the labor and materials for the project. Put simply, a “surety” is one who has agreed to be liable for another’s debt, default, or other obligation. Thus, the surety on a construction project is liable for, or guarantees, the performance by the successful bidder of the work.

Virtually all construction contracts let by a public body, built on public land or for which public funds are utilized, are subject to statutory requirements for performance and payment bonds. However, as different methods for financing, developing, and delivering construction projects gain popularity, such as public-private partnerships, design-build, and integrated project delivery systems, the role and importance of performance bonds is evolving.

\textbf{B. Bond Nomenclature}

The parties to surety bonds have unique nomenclature. The entity that issues the surety bond is called either the “surety” or the “secondary obligor” and guarantees the performance of the principal’s obligation.\textsuperscript{2} The entity for which the surety bond is issued is called the “bond principal,” the “principal,” or the

\begin{itemize}
\item \textsuperscript{1} See, e.g., N.V. Heathorn v. County of San Mateo, 126 Cal. App. 4th 1526 (2005); Walt Rankin & Assocs. v. City of Murrieta, 84 Cal. App. 4th 605, 622 (2000).
\item \textsuperscript{2} Restatement (Third) of Suretyship & Guaranty § 15 (Am. Law Inst. 1996):
\end{itemize}
“primary obligor.” The person to whom the bond is issued is called either the "obligee" or the "beneficiary." The principal is typically a contractor, although it can also be a subcontractor or supplier. The obligee is typically the project owner, although it can also be a general contractor to a subcontractor's or supplier's bond or a general contractor or subcontractor to a supplier's bond. Where a performance bond is provided by a subcontractor, the owner may require that it be designated as an obligee in addition to the general contractor (i.e., a co-obligee or dual obligee).

C. Types of Construction Bonds

Construction surety bonds are either bid bonds, performance bonds, payment bonds, or warranty or maintenance bonds. Each of the more common type of surety bonds has a different purpose and is utilized at different points in the construction process.

1. Bid Bonds

As its name suggests, a bid bond provides security during the bidding process and is intended to guarantee that the principal will faithfully accept and enter into the contract upon which it bid if the principal is selected as the successful bidder. A bid bond ordinarily must be provided to a public owner by a bidder at the time of submission of a bid on a public works project. The use of bid bonds eliminates frivolous bidders from the process and provides protection to the owner in the event the successful bidder fails to enter into the contract.

As a general rule, if the principal is the successful bidder on a contract and then accepts the contract and provides whatever performance and payment bonds the contract may require, the bid bond is nullified or the surety on the bid bond is otherwise discharged. If, however, the obligee accepts the principal's bid but the principal fails to enter into a contract with the obligee, fails to provide bonds required under the contract, or otherwise reneges on the terms

---

3. Id. § 1 cmt. d:

In many contexts, it is common to have the suretyship relationship created by a “surety bond.” Typically, in such a case, the principal obligor alone has a separate duty to the obligee, and the principal obligor and the secondary obligor both execute a “bond” pursuant to which they each agree to be liable (often, up to a stated limit) in the event of the default of the principal obligor as to the separate duty. In that case, the obligation of the secondary obligor on the surety bond is the secondary obligation, while the obligations of the principal obligor on the surety bond and on the separate duty together constitute the underlying obligation. Thus, while the principal obligor is liable on the same contract that creates the secondary obligation, the principal obligor’s duty arising from its status as a party to the contract is part of the underlying obligation.

of its bid (such as the bid price), the principal may then be liable to the obligee for damages, which the obligee may seek from the bid bond. The measure of those damages depends on the language of the bond. In the typical case, such damages consist of the difference between the principal's bid and the next lowest bid. There are some bid bonds that are forfeiture bonds, meaning that the obligee receives the full amount of the bond if the bidder fails to enter into the contract, regardless of the actual difference between the principal’s bid and the next lowest bid. The damages may also include any costs associated with reprocurement. The surety’s liability for such damages is generally limited to the penal sum of the bond, which tends to fall between 5 percent and 10 percent of the bid price.

2. Performance Bonds

A performance bond is a unique form of security for the construction industry that provides risk protection in the event of contractual nonperformance. The common description of a surety bond is that it is a “tripartite” relationship, in which one party (the surety) agrees to perform the obligations of another party (the principal) for the benefit of a third party (the obligee). In the general contract context, the performance bond secures the contractor's promise to the project owner to perform the contract in accordance with its terms and conditions, at the agreed-upon price and in compliance with the agreed-upon schedule.

Often, general contractors will require their subcontractors to provide performance bonds guaranteeing performance of the subcontract. Some states require such bonds but more often than not, the decision whether to require subcontractor bonds is made by the general contractor or its surety or bank. Because it can be difficult to obtain surety credit for construction projects, there have been concerns over the years that bonding requirements imposed on subcontractors either by the project owner or general contractors inhibit the use of small or economically disadvantaged subcontractors who cannot obtain bonding, thus, artificially excluding them from participating in significant construction projects. The Surety & Fidelity Association of America (SFAA), the federal government, and various large owners, such as the Los Angeles Unified School District, all have programs directed at fostering greater access by disadvantaged entities to the surety market.

Sureties charge a premium to issue their bonds, almost always consisting of a one-time charge at the beginning of the project. In the construction setting, the premium is a percentage of the contract price, anywhere between 1 percent and 5 percent, often with tiers of pricing depending upon the size of the bond and the financial status of the principal. Sureties typically do not charge a premium for a bid bond (though some charge a nominal fee), notwithstanding that their exposure in doing so could be as much as 10 percent of the bid price. While sureties charge for the performance bond, there is usually no additional charge for the issuance of the payment bond that accompanies the performance
bond. The surety charges additional premium on change orders based on the value of each change order because the surety is guaranteeing performance of those change orders. The actual penal sum of the bond does not increase with change orders unless the underlying bonded contract or the bond itself calls for such an increase.

Suretyship is considered an extension of credit or a financial accommodation. Thus, in the event of a contractor default, the principal is required to reimburse the surety for all losses arising out of the default. That right of reimbursement is based in common law. In California, it is a statutory right as well. Over the years, the surety industry has required indemnity agreements from the principal as well as those affiliated with the principal as a condition of issuing bonds, transforming the right of reimbursement from common law to contractual. The bond principal and other third-party indemnitors willing to add their credit worthiness to assist the principal in obtaining bonds will be required to execute the general indemnity agreement (GIA). Under this indemnity instrument, among many other provisions, the principal and indemnitors commit to provide collateral to the surety in an amount sufficient to cover the surety’s potential liability and to reimburse a performing surety’s actual losses and expenses. Most GIAs also contain a conditional assignment to the surety of materials and equipment left on the project and any contractual rights related to the bonded contract as well as appointment of the surety as the principal’s attorney-in-fact to collect the remaining contract funds. In essence, the purpose of a performance bond is to transfer the risk of a contractor default from the project owner to the surety and, ultimately, back to the contractor to the extent that the contractor must indemnify the surety.

This tripartite relationship distinguishes a surety performance bond from other types of performance risk protection. Although under a performance bond the surety agrees to take on the risk of the principal’s default, ultimately the surety anticipates a zero loss, because it expects to be reimbursed for any loss by its principal. In contrast, under an insurance agreement, the insurer expects to incur losses. An insurance policy is a two-party agreement where the

5. Cal. Civ. Code § 2847 (“If a surety satisfies the principal obligation, or any part thereof, whether with or without legal proceedings, the principal is bound to reimburse what he has disbursed, including necessary costs and expenses. . . .”).

6. The obligation to indemnify typically includes reimbursement of any engineering, accounting, or legal expenses incurred by the surety in performing the principal’s obligation.

7. Some critics of surety bonds on construction projects bemoan the fact that because of the reimbursement and indemnity obligations, sureties do not independently evaluate and act on surety bond claims, as to do so would require the bond principal and its personal indemnitors to reimburse the surety for claims they have determined are invalid. However, the vast majority of surety losses arise when the bond principal is out of or close to being out of business and is not likely to have the wherewithal to reimburse the surety in any event, let alone affect the surety’s decision whether or not to act on a claim.
insurer agrees to pay the insured directly for any losses incurred in exchange for the payment of a premium by the insured.

Similarly, a performance bond itself is typically not an indemnity contract. Under an indemnity instrument, the indemnitor agrees to reimburse the indemnitee for any loss incurred as a result of a specified default. In contrast, a performance bond ensures that the surety will step into the shoes of the principal to complete performance. Although the performance bond guarantees the completion of the project, it does not guarantee the cost of completion and the surety is only obligated up to the penal sum of the bond.

3. *Payment Bonds*

The purpose of a payment bond is to provide security for suppliers of labor and material on a project so that they are guaranteed a source of funds for payment in the event of nonpayment by the contractor. The mechanics lien also serves this purpose in the private sector; however, mechanics liens are not available on public projects because of the concept of sovereign immunity. In place of mechanics liens on public contracts, a subcontractor or supplier can ordinarily file a stop notice with the owner that enables the subcontractor or supplier to obtain payment out of undisbursed contract funds. Stop notices are discussed in more detail in chapters 10 and 11. In contrast to private contracts, however, public contracts generally require by statute that contractors procure payment bonds. Some private owners, desirous of avoiding liens on their property, have also adopted the practice of requiring payment bonds for private contracts. Many states have supported the use of payment bonds in private contracts and have enacted statutes limiting parties' abilities to use mechanics liens if a payment bond is available and recorded. Exactly who may recover on a payment bond, the extent of the available recovery, and the procedure for doing so varies by statute and by the terms of the payment bond itself.

4. *Supply or Material Bonds*

Supply or material bonds guarantee that a material supplier will provide the materials that are the subject of its purchase order. They are essentially performance bonds applicable to material purchase orders. Few states require supply bonds. Neither does the federal government. However, supply or material bonds can be particularly desirable especially if the materials needed are of a unique nature or are difficult or expensive to obtain. The prime contract between the public owner and the prime contractor typically does not require supply or material bonds but a general contractor may require them from its subcontractors or suppliers.

---

8. Stop notices are alternatively referred to as stop payment notices.
II. Surety Bonds and Bond Alternatives

5. Warranty or Maintenance Bonds
The purpose of a warranty or maintenance bond is to provide assurance during a predetermined post-completion period that the contractor will correct or replace any work or materials that are determined to be defective or not in compliance with the project requirements. The bond typically has a financial limit, or penal sum, of approximately 10 percent of the final contract amount. Such bonds are not typically required by law but something that a private or public owner may require with the cost of such bonds being passed on to the owner.

