SURETY TODAY PRESENTATION

Given by
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TENDERING A COMPLETION CONTRACTOR

I. INTRODUCTION (George)

Depending upon the language and conditions in the Performance Bond, when the principal is in default on a bonded contract, the obligee has terminated the principal's right to perform the work, and the obligee has made demand on the surety to perform under the Performance Bond, the surety may have many or few performance options.

Under some Performance Bonds, the surety may have the option to finance the principal, takeover, tender, let the obligee perform, or deny liability. Under other Performance Bonds, the surety may just have the obligation to indemnify the obligee for its loss. Finally, some Performance Bonds are silent as to the surety's performance options or even the surety's right or obligation to perform.

Mike Stover and I are hearing more and more these days about surety losses on certain Performance Bonds quickly reaching a penal sum loss. Without assessing blame to anyone, we have been involved in some of them ourselves recently. For those reasons, the financing and takeover performance options that could result in surety losses exceeding the penal sum of the Performance Bond may be out of the question. Furthermore, if the obligee completes the performance of the work, the surety may just be writing a check to the obligee for the penal sum.

It is for that reason, among others, that Mike and I will address a number of issues about the surety's tendering of a completion contractor to the obligee, whether to actually complete the performance of the work or to attempt to mitigate the surety's eventual damages.

The Bond Default Manual, 4th Ed. (2015)[1] ("BDM4") has a whole chapter entitled *Tender*[2] that discusses the various issues involving the tender of a completion contractor to the obligee.[3] The *Tender* chapter suggests that a normal tender option situation usually revolves around a bonded contract that is pretty clean, with not much work done and little or no defective work performed by the principal. The *Tender* chapter covers such issues as:

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[1] BOND DEFAULT MANUAL (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht and J. Blake Wilcox eds.), Am. Bar Ass'n, 4th ed. (2015).
[2] *Tender*, Chapter 6 of BDM4, pages 455 to 481.
[3] *See also* the papers from the 2017 FSLC Spring Surety Program entitled "The Annotated Performance Bond."

1. The surety's right to tender under the Performance Bond;[4]
2. The advantages and disadvantages of tender;[5]
3. When tendering a completion contractor is appropriate;[6]
4. Negotiations with the obligee;[7] and
5. Other factors to consider and the critical issues to address in any tender.[8]

Mike and I can't duplicate the chapter's coverage and extent in 30 minutes. We will cover some of these issues and others based upon our own experiences, and will provide some comments and suggestions for a surety to use tendering a completion contractor in some unique situations to mitigate the surety's loss and damages.

II. DISCUSSION

A. <u>**The Surety's Right/Ability To Tender**</u> (Mike)

There is no statutory authority in the Miller Act that gives a surety the "right" to tender a completion contractor and to my knowledge there is no such right in any of the Little Miller Acts across the county. Nevertheless, tendering a completion contractor has always been a recognized performance option for sureties, albeit perhaps one of the more, less understood options by many obligees.[9] At its essence tendering a completion contractor is simply one of many methods for curing the principal's default by providing a replacement contractor and paying any cost differential. In many instances, the surety's "authority" for performing via a tender can be found in the language of the performance bond itself. For example, the AIA A312 (2010) performance bond provides at Section 5.3 that the surety may:

> Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and a contractor selected with the Owner's concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages as described in Section 7 in excess of the Balance of the Contract Price incurred by the Owner as a result of the Contractor Default;

AIA A-312 (2010 ed.).

Similar provisions permitting the surety to tender as its performance can be found in the AIA A311 Performance Bond, ConsensusDocs 260 (2011 ed.) Performance Bond at paragraph 2

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4 *Tender*, Chapter 6 of BDM4, pages 456 to 458.
5 *Tender*, Chapter 6 of BDM4, pages 458 to 461.
6 *Tender*, Chapter 6 of BDM4, pages 461 to 474.
7 *Tender*, Chapter 6 of BDM4, pages 474 to 477.
8 *Tender*, Chapter 6 of BDM4, pages 477 to 481.
9 *See* Granite Computer Leasing Corp. v. Travelers Indem. Co., 894 F.2d 547, 551 (2d Cir. 1990); Aetna Cas. & Sur. Co. v. United States, 845 F.2d 971 (Fed. Cir. 1988); United States v. Seaboard Sur. Co., 817 F.2d 956, 959 (2d Cir. 1987).

