PROJECT CAPITAL AND FINANCING STRUCTURE AND ITS IMPACT ON PROJECT COMPLETION

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TOPICS TO COVER

- Capital Structure/Types of Financing Generally
  - Character/Expertise, Capacity and **Capital**

- Assets Needed for Completion
  - Parties with Interests
  - Agreements Used to Acquire/Access
  - Bonded Receivables – Tracing
  - Lender-related claims

- Payment Bond Claims – Assignees and Factoring Companies
- Bankruptcy Considerations
Capital refers to:
- Contributions (cash/assets) by owners of Principal (Equity)
- Working capital provided by lenders/others (Debt)
Capital used to acquire assets to expand the business and create a return
Financing refers to how a company employs capital
Goal of Finance: Invest/deploy capital to yield the best risk/return trade off
Capital Structure – mix of equity and debt
Companies may use internal funds first, others seek optimal debt level
Leveraged company – has interest bearing debt
Favorable leverage – Earnings > Cost of Debt
Negative Leverage – Earnings < Cost of Debt
Traditional Financing – Commercial Banks and Trade Credit

- Commercial banks (secured or unsecured)
- Short-term (< 1 yr) – cash-flow insufficient to cover current shortfall
- Revolving line of credit:
  - Borrowing base limitation – discounted collateral value
  - Usually does not include bonded receivables/federal contract receivables
- Long-term – looks to investment needs (>1 year term)
- Trade Credit – buying goods from supplier on credit
  - Often only source of credit for smaller firms
  - Larger construction companies may force smaller firms to extend trade credit (impacts cash-flow)
BOND PRINCIPAL’S SOURCES OF CAPITAL

Non-traditional/Non-bank financing (not regulated like banks)
• Look beyond balance sheet ratios
• Evaluates management, expertise, record systems, internal controls
• Higher borrowing costs, more reporting
• “Mezzanine debt” – second, subordinated to primary lender

Equity – Owners (individuals, venture capital, angel investor)
• Capital retention agreements – restrict dividends and distributions
• For sureties, could include indemnitors (individuals, affiliates)
ASSETS NEEDED FOR PROJECT COMPLETION – BONDED RECEIVABLES AND SURETY PERSPECTIVE

Surety’s Rights in Bonded Receivables Generally:

- Trust fund under Indemnity Agreement (subject to state law) (intent, res, benef.)
- Trust fund under bonded contract (subject to state law)
- State Trust Fund Statute (NY is an example)
- Assignment under Indemnity Agreement – recorded UCC
- Equitable subrogation
  - Arises on default, relates back to date of bond (or default/payment)
  - IRS liens – considerations/concerns
  - Govt right of set-off (payment v. performance surety) (Benefit to Obligee?)
Loan Covenants (Borrower must):
- Maintain debt/income ratios and thresholds
- Capital retention (no dividends or distributions unless required retention)
- Insure Collateral
- No junior liens without lender consent
- No use of lender collateral to pay other debt without lender consent
- Reporting: change in control, financial statements

Cross-Default:
- Most if not all loan documents have cross-default provisions
- So, default under mortgage, personal guarantee is a default under loan

Lenders believe bonded contract proceeds are lender collateral (even if subordinated)
Lender with bonded contract funds on deposit may try to sweep funds on default
Surety notice to lender of Subrogation/Trust Fund Rights and When?

- At the outset of the project? On default?
- But subrogation not triggered until default
- Notice may improve surety’s position (file UCC-1 and actual notice)
- Notice could impact funds flow under short-term working capital loan
- Potential liability for interference? Not if acting pursuant to rights under GAI.
- Practical Reality – Sophisticated lender knows that it is financing a principal with bonded work.
Letters of Direction to Obligee:
• Issuance could be default under principal’s loan documents
• May need to engage lender esp. if surety and/or lender considering financing

Use of Control Account (Lender/Garnishment):
• Bank may be allowed to seize funds in account if principal owes bank
• Jointly owned account may be subject to garnishment (see local law)
  ➢ Entire account may be immune, entire account may be vulnerable
  ➢ Portion may not be vulnerable if can show ownership
CONTROL ACCOUNTS CONTINUED...

• Surety finances, helps P secure loan, all funds in surety control acct.
• Disbursements on joint signatures of surety and P
• Court: surety control, so liable to collect income/FICA

Takeaway:
• P should remain responsible for payroll taxes
• Surety should not take control of principal’s general funds
• Surety advancing funds should do so only into third party payroll administrator account or segregated account controlled by Principal with Principal being responsible for taxes
TRUST FUND DISPUTES WITH LENDERS


- Surety issues bonds several projects for ESH
- ESH line of credit with bank
- Bank directs ESH to apply bonded proceeds to line of credit
- Surety advises bank of rights in bonded proceeds, trust fund nature of funds
- Bank sweeps progress payments upon deposit
- Surety filed suit against bank for conversion, Bank Motion to Dismiss:
  - Argues trust under GAI, state and federal law, and under bonded contracts
  - GAI trust = valid trust in TN (ESH is trustee, identifiable res and beneficiary)
  - Bank argued no notice (not considered b/c first time on appeal)
  - But, surety gave written notice and also recorded GAI, bank found GAI in UCC search
  - Court denies MTD. Court: Trust “begins and ends with [GAI].”
Some states require segregation of funds for trust treatment

If state does not require segregation, then must trace trust funds in commingled account.

Common Methods:

- Last-in/First Out: Last money into the account is the first withdrawn
- First-in/First Out: Court presumes funds paid out in the order paid in
- Pro-rata: Based on creditors’ respective percentage of collateral before commingling
- Lowest Intermediate Balance Test
TRACING BONDED CONTRACT FUNDS IN PRINCIPAL’S ACCOUNTS

Lowest Intermediate Balance Test

- Assumes proceeds being traced are last to be withdrawn.
- Debtor spends own money first
- If withdrawals from account during relevant tracing period do not make the balance of the account less than the amount of the trust funds, then the funds are entirely traced
- If funds partially withdrawn, balance remaining is traceable
- Withdrawn funds are lost
- Test Period:
  - Start with funds on deposit now, go back to known deposit of bonded receivables, and look at withdrawals between periods
# TRACING BONDED CONTRACT FUNDS IN PRINCIPAL’S ACCOUNTS

<table>
<thead>
<tr>
<th>Time 1</th>
<th>Time 2</th>
<th>Time 3</th>
<th>Funds on Deposit Now</th>
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CONTRACTOR CLAIMS AGAINST LENDER

- Owner’s Lender generally has no liability to pay contractor/principal absent express agreement to assume the contract. See *Tiber Constr. v. Crossland Sav.*, 1987 WL 15576 (D.D.C. 1987).

- Owner’s lender that assumes control over its borrower/owner after default, and asks contractor/principal to remain on the project may be obligated to pay the contractor.

  - Subcontractor’s lender received payments from contractor by joint check to lender and subcontractor.
  - Lender could qualify as involuntary trustee of funds owed subcontractor under trust fund statute and could be liable to subcontractor’s subcontractors.
  - But, Court also held that claimant waived trust claims because knew subcontractor financed receivables and participated in joint check arrangement.
Owner-Developer Default Under Loan Documents

- Owner Default Provisions:
  - Failure to properly disburse funds advanced by lender
  - Failure to keep property free of liens
  - Failure to timely complete project

- Default triggers acceleration, means no future disbursements and foreclosure

- No funds flow to general contractor or subcontractors
  - Impacts payment to subs and suppliers on this project
  - Impacts ability to pay overhead and debt

- Foreclosing lender may have incentive to complete project because increase in collateral value when completed
  - May be important tax incentive/credit at completion

- Possible transaction solutions
ASSETS NEEDED FOR PROJECT COMPLETION – EQUIPMENT, MATERIALS AND FACILITIES

- **Surety Rights** –
  - GAI – security interest, right to possession

- **Lender Rights – Equipment Lessor Rights**
  - Lender blanket lien – Equipment lien of equipment lessor
  - Mortgage? Foreclosure rights
  - Fixtures? Concrete batch plants?

- **Principal as Lessee of Facility (indemnitor lease to Principal?)**
  - Lease payments assigned to Lessor’s lender

- **Search UCC and real property records to identify parties**
  - Review underlying loan/security agreement
  - UCC – secured party can take possession if no breach of peace
  - UCC - commercially reasonable sale, notice to secured parties
EQUIPMENT TRANSFERS TO SURETY CONTROLLED WAREHOUSE

- Principal’s equipment may be critical to loss mitigation
- For long lead items or to prevent damage
- Actual cost of the equipment is not the issue – it’s availability for use
- Transfer does NOT defeat prior perfected security interest nor prevent foreclosure

Consider: Some Purchase Orders say that title does not pass until payment made
  - Result: If Principal has no rights in equipment, then security interest in equipment does not attach and so not subject to lender’s lien
  - So, if surety pays, then surety may own
EQUIPMENT AND FACILITIES UTILIZATION – PRACTICAL ISSUES

- **Underwriting and Pre-Default Stage:**
  - Specialized equip.: Bond issued on condition of utilization agreement with principal and lender
  - Better leverage pre-default

- **Default:**
  - Difficult to convince a lender to allow use of its collateral
  - Compensation for Use –
    - Appraisal, industry manuals (for rental rates)
    - Pay principal’s lease/loan payments
  - Transactional alternative: purchase (debt or equipment), participation interest; assign equipment, facility, or lease to completion contractor?
Standstill Agreements

- Surety/Lender agree to forbear from exercising rights against Principal or in collateral
- Forbearance is new consideration
- Often includes Principal acknowledgement of default (triggers subrogation)
- Might also include executed letters of direction and default
- Might also include lender in discussions to secure funds control agreement
Funds Control Agreements - Types

**Joint Account Agreement**
- Principal and Surety joint bank account to hold bonded contract funds
- Account signatories are Principal and Surety
- Problems: garnishment and set-off, property of bankruptcy estate

**Third Party or Surety Funds Control**
- Bonded contract funds deposited into account controlled by Surety and/or agent
- Designated agent typically consultant/accountant
- Agreement specifies approved uses
- Surety must approve disbursements
PRE-DEFAULT AND POST-DEFAULT AGREEMENTS AMONG PARTIES WITH INTERESTS IN WORKING CAPITAL AND ASSETS NEEDED FOR COMPLETION

Funds Control Agreements – Types (continued)

**Bonded Contract Proceeds Collateral Agreement**
- Often used when Surety financing principal
- Account owned by surety or its agent (not at Principal’s lender bank)
- Principal also grants security interest in the account to the extent Principal has rights
  - UCC 9-312; 314 – perfect by control
- All bonded contract funds deposited into account AND any funds surety has agreed to advance under its financing agreement with principal
- Sometimes used with Zero Balance Account (ZBA):
  - ZBA account in name of principal
  - As checks from ZBA presented to depository institution, checks draw from cash collateral account
Subordination Agreements

- Permit surety to use collateral of lender
- Lender subordinates lien in certain assets to surety
- Often used by financing surety
- Sometimes with lender whose collateral worthless unless project completed (ex: real estate or tax credits)
Intercreditor Agreements

- Between Surety and Principal’s lender or between sureties
- Acknowledge/consent to other creditor’s lien/priorities in specific assets
- Surety priority in “Bonded Working Assets”
  - Bonded Working Assets: Bonded contracts, bonded receivables, equipment, associated general intangibles and intellectual property
  - Lender priority in other Assets (other than Bonded Working Assets)
  - Standstill provisions:
    - Surety no action against “Lender Priority Collateral” until all obligations to lender satisfied
    - Lender no action against “Surety Priority Collateral” until all surety loss reimbursed and no bond exposure
- Who has leverage? Perspectives? Lender liquidation; Surety Use of Collateral
Intercreditor Agreement Variations

- Surety Purchase of lender debt and collateral rights
  - Due Diligence:
    - No defense to debt
    - Collateral value: equipment, “claims”

- Participation Agreement
  - Lender loan remains in place
  - Surety purchases portion of debt coupled with subordinated interest in collateral
  - Lender then makes credit available to principal for use under approved budget
  - Principal may pledge additional collateral to support
  - Collateral liquidation provision
PRE-DEFAULT AND POST-DEFAULT AGREEMENTS AMONG PARTIES WITH INTERESTS IN WORKING CAPITAL AND ASSETS NEEDED FOR COMPLETION

Equipment, Facility, and Intellectual Property Agreements

Typical Utilization Agreement (Lender, Principal, and Surety) Provisions:

- Principal will not permit any lien or encumbrance w/o prior consent unless the lienholder agrees to be bound by utilization agreement
- Surety/Principal utilization agreement – no payment by surety to principal
- Surety/Lender agreement – rent or other payment (loan schedule or mkt. rental rate)
- For Real Property Facilities: should record
- Fixtures (removable?): Record
- Intellectual Property (technically license):
  - Proprietary systems, software, inventions, designs, patents, patent applications, trademarks, copyrights, licenses, trade names, trade secrets and associated goodwill
- Computers low monetary value – on the front end, lender usually willing to allow use without fee
Lenders as Payment Bond Claimants


- Lender for subcontractor advanced funds on basis that would be repaid from contract funds
- Unpaid lender then sought recovery from sub’s surety on theory that GC advised bank that funds would be paid to sub on next pay estimate
- Court: Payment bond surety not liable to lender on the loan even though loaned funds used to fund labor and material costs of the subcontractor
- Lender not a subcontractor or supplier of surety’s principal nor had lender taken an assignment from those that provided labor/materials (i.e. absolute assignment versus assignment for security)
Lenders as Payment Bond Claimants


- Primo Team advances funds to RJ, Inc. to cover payroll
- Primo Team also administers RJ, Inc. labor
- Statute allowed recovery under payment bond for labor
- Court: RJ, Inc. supplied labor, not Primo Team so Primo Team not covered labor
- Court: RJ, Inc. advanced funds that made it possible to pay labor (like a loan)
- Court: Those that actually furnish labor and materials are covered, not lenders that provide funding
Assignees as Payment Bond Claimants


- Principal subcontract with S&M Constructors
- S&M issues checks to its laborers who cash checks at stores
- Checks dishonored so Stores seek recovery from payment bond surety as assignees of laborers based on endorsement of checks.
- UCC Article 3 – Negotiable Instruments
  - Where an instrument is taken for an underlying obligation, the obligation is suspended until due or presented. If dishonored, may maintain action on either the instrument or the obligation.
- Court: Said endorsement assigned laborer right of action against S&M to the stores
- Court: Said stores were equitable assignees of laborers’ rights under payment bond

Assignees as Payment Bond Claimants

Compare to *New Market Co. v Maryland Cas. Co.*, 174 P. 479 (Wash. 1918).

- Court has held that a labor claim under payment bond assignable
- Negotiation of an instrument fundamentally different
- Ordinary check is not an assignment of fund on which drawn
- Check is an order for payment of money that does not affect the debt until paid.
- If dishonored, the drawer is indebted to payee the same as drawer as though the check had never been drawn. So, endorsement did not assign payment bond claim.
  - Holder of dishonored check has 2 claims:
    - (1) payment under instrument and (2) payment bond claim
    - Right to payment under instrument is transferred by endorsement, while right to payment under payment bond transferred by assignment
Factoring Companies as Claimants under Payment Bonds

- Non-traditional lender providing short-term capital without requisite cash-flow
- Factor buys a sellers’ AR for a discount and without recourse to the seller
- So, factor injects capital like a lender, but does NOT provide labor or materials
  - General principle: Claims are typically transferrable
  - Analyzed state trust fund statute protecting labor
  - Factoring company, as assignee, could pursue claims against surety
  - Distinction w lender:
    - Factor actually buys invoices on which claim is based (absolute assign.)
    - Lender takes assignment as collateral (assign. for security)
- Surety: ES can defeat factor claim to contract funds, but must be mindful of claim on payment bond. Ask about factoring in UW and consider prohibition
Bond Obligees as Claimants under Payment Bonds

Generally no because not a “claimant” under bond form.


- Owner-obligee generally may not recover because it is not a subcontractor or supplier
- Class of protected persons excludes owner even though named as nominal obligee
- Court:
  - Denied surety motion to dismiss
  - Obligee’s status as such does not preclude obligee from asserting payment bond claim and may do so by way of subrogation
BANKRUPTCY CONSIDERATIONS

Objectives of Chapter 7 Trustee:
• Locates, collects, and liquidates assets
• Makes distributions, files a final report
• Trustee activities fee driven

Objectives of Chapter 11 (Debtor-in-Possession (“DIP”) or Ch. 11 Trustee Operates business)
• Negotiate and confirm Plan of Reorganization or Liquidation
• Abandon/reject unprofitable assets/contracts
• Sell/retain profitable assets/contracts
• Key issues: How to fund operations and pay professionals?

Surety Concerns: Bonds, Bonded Contracts, Claims and Collateral (bonded receivables) and equipment/materials for completion
BANKRUPTCY CONSIDERATIONS

Strategy in Ch. 7 or Liquidating Ch. 11

- Motion to Approve Agreement with Trustee on Collection and Uses of Bonded Contract Proceeds, and for Stay Relief
  - Surety controls collection and payment and accounts to Trustee – Ch. 7
  - In Liquidating 11 – Debtor to control with Surety Oversight? Abandon to Surety?
  - Individual indemnitor engaged?

- Funds in possession of Debtor on Petition Date? Motion for Turnover/Accounting
  - Tracing commingled funds
  - Lowest Intermediate Balance (assumes Debtor uses own funds first)
  - LIFO, FIFO, Pro-Rata
Strategy in Reorganizing Ch. 11 – Bonded Contract Proceeds

Agreement on Use of Bonded Contract Proceeds (recognizes surety rights, trust, equit. subrog.):

• Segregation of contract funds into a separate bonded receivables account
• Funds must be applied first to pay bonded payables and bonded contract completion before the debtor can use the funds for overhead and other expenses
• Bank and Debtor acknowledge surety priority to the extent funds are “cash collateral” under 11 U.S.C. § 363
• A time frame for assumption or deemed rejection without further order/action
• Surety administrative expense to the extent the debtor uses bonded contract funds from a contract that is ultimately rejected by the debtor
• Allow the surety to take control of the contracts immediately in the event the debtor defaults, including stay relief
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AND ITS IMPACT ON PROJECT COMPLETION

Questions?
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Introduction

Surety bonds are credit instruments that support payment and/or performance of a principal’s obligation. Unlike insurance, sureties issue bonds with the expectation that the principal will indemnify the surety from loss. This perspective makes a surety bond more akin to a letter of credit instrument and not dissimilar to a loan product. As a result, like lenders, sureties considering extending “credit” to a borrower (and in the case of a surety, a principal) often consider three broad categories of information: character/expertise, capacity and capital.

In broad terms, character/expertise refers to the borrower’s history of paying debts and performing its contractual obligations. In the construction context, character may also include a contractor’s history completing certain types of projects, history with certain public owners or other entities, history in the labor market in which a project is located, and other factors. Capacity refers to the borrower’s ability to repay debt based on considerations such as the borrower/principal’s income, cash flow, and projected ability to complete required performance. Capital refers to the financing structure of the principal, including the contributions of individuals or entities to the principal, working capital made available by lenders, and cash, equipment, or other contributions made to the principal by others.

In the event a surety is faced with completing a project, the surety will re-visit the “character/expertise, capacity, and capital” trinity of considerations as it evaluates the various means and methods of completion. This paper primarily addresses the capital element this trinity, with a view toward exploring how a project’s financing and capital structure may impact a performing surety. In addition to discussing various financing and capital structures, this paper addresses unique claim issues that may arise based upon how available funds and assets are utilized on a project as well as various agreements that might be utilized to help assure the continued availability of working capital and assets for completion. This paper also addresses various bankruptcy considerations and their impact on the financing and capital structure of construction projects.

I. Principal’s Sources of Capital for Projects and Operations in General

A. Primer on Finance and Capital Terminology

At its most basic level, the primary purpose of any business is to generate profit for its owners. Finance has been defined as “the application of a series of economic principles to maximize the wealth or overall value of a business,” with maximizing wealth requiring “making the highest possible profits with the least risk.”1 Thus, the goal of finance is to “budget scarce resources effectively and to invest funds in the assets and/or projects that yield the best risk/return trade-off.”2

A company uses capital to acquire assets to expand its business.3 A company’s capital structure, in turn, generally refers to the external funds derived from financing, which could include both equity (stock or similar interests issued to members for capital contributions) and

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2 Id. at 4.
3 Id. at 20.
Project Capital and Financing Structure and its Impact on Project Completion

debt. Some companies prefer to use internal funds first, followed by debt. Other companies seek to achieve “optimal debt levels” that compare the benefits of debt (such as tax deductibility) to the cost of debt. A company is said to be leveraged to the extent it has interest bearing debt. A company is favorably leveraged when its earnings on capital exceed the cost of its debt. A company is negatively leveraged when the cost of capital exceeds earnings.

How a company employs its capital on a daily basis, and how effectively it plans the use of that capital over time, will determine the success or failure of the business. A key indicator of a company’s short-term financial health, and perhaps a signal of possible down turn in long-term financial health, is its net working capital. Working capital is typically defined as current assets minus current liabilities. A company with a high net working capital is more liquid than one with a low net working capital, because more liquid assets are available to cover short-term debts.

B. Bond Principal’s Sources of Capital

A construction company, like any other entity, uses capital to acquire assets necessary to operate its business. Those assets often consist primarily of contracts that generate receivables, and in the principal’s surety’s case, bonded contract receivables. The assets may also include equipment, real estate, leases, and intellectual property, among other assets.

In a best case scenario, the bonded contract receivables are sufficient to cover project completion costs, to pay debt payments, to acquire new equipment and other assets to expand the business, and to provide a return to its owners. In a worst case scenario, the receivables are insufficient to cover costs of completion or to cover the cost of debt service. In a better, yet not ideal scenario, the receivables are sufficient to cover some or all of the costs of completion or debt service. However, this lack of liquidity means that the construction company is not equipped to “finance” unforeseen project issues without payment from the owner or a new capital infusion.

The principal’s assets may also include contract receivables on non-bonded projects. In a perfect world, bonded receivables on one project would be used and be sufficient to cover project completion costs solely on the related bonded project. But, this is simply not always the case in practice. Bonded receivables on one project might be used to fund a shortfall on a non-bonded project, or vice versa. Funds might be used to pay down lender debt or fund a distribution to the principal’s owners rather than pay subcontractors or suppliers. A principal’s cash management system might also mean it comingles bonded and non-bonded funds. It is possible that a principal that operates in this manner may never be defaulted, and its surety may never see a claim under a bond. But, in the event that the shortfalls are such that a principal is unable to pay or perform its

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4 Id. at 190.
5 Id.
6 JAY ALIX, TED STENGER, & LAWRENCE R. AHERN, III, FINANCIAL HANDBOOK FOR BANKRUPTCY PROFESSIONALS § 1.12 (2d ed. 2017).
7 Id.
8 Id.
9 A.A. GROPPELLI & EHSAN NIKBAKHT, supra note 1, at 351.
10 Id.
11 Id.
obligations, the way in which the principal’s capital is structured and the manner in which it manages its capital and project assets, could create disputes between the surety and the principal’s lender(s), as the surety attempts to secure those assets for project completion. Those disputes and others (relating to other project assets) are discussed in more detail in the Sections below.

For a surety, bonded receivables, equipment, and, in some cases, real estate and leases are key components of any project completion effort. As such, understanding how these assets are treated under the principal’s and/or the principal’s contract counterparties’ financing documents are critical to mitigating loss.

1. Traditional Financing – Commercial Banks

Like many businesses, construction companies engage in financing transactions to provide capital to acquire income producing assets and expand their businesses, all with a view toward ultimately providing a return for the owners. These financing transactions may take the form of “short-term financing” or “long-term financing.”

Short-term financing is intended to cover shortfalls when current cash flow is insufficient to cover expenses. The company borrows funds to cover expenses, anticipating income (for a construction company, project receivables) at a future date. Therefore, short-term financing is intended to fill a temporary need. Sources of short-term financing include the company owners (through capital calls in small entities or the issuance of debt instruments such as bonds) or from external sources. In contrast, long-term financing looks at the investment needs of a construction company, like new or more modern equipment, shifts in market demand, or development of improved processes and personnel. Long-term financing sources include income from operations (excess funds on projects or profit on projects is invested in new equipment) or external sources.

Commercial banks are typical, “traditional” external sources of short-term and long-term financing. These loans are typically repaid over a period of time and may be secured or unsecured. Short-term loans are typically repayable in one year (typically a revolving line of credit) and more often in less than six months. In the construction context, short-term loans may be used to cover temporary project cost shortfalls and may be repaid from project receivables. Lines of credit are also often used for this purpose. In each case, a lender will likely look for both primary (the construction company) and secondary (the owners) sources of repayment.

\[^{12}\text{Id. at 305.}\]
\[^{13}\text{Id.}\]
\[^{14}\text{Id.}\]
\[^{15}\text{Id.}\]
\[^{16}\text{Id. at 313.}\]
\[^{17}\text{Id.}\]
\[^{18}\text{Types of Financing, HAMPTON ROADS SMALL BUS. DEV. CTR., http://www.hrsbdc.org/financing-basics/types-of-financing/ (last visited Apr. 1, 2019).}\]
In addition to short-term bank loans, companies often use trade credit—an indirect loan to a customer for purchasing goods from a supplier—to finance obligations short-term.\(^{19}\) The “credit” appears as accounts payable on the customer’s balance sheet, and as an accounts receivable on the supplier’s balance sheet.\(^{20}\) For construction companies, the availability of trade credit is critical and, for smaller and medium sized firms, may be the only source of short-term financing available for operations. Additionally, market conditions may force some suppliers to extend trade credit to larger construction entities, or else they may lose a sale opportunity.\(^{21}\)

Medium and longer term loans typically refer to loans repayable in one to five years, and these funds are typically used for working capital (i.e. funding general operations), fixed asset (i.e. equipment), and/or real estate acquisition.\(^{22}\) Like with short-term loans, medium to longer term commercial lenders will look for both primary and secondary sources of repayment, and these loans may also be secured by a much broader base of a company’s assets, such as receivables. Further, how much a lender is willing to loan will often depend on the value of the collateral securing the loan, and how much of a discount the lender may apply to that collateral.\(^{23}\) In revolving lines of credit, this is referred to as a “borrowing base limitation.” In the case of a construction company with bonded accounts receivable, because these funds may be trust funds subject to a surety’s equitable subrogation rights or funds previously assigned to the surety, a lender may not include bonded accounts receivable in the borrowing base or these receivables may be discounted heavily.

2. Non-Traditional Financing and/or Non-Bank Financing

Non-traditional and/or non-bank financing generally refers to financing from lenders that, while regulated, are not regulated like traditional commercial banks.\(^{24}\) These entities may include investment and/or finance firms (which may be owned by banks) or factoring companies.\(^{25}\) Mezzanine lenders also fall into this category.\(^{26}\) Like traditional lenders, non-bank financing entities provide both short term and long term loans that may be secured broadly by a company’s assets and used for working capital or to acquire equipment, machinery, or real estate.\(^{27}\) Because non-traditional lenders are not regulated like banks, whose credit decisions are strictly limited to balance sheet and ratio analysis, non-traditional lenders often look beyond those typical limitations to things like management, expertise, record keeping systems and internal controls, and other factors related to the enterprise of the borrower as a whole.\(^{28}\) As a result, non-

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\(^{19}\) A.A. GROPPELLI & EHSAN NIKBAKHT, supra note 1, at 309.

\(^{20}\) Id.

\(^{21}\) Id.

\(^{22}\) Id.

\(^{23}\) Id. at 310-313.

\(^{24}\) Types of Financing, supra note 18.

\(^{25}\) Id. Further, “[a] ‘factor’ is one who buys a seller’s accounts receivable for a discount and without recourse” (except as to the accounts receivable). James White, Death and Resurrection of Secured Credit, 12 AM. BANKR. INST. L. REV. 139, 153 (2004).

\(^{26}\) Renaissance N., LLC v. Fifth Third Bank, 512 F. App’x. 532, 534 n.1 (6th Cir. 2013) (stating “mezzanine debt is a second, subordinate loan obtained from a lender other than the bank that serves as the primary lender”).

\(^{27}\) Types of Financing, supra note 18.

\(^{28}\) Id.
traditional lenders may be willing to allow a higher borrowing capacity than a traditional lender.29

Further, non-traditional lenders often do not require borrowers to maintain a portion of the loan on deposit to cover loan expenses and commitment fees, which are often required by commercial banks.30 Of course, a potentially higher borrowing base and more regulatory flexibility results in higher borrowing costs, and more onerous reporting requirements.31 As a result, non-traditional financing may not be available to smaller or medium sized companies that do not have well-developed internal record-keeping systems and/or accounting controls.

3. Other Financing – Equity (Owner Capital or Investor Capital)

Equity financing is generally considered funding provided by investors (which may be the entity’s founders, a venture capital firm, an angel investor, friend, or relative)32 in exchange for stock or other interests (for example, in a limited liability company, a membership interest).33 With this type of financing, the equity holder receives a return only after the business produces sufficient revenue to fund a return, usually in the form of a dividend or distribution, depending upon the type of entity.34 Many lenders, including both traditional and non-traditional lenders, attempt to restrict dividends and distributions under their loan documents as part of their loan covenants or in separate capital retention agreements. Typical capital retention agreements prohibit dividends or other asset transfers that would result in a borrower’s (or in the case of a surety, its principal’s) net worth falling below a certain threshold.35 Additionally, some shareholder agreements require preferred returns to those providing the initial seed money for the investment.

For a surety, a principal’s equity structure is significant as the equity holders are often a surety’s indemnitors under the surety’s general agreement of indemnity. So, transfers between and among the bond principal and indemnitors should be scrutinized in any default/completion scenario as those persons, firms, or entities could have assets (bonded receivables and equipment) necessary for project completion. Moreover, a related entity could be a party to a valuable lease that needs to be available to the surety for equipment and material storage, and/or operations on a project.