6. Release and Discharge Bonds
Most states also provide a property owner with one or more methods of avoiding mechanics lien foreclosure. In addition, or as an alternative to such owner remedies, most states also allow an owner or other interested person to remove a mechanics lien from real property by providing a lien discharge bond in favor of the lien claimant. Of course, mechanics liens are not permitted on public property. Instead, most jurisdictions allow for stop notices on public works projects, which allow unpaid subcontractors and suppliers to encumber the unpaid contract balances held by the public owner. A discharge bond may be provided by the general contractor to release the stop notice allowing the public owner to pay the general contractor without risk of liability to the subcontractor or supplier for failing to honor the stop notice. Many public works contracts require that general contractors post release bonds to discharge stop notices where requested by the owner and, where the general contractor fails to do so, the general contract may entitle the public owner to obtain the discharge bond and to offset the cost of the bond against contract funds otherwise payable to the general contractor.

10. For example, Kansas allows the owner to obtain a payment bond at any time to avoid mechanics lien liability. Kan. Stat. Ann. § 60-1110.
13. See, e.g., id. § 9364.
Thus, the purpose of the lien discharge bond is usually twofold. First, the lien discharge bond protects the property owner in the case of a mechanics lien by removing the lien from the real property, eliminating the owner’s risk that the claimant may foreclose and providing the owner with clear and otherwise marketable title to the property.\textsuperscript{14} Second, the bond protects the lien claimant by taking the place of the property or the contract funds and serving as a form of substitute security should the lien claimant ultimately prevail on its claims.\textsuperscript{15}

D. Alternatives to Bonds

Other forms of performance security are used in the private sector and may be available for use by a public body. The three most common alternatives to surety bonds are letters of credit, parent company guarantees, and contractor default insurance. The question on a public works projects is whether the law permits such security in lieu of otherwise required performance and payment bonds.

1. Letters of Credit

In the construction context, a letter of credit (LOC) is an irrevocable guarantee by a bank, on behalf of a contractor, that the bank will meet upon an owner’s demand for payment. The owner may call on the LOC on demand and generally without proof of any default by the contractor—documentation merely indicating a default is typically sufficient. Once the owner calls on the LOC, the LOC becomes a cash payment to the owner and an interest-bearing loan to the contractor.

Significant differences exist between letters of credit and surety bonds. Unlike surety bonds, banks require that letters of credit be secured by collateral, preferably liquid assets. Letters of credit therefore reduce a contractor’s available line of credit and constitute a contingent liability on the contractor’s financial statement. Additionally, the financial institution’s requirement that the LOC be secured by the contractor’s liquid assets has the practical effect of limiting the extent of coverage or the amount of the LOC, as contractors do not want to limit the amount of their working capital, which would otherwise be limited by the amount of outstanding LOCs. For this reason, although an LOC can conceivably be written for any percentage of the underlying contract amount, the typical range is from 5 percent to 10 percent of the contract price.


\textsuperscript{15} Hutnick, 47 Cal. 3d at 463.
II. Surety Bonds and Bond Alternatives

A bank will generally charge a contractor 1 percent of the face value of the LOC for each year of duration as a fee for providing the credit. The contractor will traditionally include the cost of the LOC in the bid price thereby increasing the contract price to the owner.

a. State Legislation Permitting LOCs as an Alternative to Surety Bonds

Some states expressly allow contractors to provide an LOC as an alternative to posting a statutory performance or payment bond on public works projects. The statutes allowing for such a substitution, however, generally restrict the extent to which an LOC is an available option. For example, in Florida, an LOC may be substituted for a surety bond, but the required value of the LOC is subject to the determination of the appropriate state, county, city, or other political subdivision. Similarly, ten other states permit the use of letters of credit in lieu of performance bonds in certain circumstances: Illinois, Indiana, Maine, Minnesota, Montana, Oklahoma, Pennsylvania, South Carolina, Tennessee, and Virginia.

16. Fla. Stat. § 255.05(7).
17. 30 Ill. Comp. Stat. 550/1 (for public works projects under $100,000 that do not involve use of motor tax funds, federal-aid funds, or other funds received from the state, political subdivisions—but not the state—may accept letters of credit).
18. Ind. Code § 36-1-12-14(h) (political subdivisions, but not the state, may accept an LOC from an Indiana financial institution for public works projects under $250,000, other than those involving highways, roads, streets, alleys, bridges, and appurtenant structures situated on streets, alleys, and dedicated highway rights-of-way).
20. Minn. Stat. § 574.261(1a) (LOC as an alternative to performance bonds permitted on public works projects of under $50,000 at the public body’s discretion).
24. S.C. Code Ann. § 11-35-3037 (LOC in an amount appropriate to cover the cost to the governmental body of preventing infrastructure service interruptions for a period up to 12 months may be required, at the government’s discretion, to secure timely, faithful, and uninterrupted provision of operations and maintenance services associated with public works projects).
25. Tenn. Code Ann. § 12-4-201(c)(4) (LOC, issued by a federally insured bank or savings and loan association that maintains its principal office or a branch office in Tennessee, permitted as an alternative to surety bonds, subject to terms approved by the contracting official).
26. Va. Code Ann. § 2.2-4338(B) (LOC as an alternative to bonds permitted only upon approval of the attorney general (or the attorney for the political subdivision, in the case of political subdivisions), only if it is equal in amount to the bonds it is substituting, and only upon a determination that it affords protection to the public body equivalent to a corporate surety bond).
In addition, several other states more generally authorize “other security” or “alternative security” in lieu of surety bonds on public works projects. Such “other security” or “alternative security” is subject to the caveat that it must be acceptable to the state or other governmental entity overseeing the project. Although letters of credit are not specifically mentioned, they are conceivably a potential substitute for surety bonds so long as they are acceptable to the government contracting entity with the discretion to decide such matters.

Using LOCs as an alternative to bonding is considered more of a European model, but the method comes with risks. As discussed above, if a contractor were to default, the owner potentially has the liquidity to fund completion of the work, but has no ready third-party expert (i.e., the bond surety) to complete the project.

b. Cost Considerations for Owners—LOCs versus Surety Bonds
The factors affecting the price of obtaining LOCs are not as variable and/or subjective as the pricing for bond premiums and are typically set by respective bank rates and policies. The general pricing structure will be 1 percent of the LOC amount, the LOC amount typically being 10 percent of the contract value. On a $500 million project, the LOC will likely be set at $50 million value, resulting in a cost for the LOC of approximately $500,000. The bond premium set by the surety is determined by a number of factors and ranges from 1 percent to 5 percent of the contract price. On the same hypothetical $500 million project, the bond premium could be $5 million at the lower end of the pricing structure. Factors affecting bond premiums will be the contract value, the bond amount, the contract type, the state, the surety company’s filed rate, the principal’s credit and/or financial standing, past job history, current work on hand, administrative or other processing costs incurred by the surety in addition to any fees charged by a surety agent or broker.27

2. Parent/Corporate Guarantees
Another potential alternative to a surety bond is a parent or corporate guarantee. In the construction context, a “parent company guarantee” (PCG) generally refers to an agreement by a contractor’s parent company or holding company to be held jointly responsible for completion of the contractor’s construction contract. Despite the name, the guarantor need not be the parent company of the contractor.

PCGs are commonly used outside of the United States because foreign performance bonds tend to only cover 10 percent of the total contract amount. In the United States, however, where performance bonds typically cover 100 percent

27. Commissions are typically paid to licensed agents and agencies when issuing performance bonds. A commission is a predetermined percentage of the premium as per an agency agreement between surety and agent. Agency commissions can run from 25 percent to 40 percent of the bond premium.
of the total contract amount, PCGs are used less frequently. The PCG benefits a project owner in that it generally does not cost much or anything as contrasted with bond premium that increases as the contract price increases. Additionally, unlike a surety bond, which usually caps liability at the amount of the penal sum of the bond, a PCG generally has no cap on liability. In theory, a PCG provides a project owner with “deeper pockets” to reach into if the contractor defaults and becomes insolvent. This benefit is tempered by the fact that a PCG is only as strong as the financial strength of the parent corporation.

The Miller Act does not permit PCGs as an alternative to surety bonds for either performance bonds or payment bonds on federal projects. Likewise, they are not widely offered as alternatives to surety bonds under state bonding requirements. Hence, their use in public contracting is extremely limited, at least as the first line of recourse for the public owner. Of course, a public owner may be able to request or require a PCG under certain circumstances in addition to performance and payment bonds.

3. Subcontractor Default Insurance

In addition to using LOCs and PCGs in lieu of (on in addition to) surety bonds, a third form of alternate security has emerged on the market, commonly known as “subcontractor default insurance” (SDI). SDI is an alternative product to subcontractor performance bonds that provides coverage for the general contractor against a “catastrophic” subcontractor default. SDI is not an alternative to general contractor performance bonds or to any form of payment bond. Since subcontractor performance bonds typically are not statutorily required on state and local projects, a public owner may on its own accord require subcontractor performance bonds or SDI but this does not eliminate the statutory requirements of performance and payment bonds from the prime contractor. Moreover, even if a public owner does not require SDI, some larger contractors will require performance bonds from certain subcontractors or put in place SDI for the project though not required by the public owner.

SDI emerged approximately 15 years ago as a result of perceived deficiencies with subcontractor performance bonds. SDI is a traditional two-party agreement between the contractor and insurance company, with the contractor procuring the policy as the named insured. The general contractor is responsible for prequalifying its subcontractors and suppliers into the program. Coverage commences upon a formal declaration of default, but the general contractor is not required to terminate the subcontract. The direct costs of default that are typically covered under the policy include costs incurred in fulfilling the defaulted subcontractor’s contractual obligations, correcting nonconforming work, and attorneys’ fees and consultant fees to remedy the default. Indirect

costs that are covered include delay damages, acceleration costs, and extended overhead. SDI policies usually have very large deductibles as SDI is meant to protect the prime contractor against catastrophic subcontractor default and not defaults of lesser consequence to the prime contractor and the project.

III. Development of Statutory Requirements for Surety Bonds on Public Construction Projects

A. The Heard Act: Precursor to the Miller Act

In response to an alarming failure rate of private companies providing construction services to the federal government in the late 1800s and concerns over the inequity created by the lack of an adequate remedy for persons furnishing labor and materials on federal projects, Congress enacted legislation in 1894 requiring contractors to provide corporate surety bonds to provide protection against such failures. The Heard Act required a single bond to cover both performance of the contract and payment of subcontractors, laborers, and suppliers. It imposed certain limitations on payments to claimants, such as requiring them to wait until six months after final payment on the prime contract before they could make a claim on the bond, regardless of when they had completed their respective portion of the project. The procedural limitations caused delay and placed a substantial burden upon these second-tier providers, who often could not afford to remain unpaid for so long. Consequently, Congress reexamined the Heard Act and, in 1935, replaced it with the Miller Act.

