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DRB UPDATE: Public Owner Beware: The Meaning of Your Dispute Resolution Provisions May Surprise You

By Ronald L. Helmuth, Esq.
Attorney, Hunt Ortmann

A recent trial court interpretation of boiler plate Dispute Resolution Board ("DRB") provisions in a public agency's contract provided a big surprise to the Owner. The Court ruled that a DRB Recommendation finding merit to several Contractor claims was binding on the Owner despite the fact that (1) the Owner had timely rejected the adverse DRB Recommendation; (2) the Contractor had timely given Notice of Intent to Litigate upon being advised of the Owner's rejection of the recommendation; and (3) the Contractor indicated when giving its Notice of Intent to Litigate that it understood that it was the Contractor's obligation to give such notice under the circumstances.

Like many public agencies engaged in heavy civil construction projects in the 1990s and into this century, the Owner had inserted into its contracts a comprehensive alternative dispute resolution ("ADR") process. The process set out in the Owner's contracts was derived from the DRB provisions recommended by the seminal publication regarding that ADR mechanism entitled Avoiding and Resolving Disputes in Underground Construction, which was initially published by the American Society of Civil Engineers in 1989.[1] Included in the DRB provisions in the Owner's contracts were procedures for the formation of the DRB, the process for bringing disputes to the DRB, the hearing process for such disputes, the issuance of DRB Recommendations for disputes presented to it, and the parties' actions to be taken in response to the DRB Recommendations. Also included were provisions concerning the conduct of the parties, the DRB panel and its members, and the payment to the DRB members for their services. (In addition there was a "Three Party Agreement" appended to the contracts for execution by the Owner, Contractor and each DRB panel member, setting forth the terms and conditions of their contractual relationship.)

At issue in the subject litigation were several of the provisions pertaining to the parties' actions to be taken in response after a DRB Recommendation has been issued. These provisions provided as follows[2]:

> "[Provision P1] Within two weeks of receiving the Board's recommendations, both the Owner and the Contractor shall respond to the other and to the Board in writing, signifying either acceptance or rejection of the Board's recommendations. The failure of either party to respond within the two week period shall be deemed an acceptance of the Board's recommendations. . . ."

> "[Provision P2] Should the Contractor and/or the Owner not accept the recommendation of the Board and the dispute remains unresolved, the Owner or Contractor may then appeal the decisions back to the Board or a notice of intent to litigate may be given within twenty-one days of receiving the Board's decision. If the Owner or the Contractor does not respond in a timely

1 The publication has been edited, updated and re-titled twice: first as Avoiding and Resolving Disputes During Construction (ASCE 1991) and then as Construction Disputes Review Board Manual (McGraw Hill 1995).

2 The document excerpts appearing in this article have been edited as necessary to shield the identity of the parties, since the litigation is still pending.

> manner, the decision of the Board will be final and binding.[3]

The need for the Court's interpretation of the meaning of these DRB provisions arose when the Contractor filed an evidentiary motion. In its motion, the Contractor asserted that the Owner was barred from challenging the DRB Recommendation finding that there was merit to the Contractor's claims because the Recommendation became final and binding when the Owner did not either appeal the Recommendation back to the DRB or give Notice of Intent to Litigate within 21 days after the DRB Recommendation was issued.

Notably, the Contractor conceded in its motion that the Owner had timely rejected the DRB Recommendation. In addition, it was not disputed that the Contractor had given its own Notice of Intent to Litigate the subject claims within the 21 day period set forth in the DRB provisions in the Contract.

It was also undisputed that when giving its Notice of Intent to Litigate, the Contractor indicated it interpreted the DRB provisions to require the Contractor to file such notice. Specifically, the Contractor advised the Owner within five days after the Owner rejected the DRB Recommendation that:

> We are in receipt of your letter [timely] rejecting the recommendations of the Disputes Review Board for the four disputes heard on [specific dates]. Upon reviewing the Disputes Review Board Specifications [of the Contract], we find that we have twenty-one (21) days to file suit.
>
> We interpret the twenty-one (21) days to start upon receiving notice of your rejection, which is [specific date]. Therefore, we must file suit by [specific date].

Thereafter, the Contractor filed its law suit against the Owner on the date specified in its Notice as the last date on which such suit "must" be filed.

Based on the language of the Contract and the exigent facts and circumstances, the Owner argued it was not obligated to either appeal the Recommendation back to the DRB or give its own Notice of Intent to Litigate within 21 days after the DRB Recommendation was issued because: (a) only days after it had timely rejected the DRB Recommendation, the Contractor gave its own Notice of Intent to Litigate; (b) the Owner and the Contractor agreed that the DRB provisions should be interpreted to require the Contractor to give such notice under the circumstances; (c) once the Contractor had given its Notice of Intent to Litigate the subject claims it was unnecessarily duplicative for the Owner to give a notice concerning the same claims; and (d) the Owner should not be required to give a Notice of Intent to Litigate a claim that it was defending (as compared to a claim for affirmative relief).

