Construction Law From Contract to Closeout

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Philadelphia, PA • February 22, 2007

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Construction Law From Contract to Closeout in Pennsylvania

BONDS AND INSURANCE

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Construction Law From Contract to Closeout in Pennsylvania

I. Bonds And Insurance

A. Distinction Between Bonds And Insurance

A surety on a bond is one who contracts to answer for the default of another. See Steams, The Law of Suretyship § 1.1 (5th ed. W.H. Anderson Co. 1951); Restatement of Security § 82 (1941). In general terms, "suretyship represents a three-party association wherein a creditor is entitled to performance of a contractual duty by the principal debtor or alternatively, if the debtor defaults, by the debtor's surety." Continental Bank v. Axler, 510 A.2d 726, 729 (Pa. Super. 1986). Stated another way, suretyship is "a three-party relationship in which the surety undertakes to perform to the obligee only if the principal fails to do so." Trident Corp. v. Reliance Insurance Co., 504 A.2d 285, 290 (Pa. 1986); see also 8 P.S. § 1. Because suretyship is a tripartite relationship, duties flow between and among all three parties – a principal (debtor), a surety, and an obligee (creditor). Suretyship is properly viewed as a credit accommodation.

An insurance contract, on the other hand, is a relationship between only two parties – the insurer and the insured. An insurance contract indemnifies the insured against loss, damage or liability arising from an unknown or contingent event. An insurer assumes the risk of loss from the insured. Therefore "there exist fundamental differences between bilateral contracts of insurance and tripartite surety based agreements." Foster v. Mutual Fire Marine and Inland Ins. Co., 614 A.2d 1086, 1099 (Pa. 1992). Suretyship is simply not insurance. See Pearlman v. Reliance Ins. Co., 371 U.S. 132, 140 n.19 (1962).

Unlike an insurer, a surety does not agree to bear and assume all risks for its principal. It does not underwrite its principal based on some actuarial determination of the risk of loss from an unknown or contingent occurrence. Instead, a surety issues bonds after consideration of the principal's past performance, the principal's ability to perform the bonded obligation, and the financial integrity and ability of the principal and the indemnitors to indemnify and hold harmless the surety against any potential losses. The Pennsylvania Commonwealth Court addressed this precise issue and explained:

> Unlike insurance policies, surety bond premiums are not determined by the [surety] on the basis of loss but rather on the [basis] of financial risk. Premiums . . . are paid 'up-front' and are not subject to adjustment. The instruments have no fixed terms and no right of cancellation or renewal.

Grode v. Mutual Fire Marine and Inland Insurance Company, 572 A.2d 798, 806 (Pa. Commw. 1990), aff'd, 614 A.2d 1086 (Pa. 1992). Because suretyship is primarily a credit accommodation and is not insurance, bond premiums are usually regarded as extremely low, bonding is often relatively easy to obtain, and bonding does not substantially increase the cost for a contractor to do business.

The nature of suretyship presupposes that the surety will sustain no loss – if there is a claim on its bond the surety has a common law right (and usually a contractual right) to be indemnified for its loss by its principal. By contrast, an insurer has no such right. An insurer expressly assumes the risk of losses, and an insured has no obligation to indemnify its insurer for losses paid out under a policy of insurance.

B. Bid Bonds

Many construction contracts, both public and private, are awarded through a bidding process. That process itself, however, is not without inherent risk. After an owner has awarded the contract to the successful bidder, the owner is still faced with the risk that the contractor will not begin construction on the project or honor the successful bid. If the successful bidder were to refuse or become unable to perform the project before any construction begins, the owner could incur substantial losses that might not be easily recouped in a lawsuit against the bidder. The owner would be left with potential additional costs and delays of re-bidding the project or accepting the next highest bidder (if that bidder were still interested and available). Therefore, owners often require bidders to supply bid bonds along with their bid submission package.