II. Assets Needed for Project Completion

A surety faced with completing a project faces a number of issues that must be addressed in a limited amount of time and often with very little available information. But, from a construction standpoint, the surety should consider whether the principal is capable of completing the project and what assets are needed for completion of the project or projects. Those assets typically

29 Id.
30 Id. See also A.A. Groppelli & Ehsan Nikbakht, supra note 1, at 306.
31 Types of Financing, supra note 18.
32 Id.
33 Id.
34 Id.
include: (1) bonded receivables and principal’s funds on deposit; (2) equipment and supplies needed for completion; (3) labor and project/office personnel; (4) computer hardware and software and other intellectual property; and (5) real property. The sections below discuss key questions a surety may have relative to each of these assets.

A. Bonded Receivables and Principal’s Funds on Deposit

Obviously, among the key assets needed for completion are the proceeds of the bonded contract at issue. These “proceeds” include the bonded receivables payable under the bonded contract, as well as funds previously paid to the principal. The funds previously paid to the principal may be held in a deposit account with the principal’s lender, in an account controlled by a surety, or held in an account held by a trustee-in-bankruptcy. Further, funds payable to the principal under the bonded contract may be payable by a public or private owner, a general contractor (in the case of a subcontractor principal default), and, in some cases, those payables could be funded by a lender. Thus, it is critical for a surety to understand the financing and capital structure of all entities on a project if for no reason other than to understand practically how funds flow to the principal on the project. The financial viability of all of the constituencies at each level of the project will impact the surety’s risks associated with completion.

B. Equipment, Supplies and Facilities

A principal’s equipment, supplies, and facilities are also key components of any surety completion effort, as continued access to and use of these items could help minimize completion days and mitigate loss.

The collateral security provision in a surety’s indemnity agreement often includes the grant of a security interest in equipment and other assets. Though, unlike a typical loan agreement, the indemnity agreement routinely grants the performing surety the rights to utilize the principal’s equipment and takeover the principal’s bonded contracts. Such provisions are necessary for a surety because, unlike a lender, the performing surety is faced with the prospect of the obligation to complete its principal's bonded work.

Whether the surety is evaluating an account in the underwriting stage, or responding to a performance claim, it should consider three preliminary questions relative to the principal’s equipment and facilities:

1. Who else has rights in the principal’s equipment and facilities?
2. Can those parties take the equipment and/or foreclose on the facilities and prevent the surety from their use?
3. Is there another source available from which the surety can obtain the equipment and facilities necessary to perform in the event these other parties do not allow the surety to use the equipment and facilities?

Understanding the principal’s capital structure will help the surety identify who else has rights in the principal’s equipment, materials, and facilities. In this regard, the principal usually has relationships with lenders, equipment lessors/financers, and potentially real property lessors, all
of whom may have been granted rights in the principal’s equipment, its accounts, the contracts
the surety is called on to perform, and/or the real property and/or leases affecting the principal’s
facilities (e.g., offices or storage yards) necessary for completion of a project.

A search of the Uniform Commercial Code financing statements filed in the state in
which the principal is organized or, if an individual, his or her principal residence, will assist
with identifying those who claim an interest in a principal’s equipment that is not subject to a
certificate of title (e.g., a vehicle).36 A search of the applicable jurisdiction's real property records
is also necessary to assist in identifying those who claim an interest in a principal’s facilities.
Further, some of the principal’s facilities (e.g., offices or storage yards) may be leased or located
on real property on which the principal’s or lessor's lender has been granted a lien. The
competing rights claimed, and whether those rights are enforceable, depend on the underlying
agreement pursuant to which those rights are granted. Thus, the authors caution against relying
solely on the results of a UCC or other search for anything beyond identifying the parties
claiming rights in equipment and facilities that the surety may need to perform its principal’s
bonded obligations.37 But, if a surety has a good understanding of its principal’s capital and
financing structure prior to default, either through a books and records request or prior
underwriting data, it should have access to at least some of the core financing documents
necessary for this evaluation, saving valuable time during the takeover and completion process.

Can other parties that have rights in the principal’s equipment and facilities take the
equipment and/or foreclose? Under the UCC, any secured party may take possession of the
equipment to the extent that can be accomplished without breaching the peace.38 Any secured
party may also sell the equipment, but the sale must be commercially reasonable.39 One of the
considerations in determining whether a sale is commercially reasonable is whether other lien
holders were provided notice of the sale (ostensibly to bid on the equipment being sold).40 Thus,
a surety with a perfected security interest in its principal’s equipment and facilities should
receive notice of any sale. The surety should also formally request notice of any sale from those
who have or assert an interest in the principal’s equipment and facilities. A surety should
likewise provide broad notice to record lienholders should it seek to dispose of its principal’s
equipment.

Ultimately, the surety's imperative in utilizing its principal’s equipment and facilities
depends upon whether that approach represents the most economical option to the surety from a
loss mitigation standpoint. A number of factors may influence the surety’s interests in this
regard, including: (1) third-party rental/acquisition costs; and (2) delivery timeline and its impact
on any performance deadline.

36 See U.C.C. §§ 9-301, 9-303, 9-307, 9-310 (2013). The Uniform Commercial Code will be referred to
hereinafter as “UCC.”
37 The authors also note that the equipment and facilities may be subject to certain non-UCC recorded (certificate
of title lien), unrecorded lien (such as a tax lien) or hidden liens (not found in a reasonable Article 9 search). A
discussion of these types of liens is beyond the scope of this article and is therefore omitted.
40 See U.C.C. § 9-611 (2013); see also Colonial Pac. Leasing Corp. v. N&N Partners, LLC, 981 F.Supp.2d 1345,
1350 (N.D. Ga. 2013); John Deere Constr. & Forestry Co. v. Mark Merritt Constr., Inc., 678 S.E.2d 183, 184-
The bottom line is that a surety that already understands the capital and financing structure of its principal (and others associated with the project) will minimize the time needed to evaluate these issues. Further, this understanding could create opportunities for a surety to be creative in how it secures access to the equipment and facilities at issue.

If the surety determines that, from a loss mitigation perspective, the most economical option is to use its principal’s equipment and facilities, what practical steps can the surety take to assure and effectuate the express rights granted under the indemnity agreement? Two potential steps are discussed below.

1. **Underwriting and Pre-Default**

First, the surety has an opportunity during the underwriting stage to determine whether there are any competing interests in the principal’s equipment and facilities. For any equipment and facilities needed to perform the bonded contract, and particularly if not the type readily available in the marketplace, the surety should condition issuance of the bond upon execution of a utilization agreement with the principal, as well as any lender or other party holding an ownership, possessory, or security interest or lien in the applicable equipment or facilities. It is not necessary to obtain a utilization agreement with respect to assets in which the surety has a first priority perfected security interest, but a utilization or other consent agreement may be necessary to obtain access to the assets. In practice many sureties do not perfect any security interest granted in the indemnity agreement on the front end, but only seek to perfect such interests once a default has occurred. By that point other competing parties generally have liens of record.

2. **Default**

Next, in the event of the principal's default, if not before in connection with a books and records review, the sophisticated surety will immediately evaluate the need for particular equipment to perform the bonded obligations. The ability to use the principal's equipment already on the job site avoids the time and expense of obtaining an alternative source for renting necessary equipment, as well as the associated mobilization costs. Often, equipment such as large cranes, certain trenching and mining equipment, specifically fabricated equipment, and other robotic equipment is difficult to replace.

There are also situations where, in addition to use of the equipment, the surety needs access to the principal's owned or leased facilities in order to complete the bonded work. For example, if the principal fabricates much of its inventory incorporated into a job, or fabricates forms that are used in connection with the work, then the surety may need access to the facilities that are used in such fabrication. Other examples where the surety needs access to facilities include when construction equipment is maintained at a yard, or when the principal is in any type of business that provides municipal or other general services, often in the areas of maintenance, trash pick-up, ambulances, school buses, and other transportation services where vehicles are maintained at facilities either owned or leased by the principal.

It is often difficult to convince a lender or other creditor that it is in its best interests to allow the surety to utilize its collateral for completion of bonded contracts, particularly when the
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other creditor is fully collateralized. But, understanding the principal’s capital structure and the lender’s or financing party’s loan documents will assist the surety in making its case from the perspective of the lender or other financing party. The advantage to securing such an agreement pre-default is that the surety will not then be held hostage by a competing creditor seeking payment of some exorbitant rent, or be denied the necessary access. At this pre-default stage, the surety has the leverage of refusing to issue the bond without utilization being addressed. Also, the borrower principal has a credit relationship with its lender that presumably the lender wants to maintain. Relationship managers with a lender are more amenable to accommodating requests of the lender's client than the special assets department. No matter when an agreement is reached though, the creditor will require compensation to allow the surety to utilize collateral to which competing rights are asserted. If the collateral is of the type that is generally rented, such as construction equipment, then the use rate can be determined by reference to the Blue Book, the Green Book, or certain Department of Transportation, Corps of Engineers, and other government issued manuals. The more unique the asset, such that it is not rented on a regular market, the more likely it will be necessary to resort to an appraisal. It may be key to continuity of performance that the surety’s right to utilize the equipment and facilities commence during the period that the surety and creditor negotiate the compensation.

Is there a transactional alternative that will allow the surety to extract value from the principal’s equipment to minimize or mitigate loss? Sometimes, the availability of the principal’s equipment to a completing contractor or other performing entity is essential to minimizing financial risks attendant to completing a project or performing an obligation. For instance, the principal may have acquired a facility or plant that produces materials on-site for construction of particular work scheduled in phases. The principal’s expectation could be that it will be awarded work in future phases, and its capital expenditure for the facility on the front end will assure profitability (and a lower bid) for later phased work. First, a surety should review whether its indemnity agreement grants it a security interest in that facility or plant. Second, if it does and the facility or plant is immovable, it could be deemed a fixture under local law.41 In that instance, a surety should consider recording its interest in that facility or plant with both the UCC filing office and as a fixture with the local office in which real estate interests are recorded. The surety should also look at the underlying bonded contract and applicable rules and specifications regarding the use of equipment. State departments of transportation and federal government contracts often include provisions that allow the owner to continue to use a defaulting contractor's equipment for completion of the contract work.

Assigning an interest in a plant or facility to a completion contractor in exchange for a reduction in the completion price (along with use consents from the defaulting principal) may be a means for extracting value to mitigate surety loss. A surety may also consider acquiring a participation interest in the lender’s lien on a principal’s plant or equipment. In such an arrangement, the surety pays a portion of the principal’s debt owed to the lender in exchange for

41 White v. Cty. Mortgagee Corp., 211 So. 2d 254, 255-256 (Fla. Dist. Ct. App. 1968) (finding that elevators and machinery that could be removed without damage to the premises were not fixtures); see also Med. Tower Corp. v. Otis Elevator Co., 104 F.2d 133, 137 (3rd Cir. 1939) (elevators became integral parts of building and were fixtures); In re Smith Materials Corp., 108 B.R. 784, 787-88 (Bankr. M.D. Fla. 1989) (concrete block and batch plant were not fixtures); Vitale v. State, 307 N.Y.S.2d 375, 376-77 (N.Y. App. Div. 1970) (concrete batch plant was a fixture because it was a permanent installation).
the use of that equipment and the right to participate in the proceeds of the subsequent sale of the equipment.

A construction default and takeover is a typical performance claim scenario that illustrates many of the discussion points contained in this paper, though the concepts and considerations discussed also apply in commercial bond contexts in which the underlying obligation contains a performance component. For instance, some U.S. Department of Agriculture bonds require a performance bond to assure certain production requirements under programs in which the principal is provided (e.g., poultry) by the Federal Government or participating state agency. Further, bonds pertaining to private entities operating public functions (e.g., correctional facilities or pharmacies and healthcare facilities in correctional facilities) may have a performance component. In either instance, the use of the principal’s facilities and equipment to perform the bonded obligation could be instrumental in minimizing surety loss and exposure.

C. Labor and Project/Office Personnel

Labor and project/office personnel are often also critical to a completing surety. While the focus of this paper is not on financing the principal, a surety should consider the role of key labor and/or project/office personnel in any completion scenario.

D. Computers, Hardware, and Software

Access to computer stored information is one of the most important items necessary for a surety to complete a bonded contract, investigate and resolve any payment bond claims, and mitigate its loss. If the principal contractor has a secured lender, then that secured lender will generally have a perfected security interest in these assets. Computers are not assets from which a creditor will be able to obtain any meaningful monetary recovery in a foreclosure and often only have ransom value to the lender. If approached on the front end, the lender is generally amenable to allowing the surety to have priority to these assets or at least access to them without any requirement that any fee be paid.

III. Seeking Control of Assets Needed for Project Completion and Concerns Generally

The focus of this paper is not to evaluate the outcome of disputes between and among the surety and lenders in the various project assets needed for completion. Instead, the focus of this paper is to provide a general, topical overview of how the sureties’ rights and interests in assets needed for completion, and its exercise of those rights and interests, could affect or intersect with the rights of third parties providing capital to the principal or a project. The most notable areas in which these rights and interests intersect are the principal’s bonded receivables and its equipment.

A. Surety’s Rights in Bonded Receivables Generally

A surety’s rights in bonded receivables are founded upon three primary theories. First, the bonded receivables are trust funds under the terms and provisions of the surety’s indemnity
agreement, under the bonded contract, and/or by statute. Second, the bonded receivables are subject to the surety’s equitable subrogation rights. Third, the bonded receivables have been assigned to the surety under its general indemnity agreement, and, to the extent the surety has recorded a UCC financing statement, the surety has a perfected security interest in those receivables.

1. Surety Rights in Bonded Receivables and Loan Covenant Defaults under Lender Documents

From the lender’s perspective, notwithstanding the surety’s position, the bonded receivables are often part of the lender’s collateral for loans advanced to the principal under the various loan agreements. Under those documents, in addition to terms governing payment, most contain loan covenants, an unexcused or unwaived breach of which typically results in a default and the acceleration of the entire unpaid debt under the loan instrument. Example loan covenants include requiring the borrower to maintain specified financial ratios and thresholds, to pay taxes, to maintain insurance on lender collateral, or to provide financial reporting. Others prohibit the borrower from granting junior liens on lender collateral without lender consent or prohibit the use of lender collateral to pay other debt without lender consent. Financial covenant examples include requiring a borrower to maintain certain debt to income ratios or requiring the borrower to retain certain capital levels prior to making distributions to the owners. Almost all loan documents contain cross-default provisions that provide, in effect, any breach or default under one loan is a breach or default under all loans. Thus, a principal with a complex and relatively sophisticated capital structure, (e.g., an equipment loan, a real estate loan, a line of credit, a short-term working capital loan, or long-term loan) could be in default of all loans if it is in breach of any covenant or condition under any one loan. Moreover, as many loans are guaranteed by the owners of the principal, a default under one loan (or in fact a default under a guaranty) could trigger a default under all loans.

42 See 3 PHILIP L. BRUNER & PATRICK J. O’CONNOR, BRUNER & O’CONNOR ON CONSTRUCTION LAW § 10:103.10 (2018); COLO. REV. STAT. ANN. § 38-22-127 (West 2018); DEL. CODE ANN. tit. 6, § 3502 (West 2018), 770 ILL. COMP. STAT. ANN. 60/21.02 (West 2018); MD. CODE ANN., REAL PROP. §§ 9-201 to 9-204 (West 2015); MICH. COMP. LAWS. ANN. §§ 570.151-153 (West 2018); MINN. STAT. ANN. § 514.02 (West 2018)); N.J. STAT. ANN. § 2A:44-148 (West 2018); N.Y. LIEN LAW §§ 70-79-a (McKinney 1993 & Supp. 2004); OKLA. STAT. ANN. tit., 42, §§ 152, 153 (West 2018); S.C. CODE ANN. § 29-7-10 (2018); S.D. CODIFIED LAWS § 44-9-13 (2004); TEX. PROP. CODE ANN. §§ 162.001-.033 (West 2017); VT. STAT. ANN. tit. 9, § 4003 (West 2018); WIS. STAT. ANN. § 779.16 (West 2017).)

43 Pearlman v. Reliance Ins. Co., 371 U.S. 132, 140 (1962); U.S. Fid. & Guar. Co. v. Hous. Auth. of Berwick, 557 F.2d 482, 484-85 (5th Cir. 1977) (surety may assert subrogation rights to exercise obligee’s set off rights against principal to recover unrelated funds the obligee owes the principal); see also In re Larbar Corp., 177 F.3d 439, 446-47 (6th Cir. 1999) (case allowing surety to exercise obligee’s right of set off and allowing surety to recover excess retainage on one project to reduce losses on other project).

44 See U.C.C. § 9-312 (2013). A Security interest in cash may be perfected by possession. See id. Security interests in a deposit account may only be perfected by control. See id. A secured party has control of a deposit account if: (1) the secured party is the bank in which the deposit account is maintained; (2) the debtor, secured party and the bank have agreed in an authenticated record that the bank will comply with instructions by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or (3) the secured party becomes the bank’s customer with respect to the deposit account.
2. Impact of Owner-Developer Default on Project

Many construction loan documents between the lender and the owner, particularly an owner-developer, contain certain “owner default” provisions that include, among other things, an owner-developer’s failure to: (1) properly disburse funds advanced by the lender; (2) keep the project free of liens; or (3) timely complete the project. In the event of an owner default, the lender typically has the right to accelerate the entire debt, refuse to make further disbursements, and foreclose its mortgage or deed of trust on the underlying real estate and other collateral. Thus, a surety for a general contractor principal, or a subcontractor principal, may see that no further funds will flow-down to the general contractor or principal. Of course, the lack of payment may present a defense to performance by both the principal and its surety. But the lack of payment may also impact the principal’s ability to pay its own subcontractors and suppliers, and other debt.

Notably, a lender that forecloses its mortgage or deed of trust in the above-described scenario often ends up owning, typically through a special purpose entity, the underlying project and may end up funding the project to completion because the value of its collateral (the development) will only be realized upon completion. Further, many development projects have tax credits associated with them that are valuable to both the developer and its lender. A surety that understands the capital and financing structure of a project, and, therefore, understands the perspectives and financial incentives of the various constituencies, may find itself with opportunities to be creative in developing its own loss mitigation strategy.

3. Contractor Claims Against Lender

Contractors have asserted that an owner’s lender that assumes control over an owner after default, and asks the contractor to remain on the project, is obligated to pay the contractor. Generally, absent an express agreement to assume the underlying contract, a lender is not likely to be held liable to pay the contractor. But, in SNS Contractors v. Algernon Blair, Inc., the Fifth Circuit found that the lender assumed the obligation to pay the contractor when it took a consent and certification from the contractor that provided the contractor would abide by an assignment from the owner to the lender. Additionally, a lender’s exercise of control over its borrower and/or its funds could expose the lender to claims. For instance, in Sandpiper North Apartments, Ltd. v. American National Bank and Trust of Shawnee, the Oklahoma Supreme Court determined that a subcontractor’s lender who received payments from the contractor by joint checks payable to lender and the subcontractor could qualify as an involuntary trustee of funds owed to subcontractor’s subcontractors under Oklahoma’s construction trust fund statute, and therefore could be liable for payments received. But, that court also found that the contractor waived its

45 See 3 BRUNER & O’CONNOR, supra note 42, § 8:101.
47 Id.
48 892 F.2d 430, 436 (5th Cir. 1990). Note that “[w]here a lender assumes control over funds available to the owner, the lender may incur liability.” See 3 BRUNER & O’CONNOR, supra note 42, § 8:106.
trust fund claims because it knew its subcontractor financed its receivables with the lender and actively participated with and cooperated in making the joint check arrangement.\textsuperscript{50}

As evidenced by the above cases, the owner’s agreements with its lender and a contractor’s or owner’s payment arrangements with a lender could create potential sources for contribution under either an assignment theory or under a trust fund theory. Thus, a surety should be mindful of these agreements and arrangements, if any, as potential loss mitigation opportunities in any completion scenario.

\textbf{B. Letters of Direction for the Surety and Control Accounts}

In a default scenario, given the surety’s rights and interests in bonded receivables payable under the bonded contract, and to mitigate loss, it is advisable for the principal to issue letters of direction to its bond obligees to make sure that those funds are used for completion of the bonded work and to pay subcontractors and suppliers on the bonded project. By the time this occurs, the principal may already be in default with its lender and the unpaid balance of the debt owed to the lender has already been accelerated. But, the issuance of those letters of direction by the principal may very well be a default under the principal’s loan documents with its lender. As such, it may be beneficial for the surety to engage the principal’s lender, particularly if the surety and/or the lender are considering providing financing to the principal for completion of the project.

A surety often considers the use of a control account to receive bonded receivables to be used for completion of a bonded contract. This may be an effective means of assuring that bonded receivables are used for completion and for the payment of subcontractors and suppliers. But, the use of a control account has some potential pitfalls.

First, a bank may be allowed to seize funds in a control account when the principal owes money to the bank.\textsuperscript{51} The account may also be subject to garnishment by claims of a principal’s creditors.\textsuperscript{52} In some jurisdictions, a jointly owned bank account may be the only interest actually owned by the garnishment debtor, and any person, including the co-owner, may seek to have garnishment dissolved.\textsuperscript{53} In other jurisdictions, it has been held that “the entire account is vulnerable.”\textsuperscript{54} But, the party opposing the garnishment can submit evidence showing his or her ownership.\textsuperscript{55} Ultimately, the range of outcomes for a creditor attempting to garnish a joint bank account could range from: (a) the entire account is immune from garnishment; (b) the entire account is vulnerable; or (c) some portion is not subject to garnishment based upon whether a

\textsuperscript{50} Id.
\textsuperscript{52} See Fleet Bank Conn., N.A. v. Carillo, 691 A.2d 1068, 1071 (Conn. 1997).
\textsuperscript{55} Id.
party can show ownership in a particular portion of the whole.\textsuperscript{56} Consider that a surety who has control over a contractor or of funds available to the contractor may also be exposed to potential liability.\textsuperscript{57} In \textit{Pacific National Insurance Co. v. United States.}, the surety provided financing to its principal in amounts equal to the principal’s net payrolls.\textsuperscript{58} The surety also worked with the principal to secure a $150,000 loan for the principal from a bank, a loan that was secured by an anticipated $150,000 to be earned on contracts bonded by the surety.\textsuperscript{59} The loaned funds along with the bonded receivables were deposited into surety controlled accounts.\textsuperscript{60} Disbursements (of both the loaned funds and collected receivables) were made only on a joint signature of an employee of the surety and the accounting firm retained by the surety to control the funds.\textsuperscript{61} Under these facts, the court held that by exercising dominion and control over all income of the principal (including the loan funds from the bank which the court noted did not belong to the surety), the surety became obligated to collect and remit surety exercised dominion and control over funds belonging to the principal, and in doing so was a person obligated to collect income and FICA tax.\textsuperscript{62} The court also stated that the surety would not be liable when acting as a mere lending agent.\textsuperscript{63}

The takeaway from the \textit{Pacific National Insurance Co.} case is that to avoid exposure, the principal contractor should remain responsible for payroll and the sureties need to be very careful should it seek to gain control over the contractor’s general funds. If a surety advances funds for payroll, it should do so only into a third-party payroll administrator account or a segregated payroll account controlled by the principal with the principal being responsible for taxes. The added protections provided from claims of other creditors makes the former the preferred method. A financing surety should also get verification from the principal that it is remitting its taxes, and the failure to provide the verification is a default that precludes further financial assistance from the surety.

\section*{C. Trust Fund Disputes with Lenders and Tracing}

A surety’s trust fund provision in its Indemnity Agreement as well as construction trust fund statutes are beneficial to a surety as the surety attempts to secure those funds for completion of a bonded project or to pay bonded payables. Those potential trust funds include both funds payable to the principal (but not yet paid) and funds paid to the principal. Those funds may be in a principal’s deposit account with its lender, and subject to being swept by the bank and applied to loan debt.

\subsection*{1. Breach of Trust Fund Obligation and Non-Dischargeability}

In the event of a bankruptcy filing, a principal that makes payments in contravention of its trust fund obligations under applicable law may not be able to get a discharge of its obligations to the

\begin{thebibliography}{1}
\bibitem{delta} \textit{Delta Fertilizer, Inc.}, 547 S.2d at 802 (citing Hayden v. Gardner, 381 S.W.2d 752 (Ark. 1964) (quoting \textit{Garnishment}, 71, HARVARD L. REV. 557 (1957-58))
\bibitem{bruner} See 3 \textit{BRUNER & O’CONNOR, supra} note 42, § 8:106.
\bibitem{bruner2} 270 F. Supp. 165, 169 (N.D. Cal. 1967).
\bibitem{bruner3} \textit{Id.}
\bibitem{bruner4} \textit{Id.}
\bibitem{bruner5} \textit{Id.}
\bibitem{bruner6} \textit{Id. at 172.}
\bibitem{bruner7} \textit{Id. at 173.}
\end{thebibliography}
surety under the indemnity agreement, or its obligations to other trust beneficiaries under trust fund statutes.\(^{64}\) Under 11 U.S.C. § 523(a)(4), a discharge will not be granted for a debt “for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny.” A dischargeability analysis under § 523(a)(4) asks: (1) whether an express or statutorily (sometimes referred to as “technical”) created trust exists; (2) whether the debtor owed a fiduciary duty arising from that trust; and (3) whether the debtor breached that duty through defalcation. Federal courts interpreting §523(a)(4) generally agree that the fiduciary capacity required must arise from a trust created prior to the defalcation and without reference to it.\(^{65}\) Further, § 523(a)(4) has a scienter requirement, meaning the conduct must be more than mere negligence.\(^{66}\) But, when a fiduciary breaches a known duty, that “per se” conduct constitutes defalcation even if the conduct does not qualify as actual fraud.\(^{67}\) So, a surety may want to consider including in correspondence to its principal a reminder of the principal’s trust fund obligations under the indemnity agreement and include a reminder that the failure to comply with those obligations may deem any debt owing to the surety non-dischargeable in bankruptcy.

### 2. Surety Claims Against Principal’s Lender

A trust fund provision in the indemnity agreement could give rise to a claim against the principal’s lender that received trust funds from its principal or otherwise swept trust funds from the principal’s deposit accounts with the lender. For instance, as the principal begins to suffer financially and is unable to meet its obligations on bonded and/or unbonded construction projects as they become due, the surety will begin to receive claims under its payment bonds and, perhaps, notices from obligees of potential performance bond claims. Additionally, the principal may not be able to meet its payment obligations to its lender under a working line of credit, resulting in a default. In addition, the principal’s bank may require the principal to allow all funds on deposit, including bonded contract proceeds, to be swept daily with the principal using the line of credit as its exclusive source of funding. While these arrangements may go without incident with financially healthy principals, when a default occurs, the bank and the surety often find themselves in conflict over proceeds of bonded contracts.

This exact situation arose in a case filed in the United States District Court for the Eastern District of Tennessee in *Selective Insurance Company of America v. Environmental, Safety & Health, Inc.*\(^{68}\) In *Selective*, the suretybonded Environmental, Safety, & Health, Inc. on several public projects, including a project for the State of Tennessee and a project for the United States Army Corps of Engineers.\(^{69}\) First Tennessee issued a line of credit to ES&H. During the performance of the bonded contracts, First Tennessee directed ES&H to apply bonded contract proceeds to pay off the line of credit. This in effect swept trust funds intended for the bonded projects.

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\(^{65}\) *In re Caples*, 454 B.R. 191, 197–98 (Bankr. N.D. Ala. 2011) (“[F]ederal courts have ‘articulated a requirement that the trust relationship have existed prior to the act which created the debt in order to fall within the statutory [fiduciary capacity] exception.’”).


\(^{67}\) *Fin. Cas. & Sur. Co. Ins. v. Thayer*, 559 B.R. 102 (D.N.J. 2016) (allowed surety’s fees for pursuing non-dischargeability claim properly included in non-dischargeable debt because would not have incurred but for the defalcation).


\(^{69}\) *Id*. at *2. Environmental, Safety, & Health, Inc. will be referred to hereinafter as “ES&H.” United States Army Corps. of Engineers will be referred to hereinafter as “USACE.”
proceeds to First Tennessee’s line of credit. Later, and after the surety had advised First Tennessee of its rights to the bonded contract proceeds and the trust fund nature of such funds, First Tennessee defiantly swept a progress payment received from the USACE immediately upon deposit into ES&H’s bank account.

Having been deprived of the benefit of the bonded contract proceeds and due to First Tennessee’s knowing violation of the surety’s rights, the surety filed suit against its indemnitors and First Tennessee seeking, inter alia, recovery from First Tennessee for any bonded contract proceeds swept by the bank and/or applied to the line of credit. Among the causes of action alleged by the surety was conversion of bonded contract proceeds. The surety asserted that the bonded contract proceeds constituted trust funds in which the surety was the beneficiary.

The basis for the trust fund theory included the trust fund language in the surety’s general agreement of indemnity, trust fund provisions under applicable state and federal law and regulations, and trust fund provisions under the respective bonded contracts.

First Tennessee filed a motion to dismiss the surety’s conversion claim. First Tennessee asserted, in general, that the bonded contract proceeds were not trust funds, the bank was not subject to any trust obligation imposed on the bonded contract proceeds, and the bank had a superior right as a secured creditor to the bonded contract proceeds. The surety sought to establish the trust fund nature of the bonded contract proceeds, its rights to those funds, and the unlawful nature of First Tennessee’s exercise of dominion/control of those funds.

In a well-reasoned opinion, the court ruled that the surety had, in fact, stated a claim for conversion against First Tennessee. The court did not address all of the trust fund theories the surety asserted, as the court concluded that dispute as to the trust fund nature of the bonded contract proceeds “begins and ends with the terms of the GAI because it finds that the GAI creates an express trust under Tennessee law.”

