The Construction Contract Surety and Some Suretyship Defenses

T. Scott Leo
THE CONSTRUCTION CONTRACT SURETY AND SOME SURETYSHIP DEFENSES

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I. INTRODUCTION

This Article briefly examines some of the principles that serve to protect the surety's unique role in construction contracts. Instruments of suretyship can secure the obligation to perform any type of contract. A construction contract is perhaps the most distinct type of obligation sureties bond.¹

Construction contracts, negotiable instruments, and payment obligations such as notes are vastly different obligations. Arriving at rules that are consistent and take into account the economic realities of very different underlying obligations is one of the formidable challenges facing the drafters of the Restatement (Third) of Suretyship. The Restatement should define principles that govern both the surety securing a negotiable instrument or other obligation to pay and the surety securing performance of the construction contract. Economic or practical sense, however, should not fall sacrifice to the desire for consistency.

The underlying obligation secured by the surety bond may be subject to differing policy considerations. Negotiability has never been a policy fostered in the world of construction contracts. On

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¹. Endorsers and guarantors are described as sureties in the Restatement of Security § 28 cmts. g, k (1941). Such obligations are suretyship obligations as defined in § 1 of the Restatement (Third) of Suretyship § 1 cmts. c-d (Tent. Draft No. 1, 1992). One of the goals of this Article is to discuss the rules that ought to apply to construction contract sureties in light of the nature of the underlying obligation secured by the surety. The primary focus will be upon the obligations and rights of the performance-bond surety, sometimes called “contract surety” or “construction contract surety” with respect to construction contracts.

The Restatement of Suretyship uses the terms “principal obligor,” “secondary obligor,” and “obligee” or “creditor” in describing the parties to a suretyship obligation or instrument. Id. at xv. In this Article, I use the terms “principal,” “surety,” and “obligee” because they are used in surety practice.
the contrary, the expectation of the construction bond surety is that the contract will be performed by the contractor/principal for a particular obligee. Although construction contracts are assignable, as are other contracts, given the nature and risks of the tasks to be performed under a construction contract, a change in parties as a practical matter nearly always entails a change in the risk of the endeavor.

A note or negotiable instrument may involve a number of payments over an extended period of time, but unlike a negotiable instrument, a construction contract is an agreement to participate in a creative process. That process may take place over an extended period of time and involve a number of unique, nonuniform tasks. It may also require a certain level of expertise and experience and be subject to the strictures of the unique financing arrangements typical of construction.

A guaranty might relate to a discrete instrument or note setting forth the precise terms for payment. Although all drafters strive to define precisely the obligations in the written contract, a construction contract, unlike a promissory note, cannot succinctly define the obligations of the parties. In large measure, this is because of the nature of the obligations to be performed. Construction, like medicine, is not the precise science that laymen believe it to be. Rather, it is fraught with uncertainty. During the course of the performance of the construction contract, there may be numerous changes or change orders that will determine the scope of the tasks to be performed. Physical conditions, the interaction of trades, or modifications of design may cause these changes. A good construction manager brings together the skills of the business manager, social scientist, engineer, and politician. There is more artistry than science in blending these skills to achieve the desired result.

Unquestionably, even the simplest construction contract contemplates skill on the part of the contractor. Moreover, every project has initial start-up costs and learning curves that make any substitution of contractors an added expense. Furthermore, the failure of the contractor to perform nearly always involves additional, substantial transactional costs such as locating a substitute contractor, determining the scope of the remaining work, and entering into contracts to perform the remaining work. For these rea-
sons, as well as others, the success of the initial contractor is of crucial importance.

The construction process has sometimes been compared to warfare. Not only does construction require the mobilization of personnel and materials, but there often is antagonism among the parties on a project arising from their respective roles. The ideologies of the owner, general contractor, subcontractor, and architect are often different—and often at odds.

The focus of the antagonism among the parties naturally relates to payment. Who gets the money on the project? Construction financing is a highly specialized area of finance, with rules and procedures adapted to the risk and nature of the business.\(^2\) A simplistic view of how money flows on a construction project and the resultant attitudes of the parties might yield the following analysis: first, the owner hires an architect to determine the scope and design of the project, sets a budget in accordance with the plans, and then opens the project to competitive bidding—his goal is to achieve the best building for the least money;\(^3\) second, the general contractor who wants the job must submit the lowest bid—for it to make a profit, however, the general contractor must do the least work for the most money; third, in preparing its bid, the general contractor may have obtained bids from subcontractors for substantial portions of the work—the general contractor seeks the most work for the least money, while the subcontractor, like the general contractor, wants to do the least work for the most money. This process also affects the relationships among other players in the construction "food chain," such as suppliers and laborers.

The foregoing describes a fixed-price contract with a designed scope. There are many construction arrangements—design-build,\(^4\)

\(^2\) See Justin Sweet, Legal Aspects of Architecture, Engineering and the Construction Process §§ 12.01-04 (4th ed. 1989) (describing generally the financing complexities particular to construction, and how these problems are typically addressed by lenders in public and private projects).

\(^3\) This describes the traditional construction process, with separation of design and construction functions. Id. § 21.03, at 375-77.

\(^4\) In this arrangement, the designer is also primarily responsible for carrying out the construction, combining the duties of designer and prime contractor into one entity. See id. § 21.04(F), at 387-89.
engineer-procure-construct, and turnkey projects—that determine the scope of the contractor’s obligations. In addition, the parties on a project might utilize numerous contractual provisions to shift the risks on the project. For instance, the parties might attempt to place the risks of insolvency or nonpayment, design defects, or warranties on the parties lower in the chain.