1. Types Of Bid Bonds

There are generally two types of bid bonds: a damage bond and a forfeiture bond.

a. Damage Bond

A damage bond obligates the surety to the obligee for the damages caused by the principal's failure to execute the contract for which it successfully bid. Generally, the measure of damages for this type of bond will be the difference between the principal's bid and that of the next highest bidder.[1] The following is an example of the language of such a bid bond:

> NOW, THEREFORE, if the Obligee shall accept the bid of the Principal and the Principal shall enter into a Contract with the Obligee in accordance with the terms of such bid,

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[1] See R. & B. Builders, Inc. v. School Dist. of Philadelphia, 202 A.2d 82 (Pa. 1964) (owner entitled to all losses incurred in soliciting new bids).

> and give such bond or bonds as may be specified in the bidding or Contract Documents with good and sufficient surety for the faithful performance of such Contract and for the prompt payment of labor and material furnished in the prosecution thereof, or in the event of the failure of the Principal to enter such Contract and give such bond or bonds, if the Principal shall pay to the Obligee the difference not to exceed the penalty hereof between the amount specified in said bid and such larger amount for which the Obligee may in good faith contract with another party to perform the Work covered by said bid, then the obligation shall be null and void, otherwise to remain in full force and effect.[2]

b. Forfeiture Bond

A forfeiture bond treats the penal sum of the bond as liquidated damages. Thus, if the principal fails to enter into a contract with the owner, the surety is liable to the obligee for the penal sum of the bond, regardless of the obligee's actual damages. Therefore, under a forfeiture bond, the sum due under the bond might exceed the obligee's damages. See e.g., Muncy Area School Dist. v. Gardner, 497 A.2d 683 (Pa. Commw. 1985) (school district entitled to full amount of bid bond based upon bidder's error in bidding documents).

2. "Firm Bid" Rule

The majority rule in the United States is that, under the appropriate circumstances, a mistake in a bid can relieve the bidder of the obligation to perform the contract under the weight of the mistake. In Pennsylvania, however, the "firm bid" rule makes the bidder and its bid bond surety strictly liable for clerical errors in a bid package. The Pennsylvania Supreme Court determined that to allow a bidder to "withdraw his bid

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[2] Bid Bond, AIA Document A310 (Feb., 1970 ed.).

under the plea of a clerical mistake, would seriously undermine and make the requirement or system of sealed bids a mockery." A.J. Colella, Inc. v. County of Allegheny, 137 A.2d 265, 267 (Pa. 1958); see also Travelers Indem. Co. v. Susquehanna County Commissioners, 331 A.2d 918, 920 (Pa. Commw. 1975) (clerical error in bid does not entitle bidder to withdraw bid without forfeiting bid bond as liquidated damages). According to the court, allowing bidders to escape their bids due to a clerical error "could likewise open wide the door to fraud and collusion between contractors and/or between contractors and the Public Authority." Colella, 137 A.2d at 267.

Under this rule, however, an owner is entitled to the forfeiture of a bond only if the conditions for bond forfeiture have fully ripened. See Travelers Indem. Co. v. Susquehanna County Commissioners, 331 A.2d 918, 920 (Pa. Commw. 1975) (where lowest bidder withdrew bid due to miscalculation and owner failed to notify the bidder of acceptance of bid, owner was not entitled to penal sum of bid bond because conditions for forfeiture under bond – that is, proper notice of acceptance of bid –had not been satisfied); see also Hanover Area School Dist. v. Sarkisian Bros., Inc., 514 F. Supp. 697, (M.D. Pa. 1981) (owner failed to follow methods for awarding of bid and therefore not entitled to forfeiture of bid bond because conditions of forfeiture did not ripen).