After considering the parties' briefs and hearing oral argument, the trial Court issued its written ruling. As indicated by the excerpt below, the Court put significant thought and effort into interpreting the DRB provisions at issue before reaching the conclusion resulting in its order. In pertinent part, the Court's ruling stated:

> [T]he issue here is the status of the DRB ruling if a party does object and whether further action is required in order to pursue litigation concerning the issue decided by the DRB.
>
> The Court's reading of the plain language of the contract is that, if a party does not give a notice of intent to litigate within twenty-one days of receiving a DRB decision, or give notice of appeal back to the DRB, the decision of the DRB becomes final and may not be challenged in later litigation.
>
> Under subpart [P1], if a party does not respond in writing within two weeks of receiving a DRB recommendation, the party is deemed to accept the DRB recommendation and must act to carry out the recommendation. But what if a party does reject the DRB recommendation in writing (as the Owner did here)? In that event, subpart [P2] applies. If a party does not accept the DRB recommendation, the dispute remains unresolved. If subpart [P2] stopped here, there would be no time limit on the parties' ability to pursue the dispute further. But the remainder of subpart [P2] indicates an intent that the dispute not be left hanging unresolved indefinitely.
>
> Subpart [P2] states that the unresolved dispute may be appealed back to the DRB or a notice of intent to litigate may be given within twenty-one days. Again, what if a party does not take action to choose one or the other avenue of pursuing the dispute?

3 The subject DRB provisions in the Contract also provided (somewhat inconsistently) that: "Although the Owner and the Contractor should place great weight on the Disputes Review Board's recommendation, they are not binding. If the Board's recommendations do not resolve the dispute, all records and written recommendations, including any minority records, will be admissible as evidence in any subsequent litigation."

The last sentence of subpart [P2] answers that question, and provides that if a party "does not respond in a timely manner," the decision of the DRB becomes final and binding.

One may ask with respect to the last sentence of subpart [P2], whether the response referred to is the notice of intention to litigate or appeal rather than the response (acceptance or rejection) in writing referred to in subpart [P1]. If the last sentence of sub[part] [P2] referred to the response in writing specified in subpart [P1], the language in subpart [P2] would be superfluous, because subpart [P1] itself already has an express provision specifying the consequence of a failure to respond in writing signifying acceptance or rejection of the DRB recommendation. Contracts should be construed, if possible, to give meaning to every provision. Therefore, the last sentence of subpart [P2] should be read to make a DRB decision binding if a party does not give notice of intent to litigate or appeal back to the DRB within twenty-one days.

It is undisputed that [the Owner] did not give notice of intent to litigate within twenty- one days of the DRB decision on the [subject] claims. Therefore, under the contract, [the Owner is] now is barred from pursuing those claims. (Emphasis added.)

Understandably, the Contractor was appreciative of the Court's ruling. The Contractor was also, however, quite possibly as surprised as the Owner by Court's interpretation of the DRB provisions in light of the instant facts and circumstances, including the parties apparent agreement as to their interpretation of the requirements for a party to give Notice of Intent to Litigate – i.e., there was no need for the Owner to file a such notice if the Contractor had already done so.

In any event, the Court's ruling in this instance serves to underscore the need to ensure that you and the Contractor establish a clear understanding of and know what your dispute resolution provisions really mean. This can be accomplished by inserting more precise language in your prospective contracts or reaching a definitive agreement with the contractor concerning the parties' understanding and intent of the ADR provisions in existing contracts. These preventative measures will (hopefully) assist you in avoiding a surprise like that bestowed on this Owner when it received the Court's ruling.

"Termination for Convenience" – What Does it Mean?

By Marilyn Klinger
Partner, Sedgwick Detert Moran & Arnold, LLP
and Matthew R. Hicks
Special Counsel,
Sedgwick Detert Moran & Arnold, LLP

Introduction

Termination for "convenience" provisions are standard clauses in construction contracts seen in both the public and private works settings, generally allowing one party to terminate a contract even in the absence of the other party's fault or breach, and without suffering the usual financial consequences of a breach. At least one dictionary defines convenience as "suitable or agreeable to the needs or purpose."[1] Absent language in the provision itself imposing a good faith requirement, can owners and/or general contractors (on their subcontracts) really terminate the contract when it suits their needs or purpose? In short, the answer is yes, if the termination is in good faith and does not involve fraud. In other words, most (if not all) courts addressing termination for convenience provisions do impose a good faith requirement.

There are many court decisions in the federal arena addressing termination for convenience provisions. Those decisions hold that an owner cannot used the provision in bad faith. And even when an owner exercises the termination for convenience provision in good faith, the owner must still pay the terminated contractor certain damages either delineated in the contract or as required by applicable law, which generally does not include lost profits.

How about in the non-federal public works or in the private works context? Interestingly, there are much fewer public works decisions addressing such provisions, and even fewer reported decisions in the private works context.

This article provides the construction litigation practitioner a general overview of termination for convenience provisions and what the phrase really means.