The court found that the surety’s GAI satisfied all of the requirements of the creation of an express trust. The court further found that ES&H was the trustee of the trust and had duties including dedicating the bonded contract proceeds for the exclusive purpose of satisfying the conditions of the surety’s bonds (such as paying ES&H’s subcontractors and suppliers), and, upon demand, depositing the bonded contract proceeds into a separate trust account. The Court

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70 Id.
71 Id.
72 Id.
73 Id. at *1-2.
74 Id. at *4. Selective’s general indemnity agreement will be referred to hereinafter as “GAI.”
75 Id. at *3
76 Id. at *4.
77 Id. But see Acuity v. Planters Bank, Inc., 362 F. Supp. 2d 885, 893 (W.D. Ky. 2005) (stating that under Kentucky law while the indemnity agreement evidenced an intent to create a trust, “there was an ‘absence of coincidence between the existence of a trust res and a declaration of intent’ which is a requirement of Kentucky law.”); see also In re Constr. Alts., Inc., 2 F.3d 670, 677 (6th Cir. 1993) (stating that the indemnity agreement at issue did not create a trust because it did not require contractor to keep funds segregated as required by Ohio law).
79 Id.
found that the surety and ES&H’s subcontractors and suppliers were definite beneficiaries under the trust. The court found that the trust contained identifiable property, which consisted of “all funds paid, due, or to become due under the bonded contract.” The court concluded “[t]hat [the surety] has properly alleged itself as the true owner of property at issue.”

Numerous courts throughout the country have acknowledged the surety’s rights to bonded contract proceeds after performance under the doctrine of equitable subrogation, and some courts have acknowledged the trust fund nature of the bonded contracts funds. However, there are very few reported decisions directly addressing the rights of a surety against a bank who improperly takes control of bonded contract proceeds prior to the surety suffering a loss. The court in Selective did just that. As is addressed in more detail in its opinion, the court clearly recognized the unique nature of bonded contract proceeds, the surety’s right to rely on those proceeds for its protection, and the bank’s liability for violation of those rights.

a. Notice to Lender

One of the issues raised by the lender in Selective was that the surety did not allege the lender had knowledge of the trust fund nature of the bonded contract proceeds. The court declined to consider that issue because the lender raised it for the first time in its reply brief. But, notably, while not referenced in the opinion, the surety gave written notice to the lender of its trust fund rights in the funds on deposit with the bank. Further, the bank performed a UCC search and found the surety’s recorded GAI in its search. The GAI included language providing that the GAI and declarations contained therein were notice of such trust. Thus, the surety argued that the bank had both actual and constructive notice of the trust created by the GAI.

Although not at issue in Selective, notice to a lender could be an issue in any action the surety might consider against the lender seeking return of funds paid to the lender by its principal, or swept by the lender from the principal’s deposit account. The question then becomes whether and when to give notice to the lender? For instance, should the surety give notice to a lender at the outset of the bonding arrangement? Or, should the surety give notice when the principal is experiencing financial difficulty or after a default?

A principal that is not paying its subcontractors and suppliers is likely also having difficulty paying its lender. Thus, a lender that has control of funds has a better opportunity to access those funds and sweep them to cover debt payments. Providing notice to the lender will likely improve the surety’s rights and position relative to any funds that are subject to the trust because a lender that has notice of the trust fund nature of those funds may not be able to offset those funds against lender debt and may in fact be liable to the surety for doing so. Another form...
of constructive notice could be to record the trust fund provision of the indemnity agreement in the public records. However, it is unclear whether a court would find this type of filing to constitute effective notice. If a surety decides to give notice, direct notice is the preferable method to buttress trust fund rights.

Conversely, notice to a lender could also impact the flow of funds to the principal under a short-term working capital loan by causing the lender to become insecure or making it aware of a possible breach of a loan representation or covenant that no other party has an interest in the borrower’s receivables superior to that of the lender. If the principal is unable to access bank funds, it may not have sufficient funds to cover short-term obligations on its projects. In some cases, principals have pursued claims against sureties relating to alleged interference with a lending relationship. But, sureties have not been held liable for tortious interference to the extent they act pursuant to their rights under the indemnity agreement.

b. Tracing

In many cases, a lender may argue that the fact that funds are not segregated are not trust funds, which may be one of the requirements for establishing a trust under local law. Thus, the fact that trust funds have been co-mingled with non-trust funds could defeat a claim against the lender.

But, if a surety finds itself in a jurisdiction that does not require segregation of funds to establish a trust, it will have to resort to tracing. The rule that a “beneficiary of an insolvent trustee debtor in bankruptcy must be able to trace its funds to claim any property of debtor applies to insolvent debtor trustees of both express and implied trusts.” Where the debtor has comingled contract funds with other funds, determining which funds belong in the bankruptcy estate and which funds constitute contract funds can be incredibly difficult. Tracing has been described as “the process used by courts in many different areas of law to identify and segregate property that has been mingled with other property in such a manner that it has lost its identity. This includes all types of property, from logs in a river or wheat in a silo to cash in a deposit account.” In order to allow the creditor-beneficiary to trace proceeds to a co-mingled bank account, courts have adopted several artificial tracing techniques.

The most common tracing technique used by courts is the “lowest intermediate balance test.” Under the lowest intermediate balance test, it is assumed that the proceeds being traced are the last funds to be withdrawn from the co-mingled account. If the withdrawals from the account during the relevant tracing period do not make the balance of the account less than the amount of the trust funds, the trust funds are entirely traced. If the trust funds are partially withdrawn, the balance remaining is traceable. However, if the traced proceeds are completely

86 Id.
87 See also In re Constr. Alts., Inc., 2 F.3d 670, 677 (6th Cir. 1993) (stating that the indemnity agreement at issue did not create a trust because it did not require contractor to keep funds segregated as required by Ohio law).
withdrawn, they are considered lost, even if the debtor makes subsequent deposits into the account. As a practical matter, the rule assumes that the debtor spends his own money from the co-mingled account before he spends funds that the creditor has asserted a right to.91

Other techniques for tracing employed by courts include: (1) the last-in, first-out approach; (2) the pro-rata approach; and (3) the first-in, first-out approach. Under the last-in, first out approach, the court will relate “deposits and withdrawals based on temporal contiguity.”92 Put simply, under this approach, the last money put into the account is considered to be the first money subsequently withdrawn. Under the pro-rata approach, “a court may consider identifiable proceeds as a pro-rata share of the co-mingled account, the share being determined by the percentage of collateral owned by the secured creditor before the proceeds were co-mingled.”93 Under the first in, first out approach, the court presumes that the funds were paid out in the order which they were paid in, and the parties claiming ownership are equitably entitled to any allowable preference in the inverse order of the times of their respective payments into the fund.94 Ultimately, “no one of [these tracing techniques] has an inherent quality that makes it superior to any other in all circumstances. However, one may be far superior to the others, depending upon the circumstances.”95 The surety should therefore be aware of the various methods of tracing to allow it to argue in favor of the most appropriate method for the circumstances at hand. It is critical that the surety identify the trust and amount at the commencement of the case so that those funds can be segregated from the Debtors’ other funds and used solely for bonded obligations.

D. Equipment Transfers to Surety Controlled/Leased Warehouse

A principal’s equipment and/or materials may be critical to loss mitigation for a surety completing a project, and, thus, control of that equipment and materials is essential to assuring its availability for the project. But, the equipment is often subject to a prior perfected security interest in favor of the principal’s lender, who may wish to take possession of the equipment and foreclose. Unless the surety is prepared to purchase the equipment, it will likely be unable to prevent a foreclosure sale96 even if the sale is for a below market price.97 Trustees for principal’s in bankruptcy or a debtor-in-possession in a Chapter 11 case may also have an interest in liquidating the principal’s equipment, or a surety may find that a taxing authority or judgment creditor has rights in that equipment under applicable law.98 Nonetheless, because some of the equipment is specialized, or perhaps the lead times associated with acquiring the equipment are lengthy, or simply to prevent it from being damaged or stolen, sureties often choose to take control of a principal’s equipment and materials by transferring these items to a surety-controlled or leased warehouse.

91 Stoddard, supra note 89, at 143.
92 United States v. Henshaw, 388 F.3d 738, 741 (10th Cir. 2004).
93 Van Diest Supply Co. v. Shelby Cty. State Bank, 425 F.3d 437, 441 (7th Cir. 2005).
95 Stoddard, supra note 89, at 149.
96 Some states require court approval while others allow private foreclosure sales. See Patrick J. O’Connor, Jr., Carter B. Reid, & Ann M. Conway, Ch. 9, Defenses, in The Surety’s Indemnity Agreement: Law and Practice 405, 418 (Marilyn Klinger et al. eds., Am. Bar. Ass’n, 2d. ed. 2008).
98 Id. at 148-50.
The transfer of the equipment and materials to a surety-controlled warehouse does not defeat a lender's security interest, nor will it prevent a lender from foreclosing on its collateral. However, it will at least allow the surety the ability to take steps to obtain ownership of the equipment if needed in order to complete the job. It is often not the actual cost of the equipment that is of critical importance to the surety, but the ability to use the equipment in order to avoid further delay in the completion of the project. In the event there is any equipment that the contract principal has ordered for which it has not been paid, the surety should consider making payment directly to the vendor and obtaining title to the equipment. Also, in many situations, the purchase orders with the supplier specifically provide that title to the equipment does not pass until payment is made in full. If payment has been made by the general contractor or owner to the principal contractor or subcontractor for the equipment, then the underlying documents are likely to provide that title to this equipment and materials has passed to the general contractor or owner and title is no longer held by the principal contractor. Accordingly, it is important that the surety look into all of these issues and the underlying documentation should there be a dispute as to rights in equipment and materials.

IV. Pre-default and Post-default Agreements Among Parties with Interests in Working Capital and Assets Needed for Completion

The surety’s indemnity agreement, state trust fund statutes, and trust fund provisions in a bonded contract present opportunities for the surety to secure bonded contract funds for completion of bonded work and thus mitigate loss. A lender shares a similar objective to a surety in mitigating loss under its loan agreements with the principal. Thus, while a surety and the lender may have competing claims to the same collateral, they may find that their interests are aligned depending on the nature of the bonded project. While a lender may not be willing to “lend into” a troubled principal situation, it may be willing to entertain other financial accommodations, particularly if doing so will help preserve collateral value and/or reduce the risk of the borrower being unable to pay indebtedness owed to the lender. Thus, an intercreditor agreement or other arrangement could be worth considering and could create opportunities for a surety and a lender to be creative in mitigating their respective losses. Typical arrangements are discussed below.

A. Standstill Agreements

Sometimes, like many debtors, the principal simply needs time to collect bonded revenue to satisfy unpaid subcontractors or suppliers, pay overhead, or finance a portion of the next phase of work. The principal may have one or more projects with substantial bonded contract balances remaining that, upon completion, would be sufficient to satisfy the principal’s inability to pay equipment finance obligations, or pay subcontractors or suppliers on other projects. A surety’s due diligence review of its principal’s financial strength, taking into account its bonded backlog, could lead the surety to conclude that the principal might prevail. In these circumstances, a surety may want to consider the use of a standstill or forbearance agreement to improve its position with respect to collateral supporting its bonding facility.

Under a standstill agreement, a surety agrees with its principal (and sometimes also the indemnitors) to standstill or forbear from exercising rights the surety may have against them and
in collateral. An agreement to forbear from exercising rights may constitute new consideration which, in the bankruptcy context, may support a new value defense to any preference actions seeking to avoid collateral pledges to the surety in connection with the standstill agreement. A standstill agreement often includes the principal’s acknowledgment of default under the bonds and the surety’s indemnity agreement and that the surety has an immediate right to enforce its rights. These rights may include the right to enforce any other agreement supporting the surety bonding facility (i.e., cash collateral agreements or other agreements under which the surety acquires rights in collateral). A standstill agreement may also be used between or among other sureties or with lenders, and may contain provisions similar to those found in intercreditor agreements.

In the event that, in connection with the standstill agreement, the surety acquires rights in new cash collateral or the principal acknowledges the surety’s rights in bonded contract balances, it may be prudent for it to also obtain certain acknowledgments from a depository institution in which cash collateral or bonded revenue is deposited. Those acknowledgments may be included in the form of a funds control agreement, which could range from a simple joint account agreement to the preferred cash collateral agreement. These documents can provide the surety with the rights of a secured party and protect funds in the account from claims of creditors.

**B. Funds Control Agreements**

A funds control agreement is often used with a financially distressed principal to assure that bonded contract funds are used to pay bonded obligations. While the primary uses include costs for labor, equipment, supplies, and obligations for which the surety is or may be liable under its bonds, some agreements have permitted the use of funds to pay certain agreed overhead cost of the principal as well as engineers, consultants, and accountants. Excess funds, if any, may be applied to surety loss.

A joint account agreement is a form of funds control agreement. Under these agreements, the principal and the surety agree to establish a joint bank account to administer bonded contract funds. The surety and the principal own the account, which can be problematic for the reasons referenced in the above Section III.B. The account requires signatures by both the surety’s and the principal’s respective representatives.

Under a third-party funds control agreement, the bonded contract funds are deposited in an account controlled by the surety and/or an agent. The designated agent is typically a consultant, accountant, or other professional retained by the surety to act as its agent to assist in the administration of the principal’s bonded contract funds deposited into the account. The agreement specifies the approved uses of the funds, and often the agent has discretion to disburse funds for those uses and/or criteria. The surety usually has the sole and absolute discretion to approve or not approve any disbursements from the control account.

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100 Michael Franks, Matthew M. Horowitz, & Cynthia E. Rodgers-Waire, supra note 35, at 133.

101 See also Martha A. Churchill, Annotation, Joint Bank Account as Subject of Attachment, Garnishment, or Execution by Creditor of One Joint Depositor, 86 A.L.R. 5th 527 (2001).
Cash collateral agreements also assure the use of funds for bonded obligations. These are sometimes used by a surety that is financing its principal. The cash collateral agreement typically provides that the account is owned by the surety or its agent (a third-party consultant or financial institution), but as a precaution will also include the principal’s grant of a security interest in the cash collateral account established under the agreement to the extent that it has any rights in the account. These agreements are intended to protect the surety from other creditor claims to the funds. All bonded contract funds are deposited into the cash collateral account, and, if the agreement is established pursuant to a surety financing arrangement, any funds that the surety has agreed to advance under its financing arrangement.

Under Article 9 of the UCC, a secured creditor perfects a security interest in a deposit account by control.\textsuperscript{102} Control under Article 9 requires: (i) that the secured party is the bank with the deposit account; or (ii) the debtor, the secured party, and the bank agree that the bank will comply with the secured party’s instructions regarding funds in the account without further consent by the debtor; or (iii) the secured party becomes the bank’s customer with respect to the account.\textsuperscript{103} The cash collateral agreement is intended to satisfy the control requirement and, therefore, perfect the surety’s security interest in the deposit account. The perfected security interest in the deposit account is intended to be in addition to, and not in lieu of, the surety’s other rights. Thus, the cash collateral agreement should also include language declaring the funds as trust funds under the surety’s indemnity agreement, by contract, and/or applicable law and include an acknowledgment of the surety’s equitable subrogation rights in and to those funds.

Cash collateral agreements sometimes include a “zero balance account” arrangement. A zero balance account is an account with the cash collateral agent in the name of the principal. The zero balance account sometimes requires joint signatures of a surety representative and the principal. As checks from the zero balance account are presented to the cash collateral agent, those checks draw from the cash collateral account. Note that sureties avoid using financial institutions that are also lenders-creditors of the principal.

\textbf{C. Subordination Agreements}

A lender may decide that it is no longer willing to lend money to a principal unable to service its debt. But, in some instances, the lender’s collateral could be worthless without any further source of financing. Some equity or venture capital financing entities may, for instance, lend on the strength of tax credits that might be available only upon completion of a project. In such a circumstance, the lender may be willing to subordinate its security interest in collateral in exchange for financing by the surety. Some subordination agreements between the lender and the surety prohibit the principal from paying the lender until the surety is paid in full.\textsuperscript{104} Other agreements allow some payments to the lender, but the surety and lender debt is restructured.\textsuperscript{105}

\textbf{D. Intercreditor Agreements}

\textsuperscript{102} U.C.C. §§ 9-312, 9-314 (2013).
\textsuperscript{103} U.C.C. §§ 9-102, 4-104 (2013).
\textsuperscript{104} Michael Franks, Matthew M. Horowitz, & Cynthia E. Rodgers-Waire, \textit{supra} note 35, at 162.
\textsuperscript{105} \textit{Id.}
An intercreditor agreement may be entered into by a surety and its principal’s lender or among sureties and lenders. In most intercreditor agreements, each party acknowledges and consents to the other party’s liens and the parties agree to priorities as to particular assets and not to challenge their respective priorities in the collateral.

A surety’s lien priority in an intercreditor agreement often depends on the financial strength of the principal, as well as the leverage of the surety (i.e., whether it is issuing bonds or providing financing). For instance, for a principal that is financially sound – i.e. the surety is providing bonds and a lender is extending credit – the lender and the surety may agree that the surety has priority in “bonded working assets” like the bonded contracts, bonded receivables, equipment, and other assets needed for completion. The lender may have priority in other assets, like non-bonded receivables (e.g., a surety might have a security interest in non-bonded receivables under its indemnity agreement) or equipment that it specifically financed. The lender and surety may also agree to share in the proceeds of collateral on a pro-rata or other basis depending on the circumstances.

If a surety that is providing greater support (e.g., new bonds or direct financing) to a financially troubled principal, then that principal’s lender may have greater negotiating leverage, depending on the priority of the lender in the collateral, the amount of its debt, and other collateral. In these circumstances, a subordination agreement (which is essentially another form of intercreditor agreement) in which the lender subordinates its liens may be appropriate.

Ultimately, the party with the prior perfected security interest in the collateral will likely control the timing of the use of and disposition of the collateral. In a surety-lender intercreditor agreement, the parties have differing objectives.106 The surety needs the collateral to complete (or have its principal complete) the bonded projects.107 On the other hand, a lender wants to liquidate the collateral to apply to its debt.108 In a typical surety-lender intercreditor agreement, the standstill provisions often provide that the surety will not take any action against the “lender-priority collateral” until obligations owing to the lender are satisfied by the principal-borrower, and the lender will not take any action against “surety-priority collateral” until all surety loss is reimbursed and the surety has no exposure under the bonds. Additionally, intercreditor agreements often include bankruptcy provisions to protect the sureties’ rights and interests upon the filing of a principal’s bankruptcy case. These provisions have been developed in some cases in response to motions and other filings by parties in bankruptcy cases. Some of these provisions include: (a) acknowledgments that the surety holds a “claim” as defined under §105 of the Bankruptcy Code; (b) acknowledgments that the surety has standing to be heard on matters in the case; (c) time is of the essence provisions requiring prompt rejection or assumption of the bonded contracts; and (d) acknowledgements that bonded contract proceeds are not “cash collateral” under § 363 of the Bankruptcy Code which, under certain circumstances, allows the trustee or the debtor to use cash collateral.109

Intercreditor agreements come in many different forms and present opportunities for sureties and their counsel to get creative. Sometimes, a surety and a lender may agree that the

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106 Id. at 158.
107 Id.
108 Id.
109 Id. at 159-160.
surety will purchase the lender’s debt and related collateral rights. In other instances, the surety may purchase a participation interest in the loan. In the latter scenario, the lender and the loan remain in place; however, the surety purchases a portion of the debt that often includes a subordinated interest in collateral securing the loan. The lender then makes available to its borrower (the surety’s principal) unrestricted credit for use in accordance with an approved budget. The principal (and often the surety’s indemnitors that are also the lender’s guarantors) may pledge additional collateral to support the loan. The agreement also typically includes provisions regarding the timing of the use of and liquidation of collateral, and the disbursement of the proceeds to the surety-participant.

E. Equipment, Facility, and Intellectual Property Agreements

A utilization agreement is an agreement among the surety, the principal, and any lender or other party that has a security interest or lien on any equipment, personalty, and facilities that the surety would need to complete its bonded projects.\(^{110}\) A utilization agreement is not needed for property in which the surety has a first priority perfected security interest. However, there are many situations where a surety cannot obtain a first priority perfected security interest in all of the necessary property and needs to rely instead on a utilization agreement.

The right to use equipment and other property needed for completion may be critical to a surety’s loss mitigation strategy, as finding alternative sources could be more expensive and result in lost time. Locating unique and/or specially fabricated equipment may also present challenges. Further, under certain circumstances, the surety must have access to its principal's facilities to complete its bonded projects. For example, if the principal is in the business of running school buses or ambulance services, the surety will need access to buses/ambulances as well as bus/ambulance storage and maintenance facilities. Those facilities are likely subject to a lender’s security interest or mortgage, and as such a facilities utilization agreement allows the surety access to those facilities.

A typical utilization agreement (and any loan agreement) provides that the principal will not permit any lien or encumbrance to exist on any of subject property at issue absent prior written consent unless the lien holder has agreed to be bound by the terms and provisions of the utilization agreement or the lienholder has entered into a separate utilization agreement with the surety. A surety’s utilization agreement with the principal usually only allows use of the property without payment to the principal.

Utilization agreements with third-party lenders typically require payment of rent or other remuneration with respect to the property. A key advantage of entering into such an agreement with a principal’s lender on the front end is that the surety and the lender can negotiate terms without a lender exacting leverage in a default scenario and demanding an above market rental rate. Some equipment loan agreements include separate schedules showing loan amounts for specific equipment and related payments. Additionally, a mortgage or deed of trust usually refers to specific real property that secures an underlying note. In those circumstances, the required payments under the loan documents and/or note may serve as the fair payment rate for the use of the equipment and facilities at issue. But, if the loan documents do not schedule loan amounts to

\(^{110}\) Id. at 133.
loaned equipment, for instance, the parties typically will use a fair market rental for payments under the utilization agreement.

For equipment, rental rates may be found in the Blue Book, Green Book, or other publications that publish standard fair market rental rates. For facilities utilization, the parties could resort to an appraiser or appraisers to determine value. But, the lender and surety should include in any utilization agreement a provision allowing the surety to use the property while the payment structure and rate are being negotiated.

For real property, the utilization agreement should be recorded in the local office in which real property records are located so as to provide notice to third parties of the surety’s rights in and its possession of the real property.

A utilization agreement may also cover intellectual property, although technically a license agreement may be a more appropriate agreement. Generally, a license with respect to intellectual property “does not require that any rent be paid to the principal or to any third-party creditor.” The licensed property or intellectual property may also include any associated goodwill. It is important that the definition of the licensed property or intellectual property to be utilized includes the right to any associated goodwill. A sample definition for Licensed Property may be:

\[
\text{[A]ll proprietary systems, software, or any other assets of a similar nature which are employed by Principal in connection with any and all contractual work referred to in the Bonded Contracts and/or the Bonds; any and all inventions, designs, patents, patent applications, trademarks, trademark applications, trade names, trade secrets, registrations, copyrights, licenses, franchises, customer lists, and any associated goodwill that is associated with or required for the completion of any Bonded Contract and/or the fulfillment of any of Surety's obligations under the Bonds; provided, however, that Licensed Property will not include any license held by Principal to use proprietary systems, software, or other assets of a similar nature pursuant to which the consent of the licensor is required to sub-license the use of such assets to Surety unless such consent has been obtained.}
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\[\text{[111 Id. at 164.}\]
\[\text{[112 Id.}\]
\[\text{[113 Id.}\]
\[\text{[114 Id.}\]

\text{F. Impact of the Federal Anti-Assignment Act}

If a principal contractor is called in default and terminated on a Federal Government project and the surety takes over completion of the project, then obtaining remittance of remaining contract proceeds to the surety is a part of the takeover process. The governmental entity will issue a modification naming the surety as the “contractor.” In order for the surety to receive payment, the surety must have an active registration in the U.S. Government System for Award Manager
Project Capital and Financing Structure and its Impact on Project Completion

(SAM) assigned by the Defense Logistics Agency Cage Program. It is important to note that a SAM registration must be renewed annually in order to remain active.

It is also important to note that under the provisions of Federal Acquisition Regulations, the surety that takes over a project is only entitled to contract proceeds to the extent it has expended amounts in completion of the project and discharging abilities under the related payment bond. Any excess contract proceeds will not be remitted to the surety by the government in connection with a takeover. The modifications prepared by the government generally refer to the payment to the surety of the remaining proceeds under the contract, including change orders, which may not cover all proceeds of affirmative claims. Therefore, it is important to expressly cover all amounts that may be paid to the contractor with respect to the completion work that is performed by or through the surety under the bonded contract.

Any proposed control of the proceeds or assignment of a contract for the construction of a Federal project in a situation where the surety does not take over the completion of the project requires more than simply the agreement of the principal contractor. The assignment must also comply with the Anti-Assignment Act that prohibits the transfer of government contracts to a third party. The FAR sets out three situations when the government may consent to the transfer of a government contract by approving a novation: (1) the sale of all of a contractor's assets, or the entire portion of the assets involved in performing a contract with a provision for assuming liabilities; (2) the transfer of assets incident to a merger or a corporate consolidation; and (3) the incorporation of a proprietorship or partnership, or formation of a partnership. The first situation is the situation that is generally applicable when a surety is involved in the proposed assignment. As is noted by the language in the FAR, it is not necessary that all of the contractor's assets be transferred to the completion contractor, but that the entire portion of the assets involved in performing a contract be transferred to the completion contractor, which would include all equipment and other hard assets required to perform the contract. Although it is not specifically stated, the Federal Government will also look upon a proposed novation more favorably when the employees of the principal contractor will remain on the project as employees of the new completion contractor. The novation strategy is generally utilized in a situation where an entire segment of a contractor's business is being assigned to another contractor and not on an individual contract-by-contract basis.

The above provisions of the FAR do not address a situation where the principal contractor is continuing to complete the project, but the surety wants to maintain control over the proceeds of the bonded contract and the use of those funds. The Anti-Assignment Act permits an assignment to a “bank, trust company, federal lending institution, or other financing institution.” The Act does not define “financing institution,” which is the only category under

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115 See U.S. SY S. FOR AWARD MGMT., https://www.sam.gov/SAM/ (last visited April 1, 2019). The U.S. Government System for Award Manager will be referred to hereinafter as “SAM.”
116 48 C.F.R. § 49.404 (2018). This provision of the Code also recognizes valid assignments to a financing institution and prohibits payments from unpaid earnings to the surety unless the assignee provides consent. Payment of payment bond claim expenditures is subject to mutual agreement of the government, the defaulting contractor, and the surety, determination of the Comptroller General as to pay an amount, or court order.) The Federal Acquisition Regulations will be referred to hereinafter as “FAR.”
118 48 C.F.R. § 42.1204 (2018).
which a surety or insurance company could arguably fall. A “financing institution” has been
defined generally to mean “an individual, partnership, or corporation dealing in money as
distinguished from other commodities, as a primary function of its business activity.”120 There is
ample case law articulating that a surety does not qualify as a bank, trust company, or other
financing institution under the Act and it is believed that an insurance company does not either.121 The Anti-Assignment Act and related Regulations do not explicitly prohibit transfers or
assignments under the doctrine of equitable subrogation. The Federal Government will usually
require that the procedures set forth in the Anti-Assignment Act, 31 U.S.C. § 3727 and FAR
32.8, be adhered to in order for contract funds to the paid to anyone other than the vendor
contractor. The Federal Government has the authority not to require strict adherence to the Anti-
Assignment Act and may voluntarily agree to remit the proceeds to the surety in situations other
than when the surety takes over the project, but this is very rare.

Unfortunately, due to the provisions of the FAR, it can be a lengthy and time consuming
process to comply with all the technical requirements to obtain the consent of the Federal
Government to the remittance of funds to an account that is not owned by the principal. In order
to secure a release of contract funds from the Federal Government, the principal must first
execute a valid assignment of claim to the surety in accordance with 31 U.S.C. § 3727(b) and
FAR Subpart 32.8. FAR 32.805(a) outlines the specific formatting and execution requirements
for the Assignment:

(1) Assignments by corporations shall be—
   (i) Executed by an authorized representative;
   (ii) Attested by the secretary or the assistant secretary
        of the corporation; and
   (iii) Impressed with the corporate seal or accompanied
        by a true copy of the resolution of the corporation's
        board of directors authorizing the signing
        representative to execute the assignment.

(2) Assignments by a partnership may be signed by one
    partner, if the assignment is accompanied by adequate
    evidence that the signer is a general partner of the
    partnership and is authorized to execute assignments on
    behalf of the partnership.

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120 Assignment of Contract Payments — Interpretation of Term “Financing Institution,” DECISION OF THE
   COMPTROLLER GENERAL OF THE UNITED STATES, 22 COMP. GEN. 1, 44-45 (1943).
government contract to a surety [is] invalid under the Anti-Assignment Act because the surety was not a bank,
trust company, or other financing institution.”); see also Royal Indem. Co. v. United States, 93 F. Supp. 891,
894 (Ct. Cl. 1950) (stating “a valid assignment may be made only to a bank, trust company, or other financing
institution; which the surety admittedly is not”). It is noted that an insurance company is a financial institution
under the the provisions of the U.S. Code that applies to monetary transaction. However, this definition is
not applicable to the Assignment of Claims Act.
(3) Assignments by an individual shall be signed by that individual and the signature acknowledged before a notary public or other person authorized to administer oaths.

The contracting officer of the general counsel for any governmental entity may impose additional requirements that are not specifically set out in the FAR. For example, contracting officers will often require that an assignment also state that the assignment will not be further assigned, or may require that the assignment include the amount of the contract funds assigned, which is not technically required under the FAR. Citing the exact provisions of the FAR back to a governmental official is not typically conducive to getting any assignment approved. Instead, any additional requirements should be met. Recently, there have been a few instances where the finance office or the contracting officer has required the Acknowledgment of the surety to the notice of assignment as opposed to mere confirmation that the surety was provided with a copy of the assignment.

It should be noted that the provisions of FAR require that assignments of a corporation be “impressed with the corporate seal or accompanied by a true copy of the resolution of the corporation's board of directors authorized and the signing representative to execute the assignment.” In situations where the corporation does not have a seal, the Federal Government will nonetheless require that a seal be impressed on the assignment and has on more than one occasion told the contractor to simply trace a quarter on the assignment next to the signature. If the corporation does not have a secretary or assistant secretary to attest to the signature, it should appoint one as this is an express requirement under the FAR.

