The A312 Performance Bond is Not a Blank Check

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YOU represent a contractor working on a bonded construction project. It comes to your attention that the owner of the project has written letters over several weeks claiming that your contractor is falling behind, that your contractor (who the surety considers as their "Principal" under the Performance Bond)[1] does not have enough workers at the job, and that the work is substandard. The letters from the owner (who the surety considers as the "Obligee" under the Performance Bond) demand the principal to furnish more workmen, more supervisors, and a new schedule, and speed up the work.

The principal does not accelerate as the obligee demands, and the obligee advises that it will rely on the terms of the bonded contract and hire other contractors to supplement and complete the job. The obligee also alleges a default and terminates the principal. No demand is made upon the surety until approximately two months later, when the obligee has completed the principal's work.

At that time, the obligee simply makes a demand for payment from the surety. What should the surety do? The answer lies in an analysis of the terms of the Performance Bond, the contract which governs the surety's obligations to the obligee. In this case, the Performance Bond is the widely used American Institute of Architects A312 Performance Bond.[2]

I. A Review of the Material Sections of the AIA A312 Performance Bond

A review of the A312 reveals that the surety's obligations are strictly conditioned, and the surety's rights are stated in detail by the express terms of the Bond. Unlike insurance policies, which are forms drafted and imposed by the insurer, the form of surety bond is typically a requirement imposed by the obligee, often in the very construction contract itself. Obligee's attorneys frequently either don't realize or intentionally try to fudge the fact that the form of the Bond was selected and mandated by their client and that the Bond form is essentially a contract of adhesion upon the surety and accordingly should be strictly construed against the obligee.

[1] Since this article focuses on the widely used AIA A312 Bond form, we will default to using the surety terms for the parties under the Bond (Contractor = Principal; Owner = Obligee) in our discussion. Also, by using Principal and Obligee, the discussion translates to a scenario involving a general contractor and a bonded subcontractor.

[2] In this article, we focus on the 2010 form of the AIA A312. Prior editions differ in detail but not in material substance. As always, the first thing to do when accessing a Performance Bond claim is to read the Bond.

Regarding terms and conditions, the A312 requires the following:

> 2. If the Contractor performs the Construction Contract, the Surety and the Contractor shall have no obligation under this Bond, except when applicable to participate in a conference as provided in Section 3.
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> 3. If there is no Owner Default under the Construction Contract, the Surety's obligation under this Bond shall arise after:
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> 3.1 The Owner first provides notice to the Contractor and the Surety that the Owner is considering declaring a Contractor Default. Such notice shall indicate whether the Owner is requesting a conference among the Owner, Contractor and Surety to discuss the Contractor's performance. If the Owner does not request a conference, the Surety may, within five (5) business days after receipt of the Owner's notice, request such a conference. If the Surety timely requests a conference, the Owner shall attend. Unless, the Owner agrees otherwise, any conference requested under this Section 3.1 shall be held within ten (10) business days of the Surety's receipt of the Owner's notice. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract, but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default; and
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> 3.2 The Owner declares a Contractor Default, terminates the Construction Contract and notifies the Surety.
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> 3.3 The Owner has agreed to pay the Balance of the Contract Price in accordance with the terms of the Construction Contract to the Surety or to a contractor selected to perform the Construction Contract.
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> 4. Failure on the part of the Owner to comply with the notice requirement in Section 3.1 shall not constitute a failure to

comply with a condition precedent to the Surety's obligations, or release the Surety from its obligations, except to the extent the Surety demonstrates actual prejudice.

5. When the Owner has satisfied the conditions of Section 3, the Surety shall promptly and at the Surety's expense take one of the following actions:

5.1 Arrange for the Contractor, with the consent of the Owner, to perform and complete the Construction Contract;

5.2 Undertake to perform and complete the Construction Contract itself, through its agents or independent contractors;

5.3 Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and a contractor selected with the Owner's concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages as described in Section 7 in excess of the Balance of the Contract Price incurred by the Owner as a result of the Contractor Default; or

5.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances;

5.4.1 After investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, make payment to the Owner; or

5.4.2 Deny liability in whole or in part and notify the Owner, citing reasons for denial.

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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
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> 7.1 the responsibilities of the Contractor for correction of defective work and completion of the Construction Contract;
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> 7.2 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 5; and
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> 7.3 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.
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> 8. If the Surety elects to act under Section 5.1, 5.3 or 5.4, the Surety's liability is limited to the amount of this Bond.