C. Payment Bonds

1. Types Of Payment Bonds

If a contractor fails to pay subcontractors and suppliers on a construction project, it may inure to the detriment of the owner. A payment bond provides the owner of a bonded project some protection that the surety will pay subcontractors and material suppliers if the contractor fails to pay them. Bonds issued for public and private projects are sometimes governed by different rules which are designed to effectuate specific purposes given the nature of each type of project.

a. Private Payment Bonds

Under Pennsylvania law, the terms and provisions of the payment bond determine the scope and extent of the surety's liability. Salvino Steel & Iron Works, Inc. v. Fletcher & Sons, Inc., 580 A.2d 853, 856 (Pa. Super. 1990). The scope of a surety's liability under a bond is strictly governed by the language of the bond. Peter J. Mascaro Co. v. Milonas, 166 A.2d 15, 17 (Pa. 1960). A bond "will be construed in the light of the terms of the contract [it secures] and the attendant circumstances, but the obligation of a bond cannot be extended beyond the plain import of the words used." Wise Investments Inc. v. Bracy Contracting, Inc., 232 F. Supp. 2d 390, 402-03 (E.D. Pa. 2002) (applying Pennsylvania law). Obligations "not imposed by the terms of the bond cannot be created by judicial construction or interpretation." Wise Inv., 232 F. Supp. 2d at 402-03; Fleck-Atlantic Co. v. Indemnity Ins. Co. of North America, 191 A. 51, 53 (Pa. 1937).

b. Pennsylvania Mechanics' Lien Law

Pursuant to Pennsylvania's Mechanics' Lien Law of 1963 (the "Lien Law"), a contractor and certain subcontractors retained on a construction project who have not been paid can file a "mechanics' lien" against the owner's property. See 49 P.S. § 1301. The Lien Law permits a lien, which is in the nature of a security interest, to be filed against property for the "payment of all debts [over $500] due by the owner to the contractor or by the contractor to any of his subcontractors for labor or materials furnished in the erection or construction, or the alteration or repair of the improvement." Id. A lien filed on a property becomes an encumbrance on the owner's interest in the property. The encumbrance continues until a notice of satisfaction of lien is filed with the prothonotary. 49 P.S. §1704.

Mechanics' liens cannot be filed against property where the labor or materials are furnished for a purely public purpose. 49 P.S. § 1303(b) ("No lien shall be allowed for labor or materials furnished for a purely public purpose."); but see American Seating Co. v. City of Philadelphia, 256 A.2d 599, 601 (Pa. 1969) (where municipality acted as absentee landlord entrusting management and control of premises to private tenants, municipality served in proprietary and quasi-private function thereby losing "public purpose exception" under Lien Law); cf Empire Excavating Co. v. Luzerne County Housing Auth., 449 A.2d 60, (Pa. Super. 1982) (public housing authority's provision of its property for use as low-income housing served purely public purpose and was exempt from strictures of Lien Law).

Having a payment bond in place provides the owner on a private project some protection against the potential for the filing of a mechanics' lien against the property by a subcontractor or material supplier who has not been paid by the contractor, as well as providing added protection against the breakdown in the provision of labor and materials to the project site by disgruntled subcontractors and suppliers who have not been paid. The provision of the bond helps the owner in its effort to maintain clear and unencumbered title on the property and an uninterrupted flow of labor and materials.

Under the Lien Law, "[e]very improvement and the estate or title of the owner or the property shall be subject to a lien." 49 P.S. §1301.[3] A contractor or subcontractor who provided labor or materials "in the erection or construction, or the alteration or repair of the improvement" and who has not been paid can file a lien. Id. The Lien Law generally defines a "contractor" as one who has a direct contract with the owner. 49 P.S. §1201(4). An architect or engineer can be considered a "contractor" under the Lien Law if either has a contract with the owner. Id.

In the summer of 2006, Pennsylvania amended the Lien Law. The amendments apply only to contracts entered into after January 1, 2007. These changes generally provide more protection for contractors and subcontractors by limiting the

[3] The Lien Law generally applies only to work done on improvements such as structures. Thus, it will not apply to demolition or earth works unaccompanied by the erection, construction, alteration or repair of a structure. See e.g., King's Oak Liquidators v. Bala Cynwyd Hotel Assocs., 7 Pa. D. & C.4th 634 (C.P. 1990), aff'd, 592 A.2d 102 (Pa. Super. 1991) (demolition not proper subject of a mechanics' lien claim); Parkhill v. Hendricks, 53 Pa. Super. 9 (1912) (grading and sodding of lawn not proper subject of mechanics' lien claim); G.R. Frank & Sons, Inc. v. Kutner, 71 Pa. D. C. &.2d 501 (Pa. Com. Pl. 1975) (installation of tennis court not proper subject of mechanics' lien claim).

