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NEWSLETTER

Fall 2007

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PERFORMANCE BOND NOTICE PROVISIONS: 36 MILLION REASONS TO COMPLY

By: Patrick Kingsley and David Burkholder

Introduction

Most standard performance bonds provide that the surety's obligations do not arise until it has received notice of the owner's declaration of the contractor's default and, in some cases, termination of the construction contract. Pursuant to the standard American Institute of Architects[1] A312 performance bond, the surety is also entitled to know twenty days in advance that the owner is *considering* defaulting the principal. A so-called "notice-to-cure" period is routinely provided for in the underlying construction contract before a default can be declared or a termination effectuated.

Are these notices mere technicalities or are they conditions precedent to the surety's liability? Courts have generally found these provisions to be valid and enforceable conditions precedent and supported by valid policy considerations. For example, in a recent Delaware federal case, the court found that the owner failed to comply with the contractually mandated notice-to-cure, thereby negating bond coverage.[2] The surety was dismissed as a matter of law, and the contractor secured a $36 million verdict for wrongful termination based on the owner's violation of the contractual cure period.[3]

The Tale Of A City And Its Contractor

In *Donald M. Durkin Contracting, Inc. v. City of Newark*,[4] the general contractor sued the owner for, among other things, breach of contract based on the owner's alleged improper termination of the construction contract to construct a large municipal reservoir. After the lawsuit was initiated by the contractor, the owner asserted a third-party claim against the surety that had provided a performance bond in connection with the general contractor's work on the project.

The construction contract required the owner to provide both the general contractor and its surety with seven days' written notice of the owner's intent to declare a contractor default and terminate the construction contract.[5] The standard AIA A312 performance bond provided by the surety also required an additional notice from the owner that it was "considering" declaring a contract default at least twenty days before formally declaring a default per the terms of the construction contract.[6]

Pursuant to the bond, the owner notified the contractor and the surety that it was "considering declaring" a contractor default and requested a meeting to discuss the methods of performing the construction contract. While the parties were in the midst of discussing the construction issues, the owner notified the general contractor and its surety of the contractor's immediate termination. The sudden and unexpected termination did not provide either the surety or the contractor with the contractually specified seven days' notice of intent to terminate.[7]

The owner argued that the letter advising that it was considering declaring a default satisfied the requirement in the construction contract that seven days' notice of termination be provided, as well as the notice requirements in the bond.[8] Thus, the owner suggested that its single letter simultaneously satisfied two different conditions precedent – one in the bond and one in the construction contract. The court rejected this argument. Just days before trial, the court dismissed the owner's multi-million claim against the surety under the performance bond based on the owner's failure to comply with the notice of default and termination procedures established by the construction contract and the performance bond.[9] As the court explained, the content of a letter meant to satisfy a notice of consideration of declaring default is fundamentally different from the language to be found in an actual notice of termination. "It is clear that the 'considering declaring' provision of the Bond functions to initiate a conflict-resolution process that could potentially obviate a declaration of default."

1 Hereinafter AIA.

2 Donald M. Durkin Contracting, Inc. v. City of Newark, No. CVIA 04-163 GMS, 2006 WL 2724882 (D. Del. Sept. 22, 2006).

3 Sean O'Sullivan, *Newark Ordered To Pay $38 Million In Lawsuit*, The News Journal, Oct. 6, 2006, *available at* www.delawareonline.com. Later, by consent of the parties, the amount of the jury award was reduced to $36 million because a clerical error had occurred in the original calculation of damages.

4 No. CV A 04-163 GMS, 2006 WL 2724882 (D. Del. Sept. 22, 2006).

5 *Id*. at *8.

6 *Id*. at n.3

7 *Id*. at *8.

8 *Id*.

9 *Id*. at *9.

