Sabo & Zahn
233 S. Wacker Dr.
Suite 8620
Chicago, IL 60606
312-655-8620
312-655-8622 fax
Http://www.sabozahn.com

Sabo & Zahn
Attorneys at Law

Recent Decisions -- Surety Bonds

A recent decision by the California Supreme Court has an interesting discussion of the law concerning surety bonds. Such bonds are often used in construction projects, particularly on public projects where they are usually required by law. In a nutshell, a construction surety bond is a document whereby the surety (usually an insurance company with substantial assets) guarantees performance and/or payment by the contractor. This gives the owner assurance that the project will be completed and that the subcontractors and material suppliers will be paid and not file liens against the owner's property. That, anyway, is the theory.

In the California case, Talbot, the owner, hired Cates to be the general contractor for a condominium project. The construction lender required a surety bond to be obtained. The surety, Transamerica Insurance Company, issued a performance bond and a labor and materials payment bond. The project was to be completed in eight months. Construction started May 1, 1989. In early November, 1990, Cates submitted its 23rd pay request which was not paid. The project was still not complete at this point and the owner claimed it had already paid Cates more than the cost of the work. The owner then demanded that the surety complete the work. Thereafter, Cates abandoned the work and filed a mechanics lien for more than $645,000. The surety refused to complete the work at that time, saying that the owner was in default for not making payments to the contractor. The bank then foreclosed on the project and by March, 1991, Cates went out of business. That same month, the surety filed suit against the owner based on an assignment of Cates' claims and also began the process of completing the project based on the performance bond.

A trial ensued based on various contract and lien claims. The court held that the contractor had breached the contract and that the surety had breached the performance bond. The surety was held liable for all damages caused by the contractor's breaches of the construction contract, with damages in excess of $3 million. A separate trial was then held on the owner's tort claims against the

This article is not legal advice. Consult with an attorney familiar with the law in your area.

Sabo & Zahn
233 S. Wacker Dr.
Suite 8620
Chicago, IL 60606
312-655-8620
312-655-8622 fax
Http://www.sabozahn.com

surety, with the jury awarding $28 million in punitive damages against the surety. After the appellate court reduced this award to $15 million, the California Supreme Court reviewed the case. The first issue addressed by the court is whether a surety is liable for delay damages caused by a contractor's failure to complete the project on time. The court held that the performance bond and the construction contract had to be read together, since the construction contract was specifically incorporated into the performance bond. Similarly, AIA's Performance Bond, AIA Document A312 contains the following incorporation provision:

> 1. The Contractor and the Surety, jointly and severally, bind themselves, their heirs, executors, administrators, successors and assigns to the Owner for the performance of the Construction Contract, which is incorporated herein by reference.

The court found that a "time is of the essence" clause in the construction contract meant that delay damages were recoverable by the owner. The A312 form specifically allows for delay damages:

> . . . the Surety is obligated without duplication for:
>
> 6.2 Additional legal, design professional and delay costs resulting from the Contractor's Default, and resulting from the actions or failure to act of the Surety under Paragraph 4; and
>
> 6.3 Liquidated damages, or if no liquidated damages are specified in the Construction Contract, actual damages caused by delayed performance or non-performance of the Contractor.

The court then went on to decide whether a breach of the implied covenant of good faith and fair dealing that was implicit in this, and every, contract, gave rise to a tort cause of action. If it did, then the punitive damages were proper. If not, then only contract, and not punitive, damages were available, meaning that the punitive damage award would have to be reversed.

In California and some other states, a breach of the covenant of good faith and fair dealing results in only contract damages. There is one exception, and that concerns insurance policies. The issue, then, is whether or not a construction surety bond is an insurance policy. Here, the court compared traditional insurance policies that insured against fire and other disasters with surety bonds that merely provide an owner with additional security in the event of default of the contractor. Normal insurance has elements of public policy considerations as well as fiduciary duties on the part of the insurance companies. These are absent in surety cases. Based on this analysis,

This article is not legal advice. Consult with an attorney familiar with the law in your area.

Sabo & Zahn
233 S. Wacker Dr.
Suite 8620
Chicago, IL 60606
312-655-8620
312-655-8622 fax
Http://www.sabozahn.com

the court found that surety bonds are not insurance policies. Therefore, only contract damages are available for a breach of the bond by the surety.

The dissenting judges noted that some other states allow a surety to be liable in tort where the surety has committed malicious acts. The jury found that the surety's conduct was "vile, base, contemptible, miserable, wretched, or loathsome." Here, as the dissent noted, the jury "found Transamerica's conduct outstandingly bad."

Very few design professionals are knowledgeable about surety bonds. Typically, it is the owner or a lender that requires a performance or labor and material payment bond. If the contractor performs properly, the bond will not come into play on the project. However, when the contractor is in breach of the contract, a bond will suddenly take on an important role in the project. At that point, the best advice would be to have counsel for the owner, lender and any other interested party review the provisions of the bonds and the current status of the project. The time requirements listed in the bonds must be carefully followed so as to avoid negating coverage under the bonds. Proper notices must be given. The architect may be called upon to certify that work is or is not being properly performed and in accordance with the contract documents. Thorough records will be very important in such a situation.

Usually, in a situation where the contractor is in breach, the design professional will be called upon to do additional work, such as additional site observations or inspections, deal with a new contractor, meet with the owner and its attorneys, deal with sureties and lenders, possible prepare new or additional contract documents, and so on. These additional services should be completely documented, both to assure payment to the architect and to provide the owner with backup in claims against the contractor and surety.

Werner Sabo, FAIA, CSI
James K. Zahn, FAIA, CSI

1. *Cates Construction v. Talbot Partners*, No. S061215 (July 29, 1999)
2. The AIA has a standard form for such bonds, AIA Document A312, Performance Bond and Payment Bond. This case does not state which bond or contract forms were used, except that it does state that A312 was not used.
3. These tort claims were for breaches of the implied covenant of good faith and fair dealing.

This article is not legal advice. Consult with an attorney familiar with the law in your area.