circumstances in which a property owner can obtain a waiver of a mechanics' lien. These changes include:

- expanding the definition of "subcontractor" to include claimants who have a contract with a subcontractor (other than a materialman) in direct privity with the contractor; 49 P.S. §1201(5)

- on all residential projects, a contractor can no longer waive lien rights on behalf of its subcontractors; such rights can only be waived by the subcontractors themselves, and on residential projects where the total contract price exceeds $1,000,000, the contractor must also provide a bond guaranteeing payment to the subcontractor in order for the lien to be waived; 49 P.S. §1401(a)(2)(ii) and §1401(b)(2)

- the waiver of lien rights on commercial buildings is only valid if given "in consideration for payment for the work, services, materials or equipment provided, and only to the extent that such payment is actually received" (previously, waiver could occur even if payment had not been received); 49 P.S. §1401(b)(2)

- extending the time within which a claim must be filed with the court after notice of the claim has been given to the owner and the contractor from four to six months. 49 P.S. §1502(a)(1)

Under the revised version of the Lien Law, the definition of the term "subcontractor" has been expanded to include:

> one who, by contract with the contractor, or pursuant to a contract with a subcontractor in direct privity of a contract with a contractor, express or implied, erects, constructs, alters or repairs an improvement or any part thereof; or furnishes labor, skill or superintendence thereto; or supplies or hauls materials, fixtures, machinery or equipment reasonably necessary for and actually used therein; or any or all of the forgoing, whether as superintendent, builder or materialman. The term does not include an architect or engineer who contracts with a contractor or subcontractor, or a person who contracts with a materialman or a person who contracts with a subcontractor not in direct privity of a contract with a contractor.

49 P.S. 1201(5). Under this definition, a subcontractor to a materialman would not be eligible to file a mechanics' lien, even though the materialman would be eligible. Id. A sub-subcontractor to a labor subcontractor would be eligible. Id.

Under the pre-amendment version of the Lien Law, the generally-accepted practice was that a prime contractor could provide a waiver of its right to file a mechanics' lien, both on its behalf and on behalf of its subcontractors, to the owner at or before the commencement of work. By doing so, the owners could be insulated from any lien claims that might later arise from either the contractor or his subcontractors regardless of the size or type (residential or commercial) of the project. The 1996 amendment to the Lien Law, however, has significantly changed this practice.

Now, the contractor can no longer waive lien rights on behalf of the subcontractor. Only the subcontractor itself may waive its own right to file a lien claim. Such a waiver must be by a written instrument signed by the subcontractor. 49 P.S. §1401(a)(2)(i). The subcontractor can only validly waive its lien rights if, in addition to a signed waiver, one or both of two conditions is met: (1) the contract price is less than one million dollars ($1,000,000); and/or (2) the contractor has posted a payment bond guaranteeing payment to the subcontractor. 49 P.S. §1401(a)(2)(ii).

On commercial buildings, the Lien Law has eliminated the owner's ability to obtain lien waivers in advance. The Lien Law provides that "a waiver by a contractor of lien rights is against public policy, unlawful and void unless given in consideration for payment for the work or materials provided and only to the extent that such payment is actually received." 49 P.S. §1401(b)(1). For subcontractors on commercial buildings,

the Lien Law declares a waiver void unless payment is received for the work or materials provided or unless the contractor has posted a payment bond guaranteeing payment to the subcontractors. 49 P.S. §1401(b)(2).

