

## SURETY'S DEFENSES TO CONSTRUCTION CONTRACT TERMINATION

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### **I. Introduction**

When a project owner is highly dissatisfied with the contractor's performance on a bonded construction project, one of the more drastic actions the owner may take is to terminate the contract and attempt to require the bond surety to complete the project or fund completion. A contractor may take similar action against a subcontractor and its surety if the subcontractor's work on the project is bonded. This paper briefly summarizes the defenses available to a bond surety in such a situation.

As most practitioners are aware, suretyship is a three-party arrangement under which the surety guarantees the obligations of the primarily responsible party (called the principal) for the benefit of a third party (called the obligee). There are two types of bonds that cover obligations under a construction contract or subcontract – performance bonds and payment bonds.

Under a performance bond, the surety generally guarantees the overall performance of the bonded contract by the contractor or subcontractor in accordance with the applicable plans, specifications, and contract terms. If the general contractor provides a performance bond, that contractor is the principal, and the owner is typically the obligee, although a lender may be identified as a co-obligee. The surety's obligations are generally limited by the penal sum of the bond, and are triggered by a contractor default, with the frequent additional requirement that the default also result in a termination of the contract by the owner. Performance bonds often have a series of notice requirements and other conditions, several of which are discussed below.

Under a payment bond, the surety typically guarantees the principal's obligation to make payment to subcontractors, suppliers, and others hired by the principal, and may also guarantee payment to others working under the principal who have lien rights. If the conditions in the bond are met, the surety has an obligation to defend and indemnify the owner against claims by unpaid subcontractors, suppliers, and other claimants, as well as to make payment to such claimants.

Because the overall seminar topic into which this paper fits is contract termination, this paper focuses on surety defenses under performance bonds rather than payment bonds. Contract termination is often required to trigger the surety's obligations under a performance bond, but termination is not required under a payment bond. Likewise, a surety's demonstrating that a contract termination was wrongful would often provide the surety with a defense under a performance bond, but not under a payment bond. Therefore, the concept of termination is much more relevant to performance bonds than to payment bonds.

Statutes, including the Federal Miller Act and the North Carolina Model Payment and Performance Bond Act, govern payment and performance bonds on *public* projects, but do not apply to *private* projects. In addition, those statutes provide various time limits that must be met and notices that must be given by claimants under *payment* bonds on public projects, but specify

no such limits and notices for *performance* bonds. Accordingly, the majority of a surety's defenses to liability under a performance bond on either a public or private project arise not under a statute, but under the terms of the bond itself, the bonded contract, and common law.

Since the terms of the bond are central to the surety's defenses, this paper focuses on one of the most commonly used performance bond forms in the industry – the American Institute of Architects (AIA) Document A312-2010 form. References to the “AIA bond form” or the “A312” refer to that form unless otherwise specified.

## **II. Statutory Defenses for Public Construction Projects**

Where a construction project involves state or federal property, statutory bond requirements may apply. Even though most of a performance bond surety's defenses on a public project do not arise under the bonding statutes, it is still important for a practitioner to determine at the outset whether the public bonding statutes apply. Whether those statutes apply has bearing on the form of bond used and therefore some relevance to the surety's defenses.

### *A. Federal*

The Federal Miller Act, 40 U.S.C. §§ 3131-3134, governs the provision of performance and payment bonds on federal construction projects. The Miller Act requires that prime contractors furnish a payment bond and a performance bond for contracts in excess of \$100,000, (40 U.S.C. § 3131(b)), and for other contracts in the contracting officer's discretion (40 U.S.C. § 3131(e)).

The performance bond must be issued by a surety satisfactory to the officer, and in an amount the officer considers adequate to protect the government. 40 U.S.C. § 3131(b)(1). The performance bond will often be set in the amount of the prime contract. The amount of the payment bond may not be less than the amount of the performance bond. 40 U.S.C. § 3131(b)(2).

