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Surety Bond Quarterly Article | AIA A312 Performance Bond; This form lays out conditions and responsibilities for the obligee and surety.

By Gregory R. Veal January 25, 2023

INTRODUCTION

The 2010 version of the AIA A312 performance bond is an effort to balance the rights and duties of the obligee and the surety. It replaces the 1984 version, with a few tweaks and one major shift of risk, in Section 4. As with almost all bonds, those rights and duties are subject to certain conditions. Even the most rudimentary performance bond usually begins, "NOW, THEREFORE, the *condition* of this bond is … ." The A312 bond, though, sets out perhaps the most developed set of conditions of any form.

The core conditions are in Section 3. "If there is no Owner Default under the Construction Contract, the Surety's obligation under this Bond shall arise after" (1) notice by the Owner and a meeting at the Surety's election; (2) the Owner's declaration of default, termination, and notice to the Surety; and (3) the Owner's agreement to pay the Balance of the Contract Price to the Surety. Section 6 contains one more condition: an additional notice from the Owner if it opposes the Surety's response.

Those conditions exist so the surety can choose from among the options for response listed in Section 5, including completion by the principal (with Owner's consent), takeover and completion, re-let to a completion contractor, payment of the Owner's damages, or denial of the claim. The entire structure of the bond fits together. The obligee must satisfy the conditions, without which the surety cannot choose its option as agreed in the bond.

The bond and its conditions reflect the evolving understanding and intent of the drafter, the American Institute of Architects, after receiving comments from numerous industry groups, including the ABA Forum on the Construction Industry, the Associated Builders & Contractors, the Associated General Contractors of America, NASBP, SFAA, and others.[Display footnote number:1] Although the "collaborative" drafting process may have intended to balance carefully the rights and obligations of the parties, how the bond functions in use ultimately is determined by the courts, which, as we know, can be unpredictable.

The Conditions of the A312 Performance Bond

Eight conditions appear in the bond, in the following order. The obligee must:

1. Not be in default (a defined term; § 3),
2. Notify principal and surety that declaring default is contemplated (§ 3.1),
3. Attend a conference if the surety timely requests it (§ 3.1),

4. Declare principal to be in default (§ 3.2),
5. Terminate the contract with principal (§ 3.2),
6. Notify surety of the default declaration and termination (§ 3.2),
7. Agree to pay the balance of the contract price (§ 3.3), and
8. Send a third notice to surety if an option is not chosen promptly (§ 6).

The first of the eight conditions is unconditional, as "Owner Default" discharges the surety's obligation. However, the question of who is in default often is the ultimate issue in dispute. Unless the principal is conceding, the surety will be challenged to know whether, at the end of the day, it will be obligated under the bond. The A312 procedure presumes the surety can tell who is in default, which often is not the case. The answer on default many times will have to wait, but the bond's other conditions do not.

A. First Notice From Obligee to Surety

Section 3.1 of the bond still requires a notice to the principal and the surety that the obligee is considering declaring default. That condition, formerly and by majority view, was an unconditional condition and applies even if the obligee does not seek completion of the work but only enforcement of other contract duties, such as indemnification. That view recently was reinforced in *Prismatic Development Corp. v. International Fidelity Insurance Co.*[Display footnote number:2] The obligee knew about the costs incurred by other subcontractors resulting from the principal/subcontractor's deficiencies, but neither notified the surety nor defaulted or terminated the principal for nine years. When another sub sued for those costs and the obligee sought indemnification from the surety, the court enforced the conditions precedent under the bond, noting the surety was deprived of the ability to investigate or remedy the principal's alleged default.

The notice requirement in Section 3 of the A312 bond is not difficult to understand or satisfy, yet obligees regularly fail to do so, for example, by sending notice to the principal's bonding agent instead of the surety. Previously, that failure would have been fatal to the bond claim; but AIA made a major change from the 1984 bond to the 2010 version. Section 4 of the latter provides that:

> (f)ailure on the part of the Owner to comply with the notice requirement in Section 3.1 shall not constitute a failure to comply with a condition precedent to the Surety's obligations, or release the Surety from its obligations, except to the extent the Surety demonstrates actual prejudice.

Therefore, what previously was an unconditional condition of advance notice to the surety, before declaration of default or termination, now is conditioned on a showing of prejudice—a potential question of fact under the circumstances of the project. Prejudice to the surety, however, should be inherent and presumed when the obligee fails to give notice under Section 3.1. The surety issued the bond in reliance on the conditions stated within it, including the right to notice before the obligee changes the situation on the ground and the right to select among several options if the surety's duties are triggered. Obligees who go rogue and ignore the surety's rights violate those conditions and deprive the surety of its options. That was not the parties' agreement.

