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Is It Ever Wise For a Performing Surety To Terminate an Owner?

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Rarely does a takeover construction surety face the question of whether it should exercise a right to terminate its completion contract with the project owner/obligee. In most situations, the issues and related expenses the obligee might create for the surety along the way to completion do not warrant the surety exercising the termination option. This is so because a surety's typical fulfillment of its performance bond obligation involves the same factors and considerations faced by principals every day. The common wisdom among contractors is that it is better to complete the work and sue for contract payments and damages owed. Consequently, most sureties will complete the work and sort out the claims and expenses post-completion, either through negotiation or litigation. However, in some instances, these issues and expenses may rise to the level where it is prudent for the surety to at least consider exercising its right to terminate the completion contract. This article explores those instances and offers a practical framework for the surety to evaluate its options and reach a risk-calculated decision. The article focuses on those instances in which the completing surety remains involved in the project after the principal defaults, such as where it funds the principal or hires a completion contractor,

thereby retaining the right to pursue its own claims for damages or terminate the completion contract.

I. The Dilemma: To Complete or to Terminate?

After the surety decides to honor a performance bond claim, it is charged with arranging to complete the work of the principal that remains to be performed or to pay the costs of completion, net of contract balances, up to the penal sum of its performance bond. Successful performance can be hindered, however, by a number of factors. The project owner may improperly withhold payments, the project specifications may be defective, or the work of the completing surety may be delayed, to cite just a few examples. Whatever the reason, the surety may find itself struggling, through no fault of its own, to carry out its performance in the time and for the cost anticipated.

When a construction project has broken down to the point that performance will be particularly difficult, delayed, or significantly more expensive than anticipated because of the actions or inaction of the obligee, the surety faces a dilemma. Should it complete the principal's work, despite the delays and the increased costs and later pursue a claim? Or,

should it seek to terminate the contract and face the owner's inevitable lawsuit?

The common wisdom is that terminating a completion contract should be the exception, not the rule. This is undoubtedly correct. In the vast majority of cases, a surety is best served fully completing the contract despite difficulties caused by the obligee in the course of that performance. Terminating the completion contract might result in a claim of unlimited magnitude over which the surety has no control. Of course, the surety can defend against a meritless or exaggerated claim, but that defense is necessarily reactive. If the surety wants to retain control, staying and completing the project more effectively attains that goal. However, when the risks and costs associated with completing the job are significant and the grounds for termination strong, the surety should at least evaluate the termination option.

To make an informed decision in the face of this dilemma, the surety may conduct a comprehensive cost-benefit analysis by considering the potential financial risks of pursuing both options. Though exercising the option to terminate the completion contract is an option with inherent risks, under particular circumstances, the risks of completing the job may outweigh the risks of terminating.

II. The Cost-Benefit Analysis

The decision to terminate will likely be based on practical considerations that will necessarily differ depending on the specific facts and relationships at issue in each case. However, there are a few general factors pertinent to any analysis, including: (a) the grounds for termination; (b) the financial status of the obligee; (c) the surety's cost to perform the remaining bonded work and the likely price the obligee would pay for completion by someone other than the surety; (d) the likelihood of others asserting meritorious, post-termination claims against the surety and the value of such claims; and (e) the possibility of consequential damages.

a) *How strong are the grounds for termination?*

A surety ordinarily will not terminate its completion contract unless the contract and applicable law provide clear grounds for doing so, and the facts clearly back up the contemplated termination. When the surety is

acting in its capacity as completing surety pursuant to the performance bond, it may generally assert any ground for termination available to the principal in the underlying bonded contract.¹ Below are a few of the most common grounds on which to terminate, and a few considerations inherent to each.

Substantial delay or suspension of work. Sometimes, construction contracts entitle a contractor to terminate when extensive delays essentially suspend the contractor from the job and thereby impose significant extra costs and burdens. If not, in some cases, the common law provides relief.² This may be a high bar to clear.