The Miller Act provides a 90-day notice requirement after the date of last furnishing for lower-tier subcontractors / suppliers to assert a *payment* bond claim. 40 U.S.C. § 3133(b)(2). The Miller Act also provides that an action on a *payment* bond must be brought within one year after the claimant's date of last furnishing. 40 U.S.C. § 3133(b)(4).

In contrast, the Miller Act provides no notice requirements or time limits for a performance bond claim.

The Miller Act does not provide a form performance bond, but accompanying regulations do. *See* 48 C.F.R. § 53.228(b), Standard Form 25. The substance of that form is reproduced below:

## OBLIGATION

We, the Principal and Surety(ies), are firmly bound to the United States of America (hereinafter called the Government) in the above penal sum. For payment of the penal sum, we bind ourselves, our heirs, executors, administrators, and successors, jointly and severally. However, where the Sureties are corporations acting as co-sureties, we the sureties bind ourselves in such sum "jointly and severally" as well as "severally" only for the purpose of allowing a joint action or actions against any or all of us. For all other purposes, each Surety binds itself, jointly and severally with the Principal, for the payment of the sum shown opposite the name of the Surety. If no limit of liability is indicated, the limit of liability is the full amount of the penal sum.

## CONDITIONS

The Principal has entered into the contract identified above.

## THEREFORE

The above obligation is void if the Principal-

(a)(1) Performs and fulfills all the undertaking, covenants, terms, conditions, and agreements of the contract during the original term of the contract and any extensions thereof that are granted by the Government, with or without notice of the Surety(ies) and during the life of any guaranty required under the contract, and (2) performs and fulfills all the undertakings, covenants, terms, conditions, and agreements of any and all duly authorized modifications of the contract that hereafter are made. Notice of those modifications to the Surety(ies) are waived.

(b) Pays to the Government the full amount of the taxes imposed by the Government, if the said contract is subject to 41 U.S.C. Chapter 31, Subchapter III, Bonds, which are collected, deducted, or withheld from wages paid by the Principal in carrying out the construction contract with respect to which this bond is furnished.

Therefore, this form is short, and does not contain the express notice requirements, conditions and protections for the surety that the AIA and other bond forms do. Variations from this suggested form require government approval. *See* 48 C.F.R. § 53.228(b), Standard Form 25, Instruction No. 1.

The language of the bond form under the Miller Act, and the common law principles discussed below, mean that as a general rule, the surety's liability under a Miller Act bond is limited to the penal sum of the bond.

B. *State*

The North Carolina Model Payment and Performance Bond Act, N.C. Gen. Stat. §§ 44A-25-35 (the “Bond Act” or “Little Miller Act”), governs the provision of performance and payment bonds on state construction projects. There are many similarities between the Miller Act and the Bond Act. Like the Miller Act, the Bond Act does not impose notice requirements and time limitations for performance bond claims as it does for payment bond claims. Also, like the Miller Act, the Bond Act contains a short model bond form which provides few express conditions and surety protections.

The Bond Act requires payment and performance bonds *from a prime contractor or construction manager at risk* on a state construction project where (1) the total amount of construction contracts awarded for the project exceeds \$300,000 (\$500,000 for UNC projects) and (2) the contractor’s or construction manager’s contract is greater than \$50,000, or (3) the contracting body requires a bond even though these thresholds are not met. N.C. Gen. Stat. § 44A-26(a).

The Bond Act only governs bonds issued by prime contractors or construction managers, i.e., contractors who have a contract with the state contracting body. Performance bonds from subcontractors under the prime contractor or construction manager are not governed by the Bond Act.

The amount of performance and payment bonds under the Bond Act should be 100% of the amount of the bonded construction contract. N.C. Gen. Stat. § 44A-26(a). The bonds must be issued by surety(ies) authorized to do business in North Carolina. N.C. Gen. Stat. § 44A-26(b).

The Bond Act provides for a 120-day notice requirement after the date of last furnishing for a lower-tier subcontractor or supplier to assert a *payment* bond claim. N.C. Gen. Stat. § 44A-27(b). The Bond Act also requires that an action on a *payment* bond must be brought within one year after the claimant’s date of last furnishing or the date of final settlement with contractor. N.C. Gen. Stat. § 44A-28(b).

