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Construction Practices News Alert, February 2011

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DECISION AGAINST THE SURETY HIGHLIGHTS THE DIFFERENCE BETWEEN THE AIA A311 BOND FORM AND NEWER FORMS

TEXAS APPELLATE COURT AFFIRMS AWARD OF SUMMARY JUDGMENT TO BOND OBLIGEE EVEN THOUGH THE PRINCIPAL HAD NOT BEEN TERMINATED

By: William J. Taylor, Esq.

The Court of Appeals of Texas recently held that a general contractor was not required to terminate its subcontractor in order to trigger the surety's performance obligations under an AIA A-311 bond. The court found that the bond instead merely required a default and a declaration of default, and that reasonable notice of the default to the surety was all that was required to trigger the surety's liability under its bond.

In *Nova Casualty Company v. Turner Construction Company*, 2011 WL 80544 (No. 14-09-00733-CV, Court of Appeals of Texas, Houston-14th District), the general contractor, Turner Construction, subcontracted for the fabrication and installation of a baggage handling system at a new cargo facility at Bush International Airport in Houston, Texas. Nova Casualty Company provided performance and payment bonds for the subcontractor. On November 9, 2004, Turner gave the subcontractor a three day notice to cure deficient performance, pursuant to the terms of the subcontract. Nova was copied on this notice. On December 15, 2004 Turner notified Nova that the subcontractor had defaulted on the subcontract. On January 21, 2005, Nova notified Turner that until the subcontractor was terminated from the project, Nova could not proceed to elect its performance options under the bond. Turner went forward and completed the subcontractor's work by July of 2005, including re-doing much of the subcontractor's previously performed work. On November 20, 2006, Nova rejected Turner's bond claim, informing Turner that "a condition precedent" for making the bond claim was that the subcontractor "shall be and be declared to be in default."

Nova's performance bond was on the AIA A-311 bond form. The court found that the bond provided the following remedies available to Turner against Nova in the event that the subcontractor defaulted on the subcontract:

Whenever [subcontractor] shall be, and be declared by [Turner] to be in default under the subcontract, [Turner] having performed its obligations thereunder:

- (1) [Nova] may promptly remedy the default subject to the provisions of paragraph 3 herein, or:
- (2) [Turner] after reasonable notice to [Nova] may, or [Nova], upon demand of [Turner], may arrange for the performance of [subcontractor's] obligation under the subcontract subject to the provisions of paragraph 3 herein:
- (3) The balance of the subcontract price, as defined below, shall be credited against the reasonable cost of completing performance of the subcontract. If completed by [Turner], and the reasonable cost exceeds the balance of the subcontract price, [Nova] shall pay to [Turner] such excess, but in no event shall the aggregate liability of [Nova] exceed the amount of this bond....

The bond also incorporated the terms of the subcontract by reference.

The parties stipulated to the following facts:

1. The subcontractor abandoned the project and subcontract on December 14, 2004;
2. Turner did not send written notice of termination to the subcontractor;
3. Damages to Turner under the bond, if due, exceeded the penal sum of the bond;
4. Nova had no evidence that it was prejudiced or harmed by Turner's conduct.

The trial court entered summary judgment in favor of Turner on its performance bond claim against Nova.

On appeal, Nova first asserted that "[b]oth the performance bond and the subcontract required that Turner terminate [the subcontractor] from the subcontract before Turner could recover on the bond." The appellate court rejected this contention, and noted

CONTRIBUTORS



**WILLIAM
TAYLOR**

Bill Taylor is co-chair of the Construction Practices Group.

Please do not hesitate to contact Bill at 215-864-6305 or taylorw@whiteandwilliams.com if you have any questions regarding this article or any of the construction and surety related work performed by White and Williams.

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that the performance bond itself did not provide that Turner must “terminate” the subcontractor as a condition precedent to the surety’s liability. Rather, the bond stated that if the subcontractor was in default and Turner declared it in default under the subcontract, Nova’s obligations under the bond were triggered. Since the parties had stipulated that the subcontractor abandoned the project on December 14, and since it was undisputed that Turner had notified Nova of the subcontractor’s default the following day, the court held that the default declaration requirement of the bond had been satisfied.

Nova further argued that under the terms of the default provision of the subcontract Turner could only recover its excess construction costs from the surety if it elected to “terminate the employment of [subcontractor] for all or any portion of the Work...” Since there was no termination, Nova argued, Turner could not recover on its claim. While the court recognized this language of the subcontract, it implicitly found that it was not controlling. Rather, the court focused on the language of the delay provision of the subcontract, which provided that if there was a subcontractor delay that resulted in “any additional cost, expense, liability or damage to Turner ... the Subcontractor and its surety shall and does hereby agree to compensate Turner ... for and indemnify [it] against all such costs, expenses, damages and liability.” The court held that “[c]learly, [subcontractor’s] abandonment of the project delayed the project and caused Turner to incur costs and expenses.” The court found that there was no termination requirement in this provision of the subcontract, and thus Turner’s bond claim was not barred by its failure to terminate the subcontractor.

In making this analysis, the court ignored the distinction between delay damages covered by the delay provision of the subcontract, and default damages covered by the default provision of the subcontract, which arguably mandated a default termination before there could be recovery against the surety.

Nova also argued that Turner failed to give it notice of the subcontractor’s default sufficient to enable Nova to exercise its performance options under the bond. Nova claimed that because Turner had already made arrangements for the performance of some of the subcontractor’s work before it notified Nova that the subcontractor was in default, Turner failed to comply with the plain terms of the performance bond, thereby rendering the bond null and void. In rejecting this argument, the court went back to the language of the subcontract’s default provision, and noted that it gave Turner two options in the event of subcontractor default: (1) step in and supplement the subcontractor’s work and deduct any expenses from the amount owed under the subcontract; or (2) terminate the subcontract and take over the project. The court found that Turner initially selected the first option, and the fact that it was intervening and supplementing the subcontractor’s work without advance notice to Nova was conduct that was permissible under the language of the subcontract. Accordingly, the court reasoned, Turner’s actions which were consistent with its rights under the subcontract could not act to render the performance bond null and void.

The court’s decision makes clear to sureties that great care must be exercised in selecting the proper bond form to use and in coordinating the terms of the bond with the terms of the underlying contract. If the surety insists that there must be a termination before its obligations are triggered the AIA A-311 bond form should not be used. Rather, the newer bond form, the AIA A-312 form, requires both a declaration of default and a termination before the surety’s performance obligations are triggered