City Attorneys Department
League of California Cities
Annual Conference
October 6, 2005

The Troubled Public Construction Project: When is it Time to Call in the Surety?

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The Troubled Public Construction Project: When is it Time to Call in the Surety?
by Michael N. Conneran

The purpose of this paper is to explore the challenges presented and options available to cities (and other public agencies) in the event of a default by a contractor undertaking a public construction project. This discussion will necessarily focus on surety bonds, which are the specific remedy intended to provide relief in the event of a default in a construction contract.

The Surety Context

Public agencies undertaking construction projects encounter a variety of types of surety bonds. (Prior to award bidders often submit a *bid bond*, but that type of bond is not implicated in this discussion of post-award defaults.) Under Civil Code Section 3247, a *payment bond*, which helps to ensure that all subcontractors and suppliers on public projects are paid, must be in place for all construction contracts exceeding $25,000.[1] The second type of bond, a *performance bond*, which is often required on public projects, guarantees that the contractor will perform the contract it has been awarded and helps to ensure (but will not absolutely guarantee) that the public will receive a completed project. For ease of discussion, except where specifically noted, we shall discuss payment and performance bonds interchangeably as "surety bonds" herein, as many of the same concerns arise for both.[2].

[1] The payment bond, together with the stop notice procedure established under Civil Code § 3179, provide a method to protect subcontractors and suppliers working on public projects, who can't perfect mechanic's liens. Under the principles of sovereign immunity, public property can not be foreclosed upon to satisfy mechanic's liens.

[2] Public agencies may also encounter two other types of surety bonds which are not discussed herein. Maintenance bonds are fairly common, either as part of a performance bond (often at 10% of the penal sum of the performance bond) or as a separate bond, to guarantee warranty obligations for a set period after the completion of the project. Although maintenance issues may arise in the default context, we will not specifically address this type of bond. Some third-party projects, particularly those subject to Disposition and Development Agreements, will involve completion bonds, which ensure that the approved project is actually constructed. Completion bonds, unlike performance bonds, are not limited to a stated amount. Since they differ from the other types of bonds discussed herein, they will not be further addressed.

In order to understand the surety context, it is important to properly define the key terms used in this area. A surety bond is a three-way relationship among the surety, the principal (contractor), and the obligee (city) to whom the performance is guaranteed. (Municipal Law Handbook, §7.1.35). It is important to note that a surety bond is not an insurance policy and that a surety is not undertaking an unlimited obligation towards the cost of completing the contract. Except in certain exceptional circumstances (in which the surety voluntarily exposes itself to obligations that exceed the penal sum) the surety's exposure will be limited to the penal sum of the bond. (See *Leatherby Insurance Co. v. City of Tustin* (1977) 76 Cal.App.3d 678, 687; *County of Los Angeles v. Margulis* (1935) 6 Cal.App.2d 57, 60.) The "penal amount" is generally the amount of the contract. It should also be noted that the surety has only "secondary" liability--it is merely "backing up" the promised performance of the contractor.

There are a number of bond forms in common use. Depending upon its wording, the surety bond form will generally incorporate the terms of the contract, which in turn, will allow the owner to issue a change order that alters the scope of the contract. As a result, the surety will generally be responsible for changes to the scope of the contract. However, where significant alterations to the scope or nature of the contract are made, it might be advisable to inform the surety of the alterations to the contract to avoid any chance that the surety will later claim it was unduly prejudiced by the change. In order to prevail on such a claim, a surety would need to show that the change in scope was so material that it placed the surety in a wholly different position than when it issued the bonds.[3] It is certainly preferable to address this at the time of the contract change, rather than after a default has occurred. It may also make sense to increase the penal sum of the bonds if the contract amount is being significantly increased. One may wish to be cautious in using certain bond forms, such as those issued by the AIA, since those forms may contain language that limits the obligation of the surety. One commenter has noted

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[3] In other jurisdictions, sureties have claimed that an excessive number of change orders has resulted in a "cardinal change" to the contract, which can wholly discharge the obligation of the surety, since the contract itself is viewed as having been abandoned. However, in *Amelco Electric v. City of Thousand Oaks* (2002) 27 Cal.4th 228), the California Supreme Court, citing strong public policy grounds, held that the abandonment theory is not available to contractors on public works projects. It would appear that this same reasoning would be extended to a surety seeking to rely on the same abandonment theory.

that the surety context is unique in that it is one of the very few times the "insurance company" does not dictate the wording of the insurance "policy." (Bond Default Manual, Third Edition, American Bar Assn. (2005), p.1) It would be unfortunate to give away that advantage by adopting a form that provides less than full coverage.