There are no notice requirements or time limits provided in the Bond Act for performance bond claims.

The Bond Act provides a model form performance bond in N.C. Gen. Stat. § 44A-33(a), and a model form payment bond in N.C. Gen. Stat. § 44A-33(b). The form performance bond is reproduced below:

‘KNOW ALL MEN BY THESE PRESENTS, That we, the PRINCIPAL AND SURETY above named, are held and firmly bound unto the above named Contracting Body, hereinafter called the Contracting Body, in the penal sum of the amount stated above for the payment of which sum well and truly to be made, we bind ourselves, our heirs, executors, administrators, and successors, jointly and severally, firmly by these presents.

‘THE CONDITION OF THIS OBLIGATION IS SUCH, that whereas the Principal entered into a certain contract with the Contracting Body, numbered as shown above and hereto attached:

‘NOW THEREFORE, if the Principal shall well and truly perform and fulfill all the undertakings, covenants, terms, conditions, and agreements of said contract during the original term of said contract and any extensions thereof that may be granted by the Contracting Body, with or without notice to the Surety, and during the life of any guaranty required under the contract, and shall also well and truly perform and fulfill all the undertakings, covenants, terms, conditions, and agreements of any and all duly authorized modifications of said contract that may hereafter be made, notice of which modifications to the Surety being hereby waived, then, this obligation to be void; otherwise to remain in full force and virtue.

‘IN WITNESS WHEREOF, the above-bounden parties have executed this instrument under their several seals on the date indicated above, the name and corporate seal of each corporate party being hereto affixed and these presents duly signed by its undersigned representative, pursuant to authority of its governing body.’

Again, this form is very short and does not provide the express conditions and protections for the surety that AIA and other bond forms do.

#### Bonds under the Bond Act:

- Must contain certain basic information, like the date the bond is executed, the name of the principal, the name of the surety, the name of the contracting body, the amount of the bond, and the contract number. N.C. Gen. Stat. § 44A-33(a).
- Must contain certain basic conditions, e.g., that if the principal fully performs, the surety has no obligations, but otherwise, the surety is bound up to the penal sum of the bond. N.C. Gen. Stat. § 44A-33(a).
- Cannot reduce the statutory time limits for giving notice of a *payment* bond claim. N.C. Gen. Stat. § 44A-30(a).
- Cannot reduce the statutory time limits for bringing suit on a *payment* bond claim. N.C. Gen. Stat. § 44A-30(a); *see also Pyco Supply Co., Inc. v. Am. Centennial Ins. Co.*, 85 N.C. App. 114, 117, 354 S.E.2d 360, 362 (1987), *rev'd on other grounds*, 321 N.C. 435, 364 S.E.2d 380 (1988).
- Cannot otherwise reduce or limit the liability of the contractor or surety as prescribed in the Bond Act. N.C. Gen. Stat. § 44A-30(a)

Every bond given by a contractor under the Bond Act is deemed to have been given in accordance with the Bond Act, and the Bond Act is deemed written into each such bond. N.C. Gen. Stat. § 44A-30(b). Therefore, the Bond Act indicates that the form of the bond can generally vary from the model statutory forms, as long as the form used does not reduce or limit the surety's liability under the Bond Act. Note here, however, that some state contracting bodies may refuse to accept any variation from the statutory model form, so that whether another form is permissible may turn on the particular state contracting body in question.

As an example of how performance bonds under the Bond Act may vary from the statutory form, there is again no limitations period prescribed by the Bond Act for actions on a *performance* bond as there is for actions on a payment bond. **“Therefore, parties entering into a public performance bond are free to contract for any reasonable limitations period they choose.”** *Town of Pineville v. Atkinson/Dyer/Watson Architects, P.A.*, 114 N.C. App. 497, 500, 442 S.E.2d 73, 74 (1994) (emphasis added) (enforcing two-year limitations period in public project performance bond).