The construction contract surety, through its bond, might agree to perform or pay the obligation of the contractors or subcontractors on a project. Even this simple description of the contract-formation process demonstrates the obvious utility of having a surety secure performance and payment obligations of the parties on the project. The risky nature of the enterprise creates the need for some guaranty that the construction job will be completed and paid for.

When the obligation secured by the surety is the performance of a construction contract, the full implications of the tripartite surety relationship emerge. If the creditor or obligee is a note-holder, it is fairly simple to determine whether there is an impairment of collateral or a modification of the underlying obligation giving rise to a suretyship defense. When the obligee is an owner administering a construction project, however, the obligee can take any number of actions that might interfere with or impair the principal's performance, making such determination more difficult. On a construction project, the obligee can commit innumerable actions that also interfere with the surety's options. Moreover, the surety looks to the prospect of its own performance of the underlying obligation as a means of reducing its risk or loss in the event the principal fails to perform. In contrast to an obligee, who has

5. In this arrangement, the designing professional organization oversees the work of the contractor(s) to promote efficiency and compliance with the design, but does not provide the construction services. This function, called construction management, may also be performed by a construction manager retained in addition to the design professional. Id. § 21.04(D), at 384-87.

6. Essentially a variation on a design-build contract, this arrangement provides one developer complete authority to design and build, with little or no oversight by the owner until the project is complete and turned over to the owner. Id. § 21.04(E), at 387.


8. See id. § 37.

9. In National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969), the court described the surety:
substantial duties to return performance under a construction contract, an obligee or creditor who is the holder of a note or other obligation to pay has no duties.

A discussion of some of the decisions addressing suretyship defenses in the context of construction contracts will reveal inconsistency on the part of the courts in recognizing these rights and uncertainty regarding the source of the substantive law. Although much of this uncertainty is a product of varied state law, additional uncertainty stems from the evolution of the underlying surety law. Most of the substantive principles that the courts struggle to apply to construction sureties evolved in connection with very different underlying obligations, such as negotiable instruments and guaranties of payment obligations. Articulating rules that treat all suretyship obligations consistently, while also recognizing the economic implications of the different underlying obligations bonded by sureties, is one of the challenges facing the drafters of the new Restatement of Suretyship.

II. CONTRACT SURETIES AND INSURANCE¹⁰

For the most part, insurance companies underwrite surety bonds in exchange for a premium. Unlike insurance policies, however, the bond forms are not drafted unilaterally by the surety or the surety industry. Many of the forms are created by the American Institute of Architects (AIA)¹¹ or promulgated by private or public owners,

This unique accumulation of subrogation rights serves to induce a function that is neither ordinary insurance nor ordinary financing. The business of a construction contract surety is not one of ordinary insurance, for the risk is not actuarially linked to premiums, nor is there a pooling of risks. . . . In this hermaphroditic situation, the "security" for the surety is not the fee but a compound of its confidence in the contractor and the opportunity to prevent or minimize its ultimate loss by its right to salvage the debacle by its own performance.

Id. at 845.

¹⁰ The discussion in this section is drawn largely from a work prepared by the author. See T. Scott Leo, Traditional Insurance Concepts and Surety Law, BRIEF, Spring 1992, at 52.

12. When the intent of the instrument is to provide indemnity coverage for particular types of losses, “bonds” are sometimes treated as insurance policies. The following discussion elaborates on the many instruments described as bonds.

Financial guaranty bond sureties agree to secure the obligation of a principal to pay the obligee or creditor.

Performance bonds secure obligations of the principal to the obligee to perform obligations other than the payment of money. Some bonds require the surety to complete the obligation upon default of the principal. As discussed above, many obligees prepare the bond forms that they require sureties to execute. Some private obligees require “completion bonds” providing that the surety’s only option is to complete the underlying obligation. In addition, courts have interpreted some public works statutes as requiring the surety to complete the obligation after the principal’s default. See, e.g., Coast Elec. Co. v. Industrial Indem. Co., 193 Cal. Rptr. 74, 75 (1983) (noting that a surety on a payment bond for a public works project, entered into pursuant to the California Civil Code, was obligated upon default by the contractor to pay all sums due plus reasonable attorney fees); see also Trane Co. v. Whitehurst-Lassen Constr. Co., 881 F.2d 996, 1005 (11th Cir. 1989) (holding, when faced with a suit against a surety after the contractor’s failure to perform, that “[t]he Miller Act, and the Alabama Public Works statute, place a sometimes heavy burden of care on general contractors and their sureties”). Other bonds, including the American Institute of Architects bond forms A311 and A312, see supra note 11, preserve certain options for the surety in curing the default of the principal. For example, the A312 bond form, which came into use in 1985, specifically reserves the surety’s option to do nothing and leave the completion of the obligation—usually a construction project—in the hands of the obligee. AMERICAN BAR ASS’N, BOND DEFAULT MANUAL 160 (Richard S. Wisner ed., 1987) [hereinafter BOND DEFAULT MANUAL]; see AIA DOCUMENT A312, supra note 11, ¶ 4.4.2, reprinted in SWEET, supra note 2, app. D at 831. The traditional options of the surety include: 1) takeover of the project by the surety; 2) tender of a new contractor by the surety; 3) financing of the principal’s completion of the work; or 4) payment of the amount required for completion of the obligation up to the penal sum of the bond. BOND DEFAULT MANUAL, supra, at 161-62; see AIA DOCUMENT A312, supra note 11, ¶ 4.4, reprinted in SWEET, supra note 2, app. D at 831. For a more detailed discussion of these options, see BOND DEFAULT MANUAL, supra, at 159-78.

