SURETY (PERFORMANCE) BONDS

How to Get Paid by the Surety

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By the time a City (or any project owner) is calling upon a performance bond surety, the construction project is almost certainly in significant trouble. At this stage, the owner is likely facing substantial project delays, significant construction defects, and any number of other material breaches by its contractor. "Not to worry" owners sometimes (maybe even often) and understandably believe—the performance bond surety will solve these problems. After all, isn't the whole point of a performance bond to assure the project is completed without costing the owner additional time and money?

Unfortunately, the answer is not a simple "Yes." Cities (and all types of owners) are often surprised in these situations to learn that sureties rarely immediately ride in to save the day, and in fact, may ultimately deny the owner's bond claim. But fear not—as with most things, knowledge is power. Read on to learn more about public performance bonds, including a process for claims and tips for avoiding common surety defenses that will put a City in the best position to enlist the surety's assistance and money to complete a troubled project.

Talking the Talk: Performance Bond Lingo

A performance bond involves a three-party or tripartite relationship among a principal, obligee, and surety.

- The **principal** is the general contractor.[1] A principal obtains the bond for the project.
- The **obligee** is the project owner (for our purposes, the City). An obligee is the beneficiary of the bond and the entity that originally contracted with the principal.
- The **surety** is the entity that issues the bond and by issuing the bond, agrees to respond if certain conditions are met. In a typical construction project, the surety issues both a payment bond and a performance bond.

Other important surety jargon:

- Every surety relationship involves one or more **indemnitors**. An indemnitor is a person or entity that has entered into an agreement to indemnify the surety from *any losses* the surety suffers as the result of issuing the bond. This means the indemnitor is responsible for covering the surety's costs for completing construction and associated costs, like consultant and legal fees.
- The **bonded contract** is the underlying construction contract between the City and the general contractor.

[1] This paper and its terminology discuss and apply to a performance bond secured by a general contractor for the benefit of the owner. However, subcontractors are sometimes required to obtain a performance bond for the benefit of the contractor. In that case, the contractor would be the obligee and the subcontractor would be the principal.

Public Performance Bonds: Contracts with Statutory Overlay

At its essence, a performance bond is simply a contract where a surety agrees to guarantee the obligations of the principal owed to the obligee under the bonded contract in return for payment of a premium. It is important to remember that performance bonds are not insurance.[2] The surety relationship is a credit relationship where the surety pledges his credit standing to secure the performance of the general contractor. For that extension of credit, the principal (and generally other indemnitors, often company principals) also signs an indemnity agreement requiring the principal to repay the surety for any losses.

Public performance bonds also contain a statutory overlay—Chapter 2253 of the Texas Government Code (also known as the McGregor Act). Governmental entities entering into a public work construction contract for more than $100,000 must require the general contractor to execute a performance bond to the governmental entity.[3] Chapter 2253 sets out the scope of the bond and required language (namely, surety contact information) that must be included in the bond document.[4] Public performance bonds must be:

1. Solely for the protection of the governmental entity awarding the public work contract;
2. In the amount of the contract; and
3. Conditioned on the faithful performance of the work in accordance with the plans, specifications, and contract documents.[5]

A suit on a performance bond must be brought within one year of final completion, abandonment, or termination of the public work contract.[6] Chapter 2253 is incorporated into every public performance bond and attempts to expand or restrict a statutory right or liability through a bond will be disregarded.[7]

Key Surety Law Principles

A surety generally "stands in the shoes of its principal" so that its liability is co-extensive with the general contractor.[8] Indeed, a surety is defined as "someone who is primarily liable for paying another's debt or performing another's obligation."[9] Accordingly, most damages arising from a contractor's material breach are recoverable from the surety, including warranty

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[2] *Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1*, 908 S.W.2d 415, 419-19 (Tex. 1995).
[3] Tex. Gov't Code § 2253.021(a)(1).
[4] *See id* at § 2253.021, .023.
[5] *Id.* at § 2253.021(b).
[6] *Id.* at § 2253.078(a).
[7] *Id.* at § 2253.023.
[8] *See, e.g.*, *Beard Family P'ship v. Com. Indem. Ins. Co.*, 116 S.W.3d 839 *845 (Tex. App.—Austin 2003, no pet.) (a surety "stands in the shoes" of its principal in the event of default by the principal in performance of the construction contract.).
[9] *Surety*, BLACK'S LAW DICTIONARY (11th ed. 2019).