B. The Miller Act

In general, the Miller Act requires contractors on federal public works projects “for the construction, alteration, or repair of any public building or public work” exceeding $150,000 to post a performance bond and a payment bond in an amount equivalent to 100 percent of the contract value. Unlike the Heard Act, the Miller Act requires separate bonds for performance and payment. The federal government retained its exclusive right to proceed against the


31. The Miller Act sets the threshold at $100,000, but implementing regulations, as discussed more fully below in the next section, have increased the threshold to $150,000. In addition, the Miller Act requires alternatives to payment bonds for payment protection for contracts that are more than $25,000 but not more than $100,000. 40 U.S.C. § 3132(a). Although the Miller Act establishes the foregoing bonding requirements, it also expressly does not limit the authority of a contracting officer to require a performance bond or other security in addition to that specified in the Act. Id. § 3131(e).
III. Development of Statutory Requirements for Surety Bonds

performance bond, but those covered by the payment bond (i.e., subcontractors, labors, and suppliers) are no longer required to wait until long after the project is completed to pursue claims against the payment bond. This measure preserves the federal government's interest in performance bond protection for its projects while securing a funding source for prompt payment to subcontractors, laborers, and suppliers in the case of insolvency or default by the contractor.

The Miller Act itself does not mandate a particular bond form to be used, nor does it set the threshold requirements for surety bonds. These requirements are established by part 28 of the Federal Acquisition Regulations (FAR). Effective October 1, 2010, part 28 of the FAR raised the Miller Act's $100,000 threshold for requiring performance bonds and payment bonds to $150,000. It also raised the range for requiring payment bond alternatives from $25,000 to $100,000 to a new range of $30,000 to $150,000.

In addition to amending the Miller Act's threshold amounts, part 28 of the FAR clarifies the penal sum required under each type of bond. For contracts over $150,000, FAR requirements dictate that, unless the contracting officer determines a lesser amount adequately protects government interests, performance bonds and payment bonds must equal 100 percent of the original contract price. The regulations also direct that the bonds must continue to increase in amount to maintain that 100 percent protection throughout any subsequent increases in the contract price, such as increases through change orders. Reductions in the payment bond amount can only occur if the contracting officer makes a written determination, supported by specific findings, that a 100 percent payment bond is impractical. Furthermore, the payment bond cannot be reduced to less than the amount of the performance bond.

The FAR also permits and defines acceptable forms of "alternative payment protection" to be an irrevocable LOC; an escrow agreement in which a federally insured financial institution serves as the escrow agent, distributing payments received from the government to the suppliers of labor and material; certificates of deposit; certain United States bonds or notes, together with a duly executed power of attorney and agreement authorizing the collection or sale of such bonds or notes in the event the principal defaults; certified checks, cashier's checks, bank drafts, or U.S. Postal Service money orders drawn to the order of the appropriate federal agency; or a cash deposit. The FAR reflects a preference for irrevocable letters of credit as an alternate payment method to surety bonds, noting that a contracting officer should give "particular consideration to inclusion of an irrevocable letter of credit as one of the selected alternatives."
C. Little Miller Acts

Once the federal government began adopting bonding requirements for its construction projects, state governments soon followed suit. Shortly after enactment of the Heard Act in 1894, state legislatures enacted similar statutes, which came to be known as “Little Heard Acts.” Upon replacement of the Heard Act with the Miller Act, the state statutes were correspondingly re-nicknamed “Little Miller Acts.” Despite all falling under the same nickname, the states’ respective Little Miller Acts differ to varying degrees from each other and do not all contain the same or similar provisions and requirements as the Miller Act.

By and large, however, state bonding requirements for public works projects tend to be similar to the federal requirements. Thirty-two states require 100 percent performance and payment bonds for public works projects exceeding certain threshold contract prices. The contract price thresholds that trigger the requirement to provide payment and performance bonds vary from requiring bonds on all contracts regardless of price (e.g., Idaho, Ohio, and Washington) to $200,000 (e.g., state public works projects in New Jersey). The bonding thresholds in 28 of the 32 states requiring 100 percent bonding fall between $50,000 and $100,000. Currently three states do not require performance bonds for all public projects, although each of these states permits the use of performance bonds.

D. Consequences for Owner Noncompliance with Statutory Bond Requirements

While the dictates of the Miller Act are mandatory, the federal government's failure to obtain the required payment and performance bonds does not render

---

34. Under the Miller Act and those state “Little Miller Acts” that require performance bonds, only the prime contractor, in privity with the public owner, is required to post the bond. In the event the prime contractor requires some or all of its subcontractors to provide bonds, those bonds are private bonds, not governed by the Miller Act or a Little Miller Act.

35. Some states, such as Connecticut, Massachusetts, and Missouri, differ from the federal model in that they do not require performance bonds on public works projects. Indeed, while all public works projects in California require payment bonds (Cal. Civ. Code § 9550), California has a patchwork of requirements for performance bonds, depending on the public entity, all of which is set out in its Public Contract Code. See, e.g., Cal. Pub. Cont. Code §§ 10221 (state entities), 10821 (California State University), 20129 (counties), 20168.5 (cities), 20192 (municipal utility districts), 20204.2 (public utility districts).

the contract illegal or unenforceable. For example, where the federal government fails to obtain the required payment bond in the first instance, such failure does not adversely impact the government’s ability to offset costs incurred under the unbonded contract against claims by a payment bond surety for the unpaid contract balance held by the government on another project that was bonded. 37 Similarly, the failure of the federal government to obtain required bonds does not create an independent right for unpaid subcontractors to sue the government or assert equitable liens to funds in the hands of the government. 38

A different result may occur with regard to the failure of a public body to obtain Little Miller Act bonds. Public entities can have a statutory duty to secure a payment bond on public works projects. 39 If a public entity is required to but fails to obtain bonds in connection with a public works project, it may be held liable to would-be bond claimants. 40 There may also be consequences for general contractors that fail to procure bonds. The failure to provide a required bond may be considered a breach, justifying termination of the contract by the obligee (i.e., public owner). 41 In some states, the public entity is statutorily forbidden from making payments to the general contractor if that contractor

38. U.S. Dep’t of the Army v. Blue Fox, Inc., 119 S. Ct. 687 (1999) (sovereign immunity barred suit by unpaid subcontractor seeking to enforce equitable lien against the government even where the U.S. Small Business Administration failed to procure required Miller Act bonds). In Kennedy Electric Co. v. United States Postal Service, 367 F. Supp. 828 (D. Co. 1973), aff’d, 508 F.2d 954 (10th Cir. 1974), the court held that an unpaid subcontractor could bring suit against the U.S.P.S. and impose an equitable lien equal to the value of labor and materials furnished on undisbursed and wrongfully disbursed funds. The decision rested, in part, on a general “sue and be sued” clause in the statute regulating the Postal Service that authorizes all civil legal procedures, including garnishment, against the Postal Service. A similar claim by an unpaid subcontractor against the SBA was rejected in J.C. Driskill, Inc. v. Abdnor, 901 F.2d 383 (4th Cir. 1990) because the SBA implementing statute specifically limits the waiver of sovereign immunity and prohibits entry of attachments, injunctions, garnishments “or other similar Process” against the SBA.
39. See, e.g., Cal. Civ. Code § 9550 (“A direct contractor that is awarded a public works contract involving an expenditure in excess of twenty-five thousand dollars ($25,000) shall, before commencement of work, give a payment bond to and approved by the officer or public entity by whom the contract was awarded. . . .”).
40. N.V. Heathhorn, Inc. v. County of San Mateo, 126 Cal. App. 4th 1526, 1529–30 (2005) (county held liable to a subcontractor under California Government Tort Claims Act for failing to require the general contractor on a public works project to provide a payment bond).
41. Airport Indus. Park, Inc. v. United States, 59 Fed. Cl. 332 (Cl. Ct. 2004) (government justified in terminating contract for default following contractor’s failure to provide an adequate surety bond after surety that issued original bond became insolvent).
fails to provide a bond on a public works project. Furthermore, if the general contractor fails to procure a bond, ostensible bond claimants may seek alternative remedies, such as stop payment notices or direct actions against the public entity owner or against the architect who certified payments to the general contractor knowing that the required bonds were not provided.

IV. Pursuing a Claim on a Bid Bond

Pursuing a claim on a bid bond is straightforward. If the bidder fails or refuses to enter into the contract and to provide performance and payment bonds in connection with that contract after the public agency has awarded the contract to the bidder, the public agency can simply demand payment from the surety. As noted above, if the bond is a forfeiture bond, the surety must pay the full amount of the bond penalty. If the bond covers the differential between the awarded bid price and the next lowest bidder, that is the amount the surety must pay. If the bid bond or the statute requiring the bond allows for additional amounts to be recovered against the bid bond, such as any expenses arising out

42. See, e.g., Cal. Civ. Code § 9552 (if a payment bond is not given and approved as required by section 9550, neither the public entity awarding the public works contract nor any officer of the public entity shall audit, allow, or pay a stop payment notice).

43. Id.; see also Ga. Code Ann. § 13-10-61 (“If a payment bond or security deposit is not taken in the manner and form required in this article, the corporation or body for which work is done under the contract shall be liable to all subcontractors and to all persons supplying labor, materials, machinery, or equipment to the contractor or subcontractor thereunder for any loss resulting to them from such failure.”); Elec. Electronic Control, Inc. v. Los Angeles Unified Sch. Dist., 126 Cal. App. 4th 601, 611–12 (2005) (“If a public entity is liable to an unpaid subcontractor for proceeding with a public works contract when it has failed to make certain the contractor provided a payment bond entirely.”); Holmen Concrete Prods. Co. v. Hardy Constr. Co., 686 N.W.2d 705 (Wis. App. 2004) (municipality liable to unpaid subcontractors for failing to ensure contractor furnished a proper bond); Kammer Asphalt Paving Co. v. E. China Twp. Schs., 504 N.W.2d 635 (Mich. 1993) (subcontractor entitled to pursue unjust enrichment claim against school district after school district failed to ensure general contractor provided valid bonds). But see O & G Indus., Inc. v. Town of New Milford, 617 A.2d 938 (Conn. App. Ct. 1992), aff’d, 640 A.2d 110 (Conn. 1994) (town not liable to subcontractor for failing to ensure general contractor procured required payment bond); accord Haskell Lemon Constr. Co. v. Indep. Sch. Dist. No. 12 of Edmond, 589 P.2d 677 (Okla. 1979) (neither school board nor school board members liable to subcontractor for failing to procure statutorily required payment bond).

44. Boren v. Thompson & Assoc., 999 P.2d 438 (Okla. 2000) (public policy prohibiting subcontractor from recovering from public body for failing to procure required payment bond inapplicable in action against architect for negligently certifying payments to the contractor with knowledge that contractor had failed to provide required bond).
of the failure of the bond principal to enter into the contract, then the surety must pay those amounts as well. If the surety fails to pay upon receipt of a demand with proper supporting documentation, then the public agency can pursue its typical remedies, such as filing suit.45

V. Pursuing Remedies against a Performance Bond Surety

The critical and primary purpose of a performance bond is to provide security for the owner that its project will be completed timely in accordance with the plans and specifications for the agreed-upon price. Sometimes, however, the actions of the owner can impede or frustrate this anticipated successful conclusion, even to the point that the surety refuses to complete the project. Even where the surety completes the work, the impact of a contractor default can cripple a project, inflicting tremendous delay in completion and incurrence of hidden, unrecoverable costs. The owner must evaluate and consider all of these potential outcomes as it is planning the project, and during administration.

