In the present economic climate, performance bonds are often important for construction projects, for several reasons: (1) although construction manager/contractor defaults have always been of concern (public agencies routinely require bonds), such defaults have increased recently with the worsening economy; (2) owners, developers, sureties, construction managers and contractors need to protect their interests to the maximum extent possible; and (3) such bonds enhance the viability of construction projects generally. The latter is true because it is important to make sureties as secure as possible, or else they won’t issue bonds, thereby drying up what little construction is in—or about to enter—the pipeline.

There are several basic concepts in the performance bond context: First, the relationship here is a tripartite one, not the normal one-on-one contractual relationship found in owner-construction manager/contractor, or construction manager/trade contractor agreements. Here, the three parties are (1) the construction manager or contractor (the principal), (2) the surety, and (3) the project owner (the obligee). Each side’s rights are interdependent, but the surety is a powerless bystander for virtually the entire duration of the construction project. The latter is injected into the process only when the project owner has formally declared a default.

Default and Surety’s Options

As noted, prior to the owner’s issuance of a formal declaration of default, there is no legal basis for the surety to take any action vis-à-vis the owner or the principal. Once the owner has formally issued its declaration holding the principal in default, the surety has five options: (1) fund the principal to completion, (2) perform the work itself, (3) tender a completion contractor, (4) tender payment to the owner, or (5) do nothing. Each option has its advantages and drawbacks.

It is important to make sureties as secure as possible, or else they won’t issue bonds, thereby drying up what little construction is in—or about to enter—the pipeline.

The financing option involves paying the principal’s bills to completion, typically done when the project is nearing completion. This option saves the time and expense of hiring a new construction manager/contractor, and thus helps avoid the assessment of liquidated damages. The primary disadvantage of this option is that it is difficult if not impossible to control completion costs, which is important because the surety’s potential liability is no longer limited to the Penal Sum of the bond—that is, the amount set forth in the performance bond to begin with, usually the principal’s guaranteed maximum price (GMP) or lump sum bid. In addition, the surety risks being held responsible for the principal’s defective work, latent defects, etc. Because of these drawbacks, this option is usually not chosen except at the very tail end of a project when the referenced risks can be easily quantified.

In the second option, the surety performs the work itself by executing a takeover agreement with the owner and retaining its own completion contractor to complete the work, an option also typically chosen where the project is near completion. The advantages for the surety include that the surety retains greater control over the project and gains the additional security of another surety bonding the completion contractor. The disadvantages include that the surety loses its right to interpose its principal’s defenses against the owner, unless it takes over under a reservation of rights. Also, the surety again loses its ability to cap its losses, and may be subject to consequential damages such as the owner’s lost rents, although such damages may not exceed the Penal Sum of the bond.

The third option is for the surety to tender a completion construction manager/contractor to the owner. Here the surety will obtain independent bids, usually bonded by another surety. This option is related to the second option,
but in this scenario the surety walks away entirely. This option is typically chosen early on in the construction project. Advantages include fixing the surety's liability and releasing it from liability under the bond. Disadvantages include the following: (a) delays associated with stopping the project to obtain bids might inject liquidated damages; (b) the independent bids submitted to the surety will likely be increased due to the completion contractor's need to maintain a contingency to avoid assuming the risks of unforeseen conditions; and (c) the surety would surrender defenses its principal might have had, as there will be no opportunity to reserve rights.

The fourth option is where the surety buys back the bond. Here the surety will simply tender payment of the cost to complete less remaining contract balance, but only up to the Penal Sum, in return for a release from the owner. This is typically done where the net cost to complete exceeds the Penal Sum. The advantages and disadvantages are similar to the third option. This option also has the potential to jeopardize the surety's indemnification rights against its principal and/or its indemnitor(s) on the ground that the tender was premature, or that the surety failed to mitigate damages, among others.

Surety Defenses to Owners

Once an owner has declared the principal to be in default under the agreement, there are several defenses available to the surety, including those that the principal may have had, unless waived, vis-à-vis the owner.

The fifth option is for the surety to waive its right to perform—the “Do-Nothing Approach,” which allows the project owner to complete without any surety input, typically done where the owner’s right to declare default is in question. This option is specifically permitted in the current AIA form, denial of liability (AIA document A312-1984, §4.4.2). The advantage here is that it avoids any surety involvement and the risks inherent in any relationship between the owner and a surety-selected completion contractor. The disadvantages are significant, however, as the surety will lose all control of costs while at the same time risking a bad faith claim by the owner. As a result, this option is rarely chosen.

