CONTRACTOR DEFAULT & SURETY PERFORMANCE:

A PRACTICAL GUIDE FOR UNDERSTANDING AND NAVIGATING A BOND DEFAULT SITUATION

TEXAS CITY ATTORNEYS ASSOCIATION
SUMMER CONFERENCE
JUNE 9-11, 2010
SOUTH PADRE ISLAND, TEXAS

JEFFREY S. CHAPMAN
FORD NASSEN & BALDWIN
111 CONGRESS AVENUE
SUITE 1010
AUSTIN, TEXAS 78701
512.275.1782(T)
512.236.0682 (F)
jschapman@fordnassen.com
www.fordnassen.com

BACKGROUND:

As owners of construction projects, cities benefit from the protection of performance bonds on all of their projects thanks to chapter 2253 of the government code. However, merely having a performance bond in place does not guarantee a smooth ride for the city when a contractor defaults on its contractual obligations. While a surety is obliged to honor its obligations under performance bonds it writes, surety performance is far from unconditional and is not guaranteed. At times, even when a surety does perform, a city may be as dissatisfied with the surety's chosen manner of performance as the original contractor's attempted performance.

So, what is a city to do when a contractor defaults? How does a city secure performance by the surety? And how can that performance be something the city is going to be satisfied receiving? Unfortunately, these questions have no easy answers, and depending on the project, these questions may not even have satisfactory answers.

Let's begin with the following situation in mind: A city is in the middle of a construction project. The contractor has not performed to the city's satisfaction for a number of months and tempers are getting heated on both sides. When the contractor slows its performance even further or fails to perform an item of work to the city's satisfaction, the city's project manager determines the contractor is finally in default of its contractual obligations.

The city then issues a notice to cure letter to the contractor identifying the items or events of default, and demands a cure within 24 hours or the city will declare a default and suspend work or terminate the contractor. The city thinks this is a good idea because there is a performance bond in place. Since the contractor didn't do its job, the city figures its surety might come in and do better. After all, isn't that what a performance bond is designed to do? Doesn't a performance bond guarantee performance of the contract to the city's satisfaction? Not exactly.

BASICS ABOUT SURETIES:

City staff and attorneys must understand that a surety is not an insurer. Unlike insurance companies who fully expect a certain percent of their policies will be triggered and benefits will be paid, sureties do not write bonds expecting to pay claims. Insurance is written with the actual certainty that losses will occur. Surety bonds are written with the expectation that no losses will occur. Insurance is expensive. Bonds are not. Insurance is expensive because insurance companies charge premiums of sufficient size to cover expected losses. Bonds are cheap because sureties charge premiums without the expectation that losses will occur. Of course, losses do occur, so bonds are not free. But the frequency with which sureties actually pay is quite small in comparison to insurance.

The price difference also represents the market difference in underwriting policies. Sureties do not bond contractors that have or appear to have inadequate capitalization and capacity to complete the project. In fact, when sureties write performance bonds, they obtain a general indemnity agreement from the contractor and its principals to cover any losses the surety might incur as a result of the contractor's default. A fair amount of research goes into the underwriting process to ensure the general indemnity agreement is worth more than the paper it is printed on.

The narrow profit margins on bonds play a role in sureties' decision making in bond default situations. However, other economic factors also influence how sureties approach the situation. The people sureties employ and the consultants they use often influence their decisions. Depending on the relationship with the surety, the recommendations these claims consultants make can vary. If the claims representatives are employed by the surety, their perspective on claims can differ from representatives who are hired as outside consultants. Because the economics behind bonds influences surety performance, the claims consultants' understanding of those economics can influence the recommendations made to the surety.

Also, most surety claims representatives are educated individuals and many of them are lawyers. Thus, they think like lawyers and evaluate risk according to their training and background. Some are employed directly by the surety and some are outside counsel. Many surety claims consultants are experienced in construction management or construction law.

The lawyers understand that sureties enjoy many defenses to paying claims and will evaluate the situations they get called into with these defenses in mind. Because sureties are not in the business of paying claims, an available defense is a valuable tool for a surety. Typically, a surety on a performance bond claim will enjoy all defenses available to the principal on the bond, as well as others available solely to it, as surety.

DEFAULT AND SURETY DEFENSES:

If a city finds itself in the situation described in this article, it's a safe bet to assume there has been considerable disagreement with the contractor. It's likely that the contractor will challenge a declaration of default as improper. The surety may adopt this defense and refuse to perform because, as it claims, the contractor did not actually default on its performance obligations. Thus, cities seeking surety performance must carefully follow all contractual requirements governing declaration of default, suspension, and termination. Observance of these procedures is of utmost importance. A failure in this regard will provide the surety with additional defenses. Adherence to these procedures is the first step in putting the city in position to make a valid claim on the performance bond.