Another important aspect of the surety context is the side that public agencies seldom see--the relationship between the principal/contractor and the surety. Sureties are careful to whom they will issue bonds. Generally, sureties do not "spread risks" or charge premiums with the intent of creating a risk pool for the spreading of the risks of anticipated losses. Instead, through its contractual relationship with contractor/principal, the surety will look to recover any sums advanced directly from the assets of the contractor or those who may have agreed to guarantee the contractor's obligations. Prior to agreeing to issue a bond to the contractor/principal, the surety will do a thorough study of the contractor's financial capacity, as well as its experience in completing projects of the size intended. The sureties often work with the same contractors for many years. Sureties are not expecting significant claims, but when they do occur, they generally have a plan to recover their assets. The surety will require the contractor/principal (or others supporting them) to enter into an "indemnity agreement" with the surety, pledging assets and waiving rights, in order to cover any potential contingencies that may be faced by the surety. (See, e.g. *Fidelity and Deposit Co. v. Whitson* (1960) 187 Cal.App.2d 751.) So, in many ways, the surety is "betting" on the success of a contractor it not only has already carefully selected, but also closely monitors.

It should also be remembered that the contractor, in order to continue to bid on public projects, must be able to obtain bonds. A loss of bonding capacity can easily force a contractor out of business, since they will no longer be able to obtain surety bonds that are required to undertake public projects. A claim that wrongful conduct by a third party resulted in the loss of bonding capacity can result in a significant damage claim. (See Municipal Law Handbook, §7.1.35; *Arntz Contracting Co., v. St. Paul Fire & Marine Ins. Co.,* (1996) 47 Cal.App.4th 464, 471 (claim against surety for causing loss of a

contractor's bonding capacity resulted in $100 million punitive damages award, which was vacated by trial court).)

A final comment should be made cautioning public agencies to take seriously the mandate to require bonds, as cities may be held directly liable to unpaid subcontractors and suppliers if they fail to either require a bond (*N.V. Heathorn Inc. v. County of San Mateo* (2005) 126 Cal.App.4th 1526; *Electrical Electronic Control Inc. v. Los Angeles Unified School Dist.* (2005) 126 Cal.App.4th 601) or to verify that the surety is an admitted surety in the State of California (*Walt Rankin & Associates, Inc. v. City of Murrieta* (2000) 84 Cal.App.4th 605). Cities should carefully follow the procedure in Code of Civ. Proc. §995.311 to verify surety's admitted status.

The Troubled Project

Before discussing how a city should react in the event of a default, it is useful to consider some steps cities may take to protect their interests before a default occurs. Some projects (or contractors) are in trouble from the start. Whether this arises due to a contractor making a poor decision in submitting a bid or due to business problems unrelated to the contract at hand, there are simply times in which a contractor becomes insolvent in the middle of a project and is unable to complete the work.[4]

Although the circumstances of the bid process may alert a city to a potential problem with a contract, sometimes the issues are not caused by the particular contract, but by another contract the contractor has or by the general financial deterioration of the business. Many times, a contractor that is experiencing cash flow problems will shift

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[4] This can easily occur due to a mistake in bidding, in which a contractor leaves a considerable amount of money on the table but is forced to enter into a contract to avoid losing its bid bonds. Assuming there are no grounds for excusing a mistake during the bidding process under Public Contracts Code §5100 et seq.,. the city is normally required to award the contract to the "lowest responsible bidder." While a city may be tempted to accept an unusually low bid from an apparently unqualified contractor, it may wish to explore the possibility of declaring such a bidder "non-responsible." However, that can be a difficult task unless there is clear evidence the contractor meets that criteria (i.e., is not capable of fulfilling the contract). (See *City of Inglewood--Los Angeles County Civic Ctr. Auth. v. Superior Court* (1972) 7 Cal.3d 861; *Raymond v. Fresno City Unified School District* (1954) 123 Cal.App.2d 626.)

funds from one project to another, waiting to get a progress payment on one project so that it can use those funds to keep a different project afloat. In such instances, work may stop on a project for no reason, as resources are shifted to another site in pursuit of the next progress payment.

Often times, cash flow problems result in a lack of payment of subcontractors and the eventual filing of stop notices. However, before subcontractors or suppliers file stop notices, they will often make their concerns known in an informal way to the city's representative on the job. This grumbling should put the city on notice that it should carefully monitor (if it isn't already) the contractor's return of payment releases (Civil Code §3262). It may also wish to consider issuing joint checks to the contractor and subcontractors, assuming the contractor will allow that practice. (If they do not, that may be a further sign that the contractor is in financial distress.)