Defaults by prime contractors occur with far less frequency than defaults by subcontractors. This generally is due to the rigorous prescreening and qualification process to which prime contractors on public contracts are subjected, either by owners who are able to prequalify or by sureties as they underwrite the contractor’s surety program. This is particularly true on the high-dollar, complicated projects that are performed through design-build, where only larger, better-financed, and better-run contractors compete. As outlined in one study on contractor default, it is not usually one single factor that leads to default, but “a combination of factors that interacted, causing company performance to spiral toward inevitable bankruptcy.”46 This combination of factors may be because “[c]onstruction is a dynamic and risky business,” and “the causes of contractor failure are similarly dynamic and involve a number of difficult-to-manage risk factors.”47

Notwithstanding the fact that a combination of events could combine to create a default, there are several common problems that arise on a construction

47. Id.
project that may trigger an owner’s decision to default terminate a contractor: (1) failure to pay subcontractors and suppliers; (2) substantial failure to maintain the progress of the work, including providing less manpower than expected or promised; (3) repeated violation of permits, laws, or regulations; or (4) falsification of certifications, such as payment applications or testing reports. The key factor is often whether the problem is a “one-off” issue, or is a repeated violation that gives the owner reasonable concerns that the contractor is incapable of completing the work successfully.

In the event an owner declares the contractor to be in default and gives notice to the surety, the performance bond form usually will enumerate the surety’s performance options. However, before the surety becomes obligated to step in and complete performance, the surety must ensure that the obligee has complied with all the preconditions to the surety’s performance. These conditions are cumulative, meaning that the obligee must comply with all of them before the surety’s obligation to perform is triggered. The failure to comply with any of the preconditions may discharge the surety’s obligations to perform.48

A. Satisfaction of Conditions Precedent

1. No Owner Default

If the owner believes that the contractor is in material breach of the contract and determines to terminate the contract and seek performance from the surety, the owner must ensure compliance with the contract and bond procedural requirements to trigger the liability of the surety. The operative point is somewhat simple. The law does not favor “forfeiture,” and expects that parties who have entered into contracts will be allowed to complete these contracts. Therefore, owners should view termination for default as a remedy of last resort.

As a starting point, the owner should confirm that it has not materially breached the contract, as most commercially available bond forms are conditioned upon the owner’s faithful performance of its contractual duties. Typical areas of concern for the owner to evaluate its compliance with the contract include confirming (1) prompt and proper payments to the contractor; (2) the sufficiency of the plans and specifications; (3) appropriate owner response to

V. Pursuing Remedies against a Performance Bond Surety

contractor claims and proposed change order requests that assert significant impacts to either or both time and cost of the work; and (4) involvement of or creation by the owner of situations or conditions creating cardinal changes to the performance of the work.

Next, 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, if the operative bond is an American Institute of Architects (AIA) A312 Performance Bond, the owner must, in addition to contract notices, 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.

2. Notice of Intent to Default

In order to trigger the liability of the surety, each of the standardized performance bond forms, with the exception of the AIA A311 form, requires that the obligee notify both the principal and surety that it is considering declaring a default. The purpose of the pre-default notice is twofold. First, it provides the surety with an early opportunity to evaluate the alleged default. To make this determination, the surety must assess and distinguish between a “breach” and a “default.” Although the terms are often used interchangeably, in this context there is a clear distinction because not every “breach” constitutes a “default.” The Fifth Circuit articulated the difference as follows:

Although the terms breach and default are sometimes used interchangeably, their meanings are distinct in construction suretyship law. Not every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it. To constitute a legal default, there must be (1) material breach or series of breaches (2) of such magnitude that the obligee is justified in terminating the contract. Usually, the principal is unable to complete the project, leaving the termination of the contract the obligee’s only option.

49. See, e.g., AIA Document A312-1984, Performance Bond, ¶ 3 (1984); see also Walter Concrete Constr. Corp. v. Lederle Labs., 99 N.Y.2d 603, 605 (2003) (“Had the parties to the contract desired notice of default as a precursor to liability under the bond, they could have elected to issue the more specific AIA–312, which by its terms requires pre-default notification be given to the contractor and surety by the owner.”). The AIA A312-1984 replaced the prior bond form, AIA A311, in 1984. The AIA A312 was updated in 2010 by the A312-2010.

50. L&A Contracting Co. v. S. Concrete Servs., Inc., 17 F.3d 106, 110 (5th Cir. 1994).
In order to determine whether a breach is material, courts will often refer to the Restatement (Second) of Contracts § 241. While the Restatement provides a list of factors to consider when determining whether there has been a material breach of the contract, ultimately it is a question of fact that is determined by the facts and circumstances on a case-by-case basis.

The second purpose of the pre-default notice is to provide the contractor, owner, and surety an opportunity to discuss different options to cure the performance issues without having the owner formally declare a default and termination. Once the owner declares a contractor default, the owner is inevitably going to incur additional costs. Therefore, it is critical that following the issuance of the pre-default notice, the obligee cooperate with the surety in its investigation of the bond claim. This involves providing the surety with access to the project site, personnel, and records. If the obligee fails to give proper notice to the surety specifically describing the principal’s conduct before terminating the principal for default, that failure can discharge the surety’s bond obligations.

As a general principle, an obligee must give notice of a principal’s default to the surety so that the surety has an opportunity to cure the default. Requiring notice is a sound rule designed to allow the defaulting party to repair the defective work, to reduce the damages, to avoid additional defective

51. Restatement (Second) of Contracts § 241 (Am. Law Inst. 1981): 
In determining whether a failure to render or to offer performance is material, the following circumstances are significant: (a) the extent to which the injured party will be deprived of the benefit which he reasonably expected; (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived; (c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture; (d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances; (e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.


54. Hunt Constr. Grp., 542 F. Supp. 2d at 96 (“As soon as [obligee] knew that [principal] would not complete the job on time, it had an obligation to decide whether to declare [principal] in default and notify the Sureties (who might have done something to aid [principal] in speeding up the work, whether by hiring more trucks, more workers, more oversight, or whatever, in its judgment, would assist the [principal]).”).
performance, and to promote the informal settlement of disputes.55 Thus, even when contracting parties have not included notice language in their contract, some courts have imposed upon contractors the duty to give subcontractors notice and an opportunity to cure before terminating the contract for faulty performance.56 Most public contracts expressly require notice and an opportunity to cure be provided to contractors though there may be exceptions. Termination provisions are discussed in chapter 7.

3. Pre-Default Meeting
As set forth above, some bond forms such as the AIA A312-1984, require the obligee to arrange for a meeting between the obligee, surety, and principal prior to declaring the principal in default or provide the option for the obligee to request such a meeting. Even in circumstances where the bond does not make such a meeting a condition precedent to the surety’s performance obligations under the bond, arranging for such a meeting has tangible benefits for all three parties. The pre-default meeting allows the obligee to discuss its concerns with the surety and the principal. This allows both the surety and principal an opportunity to address these concerns and possibly arrange a cure of the principal’s default. The meeting also allows the surety to more expeditiously complete its investigation into the validity and circumstances surrounding the default. Often during the meeting, the surety can function as a mediator to try to resolve the disputes between the obligee and principal with the goal of continuing progress on the project.

4. Notice of Default
If the performance related issues are not resolved following the pre-default notice and meeting, the A312-1984 and A312-2010 bond forms require that the obligee expressly declare a default and terminate the contractor. The purpose of this requirement is to provide a clear directive for the surety to step in and arrange for completion of the bonded work. Additionally, the obligee must satisfy any default and termination provisions contained in the underlying bonded contract.57 The surety may be released from any obligations

---

57. A typical contractual notice provision can be found in section 14.2.2 of the AIA 201-2007 General Conditions. Section 14.2.2 provides that if the owner determines that there is justification to terminate the contractor for cause, “the Owner, upon certification by the Initial Decision Maker that sufficient cause exists to justify such action, may without prejudice to any other rights or remedies of the Owner and after giving the Contractor and the Contractor’s surety, if any, seven days’ written notice, terminate employment of the Contractor.”
under the performance bond where the obligee completes the principal’s work using another contractor without providing the principal the requisite advance notice of default and opportunity to cure required under the construction contract.\


59. The notice must state that the contractor is being terminated for cause, the effective date of termination, the extent of termination, any special instructions, and the steps the contractor should take to minimize the impact of the termination. The contracting officer is also required to provide the notice to the surety.

60. Elm Haven Constr. Ltd. P’ship v. Neri Constr., LLC, 376 F.3d 96 (2d Cir. 2004) (despite providing multiple notices to the contractor that it was failing to perform and providing notice to the surety that it intended to retain another contractor to complete part of the contractor’s work, the owner failed to provide express notice of default as required under the performance bond); San-Gra Corp., 284 F. Supp. 2d at 177 (where the owner failed to provide a “clear, direct and unequivocal notice of termination” to the contractor, it failed to meet its obligation to provide notice of default); Mid-State Sur. Corp. v. Thrasher Eng’g, Inc., 575 F. Supp. 2d 731 (S. D. W. Va. 2008) (owner did comply with the notice of default provision where it sent the contractor a notice that stated it was “a notification under Article 3.2 of the captioned Performance Bond of a contractor default”).


A311 bond. Therefore, it is important to be aware of not only the terms of the bond, but also how the courts in the jurisdiction the project is located will interpret them.

5. Proffer of Contract Balance to Surety

One of the key requirements for a surety to proceed pursuant to a performance bond claim is to ensure that the bond obligee is prepared to pay the remaining contract balance to the surety, typically as the surety accomplishes project completion. Both of the commonly used AIA Performance Bond forms include this concept in their provisions. The obligee must commit to paying the contract balance and then actually pay the balance, usually in response to payment applications submitted by the surety to the obligee that follows the line item schedule of values that the original bond principal used for billing purposes to the obligee. Often, the surety has its completion contractor prepare two pay applications, one for the surety to submit to the obligee and, the other, the completion contractor’s billing to the surety.