Interestingly, although summary judgment was entered in favor of the surety, the court entered only partial judgment in favor of the bond principal as to the owner's failure to satisfy the notice of termination requirement under the construction contract. The court denied summary judgment on the issue of whether the owner had actual cause to terminate the principal's construction contract.[10] The trial went forward on the contractor's wrongful termination claim and resulted in a $36 million verdict in favor of the contractor based on the owner's wrongful termination in violation of the cure period.[11]

The Five-Step Process

The bond at issue in the *Durkin* case was an AIA A312 performance bond. The A312 bond requires that the owner provide certain notices to the surety before the surety's obligations under the bond will arise. The A312 notice provisions provide as follows:

> 3. If there is no Owner Default, the Surety's obligation under this Bond shall rise after:
>
> 3.1. The Owner has notified the Contractor and the Surety at its address as described in Paragraph 10 below, that the Owner is considering declaring a Contractor Default and has requested and attempted to arrange a conference with the Contractor and the Surety to be held not later than 15 days after receipt of such notice to discuss methods of performing the Construction Contract. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract, but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default; and
>
> 3.2. The Owner has declared a Contractor Default and formally terminated the Contractor's right to complete the contract. Such Contractor Default shall not be declared earlier than 20 days after the Contractor and the Surety have received notice as provided in Subparagraph 3.1; and
>
> 3.3 The Owner has agreed to pay the Balance of the Contract Price to the Surety in accordance with the terms of the Construction Contract or to a contractor selected to perform the Construction Contract in accordance with the terms of the contract with the Owner.

A review of the A312 performance bond provisions reveals a five-step process that an owner must satisfy to properly terminate its contractor for default and thereafter advance a performance bond claim:[12]

1. Notify the contractor and surety that the owner is considering declaring the contractor in default (¶ 3.1.);
2. Attempt to arrange a conference with the contractor and surety within fifteen days of the receipt of the notice to discuss methods of performing the construction contract (¶ 3.1.);
3. Wait at least twenty days after the contractor and the surety have received notice as provided in subparagraph 3.1 (¶ 3.2.);
4. Declare a contractor default and formally terminate the contractor's right to complete the construction contract (¶ 3.2.); and
5. Agree to pay the balance of the contract price (¶ 3.3).

Numerous courts have recognized these five steps as valid conditions precedent.[13] The obligee's failure to comply with the conditions precedent in a performance bond should act to discharge the surety of any liability to the obligee.[14] Courts routinely enforce and strictly construe these conditions precedent.[15] Courts in several states have also held that termination of a construction contract without providing the proper notice to cure can itself be a material breach of the construction contract by the owner.[16]

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[10] *Id*. at *8.

[11] *Id*. at *9 n.4.

[12] O'Sullivan, *supra* note 3.

[13] Of course, these five steps are only applicable if there is no owner default.

[14] *See, e.g*., USF&G v. Brastrepo Oil Servs. Co., 369 F.3d 34, 51 (2d Cir. 2004) ("[B]efore a surety's obligations under a [performance] bond can mature, the obligee must comply with any conditions precedent."); LBL Skysystems (USA), Inc. v. APG-America, Inc., 2006 WL 2590497, at *23 (E.D. Pa. Sept. 6, 2006)("the language of Paragraph 3 of the Performance Bond, that 'the Surety's obligations under this bond shall arise after . . .' creates conditions precedent to the duty of the surety"); *but see* Int'l Fid. Ins. Co. v. County of Rockland, 98 F. Supp. 2d 400 (S.D.N.Y. 2000).

[15] *See, e.g*., Tishman Westwide Constr., LLC v. ASF Glass, Inc., 33 A.D.3d 539, 823 N.Y.S.2d 71 (App. Div. 2006) (holding that the obligee breached its contractual duties to the contractor's surety by failing to provide the surety with 15 days' notice to cure the default in accordance with the provisions of the surety bond, thereby discharging the surety from liability under the bond).

[16] *See, e.g*., 120 Greenwich Dev. Assocs., LLC v. Reliance Ins. Co., No. 01 Civ. 8219 (PKL), 2004 WL 1277998 (S.D.N.Y. June 8, 2004); Enterprise Capital, Inc. v. San-Gra Corp., 284 F. Supp. 2d 166 (D. Mass. 2003); Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc., 986 F. Supp. 82, 86 (D. Conn. 1997); Bank of Brewton, Inc. v. Int'l Fid. Ins. Co., 827 So. 2d 747, 754 (Ala. 2002).

