

The Importance of Reviewing and Complying with Performance Bonds

Written By **Ryal W. Tayloe** (rwt@wardandsmith.com) and
Luke C. Tompkins (lctompkins@wardandsmith.com)

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As we continue to cope with the economic impacts of the COVID-19 pandemic, it is important for participants in the construction industry to take affirmative actions to protect your investments in current and planned construction projects.

One of the ways owners and contractors can protect themselves is by ensuring that you understand how to enforce any performance bonds that you have required for your projects.

Performance bonds are intended to act as a guarantee that performance, as required by the relevant construction contract, will be completed. Generally, it is the owner of the construction project who requires its general contractor to acquire a performance bond as assurance and protection against default by the general contractor under the prime contract. It is also possible, and common on large projects, for a general contractor to require its subcontractors to obtain performance bonds. There are three parties to performance bonds in the construction context: the "obligee," which is the entity who is owed the contract performance and who is protected by the bond; the "contractor," who owes obligations to the obligee to complete its contract work in accordance with the contract requirements; and the "surety," generally an insurance company that engages in the practice of suretyship, that agrees in the case of contractor default to complete the work of the contractor, pay others to complete the work of the contractor, or pay the obligee the amount of the performance bond.

In North Carolina, performance bonds are mandatory on public projects that exceed \$300,000.00 in cost for a local governmental project, or which exceed \$500,000 in cost for a State department or agency project. Additionally, they are sometimes required by the owners of private commercial construction projects. In fact, due to the negative economic impact of the current coronavirus pandemic, we can expect the frequency with which performance bonds will be required on commercial construction projects to increase. Performance bonds are paired with payment bonds on government projects and are almost always paired with payment bonds on private projects. When paired together, these bonds are commonly referred to as "P&P" bonds. Payment bonds are distinguishable from performance bonds in that they are intended to protect lower-tier contractors from the threat of non-payment by the general contractor or the contractor above them in the construction chain. This article focuses on performance bonds, but a future Ward and Smith article will cover payment bonds.

Critically, while a performance bond is intended to guarantee contract performance in accordance with contract terms, it can be rendered void and useless if the obligee fails to comply with any requirements contained in the bond. Thus, it is critical for construction project owners and general contractors to read your performance bonds carefully to ensure that you do not take actions (or fail to take actions), which might negate your rights and protections under your bonds.

Performance bonds are treated and interpreted as contracts and can be breached and enforced like contracts. If there is a contractor default, the terms of the bond will lay out any actions that are required of the obligee before the surety's obligations to correct the contractor's default arise. Additionally, the terms of the bond set out the surety's liability and provide the actions it may take in responding to a contractor default.

Notably, many performance bonds contain provisions that require the obligee to provide the surety with notice of the contractor's default before the surety's obligations to cure the contractor's default under the bond arise. As an example, the form AIA 312-2010 performance bond requires the obligee to do at least the following before the surety's obligations under the bond arise: (1) declare the contractor in default, terminate the contract, and notify the surety that such actions have been taken; and (2) to agree to pay the balance of the contract price in accordance with the contract terms to the surety or to a replacement contractor the surety selects. In some instances, the surety must also provide the contractor and the surety notice when it is considering declaring the contractor to be in default, in which case the surety can request a conference with all parties to the bond in an effort to reach a resolution which allows the contractor to correct and continue its performance of the contract. Only after complying with these notice requirements, does the surety's obligations under that performance bond arise. Upon receipt of proper notice in conformance with the terms of the bond, the surety's obligations become due, and it can elect one of multiple courses of action to correct the contractor's default. The surety can either:

- a. attempt (with the consent of the obligee) to arrange for the original contractor to cure the default;
- b. undertake to complete the contract work itself;
- c. obtain bids or negotiate proposals from qualified contractors to complete the contract work;
- d. waive its right to complete or arrange for completion of the work and agree to pay the obligee the costs it incurs to complete; or
- e. deny liability and state the basis for denial.

If the surety fails to perform its obligations in a reasonable time, the form AIA 312-2010 performance bond requires the obligee to provide additional notice to the surety demanding that the surety perform its obligations under the performance bond before the surety will be deemed to be in default with respect to the surety's obligations under the bond. While not all performance bonds are as demanding of the obligee as the AIA 312-2010, it provides a good example of requirements that might be contained in your bond, which, if not complied with, could result in a loss of your rights under the bond.

North Carolina case law does not directly address the consequences of an obligee failing to provide notice as required by a performance bond, but numerous cases from the federal courts and other state jurisdictions have made clear that such a failure constitutes a material breach of the performance bond and excuses the surety from its obligations under the bond. This is because the purpose of the notice of default requirement is to provide the surety an opportunity to protect itself against loss by participating in the process of selecting a successor contractor and ensuring that the costs of fixing the original contractor's default can be mitigated as much as possible. Where notice of default is not provided to the surety, it is deprived of its mitigation rights and suffers injury. Thus, where the obligee takes action by hiring a replacement contractor or otherwise fixes the contractor's default before notifying the surety of the default and fails to provide the surety an opportunity

to mitigate the damage from the contractor's default itself, courts from other jurisdictions have concluded that the obligee has materially breached the performance bond and that the surety is excused from performing under the bond. It appears likely that North Carolina courts will adopt this reasoning if the issue arises. Therefore, if you fail to provide proper notice of default under your performance bond, you could lose the right to enforce the bond and the valuable protections that it provides.

As the above demonstrates, performance bonds are very different from payment bonds. The surety is not guaranteeing that it will cover the costs of contractor default but is instead only guaranteeing to perform its obligations in accordance with the terms of the bond. The very nature of a performance bond is that the surety does nothing on the vast majority of projects. When the surety does have to act, it is entitled to protect itself by receiving prompt notice and an opportunity to cure the default if the bond so requires. If the bond provides multiple options for how the surety can correct the contractor default, the surety is entitled to exercise its right to select the option which is most advantageous to it. The obligee should be aware of the surety's rights and should avoid interfering or injuring the surety's rights under the bond.

In light of this, and as a precaution, it is a good idea to thoroughly review any performance bonds that contractors have supplied for your projects. An owner should thoroughly review the performance bond both at the beginning of the project, and at the first instance there is a concern about the contractor's performance. It is especially important to review your performance bond for a project if you are considering making the decision to terminate your contractor and to begin considering replacement contractors to hire in its place. The performance bond may require the owner to provide pre-default notice to the contractor and the surety or may require prompt notice of default and of the owner's decision to terminate the contractor. If the performance bond requires that the surety be provided notice before its duties to correct the contractor's default arise, then it is in the owner's best interest to provide the surety with such notice and to ensure the surety has the opportunity to be involved in the decision making process on how to fix the contractor's default. Critically, even if the owner's contract with the contractor gives it the right to terminate the contractor and to take steps to correct the contractor's default, taking such actions without first reading the performance bond could result in a material breach of the performance bond. Thus, it is imperative that you review your performance bond before taking curative actions.

To conclude, performance bonds offer a great way for owners and higher tier contractors to protect their expectations that those they contract with will perform their work as required by the contract, especially in these uncertain economic times. Thus, it is a worthwhile endeavor to review performance bonds carefully and to comply with any requirements in the bond to ensure you are able to enforce your bond rights if need be.

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