The FAR does not address assignments by limited liability corporations. The Federal Government will require that LLCs comply with the terms for an assignment by a corporation even though the LLC may consider itself to be a partnership for federal tax purposes.

G. Real Property Lease Assignments/Non-Disturbance

As set forth above, a principal’s facilities may be key to a surety’s mitigation efforts. Those facilities could include leased or owned equipment storage facilities, owned or leased office properties, owned or leased borrow pits, or owned or leased manufacturing or other facilities. Thus, a surety should consider obtaining a Facilities Utilization Agreement governing the use of and payment for those facilities.

Those facilities may be subject to a mortgage or deed of trust in favor of the principal’s lender. On default by its principal, the lender usually has the right to accelerate the entire indebtedness and foreclose. The lender often also has the right to enter the premises and take possession of equipment, computers, and other items that are part of the lender’s collateral.

The principal, as lessee, may lease its facilities from a third-party landlord (lessor). That third-party lessor may have executed a mortgage or deed of trust in favor of its lender. If the third party defaults, what impact will that have on the principal? If the lease pre-dates the landlord’s loan and is recorded, the lender, the landlord, and the principal may enter into a

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123 Limited Liability Corporations will be referred to hereinafter as “LLCs.”
Subordination, Non-Disturbance and Attornment Agreement pursuant to which the principal agrees to subordinate its lease to the lender’s lien. In exchange, the lender agrees not to disturb the principal’s possession. The principal further agrees that on default by the landlord, the lender can “step in” as landlord and operate the lease, and, in that event, the principal agrees to attorn to (or perform for) the lender under the lease. So, a surety that obtains a Facilities Utilization Agreement from a lessee principal may not only be competing with the principal’s lender, but also with the landlord’s lender for use and possession of those facilities and may be asked by the landlord’s lender to provide a form of Subordinate, Non-Disturbance and Attornment Agreement as part of the Utilization documents.

V. Unique Payment Bond Claim Scenarios

One way to view a business venture is that it essentially a set of contractual arrangements among a number of constituencies with each arrangement representing an allocation of performance to a party that has the specialized knowledge or expertise needed to provide that performance effectively and efficiently. A construction project is really no different, and could be viewed as a business venture in many respects. Viewed through this lens, a construction project is a set of contractual arrangements among an owner and its general contractor and the general contractor and its subcontractors to complete a project.

But, like any business venture, a construction project is much more complex than the “vertically integrated” structure suggested above. In fact, at each stage of the vertical model, there are other contractual arrangements pursuant to which the primary contract counterparties are funded or pursuant to which the risk of non-performance is allocated. The simplest example of the intersection of the vertical and horizontal structure on a project is the general contractor’s agreement to pay subcontractors and suppliers on the bonded contract (the vertical arrangement). A surety that provides a payment bond on behalf of the general contractor provides a contract that allocates the risk of this non-payment to the payment bond surety. Further, state statutes or other contracts (such as the prime contract, the subcontract agreement, and the surety’s indemnity agreement) may also intersect the vertical relationship by requiring the general contractor or the subcontractor to allocate payment solely to specified recipients. On the subcontractor side, to minimize the risk of non-payment and for cashflow reasons, the subcontractor could have assigned or sold its payment rights to a third party. Thus, a question becomes, how could these other arrangements impact the surety?

The following discusses a few unique claim scenarios that a surety may confront from parties that are part of a project’s financial structure. These claim scenarios are not exhaustive and are in addition to those discussed in the preceding sections above.

A. Payment Bond Claimants Generally

Historically, a payment bond was construed “to cover labor and material used by the principal in the prosecution the work.”124 Today, this remains largely unchanged, although coverage for specific items is governed by the bond or by statute.125 In many states, because public projects

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125 Id.
are typically not lienable (although public funds may be in certain jurisdictions),\textsuperscript{126} payment bonds cover those items that would otherwise be lienable.\textsuperscript{127} The categories of claims covered under a payment bond can be quite broad.\textsuperscript{128}

As discussed above, some subcontractors do not have the luxury of waiting on payment from the general contractor, and thus rely on third parties to provide short-term financing to cover gaps in the timing of payment. These third parties could include traditional lenders, or non-traditional lenders, such as factors. Would these third-party financing entities have rights under the surety’s payment bond?

\section*{B. Lenders as Payment Bond Claimants}

Generally speaking, a lender providing financing to a subcontractor is not a covered claimant under a payment bond.\textsuperscript{129} In \textit{Farmers State Bank of Waubun v. Anderson}, the lender for the subcontractor made advances to the subcontractor on the basis that the advances would be repaid from payments to the subcontractor from the general contractor.\textsuperscript{130} The subcontractor’s lender subsequently sought payment from the general contractor’s surety’s payment bond on the theory that the general contractor had advised the bank that funds would be paid to the subcontractor from the upcoming payment estimate.\textsuperscript{131} The Minnesota Supreme Court held that the payment bond surety was not liable to the subcontractor’s lender on the loan from the lender to the subcontractor even though the loaned funds were used to fund labor and material costs of the subcontractor.\textsuperscript{132} In making its decision, the Minnesota Supreme Court noted the lender was not a subcontractor or supplier of the surety’s principal (the general contractor) nor had the lender taken an assignment from those that provided labor and materials.\textsuperscript{133} Instead, the lender simply paid checks issued by the lender’s borrower (the subcontractor) to the borrower/subcontractors payees.\textsuperscript{134}

In \textit{Primo Team, Inc. v. Blake Construction Co., Inc.}, a California Court of Appeal considered whether a company—Primo Team, Inc.—that advanced funds to a subcontractor—R.J., Inc.—to R.J. cover its payroll and that administered the R.J., Inc.’s labor\textsuperscript{135} qualified as a claimant under a payment bond provided by Blake Construction Co., Inc., the general contractor’s surety. Whether Primo Team could recover from the payment bond surety depended

\begin{itemize}
\item \textsuperscript{126} See 770 ILL. COMP. STAT. ANN. § 60/23 (West 2018); see also WIS. STAT. ANN. § 779.15 (West 2017).
\item \textsuperscript{129} See 3 BRUNER & O’CONNOR, supra note 42, § 8:169; see also U.S. Fid. & Guar. Co. v. First Nat’l Bank of Lincoln, 140 So. 755, 762 (Ala. 1932) (stating that “money loaned” does not qualify as covered labor, materials and supplies the referenced state public highway statute or federal statutes upon which those statutes were premised).
\item \textsuperscript{130} 263 N.W. 443, 444-445 (Minn. 1935).
\item \textit{Id.} at 444-446.
\item \textit{Id.} at 445-46.
\item \textit{Id.} at 446.
\item \textit{Id.} at 446
\item \textsuperscript{135} 4 Cal. Rptr. 2d 701, 703 (Cal. Ct. App. 1992).
\end{itemize}
upon whether it qualified as a claimant under California Civil Code Section 3110. That section generally provided that persons providing materials to a project could pursue lien claims. The statute did not limit recovery to those performing actual labor, but included those claimants that provided labor to the project. The California Court of Appeal decided that because R.J. Inc., as opposed to Primo Team, actually supplied the labor, Primo Team was not a covered claimant under the statute and therefore could not prevail under the payment bond. Further, the Court determined that Primo Team essentially advanced funds that made it possible for R.J., Inc. to provide labor to the project. In this role as “lender,” Primo Team was not a covered claimant. In short, the people that actually furnish the labor and materials are the ones that have the lien, not the lender that provides funding to the subcontractor for those purposes.

C. Assignees as Payment Bond Claimants

In the Farmers State Bank of Waubun case discussed above, the Minnesota Supreme Court noted that the lender in that case did not qualify as a payment bond claimant in part because it had not taken an assignment from those that provided labor to the project. This statement reflects a general rule that rights under a payment bond may be assignable. In the federal context, the Miller Act provides, in pertinent part, that “[e]very person that has furnished labor or material in carrying out work provided for in a contract for which a payment bond is furnished may bring a civil action on the payment bond.” Further, assignees have been allowed to pursue claims under payment bonds to the extent they have provided notice. Several Supreme Court cases have held that, under the predecessor to the Miller Act, “assignees of the claims of persons furnishing labor or materials came within the protection of the statutory bond.” In a typical example, a third party pays the subcontractor or supplier and takes an express assignment of the subcontractor’s or suppliers’ claims against the principal and its surety. In general, the assignee in such a scenario would have standing to pursue claims under the applicable payment bond(s), as discussed below.

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136 Id. at 704.
137 Id.
138 Id. (citing Myers v. Alta Constr. Co., 235 P.2d 1 (Cal. 1951)).
139 Primo Team, Inc., 4 Cal. Rptr. 2d at 705.
140 Id. at 706-7 (citing Godfrey v. Caldwell, 2 Cal. 489 (1852)) (citing People’s Nat’l Bank v. S.Sur. Co., 288 P. 827 (Cal. Ct. App. 1930)).
141 Id. at 707-8 (citing Cadenasso v. Antonelle, 386 P. 765 (Cal. Ct. App. 1899)).
142 Farmers State Bank of Waubun, 263 N.W. at 446.
143 See 3 BRUNER & O’CONNOR, supra note 42, § 8:177; see also U.S. Fid. & Guar. Co. v. United States for the Benefit of Bartlett, 231 U.S. 237, 243 (1913) (discussing contract between general contractor and third party that allowed third party to collect on workers’ paychecks directly from general contractor); see Title Guar. & Tr. Co. of Scranton, Pa. v. Crane Co., 219 U.S. 34, 35 (1910) (assignment of payment bond right does not impact remedy); see also Quantum Corp. Funding, Ltd. v. Westway Indus., Inc., 825 N.E. 2d 117, 120 (N.Y. 2005) (permitting assignee to pursue claim under payment bond).
144 See Sherman v. Carter, 353 U.S. 210, 219 (1957) (decided under predecessor statute to Miller Act, but stating that “assignees of the claims of persons furnishing labor or materials came within the protection of the statutory bond’’); see also Nickell v. United States for Benefit of D.W. Falls, Inc., 355 F. 2d 73, 76 (10th Cir. 1966) (stating that the “payment bond is available to a party to whom is assigned the debt of the prime contractor, and who gives proper notice.”).
But, some arrangements present closer questions. For instance, what happens when a principal issues a check to a subcontractor, laborer, or supplier, that check is endorsed by the payee to a third party who is now the holder of the check, and the check is subsequently dishonored? This very question confronted a Texas Court of Appeals in *J.W.D. Inc. v. Federal Insurance Company.*

In *J.W.D.*, the surety issued a payment bond on behalf of a general contractor on a public project “for the protection of all claimants supplying labor and materials to the project.” The principal subcontracted a portion of its work to S&M Constructors, Inc. S&M, in turn, issued checks to its laborers on the project who, cashed those checks at J.W.D., Inc., The Money Store, Inc. and Crestview Minimax Food Mart, Inc. The S&M checks were subsequently dishonored for insufficient funds. Thereafter, stores sought recovery from the surety under the payment bond as assignees of the labors by virtue of the laborer’s endorsement of the checks to the stores.

In its decision, the Texas Court of Appeals looked to Texas’ version of Article 3 of the Uniform Commercial Code, which provided, in pertinent part:

> Unless otherwise agreed where an instrument is taken for an underlying obligation

> (2) … the obligation is suspended pro tanto until the instrument is due or if it is payable on demand until its presentment. If the instrument is dishonored action may be maintained on either the instrument or the obligation.

Relying on the above-quoted provision, the court stated that the stores were holders of the instruments delivered by S&M to its laborers. Further, “[w]hen the checks were dishonored, the stores, as holders thereof, were entitled to bring an action on S&M’s underlying obligation to pay wages.” “In effect, the laborers’ right to receive wages from S&M had been assigned to the stores.”

Having determined that the endorsement by the laborers of their checks to the stores assigned the stores the laborers’ wage claim against S&M, the court then evaluated whether that assignment carried with it the right to assert the laborers’ claim under the payment bond at issue in the case. The court then looked to a general proposition as part of its analysis of the issue:

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146 806 S.W.2d 327 (Tex. App. 1991).
147 *Id.* at 328.
148 *Id.* S&M Constructor, Inc. will be referred to hereinafter as “S&M.”
149 *Id.* at 329 (quoting TEX. BUS. & COM. CODE ANN. § 1.01-11.108 (1968 & Supp. 1991) & Section 3.802(a) of the Texas Uniform Commercial Code encompassed thereby).
150 *Id.* at 329.
151 *Id.*
152 *Id.*
153 *Id.*
The assignment of a debt ordinarily carries with it all liens and every remedy or security that is incidental to the subject matter of the assignment and could have been used, or made available, by the assignor as a means of indemnity or payment, even though that are not specifically named in the instrument of assignment, and even though the assignment at the time was ignorant of their existence.\textsuperscript{154}

The court then analyzed other cases reaching differing results.\textsuperscript{155}

One of these cases examined by the court held that the endorsees of checks were not proper payment bond claimants was \textit{National Market Co. v. Maryland Casualty Co.} \textsuperscript{156} In \textit{National Market}, the Washington Supreme Court stated that “[w]e have . . . held that a labor claim assertable against the bond . . . is assignable, and the assignment carries with it all of the laborer’s right of action against the contractor, and operates as an equitable assignment of the laborer’s right to assert this claim against the bond.” \textsuperscript{157} Additionally, the court stated:

It is only by virtue of his right to receive his pay from the contractor that the laborer or materialman has any right assertable against the bond as a contract made for his benefit. His right against the bond is ancillary to and dependent upon his right against the contractors. The first right is dependent upon the second. An assignment of the second therefore, operates as an equitable assignment of the first.\textsuperscript{158}

The Washington Supreme Court went on to say that negotiation of an instrument is fundamentally different, reasoning as follows:

Such an instrument is negotiated by indorsement and delivery, it is indorsed by writing the signature of the payee thereon, and, as provided [under the law of negotiable instruments], every endorser who indorses without qualification warrants to all subsequent holders in due course: (1) that the instrument is genuine, (2) that he has good title to it, (3) that all prior parties had capacity to contract, (4) that the instrument is valid and subsisting; and in addition, he engages it will be paid on presentation, and if it be dishonored, and the necessary proceedings duly taken, he will pay the amount thereof to the holder, or any subsequent endorser.\textsuperscript{159}

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\textit{….}
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\textsuperscript{154} \textit{Id.} at 329-330 (citing 6 AM. JUR. 2d \textit{Assignments} § 121 (1963)).


\textsuperscript{156} \textit{Id.} at 329 (citing 6 AM. JUR. 2d \textit{Assignments} § 121 (1963)).

\textsuperscript{157} \textit{Id.} at 480 (citing Nw. Nat’l Bank v. Guardian Cas. Co., 161 P. 473 (Wash. 1916)).

\textsuperscript{158} \textit{Id.}

\textsuperscript{159} \textit{Id.}
The fundamental error . . . was the holding that the indorsement and delivery of the check was the assignment of the debt, instead of its being simply and only what the negotiable instruments law provides it shall be. The ordinary bank check is not, either in law or in equity, an assignment of the fund upon which it is drawn . . . but is purely and simply an order for the payment of money, which in no way affects the debt for which it is given until the order is paid, and, being dishonored, leaves the drawer still indebted to the payee, the same in all respects as though the check had never been drawn and delivered. Moreover, such a check is recoverable by the drawer at any time before it is paid.160

Faced with the New Market decision and others, the Texas Court of Appeals held that under Texas’ version of the UCC, the endorsement of a check is an assignment of the underlying wage claim. Further, on dishonor of the check, stores could pursue not only the assigned wage claims, but the stores were also equitable assignees of the laborers’ rights under the payment bond.163

UCC §3-802, which is similar to the UCC provision relied upon by the court in J.W.D. provides in Official Comment 3 as follows:

It is commonly said that a check or other negotiable instrument is a “conditional payment.” By this it is normally meant that taking the instrument is a surrender of the right to sue on the obligation until the instrument is due, but if the instrument is not paid on due presentment, the right to sue on the obligation is “revived.”

…. 

On dishonor of the instrument, the holder is given his option to sue either on the instrument or on the underlying obligation.164

While it may follow that under Comment 3 and UCC §3-802 that an endorser of a dishonored check is an assignee of the underlying obligation and can therefore pursue a claim against the original obligor or under the instrument, it does not necessarily follow that the assignment carries with it an assignment of the right to pursue a payment bond claim. For instance, in the Miller case discussed in both cases, under Georgia law, a holder of a laborers’ check that has been dishonored has two claims: (1) a right to payment under an instrument; and (2) a right to recover under the payment bond. The right to payment under an instrument is transferred by

160 Id.
161 Finch, 222 N.W. at 659; Shoshoni Lumber Co., 24 P.2d at 702; Nat’l Market Co., 174 P. at 481; Miller, 123 S.E.2d at 718.
162 J.W.D., 806 S.W. 2d at 331.
163 Id. at 332.
164 U.C.C. § 3-802, cmt. 3 (2018).
165 Miller, 123 S.E.2d at 718.
166 Id.
endorsement, while the right to recover under a payment bond is transferred by assignment.\textsuperscript{167} In the \textit{Miller} case, the endorsement by itself was insufficient to assign the right to pursue a payment bond claim.\textsuperscript{168}

In \textit{Dysart Corporation v. Seabord Surety Company}, the Connecticut Supreme Court considered whether a pub owner that cashed wage checks from employees of a subcontractor to a general contractor could pursue a claim against the payment bond surety for the general contractor.\textsuperscript{169} The pub owner argued that the subcontractor’s laborers’ assigned their payment bond claims when they endorsed the checks to the pub owner.\textsuperscript{170} The parties agreed that those claimants would have rights under the payment bond had they deposited the checks and the checks were dishonored.\textsuperscript{171} While not necessarily set forth in the case, this proposition is consistent with UCC § 3-802 and Comment 3 discussed above.

The court stated that “the mere negotiation of the checks themselves to [the pub owner], with nothing more, did not operate as a legal assignment of the employees’ separate payment bond rights.”\textsuperscript{172} Further, “to constitute an assignment there must be a purpose to assign or transfer the whole or a part of some particular thing, debt, or chose in action, and the subject matter of the assignment must be described with such particularity as to render it capable of identification.”\textsuperscript{173} The court also determined that at the time the checks were endorsed, “there was no objective manifestation by the [subcontractor’s] employees or [the pub owner] that the employees were assigning to [the pub owner] any rights that they may have possessed in the payment bond.”\textsuperscript{174} Moreover, the court noted that “we have found no authority that persuades us that the endorsement of a check transfers, as a matter of law, anything other than a right to payment from the drawer of the instrument and certain rights against the endorser.”\textsuperscript{175} Under Connecticut law, while “it may be true that the assignment of a debt . . . may also entail a concomitant equitable assignment of security for that debt”\textsuperscript{176} a check is distinguishable in that it is simply an order for the payment of money, not an assignment of any particular funds.\textsuperscript{177}

The takeaways from the \textit{J.W.D.} and \textit{New Market} lines of decisions are that the endorsement of a check may also constitute an assignment of payment bond claim rights if the law of assignments in that jurisdiction so provides.\textsuperscript{178} Some jurisdictions would hold that the endorsement itself is sufficient (\textit{J.W.D.}), while others would require more (\textit{New Market}, \textit{Dysart}, and \textit{Miller}), such as a more formal assignment document. These decisions are significant to a surety evaluating payment bond claims from entities or individuals it is not anticipating, but also could be helpful to a surety taking assignments of notes or other instruments that are part of the principal’s capital and/or financing structure. While these decisions are not directly on point,
they could provide guidance to a surety on the form of assignment needed, with the better practice being to describe with some specificity the rights and claims being acquired in connection with any endorsement of a note or other payment order.

D. Factoring Companies as Claimants Under Payment Bonds

As discussed above, a factoring company is a type of non-traditional lender that can provide short-term capital to a construction company that does not have the requisite cash flow to wait for payment to be made to its contract counterparties. “A ‘factor’ is one who buys a seller’s accounts receivable for a discount and without recourse” (except as to the accounts receivable).179 Thus, a factor, like a traditional lender, injects capital and, in that role, does not provide labor or materials to a project. As such, a factor should not be a proper claimant under a payment bond.180 So, rather than taking an assignment of a contractor’s receivables as collateral security, a factor actually purchases the contractor’s receivables in exchange for a discounted, lump sum certain.

In Quantum Corporate Funding, Ltd. v. Westway Industries, Inc., a New York Court of Appeal considered whether a factoring company could recover under a payment bond provided pursuant to New York’s public works statute.181 In Quantum, Atlas Contracting, LLC—Atlas—was a subcontractor to Westway Industries, Inc.—Westway—on various public projects.182 Atlas completed its contract and thereafter sold its accounts receivable at a substantial discount to Quantum Corporate Funding, Ltd., for cash up front.183 Westway failed to pay, and Quantum Corporate Funding, Ltd. subsequently filed suit against Westway’s surety under payment bonds provided pursuant to New York law.184 The surety moved for summary judgment and prevailed, arguing that the subcontractor’s rights under the payment bond were not assignable and prevailed185 The decision was reversed on appeal, and the surety appealed.186

The Quantum court described the pertinent factors as follows:

The bond requirement [under Section 137 of New York’s State Finance Law] guarantees that subcontractors will receive payment for their work once they complete the project. That assurance is not always enough. Some subcontractors, often smaller or newer companies, may have difficulty financing their work . . . . For example, a gravel company working on a six-month project might

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180 See Bank of Auburn v. U.S. Fid. & Guar. Co., 295 F. 2d 641, 642 (5th Cir. 1961); United States ex rel. BAC Funding Cos., Inc. v. Westchester Fire Ins. Co., 998 F. Supp. 2d 1330, 1332 (S.D. Fla. 2013); United States ex rel. Owens-Corning Fiberglass Corp. v. Brandt Constr., 595 F. Supp. 117, 119 (C.D. Ill. 1984), vacated and remanded on other grounds, 826 F. 2d 643 (7th Cir. 1987) (injecting capital does not constitute furnishing labor or materials and thus a creditor in that capacity does not have a claim under the payment bond).
182 Id.
183 Id.
184 Id. at 117-118.
185 Id. at 118 (relying on Quantum Corp. Funding v. Fid. & Deposit Co. of Md., 685 N.Y.S.2d 688 (N.Y. App. Div. 1999)).
186 Id. at 118.
run out of gravel after three months. If the company lacked the means to obtain more gravel, the company would be unable to complete is contract obligations. Subcontractors in that position seek to trade their certain rights to future payment in exchange for present financing. Similarly, small subcontractors who have completed projects and await payment may be ill equipped to pursue their claims, preferring not to spend limited company resources [necessary to pursue] such claims. Such companies, like Atlas here, have therefore sold their accounts receivable to factors, companies that specialize in financing and collecting these payments. 187

The court first noted that “we bear in mind the background principle that claims typically remain transferrable.”188 The court further noted that Section 137 was “designed to protect workers, material suppliers and subcontractors from the hardship that accompanied the previous instability in the financing of public works.”189 The court rejected the surety’s argument that because subcontractor lien rights under applicable lien law (allowing liens on the contractor’s proceeds) were not assignable, the same restriction should apply to payment bond rights.190 The surety also argued, among other things, that the statute’s grant to certain labor trustees with standing to pursue claims in the place of actual workers was exclusive. 191 However, the court rejected that argument, stating that “by defining what claims are recoverable with the phrase ‘payable to or on behalf of’ the workers, [the statute] explicitly authorizes that some payments will go to parties acting ‘on behalf of’ the direct statutory beneficiaries.”192 Ultimately, the New York Court of Appeals held that a factoring company, as assignee, could pursue claims against the surety on the statutory payment bond.193

The distinction between a factor and a traditional lender is that the factor actually purchases the invoices upon which the claim is based and a lender takes an assignment as collateral security. Language in the lender cases discussed in Section V.B. above suggest that a lender that actually pays a subcontractor or supplier and takes an assignment of that claim might be able to pursue claims under the surety’s payment bond. Thus, a surety should be mindful that it could face exposure to claims from factors under the payment bond.

A surety that bonds a principal that may be considering factoring its accounts receivable should also be mindful that the factor is acquiring receivables that are subject to trust fund provisions of the surety’s indemnity agreement, by statute or contract, the assignment provision in the surety’s indemnity agreement, and the surety’s subrogation rights. Accordingly, a surety may wish to investigate during the underwriting stage its principal’s use of factors for short-term financing. If a surety decides to issue bonds for a principal that has or may factor its receivables, it should consider including an express prohibition on the assignment of bonded receivables to

187 Id. at 118-119.
188 Id. at 119.
189 Id.
190 Id. at 119-120.
191 Id. at 120.
192 Id.
193 Id.
factors in its indemnity agreement. The surety may also wish to record its indemnity agreement as a financing statement to place factors and other financing companies on notice of the surety’s rights in bonded receivables.

E. Bond Obligees as Claimants Under Payment Bonds

Bond Obligees generally may not recover under a payment bond because they do not fall within the definition of “claimant” found in the bond or the statute. Claimants are often limited to those having a direct contract with a principal or with a subcontractor to provide labor, materials or both.

In *Travelers Casualty and Surety Company v. Dormitory Authority – State of New York*, the New York Court of Appeals considered an obligee’s claim under a payment bond issued pursuant to the public work statute at issue. The surety argued that the obligee was not a “claimant” under the terms of bond, which defined claimant as “one having a direct Contract with the Principal or with a Subcontractor of the Principal for labor, material, or both, used or reasonably required for use in the performance of the Contract . . . .” The payment bond further provided as follows:

The above named Principal and Surety hereby jointly and severally agree with the Owner that every claimant as defined herein, who has not been paid in full before the expiration of a period of ninety (90) days after the date on which the last of such claimant’s work or labor was done or performed, or material were furnished by such claimant, may sue on this bond for the use of such claimant, prosecute the suit to final judgment for such sum or sums as may be justly due, and have execution thereon. The Owner shall not be liable for the payment of any costs or expenses of such suit.

The obligee asserted that some of the principal’s subcontractors filed liens on the project and sued the obligee to foreclose on those liens. The obligee made payments to those claimants and then asserted that the same should be reimbursed by the surety under the payment bond. The surety moved for summary judgment.

The court recognized that “the owner-obligee may generally not recover damages from the surety under the payment bond, as the bond is intended to provide payments to persons supplying labor and materials to the contractor, not to provide a financial recovery to the owner-

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197 Id.
198 Id.
199 Id.
200 Id.
201 Id. 
obligee.”

The court further stated that “even where an owner-obligee itself purchases labor and materials in order to complete a contract after a contractor’s default, the obligee may not make a claim [under . . .] the payment bond . . . because the obligee is not a subcontractor or supplier within the meaning of the payment bond.”

But, the court also stated that “the class of protected persons under a payment bond excludes the owner, even though the owner is named as the nominal bond obligee, [as well as] co-prime contractors and lenders, unless they are assignees of the claims of otherwise protected claimants.”

After reviewing New York case law on equitable subrogation and assignability of payment bond rights, as well as New York’s State Finance Law §137, the United States District Court for the Southern District of New York held that the obligee’s status as such under the payment bond does not, itself, preclude the obligee from asserting a claim under the payment bond. Instead, the inquiry is whether the obligee can show that it is entitled to recovery by way of equitable subrogation. The court then stated:

> equitable subrogation is broad enough to include every instance in which one party who pays a debt for which another is primarily answerable and in which in equity and good conscience should have been discharged by the latter, so long as the payment was made either under compulsion or for the protection of some interest of the party making the payment, and in discharge of an existing liability.

Thus, under the facts of the case, because the obligee was potentially able to recover under the payment bond on the basis of equitable subrogation, the surety was not able to demonstrate that the claim should have been dismissed as a matter of law and thus not entitled to summary judgment.

### VI. BANKRUPTCY CONSIDERATIONS

A contractor’s bankruptcy filing can present a number of challenges to a surety seeking to secure continued access to project assets needed for completion. This is because section 541 of the Bankruptcy Code provides, with certain exceptions, that all interests of a debtor in property as of commencement of the case become property of the debtor’s estate. Whether a debtor has an interest in property as of the petition date is determined pursuant to applicable state law. Thus, the very assets that the surety needs for project completion and/or for the payment of subcontractors and suppliers may suddenly be in control of someone else who may also prefer to use those assets for purposes other than project completion.

#### A. The Chapter 7 or Chapter 11 Trustee

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202 Id. at 87 (citing Fed. Ins. Co. v. Me. Yankee Atomic Power Co., 183 F. Supp. 2d 76, 81 (D. Me. 2001)).
203 Id. at 87 (citing STEVEN PLITT ET AL., COUCH ON INSURANCE § 165:15 (1984)).
204 Id. at 87-88 (quoting BRUNER & O’CONNOR, supra note 42, § 8:163).
205 Id. at 90-91.
206 Id. at 91.
In a Chapter 7 case, the appointed Chapter 7 Trustee’s objective is to liquidate and distribute the bankruptcy estate. To facilitate liquidation and maximize benefits to creditors, the trustee collects the debtor’s assets, liquidates those assets, objects to improper claims of creditors, and files a final report. Because the goal of a Chapter 7 trustee is to liquidate, long-term management of the estate is not generally one of the trustee’s concerns. Rather, one of the trustee’s primary concerns is “to collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest.”

As one court has articulated: “[i]ndeed, underlying all of a chapter 7 trustee’s actions, including decisions about sales of property of the estate, is the fiduciary duty to maximize distribution to creditors.” To accomplish this, the trustee is charged with investigating the debtor’s affairs, employing necessary professionals such as accountants, pursuing avoidance and fraudulent conveyance actions, examining and contesting creditor claims, and making recommendations to the court regarding, among other things, the debtor’s discharge. So, a surety confronted with a Chapter 7 case may find that the Chapter 7 Trustee believes that the bonded contract proceeds along with the principal’s equipment should be liquidated to pay the expenses of administration and fund distributions.

