CONSTRUCTION BONDS – THE OVERVIEW: WHO, WHAT, WHEN, WHERE AND WHY PARTIES; ALTERNATIVES; FORMS; LENDER CONCERNS; DEFENSES

I. CONSTRUCTION BONDS – THE OVERVIEW

Every construction project is fraught with uncertainties and threatened by so many tangible and intangible perils that it sometimes seems surprising that anything ever gets built. Although the risks clearly increase with the scope and complexity of the project, from the simple home renovation to the publicly financed sports and multi-purpose entertainment venue (i.e., indoor arena), many of these uncertainties are common. Carefully drafted contracts and careful selection of contractors can reduce the risks, but contractors, owners/developers ("owner") and lenders alike frequently turn to independent third parties to help reduce the risks inherent both with selection of the contractors and with the contractors' ability to complete with skillful and lien-free performance.

A. Who And What: The Parties And The Common Types Of Bonds And Other Financial Assurances

1. The Parties

Whether an owner dealing with a general contractor, or a general contractor dealing with subcontractors, selecting "the right person for the job" is a critical concern. No amount of research or reliance on reputation can protect against unforeseen factors that can impair a contractor's or subcontractor's ability to complete a project. The domino effect created by a contractor's difficulties in an unrelated project can wreak havoc on the business entity and the people who make it run in ways that are limited only by the scope of imagination. Disagreements between a contractor and its subs or suppliers in which the owner or general contractor has no direct involvement can also severely disrupt the project. The construction bond brings into this equation an independent third party known as the Surety (generally an insurance company or other business entity of substantial net worth, but sometimes an individual) willing to stand behind the contractor's reputation and ability to perform, with both requisite skill and pecunity. The Surety will frequently be either acquainted with or able to research the contractor's track record and able to assess the ability of the contractor's organization to render the required performance. It will investigate the finances of the contractor and obtain the kinds of financial disclosures and assurances, including personal guarantees from principals and/or valuable collateral, that the contractor is unwilling to give to the diversity of owners with which it may be dealing on numerous projects. The contractor is prepared to make financial disclosures to the independent third party Surety that it would be unwilling or uncomfortable making to an owner. Similarly, the fact that the contractor is likely to be dealing with one or a limited number of bonding companies on numerous projects gives the owner some comfort that guaranties and other financial assurances are not over extended or otherwise being depleted in connection with other projects.

Although the construction bond protects the owner against damages incurred, it is different from traditional insurance policies in several important respects. First, it is a tri-party agreement involving the Surety, the contractor (referred to as the Principal) and the owner, lender or general contractor (referred to as the Obligee). Bonds are frequently issued to more

than one Obligee, such as a subcontractor's bond being issued for the benefit of the general contractor and the owner or the general contractor's bond being issued for the benefit of the owner and its lender. In these situations, the beneficiaries of the bond are referred to as Dual Obligees or Co-Obligees. (See discussion in Part II of these materials.). The Obligee does not normally sign any documentation in connection with the issuance of the bond, but it is named in the bond as a beneficiary of the financial undertakings of the Principal and the Surety. Second, the Surety is not an insurer of, or an indemnitor against, a specific loss or peril. The bond is not intended to protect the Principal from loss or damage from an unforeseen event, as traditional insurance would but to protect the Obligee from the defaults or impecunity of the Principal. The Surety, for a one time fee or premium, stands in the shoes of the Principal for the Principal's obligations to deliver contractual performance for the benefit of the Obligee, including the obligation to pay subcontractors and materialmen. Third, the Surety does not bear the risk for the Principal, but rather shares it on equal footing with a right to recover from the Principal if the Surety is called on to perform. Fourth, unlike an insurer that undertakes an obligation to defend its insured against a claimed loss, a default by the Principal constitutes *prima facie* evidence of the Surety's liability and shifts to the Surety the burden of raising any possible defenses.

Some commentators include as a difference between sureties and insurers the fact that the primary beneficiary of the bond, the Obligee, does not pay the premium as does the Primary beneficiary, the insured, under an insurance policy. In reality, the cost of the bond is invariably included as a cost of construction that is paid by the Obligee owner as a pass- through cost of the project.

2. The Three Primary Forms of Bonds

In very broad terms, the contractor, owner and lender rely on three principal types of bonds for the traditional construction project. These bonds, with variations and combinations, are the ***bid bond***, the ***payment bond*** and the ***performance bond***. Depending on the parties to the bonding transaction, these bonds protect against damages that might be sustained at various stages of the construction process.

a. The Bid Bond

In any construction project that is put out for bid, there is a gap to be bridged between the owner's acceptance of the bid and the contractor's signing the contract to obligate itself to performance under specific terms of a construction contract. The Bid Bond, delivered by the bidder as one of the bid documents, assures the Obligee that the contractor will sign the construction contract. If the successful bidder fails to honor the bid the Surety becomes liable to the Obligee owner for the difference between the successful bid amount and the amount that the owner may be required to pay under a replacement bid, subject always to the amount stated in the Bid Bond as the face or penal amount of the bond.

