An Overview: Receivership Construction Bonds Part II

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In Part I of this article published in *Receivership News* issue 44 we discussed the types of surety bonds issued in connection with a construction project and the basic aspects of suretyship. In this second and last part, we discuss the performance options available to the surety, the principal's duty to indemnify the surety, and common defenses available to the surety.

1. Surety Obligations and Rights

(a) Performance Options Available to the Surety

After an obligee has declared a principal to be in default, and after the obligee has provided the surety with notice of the default, coupled with a demand that the surety perform on its principal's behalf, and complied with any other conditions of the bond, the surety has several options as to how to respond to the claim. Those options may be expressed in the bond or implied as a matter of law. Before determining which option to choose, however, a surety will invariably need to investigate the claim. The obligee making a claim on the bond is well advised to cooperate with the surety's investigation of the claim or risk the surety asserting the defense of exoneration. Such a defense would be based on the assertion that the obligee's failure to cooperate prejudiced the surety's interests. If the surety concludes through its investigation that its principal is in fact in default, the surety may fulfill its obligations under the bond by various means. The precise obligations of the surety will depend on the particular language in the bond.

After the surety determines that its contractor-principal, for instance, is in default, the surety generally has five options. It can: (1) "buy back" the bond by tendering to the owner-obligee an amount up to the penal sum representing the owner's damages (i.e., the cost to complete the project above the construction contract amount, plus delay damages, potentially, in the form of liquidated damages or actual damages); (2) complete the project with the defaulting contractor principal, usually by providing the contractor with interim financing; (3) hire a new completion contractor to complete the project; (4) take over and complete the project itself; or (5) simply do nothing and have the owner complete the project with a contractor of its choosing. Other options may exist depending on the express language of the bond.

Which option the surety chooses will depend on a number of factors based upon the surety's own internal calculus. However, from the perspective of a receiver who steps into the shoes of the owner, the most desirable options are typically the hiring of a new contractor by the surety, or the surety directly taking over the project. These are preferred options because they leave project completion in the hands of the surety, rather than the receiver. Alternatively, a surety financing the defaulted principal can be a viable option, but working with a contractor that just defaulted on the project can be an awkward and unproductive venture, especially when there has been a breakdown of trust in the defaulted contractor or its abilities. The options least favorable to a receiver are the "buy back" and the completing the project itself options, because these options would require the receiver to work affirmatively to hire a new contractor, or otherwise complete the project.

In the payment bond context, the surety will typically pay the subcontractor or supplier claimant the amounts earned, but unpaid by the contractor-principal, possibly also including any attorneys' fees incurred by the claimant in connection with its payment bond claim. This may involve payment of the claim in its entirety or payment of only the undisputed claim amount. For instance, the contractor-principal may contend that certain of the payment bond claimant's work or materials were deficient. Alternatively, the contractor-principal may assert that the claimant delayed the project and that liquidated damages assessed against the contractor by the owner should, in turn, be assessed against the delaying subcontractor or supplier. Under either of these circumstances, the surety may pay only the undisputed amount and either negotiate or litigate with the payment bond claimant the amount above the undisputed amount that should be paid, if any.

In the subdivision bond context, the surety generally has the same performance options as with a performance bond. However, a surety's performance options may be limited where the bond was issued pursuant to a statute as the statute will govern its options. Where subdivision bonds run to private entities (such as a homeowners association), the bond itself may further limit or describe the options available.

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(b) Indemnification by the Principal

Typically, as a condition to issuing a bond, a surety will require the principal to enter into an indemnification agreement with the surety. These agreements, often known as General Indemnity Agreements ("GIA"), obligate the principal to indemnify and "hold the surety harmless" in the event the surety

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suffers a loss on the bond it issued for the principal. Upon receipt of a claim from the bond obligee, the surety will typically give notice to the bond principal that it is obligated to indemnify the surety. In the event that litigation ensues and the bond principal breaches the GIA, the surety will often bring claims against the bond principal to enforce the GIA. Because receivers have quasi-judicial immunity as officers of the court, they are entitled to the benefits of the enforcement of a bond, without potential personal liability related to the GIAs.

2. Common Surety Defenses

(a) Right to Assert Defenses of the Principal

A surety asked to perform has numerous defenses that it may assert. In addition to a handful of independent defenses available to it, the surety can also assert defenses available to the principal. Because a surety is only liable if the principal is in default, if, by virtue of a defense possessed by the principal, the principal is not in default, the surety generally is not liable. In order to assert the defenses of the principal, the surety will typically work with the principal to gain a better factual understanding of the circumstances surrounding the principal's performance and alleged default. Common defenses available to the principal include substantial performance of the underlying contract, or breach of the underlying contract by the obligee, relieving the principal of its obligation to perform. Some examples of breaches by the obligee that may relieve the principal from its obligation to perform include a failure by the obligee to pay the principal, drastic changes in the project's scope, differing site conditions, defective contract documents, or owner interference.

(b) Independent Surety Defenses

In addition to the defenses of its principal, sureties posses independent defenses created by the terms of the bond, or common law. Discussed below are some of the more common surety defenses:

(i) Terms of the Bond

A surety may rely on the specific terms of the bond at issue, which in turn may give rise to a defense for the surety. Bonds typically contain a number of conditions on the surety's liability, and the nonoccurrence of one of these conditions is a defense available to the surety. Similarly, sureties can rely on the terms of the bond that define who a proper bond claimant is, in defending against claims by parties not specifically enumerated as obligees.

(ii) Late Notice or Insufficient Notice

Sureties may have a number of notice-based defenses. An obligee's notice of a principal's default must be both timely and sufficiently detailed. The failure to comply with the bond's notice requirements may create a defense for the surety.

(iii) Material Alteration

Material alterations of the underlying bonded contract that prejudice the surety may relieve the surety from its obligations on the bond, unless the surety has consented in advance to such changes. Even if the surety has previously consented to such changes, an alteration in the project's scope that is so drastic that it was not contemplated by the parties when the bond was executed may provide a defense to a surety. Such changes are typically referred to as cardinal changes. Similarly, material changes in the project's participants without notice to the surety may constitute material alterations giving rise to a defense.

(iv) Prepayment/Overpayment of Principal

Prepayment or overpayment by the owner-obligee to the contractor-principal in response to the contractor-principal's progress payment applications may also prejudice the surety and act as a defense, or partial defense, to the surety in a performance bond setting. More particularly, a surety has subrogation rights to the extent of any payments it may make in response to a bond claim, meaning that the surety would be entitled to its principal's earned-but-unpaid retention. However, if the obligee overpaid the principal and did not withhold sufficient sums as retention, not only has the contractor-principal's incentive to perform been reduced, the amount of project funding available to the surety for completing the project has also been reduced, thereby giving rise to an exoneration defense.

(v) Extensions of Time

Under certain circumstances, the granting of extensions of time to the bond principal, without notice to the surety, may prejudice the surety sufficiently to create a defense to its bond obligations.

3. Conclusion

Surety bonds can be an important asset to any distressed property under construction and a valuable tool available to receivers. However, surety bonds are also complicated contracts that are deeply rooted in history and tradition. Although this article has provided an introduction to surety bonds, it is not intended to be, and should not be considered, legal advice. Receivers should proceed cautiously when seeking to enforce surety bonds. Receivers also should be careful to follow proper procedures in enforcing the bonds. Doing so will permit the receiver and the estate to obtain the maximum benefit from the bonds.

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