obligations and correction of defective work.[10] But these general principles also provide two interrelated bases for a surety's defenses. First, a surety is not obligated to perform or is not liable under a bond unless the principal fails to perform.[11] Second, a surety is generally entitled to assert all defenses of its principal in response to a demand or claim under a bond.[12] Thus, many demands or claims presented against sureties on performance bonds are resolved primarily based on the general contractor's defenses.

Although performance bonds are to be read and construed in connection with the bonded contract (which is generally incorporated by reference into the terms of the contract), a surety's obligations arise out of and are imposed and measured by the bond.[13] In the case of a conflict between the terms of a bond and the bonded contract, the bond controls.[14] Texas courts strictly construe bonds and will not extend a bond beyond its express terms by implication, construction or presumption.[15] As a result, in addition to the general contractor's defenses, a surety may have additional defenses arising from the bond's terms and conditions and the common law of suretyship.

Mechanics of a Performance Bond Claim

STEP 1: Read the Bond

The first place to start an analysis of a demand or claim on a performance bond is the language of the bond itself. Performance bonds come in *many* different flavors—some simple, some complex. Appendix A contains a selection of bonds to illustrate this point. Because bonds can be so varied, owners should review the bond when it is provided by the contractor, when any trouble arises on the project, and before taking any action against the contractor or surety for the contractor's failure to perform. Let me say that again: READ THE BOND.

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[10] *City of Wolfe City v. Am. Safety Cas. Ins. Co.*, 557 S.W.3d 699, 703 (Tex. App.—Texarkana 2018, pet. denied) ("Texas courts have long held that a surety's liability under a performance bond issued to secure performance of a construction contract is determined by examining the underlying contract); *Bayshore Constructors, Inc. v. S. Montgomery Cnty. Mun. Util. Dist.*, 543 S.W.2d 898, 902 (Tex. App.—Beaumont 1976, writ ref'd n.r.e.) (construction contract, which included one-year warranty, was part of the performance bond.).

[11] This limit on the surety's liability is generally expressed in the bond through a defeasance clause. Examples of defeasance language include: "If the Contractor performs the Construction Contract, the Surety and the Contractor shall have no obligations under this Bond" and "NOW, THEREFORE, THE CONDITION OF THIS OBLIGATION is such that, if the Contractor shall promptly and faithfully perform said contract, then this obligation shall be null and void; otherwise it shall remain in full force and effect."

[12] *N. Austin MUD*, 908 S.W.2d at 419 (surety's liability is derivative and depends on the principal's liability; unless a cause of action exists against the principal, it cannot exist against the surety.).

[13] *Emp.'s Liab. Assurance Corp. v. Trane Co.*, 163 S.W.2d 398, 401 (Tex. 1942); *Bill Curphy Co. v. Elliot*, 207 F.2d 103, 108 (5th Cir. 1953).

[14] *Bill Curphy*, 207 F.2d at 107-08.

[15] *U.S. Fid. & Guar. Co. v. Borden Metal Prods. Co.*, 539 S.W.2d 170, 173 (Tex. App.—Fort Worth 2004, writ ref'd n.r.e.).

STEP 2: Understand a Surety's Potential Defenses

Successful bond claimants understand a surety's potential defenses so that they can avoid them wherever possible. The following is an explanation of the most common surety defenses.

