Payment and Performance Bonds:

Are They All They Are Cracked Up To Be?

By Thomas L. Rosenberg

As a matter of routine, on public projects contractors are required to obtain payment and performance bonds, often combined into one instrument, to guarantee payment to subcontractors and suppliers on the project, as well as to guarantee the contractors faithful performance of the work. Sometimes on private projects, we also see these bonds. Are they all they are cracked up to be? Are they providing the purpose for which they are obtained?

INDEMNITY AGREEMENT

To begin with, except in rare circumstances primarily for very large companies, a payment and performance bond is issued in connection with an indemnity agreement by which the owners of the company guarantee payment to the surety for every dollar that the surety pays out under a payment and performance bond. Further, the indemnity agreement typically provides that the guarantors (owners of the company) will also reimburse the surety for any investigatory and legal costs incurred regardless of whether the surety makes a payment under the bond. Therefore, it is prudent for a contractor to take a proactive approach with its surety. When a claim is made on a payment or performance bond, it is incumbent upon the contractor to aggressively address the claim and in circumstances where the contractor has the means to resolve the matter, investigate, pay for its lawyers, and even pay the claim if required to do so. The contactor should make demand upon the surety to tender the defense, investigation, and all other matters back to the contractor. If you do not do so, then even in a claim that does not have merit, a contractor can be faced with having to pay the investigatory and legal costs incurred by a surety.

The indemnity agreement is a very important document in connection with the surety relationship. The surety minimizes its risk by seeking a guarantee from the owners of the company that any and all losses incurred by the surety will be paid back by the owners of the company, who have signed the indemnity agreement. Often, the issue becomes identifying all owners of the company and getting them to sign the indemnity agreement. In many circumstances, there may be passive owners of the company who have either a financial investment in the company, or are the spouse of an owner. These people will, more often than not, be required to personally sign the indemnity agreement.

MATTER OF LAW

So, there is a claim on the payment or performance bond. Is the surety

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obligated to pay? This is an issue of state law and consideration must be given to the interpretations of a surety's obligation as set forth either by statute or case law in each and every state. In general, however, a surety has an obligation to pay rightful claims of subcontractors and suppliers who have not been paid. It must also provide for the faithful performance of the work under its performance bond. However, a surety is also entitled to rely upon any and all defenses that its principal (the contractor) may have. Therefore, if the principal has a defense to a claim of a subcontractor or supplier, the surety can raise it. For example, if a subcontractor has undertaken additional work without an approved change order and the contract between the contractor and subcontractor provides that the subcontractor cannot undertake additional work without an approved change order in place, then the surety is relieved from its obligation to make payment to that subcontractor, because the subcontractor performed the work without a legal basis to do so. Most often, a dispute arises between a contractor and subcontractor over defective work. The contractor claims the work of the subcontractor is defective but the subcontractor disagrees. The subcontractor's disagreement often causes a bond claim to be made. If the surety, after an investigation, determines that the work is defective and agrees with its principal (contractor), then it can rely upon the defense of the contractor and not make payment to the subcontractor.

PAY-OF-PAID CLAUSES

Of interest in many states is the applicability of pay-if-paid clauses to the surety obligation. This is an extreme matter of state law and differs from state to state. In those states in which pay-if-paid clauses have been deemed valid and enforceable, courts are often holding that if the surety's principal, the contractor, is not paid by the owner, then the surety can rely upon the pay-if-paid clause to withhold payment to the subcontractor. This is most disconcerting in situations in which the contractor is terminated for cause by the owner and the owner as a result, determines it has no further payment obligations to the contractor, yet subcontractors who performed work on the project are not paid. Under such circumstances, the applicability of a pay-if-paid clause eliminates the surety's obligation to make payment to the subcontractor or supplier. In some states, this appears to be the law. In other states, the law is to the contrary. In some jurisdictions, the surety's obligation to make payment to a subcontractor or supplier is not extinguished by the fact that its principal has not been paid by the owner, even when there is a pay-if-paid clause in the contractor-subcontractor contract.

The surety relationship is a necessary one. It is comes with challenges when claims are made on a payment or performance bond. Therefore, the contractor *must* take a proactive role in all matters in which its surety becomes involved on a project. ■