SURETY TODAY PRESENTATION
Given by
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NOTICE, CONDITIONS PRECEDENT AND PREJUDICE TO THE SURETY UNDER THE A312 (2010) PERFORMANCE BOND.

I. THE LAW OF CONDITIONS PRECEDENT (Stover)

We start first with the simple concept that "a surety bond is a contract."[1] Therefore, a bond, as a contract, must be interpreted in accordance with established rules of contract construction.[2] Further, under the law of suretyship, the surety's liability for damages is limited by the terms of the bond.[3] Courts have long recognized that the liability of a surety should not be extended by implication beyond the terms of the bond.[4]

Under contract law, there arises a type of provision known as the "condition precedent." A condition precedent is defined as "a fact, other than a mere lapse of time, which, unless excused, must exist or occur before a duty of immediate performance of a promise arises."[5] In other words, when a condition precedent exists in a contract and it is Party A's obligation to satisfy the condition, Party A must perform that condition before Party B has any obligation to perform under the contract and there can be no breach of the contract by Party B until the condition precedent is either performed by Party A or the condition is excused.[6] In terms of a surety bond, if an obligee must satisfy a condition precedent before the surety's obligation under

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[1] *Goldberg, Marchesano, Kohlman, Inc. v. Old Republic Sur. Co.*, 727 A.2d 858, 860-61 (D.C. 1999); *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*, 376 F.3d 96, 100 (2d Cir.2004); *Purcell v. Thomas,* 28 A.3d 1138, 1144 (D.C. 2011); *United States v. Summit Fidelity & Surety Co.*, 408 F.2d 46, 47 (6th Cir.1969); *Williams v. United States*, 444 F.2d 742, 744 (10th Cir.1971), cert. den. 404 U.S. 938; *United States v. Varner*, No. 5:05CR00025-01, 2006 WL 482398, at *2 (W.D. Va. Mar. 1, 2006); *Fid. & Guar. Ins. Co. v. Blount,* 63 So.3d 453, 461 (Miss. 2011).
[2] *Hartford Fin. Servs. Grp., Inc. v. Hand*, 30 A.3d 180, 187 (D.C. 2011); *United States v. Insurance Company of North America,* 131 F.3d 1037, 1041–42 (D.C.Cir.1997); *Board of Supervisors v. Safeco Ins. Co.,* 226 Va. 329, 336, 310 S.E.2d 445, 449 (1983); *In re Collins*, 173 F.3d 924, 932 (4th Cir. 1999).
[3] *Fidelity & Deposit Co. v. Sholtz*, 123 Fla. 837, 168 So. 25 (1935); *Bevard v. New Amsterdam Casualty Co.,* 132 A.2d 157, 159 (D.C. 1957); *Frank Powell Lumber Co. v. Fed. Ins. Co.*, 817 S.W.2d 648, 650 (Mo. Ct. App. 1991); *National Gypsum Co. v. Travelers Indemnity Co.,* 417 So.2d 254 (Fla.1982).
[4] *State v. Wesley Constr. Co.*, 316 F.Supp. 490, 497 (S.D.Fla.1970), *affirmed*, 453 F.2d 1366 (5th Cir.1972); *May v. Cont'l Cas. Co.,* 936 A.2d 747, 750 (D.C.2007); *Standard Accident Ins. Co. v. Bear*, 134 Fla. 523, 184 So. 97 (1938); *Gato v. Warrington*, 37 Fla. 542, 19 So. 883 (1896).
[5] *Chirichella v. Erwin,* 270 Md. 178, 182 (1973).
[6] *Pradhan v. Maisel*, 26 Md.App. 671, 677, 338 A.2d 905 (quoting *Laurel Race Course, Inc. v. Regal Constr. Co., Inc.*, 274 Md. 142, 154, 333 A.2d 319(1975)), cert. denied 276 Md. 748 (1975).

the bond will arise, the surety has no obligation under the bond until that condition precedent is satisfied by the obligee.

Whether a provision in a contract is a condition precedent depends, not upon formal words or special phrases, but upon the intent of the parties, to be deduced from the whole instrument.[7] "The question whether a stipulation in a contract constitutes a condition precedent is one of construction, dependent on the intent of the parties to be gathered from the words they have employed and, in case of ambiguity, after resort to the other permissible aids to interpretation." *Chirichella,* 270 Md. at 182. In *Gilbane Building Co. v. Brisk Waterproofing Co., Inc.,* 86 Md.App. 21, 27, 585 A.2d 248 (1991), the Court held that no special language is required to create a condition precedent, words and phrases such as "if," "provided that," "when," "after," "as soon as" and "subject to," have commonly been associated with creating express conditions. *Gilbane,* 86 Md.App. at 26-27, 585 A.2d 248.[8]