1. Liability Limited to the Bond's Penal Sum

Performance bonds include a stated sum on the bond, usually in the original amount of the bonded contract, which is referred to as the "penal sum."[16] The penal sum is the maximum liability of the surety for an obligee's actual damages, even if the contractor is liable for damages that exceed that amount.[17]

2. Limitations

A suit against a surety on a public performance bond is subject to a 1-year limitations period.[18] Section 2253.078 of the Government Code provides:

> A suit on a performance bond may not be brought after the first anniversary of the date of final completion, abandonment, or termination of the public work contract.[19]

In "legal parlance," final completion occurs upon substantial completion—*i.e.*, generally when the owner can take occupancy, a punch list is generated, and warranties begin to run.[20] The date of substantial completion may be certified by the architect and agreed to by the parties.[21]

Owners should proceed carefully and conservatively in determining this date where no such certification exists, as it can be a hotly contested and fact-intensive issue. Owners should also recognize that the warranty period (usually one year) and limitations period are generally coextensive. Owners should be especially alert to limitations for performance bond claims

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[16] Typical penal sum language is: "[Principal] and [Surety] are held and firmly bound unto [Obligee] in the sum of [$_____], for the payment whereof Principal and Surety bind themselves and their heirs, administrators, executors, successors and assigns, jointly and severally, firmly by these presents." Chapter 2253 requires the bond to be in the amount of the bonded contract. Tex. Gov't Code § 2253.021(b)(2).

[17] *N. Austin MUD*, 908 S.W.2d at 426-27 (although obligee obtained a judgment against principal for actual damages of $411,000, surety's liability for actual damages could not exceed $397,503.20, the penal sum of the bond).

[18] Tex. Gov't Code § 2253.078(a).

[19] *Id.*

[20] *Transamerica Ins. Co. v. Hous. Auth. of City of Victoria*, 669 S.W.2d 818, 822-23 (Tex. App.—Corpus Christi 1984, writ ref'd n.r.e.) (date of substantial completion is regarded "in legal parlance" as full performance and final completion for purposes of the 1-year statue of limitations). Note that *Transamerica* also held that limitations did not begin to run until the one-year warranty period expired. The author believes this portion of the holding is no longer valid because *Transamerica* was decided prior to amendments to Chapter 2253 that added (i) abandonment and termination as accrual dates for limitations, and (ii) the prohibition on varying from rights and liabilities under the statute. *See Am. Prods. Co. v. Reynolds & Stone, Rogers-O'Brien Constr. Co.*, No. 05-96-01628-CV, 1998 WL 821540, at *4 (Tex. App.—Dallas Nov. 30, 1998, pet. denied).

[21] *Hartford Fire Ins. Co. v. City of Mont Belvieu*, 611 F.3d 289, 295 (5th Cir. 2010).

concerning a contractor's failure to honor its warranty, as the time to file suit will generally expire on the same day as the warranty.

3. Failure to Give Surety Notice of Default or to Comply with Other Conditions Precedent

A frequent defense of the performance bond surety is lack of proper notice of the contractor's default or other similar conditions precedent provided by the bond. As the guarantor of performance, a surety understandably wants to be notified of any problems with its contractor's performance that might lead to a demand on the bond, and if so, given the opportunity to investigate and determine a course of action. Notice requirements and other conditions precedent are controlled by the language of the bond (and the bonded contract);[22] so again, read the bond (and the bonded contract). Many bond forms contain one or more notice requirements and one or more options for the surety to perform.[23]

The primary case in Texas in relatively recent years concerning notice in the commercial construction context is *Nova Casualty Co. v. Turner Construction Company.*[24] This case provides a good example of the complexities of these cases, and although the obligee ultimately prevailed, it should illustrate the wisdom in erring on the side of "too much" notice to avoid a protracted dispute. The key facts affecting the *Nova* decision include:

- Public project to install a new cargo facility at Bush International Airport for the City of Houston;[25]
- Subcontractor performance bond where Turner was the contractor/obligee, BOCA was the subcontractor/principal installing the baggage handling system, and Nova was the surety.[26]
- BOCA's subcontract work needed to be installed during a narrow window near the end of the project;[27]
- The subcontract allowed Turner to supplement BOCA's work and/or terminate BOCA upon default;[28]
- When BOCA fell behind schedule, Turner notified BOCA (but not the surety) of default and demanded BOCA cure;[29]

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[22] *See Harrison, Walker & Harper, L.P. v. Federated Mut. Ins. Co.*, No. 2-03-048-CV, 2004 WL 726813 at *2 (Tex. App.—Fort Worth Apr. 1, 2004, no pet.) (surety's liability determined by language of bond itself and applying rule of strict construction.).
[23] *See, e.g.*, AIA Document A312-210 Performance Bonds; EJCDC C-610, Performance Bond.
[24] 335 S.W.3d 698 (Tex. App.—Houston [14th Dist.] 2011, no pet.).
[25] *Id.* at 700.
[26] *Id.* at 700-01.
[27] *Id.* at 700.
[28] *Id.*
[29] *Id.* at 701.