(b); EJCDC form C-610 (2013 ed.) Performance Bond at paragraph 5.3.[10] Courts have held that denying a surety its right under the AIA bond form generally to utilize the tender option or other options in the bond can discharge the surety.[11]

In Federal contracting, the Performance Bond, Standard Form 25 under the Miller Act, does not reference any surety performance options. However, the fact that the Miller Act and Standard Form 25 are silent about a tender option does not mean that a tender is prohibited. On the contrary, the Federal Acquisition Regulations ("FAR"), Section 49.4053, states that after the default of the contractor, and if the surety is not willing to takeover, the contracting officer may arrange for the completion of the project by *any appropriate contracting method or procedure*. Which clearly gives the contracting officer sufficient authority to agree to a tender as the surety's performance. While there is not a lot of case law regarding tender in federal contracting, there are a handful of cases where the court has at least recognized the surety's and the government's tender arrangements.[12]

While the tender option may be specifically addressed in a bond form, the option in those forms also typically requires some form of obligee consent. This can make matters somewhat more challenging, because often, the obligee representatives are not familiar with the tender concept. This means that the surety will be required to do a good job of educating the obligee representatives of the merits and benefits of tendering. The authors of the Tender chapter in the BDM4 have done a good job of laying out the benefits of choosing the tender option and you can refer to that discussion when you are trying to convince an obligee of the merits of a tender. The authors observed that "tender agreements with obligees are generally the product of skillful negotiation and thoughtful analysis."

B. <u>Specific Issues In The Tender Process</u>

As with any of the surety's performance options, before the surety goes down the "tender road" with an obligee after a principal's termination, the surety must obtain some critical information concerning the bonded contract such as: the remaining scope of work, the status of the bonded contract funds, and the time of completion.

1. <u>"Time of Completion"</u>

The time of completion can often be a point of contention and will need to be negotiated and addressed in any Tender Agreement. Typically, the completion contractor will provide an estimate of time that it believes it will take to complete the remaining scope of work and that will

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10 *Nat'l Fire Ins. Co. of Hartford v. Fortune Constr. Co.*, 320 F.3d 1260 (11th Cir. 2003) (holding that the language of an AIA A311-based subcontractor bond was broad enough to include a tender option).

11 *St. Paul Fire & Marine Ins. Co.* v. *City of Green River, Wyo.*, 6 F. App'x 828, 829 (10th Cir. 2001)(the court held that the surety was discharged under its bond when the obligee prohibited the surety from exercising its contractual right to perform or to participate in the selection of the completion contractor.); *see also St. Paul Fire & Marine Ins. Co. v. VDE Corp.*, 603 F. 3d 119, 123–125 (1st Cir. 2010).

12 *Hanover Ins. Co. v. U.S.*, 116 Fed. Ct. 303, 305 (2014); *Wagner v. U.S.*, 71 Fed. Cl. 355, 358 (2006); *Aptus Co. v. U.S.*, No. 05-106C, 2005 WL 6112638 at *1 (Fed. Ct. June 27, 2005); *Appeals of L&M Thomas Concrete Co., Inc.*, ASBCA No. 49198, 98-1 B.C.A. (CCH) ¶29560 (Feb. 2, 1998); *Exec. Const., Inc.*, GSBCA No. 15224, 00-2 B.C.A. (CCH) ¶30977 (June 9, 2000).

be used as the new completion date in the Tender Agreement. Usually, the new completion date will be further out than the original scheduled completion date. This delta can give rise to a potential claim for liquidated damages. In addition, in some cases, the principal may have been behind schedule at the time of the default and LD's may have already been incurred when the surety gets on the scene.