1 Random House Webster's College Dictionary (Random House, Inc. 1999).

Termination for Convenience Provisions in the Federal Context

Of the many federal court opinions addressing termination for convenience provisions over the years, perhaps Krygoski Construction Co., Inc. v. United States, 94 F.3d 1537 (Fed. Cir. 1996) provides the best historical summary tracing its application in federal court. Krygoski identifies and discusses several key federal court decisions addressing termination for convenience provisions, such as Kalvar Corp. v. United States, 543 F.2d 1298 (Ct. Cl. 1976)[cementing the bad faith/abuse of discretion standard for applying termination for convenience provisions], Torncello v. United States, 681 F.2d 756 (Ct. Cl. 1982)[court of claims adopting a broader "change of circumstances" test for gauging the sufficiency of a convenience termination than Krygoski], Salsbury Indus. v. United States, 905 F.2d 1518 (Fed. Cir. 1990)[rejecting Torncello], and Caldwell & Santmyer, Inc. v. Glickman, 55 F.3d 1578 (Fed. Cir. 1995)[reinforcing the "bad faith" standard and agreeing with Salsbury that Torncello's "change in circumstances" rule has a narrow application].) Indeed, most, if not all, of the federal decisions since 1996 substantively dealing with termination for convenience provisions cite to Krygoski as the standard.

Turning to Krygoski, the termination for convenience provision in that construction dispute read: "The Government may terminate performance of work under this contract in whole or, from time to time, in part if the Contracting Officer determines that a termination is in the Government's interest." In that case, there was an increase in the cost of asbestos removal from what was thought to be ten percent of the total contract cost to about fifty percent of contract cost. The federal government then terminated its contract with the demolition contractor (Krygoski) for convenience based on this error after Krygoski had begun the work. The federal government rebid the work and awarded the contract to another contractor. Krygoski was only the sixth lowest bidder on the rebid.

Krygoski sued in the Court of Federal Claims. Relying on Torncello, the trial court held the federal government improperly terminated the contract under the convenience provision and awarded Krygoski nearly $1.5 million in damages, which included anticipatory lost profits.

The appellate court reversed the trial court. The appellate court rejected the Torncello court's rule that the federal government could not invoke a convenience termination unless some change in circumstance between the time of award of the contract and the time of termination justified the action. The Krygoski court stated that this "change in circumstances" test only applied in factual circumstances where the federal government enters a contract with no intention of fulfilling its promises. Krygoski adhered to the bad faith standard and, given new legislative enactments under the Competition in Contracting Act, held that termination for convenience satisfies the good faith standard where the termination promulgates full and open competition. Thus, because the federal government showed it terminated the contract to preserve full and open competition and the contracting officer did not act arbitrarily or capriciously (i.e., without bad faith), the court upheld the government's termination for convenience. The terminated contractor was entitled to its performance costs, profits on that performance, and termination costs, but not anticipatory lost profits.

Thus, courts will not typically uphold termination for convenience provisions on federal projects where the contractor can show that the federal government acted in bad faith and/or where the termination contradicts notions of full and open competition. (See also post-Krygoski decisions, e.g., T&M Distributors, Inc. v. United States, 185 F.3d 1279 (Ct. of App. Fed Cl. 1999), Northrop Grumman Corp. v. United States of America, 46 Fed.Cl. 622 (2000), and Custom Printing Co. v. United States, 51 Fed.Cl. 729 (2002).) It is true, however, that "the contractor's burden to prove the Government acted in bad faith…is very weighty." (Krygoski, 94 F.3d at 1541 citing Kalvar, 543 F.2d at 1301.) Thus, "[d]ue to this heavy burden of proof, contractors have rarely succeeded in demonstrating the Government's bad faith." (Id.)

Decisions Regarding Termination for Convenience Provisions on Non-Federal Public Works Projects

There are several state court decisions involving non-federal public works contracts worth mentioning.

In RAM Engineering & Construction, Inc. v. University of Louisville, 127 S.W.3d 579 (2003), the court found that the public entity invoked the termination for convenience provision improperly. This case involved the construction of a new stadium for the University of Louisville. The University, after negotiations with the three lowest bidders, declared RAM the lowest bidder at $7.6 million although another contractor, MAC, was initially lower. The University rejected MAC's protest and issued a notice to proceed to RAM. MAC filed suit, at which point the University reversed course and declared the contract with RAM null and void and, thereafter, rebid the project. This time, RAM was the low bidder at $7 million and the University issued a notice to proceed to RAM. However, RAM filed a protest arguing that it should be entitled to the original price of $7.6 million because the University should not have terminated its original $7.6 million contract. The University rejected the protest arguing, in part, that it had the power to terminate the earlier contract at its convenience.

The University prevailed at the trial court level, the court finding that the MAC lawsuit was a substantial change in circumstances allowing the University to terminate the first contract with RAM for convenience. The appellate court affirmed the trial court's ruling. However, the Kentucky Supreme Court reversed. After a detailed analysis of Kyrgoski and federal case law, the Court confirmed that the invocation of the termination for convenience provision must be in good faith. The Court held that the standard for determining good faith is whether there was a substantial change in circumstances justifying the termination. If there was, then the termination was in good faith; and if there was not, the termination was in bad faith. Under the set of facts before it, the Court determined that the MAC litigation was not sufficient to justify a termination for convenience and "did not change the circumstances of the bargain or the expectations of the parties significantly enough to justify termination." (127 S.W.3d at 587.)