Payment bonds secure the obligation of the principal to pay parties, other than the obligee, who furnish labor and materials to the principal to enable the performance of the underlying obligation. Typical payment bonds cover the obligation to pay parties having “just claims” for material and labor provided to the principal and do not contemplate that the obligee will be a payment bond claimant.

Other forms of contract surety bonds may include fiduciary and other obligations, including court bonds, trustee bonds, and public official bonds. These types of “miscellaneous” bonds are discussed elsewhere in this Symposium. See James A. Black, Jr., Miscellaneous Surety Bonds and the Restatement, 34 WM. & MARY L. REV. 1195 (1993). Trustee bonds and public official bonds cover the obligations of the official or trustee to perform faithfully the duties of the office. See EDWARD W. SPENCER, THE GENERAL LAW OF SURETYSHIP § 358, at 362 (1913). When an instrument provides for blanket coverage, applying to the duties of a number of officials who may or may not know of the existence of the bond, it may be construed as an insurance policy as opposed to a suretyship instrument. See, e.g., Kinzer v.
cept the obligee's bond form or decline to execute the bond. Nonetheless, surety bonds often are construed as insurance policies. When the language is ambiguous, the bond will be construed most strongly against the insurance company writing the bond. Some courts have expanded this rule of construction to justify the application of substantive insurance law to surety bonds and the surety relationship.

Unlike an indemnity insurer, a contract surety does not agree to bear any risks for its principal. The purpose of the surety relationship is to provide another party to which the obligee can look for performance of the underlying obligation should the principal fail to perform. Because the principal always remains liable to perform the underlying obligation, the surety's liability to the obligee is coextensive with that of the principal as provided in the bond. Bonds ordinarily contain a penal amount that serves as a limit on the surety's liability. The principal, who under the contract may have an obligation to perform no matter what the cost, receives no protection from the bond's penal amount. The principal's liability therefore extends beyond that of the surety.

Some courts have confused suretyship with insurance by mistaking the obligation of the surety as an obligation to hold harmless the principal. The surety has no such obligation. To the contrary, the principal must exonerate and reimburse the surety. Unlike


13. See, e.g., Associates Fin. Servs. Co. v. Eisenberg, 186 N.W.2d 272, 274 (Wis. 1971) (indicating that when a surety contract is executed for a premium or other consideration, the general rule that ambiguities are resolved in favor of the surety is inapplicable).


17. See Restatement of Security § 112 (1941).

18. Id. § 104.
insurance, a contract surety obligation is not an aleatory contract.\textsuperscript{19} The contract surety does not underwrite a contractor based on some actuarial determination of the risk for the appropriate premium. Instead, contract bonds, like loans, are written based on the financial integrity of the principal, premised on the idea that no losses should follow.\textsuperscript{20}

In attempting to grapple with suretyship principles, courts sometimes confuse the principles of construction with substantive principles of law by treating surety bonds as insurance policies.\textsuperscript{21} In some jurisdictions where both surety bonds and insurance policies are strictly construed, different substantive principles apply to suretyship obligations.\textsuperscript{22}

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19. An aleatory contract is "[a] mutual agreement, of which the effects, with respect both to the advantages and losses, whether to all the parties or to some of them, depend on an uncertain event." \textsc{Black's Law Dictionary} 70 (6th ed. 1990) (citing \textsc{Restatement of Contracts} § 291 (1932)).


22. For example, in Meyer v. Building & Realty Service Co., 196 N.E. 250 (Ind. 1935), the court observed:

While insurance contracts are in many respects similar to surety contracts, yet there is a very wide difference between the two kinds of contracts. Insurance has been defined as a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from an unknown or contingent event; whereas a contract of suretyship is one to answer for the debt, default, or miscarriage of another, and a contract of suretyship is not altered because made by a corporation for compensation. Notwithstanding the fact, surety contracts, when executed by a corporation for compensation has sometimes been spoken of by the courts as insurance contracts, the fact still remains that the wide difference, above mentioned, still exists.

\textit{Id.} at 253-54.

Similarly, the court in Garco Industrial Equipment Co. v. Mallory, 485 N.E.2d 652 (Ind. Ct. App. 1985), drew the following distinctions:

There are, however, definite differences between insurance contracts and surety contracts. First a contractor does not purchase a performance or pay-
The surety’s obligation arises upon the principal’s default on the underlying obligation. The surety possesses the duty to cure the default. Default may also have consequences for the surety in attempting to enforce its rights against the principal. The surety may have no rights against its principal until the principal defaults. Some courts have expanded this rule to support the view that the surety has no right to collateral or property (such as contract funds) held to secure the performance of the obligation until the principal actually defaults. A majority of courts find that the surety’s rights in such collateral relate back to the time of the execution of the bond. At least one court observed, however, that the surety’s subrogation right prior to default remains a “shadowy thing.”

III. THE SURETY’S EQUITABLE RIGHTS IN CONTRACT FUNDS

The surety, by virtue of its status, possesses equitable rights to contract funds due the principal. The recognition of these rights has been a source of frustration to those representing secured lenders in attempting to recover receivables due contractors/principals. Most of the litigation over the surety’s rights to contract funds involves disputes with those claiming an interest in those funds by virtue of a security interest in receivables.

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23. E.g., Kansas City v. Tri-City Constr. Co., 666 F. Supp. 170, 172 (W.D. Mo. 1987); see also In re Bagwell Coatings, Inc., 34 B.R. 193, 196 (Bankr. M.D. La. 1983) (explaining that subrogation arises only when a claim has been made).

