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A Georgia Practitioner's Guide to Construction Performance Bond Claims

Cheryl S. Kniffen

A Georgia Practitioner's Guide to Construction Performance Bond Claims

by Cheryl S. Kniffen*

I. INTRODUCTION

The recent ills of the construction industry have resulted in bonds being required in record numbers on both public and private projects. Typically in a construction project on which a surety bond is required or demanded, the contractor will provide both a performance and a payment bond.[1] This Article focuses exclusively on the performance bond and the claims and defenses related to that bond. This Article also offers practical advice to the general practitioner navigating a performance bond claim or raising defenses to a performance bond claim.

The use of performance bonds dates to the beginning of the construction industry.[2] While not referred to as performance bonds, in ancient times bondsmen would secure real estate to ensure the performance of a contractor.[3] Despite their long history, however, performance bonds are often misunderstood and confused with liability insurance. Given the ever increasing complexity of the construction industry and the confusing caselaw created when courts attempt to apply insurance principles to performance bond claims (or refer to performance bond and payment bond claims interchangeably), the general practitioner can

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* Associated with the firm of Thompson, Slagle & Hannan, LLC, Duluth, Georgia. Mercer University (B.B.A., summa cum laude, 1982); Mercer University, Walter F. George School of Law (J.D., magna cum laude, 1986). Member, Mercer Law Review (1984-1986); Managing Editor (1985-1986). Contributing Author, Georgia Section of the ABA Performance Bond Manual (Lawrence Lerner & Theodor Baum eds., 2006). Member, State Bars of Georgia and South Carolina.

1. *See* 40 U.S.C. § 3131 (Supp. V 2005).
2. J. Harry Cross, *Suretyship Is Not Insurance*, 30 INS. COUNS. J. 235, 235 (1963).
3. *Id.*

easily become confused when asserting or defending performance bond claims. This primer on performance bond claims in Georgia is offered as a road map for navigating such claims.

A. *The Nature of Performance Bonds*

In a performance bond, a party known as a surety agrees to be responsible for the performance of a contractor on a project.[4] In the performance bond arrangement, there are two underlying agreements. The first is the construction contract, a two-party agreement between the bonded contractor and either the owner or general contractor for the construction project. The second is the performance bond, which is a tripartite agreement under which the surety assures the performance of the construction contract by pledging that if the bonded contractor should fail to perform as required, the surety will be obligated to complete the contract work or be responsible for the cost thereof.[5]

The three parties in all performance bond arrangements are (1) the principal—the bonded contractor whose performance is guaranteed by the performance bond and who is the primary obligor on any obligations arising from the bond; (2) the obligee—the owner of the project (or the general contractor if the principal is a subcontractor), who receives assurance of performance of the contracted work; and (3) the surety—either an individual or more typically a corporate entity that acts as a guarantor or secondary obligor of the contracted work through issuance of a performance bond.[6] The performance bond is essentially a guarantee that if the principal obligor (the contractor) fails or wrongfully refuses to perform the work governed by the construction contract, then the secondary obligor (the surety) will either perform in the principal's place or pay damages to the obligee (the owner or general contractor) for the breach of its principal.[7]

As a prerequisite to issuing the performance bond, the surety will usually require the principal to execute a general agreement of indemnity. In that agreement, the surety is assured by the principal that should any claim be made upon the performance bond, the surety will be held harmless and indemnified by the principal for all claims and demands that are made upon the surety.

The relationship created by the issuance of a performance bond may seem rather simplistic. The surety acts as a guarantor for the principal

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4. 40 U.S.C. § 3131(b)(2).
5. *See* Cross, *supra* note 2, at 236-37.
6. *Id.* at 237.
7. If the bonded contract is a subcontract between the general contractor and a subcontractor, the general contractor is the obligee.

who ultimately must either complete the contract or be liable for all sums spent completing the contract work. However, the complexity inherent in the construction industry often jeopardizes the success of projects and makes the process of making and defending performance bond claims complicated. While many contractors are construction "professionals," others are not.[8] The risks inherent within the project itself are added to the risk of the contractor not being qualified to complete the project. These risks include (1) design errors made by architects and engineers that can delay the project for months; (2) severe weather, such as earthquakes, hurricanes, tornados, and extreme heat and cold, which can shut down the project for days and sometimes longer; (3) site risks, such as subsurface conditions and environmental contaminations; (4) material shortages and delays; (5) vandalism and theft on the job site itself; and (6) because performance bonds are generally required on all governmental projects, political risks, such as delays caused by administration changes or the contractor falling out of political favor.[9]