Section 3.1 also contains a requirement that the obligee "shall attend" a 3.1 meeting if the surety requests

it within five days. Nothing in Section 4 requires a showing of prejudice if the obligee fails to participate in a meeting that the surety requests. The courts may conclude that the obligee can decide either to meet or to take the risk of prejudicing the surety. Yet the surety loses its options under the bond (including the option to request a meeting) in the absence of notice, which therefore should be considered inherently prejudicial.Display footnote number:3 The Section 4 requirement for the surety to demonstrate "actual prejudice" truly ought to be a burden shifted to the obligee, to demonstrate that its breach of the Section 3 conditions actually did not prejudice the surety.

B. Declaration of Default, Termination, and Notice

Section 3.2 of the bond contains three conditions: declaration of default, termination, and a subsequent notice to the surety. These conditions are **not** subject to the requirement of prejudice imposed by Section 4. Other than the outlier decisions rejecting the bond's conditions precedent entirely, the majority of courts have enforced these requirements under the 1984 version and up to this year.

The obligee in *Arch Insurance Co. v. Graphic Builders LLC*Display footnote number:4 found the principal's work to be more than a little defective—260 leaking windows and misaligned exterior components—but chose not to terminate the subcontract. According to the obligee, doing so "would be the equivalent of shooting [itself] in the face," and termination did not give it "the warm and fuzzies." Regardless, the court held the failure to terminate materially breached the 2010 A312 bond and discharged Arch from "any and all liability relating thereto, including investigating and indemnifying [obligee's] claims thereunder."

In *Western Surety Co. v. United States Engineering Construction, LLC,*Display footnote number:5 the obligee defaulted and terminated the principal for various alleged breaches of the bonded subcontract but failed even to notify the surety until nearly nine months later. When the surety objected, the obligee argued the bond had no deadlines for notice of default or termination, which therefore should not be required in any particular time. Seeing the flaw in that argument, both the trial and appellate courts held that the explicit grant to the surety of a right to choose options in remedying any default "necessarily implies that *timely* notice is required to trigger Western Surety's obligation under the Bond because Section 5 operates only if timely notice is given."

The bonded contract itself may be a pitfall for the surety. The A312 bond has conditions, but it also incorporates the bonded contract, which becomes part of the bond. The specifics in the bond should govern over general terms in the contract, but the contract can become a backdoor for a creative court. Supplementation clauses, allowing the obligee to act unilaterally, are allowed by some judges to interfere with the surety's options. When the incorporated contract supersedes the express conditions of the bond, underwriters should take note. At a minimum, the surety will need to confirm that the obligee in fact complied with the requirements of its own supplementation clause before accepting any contractual override of the bond.

The flipside also is true: the incorporated contract provisions may supplement the *surety's* rights under the bond conditions. In *Donald M. Durkin Contracting, Inc. v. City of Newark,*Display footnote number:6 the obligee City followed the bond conditions to the letter but overlooked the additional seven days required by the contract after notice and before termination. In an unusual case where the surety lost

initially, the court nonetheless granted reconsideration and reversed itself, because the City admitted its only written notice neither stated intent to terminate nor declared a default but described itself as only a "precautionary letter."

Another potential trapdoor is waiver. If the surety denies the claim without reserving its rights as to the bond's conditions, failures by the obligee to comply with those conditions may be overlooked. The courts leaning this way do not seem concerned with the timing problem caused by breach of the bond conditions *before* the surety's denial. A practice pointer is to include any failed conditions in the denial letter even if the primary basis for that denial is different.

C. Agreeing to Pay the Balance of the Contract Price

Section 3.3 of the bond requires the obligee to agree to pay the contract balance, per the contract, to the surety or to a selected completion contractor. Some obligees believe they, not the surety, can select that contractor, so that this condition actually can be argued to justify supplementation without proper notice. But the bond gives the option to the surety, albeit with the obligee's consent, so the condition does not mean the obligee can just spend the money on any contractor it picks.

Likewise, amounts potentially owed but not yet paid cannot qualify as "payments made." Just what can the obligee "properly" deduct from the balance of the contract price before agreeing to pay it to the surety? The courts have not been clear, but pre-existing debts to subcontractors and suppliers probably reduce the balance, while payments to a replacement contractor hired by the obligee should not.

D. Third Notice to Surety

If the obligee objects to the surety's chosen option under the bond or with its promptness, Section 6 comes into play. The surety is not in default until "seven days after receipt of an additional written notice from the Owner" demanding performance. At that point, the obligee may enforce any available remedy. Sureties easily might overlook the condition of this additional notice, but it is enforceable and an important red line, providing one last chance to consider, and possibly negotiate over, its options under the bond.

CONCLUSION

The 2010 A312 performance bond and its conditions precedent are fairly well settled after almost 12 years, but obligees continue to raise arguments against the surety's protections, mostly based on their desire for the bond to be treated as insurance, not a simple contract allocating risks. The bond conditions are not burdensome, requiring generally only communication and clarity; and they are not "technicalities" to be ignored. The carefully balanced form expects the obligee to notify, inform, and involve the surety at appropriately early stages. It then requires the surety to decide reasonably promptly how to respond, and it requires the obligee to alert the surety if that response is unacceptable or too delayed. Sureties should be able to depend on those conditions (always subject to the vagaries of judge and jurisdiction).