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Construction Surety Bonds: Buyers Beware

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If you're in the market for construction surety bonds, let this article serve as a cautionary tale. Not all surety bonds are the same. Some types of surety bonds offer only limited protection, while others may impose strict limitations on when and how an owner may file a claim against the bond. In the end, construction owners should heed a simple message: buyers beware.

Generally, a surety bond is an obligation by which one party (the surety) agrees to guarantee performance by another (the principal or, in our case, the contractor) of a specified obligation for the benefit of a third person (the obligee or owner). There are three general types of surety bonds and their names are indicative of their functions: (1) bid bonds, (2) payment bonds and (3) performance bonds. Bid bonds guarantee that a contractor will honor its bid, commonly up to a certain percentage of the bid or the difference between the bid and the next highest bidder, whichever is less. Payment bonds guarantee the contractor's payment of its obligations to subcontractors, laborers and suppliers. Lastly, performance bonds provide financial assurance that the contractor will perform its obligations to the owner under the construction contract.

While these descriptions may sound a lot like insurance, surety bonds are not insurance. Insurance policies are based on a concept of fortuity, or truly accidental property damage or personal injury. Surety bonds, on the other hand, cover breaches of contract. Also, when there is a claim under an insurance policy, the insured is typically only required to pay a premium and the insurer will pay the claim, subject to policy limitations. When there is a claim under a surety bond, however, the contractor for whom the bond is provided (the principal) is required to repay the surety, dollar for dollar, for all expenses, including the underlying claim amount that the surety pays to the claimant. These reimbursement obligations between the principal and the surety are commonly memorialized in strictly worded indemnity agreements and are secured by personal assets of the principal. For these reasons, sureties should, in theory, never lose money.

For public owners in Ohio, choosing a surety bond is easy — there is no choice. Section 153.54 of the Ohio Revised Code mandates the form of bond that must be used on public works projects that exceed a certain dollar amount. For private construction owners, however, there are many different forms of bonds (and even a few insurance products as we will discuss below) that are available for use. When evaluating the type of surety bond to be used on your next project, construction owners should always evaluate three key provisions of the surety bond: (1) notice of claims, (2) time limit on claims and (3) surety takeover obligations.

The obligation of a surety to investigate a claim typically kicks in upon the default of the contractor. See *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106 (5th Cir. 1994). It only makes sense that an owner would have to tell the surety if the contractor is in default. Some forms of surety bonds, however, impose strict notice requirements on ***how*** the surety is to be notified of contractor defaults. For example, one commonly used surety bond requires the owner to first send a letter to the contractor and surety informing the contractor that the owner is considering declaring the contractor in default and then arrange a meeting between the owner and contractor within a certain number of days of the letter being sent. Next, the owner must formally declare the contractor in default in writing and terminate the contractor's right to complete the project. Lastly, the owner must agree to pay the balance of the contract price to the surety. Only then will the surety investigate and possibly pay on the claim.

Although such a procedure may seem draconian, courts will strictly enforce these notice requirements. In *Safety Signs, LLC v. Niles-Wiese Construction Company*, a contractor working on the construction

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of an airport runway had a payment bond that required its surety to pay its subcontractors if the contractor did not. One subcontractor sent a notice of payment bond claim to the contractor's primary business address rather than the address listed on the payment bond, as required by the applicable statute. Even though the surety agreed that the subcontractor had completed its work and had not been paid in full, the subcontractor could not recover payment from the surety because it did not strictly comply with the notice requirement in the statute and this defect could not be waived. *Safety Signs, LLC v. Niles-Wiese Constr. Co.*, 820 N.W.2d 854 (Minn. Ct. App. 2012).

Another key issue to consider is the time period during which claims can be made on the surety bond. The AIA Document A312-2010 Performance Bond, for example, requires that legal proceedings under the bond be instituted no later than two years after the contractor stopped working on the project. The A312-2010 Payment Bond requires that legal proceedings occur no later than one year after the contractor finishes work on the project. This is as compared to the form of bond created and mandated by Section 153.54 of the Ohio Revised Code (often referred to in Ohio as the statutory form of bond) that runs for the life of the contract, which, in Ohio, is eight years under the Ohio statute of limitations. When a contractor is found to be in default by the surety, the surety typically has three different options under the terms of most performance bonds: (1) pay the owner for its damages in an amount up to the penal sum of the bond, (2) tender a completion contractor to the owner or (3) finance the defaulting contractor to complete the project.

