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HANDLING SURETY PERFORMANCE BOND AND PAYMENT BOND CLAIMS

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I. Introduction

A. What is a surety bond?

1. A surety bond is a three-party agreement between the principal, the obligee, and the surety in which the surety agrees to uphold, for the benefit of the obligee, the contractual obligations of the principal if the principal fails to do so.

2. If the principal fulfills its contractual obligations, the surety's obligation is void. However, if the principal defaults on the underlying contract, the obligee can make a claim against the surety under the surety bond.

3. Suretyship is distinguishable from insurance. Suretyship is not a form of insurance. The suretyship relationship is a three-party relationship (surety, principal and obligee). In an insurance contract, there are only two parties (insurer and insured).

4. In an insurance relationship, the insurer undertakes to indemnify the insured against loss as a result of an unknown or contingent event. In a suretyship relationship, the surety undertakes to answer for the debt or default of the principal.

B. Who are the three parties to a surety bond?

1. Principal - the principal is the primary obligor who performs the contractual obligations (e.g. the contractor on a construction project).

2. Obligee - the obligee is the entity that enters into the contract with the principal and is the recipient of the obligations (e.g. the governmental unit on a construction project).

3. Surety - the surety is the secondary obligor which guarantees that the principal's obligations will be performed.

C. What are the types of surety bonds?

There are two main types:

1. Contract Surety Bonds - They guarantee a specific contract and include: (a) performance bonds (discussed in Section II below); (b) payment bonds (discussed in Section III below); and (c) bid bonds.

2. Commercial Surety Bonds - They guarantee the terms of the bond, rather then a specific contract, and include: (a) license and permit bonds (e.g. motor vehicle dealer bonds; (b) notary bonds; and (c) other types of miscellaneous bonds- public official bonds, fuel tax bonds, etc.

D. What is the penal sum of the surety bond?

1. The penal sum is the maximum amount set forth in the bond which the surety will be required to pay in the event of the principal's default.

2. Generally, the penal sum is the amount of the contract entered into between the principal and the obligee.

E. What are the surety's rights of indemnity?

1. In consideration for issuing bonds on behalf of the principal, the surety will generally require the principal, individuals with an ownership interest in the principal entity (and their spouses), and related entities to execute an Indemnity Agreement in favor of the surety which, among other things, requires the indemnitors to indemnify/reimburse the surety for all losses and expenses (including attorney's fees, consultant's fees, and court costs) that the surety incurs as a result of issuing the bonds.

2. If the surety pays a claim under a surety bond, it can seek indemnification/reimbursement from the principal and the indemnitors who have signed an Indemnity Agreement in favor of the surety.

II. Performance Bonds

A. Purpose of performance bonds

1. A performance bond protects the owner against the risk of default on a construction contract.

2. A performance bond provides available funds to complete the principal's contract should the principal be in default of the performance that is owed to the obligee.

3. The surety's obligation tracks that of the principal under the bonded contract up to the penal sum of the bond, subject to the specific terms and limitations in the bond, and is conditioned upon the principal's material default of its performance obligations under the bonded contract.

B. Parties to performance bonds

1. There are three parties: the principal (typically the general contractor) who has assumed a contractual undertaking; the obligee (typically the project owner) who is entitled to the benefits of the principal's performance; and the surety who provides a performance bond that secondarily guarantees to the obligee performance of the principal's contractual undertaking.

2. If the surety pays an obligee under the performance bond, it is entitled to be indemnified for its loss pursuant to a written indemnity agreement, which is part of the consideration for issuing the bond.

C. Types of performance bonds

1. Federal Miller Act Bonds

(a) Before any contract of more than $100,000 is awarded for the construction, alteration or repair of any public building or public work of the federal government, a performance bond must be furnished. 40 U.S.C. § 3131(b)(1).

(b) The performance bond shall be in an amount the contracting officer considers to be adequate for the protection of the Government, including coverage for taxes. 40 U.S.C. § 3131(b)(1).

(c) The Miller Act does not prescribe the form of the required performance bond, but the Code of Federal Regulations provides a standard form, Federal Standard Form 25 Performance Bond, that is commonly used.

2. State Public Works (Little Miller Act) Bonds

(a) All states have public work statutes that require contractors that are awarded contracts on state public projects to provide performance bonds.

(b) These statutes are often referred to as "Little Miller Acts," since most of them contain provisions that are similar to the Miller Act.

3. Pennsylvania Little Miller Act Bonds

(a) The statutory bonding requirements for Pennsylvania public works projects are set forth in the Pennsylvania Public Works Contractors' Bond Law of 1967, 8 P.S. §§ 191 et seq. ("PA Bond Law") and in Part I of the Commonwealth Procurement Code, 62 Pa. C.S.A. §§ 101 et seq. ("PA Procurement Code"), which was enacted in 1998.

(b) Prior to the adoption of the PA Procurement Code in 1998, the PA Bond Law was the controlling statute with regard to bond requirements for all public bodies in Pennsylvania.

(c) As a result of the enactment of the PA Procurement Code, the PA Bond Law only applies to public projects that are not with Commonwealth purchasing agencies (e.g. municipalities, school districts, municipal authorities, etc.). The PA Procurement Code applies to public contracts with a Commonwealth purchasing agency.

(d) For projects subject to the PA Bond Law (contracts exceeding $10,000 for the construction, reconstruction, alteration or repair of any public work not with a Commonwealth purchasing agency), a contractor must furnish to the contracting body a performance bond in the amount of 100% of the contract amount, conditioned upon the faithful performance of the contract in accordance with the plans, specifications and conditions of the contract. 8 P.S. § 193.1(a)(1).

(e) For projects subject to the PA Procurement Code involving contracts between $25,000 and $100,000, the contractor must provide a performance bond or other acceptable security in an amount equal to at least 50% of the contract price as the purchasing agency, in its discretion, determines is necessary to protect the interests of the Commonwealth. 62 Pa. C.S.A. § 903(a).

(f) For projects subject to the PA Procurement Code involving contracts in excess of $100,000, the contractor must provide a performance bond or other acceptable security in an amount equal to 100% of the contract price. 62 Pa. C.S.A. § 903(a)(1).

(g) Both the PA Bond Law and the PA Procurement Code provide that the performance bond shall be solely for the protection of the purchasing agency which awarded the contract. 8 P.S. § 193.1(a)(1); 62 Pa. C.S.A. § 903(b).

4. Private Project Bonds

(a) An owner on a private project may require a contractor to provide a performance bond for a construction project even though it is not required by statute.

(b) No statutes in the Commonwealth of Pennsylvania require performance bonds on private projects.

(c) Performance bonds on private projects vary in form and need to be examined carefully to determine the rights of the parties.

5. AIA Bonds

(a) The American Institute of Architects ("AIA") has drafted several types of performance bonds to be utilized by owners on construction projects (both public and private), including the AIA A312 performance bond and the AIA A311 performance bond. (Note: The A311 bond is the predecessor to the A312 bond, but it is still in use).