Normally, a trustee is not appointed in a Chapter 11 case. Rather, the debtor exercises the trustee’s function, as debtor-in-possession. The debtor-in-possession usually operates the business, and is granted all the powers of a trustee, except the right to compensation as a trustee. The debtor-in-possession is subject to the oversight of the court, and possibly, a creditors’ committee. “A debtor-in-possession owes fiduciary duties to the bankruptcy estate[,]” which include the duty of loyalty, the duty of impartiality, and a duty of care to protect estate assets. In order to fulfill its duty of loyalty, a debtor-in-possession must “avoid self-dealing, conflicts of interest and the appearance of impropriety.”

B. Sources for Funds, – Extending Credit and the Use of Collateral

Whether the debtor-in-possession or a trustee is in control, funding the expenses of administration, such as attorney and professional fees, and operating the debtor, is a major concern. In a Chapter 11 case, a debtor-in-possession may seek to incur new debt under 11 U.S.C. § 364 to cover these expenses, and may look to either a lender or its surety for funding. If new funding is not available, or in a Chapter 7 case, the debtor-in-possession or the Chapter 7 trustee, may attempt to use bonded receivables to fund the expenses of case administration or operations (in the case of a Chapter 11). The debtor-in-possession or trustee may prefer liquidate equipment necessary for completion of projects. Further, lenders seeing little to no equity in their equipment may seek stay relief to foreclose.

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212 See 2 DUNAWAY, supra note 209, § 28.13.
213 The appointment of a trustee removes the debtor-in-possession as manager of the estate. Section 1104 of the Bankruptcy Code governs the appointment of a Chapter 11 Trustee. A discussion of Section 1104 and Chapter 11 Trustees is beyond the scope of this paper.
Section 364 of the Bankruptcy Code governs extensions of credit to a debtor post-petition. First, Section 364(a) authorizes the debtor-in-possession to obtain unsecured credit/incur unsecured debt in the ordinary course without Court approval. The debt will be allowable as an administrative expense (post-petition priority) as an actual, necessary cost or expense of preserving the estate. Suppliers may fall into this category. A debtor often will file a first day motion to continue these arrangements so that they are considered ordinary course and thus afforded administrative priority.

Next, 364(b) authorizes the debtor-in-possession to obtain/incur unsecured credit/unsecured debt outside the ordinary course, after notice and a hearing. The underlying debt will be allowable as an administrative expense (priority), as an actual, necessary cost or expense of preserving the estate. This is often limited to trade credit, but sometimes the terms are not as favorable as they were pre-petition considering the debtor is in Chapter 11. So, Bankruptcy Court approval is required to incur this debt because it is “outside the ordinary course.”

The debtor may also incur secured debt post-petition under Sections 364(c) and (d). 364(c) authorizes debtor-in-possession to obtain credit with (1) priority over all administrative expenses, (2) secured by a lien on unencumbered property, or (3) secured by a junior lien on property that is already encumbered. The Bankruptcy Court must approve this type of credit, and the Debtor must show that it cannot obtain credit on an unsecured basis.

Section 364(d) is often referred to as super-secured credit and is most often the type of credit extended by debtor-in-possession lenders providing a credit facility to the debtor post-petition. This section authorizes the debtor-in-possession to obtain credit secured by a lien that is senior to or equal to an existing lien on collateral. The Bankruptcy Court must approve this type of credit and the debtor must show that it cannot obtain credit on any less intrusive basis (i.e. not under 364(a), (b), or (c)). Further, the Debtor must provide adequate protection to the primed lienholder. Adequate protection, referenced in 11 U.S.C. § 361, refers to the ability to protect a party’s secured interest in the collateral and may require periodic cash payments to the secured party, replacement liens on other assets, or the realization of “the indubitable equivalent” of its interest in the collateral.

Section 363 governs the use, sale or lease of property of the estate. Generally speaking, the debtor may not use a surety’s (or other secured party’s) collateral without such party’s consent. Further, to use such collateral, the debtor must provide adequate protection to such party.

The foregoing sections implicate a surety’s rights and interests in a number of ways, not the least of which includes a surety’s rights in bonded contract funds. For a construction surety, the protection and preservation of bonded contract proceeds is paramount as those funds are often the surety’s only source of “collateral.” As a threshold matter, a surety should argue that

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219 A surety seeking to preserve and protect bonded contract proceeds has a number of theories upon which it may rely. First, it may assert trust fund rights arising by statute and/or under its indemnity agreement (arguing that the debtor may not “use” cash collateral because the property is not the debtor’s property to use. Second, the
these funds are not property of the estate because they are either subject to trust fund treatment under the surety’s indemnity agreement, a statute or other contract, or they are subject to a surety’s right of equitable subrogation. A surety asserting equitable subrogation rights should consult local law as at least one case has held that bonded contract funds are property of the estate although they may be subject to the surety’s equitable subrogation rights. Subrogation rights are also triggered on default, and so to the extent a debtor is not in default the surety’s subrogation “claim” may not be fully ripened. As such, it is possible that funds earned but unpaid are property of the debtor.

To the extent it is determined that bonded contract funds are property of the estate and therefore potentially subject to use by debtor for non-bonded purposes (i.e. to fund administrative expenses of the debtor while it operates in a Chapter 11), a debtor should be required to provide adequate protection to the surety in the same way (but with some different provisions) as it would a lender providing financing to the debtor-in-possession. Sample terms and provisions are discussed below.

In many cases, the construction company’s bank possesses a blanket lien or security interest in virtually all of the debtor's assets. This lien often includes bonded receivables and equipment needed for project completion. So, a key issue for a secured creditor lender is whether there are sufficient assets to adequately protect the security interests of the lender and whether the lender will go along with reorganization efforts or attempt to liquidate its collateral. For instance, in the case of equipment collateral, a bankruptcy court may look to see if an adequate “equity cushion” is available to protect the security interest of the lender. If the debtor has no equity in the equipment and the equipment is a depreciating asset, the bank may prefer to seek stay relief and foreclose. Thus, a surety needing to use equipment subject to the bank’s lien will need to consider the available means to secure the use of the equipment during the pendency of the Chapter 11 case (i.e. by way of an equipment utilization agreement, broader intercreditor agreement with utilization provisions, or acquisition of lender debt, among other options). A surety may also negotiate such an agreement pre-bankruptcy with a view toward seeking approval of the same very early in the case.

Often, the bank may permit the debtor to use its collateral conditioned upon strict control of the debtor’s accounts, stringent reporting requirements and the achievement of certain milestones in the Chapter 11 case. These orders will often give the bank the ability to cease funding and foreclose on its collateral in the event the debtor fails to meet the terms of the order. An order permitting the debtor to use cash collateral will also typically grant to the financing bank replacement liens in the debtor's otherwise unencumbered assets to assure the bank is afforded adequate protection. To the extent there is a failure of adequate protection, the secured party will acquire a secured interest in the assets of the estate through replacement liens. A surety

surety can assert its right of equitable subrogation and/or its assignment rights as a UCC creditor (if perfected) under its indemnity agreement. A surety should carefully review local law on both issues as the protection afforded sureties and trust beneficiaries is highly dependent on local law.

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will want to carve out from the bank’s collateral its bonded contract proceeds and other surety collateral, as applicable.

A surety similarly will want to protect its interest in assuring that bonded contract proceeds are used to complete its bonded projects and to pay for labor and materials before the debtor uses these funds for its overhead and operations. The surety's arrangement with the debtor, often obtained by agreement, may include the following terms:

1. Segregation of contract funds into a separate bonded receivables account;

2. A requirement that these funds must be applied first to pay payables and completion costs that would otherwise be claims against the bond before the debtor can use the funds for overhead and other expenses;

3. Acknowledgments from the bank and debtor that to the extent that the funds are “cash collateral” under 11 U.S.C. § 363, surety has priority in these funds to the extent that payables and completion costs are not paid;

4. A time frame by which the debtor must assume the contracts or the same are deemed rejected without further order or action by the parties;

5. Allowance of an administrative expense claim to the extent the debtor uses contract funds from a contract that is ultimately rejected by the debtor; and

6. Provisions that allow the surety to take control of the contracts immediately in the event the debtor defaults, including a provision that provides the automatic stay is lifted to pursue that relief.

While a number of other provisions can be added to such an agreement, the key objectives of such an agreement are to assure that the debtor uses bonded contract funds to reduce the surety’s exposure, and to provide for the debtor’s assumption of the contracts under § 365 of the Bankruptcy Code and bring the obligation to perform the contract into the debtor's estate. Such an agreement is required to adequately protect the surety’s interest because it (i) protects the surety’s interest in bonded contract funds by insuring that the debtor’s use of the funds will not increase the surety’s loss, and (ii) incentivizes the debtor to complete the bonded contracts by making the obligations of these contracts obligations of the debtor's estate. By assuming the contracts, any losses arising out of an assumed contract become administrative expenses of the debtor's estate.
C. Liquidating Chapter 7 or Chapter 11; Turnover of Collateral to the Surety

When faced with a liquidating debtor under Chapter 7 or Chapter 11, the surety’s main concern will likely be the preservation of collateral and/or the debtor’s use of collateral during the bankruptcy proceeding. A surety may be willing to permit the use of a surety’s bonded contract funds as “cash collateral” under 11 U.S.C. § 363 with some of the conditions and limitations referenced above for a short period of time while the surety is working to transition the bonded contracts to a completion contractor.

Of course, if the principal or Chapter 7 trustee is not cooperating, a surety may want to protect itself and its rights to the contract funds by seeking to compel the rejection of the bonded contracts (Chapter 11 case), and stay relief to collect the remaining bonded contract proceeds as trust funds under the terms and provisions of the indemnity agreement. As trust funds, the contract funds are not property of the debtor and thus the debtor has no rights in the trust funds. To the extent the debtor has rights, it holds only bare legal title to those funds and can use them solely for purposes permitted under the trust. Those “permitted uses” are typically the payment and performance of the bonded obligations.

In addition to its trust fund rights, a surety may argue that it has a perfected security interest in the bonded contract funds and that the funds are otherwise subject to its equitable subrogation rights.

The surety may assert its rights to collateral such as contract funds in several ways, including that the funds are trust funds, that they are subject to the surety’s perfected security interest and not necessary for an effective reorganization, or that they are subject to the surety’s equitable subrogation rights. A surety may also seek the turnover of funds in possession of the debtor or a trustee. A surety seeking turnover of trust funds may find that courts require the surety to trace those funds under the methods discussed in Section III(C)(2)(b) above.

D. Rejection of Bonded Contracts – Bonds as Financial Accommodations

The principal’s conduct leading up to a performance bond claim, such as failure to satisfy payables, delayed performance on the project, and disputes with vendors and the owner, may also lead to the principal filing a voluntary petition for bankruptcy relief. The principal may choose to file under Chapter 7 or Chapter 11 of the Bankruptcy Code, but in either case, the immediate result for the surety is the same – the project comes to a halt due to the application of the Bankruptcy Code’s automatic stay. The automatic stay is a broad injunction which arises immediately upon the filing of a bankruptcy petition and acts to protect the property of the bankruptcy estate from the exercise of remedies by a creditor or a contract counterparty. A creditor seeking relief from the automatic stay must seek permission from the Bankruptcy Court. All property interests of the entity or person filing bankruptcy become property of the bankruptcy estate upon a bankruptcy filing. Consequently, contracts that are not fully completed prior to the bankruptcy filing become property of the debtor’s estate and are subject to the

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224 11 U.S.C. § 509(a) (2016); see also In re Celotex Corp., 472 F.3d 1318, 1320-21 (11th Cir. 2006).

automatic stay. The unfinished contract is considered an executory contract, defined by most courts as an agreement where “the obligations of both the bankruptcy and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.”

Unsurprisingly, a bankruptcy filing may cause a great deal of frustration for the non-debtor parties to an executory contract. The owner-obligee cannot terminate the bonded construction contract and call on the surety to take over and complete post-petition. The general contractor-obligee may find itself facing significant work disruptions, as the subcontractor-debtor’s work will inevitably grind to a halt after the bankruptcy filing, and the path to completion is uncertain. The surety also faces problems as the project delay continuously increases the surety’s exposure for liquidated damages and other consequential losses. Consequently, an obligee with a legitimate fear that a defaulted contractor is headed down the path to bankruptcy may be wise to terminate the contract.

Of course, while the unfinished, non-terminated contract clearly constitutes an executory contract, the contract which has been terminated by the non-debtor party may also sometimes be treated as an executory contract. To escape treatment as an executory contract, the termination “must be complete and not subject to reversal, either under the terms of the contract or under state law.” Therefore, where termination notice has been given pre-petition, but the cure or termination period was set to expire at some point after the bankruptcy filing occurs, courts may treat the underlying contract as an executory contract. Moreover, Section 365 of the Bankruptcy Code provides that clauses terminating an executory contract upon a bankruptcy filing or insolvency, often referred to as “ipso facto” clauses, are generally unenforceable. Thus, the parties involved in these contracts must proceed in accordance with the rules set forth in the Bankruptcy Code. To avoid the issues caused by a cure period which has not expired at the time of a bankruptcy filing, the obligee may wish to negotiate with the contractor for a voluntary default and waiver of the cure period.

Where the parties are left with an executory contract, the non-debtors to the contract are bound to honor it pending assumption, assignment, or rejection of the contract by the debtor. In a Chapter 7 liquidation, executory contracts are generally rejected sixty days into the bankruptcy case absent special relief from the bankruptcy court, but in a Chapter 11 case, the decision to reject or assume a general executory contract is typically not made until a Chapter 11

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227 See, e.g., 4A BRUNER & O’CONNOR, supra note 42, § 12:111.

228 Moody v. Amoco Oil Co., 734 F.2d 1200, 1212 (7th Cir. 1984).

229 In re C.W. Mining Co., 422 B.R. 746 (10th Cir. BAP 2010); In re Masterworks, Inc., 100 B.R. 149 (Bankr. D. Conn. 1989).

230 See T. Scott Leo, Surety Takeover and the Bankruptcy of the Principal (unpublished paper submitted at ABA Tort & Ins. Prac. Section Spring Meeting on May 9, 2002) (“It is unlikely that anyone would challenge the future debtor's waiver of the cure period in the event there is an involuntary bankruptcy filing during what would have been the cure period without the waiver.”).

plan is confirmed or until the division, assets, or entity which the contract relates to is sold or liquidated.

Section 365 of the Bankruptcy Code governs assumption or rejection of an executory contract. Rejection essentially declares the debtor’s intent not to perform its remaining obligations under an executory contract. Upon rejection, the debtor can no longer be compelled to perform, leaving the non-debtor with a breach of contract claim against the bankruptcy estate, which ordinarily will constitute only a general unsecured claim as of the petition date. The end result for the non-debtor in this situation is generally a payment of pennies on the dollar. A debtor may not choose to reject in part and assume in part. Thus, in situations where the executory contract is found to form a part of a series of related agreements, all the agreements will be deemed to constitute a single integrated transaction, requiring that all of such agreements either be assumed or rejected as a group.232 Bankruptcy courts review the debtor’s decision to reject under the business judgment standard. There are two methods by which a debtor may elect to assume an executory contract: (1) by providing notice and an opportunity for the non-debtor counterparty to be heard and obtaining an order from the bankruptcy court permitting assumption; or (2) by confirming a Chapter 11 plan of reorganization providing for assumption upon the effective date of the confirmed plan. If the contract is in default at the time the debtor seeks to assume it, the debtor must promptly cure all monetary defaults and provide adequate assurance of future performance of the debtor’s obligations under the contract before assumption will be permitted. Upon assumption, the bankruptcy estate becomes bound by the contract, and all amounts owed by the debtor under the contract thereafter will constitute administrative expense claims, which are generally entitled to be paid in full.

A non-debtor counterparty can also file a motion to seek to compel an assumption or rejection of the contract, but such relief is extremely difficult to obtain.233 So, a surety seeking to compel assumption should be prepared to support its motion with sufficient evidence to support the motion. This may include proof from accounting and construction consultants evidencing misappropriation of contract funds for non-bonded uses. The debtor should be required to establish precisely how it plans to cure any defaults and provide adequate assurance of its own performance (i.e. it cannot substitute the surety’s performance as its own) of the bonded contract. A debtor-principal does not have any interest in a surety bond, which is issued to protect other non-debtor third party obligees.234 As explained by the United States Bankruptcy Court for the Middle District of Florida, “[a surety] bond is essentially a third-party beneficiary contract to protect certain specified classes of people. A surety bond is not property of the estate.”235 Surety bonds are predicated upon the financial strength of the debtor and obligate the surety “to make

233 11 U.S.C. § 365(d)(2) (2016); In re Physicians Health Corp., 262 B.R. 290, 292 (Bankr. D. Del. 2001) (“the court must balance the interest of the contracting party against the interests of the debtor and its estate”). Further [s]ome courts have held that even a post-petition breach of an executory contract is not sufficient cause to compel a debtor to assume or reject the contract before confirmation.” In re Physicians Health Corp., 262 B.R. at 296 n.2.
235 Id.; see also In re Mansfield Tire & Rubber Co., 660 F.2d 1108, 1115 (6th Cir. 1981); In re Buna Painting & Drywall Co., Inc., 503 F.2d 618, 619 (9th Cir. 1974) (per curiam); In re Nelson Quality Eggs, Bk. No. 6-89-60, 1989 WL 29877, at *1 (Bankr. D. Minn. Mar. 29, 1989); accord Hallmark Builders, 205 B.R. at 976 (“The Debtor was never entitled to the bond because the Debtor never had a property interest in it.”).
good on certain financial liabilities of the debtor in the event the debtor does not or cannot pay.”236 Given that surety bonds guarantee the financial obligations of a debtor-principal, courts have roundly categorized surety bonds as contracts of financial accommodation under 11 U.S.C. § 365(c)(2).237 Thus, to allow the principal to continue performing without adequate assurance arguably forces the debtor to continue to provide credit in the form of surety bonds involuntarily.

Note that the fact that a surety bond is a financial accommodation and that the surety might have a right to termination does not necessarily allow the surety to circumvent the provisions of the automatic stay. For example, in Edwards Mobile Home Sales Inc. v. Ohio Casualty Insurance Co., the Chapter 11 debtor sought to enjoin Ohio Casualty from revoking a bond and from preventing the state from revoking the debtor's license to sell mobile homes.238 The court held that even though the bond issued to the debtor was a financial accommodation within the meaning of the Bankruptcy Code, the surety was required to seek relief from the automatic stay before terminating the bond.239

E. Assignment of Contracts Under the Bankruptcy Code

Upon assumption, the debtor may assign an executory contract to a third party provided there is adequate assurance of future performance by the assignee of the executory contract. It is the bankruptcy court that ultimately determines whether the proposed assignee meets the standards, not the nondebtor counterparty.240 Consequently, a construction contract may be assigned by the debtor following assumption. On the other hand, the surety bonds are non-assumable financial accommodations and they are not property of the Debtors or their estates.241 A surety bond is not an insurance policy.242 Unlike insurance, which is a two-party relationship, surety bonds are tripartite agreements in which the named principal is the primary obligor and the surety is the

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239 Id. at 860.

240 The use of contract balances by the debtor following assumption is beyond the scope of this paper. However, protecting the money is of great concern to the surety, who may want to obtain an order protecting its rights. This may be done, for example, through a cash collateral order providing that bonded contract funds are trust funds for the benefit and payment of all persons to whom the debtor owes an obligation to under the bonded contract, and providing that if the surety discharges any of those obligations, it has a right to assert a claim of that person to the trust funds.

241 See 11 U.S.C. § 365(c)(2) (2016); see also Matter of Lockard, 884 F. 2d 1171, 1177 (9th Cir. 1989); In re Mansfield Tire and Rubber Co., 660 F. 2d 1108, 1115 (6th Cir. 1981) (the surety bonds not property of the estate); In re Edwards Mobile Home Sales, Inc., 119 B.R. 857, 859 (Bankr. M.D. Fla. 1990) (surety bonds are financial accommodations and cannot be assumed); In re Wegner Farms Co., 49 B.R. 440, 4440 (Bankr. N.D. Iowa 1985); see also In re McLean Trucking Co., 74 B.R. 820, 826 (Bankr. W.D.N.C. 1987) (surety bond is not property of the debtor’s estate).

242 See Pearlman, 371 U.S. at 139 n. 19 (“Suretyship is not insurance.”); Meyer v. Building & Realty Serv. Co., 196 N.E. 250, 254 (Ind. 1935) (“We are clearly of the opinion that the contract here in question is a contract of suretyship and not an insurance policy.”); Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc., 983 S.W. 2d 501, 504 (Ky. 1998) (“A contract of suretyship is not a contract of insurance.”).
secondary obligor on the bonded obligation owing to the obligee.\textsuperscript{243} A surety has no obligation to assure performance of any party other than its bond principal. The entire burden of payment and performance of the bonded obligation therefore remains with the bond principal, and any arrangement shifting that burden from the bond principal (or otherwise increasing the surety’s risk or impairing the surety’s rights), by way of an involuntary substitution of principal or otherwise, constitutes a cardinal change in the underlying risk and discharges the bonds.\textsuperscript{244}

Assuming that the surety is comfortable with the debtor’s assumption and assignment of the bonded contract, what is needed from the assignee? In light of the foregoing principles, an obligee is unlikely to consent to an assignment of the contract without the related consent from the surety to such an assignment. Additionally, the obligee is likely unwilling to release the surety from its performance obligations under the bond unless and until the assignee completes performance of the assigned contract. A surety is also not likely willing to bond the assignee without further assurances from the assignee that it can and will perform the assigned contract. These assurances may take the form of a new indemnity agreement, and possibly collateral acceptable in the surety’s discretion, from the assignee. If the surety is not willing to bond the assignee, then the surety should require that the assignee provide replacement payment and performance bonds (from another surety) naming both the surety and the obligee as co-obligees.

A further option may be to add the assignee as an additional principal on the existing principal’s bond. In that event, the surety will need to consider doing so through its customary underwriting process and obtain appropriate indemnity from the assignee contractor. The assignee may object to its inclusion as an additional principal on the existing bond to the extent that in doing so it could be deemed to assume greater obligations than it intends to assume under the assignment agreement. In that event, a proper, manuscripted indemnification agreement may be appropriate. Or, to the extent the assignee is an existing surety account, a modification to the account’s existing indemnity agreement with the surety to include the assignment agreement as an indemnity obligation may be an option.

\section*{Conclusion}

A surety electing to complete a project on its own or through its principal faces myriad issues, not the least of which involves identifying and securing bonded contract funds for completion. A surety’s tasks also include evaluating the operational needs of a project and obtaining continued access to other project assets. Those assets may be subject to rights and interests of third-party lenders and other entities whose perspectives and objectives do not align with those of the completing surety. Thus, a surety must understand its principal’s capital and financing structure, as well as the capital and financing structure of the various parties to the construction project in order to better understand how best to secure continued access to funds and project assets. A surety that understands the financing structure on a project and the perspectives of the parties may find opportunities for transactional solutions that address those perspectives, and mitigate


\textsuperscript{244} \textit{See} \textit{RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY} §§ 37, 41 (1996).
loss for the surety. Finally, a bankruptcy filing by a construction bond principal creates its own set of hurdles, including a potential disconnect between a surety, on the one hand, and the other parties to the proceeding - the principal’s attorneys, banks, accounting and financial consultants or U.S. Trustee – on the other hand, who may view a surety’s bonded contract proceeds and other project assets as a source for funding the expenses of case administration and paying claims, not project completion. Thus, a surety seeking to secure access to assets needed for project completion in a bankruptcy context must “know the language” of the Bankruptcy Code so that it may articulate its positions on preservation of project assets in a way that the other constituencies understand.
CONSTRUCTION CONTRACT DAMAGES

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Introduction

Disputes frequently arise during the course of a construction project. Often, those disputes are largely governed by the contract negotiated and entered into between the owner and contractor and are resolved by a payment from one party to another. This paper will review damages to which a party may be entitled in the context of a construction dispute and the contract associated therewith, including, specifically, the damages typically available to and/or from an owner, contractor, or surety.

I. Damages Generally

When a construction contract is breached, the measure of damages to which the aggrieved party is entitled should be no different than the measure of damages awarded in the event of any contractual breach—the sum required to place the injured party in the same position that it would have been but for the breach. Though modern construction contracts tend to contain provisions governing the rights and obligations of the parties in the event of a default, only in rare instances are damages intended to punish or reward a party. They are instead intended to make an injured party whole.

A. Direct v. Consequential Damages

“Making an injured party whole” is deceptively simple when an injured party seeks what are commonly known as indirect or consequential damages. Recoverable damages are generally described as either “direct” and “consequential,” and distinguishing between the two has long been a difficult task for courts. “Direct damages” are generally thought to flow naturally or ordinarily from a breach. “Consequential damages” are thought to be those that “do not necessarily, but do directly, naturally, and proximately result from” the injury for which compensation is sought. Stated otherwise, direct damages arise in the natural course of events following a breach while consequential damages are “secondary or derivative losses arising from circumstances that are particular to the contract or to the parties.”

The Virginia Supreme Court has explained:

Consequential Damages are those which arise from the intervention of “special circumstances” not ordinarily predictable. If damages are determined to be consequential, they are compensable only if it is determined that the special

2 Id.
circumstances were within the “contemplation” of both contracting parties. Whether damages are direct or consequential is a question of law. Whether special circumstances were within the contemplation of the parties is a question of fact. 5 A. Corbin, Contracts §1012(89) (1964); C. McCormick, Damages § 140(574) (1935). As a general rule, contemplation must exist at the time the contract was executed. Corbin, Supra at §1008(74); Restatement of Contracts §330 (1932); 11 S. Williston, Contracts §1357 (293-94) (1968). However, that rule is not absolute.7

The law of consequential damages is often traced to the English common law, specifically Hadley v. Baxendale, an English case holding that consequential damages are only recoverable when they were contemplated by both parties at the formation of the contract.8 Thus, though consequential damages are often thought to be the result of special circumstances, like other damages, they must be directly traceable to the breach of contract, caused by the breach of contract, and be reasonably foreseeable.9 Unlike other damages, however, they “will not be presumed by mere breach.”10 Rather, courts have held that they are recoverable when “the special or particular circumstances from which they arise were actually communicated to or known by the breaching party or were matters of which the breaching party should have been aware at the time of contracting.”11

Over the years, courts have somewhat relaxed the stringent foreseeability requirement set forth in Hadley and its progeny. In Perini Corporation v. Great Bay Hotel & Casino, for example, a general contractor contracted to perform construction management services for an Atlantic City hotel and casino.12 For a fee of $600,000.00, the general contractor agreed to manage a project involving the construction of a large, non-functional ornamental glass façade.13 By contract, the general contractor was required to achieve substantial completion by May 31, 1984.14 However substantial completion was not achieved until September 14, 1984.15

In an arbitration with the general contractor, the casino sought lost profits that it allegedly incurred as a result of the delay.16 Though the project was only delayed by about four months, the arbitration panel awarded, and the court affirmed, over $14.5 million in damages to the owner—twenty-four times the contract fee.17 The New Jersey Supreme Court reasoned that so long as the consequential damages were reasonably foreseeable, the plaintiff would be entitled to recover its lost profits.18

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7 Roanoke Hosp., 214 S.E.2d at 155.
10 Lewis Jorge, 102 P.3d at 261-262.
11 Id.; see also Globe Ref. Co. v Landa Cotton Oil, 190 U.S. 540, 544-545 (1903).
13 Id. at 367.
14 Id. at 374.
15 Id. at 367-368.
16 Id. at 368.
17 Id. at 374-375.
18 Id.
B. Damages Provisions in Contract

Damage provisions in construction contracts, including waivers of consequential damages, have become critical risk allocation devices, and in the case of Perini, for example, could have substantially reduced the damages for which the general contractor was liable. Thus, a review of the relevant contract is critical in any damages analysis. Some of the more common contractual provisions are discussed below.

1. Waiver of Consequential Damages

Since Perini, contractual waivers of consequential damages have become widespread, and, since 1997, the American Institute of Architects has included a mutual waiver of consequential damages in its standard General Conditions for Construction. Though some contracts, including the AIA A201-1997 General Conditions, attempt to clarify the waived damages, varying judicial interpretations and transaction-based facts make non-direct damages difficult to define with any predictability or uniformity.

Though waivers are discouraged by principles of contract law, they are generally found to be enforceable if: (1) the waiver is written in clear and unambiguous terms; (2) in the contract; and (3) is brought to the attention of the party against whom it is enforced.

2. No Damage for Delay Clauses

As a general rule, in the absence of a contractual provision to the contrary, a contractor or subcontractor delayed in the performance of its contract can recover damages resulting from a delay caused the owner or general contractor. As would be expected, a “no damage for delay” clause reallocates the risk of delay and waives a contractor or subcontractor’s entitlement to damages that would otherwise be recoverable.

These waiver provisions are disfavored and are strictly construed against the party seeking to enforce them. However, they are generally enforceable. Courts have, however, noted the following exceptions to the enforcement of a no damage for delay clause:

21 When determining if a delay was contemplated by the parties when they agreed to a “no-damages-for-delay” clause, courts strictly construe these clauses against the drafter. See, e.g., Wells Bros. Co. of N.Y. v. United States, 254 U.S. 83, 87 (1920); Dep’t. of Trans. v. Arapaho Constr., Inc., 357 S.E.2d 593, 594 (Ga. 1987); see also Williams & Sons Erectors v. S.C. Steel, 983 F.2d 1176, 1184 (2d Cir. 1993) (holding that portions of a contract were ambiguous and thus allowed the contractor to proceed with its delay claim despite a no-damages-for-delay-clause).
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(1) delay caused by fraud or bad faith;
(2) delay caused by active interference;
(3) delay so unreasonable that the delayed party justifiably could have abandoned the contract;
(4) delay not contemplated by the parties; and
(5) delay caused by gross negligence.23

A “no damage for delay” clause may also be avoided if the owner, expressly or impliedly, assumes responsibility for causing the delay. In Commonwealth State Highway & Bridge Authority v. General Asphalt Paving Co., for example, the contractor was delayed due to pressure problems in a water main owned by the City of Philadelphia.24 The owner assumed the responsibility of negotiating with the city to have the water main removed.25 On appeal from the claims board, the court held that the contractor could recover delay damages despite a “no damage for delay” clause because the owner had assumed the responsibility of the main’s presence when it entered into negotiations with the city to have it removed.26

Further, at least two federal courts have held that no damage for delay clauses contained in subcontracts on federal projects violated the Miller Act and were thus void and unenforceable.27 Such clauses are similarly void and unenforceable under certain circumstances, most commonly on public projects, in a number of states.28

(a) Liquidated Damages

In construction contracts, liquidated damages clauses are a common way for a project owner to protect against delays in completion by the contractor. Such clauses typically provide that, for each day of delay beyond the contractually mandated substantial completion date, the contractor will pay to the owner a "liquidated" sum rather than actual damages. The clauses are generally thought to provide financial protection for delayed substantial completion by eliminating certain difficulties inherent in recovering actual damages.