If an owner has gone through the process of declaring the contractor to be in default and terminating its contract, the third option (i.e., letting the defaulting contractor finish the job) may not be that appealing to an owner. Depending on the language of the bond, however, an owner may be stuck with such an outcome. In *St. Paul Fire & Marine Insurance Co. v. VDE Corp*, the owner of a construction project declared the principal contractor in default after the contractor refused to complete its obligations in the contract, did not work at a reasonable pace, abandoned work on the project and insisted on collecting payments that were not yet due. The owner then requested that the contractor's surety perform its obligations under the bond by completing the work. The owner also informed the surety that it was opposed to having the defaulting contractor complete the job. The surety argued that the owner was therefore in breach of the bond terms and the surety would no longer have any obligations under the bond. The court agreed, holding that the owner's refusal to allow the defaulting contractor to complete the work was a material breach of the bond because the language of the bond placed no restrictions on which contractor the surety could use to complete the project. See *St. Paul Fire & Marine Ins. Co. v. VDE Corp.*, 603 F.3d 119 (1st Cir. P.R. 2010).

Construction owners may avoid this result not only by selecting a form of bond that does not contain limiting language, but also with properly worded construction contracts. This is because performance bonds will commonly incorporate the language of the underlying construction agreement between the owner and contractor. Construction owners are thus advised to specify duties of the surety in their contractor agreements, including time frames for investigation of a claim and limitations, if any, that the owner may want to impose on possible takeover contractors tendered by the surety.

Approximately 17 years ago, insurance companies began creating insurance products to simulate the function of a bond. Subcontractor default insurance is a policy that a contractor can purchase to protect itself from subcontractor default. Just like insurance, subcontractor default insurance will provide coverage up to certain policy limits. Also, like insurance, subcontractor default insurance may require the prime contractor (i.e., the construction contractor who is in direct contract with the owner) to pay a deductible; however, there is no requirement that the contractor reimburse the insurer its costs and expenses in satisfying a claim.

While subcontractor default insurance presents a viable alternative to surety bonds, there are several key considerations that must be taken into account from an owner's point of view. First, it is the contractor and not the owner that is the insured party under subcontractor default insurance. This means that if there is a default on the project, it is the contractor, and not the owner, who may bring a claim against the policy. There are riders available that allow owners to be additional insureds under subcontractor default insurance policies; however, in many cases, these riders still require the principal contractor to be declared insolvent before a claim may be made by the owner directly against the policy.

Another issue to consider is that subcontractor default insurance covers just that: defaults by the subcontractor. As a result, defaults by the prime contractor (e.g., defaults by the prime contractor on self-performed work) are not covered under subcontractor default insurance policies. To the extent that the prime contractor is self-performing

a significant amount of work, or to the extent that the prime contractor's self-performed work will greatly impact other subcontractors on the project, not having surety bond coverage for this work may expose the owner to significant risks. These risks should be balanced against cost savings and other advantages that are gained through the use of subcontractor default insurance. Lastly, note that subcontractor default insurance cannot be used as a substitute for the statutory form of bond required on public works projects in Ohio under Section 153.54 of the Ohio Revised Code.

For private construction owners, there are many different options available for bonding. Owners are warned to closely read the language of the bond before agreeing to use a certain type of bond for their construction project. Carefully crafted contract provisions will also allow owners to shift the risk of loss to the surety.

Under *Coleman et al. v. Portage County Engineer,* Failure to Upgrade Sewer Capacity is Immune Governmental Function

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The Sixth Appellate District recently applied the Ohio Supreme Court's 2012 rule on government immunity for failure to upgrade an existing sewer.[1] In *Hirt v. Crestline Paving & Excavating, Inc.*, 2013 Ohio 200 (Ohio Ct. App., Sandusky County, Jan. 25, 2013), a group of three homeowners sued a township and a contractor claiming that flooding and sewer backups occurred on their property due to the negligent construction, design, operation and maintenance of the sewer system. The homeowners also claimed that this continual flooding was a "taking" of their property by the government.

The township had employed the contractor for the construction of a sanitary sewer in the homeowners' neighborhood. Before this construction, none of the homeowners had experienced water or sewage problems. Following the construction of the sanitary sewer, the homeowners reported flooding in their homes of 2-6 feet of water and sewage.

Noting the Supreme Court's rule from *Coleman*, the appellate court stated that the township would be immune from liability on the claims of negligent design and construction because the design and construction of a sewer system is a "governmental function." However, under the same rule, the township would not be immune from liability for negligent maintenance and repair of the sewer system.