24. E.g., Balboa Ins. Co. v. United States, 775 F.2d 1158, 1161 (Fed. Cir. 1985) (citing Fidelity & Deposit Co. v. United States, 393 F.2d 834, 837 (Ct. Cl. 1968)); Gray v. Travelers Indem. Co., 280 F.2d 549, 552 (9th Cir. 1960) (holding that the subrogation rights of a surety upon default by a principal are deemed to have accrued as of the time the bond was executed); National Sur. Corp. v. United States, 319 F. Supp. 45, 48 (N.D. Ala. 1970); see SPENCER, supra note 12, § 136, at 181.


26. See, e.g., In re Ward Land Clearing & Drainage, Inc., 73 B.R. 313, 314 (Bankr. N.D. Fla. 1987) (involving a claim by a surety to the contract funds held in escrow, following default by the contractor and completion of performance by the surety); City Bank & Trust
Allowing the surety a prior and superior interest in earned contract funds furthers the policy of ensuring completion of the work and payment of the parties furnishing supplies and executing the work. The surety's interest is typically found to be prior and superior to that of the parties claiming an interest in the contractor/principal's receivables because the surety is subrogated to the obligee/creditor's rights to the contract funds.\textsuperscript{27} Courts finding that the surety did not have a superior or prior interest in the contract funds due its principal commonly have advanced the following reasons for their decisions: 1) the event required for the surety's rights to "vest" in the contract funds did not occur;\textsuperscript{28} 2) the surety's equitable interest did not relate back to the date of the execution of the bond;\textsuperscript{29} 3) procedurally, there was some impediment to the surety's attempt to enforce its equitable rights;\textsuperscript{30} or 4) the surety failed to record its interest under Article 9 of the Uniform Commercial Code.\textsuperscript{31}

\textsuperscript{27} Restatement of Security § 141 cmt. c (1941); Bond Default Manual, supra note 12, at 73 (citing Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962)).

\textsuperscript{28} For example, the required default may not have occurred. See International Fidelity Ins. Co. v. United States, 949 F.2d 1042 (8th Cir. 1991) (holding that the IRS had priority over the surety on liens filed before the default and that the surety had priority over the IRS liens filed after the default); In re Bagwell Coatings, Inc., 34 B.R. 193, 196 (Bankr. M.D. La. 1983).


\textsuperscript{30} See, e.g., American Fidelity Fire Ins. Co. v. United States, 623 F. Supp. 722 (W.D. Tenn. 1985) (holding that a failure to challenge an IRS levy on contract funds within the nine-month statutory limitation served as an obstacle to enforcing the surety's rights).

\textsuperscript{31} Initially, the U.C.C. Editorial Board proposed a subsection (7) to Article 9-312 that would have provided that a security interest that secured an obligation to reimburse a surety would be subordinate to a lender that later perfected a security interest in the property. See Uniform Commercial Code: Official Draft 773-74, 777 (text and comments ed. 1962). After a meeting with surety representatives in 1963, the Editorial Board rejected that version of subsection (7). See Uniform Laws Annotated, Uniform Commercial Code: Changes in the Text and Comments 25-26 (1963). Extensive discussion of the rejection of this subsection by the Editorial Board appears in National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843, 846 (1st Cir. 1969).
Those decisions requiring that a technical default of the principal's contract occur before the surety's equitable rights vest in the contract funds tend to elevate form over substance. This question is especially troubling in the context of the principal/contractor's bankruptcy, in which case the surety might seek some control over the use of contract funds to insure that the principal completes the work and pays the parties furnishing labor and materials. The surety's inchoate lien in the funds ought to be protected in order to insure that the project is finished and the parties are paid.

Some cases suggest that by executing an indemnity agreement with the principal, the surety is electing to pursue legal rights that must be recorded, as opposed to equitable rights that are not subject to recordation requirements. See Rush Presbyterian St. Luke's Med. Ctr. v. Safeco Ins. Co., 712 F. Supp. 1344, 1349 (N.D. Ill. 1989) (refusing to enforce equitable rights of the surety against the contractor because of explicit rights under the contract).

In some cases, the courts treat the surety's rights in progress payments and retainage differently. Some courts hold that an Article 9 secured party's or other lienor's interest in progress payments can attach prior to that of the surety because those funds were actually due the principal before the default. See, e.g., National Union Fire Ins. Co. v. United States, 304 F.2d 465, 467 (Cl. Ct. 1962) (holding that a surety has no claim to progress payments made to an assignee of the contractor prior to a default by the contractor); Bank of Ariz. v. National Sur. Corp., 237 F.2d 90, 94 (9th Cir. 1956) (holding that a paying surety could not recover progress payments made by the owner to an assignee bank prior to the contractor's default and where the assignee bank was not put on notice of the surety's interest). Like the requirement that there be a default, the distinction between progress payments and retainage is not uniformly recognized. Some cases recognize the surety's priority to progress payments. See, e.g., In re Ward Land Clearing & Drainage, Inc., 73 B.R. 313 (Bankr. N.D. Fla. 1987) (upholding the surety's priority); Tri-city Serv. Dist. v. Pacific Marine Dredging & Constr. (In re Pacific Marine Dredging & Constr.), 79 B.R. 924 (Bankr. D. Or. 1987) (recognizing the surety's rights in funds). Other decisions, especially in the context of the principal's bankruptcy, treat the surety's interest in progress payments and retainage differently. See, e.g., American States Ins. Co. v. Glover Constr. Co. (In re Glover Constr. Co.), 30 B.R. 873 (Bankr. W.D. Ky. 1983) (recognizing the debtor's interest in the funds under 11 U.S.C. § 541, but allowing the surety joint control and requiring payment to satisfy bonded payables on assumed projects first). At least two courts have attempted to reconcile these differences, noting that the distinction between retainage and progress payments is actually illusory, see Balboa Ins. Co. v. United States, 775 F.2d 1158, 1163 (Fed. Cir. 1985), but that courts have often discussed the surety's rights to retainage exclusive of any discussion of progress payments because retainage was all that was available to the surety at the time of trial. See National Sur. Corp. v. United States, 319 F. Supp. 45, 49 (N.D. Ala. 1970).