The greatest risk on any project, however, is contractor insolvency and default caused by the inability of the contractor to purchase needed materials or pay essential laborers.[10] Most of a contractor's profits on any project are made toward the end of the job after materials have been purchased and laborers have been paid. It is not uncommon for contractors to teeter on the brink of insolvency, using funds from one project to finance another. When a contractor falls behind in payments to suppliers and subcontractors, the service and material providers refuse to provide products and labor until paid. This results in substantial delays to the project and, on many projects, the assessment of liquidated damages when the construction contract provides for them. Because contractors are generally only paid for work they have performed, and a portion of that amount is typically withheld by the owner as a retainage for additional security, even a slight financial difficulty can quickly spiral out of control. This leaves the contractor either financially drained or in bankruptcy and leaves the owner with only the security offered by the performance bond.

Given the difficult terrain of the construction industry, the performance bond has become the quid pro quo for almost all governmental

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8. Georgia adopted a contractor licensing statute requiring all construction contractors to hold a valid license on or after July 1, 2008. O.C.G.A. § 43-41-17 (2008).

9. David J. Barru, *How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds with Bank Guarantees and Standby Letters of Credit*, 37 GEO. WASH. INT'L L. REV. 51, 52 (2005).

10. *Id.*

contracts and is becoming increasingly popular in private sector construction contracts. The appeal of the performance bond is clear. Given the increasing complexity of construction projects, owners (the bond obligees) seek the security provided by the surety in the event that the contractor fails to perform the contract work—the promise that the surety, as a guarantor to the project, will perform the underlying construction obligations.

B. *Distinguishing Between Suretyship and Insurance*

For those who are not involved in the construction industry, and sometimes for those who are, there is confusion about the concept of suretyship and how it differs from insurance. This confusion is understandable because state legislatures generally lump suretyship into the insurance code out of convenience. Thus, sureties, like insurers, are regulated by the insurance code.[11]

The rationale for the inclusion of suretyship in the insurance code is that most corporate sureties are also insurance companies with separate divisions of the company offering suretyship products. These divisions differ from those offering insurance. Because such companies should properly be governed by the insurance code to the extent that they offer insurance products, it is generally perceived as easier to regulate them through the insurance code and the insurance commissioner's office. The regulation of sureties by the insurance code often confuses courts and leads to decisions in which regulations that are purely designed for insurance are extended to suretyship.

Rather than being akin to insurance, suretyship is more analogous to the lending of credit by banks. The similarity of the surety/principal relationship to that of the bank/loan customer relationship is highlighted by the prevalent practice outside the United States of construction project owners requiring contractors to furnish bank guarantees or stand by letters of credit in lieu of performance bonds.[12]

In an insurance arrangement, insurance companies collect insurance premiums, or fees from policy holders, based upon the assumption that a certain number of those policy holders will have losses for which the insurance company will become liable.[13] Some amount of loss is expected and reserves are established to cover those losses by adjusting

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11. "[T]he usual view, grounded in commercial practice, [is] that suretyship is not insurance." Pearlman v. Reliance Ins. Co., 371 U.S. 132, 140 n.19 (1962).

12. Barru, *supra* note 9, at 53.

13. *Id.* at 55.

the premium to accommodate the anticipated loss.[14] Losses, however, are not anticipated in the surety relationship. Sureties, like banks making loans, issue bonds only if the borrower/principal is considered viable and credit worthy.[15]

A surety examines a contractor's specific risk factors, including (1) what reputation the contractor has developed in the industry and if he has fulfilled his obligations on past projects; (2) whether the contractor is capable of successfully performing the bonded project with adequate personnel, resources, and expertise; and (3) whether the contractor has adequate financial resources to weather problems that might occur on the project. By contracting with a bonded principal, an owner or general contractor is assured that the surety has conducted a preliminary review of the contractor's finances, business model, and prior projects, and is comfortable with the contractor's ability to meet obligations with regard to the bonded project. Almost all projects are plagued by a number of unexpected problems, and if a contractor has a precarious financial situation when the project begins, the contractor's ability to weather those bumps is severely diminished.