b. The Performance Bond

After the contractor has stood behind its bid and entered into a binding construction contract, the owner is faced with the risk that the contractor cannot or will not complete performance in the manner specified by the contract. Under the Performance Bond, the Surety issuing the bond stands side by side with the contractor to assume the obligations and responsibilities of the Principal for performance of the terms of the contract. If the contractor defaults, the Surety traditionally has several options under the terms of the bond. These include

(i) obtaining a new contractor to complete the work at the Surety's expense, but subject to the payment obligations of the Obligee under the bonded contract, (ii) taking over the construction of the project or the portion thereof covered by the bonded contract, (iii) financing the Principal so that the Principal is able to complete the work, or (iv) paying the Obligee the amount required to complete the work, again subject always to the face or penal amount of the bond.

c. The Payment Bond

Assuming that the contractor or subcontractor is able to adequately perform the physical or mechanical aspects of its work, there remains the risk that it will fail to make payment to its subcontractors, laborers or suppliers resulting in lien claims against the project. The Payment Bond, sometimes called a labor and materials bond, protects the owner from this risk and will pay the subcontractors and suppliers for the services and materials used on the project.

It is very common for a Surety to undertake both performance and payment obligations in a single bond.

3. Alternatives to the Traditional Construction Bond

As noted above, the primary purpose of the construction bond is to protect the Obligee from financial loss if the Principal is unable to perform or fails to make payment to those who have supplied services or materials to the project. There are several alternatives to the standard construction bond, all of which share with the construction bond the element of being provided by a financially able third party. The three forms of alternative assurances are the ***personal guaranty***, the ***letter of credit*** and the ***set aside agreement***.

a. The Personal Guaranty

Requiring no specific explanation beyond its name, a Personal Guaranty is good only to the extent of the assets of the entity or individual issuing it. It is subject to the inconvenience and uncertainty of having to do one's own due diligence with regard to those assets, and to the ability of the issuer to cause the Principal to perform. With the threat of personal liability being the primary motivating factor, the value of the Personal Guaranty is limited by both the integrity of the issuer and his, her or its continuing financial viability.

b. The Letter of Credit

Issued by a presumably stable and adequately capitalized financial institution, the value of a Letter of Credit is directly related to the detail and skill with which the terms and conditions of the beneficiary's ability to draw are drafted. Generally issued for substantially less than the value of the contract that it assures, it gives less protection than the traditional construction bond, although it may be easier to collect under a Letter of Credit than to obtain payment of performance from the Surety under a bond. The Letter of Credit may also create problems from the perspective of the construction lender or the owner in the event of a subcontractor's Letter of Credit. (See discussion in Part II of these materials.)

c. The Set Aside Agreement

The Set Aside Agreement is really not a bonding technique at all. Rather, it is a facilitating arrangement under which the construction lender can give assurance to the Principal and Surety that the construction loan provides sufficient funds to enable the owner to pay the hard costs of the bonded contract. Without these assurances, soft costs and other project work being performed by the owner could substantially reduce the construction loan proceeds

available for paying the Principal. Although the owner's default under the bonded contract is generally a defense to a claim against the Surety, a Set Aside Agreement may be necessary for the contractor to obtain a bond for the benefit of an owner with a spotty record of payment or for an owner without sufficient operational history to give the Surety and the Principal some comfort that the project can be completed without litigation. (See discussion in Part III of these materials)

B. When Where & Why Shalt Thou Bond?

Almost every construction project runs on a budget that is sensitive to unnecessary soft costs. The cost of performance and payment bonds, and in the case of the successful bid the cost of a bid bond, is invariably passed on to the owner as part of the total cost of the contract. Because one of the primary purposes of the bond is to give the owner comfort that the investigation by the Surety into both the performance track record and financial stability of the Principal has yielded satisfactory results, many owners feel that so long as the contractor is capable of posting the bond, the bond is not necessary. To say that this approach is penny wise and pound foolish may be an overstatement but unless the owner or general contractor has direct experience with the contractor proffering the bond, or unless the contractor proffering the bond has an impeccable reputation, the decision not to require the bond from a bondable contractor could well be regrettable. General economic conditions, such as whether the construction industry in the area in which the contractor does business is active or may be at a plateau or downturn, can affect the contractor's ability to continue to support an organization put together during good times and not dismantled quickly enough. Many a contractor has succumbed to the unwillingness to be less than fully staffed and ready for the next big job. This is the type of financial risk against which payment and performance bonds were designed to protect.