D. Conditions precedent to asserting a performance bond claim

1. Possible conditions precedent under performance bond forms that are commonly in use include the following:

(a) the obligee is required to comply with its obligations to the contractor under the bonded contract;

(b) the obligee is required to hold a pre-default meeting;

(c) the obligee is required to formally default the principal and terminate its right to complete the contract;

(d) the obligee is required to give notice to the surety of the default and termination of its principal so that the surety has an opportunity to select its preferred performance or completion option;

(e) the obligee is required to dedicate the undisbursed contract balance to the completion of the bonded contract.

2. Most performance bonds are "defeasance" bonds in that they state that the bond obligation is null and void if the contractor performs in conformance with the terms and conditions of the contract. Otherwise, the bond obligation remains in full force and effect.

(a) The rights and obligations of the surety and the obligee pursuant to a defeasance bond depend upon the specific provisions in the bond form being utilized.

(b) Two widely used defeasance bond forms are the A312 Performance Bond and the A311 Performance Bond.

3. Conditions precedent under A312 Performance Bond (1984 version) - The surety's obligation arises only if:

(a) the obligee is not in default;

(b) the obligee notifies the contractor and the surety that it is considering declaring a default;

(c) the obligee requests and attempts to arrange a conference with the contractor and the surety not later than 15 days after receipt of the notice;

(d) following the conference, the obligee declares a default and formally terminates the contractor's right to perform (at least 20 days after receipt of the notice of default); and

(e) the obligee agrees to pay the contract balance to the surety or a contractor selected to take over performance.

4. Conditions precedent under A312 Performance Bond (2010 version):

(a) Although similar to the 1984 form, the 2010 form contains a more streamlined process for the obligee to make a claim based upon the contractor's default.

(b) The 2010 form does not require a conference, but allows the surety to request that a conference be held within 10 days of receipt of the obligee's notice;

(c) The 2010 form provides that the obligee's failure to comply with the notice requirements shall not release the surety from its obligations except to the extent the surety can demonstrate actual prejudice.

(d) The 2010 form still provides that the surety's obligation under the Bond does not arise until: (1) the obligee provides notice to the contractor and surety that it is considering declaring a contractor default; (2) after the time period for requesting and holding a conference expires, the obligee declares a default and terminates the contract; and (3) the obligee has agreed to pay the balance of the contract price to the surety or to a contractor selected to complete the contract.

5. Conditions precedent under A311 Performance Bond (less detailed than A312 bond):

(a) the principal is in default;

(b) the obligee declares the contractor to be in default; and

(c) the obligee has performed its obligations under the underlying contract. *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F. 3d 106 (5th Cir. 1996).

6. Conditions precedent under Federal Standard Form 25 Performance Bond. The surety's obligation arises if:

(a) the principal fails to: (1) fulfill "all the underlying, covenants, terms, conditions, and agreements" of the contract with the obligee and any modifications to the contract during the original term of the contract and any extensions granted by the government, and during the life of any guaranty required under the contract and (2) pay to the government the full amount of the taxes imposed by the government (e.g. taxes collected, deducted or withheld from wages).

(b) Otherwise, the surety's obligation under the bond is void.

E. Surety's performance options

1. Surety's investigation

(a) A surety's first obligation upon receiving a performance bond claim is to commence an investigation of the claim.

(b) The surety's investigation is a fact-finding exercise intended to promptly determine whether the bond principal is in default of its contractual obligations and if so, whether the surety has liability under the performance bond.

(c) Because the surety's investigation will determine its response to the claim, it is important that the surety conduct the investigation in an expeditious and comprehensive manner and gather as much information as is reasonably available.

(d) In making its investigation, the surety should gather information from as many sources as possible including the surety's own files, the obligee, and the bond principal.

(e) After receiving a notice of a claim from the obligee, the surety should acknowledge the claim, request further documentation to substantiate the claim, and reserve its rights and defenses.

(f) The surety should also send a letter to the principal and the indemnitors under the Agreement of Indemnity, notifying them of the claim, of the surety's exposure to potential losses under the bonds issued on behalf of the principal, of the principal's duty to cooperate with the surety during its investigation of the claim, and of their indemnity obligations under the Agreement of Indemnity.

2. Under many performance bonds, before a surety is required to act, the obligee must formally declare the principal in default of its contractual obligations.

(a) Depending upon the bond form and its interpretation by the courts, an obligee's failure to comply with the bond provisions or the underlying contract terms incorporated by reference under the bond for declaring a principal in default may discharge or exonerate the surety's liability. *L & A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106 (5th Cir. 1994).

(b) When the bond does not require the obligee to declare a default and the obligee has not terminated the principal, but the surety has been advised that the principal is in default of its bonded obligations, it may be prudent for the surety to begin its investigation.

F. Surety's use of construction consultants

1. A construction consultant is an engineer or construction manager who

specializes in project and construction management.

2. At the preliminary stage of the bond default process, the construction consultant can furnish information such as the following:

(a) the percentage of completion of the principal's work;

(b) the quality of the work;

(c) the projected completion date;

(d) estimates of the cost to complete the work, either by the principal or another contractor; and

(e) the identification and analysis of claims made by the principal, the obligee, or subcontractors.

3. If the surety decides to procure bids for the completion of the contract, the construction consultant will put together the bid package and evaluate the bids.

4. If the surety takes over the completion of the work, the construction consultant will:

(a) monitor the completion of the work by the completion contractor;

(b) approve requisitions for payment submitted by the completion contractor; and

(c) act as a liaison between the obligee and the obligee's project representative.

5. Generally, a surety needs a consultant whenever the surety's own personnel lack the skill, knowledge or expertise to perform the investigation.

G. Surety's use of other consultants

1. Legal consultants to provide services in the following areas:

(a) the identification and evaluation of defenses that may be available to the surety;

(b) the interpretation of legal documents;

(c) the drafting of documents relating to the bond default, including takeover agreements, completion agreements, tender agreements, tri-party agreements, etc.

(d) the handling of litigation that arises from the bond default, such as claims against performance bonds and payment bonds, and recovery actions against the principal and indemnitors;

(e) participation in meetings and negotiations related to the bond default;

(f) miscellaneous services.

2. Accounting consultants to provide services related to ascertaining the principal's financial condition to enable the surety to determine its exposure to loss from the bond default and to enable the surety to assess which option it should choose to respond to the default.

3. Technical consultants to advise the surety on specialized issues of engineering that may arise in connection with a bond default. For example:

(a) If there was a structural failure on the project, the surety may need to retain a structural engineer to analyze the adequacy of the design.

(b) A surety may need to retain an architect to review the competency with which the plans and specifications for the project were prepared.