In one article examining the surety's lien on funds in the context of the principal's Chapter 11 proceeding, the authors noted:

Whether you characterize [the surety's] interest as one of ownership, a lien or a priority, the result is the same. The debtor's interest, whatever it is, requires that contract funds, earned or unearned, be used to complete the contract before such funds can be used by the debtor for other purposes. In other words, while it might be argued that the estate has a property interest, that
Some bankruptcy cases concede the value of the surety's lien by applying the contemporaneous exchange preference exception and finding prepetition payments that benefit a surety before default to be contemporaneous exchanges for value.\textsuperscript{34}

As noted above, the surety's equitable interest is not subject to the requirements of Article 9 of the Uniform Commercial Code.\textsuperscript{35}

As a general rule, because the surety asserts its rights to contract funds as the subrogee of the obligee's or creditor's rights to the funds, there is no receivable due the principal, and thus, there is no receivable to which a secured interest can attach.\textsuperscript{36} The surety's interest in contract funds is therefore not a security interest subject to the strictures of Article 9.

The 1947 Supreme Court decision in \textit{United States v. Munsey Trust Co.}\textsuperscript{37} cast into doubt the surety's ability to utilize contract funds on federal projects by holding that the obligee, the United States, could assert its right to set off contract funds remaining to satisfy a nonmutual obligation of the principal.\textsuperscript{38} The reasoning of...
the *Munsey Trust* decision has received some criticism.\(^3\) *Munsey Trust* gave rise to an irrational distinction between the circumstances in which the surety satisfies a payment obligation and the government *can* set off nonmutual obligations, and those in which the surety satisfies a performance obligation and the government *cannot* set off nonmutual obligations. By allowing set-off for unrelated obligations, *Munsey Trust* increased the risk to the surety.\(^4\)

The obligee's set-off rights, the surety's right to use contract funds, and the priority of the surety's right to these funds are issues that arise primarily in connection with construction contract sureties. The rights of the surety to use contract funds to defray the risk of nonperformance by the principal, and to undertake performance in the event of the principal's default, are the rights that the obligee might impair or modify by some action or inaction. The policy favoring protecting the surety from such obligee inaction or action is the avoidance of economic waste. The surety, however, is not a garden-variety secured creditor looking to recover ordinary collateral. Moreover, in the complicated series of actions and relationships that arise during the course of a construction project, determining the impact of the obligee/creditor's conduct on the surety's rights is difficult.

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40. In two decisions near the turn of the century, the Supreme Court did recognize the surety's equitable rights to contract proceeds. See *Henningsen v. United States Fidelity & Guar. Co.*, 208 U.S. 404, 411 (1908); *Prairie State Bank v. United States*, 164 U.S. 227, 240 (1896). The Court in *Henningsen* found that a payment bond surety had a right to contract funds despite the claim of an assignee bank to those funds, noting that the payment by the surety released the government's equitable obligations to insure that laborers and material-men were paid. *Henningsen*, 208 U.S. at 410-11. In *Prairie State*, the Court held that a performing surety had a right superior to the bank to whom the contractor assigned the right to final payment, the surety having stepped into the shoes of the government to use the funds for the completion of the work. *Prairie State*, 164 U.S. at 232, 240. However, the primary Supreme Court cases relating to surety's rights—*Munsey Trust* and *Pearlman*—are more recent, postdating the original *Restatement of Security*, which was published in 1941.
IV. Obligee's Duties to the Surety—Impairment of the Contract Surety's Collateral and Modification of the Underlying Obligation

Construction, as discussed, involves the interaction of many parties over time in the performance of a number of tasks. For example, the architect often acts as the agent of the owner on the project and thus may be charged with certain duties, such as certification of payments due the contractors and subcontractors. Furthermore, during the course of construction, any number of acts or omissions on the part of the owner might affect the prospects for successful completion of the work.

Therefore, construction contracts typically involve progress payments—payments released to the contractor in accordance with the certified state of completion. This payment system adds incentive for the contractor to complete the work and reduces the risk of nonperformance for the owner. A percentage of funds held until completion of all of the work is called retainage and is intended both to reduce the risk of nonperformance by the contractor and to assure the completion of the work in accordance with the contract terms.

Sureties rely on the underlying contract terms in underwriting bonds. Progress payment and retainage serve to reduce the surety’s, as well as the owner’s, risk. A surety facing a demand for performance after a declaration of default by the owner may find that the amount of the contract funds remaining unpaid at the time of the declaration of default falls far below the amount required for completion of the work. This may be because the owner or obligee has either knowingly or inadvertently paid the contractor more than the amount of compensation to which it was entitled based on the percentage of completion.