Examples of "condition precedent" language can be found in the AIA A312 (2010) performance bond. For example, Section 3 provides "[i]f there is no Owner default under the Construction Contract, the Surety's obligation under this bond *shall arise after* . . ." noting several conditions such as notice, meeting, declaration of default, termination and commitment of the contract funds. The use of the word "If" before no Owner Default establishes the condition that the Owner must not be in default for the surety to have liability under the bond. The use of the words "the Surety's obligation under this bond shall arise after . . ." creates the condition that the terms noted must be satisfied before the surety has any liability under the bond. The vast majority of courts have held that the Section 3 requirements of the A312 performance bond are conditions precedent which the obligee must satisfy before the surety has any obligation under the bond.[9] We have collected a listing of over a dozen cases holding that various provisions of the A312 constitute conditions precedent and you can see those cases in the paper we will post after the presentation later in the week. It should be noted that at least one court refused to recognize the notice provisions as a condition precedent in the A312 under the

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[7] *Fid. & Cas. Co. of New York v. DeLoach*, 195 So. 2d 789, 793 (Ala. 1967).

[8] *Richard F. Kline, Inc. v. Shook Excavating & Hauling, Inc.*, 165 Md.App. 262, 273-274 (Md.App. 2005)

[9] See, e.g., *U.S. Fidelity and Guar. Co. v. Braspetro Oil Services Co.*, 369 F.3d 34, 51 (2nd Cir. 2004); *Mid-State Surety Corp. v. Thrasher Eng., Inc.*, 575 F.Supp.2d 731, 741 (S.D.W.Va. 2008); *Developers Surety and Indemnity Co. v. Dismal River Club, LLC*, 2008 WL 2223872, *7-8 (D. Neb. 2008); *120 Greenwich Dev. Associates, LLC v. Reliance Ins. Co.*, 2004 WL 1277998, *12 (S.D.N.Y. 2004); *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F.Supp.2d 166, 179 n.4 (D. Mass. 2003); *AgGrow Oils, L.L. C. v. National Union Fire Ins. Co. of Pittsburgh*, 276 F.Supp.2d 999, 1017 (D.N.D. 2003); *Bank of Brewton, Inc. v. Int'l Fid. Ins. Co.*, 827 So.2d 747, 754 (Ala. 2002); *North American Specialty Ins. Co. v. Chichester School District*, 2000 WL 1052055, *16 (E.D. Pa. 2000); *Travelers Casualty & Surety Co. v. Dormitory Auth. – State of New York*, 735 F. Supp. 2d 42, (S.D.N.Y. 2010); *New York trial court in Independent Temperature Control Services, Inc. v. Parsons Brinckerhoff, Inc.*, 2017 WL 318654 (N.Y. Sup. Ct. Jan. 20, 2017); *Breath of Life Christian Church v. Travelers Insurance Co.*, 2010 WL 1172080 (Tenn Ct. App. March 26, 2010); *Stonington Water Street Assoc., LLC v. Hodess Bldg. Co., Inc.*, 2011 WL 861688, *8 (D.Conn. 2011); *United States ex rel. Platinum Mechanical, LLC v. U.S. Surety Co.,* No. 07 Cv. 3318(CLB), 2007 WL 4547849, *3 (S.D.N.Y. Dec. 21, 2007) (granting summary judgment to surety where owner failed to provide proper notice under AIA A312 performance bond that it was considering declaring contractor in default)

facts and law of that case. *See International Fidelity Insurance Co. v. County of Rockland,* 98 F.Supp.2d 400 (S.D.N.Y. 2000).

Finally, while nearly all courts find that the various provisions of the A312 constitute conditions precedent, it is important to keep in mind that conditions precedent can be waived by the surety either expressly or by implication resulting from the surety's acts or conduct. *AgGrow Oils,* 276 F.Supp.2d at 1017–18; *C & I Entertainment, LLC v. Fidelity and Deposit Company of Maryland*, 2014 WL 3640790 (N.D. Miss. July 22, 2014). Thus, the surety must be careful in its dealings with the obligee not to waive any conditions precedent.

II. THE AIA A312 (2010) PERFORMANCE BOND (Stover)

The authors of the treatise, Bruner & O'Connor on Construction Law have remarked that the A312 Performance Bond is one of the clearest, most definitive, and widely used type of traditional common law "performance bonds" in private construction. 4A Bruner & O'Connor Construction Law § 12:16. The A312 form was developed to define clearly the scope and extent of the surety's liability, the "trigger" of the surety's obligation to perform, the options available to the surety in satisfying its bond obligations, and the duration of the surety's obligations.

Section 1 of the AIA A312 (2010) Performance Bond establishes the familiar commitment and joint and several liability of the surety and principal to perform the construction contract and it incorporates the construction contract by reference into the bond. Section 2 makes clear that if the principal performs the construction contract then the surety and the principal have no obligation under the bond. In other words, the principal must first be in default under the bonded contract before the surety's obligation arises under the bond.