Under the previous version of the Lien Law, a subcontractor was required to provide preliminary notice of a claim for non-payment to the owner, on or before the date of the completion of his work. See 49 P.S. §1501(a) (repealed). If the subcontractor remained unpaid, the subcontractor next had to serve formal notice on the owner of the subcontractor's intention to file a claim at least thirty (30) days before the claim is filed. 49 P.S. §1501(b) (now §1501(b.1)). The amendment to the Lien Law deleted the preliminary notice requirement and now requires only formal notice by a subcontractor to the owner of its intent to file a claim at least thirty (30) days in advance of the filing. 49 P.S. §1501(b.1). Once notice has been properly served,[4] the claimant must file the claim with the prothonotary within six (6) months after the completion of his work. 49 P.S. §1502(a)(1). The claimant previously had to file within four (4) months.

How does the contractor get the lien of record? The Lien Law provides that a general contractor can file a lien waiver of public record (i) before commencement of work on the ground, (ii) within ten (10) days after execution of the general contract, or (iii) at least ten (10) days before the lien claimant's subcontract is signed. 49 P.S. §1402(a).

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[4] Notice is properly served if accomplished by first class, registered or certified mail or by personal service. 49 P.S. §1502.

c. Public Payment Bonds

On public projects, the federal Miller Act, 40 U.S.C. § 3131 et seq., and the Pennsylvania Public Works Contractors Bond Law of 1967 (the "Bond Law"), 8 P.S. §§ 191-202, together with Part I of the Commonwealth Procurement Code, 62 Pa. C.S. §§101-2318, require the provision of payment bonds on certain public construction projects.[5] These laws are meant to protect subcontractors and material suppliers who have provided labor and/or materials to the project but who do not benefit from mechanics' lien laws. See Valley Forge Indus., Inc. v. Armand Constr., Inc., 374 A.2d 1312, 1315 (Pa. Super. 1977); Visor Builders, Inc. v. Devon E. Tranter, Inc., 470 F. Supp. 911, 920 (M.D. Pa. 1978). The Bond Law is similar to the federal Miller Act.[6] For that reason, the Bond Law is sometimes referred to as the Pennsylvania "Little Miller Act."

The Bond Law provides that for all public contracts exceeding $5,000 for the construction or repair to any public building or highway work, the prime contractor must furnish to the contracting body a performance bond and a payment bond. Each bond must be in a penal sum of one hundred percent (100%) of the contract amount and each bond must be issued by a surety company that is authorized to do business in

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[5] The Bond Law applies to contracts for public projects with "contracting bodies" that are not "purchasing agencies," as defined by the Procurement Code. The Procurement Code applies to public contracts with a "purchasing agency." "Purchasing agency" is defined as "[a] Commonwealth agency authorized by [the Procurement Code] or by other law to enter into contracts for itself or as the agent of another Commonwealth agency." 62 Pa. C.S.A. §§ 102(a), 103.

[6] Therefore, Pennsylvania courts often rely upon decisions analyzing like provisions under the Miller Act. See Walters Tire Serv., Inc. v. Nat'l Union Fire Ins. Co., 252 A.2d 593, 595 (Pa. 1969); Visor Builders, 470 F. Supp. at 920; Lite-Air Prod., Inc. v. Fidelity & Deposit Co. of Maryland, 437 F. Supp. 801, 803 (E.D. Pa. 1977).

Pennsylvania. 8 P.S. §§ 193(a) and (b). The payment bond protects those claimants supplying labor or materials either to the prime contractor or to a subcontractor to the prime contractor and is conditioned on the prompt payment of all labor performed or materials supplied in the performance of the work. 8 P.S. § 193(a)(2). Under the Procurement Code, however, where a contractor has made payments to the subcontractor, any future claims for payment against the contractor or its surety by parties owed money from the subcontractor are barred. See 62 Pa.C.S. § 3939(b). Therefore, where a contractor has paid his direct subcontractors in full, none of the sub-subcontractors can make a claim against the surety.

