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Performance and Payment Bonds: Less is More

IN THIS ISSUE

- **Performance and Payment Bonds: Less is More**
- **County Engineer Not Liable for Damage Relating to Drainage Project**

Public Construction

A performance bond is a financial promise from the surety to the owner (obligee) that the contractor (principal) will perform the contract — hopefully all provisions of the contract, including warranty obligations and indemnities, which may run to third parties. A payment bond is a promise to subcontractors and suppliers that the contractor will pay them. Performance and payment bonds on public construction projects have been around a long time. Every state and the federal government require them for the protection of the public owner, subcontractors and suppliers, with varying thresholds for when they are required.

Nearly all statutorily mandated performance and payment bonds are simple indemnity bonds, meaning that the surety's sole obligation is to reimburse the obligee for its damages in the event of a contractor default. The surety's options are limited, which may be a good thing or a bad thing, depending on the circumstances and perspective. Anything is negotiable, but the starting point with a performance bond is that the surety has neither the right nor the obligation to do many of the things we think of as standard surety actions, such as taking over the contract or tendering a replacement contractor.

An indemnity bond form will typically guarantee all parts of the contract, including warranty and indemnity obligations, meaning that a surety could end up paying a bond claim years after completion of the contract, and possibly to some third party it had never contemplated as a result of some indemnification provision in the contract.

With an indemnity bond, the surety and the obligee often negotiate a takeover agreement or some other type of resolution after the principal's default because the surety may desire to have as much control as

possible to control its costs. And the obligee may be cash poor and anxious to see its project completed.

In Ohio, the bid guarantee, performance bond and payment bond are of the indemnity type on design-bid-build projects. All three may be combined into a single "contract bond," depending on the contractor's preferred bid security.

Private Construction

Naturally, private construction owners desire some sort of financial guarantee for the performance of their contracts as well. Some shun performance bonds in favor of other security, viewing bonds as too blunt an instrument, costing somewhere between 0.5 and 1 percent of the project value. Others still use performance bonds, although it is rare to see the simple indemnity form of bond on a private project. Instead, you are much more likely to see a bond form published by the American Institute of Architects (AIA) or some other third party. But third-party bond forms are much more complex and less protective of the owner's interests than a simple indemnity bond form. Indemnity bond forms are typically a few paragraphs. Third-party bond forms are typically several pages. It is like comparing the Gettysburg Address to the instructions for assembling a gas grill.

The AIA Document 311 Performance Bond was first published in 1963 and updated in 1970. The AIA Document 312 Performance Bond was first published in 1984 and updated in 2010. All four versions are somewhat similar, but with key differences. For purposes of this article, we will focus on the AIA Document 312 Performance Bond (2010).

The AIA 312 Performance Bond (2010) provides that the surety's obligations only arise after a number of conditions are met:

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1. The owner gives notice that it is considering declaring a default. The surety may then request a conference within five days, which must be held within 10 days;
2. The owner declares default; and
3. The owner has agreed to pay the balance of the contract to the surety or a contractor selected by the surety.
4. Pay money to the owner up to the penal sum of the bond; or
5. Deny liability.

Perhaps most importantly, the AIA 312 is enforceable only for the two years following the owner's declaration of a default. A statutory indemnity bond is enforceable for as long as the underlying contract is enforceable. In Ohio, that is eight years from the date the cause of action arose.

Another wrinkle is that in Ohio, like most other states, if a public owner makes a mistake and accepts a third-party bond form such as the AIA 312, the bond's language will be ignored and the statutory form will be read into the bond.

Conclusion

You do not find the many conditions and obstacles of a third-party bond form in a simple indemnity bond form. Less language is indeed more protection for the obligee-owner. That is why you are unlikely to see an indemnity bond form on most private projects. Sureties and contractors will not offer them. It is up to the owner to require them if desired.

The third condition can be a problem. What if the owner is entitled to liquidated damages or has third-party liability arising from actions or inactions of the defaulted contractor — who is on the hook for those indemnity obligations? Must the owner agree to forego those things to get the surety to act? It could get expensive fighting through such issues and in the meantime, the owner is stuck with an uncompleted project, meaning that the surety has negotiating leverage.

Next, the surety has express options. It may:

1. Arrange for the defaulted contractor to complete the contract, with the owner's consent;
2. Complete the contract itself through a third party;
3. Bid out the remaining work on behalf of the owner;

County Engineer Not Liable for Damage Relating to Drainage Project

Recently, in *State ex rel. Rohrs v. Germann*, 2013-Ohio-2497 (Ohio Ct. App., Henry County, June 17, 2013), the Court of Appeals held that the county engineer in the case was not liable for damage relating to a drainage project. In the late 1990s, a landowner in Washington Township approached the Henry County engineer about an open ditch on the landowner's property that was causing drainage and flooding problems in his field. The county engineer completed an inspection of the ditch and determined that deepening and widening it was not possible due to the amount of erosion in the ditch and because it was too close to a county road.

To remedy the problem, the county engineer installed a new wide plastic drainage pipe in place of the open ditch and then filled the ditch. The project was categorized as a "road safety improvement

project" and was entirely covered by the county engineer's budget, with no cost assessed to the landowner. During the work, county employees encountered a metal crossover pipe and a buried catch basin. The county employees reported this situation to the county engineer, and the decision was made not to tie this crossover pipe into the new drainage system, but to fill it with cement-like material.

Not long thereafter, the landowner leased his field, assuring the tenants there was adequate drainage. Later that year, the tenants had drainage and flooding issues in the field. The county engineer reported one to five acres with standing water. The county engineer then worked with the landowner to locate a drainage exit or a field tile and, at the landowner's direction, attempted unsuccessfully to



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locate the field tile by digging areas throughout the field. The county engineer, at his own cost, installed a new catch basin with an open grate for surface water drainage near the southeast corner of the field. The county engineer also installed a new catch basin underneath the county road.

The tenants then filed a lawsuit against the county engineer, alleging that the county's work caused poor drainage of surface water on the property they leased from the landowner, and that they sustained major losses to their crops, suffering in excess of \$70,500 in damage as a result of the drainage problems. The tenants' independent engineering firm performed an excavation, which revealed that a functioning field tile was located approximately 15 feet from the catch basin that had been filled with cement by the county employees and a seed bag was stuffed into the field tile near the catch basin. The county employees who worked on the project denied that they intentionally placed the seed bag into the field tile and stated under oath that if the landowner or anyone else had reported the existence of this field tile or had it been found, the crossover pipe and catch basin would not have been filled with cement.

Ohio law provides that a political subdivision, such as the county in this case, is liable for the negligent acts of its employees with respect to "proprietary functions" of the political subdivision, but is immune from liability for "governmental functions." Proprietary functions include projects such as the establishment of a utility or the maintenance of a sewer system, while governmental functions include projects such as the construction or reconstruction of a sewer system.

The court held that the drainage project in this case constituted a governmental function because the purpose of the project was not only to redesign and reconstruct the existing drainage system, but also to improve the safety of the county road by filling in the ditch. The court cited previous Ohio cases that recognized reconstruction and improvement projects similar to the ones performed in this case as governmental functions. Accordingly, the county engineer was immune from liability and no other exceptions to immunity applied in this case.

Special thanks to summer associate Bryan Evans for his assistance in preparing this summary.

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