Sureties have attempted to assert affirmative claims against owner/obligees who, by violating the payment terms of construction contracts, have increased the surety’s exposure from the principal’s nonperformance. The difficulty for sureties asserting these

41. See, e.g., American Casualty Co. v. Board of Educ., 228 F. Supp. 843, 846 (W.D. Okla. 1964) (involving a surety’s claim against an owner on the ground that the owner’s release of 10% retainage to the principal prior to the principal’s completion of the work subjected the surety to excessive postdefault loss).
claims is that the rules as stated in the Restatement of Security do not offer clear support for such claims.42 Sureties argue that owner violations of the payment terms resulting in overpayments to the

42. Sections 128 and 132 of the Restatement of Security, dealing with material modifications and impairment of collateral, respectively, address suretyship defenses and not affirmative claims by the surety to recover contract funds wasted because of a breach by the obligee of its duties. See Restatement of Security §§ 128, 132 (1941). Frequently, the construction contract surety will discover a premature payment defense only after it has paid for the completion of work that the principal has left unfinished. Courts are reluctant to allow such claims after payment. E.g., Firemans’s Fund Ins. Co. v. United States, 909 F.2d 495, 499 (Fed. Cir. 1990). In some cases, the surety must show that the obligee paid for unperformed work and that it did so absent a good faith belief that the principal would complete the balance of the work. E.g., Transamerica Ins. Co. v. City of Kennewick, 785 F.2d 660, 662 (9th Cir. 1986). The obligee can rely on the certifications made by the design professional. Argonaut Ins. Co. v. Town of Cloverdale, 699 F.2d 417, 420 (7th Cir. 1983). Presumably, such a rule would not harm the surety that can later, after payment, assert a subrogation claim against the architect for improper certification.

On the question of a surety asserting an affirmative claim based on the obligee’s release of contract funds, § 33(4) of the Restatement (Third) of Suretyship would now appear to allow such recovery when the surety performs the balance of the work under business compulsion and without knowledge that the obligee prematurely paid the principal. Subsection 33(4) states:

(4) If the obligee impairs the recourse of the secondary obligor against the principal obligor
   (a) after the secondary obligor performs any portion of the secondary obligation; or
   (b) before the secondary obligor performs a portion of the secondary obligation, if the secondary obligor performs:
      (i) without knowledge of such act;
      (ii) for the benefit of an intended beneficiary who can enforce the secondary obligation notwithstanding the impairment of recourse; or
      (iii) under business compulsion; then, the secondary obligor has a claim against the obligee with respect to any portion of the secondary obligation that has been performed to the extent that such impairment would have discharged the secondary obligor with respect to that performance.

Restatement (Third) of Suretyship § 33(4) (Tent. Draft No. 2, 1993). Unfortunately, § 33(4) discusses “impairment of recourse” without clearly stating that such recourse includes available contract funds. In fact, “recourse,” a term borrowed from Article 3 of the U.C.C., first appears in the Restatement in § 14 and § 33, but with little explanation. Section 14 appears to describe recourse as all of the secondary obligor’s rights against the principal obligor—exoneration, reimbursement and subrogation. See Restatement (Third) of Suretyship § 14 (Tent. Draft No. 1, 1992). The problem with the use of the term “recourse” is that it places special emphasis on the ability of the surety to recover from the principal. And, although § 14(1) discusses the secondary obligor’s rights to require the principal to perform the underlying obligation, id. § 14(1), neither § 14 nor § 33 addresses the obligation of the obligee to return performance. Comment b to § 33 states that any act impairing a principal obligor’s performance and the secondary obligor’s rights of reimbursement and
principal and increased postdefault losses for the surety amount to either impairment of collateral or material modification of the contract.\textsuperscript{43}

The obligee should refrain from conduct that reduces or eliminates the incentive for the principal to perform the underlying obligation or that actually impairs the performance of that obligation. When the underlying obligation is the payment of money, the obligee should avoid harming the surety through a release or modification of the principal's obligation. Because of the duty of the obligee to return performance under a construction contract, there is a vast range of conduct that might reduce or eliminate the incentive of the principal to complete the work, thereby increasing the exposure of the surety.\textsuperscript{44} Courts only reluctantly allow the surety to assert affirmative claims against obligees for this conduct, partly because premature payment of contract funds or failure to administer construction payments properly cannot be neatly defined as an impairment of collateral or material modification of the contract.\textsuperscript{45}

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\textsuperscript{43} See Balboa Ins. Co. v. United States, 775 F.2d 1158, 1163-65 (Fed. Cir. 1985) (allowing a surety's action against the government where the government made a progress payment to the principal after the surety notified the government of the principal's default, because the government must consider the surety's interest in its administration of contracts); United States Fidelity & Guar. Co. v. United States, 475 F.2d 1377, 1384-85 (Ct. Cl. 1973) (considering the government's duty to consider possible harm to the surety in making progress payments); Argonaut Ins. Co. v. United States, 434 F.2d 1362, 1366-67 (Ct. Cl. 1970) (involving a surety who argued that the government had a legal obligation to withhold payments inconsistent with the surety's subrogation rights under the contract).

\textsuperscript{44} For example, unwarranted progress payments reduce the incentive of the principal to complete its duties.

\textsuperscript{45} For recent cases involving a surety asserting an impairment of collateral or material modification defense, or seeking recovery from the obligee for the improper disbursement of contract funds, see Fireman's Fund, 909 F.2d at 495 (declining to apply an overpayment defense on a federal contract); United States v. Reliance Ins. Co., 789 F.2d 1382 (9th Cir. 1986) (finding a material modification of the payment guaranty); Transamerica Insurance, 785 F.2d 680 (allowing the surety to recover payments made in the absence of good faith); Argonaut Insurance, 699 F.2d 417 (holding that the obligee's good faith reliance on an engineer's estimates rendered the defense of premature payment unavailable to the surety);
V. The Incompatibility of Some Article 3 Principles with Contract Surety Obligations

During the course of construction, extensions and modifications are routinely sought and granted. Because of the uncertainties of the construction process, change orders may be frequent. Although a change order is usually an immaterial change that is accommodated by adjusting the contractor’s compensation, the surety expects and is entitled to be notified of any material changes that modify the underlying obligation.\(^{46}\) If the principal/contractor has committed a material breach of the contract, then the obligee, if it intends to assert a claim against the surety, should not continue to pay the principal/contractor or allow it to perform without notifying the surety.