If the bond itself does not provide a time limit for suit, suit on a performance bond is governed by the three- year statute of limitations for breach of contract in N.C. Gen. Stat. § 1-52(1). *See Bernard v. Ohio Casualty Ins. Co.*, 79 N.C. App. 306, 308, 339 S.E.2d 20, 21 (1986).

A surety's liability under a *payment* bond required by the Bond Act is *expressly* limited by the statute to the penal sum of bond. N.C. Gen. Stat. § 44A-29. A surety's liability under a *performance* bond required by the Bond Act is also generally limited by the penal sum of bond, although this protection is not as explicit in the statute. *See* model bond form in N.C. Gen. Stat. § 44A-33(a) (which says surety is bound “in the penal sum of the amount stated . . .”), as well as the common law principles discussed below.

The conclusions regarding the surety's defenses under a performance bond on a public project can be summarized as follows:

- The practitioner should first determine whether the bond is governed by one of the public bond statutes (e.g., whether the project is public, the value threshold is met, and the bond is from a prime contractor). If not, the requirements of those statutes don't apply.
- The Miller Act and Bond Act do not contain notice or limitations periods for *performance* bond claims.
- The surety's liability under a public project bond is generally limited to the penal sum of the bond.
- Additional protections for the surety can be provided in the bond (such as a limitations period), as long as they do not contradict the relevant bonding statute, and as long as the relevant government agency or agent will accept a bond form that varies from the statutory model form.

### III. Defenses for Private Construction Projects

North Carolina has no specific statutes governing performance or payment bonds on private projects. Therefore, the express terms of the bond and the construction contract govern private projects. Set forth below are some common defenses available to a surety based on the ordinary terms of performance bonds (modeled after the AIA forms).

#### A. *Liability Limited to the Bond Amount*

The most obvious defense that arises under the terms of the bond itself is the penal sum of the bond, which limits the surety's potential liability. *See State v. U.S. Guarantee Co.*, 207 N.C. 725, 178 S.E. 550 (1935). The AIA performance bond reflects this concept by providing that the surety's liability is limited to the amount of the bond unless the surety elects to perform and complete the construction contract itself rather than exercising one of its other options, i.e., having the original contractor complete (with the consent of the owner), having a replacement contractor complete, paying the owner, or denying liability. AIA A312 – Performance Bond § 8.

There is a split of authority among the states on whether and to what extent an obligee may be able to recover in excess of the penal sum of the bond by way of a bad faith claim against the surety. *See Philip L. Bruner and Patrick J. O'Connor, Jr., BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:7 (2009)*. No North Carolina case addresses this issue. There is one federal case from the Middle District of North Carolina that does address the issue, i.e., *Cincinnati Ins. Co. v. Centech Bldg. Corp.*, 286 F. Supp. 2d 669 (M.D. N.C. 2003). In that case, the court recognized that there was no North Carolina precedent on this issue, and adopted the “less expansive approach” of the Texas Supreme Court, holding that “an obligee may *not* assert a bad faith cause of action against a surety.” *Cincinnati*, 286 F. Supp. 2d at 691.

#### B. *Lack of Owner Default*

Both the AIA performance and payment bonds provide that a surety's obligations only arise if there is no “Owner Default.” AIA A312 – Performance Bond § 3; AIA A312 – Payment Bond § 3. “Owner Default” is defined as follows: “Failure of the Owner, which has not been remedied or waived, to pay the Contractor as required under the Construction Contract or to perform and complete or comply with the other material terms of the Construction Contract.” AIA A312 –Performance Bond § 14.4; AIA A312 – Payment Bond § 16.4. Since the lack of an owner default is a condition precedent to the surety's obligation under the bond, if the Owner defaults under the construction contract, the Surety has a defense against any claims against the bond.

#### C. *Existence of Contractor Default and Termination of Construction Contract*

A default by the contractor is required in order to trigger the surety's obligations under a performance bond. That is, a surety's obligation is not triggered under a performance bond until the owner, among other things, declares a “Contractor Default” and terminates the construction contract. AIA A312 - Performance Bond § 3.