Regardless of a surety's diligence during the underwriting process, no surety can be certain that it will not experience losses on the bonds it issues. Because no losses are anticipated in the suretyship arrangement,[16] in consideration for the surety agreeing to issue a bond for a principal, the surety typically requires the principal, the principal's owners, spouses of owners, or other key personnel to execute a general agreement of indemnity, whereby they agree to exonerate and reimburse the surety for any loss or expense the surety incurs due to the principal's default.

C. *Georgia Statutory Bonds*

Performance bonds in Georgia come in three varieties: (1) Miller Act[17] bonds; (2) Georgia Little Miller Act[18] bonds; and (3) private bonds. Both Miller Act bonds and Little Miller Act bonds are required

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14. *Id.* at 55 n.11 (quoting EDWARD G. GALLAGHER, THE LAW OF SURETYSHIP (2d ed. 2000)).

15. *Id.* at 55-56 & n.15. An exception to this general rule that sureties independently investigate a principal's credit worthiness is that certain sureties agree to bond contractors whose bonds are guaranteed through governmental programs designed to allow minority and other disadvantaged contractors access to bonds and, by virtue of being "bondable," to projects for which they might not otherwise qualify. These principals are not subject to the same vigorous underwriting requirements that non-disadvantaged contractors must meet.

16. *Id.* at 55 n.11.

17. 40 U.S.C. §§ 3131 to 3134 (Supp. V 2005).

18. O.C.G.A. §§ 13-10-1 to -91 (1982 & Supp. 2008).

for certain public projects by statute.[19] Pursuant to the Miller Act, contractors seeking a contract with the federal government for more than $100,000 are required to furnish performance bonds guaranteeing their completion of such project.[20]

Georgia has also mandated performance bonds for state and local public contracts through statutes known as the Little Miller Acts.[21] Pursuant to Georgia's Little Miller Act, performance bonds are required for all state public work construction contracts that are in an estimated contract amount greater than $100,000.[22] For such projects, a performance bond in the amount of the contract is required, and if the contract is increased, the performance bond must also be increased.[23] However, when the project does not exceed $300,000, the state has the option to accept an irrevocable letter of credit by a bank or savings and loan association in lieu of the performance bond.[24] Performance bonds for a project being completed for the Department of Transportation are required when the project exceeds $100,000.[25] Public works projects for counties, municipal corporations, and other governmental entities are also governed by the Georgia Local Government Public Works Construction Law.[26]

When performance bonds are issued in accordance with Georgia's Little Miller Act, the surety's obligation under the bond is consistent with the statutory requirements and cannot be varied by agreement of the parties.[27] Only the obligee can maintain an action against the surety for breach of the performance bond.[28] Furthermore, any claim or action on the performance bond must be instituted within one year from the completion of the contract and acceptance of the public work by the state.[29] As the Georgia Supreme Court clarified in *United States Fidelity & Guaranty Co. v. Rome Concrete Pipe Co.*,[30] the one-year statute of limitations for actions on performance bonds begins to run on the date the work is accepted by the governmental entity, not after the

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19. 40 U.S.C. § 3131; O.C.G.A. § 13-10-1 (1982 & Supp. 2008).
20. 40 U.S.C. § 3131(b).
21. O.C.G.A. §§ 13-10-1 to -91.
22. *Id.* § 13-10-40 (Supp. 2008).
23. *Id.*
24. O.C.G.A. § 13-10-41 (Supp. 2008).
25. O.C.G.A. § 32-2-70 (Supp. 2008).
26. O.C.G.A. §§ 36-91-1 to -95 (2006 & Supp. 2008).
27. Campbell v. Benton, 217 Ga. 368, 371, 122 S.E.2d 223, 226 (1961).
28. O.C.G.A. § 13-10-42 (Supp. 2008).
29. *Id.*; O.C.G.A. § 13-10-65 (Supp. 2008).
30. 256 Ga. 661, 353 S.E.2d 15 (1987).

governmental entity has completed all of its internal contract closing requirements.[31]

D. *Private Contract Bonds*

Georgia law does not mandate performance bonds for private, rather than governmental, projects. For laborers and materialmen on private projects, the absence of a bond is not significant because they are able to lien the property to the extent of their claims.[32] However, as discussed above, because of the ever increasing complexity of the construction process, more private owners are requiring performance bonds to shield themselves from the risks inherent in the construction process. Although rarely used for residential projects, such bonds are increasing in popularity for commercial and industrial projects.