A surety facing delays in the performance of its completion contract should track the length of any delay, all costs incurred during delay, and whether a particular delay was actually attributable to the obligee. Even if the obligee never formally suspends the completion surety's work, it may still prevent performance to such an extent that it creates a "constructive suspension," thereby justifying termination.³

¹ See *McAlpine v. Zangara Dodge, Inc.*, 183 P.3d 975, 981 (N.M. 2008) ("[T]he [surety] may raise as a defense to the secondary obligation any defense of the principal ... to the underlying obligation[.]") (citing Restatement (Third) of Suretyship and Guaranty § 34(1) (alterations in original)).

² See, e.g., *Farrell Heating, Plumbing, Air Conditioning Contractors, Inc. v. Facilities Dev. & Imp. Corp.*, 414 N.Y.S. 2d 767 (N.Y. App. Div. 1979) (holding contractor who terminated state hospital construction contract was entitled to delay damages for owner's breach where owner refused to timely move patients from hospital so that contractor could safely perform its tasks).

³ See, e.g., *O'Brien & Gere Technical Services, Inc. v. Fru-Con/Fluor Daniel Joint Venture*, 380 F.3d 447, 456 (8th Cir. 2004) (holding that a contract was "effectively suspended" by the obligee's failure to properly carry out the change order process set forth in the contract). Constructive suspension (at least in the context of government contracts) occurs "when work is stopped absent an express order by the contracting officer and the government is found to be responsible for the work stoppage." *K-Con Bldg. Sys., Inc. v. United States*, 100 Fed. Cl. 8, 27 (2011) (citation omitted). Because constructive suspension has the same effect as an actual suspension "relief should be granted as if an actual suspension order had been issued." *Id.*; see also *Gevyn Const. Corp. v. United States*, No. 158-74, 1979 WL 16487 (Ct. Cl. Mar. 16, 1979) (holding contractor entitled to damages for delay caused by owner's continuing

A surety should carefully consider what the obligee will argue was the cause of the delay, and whether the delay at issue could later be perceived as having been caused by something *other* than the obligee's conduct or the conduct of those for whom the obligee is responsible. For example, if a public entity obligee openly blames the delay on its own design professional, the surety may have strong evidence of delay supporting a termination. However, few cases are likely to involve such clear evidence demonstrating that the delay was attributable to the obligee.

Thus, it is important for the surety to weigh its costs of completion, accounting for its own expected delay damages as well, against the likely higher cost of the obligee completing with a replacement contractor. The surety will need to consider the likelihood of the obligee succeeding against it on a claim for such increased costs premised on an allegedly improper termination by the surety. If it is later determined that the surety's termination was improper, the surety will face liability for the owner's costs of completion over the completion contract balance remaining as of the date of termination. In some instances, the risk-adjusted exposure to the surety for a wrongful termination may be substantially lower than the expected costs to weather the storm and complete the bonded work.

Cardinal changes to the contract.

Any "cardinal change" to the contract – or a change that significantly increases the burden on the contractor and, by extension, the surety – may be grounds to terminate.⁴ Thus, the

failure to rectify defective design specifications in an expeditious manner).

⁴ See, e.g., *ThermoCor, Inc. v. United States*, 35 Fed. Cl. 480, 490 (1996) (defining "cardinal change" as "a substantial deviation from the original scope of work that changes the nature of the bargain between the parties"). Notably, even before the surety's principal has defaulted, the surety's liability under a bond will not extend to cardinal changes. See, e.g., *Hartford Cas. Ins. Co. v. City of Marathon*, 825 F. Supp. 2d 1276 (S.D. Fla. 2011), *rev'd in part, vacated in part on other grounds*, 501 Fed. App'x 929 (11th Cir. 2012) (holding surety's performance bond obligations did not extend to covering a cardinal change that added a separate facility to the bonded contract); *In re Technology for Energy Corp.*, 89 B.R. 692 (Bankr. E.D. Tenn. 1988) (holding significant changes not previously contemplated by

completing surety might consider termination where the owner insists on changes to the project that will significantly increase the expense or time required to complete the work consistent with the change, as such a position places the owner in breach of contract.⁵ If, however, the changes insisted upon were or could have been foreseen by the parties as incident to the work to be performed, such changes will not be considered "cardinal" changes sufficient to justify termination.⁶ Obviously, the surety should take a close look at the law of the jurisdiction involved to evaluate whether a particular change in scope justifies termination.

