

# Construction Surety Bond and Bond Claims

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## **Construction Surety Bond and Bond Claims**

### **A. Introduction.**

In addition to Mechanics' Liens and Attested Account Claims, a construction surety bond is another mechanism by which a lower-tier contractor or supplier may recover for costs incurred in furnishing material and labor to a project (although a claimant will only be able to recover once). Typically, most public construction projects and many private projects involve one or more payment or performance bonds that guarantee a contractor's performance. This section will identify the parties to a construction surety bond and their relationship to each other; address some of the differences between a construction surety bond and insurance; and describe the types of surety bonds and the distinctions between them. The section will also generally discuss the process for making claims against a construction surety bond, as well as identify some typical surety defenses.

### **B. What is a construction surety bond, and who are the parties?**

A surety bond is a written indemnity agreement given as security for construction projects. Surety bonds fall into three (3) different categories: bid bonds, payment bonds and performance bonds. Surety bonds are not insurance, and there are several critical differences between the two. Insurance is a two-party contract between an insurer and an insured. The insured pays a premium to an insurer, a third-party makes a claim against the insured in tort, and the insurer ultimately pays proceeds to the third-party. Surety bonds, however, establish a contractual relationship among three parties, the principal, the surety and the obligee(s). The obligee thus has a direct contractual relationship with the surety and can make a claim directly against the surety.

The general contractor or a subcontractor who purchases the surety bond is called the principal. The principal owes a duty of performance or payment to the obligee, also referred to

as the bond claimant, who is the beneficiary of the bond. For a performance bond, the owner or general contractor is typically the obligee who is entitled to compel the surety to arrange for contract performance in the event of the principal's default. For a payment bond, an individual or entity that furnishes labor, materials or equipment may qualify as an obligee and pursue a claim for payment against the payment bond. The surety guarantees the principal's payment and/or performance of the bonded work. The surety is typically an insurance company or a lending institution.

Surety bonds are indemnity agreements, and in addition to the contractual bond itself, include a separate general indemnity agreement between the principal and the surety. This agreement of indemnity provides the surety with a contractual right of recovery against the principal (and usually other indemnitors relating to the principal such as the owners or directors if the principal is a corporation) in specific terms that may vary from surety to surety.

In order to secure a bond, the principal must meet the qualifications of the surety through the surety's underwriting process, which typically includes confirmation of financial stability and a proven ability to perform the particular scope of work. The surety is essentially guaranteeing to the project owners, whether public or private, that the project will be completed on time and in accordance with the plans and specifications under a performance bond. Under a payment bond, the surety is protecting the project laborers, subcontractors, and suppliers by guaranteeing that all labor and materials will be paid.

### **C. What are the types of construction surety bonds?**

Surety bonds fall into three (3) different categories: bid bonds, payment bonds, and performance bonds.

## **1. Bid bonds.**

Generally, a bid bond states that, if the owner awards the project to the contractor, the contractor will enter into a contract with the owner on the terms outlined in the original bidding documents. Most public owners and many private owners require contractors who wish to bid on their proposed contract to provide a bid bond in an amount designated as a percentage of the amount bid by the contractor. If, however, the contractor fails to enter into the contract, the owner of the project has recourse against the bid bond for the stated penalty: a percentage of the amount bid by the contractor. This amount, theoretically, can be used to offset the additional costs the owner will incur to re-bid the contract. The bid bond does not in any way, however, assure to the owner the contractor's full performance of the contract, or guarantee payment to anyone furnishing material or labor. Rather, it acts as a penalty to the contractor for failing to enter into the contract, and provides some compensation to the owner for additional costs to secure another contractor.

## **2. Performance bonds.**

A performance bond represents a binding obligation of the contractor and surety for the performance of the construction contract. The performance bond provides that, should the bond principal default in performance, the surety will arrange for completion of the contract work. The contractor and surety are jointly and severally liable to the obligee in the event of default by the contractor. Under the agreement of indemnity contained in the performance bond, the surety will seek to recover from the contractor the surety's expenses in performing the contractor's obligations under the contract. The surety may also seek to recover from other indemnitors, which usually includes any officers, directors, or principals of a company.

### **3. Payment bonds.**

A payment bond represents the obligation of the principal and surety to protect persons furnishing labor, materials and/or equipment for the value of that labor, material and/or equipment used, or intended for use, in the performance of the construction contract referred to in the bond. The payment bond may be a separate instrument, or it may be combined with the performance bond. Under a labor and materials bond, a subcontractor can recover for additional labor and materials expenses caused by a project delay, but may not recover for other non-labor or materials delay damages. *Lexicon, Ins. v. Safeco Ins. Co. of America, Inc.* (6<sup>th</sup> Cir. 2006), 436 F. 3d 662, at [1]. In *Lexicon*, the subcontractor sought delay damages for such things as administrative expenses and lost profits. The district court ruled that expenses incurred as a result of delay, other than the increased cost of labor and material actually used on the project, were not recoverable under the payment bond. *Id.* at 2. The Sixth Circuit Court of Appeals agreed to the extent that the subcontractor was owed nothing more than the increased labor and material costs caused by the delay. *Id.*

### **D. What are the standard provisions in a general indemnity agreement?**

There are several important provisions and clauses which are typically included in a general indemnity agreement, including the indemnity provision itself, right-to-settle provisions, collateral deposit provisions, assignment provisions, and right to recover attorneys' fees and costs of litigation.