In A.J. Temple Marble & Tile, Inc., 659 N.Y.S.2d 412 (1997), a cleaning contractor sued a public railroad after the railroad terminated the contract under the convenience provision. The New York appellate court, acknowledging that the law on termination for convenience provisions developed primarily in the federal courts, looked to federal decisions for guidance, such as Krygoski and Torncello. The court upheld the good faith standard. On its facts, it found that the railroad did not act in bad faith and upheld the termination.

In New Jersey, the appellate court in Capital Safety, Inc. v. State Division of Building and Construction, 848 A.2d 863 (2004) also found that the standard was whether the termination was in bad faith. There, an asbestos removal contractor sued the public agency, which terminated its contract for convenience. Like the New York court in A.J. Temple, the New Jersey court acknowledged that there were no state decisions and

that federal law would guide it. The court found that the public agency had no improper motive and that it simply exercised its discretionary authority for ordinary business purposes, i.e., without bad faith.

Decisions Involving Termination for Convenience Provisions in Private Works Settings

For example, Edo Corp. v. Beech Aircraft Corp., 911 F.2d 1447 (10th Cir. 1990) involved an action by a research and development contractor against an aircraft manufacturer after the manufacturer terminated the contractor's contract for convenience. The district court upheld the termination. The Tenth Circuit, applying Kansas law and guided in part by federal cases, held that the right to terminate for convenience must be in good faith. On its particular facts, the appellate court found that there was sufficient evidence finding that the termination was in good faith and, thus, upheld the termination for convenience.

In Harris Corp. v. Giesting & Assoc., Inc., 297 F.3d 1270 (11th Cir. 2002), another contractor versus manufacturer action, the Eleventh Circuit, analyzing Florida contract law, reversed a jury award in favor of the contractor and held the manufacturer's termination for convenience was valid. The Eleventh Circuit court noted that "termination for convenience clauses may not be used to shield the terminating party from liability for bad faith or fraud." (297 F.2d at 1272-1273) Nonetheless, the court upheld the termination because the two parties were sophisticated, the express terms of the contract controlled, and there was no evidence of bad faith.

In Questar Builders, Inc. v. CB Flooring, LLC, 978 A.2d 651 (2009), a Maryland appellate court vacated and remanded a trial court's judgment awarding a terminated subcontractor's "expectation" damages against the general contractor for improperly invoking the termination for convenience provision. The appellate court confirmed that the termination for convenience provision did not allow the general contractor to terminate the subcontractor for any reason whatsoever. It held that a termination for convenience right may be enforceable, but it is subject to the implied limitation that the provision be exercised in good faith and in accordance with fair dealing. (978 A.2d at 674.) Relying on Krygoski and state law implying a covenant of good faith and fair dealing in every contract, the court applied the good faith standard. Notably, however, this appellate court recognized the difference between public projects (particularly federal jobs) and private works contracts stating, "we decline to recognize for private parties the near carte-blanche power to terminate that courts have given the federal government under convenience termination clauses." (978 A.2d at 670.) The appellate court held that courts should apply an objective standard of what constitutes good faith requiring the terminating party to exercise its discretion in accordance with the reasonable expectation of the contracting parties.

What Happens When Wrongful Default Termination is Deemed Termination for Convenience?

A number of contracts contain a provision similar to the one quoted below:

> "If the owner terminates the contract for default or cause, and it is later determined that none of the grounds set forth in the termination for default or cause exist, then such termination shall be deemed a termination for convenience."

Traditionally, the amount a contractor can recover resulting from an owner's termination for convenience is very limited–demobilization costs plus the profit already earned. In some contracts, the owner will pay the profit the contractor would have earned had it been able to complete the project. The story is different where there is a wrongful default termination, which constitutes a breach of contract. Hence, if an owner did not have grounds for terminating for default, it could very well have exposure to the contractor's consequential damages unless there is (1) a provision similar to the above, or (2) a waiver of consequential damages.

When an owner wrongfully terminates a contractor, it begins a cavalcade of problems for the contractor. First, until the contractor is vindicated by virtue of a pronouncement that the termination was improper, by either court order or settlement, the contractor must indicate on all future pre-qualification forms that it has been default terminated. While some owners may agree to overlook the default termination based on the contractor's explanation, because default termination is such a serious step, many owners will simply refuse to pre-qualify the contractor until the contractor has resolved the dispute. Moreover, the contractor must explain the situation to its bonding company, hoping that the bonding company can ignore the default termination in its underwriting for the extension of

future surety credit. Hence, the contractor has very little choice but to fight the defaulting owner.

