

**OWNER'S CHECKLIST ISSUES FOR  
PERFORMANCE AND PAYMENT BONDS**

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Division 12: Owners and Lenders

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1. Is the Owner timely requiring bonds or has construction commenced?

*Surety underwriting standards typically prohibit the surety from bonding a contract once construction commences. Performance and payment bonds, while separate instruments, are ordinarily issued together for one premium. However, each must be viewed separate from the other.*

2. Has the Owner considered requiring bid bonds on projects utilizing competitive bidding to ensure the Contractor will be able to bond the project if it is awarded?

*Failing to ensure the Contractor who is awarded the contract can satisfy the bonding requirements could derail a project from the beginning. By obtaining a bid bond, the Owner receives assurance the Contractor will be able to complete the contract.*

3. Are the Owner, Contractor and Surety identified by the full legal names and addresses and the legal status of the parties? Is the lender requiring dual-obligee bonds and requires the rider so that it becomes a party to the bonds?

4. Is the Construction Contract described by date and amount with the official name and location of the Project?

5. Should the bond be for the full amount of the contract price?

- a. *Premiums for payment and performance bonds are typically based upon the amount of the contract, not the amount of the bond. Thus, it is generally advisable for the Owner to require the bond for the full value of the contract. Nevertheless, if the Owner desires to work with a Contractor who cannot obtain the bond on the full contract amount (e.g., aggregate limit is exhausted), the Owner should consider purchasing materials itself and issuing a labor only contract. Depending upon the project economics (scope, amount at risk, owner capital), this Contractor may not be the best one for the job. The fact that the Contractor cannot be bonded or does not have adequate bonding capacity should be a reason to inquire further about the Contractor's financial and project management (i.e., whether it pays the subcontractors timely)*

- b. *While most states prohibit prospective lien waivers, some prevent liens from being recorded against the project if the Owner or Contractor provides a payment bond for the full value of the contract and records the bond in the public records. In the event the bond is not for the full contract amount, an Owner leaves the project open to lien claims.*

6. Is the amount of each bond both spelled out and indicated numerically?
7. Are the bonds fully executed by the Contractor and the Surety? Is the Surety's original power of attorney attached?
8. If the payment bond is a "conditional payment bond," does it comply with the bonded contract terms (*i.e.*, does the bonded contract allow the Contractor to provide a conditional payment bond or has the Contractor breached the contract by providing a conditional payment bond?)
9. Does the conditional payment bond comply with state law, if any (e.g., Florida)?
  - a. *Does the bonded contract contain payment provisions which do not require the Contractor to pay its subcontractors until the Owner pays the Contractor?*
  - b. *Although a conditional payment bond provides few, if any, benefits to an Owner, ensure the bond/contract comply with all statutory requirements. The failure to comply with these requirements opens the project up to liens and disputes of coverage between the Contractor and Surety;*
10. Has the Owner considered how federal, state, or local laws affect the validity of the bond?
11. In states where the Surety has right of equitable subrogation, does the bonded contract contain a waiver of subrogation in the Owner's favor to prevent the Surety from filing a construction, or mechanics' and materialmen's lien as an assignment of the claim?
12. Is the project a Public-Private Partnership? If so, should the contract or payment bond form preclude the Surety from asserting common rights and defenses under form bonds like the AIA A312 (e.g., preventing the Surety from exercising its rights until the Owner is fully compensated)?

*On a Public-Private Partnership, a Contractor default not only affects construction of the project, but the relationship between the Owner and the Contractor after construction. To ensure efficient completion of the contract, consider prohibiting the Surety from stepping into the shoes of the defaulting Contractor until after the Owner is fully compensated for any losses and the project is completed.*

13. Should the bond be modified to prevent an Owner's default under the bonded contract from nullifying or delaying the Surety's obligations?

*Many bond forms contain a provision that states "IF there is no Owner default under the bonded contract, the Surety obligations to the Owner shall arise after the Owner has promptly notified the Surety . . ." This provision could allow the Surety to escape its obligations under the bond. What if the Contractor were responsible for the first material breach of the contract followed by a subsequent breach by the Owner? Contractually, the Owner would be able to obtain relief against the Contractor; however, provisions like that above could allow the Surety to escape its obligations.*

14. Should the Owner include expedited alternative dispute resolution to resolve any coverage disputes?

*As indicated above, an Owner default could prohibit the Owner from obtaining relief against a Surety. Moreover, what if a Surety later challenges the Owner's declaration of default as a nullity? To address these questions, among others, consider including an expedited alternative dispute resolution procedure to address these questions at the beginning. If the Owner is adjudged to have declared a default where none existed, the Owner could provide itself a "safe harbor."*

15. Should the bond include language waiving the Surety's right to seek consequential damages if it takes over construction (e.g., Owner delay/impact damages)? Is such a bond provision necessary if the contract contains a waiver of consequential damages? (NOTE: Owners are not well advised to waive consequential damages as under the AIA 2007 documents).