#### **1. Indemnity provision.**

The indemnity clause is an express indemnification that is typically very broad and imposes upon the principal the contractual obligation to indemnify the surety of all costs and expenses incurred as a result of any claim under a bond. It is here that the parties can extend the

principal's common law obligations to indemnify the surety. These contractual indemnity provisions are typically upheld by courts, provided that the surety does not pay any claim fraudulently or in bad faith.

## **2. Right-to-settle provisions.**

Most surety bonds contain a "right-to-settle" provision. In order for sureties to effectively and efficiently resolve claims and avoid unnecessary litigation, the surety is given the right to discharge the principal's obligations prior to suit without waiving the surety's right to indemnification from the principal. The surety must act in good faith to settle claims under a right-to-settle provision. Factors to be considered when determining whether the surety acted in good faith include 1) the type of investigation performed by the surety, 2) communications between the surety and obligee, 3) whether the principal demanded that the surety deny the claim, 4) whether the principal provided documentation to the surety supporting the denial of the claim, and 5) whether the base amount of the bond has been exceeded by the amount paid on the claim.

## **3. Evidence provision.**

A surety bond may also include an evidence clause providing that vouchers and other proof of payment constitute *prima facie* evidence of the propriety of the surety's payment and the amount of the indemnitor's liability to the surety. Typically, such documentation does not constitute conclusive evidence of the indemnitor's liability to the surety. Instead, these provisions may shift the burden of proof to the principal and/or the indemnitors to establish that the surety did not act in good faith in settling claims and incurring expenses. Thus, it is important for a principal to cooperate with and maintain a good relationship with its surety during the claims process.

#### **4. Collateral deposit provisions.**

A collateral-deposit provision contained in a surety bond requires that, after a claim on the bond is received by the surety, the principal/indemnitor must deposit with the surety sufficient funds or collateral to give the surety the ability to satisfy the claim. This provision compels the principal or indemnitor to provide collateral or fund reserves to protect the surety when it is faced with a bond claim. The surety's right to require the principal/indemnitor to provide collateral can be triggered by an assertion of the claim, although the ultimate liability of the principal to the claimant is unresolved. The surety's requirement of collateral-deposit often discourages the principal and/or indemnitor from raising defenses that lack merit merely to delay payment. The collateral would normally be in the amount of the claim, together with the surety's anticipated costs of defense.

#### **5. Assignment provision.**

A general indemnity agreement may further provide for an assignment clause. Under an assignment clause, the principal assigns to the surety the proceeds of the principal's contracts, or the surety may be granted a security interest in the contractor's equipment and receivables, as well as an assignment of legal causes of action.

#### **6. Attorneys' fees.**

Although one attorney may represent both the principal and surety in litigation filed by the bond claimant, the agreement of indemnity typically requires the principal to reimburse the surety for its attorneys' fees incurred in handling the bond claim and enforcing the general indemnity agreement itself. The interests of the principal and surety may still be adverse, requiring separate legal representation. This situation may occur when the principal does not furnish adequate collateral to protect the surety's interests. The surety may also have different



defenses than the principal in the claims asserted by the bond claimant, as well as individual claims by the surety against the principal for breach of the general indemnity agreement. As long as the surety has acted in good faith, courts have generally upheld the surety's right to recover attorneys' fees.

#### **E. What are the requirements for performance bond claims?**

Most performance bonds, including the AIA bond forms, require the owner/obligee to provide the surety a notice of default and request an opportunity to meet within a certain timeframe to decide how the parties are going to proceed with completion of the project. The requirements, like any contract, will be found in the express written terms of the bond.

Once a claim is made, the surety then typically has a number of options available to it. The surety can request that the owner allow the defaulting general contractor to remain on the project; find another general contractor to complete the project and pay the difference in the amount above the contract; or allow the owner to retain a general contractor to complete the work and have the surety pay the difference, if the cost to complete exceeds the unpaid contract proceeds.

#### **F. What are the requirements for payment bond claims?**

##### **1. Federal public improvement projects.**

If the claimant does not have a direct contract with the prime contractor, that claimant must serve the prime contractor with notice of its intended claim within 90 days after performing the last work or furnishing the last material. If the claimant has a direct contractual relationship with the prime contractor, that claimant must wait 90 days after performing the last work, or furnishing the last material before bringing suit against the payment bond. Under either scenario,

the lawsuit to enforce the claim must be brought in a federal court within one year after the last work was performed or the last material was furnished.