H. Surety's performance options

1. Once the surety completes its investigation, it must decide the most appropriate means of responding to the performance bond claim.

2. Generally the surety has six options:

(a) take over and complete the project;

(b) tender a new contractor;

(c) finance the bond principal's completion of the work;

(d) indemnify the obligee;

(e) buy out the bond obligation; or

(f) deny the claim.

I. Takeover and completion of project

1. The surety usually has the opportunity to enter into a takeover agreement with the obligee under which the surety agrees to complete the project using a completion contractor.

2. The surety will also need to enter into a completion agreement with the completion contractor.

3. The advantages of this option are:

(a) It allows the surety to control completion costs.

(b) The surety can select a qualified completion contractor at a competitive price.

(c) This option can be attractive when the project is close to completion, and completion by the principal is no longer possible.

(d) The obligee may not be willing to accept a tender, and therefore the takeover option may be the only viable alternative.

4. The disadvantages of this option are:

(a) The surety is in a direct contract with the obligee to complete the project, and the surety must see the contract to completion despite any problems that are encountered.

(b) The risk to the surety is unknown.

(c) Once a surety undertakes to complete the work, its ultimate liability will no longer be limited by the penal sum of the bond unless the takeover agreement limits the surety's liability to the penal sum of the bond. However, the obligee is under no obligation to agree to such a limiting provision.

5. In negotiating the Takeover Agreement, the surety should attempt to obtain a waiver from the obligee of liquidated damages and an agreement that the surety's liability is limited to the penal sum of the bond.

J. Tender of completion contractor

1. The surety can attempt to fulfill its performance bond obligations by:

(a) obtaining bids from contractors to complete the work;

(b) tendering the low bidder to the obligee;

(c) requiring the low bidder to provide the obligee with a new performance bond and payment bond;

(d) paying to the obligee a sum of money equal to the difference between the original contract balance and the amount of the bid; and

(e) obtaining a release from the obligee of all claims under the Performance Bond.

2. The advantages of a tender are as follows:

(a) It allows the surety to limit its losses.

(b) The risk of completion is shifted from the surety for the principal to the surety for the completion contractor.

(c) The risk of loss on the project will not exceed the penal sum of the bond.

3. The disadvantages of a tender are as follows:

(a) There may be substantial up-front costs in putting together a bid package and obtaining bids.

(b) The cost of a bonded completion contract usually exceeds the cost of the original contract by a substantial amount.

(c) The obligee may refuse to accept a completion contractor unless the bond language specifically permits it, as in the case of the A312 Performance Bond.

4. The tender option can be formalized either by:

(a) the surety and the obligee entering into a tender agreement and the obligee and the completing contractor entering into a completion agreement; or

(b) the surety, obligee and completion contractor entering into a tri-party agreement.

5. In negotiating the agreement, the surety should attempt to obtain a waiver from the obligee of liquidated damages and an agreement that the surety's liability is limited to the penal sum of the bond.

K. Financing the principal

1. The surety's objective in financing the principal is to remedy a potential or existing default under the bonded construction contract, and to avoid a termination by the obligee of the principal's right to proceed under the bonded contract.

2. In financing the principal, the surety provides direct or indirect financial assistance to the principal in the hope that the contract obligation secured by the performance bond will be completed by the principal.

3. Financing the principal is probably the most potentially dangerous completion option available to the performance bond surety. However, financing the principal may be the quickest, most efficient and most economical way to get the bonded contract completed.

4. In deciding whether to finance the principal, the surety must review and analyze the cash, capacity and character of the principal. The surety also needs to analyze the collateral of the principal and the indemnitors that may be available to reduce the surety's actual or potential loss.

5. Financing the principal is not a viable option if either the principal does not have the capacity to perform the work or it does not have sufficient collateral to indemnify the surety.

6. There are a number of methods by which the surety can finance the principal, including:

(a) advancing or lending money to the principal;

(b) guaranteeing a bank loan to the principal;

(c) paying subcontractors and suppliers of the principal directly;

(d) providing additional bonds to the principal on other projects in an effort to rehabilitate the principal.

7. The surety's right to finance the principal

(a) Most indemnity agreements contain a provision that allows the surety to guarantee loans or advance or lend money to the principal.

(b) The surety has the option of financing the principal under most performance bonds, including the Federal Standard Form 25 Performance Bond, the A311 Performance Bond and the A312 Performance Bond.

8. Advantages in financing the principal include the following:

(a) The principal is familiar with the construction means and methods employed on the project site, and therefore there is no learning curve which a completion contractor would experience;

(b) The costs of demobilization and mobilization on the project site that would be incurred if a completion contractor is utilized can be avoided; and

(c) If a completion contractor is utilized, it will mark up its cost to complete by including in its bid price the cost of obtaining bonds, mobilization, correcting possible defective work, and other contingencies that result in a price that is more expensive.

9. Disadvantages in financing the principal include the following:

(a) Unless agreed to by the obligee, money advanced by the surety to its principal under a financing agreement does not decrease the penal sum of the surety's performance bond;

(b) The surety is unable to fix the amount of its loss by financing the principal since the surety will not know the final amount of the loss until the bonded contract is completed and the bonded contract funds are collected;

(c) A surety financing the principal must frequently satisfy the principal's debts that are not covered by either the performance bond or the payment bond. Specifically, the surety generally must make a substantial contribution to the principal's overhead;

(d) The cost of monitoring the work of a financed principal by the surety's consultant can be substantial; and

(e) Some court cases have held that if a surety finances the principal, the surety risks being subject to a loss in excess of the penal sum of the performance bond.

10. If a surety decides to finance the principal, the surety should require that a separate agreement be entered into with the principal and the indemnitors, generally referred to as a"Joint Control Trust Agreement" or a "Financing and Collateral Agreement."

L. Completion by bond obligee

1. Whether the surety has the right to demand that the obligee complete the work depends on the language of the bond, the applicable statutes, and the underlying contract between the obligee and the contractor.

2. Federal Standard Form 25 Performance Bond (used on Miller Act projects)

(a) The language of the bond provides no guidance on what options the surety has in responding to a claim under the bond.

(b) However, case law holds that under the bond, the surety is not obligated to complete the work, but rather must indemnify the obligee for damages incurred in the event of the termination of the principal for default. *Trinity Universal Ins. Co. v. U.S.*, 382 F. 2d 317 (5th Cir. 1967).

(c) Therefore, the surety can opt to have the obligee (the federal government) complete the work.

3. A311 Performance Bond

(a) Upon the default of the principal/contractor, the surety only has two options: (1) to complete the contract itself; or (2) obtain bids from completing contractors and finance the project to completion.

(b) The surety does not have the option to demand that the obligee complete the work.