“Contractor Default” is defined in AIA A312 – Performance Bond § 14.3 as follows: “Failure of the Contractor, which has not been remedied or waived, to perform or otherwise to comply with a material term of the Construction Contract.”

In order for a default to be legally sufficient to trigger a surety’s obligation to perform under the performance bond, it must be based on a material breach or a series of material breaches by the contractor which is of such a magnitude that the owner would be justified in terminating the contract. *L & A Contracting Co. v. Southern Concrete Servs.*, 17 F.3d 106 (5th Cir. 1994). Thus, not every breach of a construction contract constitutes a default sufficient to trigger’s the surety’s obligation under the bond. *Id.* at 110.

#### *D. Notice Requirements*

The owner must also give a series of notices to the surety under a performance bond, discussed below.

First, the owner is required to provide notice to the contractor and the surety that the owner is *considering* declaring a “Contractor Default.” AIA A312 – Performance Bond § 3.1. In this initial notice, the owner can request a conference with the contractor and the surety to discuss the contractor’s performance. *Id.* If no conference is requested by the owner, the surety may request such a conference within five days of receiving the initial notice. *Id.*

Second, the owner must then actually declare a contractor default, terminate the construction contract, and notify the surety. AIA A312 – Performance Bond § 3.2. Once a default has occurred and the contract has been terminated, the notice given to the surety must be reasonably clear.

A declaration of default sufficient to invoke the surety's obligations under the bond must be made in clear, direct, and unequivocal language. The declaration must inform the surety that the principal has committed a material breach or series of material breaches of the subcontract, that the obligee regards the subcontract as terminated, and that the surety must immediately commence performing under the terms of its bond.

*L & A Contracting*, 17 F.3d at 111.

In addition to the providing the two notices described above, the owner must agree to pay the balance of construction contract price to the surety or to the new contractor selected to complete performance of the construction contract, before the surety’s obligation under the bond will be triggered. AIA 312 – Performance Bond § 3.3.

Failure to comply with the notice requirements above, however, is not necessarily fatal to an owner’s claim against a bond. Under the current AIA bond form, lack of compliance with notice requirements only provides a defense for the surety “to the extent the Surety demonstrates actual prejudice.” AIA A312 – Performance Bond § 4.

Additionally, once the surety's obligations under the bond have been triggered, if the surety does not take prompt action as required under the bond, then the owner must give the surety seven days' additional written notice before the surety is deemed to be in default under bond. AIA A312 – Performance Bond § 6.

*E. Time Limit to File Suit under Bond*

Suit must be commenced under the AIA performance bond within two years after the earlier of (i) the contractor being declared in default, (ii) the contractor ceasing work, or (iii) the surety refusing or failing to perform obligations under bond. AIA A312 – Performance Bond § 11. *See Town of Pineville v. Atkinson/Dyer/Watson Architects, P.A.*, 114 N.C. App. 497, 442 S.E.2d 73 (1994). Again, in the absence of such a provision in the bond, the time for filing suit would be governed by the three-year statute of limitations for breach of contract.

*F. Doctrine of Waiver*

Another potential defense available to sureties is the “doctrine of waiver.” Under the “doctrine of waiver,” the owner's acceptance of a bonded project which has been completed generally constitutes a waiver of claims against the performance bond surety for known or patent construction defects, but not for latent defects. *See Salem Realty Co. v. Batson*, 256 N.C. 298, 123 S.E.2d 744 (1962) (holding that owner's acceptance and payment for the contractor's work under the honest, but mistaken, belief that the contractor had fully performed the contract, did not release the surety because the defects were latent and unknown to the owner at the time of acceptance).