Section 3 of the A312 (2010) sets forth the notice and other conditions that must be met by the obligee to initiate a claim under the bond against the surety. As noted above, Section 3 begins by providing that "[i]f there is no Owner Default under the Construction Contract, the Surety's obligation under this Bond shall arise after . . ." This wording provides clear condition precedent language that suggests that if there is an "owner default" the surety shall have no obligation under the bond.[10] Thus, determining whether the owner is in default is an important threshold issue.

The A312 defines an "owner default" in § 14.4 as essentially the Owner's failure to pay the Contractor as required under the Construction Contract or to perform and complete or

[10] In *Gulf Liquids New River Project, LLC v. Gulsby Eng'g, Inc.*, 356 S.W.3d 54, 83 (Tex. App. 2011) the court observed that "[I]t is true that an 'owner default' by nonpayment is a defense to the surety's liability. *Id.* Similarly, in *Roel P'ship v. Amwest Sur. Ins. Co.,* 258 A.D.2d, 780, 781–82, 685 N.Y.S.2d 832, (N.Y.App.Div.1999) the court held that owner's default for failing to pay contractor according to the contract is a defense to the surety's liability.

comply with the other material terms of the Construction Contract.[11] In many instances when the surety gets involved it will be discovered that the owner has failed to timely make payment, failed to timely address change orders, claims, RFI's or other issues that affected the principal's ability to timely pay its subcontractors and suppliers or timely perform the work. The surety should examine whether the owner is in default as part of its investigation.

Only if there is no owner default, Section 3.1 requires that the owner provide notice to the contractor and the surety that the owner is "considering declaring a Contractor Default." Such notice is required to indicate whether the owner is requesting a conference to discuss the contractor's performance. If the owner does not request a conference, the Surety may do so. If the Surety timely requests a conference, the owner is required to attend. This provision is a change from the 1984 A312 which required that the owner request and attempt to arrange the conference and which did not give the surety the right to request a conference. In *Breath of Life Christian Church v. Travelers Insurance Co.*, 2010 WL 1172080 (Tenn Ct. App. March 26, 2010), the Tennessee Court of Appeals characterized the conference requirement as being "a mediation mechanism that seeks to avoid default." Just last month I got a new where the Owner did not request a meeting but we did on behalf of the surety. We got the owner and principal in a room and worked out a deal where they are now working together to address the issues.

If the issues are not resolved in the conference, Section 3.2 requires the owner to declare the contractor in default, terminate the Construction Contract and notify the surety. The 2010 Section 3.2 speeds up the claim process from the 1984 version of the A312 by eliminating the requirement that the owner wait at least twenty days after notice before declaring a Contractor Default. Finally, Section 3.3 requires the owner to agree to pay to the surety the "Balance of the Contract Price" in accordance with the terms of the Construction Contract. The bond defines Balance of the Contract price at Section 14.1.[12]

The 2010 A312 added a new Section 4 that made a significant change from the A312 (1984) version. The 2010 Section 4 provides that an owner's failure to comply with the notice requirement in section 3.1 "shall not constitute a failure to comply with a condition precedent to the Surety's obligations, or release the Surety from its obligations, except to the extent the Surety demonstrates actual prejudice." *Id.* Under this provision, the surety will have the burden of showing "actual prejudice" due to the obligee's failure to provide proper notice and, if the surety does so, its obligation would be reduced to the extent of that prejudice, as opposed to being discharged entirely. Courts interpreting Section 4 have noted the clear language that limits

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[11] Section 14.4 provides: "[f]ailure of the Owner, which has not been remedied or waived, to pay the Contractor as required under the Construction Contract or to perform and complete or comply with the other material terms of the Construction Contract."

[12] Section § 14.1 of the A312 (2010) defines the "Balance of the Contract Price" as the "total amount payable by the Owner to the Contractor under the Construction Contract after all proper adjustments have been made, including allowance to the Contractor of any amounts received or to be received by the Owner in settlement of insurance or other claims for damages to which the Contractor is entitled, reduced by all valid and proper payments made to or on behalf of the Contractor under the Construction Contract."

Section 4 to just Section 3.1.[13] Further, although the new Section 4 eliminates the failure to provide notice of the obligee's intent to declare a default and participate in a meeting from barring a claim without a showing prejudice, the limited nature of Section 4 should actually strengthen the argument that the other requirements of Section 3 are condition precedents to a surety's obligations under the bond and that a showing of prejudice from a violation of those conditions is not necessary.[14]

The argument is that if the other requirements (the owner's declaration of default, termination of the construction contract, and agreement to pay the contract balance to the surety or completing contractor) were not to be considered conditions precedent or required a demonstration of prejudice, they would have been included in Section 4. The failure to so include can be construed as evidence of intent not to do so.

When the Owner has satisfied the conditions of Section 3, the Surety is required to promptly, and at the Surety's expense, take one of the actions identified in the 2010 A312 bond at Section 5. Those actions include:

§ 5.1 Arrange for the contractor, with owner's consent, to complete (takeover/finance);

§ 5.2 Undertake to perform itself through an independent contractor (takeover);

§ 5.3 Obtain bids or proposals from contractors acceptable to owner and pay excess costs (tender);

§ 5.4 Pay to the owner the cost of completion; or deny liability.