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Case Law Construing Notice Requirements In Performance Bonds

In *Bank of Brewton, Inc. v. International Fidelity Insurance Co.*,[17] the court outlined the proper procedure for declaring a contractor default under a construction contract and a performance bond that contained the language of the A312 performance bond. The owner, Bank of Brewton, hired a contractor for the renovation of the bank's main office in Brewton, Alabama. The surety issued a performance bond on the project as security for the contractor's performance. Some time after work on the project had commenced, the bank sent a letter to the surety stating that the bank was "considering declaring a contractor default" because the contractor was not complying with certain provisions of the construction contract.[18] The bank subsequently sent numerous letters to the surety demanding that the surety assume the completion of the project. The surety declined, citing the bank's failure to provide the surety with a formal termination of the construction contract.[19]

The bank sued the surety, arguing that the surety breached the performance bond by failing to assume liability under the bond. The surety moved for summary judgment claiming that the bank had not complied with the unambiguous terms of the contracts. The court agreed with the surety, stating that, because the bank failed to terminate the contractor's rights under the construction contract, the surety's duties under the bond had not been triggered.[20] The court determined that the bank's obligations under the bond were clear:

> The plain language of paragraph 3 is that in the event of a contractor default, the surety's obligation under the bond shall arise *after* the occurrence of the events listed in subparagraphs 3.1, 3.2 and 3.3. The owner first must give proper notice, call a meeting, discuss the problems, and attempt to resolve them (subparagraph 3.1); then, if the problems are not resolved, the owner must declare a contractor default, formally terminating the contractor's right to complete the contract, and must declare the default at least 20 days after giving notice (subparagraph 3.2); . . . .[21]

In *120 Greenwich Development Associates, LLC v. Reliance Insurance Co.*,[22] the United States District Court for the Southern District of New York likewise held that the provisions of paragraph 3 of an A312 performance bond are conditions precedent, which must be satisfied before any duty to perform arises on behalf of the surety.[23] The owner entered into a construction contract with a contractor to oversee the rehabilitation and conversion of a warehouse into residential space. The contractor obtained a performance bond. Shortly after the commencement of construction, a series of disputes arose between the owner and contractor. The owner claimed that it discovered that the contractor had diverted significant funds from the construction project for its own use. Later, the owner sent a letter to the contractor, with a copy to the surety, in which it demanded more than six million dollars in damages based on several alleged defaults.[24] The owner ultimately sued the surety under the performance bond seeking damages for the contractor's alleged defaults.

The surety moved for summary judgment on the basis that, among other things, the owner failed to comply with the conditions precedent to coverage under paragraph 3 of the bond. The owner did not contest that it failed to satisfy the conditions of paragraph 3 of the bond; rather, it argued that the provision did not constitute a condition precedent at all but "merely provide[d] [the surety] a defense to the extent it can show prejudice as a result of [the owner's] failure to provide timely notice" of the principal's default.[25]

The district court rejected the owner's argument. In doing so, the court noted that the language of paragraph 3 of the performance bond "creates unambiguous preconditions triggering [the surety's] obligations under the Bond . . . ."[26] The court explained that paragraph 3 of the bond clearly states that the surety's obligation

17 *See* Blaine Econ. Dev. Auth. v. Royal Elec. Co., 520 N.W.2d 473, 477 (Minn. Ct. App. 1994) (owner breached construction contract by failing to provide contractor with seven days' written notice of termination); Cuddy Mountain Concrete, Inc. v. Citadel Constr., Inc., 824 P.2d 151, 158 (Idaho Ct. App. 1992) (general contractor breached construction contract by failing to provide subcontractor with seven days' written notice of termination); Bruning Seeding Co. v. McArdle Grading Co., 439 N.W.2d 789, 792 (Neb. 1989) (failure to provide five days' notice for opportunity to cure under construction contract constituted breach of contract).

18 827 So. 2d 747 (Ala. 2002).

19 *Id*. at 749.

20 *Id*. at 749-50.

21 *Id*. at 754.

22 *Id*. at 753.

