A Bond Can Affect Your Claim

A Single Document Constituting Both “Performance” and “Payment” is Significantly Different From Separate Documents

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All potential claimants under a performance bond or a payment bond (which includes just about everyone in the business of construction) should be aware that their rights could be significantly affected merely by the form of the bond. There can be a substantial difference between a single document issued by a surety constituting a “Performance and Payment Bond” and separate documents issued by a surety for each the “Performance Bond” and the “Payment Bond.”

Such bonds generally state a “penal sum” which is usually the dollar amount of the principal’s construction contract or some stated proportion of that amount. This amount provides the maximum liability of the surety under the bond. In the case of separate performance and payment bonds each bond would generally state its own separate penal sum.

With separate bonds, the full penal sum would be available to satisfy the obligations under both the performance bond (generally protecting the “upstream” parties in the contractual chain) and the payment bond (general-

This article presents timely ideas and information on legal matters of interest to the construction industry. The text of these articles is necessarily generalized, and we recommend that you consult legal counsel as to the legal implications of any given actual circumstances.

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ly protecting the parties “downstream” of the principal in the contractual chain from the owner).

However, the protection might not be as substantial in the single document “Performance and Payment Bond” situation where there is, in essence, a single “penal sum.” There are a number of sureties today who market such combined performance and payment bond documents and in most cases there is a single penal sum against which all liabilities under both the performance and the payment aspects of the bond must be measured.

If the principal defaults not only in the performance of his obligations upstream but also in failing to pay his subcontractors and suppliers downstream, all of the claimants, whether upstream or downstream, under this single bond obligation would be claiming against a single “pot” of money.

This problem can be illustrated by a hypothetical situation involving a contract for $100,000 which is required to be bonded both for performance and payment obligations. Assume, the contractor/principal on the bond defaults after it has completed and been paid for 50% of the contract scope of work leaving its obligations to both the owner and its own subcontractors and suppliers unsatisfied. After making appropriate demands and giving appropriate notices, the owner proceeds to complete the last half of the contract scope of work on a relet basis. This ends up costing the owner $85,000.00 more than the amount remaining under the contract. Furthermore, the defaulting contractor still owes $35,000.00 downstream to its subcontractors and suppliers for labor and material provided to the job prior to its default. Assuming those parties comply with the specified notice and other procedures in the bond, they are also entitled to claim against the bond. The bond states a single penal sum of $100,000.00. The aggregate claims against it total $120,000 ($85,000 by the owner and $35,000 by the subcontractors and suppliers).

Obviously, with a $20,000.00 gap, not everyone will get paid by the bond coverage or all will have to take a reduced amount of their otherwise valid claims against the surety. There simply is not enough money in the pot to cover all the claims asserted against the bond.

In contrast, had the contractor’s bonds been separate performance bond and payment bond documents, such as the AIA Document A-311 in its current form, then the pot would have been twice as large since the penal sum of each bond would have been separate and unaffected by satisfaction of liabilities under the other bond. Each bond creates its own separate set of obligations by the surety.

Consequently, be wary of the bonds that are provided by a surety or a party with whom you are contracting since a combined bond in a single document may not give you the same range of protection as separate bond documents. Read those bonds closely!

Getting Agreement . . .

Quite often, subcontract “agreements” evolve out of oral quotes or proposals issued in response to written or oral invitations to bid work defined by portions of the prime contractors’ contract documents with the owner. While some written correspondence may be exchanged, the prime contrac-
tor’s “standard form” subcontract document quite frequently is not exchanged between the parties prior to selection of the subcontractor for the work involved.

Sometime later, perhaps even after the subcontractor has commenced its performance, it often receives a transmittal of the prime contractor’s “standard form” subcontract, and in many cases, that subcontract form includes numerous terms and conditions which had not been included in prior discussions, communications and negotiations between the prime and the subcontractor. A recent decision by the North Carolina State Court of Appeals in Industrial and Textile Piping, Inc. v. Industrial Rigging Services, is a reminder to all involved in such transactions that a subcontractor’s refusal to sign a subcontract form presented to him which contains terms and conditions to which it had not previously agreed is not a breach by the subcontractor. In that case, the court found that a contract had been established by virtue of a verbal communication of acceptance of the subcontractor’s bid, including verbal definition of the scope of work to be performed by the subcontractor and other relevant terms regarding schedule and payment. After a written notification to the subcontractor to proceed, the subcontractor began work. However, when the subcontractor later received the “standard form” subcontract agreement with new and additional terms and conditions which were not included in the earlier understanding with the prime, he ceased work. The court in that case found that such cessation of work by the subcontractor was not a breach on its part because the subcontractor had never agreed to be bound by the additional and new terms of the general contractor’s form. When the contractor told the subcontractor that he had to sign the subcontract form or he would be terminated, the contractor actually committed the act of breach. Accordingly, the court permitted recovery to the subcontractor for the damages resulting from the contractor’s breach including lost profit and the actual costs incurred of the work performed prior to the date of cessation.

The moral of this story is that both sides to such transaction should be aware that parties can only be bound to terms and conditions which were reasonably understood by both sides as being included in the transaction. Consequently, prime contractors that wish to be assured that their standard form agreements are part of the bargain should make sure that the subcontractors they are negotiating with and receiving proposals from are fully apprised of this in advance of culminating any agreements. Subcontractors, on the other hand, should be aware that, if such standard form contract documents are indicated to be part of the subcontract documents, any bids submitted in response must specifically take exception to objectionable terms and conditions or otherwise be qualified in such a way as to avoid being bound by onerous provisions in the prime’s standard subcontract document. Moreover, to the extent that an agreement is reached between the subcontractor and the prime prior to the subcontractor reasonably becoming aware of the prime’s intent to bind him to the standard form “subcontract,” the subcontractor is under no obligation to proceed or to agree to the additional terms and conditions that are contained in this document received “after the fact” of agreement.