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Separate and apart from maintaining the claims and defenses available to the principal, there are several defenses unique to the surety. What the surety will argue is that certain owner acts have relieved or discharged the surety from its obligations under the bond. Among the bases for such a discharge claim are any of the following: (1) relinquishing security, including overpayment to the principal; (2) material alteration of the bonded contract; (3) misrepresentation, concealment or fraud; and (4) owner’s release of the principal. The first two of those defenses are addressed below.

The overpayment defense is based on the concept that the surety has relied on the owner’s compliance with the construction contract’s terms, including the requirement that the owner make timely payments to the principal, but not overpay. For these purposes, the contract balance/retainage acts as security for the surety, not just the owner. For example, if the owner were to pay its construction manager/contractor 80 percent of the GMP or lump sum for only 40 percent completed work, the surety will have lost collateral valued at 40 percent of the GMP/lump sum. This is not a theoretical concern, as owners often advance funds to their construction managers/contractors.

That is why it is important for the owner and construction manager/contractor to obtain a “consent of surety” for each such advance. Whether an advance is in fact a violation of the bond sufficient to discharge the surety is a fact-specific determination, where the legal standard is whether (1) the owner failed to use reasonable prudence, (2) the owner lacked a good faith reasonable basis for making the payment, and (3) the resulting payment created actual harm to the surety.

The barriers to a complete discharge
are many. First, in terms of burden of proof, it is on the surety to demonstrate both the fact of overpayment and prejudice (harm) created thereby. But even where the surety is able to meet both of those criteria regarding an overpayment, it will only gain a so-called pro tanto discharge, that is, a discharge limited to the extent of the overpayment.\footnote{Just as the surety may maintain its defense available only to the surety that there were material alterations to the bonded agreement, either regarding contract terms, e.g., extensions of time, failure to give notice, etc., or regarding materially changing the scope of the work to be performed—a fact-specific determination. Examples of material alterations include changing the project from building a warehouse to building a hospital; adding an entire floor to a building; imposing an inordinate number of change orders; a material change in allocation of revenues; and failure to obtain lien waivers.\footnote{Examples of non-material alterations include changing the location of the building; adding a basement; and failure of the owner to obtain builder’s risk insurance from the contractor.} In analyzing each fact situation, the court will not permit ex post facto perspective—that is, the situation must be viewed from the perspective of when the bond was issued.}

**Conclusion**

While in many instances, certain technical defenses might appear to let a surety disclaim coverage or be discharged, such a result will not always obtain. Key to any such determination will be whether the surety can sustain its burden of proof both as to the defense itself and also that the event giving rise to that defense caused actual prejudice to the surety, something that is often difficult to demonstrate.

Where the surety’s defenses are not permitted and liability is assessed against it, however, the ultimate liability will usually not lie with the surety itself, but with the principals of the construction manager/contractor for which it has issued the bond, as they will have issued the general agreement of indemnity for the bond, which usually includes a personal guarantee. In that sense liability will come full circle and ultimately fall on the defaulted construction manager/contractor, or at least its principals.\footnote{As a result, corporate insolvency/bankruptcy will not help the construction manager/contractor.}

The key factor in seeing that the process is handled properly, as is often the case for construction projects, is close project monitoring, of claims, change orders, time extension requests, etc., together with providing proper notice thereof, and especially obtaining consent of surety for such matters. This monitoring will help all parties—owner, construction manager/contractor, and surety—see that the inevitable project difficulties and obstructions are handled as effectively and painlessly as possible.

1. There is one narrow window through which the surety might be able to inject itself into the process prior to an owner’s formal declaration of default. The AIA form performance bond, AIA document A312-1984, requires that a conference be held within 15 days after the owner has formally announced that it is considering declaring a default. Where a surety becomes suspicious about its principal’s ability to complete its work, the surety can preempt matters by requesting that the owner conduct such a meeting.


3. Typically, before issuing a performance or payment bond to a construction manager/contractor, a surety will require that construction manager/contractor to execute a general agreement of indemnity (GAI), which typically involves personal liability of the principal of the construction manager/contractor.

4. See, St. John’s Coll., Fordham v. Aetna Indem. Co., 201 N.Y.335, 94 N.E. 994 (1911), where the New York Court of Appeals reduced a damage award to an owner from the surety in the amount of two “advance” payments by the owner to the contractor not made in accordance with the owner/contractor agreement.


7. See, id. The last-referenced holding is troubling in that a failure to procure insurance appears to be a very material alteration of agreement as it jeopardizes the surety’s (and the owner’s) interest in the project.

8. The AIA document A312-1984 § 6.3 permits liquidated damages if specified in the underlying agreement, or if not specified in the agreement, then “actual damages.”

9. See, e.g., Carrols Equities Corp. v. Villnave, 57 A.D.2d 1044, 395 N.Y.S.2d 800 (4th Dept. 1977), where the court granted judgment for the owner against the surety and also granted judgment over for the surety against the principal.