A. Do the Obligee's Letters Trigger the Surety's Obligations?

As a matter of law, cure letters do not trigger any surety obligations or performance under AIA A312 Performance Bond. Cure letters that contain only allegations of defaults or notices of noncompliance do not constitute the notice of default and termination as required by Section 3.1 of the Bond.[3]

It is universally held that giving a surety notice of default under the Bond is a mandatory condition precedent and that notice must be "clear, direct and unequivocal."[4] While sometimes sureties will choose to move forward for their own strategic or tactical reasons under a reservation of rights, the surety has no obligation to take any

[3] Balfour Beatty Construction, Inc., v. Colonial Ornamental Iron Works, Inc., 986 F. Supp. 82, 85 (D. Conn. 1977).

[4] *See e.g.,* L&A Contracting Co., v. Southern Concrete Services, Inc., 17 F.3d 106 (5th Cir. 1994).

action under the Bond, in accordance with "black letter" contract law, absent satisfaction of the Section 3 conditions precedent.

B. Enforcement of Conditions Precedent

A condition precedent is a condition or an event that much occur before a right, claim, duty, or interests arises under a contract. Section 3 of the AIA A312 Bond has been held by most courts as enumerating conditions precedent, each of which must be complied with to trigger the surety's obligation to perform. ("Failing to comply with Section 3 conditions precedent before completing the work through other subcontractors was a failure of conditions precedent by the obligee"); ("Unilaterally completing" or engaging in "self-help" remedies is a failure of conditions precedent); ("Replacing the principal/contractor before a demand upon the surety to perform is a failure of conditions precedent").

Additionally, another condition precedent under the Bond is that there be "no Owner default under the Construction Contract." However, outside of the obligee failing to comply with the termination process under the contract, thereby wrongfully terminating and materially breaching the contract, it is probable that any dispute about an obligee default would entail triable issues of fact. Failure of the other conditions set forth in Section 3 (or Section 6 discussed below) are typically clear cut and therefore more likely to be successful on summary judgment.

C. Discharge or Void Bond?

A failure to follow conditions precedent constitutes a material breach of the Bond by the obligee (e.g., not following the specific termination and notification procedures of the Bond). A material breach of the Bond as a matter of contract law voids the Bond and excuses the surety's performance.

Hiring successor contractors to complete the work without the complete consent of the surety, and disbursement of the entire contract balance breaches the terms of the Performance Bond, thus discharging the surety. A failure by the obligee to comply with Section 3 of the Performance Bond before completing the work through other subcontractors constitutes a failure conditions precedent, and the surety is discharged. If an obligee hires a new subcontractor before the surety has an opportunity to respond to the termination, the surety's obligations are discharged. Preventing the surety from employing a completion contractor, even without the obligee's consent, constitutes a material breach of the

A312 Performance Bond and a discharge of the surety.

II. Reasons for the Surety's Legal Discharge

A seminal rule of contract law is that a material breach excuses the performance of the other party.[5] A failure of conditions precedent constitutes a material breach of contract, and that material breach excuses the "performance" of the surety.[6] The provisions of A312 Section 5 establish the rights of the surety upon a termination of its principal and a claim and demand upon the Bond to elect to either finance the principal (if the performance issue is financial); takeover and complete the work itself or through its agents; tender a replacement contractor; or deny the claim based upon its investigation. These rights are material to the surety under the Bond, since they allow the surety to determine the best means to mitigate any loss or otherwise reserve the surety's rights to assert its defenses.

The obligee's failure to follow conditions precedent and its unilateral decision to hire a substitute contractor deprive the surety of the opportunity to mitigate its damages and constitute material breaches of the Bond. Hiring successor contractors and disbursing the remaining contract balance are material breaches of the express terms of the Bond and result in the surety's discharge. The actions of the obligee in contravention to the Bond eliminate the surety's rights under the Bond and therefore promote discharge. The self-help remedies and unilateral decisions of the obligee renders the Bond "meaningless."