4. A312 Performance Bond (1984 and 2010 versions)

(a) After the obligee has declared the principal to be in default, the surety has five options:

(1) arrange for the principal, with the consent of the owner, to complete the construction contract (i.e. financing the principal);

(2) completion by the surety (i.e. takeover by surety);

(3) obtaining bids from contractors acceptable to the obligee, arranging for a contract to be executed by the obligee and the completing contractor to be secured by surety bonds provided by the completing contractor to the obligee, and paying to the obligee the difference between the remaining contract balance and the amount of the completing contractor's bid (i.e. tendering a new contractor);

(4) waiving its right to perform and complete, to arrange for completion, or to obtain a new contractor and tendering payment to the obligee of the amount it determines it is liable to the obligee (i.e. tendering cash only); or

(5) denying liability.

(b) Under the "tendering cash only" option, the surety has the right to tender cash to the obligee so that the obligee can complete the work. However, this right is conditioned upon the surety investigating the claim with reasonable promptness and tendering payment as soon as practicable.

(c) A cash payment to the obligee is the simplest option available to a surety.

(d) If the surety's investigation shows that its exposure is likely to exceed the penal sum of the bond, "buying back the bond" with a cash payment to the obligee is the preferred option since the surety's liability will be limited to the penal sum of the bond.

(e) The biggest disadvantage of this option (unless the penal sum is tendered) is that the surety loses control over the project's completion, including control over the project costs.

M. Denial of claim

1. If the surety, after investigation, concludes that it has no liability under its bond, the surety may deny the claim and decline to perform.

2. However, if that decision is disputed, the consequences may be costly since not only have courts awarded compensatory damages to an obligee that completed a project with its own funds, but also they have awarded prejudgment interest on those funds. *USF&G v. Braspetro Oil Serv. Co.*, 369 F.3d 34 (2d Cir. 2004).

3. Courts in some jurisdictions have held that a surety's failure to act constitutes bad faith sufficient to justify punitive damages. See *Transamerica Premier Ins. Co. v. Brighton Sch. Dist.*, 940 P.2d 348 (Colo. 1997). However, cases decided under Pennsylvania law (although none of those cases are Pennsylvania Supreme Court cases) have held that the Pennsylvania bad faith statute does not apply to sureties.

N. Defenses to performance bond claims

1. The surety can assert all of the defenses of its principal including:

(a) the obligee's failure to provide plans and specifications that are free from defects. See *U.S. v. Spearin*, 248 U.S. 132 (1918) and its progeny (known as the "Spearin Doctrine");

(b) the obligee's failure to act - Unreasonable delays by the obligee, as well as the obligee's failure to act, may constitute a breach that will relieve the principal, and ultimately the surety, from liability;

(c) impossibility of performance – A determination that work which the principal was to have performed has become impossible to perform can be a defense available to the surety;

(d) the obligee's wrongful termination of the principal's contract;

(e) the obligee's failure to provide notice to the principal and an opportunity for the principal to cure incomplete or inadequate performance;

(f) setoffs or counterclaims – A surety is entitled to assert any setoffs available to its principal against the obligee.

2. The surety must be given notice of default and the opportunity to perform.

(a) When notice of default is required under the bond, the declaration of default must be stated in clear, direct, and unambiguous terms; and

(b) A failure by the obligee to provide the principal and the surety with an opportunity to perform (i.e. cure incomplete or inadequate performance by the principal) can discharge the surety from liability under the performance bond.

3. Material alteration of the underlying contract

(a) A material alteration is a nonconsensual increase of the surety's risk by some act of the obligee that changes the bonded contract;

(b) A material alteration is a fact-dependent inquiry often to be decided by a jury;

(c) Relatively minor changes do not amount to material alterations;

(d) The alteration must be a material, substantial departure from the original risk so that a reasonable person would either have not undertaken the risk at all, or would have charged a greater premium;

(e) If the obligee materially alters the contract, the surety is discharged from liability under the performance bond.

4. Overpayment by obligee

(a) When an obligee improperly pays the principal without the consent of the surety, this can result in a discharge of the performance bond. Improper payments include (1) making progress payments for work not completed; (2) paying for work which the obligee knew or should have known was defective; (3) prematurely releasing the contract retainage; and (4) making final payment without the required consent of the surety;

(b) However, courts have been reluctant to discharge the bond when an obligee has relied in good faith on an architect's certification, even through the obligee overpaid the contractor as a result of an improperly certified payment obligation. See *Argonaut Ins. Co. v. Town of Cloverdale, Ind*., 699 F.2d 417 (7th Cir. 1983).

(c) Many courts have held that the discharge is limited to the extent of the prejudice suffered by the surety (i.e. a pro tanto discharge). *National Surety Corp. v. U.S.*, 118 F. 3d 1542 (Fed. Cir. 1997).

4. Termination for convenience

(a) A termination for convenience clause in a construction contract allows the obligee to terminate the contract without cause and without having to justify the termination decision.

(b) When a contract is terminated for convenience, the obligee cannot call upon the surety to perform because no default has occurred that triggers any obligation on the part of the surety.

5. Release of principal

(a) Similar to a termination for convenience, an obligee cannot pursue any remedies against the surety after the obligee has released the principal in a settlement agreement.

6. Failure to mitigate

(a) The most common situation where this defense is applicable is one in which the obligee takes over the arrangements for project completion without affording the surety an opportunity to complete;

(b) Courts have held that this "strips" the surety of its contractual right to minimize its liability under the performance bond, resulting in a material breach that renders the bond null and void. *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E. 2d 55 (Ill. Ct. App. 1997), appeal denied, 684 N.E. 2d 1355 (Ill. 1997).

O. Suit limitations

1. In Pennsylvania, the statute of limitations for an action on a performance bond is one year from the date the cause of action accrued. 42 Pa. C.S.A. § 5523(3), §5502(a).

2. The cause of action on a performance bond accrues at the time of the principal's default. *Turner Construction, Inc. v. American States Ins.Co.*, 397 Pa. Super. 29, 579 A.2d 915, appeal denied, 527 Pa. 603, 589 A.2d 693 (1990).

3. At least one Pennsylvania Court has applied the "discovery rule" to when the statute of limitations begins to run under a performance bond in *Pennsylvania. Altoona Area School Dist. v. Campbell*, 152 Pa. Cmwlth. 131, 618 A.2d 1129 (1992) (the discovery rule tolls the running of the statute of limitations until the plaintiff knows or reasonably should know that an injury has occurred).

4. The Commonwealth of Pennsylvania and its agencies are immune from the running of the statute of limitations under the doctrine of nullum tempus occurrit tegi ("nullum tempus") which means "time does not run against the king." *Commonwealth, Department of Transportation v. J. W. Bishop & Co.*, 497 Pa. 58, 439 A.2d 101 (1981).