- BOCA did not cure, and Turner elected to supplement and deduct the cost of supplementation from any money due to BOCA (but still did not notify the surety);[30]
- BOCA abandoned the project roughly a month later, and Turner notified the surety the next day of BOCA's default, stating this letter "constitutes notice of default by BOCA, Inc. per the terms of the bond."[31]
- The cost to supplement and complete BOCA's work was over twice as much as the penal sum of the bond due to rework and delays;[32]

BOCA's bond required Nova to perform "Whenever [BOCA] shall be, and be declared by [Turner] to be in default under the subcontract."[33] Relying on an out of state case interpreting similar language, Nova rejected Turner's bond claim, arguing that Turner did not meet a condition precedent of the bond because it had not terminated BOCA's subcontract.[34] The 14th Court of Appeals disagreed, holding that the plain language of the bond did not require termination and the court would not imply terms into an unambiguous contract.[35] The court also found that Nova had adequate notice to allow it to exercise its performance options, even though Turner did not notify Nova before supplementing BOCA's work.[36] The court reasoned that Nova knew that the construction contract gave Turner the right to supplement without notice when it executed the bond, because the bond incorporated the construction contract.[37]

4. Improper Default or Termination and Other Contractor Defenses

Generally, a surety may assert any defense available to the general contractor even if the contractor does not raise the defense on its own.[38] Thus, Owners must be careful to comply with their obligations under both the bond and the bonded contract. Termination and default are fertile grounds for mistakes, as both generally require specific notices and an opportunity to cure.

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[30] *Id.*
[31] *Id.*
[32] *Id.* at 702.
[33] *Id.* at 700-01.
[34] *Id.* at 703, n.3.
[35] *Id.* at 703-04.
[36] *Id.* at 705.
[37] *Id.* at 704-705 (citing *In re Lyon Fin. Servs., Inc.*, 257 S.W.3d 228, 232 (Tex. 2008) (stating that a party who signs an agreement is presumed to know its contents as well as the contents of documents incorporated by reference).
[38] *See* Restatement (Third) of Suretyship & Guaranty § 34 cmt. A (1996); *see also Cnty. of Dauphin, Penn. v. Fid. & Deposit Co. of Maryland*, 770 F. Supp. 248, 254 (M.D. Pa. 1991), *aff'd*, 937 F.2d 596 (3d Cir. 1991) (noting surety can generally avail itself of all defenses available to its principal); *Wright Way Constr. Co., Inc. v. Harlingen Mall Co.*, 700 S.W.2d 415, 426 (Tex. App.—Corpus Christi 1990, writ denied) (reversal of judgment against the principal would cause of reversal of judgment against the surety, even in the absence of the taking of an appeal by the surety.).

In *Milton Regional Sewer Authority v. Travelers Casualty & Surety Company of America*, a Pennsylvania federal district court granted the surety's motion to dismiss for improper termination.[39] The underlying bonded contract included a cure provision prior to termination.[40] The owner failed to follow the cure provision, claiming it was entitled to an immediate termination because the principal had materially breached the contract.[41] The court recognized that the contractor had "probably breached the contract" but found the breach was not material because the contractor did not have a chance to cure.[42] In reaching its holding, the court explained the importance of the improper default/termination defense to the surety industry:

> For the court to conclude and hold otherwise would result in a perverse result for Travelers and other sureties. To expect a surety to insure a contract, but then allow one party to the contract to avoid the express terms of the insured contract would expose the sureties to increased risk. A surety must rely on the parties' compliance with contractual provision in order to adequately assess the risk of insuring its insured.[43]