The actions of the obligee forgoes the surety's ability to choose among the options it has for remedying the principal's default. The surety's performance options contained in the A312 Bond are "standard in the industry" and the obligee has no right to interfere with the surety's selection of its completion contractor unless the Bond provides otherwise. An obligee's unilateral hiring of a substitute contractor to complete the project work excuses the surety and deprives it from its ability to choose among options it had for remedying its principal's default and thus the surety's liability is relieved under the Bond.

III. Does the Surety Need Prove "Prejudice?"

To satisfy the express conditions precedent under the A312, the obligee must declare a default, terminate the principal,

[5] Restatement (Second) of Contracts §242 (1981).

[6] Restatement (Second) Contracts §237 (1981).

make a claim and a demand for performance on the surety and expressly commit to paying the balance of the contract price in accordance with the Bond to the surety or a contractor selected to perform the work. The only exception to the express conditions precedent is stated under Section 4.1, is if the obligee fails to give pre-default notice and request a meeting under Section 3.1, the surety can only be "released" from liability upon a showing of "actual prejudice". By the express terms of the A312, the surety is otherwise never burdened with having to show prejudice for any other violation of conditions precedent in Section 3 of the Bond.

IV. Surety Default and Further Notice

The surety is entitled to an additional notice before it can be placed in default under Section 6 of the Bond, which reads:

> 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 by the Owner. If the Surety proceeds as provided in Section 5.4, and the Owner refuses the payment tendered 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.

Reading the express conditions precedent contained in Section 3 together with Section 6, it is apparent that in order for the surety to be found in breach of the Performance Bond, the obligee must satisfy the conditions contained in Section 3, the surety must fail to make an election under Section 5 "with reasonable promptness," and then the obligee must serve the Section 6 notice described above, which in effect calls for a seven-day cure period. It should be noted, that even if the surety is held to have defaulted under the Bond under Section 6, the penal sum is still in full force and effect.

V. Obligee Arguments

Section 1 of the A312 reads: "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."

Typically, the obligee will attempt to circumvent its failure to satisfy the expressly stated conditions in Section 3 and the cure notice requirement of Section 6 by arguing the following: (i) the obligee is not seeking performance but "indemnification" under the bonded contract; or (ii) the obligee is seeking "damages" under the underlying construction contract, not performance or completion of the contract.

A. Obligee Cases

Forest Manor, LLC v. Travelers Casualty and Surety Co.[7] holds that because the A312 Performance Bond expressly incorporates the underlying contract, and because under Connecticut law they are to be read together, since the principal can be held liable for breach of the construction contract, so can the surety. The obligee sought "indemnification" under the construction contract for the costs associated with "demolishing the structure which was being built by the principal." The court reasoned that since the obligee did not seek performance of the construction contract, it did not have to comply with any of the Section 3 conditions precedent and could seek "indemnification" for the principal's breach of the underlying contract. An obligee may use this strategy to sidestep the Bond and seek "indemnity" under the terms of the bonded contract.

The trial court in *Developers Surety and Indemnity Cox v. Archer Western Contractors, LLC*[8] read the subcontract and the Bond "in harmony", as required by Florida law, and held the surety liable for breaching the Bond for failing to take corrective action within fifteen days of receiving the claim. Here, Archer unilaterally engaged a replacement subcontractor to remedy and complete the principal's work before the surety had a chance to take action under the Bond and to mitigate damages. The court agreed that the surety was not required to "perform" but that the underlying contract required the surety to pay for the "costs of completion."

B. Why these Arguments Fail

Courts recognize that A312 Bond form is widely used in the construction industry, its terms are based on a compromise amongst interested parties, and it has been

[7] 2018 WL 1137580 (Conn. Sup. Ct. Jan. 30, 2018) (unpublished).

[8] Developers Surety and Indemnity Cox v. Archer Western Contractors, LLC, 2018 WL 2100032 (M.D. Fla. May 7, 2018).

held as a matter of law as being "unambiguous."[9] The underlying contract does not change the terms of the Bond, and as the Bond is the only contract between the surety and the obligee, the terms of the Bond should control and take precedence over the contract. However, frequently obligees make arguments in an attempt to stretch the terms of the underlying contract to the point where the most material terms of the Bond would be rendered null, for example arguing that the indemnification clause in the contract supervenes the penal sum of the Bond itself.