A more subtle (and more difficult) situation involves a job in which there have been significant problems on a project, perhaps due to disagreements over the scope or quality of work, with multiple claims filed by the contractor. Prior to abandoning the project, the defaulting contractor may submit numerous construction claims (in hopes of collecting more compensation) or attempt to cut costs on the project by doing less-than-adequate work to avoid incurring a loss. As a result, many defaulted contracts often have claims and warranty issues associated with them. When the contractor is unable to complete the job and the surety is asked to respond, it may place the blame on the owner (perhaps claiming that defective plans and specifications, unanticipated site conditions or extensive change orders caused the default). In such a situation, it may be difficult to determine whether the breakdown on the job is the fault of the city or the contractor (or is shared by both). In such cases, it may be difficult to get a surety to respond, since the surety will often take the side of the contractor in pursuing claims. (For a good example of a troubled project where the surety did step in (with disastrous consequences), see *Arntz Contracting Co., v. St. Paul Fire & Marine Ins. Co.* (1996) 47 Cal.App.4th 464.)

Public owners normally start to think about the surety bond when they strongly suspect their contractor is going to default. The signs listed above may trigger such concerns, or the contractor may simply stop work altogether. It is also possible that the contractor continues to work, but there are other clear signs of problems, from shoddy work that goes uncorrected to significant delays in project progress. It is at this point that owners begin to think about contacting the surety in hopes that they will come to the rescue of the city. This outreach may occur by either contacting them directly or by providing them with copies of correspondence to the contractor warning of a potential default of the contract.

Contractor's Default

Since the surety is only liable if the contractor is in default (Civil Code §2807), a critical issue is determining if a default has really occurred. This requires a review of the terms of the contract, which may not only define what a default is, but may also set forth specific procedures to declare a default. If such procedures are stated, they should be scrupulously followed.

The first challenge is to understand what a default really is. Although many attorneys use the terms "breach" and "default" interchangeably, in order to declare a default in a construction contract, an owner must be able to show that there has been a "material" breach in the contract. "Not every breach of a construction contract constitutes a default sufficient to require a surety to step in and remedy it. To constitute a legal default, there must be a (1) material breach or series of material breaches (2) of such a magnitude that the obligee is justified in terminating the contract." (*L & A Contracting v. Southern Concrete Services* (5th Cir. 1994) 17 F.3d 106, 110.) Where a contractor is insolvent, has halted all work on a project or is otherwise clearly unable to continue, an owner can easily infer that a default has occurred. If in doubt, however, particularly if issues relating to the quality of performance are at issue, a city may wish to consult with experienced construction counsel prior to declaring the contract in default. Clearly there can be minor breaches of a contract (using materials that differ from those specified,

violating work procedures, failing to perform required dust-control activities) which do not rise to the level of a default. Of course, the best time to address the definition of default is during the preparation of the construction contract, so it may be worthwhile to review your standard terms to make sure the default process is property addressed.

When a contractor is in default, an owner usually acts to terminate the contract. It is generally felt that contract termination is necessary to trigger the obligation of the surety to perform under the surety bond, although it is also possible to terminate the contractor's "performance" under the contract without terminating the entire contract. It is important to make sure that the surety has official notice of the default, as a failure to notify the surety may excuse its failure to respond. Clearly any notice requirements in the bond or contract should be followed. Cities often will wish to put the surety on notice early of a potential default, in hopes that the surety will step in and motivate the contractor to fulfill its contractual obligations.

Since the surety has the same rights as the contractor, it may assert any defenses or claims as the contractor, including a claim that the contractor is not really in default. The surety not only will stand in the shoes of the contractor in raising defenses and claims, but has certain legal obligations to the contractor not to undercut the contractor's ability to fulfill the contract. The surety will not volunteer to assist on a contract if it will expose it to potential claims from the contractor, such as a claim that in responding, the surety acted as a "volunteer" in advancing funds prior to any legal obligation to do so. Nor will it automatically take the side of the public entity and take over a project if the problems are or can be attributed to the actions of the owner. Clearly, the surety's preferred outcome would be for the contractor to finish the work and there to be no claim on the surety. As long as that goal seems realistic, the surety may support the contractor and object to the declaration of default.

The Surety Steps Up . . . Or Not

It may be a significant challenge for cities and their counsel, who may only rarely deal with sureties, to step into a situation where a contractor has defaulted. Sureties, on the other hand, are well-prepared for such a contingency. Initially, the surety will want to thoroughly investigate the situation, both to confirm that a default has indeed taken place and to get a handle on what will be required to complete the project. Sureties often have arrangements with qualified construction industry consultants who are experienced in stepping into default situations. Through their agreement with the contractor, the surety will often have access to the contractor's records. They may also request access to the city's records, particularly with regard to the status of progress payments and subcontractor releases. Cities seeking a prompt resumption of work on a project may wish to facilitate the surety's efforts to familiarize itself with the project.