Keep in mind that if the city has, or can legitimately be said to have, breached the construction contract, the contractor and the surety may be released from their performance under the contract and the bond. In situations where the city has committed a prior breach, as in the case of failing to pay the contractor for certified and approved work, the contractor may be excused from any additional performance under the contract. Even if a material breach by the city is followed by a complete abandonment of the project by the contractor, the surety's obligations under the bond will be extinguished.

In other situations, where a contractor faces claims by the city related to delayed or defective performance, the surety may assert the contractor's defenses of failure to provide adequate plans and specifications, concurrent delay by the owner, interference by the owner or its agents, design defects, unforeseen conditions, impossibility of performance, etc. An assertion of these defenses will almost always result in the surety's refusal to perform any remaining contractor obligations on the project. Typically, these contractor defenses are

very fact specific and typically require the cooperation of the contractor to document such defenses.

Separately, sureties also have defenses available specifically to them. These defenses can be asserted in addition to the shared contractor/surety defenses and can discharge the surety's obligation under the bond regardless of the contractor's default. The surety may claim that the scope of the project materially changed during the project. Since the bond was written to guarantee performance of the original contract, a material change in scope provides a defense to the surety because it only underwrote a guarantee of performance as originally anticipated. Another defense might arise if the city has materially deviated from the contractual payment provisions. If the city has underpaid or overpaid the contractor, the surety's rights may have been prejudiced. Such prejudicial conduct by the city might reduce or alleviate the surety's performance obligations.

Knowing that sureties will evaluate each bond default situation from an economic and legal perspective can serve a city's interest. While it can be difficult for a city to step back and judge its own conduct, and that of its engineers and design professionals, to determine whether the surety has adequate defenses to performance, such an examination should occur prior to making the decision to terminate a contractor and invoke rights under the bond.

DEFAULT! WHAT'S NEXT?

Understanding these defenses, let's continue with the example and assume the city has determined the contractor has defaulted. What happens after a declaration of default? Performance bonds do not have the same notice requirements of payment bonds. Unless the terms of the bond require notice, sureties may not insist upon notice of default from the city. However, if the city hopes to secure the surety's cooperation and performance, immediate notice of default should be provided to the surety. Keep in mind that the surety will not have been monitoring the project in most cases. Unless the contractor has had serious payment problems to its subcontractors and suppliers and the surety has become involved in the project because of its payment bond, the first notice to the surety of a

contractor default is often the notice to cure letter or some correspondence that immediately preceded that letter.

Typically, the city will want a meeting with the surety representative to discuss the default. At this meeting, the city will be looking for the surety to say, "I've got this one covered." However, most sureties will not be in a position to say that in the initial meeting. Based on what we know about sureties, it is reasonable to assume the surety will want an opportunity to evaluate the job and determine what, if any, default has occurred. This will take some time. Most every performance bond is silent as to time limitations for surety performance. If quick action is required, the city can hire a replacement contractor to correct the work and seek recovery of any extra-contractual expenditure after completion.[1]

While completing the project with a replacement contractor can sound attractive, this option can often lead to significant problems and fighting between the city and the surety. Without adequate opportunity to inspect the job and the project records prior to completion with another contractor, the surety might argue its position was prejudiced by the city's unreasonable actions in refusing to wait or the investigation. Further, the surety may challenge the reasonableness of the completion costs. If the replacement contractor spends significantly more than the remaining contract balance to complete the project, the surety's defense increases in strength. Of course, facts are important. The nature of the default, the type of project, and the percent completeness achieved prior to default all influence this defense.

Most sureties do not have claims representatives in the cities where projects are located. As stated earlier, sureties are not insurance companies and they do not maintain a network of claims representatives like insurance companies do for adjusters. If the surety representatives can not make it to the project due to calendar constraints, there is no rule that prevents city staff from travelling to the sureties' office for a meeting to discuss the

[1] The procurement question comes up here. If time is not of the essence, the city is free to put the project out to bid again. However, if the existing work has been damaged by the original contractor or exposure to the elements in an unfinished state is causing damage to existing work, the city may be exempt from competitive bidding requirements based upon section 271.056(3) of the local government code.

project and get a plan of action in place. Reaching out to the surety in this manner might make a difference in the way it views the project and its obligations after the default.

Regardless of where a meeting occurs, the city should provide the surety access to the project records and all documentation that supports the declaration of default. Access to the project for any consultants or representatives the surety chooses to bring in should also be freely given. During the surety's evaluation process, it is perfectly normal to feel that things are not progressing fast enough. The city should stay in constant contact with the surety to ensure the evaluation is completed. If the process is not moving, the city should use its own judgment about the need to elevate the discussion beyond accommodation and cooperation.

Remember, the surety can breach its obligations under the bond. A performance bond is a contract. The city is a third party beneficiary of that contract and may enforce it. If legal fees are incurred in the enforcement of that contract, the civil practices and remedies provide a means for recovery of those fees from a breaching surety. An unreasonable grasp onto a defense to avoid performance is an example of that breach. If the surety breaches its obligations and refuses to perform, the city should move forward with completion and seek reimbursement for costs to complete from the defaulted contractor and the surety.