While there is no mandated statutory language or minimum requirements for private contract bonds, owners seeking the guarantees that come from such bonds must make sure the performance bond is "facially" regular or valid. The guarantee or performance bond must be in writing to satisfy the statute of frauds.[33] Also, the power of attorney for the bond must be in writing and must contain the indicia of authority to issue the subject bond.[34] For example, if the performance bond was in the contract amount of $175,000, but the power of attorney for the person issuing the performance bond recited that their power of attorney was valid for bonds up to but not exceeding $150,000, the bond would be facially irregular. The obligee under the bond would be assumed to be on notice that the bond was not valid; therefore, the obligee would not be able to assert a claim under it.

II. THE SURETY'S LIABILITY FOR A PERFORMANCE BOND CLAIM

A. *Coextensive Liability with the Principal*

For all Georgia public works projects, the Official Code of Georgia Annotated (O.C.G.A.) § 13-10-40[35] requires that the performance bond be in an amount equal to the contract, and it requires that if the

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31. *Id.* at 662, 353 S.E.2d at 16.

32. *See* O.C.G.A. §§ 44-14-360 to -369 (2002 & Supp. 2008) (stating lien rights in Georgia). Governmental or public projects, because they are owned by a governmental entity and indirectly by the tax-paying public rather than a private individual, cannot be liened.

33. O.C.G.A. § 13-5-30(2) (1982 & Supp. 2008).

34. O.C.G.A. § 10-6-2 (2000).

35. O.C.G.A. § 13-10-40 (Supp. 2008).

contract amount increases, the performance bond must also increase.[36] The O.C.G.A. states, and the cases interpreting it have repeatedly held, that a contract of suretyship is one of strict law, and the surety can in neither law nor equity be bound further than the terms of its contract, the "penal sum."[37] One change that has brought the sanctity of the penal sum into question, however, is the adoption of O.C.G.A. § 10-7-30,[38] which allows for penalties against sureties if they deny claims in bad faith.[39] Ramifications of that statute will be discussed below.

The surety's liability on a performance bond as the secondary obligor is generally co-extensive with that of its principal,[40] except that the surety's liability is limited to the amount or penal sum of the bond.[41] As a general rule, the surety's potential liability—the cost of completing the contract—should be no greater than the remaining contract balance. If the obligee manages the construction project well and carefully monitors contract funds, there should generally be sufficient contract funds to finish the project should the bonded contractor default. On the typical construction project, contractors are not paid in advance but are paid based upon the percentage of the work they complete. Even then, for completed work, the obligee/owner or general contractor will withhold ten percent or more as a retainage in the event that the contractor should default and claims are made against the project. Therefore, upon a declaration of default of a bonded contractor, the obligee should have sufficient contract funds available to allow the surety to hire another acceptable contractor to complete the contracted work or to self-perform the remaining work. While that is how the construction contract should be managed, typically the remaining contract funds are insufficient to satisfy the remaining obligations of performance.

B. *Who Can Bring a Performance Bond Claim*

As discussed above, the obligations of the performance bond run only to those persons named in the performance bond as obligees. As an illustration, if a general contractor on a Gwinnett County project furnishes a performance bond to Gwinnett County for his project work and only the Gwinnett County Board of Commissioners is named as the

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36. *Id.*

37. O.C.G.A. § 10-7-3 (2000); Roswell Festival LLLP v. Athens Int'l, Inc., 259 Ga. App. 445, 448, 576 S.E.2d 908, 911 (2003); Avec Corp. v. Schmidt, 207 Ga. App. 374, 375, 427 S.E.2d 850, 851 (1993).

38. O.C.G.A. § 10-7-30 (2000).

39. *Id.*

40. Westbrook v. Moore, 59 Ga. 204, 205 (1877).

41. Long v. City of Midway, 169 Ga. App. 72, 77, 311 S.E.2d 508, 513 (1983).

obligee under the performance bond, a lender who made a loan to that same general contractor for the project could not make a claim against the performance bond if the general contractor failed to pay that loan. However, in the same factual scenario, if the lender had also been named as a "dual obligee" along with Gwinnett County, then either Gwinnett County or the lender could make a claim under the performance bond.[42]