C. Forms:

One should never assume that the surety's printed form of bond is chiseled in stone. Although the terms of the traditional insurance policy are generally dictated by the forms developed by the insurers and their rating organizations and are not subject to substantial negotiation, the forms of construction bonds are very frequently written on the forms of the American Institute of Architects or on forms proffered by private or public owners. Every jurisdiction has its own legal requirements, but many public construction projects prohibit or severely limit the ability of a contractor or supplier to file mechanics or construction lien claims. Many of these jurisdictions require payment bonds both to protect the interests of the public in the project being constructed and to protect the interests of the contractors and suppliers whose lien rights may be limited. The most well known of these statutes is the "Miller Act" governing federal construction projects (40 U.S.C. §§270a - 270d (1982 and Supp. 1984)). The diverse state statutes modeled after the federal legislation are referred to as "little Miller Acts." With the exception of Miller Act and little Miller Act bonds, the terms and conditions of the construction bond are subject to liberal negotiation.

In the private project the amount of the bond is a matter that is subject to the requirements of the Obligee(s). Generally, the bond is written in an amount equal to the value of the work covered by the bonded contract. It is not unheard of, however, for bonds to be written in lesser amounts. Labor and materials or payment bonds, although designed to protect against construction liens, frequently have contractual limitations for the filing of claims and the institution of suit to enforce those claims that differ substantially from the time from which the

claimant has under local law to file the lien. These provisions can be useful to the Principal and Surety in avoiding liability and should be reviewed carefully since they may leave the Oblige vulnerable to a lien claim.

Similarly, some jurisdictions limit the eligibility to file construction lien claims. As an example, New Jersey limits construction lien claimants to those within three "tiers" of contract privity from the owner of the project. The standard form of construction bond (see discussion below) would protect all individuals or entities supplying labor or materials to the project against risk of non-payment. With the exception of Miller Act and many little Miller Act bonds, the terms of which are mandated by their respective enabling legislation, the form of a private construction bond can be negotiated to protect the Principal from having to make a double payment as a result of claim made against the bond by a claimant not otherwise eligible to file a construction lien.

II. CONSTRUCTION BONDS FROM THE LENDER'S PERSPECTIVE

In most instances, the interests of the developer and its lender are aligned in requiring and asserting rights under construction bonds. Both parties are concerned with insuring that the project will be completed to standards and that all parties who might assert liens against the project have been paid. The same considerations that might cause the owner to consider alternate security for the contractor's obligations also will apply to the lender. Discussion in Part I of these materials highlights some alternate security devices.

However, because the lender is not a party to the construction contract and does not have a direct contractual relationship with the contractor and its surety, the lender typically requires that it be granted a direct right against the surety, either by being named as a co-obligee in the payment and performance bonds or by being added in a co-obligee or dual obligee rider. For convenience, both the co-obligee bond and the co-obligee or dual obligee rider will be referred to as a "Dual Obligee Rider". While the Dual Obligee Rider is demanded by the lender to protect its interest, language in the typical rider inures to the benefit of the surety. In addition to protective language in the Dual Obligee Rider, the surety and the contractor also often typically request or require a set-aside letter or similar assurance as to the availability of funds for the developer to discharge its payment obligations under the construction contract.

A. Dual Obligee Riders

1. Who is Protected under a Payment or Performance Bond?

Typically the obligee (the developer) is the beneficiary under performance bonds while subcontractors, materialmen, and others furnishing labor or materials (for convenience, this will be called the "Subcontractor Group") are typically the beneficiaries of payment bonds. The developer may have no right to claim under a payment bond unless and until it has suffered a loss by being forced to pay direct claims of the Subcontractor Group. The developer's lender typically has no direct right of action against the surety under either the payment or the performance bond. The lender may take an assignment of or security interest in the rights of the developer against the surety, but this right is typically asserted through the developer, rather than representing a direct right against the surety.

2. The Dual Obligee Rider

a. <u>Why obtain a Dual Obligee Rider?</u>

In order to enable it to have a direct right of action on a payment and performance bond, a lender may require a Dual Obligee Rider. While it is possible for the lender to be named as an obligee in the face of the bond itself it is more customary to add the lender by rider. Based upon a Dual Obligee Rider, the lender acquires independent rights directly against the surety. The benefits of such a direct relationship are obvious. In a troubled project, or with a distressed

borrower, the lender may find it desirable or necessary to deal directly with the surety in an attempt to salvage a project.

b. What is the form of the Dual Obligee Rider?

While there are statutory bond forms in many jurisdictions and the AIA has suggested forms of performance, payment and bid bonds (Exhibit "A"), there does not appear to be a single or common form of Dual Obligee Rider. From the lender's perspective, a rider that simply added its name as an obligee, similar to an endorsement adding an additional insured or loss payee to liability or property insurance, would be ideal.