The obligee has failed to make payments.

If the obligee has failed to make progress payments as required, the surety may have grounds for termination.⁷ In this context, the surety should closely review the bonded contract and the completion contract to determine whether the obligee may be entitled to withhold payments under certain circumstances, as is sometimes the case, and analyze the facts relating to such potential justifications.

In many cases, the owner will withhold payment due to some alleged shortcoming on the part of the principal that occurred before the

the parties discharged surety's liability in excess of its exposure under the original bond).

⁵ See, e.g., *Becho, Inc. v. United States*, 47 Fed. Cl. 595 (2000) (denying summary judgment for owner who terminated contractor for default where contractor failed to perform modification to contract requiring significant extra work in sorting and stacking stone on the ground that such modification constituted cardinal change); *Big Chief Drilling Co. v. United States*, 26 Cl. Ct. 1276 (1992) (holding defective design specifications resulting in the loss of contractor's work and requiring extra remedial work constituted cardinal change entitling contractor to damages from the owner for breach of contract).

⁶ See *In re Boston Shipyard Corp.*, 886 F.2d 451 (1st Cir. 1989) (holding numerous changes to contract for repair of ship were anticipated by parties and thus did not amount to a cardinal change justifying contractor's abandonment of the project).

⁷ See, e.g., *Gen. Ins. Co. of Am. v. K. Capolino Const. Corp.*, 983 F. Supp. 403 (S.D.N.Y. 1997) (holding surety was entitled to recover from project owner costs to complete contract where contract had been properly terminated by contractor for owner's material breach when its agent refused to certify uncontested progress payments).

surety's involvement. In that instance, the surety may have already decided to honor the bond claim with knowledge of the principal's failures. In that case, termination is most likely not the right decision because the surety would be effectively reversing its earlier decision. But if the owner's refusal to make payment is based uniquely on the surety's conduct, the surety has the right to separately evaluate whether to complete or terminate. If the monetary value of the work yet to be performed is significant and the grounds for non-payment specious, the surety should consider whether it wants to finish this work and seek recovery or terminate and face the owner's meritless claim for completion costs incurred.

b) Is the owner credit-worthy?

The obligee's financial condition will be a significant factor in weighing the risks of potential litigation arising from termination. A well-funded obligee is more likely to pursue aggressive litigation against the surety if it believes the surety wrongly terminated and it incurred increased costs to complete the bonded work post-termination. Moreover, a credit-worthy obligee will be able to satisfy a judgment if the surety successfully prosecutes its claim. In such instances, it may be more prudent for the surety to complete the bonded work, notwithstanding the obligee's material breach, and seek damages after the fact, especially if the grounds for termination are not particularly strong or are not supported by very clear contractual language. Conversely, if the owner is facing financial hardship, it may not be able to pay a judgment awarded to the surety for its increased costs to complete the bonded work. If the amount of the surety's claim is significant, this factor should weigh in favor of the surety exercising its right to terminate.

c) How much cost remains on the completion contract?

Whenever the surety terminates, the obligee will be left to complete the bonded work, regardless of the amount of time left for performance or the cost and amount of work that remains to be completed. If only a small amount of work remains to be completed, the surety likely should follow the conventional wisdom and finish the job. In such cases, the costs of defending litigation brought by the obligee are likely to exceed the costs to the surety of

prosecuting its claim for extra work or delay damages. If the surety has a claim after completion, it can decide for itself whether to pursue it. By completing, the surety retains control of this decision.

If a significant amount of time remains for contract completion, or a significant amount of work remains to be performed, the risks increase, regardless of what the surety chooses. The more work to be completed, the greater the potential cost overage generated by the replacement contractor. If the surety was without a proper basis for terminating, the obligee could recover these significant costs as damages from the surety who would have otherwise been required to cover the cost of completion. The obligee might be able to assert claims for other damages related to the delay in completion caused by the surety's termination. On the other hand, if, for example, the surety anticipates that it will get bogged down in endless delays by the obligee or face chronic re-design problems, then the costs to complete under these conditions may exceed the costs of termination. If, however, the obligee is likely to incur significant costs to complete the project after termination, and the grounds for termination are not particularly strong, it very well may be better to complete the job and maintain control over the amount of damages.