The 90-day notice requirement of the Miller Act is strictly construed to require that notice is received, not merely sent, within 90 days. Claimants that argue that notice was *sent* prior to the expiration of the 90-day period may have their claims dismissed if notice was not actually received within the 90-day period. See *United States of America for the Use of Pepper Burns Insulation, Inc. v. Artco Corp.* (4<sup>th</sup> Cir. 1992), 970 F.2d 1340. Although states have autonomy in how strictly they adopt the Miller Act in creation of little Miller Acts, the majority of states adhere to the receipt within 90 day requirement. *U.S. for Use and Ben. Of B&R, Inc. v. Donald Lane Const.* (1998), 19 F. Supp. 2d 217,223.

## **2. Ohio public improvement projects.**

A claimant on a public improvement project in Ohio must, at any time after performing the labor or work or furnishing the materials, but not later than 90 days after the acceptance of the public improvement by the duly authorized board or officer, furnish the sureties on the bond, a statement of the amount due to the person. This is typically completed by letter addressed to the surety, sent by certified mail, setting forth the name of the project, name of the insured and the amount that has not been paid to the claimant. In addition, if the labor and materials provided to the project are in excess of \$30,000, and the entity furnishing the labor and materials is not in direct privity with the principal contractor, a claimant is required to have served a Notice of Furnishing upon the principal contractor, similar to that which is required for an attested account and mechanics' lien claim.

A lawsuit may not be filed against the bond surety until after 60 days following the furnishing of the statement of amount due to the surety. If the indebtedness is not paid in full at

the expiration of that 60 days, the claimant may bring an action in his own name upon the bond, but that action must be commenced not later than one year from the date of acceptance of the public improvement.

**G. What are the typical defenses available to the surety?**

A surety may raise any defenses to payments that are available to the principal. *Black v. Albery* (1914), 89 Ohio St. 240, 246, 106 N.E. 38, 40, citing *Stone v. Vance* (1833), 6 Ohio 246. In addition, the surety may have separate defenses arising out of the bond, its terms, or out of the conduct of the bond obligee or principal, acting alone or in concert. Thus, any common law or statutory defenses that may be raised by the contractor may relieve the surety of liability, and counterclaims may be asserted against subcontractor or materialmen claimants who bring suit on the bond. The surety normally assumes no obligation greater than the principal has to the obligee. *See Walsh v. Miller* (1894), 51 Ohio St. 462, 38 N.E. 381. The surety has a separate duty and obligation contractually with the obligee. *Cusack v. McGrain* (1939), 136 Ohio St. 27, 29, 15 O.O. 532, 533, 23 N.E.2d 633, 635 (“[a] bond is a contract and, in the absence of some controlling statute, is to be construed according to the fair import of the language used”).

An obligee’s breach of a duty or obligation to the surety can eliminate the surety’s obligations under the bond, and is one common surety defense. Material changes made to the contract without the surety’s knowledge is also a valid and common defense. In *Current Builders of Fla., Inc. v. First Seabord Surety* (Fla. App. 4<sup>th</sup> Dist.) 2008 WL 859341, contrary to the terms of the contract, the contractor did not pay the contract balance to the surety and it hired a replacement subcontractor without the surety’s knowledge. Since the contractor acted outside of the terms of the contract, the court found that the surety’s obligations were not triggered and the surety was not liable.

Another typical defense used by the surety is that the principal has not materially breached the contract, and the obligee wrongfully terminated the principal. If the principal has a complete defense to the obligee's claim, the surety also has a complete defense. Other defenses that arise from the principal's defenses include the impossibility of performance due to defective plans and specifications provided by the owner to the principal; a substantial extension of time by the obligee for principal's performance of the contract; the obligee's overpayment or failure to mitigate damages; and improper or inadequate notice of default and opportunity to cure.

In addition to these defenses that are available to both the surety and the principal, there are separate defenses that are unique and available only to the surety. One of the most critical of these separate surety defenses is the notice defense for a performance bond claim. Most performance bonds have some notice requirement that mandates an obligee put the surety on notice of a default prior to termination. Likewise, payment bonds on private projects have similar notice requirements, and payment bonds on public projects (both Federal and State) have statutorily-mandated notice provisions.

Courts in Ohio and across the country consistently hold that these notice requirements are conditions precedent to the liability of the surety on the bond, which demonstrates how important it is for a bond claimant to strictly comply.

## **H. Conclusion.**

Construction surety bonds are three-party contracts between a principal (typically the general contractor), a surety, and an obligee (typically an owner on a performance bond and the lower-tier contractors and suppliers on a payment bond). The bond is secured through a separate general indemnity agreement between the principal and the surety that typically includes many terms very favorable to the surety.

Performance bonds protect an owner or general contractor by guaranteeing the contractor's performance of the contract work scope. Payment bonds protect lower-tier contractors and suppliers from the contractor's failure to pay for material and labor furnished to the project. A surety may use any defense available to the principal. A surety also has additional defenses available to it, the most common of which is a failure of the obligee to provide adequate notice to the surety. Consequently, as a claimant, it is particularly important to know the statutory or contractual notice requirements when making a claim under either a performance bond or a payment bond.