Many times the obligee will readily agree to waive liquidated damages or other delay costs in exchange for the surety's agreement to tender. Other times, LD's can become a sticking point that must be negotiated. In some instances, the obligee will say things like they "don't have the authority to waive LD's" or they "will need to go to a higher authority to get LD's waived." The surety's response that often works the best is to point out that LD's don't need to be waived; all the obligee needs to do is grant a non-compensatory time extension. A time extension will have the effect of erasing the "delay" and any LD's associated with it. Most obligees have the authority at the project level to adjust the schedule and recognize "excusable" delay. If there needs to be a fight over LD's, I recommend that you check out our prior Surety Today episode on Liquidated Damages, which was presented on August 13, 2018, for a discussion of the various defenses that can be asserted to eliminate or mitigate LD's.

2. <u>"Remaining Contract Funds"</u>

Typically, the principal will have performed some portion of the underlying contract and will have been paid some portion of the contract funds prior to its termination. Accordingly, in the tender process the surety will need to determine what the remaining contract funds are for the project. The amount of remaining funds are critical, because that amount is ultimately used to determine the excess costs of completion and the amount the surety will have to pay as part of the tender.

The contract balance is generally a function of calculating the present amount of the contract (the original contract price plus or minus the value of any approved change orders or modifications), less the obligee's payments already made to the principal. You would think that determining the remaining contract balance would be simple and straight forward, but sometimes, especially when dealing with a general contractor as the obligee, it can become an issue. For example, the obligee may claim deductions from the contract balance for backcharges, supplementation, the ubiquitous "clean up" charges, deductive or unilateral change orders, etc. On the other hand, the principal may be contending that it has extra work, unapproved change orders or claims that should be part of the contract balance. These issues will all need to be sorted out in the negotiation process to determine the amount of remaining funds. I had a case recently, where we were getting ready to sign an Agreement with an obligee when the obligee added a provision regarding some water damage sustained. No information had been provided on these alleged damages. Ultimately, the obligee provided information on $250,000 in alleged damages, which was more than the remaining contract funds. Obviously, that brought the process to a grinding halt while we investigated these alleged damages.

3. <u>"Scope of Work"</u>

Determining the remaining scope of work is essential in the tender process. The obligee, the surety, the surety's consultant and the eventual completion contractor may encounter the most disputes surrounding this issue. I will address the scope of work issue from the obligee and surety perspective, and George will later address this issue from the surety and completion contractor perspective.

Because the surety will be seeking a release from the obligee of any further obligations under the Performance Bond as part of the tender process, the obligee will want to know that ALL of the remaining scope of work under the contract will be performed. From the obligee's perspective this is where the risk in a tender arrangement resides. To examine what the remaining scope of work is, we will analyze it in four broad "buckets."

(a) <u>First Bucket</u> - The remaining unperformed work that is described in the underlying contract, including the approved submittals, addenda, and approved change orders and modifications. In its analysis, the surety should attempt to have the obligee affirm that the work performed to date has met the contract requirements, or if there are any known issues to specifically identify those issues. We just had a project where the principal had been on the job for over a year and over half of the contract funds had been paid out. We assembled a bunch of potential completion contractors and we went to the project site with a representative of the obligee to view the site and when one of the prospective bidders asked what percentage of the work had been approved, the obligee representative said "none." After that, many of the bidders refused to bid and others inflated their bids. That necessitated a lengthy letter from me to the obligee advising among other things that if over half of the contract funds had been paid out and none of the work was approved, the obligee had seriously overpaid and impaired the surety's rights. Subsequently, the obligee approved the majority of the work and we got new bids.

(b) <u>Second Bucket</u> - Patently defective work of the principal that must be corrected by any completion contractor. This work will be part of the remaining work to be performed, regardless of whether the obligee has already paid for that poorly performed work.

(c) <u>Third Bucket</u> - Latent defective work performed by the principal – unknown at the time of the principal's termination and during the negotiations between the obligee and the surety. Because by definition latent defects are "unknown" this category can provide the most concern to an obligee, particularly in light of the release to be given to the surety as part of the Tender Agreement. There are a number of ways to address this issue. First, as George will discuss, it can be handled through agreement with the completion contractor. Second, the surety and obligee can negotiate a set price for the risk to be paid as part of the tender. Third, the surety and obligee can carve the latent defects out of the release in the Tender Agreement and add provisions to the Agreement to address latent defects as they arise post-Tender.