It is thus advisable, before proceeding with termination, for the surety to estimate the costs remaining on the project, as well as the likely increased costs to the owner of completing the remaining work if the surety terminates. On public contracts, for example, the cost to complete the project, if put to bid after termination, could be significantly more than it would have been months or years earlier. If the grounds for termination are not particularly strong, the surety may find it makes better economic sense to finish the project and seek damages from the obligee rather than run the risk of the obligee incurring significant additional costs, entirely beyond the surety's control.

d) Are others likely to bring claims against the surety?

If the surety terminates the completion contract, it may be creating litigation risk with parties other than the obligee. A termination would impact the surety's hired completing contractor. If the completion contract contains

no right to terminate for convenience, would this party have a claim for lost profits against the surety for its alleged wrongful termination? Similarly, what is the impact of a termination upon downstream subcontractors and suppliers? Are these parties owed payment for completed work? Would they potentially assert claims arising from an early termination? If the project involves co-prime contractors, they are almost certainly likely to face delays, thereby incurring damages resulting from early termination by the completing surety. Whether they may be entitled to assert claims will depend upon the parties' contracts. The rights and obligations of the surety's principal and other indemnitors may also be impacted by an early termination. These are all important questions to ask and answer when analyzing a potential termination.

e) Can the owner recover consequential damages?

Sureties contemplating termination should consider whether the owner may have a viable claim for consequential damages arising from the delay caused by an improper termination.⁸ Some construction contracts include a provision whereby the parties agree to waive any claim for consequential damages. The amount of consequential damages arising from delay in completion could be significant. Accordingly, sureties must be sure to consider whether the bonded contract or completion contract permits recovery of consequential damages, and if so, the potential amount of any such damages should its termination be deemed improper. If the surety terminates before completion, will the project owner be prevented from opening its business, resulting in lost profits? Would such lost profits be considered reasonably foreseeable? Will the owner be required to take some substitute measures, likely to be costly, until the work is completed? If consequential damages are recoverable, and if the amount the owner may claim is significant, the surety may be better served by completing

the project and avoiding the risk of liability for such damages.

III. The Takeaway: Proceed with Caution!

If a surety ever finds itself contemplating whether to terminate its takeover agreement with the obligee, it should cautiously evaluate this question: is it better to complete the work and sue or walk away from the work and be sued? Completing the job is usually the presumptive default position of the completing surety. However, if the factors discussed above converge appropriately, then it would be wise for the surety to at least consider the option of termination. Factors weighing in favor of termination include:

- The grounds for termination are supported by the contract, the law, and the facts of the case.
- The extra costs to complete are significant.
- The obligee is not financially secure and will likely be unable to pay a damage award.

Factors weighing against termination include:

- A well-funded obligee.
- Little work remains to be completed on the project.
- Other parties might bring legitimate claims against the surety.
- The obligee may be entitled to consequential damages arising from the surety's wrongful termination.

In most cases, the risks inherent in terminating a completion contract will not outweigh the potential benefits. However, in some scenarios, termination might prove more economical than performance. But the right to terminate should not be lightly exercised. A surety should only terminate its completion of the bonded work after a close and careful review of the relevant contract terms, a careful analysis of the potential grounds for termination, the obligee's financial condition, and the surety's likely financial exposures under all potential scenarios. Though often risky and perhaps underutilized as a result, termination remains a viable and important option for sureties who face completion with a difficult obligee in breach of contract, resulting in more costly than anticipated performance.

⁸ Consequential damages are those damages "which result naturally, *but not necessarily*, from the breach. ... Consequential damages are recoverable only if they are foreseeable and directly traceable to the wrongful act and result from it." *Powell Elec. Sys., Inc. v. Hewlett Packard Co.*, 356 S.W.3d 113, 118 (Tex. App. 2011) (internal citations omitted) (emphasis in original).