23 No. 01 Civ. 8219 (PKL), 2004 WL 1277998 (S.D.N.Y. June 8, 2004).

24 In Int'l Fid. Ins. Co. v. Co., 98 F. Supp. 2d at 400, the United States District Court for the Southern District of New York determined that the requirements of paragraph 3 of an A312 performance bond do not constitute conditions precedent. The court's decision on this issue has not been generally followed, and, in *120 Greenwich Dev. Assocs., LLC* and other decisions that post-date *Rockland,* that decision has been rejected.

25 *120 Greenwich*, 2004 WL 127798, at *5.

26 *Id*. at *11.

under the bond shall arise after "the owner has taken the steps detailed in subparagraphs 3.1-3.3."[27] According to the court, the owner was required to:

> (1) notify the contractor and the surety that it is considering declaring a default and request a meeting with the contractor and the surety to attempt to resolve the problems with the contractor's performance; if the problems are not resolved the owner must then (2) formally declare a contractor default and terminate the contractor's right to complete the contract, and (3) pay the balance of the contract price to the surety or to the contractor selected to complete the construction contract.

The court noted that courts "have consistently interpreted the language in this [A312] Performance Bond – 'the Surety's obligation under this Bond shall arise after . . .' – to indicate the listing of conditions precedent."[28] Because the owner failed to satisfy the conditions precedent in paragraph 3 of the performance bond, the court granted the surety's motion for summary judgment and dismissed the action against the surety.

In *Enterprise Capital, Inc. v. San-Gra Corp.*,[29] the United States District Court for the District of Massachusetts determined that an obligee failed to make a specific declaration of termination of the bond principal and thereby failed to satisfy the strict conditions precedent for coverage under the bond. The owner entered into a construction contract with a bonded contractor for the construction of a building and the performance of various site improvements and code upgrades. Subparagraph 3.2 of the performance bond provided: "3.2 The Owner has declared a Contractor Default and formally terminated the Contractor's right to complete the contract ...."[30] The bond also incorporated the terms of the construction contract, which set forth specific requirements for the notice of termination of the contractor. Paragraph 14.2.2 of the construction contract provided as follows:

> The Owner, upon certification by the Architect that sufficient cause exists to justify such action, may without prejudice to any other rights or remedies of the Owner after giving the Contractor and the Contractor's surety, if any, seven days' written notice, terminate employment of the Contractor . . . .[31]

In early 2001, the owner notified the contractor that the project was late and that the budget for construction appeared inadequate. The owner also requested a conference with the surety and notified the surety that the owner was "considering declaring a Contractor Default" pursuant to subparagraph 3.1 of the bond.[32] At the conference, the owner did not indicate that it intended to declare the contractor in default, to terminate the construction contract, or to complete the contract work itself.[33]

After the conference, the parties exchanged a series of letters, making various threats and stating their positions. Thereafter, the owner sent the contractor's counsel a letter, in which the owner called upon the surety to honor its obligations under the bond and provide funds sufficient to complete the project. However, the letter was not sent to the surety, did not state that the contractor was in default or terminated, and did not foreclose the contractor from completing the construction contract.[34] While the parties continued to exchange correspondence, completion work had begun on the project with another contractor.[35]

Early the following year, the owner sued the surety, seeking coverage under the performance bond. The surety moved for summary judgment, arguing, among other things, that the owner failed to notify the surety of the contractor's alleged default and, therefore, did not comply with the conditions precedent to coverage under the bond.[36] The owner countered by arguing that the series of letters did, in fact, provide notice to the surety of the default termination of the principal.[37] The district court, however, agreed with the surety and entered summary judgment in favor of the surety.

The court concluded that the owner never adequately terminated the contractor in writing, which was a condition precedent to the surety's performance obligations under the bond. The court noted that the bond itself

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27 *Id*. at *12.
28 *Id*.
29 *Id*. (quoting *Enterprise Capital, Inc*., 284 F. Supp. 2d at 179).
30 284 F. Supp. 2d 166 (D. Mass. 2003).
31 *Id*. at 175.
32 *Id*. at 175-76.
33 *Id*. at 169.
34 *Id*. at 170.
35 *Id*. at 171.
36 *Id*. at 173.
37 *Id*. at 174-75.