The genesis of the surety’s right to have the obligee pay the remaining contract balance as the project is completed is the doctrine of equitable subrogation. In the absence of a performance bond, if a contractor defaults, the obligee will use and has the right to use any unpaid contract balance to complete the project. If there is a shortfall, the obligee has the right to recover against the contractor. A performance bond protects the obligee from that shortfall. However, the performance bond is not there to provide a windfall to the obligee for those excess costs. Accordingly, pursuant to the doctrine of equitable subrogation, the surety, upon meeting its bond obligation, is entitled to stand in the shoes of the obligee. If the obligee has the right to use the remaining contract balance for project completion, so does the surety. Unless the obligee is justified in withholding some or all of the contract balance, a surety is entitled pursuant to its rights of equitable subrogation to require the obligee to agree to

64. AIA A312-2010 Performance Bond (“If there is no Owner Default under the Construction Contract, the Surety’s obligation under this Bond shall arise after: the Owner has agreed to pay the Balance of the Contract Price in accordance with the terms of the Construction Contract to the Surety or to a contractor selected to perform the Construction Contract”); see also AIA A312-1984 Performance Bond. The ConsensusDocs 260 Performance Bond provides, in relevant part: “Upon making demand on this Bond, the Owner shall make the Contract Balance (the total amount payable by the Owner to the Contractor pursuant to the Contract less amounts properly paid by the Owner to the Contractor) available to the Surety for completion of the Work.”
65. In this way, the obligee is only paying the contract balance but the surety is paying the completion contract in accordance with its completion contract price, which is often more than the remaining contract balance.
pay the remaining contract balance to it as a condition of proceeding forward to meet its performance bond obligations.  

**B. Surety Defenses to Performance Bond Demands**

One of the critical inquiries a surety undertakes following a default and termination is the evaluation of whether the termination is justified, as wrongful termination of the contractor’s right to proceed will relieve the surety of liability under the performance bond. The determination by the surety of whether to admit liability and perform, or deny liability on grounds that the termination was wrongful, is fraught with competing risks, and may be the most difficult of all decisions for the surety. If the surety admits liability and performs, it risks unnecessary loss in the event the termination is later overturned, the possible rupture of its relationship with its principal and indemnitors, and possible claims for tortious extra-contractual damages for bad faith. Wrongly denying liability to the obligee, however, can result in increased losses associated with excess reprocurement costs over which it has no control, legal and consultant fees to litigate with the obligee, potential claims of bad faith by the obligee, and the possible destruction of the relationship with the principal.

---


68. In the federal arena, the FAR provides that in the event a termination for default is later found to be unjustified, the termination converts to a termination for convenience, under which the contractor receives certain payments and the surety’s obligation to perform is discharged. 48 C.F.R. § 52.249-10. Some private contracts contain a similar provision, although the industry-standard AIA, EJCDC, and ConsensusDocs forms do not. Termination for convenience clauses and automatic conversion clauses are common in state and local public works contracts. See chapter 7.


70. Id. at n.8.
There is a perception, whether correct or not, that where a contractor has been terminated for default and contests the propriety of the termination, sureties do not often break ranks with their contractor. This perception has led to frustration by public owners when the surety does not step in to complete the bonded contract and has, over the years, caused some public owners to question the value of performance bonds in cases other than contractor bankruptcy or insolvency. The perception is even greater on the part of general contractors. One of the best solutions in a scenario like this is where the surety agrees to arrange completion pursuant to full reservation of all rights and defenses of all the parties, the owner, the contractor, and the surety, allowing the merits of the termination to be determined at a later time, thereby avoiding as much delay to the construction as possible.

In default termination situations, the surety may assert any number of defenses in response to a demand on the performance bond. A surety is entitled to assert all the defenses of its principal\(^\text{71}\) and, in addition, the surety may have available particular “surety defenses” pursuant to which its obligation to perform has been discharged. These surety defenses include alteration of the bonded contract; changes in the obligee or principal; overpayment; notice; contractual and statutory limitations; and fraud.\(^\text{72}\)

1. Limitations on Suit

The A312-2010 Performance Bond, like many performance bonds, contains an express deadline within which suit must be brought:

Any proceeding, legal or equitable, under this Bond may be instituted in any court of competent jurisdiction in the location in which the work or part of the work is located and shall be instituted within two years after a declaration of Contractor Default or within two years after the Contractor ceased working or within two years after the Surety refuses or fails to perform its obligations under this Bond, whichever occurs first. . . .\(^\text{73}\)

---

\(^{71}\) Restatement (Third) of Suretyship & Guaranty § 34 (“(1) [T]he secondary obligor [surety] may raise as a defense to the secondary obligation any defense of the principal obligor to the underlying obligation except: (a) discharge of the underlying obligation in bankruptcy proceedings; (b) unenforceability of the underlying obligation due to the principal obligor’s lack of capacity.”).

\(^{72}\) Bruner, O’Connor & Haley, supra note 67, at 137–49.

\(^{73}\) A312-2010 Performance Bond § 11. This same provision is contained in the frequently utilized 1984 edition of this bond form, the A312-1984 Performance Bond § 9.
Many courts have enforced performance bond suit limitation provisions.\textsuperscript{74} However, a number of jurisdictions have statutes that proscribe bond limitation periods that are shorter than statutory minimums for suits on bonds\textsuperscript{75} and also prohibit shortening of the limitation period.\textsuperscript{76}

\begin{itemize}
  \item \textsuperscript{74} W. Glenn Speicher & Carol Z. Smith, \textit{The Surety's Obligation to Correct Defective Work and Performance of Warranty Work and Their Effect on Negotiating Terms of Completion}, Constr. Issues 122, 130 n.17 (Jan. 20, 2011) (citing Montreal Funeral Home, Inc. v. Ohio Farmers Ins. Co., 2010 WL 3212993 (Ohio App. Aug. 13, 2010) (obligee’s performance bond claim was barred by the two-year suit limitations period set forth in the bond); Five Star Lodging, Inc. v. Geo. Constr., LLC, 2010 WL 2976524 (Ky. App. July 30, 2010) (as a third-party beneficiary of the bond, the obligee was bound by the limitations provision of the bond); J.B. Mouton & Sons, Inc. v. Alumawall, Inc., 583 So. 2d 157 (La. App. 1991) (suit limitation provision in the bond controlled even though the bond incorporated the subcontract, which had a longer warranty period); Yeshiva Univ. v. Fid. & Deposit Co. of Md., 500 N.Y.S.2d 241 (N.Y. App. Div. 1986) (cause of action against surety was barred by two-year limitation in the bond even though obligee’s claim against the principal was still timely); Town of Pineville v. Atkinson/Dyer/Watson Architects, P.A., 442 S.E.2d 73 (N.C. App. 1994) (bond’s two-year suit limitation provision was enforced even though the claim involved latent defect and two-year period was shorter than applicable statute of limitations would have been). \textit{But see} City of Santa Fe v. Travelers Cas. & Sur. Co., 228 P.3d 483 (N.M. 2010) (time limitations for suit contained in performance bond was unenforceable against a governmental entity unless the governmental entity directly contracted for a shorter time than the applicable statute of limitations)).
  \item \textsuperscript{75} \textit{Id.} at 130 n.18 (citing \textit{Ala. Code} § 6-2-15 (2010) (“Any agreement or stipulation, verbal or written, whereby the time for the commencement of any action is limited to a time less than that prescribed by law for the commencement of such action is void.”); \textit{Fla. Stat.} § 95.03 (2010); \textit{Miss. Code Ann.} § 15-1-5(2010); \textit{Mo. Rev. Stat. Ann.} § 431.030 (2010); \textit{Mont. Code Ann.} § 28-2-708; \textit{N.D. Cent. Code} § 9-08-05 (2010); \textit{Okla. Stat.} tit. 15, § 216 (2010); \textit{S.C. Code Ann.} § 15-3-140 (2010); \textit{Vt. Stat. Ann.} tit. 12, § 465 (2010)); \textit{see also} \textit{Md. Code Ann.}, Ins. § 12-104(a) (prohibiting enforcement of any provision in a surety contract that shortens the applicable period of limitation required by the law of the State of Maryland).
  \item \textsuperscript{76} \textit{Id.} at 130 n.19 (citing \textit{Conn. Gen. Stat.} § 38a-290 (2010) (“No insurance company doing business in this state shall limit the time within which any suit shall be brought against it [on] . . . (2) a construction performance bond to a period of less than three years from the date on which the principal last performed work under the contract.”); \textit{Md. Code Ann.}, Ins. § 12-104(a) (2010) (“A provision in an insurance or surety contract that sets a shorter time to bring an action under or on the insurance contract or surety contract than required by the law of the State when the insurance contract or surety contract is issued or delivered is against State public policy, illegal, and void.”); S.D.\textit{Codified Laws} § 53-9-6 (2010) (“Every provision in a contract restricting a party from enforcing his rights under it by usual legal proceedings in ordinary tribunals, or limiting his time to do so, is void. However, . . . any provision in a surety contract which limits the time for enforcement is valid and enforceable if the limitation of time is not less than two years after the cause of action has accrued.”); \textit{Tex. Civ. Prac. & Rem. Code Ann.} § 16.070(a) (2010) (“A person may not enter a stipulation, contract, or agreement that purports to limit the time in which to bring suit on the stipulation, contract, or agreement to a period shorter than two years.”)).
\end{itemize}
a. Statutory Limitations

Where the bond does not contain a suit limitation period, or a particular state refuses to apply the suit limitation period, the state statute of limitation will apply. Those limitation periods can be long, as in Maryland where the limitation period is 12 years.77

Commencement of the limitation period varies from state to state. Some states start running of the statute on the date when the principal’s work is completed and/or accepted.78 In other states, a discovery rule applies, which has the effect of tolling the running of the limitation period until the injury or damage is “reasonably ascertainable.”79

b. Statutes of Repose

Unlike statutes of limitation, which depend upon the accrual of a cause of action and which may be told by certain events, statutes of repose set forth an absolute deadline after which the claim and the right to pursue it expires. In the construction industry, statutes of repose most typically are a fixed period of time from project completion or acceptance. Statutes of repose add certainty to the construction context because they establish an absolute end

77. Md. Code Ann., Ct. & Jud. Proc. § 5-102(a)(2); Anne Arundel County v. Fid. & Deposit Co. of Md., 336 Md. 282, 284, 648 A.2d 193 (1994) (12-year statute of limitations applicable to specialties applies to actions on performance bonds); see also Hagerstown Elderly Asso. LP v. Hagerstown Elderly Bldg. Assoc. LP, 368 Md. 351, 364, 793 A.2d 579 (Md. 2002) (substituting a statutory 12-year statute of limitations for the two-year limitation contained in the performance bond, and holding that that the limitations on the obligee’s performance bond claim began running on the date that final payment falls due); President & Dir. of Geo. Coll. v. Madden, 505 F. Supp. 557 (D. Md. 1980) (the cause of action accrued with final payment, meaning that the claim against the principal was extinguished under an applicable five-year statute of limitations but the surety remained liable under the longer 12-year limitation period applicable to surety bonds).