25 Id.
26 Id. at 1141.
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Generally, courts will enforce a liquidated damages clause if: (1) the amount fixed is a reasonable forecast of compensation for the harm caused by a delay; and (2) the harm caused by the breach was, at the time of the contract’s execution, difficult or impossible to calculate. A liquidated damages provision will generally be unenforceable as a violation of public policy if the stipulated sum is found to be unreasonably large.

Liquidated damages are intended to take the place of actual damages and, consequentially, are an exclusive remedy to be used in lieu of, and not in addition to, actual damages. Even if actual damages exceed the stipulated, or “liquidated” sum, recovery will be limited to the stipulated amount.

3. Damages Available to the Owner

If a contractor abandons the project, the owner terminates the contractor for cause, or the contractor otherwise fails to fulfill its contractual obligations, the owner may be entitled to recover certain damages. As with any damages analysis, a determination of the damages to which the owner is entitled should begin with a review of the contract. More often than not, the contract documents are drafted or provided by the owner and will thus contain remedies and damage provisions that favor the owner.

(a) Delay Damages

If a contractor has inexcusably delayed completion, the owner may demand that the contractor accelerate its performance to meet the schedule, recover actual or liquidated damages from the contractor, and, in some cases, terminate the contract for default. If the contract contains no liquidated damages provision, as a general rule, the contractor is liable for the foreseeable costs incurred by an owner as a result of the contractor’s delay in completing a project. Those costs may include interest, rental charges, and other expenses incurred as a result of the delay. Commonly, though, by utilizing a liquidated damages clause, the owner and contractor have by contract established a per diem dollar figure representing an approximation of the actual damages the owner will suffer if the contractor fails to complete his contractual obligations within the time frame required by the contract.

(b) Defective and/or Incomplete Work

There are generally two methods by which a court will calculate damages to which the owner is entitled as a result of defective and/or incomplete work performed by the contractor. One, generally called the “cost of performance,” determines the reasonable cost of correcting the work.
defects or completing the work. The other, generally referred to as “diminution” or “difference in value,” determines the difference between the value of the project with and without the defects and/or incomplete work.

In describing the application of the two methods, § 348(2) of the Restatement (Second) of Contracts provides:

(2) If a breach results in defective or unfinished construction and the loss in value to the injured party is not proved with sufficient certainty, he may recover damages based on:

(a) the diminution in the market price of the property caused by the breach, or

(b) the reasonable cost of completing performance or of remediying the defects if that cost is not clearly disproportionate to the probable loss in value to him.35

In comment (c) to this portion of the Restatement, the drafters explain that the owner “can usually recover damages based on the cost to remedy the defects. Even if this gives him a recovery somewhat in excess of the loss in value to him, it is better that he receives a small windfall than he be under compensated by being limited to the resulting diminution in the market price of his property.” Sometimes, however, “such a large part of the cost to remedy the defects consists of the cost to undo what has been improperly done that the cost to remedy the defects will be clearly disproportionate to the probable loss in value to the injured party.”36 In such a case, “[d]amages based on the cost to remedy the defects would then give the injured party a recovery greatly in excess of the loss in value to him and result in a substantial windfall. Such an award will not be made.”37

For example, in the oft cited case of Jacob & Youngs, Inc. v. Kent, a builder contracted to build a country home for an attorney in New York.38 Though the contract provided that only Reading pipe would be used in construction, the builder used other materials.39 In an opinion by Judge Cardozo, the court ruled that in order for the contractor to replace the non-conforming, but, apparently good pipe with Reading pipe, a great deal of contractually conforming work would have to be destroyed.40 Thus, the court stated that in a case of this kind, where the cost of completion was “grossly and unfairly out of proportion to the good to be attained,” the appropriate measure of damages was not the cost of completion, but the diminution in value of the property, which, Judge Cardozo explained would be “nominal or nothing.”41

36 Id. at cmt. c.
37 Id.
38 129 N.E. 889 (N.Y. 1921).
39 Id. at 890.
40 Id. at 891-892.
41 Id.
In *Grossman Holdings, Ltd. v. Hourihan*, the Florida Supreme Court adopted a similar analysis and held:

The purpose of money damages is to put the injured party in as good a position as that in which full performance would have put him; but this does not mean that he is to be put in the same specific physical position. Satisfaction for his harm is made either by giving him a sum of money sufficient to produce the physical product contracted for or by giving him the exchange value that that product would have had if it had been constructed...The law does not require damages to be measured by a method requiring such economic waste.  

North Carolina courts similarly prefer the “cost of repair” method to ensure the owner has received the full benefit of his bargain. However, the diminution in value method will be utilized if two conditions exist: (1) the completed project substantially conforms to the contract requirements with only minor defects which do not substantially lower the value of the structure; and (2) the repair method would require a significant portion of the work to be reconstructed or demolished to enable the structure to fully conform.

4. **Damages Available to the Contractor**

Most construction contracts contain comprehensive provisions governing the rights and obligations of the parties in the event of a material breach, and the interpretation of these provisions dominates the landscape of construction claims. Thus, negotiating the terms of the contract between the owner and contractor is of paramount importance. This section will not endeavor to analyze these heavily negotiated provisions but will examine ways that the contractor may be damaged by acts or omissions of the owner.

In most states, nonpayment by the owner entitles the contractor to damages equaling the amount owed, plus interest calculated from the due date of the payment. The interest rate can either be set by statute or negotiated by the parties in the contract between them. Additionally, if a contractor is unlawfully or improperly terminated, the contractor is entitled to damages stemming from that improper termination. Damages stemming from an owner default (e.g., improper termination) include payment for the work performed through the improper termination, the cost of terminating the contract (e.g. settling with subcontractors/suppliers, demobilization costs, etc.), and lost profits on the unperformed portions of the contract.

However, in all circumstances, the recoverable damages are limited by certain legal principles. Among these are foreseeability, uncertainty, mitigation, betterment, economic waste, and disproportionality. Under no circumstance is the contractor allowed to create a situation where more damages are incurred solely in an attempt to recover more from the owner on the backend. *Rockingham County v. Luten Bridge Co.* provides the best (or worst) example of a contractor’s attempt to create damages. In *Luten Bridge*, a county, after awarding a contract for

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42 414 So. 2d 1037, 1039 (Fla. 1982).
45 Rockingham Cty. v. Luten Bridge Co., 35 F.2d 301 (4th Cir. 1929).
the construction of a bridge, a county notified the contractor that the bridge was not needed because the highway had been re-routed.\textsuperscript{46} The county viewed this as rescinding the contract.\textsuperscript{47} Despite receiving notice that the bridge was not going to be needed, the general contractor built the bridge, and then brought suit to recover the contract price. The trial court awarded the general contractor the contract price as actual damages, and the result was appealed to the Fourth Circuit.\textsuperscript{48} In reversing the judgment of the trial court, the Fourth Circuit found:

\begin{quote}
[A]s to the measure of plaintiff's recovery— we do not think that, after the county had given notice, while the contract was still executory, that it did not desire the bridge built and would not pay for it, plaintiff could proceed to build it and recover the contract price. It is true that the county had no right to rescind the contract, and the notice given plaintiff amounted to a breach on its part; but, after plaintiff had received notice of the breach, it was its duty to do nothing to increase the damages flowing therefrom. If A enters into a binding contract to build a house for B, B, of course, has no right to rescind the contract without A's consent. But if, before the house is built, he decides that he does not want it, and notifies A to that effect, A has no right to proceed with the building and thus pile up damages. His remedy is to treat the contract as broken when he receives the notice, and sue for the recovery of such damages, as he may have sustained from the breach, including any profit which he would have realized upon performance, as well as any other losses which may have resulted to him. In the case at bar, the county decided not to build the road of which the bridge was to be a part, and did not build it. The bridge, built in the midst of the forest, is of no value to the county because of this change of circumstances. When, therefore, the county gave notice to the plaintiff that it would not proceed with the project, plaintiff should have desisted from further work. It had no right thus to pile up damages by proceeding with the erection of a useless bridge.\textsuperscript{49}
\end{quote}

While the actions taken by the general contractor may seem extreme, it is a good example of a contractor’s attempt to create damages, which is clearly impermissible. Below is a brief discussion of other types of damages commonly available to a contractor from the owner.

\textbf{A. Owner Caused Delay Damages}

Construction contracts carry with them certain implied obligations between the owner and the prime contractor. In every construction contract, there is an implied obligation that the owner will not interfere with the continuation of the contractor’s work.\textsuperscript{50} If the owner interferes with the continuation of the contractor’s work and causes a delay to the contractor, in most cases the contractor will be allowed to demand compensation in addition to extra time needed to complete the project. Examples of owner caused delays include unilateral changes to the contract, an improper start date, defective plans and specifications, owner issued stop work orders, an

\begin{footnotes}
\footnote{Id. at 303.}
\footnote{Id.}
\footnote{Id. at 302.}
\footnote{Id. at 307.}
\end{footnotes}
owner’s refusal to allow contractor to use an acceptable procedure consistently allowed in the past. As you can see, the types of owner caused delays are endless; however, the remedy for an owner caused delay should be analyzed in conjunction with the presence of (or lack thereof) a no damage for delay clause. However, it should be noted that active owner interference may entitle the contractor to compensation despite the contract having a no damages for delay clause.

As an aside, an owner’s liability to its prime contractor for owner -caused delay does not necessarily mean that the prime contractor is responsible to any of its subcontractors for an owner-caused delay. In a 1991 case out of New York, the court examined this issue and held that “absent a contractual commitment to the contrary, a prime contractor is not responsible for delays that its subcontractor may incur unless those delays are caused by some agency or circumstance under the prime contractor’s direction or control.”\(^{51}\) A clause recently encountered by the author contained the following language, wherein the contractor explicitly discussed owner delays:

If in Contractor’s sole discretion, Subcontractor falls behind the Schedule for the Subcontract Work or if Subcontractor is otherwise not maintaining a satisfactory rate of progress so as to complete the Project in the most expeditious and economical manner, Contractor may direct Subcontractor to take such action as Contractor in good faith deems necessary or appropriate to improve Subcontractor’s rate of progress. In addition, Contractor shall have the right, but not the obligation and without prejudice to any other right or remedy, upon notice to Subcontractor, to provide any additional labor, materials, equipment, supervision, or other item and to take such additional action as Contractor in good faith believes to be necessary or appropriate under the circumstances, and any such action undertaken by Contractor shall be at Subcontractor’s cost, which Contractor shall be entitled to deduct from any payment whether then due or thereafter to become due, to Subcontractor. If Owner delays, disrupts or interferes with the Subcontract Work, Subcontractor as its sole and exclusive remedy may, upon written request properly and timely made to Contractor, obtain reasonable time extensions and a reasonable increase in the Subcontract Price but only to the extent of any extensions of time and additional amounts that Contractor, given proper notice, shall be entitled to from owner. Regardless of the cause or source of delay, disruption or interference with Subcontract Work, and even if caused in whole or in part by Contractor, Subcontractor shall not be entitled to any compensation or damages for delay, disruption, or interference (including, without limitation, impact, inefficiency, and extended overhead claims) except to the extent Contractor receives, on Subcontractor’s behalf, such compensation or damages from Owner or other third party.

As a condition precedent to any relief, Subcontractor must give Contractor timely written notice of delay, disruption, and/or damage to the Subcontract Work.

This provision is an example of those commonly found in construction contracts, which set out the down-stream contractor’s remedy for upstream delays.

After a delay occurs, a “value” must be put on this delay. Delays to a specific scope of work generally have no value if the overall progress of the job is not delayed. Put another way, the delay must impact the construction schedule in a significant manner. Establishing the value of the delay is generally an expensive endeavor requiring an analysis of the impact under the critical path method as only delays that affect the critical path of the project warrant relief based on the delay.

In addition to the effect a particular delay has on the completion of the project, the value of the delay can also be determined by the overall effect the delay has on the contractor. For example, if the owner is unable to turn over the site to the contractor to begin work at the time it was contractually required to do so, a mere extension of the contract time may not suffice to place the contractor in the place it was before the delay occurred. In this example, if the delay caused the contractor to field the job with employees because it was preparing to begin construction, it may be entitled to recover these direct job costs, which may include field observation and overhead, idle labor and equipment, and material and labor escalation costs resulting from the delay. Other types of damages a contractor may be entitled to recover from an owner caused delay are home office and overhead costs, inefficiency costs, and, as mentioned above, lost profits. In *Luria Bros. & Co. v. United States*, the court summarized the compensable damages resulting from an owner’s delay:

The trial commissioner has determined that the plaintiff suffered delay damages and additional expenditures directly attributable to the defendant's breaches in the amount of $85,544.92. This amount is made up of 81 percent (420/518) of the overrun period costs for idle equipment, field supervision, winter protection, rehandling materials, maintaining excavations, and wage and material price increases plus 100 percent of an insurance premium plaintiff was required to pay. (See infra findings 46-54, 57.) This fairly represents the damages suffered by plaintiff with regard to those items.

We are of opinion that the trial commissioner was in error in finding that plaintiff was not entitled to home office overhead and hence in failing to determine the amount thereof. Home office overhead is a well-recognized item of damage for delay and plaintiff would be entitled to recover it, if it did not release its claim to it. *J. D. Hedin Constr. Co. v. United States*, 347 F.2d 235, 171 Ct.Cl. 70 (1965); *F. H. McGraw & Co. v. United States*, 130 F.Supp. 394, 131 Ct.Cl. 501 (1955); *Fred R. Comb Co. v. United States*, 103 Ct.Cl. 174 (1945).

That loss of productivity of labor resulting from improper delays caused by defendant is an item of damage for which plaintiff is entitled to recover admits of no doubt, *Abbett Electric Corp. v. United States*, 162 F.Supp. 772, 142 Ct.Cl.
There are also excusable delays, which generally are either compensable or non-compensable. A compensable excusable delay is typically governed by the express terms of the contract and gives rise to the right to additional time and/or compensation. In order for the delay to be compensable, it must be more than an ordinary delay and not reasonable contemplated by the parties. A non-compensable excusable delay is a delay caused by neither party and for which the contract allows for an extension of time, but no additional compensation. An example of this would be excessive rain delaying the project.

There can also be concurrent delays, which may serve to offset any damages that would otherwise be the responsibility of the contractor. Thus, when faced with the imposition of liquidated damages, a contractor may use as a defense a concurrent delay. A concurrent delay occurs when there are delays occurring simultaneously caused by both the contractor and the owner, which operate to hinder or delay the timely completion of project. As liquidated damages are generally assessed at the completion of the project, that is generally when a claim for concurrent delays is submitted. However, to combat the delayed assertion of concurrent delays, most construction contracts include provisions requiring written notice of delay events, as well as specific contractual requirements for how and when a contractor must submit requests for time and money on these delays. Below is an example of a provision governing delays, including concurrent delays:

22. **DELAYS, EXTENSION OF TIME:**

Delays. If the Contractor is delayed in progressing any task which at the time of the delay is then critical, as set forth in the Contractor’s Critical Path Method schedule approved by the Awarding Authority and Designer under Article 9, or which during the delay become critical, as set forth in the Contractor’s Critical Path Method schedule approved by the Awarding Authority and Designer under Article 9, as the sole result of an act or omission of the Awarding Authority or of any other contractor on the site employed by the Awarding Authority, by strikes, lockouts, fires, abnormal flood, tornadoes, or other cataclysmic phenomenon of nature, or by causes beyond the Contactor’s control, then Contractor may be entitled to an extension of time, conditional that the Contractor does not experience a concurrent delay, in which to complete the Work, provided however, that the Contractor shall give written notice of such cause to the Awarding Authority not more than seven (7) days after the occurrence of the event or the first appearance of the condition giving rise to the claim and shall set forth in detail the Contractor’s basis for requiring additional time in which to complete the Work. Such time extensions shall only be allowed upon
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approval of the Awarding Authority. The failure of the Contractor to give such notice within seven (7) days shall constitute a waiver of any such claim for an extension of time in which to complete the Work.

This provision is very typical of what you might see in a contract, specifically with regard to the notice provision contained therein. One thing to consider when faced with these provisions is whether or not the jurisdiction you are in will enforce the notice provision strictly or if prejudice must be proven in order for the notice provision to be upheld. With concurrent delays, it is also important to note that the owner may be entitled to assess liquidated damages for contractor delays if the owner’s delays were not on the critical path.\(^\text{54}\) Although there are unlimited types of delays on a construction project, hopefully the above sheds some light on the types of damages available to the contractor under its contract with the owner.

Before moving to damages available from the surety, it should be noted that the surety has the ability to assert the defenses of its principal. Thus, if the surety is called upon to complete the project after its principal has been declared in default, it is entitled to assert the defenses available to the principal, whether or not the principal has asserted these defenses. An addition to the principal’s defenses, the surety can also assert specific surety defenses, such as overpayment and failure to comply with the conditions precedent to default to lessen or avoid liability under the performance bond.\(^\text{55}\)

5. **Damages Recoverable from the Surety**

In all public projects where the total contract price exceeds that set by statute, and in many large private projects, a surety issues a performance bond guaranteeing the contractor’s performance of its contract with the owner. In instances where the contractor fails to perform the terms of its contract, the obligee will often make a claim on the performance bond, which gives the surety the option, among other things, to affect completion of the project. As a result of the principal’s default, the obligee oftentimes incurs damages as a result of the contractor’s default under the contract and, in many cases, seeks to recover those damages from the surety. In these instances, the recovery of damages by the obligee may be based on the obligee’s right of recovery against the principal (contractor) or may be based on the surety’s failure to fulfill its obligations under the performance bond. At the center of any such claim are two documents that largely dictate the damages recoverable from the surety: (1) the performance bond; and (2) the underlying construction contract between the principal and the obligee.

The language contained in the performance bond will be a determinative factor as to the type of damages recoverable by the owner/obligee. In addition to the damages that the surety can be liable for vis-a-vis its principal, the language of the performance bond will impose upon the

\(^\text{54}\) Blackhawk Heating & Plumbing Co., Inc., G.S.B.C.A. No. 2432, 76-1 B.C.A. (CCH) ¶ 11649, 1975 WL 1482 (Gen. Servs. Admin. B.C.A. 1975) (government entitled to assess liquidated damages for contractor delay because "delays" caused by government were not on the critical path).

\(^\text{55}\) For a more comprehensive review of the surety’s potential defenses to a claim by the owner, see, Eric G. Korphage, Derek A. Popeil, & Diane J. Schumaker, *Ch. 11, Defenses Available to the Surety, in THE LAW OF PERFORMANCE BONDS* 487 (Gregory M. Weinstein & Kimberly Zanotta eds., Am. Bar. Ass’n 3d 2018).
Construction Contract Damages

surety certain liabilities. For example, the AIA A312-2010 Performance Bond states that the surety is liable for the following damages:

§6 If the Surety does not proceed as provided in Section 5 with reasonable promptness, the Surety shall be deemed to be in default on this Bond seven days after receipt of an additional written notice from the Owner to the Surety demanding that the Surety perform its obligations under this Bond, and the Owner shall be entitled to enforce any remedy available to the Owner. If the Surety proceeds as provided in Section 5.4, and the Owner refuses the payment or the Surety has denied liability, in whole or in part, without further notice the Owner shall be entitled to enforce any remedy available to the Owner.

§7 If the Surety elects to act under Section 5.1, 5.2 or 5.3, then the responsibilities of the Surety to the Owner shall not be greater than those of the Contractor under the Construction Contract, and the responsibilities of the Owner to the Surety shall not be greater than those of the Owner under the Construction Contract. Subject to the commitment by the Owner to pay the Balance of the Contract Price, the Surety is obligated, without duplication, for:

1. the responsibilities of the Contractor for correction of defective work and completion of the Construction Contract;
2. additional legal design professional and delay costs resulting from the Contractor’s Default, and resulting from the acts or failure to act of the Surety under Section 5; and
3. liquidated damages, or if no liquidated damages are specified in the Construction Contract, actual damages caused by delayed performance or non-performance of the Contractor

§8 If the Surety elects to act under Section 5., 5.3 or 5.4, the Surety’s liability is limited to the amount of this Bond.

§9 The Surety shall not be liable to the Owner or others for obligations of the Contractor that are unrelated to the Construction Contract, and the Balance of the Contract Price shall not be reduced or set off on account of any such unrelated obligations. No right of action shall accrue on this Bond in any person or entity other than the Owner or its heirs, executors, administrators, successors and assigns.56

Similarly, the AIA A312-1986 Performance Bond states the following:

§6 After the Owner has terminated the Contractor’s right to complete the Construction Contract, and if the Surety elects to act under Section 4.1, 4.2, or 4.3 above, then the responsibilities of the Surety to the Owner shall not be greater than those of the Contractor under the Construction Contract, and the

56 AM. INST. OF ARCHITECTS, AIA A312 Performance Bond-2010, §§ 6-9 (2010).
The responsibilities of the Owner to the Surety shall not be greater than those of the Owner under the Construction Contract. To the limit of the amount of this Bond, but subject to commitment by the Owner of the Balance of the Contract Price to mitigation of costs and damages on the Construction Contract, the Surety is obligated without duplication for:

§6.1 The responsibilities of the Contractor for correction of defective work and completion of the Construction Contract;

§6.2 Additional legal, design professional and delay costs resulting from the Contractor’s Default, and resulting from the actions or failure to act of the Surety under Section 4; and

§6.3 Liquidated damages, or if no liquidated damage are specified in the Construction Contract, actual damages caused by delayed performance or non-performance of the Contractor.57

Thus, as both the 1986 and the 2010 iterations of the A312 Performance Bond plainly state, and as numerous courts have held, a surety is liable for actual damages if, for no other reason, because the principal will be liable for actual damages, and the surety’s liability is coextensive with that of its principal.58

Conversely, the AIA A312 Performance Bond and many other performance bonds do not explicitly address a surety’s liability for consequential damages caused by the principal’s default. However, due to the incorporation by reference language in almost every performance bond, it is prudent to examine the contract between the principal and the obligee to determine if there is a waiver of consequential damages provision that the surety can rely upon or a provision expressly providing for the imposition of consequential damages.59 As can be imagined, the scope of performance bond coverage as it relates to the potential imposition of consequential damages to the surety has sparked controversy nationally. Some of the most common types of consequential damages litigated include:

1. delay Damages;60
2. liabilities arising from the principal’s failure to pay certain taxes;
3. attorneys’ fees;61

58 BMD Contractors, Inc. v. Fid. & Deposit Co. of Md., 679 F.3d 643, 653 (7th Cir. 2012).
59 See Gen. Builders Supply Co. v. MacArthur, 179 A.2d 868, 871-872 (Md. 1962) (the construction contract was incorporated by reference into the performance bond and made a part thereof, and as a result, the surety was liable for all damages that the principal could be liable for.)
Construction Contract Damages

4. prejudgment interest;  
5. extracontractual damages;  
6. damages in excess of the penal sum of the bond.

In addition to the possibility of a court finding the surety liable for consequential damages due to its principal’s conduct, a surety’s actions (or inactions) can result in the imposition of consequential damages to the surety. One situation where this can occur is when the surety does not respond to a performance bond claim or does not respond “with reasonable promptness” as is required by the AIA A312-2010 Performance Bond. In either instance, the surety opens itself up to a host of damages for which the surety may not have otherwise been liable. In fact, one court found that a surety’s decision to “do nothing” following default and termination of the bonded contract was found to have constituted a “breach of the bond” that exposed the surety to liability for all actual compensatory contract damages sustained by the obligee without limit by the bond amount. While this opinion is an outlier, it bears mentioning.

Conclusion

As this paper demonstrates, there are a host of damages available to and from all parties to a construction contract. As this area of law is ever changing as new provisions are included, omitted, and/or revised in construction contracts, it is incumbent upon practitioners to advise clients prior to them entering into construction contracts of any provisions contained therein that can affect a claim for damages at any point during performance of the contract. As the contract will provide the types of damages available to both parties and any notice provisions required in order to perfect a right to claim those damages in the future, both parties are in a much better position to negotiate these provisions on the front end. While doing this will not eliminate litigation in all cases, it should help narrow the issues, and, accordingly, reduce the cost of litigation. However, all too often the performing surety enters the picture long after contractual provisions have been negotiated and, as such, is restricted to the provisions governing the contract it guaranteed or those negotiated in a subsequent takeover/completion agreement.


62 Ins. Co. of N. Am. v. United States, 951 F.2d 1244, 1246-1247 (Fed. Cir. 1991) (prejudgment interest recoverable under Miller Act performance bond); Centex Great Sw. Corp. v. Aetna Cas. & Sur. Co., 718 So. 2d 1269, 1271 (Fla. Dist. Ct. App. 1998) (general contractor not entitled to recover from subcontractor’s performance bond surety interest on funds withheld by owner for defective welds performed by subcontractor as bond merely indemnified contractor for liability it would incur from owner’s claims); see also Morse/Diesel, Inc. v. Trinity Indus., Inc., 875 F. Supp. 165, 176 (S.D.N.Y. 1994) (surety found liable for two types of prejudgment interest: (1) attributable to its principal which is capped by the bond’s penal sum and (2) that stemmed from its own defaults which is not so limited).


Therefore, it is important for the performing surety, as soon as it called upon, to analyze the obligee/principal contract to determine provisions that could affect the liability of the surety during the completion process.
CONSTRUCTION CONTRACT DAMAGES

Alec Taylor, Krebs, Farley & Dry, Flowood, Mississippi
Rachel Walsh, Liberty Mutual, King of Prussia, Pennsylvania
Dennis O’Neill, Beacon Consulting Group, Medford, Massachusetts
WHAT CAN YOU EXPECT OVER THE NEXT 40 MINUTES?

• Numerous winks and “How you doing’s” from Dennis
• Cool pictures and videos to support this fascinating subject matter
• A refresher on damages provisions in construction projects and their potential affect on a performing surety
DAMAGES

• Goal
  • Make the injured party whole
  • Seems simple enough, right?
TYPES OF DAMAGES

• Direct Damages
  – flow naturally from a breach
  – Examples
    • Unpaid amounts due to contractor
    • Costs incurred to repair defective work
    • Costs incurred to complete the work of contractor
Direct Damages?
TYPES OF DAMAGES

• Consequential

• “Consequential Damages are those which arise from the intervention of ‘special circumstances’ not ordinarily predictable. If damages are determined to be consequential, they are compensable only if it is determined that the special circumstances were within the ‘contemplation’ of both contracting parties.” Roanoke Hosp. Ass’n v. Doyle and Russell, Inc., 214 S.E.2d 155, 160 (Va. 1975).
CASE STUDY

• Perini Corporation v. Great Bay Hotel & Casino (New Jersey)
• GC entered into $600,000 contract to manage construction of glass façade.
• Substantial completion date - May 31, 1984
• Actual completion date – September 14, 1984
• Arbitration awarded over $14.5 million in damages to owner.
• affirmed by New Jersey Supreme Court?
DAMAGES PROVISION IN CONTRACTS

• Waiver of Consequential Damages
• No Damages for Delay
• Liquidated Damages
WAIVER OF CONSEQUENTIAL DAMAGES

• Since *Perini*, these provisions have become popular.
• Has become standard in the AIA-A201 for over 20 years
§ 15.1.6 CLAIMS FOR CONSEQUENTIAL DAMAGES

The Contractor and Owner waive Claims against each other for consequential damages arising out of or relating to this Contract. This mutual waiver includes

.1 damages incurred by the Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and

.2 damages incurred by the Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit except anticipated profit arising directly from the Work.

