Meeting Different Expectations: A Consensus Approach to Bonding

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Meeting Different Expectations: A Consensus Approach to Bonding[♦]

In September 2020 ConsensusDocs published eight newly revised performance and payment bond forms.[1] The forms were a result of dialogue and discussion among the members of the ConsensusDocs bond forms working group, which included representatives from owners, prime contractors, subcontractors and the surety industry. The forms were redesigned out of a recognized need to reconcile the demands and expectations of the parties to the surety bond – demands and expectations that often are not in alignment. This paper presents the differing expectations concerning the performance and payment bond and offers a brief discussion of the legal considerations in the context of those expectations. This paper then describes the forms' key provisions and how they reflect a balancing of each parties' interests.

I. The parties to a surety bond and the differing expectations

A. Brief Primer on a Surety Bond

A surety bond is a three-party agreement between the surety, principal and obligee.[2] A contract surety bond secures the obligations of an underlying contract. It generally includes a performance, payment and maintenance obligation. The obligations may be separate bonds or combined into a single bond.

1. Principal - The principal is the party that is primarily responsible for performing the contractual obligations (e.g. the prime contractor on a prime contract or a subcontractor on a subcontract). The Principal is considered the primary obligor.

2. Obligee - The obligee is the entity that enters into the contract with the principal and is the party to whom the contractual obligations are owed (e.g. the project owner on a prime contract or the general contractor on a subcontract).

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[1] ConsensusDocs 260 Performance Bond, ConsensusDocs 261Payment Bond, ConsensusDocs 470 Design-Build Performance Bond (Surety Design Liability), ConsensusDocs 471 Design-Build Performance Bond (Surety has No Liability for Design), ConsensusDocs 472Design-Build Payment Bond (Surety Design Liability), ConsensusDocs 473Design-build Payment Bond (Surety has No Liability for Design), ConsensusDocs 706 Subcontract Performance Bond, ConsensusDocs 707 Subcontract Payment Bond.

[2] Gregory L. Dailey, et al., *The Creation of the Relationship*, *in* THE LAW OF PERFORMANCE BONDS, 1, 5 (3d Ed., Gregory M. Weinstein and Kimberly Zanotta eds, 2018) (hereinafter Dailey)

3. Surety - The surety is the entity that guarantees that the principal's obligations will be performed. The surety is secondarily liable. That is, its obligations under the bond are not triggered unless and until the principal defaults under the construction contract.

With respect to a construction performance bond, the underlying obligation is performance of the construction contract between the principal (the contractor or subcontractor) and the obligee (the project owner or general contractor).[3] The performance bond is security that if the principal defaults or materially breaches the contract (which typically is incorporated by reference into the bond), the surety and principal agree to provide a remedy per the terms of the bond.

With respect to a construction payment bond, the underlying obligation is payment of the principal's payment obligations to subcontractors, suppliers, laborers and other vendors of the principal (the contractor or subcontractor) that supplied goods and services to the project and the obligee (the project owner or general contractor). The payment bond is security that if the principal defaults on its payment obligations, the surety and principal agree to provide payment per the terms of the bond.[4]

B. Parties' Expectations

At the outset, the parties' goals and expectations share the common goal of the successful completion of the project. Nevertheless, and understandably, the three parties also have differing interests and expectations with respect to the performance and payment bond.

Obligee

The obligee has required the bonds as security that the contract will be fully performed on time and within budget and that all subcontractors and suppliers will be paid. The expectations that an obligee may have of the surety when problems arise on the project may vary depending on the nature of the obligee (project owner or prime contractor) and the level of contracting expertise, experience and resources. That is, a prime contractor that has the expertise to maintain the progress of a project on which the bond principal defaulted may want some opportunity to do so, while a project owner that is not regularly involved in construction may not. Nevertheless, any obligee, regardless of its particular circumstances, expects a surety to respond to a performance bond claim in an efficient and timely manner, ultimately allowing the project to continue to progress toward completion.[5] It expects that the surety will promptly respond to notice of default of the principal, and will get involved in the dispute investigating

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[3] AGC of America, THE CONTRACT BOND CLAIMS PROCESS (2014)
[4] *Id.*
[5] AGC of America, AN OVERVIEW OF THE SURETY BOND CLAIMS PROCESS (2004) (hereinafter AGC Overview)

the declaration of default and, in certain circumstances, help facilitate completion of the contract by the principal prior to any termination notice. If the principal fails to cure its default, and the obligee terminates the principal, then the oblige expects the surety to promptly make an election under the bond to complete the principal's work or pay the oblige to do so.