(d) <u>Fourth Bucket</u> - Warranty work that may subsequently have to be performed within the bonded contract's warranty periods.

The scope of work issues can be a complicating factor in any tender and is one of the reasons why many "experts" contend that the tender option is not suited for projects where the work has progressed too far along and there are many unknowns. Nevertheless, there are a number of reasons that we will discuss today why a tender may work to mitigate the surety's loss notwithstanding the high percentage of completion of the work when the principal is terminated.

C. <u>Potential Obligee Impediment To A Tender</u>

One of the more common potential "obligee impediments" that sureties may encounter when tendering to a governmental obligee is the misbelief that the obligee must comply with public competitive bidding requirements before it can execute a direct contract with the completion contractor tendered to it by the surety. The surety's response to this impediment is that the contract was already publicly bid out once and awarded to the surety's now terminated principal; the surety is paying the price increase difference due to the completion contractor's price, and the public owner does not shell out any additional public funds. Further, under general suretyship law sureties are afforded the opportunity to perform under the performance bond and tendering is constitutes that performance and it is therefore not a new procurement and not subject to the competitive bidding requirements. Finally, even public owners have an obligation to mitigate damages and accepting the tender in most circumstances would be considered mitigation of damages.

Arguments such as this leads to one of the fundamental requirements when considering a tender option – always be upfront with the obligee right from the beginning that the surety is considering a tender of a completion contractor. This includes explaining exactly what a tender is, the documents involved, and what the surety is looking for in a tender, including a release of its Performance Bond. Be sure that the decision makers, not just the obligee's field people, understand what a tender is and how it works, and confirm this in writing. Getting the issues out in the open up front can help to avoid a lot of lost time and lost expenditures. It can also serve to flush out a lot of other issues in a timely fashion that will give the parties more time to address them and find solutions.

D. <u>Completion Contractor Considerations In A Tender</u> (George)

1. <u>Bidding And/Or Negotiating The Scope Of Work Issues</u>.

While the obligee's main concern is to have the tendered completion contractor timely perform and complete the remaining scope of work on the project, the completion contractor has two main concerns – first, defining the scope of work to be performed in order to then, second, price that work for its bid to the surety and/or negotiation of a contract with the obligee. The completion contractor can't price the work or determine its time of completion until it knows the scope of work to be performed.

Just as the obligee wants to have all of the work required in the original contract with the principal performed and completed, the completion contractor, who will be contracting with the obligee to do that scope of work, will want to know what that work is so it can be quantified and agreed to as it relates directly to both the completion contractor's price to do the work and the time of completion of the work. The factors of scope of work, price and time are interrelated, but an accurate definition of the scope of the work is the critical starting point.[13]

If there is sufficient time, the usual process for obtaining a completion contractor is to bid the work using a full bid package, or Invitation to Bid, that provides the bidders with all of the information and documentation they need – the original contract, plans, specifications, addenda to the contract, approved submittals, any obligee responses to requests for information, and other documentation – to bid the project as it now stands, partially completed by the principal. Even if the project is not bid out, but negotiated instead among the surety, the obligee and the completion contractor, the same information and documentation is required.

The completion contractor has to look at the same four buckets of work to perform that Mike has listed as part of the obligee's concerns. Identifying and completing the unperformed work that remains after the principal is terminated from the project is one thing – it may be complex, but it can be accomplished. The same is true for any known patently defective work of the principal that can be readily ascertained for purposes of correction and pricing.

What is much more difficult for the completion contractor to determine is possible latent defective work – the electrical outlets are in place, the drywall has been installed, but the wires to the electrical outlets have not been pulled and attached. There are hundreds of such examples of work not done or defectively performed that is hidden behind walls, under floors, in ceilings and unknown to anyone – the obligee, the surety and the completion contractor. In addition, there may be warranty problems for work performed or equipment installed that later fails to work during the warranty period.

If the surety receives multiple bids, it can compare how each bidder addresses each of the four buckets of work. Hopefully, for the first two buckets, the bid spreads for the unperformed work and the correction of the patently defective work will be pretty close. The gaps will be in the "premium pricing" charged for the unknowns – the second two buckets for correction of any latent defective work and subsequent warranty work. While the surety's goal in any tender is to write one check and get a release from any further liability under the Performance Bond, if the cost of buying out the unknowns is too high, the surety may have to switch gears.