The Bond Law provides a substitute remedy for subcontractors that supply labor and materials on public projects, but that do not receive the protections afforded by the Lien Law. Valley Forge Industries, Inc. v. Armand Construction, Inc., 248 Pa. Super. 53, 58, 374 A.2d 1312, 1315 (1977); Can-Tex Industries v. Safeco Ins. Co. of America, 460 F. Supp. 1022, 1024-25 (W.D. Pa. 1978). The Lien Law permits suppliers of labor or materials to hold liens on the improved property under certain circumstances. See 49 P.S. §§ 1101-1902. The courts have generally found the scope of the Bond Law to be similar to the scope of the Lien Law. Can-Tex Industries v. Safeco Insurance Co. of America, 460 F. Supp. 1022, 1024-25 (W.D. Pa. 1978).

d. Contractor And Subcontractor Payment Act

The purpose of the Pennsylvania Contractor and Subcontractor Payment Act (the "Payment Act"), 73 P.S. § 501 et seq., is to ensure the prompt payment of contractors and subcontractors supplying labor and materials to a construction project. The Payment Act

permits, among other things, subcontractors on certain construction projects to sue owners and/or contractors for payment "in accordance with the provisions of the contract" and provides that a statutory penalty of 1% per month of the amount wrongfully withheld can be imposed. Id. at §§ 507(a) and 512(a). This is twice the interest rate otherwise allowed under Pennsylvania law. See 41 P.S. § 202 (statutory pre-judgment interest rate is 6% per annum). Further, in actions brought pursuant to the Payment Act, a court or arbitrator may award the substantially prevailing party its reasonable attorneys' fees and expenses. Id. at § 512(b).

No Pennsylvania state court has yet addressed the applicability of the Payment Act to sureties. However, a recent federal court decision applying Pennsylvania law held that the Payment Act's provisions do not extend to surety bonds. R.W. Sidley, Inc. v. United States Fidelity & Guaranty Co., 319 F. Supp. 2d 554 (W.D. Pa. 2004). The federal court reasoned that the very provisions of the Payment Act awarding penalties and attorneys' fees "do not make any reference to the assessment of such costs against sureties." Id. at 561. Given this, the court concluded "that the plain meaning of the sections of the [Payment] Act is that a subcontractor may seek penalty payments and attorneys' fees against a contractor according to the provisions of their subcontract agreement." Id. The Payment Act, in the court's opinion, did not address or provide for "the recovery of such damages against a surety." Id.

2. Tiers Of Coverage

Regardless of whether the bonded project is public or private, identifying who is a proper claimant under a payment bond is crucial. The term "tiers" refers generally to the

remoteness of a claimant from the payment bond principal (usually the general contractor). A first tier claimant has a direct contractual relationship with the principal. A direct subcontractor in contractual privity with the principal (the general contractor) would be considered a first tier claimant. A second tier claimant has a direct contractual relationship with the principal's subcontractor (a "sub-subcontractor") but not with the principal itself. A third tier claimant has a direct contractual relationship with the second tier claimant. And so on.

Under Pennsylvania's Bond Law, only those entities who supplied labor or materials to the prime contractor or its subcontractors are eligible claimants pursuant to a payment bond on a public project. See 8 P.S. §§ 193(a)(2) and 193.1 (a)(2); Lezzer Cash & Carry, Inc. v. Aetna Ins. Co., 537 A.2d 857, 860-61 (Pa. Super. 1988) (third-tier material supplier not a proper claimant under public project payment bond); see also, Nicholson Construction Co. v. Standard Fire Ins. Co., 760 F.2d 74, 77 (3d Cir. 1985) (under Pennsylvania law, sub-subcontractor not a proper claimant under payment bond on public works project). Thus, only first and second tier claimants are generally covered under the Bond Law.[7] See also Webster Brick Co., Inc. v. Fidelity & Deposit Co. of Maryland, 27 Pa. D.&C.3d 7 (Erie Co. C.C.P. 1983) (brick company that supplied bricks to material supplier middleman who in turn had contract with bonded prime contractor is not entitled to recover under statutory payment bond where bond defines "claimant" as "one having direct contract with the Principal [prime contractor] or with a subcontractor

[7] Under the federal Miller Act, generally only entities who have either expressly or impliedly contracted with the prime contractor (first tier) or directly with the subcontractor (second tier) are proper claimants. 40 U.S.C. § 3133(b).

of the Principal for labor material, or both, used or reasonably required for use in the performance of the contract;" material supplier middleman with whom brick company contracted, determined not to be a "subcontractor" under the Bond Law.)