What's a Surety to do?

Perhaps the most crucial concern a city will face in the event of a default is determining what the surety's obligations are. The somewhat surprising answer is that a surety oftentimes is not *required* to do anything, but can simply sit back, allow the city to complete the job, and settle financially with the city when the job is complete. In actuality, sureties may take any number of courses, from propping up a financially-troubled, but otherwise competent, contractor to providing ("tendering") a new contractor, to completing the job itself using its own contractor, depending on the status of the project at the time of default, as well as the sureties' own preferences.

The choice a surety makes among these alternatives will often depend on the results of its investigation of the project (and perhaps other projects of a troubled contractor.) While the terms of the bond form may require or preclude particular options, due to the nature of the surety relationship the surety is not required to do any more than make the city financially whole as a result of the contractor's default. However, it may well be in the surety's interest to step in and see to it that the contract work is completed expeditiously.

Life Support for the Contractor

The surety clearly has the option of supporting the existing contractor, and may do so prior to the point where an actual default is declared, particularly where the cause of the problem is a short-term cash flow issue. It may be much more advantageous for the surety to do this prior to default and a possible shutdown of the job, since it can more easily keep the subcontractors on board and avoid the cost of having a new contractor mobilize to begin work. If this occurs prior to default, the surety would not enter into any sort of arrangement with the city, but would merely fund or otherwise support the existing contractor.

Takeovers

A second option is known as a "takeover," where, following a termination, the surety assumes, or "takes over," the job from the principal and arranges for the work to be completed. This is often accomplished by entering into a "Takeover Agreement" with the public agency. In this instance the surety could continue to use the defaulted contractor (this time under its own direction) or it could contract with a different contractor to perform the work. Since the surety then becomes responsible, like the contractor, to complete the work, this is one scenario in which the surety may become exposed beyond the penal amount (although it may attempt to limit this exposure contractually through the terms of the Takeover Agreement). (*Caron v. Andrew* (1955) 133 Cal.App.2d 402, 411.) The key feature of this approach is that the surety remains "on the hook," not only for the contract performance itself, but for warranty claims, subcontractor payments and liquidated damages. Sureties tend to favor this approach when the contract is clearly going to be completed within budget.

Tender

A third option is the "Tender Agreement" in which the surety locates a new contractor willing to take on the project (perhaps at a significant premium to cover mobilization and profit) and then "tenders" that performance to the city to replace the defaulting contractor. In this context the surety is looking to cap its exposure by substituting a new

contractor (with new surety bonds) who will be responsible to complete the work. The surety is often looking at making a single payment and stepping out of direct responsibility for the contract's completion, although it may remain liable for unpaid sums to subcontractors or suppliers and for warranty claims and liquidated damages. An owner/obligee may prefer this arrangement, as it permits it to receive a direct relationship with a contractor with whom it may feel more comfortable dealing than with a surety.

City Completes Project on its Own

It is not uncommon, particularly if the surety fails to respond in any meaningful way after a city declares a contractor in default, for the city to complete the job on its own. Since it would be fairly unusual for a city to complete a major public works contract with its own forces, the city would normally need to engage a new contractor to complete the work, which will generally require it to seek competitive bids. Delays may result while a new bid package is produced and bids are sought. Generally, the significant disputes may arise when the city seeks to recover its costs from the surety after the job is completed. For example, it can be anticipated that the surety will object to paying liquidated damages for the entire period it takes to re-advertise the contract and complete the work, as well as the city's consultant expenses in reformatting the bid package.

In some instances, however, sureties may simply wish to avoid the trouble and expense of monitoring a completion contractor and may simply prefer to pay the city a lump sum. Such an approach does provide the city with more direct control over the completion work. In other cases, the project may be so close to completion that the city and surety can agree to the value of the "punch list" items remaining.

Areas of Concern

One area of concern in both Takeover and Tender Agreements is the treatment of defects and warranty claims. Simply due to the fact that the job is not complete, there will be significant patent defects in the job that a new contractor assumes. The new contractor is bidding on a job with many uncompleted tasks, some of which may suffer from poor workmanship, perhaps due to a defaulting contractor cutting corners or otherwise

attempting to limit costs. But the treatment of hidden or latent defects can be tricky, as it may not be easy to determine, once the job is complete, whether the defect was caused by the defaulting contractor or by its replacement (or whether the replacement contractor was aware of the defect at the time of their bid.) This is more of a concern to a city in the tender context, since the surety is still responsible for the performance of the takeover contractor (unless the agreement provides otherwise). One solution is to have the tendered contractor provide a warranty for the entire project, hopefully at the expense of the surety, who may wish to avoid facing any future defect claims.