(a) Nullum tempus is also available to political subdivisions in Pennsylvania when they are seeking to enforce strictly public rights as opposed to an obligation arising out of an agreement voluntarily entered into by the political subdivision. *Altoona Area School Dist. v. Inter-State Tile & Mantel Co. Inc.*, 152 Pa. Cmwlth. 131, 618 A.2d 1129 (1992); *Montgomery County v. Microvote Corp.*, 320 F.3d 440 (3d Cir. 2003); *Mt. Lebanon School Dist. v. W.R. Grace & Co.*, 414 Pa. Super. 455, 607 A.2d 756 (1992).

(b) A governmental entity can waive the application of nullum tempus when a bond provides for a specific statute of limitations. *Wilson Area School District v. Skepton*, 71 Pa. D.&C. 4th 142, 2005 WL 1595430 (C.P. Northampton).

5. The Miller Act does not have an express limitation period with regard to performance bond claims.

6. Many performance bonds contain an express limitations provision.

(a) The A312 Performance Bond (1984 version) provides that an action must be commenced within two years after contractor default or within two years after the contractor ceased working or within two years after the surety refuses or fails to perform its obligations under the bond, whichever occurs first. The only change made in the 2010 version is that the two year period begins to run after the "declaration" of a contractor default.

(b) The A311 Performance Bond provides that an action must be commenced within two years "from the date on which final payment under the contract falls due."

(c) Under Pennsylvania law, the parties may agree on appropriate limitation periods even if different than the statutory limitations period so long as they are reasonable. *Redevelopment Auth. of City of Philadelphia v. Fidelity and Deposit Co. of Md.*, 665 F. 2d 470 (3d Cir. 1981) (the limitations period set forth in the bond prevailed even though it was longer than the statutory limitations period).

P. Notice requirements

1. Pennsylvania has no statutory provisions regarding notice requirements for a performance bond claim.

2. The federal Miller Act has no statutory provisions regarding notice for a performance bond claim.

3. As discussed above, both the 1984 and the 2010 versions of the A312 Performance Bond require the obligee to provide notice to the contractor and surety that it is considering declaring a contractor default before the surety's obligation under the Bond arises.

Q. Damages covered by performance bond

(a) Under Pennsylvania law, when determining whether a surety is liable for certain types of damages, the bond itself is the "primary determinant." *North American Specialty Ins. Co. v. Chichester School Dist.*, 158 F. Supp.2d 468 (E.D. Pa. 2001) (applying Pennsylvania law).

(b) Where a performance bond surety fails to complete its properly defaulted principal's work, the surety is liable for the loss sustained by the obligee, not exceeding the amount of the bond. *Turner Construction Co. v. First Indemnity of America Ins. Co.*, 829 F. Supp. 752 (E.D. Pa. 1993), affirmed 22 F.3d 303 (3d Cir. 1994).

(c) Depending on the language of the performance bond, the surety may be held liable for damages beyond the mere cost of the completion of the project. *Downingtown Area School Dist. v. International Fid. Ins. Co.*, 671 A.2d 782 (Pa. Cmwlth. Ct. 1996).

(d) If a performance bond, such as the A312 Performance Bond, specifies the damages for which a surety is liable, it will be followed. *North American Specialty Ins. Co. v. Chichester School Dist.*, 2000 WL 1052055 (E.D. Pa. July 20, 2000) (the A312 Performance Bond specifically states that the surety is obligated to correct the contractor's defective work and to complete the contract; for additional legal, design professional and delay costs resulting from the contractor's default and the actions or failure to act of the surety; and liquidated damages or actual damages caused by delayed performance or non-performance of the contractor).

(e) A surety may be exposed to liability that exceeds the penal sum of the bond if it takes over and completes the project.

(f) Cases interpreting the Pennsylvania bad faith statute (42 Pa. C.S.A. § 8371) have declined to apply that statute and to award damages thereunder to claims under surety bonds.

R. Recovery of attorney's fees

1. Attorney's fees are not recoverable unless the bond so provides. *Downingtown Area School District v. International Fid. Ins. Co.*, 769 A.2d 560 (Pa. Cmwlth. 2001).

2. A surety will be obligated to pay attorney's fees where the performance bond explicitly so provides. *Department of Transportation v. Manor Mines, Inc.*, 117 Pa. Cmwlth. 342, 544 A.2d 538 (1988), affirmed 523 Pa. 112, 565 A.2d 428 (1989).

III. Payment Bonds

A. Purpose of payment bonds

1. A payment bond is also known as a labor and material bond.

2. It is a contractual guarantee to the owner-obligee that the surety-obligor will pay labor and material suppliers and subcontractors should the contractor-principal fail to pay.

3. A payment bond limits claimants on the bond to those having a direct contract with the principal or with a subcontractor of the principal.

4. Generally, an owner-obligee cannot make a claim against a payment bond.

B. Parties to payment bonds

1. A payment bond is a type of surety bond.

2. A surety bond is a written instrument based upon a three-party relationship.

3. The three parties are the principal, the surety, and the obligee.

4. The principal-contractor provides a payment bond pursuant to its contract with the obligee-owner to protect laborers and materialmen on a project.

5. In the event the principal or its subcontractors fail to pay persons or entities who supplied labor and/or materials to them, the surety is obligated to step in and pay the entities the amount owed to them, up to the penal sum of the bond.

6. If the surety pays a claimant under the payment bond, it is entitled to be indemnified for its loss pursuant to a written indemnity agreement, which is part of the consideration for issuing the bond.

C. Types of payment bonds

1. Federal Miller Act Bonds

(a) Before any contract of more than $100,000 is awarded for the construction, alteration or repair of any public building or public work of the federal government, a payment bond must be furnished. 40 U.S.C. § 3131(b)(2).

(b) A Miller Act payment bond is for the "protection of all persons supplying labor and material in carrying out the work provided for in the contract for the use of each person." 40 U.S.C. § 3131(b)(2).

(c) The amount of the payment bond shall equal the total amount of the contract unless the officer awarding the contract determines otherwise.

(d) The Code of Federal Regulations provides a standard form, Federal Standard Form 25A Payment Bond, that is commonly used.

2. State Public Works (Little Miller Act) Bonds

(a) All states have public works statutes that require contractors that are awarded contracts on state public projects to provide payment bonds.

(b) These statutes are often referred to as "Little Miller Acts."

3. Pennsylvania Little Miller Act Bonds

(a) The statutory bonding requirements for Pennsylvania public works projects are set forth in the Pennsylvania Public Works Contractors Bond Law of 1967, 8 P.S. §§ 191 et seq. ("PA Bond Law") and in Part I of the Commonwealth Procurement Code, 62 Pa. C.S.A. §§

101 et seq. ("PA Procurement Code"), which was enacted in 1998.

(b) Prior to the adoption of the PA Procurement Code in 1998, the PA Bond Law was the controlling statute with regard to bond requirements for all public bodies in the Commonwealth of Pennsylvania.

(c) As a result of the enactment of the PA Procurement Code, the Bond Law only applies to contracts for public projects that are not with Commonwealth purchasing agencies (e.g. municipalities, school districts, municipal authorities, etc.). The PA Procurement Code applies to public contracts with a Commonwealth purchasing agency.