Georgia law is well-established that unless a surety contractually provides for third party liability, the third party must look to insurance liability policies rather than to the performance bond for payment.[43] Georgia courts have carefully restricted the surety's obligations to only those parties named in the bond as obligees, as illustrated in the case of *TRST Atlanta, Inc. v. 1815 The Exchange, Inc.*[44] In that case, the lender of an obligee on a performance bond sought to make a claim under the performance bond. Because the lender was an assignee to the obligee rather than a successor, and the bond expressly provided that no right of action would exist for anyone other than the obligee or its successors, the Georgia Court of Appeals held that the lender lacked standing to make such a claim.[45]

C. *Making a Performance Bond Claim*

Because a surety acts as a guarantor for its principal and its obligation is secondary to that of its principal to complete the contract work, it is imperative that there be a triggering event, called the default, that makes the surety's obligations under the performance bond ripe. Default can be generally defined as a material breach of the contract. A minor breach, which is harmless and easily curable, does not constitute a default and is not sufficient to justify the removal of the principal or the request for performance by the surety under the performance bond.[46] The obligee must declare the principal in default and should promptly notify the surety.[47]

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42. *See* O.C.G.A. § 13-10-42 (Supp. 2008) (providing that only an obligee may maintain a cause of action under the performance bond). The statute does not endorse or restrict the use of a joint obligee; therefore, multiple obligees are presumptively authorized under the statute. *See generally* TRST Atlanta, Inc. v. 1815 The Exch., Inc., 220 Ga. App. 184, 469 S.E.2d 238 (1996).

43. *Long*, 169 Ga. App. at 77, 311 S.E.2d at 513.

44. 220 Ga. App. 184, 469 S.E.2d 238 (1996).

45. *Id.* at 185, 469 S.E.2d at 240.

46. *See generally* James A. Knox, *What Constitutes a Default Sufficient to Justify Termination of the Contract? The Surety's Perspective*, 2:1 CONSTR. LAW. 1 (Summer 1981).

47. The better practice to salvage the project is to notify the surety as soon as a problem arises with the bonded contractor and it becomes obvious that if the problem is

If the contract contains a time period that the principal must be given to cure his performance, then the principal must be given the cure period to correct its default. If the principal does not correct its default, the obligee must then terminate the principal and notify the surety it is exercising its rights under the performance bond.

Obligees often confuse notifying a surety of problems on a project with declaring the principal in default. Until the obligee has declared an actual default and the surety is notified of that default, correspondence concerning problems that the principal has encountered on the project will generally be considered by the surety as a mere status update. It is only the declaration of default by the obligee that begins the time period to cure in which the surety must perform its obligations under the performance bond.

D. Declaring Default and Making a Performance Bond Claim

Any obligee who believes it may need to make a performance bond claim on a project should carefully read the terms of the contract concerning default and the language of the performance bond. Whether a default has been declared sufficiently and the surety properly notified generally requires that the bond and the underlying construction contract be read together because the bond typically incorporates the contract. As discussed more fully below, an improper declaration of default or faulty notice can bar an otherwise proper performance bond claim. Georgia courts have consistently construed the contract and the bond together to give plain and unambiguous meaning to both as long as each document can be read consistently with the other.[48] Georgia courts have also strictly construed the obligations of the surety in the surety's favor.[49]

The proper manner for declaring a default and making a performance bond claim may vary depending on the contract and bond language.[50] For example, in a bond approved by the American Architects Association,

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not corrected, the obligee will declare the bonded contractor in default. The surety will prompt the contractor to fulfill his contractual obligations or risk losing his bonding capacity if a performance claim is made against his bond.

48. *See* Commercial Cas. Ins. Co. of Ga. v. Mar. Trade Ctr. Builders, 257 Ga. App. 779, 783, 572 S.E.2d 319, 321 (2002); R.J. Griffin & Co. v. Cont'l Ins. Co., 230 Ga. App. 822, 823, 497 S.E.2d 586, 587 (1998).

49. *See Commercial Cas.*, 257 Ga. App. at 783, 572 S.E.2d at 321; Tucker Materials (Ga.), Inc. v. Devito Contracting & Supply, Inc., 245 Ga. App. 309, 310, 535 S.E.2d 858, 860 (2000) (quoting *R.J. Griffin & Co.*, 230 Ga. App. at 823, 497 S.E.2d at 587).