5. Material Alteration of the Bonded Contract

Material alteration is an affirmative defense that a surety must plead and prove.[44] The elements are: (i) the parties to the bonded contract materially altered or deviated from its terms, (ii) without the consent of the surety, and (iii) to the surety's prejudice.[45] If proved, a material alteration discharges the surety from liability under the performance bond.[46]

Proof of material alteration often turns on the language of the performance bond. It is rare to have evidence of a surety's actual consent to a material alteration. But most bonds include some form of a provision waiving material alterations such as: "No alteration or change to the terms of contract, or in the work to be done thereunder, or an extension of time for the performance of the contract, shall in any way release the principal or surety hereunder, notice to surety of any such alteration, change or extension being hereby waived."

Some courts have held that similar language meant the surety consented up front to "any and all alterations and changes" regardless of their nature or magnitude,[47] while other

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[39] No. 4:13-CV-2786, 2014 WL 5529169, at *8 (M.D. Pa. Nov. 3, 2014).
[40] *Id.* at *4.
[41] *Id.* at *5.
[42] *Id.* at *8.
[43] *Id.*
[44] *Sonne v. Fed. Deposit Ins. Corp.*, 881 S.W.2d 789, 793 (Tex. App.—Houston [14th Dist.] 1994, writ denied).
[45] *Frost Nat'l Bank v. Burge*, 29 S.W.3d 580, 587-88 (Tex. App.—Houston [14th Dist.] 2000, no pet.); *see Old Colony Ins. Co. v. City of Quitman*, 352 S.W.2d 452, 455 (Tex. 1961)
[46] *Old Colony*, 352 S.W.2d at 455.
[47] *See, e.g.*, *Star Ins. Co. v. Skanska USA Bldg., Inc.*, No. SA-13-CA-640-OLG (HJB), 2015 WL 11538254, *4-5 (W.D. Tex. Dec. 2, 2015) (citing *Jones v. Gambill*, 241 S.W. 1067 (Tex. App.—Amarillo 1922, no writ); *U.S. ex.*

courts have interpreted such provisions to apply only to immaterial changes to the contract.[48] In light of this split, the safest course is to seek surety consent for significant changes, or at the very least, keep the surety in the loop on such changes so it has an opportunity to object.

Some examples of the most common types of material alterations include:

- *Improper payment or overpayment to contractor*

Texas courts consistently hold that the bonded contract's payment terms inure to the benefit, protection, and security of the surety, and when an obligee materially deviates from or "impairs" those terms, the surety is discharged from liability on the bond.[49] A material alteration by payment can occur when an owner knowingly pays for defective or incomplete work, pays without receiving a contractually-required architect's certificate, releases retainage before it's due, and/or pays contract funds without obtaining contractually-required close out documents like a consent of surety or all bills paid affidavit.

- *Changes to scope of work or price*

Although most construction contracts allow an owner to make changes to the scope of work without invalidating the contract, sometimes changes are so significant that they materially increase the risk of loss or harm the surety.[50] Potential material alterations might include: (i) bonded price increase of more than 20%, (ii) addition of scope that is materially different and outside the expertise of the general contractor, (iii) changes that make the contractor's ability to perform substantially more difficult, and/or (iv) a change to the method of payment that materially increases the surety's risk of loss.[51]

Rel. T.M.S. Mech. Contractors v. Millers Mut. Fire Ins. Co. of Tex., 942 F.2d 946, 954, n.6, 8 (5th Cir. 1991) (rejecting surety's material alteration defense because surety waived notice of "duly authorized modifications" of the contract in the bond.).

[48] *See, e.g.*, *Fort Worth Indep. Sch. Dist. v. Aetna Cas. & Sur. Co.*, 48 F.2d 1, 5-6 (5th Cir. 1931) (provision in bond that "any alterations which may be made in the terms of the Contract . . . shall not in any way release the Principal and the surety . . . notice to the surety . . . of any such alteration . . . being hereby waived" did not authorize any substantial change in the contract.).