For the unknowns – latent defects and warranty issues – the surety may consider having an agreed price list for "time and materials plus a percentage fee," or T&M Work, for the completion contractor to perform any such corrective work rather than for the surety to pay a large premium fee that may just become a windfall to the completion contractor. The surety would need to get notice of any obligee demands, have its consultant confirm the existence of the latent defective work or necessary warranty work, and then quantify and mitigate the surety's loss as a result. That would increase the surety's exposure due to the additional cost of the T&M Work and the expense of having its consultant remain on the project. The surety needs to make its best guess and use its "crystal ball" of experience when picking the best poison – a high "premium price" or a potentially never-ending T&M Work scenario to pay for the "unknowns."

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[13] *See, The Surety's Relationship with the Completion Contractor*, Chapter 9 of BDM4, pages 543 to 562, for a discussion of the many issues that a surety and a completion contractor, whether under a tender or takeover arrangement, may need to address in any negotiations and agreements.

There remains the issue of the time of completion and the costs of delay. If there are liquidated damages, many sureties require its bidders to provide a proposed new completion date and extend the delay, day by day, from the original completion date to the new completion date. That calculation will provide a cost number for delay to be added to the bid (the original completion date to the new completion date comes in at a delay of X days times $Y in liquidated damages per day, which equals "many dollars" in liquidated damages that will be added to the bid). There are two factors which may change this worst case scenario: (a) legitimate time extensions due to the principal; and (b) what the surety may negotiate with the obligee for either compensatory or non-compensatory time extensions as will be discussed later.

2. Lock In The Bid For A Specific Amount Of Time In Writing (45 To 60 Days).

Once the surety has its deal with the proposed completion contractor that the surety intends to tender to the obligee, the surety needs to "lock in" the completion contractor's bid and agreement to be the tendered completion contractor. The completion contractor must be bound in writing to its deal with the surety for at least 45 to 60 days that it will remain the tendered completion contractor to the obligee. The surety can't afford to be "loosey-goosey" on this. The timing of the tender negotiations and drafting of the tender agreement between the surety and the obligee can take time.

Having the completion contractor waffle at the last minute and make additional money demands and changes to the scope of work AFTER the surety has tendered the completion contractor to the obligee at a specific price has happened to Mike and me before, and the surety needs to have the written confirmation of the existing bid and "deal" from the completion contractor. We have not been required, yet, to try and enforce such a "deal."

Some surety clients have another method of protecting against this problem, at least to reduce its potential loss, which Mike will discuss next.

3. Use Of A Bid Bond To The Surety. (Mike)

One consultant I recently worked with when we were tendering several projects had a policy of always requiring the prospective bidders in the rebid process to provide bid bonds. I thought that was a good policy because it requires the bidders to be more serious about their bids and protects the investment in time and money that the surety has made in conducting the rebidding process. True there is an extra cost for the bidders, but the premiums for bid bonds are fairly nominal and most bidders who bid on government projects are familiar with bid bonds and are used to providing them with their bids for governmental work.

Of course, as everyone knows, a typical bid bond guarantees that if the bidder is the successful bidder, it will enter into a contract with the Obligee and will provide the required payment and performance bonds. The penal sum on a bid bond is typically expressed as a percentage, such as 5% or 10% of the bid amount. The bid bond surety's maximum liability is the penal sum on the bid bond. There are two general types of bid bonds generally speaking – "Forfeiture" and "Damages." In a "forfeiture" bid bond the surety forfeits or pays the penal sum on the bid bond whenever liability is established regardless of the amount of actual damages or whether the obligee has incurred any damages at all.

Coincidentally, on one of the tender projects where we required a bid bond, the selected completion contractor got into a dispute with the obligee and was refusing to enter into a completion contract with the obligee. Because of the bid bond, we were able to apply pressure on the completion contractor and got the issue resolved. For a further discussion of Bid Bonds in general, I recommend our Surety Today presentation on May 8, 2017 on that topic.