Litigation is expensive. However, in the bonding business, cash is king. Therefore, the bonding company will carefully watch the amount of cash expended and could very likely decrease the contractor's bonding limit based on the contractor's expenditure of attorney's fees in fighting the owner's default termination. However, with the black mark of the default termination, the contractor has little choice but to spend the money to "clear its name." As its cash diminishes, its bonding line lessens, its bidding opportunities decrease, and it loses profitable business opportunities.

When the contractor finally proves that the owner was wrong in terminating the contractor for default, a year or two later, the contractor is in a much worse position financially than before the termination, having lost out on various profitable projects. However, because of the above-quoted provision, even if the contractor is successful in court, it will only be able to recover the limited amounts available for terminations for convenience.

Admittedly, this provision is common in federal contracts—not so much in private construction or in many public contracts at the state and municipal level. It is not included in either the AIA or ConsensusDocs standard contract forms. However, both the AIA and ConsensusDocs do include a provision waiving consequential damages.

Surety's Rights: Perform Default-Terminated Contract

By Robert Watt
Watt Tieder Hoffar & Fitzgerald

Introduction

A surety that has issued a performance bond for a construction contract may become liable under the bond when the principal fails to fully and correctly perform the underlying contract between the principal and the obligee/owner ("owner"). Typically, a surety's obligations under a performance bond are triggered when the owner declares the principal to be in default or terminates the principal's contract for default. After receiving notice of its principal's default, the surety generally is entitled to a reasonable period in which to investigate the circumstances surrounding the propriety of the default and to choose a course of action in performing its bond obligations. Of course, if the surety believes that the obligee has acted improperly, it may elect to deny liability and not perform under the performance bond or else it may choose to perform under a reservation of rights.

In either case, once the surety elects to perform, it must initially determine the best performance option given the circumstances and available options. Some bonds, such as the familiar AIA-A312, expressly delineate the performance options available to the surety, thereby restricting the surety's options to those set forth in the plain terms of the bond form. Other bonds, such as the SF-25 Miller Act bond and other similar common-law bonds utilized on many private or local government projects, do not explicitly identify any specific performance options for the surety. These bonds merely bind the surety to fully perform the obligations undertaken by the principal in its contract with the obligee. In such instances, the applicable common law generally defines the surety's rights and obligations upon default of the principal, although, in the case of Miller Act bonds and many other bonds utilized by public entities, the applicable regulations often provide further guidance regarding the surety's performance obligations.

With the AIA-style bonds attaining more popularity, some owners have labored under the mistaken impression that—in derogation of the surety's common-law rights and obligations—they can terminate the principal's contract and complete the work in any manner that they see fit, unless the bond explicitly sets forth the surety's performance options. Of course, such owners still expect the surety to pay the bills even though the surety was given no opportunity to perform its bond obligations, no control over any aspect of the completion, and no opportunity to mitigate its damages.

Owners who take such positions demonstrate a misunderstanding of the long-standing principles of suretyship, including the surety's most basic rights and obligations under the common law. The common law of suretyship obligates the performance bond surety to complete the obligations of its principal, preserving the surety's right to choose from among the full panoply of performance options in discharging its obligations. The more recent bonds that expressly delineate the surety's performance options, such as the AIA-style bonds, merely codify the common law and often serve to restrict the surety's performance options.

Even when AIA-style bond forms are utilized, however, courts are still often faced with the dilemma of reconciling the surety's performance rights with any express completion rights that may belong to the obligee under the terms of the bonded contract. In such instances, courts seem to parse the language of both the bond and the contract in light of the project-specific context to determine whether these apparent conflicting rights can be reconciled. When faced with such a circumstance, a surety would be well served by making sure that the judge understands the purpose of a performance bond and the theoretical basis for a surety's completion rights—mainly, that the surety should be entitled to mitigate its losses.

Obligee's Right to the Benefit of Its Bargain and the Surety's Right to Mitigate Damages

A performance bond is a three-party agreement whereby a surety assures the principal's performance of an underlying agreement between the principal and the obligee. In issuing the performance bond, the surety pledges to complete the principal's obligations in accordance with the underlying bonded contract in the event that the principal fails to do so. Because the driving purpose behind the use of performance bonds has been simply to assure obligees that they will receive the performance that they bargained for, courts interpreting sureties' common-law rights have acknowledged the rights of sureties to choose their means and methods

so long as the obligee was made whole. See 4 Bruner & O'Connor on Construction Law § 12:77 ("The [surety's] performance options were perceived as the specific 'means and methods' to be implemented by the surety in satisfying its bond obligations ...."); see also Morrison Assurance Co., Inc. v. United States, 3 Cl. Ct. 626 (1983) ("Performance bond protects the [obligee] by making sure that it is not left with a partially completed project ...."); Trinity Universal Ins. v. United States, 382 F.2d 317 (5th Cir 1967) (the purpose of a performance bond is to "assure that the government has a completed project for the agreed contract price."); New Amsterdam Cas. Co. v. Moretrench Corp., 35 S.E.2d 74 (Va. 1945) (performance bond surety is liable for completing work that principal contractor agreed to perform).