This mutual waiver is applicable, without limitation, to all consequential damages due to either party’s termination in accordance with Article 14. Nothing contained in this Section 15.1.6 shall be deemed to preclude an award of liquidated damages, when applicable, in accordance with the requirements of the Contract Documents.
WAIVER OF CONSEQUENTIAL DAMAGES

• Generally enforceable if:
  1. Waiver is clear and unambiguous
  2. It’s in the contract (obvious one)
  3. Brought to the attention of the party that it will be enforced against
NO DAMAGES FOR DELAY

• Without provision?
  – Contractor or subcontractor delayed in the performance of contract can recover damages resulting from delay of owner/contractor
NO DAMAGES FOR DELAY

• A no damages for delay clause reallocates the risk of delay and waives contractor or subcontractor’s entitlement to otherwise collectible delay damages

• Disfavored and strictly construed against party seeking to enforce them
NO DAMAGES FOR DELAY

• Even if otherwise enforceable, courts have held that NDFD clauses won’t be enforced if:
  1. Delay caused by fraud or bad faith
  2. Delay caused by active interference
  3. Delay so unreasonable that the delayed party justifiably could have abandoned the contract
  4. Delay not contemplated by the parties
  5. Delay caused by gross negligence
NO DAMAGES FOR DELAY

• *Commonwealth State Highway & Bridge Authority v. General Asphalt Paving Co.*
  – Contractor was delayed due to pressure problem in water main owned by City of Philadelphia, PA
  – Owner assumed responsibility of negotiating with City to have water main removed
  – On appeal, court held Contractor could recover delay damages even though there was a NDFD clause
  – Reason? Owner assumed responsibility when it entered into negotiations with City
NO DAMAGES FOR DELAY

• Miller Act?
  – At least two federal courts (Kentucky and Idaho) held that NDFD clauses in subcontracts on federal project violated Miller Act and were void and unenforceable
LIQUIDATED DAMAGES

• Remember – contractor can’t recover both actual and liquidated damages

• Generally enforceable if:
  1. Amount is commensurate with harm caused by delay
  2. Harm caused by breach was, at the time of the execution of the contract, difficult or impossible to calculate
DAMAGES AVAILABLE TO OWNER

• When does this arise?
  – Abandonment by contractor
  – Termination of contractor
  – Default of contractor

• Read the contract.
DELAY DAMAGES
DELAY DAMAGES

• Contractor inexcusably delayed completion.
• Remedies?
  – Demand acceleration
  – Recover actual or liquidated damages. Not both.
  – If not LD provision, owner may recover
    • Foreseeable costs incurred by owner as a result of the contractor’s delay in completing project
DEFECTIVE WORK
DEFECTIVE/INCOMPLETE WORK

• Two methods courts use to calculate damages to owner.
  1. Cost of performance
  2. Diminution or differences in value
DEFECTIVE/INCOMPLETE WORK

• Owner can usually recover damages based on cost to remedy defects.
  – Even if owner would receive a small windfall
  – “it is better that he [owner] receives a small windfall than he be under compensated by being limited to the resulting diminution in the market price of his property.” Comment (c) to Section 348 Restatement (Second) of Contracts
DEFECTIVE/INCOMPLETE WORK

• When diminution of value is proper
• “such a large part of the cost to remedy the defects consists of the cost to undo what has been improperly done that the cost to remedy the defects will be clearly disproportionate to the probable loss in value to the injured party.”
DEFECTIVE/INCOMPLETE WORK

• *Grossman Holdings, Ltd. v. Hourihan (Fla Supreme Court)*
  – The purpose of money damages is to put the injured party in as good a position as that in which full performance would have put him; but this does not mean that he is to be put in the same specific physical position. Satisfaction for his harm is made either by giving him a sum of money sufficient to produce the physical product contracted for or by giving him the exchange value that that product would have had if it had been constructed...The law does not require damages to be measured by a method requiring such economic waste.
DAMAGES AVAILABLE TO CONTRACTOR/SURETY

• Nonpayment by owner?
• Owner default?
  – Payment for work performed
  – Cost of terminating contract
  – Lost profits
DAMAGES AVAILABLE TO CONTRACTOR/SURETY

• Legal principles determining damages:
  1. Foreseeability
  2. Uncertainty
  3. Mitigation
  4. Betterment
  5. Economic waste
  6. Disproportionality
DAMAGES AVAILABLE TO CONTRACTOR/SURETY

• Contractor may never create situation where more damages are incurred just to recover from owner.

• *Rockingham County v. Luten Bridge Co. (4th Circuit)*
If in Contractor's sole discretion, Subcontractor fails behind the Schedule for the Subcontract Work or if Subcontractor is otherwise not maintaining a satisfactory rate of progress so as to complete the Project in the most expeditious and economical manner, Contractor may direct Subcontractor to take such action as Contractor in good faith deems necessary or appropriate to improve Subcontractor's rate of progress. In addition, Contractor shall have the right, but not the obligation and without prejudice to any other right or remedy, upon notice to Subcontractor, to provide any additional labor, materials, equipment, supervision, or other item and to take such additional action as Contractor in good faith believes to be necessary or appropriate under the circumstances, and any such action undertaken by Contractor shall be at Subcontractor's cost, which Contractor shall be entitled to deduct from any payment, whether then due or thereafter to become due, to Subcontractor. If Owner delays, disrupts or interferes with the Subcontract Work, Subcontractor as its sole and exclusive remedy may, upon written request properly and timely made to Contractor, obtain reasonable time extensions and a reasonable increase in the Subcontract Price but only to the extent of any extensions of time and additional amounts that Contractor, given proper notice, shall be entitled to from owner. Regardless of the cause or source of delay, disruption or interference with Subcontract Work, and even if caused in whole or in part by Contractor, Subcontractor shall not be entitled to any compensation or damages for delay, disruption, or interference (including, without limitation, impact, inefficiency, and extended overhead claims) except to the extent Contractor receives, on Subcontractor's behalf, such compensation or damages from Owner or other third party.

As a condition precedent to any relief, Subcontractor must give Contractor timely written notice of delay, disruption, and/or damage to the Subcontract Work.
22. DELAYS; EXTENSION OF TIME:

Delays: If the Contractor is delayed in progressing any task which at the time of the delay is then critical, as set forth in the Contractor’s Critical Path Method schedule approved by the Awarding Authority and Designer under Article 9, or which during the delay became critical, as set forth in the Contractor’s Critical Path Method schedule approved by the Awarding Authority and Designer under Article 9, as the sole result of an act or omission of the Awarding Authority or of any other contractor on the site employed by the Awarding Authority, by strikes, lockouts, fires, abnormal floods, tornadoes, or other cataclysmic phenomenon of nature, or by causes beyond the Contractor’s control, then Contractor may be entitled to an extension of time, conditional that the Contractor does not experience a concurrent delay, in which to complete the Work, provided however, that the Contractor shall give written notice of such cause to the Awarding Authority not more than seven (7) days after the occurrence of the event or the first appearance of the condition giving rise to the claim and shall set forth in detail the Contractor’s basis for requiring additional time in which to complete the Work. Such time extensions shall only be allowed upon approval of the Awarding Authority. The failure of the Contractor to give such notice within seven (7) days shall constitute a waiver of any claim for an extension of time in which to complete the Work.
WHAT ABOUT THE SURETY?

• Read the Bond and the Contract
• Examples of damages that surety can be liable for:
  1. Delay damages
  2. Liability from principal’s failure to pay certain taxes
  3. Attorneys’ fees
  4. Prejudgment interest
  5. Extracontractual damages
  6. Damages in excess of the penal sum of the bond
WHAT ABOUT THE SURETY?

• How do we mitigate the risk of exposure to damages?

• Takeover/completion agreements
  – Make as many terms definite as possible (define contract amount, contract balances remaining, days remaining, delays that are being credited)
  – Distance the surety from the principal.
  – Shift potential liability to completing contractor
  – Preserve the penal sum!
  – Reserve rights against Obligee
UNTIL NEXT TIME...
CONSTRUCTION CONTRACT DAMAGES

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A ROADMAP FOR SUCCESSFUL PROJECT CLOSEOUT AND KEEPING IT CLOSED

May 10, 2019
11:00 A.M. – 11:45 A.M.

American Bar Association • Tort Trial & Insurance Practice Section
2019 Fidelity & Surety Law Spring Conference

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Introduction

Project closeout can be an unanticipated source of loss and exposure for an unsuspecting surety. A completing surety that does not abide by the age-old adage of “beginning with the end in mind” can be beset with problems ranging from unobtainable warranty coverage to unachievable performance criteria. Even after substantial completion or acceptance of a construction project, a surety may still have lingering liability under a performance bond. The bond or contract most likely includes warranty or guarantee provisions, or the problem could involve a latent defect.

To assist completing sureties in achieving successful project closeout, Part I of the paper will first canvass strategies to avoid closeout pitfalls when arranging for project completion. Part II provides a practical tutorial for a surety monitoring and managing the performance of closeout obligations. Part III addresses the potential for disputes to arise relating to the performance of punch list work. Part IV provides an overview of potential warranty and latent defect claims that a surety may face after the project is complete. Part V provides insight on two potential surety defenses to these claims: (1) an obligee’s failure to satisfy a condition precedent; (2) and the expiration of contractual or statutory limitation periods.

I. Contemplating Completion in the Completion Agreements

In order to begin with the end in mind, certain closeout issues should be considered during the takeover/ratification process.

A. Contracts and Continuity When Completing

A surety must know what is required when taking actions to complete the work in satisfaction of its bond obligations. When a surety completes a project, it directly encounters closeout concerns that are typically not dealt with in contracts performed without surety support. The standard contract obligations are all applicable and the responsibility to adhere to them should remain, regardless of any dislocation in performance. A careful reading of the construction contract, including the general conditions and special provisions to the contract, is important to assure that all appropriate considerations are examined. To the extent that the defaulted contractor or any of its subcontractors or suppliers are replaced, particular care must be given to make sure, to the extent possible, that there are no scope gaps and that closeout obligations are carried forward. If the contract team remains the same, the surety should audit compliance with closeout responsibilities to date and develop compliance checklists during the takeover and ratification process to ensure the efficient monitoring and completion of project closeout activities.

When ratifying agreements with subcontractors/suppliers who were contracted by the original contractor, the surety must make sure that the original closeout obligations of the construction contract are preserved in the new agreements. A surety should particularly worry when a subcontractor/supplier wants to just close out one contract and start another as it may indicate an intent to avoid responsibility for an error committed in the original contract.
B. Avoiding Scope Gaps and Liability for Defects

When engaging a new subcontractor/supplier, the unfulfilled obligations of the original subcontractor/supplier must be addressed, including responsibility for the adequacy of work already performed. Here, a key consideration is how the original subcontractor/supplier work was inspected and accepted. As an example, a replacement plumbing subcontractor is not usually going to accept responsibility for the underground plumbing installed by the original plumbing subcontractor. If there is concern expressed that work of an original subcontractor/supplier is deficient, the surety should contact the original plumbing subcontractor, place them on notice of their potential liability, and perform testing as needed to determine if an actual deficiency exists and the recommended corrective action. Any claim for a latent deficiency made by an owner after completion is invariably more difficult to correct, and if the responsible contractor is no longer in existence, that liability falls to the surety.

Separately, the surety must take care that the remaining work is properly identified, and that past and future changes are expressly considered. Almost every construction contract includes provisions for the owner to modify the contract requirements through either change orders or supplemental instructions. The completion subcontractor/supplier must include as a part of their scope of work the completion of all unfinished work, as modified, including the correction of all known or visible deficiencies of the original subcontractor/supplier. One of the surety’s first actions should be the separation of these owner-initiated modifications into categories, as indicated below:

- Issued, estimate submitted, settled, executed, and work completed – this scope of work should be incorporated into the replacement subcontractor/supplier agreement to assure that the subcontractor/supplier is aware of the change and incorporates it into appropriate as-built documents.

- Issued, estimate submitted, settled, executed, and work not completed – this scope of work should be incorporated into the replacement subcontractor/supplier agreement to assure that the subcontractor/supplier is aware of the change and the work is performed as required.

- Issued, estimate submitted, not settled, but work completed – this scope of work should be incorporated into the replacement subcontractor/supplier agreement to assure that the subcontractor/supplier is aware of the change and incorporates it into appropriate as-built documents. Further, in settlement with the original subcontractor/supplier, the surety should insist that the subcontractor/supplier provide all required documentation applicable to justify their estimated costs, as payment for that modification will only be made after settlement is reached with the owner. If the original subcontractor/supplier is unavailable or unable to support the estimate, the estimate should be voided and the surety will need to make a business decision as to whether the value should be determined by an independent expert or the claim dropped.

- Issued, estimate submitted, not settled, and work not completed – this scope of work should be incorporated into the replacement subcontractor/supplier agreement to assure
that the subcontractor/supplier is aware of the change and the work is performed as required. Further, the original estimate should be voided and the new subcontractor/supplier should estimate and pursue this work as a change to their agreement, as if it is the original subcontractor/supplier.

- Issued, estimate not submitted, not settled, nor is work completed – the new subcontractor/supplier should estimate and pursue this work as a change to its agreement, as if it is the original subcontractor/supplier.

C. Making Certain Warranties Are Not Voided

Warranties typically consist of a general warranty, usually covering one year, and special warranties that may be specified within each of the individual specification sections of the construction contract. Special warranty obligations are typically divided between materials and installation. Often the original subcontractor ordered the materials that are then installed by the new subcontractor. The surety should make sure that all required warranties are deliverable by the supplier prior to making any payments to the supplier.

Some warranties require that the installer be certified or approved to validate a manufacturer’s warranty. As an example, special roofing and waterproofing warranties are commonly specified. Further, the manufacturer typically requires the installers be trained by the manufacturer and often will not even sell to other installers. If the material from an original subcontractor is stored on site and payments for the material have been made to the manufacturer, the manufacturer’s warranty can be voided by contracting with a new subcontractor that is not certified by the manufacturer. Owners know that the typical lifespan of the installation firm is far shorter than that of the manufacturer and will, therefore, not accept an installer’s warranty as a substitute. Similar concerns often arise regarding HVAC equipment and its installers.

D. Contemporaneously Maintaining As-Built Drawings

Construction contracts often include requirements to provide documentation relating to the final design. For buildings, this typically includes a set of the original contract documents with all applicable owner changes incorporated into the documents, which are commonly known as as-built drawings. Every effort should be made to audit this requirement at the time of project changeover so that the necessary records are available to document project changes. Although these can usually be recreated from the project documentation, it can be a very expensive process. Therefore, when possible, these documents memorializing changes should be recovered from the original contractor. Notwithstanding these efforts, projects with extensive sitework often require that a surveyor locate exact locations of subterranean construction, prior to the backfilling. Every effort should be made to recover this information from the outgoing contractor or the surveyor as soon as possible. The replacement contractor should maintain the existing as-built record by including their work onto the existing as-built documents.

A cautionary tale may well drive home the importance of contemporaneously tracking as-built data. A project in central Virginia was situated in the middle of a large parcel of land being
developed by the Federal Government. The exact locations of the utilities were not indicated on
the contract drawings, allowing the subcontractor the latitude to make turns in the underground
utility lines wherever it chose. As the project was nearing completion, the engineer planning the
adjacent project asked for utility plans so that it could complete its design. Unfortunately for the
subcontractor, the as-built drawings specification necessitated that each turn be excavated,
surveyed and backfilled. The moral of this story is that attention to contractual obligations and
contemporaneously developing as-built records can be the difference between a successful
project closeout and substantial additional costs.

E. Financial Considerations in Your Closeout Plan

Closeout requirements should also be expressly considered when determining the amounts
payable/liabilities during the ratification process. In any financial resolution with a departing
subcontractor/supplier, care should be taken to hold any financially viable subcontractor/supplier
responsible for their work as it relates to latent deficiencies, as-built documentation, warranties,
and unresolved contract modifications. If there is a potential subcontractor/supplier liability
relating to potential liquidated damages, it should be addressed at the time any payment to the
subcontractor/supplier is considered. A release of liens should be provided by any departing
subcontractor/supplier and any of their subcontractors and suppliers. They may have a claim
filed against them by one of their subcontractors that is not related to an owner initiated change.

II. Monitoring and Management of Closeout Obligations

Closeout of the project typically includes field work, which is usually handled by the
project superintendent, and administrative functions which are usually handled by the project
manager. The start and the end of a project are crucial to the timely completion of the work. The
best contractors will make every effort to resolve issues when they first develop and not wait
until the end of the project. However, even the most conscientious contractor can find the close-
out process to be overwhelming. The end of a project usually involves the largest number of
subcontractors, the highest pressure to complete the work, and the contractor’s home office
pushing for a reduction in personnel working on the project.

A. Field Closeout

1. Development and Resolution of a Project Punch List

A typical construction contract requires that the contractor prepare a detailed list of deficient and
non-compliant work that is turned over to the architect/engineer when the contractor provides the
required notice of substantial completion to the owner’s representative. The architect/engineer
typically inspects and adds to the list additional deficiencies as he deems appropriate. In some
cases, the substantial completion is for only a portion of the project and sometimes it is for the
entire project.

The contractor must assign responsibility for individual punch list items and monitor the
detailed punch list. There are numerous computer programs to manage punch lists. At a
minimum, each item listed should indicate which subcontractor is expected to resolve the item,
the location of each listed deficiency and a clear description of the deficiency. The typical computer program records the history of each item, allows the inclusion of contract documents/photographs, and can be sorted to indicate the affected areas of the building or specific subcontractors/trades. This listing can be sent to the appropriate subcontractors for performance of the corrective or completion work with a schedule indicating the work priorities. As the contractor receives sufficient notices from its subcontractors that punch list items are resolved, the architect/engineer must be notified by the contractor so that the corrected deficiencies can be formally inspected and accepted.

The proper maintenance of the punch list will also clearly represent what firm is responsible for any delays to completion of work. If the contractor fails to create his punch list and provide it to the architect/engineer with his claim of having achieved substantial completion in a timely manner, the contractor may be responsible for the delays. If the architect/engineer fails to review the contractor punch list, supplement it with deficiencies found by the architect/engineer, and return it to the contractor in a timely manner, the owner and/or architect/engineer may be responsible for the delays. If a subcontractor fails to correct their deficiencies listed on the punch list in a timely manner, the subcontractor may be responsible for the delays.

Proper management of the punch list requires that authorized individuals inspect the work in accordance with the governing standards. Contractors are justifiably upset to find that they are being asked to finish myriad punch lists developed from varying standards. Also, it is important to make certain that the “punch list” item in question is the result of defective work. This was not the case on a certain Navy housing project. One Navy Bachelor Enlisted Quarters in Southeast Washington, D.C. included a punch list identifying broken windows as needing to be replaced. Numerous windows were replaced. Eventually the contractor determined that the same windows were being replaced. The Navy ultimately recognized that the glass windows were being broken by individuals in the neighborhood and the contractor was paid to replace all glass with Plexiglas.

2. **Performance of Operation and Maintenance Training**

Larger construction contracts typically include provisions for the training of the owner’s maintenance team by personnel knowledgeable of the project systems. Often the specifications require that the training be provided by a manufacturer’s representative. Since the companies providing the training are often not local and the owner’s personnel are usually just being hired, the scheduling of this training can often be difficult. A list of any training obligations must be created through a careful review of the specifications by the contractor. The training often includes the requirement that certain documentation be provided prior to the training and that the actual training sessions be videotaped.

3. **Turnover of Project Deliverables**

The project specifications often require spare parts or touch-up paint be provided to the owner. A list of such deliverables must be created by a careful review of the specifications. As such
deliverables are turned over by the subcontractors, a receipt should be signed by a representative of the owner.

B. Administrative Closeout Obligations Checklist

1. Notice of Substantial Completion and Follow-Up Until Substantial Completion Declared

The typical construction contract requires that the contractor achieve substantial completion by a specific date. The contract typically allows revisions to this date as a result of changes and delays. Further, the definition of substantial completion is usually defined as the stage of construction when the project can be used for its intended purpose.

Construction contracts usually establish an amount of liquidated damages for each day that the project is completed after the established date. For that reason, it is important that the contractor establish that substantial completion is attained as early as possible. Sometimes the substantial completion applies to a portion of the project and sometimes it is for the entire project. If the project turnover is being performed in phases, the warranty, utility, security, insurance, and liquidated damages need to be addressed at the time that each portion of the project is accepted by the owner to coordinate the turn-over of responsibility.

2. Utility Turnover

As areas of the project are turned over to the owner, it is important to assure that any responsibility for utility payment be transferred to the owner. At the end of a project some of the utility bills can be very large and failure to turn-over the account to the owner may mean that the contractor retains responsibility for the costs incurred. The electrical meter fees for multi-family residential construction often involve a separate billing for each individual unit.

3. Security Turnover

As areas of the project are turned over to the owner, it is important to turn over all keys and clearly advise the owner that the contractor is no longer responsible for security in the area that has been transferred. If vandalism occurs before the contractor has clearly turned over the security responsibilities to the owner, there may be a dispute as to who is responsible for the resulting delays and costs to the project.

4. Insurance

Often the contractor holds the Builder’s Risk insurance policy. Once the project has achieved substantial completion, the contractor should notify the owner that it is expected that the owner will acquire all necessary insurance for the project.
5. **Special Warranties**

The project specifications often require that special warranties be provided to the owner. A list of such special warranties must be created by a careful review of the specifications by the contractor. As such special warranties are often provided by subcontractors, the contractor should verify that the subcontractor submissions are consistent with the contract requirements. Often subcontractors indicate incorrect dates or substitute their warranties in lieu of the specified manufacturer’s warranty. If the project turn-over is done in phases, the warranty start dates should commence with the date that the applicable substantial completion is established.

6. **Lien Releases**

The contractor must typically provide a conditional release of liens for each monthly pay application from each subcontractor, as well as the contractor, indicating that all will not file a lien if their invoice is paid. The contractor must also provide an unconditional release of liens for each monthly pay application from each subcontractor, as well as the contractor, indicating that all previous invoices have been paid.

The contractor should maintain a list of each subcontractor performing work on the project to assure that all appropriate releases are received. The maintenance of this protocol is important to assure that the contractor properly processes payments received for the account of these subcontractors.

7. **Submission of As-Built Documentation**

Construction contracts often include requirements to provide documentation relating to the final design. For buildings, this typically includes a set of the original contract documents with all applicable owner changes incorporated into the documents. As such as-built documentation is turned over, a receipt should be signed by a representative of the owner. Projects with extensive sitework often require that a surveyor locate exact locations of subterranean construction, prior to the backfilling. The contractor must maintain the existing as-builts by including their work onto the existing as-built documents.

8. **Leadership in Energy and Environmental Design Certification Requirements**

Construction projects often have requirements that the project meet a certain Leadership in Energy and Environmental Design (LEED) certification. The levels of certification for buildings are Certified (the lowest level), Silver, Gold and Platinum (the highest level). The certification level is determined by the number of points earned by the project. Points are granted based on how a low “carbon footprint” is achieved for the building. Often local governments either require or incentivize a specific LEED certification level.

Some points are granted based on non-construction considerations, like the distance of the project from mass transit. Most points are generated by design considerations that are created during the design phase of the project, like the inclusion of high efficiency appliances, incorporation of extensive building environmental controls, or incorporation of showers available for those who bicycle to work.
However, some points are also granted based on the work performed by the contractor. These requirements are usually incorporated in the project specifications. Often the contractor points include requirements like documenting the use of recycled materials, documenting the segregation of waste so that it can be recycled, protecting ductwork from contaminants during the construction process, and documenting the purchase of the specified high efficiency equipment that was specified. This documentation is usually turned over to the LEED consultant who will coordinate and submit the needed documentation to receive the LEED certification.

Early in the procurement of the replacement contractor, the surety should determine the extent and importance of the contractor LEED responsibilities. Most of the LEED points are achieved through the design process, but if the contractor portion is important to meeting a certain LEED certification, the contractor’s failure to meet its obligations may necessitate the attaining of the missing LEED points by alternate means. These alternate means could be expensive. The defaulted contractor’s documentation should be preserved and the requirements reviewed with the new contractor to assure compliance as the project is closed out.

9. Resolution of Outstanding Owner Changes and Claims

An important part of the completion of the project involves the resolution of the accounting for the project. Often there are unsettled changes, disputed claims for additional compensation/time, or claimed liquidated damages. Every effort should be made to resolve these issues as they occur. As the project is reaching final completion, efforts should be increased to prevent delay in the conclusion of the project.

Often the resolution of these outstanding issues overlaps with the resolution of the final punch list items. In some cases, the cost for correction of a punch list item would constitute an economic waste. In those cases, the settlement of the outstanding changes should include resolution of these punch list items.

As part of this process, the contractor needs to contact each subcontractor/supplier with an open account and determine if there are any open claims or issues that could impact the closeout of the project. Sometimes a subcontractor may intend to make a claim against a contractor that is actually related to an owner liability. If the contractor settles with the owner while being unaware of the subcontractor’s claims, it may become liable for the costs.

10. Notice of Final Completion and Final Invoicing

As soon as the project is complete, the contractor should prepare the final invoice, complete with an appropriate conditional release of liens, and submit same to the owner/architect/engineer, in accordance with the contract requirements. Upon receipt of the payment the contract should usually be considered complete, except for the applicable warranty obligations.
III.  Punch List as a Potential Basis for Disputes Between Owner and Completing Surety

A punch list details the outstanding items that must be completed or corrected before a project is considered fully complete. It is generally performed by the contractor after substantial completion has been achieved.\(^1\) Despite the end being in sight, a completing surety must remain engaged because the punch list phase of the work is fertile ground for disputes. An owner’s occupation of a structure after substantial completion can give rise to disagreement over responsibility for corrective work, and owners have been accused of leveraging the punch list to avoid paying over contract balances.\(^2\)

An owner’s intransigence over punch list work can give rise to a claim for compensable delay by a contractor or completing surety. In *Neal & Co. v. United States*, the owner’s representatives compiled a punch list of work on a public housing project that was ultimately held to be unreasonable and the cause of a two-month delay in the contractor’s final completion.\(^3\) The contractor reached substantial completion after the project had suffered from numerous delays and was met by a punch list of over 6,000 items.\(^4\) At the point that the contractor left the site, the government asserted to its surety that almost 3,000 items remained outstanding.\(^5\) The contractor ultimately submitted claims for amounts withheld from the contract balance and compensation for cost overruns, while the government asserted counterclaims for delay and completion of the punch list work, among others.\(^6\) The consultant hired by the surety to investigate the project testified that the punch list items were poorly defined, such that a “workman would have difficulty determining what was listed, without [the government representative] standing there alongside of them pointing out what was to be done,” and that “any type of scratch someplace would show up on this list.”\(^7\) The contractor’s superintendent in charge of the completion effort described the punch lists as containing items that had been poorly designed but properly installed, and attributed much of the delay to the government representative constantly adding items to the lists and disrupting the order in which items were addressed.\(^8\) The court awarded the contractor damages for delay attributable to the “over-zealous inspection” and “nit-picking punch list.”\(^9\)

Courts have also granted damages arising out of owners’ mismanagement of punch lists, such as where an owner failed to provide a punch list despite numerous requests over several months from the contractor.\(^10\) A completing surety must fulfill its principal’s contractual obligations to complete the project through final completion, but it may have grounds to resist an overreaching owner that abuses the punch list process.

\(^2\) Id.
\(^3\) Neal & Co. v. United States, 36 Fed. Cl. 600, 605 (1996), aff’d, 121 F.3d 683 (Fed. Cir. 1997).
\(^4\) Id. at 609-10.
\(^5\) Id. at 610.
\(^6\) Id.
\(^7\) Id. at 632.
\(^8\) Id.
\(^9\) Id. at 648-49.
IV. The Impact of Warranty Provisions on a Surety’s Post-Completion Liability

A surety’s obligations for post-completion construction defects are often framed by the terms of the bond and the underlying contract. Most performance bonds incorporate the bonded contract by reference and the completing surety must adhere to the underlying contract’s terms.11 As a result, the terms of the contract generally frame a surety’s obligations for post-completion construction defects.12 Obligations that arise after the completion of a project are primarily addressed by contractual warranty provisions. Latent defects, as they are commonly called, refer to defective work that is not manifest at acceptance and can give rise to claims beyond the contractual warranty period. If a latent defect appears within a warranty period, an obligee can simply file a relatively straightforward warranty claim, as opposed to the more complicated task of proving a surety’s liability for latent defects.13

A. Warranty Claims

Under most bonds, a surety’s warranty obligations are defined by the construction contract. Accordingly, a completing surety may be liable after project completion for defects in the principal’s work or the work performed by the surety during closeout under a warranty or guarantee provision.14 Unless modified by the terms of a takeover agreement, a surety’s obligations in response to a warranty claim generally do not extend beyond those of its principal.15 For example, under the AIA A201-2017 General Conditions—a standard construction contract issued by the American Institute of Architects—the contractor warrants that, unless otherwise specified, material and equipment furnished under the contract will be of good quality and new, the work will conform to the requirements of contract documents, and the work will be free of defects.16 The AIA A201-2017 General Conditions further state that the warranty applies for one year after the date of substantial completion.17 During this one-year warranty period, if the obligee fails to notify the contractor about defective work or allow enough time for the contractor to correct it, the owner waives the right to require corrective work and, by extension, to make a claim for breach of warranty.18 However, if the owner gives the contractor

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11 See AM. INST. OF ARCHITECTS, AIA A312-2012, Performance Bond § 1 (2010) [hereinafter AIA A312-2010 Performance Bond] (The Contractor and Surety, jointly and severally, bind themselves, their heirs, executors, administrators, successors and assigns to the Owner for the performance of the Construction Contract, which is incorporated herein by reference.”); see also CONSENSUS DOC 260, Performance Bond § 1 (2007) (“The Contract is incorporated by reference into this Performance Bond (the ‘Bond.’”).


13 See WILLIAM SCHWARTZKOPF, PRACTICAL GUIDE TO CONSTRUCTION CONTRACT SURETY CLAIMS § 17.03 (3rd ed. 2018).


15 See WILLIAM SCHWARTZKOPF, supra note 13, § 17.02.

16 AIA A201-2017 General Conditions § 3.5.1.

17 Id. at § 9.8.4.

18 Id. at § 12.2.2.1.
valid notice of the defect and the contractor fails to correct it, the surety may be responsible for its principal’s breach of the warranty.¹⁹

If a contract lacks an express warranty provision or the provision does not cover the claim, the principal, and thus the surety, are often still held to an implied warranty to perform services in a workmanlike manner.²⁰ Even where a contract includes an exclusive warranty, and disclaims all other warranties, an obligee still may be able to sue for breach of contract under the common law duty to perform with reasonable care.²¹ Without a clear intent to disclaim implied warranties, warranties implied into a construction contract may survive the expiration of an express warranty.²² A surety should be aware of the various forms a warranty claim can take when navigating the takeover and completion of a project.