If the Surety does not proceed as provided in Section 5 with "reasonable promptness," the Owner can provide written notice to the Surety demanding that the Surety perform its obligations under the Bond. If the Surety has not proceeded after seven days from receipt of the Owner's notice, the Surety will be deemed to be in default. *See* A312 § 6. If the Surety is in default the Owner shall be entitled to enforce any remedy available to the Owner. If the Surety proceeds as provided in Section 5.4 and the Owner refuses the payment or the Surety has denied liability, in whole or in part, then without further notice the Owner shall be entitled to enforce any remedy available to the Owner.

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[13] *See Independent Temperature Control Services, Inc. v. Parsons Brinckerhoff, Inc.*, 2017 WL 318654 (N.Y. Sup. Ct. Jan. 20, 2017); *W. Sur. Co. v. U.S. Eng'g Co.*, 375 F. Supp. 3d 1, 6 (D.D.C. 2019).

[14] The Court in *U.S. Eng'g Co.*, reached that conclusion and observed: "Taking the whole Bond into account and giving full effect to Section 4, the court finds that the provision requiring [the surety] to demonstrate actual prejudice to be released from its obligation is limited to [the obligee's] failure to provide notice pursuant to Section 3.1. Put differently, while [the obligee's] noncompliance with the notice requirement in Section 3.1 requires an actual prejudice showing from [the surety], [the obligee's] noncompliance with the notice requirement in Section 3.2 requires no such showing." *Id*.

If the Surety elects to act under Sections 5.1, 5.2 or 5.3, then the responsibilities of the Surety to the Owner shall not be greater than those of the Contractor under the Construction Contract, and the responsibilities of the Owner to the Surety shall not be greater than those of the Owner under the Construction Contract. *Id.* A312 § 7.

Section 7 of the bond provides that subject to the commitment by the Owner to pay the Balance of the Contract Price, the Surety is obligated, without duplication, for: correcting defective work; completing the work; additional legal, design professional and delay costs resulting from the Contractor's Default, and resulting from the actions or failure to act of the Surety under Section 5; and liquidated damages, or if no liquidated damages are specified in the Construction Contract, actual damages caused by delayed performance or non-performance of the Contractor.

If the Surety elects to act under Section 5.1, 5.3 or 5.4, the Surety's liability is limited to the penal amount of the Bond. Thus, electing to takeover under Section 5.2 of the A312 (2010) can expose the Surety to liability in excess of the penal sum.

III. PREJUDICE/IMPAIRMENT TO THE SURETY – CONSEQUENCES FOR THE OBLIGEE'S FAILURE TO COMPLY WITH CONDITIONS PRECEDENT (Moran)

An obligee who fails to comply with the conditions precedent set forth in an A312-2010 bond risks losing the benefit of the bond entirely. The notice provisions in a performance bond are not mere procedural hurdles. They ensure that a surety whose principal has defaulted in its obligations can act swiftly to mitigate its potential losses arising from the default. When the surety doesn't have a meaningful right to investigate the project and choose among the options in Section 5 because the obligee was late giving notice, or didn't give the proper type of notice, the bond may be discharged. While there are few reported decisions dealing with the 2010 bond form, for the most part courts have been willing to strictly apply the conditions precedent as they would to any other type of contract.

The changes made in the A312 (2010) bond form include a new paragraph 4 which provides that failure on the part of the owner to comply with the notice requirements in section 3.1 of the bond shall not constitute a failure to comply with a condition precedent to the surety's obligation or relieve the surety from its obligations, except to the extent the surety demonstrates actual prejudice. So, when you're looking at these situations, you have to read the bond and know which bond form you're dealing with, so you can determine what type of failure of notice will result in an absolute defense. Or, what type of failure will require additional proof from the surety in order to set up the defense.

One recently decided case that touched on that issue is a case that I'm working on, *Western Surety Co. v. U.S. Engineering Co.*, 375 F. Supp. 3d 1 (D.D.C. 2019), a case from the

US District Court for the District of Columbia. This was a case involving the South African Embassy Project. The principal was a mechanical subcontractor, which was terminated by the obligee after issues arose without notice to the surety. The obligee then proceeded to complete the work using its own personnel as well as hiring several other contractors to complete the scope of work. Meanwhile the principal initiated arbitration proceedings against the obligee. During the arbitration proceedings, the principal closed its doors. Around that time, the obligee realized it had rights under a performance bond (its project manager had, not coincidentally, left abruptly in the middle of the project), and submitted a claim to the surety. This was about 9 months after the termination and some time after the principal's scope of work was complete, and it was the first notice the surety had received that there were problems on this project.