There are no provisions in the Bond or the underlying contract that distinguishes between claims as to which the Bond's conditions "apply" or do not apply. The Bond is clear and expressly states what the obligee must do/satisfy to trigger the surety's obligations. The cases favorable to obligees typically are trial court cases, they are unpublished, and no subsequent court has cited them as authority. Sureties should more forcefully argue that the Bond should be viewed as a contract of adhesion imposed by the obligee on the surety, rather than taking for granted that the court will make the distinction. Indeed, many judges do not distinguish between surety bond contracts and insurance policies and will default to construing the Bond against the surety, as they would construe an insurance policy against an insurer. If the obligee had wanted to change the terms of the Bond, it could have easily done so through Section 16 which reads: "Modifications to this Bond are as follows".

C. Cases Favoring the Surety

Section 3 of an AIA A312 Bond enumerates conditions precedent that must be complied with in order to trigger the surety's obligations to perform. A sampling of the numerous cases favorable to sureties follows:

In *St. Paul Fire & Marine Insurance Company v. City of Green River*,[10] the Wyoming District Court held that "an obligee's action that deprives a surety of its ability to protect itself pursuant to performance options granted under a performance bond constitutes a material breach, which renders the bond null and void." *Green River* is a good place to start when researching the enforceability of the AIA A312 conditions.

Stonington Water Street Associates, LLC v. Hodess Building

[9] Developers Surety and Indemnity Company v. Dismal River Club, LLC, 2008 WL 2223872 at *12 (D. Neb. May 22, 2008).

[10] St. Paul Fire & Marine Insurance Company v. City of Green River, 93 F. Supp.2d 1170, 1178 (D. Wyo. 2000), aff'd, 6 Fed. Appx. 828 (10th Cir. 2001).

Company, Inc.[11] held that Section 3 of an AIA A312 Bond "sets forth the conditions precedent that must be complied with in order to trigger the surety's obligation to perform . . . the hiring of successor contractors without the consent of the surety and disbursement of the entire contract balance without the express approval and consent of National Fire materially breached the terms of the performance bond" and found National Fire was entitled to summary judgment. The court voided the Bond and excused the surety's performance, noting that an obligee's "unilateral decision to hire successor contractors to complete the project deprived [the surety] of the opportunity to mitigate its damages and represent material breaches of the bond."[12] In *Dragon Cons. Inc. v. Parkway Bank & Trust,*[13] the court similarly found a material breach where the obligee did not follow the specific termination and notification or the procedures provided in the construction contract and hired a successor contractor without the surety's knowledge.

Relying on *Hunt Construction Group v. National Wrecking Corporation*,[14] the court in *Western Surety Company v. U.S. Engineering Construction, LLC,* held that a failure by the obligee to comply with Section 3 of the AIA A312 (2010) before completing the work through other subcontractors "was a failure of "conditions precedent" and "the surety's obligations under the bond are discharged." "By unilaterally completing … U.S. Engineering deprived Western Surety of its contractually agreed upon opportunity to participate in remedying … [the] default."[15] The court recognized that the obligee engaging in "self help" remedies rendered the options in Section 5 "meaningless."

In *International Fidelity Insurance Company v. Americaribe-Moriarty JV*, the Eleventh Circuit determined that if an obligee hires a new subcontractor before the surety has an opportunity to respond to the termination, the surety's obligations under the Bond are discharged. The court emphasized that such an action "thwart[s] [the surety's] ability to choose among the options it had for emedying [the subcontractor's] default under §5 of the bond."[16]

The District Court of Nevada in *United States For the Use and Benefit of Agate Steel, Inc., v. Jaynes*

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[11] Stonington Water Street Associates, LLC v. Hodess Building Company, Inc., 792 F. Supp.2d 253, 266-267, 269 (D. Conn. 2011).
[12] *Id.* at 266-267.
[13] Dragon Cons. Inc. v. Parkway Bank & Trust, 287 Ill.App.3d 29, 33, 222 Ill. Dec. 648, 678 N.E.2d 55 (Ill. App. Ct. 1997).
[14] 587 F.3d 1119 (D.C. Cir. 2009).
[15] Western Surety Company v. U.S. Engineering Construction, LLC, 955 F.3d 100, 104 (D.C. Cir. 2020).
[16] 681 Fed. Appx. 771, 776-777 (11th Cir. 2017).