Under the Lien Law, contractors, architects or engineers with a direct contract with the owner, whether express or implied, are generally able to file mechanics' liens. 49 P.S. § 1301. The Lien Law also provides that subcontractors, or second tier claimants, in direct privity with the contractor can file a lien. 49 P.S. § 1201(5). The law, however, does not permit sub-subcontractors to a materialman in direct privity with a contractor to file a mechanics' lien. The law thus differentiates between material subcontractors and labor subcontractors. Id.

3. Scope Of Coverage

For private projects, the scope of a surety's liability is generally determined by the precise terms of the bond itself. Salvino Steel & Iron Works, Inc. v. Fletcher & Sons, Inc., 580 A.2d 853, 856 (Pa. Super. 1990). Some bonds limit the surety's obligation to costs associated only with the provision of labor and materials. Such limitations are honored and enforced by the courts. See e.g., Salvino Steel, 580 A.2d at 856.

On public projects subject to the Bond Law, the payment bonds cover "all materials furnished or labor supplied or performed in the prosecution of the work." 8 Pa. Stat. Ann. §§ 193(a)(2) and 193.1(a)(2). This includes the cost of public utility services, rented equipment and ordered but unused materials. Id.; see also Roman Mosaic & Tile Co. v. Thomas P. Carney, Inc., 729 A.2d 73, 78-79 (Pa. Super. 1999).

a. Finance Charges

Bonds drafted to track the language of the Bond Law do not generally allow recovery against a surety "for service or finance charges that were included in subcontract agreements between a general contractor and subcontractor." R.W. Sidley, Inc. v. United States Fidelity & Guaranty Co., 319 F. Supp. 2d 554, 559 (W.D. Pa. 2004). A labor and materials payment bond does not generally cover finance charges. See Lite-Air Prods., Inc. v. Fidelity & Dep. Co. of Maryland, 437 F. Supp. 801 (E.D. Pa. 1977) (surety not liable for finance charges on late payments; such charges are like penalties and not related to materials' value); Reliance Universal, Inc. of Ohio v. Ernest Renda Contracting Co., 454 A.2d 39 (Pa. 1982) (surety not liable for service charge on late payments because these payments are not part of the cost of labor or material).

b. Attorneys' Fees

Under Pennsylvania law, a party cannot recover attorneys' fees associated with litigation unless authorized to do so by statute, agreement of the parties or some other exception. Chatham Communications, Inc. v. General Press Corp., 344 A.2d 837, 842 (Pa. 1975). Unless the terms of the payment bond specifically permit the recovery of a claimant's attorneys' fees, the courts have been reluctant to extend the surety's liability under a payment bond to include such fees. See Can-Tex Indus. v. Safeco Ins. Co. of Am., 460 F. Supp. 1022 (W.D. Pa. 1978) (surety's liability not extended by terms of subcontract by which general contractor agreed to pay attorneys' fees upon default); J.C. Snavely & Sons, Inc. v. Web M&E, Inc., 594 A.2d 333 (Pa. Super. 1991) (surety not liable for attorney fees under agreement between claimant and contractor because those

fees and charges were not set forth in the payment bond); Ragan v. Tri-County Excavating, Inc., 62 F.3d 501 (3d Cir. 1995) (applying Pennsylvania law to hold that terms "sums justly due" in surety bond do not extend coverage of bond to include attorneys' fees or penalties); but see Dep't of Trans. v. Manor Mines, Inc., 544 A.2d 538, 543 (1988), aff'd, 565 A.2d 428 (1989) (where bond so provides, surety obligated to pay attorneys' fees).