The surety moved for summary judgment, arguing that the obligee failed to comply with all the conditions precedent under 3.1, 3.2 and 3.3. In other words, it didn't give notice of intent to meet, it didn't give notice of termination, and it didn't agree to commit the remaining contract funds to the surety. The obligee countered that it did in fact do all these things and the fact that it did them nine months after termination was irrelevant because the bond doesn't give a time frame for when these conditions need to be met.

The key question to the Court was whether the bond contained a provision requiring specific action within a certain amount of time. While the principal was correct that there was no explicit provision in the bond requiring notice within a certain period of time, the Court found that the right to cure and other options under Section 5 would be meaningless if notice of termination could be given after the work had been supplemented.

On the issue of prejudice, the Court found that prejudice was not a required showing by the surety for the notice of termination under section 3.2. This is because section 4 only requires a showing of prejudice with respect to delayed notice of the meeting under section 3.1. Because there was a valid contractual provision giving the surety an opportunity to cure the default, the denial of that right was a sufficient breach of the bond to effect a discharge. Mike will talk more about the prejudice issue in a few minutes. The Court relied heavily on *Hunt Construction Group, Inc. v. National Wrecking Corp.*, 587 F.3d 1119 (D.C. Cir. 2009), a case from the D.C. Circuit with similar facts but evaluated under the A311 bond form.

The U.S. Engineering case has been appealed to the U.S. Court of Appeals for the D.C. Circuit, so we may revisit this in a future Surety Today depending on how it comes out on appeal.

The next case is *Granger Construction Co. v TJ LLC,* 2015 NY Slip Op 09335 (NY App 12/17/2015). The case arose from the construction of a hotel. The hotel was substantially completed and open for business before all of the repair work was actually done. A problem

with the fire alarm system that forced the hotel to close down. The owner made demand upon the principal to repair the alarm system, but the principal refused because the principal had not been timely paid. So, the owner hired another contractor to fix the alarm issue and in the course of doing that it found other issues of defective work and the owner then hired other contractors to fix the other defective work.

After the repairs were completed, the owner then sent its notice of intent to declare a default to the surety. The contractor filed suit against the owner for failure to pay and the owner filed a third-party claim against the surety making a claim on the performance bond. The surety promptly moved for summary judgment, asserting that the owner had violated several conditions precedent in the bond - namely, failed to provide the notices required by the bond, failed to allow the surety to elect options to perform, failed to give additional notice before filing suit and basically just ignored all of the conditions of the bond. The trial court granted summary judgment for the surety and on appeal, the appellate court affirmed finding that the language of the bond provided clear, unambiguous conditions precedent and that the surety's obligation did not arise until those conditions precedent were satisfied. Because the conditions precedent were not satisfied, the court affirmed the summary judgment and the surety was out of the case.

Another aspect of the case that the opinion did not address is the principal's claim that it was not paid timely. In fact the principal filed suit because of lack of payment. The surety's obligation under the A312 is conditioned on there being no owner default. As noted earlier, an "owner default" is defined in the A312 as failing to timely pay in accordance with the terms of the contract. Accordingly, that's another potential condition precedent that could give rise to a defense. The takeaway is look at the terms of the bond and see if you have a condition precedent defense. Be careful because conditions precedent can be waived or excused. So, the surety's conduct might come into play.

IV. LEVELS OF PREJUDICE AND DISCHARGE (Stover)

In this segment I will briefly discuss the concepts of prejudice and discharge. Historically, sureties were favored under the law and any change or modification or failure to follow the terms of the bond resulted in a discharge of the surety, regardless of whether there was any actual prejudice or harm to the surety. Over time, courts began to note the distinction between a personal surety and a compensated surety. The law in many jurisdictions began to change with respect to compensated sureties and courts began to require a showing of prejudice to the surety before there could be a discharge; and some courts even limited the discharge to the amount of the prejudice.

For example, in *Plowden & Roberts, Inc. v. Conway*, 192 So.2d 528 (Fla.App. 1966) the Court held that the surety must prove damages, if any, resulting from the obligee's failure to

permit it to promptly remedy the alleged default in accordance with the terms of the bond.[15] In *Blackhawk Heating & Plumbing Co. v. Seaboard Sur. Co.*, 534 F. Supp. 309, 316 (N.D. Ill. 1982) the Court stated, "[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."[16]

To a great extent the A312 (2010) performance bond changed the course of the law requiring a showing of prejudice before there could be a discharge by incorporating conditions precedent into the bond. As noted earlier, conditions precedent are a creature of contract law, not suretyship and so are not subject to the prejudice limitation. If the conditions precedent are not satisfied, the surety can have no liability or obligation under the bond and it is discharged. Section 4 is the only express limitation on the operation of the condition precedent law and that exception is limited to the conditions in Section 3.1. The Court in *W. Sur. Co. v. U.S. Eng'g Co., 375 F. Supp. 3d 1, 6 (D.D.C. 2019)* noted that the A312 bond language does not require a showing of actual prejudice anywhere else.