Construction activities demand enormous transactional costs. Kicking someone off a project for nonperformance will nearly always result in increased costs to virtually all of the parties. For this and other reasons, the parties expect that the principal will perform the obligation, and that the obligee has a right to demand that the surety perform only in the event of a default by the principal. Rules that will allow construction activity to proceed in a sensible and economic fashion should: 1) allow for changes and modifications that do not affect the fundamental agreement of the parties; 2) prevent or discourage the obligee from committing economic waste; and 3) recognize the value of the performance of the

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When the surety has been harmed by the release of contract funds wrongfully certified by the architect or engineer, the owner or obligee may be exonerated from liability through its good faith reliance on the certification. Argonaut Insurance, 699 F.2d at 419. However, the courts will allow sureties to recover from negligent design professionals. See Aetna Ins. Co. v. Hellmuth, Obata & Kassabaum, Inc., 392 F.2d 472, 475 (8th Cir. 1968); Peerless Ins. Co. v. Cerny & Assoc., 199 F. Supp. 951, 953-54 (D. Minn. 1961); Calandro Dev. v. R.M. Butler Contractors, 249 So. 2d 254, 265 (La. Ct. App. 1971); State ex rel. National Sur. Corp. v. Mulvaney, 72 So. 2d 424, 431 (Miss. 1954); Westerhold v. Carroll, 419 S.W.2d 73, 80-81 (Mo. 1967).

46. The bond forms utilized in the industry contemplate the prospect of change orders, providing a waiver of notice of such changes: “The Surety hereby waives notice of any change, including changes of time, to the Construction Contract or to related subcontracts, purchase orders and other obligations.” AIA DOCUMENT A312, supra note 11, ¶ 8 (Performance Bond), reprinted in SWEET, supra note 2, app. D at 831.
principal who originally contracted to perform the work as well as the option of the surety to reduce its loss through its own performance.

The discharge, modification, and extension rules incorporated in revised section 3-605 of the Uniform Commercial Code cannot be readily adapted to apply to surety obligations involving performance of construction contracts. Subsection (b) provides that the release of the principal will not release the surety, and subsections (c) and (d) provide that extensions can be a defense to the holder’s (obligee’s) claim. These rules might encourage releases of principals in lieu of extensions and modifications. Although they enhance negotiability, when applied in the context of construction contracts these rules could lead to unnecessary releases of parties otherwise able to perform under extensions.

The rule in section 3-605(b)—that a release of a principal obligor never discharges the secondary obligor—would lead to absurd economic and practical consequences if applied to secondary performance obligations in construction contracts. One of the reasons stated for justifying this rule in Article 3 is that such a release is

47. Section 3-605 states in part:
(b) Discharge . . . of the obligation of a party to pay an instrument does not discharge the obligation of an indorser or accommodation party having a right of recourse against the discharged party.
(c) If a person entitled to enforce an instrument agrees, with or without consideration, to an extension of the due date of the obligation of a party to pay the instrument, the extension discharges an indorser or accommodation party having a right of recourse against the party whose obligation is extended to the extent the indorser or accommodation party proves that the extension caused loss to the indorser or accommodation party with respect to the right of recourse.
(d) If a person entitled to enforce an instrument agrees, with or without consideration, to a material modification of the obligation of a party other than an extension of the due date, the modification discharges the obligation of an indorser or accommodation party having a right of recourse against the person whose obligation is modified to the extent the modification causes loss to the indorser or accommodation party with respect to the right of recourse. The loss suffered by the indorser or accommodation party as a result of the modification is equal to the amount of the right of recourse unless the person enforcing the instrument proves that no loss was caused by the modification or that the loss caused by the modification was an amount less than the amount of the right of recourse.

U.C.C. § 3-605(b)-(d) (1990).
48. Id. § 3-605(b).
unlikely to harm the secondary obligor. In connection with negotiable instruments, this might be an accurate observation. A surety or secondary obligor knows from the instrument that payment is expected and that it can pursue its rights to recourse from the principal obligor in the event payment is demanded.

A construction surety, in contrast, has an expectation that the principal will perform. The transactional costs involved in construction give this expectation added significance. A release rule allowing for the full reservation of rights of the creditor against the secondary obligor of an obligation to pay might serve to reduce the transactional costs. Moreover, it will cause no harm because of the secondary obligor's rights of recourse against the principal obligor. Replacing a principal/contractor on a construction project, however, nearly always results in additional costs. In addition, the surety cannot rely on its right to recourse or reimbursement from a contractor/principal that may be operating at the brink of insolvency. The most meaningful recourse for the construction bond surety is often the least expensive arrangement for concluding the work. As noted earlier, the construction contract surety has an interest in the performance of the work.

49. Id. § 3-605 cmt. 3.

50. Both the Restatement of Security and the tentative draft of the Restatement (Third) of Suretyship, in defining suretyship, state that the principal is primarily obligated to perform. RESTATEMENT OF SECURITY § 82 (1941) ("'[A]s between the two who are bound, one rather than the other should perform . . . .'"); RESTATEMENT (THIRD) OF SURETYSHIP § 1(1)(d) (Tent. Draft No. 1, 1992) ("'[A]s between the principal obligor and the secondary obligor, the principal obligor has a duty to perform the underlying obligation or bear the cost of performance.'").

