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Beware A Surety's Declination Option In Performance Bonds

Law360, New York (August 13, 2012, 1:15 PM ET) -- In the whirl of paperwork that accompanies construction loans, most developers and their lenders are careful to include the purchase of performance and payment bonds. But do they actually inquire about the terms of the bonds they are purchasing or review them upon receipt, to make sure the terms are correct and best serve their interests? Not necessarily.

Developers and lenders would be well advised to spend more time on the purchase of surety bonds than it takes to put a check mark on their to-do lists. What they may not realize — at least, until they run into a problem — is that there can be significant wording variations in the bonds they are provided.

It is well known in the construction industry that the standard format for most nongovernmental performance and payment bonds is, currently, the 2010 version of the American Institute of Architects (AIA) Document A312. But developers and lenders should be aware that it is relatively common for sureties to use different bond formats, such as the 1984 version of this bond, the 1970 version of Document A311 and to issue manuscript versions of their own bonds, printed on their own letterheads.

Developers and lenders also should be aware that bonds that appear to be standard form may actually contain internal variations. Sureties have been known to vary the standard-form text by adding provisions such as a modification to Paragraph 18 stating, “Notwithstanding anything to the contrary herein, the Surety’s total obligation under this Bond shall not exceed the amount of this Bond.” Such modifications may not be evident on the covers of what would appear to be standard forms; lenders would become aware of them only if they take the time to page through the entire document.

The same is true for a very common, but very important, endorsement known as the “dual obligee rider.” This rider is needed to provide lenders the protections that are automatic under surety bonds for developers. Lenders traditionally are not parties to the construction contracts that underlie the surety bonds and do not have direct contractual relationships with the contractors and the sureties.

Without such riders, therefore, they may have trouble asserting direct rights against sureties in the event of contractor defaults. Lenders also may enter into direct contractual agreements with contractors to define their rights with respect to the project and to protect themselves in the event of disputes with the borrower or contractor.

The practice of altering standard-form provisions may work to the advantage of developers and lenders with regard to a provision in certain performance bonds that some sureties blithely call the “do nothing” option. Others term this provision the “declination” or “owner completion” option. In the 2010 version of the AIA Document A312 performance bond, this provision can be found in Section 5.4.2:

> "§ 5When 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:
> "... § 5.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances:
> "... .2 Deny liability in whole or in part and notify the Owner citing the reasons for denial."

At times, sureties attempt to claim that this provision authorizes them simply to refuse to perform when a problem arises, with the effect of compelling the developers and/or lenders to complete the project on their own and litigate to enforce the surety’s obligations to complete the project.

This argument flies in the face of the inherent purpose of purchasing the bond — the surety’s promise to remedy promptly a default on a construction project. The argument also misinterprets the meaning of Section 5.4.2 or its equivalent under the 1984 version of this standard-form, which was officially in use until the end of 2011.

The so-called “do nothing” option was not actually designed to give sureties the right to do nothing and force the obligees into litigation. Naturally, under any bond form, sureties could refuse to perform and litigate which party breached the bond, whether the bond explicitly acknowledges it as an option or not.

Instead, the provision supports the argument of developers and lenders that sureties who take the position that they have no liability had better be right. If they are wrong, then they will face the potential for additional exposure under the bonds, relinquish their authority to choose the most cost-effective completion option and be at the mercy of the obligees’ choices in completing the project.

In certain jurisdictions, an improper refusal to perform even provides a basis for a tortious bad faith claim against the surety, forfeiture of the surety’s subrogation rights or liability in excess of the penal sum of the bond.

For developers and lenders that already are saddled with the consequences of an underlying contractor default, the litigation “option” is not a good one. Sureties can have inherent advantages in litigation, such as relationships with law firms or construction industry professionals and discounted billing arrangements with law firms or in-house legal departments.

In addition, they are not facing a “two-front war.” Thus, sureties often are better-positioned to press and weather litigation than the developers or lenders whose interests they are choosing to abandon and who are saddled with the costs of completing the project in a timely manner absent the surety’s involvement.

The answer, for developers and lenders, may lie in taking a page from the practice book used by the sureties themselves. When agreeing to pay for surety bonds as part of construction contracts, attempt to negotiate modifications or alterations that provide protection against such inappropriate claims of the right to "do nothing."

One option may be to seek the removal that provision altogether. Another may be to incorporate a provision expressly providing for damages outside the penal sum or legal fees in the event the option is exercised improperly and litigation ensues.

In short, if developers and lenders develop a practice of "doing something" at the outset of a project, the so-called "do nothing" option may not become a problem in the end.

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