In a variety of cases involving the A312, obligees have attempted to insert a prejudice requirement, but the majority of courts have refused to up hold such arguments. For example, the Court in *United States ex rel. Agate Steel, Inc. v. Jaynes Corp.*, No. 2:13-CV-01907-APG-NJK, 2016 U.S. Dist. LEXIS 79888 at *21-25 (D. Nev. June 17, 2016) found that the surety was not required to show prejudice as a result of the obligee's failure to give the required notice because the A312 bond terms clearly and unambiguously required notice as a condition precedent. The obligee's failure to provide the required notice was more than a mere technical violation.[17]

Different jurisdictions may still attempt to engraft a prejudice requirement onto the surety's discharge defense under the A312, particularly relating to terms that are not conditions precedent, so the surety must be aware of the issue.

V. <u>THE LINE BETWEEN THE OBLIGEE'S RIGHTS UNDER THE CONTRACT AND THE SURETY'S RIGHTS UNDER THE BOND</u> (Moran)

A surety's performance rights under the A312-2010 bond will sometimes come into conflict with the obligee's interest in completing the work pursuant to its right to supplement under its contract or its right to keep the project lien-free. Usually the obligee will be entitled to supplement the principal's work once it declares a default after an applicable notice period. If

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[15] *LaSalle Grp., Inc. v. JST Properties, L.L.C.*, No. 10-14380, 2011 WL 3268099, at *5 (E.D. Mich. July 29, 2011); *Maule Industries, Inc. v. Gaines Construction Co., Inc*., 157 So.2d 835 (Fla.App.1963).

[16] See also *Conesco Industries, Limited v. Conforti and Eisele*, 627 F.2d 312, 316 (D.C.Cir.1980); *New Amsterdam Cas. Co. v. U. S. Shipping Bd. Emergency Fleet Corp.*, 16 F.2d 847 (4th Cir. 1927); and *Robertson Lumber Co. v. Progressive Contractors, Inc.*, 160 N.W.2d 61 (N.D.1968).

[17] *See also Borough v. Peter V. Pirozzi Gen. Contracting,* No. 2:13-CV-01470-PBT, LLC, 2015 U.S. Dist. LEXIS 45079 at *41 (E.D. Pa. Apr. 7, 2015); *Town of Plainfield v. Paden Eng'g Co.,* 943 N.E.2d 904, 914-916 (Ind. Ct. App. 2011); *Stonington Water St. Assoc., LLC v. Hodess Bldg. Co.,* 792 F. Supp. 2d 253, 263-65 (D. Conn. 2011).

the principal fails to cure, the obligee has the right to do the work itself or hire a supplementing contractor to do so.

That tension was resolved in favor of the surety in *United States ex rel. Agate Steel, Inc. v. Jaynes Corp.*, No. 2:13-CV-01907-APG-NJK, 2016 U.S. Dist. LEXIS 79888 (D. Nev. June 17, 2016). The project was construction of a rescue station at Creech Air Force Base in Nevada. The general contractor subcontracted with American Steel Corporation for steel fabrication, which provided its performance and payment bonds using the A312-2010 language.

The general contractor and American Steel saw their relationship break down, with each party blaming the other for delays and problems on the project. The general contractor wrote a letter to American Steel advising that its steel erection plan was late and that it would be responsible for any delays. That first letter said it was copied to the surety, which didn't have a record of receiving it.

About 7 weeks later, the general contractor send a 3-day notice to cure advising American Steel it was in default and invoking the right to supplement work. The letter stated that it was being copied to the surety's local agent, but not to the surety itself. Then, about 5 weeks after the notice to cure letter, the general contractor sent another letter to American Steel stating that because American Steel refused to continue its work on the project, it would be supplementing the work with another steel contractor. The new steel contractor went on the jobsite the next day and took about a month to complete the steelwork.

Then, about a month after *that*, the general contractor finally submitted a written notice of claim under the performance bond, agreeing to offset the remaining contract funds. The Court recognized that Ohio Casualty's obligations did not arise until after the general contractor followed the requirements of § 3.2: that is, declaring a contractor default, terminating the contract, and notifying the surety. There was "no evidence that [the general contractor] terminated the contract or notified [surety] of the termination so that [surety] could exercise its options under section 5 of the performance bond." It observed that the notices provided by the general contractor did not terminate but only threatened supplementation, which was provided for in a different section of the subcontract. The general contractor did not provide a seven-day notice of termination as the subcontract required or any other notice that the surety was expected to commence performance under the bond.

The general contractor argued that the surety was eventually informed of the default, so it was not prejudiced. It pointed to the concept that the bond of a compensated surety is to be liberally interpreted in the interests of the beneficiaries. Thus, the failure to comply with the procedural notice requirements was just a technical violation that should not relieve the surety of its obligations. But the court said that there was no ambiguity to be liberally construed. By the "plain language" of the bond, compliance with section 3.2 was a condition precedent to the

surety's obligations. And, there was no need to show prejudice because section 4's prejudice requirement only applied to section 3.1 of the bond, not sections 3.2 and 3.3. The lack of notice of termination was a not a technical violation but a material breach which excused the surety's performance. Further, the surety was deprived of its rights under the bond and the option to cure the default, which in and of itself constituted prejudice.