While some riders may be available in such an abbreviated form, these are the minority. Many of the defenses that the surety has to its obligations under the bond arise from the terms of the contract between its principal (the contractor) and the obligee (the developer), as the surety stands in the place of its principal. A lender, which is not a party to that contractual relationship, would generally not be subject to those defenses or objections. It has been observed that a Dual Obligee Rider that merely adds the lender, without in some fashion subjecting the lender to defenses under the construction contract, transforms the payment and performance bond into a "completion bond." Completion bonds, which apparently were in use in the 1920's and 1930's, essentially guaranteed lien-free completion of a project without affording any defenses to the surety – including the failure of the developer to pay the contractor. Discussions at part III of these materials explores the surety's defenses in greater detail.

As a result, the Dual Obligee Rider most often available conditions the obligations of the surety on the payment and/or performance by either the owner or the lender of the obligations of the developer under the contract. Exhibit "B" contains several examples of Dual Obligee Riders. While these give the lender the benefits of the bond, they may subject the lender to defenses that the surety has against the developer, such as failure to perform under the contract and to pay for work performed thereunder. Other defenses include impermissible modifications of the contract of a substantial nature.

Centerre Trust Co. v. Continental Ins. Co., 521 N.E.2d 219 (Ill. App. Ct. 1988) involved a claim by the lender under a Dual Obligee Rider for liquidated damages under the construction contract arising from delay in completion of the project. The court found that, under the terms of the construction contract (to which the lender, of course, was not a party), release of the final draw request constituted a waiver by the owner (and thus, its co-obligee the lender) of all claims, other than certain specific warranty or defective work claims. Although the Dual Obligee Rider required that neither the retainage nor the final payment be released without specific consent from the surety, no consent was obtained. Further, the bond referred to plans drawn in 1977, while the project was in fact built according to a different set of plans, completed after the date of the issuance of the bonds. All of these points were cited by the court as reasons for denial of recovery by the lender. While some cases have upheld recovery for a lender even when its co-obligee developer knew of and participated in the submission of incorrect draw requests, they seem to be in the minority.

c. What provisions should the Loan Agreement make?

While there are surprisingly few cases in this area, lenders should be aware that the broad conditional language of the Dual Obligee Rider may be cited to deny recovery. Although a Dual Obligee Rider may require that either obligee perform the contract "strictly in accordance with its terms," if a developer defaults, the lender often cannot remedy the problem without delay or default. The relative lack of cases may indicate that the surety does not expect "strictly" to mean without delay if a lender must step in to take over a troubled project. Certainly, the Loan Agreement should authorize the lender to make direct payments to the contractor, even after a default. While assignments of, or security agreements affecting, the developer's rights in the construction contract may state that the lender has no, or limited, obligations to the contractor,

the realistic lender should be aware that payments to the contractor may be required to preserve rights under the bonds.

Additionally, lenders should be aware that their rights under construction bonds may be adversely affected by actions or inactions of the developer. The Loan Agreement should restrict the developer's ability to make material changes in the project without the consent of the surety. Additionally, the Loan Agreement should restrict construction draws to work completed and materials furnished or purchased for the project. Yet, the language of the Loan Agreement alone, without careful monitoring by the construction lender, will not prevent potential defenses to payment by the surety. Materials in Part III should be of concern to the lender as well as the developer.

d. <u>Rights of the Lender under the Dual Obligee Rider</u>

While the language of the Dual Obligee Rider may work against the lender in some instances, it can permit the lender to assert its own rights against the surety. There are few cases in this area, but they do indicate the benefits to the lender with rights under bonds. For instance, in *Cates Construction, Inc. v Talbot Partners,* 980 P.2d 407 (Cal. 1999), *reh'g denied*, 1999 Cal. LEXIS 6614 (Cal. Sept. 29, 1999), the surety issued both a performance bond and a labor and materials payment bond naming the lender named as co-obligee. Work proceeded on the project, and 22 progress payments were made regularly to the contractor after review and confirmation of work by the owner and lender. The 23rd request was refused on the grounds that the contractor had already substantially overdrawn the contract amount. The contractor abandoned the project and filed a $600,000 lien. The developer called upon the surety, which refused on the grounds that the owner had failed to make necessary payments. The impasse continued, and additional liens were filed. The lender began the foreclosure action; the surety, as assignee of the contractor, began foreclosure of the contractor's lien. In its original decision, the court awarded not only the contractual amounts against the surety, but an additional $28,000,000 for failure to act in good faith. While the appellate court reversed the punitive damages and tort recovery, it did uphold the contractual recovery against the surety for failure to perform the contract and complete the project promptly. The award to the bank consisted of $1,200,000 for impairment of its security interest and $250,000 for defective work to the property.

Although the language of the Dual Obligee Rider may, in certain instances, preclude recovery by one or more of the co-obligees if payment is not made in a timely fashion, those defenses may not be available to other third party beneficiaries. For instance, in *Acoustics, Inc. v. Hanover Ins. Co.*, 287 A.2d 482 (N.J. Super. Ct. Law Div. 1971), the contractor furnished a payment bond in favor of the developer and its lender as a co-obligee. The language of the rider provided that:

> The Surety shall not be liable under this Bond to the Obligees, or either of them, unless the said Obligees, or either of them, shall make payments to the Principal strictly in accordance with the terms of said Contract as to payments, and shall perform all the other obligations to be performed under said Contract at the time and in the manner therein set forth.