“Where work is accepted with knowledge that it has not been done according to the contract or under such circumstances that knowledge of its imperfect performance may be imputed the acceptance will generally be deemed a waiver of the defective performance.” *Id.* at 308, 123 S.E.2d at 751. “The acceptance of work which has been defectively done, the defects being unknown and not discoverable by inspection, does not amount to a waiver of the imperfect performance.” *Id.*

*G. Defenses Related to Construction Contract*

The obligations of the surety under a performance bond or payment bond are dependent primarily upon the obligation of the contractor under the terms of the construction contract with the owner. *See RGK, Inc. v. U.S. Fidelity & Guaranty Co.*, 292 N.C. 668, 686, 235 S.E.2d 234, 245 (1977) (“If there has been no default by the principal there can be no enforceable debt against the surety.”).

Most performance and payment bonds incorporate the construction contract by reference. AIA A312 – Performance Bond § 1; AIA A312 – Payment Bond § 1. Therefore, the surety will be entitled to the benefit of any defense available to the contractor under the construction contract. *People's Bank v. Loven*, 172 N.C. 666, 670, 90 S.E. 948, 950 (1916). For example, in defending a performance bond claim, a surety would be able to assert a defense based on:

- Prior material breach by the owner
- Interference by the owner
- “Cardinal change” by the owner
- Owner’s breach of the implied warranty of the sufficiency of the construction plans
- Failure of any condition in the construction contract, such as notice of default, an opportunity to cure, or independent certification of the grounds for default by a design professional
- Waiver of default by the owner
- Substantial performance by the contractor

*See* Conner Gwyn Schenck PLLC, NORTH CAROLINA CONSTRUCTION LAW § 4:31 (2014-2015); *see also* BRUNER & O’CONNOR §§ 12:40 – 12:48. Also, a payment bond surety would be able to assert any defense available to the contractor, such as valid setoffs or backcharges the contractor may have against the subcontractors or suppliers. *See* NORTH CAROLINA CONSTRUCTION LAW § 4:31.

Similarly, the surety’s obligations under the bond shall not exceed the requirements under the construction contract. A surety’s obligation under a bond is co-extensive with, but does not exceed, the contractor’s obligation under the bonded contract. The surety will not be liable to the owner for obligations of the contractor that are outside of what is required by the construction contract. AIA A312 – Performance Bond § 9; AIA A312 – Payment Bond § 10. For example, where the owner makes payments to the contractor in excess of the amount set forth in the construction contract, the surety will be relieved from liability on such amount. *See Commercial Cas. Ins. Co. v. Durham County*, 190 N.C. 58, 128 S.E. 469 (1925).

#### *H. Material Change or Modification*

Additionally, changes or modifications made to the construction contract that materially increase the surety’s risk may limit or discharge the surety’s liability under a performance bond. *See Bd. of Cnty. Supervisors of Henrico Cnty, Va. v. Ins. Co. of N. Am.*, 494 F.2d 660 (4th Cir. 1974) (holding that surety was prejudiced and released from obligation to perform restoration work where the owner permitted the contractor to proceed without a permit and on land outside the original area of construction, permitted construction of a building beyond the scope of the bonded contract, and permitted work by the contractor’s successor, all without consulting or advising surety); *Fidelity & Cas. Co. of N.Y. v. Metal Window Prods. Co.*, 30 F.2d 56, 58 (4th Cir. 1929)(“[W]here the original contract between the parties, the contract guaranteed by the bond, is materially changed, and the conditions and obligation of the modified contract are radically different from those in the contract guarantee, the surety cannot be held for breach of the modified contract.”).

The modification defense, however, may be limited by the terms of the bond. For example, the AIA performance bond provides: “The Surety hereby waives notice of any change, including changes of time, to the Construction Contract or to related subcontracts, purchase orders and other obligations.” AIA A312 – Performance Bond § 10; AIA A312 – Payment Bond § 11.

#### **IV. Conclusions**

In considering the surety’s defenses that may apply in the event of termination of a construction contract, the construction practitioner is well advised, at a minimum, to: (a) determine whether public bonding statutes apply; (b) review the particular terms of the bond in question; (c) review the terms of the bonded construction contract and interpretive cases; and (d) analyze the facts surrounding the termination.