(d) For projects subject to the PA Bond Law (contracts exceeding $10,000 for the construction, reconstruction, alteration or repair of any public building or other public work or public improvement), the contractor must furnish to the contracting body a payment bond in the amount of 100% of the contract amount or "financial security" equal to 100% of the contract amount. 8 P.S. § 193.1.

(e) For projects subject to the PA Procurement Code involving contracts between $25,000 and $100,000, the contractor must provide a payment bond or other acceptable security in an amount equal to at least 50% of the contract price. For projects subject to PA Procurement Code involving contracts in excess of $100,000, the contractor must provide a payment bond or other acceptable security in an amount equal to 100% of the contract price. 62 Pa. C.S.A. § 903(a).

4. Private Project Bonds

(a) An owner on a private project may require a contractor to provide a payment bond for a construction project even though it is not required by statute.

(b) Payment bonds on private projects vary in form and need to be examined carefully to determine who is entitled to recover, the scope of the surety's obligation, and any conditions precedent to recover under it.

5. AIA Bonds

(a) The American Institute of Architects ("AIA") has drafted several types of payment bonds that are utilized by owners on construction projects, (both public and private) including the AIA A311 Payment Bond and the AIA A312 Payment Bond. (Note: the 1984 version of the A312 Payment Bond was revised in 2010).

D. Claimants entitled to recover under payment bonds

1. First-tier claimants

(a) A first-tier claimant is in a direct relationship with the principal; e.g. a subcontractor or direct supplier.

2. Second-tier claimants

(a) A second-tier claimant is in a direct relationship with the principal's subcontractor or direct supplier, e.g. a supplier to a subcontractor.

3. Third-tier claimants

(a) A third-tier claimant is in a relationship with a second-tier claimant, e.g. a supplier to a subcontractor.

4. The Federal Miller Act restricts coverage under a Miller Act payment bond to first-tier and second-tier claimants.

5. The PA Bond Law and PA Procurement Code limit coverage under a payment bond to first-tier and second-tier claimants.

6. Only first-tier and second-tier claimants are entitled to recover under an A311 Payment Bond or an A312 Payment Bond.

7. A third-tier material supplier is not a proper claimant under a payment bond issued under the PA Bond Law. *Lezzer Cash & Carry, Inc. v. Aetna Ins. Co.*, 371 Pa. Super. 137, 537 A.2d 857 (1988).

E. Types of claims covered

1. Labor and materials

(a) Claims for labor and materials are covered by the express terms of the Miller Act, the PA Bond Law and the PA Procurement Code.

(b) Both the PA Bond Law and the PA Procurement Code cover all "material or labor supplied or performed in the prosecution of the work." 8 P.S. § 193.1(a)(2); 62 Pa. C.S.A. § 903(a).

(c) Both the PA Bond Law and the PA Procurement Code define "labor or materials" to include "public utility services and reasonable rentals of equipment, but only for periods when the equipment rendered is actually used at the site." 8 P.S. § 193.1(a)(2); 62 Pa. C.S.A. § 903(a).

(d) The A312 Payment Bond covers "labor, materials and equipment furnished for use in the performance of the construction contract."

(e) The A311 Payment Bond covers "all labor and materials used or reasonably required for use in the performance of the contract."

2. Equipment

(a) The purchase price for equipment purchased and owned by the contractor or subcontractor and used on the construction project will generally not be allowed under Miller Act, PA Bond Law and PA Procurement Code payment bonds. However, if a claimant can show that the equipment was substantially consumed on the bonded project, the claim may be allowed.

(b) Claims for unpaid rental charges for equipment are generally allowed.

(c) Claims for repairs or maintenance to equipment and other items substantially consumed in the construction project are generally allowed.

(d) The PA Bond Law is similar to the Federal Miller Act, and therefore Pennsylvania courts interpreting the PA Bond Law have relied, and generally followed, decisions interpreting similar statutory provisions in the Miller Act.

3. Services

(a) Skilled professional work involving actual superintending, supervision, or inspection at the job site, as distinguished from physical labor, is generally a type of service covered by payment bonds.

(b) Claims for architectural and engineering services performed on site generally have been held to be recoverable under payment bonds.

(c) Freight charges, or the cost of transporting materials or equipment to the bonded job site, are other services that have been the subject of payment bond claims. Cases deciding whether they are recoverable have gone both ways. Generally, it appears that they will be allowed if the charges are for transporting materials consumed or incorporated in the construction project.

4. Contract damages

(a) A number of federal courts have found that a surety can be liable under a Miller Act payment bond for a claimant's increased labor and material cost incurred by reason of delay caused by the general contractor in order to compensate a subcontractor for additional out-of-pocket costs for labor and material furnished in the performance of the contract. However, claims for lost profits caused by delay are generally not allowed by courts interpreting claims made under Miller Act payment bonds.

(b) Pennsylvania courts have held that unless the express language of the payment bond states to the contrary, a payment bond claimant cannot recover delay damages or lost profits. *Salvino Steel & Iron Works, Inc. v. Fletcher & Sons, Inc.*, 398 Pa. Super. 86, 580 A.2d 853 (1990) (delay damages); *Lite-Air Products, Inc. v. Fid. & Deposit Co. of Md.*, 437 F. Supp. 801 (E.D. Pa. 1977) (lost profits).

5. Extra-contractual damages

(a) Extra-contractual damages, such as punitive damages, resulting from a contractor's negligence, etc., are generally not recoverable under a Miller Act payment bond or a Little Miller Act payment bond.

6. Attorney's fees

(a) Attorney's fees are not recoverable under the Miller Act absent a federal statute or an enforceable contract provision providing for the award of attorney's fees. *F. D. Rich Co., Inc. v. U.S. ex rel. Industrial Lumber Co.*, 417 U.S. 116 (1974).

(b) Under the PA Bond Law and the PA Procurement Code, a payment bond claimant cannot recover attorney's fees unless the express language of the bond provides for the recovery of attorney's fees. *J. C. Snavely & Sons, Inc. v. WEB M&E, Inc.*, 406 Pa. Super 271, 594 A. 2d 333 (1991).

7. Interest

(a) Most claims decided under the Miller Act look to state law to determine issues relating to prejudgment interest.

(b) Under Pennsylvania law, a payment bond claimant can recover prejudgment interest at the legal rate of 6%, but cannot recover finance charges or service fees unless the express language of the bond provides to the contrary. *Can-Tex Industries v. Safeco Ins. Co. of America*, 460 F. Supp. 1022 (W.D. PA. 1978).

(c) However, where the payment bond does not limit the surety's obligation to labor and materials, but expressly permits suits against the surety for "such sum or sums as may be justly due" to the supplier or subcontractor, Pennsylvania courts have held that payment bond sureties are liable for the full amount owed by their principals, including interest. *Commonwealth v. Cont'l Cas. Co.*, 429 Pa. 366, 240 A.2d 493 (1968).