78. Speicher & Smith, supra note 74, at 131 n.22 (citing BDI Constr. Co. v. Hartford Fire Ins. Co., 955 So. 2d 576 (Fla. Dist. Ct. App. 2008) (general contractor’s claim against subcontractor’s surety was barred by five-year statute of limitations in that general contractor had accepted subcontractor’s work and made final payment to subcontractor more than five years before filing suit, even though the project was never completed because it was allegedly not constructed in accordance with the plans and specifications); Clark Constr. Grp., Inc. v. Wentworth Plastering of Boca Raton, Inc., 840 So. 2d 357 (Fla. Dist. Ct. App. 2003) (claim against surety was barred by five-year statute of limitations, which ran from time that construction project was completed and accepted); Fed. Ins. Co. v. Sw. Fla. Ret. Ctr., Inc., 707 So. 2d 1119 (Fla. 1998) (claim against surety for latent defects was barred by the statute of limitations, which began to run on the date of acceptance of the project)).

79. Id. at 131–32 n.23 (citing Adesta Comm., Inc. v. Utica Mut. Ins. Co., 2010 WL 1240354 (D. Colo. Mar. 19, 2010) (statute of limitations ran from the date the breach (latent defect) was or should have been discovered); Travelers Indem. Co. v. Hennepin County, 918 F.2d 66 (8th Cir. 1990) (claim against surety for warranty work was governed by two-year statute of limitations, which ran from date of discovery of defect)).
to a party’s risk of liability exposure at some predetermined point following project completion.

While all but two states have enacted statutes of repose, not all statutes of repose protect the same types of claims and the same categories of project participants. Some statutes of repose only apply to tort claims, and others exclude from application of the statute persons who have purposefully concealed a defect or deficiency. Only four states’ statutes of repose expressly include sureties, however, sureties have successfully raised the statute of repose notwithstanding the lack of specific application of the statute to sureties.

2. Overpayment

As part of the investigation, the surety must determine how much money is left in the contract to complete the work. This inquiry necessitates an examination of payments made to the contractor prior to default. One of the more significant obligations of the owner/obligee under any construction contract is the proper payment of earned contract funds to the contractor. The obligee’s failure to timely make payments to the contractor may constitute a material breach of the contract, relieving the contractor from the obligation to perform, and it may potentially release the surety from performance because of the failure of a material condition precedent to recovery under the bond. The concept of correctly paying the contractor also implicates the surety where the obligee either purposefully or inadvertently overpays the contractor. While an overpayment to the contractor may be welcomed by the contractor, and may not be deemed a breach by the contractor, such action may have dire consequences in that the surety may be discharged, at least to the extent of the overpayment.

---

80. Id. at 132 n.24 (“Only New York and Vermont have not enacted some type of statute of repose.”).


83. Id. at n.33 (citing County of Hudson v. Terminal Constr. Corp., 381 A.2d 355 (N.J. 1977) (running of the statute of repose against the principal prevented a cause of action from accruing, and thus, having no cause of action against the principal, the plaintiff had no cause of action against the surety)).

84. Bruner & O’Connor, supra note 67, § 8:60.
The surety has an equitable interest in the contract balance that serves as a fund to complete the contract after default, and any overpayment by the owner to the contractor may be viewed as an impairment of the surety's collateral. The prevailing rule is that “a compensated surety is discharged from its obligations on the performance bond to the extent that such unauthorized payments result in prejudice or injury.” To obtain a “pro tanto” discharge, or discharge to the extent of the unauthorized payments, most courts do not require the surety to prove it was prejudiced by the overpayments, finding instead that the very nature of the overpayment constitutes prejudice to the surety, without need for the surety to make a separate showing of prejudice.

Overpayment is a defense that is available to the surety even though it would not be available to the bond principal. “[I]f the owner and contractor engage in practices that constitute a material change in the construction contract provisions, and the contractor subsequently defaults on the contract, the surety is entitled to a discharge of its obligation to pay the contractor’s debt.” Such action by the owner may also give the surety a sword, as at least some courts have allowed a surety to recover amounts improperly paid by the owner to the contractor.

---

85. See Restatement (Third) of Suretyship & Guaranty § 31 & § 42 (contract balance “serves as security for the performance of the underlying obligation” and surety may be discharged by reason of obligee’s release of collateral); see also Pa. Nat’l Mut. Cas. Ins. Co. v. City of Pine Bluff, 354 F.3d 945, 953, 954 (8th Cir. 2004) (where city paid funds to a contractor that were “equitably owed” to the payment bond surety, the city impaired the surety’s right to reimbursement from remaining security).


88. Southwood Builders, Inc. v. Peerless Ins. Co., 366 S.E.2d 104 (Va. 1988) (“A separate showing of prejudice to the surety is unnecessary because a material deviation, in itself, establishes sufficient prejudice.”); Nat’l Union Indem. Co. v. G.E. Bass & Co., 369 F.2d 75 (5th Cir. 1966) (“the material departure from the terms of the contract deprives the surety of the inducement to perform which the contractor would otherwise have, and destroys, diminishes, or impairs the value of the securities taken”); see also N. Am. Specialty Ins. Co. v. Chichester Sch. Dist., 2000 WL 1052055, at *12 (E.D. Pa., July 20, 2000) (“The reasoning is that unauthorized advances reduce the principal’s incentive to complete the contract, which increases the surety’s risk, as well as the cost of the surety’s substitute performance.”). But see Mergentime Corp. v. Wash. Metro. Area Transit Auth., 775 F. Supp. 14, 21 (D.D.C. 1991) (proof of prejudice is required, but obligee bears the burden of proof).


90. Id. at 360–61 (citation omitted).

91. Id. (relying upon Am. Sur. Co. v. Plank & Whitsett, Inc., 159 Va. 1, 17, 165 S.E. 660, 666 (1932)).
3. Penal Sum Limitations

One of the most sacrosanct surety defenses is the penal sum limitation, that is, that the surety is not liable beyond the penal sum.92 Notwithstanding the penal sum cap to liability, the surety may waive its limit of liability by completing the principal’s contract without conditioning its performance on the bond’s limit of liability.93 Arguably, the surety’s waiver of the penal sum of the bond as a limit on its liability must be in writing in order to satisfy the statute of frauds. Also, there may be a number of bases to support the argument that a performing surety’s liability is limited to its penal sum notwithstanding the surety’s failure to reserve the bond limit as a condition of its performance.

The cases that hold that a performing surety waives its right to rely on the terms of the bond, including the penal sum of the bond as a limit on liability, if it takes over and completes a project uniformly share the following factual pattern: the principal defaults during performance, the bond contains a penal sum but is silent as to the surety’s options upon the principal’s default, the surety takes over and commences performance of the principal’s contract, the surety performs the principal’s obligation without limiting its liability as a condition of performance, and without reserving its rights to assert the bond amount as its limit of liability, and the obligee seeks damages, which, if collected from the surety, will be in excess of the bond amount. Under this typical factual pattern, the performing surety waives its penal sum as the limit of its liability because it is deemed to have stepped into the shoes of its principal and acted as a primary obligor with its obligee instead of resting on its rights as surety under the bond.

4. Failure to Timely Default

Historically, if the performance bond or the underlying bonded contract expressly requires notice to the surety, failure of the obligee to give notice can

---


be fatal to the obligee’s claim on the performance bond.\textsuperscript{94} Other courts have determined that the failure of notice only affects the obligee’s claim against the surety if the surety suffers prejudice as a result of the obligee not declaring a default and providing notice of same to the surety.\textsuperscript{95} If the bond does not expressly require a declaration of default, there typically is no defense available to a surety for the failure of the obligee in that regard.\textsuperscript{96}


\textsuperscript{95} See, e.g., Winston Corp. v. Cont’l Cas. Ins. Co., 508 F.2d 1298 (6th Cir. 1975) (court convinced that surety not harmed by absence of notice and no reason to allow surety “off the hook” without injury to surety); Blackhawk Heating & Plumbing Co. v. Seaboard Sur. Co., 534 F. Supp. 309, 315 (N.D. Ill. 1982) (surety to establish defense to extent damages suffered as result of no notice); Plowden & Roberts, Inc. v. Conway, 192 So. 2d 528, 533 (Fla. Dist. Ct. App. 1966) (“[t]he compensated surety’s liability is merely reduced by any harm which it has suffered by the fact that it was not accorded its rights to remedy the default”); Cont’l Bank & Trust Co. v. Am. Bonding Co., 605 F.2d 1049 (8th Cir. 1979) (although no notice requirement, obligee may not recover escalated costs that occurred because of the obligee’s delay in notifying surety); City of Whitehall v. S. Mech. Contracting, Inc., 269 Ark. 563, 599 S.W.2d 420 (1980) (obligee might lose claim if failed to give notice such that surety not afforded opportunity to complete); Chrysler Corp. v. Hanover Ins. Co., 350 F.2d 652 (7th Cir. 1965).

5. Failure to Mitigate
To the degree the bond principal would have a failure to mitigate defense against an obligee, so would the bond principal’s surety. One other common situation where the defense of failure to mitigate is applicable is when the obligee takes over the arrangements for project completion without affording the surety an opportunity to complete. Courts have held that this essentially eliminates the surety’s contractual right to minimize its liability under the performance bond, resulting in a material breach that renders the bond null and void.

6. Void Construction Contract
In some jurisdictions, a contract procured in violation of various governing statutes, such as competitive bidding requirements or licensing laws, is void. Whether the surety will continue to have liability on its performance bond is an open question. It is more likely that the surety will have liability based upon the issuance of a payment bond for a void contract.

7. Fraud in the Inducement
If the surety is induced to issue a bond by the misrepresentation of the obligee, the surety typically has a defense against a performance bond claim. Section 12(1) of the Restatement (Third) of Suretyship & Guaranty provides:

If the secondary obligor’s [surety’s] assent to the secondary obligation is induced by a fraudulent or material misrepresentation by the

99. See, e.g., Taylor v. Exnicious, 197 Cal. 443 (1925) (bond exacted by court with no authority to require bond did not bind surety); Town of Mill Valley v. Nat’l Sur. Co., 41 Cal. App. 540, 542 (1919) (“Where a bond is given for performance of a contract, and the latter is not binding upon the parties for any reason, there is no consideration for the bond, and no action, therefore, can be maintained on it.”); City of Arcata v. Green, 156 Cal. 759 (1909) (surety had no liability on bond issued for public contract entered into without public bidding). If the performance bond is void, an owner might argue that this is equivalent to discharge “by operation of law” and the surety should not be exonerated. See Cal. Civ. Code § 2825 (“A surety is not exonerated by the discharge of his principal by operation of law, without the intervention or omission of the creditor.”).
100. See, e.g., L.A. Stone Co. v. Nat’l Sur. Co., 178 Cal. 247, 250 (1918) (“The obligation of the surety does not depend upon the validity of the contract or the faithful performance thereof by the contractor. It exists independently of such facts.”).
V. Pursuing Remedies against a Performance Bond Surety

obligee upon which the secondary obligor is justified in relying, the secondary obligation is voidable by the secondary obligor.\textsuperscript{101}