The defense on the bond was that the owner failed to pay all amounts due to the contractor. The court held that while this provision might affect the liability of the surety to one or both of the obligees, it did not affect its liability to a subcontractor, a third-party beneficiary of the bond. (*Accord*, *Guin & Hunt, Inc. v. Hughes Supply, Inc.*, 335 So. 2d 842 (Fla. Dist. Ct. App. 1976); *Aetna Ins. Co. v. Maryland Cast Stone Co.,* 253 A.2d 872 (Md. 1969)).

B. Alternate Forms Of Security

If the owner and lender agree to some other form of security for the obligations of the contractor, such as a letter of credit in lieu of a bond, the lender will have other considerations. For instance, if a letter of credit is issued to the developer, the lender may take a security interest

in the proceeds of the letter of credit. However, merely taking a security interest in proceeds would not enable the lender to make draws for its own account in the event of the developer's insolvency or refusal to draw. If a letter of credit is selected in lieu of a bond, the lender may turn to other means to obtain the same direct right of action available against a surety under a Dual Obligee Rider. For instance, the lender may consider requiring the issuer to accept drafts by either the developer or the lender, and the lender should insure that the conditions to the draw are not so narrowly drafted that they could be satisfied only by a draw presented by the developer.

C. The Set-Aside Letter

As noted above, the very language of the typical Dual Obligee Rider may impose an obligation on a lender to fund the contractor in the event of a borrower default in order to preserve rights on the bond. The lender may also have other direct agreements with the contractor, such as a collateral assignment of construction contract with a related consent or acknowledgment of the contractor. Typically, the contractor or its surety will request a clause in that agreement or in a separate agreement, a "set-aside" provision. While these clauses may vary in scope, they typically reflect the desire of the contractor and its surety to insure that funds are "set aside" from the construction loan for the purpose of payment of the construction costs. In the absence of a set-aside letter or other special relationship between the lender and the contractor, the lender would generally be free to allow draws for valid purposes under the loan agreement without requiring that they be specially earmarked for payments to the contractor. Use for those purposes would not necessarily defeat a claim of the lender under the bond.

1. Risks of the Set-Aside Letter

Such agreements must be carefully reviewed by lender's counsel. While a lender may be sued after a failed project on any number of lender-liability theories such as fraud or negligent misrepresentation, the existence of a poorly drafted set-aside letter may give the contractor a direct contractual hook to the lender. For instance, *U.S. Pac. Builders, Inc. v. Mitsui Trust & Banking Co.*, 57 F. Supp. 2d 1018 (D. Haw. 1999) involves a suit under a set-aside letter. While the case merely addresses the jurisdictional question of whether the arbitration provision of the construction contract is applicable to litigation over the set-aside letter, the facts of the case show the risks in this area. The lender committed a $60,000,000 construction loan to the developer of a major condominium project. The contractor furnished performance and labor and materials bonds. The lender was named as obligee on the face of the performance bond; and received a Dual Obligee Rider to the payment bond. The lender, at the request of the contractor, executed a letter in its favor providing:

> From the Loan Proceeds, the sum of $36,225,000.00, corresponding to [certain] line items in the Project Budget (as defined in the Loan Agreement) (as such sum may be adjusted pursuant to approved change orders to the Construction Contract approved by the Lender in writing, in accordance with the Loan Agreement, the "Set-Aside Amount") shall be used to pay the General Contractor for work performed by the General Contractor under the Construction Contract and, except as otherwise provided herein, such portion of the Loan Proceeds shall not be disbursed for any other purposes.

When the project cratered, the contractor claimed recovery from the lender for the price of its work, including change order and other sums, from the undisbursed loan proceeds. The claim is hinged upon the language of the set-aside letter.

An additional method of attack against a lender under a set-aside letter appears in *Fretz Constr. Co. v. Southern Nat'l Bank*, 626 S.W.2d 478 (Tex. 1981). In this case the unpaid contractor sued the lender for damages for breach of contract, promissory estoppel, and fraud.

The surety for the contractor required evidence of the ability of the contractor to be paid; the lender issued a set aside letter stating:

> This is to confirm that $2,372,715.00, which represents the bonded construction costs of the above-captioned project to be owned by Aqua-Con of South Texas, Inc., has been set aside by Southern National Bank of Houston to be paid to Fretz Construction Company (Contractor) in progress payments as set out in the loan documents and construction contract. No brokerage fees, inspection fees, taxes, insurance, interest, or any other costs or fees incurred by borrowers or lenders will be removed from the contract sum.