F. Notice requirements

1. Most payment bonds require some sort of notice as a condition precedent to asserting a claim, regardless of whether the bond is a Miller Act bond, a Little Miller Act bond, a private payment bond, or an AIA payment bond.

(a) Pennsylvania courts have enforced reasonable notice provisions in a bond on the ground that they are "sensible and necessary provisions" that permit general contractors to make payments to subcontractors without fear of subsequent suits by material suppliers who have not made their claims known. *Barati v. M.S.I. Corp.*, 212 Pa. Super. 536, 243 A.2d 170 (1968).

2. Miller Act

(a) First-tier claimants are not required to give notice prior to filing suit under a Miller Act payment bond.

(b) Second-tier claimants who have a direct relationship with the subcontractor, but not with the prime contractor, must give written notice to the prime contractor within 90 days from the date on which the claimant provided the last of the labor and material for which the claim is made prior to filing suit under a Miller Act payment bond.

(c) The Miller Act requires that notice be given to the prime contractor. 40 U.S.C. § 3133(b)(2).

(d) Under the Miller Act, the notice shall be in writing and shall be served by any means that provides written, third-party verification of delivery to the contractor at any place the contractor maintains an office or conducts business or at the contractor's residence, or in any manner in which the United States marshal of the district in which the public improvement is situated by law may serve a summons. 40 U.S.C. § 3133(b)(2)(A).

(e) The notice shall state with substantial accuracy the amount claimed and the name of the party to whom the material was furnished or supplied or for whom the labor was done or performed. 40 U.S.C. § 3133(b)(2).

3. PA Bond Law

(a) First-tier claimants are not required to give notice prior to filing suit under a PA Bond Law payment bond.

(b) Second-tier claimants may only bring an action under the payment bond if the claimant gives written notice to the prime contractor within 90 days from the date on which the claimant performed the last of the labor or furnished the last of the materials for which the claimant seeks payment. 8 P.S. § 194(b).

(c) The PA Bond Law requires that notice be given to the prime contractor. 8 P.S. § 194(b).

(d) The notice shall state with substantial accuracy the amount claimed and the name of the person for whom the work was performed or to whom the material was furnished. 8 P.S. § 194(b).

(e) Notice shall be served by registered or certified mail, postage prepaid, in an envelope addressed to the prime contractor at any place where his office is regularly maintained for the transaction of business or served in any manner in which legal process may be served in the manner provided by law for the service of a summons, except that service need not be made by a public officer. 8 P.S. § 194(b).

4. PA Procurement Code

(a) The PA Procurement Code contains no statutory notice provisions applicable to bond claims.

5. Payment Bonds on Private Projects

(a) Pennsylvania has no statutory notice provisions for claims under payment bonds on private projects. To the extent the payment bond contains a notice provision, it will be followed if it is deemed to be reasonable.

6. AIA Payment Bonds

(a) AIA A311 Labor and Material Payment Bond - This bond provides that a second-tier claimant shall give written notice to any two of the following: the principal, the owner, or the surety, within 90 days after such claimant performed the last of the work or labor or furnished the last of the materials for which the claim is made, stating with substantial accuracy the amount claimed and the name of the party to whom the materials were furnished, or for whom the work or labor was performed. The notice shall be served by registered mail or certified mail, postage prepaid, in an envelope addressed to the principal, owner or surety, at any place where an office is regularly maintained for the transaction of business, or served in any manner in which legal process may be served in the state in which the project is located, except that service need not be made by a public officer.

(b) AIA A312 Payment Bond - The notice requirements in this bond are more onerous than those contained in the A311 payment bond.

(c) A312 Payment Bond (1984 version)

(1) Claimants who have a direct contract with the prime

contractor (first-tier claimants) must give notice to the surety and send a copy to the owner stating that a claim is being made under the bond and, with substantial accuracy, state the amount of the claim. (No time period is set forth for giving the notice). Claimants who do not have a direct contract with the contractor (second-tier claimants) must furnish written notice to the contractor and send a copy to the owner within 90 days after having last performed labor or last furnished materials or equipment included in the claim stating, with substantial accuracy, the amount of the claim and the name of the party to whom the materials were furnished or supplied or for whom the labor was performed.

(2) Significantly, the surety has 45 days after receiving notice of the claim to provide the claimant with a response stating the amounts that are undisputed and the basis for challenging any amounts that are disputed, and to pay the undisputed amounts.

(3) A 2005 Maryland Court of Appeals case (which was followed in several jurisdictions and rejected in others) held that when the surety fails to provide the required response, it waives its defenses to the claim, regardless of whether the claim is valid. *National Union Fire Ins. Co. v. Bramble*, 388 Md. 195, 879 A.2d 101 (2005).

(4) However, in *Sloan & Company v. Liberty Mutual Ins. Co*., 653 F.3d 175 (3rd Cir. 2011), the Third Circuit Court of Appeals, applying Pennsylvania law, stated that the surety's response (made within the 45 day period) which generally denied the claim and reserved the surety's rights and defenses, but did not state the exact amount that it was disputing, met its obligations under the "45 day" provision of the bond. The Court distinguished National Union v. Bramble on the ground that there the surety did not dispute the claim, but merely acknowledged receipt of the claim and requested proof of the claim.

(d) A312 Payment Bond (2010 version)

(1) Claimants who are employed by or have a direct contract with the principal must send a claim to the surety providing detailed information regarding the claim (no time period is set forth for sending the claim)

(2) Claimants who do not have a direct contract with the principal must furnish written notice of nonpayment to the principal, stating with substantial accuracy the amount claimed within 90 days after having last performed labor or furnished materials or equipment and also send the claim to the surety.

(3) Importantly, under this bond form, the surety has 60 days after receipt of the claim to respond to the claimant, stating the amounts that are undisputed and the basis for challenging any amounts that are disputed and to pay the undisputed amounts. If the surety fails to respond, it does not waive its defenses to the claim, but shall indemnify the claimant for reasonable attorney's fees incurred in seeking amounts found to be due and owing to the claimant. (Note: This provision was included to address the problems for sureties resulting from the Bramble

decision, discussed above).

G. Suit Limitations

1. Miller Act

(a) An action must be brought under the Miller Act no later than one year after the day on which the last of the labor was performed or material was supplied by the person bringing the action.

2. PA Bond Law and PA Procurement Code

(a) The statute of limitations for an action on a bond in Pennsylvania is one year from the date the cause of action accrues. 42 Pa. C.S.A. § 5523(3), §5502(a).