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did not prescribe the specific declaration of and termination by default procedures, but the bond did incorporate by reference the construction contract, which mandated that both the surety *and* the contractor receive seven days' advance written notice of termination.[38] The district court analyzed a series of letters–individually and collectively–to determine whether there was "clear, direct, and unequivocal" notice of termination to the contractor and surety.[39] The court concluded that none of these letters was clear notice to the surety that the contractor was in default and terminated.[40] Thus, according to the court, there existed no "clear, direct, and unequivocal formal declaration of termination to the contractor."[41] Accordingly, the court found that the owner failed to meet the conditions precedent of the performance bond and that the surety was relieved of any obligations to perform under the bond.[42]

Likewise, in *Balfour Beatty Construction, Inc. v. Colonial Ornamental Iron Works, Inc.*,[43] the court determined that an obligee failed to satisfy the conditions precedent to coverage under a performance bond when it failed to provide adequate notice of the declaration of default of the principal. The general contractor on a drawbridge project entered into a contract with a subcontractor for the provision of structural steel for a railway bridge.[44] Some time after the construction project was underway and in consideration for agreeing to a revised payment and performance schedule, the general contractor required the subcontractor to obtain a performance bond. The language of the performance bond obtained by the subcontractor provided as follows:

> Whenever Principal [Colonial] shall be, and declared by Obligee to be in default under the subcontract, the Obligee having performed Obligee's obligations thereunder:
>
> 1) Surety [NSC] may promptly remedy the default, subject to the provisions of paragraph 3 herein, or;
>
> 2) Obligee after reasonable notice to Surety may, or Surety upon demand of obligee may arrange for the performance of Principal's obligation under the subcontract subject to the provisions of paragraph 3 herein;
>
> 3) The balance of the subcontract price, as defined below, shall be credited against the reasonable cost of completing performance of the subcontract ....[45]

The general contractor sent two letters that it claimed provided notice to the surety that the general contractor considered the bonded subcontractor to be in default.[46] Neither letter, however, mentioned the term "default" nor declared the subcontractor to be in default. Rather, each letter merely complained that the subcontractor had failed to meet certain delivery dates and advised that the general contractor would seek reimbursement for any damages caused by the subcontractor's purported failures to perform.[47]

The general contractor later sued the surety, seeking damages for the subcontractor's alleged defaults. The surety moved for summary judgment, arguing that it was not liable under the bond because it never received the notice required by the bond that, among other things, the subcontractor was declared in default. The general contractor claimed that the surety was liable under the bond because, among other things, the bond did not expressly provide for any such notice of default.[48]

The district court held that the notices provided by the general contractor did not declare the subcontractor in default and, therefore, failed to satisfy the conditions precedent in the bond. The court noted that "[p]erformance bond requirements for notice of default demand that the surety step in and perform under the bond must be met before an obligee can recover damages under the performance bond."[49] The language of the bond required: 1) that the principal be in default; and 2) that the obligee declare the principal to be in default "so as to allow the surety to step in and take over the principal's obligations under the contract."[50] According to the

38 *Id*. at 180 n.22.

39 The court explained that "the entire purpose of the seven-day written notice requirement in the Construction Contract is to set forth the manner in which an owner must respond to a contractor's failure to perform." *Id*. at 178.

40 *Id*. at 179.

41 *Id*. at 180.

42 *Id*. at 181.

43 *Id*.

44 986 F. Supp. 82 (D. Conn. 1997).

45 *Id*. at 83.

46 *Id*. at 84.

47 *Id*. at 83.

48 *Id*. at 85-86.

49 *Id*. at 95.

50 *Id*. at 86.

court, the letters sent by the contractor were insufficient notification that the subcontractor was in default. Thus, the district court concluded that the general contractor failed "to meet a necessary condition for [National's] liability under the bond."[51]

Policy Considerations Behind The Law

Why does the law generally favor the strict construction of these notice provisions? The courts interpreting these provisions have found that they serve several important purposes.

First, such notice provisions prevent a complete forfeiture by the principal through a default. It is well-established that the law regards default termination as a drastic measure and, as such, the law disfavors it as a remedy.[52] Mandating compliance with these provisions as conditions precedent obligates the parties to take extra time to effectuate the termination process. That time provides not only a period for the controversy to "cool off," but also it gives the principal the opportunity to cure the alleged default and avoid the termination entirely.