*When Owners utilize form AIA Contract Documents, they frequently include a waiver of consequential damages. Where a Surety takes over construction, consider including a similar waiver of consequential damages to preclude impact/delay damages.*

16. Should the Owner insist on a specific time frame in which the Surety must decide whether to arrange for a replacement contractor, take over construction or make payment to the Owner?

*Performance bonds require the Surety to take action promptly, but do not define a specific time period in which to actually decide. Consider inserting a specific time requirement in which the Surety must take action to ensure delays associated with a Contractor default are kept to a minimum.*

17. Should the Owner delete the requirement that the Contractor actually be in default?

a. *A breach under the construction contract does not necessarily equate to a default under a performance bond. Consider exchanging the word "default" for the words "breach of the construction contract." Doing so will allow the Owner to insist upon the Surety's performance for a breach that is considered material to the Owner but one the Surety may not necessarily consider a default.*

b. *See also, 19a.*

18. Should the Owner modify the default language with an option that the Contractor was terminated in accordance with the contract (allowing a termination for a breach), instead of a default and a declaration of a default?

*As indicated above, a Contractor may be in breach of the construction contract, which may not trigger the bond provisions.. Consider including a provision that requires the Surety to act when the Contractor is terminated in accordance with the construction contract. This could eliminate the requirement that the Owner provide notice of its intent to declare the Contractor in default and actually declare the Contractor in default, as well as the question of whether the Contractor was actually in default.*

19. Regarding the penal sum of the bond, should the Owner add language that does not allow for a reduction in the penal sum, regardless of whether there is a deductive change order?

*As indicated above, premiums for performance and payment bonds are often calculated based upon the contract amount, not the bond amount. Generally, the Surety will adjust the cost for the bond based upon the final contract amount. However, where there is a Contractor default, it may be advantageous for the Owner to include a provision that allows for an increase in the bond amount due to change orders, but to eliminate a reduction in the bond amount for deductive change orders. In this manner, the Owner will receive the benefit of any increases without losing coverage for deductive change orders if the Surety decides to pay the penal sum of the bond.*

20. Did the Owner consider including a provision that removes the monetary cap if the Surety fails to timely act?

*Many performance bond forms require the Surety to “promptly” take action to remedy a Contractor default, whether it is the payment of the penal sum or arranging to take over the project. However, “promptly” is not a defined term. Consider including a provision that removes the monetary cap for the penal sum. Doing so will encourage the Surety to take action quickly and also shift any increase in the cost of construction from the Owner to the Surety. However, be advised that if the Surety moves to pay the penal sum of the bond, as opposed to taking over construction, the Owner will likely not be reimbursed until the conclusion of the project.*

21. Should the Owner limit the Surety’s options to complete the contract and instead include a provision that, instead, requires the Surety to pay the full penal sum of the bond?

*A Surety typically has several options to consider to allow it to satisfy its obligations under a performance bond. If the Owner is satisfied its personnel can complete the project, or believes it can obtain a replacement contractor for a value, consider requiring the Surety to pay the full penal sum instead of completing construction. Requiring the full penal sum, as opposed to the penal sum less payments already made, will ensure sufficient funds to complete the project. However, because the Surety would likely argue to a court that such recovery results in a windfall to the Owner, an alternative is to require the Surety to pay the full penal sum sufficient to cover the costs to complete and any consequential damages resulting from the Contractor’s default. In any event, the Owner can expect that the Surety will require the Owner to pay any and all additional premium as the result of change orders increasing the contract amount.*

22. On a design-build project, should the Owner modify the bond to address liability for liability related to a faulty design?

*Design-build projects pose unique challenges in bonding. Is the Surety responsible for costs associated with re-designs? Although the Surety will face liability for any construction costs associated with a Contractor default during construction, it is important to protect the Owner from any increased costs associated with the re-design for faulty work of the Architect. In an effort to have these costs passed along to the Design-Build Entity, include language explicitly providing for design liability. Also,*

*examine the professional liability policy to confirm that it will cover what the Surety underwriters refuse to bond.*

23. On a design-build project, should the Owner modify the bond to eliminate a cap on liability for design errors or create an extended coverage period that corresponds with the applicable statute of repose?
- a. *On a design-build project, consider eliminating the cap on liability for design errors during construction. If there is a failure that must be redesigned and the contract is a cost-plus, it may be prudent to eliminate the cap on the penal sum. Confirm that the contract and the bond provisions are coordinated on this issue.*
  - b. *Moreover, consider extending the bond period to extend to the applicable statute of repose to ensure the project will continue to function as planned for at least as long as the Owner could seek damages from the Design-Build Entity.*