Another problem area is the relationship with subcontractors of the defaulted contractor, who are technically released from their contractual obligations upon the default of the original contractor (*General Insurance Co. of America v. St. Paul Fire and Marine Insurance Co.* (1974) 38 Cal.App.3d 760). They may wish to continue with the work and may therefore sign "subcontractor hold" agreements to remain on the job, although they may seek some premium to cover their remobilization costs if they have already left the job. If the prior subcontractors do not return, the new contractor will need to find new ones and any additional costs that result must be addressed in the Tender Agreement.

The subject of claims is also one of concern. A surety is entitled to raise any claims that the original contractor could have raised (and may be more skilled at pursuing them than the contractor, although it may lack familiarity with the details of the project). Sometimes it may make sense to reach an agreement on claims as part of the negotiation of the Takeover or Tender Agreement, particularly if each party wishes to quantify their exposure. The surety may be motivated to cut a single deal, pay whatever obligation is owed and exit the scene. Therefore, they may be willing to cut deals on claims, defects and liquidated damages. While this may be an opportunity for an owner to clarify its exposure on such issues, it is also an opening for a bad deal as well, particularly if a city is overly eager to get a project completed.

A final issue would involve the scope of the new surety bonds. Generally, unless the new contractor specifically undertakes coverage for payment or warranty issues relating back

to the defaulted contractor, the new performance bond will not apply to the work of the prior contractor. (See Civil Code §3267; *Electrical Electronic Control Inc. v. Los Angeles Unified School Dist., supra* (2005) 126 Cal.App.4th at 616.)

Other Issues Involving Surety Bond Claims

Can the surety be held liable for tort damages if it acts in "bad faith"?

No. While some other states have applied bad faith concepts to the surety context, the decision of the California Supreme Court in *Cates Construction Inc. v. Talbot Partners* (1999) 21 Cal.4th 28 effectively closed the door on the issue of bad faith liability for sureties. In short, the surety context is different than the insurance context, and an obligee is not the same as the "first party" in an insurance relationship, which is owed a duty of "good faith."

Must a replacement contractor be selected through a competitive bidding process?

To the author's knowledge, there are no California cases that address this issue directly. Applying common law principles, however, one would conclude that, in both the tender and takeover situations, the city would simply be receiving the performance it contracted for originally. If the city steps in to complete the contract, however, the work may need to be rebid, which could add further delays to the project.

Is the surety liable for the payment of liquidated damages and how should they be addressed in a takeover or tender context?

Assuming that the bond form incorporates the construction contract and the contract features a liquidated damages provision, the surety will be liable for the payment of those damages. (*Cates Construction Inc. v. Talbot Partners, supra,* (1999) 21 Cal.4th 28; *Pacific Employers Insurance Co. v. City of Berkeley* (1984) 158 Cal.App.3d 145.) However, since a tendered contractor will demand some certainty as to its responsibility for damages, it is recommended to establish with the surety the amount of liquidated damages due in the tender agreement. As with the close-out of many construction contracts, amounts due for liquidated damages are often offset by amounts credited to the

contractor for contract claims. It is always good practice to ensure that the amount of liquidated damage is adequate to motivate timely performance and, in case of a challenge, supported by a written justification of the daily amount prepared prior to contract award.

<u>What costs of the city in responding to a default can be recovered from the surety?</u>
Although such costs will likely be the subject of negotiations with the surety as part of any tender or takeover agreement, most costs incurred in responding to the default will be recoverable, including staff and attorney time in arranging the takeover or tender agreement, as well as expenses in handling stop notices and subcontractor claims.

<u>In what cases can the surety be responsible above the penal sum?</u>
Assuming the surety has taken over the job and has not obtained a contractual term limiting its exposure in the takeover agreement, if the cost of completion exceeds the penal sum, the surety would be responsible for that cost.

<u>Can the city find itself exposed to unexpected costs?</u>
Yes. In a default situation, the city should pay particular attention when making progress payments, being sure to obtain releases from subcontractors and suppliers. In a near-default situation, it is not uncommon for contractors to accept progress payments and fail to pay subcontractors. If the city overpays and the contractor defaults, the surety will claim that it was prejudiced by the fact that the city overpaid the contractor. In a less likely scenario, it is conceivable that a city could essentially overpay for what is clearly substandard work, thereby prejudicing the ability of the surety to complete the contract for the contract amount.