50. Obligees often dictate the required language concerning the declaration of default in the performance bond it will accept.

commonly referred to in the construction industry as the A312 bond, the bond contains the following language:

> § 3 If there is no Owner Default, the Surety's obligation under this Bond shall arise after:
> § 3.1 The Owner has notified the Contractor and the Surety . . . that the Owner is considering declaring a Contractor Default and has requested and attempted to arrange a conference with the Contractor and the Surety to be held not later than fifteen days after receipt of such notice to discuss methods of performing the Construction Contract. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract, but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default; and
> § 3.2 The Owner has declared a Contractor Default and formally terminated the Contractor's right to complete the contract. Such Contractor Default shall not be declared earlier than twenty days after the Contractor and the Surety have received notice as provided in Section 3.1; and
> § 3.3 The Owner has agreed to pay the Balance of the Contract Price to the Surety in accordance with the terms of the Construction Contract or to a contractor selected to perform the Construction Contract in accordance with the terms of the contract with the Owner.[51]

Thus, in order to properly declare a default under the terms of the A312 bond, the obligee (owner/general contractor) must follow this procedure: (1) give the surety notice that he is considering declaring the principal in default; (2) arrange a conference with the surety and its principal about the project no later than fifteen days after notifying the surety that the obligee considers the principal to be in default; (3) give the contractor a reasonable amount of time to correct its default; (4) if the contractor does not correct its default within the additional time, the obligee must formally declare the contractor in default; (5) the obligee must then terminate the contractor's right to complete the contract (however, the obligee cannot terminate the contract until at least twenty days have elapsed from the date the contractor and its surety were notified of the impending default); and (6) any contract funds that remain to be paid to the principal must be offered to the surety to allow the surety to complete the contract.[52] Anything less than what is

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51. A312 Bond, *available at* http://academics.triton.edu/faculty/fheitzman/A312%20-%20Performance%20Bond.pdf.
52. *Id.*

required by the bond offers a defense to the performance claim for the surety.

Because of the burden placed on the obligee under a typical bond, most owner/obligees refuse to accept standard bonds and instead dictate the required bond language. Generally these more obligee-friendly performance bonds simply require that the surety perform after the principal is declared in default without obligating the obligee to give the surety prior notice or to wait a certain period of time before the contract is formerly terminated. While at first such language would appear to offer the obligee a quicker resolution to the problems caused by a contractor who is not performing adequately, it has the unexpected result of often delaying the project. The owner or general contractor's inclination to quickly declare the bonded contractor/principal in default will usually lead to greater delays in the project than if the original bonded contractor had been given an opportunity to correct his default and finish the project with which it is already familiar. The process of finding another contractor and allowing the new contractor to become familiar with the project, at a minimum, will usually take weeks and can take several months.

E. Sureties' Options Upon Notice of a Claim

Upon notice of default and the filing of a performance bond claim, the surety will investigate the claim and must be given a reasonable time to either accept or deny the claim.[53] While Georgia law is not clear about what constitutes a reasonable time period,[54] whether a surety acted reasonably will be measured by the complexity of the dispute between the principal and obligee and whether the surety had time to assess its exposure, obligations, and liabilities. Whether to accept the claim often places the surety in a difficult dilemma. No other decision in suretyship is made under as much tension as when both the principal and the obligee are pointing fingers at each other claiming the other caused the project to fail.[55]

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53. *See* JOHN J. CURTIN, JR., THE BASIC BOND BOOK 20-21 (1980).

54. *See* O.C.G.A. § 10-7-30 (allowing bad faith claims to be asserted against sureties within sixty days of filing the surety notice of the claim and suggesting that sixty days should be considered a reasonable time for the surety's investigation).

55. Sometimes the surety can merely expedite and pay claims made by laborers and suppliers on the payment bond for the project to infuse enough money to keep the principal financially viable enough to finish the project, thereby negating a more expensive performance bond claim.

F. Surety Accepts the Performance Bond Claim

If the surety accepts the claim, it has several options. If the obligee is still willing to work with the principal, and problems on the project have arisen because the principal/contractor is experiencing financial difficulty, the surety may take over the remaining contract funds and work with its bonded contractor and that contractor's laborers and material suppliers, infusing funds if necessary, so that the project can be completed. Frequently this is done by paying the principal suppliers and laborers who would otherwise have a valid payment bond claim.