Although the expectation that the principal will perform is reflected in the Restatement definitions, there is no explicit requirement that the principal be in actual default before a demand is placed upon the surety. Cf. supra note 28 and accompanying text (discussing cases requiring default). Construction contracts and bonds often contain detailed provisions dealing with what constitutes a default, the procedures for declaring a default and terminating the contractor, and the consequences of a termination. Construction bonds indicate by their terms that an event of default must occur before a demand can be made to the surety to perform. A defeasance clause in a current form bond states: "If the Contractor performs the Construction Contract, the Surety and the Contractor shall have no obligation under this Bond . . . ." AIA DOCUMENT A312, supra note 11, ¶ 2 (Performance Bond), reprinted in SWEET, supra note 2, app. D at 831. That form bond also provides for specific options in the event the principal's contract is terminated. Id. ¶¶ 3.2, 4-6, reprinted in SWEET, supra note 2, app. D at 831.
In the world of construction contracts, the release rule in Article 3 makes no sense. Without an act of default on the part of the principal, it would be absurd for an obligee to release the principal/contractor and make demand upon the surety to pay for or to prosecute the balance of the work.\textsuperscript{51} Good sense requires rules in the construction world that directly contradict the rules of the Uniform Commercial Code. In order for construction to proceed and for the principal to prosecute the work successfully, some mechanism for granting extensions and immaterial modifications during the work, while preserving the basic bargain of the parties, must be available. As noted, terms relating to immaterial changes are often provided in the contract or bond.\textsuperscript{52} Given the transactional costs for substituted performance, absent a default on the part of the principal, a release of the principal presumably should release the surety.

The \textit{Restatement of Security} does not emphasize the importance of performance by the principal or surety as a means of avoiding loss.\textsuperscript{53} For the performance bond surety, the capacity or

\begin{itemize}
\item \textsuperscript{51} The \textit{Restatement of Security} provides:
\begin{quote}
Where the creditor releases a principal, the surety is discharged, unless
(a) the surety consents to remain liable notwithstanding the release, or
(b) the creditor in the release reserves his rights against the surety.
\end{quote}
\begin{flushright}
\textit{Restatement of Security} § 122.
\end{flushright}

The reservation-of-rights rule of subparagraph (b) does not appear to have much application in the world of construction contracts, although some court decisions discuss such reservations by payment claimants. See, e.g., Griffin Wellpoint Corp. v. Engelhardt, Inc., 414 N.E.2d 941, 948 (Ill. App. Ct. 1980) (stating that an extension of time for payment on a contract will not release a surety from his obligations if the creditor expressly reserves his rights against the surety). I could not find, however, a single case involving release by an obligee of a principal with a reservation of rights to proceed against the surety on a construction contract.

\item \textsuperscript{52} See \textit{supra} note 46 and accompanying text.

\item \textsuperscript{53} The \textit{Restatement of Security} sections relating to release, impairment, and modification use language and draw upon illustrations involving, for the most part, payment obligations. See \textit{Restatement of Security} §§ 122, 127-128, 130, 132. The drafters of the \textit{Restatement} noted some problems in the application of the principles to construction obligations:

The rules stated in Clause (b) find important application in the case of building contracts. The modifications of contract between creditor and principal may be such as are contemplated by the contract in which case no surety would be discharged. They may be slight variations which by the technical rules which have prevailed in respect to non-compensated sureties would discharge them, although not in fact disadvantageous to the surety. In such a case the compensated surety would not be discharged. They may cause slight and
ability of the principal to perform the work is security like any other collateral. To address this situation, the Restatement of Suretyship might describe the affirmative duties of the obligee or deal with impairment of performance. In addition, the rules allocating the burdens of proof and persuasion should recognize the difficulty for the construction contract surety to prove prejudice resulting from a release of the principal, modification of the contract, or impairment of collateral.54

The premature payment defense provides a natural focus for a discussion of suretyship defenses and the construction contract surety. This issue concerns sureties who face both increased exposure from the improper administration of payments on projects, and court decisions that reflect a great deal of uncertainty over the substantive law that applies. Ironically, although court decisions in general infrequently cite the Restatement of Security, the court decisions on the premature payment defense tend to refer to it as authority.55

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54. Some rules to this effect have been proposed recently. See Restatement (Third) of Suretyship §§ 35, 37-38 (Tent. Draft No. 2, 1993). Courts have struggled with how to allocate the burden of proof in premature payment cases. See, e.g., Reliance Ins. Co. v. Colbert, 365 F.2d 530, 534 (D.C. Cir. 1966) (holding that the obligee must notify the surety in the event of a substantial change in the contract); Fireman’s Fund Ins. Co. v. United States, 15 Cl. Ct. 225, 230 (1988) (holding that a surety is released from its obligations because of changes in the payment provisions of a contract only to the extent that the surety can show the modifications caused injury, loss, or prejudice), rev’d on other grounds, 909 F.2d 495 (Fed. Cir. 1990); Gibbs v. Hartford Accident & Indem. Co., 62 So. 2d 599, 604 (Fla. 1952) (holding that the surety had the burden of proving that delinquencies or misconduct resulted in damage to the surety and that the surety must prove the extent of the damage).

55. See, e.g., Reliance Insurance, 365 F.2d at 535 n.5 (citing Restatement of Security § 128 cmt. f, at 344-46).
The *Restatement of Suretyship* should enunciate principles that apply to suretyship obligations while recognizing the practical differences between types of obligations. In the case of the construction contract surety, adopting principles from the Uniform Commercial Code may not be logical or useful. This does not mean that the performance bond surety needs a separate set of rules, but that the rules should reflect the crucial importance of the performance of the underlying obligation and the practical impact of the transactional costs.
APPENDIX

BIBLIOGRAPHY

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