Principal

With respect to the principal, it expects that a claim will not be made against its performance bond unless it is in default of its contractual obligations. Similarly, it expects that the obligee will comply with its obligations pursuant to the terms and conditions of the contract (and the bond) and that in the event a claim is made against the performance bond, the surety will thoroughly investigate the claim and make a determination as to its validity before taking action. As an extension of that concept, the principal also expects that if it has valid legal defenses to any claim asserted against the performance or the payment bond, the surety will assert those defenses in response to the claim. Specifically, as primary obligor, the principal is the party that will ultimately be liable for any loss caused by a default based on the fact that under common law and in accordance with the indemnity agreement it executes for the benefit of the surety, it is obligated to reimburse the surety for any losses incurred by the surety under the bond. Consequently, the principal is motivated to exert defenses to challenge any perceived wrongful declaration of default or termination. The surety must be disciplined and thorough when the principal exerts defenses, as the surety must consider its obligations to the obligee.

Surety

A surety's underwriting and pricing contemplate certain expectations. The surety expects to underwrite a clear and definable risk, both in terms of the scope and nature of the contractual obligations and the size of the risk (bond amount and contract price). In this way, the surety is able to determine if the contractor has the capabilities and financial resources necessary to perform the contract successfully.[6] A vague scope or an indefinite bond amount makes this underwriting task difficult, if not impossible

When a surety underwrites a performance bond, it does not contemplate that the bond will be used or viewed as "dispute insurance" that responds to every contractual dispute.[7] Rather, the bond only responds in the event there is a default, specifically a material breach that rises to the level of allowing the obligee to terminate the contract. In addition, for an obligee to look to the surety to perform

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[6] Dailey supra note 2, at 9.
[7] AGC Overview, supra note 5 ("The performance bond does not guarantee that there will be no disputes or disagreements.").

while the current contractor remains in place creates significant ambiguities regarding the rights and obligations of the parties, thus highlighting the importance that a performance bond contain a provision requiring the obligee to terminate the principal before the surety has an obligation to perform To that end, it has been noted that "Two contractors cannot perform the same work at the same time. That is one reason most bond forms make the formal termination of the principal's contract a condition precedent to the surety's performance obligations."[8]

Finally, the surety is an independent party that expects to have the opportunity and time to investigate a claim fully to determine whether the bond's coverage is triggered. That is, a surety expects to independently determine whether the contractor was in default of the construction contract (for a performance bond claim) or that amounts were due and owing to a subcontractor (for a payment bond claim). Further, the investigation facilitates the surety's decision regarding the most appropriate and efficient approach to remedying a default. This investigation requires time and is not susceptible to an instantaneous decision.

II. Legal Consideration in Light of Differing Expectations

A. Implications of a changing bond penalty

The obligee's expectation that the performance bond will cover all costs of completion, including any subsequent change orders that may be issued, often drives a requirement that the bond penalty (which is usually set at 100% of the initial contract price) automatically increase with any subsequent increases of the contract price. Understandably, the obligee wants to be certain that there is sufficient financial protection to cover the cost of completion of a defaulted project. However, this "automatic increase requirement" creates certain issues for the surety. As noted above, the surety expects to be able to quantify its potential financial exposure when underwriting a bond. A changing bond penalty, particularly with no notice to the surety, does not provide such certainty. In addition, a surety's decision to write a bond is effectively a statement of the surety's comfort that the principal qualifies for a bond of a certain size. The surety desires involvement in subsequent increases of the bond so that it can re-evaluate the principal's qualifications relative to the new bond amount. Finally, insurance regulations set the maximum single bond that a surety typically can write. For example, California Insurance Code §12090 limits the risk a surety can accept under a single bond, after crediting for reinsurance and co-surety, to 10% surplus and capital. With a changing bond penalty, a surety cannot be certain in all cases that it is compliant with this requirement.

[8] *Id*.

B. Reconciling obligees's remedies under construction contract and surety's obligations under bond.

Typically, a construction contract affords the obligee certain remedies in the event the contractor defaults. For example, under ConsensusDocs Form 200, in the event of an uncured default, the obligee has a right to "complete all or any part of the Work." Under a performance bond, the surety's obligations are triggered upon a notice of default and the surety typically has options to provide a remedy including taking over the work, tendering a completion contract or providing a financial settlement. How do the obligee's rights under the construction contract relate to the surety's rights and obligations under the surety bond? Can an obligee expect to undertake completion without terminating the contractor and hold the surety financially responsible?