A significant policy rationale behind the surety's right to take over the defaulted principal's work is the surety's right to mitigate damages resulting from the default. Numerous court decisions have highlighted the surety's right to mitigate damages in cases in which the surety's rights under a performance bond have been at issue. In a significant recent case, St. Paul Fire & Marine Ins. v. City of Green River, 93 F. Supp. 2d 1170 (D. Wy. 2000), the obligee refused to allow the surety to complete a project on which the contractor had defaulted on the grounds that: (1) the surety was going to use the defaulted principal's employees and (2) the surety's estimated completion date exceeded the completion date called for by the original contract. Although the performance bond involved was an AIA A-312 bond, the court's decision addresses the surety's general right to mitigate damages. In granting the surety a discharge of further duties under the performance bond, the court stated:

> "The effect of the Board's termination of [the surety] was to divest [the surety] of its ability to minimize its liability by selecting the lowest cost option and directing the construction or participating in the contractor selection process. Courts have consistently 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."

St. Paul Fire & Marine Ins., 93 F. Supp. 2d at 1178.

In another significant case, Dragon Constr., Inc. v. Parkway Bank & Trust, 678 N.E.2d 55 (Ill. App. Ct. 1997), the owner on a construction project terminated the contractor for lack of progress without providing notice to the surety. The owner then unilaterally hired a replacement contractor with no input from the surety. The court held that the surety was discharged from any obligations under the performance bond because the owner's actions in replacing the contractor without notice to the surety stripped the surety of its right to limit its liability through involvement in the termination and hiring of a successor contractor. Id. at 58; see also Seaboard Sur. Co. v. Town of Greenfield, 266 F. Supp. 2d 189 (D. Mass. 2003) (upon the obligee's notice of default, the performance bond surety is allowed a reasonable amount of time to investigate the circumstances before selecting from the available performance options); School Bd. of Escambia County v. TIG Premier Ins. Co., 110 F. Supp. 2d 1351, 1354 (N.D. Fla. 2000) (holding that a surety's performance bond obligations were discharged by the obligee's failure to provide the required notice and thereby deprived the surety of its right to mitigate damages); Tishman Westside Constr. LLC v. ASF Glass, Inc., 33 A.D.3d 539, 540 (N.Y. App. Div. 2006) (holding that surety was discharged because obligee failed to provide an opportunity for the surety to exercise its options under the bond). These decisions demonstrate that while the obligee has the right to receive the benefit of its bargain under a performance bond, the surety has a coequal right to limit its liability in discharging its obligation to make the obligee whole.

Surety's Common Law Right to Choose to Either Complete Performance or Finance the Obligee's Completion

In enforcing the performance bond surety's right to mitigate damages, courts have consistently acknowledged in a variety of circumstances that the surety has the right to choose its method of performance in the event of the principal's default. In Miller Act cases, courts have construed the non-specific performance bond language as reserving the surety's traditional rights to complete the principal's work itself or to pay for completion by the obligee.[1] See, e.g., Granite Computer Leasing Corp. v. Travelers Indem. Co., 894 F.2d 547, 551 (2d Cir. 1990); Island Co. v. Hawaiian Foliage & Landscape, Inc., 288 F.3d 1161, 1170 (9th Cir. 2002); Aetna Cas. & Sur. Co. v. United States, 845 F.2d 971, 975 (Fed. Cir. 1988); Morrison Assurance Co., Inc. v. United States, 3 Cl. Ct. 626, 632 (1983); Trinity Univ. Ins. Co. v. United States,

1 Of course, the surety choosing to complete performance itself may generally effect its obligation by several different methods including: (1) literally completing the work itself, (2) entering into a completion agreement with a replacement contractor to complete the work, (3) financing the defaulted principal, or (4) hiring employees of the defaulted principal to complete the contract.

382 F.2d 317, 321 (5th Cir. 1967); Morgenthau v. Fid. & Deposit Co. of Md., 94 F.2d 632, 635 (D.C. Cir. 1937); ZP No. 54 Ltd. P'ship. v. Fid. & Deposit Co. of Md., 917 So.2d 368, 373 (Fla. Dist. Ct. App. 2005). Illustrating the surety's broad rights to take over the work, the Aetna court observed that "a performing surety may satisfy its obligations in various ways … the surety may formally take over the project and contract for its completion, or it may allow the project to be defaulted and let the government complete or contract for the completion of the project, in which case the surety is responsible for costs in excess of the contract price. A performing surety may also satisfy its obligation by providing funds to an insolvent contractor to complete performance." 845 F.2d at 975.