Based upon this letter, the bonds were issued and the lender was made a dual obligee. When the final payment request was submitted, the lender paid only 25% of it, which was all that remained of the loan proceeds. Apparently, and in contrast to the provisions of the letter, some $800,000 of soft costs and fees were paid from the loan proceeds, thus leaving the shortfall. The court found substantial support for jury findings against the lender on all claims, remanding to the trial court to enter judgment based on the findings.

While the *Mitsui* and *Fretz* cases involve a direct action against the lender under the terms of the set-aside letter, the existence of such a letter may provide a basis for the contractor or its surety to seek to subordinate the lender's mortgage or deed of trust to lien claims of the contractor. In *In re 5000 Skelly Corp.*, 142 B.R. 442 (Bankr. N.D. Okla. 1992), the contractor provided a performance bond for its work but requested a payment bond from the lender to insure that it would be paid for its work. Even assuming such a bond could be obtained, the lender refused; however, there were apparently discussions that funds from the loan would be set aside for the contractor. After much discussion, the contractor stated that it could not obtain the performance bond without a set-aside letter from the lender. A letter was issued providing:

> Gentlemen:
>
> Please accept this letter as confirmation that Figgie Acceptance Corporation ("FAC") has, under the Loan Agreement between 5000 Skelly Corporation and FAC, dated July 7, 1989, provided for the funding of the following contracts at the stated amounts.

CONTRACT FOR Base Bid Including	
Alternatives Numbers 1and 2	$141,730.00
CHANGE ORDER NO: 01	$9,920.00
Total	$151,650.00
CONTRACT FOR Alternate #3	$398,000.00
CHANGE ORDER NO: 01	$27,860.00
Total	$425,860.00

> These funds are now available for disbursement in accordance with the Loan Agreement.
>
> We trust this satisfies your requirements.

The contractor began work and received regular progress payments. When one payment was late, the contractor was verbally assured by the lender that the contractor would be paid upon completion of the work. Later, however, the lender declared the loan in default and accelerated the balance of the loan. The lender then refused to pay the contractor for the work, contending that its only obligation was to set aside funds from the loan if the loan were completely funded.

The lender argued that it had no further obligation to the contractor because there was no further obligation to disburse loan proceeds. The contractor filed a lien against the project and applied to the court to subordinate the bank's mortgage to its lien on the grounds of equitable estoppel. The court granted this relief.

2. Drafting a Set-Aside Letter

While the first response of a lender to a set-aside letter is a flat "no," many contractors claim that some assurance of payment is a requirement of their obtaining the required bonds with the required riders. The cases, as well as common sense, indicate that committing to set-aside a specific fund for the benefit of the contractor is risky. The letter should avoid any commitment to reserve funds for the contractor (unless, of course, the lender actually does so). To avoid the result in the *Skelly* case, the set-aside letter should negate any obligation to fund after defaults under the credit agreement, unless the lender is willing to continue funding the contractor despite developer default.

III. COMMON SURETY BOND DEFENSES

A. The Players

Part I of these materials generally described the purposes for and intended protections of performance and payment bonds and set forth the cast of characters: the Surety, the party obligated under the bond and secondarily liable for the Principal's obligations; the Principal, the primary party obligated for the obligations being bonded (generally, a contractor or subcontractor under a construction contract); and the Obligee, the party to whom the Principal and the Surety are obligated (usually the owner/developer, but as stated in Part II, this may be extended to the lender under a Dual Obligee Rider or by direct incorporation of the Lender in the bond).

This Part III is a general summary of the more common defenses that a Surety, under appropriate circumstances, may raise. The discussion does not take into consideration particular federal or state statutory requirements or limitations applicable to the bonds and their interpretations (especially for public construction projects for which the federal "Miller Act" or the state "Little Miller Acts" may apply) or the different terms and conditions that may be contained in various bond forms.

When a Surety is called upon to respond under the bond, matters obviously have not gone as expected and the environment can be hostile, especially if the players are not in agreement.

B. The Environment

The construction process is a creative and fluid process and has been compared to warfare that requires the mobilization of personnel and materials and where there is often antagonism among the parties. It is in this "battlefield" environment, together with the complexities of the construction process, that a Surety must respond and elect its options. A Surety's wrong decision to admit or deny liability can have severe and long-term repercussions that cannot be easily reversed and that may be subject to second-guessing in the courts years after its decision is made. Often the Surety is required to "divide" its loyalty between the Principal and the Obligee and to make the difficult decision to comply with the demands of the Obligee or abide by the position of the Principal.

It is within this pressurized environment that the Surety must investigate and analyze its response to a claim. Depending on the alternatives available under the terms of the bond, the Surety generally has the following options under a performance bond: (i) buy back the bond; (ii) arrange with the Principal for completion; (iii) tender a completion contractor to the Obligee; (iv) contract with a completion contractor; or (v) do nothing or deny liability in whole or in part. <u>See</u> Exhibit "A", AIA Performance Bond clause 4 that provides for these options. Each of these options has its advantages and disadvantages. However, in exercising options (ii) and (iv),

above, the Surety's liability is not limited to the penal sum of the bond. With respect to a payment bond, the Surety either pays or does not pay.