(b) However, a claimant may not bring an action under the payment bond until the expiration of 90 days after the date on which the claimant performed the last of the labor or furnished the last of the materials for which he claims payment. Therefore, the limitations period under the PA Bond Law and PA Procurement Code is effectively one year and 90 days from the date that the claimant last performed labor or furnished materials, unless the bond provides otherwise. *Centre Concrete Co. v. A.G.I., Inc.*, 522 Pa. 27, 559 A.2d. 516 (1989).

3. Private Bonds

(a) Unless the payment bond provides otherwise, the claimant has one year from the accrual of the cause of action (usually the date the claimant performed the last of the labor or furnished the last of the materials) to bring suit under a payment bond on a private contract. 42 Pa. C.S.A. § 5523(3).

4. A311 Payment Bond

(a) A claimant may not commence suit after the expiration of one year following the date on which the principal ceased work on the contract.

5. A312 Payment Bond (1984 and 2010 versions)

(a) A claimant may not commence suit after the expiration of one year from the date on which the claimant gave notice of the claim or on which the last labor or service was performed by anyone or the last materials or equipment were furnished by anyone under the construction contract, whichever first occurs.

6. When does the limitation period begin running for purposes of last of the labor performed or materials furnished?

(a) A distinction has been drawn between the essential work performed by the bond claimant within the scope of the original contract and incidental, repair or warranty work to determine when the suit limitation period begins running. The limitation period does not run while the claimant is performing essential, non-remedial work within the scope of the original contract. However, performing incidental or minor work, including warranty and punchlist work, does not toll the statute of limitations.

H. Investigation of claim by surety

1. When a surety is presented with a claim under a payment bond, it should contact its principal and request that the principal acknowledge the amount of the claim or explain why the claim should not be paid.

2. The surety should also acknowledge receipt of the claim and inform the claimant that it has begun its investigation by contacting its principal. This acknowledgment should include a reservation of rights. The acknowledgment to the claimant should also request a description of the claim, the basis for the claim and supporting documentation for the claim.

3. If the surety determines that the claim is covered under the bond, its payment to the claimant should be in consideration for a release of the surety from the claim and the assignment of the claim against the principal to the surety.

4. If the surety concludes that the claim is improper, the surety should advise the claimant of its decision to deny the claim. However, if any portion of the claim is determined to be undisputed, the surety should tender payment of the undisputed portion and obtain a partial Release and Assignment from the claimant.

5. As part of the investigation process, the surety should consider hiring a construction consultant. See Section II. F above for a discussion of the use of construction consultants.

I. Defenses to payment bond claims

1. A payment bond surety has a number of defenses that it can assert to payment bond claims including the following:

(a) the principal's defenses;

(b) the principal's setoffs/counterclaims;

(c) the claimant's material breach of contract;

(d) the failure of the claimant to give proper notice;

(e) the failure of the claimant to commence suit within the time prescribed by the bond or by statute;

(f) the failure of the claimant to bring suit in the proper court;

(g) the penal sum of the bond as a limitation of liability;

(h) the claimant's failure to mitigate its damages; and

(i) defenses based on particular subcontract provisions, including the pay-when-paid and pay-if-paid defenses.

2. Pay-when-paid/pay-if-paid clauses in the underlying construction contract as a defense to a payment bond claim.

(a) The general rule of law that a surety on a bond is not liable unless the principal is, and therefore the surety may assert any defenses and claims available to its principal is followed in Pennsylvania. *General Equipment Manufacturers v. Westfield Ins. Co.*, 430 Pa. Super 526, 635 A.2d 173 (1993).

(b) In view of this general rule, the issue arises as to whether a surety's principal can successfully rely upon a pay-when-paid or a pay-if-paid clause in a subcontract to avoid payment thereunder and, if so, whether the surety can successfully assert this defense to avoid payment under the payment bond.

(c) Under a pay-when-paid clause, a contractor's obligation to pay the subcontractor is triggered upon receipt of payment from the owner. A typical pay-when-paid clause might read: "Contractor shall pay subcontractor within seven days after a contractor's receipt of payment from the owner."

(d) Under a pay-if-paid clause, receipt of payment by the contractor from the owner is an express condition precedent to the contractor's obligation to pay the subcontractor. The intent of a pay-if-paid clause is to shift the risk of the owner's nonpayment under the subcontract from the contractor to the subcontractor. A typical pay-if-paid clause might read: "Contractor's receipt of payment from the owner is a condition precedent to contractor's obligation to make payment to the subcontractor; the subcontractor expressly assumes the risk of the owner's nonpayment."

(e) The majority of jurisdictions, including Pennsylvania, construe pay-when-paid clauses as allowing payment under a subcontract to be delayed, but not stopped altogether, and have treated such clauses as a "timing mechanism," not a condition precedent to payment." *United Plate Glass Co. v. Metal Trims Industries, Inc.*, 106 Pa. Cmwlth. 22, 522 A.2d 468 (1987).

(f) Most cases addressing pay-when-paid clauses only address the issue of whether a principal can assert the defense, not whether a surety can do so. Courts in most jurisdictions have generally construed pay-when-paid clauses as providing a "reasonable" period of time after a subcontractor's work is completed for a surety to pay a subcontractor under a payment bond although some courts have held that a surety cannot rely upon a pay-when-paid clause.

(g) The majority of jurisdictions have held that although a principal can rely upon a pay-if-paid clause, a surety cannot unless the clause is incorporated into the payment bond itself.

(h) However, in a West Virginia case, *Wellington Power Corp. v. CNA Surety Corp.*, 217 W.Va. 33, 614 S.E.2d 680 (W.Va. 2005), the Supreme Court of Appeals of West Virginia ruled that a pay-if-paid condition precedent clause in the subcontract could be asserted by a surety to avoid paying a claim on a West Virginia Little Miller Act bond, on the ground that the liability of the surety is commensurate with that of its principal and the principal had no liability by virtue of the pay-if-paid clause.

(i) Relying upon the *Wellington Power* case, the United States District Court for the District of New Jersey (applying New Jersey law) in *Fixture Specialists, Inc. v. Global Construction, LLC*, 2009 WL 904031 (D.N.J.) held that a surety may assert a pay-if-paid clause as a defense against a contractor's claim on a payment bond.

(j) Recently, in *Sloan & Company v. Liberty Mutual Ins. Co.*, 653 F.3d 175 (3rd Cir., 2011), the Third Circuit Court of Appeals, applying Pennsylvania law, found that a surety could rely upon a pay-if-paid clause in the subcontract between the surety's principal and its subcontractor.

Mr. Reynolds has over 40 years of experience in civil litigation and has represented clients before state and federal trial and appellate courts, arbitration panels, and administrative agencies. His principal practice areas include surety law, construction law, and commercial litigation. Prior to joining Margolis Edelstein as a partner, Mr. Reynolds was senior litigation counsel in a Harrisburg law firm where he practiced for 11 years. Before that, he was a founding officer and shareholder of a respected Harrisburg litigation firm, where he practiced for 15 years