E. **Mitigation Of The Surety's Damages**. (George)

1. **The Surety's Cards To Play**.

Our last discussion is about the surety's ability to mitigate its damages. At the time of any default and termination situation resulting in an obligee's claim against the Performance Bond, the dollar numbers involved may be hard numbers, soft numbers, or somewhere in between. For example:

a. One would think that the balance of the original contract price would be a hard number, but there may be pending and unapproved change orders, claims and other disputes that could increase or decrease the contract balance at the time of the principal's default and termination.

b. Similarly, the time of completion may be established in the original contract and any extensions of time granted during the principal's performance of the work, but the actual completion date and the compensation associated with any claims for time extensions may be in dispute.

These issues and disputes, and others in the gray area, may give the surety some cards to play in negotiating with the obligee. For example, the surety may have some defenses to the obligee's claims, such as the obligee's overpayment of the principal, the obligee's failure to follow or comply with the contract provisions with the principal or the Performance Bond provisions with the surety, and others. Furthermore, the surety may have some of the principal's defenses, such as the obligee's failure to timely pay or perform under the contract provisions, the obligee's delays, and the wrongful termination of the principal. Finally, the obligee may be asserting liquidated and other delay damages to which the surety and/or the principal dispute.

Assuming that the scope of work and the contract balance issues have been resolved between the surety and the obligee, the next issue is the damages, if any, that may be assessed and defended against for the inevitable delay in the performance of the work. The obligee may be adamant about the costs of delay, and the surety may not want to expend the costs of proving that the principal is entitled to compensated additional time. As one goal, the surety would like to negotiate a time extension with the obligee up to the completion contractor's proposed new completion date, even if it is a non-compensatory time extension. Any delays thereafter would be the fault of the completion contractor for which the surety would not be responsible. Any time extension has some dollar value in mitigating the surety's loss.

One method for the surety to get to this point, and in resolving other disputes that the principal and/or the surety may have with the obligee, is for the surety to obtain what it wants in return for resolving ALL of the principal's affirmative claims against the obligee and agreeing that the surety won't attempt to assert those claims. The principal is obviously in default under the Indemnity Agreement – including the default and termination under the bonded contract and any collateral demands made by the surety that the principal and the indemnitors ignore – and this default can give the surety the right to settle and release the principal's affirmative claims against the obligee and bring some peace between those parties.

Note: ***After the presentation, Larry Jortner of CNA Surety asked a question to which we and he made comments, and the points Larry made are important to add to this written transcript. This is being done with his revisions and permission.***

Notwithstanding the surety's ability to settle and release the principal's affirmative claims against the obligee, the principal may still be viable and want to assert its affirmative claims against the obligee, such as a claims for additional compensation, time and/or for wrongful termination. The surety would like the benefit of any successful principal affirmative claims against the obligee, including wrongful termination, despite the surety's tender of a completion contractor to the obligee, while still protecting the surety against any delay damages, including liquidated damages, being assessed by the obligee. Further, the obligee may want to make claims against the principal and recover damages even if it has resolved its claims against the surety's Performance Bond under the Tender Agreement signed by the parties.

For example, under the Tender Agreement, the surety may agree with the obligee that the surety will not assert the principal's claims against the obligee in return for the obligee's granting of time extensions to the surety *for purposes of the payment of the contract balance to the surety only*. This has the effect of giving the surety the full benefit of a time extension for the payment of the contract balance; however, this still allows the obligee to assert against the principal, without reduction, the obligee's liquidated damages that could have been asserted and otherwise recovered against the surety under the Performance Bond. Those liquidated damages would remain as both an obligee offense against the principal for damages and a defense against the principal's affirmative claims, either to reduce the principal's recoveries if the principal succeeds or to provide a monetary recovery benefit to the obligee against the principal. The surety would obtain what it wants – a time extension to avoid, in whole or in part, either the reduction of the contract balance under the Tender Agreement or the surety's liability under the Performance Bond for the assessed liquidated damages.