C. The Bond

The bond is a contract and the law of suretyship is a species of contract law and, where the law of suretyship provides no principle or rule to guide the interpretation of a bond, general contract law applies. Generally, a Surety's liability is limited to the penal sum stated in the bond. "It is well stated that a performance bond is enforceable only to the extent of the obligee's actual damages. Likewise, when an obligee's actual damages exceed the penal amount of a bond, a surety's liability generally is limited to the penal sum of the bond. When a demand is made of the Surety, it must assess the claim, investigate the facts and analyze the underlying documents to determine the extent, if any, of its liabilities and whether it is able to assert defenses that, in whole or in part, can eliminate or reduce its liabilities.

D. Some of the Weapons

A Surety, as a general rule, is not liable unless the Principal is liable and, therefore, may plead as a defense any defense that the Principal may plead. The bond provisions and the Obligee's acts and/or omissions, or both, may provide additional defenses. In analyzing these defenses, it is imperative to investigate the construction documents, the Obligee's and Principal's performance under those documents, the terms and procedures of the bond and any applicable statutes.

Under a performance bond the obligee's termination of the principal under the termination clause of a bonded contract can be upheld only if the obligee sustains its burden of proof that (1) the principal materially breached its contract, (2) the principal's breaches were not induced or preceded by the obligee's own supervening material breaches of contract, such as nonpayment, mal-administration of the construction process, or refusal to grant proper time extension or other recognized "contract defenses," (3) the obligee's termination was not improperly motivated or conceived in bad faith and was made independently and with the exercise of discretion by its representative having authority to terminate the contract, (4) the principal was given ample notice of deficiencies so as to understand what needed to be "cured," (5) the obligee did not "waive" any contract completion dates or requirements upon which it relied to supports its termination.

A Surety may rely on contractual or procedural defenses as well as those of suretyship. Some of the common defenses to a Surety are summarized as follows:

1. No Principal Default

Before the Surety is liable, the Principal must be in default. See Exhibit "A", AIA Payment Bond, subparagraph 2.1 and, AIA Performance Bond, clause 2. A Principal's default must be a material breach that warrants termination. Not every breach constitutes a default sufficient to require the Surety to step in and remedy it. To constitute a legal default, there must be a (1) material breach or series of material breaches (2) of such magnitude that the obligee is justified in terminating the contract. Likewise, under a payment bond, a Surety incurs no liability if the Principal is not in default. Therefore, the first step is to determine whether a default has occurred. A corollary to this defense is that a contract may not be terminated for default where the contract has been "substantially performed." If the contractor has substantially performed the contract, the contractor cannot be in material breach. What constitutes substantial performance varies with the facts and circumstances and judicial interpretation.

Another issue concerning whether a default has occurred is whether the appropriate contractual procedures for notice of default were given to the Principal to provide an opportunity to cure. Such notice must be specific enough to put the Principal on notice of the default. A cure notice and a reasonable opportunity to cure are also deemed necessary even if the contract does not contain such provisions. Also, to terminate properly the Principal, the Obligee must adhere

to the termination procedures that are provided for in the bonded contract. If the Obligee does not follow these procedures, there could be a wrongful termination and the Surety could escape liability.

2. Obligee's Acts; Omissions

The terms of a bond generally require that the Surety will be obligated to perform under the bond only if the Obligee is not in default under the bonded contract. See Exhibit "A", AIA Performance Bond, clause 3 and clause 4. The Obligee's failure to perform its conditions under the contract is a condition to the Surety's performance. An Obligee's acts or omissions giving rise to a defense may occur under several circumstances.

a. Project design

Where the Obligee is responsible for the design of the project, there is an implied warranty as to the adequacy of the plans and specifications. A contractor is not responsible for the consequences of defects in the plans and specifications and the implied warranty is not overcome by requiring the contractor to examine the site or check the plans or specifications. In addition, if the owner has specified a single source product, there is an implied warranty that it is available.

b. Improper or misapplication of payments

Because the Surety is relying that its monetary obligation of performing or paying are subject to the equitable subrogation of the payments due from the Obligee to the Principal under the bonded contract, improper payments reduce the funds that would otherwise have been available to the Surety. Improper payments could be associated with progress payments, retainages and final payments. Most construction contracts provide for specific conditions or requirements before payments are made. These precautions are intended to ensure proper application of the funds. An Obligee's failure to adhere to the contract requirements by making progress payments before the work is completed, for paying for defective work or prematurely releasing the retainage or making final payment, to the extent the Surety is prejudiced, may entitle the Surety to a partial discharge of its obligations. Some courts, however, have allowed for a full discharge. An Obligee's defense to an improper payment allegation may be available if the Obligee relied in good faith on a payment certification given by the architect or engineer.

c. <u>Obligee's control and approvals</u>

If the construction documents require or if the Obligee takes an active role in approving a contractor's work plan for the construction or exerts undue field control over the contractor's methods, this may provide a defense for a default under the construction documents.

d. <u>Obligee's fraud; failure to disclose</u>

A Surety generally cannot assert as a defense ignorance of the facts that the Surety should have known or could have known after reasonable investigation. However, if the Obligee fraudulently concealed pertinent facts concerning site conditions or other similar factors that materially increased the Principal's or the Surety's risk, such failure to disclose could act as a defense.

e. <u>Failure to mitigate</u>

An Obligee must make reasonable efforts to mitigate its damages. Although a failure to mitigate will not discharge a Surety, it may be considered in assessing its damages.