Courts have similarly construed the surety's performance options broadly in cases involving private, common-law bonds. See, e.g., Bd. of County Supervisors of County of Henrico v. Ins. Co. of N. Am., 494 F.2d 660, 668-69 (4th Cir. 1974) (court rejected argument that performance bond's lack of express performance options rendered the bond a penal bond that deprived surety of takeover rights); Biomass One, L.P. v. S-P Constr., 799 P.2d 152, 156-57 (Or. Ct. App. 1990) (in the event of a breach by the principal, the surety can either take over and perform the contract or pay the damages caused by the principal's breach); Standard Accident Ins. Co. v. Rose, 234 S.W.2d 728, 730 (Ky. Ct. App. 1950) (performance bond guarantees that if contractor defaults, the surety can complete the contract or pay the full amount of its obligation). There are numerous cases involving AIA-style bonds where sureties have been discharged where the obligee replaced the defaulted principal with another contractor without the surety's involvement or consent, thereby depriving the surety of its rights to investigate the default and pursue its available performance options. See Elm Haven Constr. Ltd v. Neri Constr., LLC, 376 F.3d 96, 100-01 (2d Cir. 2004); Enterprise Capital, Inc. v. San-Gra Corp., 284 F. Supp. 2d 166, 176-77 (D. Mass 2003); Seaboard, 266 F. Supp. 2d at 194-95; Dragon Constr., Inc. v. Parkway Bank & Trust, 678 N.E.2d 55, 58 (Ill. Ct. App. 1997). This principle should apply with equal force even where the bond does not expressly codify the surety's specific performance options. Cf County of Henrico, 494 F.2d 669. In County of Henrico, in addition to relying on the material alteration doctrine as the basis for discharging the surety, the Fourth Circuit observed that the surety was not given an opportunity to perform the principal's obligations after the alleged default occurred. 494 F.2d at 668-69. The court held that the surety was excused from its performance bond obligations because the obligee arranged for a replacement contractor to perform the bonded reclamation work without involving the surety. Id.

The law of suretyship continues to acknowledge the inherent right of a performance bond surety to mitigate the damages associated with the default of its principal. Courts have preserved this important right by ensuring that sureties are afforded the right to investigate principal defaults and to choose whether to directly take over responsibility for the performance and completion of the principal's work or to finance the obligee's completion of the work. Common-law bonds that lack specific performance options and/or limitations similarly preserve these important surety rights, while newer AIA-style bonds have actually served to restrict the surety's performance options. Regardless of the bond form, however, in cases where obligees have interfered with the surety's rights to take over the principal's work, courts have discharged sureties from their performance bond obligations.

Codification and/or Limitation of the Common Law in Bonds with Express Performance Options

Performance bonds that specifically delineate a surety's performance options, such as the AIA-style bonds, are a relatively recent development on the suretyship landscape. See 4 Bruner & O'Connor on Construction Law § 12:77. These bonds do not create or give rise to surety rights and performance options by expressly listing the surety's performance options in the bond. In fact, these bonds serve to either (1) provide procedures for the implementation of the surety's common law rights and obligations or (2) abrogate the surety's common law rights and obligations by restricting the surety's performance options to those expressed in the bond. For example, the AIA-A312 bond generally codifies the common law performance options and mandates procedures that the obligee must follow to trigger the surety's obligation. On the other hand, the AIA-A311 bond has been held to restrict the surety's common law performance options by requiring the surety to either (1) remedy the principal's default, (2) take over performance itself or (3) tender the lowest bidding completion contractor to the obligee. See Nat'l Fire Ins. Co. of Hartford v. Fortune Constr. Co., 320 F.3d 1260 (11th Cir. 2003) (due to the restrictive language of the AIA-A311 performance bond, the surety did not have the option to not perform and tender the completion costs to the obligee). In this regard, the AIA-A311 and similar bonds dictate and limit the means and methods

available to the surety in discharging its obligation to provide the obligee with the benefit of its bargain. In contrast, common-law bonds that are silent with regard to the surety's performance options leave intact the surety's broad rights to determine its own means and methods of performance by choosing from among its traditional common law performance options.

Interplay of Surety's Performance Options with Contract Clauses that Allow the Obligee to Complete the Terminated Work

The inherent tension between a surety's performance rights and an obligee's desire to complete the terminated work as expeditiously as possible becomes manifest where the obligee asserts a competing right to complete the work based upon express language in the contract (typically found in the default clause). The default clause in many subcontracts, for example, provides that the general contractor shall have the rights (i) to supplement the work of a non-performing subcontractor and (ii) to correct defective work, after a short notice period. Two recent cases analyzed whether such provisions effect a surety's ability to assert its express performance rights under the AIA-A312 Bond, with one court deciding in favor of the surety and the other in favor of the obligee. Compare Solai & Cameron, Inc. v. Plainfield Comm. Consol. Sch. Dist. No. 202, 871 N.E.2d 944 (Ill. Ct. App. July 10, 2007) (finding that surety's express performance options defeated competing contractual right to complete by obligee) with Commercial Cas. Ins. Co. of Ga. v. Maritime Trade Ctr. Builders, 572 S.E.2d 319, 320-21 (Ga. App. 2002) (reaching contrary result). Both courts acknowledged that the bond and the underlying contract must be read together as one instrument, and each decision turned on the parsing of the specific contractual and bond language within the specific factual context in an attempt to reconcile the conflicting terms.