In most cases, courts have upheld specific warranty provisions that are inconsistent with general warranty provisions. In Milwaukee Board of School Directors v. BITEC, Inc., the Wisconsin Court of Appeals found that, absent a durational limit in the bond language, the surety was liable for defects under the roofing contract’s five-year workmanship warranty instead of the general one-year workmanship warranty.²³ The general warranty was listed in the standard general conditions of the contract; however, the general conditions also provided that the provision applied unless modified in detailed specifications governing the contractor’s work.²⁴ Finding the parties’ intent was to contract for a warranty modification, the court upheld the five-year warranty incorporated in the detailed project specifications over the general one-year warranty provision.²⁵

When a warranty provision in an incorporated contract and a suit limitation period in a performance bond conflict, courts often attempt to remedy the conflict by construing the contract and the bond together.²⁶ In Kiva Construction & Engineering, Inc. v. International Fidelity Insurance, Co., the performance bond at issue included a straightforward suit limitation clause that barred suits from commencing two years after the date of final payment under the contract.²⁷ The bond also incorporated the construction contract, which included a ten-year warranty

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¹⁹ Keith A. Langley & Marchelle M. Houston, Ch. 8, Liability of the Performance Bond Surety for Damages (Under the Contract of Suretyship), in THE LAW OF PERFORMANCE BONDS 431, 454 (Lawrence R. Moelmann et al., eds., Am. Bar Ass’n, 2d ed. 2009).
²⁰ See 3 BRUNER & O’CONNOR, supra note 1, § 9:1
²¹ See 6 PHILLIP L. BRUNER & PATRICK J. O’CONNOR, BRUNER & O’CONNOR ON CONSTRUCTION LAW § 19:58 (2018) (citing Mead Corp. v. ABB Power Generation, Inc., 319 F.3d 790, 795–96 (6th Cir. 2003) (“Under Ohio law, ‘[a]ccompanying every contract is a common law duty to perform with care, skill, reasonable expedition, and faithfulness the thing agreed to be done, and a negligent failure to observe any of these conditions is a tort, as well as a breach of contract.’”).
²² See Mead Corp. v. ABB Power Generation, Inc., 319 F.3d 790, 797 (6th Cir. 2003) (holding that the owner could bring breach of contract claim for defects although warranty provision for repair had expired, where the contract did not state that the claim for breach of warranty was the exclusive remedy for defective workmanship).
²³ 775 N.W.2d at 134.
²⁴ Id. at 131-32.
²⁵ Id. at 132-133.
²⁷ 749 F. Supp. 753, 754 (W.D. La. 1990), aff’d, 961 F.2d 213 (5th Cir. 1992).
provision for materials and workmanship. Further, the terms of the bond stated that if the principal defaulted by failure to complete its construction obligations in the contract, the surety could either: (1) complete the contract in accordance with its terms and conditions; or (2) obtain bids for completing the contract. The court concluded that these bond terms required a failure to complete to trigger liability, and, thus, the incorporated warranty provisions in the contract were never contemplated by the bond. Therefore, the surety’s liability was extinguished when no claim was brought within the two-year period.

**B. Latent Defect Claims**

As performance bonds often incorporate the bonded contracts, a surety may be liable for any latent defects discovered after substantial completion, to the extent that the principal fails to address such claims. A latent defect is one that is “not discoverable by reasonable inspection” and does not become readily apparent until after the completion of construction. Although obligees are often held to have waived the right to bring a claim for a patent defect after project acceptance, an obligee may bring a latent defect claim even after the expiration of a warranty provision. Most standard bonds attempt to limit a surety’s liability for latent defect claims by including a suit limitation provision. In addition, a surety should be careful to investigate whether the alleged defect was truly latent. If a defect is not latent, but was known or should have been known, the obligee will likely have waived its right to raise a post-completion claim against the surety.

To establish a latent defect claim, an owner must show both that the work failed to conform to the contract requirements and that the owner did not know or have reason to know that the defect existed. When examining a latent defect claim, courts have analyzed: (1) the language of the bond; (2) the time that passed between substantial completion and discovery of

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28 Id.
29 Id. at 755-56.
30 Id. at 756.
31 Id.
34 Town of Tonawanda v. Stappell, Mumm & Beals Corp., 270 N.Y.S. 377, 379 (N.Y. App. Div. 1934) (“The town had accepted the improvements constructed under the contract and paid for them,” therefore it “waived its right to recover for all defects which were known to it or which were discoverable by reasonable inspection.”).
35 See BITEC, Inc., 775 N.W.2d at 133 (“Conditioned upon the contractor’s faithful performance of all of its obligations under the contract, a majority of courts have held the performance bond surety liable for latent defects of its principal’s work, whether those defects are discovered before or after the applicable warranty period, if any, has run.”) (citing Marilyn Klinger, James P. Diwik, and Kevin L. Lybeck, Ch. 6, Contract Performance Bonds, in THE LAW OF SURETYSHIP 81, 116 (Edward G. Gallagher ed., Am. Bar. Ass’n, 2d ed. 2000)).
36 See AIA A312-2010 Performance Bond § 11 (limiting commencement of claims under the bond to two years from either the date of declaration of default, when contractor ceased work, or when surety refuses or fails to perform, whichever occurs first).
38 WILLIAM SCHWARTZKOPF, supra note 13, 17.03.
the defect; (3) the nature and extent of the defect; and (4) the relevant case law in the jurisdiction. A latent defect is distinguished from a patent defect by considering: (1) when the defect manifested itself; (2) whether the owner knew or should have known of the defect prior to acceptance; and (3) whether the pre-acceptance inspection was reasonable. The First District of the California Court of Appeals noted that the reasonableness of a latent defect inspection “must vary with the nature of the thing to be inspected and the nature and gravity of the harm which is sought to be averted.”

Although at least one court has found that latent defect claims cannot be brought against a surety after substantial completion, most courts have held that a surety’s potential liability for latent defects extends beyond the date of substantial completion. For instance, in *Federal Insurance Co. v. Southwest Florida Retirement Center, Inc.*, the surety issued an AIA Document A311-1970 Performance Bond to a general contractor for construction of a retirement center. The bond incorporated the construction contract by reference. Ten years after completion, the owner found latent defects while investigating water damage from a storm. Reasoning that performance bonds should cover both patent and latent defects, the Florida Supreme Court found that sureties can be liable for latent defects in a post-completion claim.

A surety’s exposure to a latent defect claim may not only surpass substantial completion, but also survive the expiration of a warranty period. In *All Seasons Water Users Ass’n v. Northern Improvement Co.*, a construction company breached its contract by using the wrong solvent-welding procedure and by installing pipes at a depth different from that specified in the contract. The court concluded these were latent defects. The Supreme Court of North Dakota determined that the construction company’s liability for latent defects was not limited to the contract’s one-year warranty provision. The court also observed that if the one-year warranty was to be the exclusive remedy, the contract should have had clear and unequivocal language to that effect.

Another defense to a surety’s potential liability for latent defects could be found in an applicable state statute of repose. Unlike a statute of limitations, a statute of repose allows courts little flexibility in determining when a claim accrues. For example, California’s statute of repose prevents the commencement of actions to recover damages for latent defects more than

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39 *Id.*

40 *Id.*


42 *Id.*

43 Indep. Sch. Dist. No. 74 v. Shurtleff-Gaharan, Inc., No. Civ-06-523, 2007 WL 2248159, at *1 (E.D. Okla. Aug. 2, 2007) (holding that the performance bond did not cover latent defects because there was no “default” in completion, noting that the bond’s assurance of “proper” completion did not qualify as “perfect” completion).

44 *707 So. 2d 1119, 1120 (Fla. 1998).*

45 *Id.*

46 *Id.* at 1121.

47 *399 N.W.2d 278, 285 (N.D. 1987).*

48 *Id.*

49 *Id.*

50 *Id.*

ten years from the date of substantial completion, regardless of the date that the defect is discovered. The statute of repose under Massachusetts law allows for tort claims arising from negligent design or construction within a three-year period from the date of accrual of the cause of action but no later than six years from the completion of the project. Similar to a statute of repose, the AIA A201 General Conditions, which are incorporated into many AIA bonds, prohibit claims from being raised ten years after the date of substantial completion.

V. Surety-Specific Defenses to Post-Completion Defect Claims

A. Obligee’s Failures to Satisfy Conditions Precedent

If an obligee files a post-completion claim against a surety, the surety should ascertain whether the obligee satisfied the necessary conditions precedent to trigger the surety’s liability under the bond. If an obligee does not adhere to one or more of the performance bond conditions precedent, a surety may not have an obligation to perform. Although conditions precedent differ from bond to bond, most bonds require the principal to be in default and that the obligee declare a default to trigger a surety’s obligations. Courts also generally hold that a declaration of default must include a termination of the contract to trigger the surety’s liability.

The majority of courts have interpreted the AIA A312 Performance Bond to require the obligee to fulfill the following conditions precedent to trigger a surety’s liability: (1) provide notice to the principal and surety that obligee is declaring the principal in default; (2) declare principal in default, terminate contract, and notify surety; and (3) agree to pay the balance of the contract price. Interestingly, the AIA added a new provision to the A312-2010 Performance Bond that was not in the prior 1984 version, removing the notice and meeting requirements as a condition precedent to trigger a surety’s liability. The new provision provides that failure to comply with the notice and meeting requirements in § 3.1 does not extinguish a surety’s liability unless a surety can show “actual prejudice.” Courts have found actual prejudice when a surety is deprived of its ability to exercise its right to mitigate damages. This addition to the AIA

52 CAL. CIV. PROC. CODE § 337.15(a) (West 2018).
54 AIA A201-2017 General Conditions § 15.1.2.
55 See Bank of Brewton, Inc. v. Int'l Fid. Ins. Co., 827 So. 2d 747, 754 (Ala. 2002) (finding surety not liable for post-completion defects because the owner did not declare contractor in default to trigger bond conditions).
56 Keith A. Langley & Marchelle M. Houston, supra note 19, at 464 (“The liability of a surety under a performance bond is not triggered unless there is a default by the principal.”).
57 See L & A Contracting Co. v. S. Concrete Servs., Inc., 17 F.3d 106, 111 (5th Cir. 1994) (noting that the declaration of default “must inform the surety that the obligee regards the subcontract as terminated.”); but see Nova Cas. Co. v. Turner Constr. Co., 335 S.W.3d 698, 703 (Tex. App. 2011) (finding where a performance bond did not include termination as a condition precedent, the contractor did not have to terminate its subcontractor to trigger the surety’s liability).
58 AIA A312-2010 Performance Bond § 3.
59 Id. at § 4.
60 Id.
61 See Sleeper Vill., LLC v. NGM Ins. Co., No. 09-CV-44-PB, 2010 WL 3860373, at *4 (D.N.H. Oct. 1, 2010) (where a surety did not deny its liability under the A312 Performance Bond, the obligee's failure to provide notice prejudiced the surety by depriving it of its ability to exercise its rights to mitigate its exposure); see also Town of Plainfield v. Paden Eng'g Co., 943 N.E.2d 904, 916 (Ind. Ct. App. 2011) (holding that a lack of notice
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A312-2010 Performance Bond may increase a surety’s risk for liability under the bond because failure to meet the notice requirements under § 3.1 is no longer an absolute procedural bar to liability.

Courts have generally held that a declaration of default will only be sufficient to invoke a surety’s obligations if the declaration is “made in clear, direct, and unequivocal language.” In a frequently cited case, *L & A Contracting Co. v. Southern Concrete Services, Inc.*, the Fifth Circuit found that letters sent by the general contractor to the subcontractor were insufficient to establish an unequivocal declaration of default as none of them contained the word “default.” Similarly, the Supreme Court of Alabama in *Bank of Brewton, Inc. v. International Fidelity Insurance Co.* found that threats to declare a default and communications of an owner’s belief that a default had occurred were not enough to satisfy the notification of default condition precedent.

Courts have also required notice of a declaration of default be timely. In *Hunt Construction Group, Inc. v. National Wrecking Corp.*, the contractor sought delay damages from the subcontractor’s sureties several months after the subcontractor completed the work and was no longer on the site. The bond stated that, upon the subcontractor’s default and contractor’s notice to the sureties thereof, the sureties “could promptly remedy the default…” or “arrange for the performance of [subcontractor’s] obligation under the subcontract…,” and that “[t]he balance of the subcontract price… shall be credited against the reasonable costs of completing performance on the subcontract….” The District Court for the District of Columbia found that the contractor’s failure to notify the sureties of the subcontractor’s delay rendered the bond null and void because it prevented the sureties from exercising their bond options. Similarly, in *CC-Aventura, Inc. v. Weitz Co., LLC*, a contractor sued a subcontractor and its surety after project completion for alleged defects that resulted in mold and leaking. However, the contractor did not notify the subcontractor’s surety of the alleged defects until after the contractor had unilaterally hired a replacement contractor to remedy the defective work. The performance bond at issue required “reasonable notice” to the surety before arranging for the performance of the surety’s obligation under the bond. The court granted the surety’s motion for summary judgment, finding that the surety did not have “reasonable notice,” as the contractor had provided no notice until after it had already arranged for completion of the work.

Other jurisdictions have found that a declaration of default sufficient to trigger a surety’s liability must include a termination of the contract. Without explicitly addressing the

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62 *L & A Contracting Co.*, 17 F.3d at 111.
63 *Id.*
64 *Bank of Brewton, Inc.*, 827 So. 2d at 754.
66 *Id.* at 91.
67 *Id.* at 96.
69 *Id.* at *5.
70 *Id.* at *3.
71 *Id.* at *7.
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performance bond language, the Fifth Circuit in *L & A Contracting Co.* stated that the surety’s liability would trigger if: (1) the subcontractor was in default; and (2) the contractor declared the subcontractor to be in default.\(^\text{72}\) The court noted that the declaration of default “must inform the surety that … the obligee regards the subcontract as terminated.”\(^\text{73}\) Following the Fifth Circuit’s reasoning, the Second Circuit in *Elm Haven Construction Ltd. Partnership v. Neri Construction LLC* noted that the contractor needed to have terminated the subcontract to trigger the surety’s obligations under the performance bond, giving the surety an opportunity to complete the project itself or to hire others.\(^\text{74}\) Other courts, such as the Court of Appeals of Texas, have disagreed with the reasoning in *L & A Contracting* and held that, absent a requirement for termination of the contract as a condition precedent, termination is not required to trigger a surety’s liability under a performance bond.\(^\text{75}\)

**B. Contractual and Statutory Limitation Periods**

Sureties may defend a warranty or latent defect claim if the suit is brought outside the suit limitation periods set forth in the performance bond and incorporated contract. When a performance bond and contract fail to include a suit limitation provision, claims will be subject to the applicable statute of limitations. If a performance bond or incorporated contract includes a suit limitation period different than an applicable statute of limitations, there are differing approaches among jurisdictions governing the ability to contractually limit a statutory limitation period.

Several common performance bond forms include two-year claim limitation periods, but the date on which the two-year period commences varies from bond to bond. Under the AIA A312-2010 Performance Bond, an owner must bring suit two years either after a declaration of contractor default, after the contractor ceased work, or after the surety refuses or fails to perform obligations under the bond, whichever occurs first.\(^\text{76}\) In contrast, the older AIA A311-1984 Performance Bond requires an obligee to file suit within two years after the contracted date that final payment is due.\(^\text{77}\) The ConsensusDocs 260 bond form requires a suit to commence within two years after contractor default or substantial completion of work, whichever is first.\(^\text{78}\)

Many courts have upheld contractual suit limitation periods, whether in a contract or bond, despite longer statute of limitations.\(^\text{79}\) Absent a statute that prohibits contractual suit limitations, contractual limitation provisions are generally upheld, subject only to a

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\(^{72}\) 17 F.3d at 111.

\(^{73}\) *Id.*

\(^{74}\) 376 F.3d 96, 101 (2nd Cir. 2004).

\(^{75}\) *Nova Cas. Co.*, 335 S.W.3d at 703.

\(^{76}\) *AIA A312-2010 Performance Bond § 11.*

\(^{77}\) *AIA A311-1984 Performance Bond § 11.*

\(^{78}\) *CONSSENSUSDOCS, ConsensusDOCS 260 Performance Bond § 3* (2007).

\(^{79}\) *[See, e.g., Ibson v. United Healthcare Servs., Inc., 776 F.3d 941, 946 (8th Cir. 2014) (applying Iowa’s law that permits parties to contractually agree to shorter limitation periods for bringing suit); Bd. of Educ. v Hartford Accident & Indem. Co., 504 N.E.2d 1000, 1005 (Ill. App. Ct. 1987) (imposing two-year suit limitation provision in bond despite a longer general statute of limitations); Yeshiva Univ. v. Fid. & Deposit Co. of Md., 500 N.Y.S.2d 241, 245 (N.Y. App. Div. 1986) (enforcing a bond’s two-year suit limitation provision over the state statute of limitations).]*
reasonableness requirement.\textsuperscript{80} Other jurisdictions override a contract or bond’s provision limiting a time period to bring suit if it shortens the applicable statute of limitation.\textsuperscript{81} Many of these are states that statutorily prohibit contracts from reducing statutory limitation periods.\textsuperscript{82} Generally, contract provisions that attempt to lengthen applicable statutory limitation periods have been held null and void.\textsuperscript{83} However, courts have allowed a bond for a public project to extend the limitations period beyond the otherwise applicable statute of limitations period.\textsuperscript{84}

Statute of limitations periods in post-completion claims are often longer than the periods set forth in the common performance bonds. Depending on the basis for the claim, such as breach of contract, warranty, or negligence, statutes of limitations will vary in length and accrual point. The Florida Supreme Court in \textit{Federal Insurance Co. v. Southwest Florida Retirement Center, Inc.} held that the Florida five-year statute of limitations for contract claims for latent defects would begin to accrue on the date of the project acceptance.\textsuperscript{85} In \textit{BDI Construction Co. v. Hartford Fire Insurance Co.}, the District Court of Appeal of Florida distinguished that case from the facts of \textit{Southwest Florida Retirement Center} by noting that it involved a dispute between a contractor and subcontractor, not between an owner and contractor.\textsuperscript{86} The district court held where a subcontractor finished the work and contractor paid in full, the “date of acceptance of the project, in terms of a subcontractor, is the day the subcontractor finished its work.”\textsuperscript{87} In contrast, the United States District Court for the District of Colorado held in \textit{Adesta Communications, Inc. v. Utica Mutual Insurance Co.} that the Colorado statute of limitations for a contract claim required claims to commence within three years “after the cause of action accrues.”\textsuperscript{88} The statute also provided that the accrual date is considered the date that the breach is discovered or should have been discovered by reasonable diligence.\textsuperscript{89} In \textit{Hartford Fire Ins. Co. v. City of Mont Belvieu, Texas}, the Fifth Circuit found that the Texas one-year statute of limitations for public work projects barred a post-completion claim.\textsuperscript{90} The statute provided that the


\textsuperscript{83} See John Jay Kassner & Co., Inc. v. City of New York, 389 N.E.2d 99, 104 (N.Y. 1979) (holding that where a contract provision concerning when cause of action would accrue against the city was adopted at inception of contract, it could not serve to extend the statute of limitations).

\textsuperscript{84} \textit{William Schwartzkoff, supra} note 13, § 10.02 (citing Milwaukee Metro. Sewerage Dist. v. Fid. & Deposit Co. of Md, 56 F.3d 821, 824-825 (7th Cir. 1995)); \textit{see also John Jay Kassner}, 389 N.E.2d at 104.

\textsuperscript{85} \textit{Sw. Fla. Ctr., Inc.}, 707 So. 2d at 1121.

\textsuperscript{86} 995 So. 2d 576, 578 (Fla. Dist. Ct. App. 2008).

\textsuperscript{87} \textit{Id}.

\textsuperscript{88} No. 08-cv-01817-RPM, 2010 WL 1240354, at *3 (D. Colo. Mar. 9, 2010).

\textsuperscript{89} \textit{Id}.

\textsuperscript{90} 611 F.3d 289, 295 (5th Cir. 2010).
limitation period commenced from “the date of final completion.” However, the court clarified that it commenced from the date set for “substantial completion” because Texas case law has uniformly held that substantial completion is regarded as full performance.

In Sweetwater Apartments, P.A., LLC v. Ware Construction Services, Inc., the United States District Court for the Middle District of Alabama held that an Alabama statute voided the two-year suit limitation in the AIA A312 Performance Bond. The statute provided “any agreement or stipulation, verbal or written, whereby the time for the commencement of any action is limited to a time less than prescribed by law for the commencement of such action is void.” The statute of limitations on a contract claim in Alabama was six years, while the bond limitation shortened the time to commence suit to two years. In contrast, Illinois does not have a statute prohibiting the shortening of a statute of limitations. In Board of Education of Community High School District No. 99, DuPage County v. Hartford Accident and Indemnity Co., the court noted that, in the absence of a prohibitory statute, other jurisdictions generally uphold bond provisions limiting time for which suit may be brought. The court permitted the bond provision to limit the time to bring suit despite the ten-year statute of limitations for written contracts under state law.

A surety completing a project subsequent to its principal’s default must carefully proceed to avoid forfeiting its right to enforce a valid suit limitation period in its bond. In Cooper Industries, Inc. v. Tarmac Roofing Systems, Inc., a project owner sued the surety who took over the contract when its principal defaulted. The Fifth Circuit rejected the surety’s argument that the two-year suit limitation in the AIA A311 Performance Bond barred the owner’s claim. The court held that by taking over and completing the contract, the surety stepped in the contractor’s shoes and “voluntarily subjected itself to a new set of liabilities apart from the bond.” The Mississippi six-year statute of limitations for contract breaches, therefore, was applied to the obligee’s claim. Even without formally entering a takeover agreement, a surety may be found to have relinquished the protections of a bond limitations period when it involves itself in the project completion effort. The court in Carle Place Union Free School District v. Bat-Jac Construction, Inc. reversed a summary judgment granted in favor of the surety, finding that a triable issue of fact existed as to whether the surety could be estopped from raising the limitation period in its bond. The surety’s extensive negotiations with the owner and payments to subcontractors were held to have potentially misled the owner into sleeping on its rights, which the court was willing to entertain as a basis for estopping a defense asserting that the claim was time-barred.

91 Id. at 294.
92 Id. at 295.
93 2012 WL 3155564, at *3.
94 Id.
95 Id.
97 Id. at 1005.
98 276 F.3d 704, 707 (5th Cir. 2002).
99 Id. at 707.
100 Id. at 713.
101 Id.
103 Id.
Conclusion

In the tumult of resuscitating a terminated contract, project closeout requirements can be overlooked. Once the dust settles, however, unplanned for closeout obligations can be the source of significant extra costs and delay. Section I and II herein provide sureties with a convenient checklist of issues to be considered when contracting for and managing project closeout. Thereafter, legal considerations governing a surety’s post-completion liability are presented, including the consideration of several surety-specific defenses, so that your project, once closed, can stay that way.
HOW TO CLOSEOUT A PROJECT
AND KEEP IT THERE!

Vivian Katsantonis
Christopher Brasco
vkatsantonis@watttieder.com
cbrasco@watttieder.com

Robert Lockhart
rlockhart@ccci-dc.com
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Takeover Provisions Punch Points

• All Contractors should include takeover provisions
  – Subcontracts
  – Purchase Orders

• Allow Surety the option to accept the assignment of the contract or purchase order
### CONTRACT FORMATION Punch Points

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4
## TAKEOVER Punch Points

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Project Documents Punch Points

• Read and understand the responsibilities from the Contract
• Retrieve existing project documents
  – As-builts – if unavailable, have them reproduced
  – Testing Reports
  – LEED Documents
# TAKEOVER Punch Points

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</table>
Subcontractor Replacement Punch Points

• Notify original subcontractor that it is still responsible for the paid work
• Arrange for transfer of material warranties and/or manufacturer training
  – Ensure that replacement contractor has all needed approvals to maintain warranty if original subcontractor’s materials are being used
• Resolve outstanding changes performed by subcontractor for which change orders have not been issued
  – New subcontract must include change directives not completed
• Get release of liens
## TAKEOVER Punch Points

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<td>Other Considerations</td>
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</table>
Other Considerations Punch Points

• Ensure that completion contractor picks up close out responsibilities
• If a commissioning of the project mechanical systems is required – make sure commissioning agent is included in the process
• Determine whether LD’s are associated with period from substantial completion to final completion
# TAKEOVER Punch Points

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Punchlist Punch Points

• Immediately establish a method to track non-compliant work
  – List will become punchlist after substantial completion
  – Add incomplete work and Architect issues

• Punchlist elements
  – Tracking Number
  – Location
  – Description
  – Status
  – Responsible Contractors
  – Method for recording change in status
  – Photos – if software allows

• Transmit punchlist to each responsible Contractor
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**TAKEOVER Punch Points**

- 001.A Takeover Provision Contract Formation is Closed
- 002.A Project Documents Takeover Surety/Completion Contractor is Closed
- 002.B Subcontractor Replacement Takeover Surety/Completion Contractor is Closed
- 002.C Other Considerations Takeover Surety/Completion Contractor is Closed
- 002.D Punchlist Takeover Surety/Completion Contractor is Closed
# CLOSEOUT Punch Points

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<td>Closeout</td>
<td>Surety/Completion Contractor</td>
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Successful Closeout Punch Points

• Resolution of punchlist items
• Turnover of utilities to Owner
• Turnover of attic stock materials/deliverables to Owner
• Training of Owner personnel
• Turnover responsibility for project security
• Turnover responsibility for project insurance
• Receipt of Releases of Liens from Contractor and Subcontractors
• Submission of as-built documentation
• Completion of LEED documentation
• Resolution of outstanding financial issues and release of bonds
# CLOSEOUT Punch Points

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<td>004.A</td>
<td>Owner Mishandled Punchlist Claim</td>
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Common Punchlist Problems

• Excessive Items / Includes Normal Wear
• Excessive Items / Overinspection
• Revolving Punch Lists Utilizing Differing Standards
Neal & Co. v. United States, 36 Fed. Cl. 600 (1996), aff’d, 121 F.3d 683 (Fed. Cir. 1997)
Neal & Co. v. United States, 36 Fed. Cl. 600 (1996), aff’d, 121 F.3d 683 (Fed. Cir. 1997)

COUNTERCLAIM

Delay!
Not Complete!

CONSULTANT

PUNCHLIST IS POORLY DEFINED!
“workman would have difficulty determining what was listed, without [Gov’t Rep] standing there alongside of them pointing out what was to be done”

SURETY
Neal & Co. v. United States
aff’d, 121 F.3d 683 (Fed. Cir. 1997)

The Government was constantly adding items to the punchlist and disrupting the order in which items were addressed!
Neal & Co. v. United States, 36 Fed. Cl. 600 (1996), aff’d, 121 F.3d 683 (Fed. Cir. 1997)

COURT AWARD

Contractor is awarded damages for:

“Over-zealous inspection”
“Nit-picking punchlist”
# CLOSEOUT Punch Points

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<td>004.B</td>
<td>Claims and Defenses</td>
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Post-Completion Claim - Breach of Warranty

- A Surety’s secondary liability on a bonded contract may extend to any warranty provisions, including implied warranties to perform in a workmanlike manner or with reasonable care.
- Implied warranties are particularly perilous because they have been known to survive the expiration of express warranty periods.
Post-Completion Claim - Latent Defects

• In a highly fact specific context, a Surety can again find itself on the hook if latent defects emerge after evading “reasonable inspection” and only appear after construction is complete

• As with implied warranties, liability for latent defects can outlive the duration of express warranty periods
Surety Defense - Failure to Trigger Bond Obligation

• A post-completion claim must still satisfy the bond’s conditions to hold the Surety liable – including default by the Principal and a clear, timely declaration of default from the Obligee
Recipe for Performance Bond Options

NOTICE OF DEFAULT

COMMON LAW

MITIGATION EFFORTS

“Miller Act” Bond

Prescriptive Surety Bond

Default provisions
Triggering a Surety’s Liability/Performance Options

• “Having failed to comply with the conditions precedent to [Surety’s] obligations under the Bond, [Obligee] may not maintain the present action. Accordingly, the case must be dismissed.”
Surety Defense - Bond Limitation Periods

• Sureties can find refuge from post-completion claims when the bond contains a suit limitation clause
  – In a Fifth Circuit case, the Surety had a two-year limitations period in its bond and one-year statutory limitations period for Sureties
  – The Surety opted to take over the contract after its Principal defaulted, so the court held that it was subject to the six-year statute of limitations for contractors
  • Cooper Industries, Inc. v. Tarmac Roofing Systems, Inc., 276 F.3d 704 (5th Cir. 2002)
### CLOSEOUT Punch Points

<table>
<thead>
<tr>
<th>001 CONTRACT FORMATION</th>
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</thead>
<tbody>
<tr>
<td>ITEM NO.</td>
</tr>
<tr>
<td>001.A</td>
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<table>
<thead>
<tr>
<th>002 TAKEOVER</th>
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<tbody>
<tr>
<td>ITEM NO.</td>
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<tr>
<td>002.A</td>
</tr>
<tr>
<td>002.B</td>
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<td>002.C</td>
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<td>002.D</td>
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<tr>
<th>003 CLOSEOUT</th>
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<tr>
<th>004 POST COMPLETION</th>
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<tr>
<td>ITEM NO.</td>
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<tr>
<td>004.A</td>
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<td>004.B</td>
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## 001 CONTRACT FORMATION

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<tr>
<th>ITEM NO.</th>
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<tbody>
<tr>
<td>001.A</td>
<td>Takeover Provision</td>
<td>Contractor/Principal</td>
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## 002 TAKEOVER

<table>
<thead>
<tr>
<th>ITEM NO.</th>
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<tbody>
<tr>
<td>002.A</td>
<td>Project Documents</td>
<td>Completion Contractor</td>
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<td>002.B</td>
<td>Subcontractor Replacement</td>
<td>Completion Contractor</td>
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<tr>
<td>002.C</td>
<td>Other Considerations</td>
<td>Completion Contractor</td>
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<td>002.D</td>
<td>Punchlist</td>
<td>Completion Contractor</td>
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## 003 CLOSEOUT

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<thead>
<tr>
<th>ITEM NO.</th>
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<tbody>
<tr>
<td>003.A</td>
<td>Successful Closeout</td>
<td>Surety/Completion Contractor</td>
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## 004 POST COMPLETION

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<tr>
<th>ITEM NO.</th>
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<tbody>
<tr>
<td>004.A</td>
<td>Owner Mishandled Punchlist Claim</td>
<td>Surety/Completion Contractor</td>
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<td>004.B</td>
<td>Claims and Defenses</td>
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HOW TO CLOSEOUT A PROJECT AND KEEP IT THERE!

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