C. Damages Recoverable under a Performance Bond

1. Cost to Complete in Excess of Contract Balance/
Cost to Repair Defective Construction

Where there has been a breach of the construction contract and a default declared, the obligee has been able to recover from the surety the cost of construction, that is, the direct cost of completion as well as repair of defective construction. Put another way, the obligee is entitled to recover the reasonable amount it would cost over and above the remaining contract balance to remedy the defective work and/or to complete the project.\textsuperscript{102}

2. Surety Liability for Extended Warranties

State and local agencies and departments have recently sought to shift responsibility for quality control and maintenance to contractors through contractual warranty periods with extended durations, some lasting 15 to 20 years.\textsuperscript{103} This is not a surprising trend, given the financial pressures faced by states and local agencies. Public entities facing budget deficits have reduced the number of public employees on their payrolls, thereby affecting their ability to perform inspections and maintenance. As a result, and in particular, state transit agencies and departments of transportation are now using long-term warranties with increasing frequency.\textsuperscript{104}

Though longer warranties periods are embraced on the owner side, contractors and the surety industry are generally opposed to this risk-shifting trend.\textsuperscript{105} The SFAA issued a policy statement opposing extended warranties. The SFAA argues that to compensate for the increased risk due to the diminished certainty of underwriting and the method of payment, sureties typically


\textsuperscript{104}. Qingbin Cui, Philip Johnson & Elizabeth Sees, Long-Term Warranties on Highway Projects (Dep’t of Civil, Constr. & Envtl. Eng’g, Univ. Transp. Ctr. for Ala., Sept. 2008).

raise their underwriting standards and provide long-term bonds only to the largest and most financially sound contractors. As a result, many smaller contractors who are fully qualified to do the work are precluded from bidding on these projects. If sureties raise their underwriting thresholds high enough to address the risks and uncertainty of an obligation lasting 10, 15, or 20 years, very few contractors can compete for the project, which may cause an increase of bid prices and construction costs. Finally, long-term warranties also increase the costs of the surety bond itself.

3. Surety Liability for Punch List and Latent Defects
The A312-2010 Performance Bond places upon the surety “[t]he responsibilities of the Contractor for correction of defective work.”\(^{106}\) The principal, and, hence, the surety, are required under the AIA General Conditions to

promptly correct Work rejected by the Architect or failing to conform to the requirements of the Contract Documents, whether discovered before or after Substantial Completion and whether or not fabricated, installed or completed. Costs of correcting such rejected Work, including additional testing and inspections, the cost of uncovering and replacement, and compensation for the Architect’s services and expenses made necessary thereby, shall be at the Contractor’s expense.\(^{107}\)

This provision requires correction at any time before substantial completion, and section 12.2.2.1 of AIA A201 limits the obligation to correct the work after substantial completion to the one-year warranty period. Accordingly, the performing surety is liable for correcting the work before substantial completion and for the one-year period thereafter to the same extent as its principal for work that is properly rejected or otherwise is nonconforming.

Defective or noncomplying work can be categorized in two varieties, patent and latent. The difference between the two is that:

Patent defects are plainly visible or can be discovered by an inspection made with the exercise of reasonable or ordinary care. Black’s Law Dictionary defines “patent” as “open”, “manifest”, and “evident”. Patent defects are items that the architect or the inspector should have noticed and had corrected during the course of construction of the project but somehow missed. The obligee has typically already paid for this defective work. The contractor and surety’s position is

\(^{107}\) AIA A201-2007, General Conditions, § 12.2.1.
V. Pursuing Remedies against a Performance Bond Surety

that the architect’s certification of the contractor’s pay application and the obligee’s payment constitutes acceptance of this purportedly defective work.

Latent defects on the other hand are hidden. Latent defects are problems that a reasonable inspection will not reveal. As a result, a different set of rules has been developed to deal with latent defects. Claims for latent defects survive the project close out and final payment by the owner. This type of defect rears its ugly head later—typically, when the surety claims counsel is getting ready to go on vacation or after the completing contractor has filed Chapter 7 bankruptcy.¹⁰⁸

If defective work is discovered and reported to the principal within the warranty period, the principal (and its surety) must correct the work. If the defect is patent and is not reported within the warranty period, the obligee will have waived its rights and neither the principal nor the surety has any obligation to correct that defect.¹⁰⁹ Notwithstanding the relief from the obligation to correct the defect, the principal may still be subject to a claim for damages for breach for its noncompliance with the contract,¹¹⁰ and may also be subject to a breach of implied duties.¹¹¹ There is a clear distinction between the principal’s obligation to correct, which may expire or be waived, and the principal’s liability for exposure to damages.

By definition, latent defects are discovered after project completion. The surety’s liability for correcting latent defects discovered after substantial completion or project completion may depend upon the language of the bond. Where the bond does not define default or require termination as a condition of the surety’s obligation to perform, the surety’s obligation to correct latent defects has been construed to be co-extensive with the obligation of the

¹⁰⁸. Speicher & Smith, supra note 74, at 122-23.
¹⁰⁹. Id. at 125 n.5.
¹¹⁰. Id. at 126 n.6 (citing Bd. of Regents v. Wilson, 326 N.E.2d 216, 220 (Ill. App. 1975) (“[The correction of work and guarantee] provisions do nothing more than establish that for a period of one year defendant has a duty to rectify any such defects; the provisions in no way limit plaintiff, after that one year, from claiming damages as the result of faulty work or material.”); see also President & Dir. of Geo. Coll. v. Madden, 505 F. Supp. 557, 580 (D. Md. 1980); Baker-Crow Constr. Co. v. Hames Elec., Inc., 566 P.2d 153 (Okla. App. 1976). But see Mountain View/Evergreen Imp. & Serv. Dist. v. Casper Concrete Co., 912 P.2d 529 (Wyo. 1996) (under terms of contract, final payment waived claims for defective work and suit was untimely when filed after expiration of one-year warranty period)).
¹¹¹. Id. at 126 n.8 (citing Stanley P. Sklar, Edward L. Filer & Tina M. Bird, 21 Constr. Law. 11 (2001)). The implied duties that might be breached include the implied warranty of workmanlike construction, the implied warranty of habitability, the implied warranty of fitness for a particular purpose, and the principal’s duty to warn the obligee regarding defective design.
principal. That is, if the principal is liable for the correction or damages associated with the defect, so is the surety. In contrast, where the bond requires termination of the principal as a condition of the surety’s obligation to perform and the principal is not terminated and latent defects are not discovered until after project completion, the surety may have no liability.

5. Surety’s Liability for Delay Damages or Consequential Damages
The trend is to find sureties liable for consequential damages in the form of actual delay damages (assuming no liquidated damages provision), particularly when the underlying bonded construction contract contains a “time is of the essence” provision.

6. Surety’s Liability for Liquidated Damages
Liquidated damages are, other than cost to complete plus repair of defective work, the most common type of damages recoverable against a surety. Sureties are liable for liquidated damages of the owner when the performance bond incorporates by reference the underlying bonded contract and that contract contains an enforceable liquidation damages provision. Sureties who have
issued bonds on behalf of subcontractors can be liable for the liquidated damages that the owner assesses against the general contractor by virtue of the flow down or indemnity provisions in the subcontract agreement.\(^\text{116}\)

### 7. Surety’s Liability for Attorneys’ Fees and Attorneys’ Fee Clauses in Bonds

A surety’s liability is generally limited to the penal sum of the bond, including attorneys’ fees incurred in enforcing the bond. A term sureties sometimes find in nonstandard bond forms that tries to expand the penal sum is as follows:

Principal and Surety agree that if Obligee is required to engage the services of an attorney in connection with enforcement of this Bond, each shall pay Obligee’s costs and reasonable attorney’s fees incurred, with or without suit, in addition to the above penal sum.

The above provision is premised on the theory that the penal sum corresponds with the contract default and the costs to complete, but that an owner’s attorneys’ fees spent in trying to recover against the bond should be recoverable over the penal sum. "If the attorney’s fees that an obligee must expend to recover against a surety can eat away at the penal sum, there is less money available for the obligee to complete the project or reimburse itself for the costs of completion."\(^\text{117}\) Needless to say, sureties object to this clause, as they view their obligations as being limited to the penal sum for any theory or type of claim arising out of the default.

The above quoted attorney’s fee clause is a one-way clause—the prevailing obligee or owner on a performance bond is entitled to recover its attorneys’ fees against the surety or the contractor. This clause does not provide that the prevailing surety or the contractor is entitled to recover its attorneys’ fees upon prevailing. States like California have a statutory provision that, with certain exceptions, make unilateral attorney’s fee clauses mutual.\(^\text{118}\) Public agencies have found that even where sureties agree to one-way attorney’s fee clauses in favor of the obligee on a California publics works project, a prevailing contractor or surety may be entitled to recover their attorneys’ fees against the public owner.\(^\text{119}\) Public agencies and contractors need to be mindful of applicable law and whether it might convert an otherwise unilateral attorneys’ fees clause in

---

117. See id.
119. Mepco Servs., Inc. v. Saddleback Valley Unified Sch. Dist., 189 Cal. App. 4th 1027, 1045–48 (2010) (affirming award of attorneys’ fees in favor of prevailing contractor and against school district where unilateral attorneys’ fees clause made reciprocal based on state statute); see also G. Voskanian Constr., Inc. v. Alhambra Unified Sch. Dist. 204 Cal. App. 4th 981, 996 (2012) (affirming award of attorneys’ fees in favor of prevailing contractor where clause in bond provided “the prevailing party shall be entitled to recover reasonable attorney fees” and did not expressly limit liability for fees to the surety).
favor of the owner into a reciprocal clause that entitles the prevailing contractor (or surety) to recover attorneys’ fees against the owner.

8. Surety Liability for Penalties
The issue of a surety’s liability for penalties arises primarily in the area of prevailing wage violations and prompt payment penalties. The courts vary as to whether sureties are so liable.120

VI. Pursuing Claims against a Payment Bond and Release and Discharge Bonds

A. Coverage—Definition of Claimant/Limitation on Subcontractor Tiers
Payment bonds are intended to protect unpaid persons who supplied labor and material to the project. However, most bonds limit coverage to certain categories of project participants or “claimants,” often defined by tier, so that only those proper claimants can recover under a payment bond. A first-tier claimant stands in direct privity with the principal; for example, a subcontractor or direct supplier. A second-tier claimant has a contract with the principal’s subcontractor or supplier, but has no contract with the principal. Finally, a third-tier claimant is one who stands in privity with a second-tier claimant such as a supplier to a subcontractor or sub-subcontractor. Like most bonds, the federal Miller Act restricts coverage under a Miller Act payment bond claim only to first-tier and second-tier claimants. In addition, under the A311 and A312 Payment Bonds, only first-tier and second-tier claimants are entitled to recover.