The court in Solai affirmed summary judgment in the surety's favor, finding that the surety was discharged because the general contractor had replaced the bonded subcontractor without first providing proper notice to the surety under Paragraph 3.2 of the A312 Bond and agreeing to pay the Contract Balance under Paragraph 3.3. The obligee had asserted that its actions were proper under the subcontract, which provided that, after the issuance of a required three-day written notice letter, "[i]f … subcontractor continues to fail in properly executing his responsibilities, the General Contractor shall have the right to properly complete this subcontract with its own or other forces. All costs for the General Contractor to then complete this subcontract shall be charged to this subcontractor." Solai, 871 N.E.2d at 947.

The court in Solai acknowledged that it could not reconcile the competing rights of the obligee and the surety when reading the bond and the subcontract together as one instrument. Solai, 871 N.E.2d at 952. To resolve this conflict, the court examined the unique context of the subcontract negotiations, noting (i) that the subcontract did not explicitly require a bond and (ii) that the effective date of the bond predated the execution of the subcontract. Id. While these considerations may seem arbitrary, the court properly acknowledged the primacy of the surety's performance rights as an outgrowth of its duty to mitigate damages:

> "A savvy owner should not be allowed to eviscerate a surety's options and protections with language selected later in a subsequent contract with another party. This is especially true when, as here, the language of the subsequent contract has been argued to broaden the authority of [the obligee] and to diminish the right of [the surety] to mitigate the damages. *** We hold the surety's rights arising out of the performance bonds cannot be diminished by the owner's authority under the terms of the subcontracts that became effective after the performance bonds."

Id. Thus, the court in Solai appears to have been swayed by what it perceived as an attempt to "eviscerate" the surety's performance rights in the negotiations of the underlying bonded contract.

The court in Commercial Casualty, on the other hand, ruled in favor of the obligee when faced with an express subcontract provision that conflicted with a surety's performance rights under the A312 Bond form. The terms of the underlying subcontract provided that, in the event of the subcontractor's lack of performance, the obligee/general contractor was entitled to supplement the subcontractor's work or replace the subcontractor after providing a 48-hour written notice; this provision also required both the subcontractor and its surety to indemnify the general contractor for its losses arising from any breach by the subcontractor. Commercial Cas., 572 S.E.2d at 321. Construing the surety's bond rights together with the contract, the court held that the surety was not discharged by the general contractor's failure to comply with the bond's specific notice and termination provisions.

The court in Commercial Casualty reconciled the conflicting bond and contract terms by distinguishing a breach of contract from a default under the bond. The court reasoned that "[t]he bond itself contains a detailed notice provision in the event of a default, but does not address the contingency of the contractor supplementing the subcontractor's work before it defaults." Id. at 322. This reasoning is disingenuous because it appears that the general contractor, for all practical purposes, terminated the subcontractor under the guise of supplementing the work—the general contractor took over the work and installed a new project management team to supervise the field laborers until the work was completed. Id. at 321-22. Thus, the court seemingly allowed the obligee to complete the terminated work itself and charge the costs to the surety merely by declaring a "breach" of the subcontract rather than a "default" under the bond.

This case can also be distinguished from Solai in that the underlying subcontract explicitly required the surety to indemnify the obligee for all losses arising from any breach of the subcontract. The court, however, did not expressly advance this interpretation as a basis for its decision. Another potentially implicit justification for the court's decision in Commercial Casualty is that it does not appear that the surety in that case took any steps to attempt to mitigate its potential bond losses. The court recounted the general contractor's notices to the surety related to the subcontractor's non-performance and the plan to supplement its work, observing that the surety took no action in response to these notices. Id. at 321. While not advanced as an explicit justification for its decision, the court may have interpreted the surety's silence after receiving notice of its principal's non-performance as a failure by the surety to mitigate its potential bond losses.

These seemingly contradictory decisions indicate that courts continue to acknowledge a surety's performance options (particularly where these options are explicit under the bond), but struggle to assess liability where the obligee has asserted a competing contractual right to complete the work. Perhaps the lesson to be learned from these decisions is the importance of the equities in cases involving competing assertions of the right to complete the terminated work. The court in Solai made explicit its belief that the obligee, as drafter of a subcontract that was executed after the bond's effective date, was attempting to "eviscerate" the surety's rights to perform the work in order to mitigate its losses. In contrast, the court in Commercial Casualty sidestepped the question of whether the subcontractor's breach was a default under the terms of the A312 Bond by finding that the obligee had a right to complete the work under the supplementation clause on a project where the surety failed to respond in any manner to several notices provided by the obligee.

Conclusion

Despite the recent arguments of some owners, the performance bond surety retains traditional rights and performance options under the common law of suretyship that cannot be abrogated unless expressly done so. Standard bond forms such as the AIA-type bonds acknowledge and alter these common law rights rather than give rise to surety rights through express language.

It does not escape the authors that most sureties would rather avoid unnecessarily litigating the extent of their common law rights. As such, this paper will close with a few basic suggestions with regard to bond forms: (1) utilize a standard bond form such as the AIA-A312 that expressly provides a wide range of performance options available to the surety; (2) utilize a customized bond form that specifically preserves the rights and performance options that the surety desires to have available in the event of default; or (3) add a provision to a common law bond expressly reserving all rights and performance options available under the applicable common law.