c. The Nether Providence Doctrine

Pennsylvania law provides that "[w]here a public contract states the procedure in regard to work changes and extras, claims for extras will not be allowed unless these provisions have been strictly followed." Nether Providence Township Sch. Auth. v. Thomas M. Durkin & Sons, Inc., 476 A.2d 904 (Pa. 1984).[8] In reaching the holding in Nether Providence, the Pennsylvania Supreme Court stated that its primary purpose in requiring provisions concerning change orders or extras to be strictly enforced was to prevent the "unwarranted plundering of public funds" and "to uphold the integrity of the bidding process." Id. at 907. Therefore, in the context of public works contracts, oral modifications and change orders are often a nullity. The Nether Providence Doctrine has been routinely applied. See e.g., J.C. Snavely & Sons, Inc. v. WEB M& E, Inc., 594

[8] This doctrine applies only to public works contracts. Private contracts can be orally modified even though a provision in the contract states otherwise. See Wagner v. Graziano Constr. Co., 136 A.2d 82, 84 (Pa. 1957) ("Even where the contract specifically states that no non-written modification will be recognized, the parties may yet alter their agreement by parol negotiation. The hand that pens a writing may not gag the mouths of the assenting parties."); In re Franks, 95 B.R. 346, 352 (E.D. Pa. Bankr. 1989) (recognizing under Pennsylvania law, "[t]he law is crystal clear that a written contract may be modified orally.").

A.2d 333, 336 (Pa. Super. 1991); School Dist. of Phila. v. Tri-County Associates Builders, Inc., 2005 WL 1278113 (CCP Phila. 2005).

Often despite the well recognized Nether Providence doctrine, owners will issue and general contractors will accept oral modifications and change orders which are then presented to subcontractors. When the inevitable happens and the owner refuses to pay for the work performed by the subcontractors, what liability does the surety have?

A payment bond surety is generally not liable to a subcontractor for separate agreements between the subcontractor and general contractor that are not within the coverage of the bond. J.C. Snavely & Sons, Inc. v. WEB M& E, Inc., 594 A.2d 333, 336 (Pa. Super. 1991) ("we are bound by the terms of the bond in ascertaining the liability of the surety, and we need not look to some subsidiary agreement between a general contractor and supplier for such does not impact upon the obligations of a surety under a bond agreement"); see also Reliance Universal, Inc. v. Ernest Renda Contracting Co., 454 A.2d 39, 45 ("[w]hen a bond is executed, it is the language of the bond that is determinative of the surety's obligation and not the agreement between the municipal contractor and his materialman").

Typically the payment bond covers the prime contract between the owner and the general contractor. That is the bonded contract. If the bonded contract cannot be orally modified on a public works project, then the scope of the payment bond cannot be expanded in this manner either. Therefore, any alleged changes to a subcontract agreement – even valid changes – should not expand the surety's obligations under the payment bond.

Case Illustration: In the case of E.P. Donnelly, Inc. v. Bilt-Rite Contractors, Inc., Court of Common Pleas, Chester County, Docket No. 04-01904, a school district contracted with Bilt-Rite, a general contractor, to perform general construction work at the school (the "prime contract"). The prime contract between the school district and the general contractor specified the work that was to be performed on the project. The surety issued a payment bond which provided coverage only if a claimant was not paid for labor or materials provided in the performance of the work in accordance with the prime contract. The prime contract could only be modified in a writing signed by the owner.

E.P. Donnelly, Inc. ("Donnelly") subcontracted to perform a defined portion of the work on the project that was specified in the prime contract. Despite the Nether Providence doctrine, the school district allegedly issued oral work directives to the general contractor, which were then passed on to Donnelly. Donnelly later asserted a claim under the payment bond for this extra work.

The court dismissed the payment bond claim as precluded by the Nether Providence doctrine. The court could "discern no limitation from the Supreme Court restricting the holding in Nether Providence to first-tier contractors," reasoning that the "policy rationale behind the Nether Providence decision is no less compelling in the context of subcontractors engaged in a public works project than for primary contractors." September 20, 2004 Opinion at 7. Therefore, the court found that the