3. Principal's Fraud

Generally, if the Principal perpetrates a fraud on the Surety, absent the Obligee being a party to the fraud, the Surety is not released.

4. Material changes to the underlying contract

Changes to the plans and specification of or the scope of a Principal's obligations under the construction documents are not uncommon and are part of the normal construction process. Some bonds, however, may require the Surety to consent to an increase in the project costs over a certain sum or other material changes to the Principal's obligations. In those instances, if the Surety's consent was not obtained, a defense may be available to the extent that the Surety was prejudiced. Even without such bond provisions, a surety may raise a defense if the changes to the underlying obligation were so severe as to significantly alter its risks, so called "cardinal" changes. These would include substantial increases to the cost of the work or changing significantly the method or procedures of payment or construction performance. However, most performance bonds provide that the Surety waives notice of any changes to the underlying contract documents. <u>See</u> Exhibit "A", AIA Payment Bond, clause 10, and AIA Performance Bond, clause 8.

5. Waiver of contract requirements

If the Obligee waived performance of the contractual terms, it may be estopped to compel the Principal's performance. The waiver could be to the completion date, nonconforming work or similar matters.

6. Bond notice requirements

Most performance and payment bonds require the Obligee to provide written notice to the Surety and often more than one type of notice may be required. <u>See</u> Exhibit "A", AIA Performance Bond and note the types of notice under subparagraphs 3.1 and 3.2 and subparagraphs 4.1 and 4.2 of the Payment Bond that distinguishes between claimants that have and do not have a direct contract with the contractor. A failure to follow the appropriate notice requirements provides the Surety with a defense.

7. Contractual or Statutory Limitations

The bond or applicable statutes may require that the Obligee commence suit against the Surety within a specific time period. <u>See</u> Exhibit "A", AIA Payment Bond and AIA Performance Bond and note clause 11 of the Payment Bond and clause 9 of the Performance Bond. States may also have statutes that override the contractual provisions of the bond and the clauses noted above take this into consideration. A suit that is not timely filed is a defense.

E. Special Considerations in Payment Bonds

Although most of the defenses stated above apply to both performance and payment bonds, payment bonds raise some other unique and unsettled considerations. Two of these are the contingent payment clause (pay-when-paid or pay-if-paid) and who is a proper claimant under a payment bond.

Generally, a payment bond provides that the Surety has no obligation if the Principal promptly makes payment to the claimants for all sums due. See Exhibit "A", AIA Payment Bond, clause 3. Contingent payment clauses are attempts to shift the risk of owner nonpayment from the prime or general contractors to the subcontractors. Much has been written on this subject matter.

Unless the language in these clauses is clear and unambiguous, many courts have held that these clauses only go to the timing of payments and provide that the contractor must pay the subcontractors within a reasonable time regardless if the owner pays. Where the language is explicit and not ambiguous, courts have upheld these clauses. The availability of this defense to a Surety, however, has been challenged (even though a court may conclude that the Surety's Principal, because of such clause, was not in default of payment) because it was against public policy and would circumvent state lien laws or because the bond did not explicitly incorporate the terms and conditions of the subcontracts into the payment bond.

Another issue under payment bonds is whether or not the claimant is a proper claimant under the bond. See Exhibit "A", AIA Payment Bond, subparagraph 15.1, restricting a claimant to someone that has a direct contract with the contractor or with a subcontractor of the contractor. Cases interpreting the Miller Act are informative. The distinction among first tier, second tier and third tier subcontractors or suppliers become important in determining a Surety's liability. Third tier (and lower) subcontractors and suppliers may not recover under the Miller Act.

IV. CONCLUSION

The Surety, when there is a default and claim under a bond, must investigate and analyze its course of action by looking to the underlying contract documents and the bond terms to determine if the Principal was in default, a default or termination of the Principal was properly accomplished and whether the Obligee was also in default or failed to follow proper procedures. This is usually done in a hostile and high stakes environment. However, before exercising its alternatives under the bond, the Surety needs to understand its risks, minimize its risks and determine if there are proper defenses to its potential liabilities. The defenses that the Surety has in its arsenal could, under the proper circumstances, be many and the Obligee should be aware of these and take appropriate steps and precautions to avoid unexpected results.

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