The homeowners did not identify any particular part of the sanitary sewer that was broken and had not been repaired and simply argued that upgrades or changes could be made to prevent their properties from being flooded. Applying the rule from *Coleman*, the court held that the "failure to upgrade" the sewer system is different from the failure to maintain or repair the system. The court held that the township's failure to upgrade the sewer system capacity is an immune governmental function under R.C. 2744.01 and therefore, the township was not liable for those claims.

In addition, the court held that some of the homeowners' claims could not be brought because the four-year statute of limitations had passed. The homeowners alleged that the contractor had cut an existing drain system during the construction of the sewer system, which was completed in 2001, and that this had caused the flooding in 2005. However, one of the homeowners had admitted to water entering the basement, the lifting of the basement flooring, moisture on the foundation walls, and to making complaints to the contractor in 2000 and 2001.

Despite this, the homeowners argued that their claim had not accrued for statute of limitation purposes until 2005. Even though these homeowners may not have *actually* known about the flooding problem until 2005, the court held that they reasonably *should* have known of the problem in 2001 and therefore, their claim accrued in 2001. Because of this, some of the claims were barred by the four-year statute of limitations.

Finally, the court addressed the homeowners' claims that the continual flooding constituted a "government taking" of their property and found that several of the claims would need to be argued at trial.

First, the homeowners' expert witness had testified that he "believed" the drain system that was cut by the contractor had caused the flooding on some of

the homeowners' property. However, the township's expert witness testified that it was not the cause of the flooding. Due to this conflict, the appellate court found that this was an issue to be determined at trial.

Next, the court examined the testimony from the township's expert witness regarding another homeowner's property. There, the expert had testified that it was the high groundwater elevation and lack of drainage pipes that were the cause of the flooding at that property. The homeowners did not give the court evidence to counter this testimony, so the court found in favor of the township on that portion of the claims.

Last, as to another property, the township argued that there was no evidence of design, construction or maintenance issues with the sanitary sewer system. However, because the township did not prove that the sewer lines were *not* the cause of the homeowners' flooding, the court held that this was an issue to be examined at trial. Accordingly, the township was immune from some of the homeowners' claims while other claims remained to be decided at trial.

Footnote

[1]For a summary of this Ohio Supreme Court case, *Coleman et al. v. Portage County Engineer* (2012), 133 Ohio St. 3d 28, see Bricker & Eckler's Spring 2013 Water & Wastewater Law newsletter available at http://www.bricker.com/publications-and-resources/publications-and-resources-details.aspx?Publicationid=2590.

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Arbitration Clause in Agreement Applied to Unattached Scopes of Work

A recent case by the Twelfth Appellate District Court confirms that an arbitration clause in one contract document may apply to claims based on other related documents for the same project.

In *Gaffin v. Schumacher Homes of Cincinnati, Inc.*, 2013 Ohio 992 (Ohio Ct. App., Clermont County, Mar. 18, 2013) a contractor contracted for drywall and painting services from a subcontractor. The contractor and subcontractor signed a Trade Partner Agreement (agreement) that contained a provision in which the parties agreed to arbitrate any disputes that arose from the agreement. At the same time, the contractor and subcontractor signed a "Scopes of Work" agreement, which included the details and specifications for the work the subcontractor would do.

Six years after their initial agreement, the subcontractor sued the contractor claiming that it was owed money for work it had performed, breach of contract and unjust enrichment. The contractor argued that the parties were required to arbitrate the dispute.

The trial court noted that the subcontractor's claims related only to the "Scopes of Work" and not the agreement itself. Because the arbitration clause was in the agreement, the trial court held that the arbitration clause applied only to the agreement and anything attached to the agreement. The "Scopes of Work" was not attached to the agreement. Since the subcontractor's claims were based on the unattached "Scopes of Work," the trial court held that the arbitration clause did not apply to the subcontractor's claims.

The appellate court disagreed, noting that each of the parties signed the agreement and the "Scopes of Work" on the same date, the agreement referenced the "Scopes of Work" as being "attached," and the "Scopes of Work" was referred to throughout the agreement. The appellate court determined that even if the "Scopes of Work" was not physically attached to the agreement, it was clearly incorporated through the language of the agreement. In addition, the "Scopes of Work" did not override or end the terms of the agreement in any way. Thus, the appellate court held that the agreement's arbitration clause did apply to the "Scopes of Work" and that the arbitration clause was broad enough to apply to the claims brought by the subcontractor. Accordingly, the parties were required to arbitrate their dispute.

This document has been prepared as a general reference document for informational purposes. The information contained herein is not intended to be and should not be construed as legal advice. Each circumstance should be considered and evaluated separately, and possibly with involvement of legal counsel.

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