In *Commercial Cas. Ins. Co. of Ga. v. Maritime Trade Ctr. Builders*, 572 S.E.2d 319, 320-21 (Ga. App. 2002), the Court found in favor of the obligee when it relied on subcontract provisions that conflicted with the bond form. Under the subcontract, if the subcontractor failed to perform, the obligee/general contractor could supplement or replace the subcontractor upon 48-hours' written notice. There was also an indemnity provision for losses arising from the subcontractor's breach.

The Court held that there was no discharge even though there was not strict compliance with the general contractor's failure to provide notice of termination as required by the bond. The court reasoned that "[t]he bond itself contains a detailed notice provision in the event of a default, but does not address the contingency of the contractor supplementing the subcontractor's work before it defaults." *Id.* at 322. A line was drawn between the condition allowing the obligee to supplement the work and the declaration of default under the bond. The obligee completed the principal's scope of work itself and charged the costs to the surety just by declaring a breach of the subcontract.

It is worth noting that this case was decided using a previous bond form. Also, the surety appeared to take little action in response to the notices it received from the obligee regarding the principal's failure to compensate its subcontractors, that it was late in its work, and that it was not progressing satisfactorily. Without any response from the surety, the Court may have decided that it tacitly approved the obligee's ultimate choice to supplement the work, even though it did not receive specific notice of this choice as it was ostensibly entitled to under the bond.

A surety also needs to be wary of the obligee's right to ensure a lien-free project under the subcontract and deduct the costs of doing so from the remaining contract funds. This was the main issue in *Whiting-Turner Contracting Co. v. Guar. Co. of N. Am. USA*, 440 P.3d 1282 (Colo. App. 2019), a very recent case involving the A312 bond form. The bonded subcontractor was engaged to construct the anchor system of a parking garage in a project to build an office building. The subcontractor fell behind schedule almost immediately and stopped paying the sub-subcontractors. It told Whiting-Turner to take responsibility for shotcrete (sprayed concrete) and work directly with its sub-subcontractors.

Whiting-Turner declared the subcontractor in default and issued a 3.1 notice. The meeting took place with the surety's involvement and Whiting-Turner and the subcontractor agreed to delete the shotcrete work from the subcontract. Two days later, the subcontractor said that because Whiting-Turner had declared it in default and stopped paying, it would demobilize. Whiting-Turner asked the surety in writing how it should proceed. The opinion states that the surety didn't respond.

Whiting-Turner then terminated the subcontract and made demand to the surety to perform under the bond. Again, the opinion states that the surety did not respond to this notice. Whiting-Turner wrote the surety again, including a calculation of the "Balance of the Contract Price." This is a defined term under section 14.1 of the bond: "The total amount payable by the Owner to the Contractor under the Construction Contract after all proper adjustments have been made…" Whiting-Turner deducted (1) payments to five sub-subcontractors who had recorded or threatened liens against the project, (2) the price of the shotcrete work, and (3) a backcharge. This resulted in a negative Balance of the Contract Price.

The subcontractor filed suit against Whiting-Turner for failure to pay under the subcontract. Whiting-Turner counterclaimed against the subcontractor and filed a third-party claim against the surety for breach of the performance bond. The surety's argument was that Whiting-Turner had failed to comply with the condition precedent in section 3.3 – to pay the Balance of the Contract Price – to the surety. Specifically, the surety said that the balance was miscalculated and by stating a negative balance Whiting-Turner could not trigger the obligations under the performance bond.

The case went to a bench trial, where the trial court found against the subcontractor and the surety. It held that Whiting-Turner had complied with its obligations under section 3.3 and that the surety had breached the bond. It also found in the alternative that the surety had waived any condition precedent arguments because it failed to respond to the requests for guidance made by Whiting-Turner. The surety was also found liable for all of Whiting-Turner's attorneys' fees, including those related to the litigation of the subcontractor's claims.

The appellate court affirmed the trial court's rulings. It found that Whiting-Turner satisfied the condition precedent in section 3.3 of the bond. Because the subcontract gave Whiting-Turner the right to take all actions necessary to keep the project free and clear of liens, which included the amounts paid to subcontractors after the termination. The surety claimed that the Balance of the Contract Price was fixed at the time of termination. The Court disagreed and found that there was nothing in the bond preventing Whiting-Turner from making post-termination payments and designating them as proper adjustments to the balance. It specifically distinguished this situation from that where the obligee selects a replacement subcontractor without notice to the surety. Finally, the Court found that the reduction for the shotcrete work was proper because the surety had been involved in the meeting where Whiting-Turner agreed to accept responsibility for it.