B. Notice
Most payment bonds require some sort of notice as a condition precedent to asserting a claim, regardless of whether the bond is a Miller Act bond, a Little Miller Act bond, or a private payment bond, including the AIA form of payment bond. Some courts have enforced reasonable notice provisions in a bond on the premise that they are “sensible and necessary provisions” that permit general contractors to make payments to subcontractors without fear of subsequent suits by material suppliers who have not made their claims known.121

Under the Miller Act, first-tier claimants are not required to give notice prior to filing suit under a Miller Act payment bond. Second-tier claimants who have a direct relationship with the subcontractor, but not with the prime contractor,

must give written notice to the prime contractor within 90 days from the date on which the claimant provided the last of the labor and material for which the claim is made, prior to filing suit under a Miller Act payment bond. The Miller Act does not require notice to be sent to the surety, but prudence dictates a claimant include the surety on the notice to the prime contractor. Although it varies by jurisdiction, most courts strictly construe this notice requirement, viewing the notice as a condition precedent to the right to recovery.

The notice must be written and served in a way that permits third-party verification of delivery to the contractor’s office. The notice must include the amount claimed and the name of the party to whom the material was furnished or for whom the labor was done or performed.

C. Deadline for Suit Filing

The deadline for filing suit depends upon the type of payment bond. Claimants wishing to pursue recovery under a Miller Act suit must bring the action no later than one year after the day the last of the labor was performed or material was supplied by the entity bringing suit. For claimants doing business with state entities, the operating statute of limitation will be found in the Little Miller Act. Under the AIA-A311 bond, a claimant must file suit before the expiration of one year following the date on which the bond principal ceased work on the project. Under the 1984 and 2010 versions of the AIA A312 bond, a claimant may not commence suit after the expiration of one year from the date on which the claimant gave notice of the claim or on which the last labor or service was performed by anyone (or the last materials or equipment were furnished by anyone under the construction contract), whichever occurs first. Private payment bonds may include a deadline for filing suit. Otherwise, suits against a private payment bond are controlled by the state’s statute of limitations. In some jurisdictions, an action on a bond must be brought one year from the date the cause of action accrues. In others, the statute of limitations permits claimants 12 years to file suit against the surety.

Commencement of the running of a statutory or contractual limitations typically depends upon the claimant’s “last day of work performed.” A distinction has been drawn between the essential work performed by the bond claimant within the scope of the original contract and incidental, repair, or warranty work to determine when the suit limitation period begins running. Typically, the limitation does not begin to run while the claimant is performing essential, nonremedial work within the scope of the original contract. However,

123. Bowden v. United States ex rel. Malloy, 239 F.2d 572 (9th Cir. 1956).
performing incidental or minor work, including warranty and punch list work, does not toll the statute of limitations.

D. Damages Recoverable against a Payment Bond

1. Labor

Labor is typically the largest dollar value of any claim, and is covered by the payment bond. “Labor” costs recoverable by an appropriate claimant include not only the wages of workers providing physical labor to the project, but also the wages of field supervisors overseeing the physical labor. Executive home office personnel above the field superintendent level, however, have been held not to be considered “labor.”

2. Materials

The question of what constitutes “material” furnished in the prosecution of the work is somewhat less defined. When the material was incorporated into the project, there is little dispute that such materials are covered by the bond. However, disputes arise when materials are not used or consumed in the project. Materials such as, oil, fuel, tires, and repairs to tires have been held to be covered whether or not consumed by the project. Other covered materials include tools and formwork, portable restrooms, and food and lodging of project personnel.

3. Rental Equipment Charges

The fair rental value of equipment, either incorporated into the work or used in the construction, may also be recoverable under the payment bond, even though the equipment may have been idle for some period.

E. Defenses to Payment Bond Claims

1. Defenses of the Surety’s Principal

A payment bond surety has a number of defenses that it can assert to payment bond claims, including the following: (1) the principal’s defenses; (2) the principal’s offsets/counterclaims; (3) the claimant’s material breach of the contract;

132. It is axiomatic that a surety’s liability is co-extensive with that of its principal; thus, the surety is typically entitled to step into the principal’s shoes and assert all of their contractual and legal defenses.
VI. Pursuing Claims against a Payment Bond and Release and Discharge Bonds

(4) the failure of the claimant to give notice; (5) the failure of the claimant to commence suit within the time prescribed by the bond or by the statute; (6) the failure of the claimant to bring suit in the proper court; (7) the claimant’s failure to mitigate its damages; and (8) defenses based on particular subcontract provisions. Those legal defenses that are shared by the principal and surety also include statute of limitations, collateral estoppel, waiver, unjust enrichment, release, accord and satisfaction, novation, estoppel, and failure to mitigate damages.

2. Pay-When-Paid Clauses/Pay-If-Paid Clauses

While the general rule of law is that a surety on a bond is not liable unless the principal is liable, not all jurisdictions follow this rule concerning enforcement of contractual condition precedent payment language. Under a pay-when-paid clause, a contractor’s obligation to pay the subcontractor is triggered upon receipt of payment from the owner. Under a pay-if-paid clause, in contrast, receipt of payment by the contractor from the owner is an express condition precedent to the contractor’s obligation to pay the subcontractor. The intent of a pay-if-paid clause is to shift the risk of the owner’s nonpayment under the subcontract from the contractor to the subcontractor.

The majority of jurisdictions construe pay-when-paid clauses as allowing payment under a subcontract to be delayed, but not conditional altogether, and have treated such clauses as a “timing mechanism,” not a condition precedent to payment. Most cases addressing pay-when-paid clauses only address the issue of whether a principal can assert the defense, not whether a surety can do so. Courts in most jurisdictions have generally construed pay-when-paid clauses as providing a “reasonable” period of time after a subcontractor’s work is completed for a surety to pay a subcontractor under a payment bond. However, some courts have held that a surety cannot rely on a pay-when-paid defense. Similarly, the majority of jurisdictions hold that a surety cannot rely upon a pay-if-paid clause, unless the clause is incorporated into the payment bond itself. Pay-if-paid and pay-when-paid clauses are discussed further in chapter 11.

133. A typical pay-when-paid clause might read: “Contractor shall pay subcontractor within seven (7) days after a contractor’s receipt of payment from the owner.”

134. A typical pay-if-paid defense clause states: “Contractor’s receipt of payment from the owner is a condition precedent to contractor’s obligation to make payment to the subcontractor; the subcontractor expressly assumes the risk of the owner’s nonpayment.”


3. Unique Surety Defenses

In addition to those shared defenses that arise from the contract, project, and/or merits of the underlying case, the surety may also assert procedural/technical defenses not available to the principal, such as the failure to satisfy the requirements of the bond. As discussed above, many courts have held that failing to comply with notice requirements of the bond is a strict condition precedent to the court’s having subject matter jurisdiction over a claim. Those unique defenses are not ironclad, however, but may be waived if the surety fails to respond to a claim in the manner and/or time limits prescribed by the bond.\(^{138}\)

Other unique legal defenses arise in the context of failing to comply with statutory notice requirements under the Miller Act or Little Miller Acts that could provide the surety with a unique defense. Under most payment bonds, a claimant who is not in direct privity with the general contractor is required to give written notice to the general contractor within 90 days after the labor or materials for which the claim is made has been furnished. There are also statutes of limitations for filing a claim, most of which require a claim to be filed in an appropriate court within one year. For federal projects, and in some states that model Little Miller Acts after the federal Miller Act, like the District of Columbia, if a claimant is a third-tier claimant, or second-tier supplier, the payment bond protections do not extend to them.

The payment bond surety may also be in the unfortunate scenario of asserting a penal sum defense where significant claims amounting to the penal sum have been presented and paid prior to submission of the claimant’s claim. Alternatively, the surety may receive claims that aggregate more than the penal sum such that the surety’s only course of action is to interplead the penal sum of the payment bond and allow the court to determine the allocation of the penal sum to the claims. The penal sum amount, which equals the underlying contract, is the ultimate limitation of the surety’s liability.\(^{139}\)

VII. Bad-Faith Claims against the Surety

A breach of contract cannot give rise to remedies in tort in the absence of an independent duty owed by the breaching party. When a party fails to fulfill its contractual obligations, including the implied duty of good faith and fair dealing, there is no actionable tort. Instead, a party’s liability for breach is limited to the foreseeable damages stemming from the breach of the contractual relationship. Thus, an independent tort action is not cognizable where there is no duty owed to the plaintiff other than the duty of the defendant arising out of the contract itself.


An exception to this rule emerged when courts began holding that a breach by an insurer of its implied duty of good faith, coupled with the fiduciary duty of the insurer to its insured, created an affirmative claim in favor of insured for insurance “bad faith.” Courts recognizing such a cause of action often ruled that there is a “special relationship” between an insurer and its insured, based principally on the unequal bargaining power of the parties. That rule soon spilled over to the surety industry.

States such as Arizona, Alaska, Oklahoma, Colorado, and Ohio have ruled that the governing common law or statutory bad-faith claims in those jurisdictions should apply equally to sureties. Those courts have recognized a cause of action for bad faith against a surety. The justification for extending the rule to sureties is the inclusion of suretyship within the state’s insurance statutes as purported evidence of that state’s intention to treat sureties just like insurers. Additionally, state appellate courts in Florida, Illinois, Montana, and North Dakota, have permitted statutory bad-faith claims against sureties (as opposed to common law claims). Other states have addressed the issue and have refused to recognize bad-faith claims against sureties, including California, Texas, South Carolina, Nevada, North Carolina, and Maryland. Generally, these decisions have held that the creation of tort remedies for bad faith are inappropriate where contract damages exist for breach of a covenant of good faith and fair dealing. The most instructive decision on this issue is Cates Construction, Inc. v. Talbot Partners, which soundly rejected the argument that the


inclusion of sureties within the state’s regulatory scheme evidenced an intent by the legislature that sureties should be treated as insurers for all purposes.\footnote{144}

There is no consistent or precise definition of conduct constituting bad faith by a surety. In the cases recognizing bad-faith claims against sureties, bad faith has been defined most commonly as an absence of a reasonable basis for refusal to honor bond obligations with knowledge that such conduct is unreasonable or with reckless disregard for the fact the conduct is unreasonable. The Alaska Supreme Court, for instance, stated that a “surety may satisfy its duty of good faith to its obligee by acting reasonably in response to a claim by its obligee, and by acting promptly to remedy or perform the principal’s duties where default is clear.”\footnote{145} The Colorado Supreme Court held that “a commercial surety acts in bad faith when the surety’s conduct is unreasonable and the surety knows that the conduct is unreasonable or recklessly disregards the fact that its conduct is unreasonable.”\footnote{146}

\begin{itemize}
\item \footnote{144}{Cates Constr. Inc., 21 Cal. 4th at 52.}
\item \footnote{145}{Loyal Order of Moose, Lodge 1392, 797 P.2d at 628.}
\item \footnote{146}{Transamerica Premier Ins. Co., 940 P.2d at 354 (relying upon Travelers Ins. Co. v. Savio, 706 P.2d 1258, 1275 (Co. 1985)).}
\end{itemize}