[49] *See, e.g., Ryan v. Morton*, 65 Tex. 258, 261-62 (1886) (payment in full under different payment schedule and without completion of work); *Bullard v. Norton*, 182 S.W. 668, 671-72 (Tex. 1916) (early payment of retainage); *Williams v. Baldwin*, 228 SW. 554 (Tex. Comm'n App. 1921, jdgmt. adopted) (payment without certification of architect and without sufficient work in place); *Old Colony*, 352 S.W.2d at 456 (payment of contract balance without obtaining results from contractually-required water testing.).

[50] *See, e.g., Emps. Ins. of Wausau v. Constr. Mgmt. Eng'rs of Fla., Inc.*, 297 SC. 354, 377 (Ct. App. 1989) (discharging surety from bond where bonded contract that increased the scope and price from $2.3 million to $6.2 million.).

[51] *See, e.g.*, *Lonergan v. San Antonio Loan & Trust Co.*, 104 S.W. 1061, 1062-63 (Tex. 1907) (surety discharged when obligee and principal added additional work not mentioned or contemplated by the original contract without reducing same to writing contrary to terms of the contract.).

STEP 3: Pre-Dispute Best Practices

A successful bond claim starts by implementing pre-dispute practices to avoid losing coverage under the bond. These practices all stem from (1) involving the surety and (2) recognizing situations that might result in a surety defense. Performance bond sureties are generally involved in decisions made by an owner through a consent, rider, or amendment.

Consents are just what they say they are and are very common.[52] Riders are frequently used where significant changes to the underlying contract are being made (e.g., next phase of work). Riders become an attachment to the performance bond that recite the purpose of the rider and the amount the performance bond is being increased. A rider is typically executed by the surety only to unilaterally add the associated scope and money changes to the bond. Amendments are used for very significant changes to the contract (often for design-build, where the design and scope of the work to be performed are not well developed at contract inception). Both the contractor and the surety execute an amendment to demonstrate each parties' intention to enter into a much larger and potentially different scope of work and financial commitment.

Some recommended, pre-dispute best practices include:

- Upon receipt of the bond, confirm the bond includes the information required by Section 2253.021 of the Texas Government Code and is in the penal sum of the bonded contract.
- Review the bond thoroughly for familiarity with notice provisions and anything out of the ordinary. Remember that the bond cannot expand or restrict a party's rights or liabilities as defined by Chapter 2253. Inconsistent provisions (e.g., a longer or shorter limitations period) will be construed to conform to the statute.
- Review the bonded contract for any provisions referencing the surety. Many construction contracts contemplate or require surety consent for various actions. Follow these requirements.
- Require the contractor to update the penal sum of the bond, as additive change orders are granted to conform to the Government Code requirement that the bond be "in the amount of the contract."
- Obtain surety consent before varying materially from contract requirements; particularly payment. Specific instances where consent is advisable include:
    - Advances on materials and payroll. Advances are a prepayment of contract proceeds that could prejudice the surety.
    - Payment when liquidated damages exceed the remaining contract balance.

[52] *See, e.g.*, AIA G707 (Final Payment), AIA G707A (Partial Release of Retainage).

- Early release of some or all retainage. Generally, this is not an issue on public projects because retainage is statutorily required. Of course, that doesn't mean it never happens.
- Payment based on additional warranties or promises for work in place that is potentially defective.

- Keep the surety informed of defaults and potential defaults by the contractor.

STEP 4: Making the Performance Bond Claim

When a contractor has acted in a manner that constitutes default under the bonded contract, the owner must carefully follow both the bond and bonded contract requirements to engage the surety and preserve the owner's rights under the bond. The following steps provide an outline for doing so:

1. Review the bond for notice requirements and other conditions precedent to the surety's liability under the bond, such as conference requirements.

2. Compare the bond notice requirements with the notice, default, supplementation and/or termination requirements in the bonded contract. The requirements in the bond and bonded contract often differ. For example, the bonded contract may allow three days to cure while the bond allows for seven days to cure. Comply with the longer or more onerous requirement to avoid arguments that the surety was prejudiced.