There are two takeaways from *Whiting-Turner*. The first is that the "Balance of the Contract Price" isn't necessarily immutable at the time termination is declared. The obligee can satisfy the condition precedent under section 3.3, even when the Balance goes into negative numbers after post-termination deductions, as long as the payments are authorized under the bonded contract. The second is that a surety needs to be careful in relying on the need for strict compliance with conditions precedent when it is receiving repeated notice from the obligee that there are serious problems with the principal's performance.

The next case that I would like to discuss is *International Fidelity Insurance Company v.*

Americaribe-Moriarity, JV, 192 F. Supp.3d 1326 (S.D. Fla. 2016). This is out of the Southern District of Florida. The case involves the discharge of the surety as a result of the obligee's failure to comply with the conditions precedent in the 2010 bond form. The case also addresses the interplay between the surety's rights under the performance bond and the obligee's right to supplement and perform the work for the defaulting principal. The surety filed for declaratory judgment seeking a discharge of the bond. The Obligee asserted a counterclaim contending that IFIC breached the bond by failing to cure the default or arrange for performance. Both parties moved for summary judgment.

The JV was the general contractor and IFIC bonded the subcontractor – Certified Pool Mechanics or "CPM". CPM was contracted to perform pool work on the project. Unlike in some of the other cases we've reviewed, there was some communication between the surety and the obligee before the principal's work was supplemented. The following is a quick rundown of the communications:

- July 15, 2015 – the JV sent a letter to CPM notifying that it was in default and they gave them three days to cure.
- August 17, about a month later, the JV sent a letter to IFIC and CPM advising of delays, poor workmanship and making a demand for an A312 conference.
- August 20, three days, later, IFIC responded advising that it was investigating, requesting additional documents and information and advising the JV not to complete the work without IFIC's prior consent.
- September 2, the parties held the A312 conference.
- September 15, IFIC sent another letter advising that it was continuing its investigation, noting some issues that it had discovered with respect to the schedule, asking for additional information and once again advising the JV that any attempt to complete the work without IFIC's consent would be a violation of the bond.
- September 16 (One day later), the JV obtained a proposal from another subcontractor to complete CPM's work.
- September 17, (Next day), the JV and the new subcontractor set a tentative start date for work which was to be 9/21.
- September 21 the JV sent a letter to CPM and IFIC declaring a default, terminating CPM and demanding that IFIC perform.
- September 22 the JV sent a letter advising IFIC that it intended to subcontract with the new subcontractor and
- September 23, the subcontractor began performing the work.

The JV made some later attempts to provide additional notices, but the Court held that under such facts the JV failed to give proper and timely notice to IFIC as required by the Performance Bond, failed to allow IFIC reasonable time to select a performance option and failed to give IFIC the additional seven days notice required under the Performance Bond. The Court noted that coordinating with the replacement contractor before meeting the requirements of the bond was a clear breach of the bond.

I think everyone would agree that IFIC was given little time to investigate or consider its options, but the JV argued that under the terms of the subcontract with CPM, the JV was justified in arranging for a new subcontractor to complete the work. The Court held that the Performance Bond and the Subcontract must be read together "harmoniously" in order to give effect to all terms and provisions of both contracts. In other words, effect had to be given to the language in the bond and the subcontract, and there was nothing in the subcontract that conflicted with the surety's right to notice. Where the JV was required to give notice under both the Performance Bond and the Subcontract before it could undertake completion efforts, the surety was entitled to reasonable notice and was entitled to exercise its rights under the Performance Bond.

In concluding, the Court stated "[a]lthough the [JV] may have had a right under the subcontract to hire a replacement subcontractor to complete the subcontract, it did not have the right to do so without first allowing IFIC an opportunity to exercise its rights under the Performance Bond."

To address the interplay between the subcontract provisions and the performance bond provisions, the Court essentially reverted to the time-honored rules of contract construction. Thus, it is a generally accepted rule that when provisions of a contract appear to be in conflict, the court should attempt to reconcile those provisions, if possible. An interpretation of a contract which gives a reasonable, lawful and effective meaning to all of the terms is preferred to an interpretation which leaves a part unreasonable, unlawful or with no effect. How this interpretation of the performance bond and subcontract will play out in a given jurisdiction will depend in part on how that jurisdiction applies the incorporation by reference. In some jurisdictions when a document is incorporated by reference the two documents become as one and it is as if the surety is a party to the subcontract. In other jurisdictions, the incorporation by reference is more limited. So, that will be an issue when you're looking at this question of how do you determine whether the obligee can just supplement and complete work or whether they've got to comply with the bond terms.

Finally, as a practice pointer, the IFIC folks really did a good job in their communication, reminding the obligee that you can't just jump off here and start completing the work, we've got rights under the bond and to do that, you're going to be in violation of the bond and they did that in several of the communications, and I think that was an important factor as well and something that everybody should try to emulate, particularly when you've got that A312 bond form.