

# PERFORMANCE BONDS: Making Sure The Protection Is There When You Need It

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**Y**ou are a general contractor on a construction project. As part of the contract, your subcontractors have provided performance bonds. You have one subcontractor, Subcontractor A, who appears not to be able to keep up because of manpower shortages. You send a letter to Subcontractor A, giving it five days to cure the default, with a copy to its bonding company. Subcontractor A realizes that you are serious and its performance immediately improves. When the bonding company sends a letter to you regarding the status of Subcontractor A's performance, you respond by telling the bonding company that the subcontractor is back on schedule. Six months later, however, Subcontractor A has fallen back into its bad habits. Again, you send a letter to the bonding company, asking it to take any steps necessary to prevent further delays and costs to your company. You do not get a response.

At the end of the project, the owner assesses liquidated damages against you. In addition, a number of other subcontractors have made claims for delay damages against you. Finally, you have incurred a substantial amount of additional costs as a result of the delay. These costs are all attributable to Subcontractor A's poor performance on the job. You make demand on Subcontractor A and its bonding company to pay these damages. Unfortunately, the bonding company refuses to pay -because you have not complied with the provisions in the bond that state that before the bonding company can become liable, the subcontractor must be in default and the general contractor must "declare" that the subcontractor is in default. In a case based on these facts, a federal appeals court in Mississippi agreed with the bonding company, and ruled that the bonding company was relieved of its obligations because the general contractor's failed to clearly and unequivocally inform the bonding company of the subcontractor's default, which, in turn, prevented the bonding company from protecting its own interests. As a result of this "prejudice," the bonding company could not be required to pay for the delay damages incurred by the general contractor.

It is unlikely that Arizona courts will follow this rule. Unlike a number of other states, Arizona treats bonding companies like insurance companies. In Arizona, an insurance company can only escape its responsibilities if it is prejudiced by the insured's failure to comply with the provisions of the insurance policy. The insurance company is the party that must prove prejudice. In the factual scenario described above, the bonding company would probably have to be able to prove that if it had received the proper notice, the delays that caused the damages would not have occurred or, at a minimum, would have been reduced. Such facts might be very difficult to prove. Despite the more relaxed legal rule in Arizona, anyone who is the obligee under a performance bond should make every effort to comply with the provisions of the bond, so that the bonding company cannot avoid its obligations on a technicality. For example, a performance bond that has been commonly used in Arizona is the 1984 edition of "AIA A312 Bond. It contains the following provisions, which state that before the bonding company will be required to take action the following must have occurred

3.1 The Owner has notified the Contractor and the Surety at its address described in Paragraph 10 below that the Owner is considering declaring a Contractor Default and has requested and attempted to arrange a conference with the Contractor and the surety to be held not later than fifteen days after receipt of such notice to discuss methods of performing the Construction Contract. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract, but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default; and

3.2 The Owner has declared a Contractor Default and formally terminated the Contractor's right to complete the contract. Such Contractor Default shall not be declared earlier than twenty days after the Contractor and the Surety have received notice as provided in Subparagraph 3.1; and

3.3 The Owner has agreed to pay the Balance of the Contract Price to the Surety in accordance with the terms of the Construction Contract or to a contractor selected to perform the Construction Contract in accordance with the terms of the contract with the Owner.

Each of these provisions could contain a trap for the unwary. For example, to comply with paragraph 3.1, the general contractor probably should not simply send a demand letter or a notice to cure to the subcontractor. It should use the term "considering declaring a default" and formally request a meeting with the subcontractor and its surety.

The second provision is much more troublesome. Terminating a contractor or subcontractor is a drastic measure- especially lithe issue is delay, rather than workmanship, because finding a replacement could cause even more delay. At any meeting with the surety, the option to terminate the offending party must be thoroughly discussed; and those discussions must be thoroughly documented. In addition, the obligations of a performance bond surety survive final completion of the project, and continue through at least part of the warranty period -"terminating" a subcontractor which is long gone from the project, and may even be out of

business, would appear futile -but, the bonding company may demand it.

The third provision can also cause problems -the terminated sub- contractor and the general contractor may disagree as to what the balance due on the contract is. Because sureties' obligations often do not arise lithe obligee is itself in default, the surety might try to wiggle off the hook, by claiming that the obligee has not complied with the tender of payment requirement.

The A312 is just one form of bond. Many others exist. Therefore, if a general contractor intends to make a claim against a subcontractor' s performance bond and does not want to litigate the bonding company's liability, it should: a) read the bond very care- fully; b) make sure it understands precisely what it needs to do, contacting legal counsel, if necessary; c) do everything that might be required by the bond; and d) document every contact it has with the bonding company, just in case it forgot to cross a t or dot an i.