In the scenario where a notice of default has been issued but the city has only suspended the contractor's performance, the surety may determine that the declaration of default is insufficient to trigger its obligations under the bond. In this scenario, the surety may advise the City that a termination is necessary prior to any activity by the surety. At that point, the City would need to officially terminate the contract and make a formal demand for surety performance. Termination is typically a path from which there is no turning back, so cities should be careful in choosing this remedy.

GETTING THE WORK COMPLETED:

In continuing with the example, let's assume the surety agrees that a default has occurred. Will the city be satisfied with the actions the surety chooses to take in remedying the default? The answer to that question is a definite "Maybe." The security all sureties

enjoy is the right to control the contract balance assuming the default occurred during construction and the contractor has not already received full payment. Hence, if the surety agrees that there has been a default that triggers the obligations under the performance bond, the surety will demand direct payment of the contract balance in exchange for performance.

Once the surety has the funds, it will try to complete the job for no more than what it has received from the city. The easiest place to find a contractor who says it can complete the work for the contract balance is behind the door of the original contractor who already agreed to that price. The surety has every right to rehire the original contractor to redo the work. This particular path to performance is often one the city finds distasteful. This option can work though because the surety has leverage over the contractor that the city may not have and there is typically a good relationship between the contractor and its surety that will foster better performance. In the alternative, the surety may hire a substitute contractor to come in and correct deficiencies using the balance paid to it by the city.

Stepping back the surety may, after its evaluation, refuse to act. Such refusal could be because the surety believes it has defenses to performance. Perhaps the surety does not believe the notice of default was proper; perhaps the surety believes the city's demand on the contractor was unreasonable and that the city actually breached the contract first; or perhaps the surety simply thinks the economics of the situation are such that its best and least costly option is to try to minimize its losses by negotiating or fighting with the city after completion.

If the surety refuses performance and the city terminated the contractor, the burden would fall on the city to complete the work in accordance with the plans and specifications. Upon completion, the surety would be able to evaluate the expenditures made by the city. To the extent those expenditures exceed the original contract amount and no additional defenses have arisen in the interim, the surety may reimburse the city for the overage costs. If the contractor has not been terminated, the city could supplement the contractor's forces to correct the default and allow the contractor to complete the work after back-charging it for the correction costs. This option would require the contractor's assent to the back-

charge by change order, but it could preserve the project and eliminate a fight with the contractor and surety post-project.

If the city completes the project after a refusal to honor its obligations under the bond, the surety may still refuse to reimburse the city for costs in excess of the contract balance. Presumably this action would be chosen by the surety as a calculated effort to secure a better result during litigation based on available defenses and perceived strengths in negotiated positions.

FORCING COMPLIANCE WITH BOND OBLIGATIONS:

The city can always sue the surety and the contractor to recover the costs to complete. A lawsuit can be brought either before or after the work has been done. Given the city's financial situation and how deep it is into the project, the determination about performing the work prior to recovery from the surety and contractor remains a strategic decision. Another strategic concern for the city is the relative health of the contractor. If the contractor is in relatively poor economic health, the less cooperative the surety will likely be in any negotiations before and after suit is filed. When a defaulting contractor is in good economic health, the surety can be relatively assured that it can recover any money spent to complete the project on behalf of the defaulting contractor under the general indemnity agreement (GIA) that sureties require their principals sign.

Under the typical GIA, a surety has no limitations placed on it for amounts recoverable in an indemnification action against its principal. Therefore, a surety might be willing to expend considerable attorneys' fees in an effort to lessen their ultimate liability if they believe that option is the most economical. If the surety settles a claim or faces a judgment, it will then seek to recover all of its costs, including attorney's fees, from their principal through separate litigation.

Of course, depending on the parties involved, there may simply be situations where a final judgment is all that will suffice to force a surety to perform. Remember, sureties are not in the business of paying claims. Sureties typically do not have any emotional connection to projects and their decisions are largely driven by the economics of a situation.

If there is a high likelihood that the notice of default will stand up in court and the surety will be exposed to damages, performance may be easier to get. Also, if the contractor has clearly defaulted but has the ability to reimburse the surety in an indemnity action, the surety may have a higher willingness to perform. If, on the other hand, the contractor is basically bankrupt and undercapitalized, whether the notice of default is proper or not may not matter. The surety may conclude that its risks are less by not performing.

In sum, there is no way to guarantee surety performance after a notice of default. Every project is different and cash surety is somewhat unique. However, sureties are controlled by people. Remember, if you want a surety to perform, be nice. That may or may not work, but it never hurts. There may be a time when it's appropriate to stop being nice, but starting that way may help. For cities, understanding how sureties behave, at least in very broad and general terms, as outlined here, can help in the evaluation of construction disputes and contractor defaults.