3. Send written notice of default to both the contractor and the surety. Send the letters certified mail, return receipt requested, and be certain to send the letters to the addresses and/or persons as stated in the bonds regardless of whether you have been dealing or communicating with others (those folks may be copied). Adding the suspenders to the belt, also send a copy of the notice to the surety's registered agent. You can find the registered agent and its contact information on the Texas Department of Insurance's website using the surety search function.[53]

4. Call the surety and request a conference with the agent for the surety to discuss the contractor's default before supplementing the contractor's work or terminating the contractor. Document the call was made and any messages that were left. Again, the purpose of these efforts is to eliminate an argument from the surety that it was prejudiced by lack of notice or opportunity to perform.

[53] https://www.tdi.texas.gov/consumer/company-profiles-and-agents-for-service-of-process.html

5. Write any termination letters with extreme care. The substance of an effective contractor termination letter is beyond the scope of this paper, but an owner should know that this letter will eventually be closely examined in determining whether termination was proper.

6. At the end of any required cure periods, send a second notice of default to both the contractor and surety before moving forward with supplementation or termination. Identify all the attempts made to request assistance from the surety and enclose copies of those letters, emails, and other correspondence.

7. Comply with any other notices or conditions of the bond, which may include an agreement to provide the contract balance, additional requests for the surety to perform before surety default, etc.

The Surety's Response to a Claim

Investigation

When a surety is advised of a claim or a potential claim on a performance bond, the surety has the right to investigate before being expected to act.[54] At the beginning of its investigation, the surety is likely to request a considerable amount of documentation, which may include: construction contract documents, bid documents, job status inquiries, the owner's and contractor's project accounting information, change orders, pay applications, subcontracts, correspondence, and job schedules.

The surety may also want to visit the site to review the work and to see and inventory stored materials. The surety's efforts are aimed at gathering a complete picture of the status of the project and answering the following questions:

- Why did the claim arise?
- If the contractor has been terminated, was termination proper?
- Has the owner met its obligations under the bond and construction contract?
- What is the scope of the remaining work?
- How much of the contract price is the owner still holding?
- What is the likely time for completion of the project?
- Does the contractor have any defenses to the claim?
- Does the surety have any independent defenses to the claim?
- What will the surety's performance options cost?

[54] *See Seaboard Sur. Co. v. Town of Greenfield*, 266 F. Supp. 2d 189, 194 (D. Mass. 2003), *aff'd*, 370 F.3d 215 (1st Cir. 2004).

The Surety's Options

1. *Deny the Claim*

If the surety's investigation reveals that the default or termination of the contractor was improper or that the surety has a defense to the claim, the surety can deny the claim. Owners are often surprised to learn that denials are common. But remember, the surety's defense costs must be covered by the contractor and any other indemnitors. So, the cost to the surety to wait and see if the owner will prevail is low (so long as the indemnitors are solvent).

2. *Assist the Contractor: Finance/Funds Control/Consultant Assistance*

A surety can choose to provide assistance to the defaulting contractor to help it cure the default and/or complete the project. A surety's assistance is generally aimed at solving a cash-flow problems. The surety may provide the cash or, more likely, will offer to provide oversight and control of the funds paid by the owner to ensure such funds are paid to subcontractors and otherwise properly used by contractor.

3. *Take Over the Project*

A surety has the option to take over for the contractor and complete the project. Under this option, two new agreements would be negotiated and signed. The owner and surety would typically enter into a takeover agreement, and the surety and completion contractor would execute a completion agreement. In some cases, the surety hires the original contractor as its completion contractor.

Takeover agreements are generally lengthy and complex, addressing a myriad of issues, including: memorializing the termination of the original contract; the owner's acceptance of the completion contractor; the contract amount, any change orders, the contract balance, and amounts to be paid by the owner; the scope of work to be completed; delay and liquidated damages; the surety's maximum liability; costs that may be charged against the penal sum; insurance; warranty obligations; and the date for completion work to commence. The owner typically commits to paying the contract balance available for the completing the project and the surety agrees to pay an excess up to the penal sum of the bond.

The surety will then typically enter into a separate construction contract with the completion contractor, which usually requires the completion contractor to post a payment and performance bond.