Corporation,[17] concluded that the obligee's failure to comply with the conditions precedent in Section 3 of the Performance Bond—replacing the principal/contractor before a demand upon the surety to perform—constitutes a material breach that excuses the surety's performance.

In *Developers Surety and Indemnity Company v. Dismal River Club, LLC,* the court held that the language of Section 3 "creates unambiguous preconditions for triggering [the surety's] obligations under the bond." The *Dismal River* court held that the surety's obligation to act under the AIA A312 Performance Bond, "does not arise unless such conditions are met." Further, many courts consider the language of the AIA A312 Performance Bond to be "unambiguous language."[18]

In *St. Paul Fire & Marine Insurance v. VDE Corp.*,[19] the court held that preventing the surety to employ a completion contractor, even without the obligee's consent, constituted a material breach of the A312 Performance Bond. The court went on to state:

> Our interpretation of Paragraph 4.2 is also consistent with common practices in the construction industry. The surety performance options contained in Paragraph 4 of the AIA A312 Bond, the Bond at issue here, are "standard in the industry." *Green River*, 93 F. Supp.2d at 1178; see also Bruner & O'Conner, *supra*, at §12.16 (describing the A312 Performance Bond as "one of the clearest, most definitive, and widely used type of traditional common law performance bonds in private construction")…. *Bruner & O'Conner*, *supra*, at §12:80 (stating that "[t]he obligee has no right to unreasonably interfere with the surety's selection of its completion

[17] United States For the Use and Benefit of Agate Steel, Inc., v. Jaynes Corporation, 2016 WL 873223602 (D. Nev. June 17, 2016).

[18] *Dismal River Club,* 2008 WL 2223872 at *14.

[19] St. Paul Fire & Marine Insurance v. VDE Corp. 603 F.3d 119 (1st Cir. 2010).

> contractor, unless the bond provides otherwise"). . .[20]

An obligee's unilateral hiring of a substitute contractor to complete the project work eliminates the surety's ability to choose among options it had for remedying its principal's default under Section 5 of the AIA A312 (2010) Bond. As stated in *International Fidelity Insurance Co., v. Americaribe-Moriarty JV,*[21] the actions of the obligee "stripped the surety" of its bargained-for right to elect among options for remedying defaulted work and thus relieved the surety of its liability under the Bond. Courts also routinely hold that an obligee's failure to follow conditions precedent in a Performance Bond constitutes a material breach.[22]

In the unpublished decision of *Arch Insurance Co., v. The Graphic Builders, LLC*,[23] the court enforced the conditions precedent in Section 3 over the arguments of the obligee to enforce the terms of the bonded contract. The obligee must agree to pay over the contract price to the surety to trigger the surety's obligations to perform. In *Sonoma Springs Ltd. Partnerships v. Fidelity and Deposit Co., of Maryland*,[24] the court held that a failure to do so is a material breach that renders the Bond "null and void".

VI. Conclusion

The A312 Bond form is widely used across the construction industry. Its unambiguous terms and conditions must be satisfied to trigger the surety's performance obligation and options. The express terms cannot be ignored by an obligee owner or general contractor simply to demand payment from the surety. Any obligee who does so, does so at their own risk.

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[20] *Id.* at 124.
[21] 681 Fed. Appx. at 776-777.
[22] *See* USF&G v. Braspetro Oil Servs. Co., 369 F.3d 34, 51 (2d Cir. 2004); LBL Skysystems (USA), Inc. v. APG-America, Inc., 2006 WL 2590497, at *23 (E.D. Pa. Sept. 6, 2006); *Green River,* 93 F. Supp.2d at 1170; Bank v. Brewton, Inc. v. Int'l Fid. Ins. Co., 827 So. 2d 747 (Ala. 2002).
[23] 2021 WL 534807 (D. Mass. Feb. 12, 2021).
[24] 409 F. Supp.3d 946 (D. Nev. 2019).