As noted above, a surety's obligations are triggered upon a default. *L & A Contracting* is the seminal case that illuminates the nature of the default. The Court stated, "To constitute a legal default, there must be (1) a material breach or series of material breaches (2) of such magnitude that the obligee is justified in terminating the contract."[9] Further, in construing bond forms with explicit conditions that the obligee declare a default, courts have held that a notice of default is a predicate to the surety's obligations, and the surety is not liable for completion costs incurred by the obligee absent this notice of default.[10]

In reconciling the obligee's rights under the construction contract and the surety's rights to notice and an opportunity to provide a remedy, courts will look to the language of the bond form. Does the bond form establish certain predicates that must occur before the surety has obligations under the bond? Unfortunately, there has not been a consistent approach across jurisdictions. The jurisdiction of the contract, the language of the bond, the language of the bonded contract require analysis and consideration to determine the point at which the surety's obligations begin (and whether costs incurred by the obligee's remedial actions are covered by the bond).[11]

III. Revised ConsensusDocs Bond Forms

The newly revised ConsensusDocs bond forms offer more balance to the differing expectations of the bond's parties. For example, in the newly revised ConsensusDocs 706 Subcontract Performance Bond, there is a recognition of the importance of maintaining the progress of the work, specifically during the

[9] *L & A Contracting Co. v. S. Concrete Servs., Inc*., 17 F.3d 106, 110 (5th Cir. 1994).
[10] See, e.g., *International Fidelity Insurance Company v. Americaribe -Moriarty JV*, 681 Fed. Appx. 771 (11th Cir. 2017) (holding that surety was not liable on performance bond due to contractor's failure to comply with bond's requirements).
[11] Alberta L. Adams, et al., *Conditions Precedent to Asserting a Performance Bond Claim*, in THE LAW OF PERFORMANCE BONDS, 19, 56 (3d Ed., Gregory M. Weinstein and Kimberly Zanotta eds, 2018)

surety's claim investigation, and the prime contractor's expertise in marshalling the resources necessary to maintain the project's progress. To that end, the subcontractor performance bond form (Form 706) contains a "self-help" option that allows the prime contractor to continue progressing the work after a declaration of default and while the surety is investigating the claim.[12] The performance bond establishes a timeline for the surety's investigation to provide the prime contractor with certainty in terms of the time it will take for the surety to investigate and make a decision as to the option it may undertake. The form is clear that the surety's obligations arise only after a notice of default, termination of the principal, the surety's investigation and the surety's determination of the claim. Thus, the form balances the prime contractor's need for a timely response from the surety and continued progress of the work, with the important concept that a surety's obligation is conditioned on default and termination.

The form establishes a two-step process for responding to a default. After receiving a notice of default, the surety must commence an investigation of the default to make its own evaluation. The investigation must commence with a stated number of days (or if no number is inserted in the form, 30 days). Then if the surety determines that 1) the principal is in default, 2) the obligee is not in default and 3) the principal has been terminated, the surety must provide one of the following remedies:

> (i) Complete the Work, with the consent of Owner, through Constructor;
>
> (ii) Enter into a takeover agreement with the Owner to undertake Contract Work completion;
>
> (iii) Arrange for the completion of the Work by a contractor acceptable to Owner and secured by performance and payment bonds equivalent to those for the Contract issued by a qualified surety. Surety shall make available as the Work progresses sufficient funds to pay the cost of completion of the Work less the Contract Balance up to the Bond Sum; or
>
> (iv) Waive its right to complete the Work and reimburse Owner the amount of its reasonable costs, not to exceed the Bond Sum, to complete the Work less the Contract Balance.

This provision recognizes that a surety must first independently investigate a claim to determine whether a default has occurred and, if so, to determine the

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[12] The self-help provision is only in the subcontract performance bonds, noting that the prime contractor has the resources and expertise to continue the progress of the work. The form is not in the bond forms between owner and prime contractor. Although some owners may have such expertise, not all do. Therefore, the provision is not in the base form.

appropriate remedy. As noted above, the provision also recognizes the importance of timely involvement by the surety, requiring the investigation to begin withing a certain number of days. Note that the form does not provide a set time to begin completion, as the time needed to investigate a claim may vary from claim to claim.

The performance bond forms balance the obligee's expectation that the bond amount will be sufficient to cover completion costs with the surety's need to a have a definitive penal sum. The forms state that the penal sum increases automatically with change orders, but such automatic increases are capped when the aggregate amount of increases total 25% of the original penal sum. After the cap is reached, surety consent is required.

The payment bond forms similarly state that the penal sum increases automatically with change orders, but such automatic increases are capped when the aggregate amount of increases total 25% of the original penal sum. After the cap is reached, surety consent is required.

The three parties of a bond are "coming to the bond" with different perspectives, interests and expectations. The newly revised ConsensusDocs bond forms are consistent with the mission and philosophy of ConsensusDocs - to develop forms that represent fairly the interest of all stakeholders and the shared desire for a completed project as the common denominator.