Second, these provisions promote efforts to mitigate any potential costs.[53] Termination of a construction contract can be very expensive for all parties involved. If a default termination is inevitable, these provisions provide for early involvement by the surety. This gives the surety the opportunity to assess the controversy and choose the most economical way to proceed. That choice might include tendering the penal sum of the bond, financing the principal, or tendering a replacement contractor.

Finally, the notice provisions promote settlement of any disputes.[54] Because the provisions require the participation of all parties–the owner, the principal, and the surety–the potential for settling the pending disputes will necessarily increase. The notice provisions force the owner, the principal, and the surety to specifically discuss the methods of performing the construction contract.[55] Those discussions could lead to the development of new or different methods of contract performance that might otherwise not have been contemplated. Failing that, a simple monetary solution could always be worked out, which is more likely to happen if the bond conditions are satisfied.

The Thirty-Six Million Dollar Question

Can a single letter simultaneously satisfy a notice-to-cure provision in a construction contract and a "considering declaring" provision in a performance bond? The court in *Durkin* rejected that notion as negating the obvious purpose of the notice provisions found in the performance bond. Such notice provisions provide sureties with the opportunity to become involved in disputes before they have escalated to the point of no return. By being notified that the obligee is contemplating declaring a default, the surety can become involved while there is still time to meaningfully rectify the situation and, perhaps, avoid a termination. The surety's early involvement allows it to maximize its options to resolve the conflict or, if not, at least proceed in the most efficient, prompt and economical way to minimize and mitigate damages. All of these sound policy reasons for enforcing notice obligations would, in many cases, be lost if a single letter could satisfy both provisions. Indeed, the opposite view would effectively eliminate the bond notice provision entirely.

Each step in the five-step process outlined in the typical AIA A312 performance bond is a condition precedent, which the courts have generally embraced as valid, enforceable, and supported by sound policy considerations. These steps are in addition to any steps outlined in the underlying construction contract. The lesson from *Durkin* and the other cases discussed above is clear: miss a single step and it could have severe repercussions. Just ask one town in Delaware. It can point to at least thirty-six million reasons why an owner should be careful to satisfy the five steps.

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51 *Id*.

52 *Id*.

53 *See* Clay Bernard Sys. Int'l, Ltd. v. United States, 22 Cl. Ct. 804, 810-11 (Cl. Ct. 1991) (termination for default is drastic remedy); DeVito v. United States, 413 F.2d 1147, 1153 (Ct. Cl. 1969) (termination for default is drastic remedy); J.D. Hedin Constr. Co. v. United States, 408 F.2d 424, 431 (Ct. Cl. 1969) (same); *Bank of Brewton, Inc*., 827 So. 2d at 754 ("A declaration of default and the termination of a contract are not to be undertaken lightly.").

54 *See Enterprise Capital*, 284 F. Supp. 2d at 177 (stating that the related notice of termination provisions under the principal's construction contract "exists precisely to provide the surety an opportunity to protect itself against loss by participating in the selection of the successor contractor to ensure that the lowest bidder is hired and damages mitigated"); *see also* New Viasys Holdings, LLC, v. The Hanover Ins. Co., No. 2:06cv488, 2007 WL 783179 (E.D. Va. Mar. 12, 2007) ("Had the defendant been given notice of [the principal's] defaults within a reasonable time, it could have taken action to mitigate the damages."); Dragon Constr. Inc. v. Parkway Bank & Trust, 678 N.E.2d 55 (Ill. App. Ct. 1997) (although not dealing with an A312 performance bond, the court found that, because the owner failed to satisfy the notice provision of the construction contract, the surety "was stripped of its contractual right to minimize its liability under the performance bond by ensuring that the lowest responsible bidder was selected to complete the job").

55 *See, e.g*., *Durkin*, 2006 WL 2724882, at *8 ("It is clear that the 'considering declaring' provision of the Bond functions to initiate a conflict-resolution process that could potentially obviate a declaration of default.").

56 The very terms of the AIA A312 bond require the owner, surety, and principal ¶ 3.1 of the A312 Performance Bond.