However, the surety must protect itself if the principal succeeds and establishes a monetary claim and right against the obligee. The surety has paid a price to tender the completion contractor to the obligee. The surety must be able to collect any recovery that would otherwise be due from the obligee to the principal to reduce or eliminate the surety's loss. If the obligee was at fault and becomes liable to the principal for damages, it must be required to pay those damages to the surety up to an amount that fully reimburses the surety for its loss prior to the obligee making any payment to the principal.

2. **<u>Subcontractor Principal To General Contractor Obligee</u>**.

Tender may be used in other ways, such as for defaulted subcontractor principals. Mike and I, as a "semi-firm rule," advise our surety clients NEVER to take over under a Performance Bond[14] with large general contractor obligees, and you all know who they are, when there are four or less months to go to completion for its subcontractor principal's performance of the work. Why is that? When the surety takes over, the completion contractor is performing and billing the surety, payment applications are being submitted by the surety to the obligee, and it takes up to three months for the surety to determine that the general contractor obligee has no intention of ever paying the surety any of the contract balance. The surety is legally obligated to pay the completion contractor, and may have to fight with the general contractor obligee to get a dime of the contract balance.

Instead, we suggest that the surety request that the general contractor obligee promptly solicit prices to complete the work from its favorite and appropriate subcontractors (electrical, mechanical, roofing, etc.) and provide those prices to the surety. If cost to complete appears to be reasonable, the surety "tenders" that favorite completion subcontractor to the general contractor obligee with a check for the excess completion costs. The surety can frequently get a release at the same time. When the general contractor obligee pays the tendered subcontractor, it does so with a combination of the contract balance and the surety's payment. Even if the surety has to hang around for a while due to the correction of the principal's potential latent defective work, the surety is still getting the benefit of the general contractor obligee's use of the contract balance to pay for the completion of the work.

That is a lot better than the surety having to pay the takeover completion subcontractor directly and never getting reimbursement of at least a part of the loss from the contract balance.

3. **<u>Tendering A Completion Contractor To An Obligee Who Won't Accept A Tender</u>**

There is one other mitigation strategy, namely tendering a completion contractor to an obligee that won't accept a tender. Remember, the thought of a surety financing its principal or taking over a bonded project, each of which may have costs exceeding the penal sum, may be too much for the surety to stomach, and those options may not be available. If the financing and takeover options are too dangerous and the outright denial of the obligee's Performance Bond claim is also not legally feasible or justifiable, then the surety may have just two options: (a) let the obligee complete and write a check; or (b) propose a tender. If the surety obtains pricing for the performance of the remaining scope of work, and the obligee rejects a tender, the surety may consider tendering the completion contractor anyway to the obligee along with a good faith payment in the appropriate amount in order to try and mitigate the surety's damages. This is much like the AIA A-312 (2010) Performance Bond option, paragraph 5.4.1, where the surety

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[14] The same "semi-firm rule" may also apply to financing the subcontractor principal in the same situation. This is a complex discussion that is beyond the scope of this written presentation. The issue is the same, however – will the surety receive payment of the contract balance from the general contractor obligee. This answer is a "definite maybe" and a very possible "no."

determines what it may owe to the obligee and makes a payment to the obligee in that amount. This time, the amount of the payment would be determined by a firm price from a willing completion contractor ready to perform the work.

If the surety has done its job and has a completion contractor to tender to the obligee at a fixed price, it may later have a defense of mitigation of damages if the eventual obligee claim exceeds the surety's tender offer. Even if the surety does not request a release for the tender and its payment, it is a sign of good faith – and it is probably in an amount that the surety would owe anyway at some point. If the surety does not obtain a release, the surety should, however, demand that the obligee keep detailed records of its correction of any patent or latent defective work and warranty work that makes up its later claim, including a demand for specific record keeping, photos of defective and corrective work, accounting of the use of the tendered funds, and other protections to make sure that the surety's check gets used for the particular bonded contract. The surety will have no basis to defend against the obligee's additional claims if it does not demand proof of why additional claims are valid, or not.

Will this work to mitigate the surety's loss? It may, especially if the original bonded contract was to build a Ford and the obligee ends up building a Cadillac, or the amount of the alleged corrective work reveals overpayment of the principal for deficiently performed work, or other surety defenses. Such a strategy may at least get the obligee to be more honest going down the road.