Often the obligee wishes to "tender" the project to the surety. In a typical surety tender arrangement, the owner/obligee agrees to pay to the surety any remaining contract funds, and the arrangement simply requires the surety to take over the project and complete it as required by the bonded contract.[56] While some sureties may have the ability to self-perform, usually by the use of preferred contractors who work with the surety, that is not always true. Upon a project being tendered, the surety is put in the position of having to either accept or deny liability. If the surety accepts liability, it generally must hire a completion contractor or tender damages equal to the completion cost to the obligee.[57] If the surety must hire a completion contractor, typically the same process that the obligee used to hire the original bonded contractor will be used: bids will be taken, and contractors will be evaluated based upon their bids and their ability to perform. Upon finding a completion contractor, the surety will enter into an agreement with the owner/obligee in which the owner agrees to accept the tendered completion contractor; such an agreement is generally known as a tender agreement. The owner and the completion contractor then enter into a separate agreement—with the completion contractor providing its own performance bond—which is usually from a different surety than the original bond. The original surety is either completely released or remains responsible for only those aspects of the project completed by the principal/contractor under its bond or for latent defects.

Another option is generally referred to as "buying back the bond." In this situation, the surety allows the owner to finish the project on its own, either by self-performing or hiring a completion contractor, and the surety tenders to the owner/obligee an amount that those parties agree

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56. To the extent the principal has defectively performed on the project, contract funds may be offset against the repair cost of the defective condition. If the cost of the defective work is greater than the contract funds, the contractor and its surety jointly and severally will be liable to the obligee for the excess cost.

57. *See* CURTIN, JR., *supra* note 53, at 22.

is sufficient for the obligee to release the surety from its liability under the bond.

G. *Surety Rejects the Performance Bond*

If the surety concludes after its investigation that it is not liable, the surety should simply advise the obligee that it does not accept responsibility and should deny the performance bond claim as submitted. Because of the advent of bad faith claims against sureties, which will be discussed below, sureties will typically explain why they do not consider themselves to be liable on the bond to avoid a bad faith claim or to establish a defense to a bad faith claim should one be asserted.

III. CLAIMS AND DAMAGES AVAILABLE AGAINST THE SURETY

A. *Statutes of Limitations Particular to Performance Bonds*

If a surety denies a performance bond claim that it receives, the owner/obligee has the option of filing suit against the surety upon denial.[58] For statutory bonds issued pursuant to Georgia's Little Miller Act,[59] performance bond claims must be instituted within one year from the completion of the contract and the acceptance of the public work by the state.[60] However, if the subject bond is not a Georgia Little Miller Act bond, the statute of limitations period is significantly expanded.[61] Nonstatutory bonds are subject to the statute of limitations contained in O.C.G.A. § 9-3-23[62] for actions on bonds. Under that statute, actions on bonds or other instruments under seal can be brought within twenty years after the right of action has accrued.[63] For an instrument to be considered under seal, the document must recite that it is under seal within its body.[64]

Parties to performance bonds should also be aware that under long established Georgia common law, parties to contracts in Georgia may shorten the period of time for filing suit below the statutory time frame so long as the stipulation violates no principle of public policy and the period fixed is not unreasonable as to show undue advantage.[65]

58. O.C.G.A. § 36-91-72 (2006).
59. O.C.G.A. §§ 13-10-1 to -91 (1982 & Supp. 2008).
60. O.C.G.A. § 13-10-42 (Supp. 2008).
61. *See* O.C.G.A. § 9-3-23 (2007).
62. O.C.G.A. § 9-3-23 (2007).
63. *Id.*
64. *Id.*
65. Brown v. Savannah Mut. Ins. Co., 24 Ga. 97, 101 (1858).

If suit is filed by the owner/obligee against the surety and does not name the principal/contractor, the surety has the option of filing a third party claim for indemnification and exoneration against its principal. However, the surety is not required to bring the indemnification claim as a third party claim and may wait until the performance bond claim has been resolved to seek indemnity from the indemnitors.[66] Obligees should be mindful that O.C.G.A. § 10-7-24[67] provides that any time a surety becomes liable on a debt, the surety has the option of giving notice to the person controlling the debt to proceed to collect the debt from its principal; if the creditor/obligee refuses to commence such an action within three months of receiving notification from the surety, the surety is discharged.[68] Therefore, the better practice is to name both the principal and the surety as defendants in a performance bond suit.

IV. CLAIMS AND DAMAGES AVAILABLE AGAINST THE SURETY

Performance bond claims are breach of contract actions. The bond constitutes the contract between the surety and the obligee. Like other contract actions, the measure of recoverable damages are those that would compensate the injured party for the loss that fulfillment of the contract would have prevented.[69] As with all parties in breach of contract actions, obligees have a duty to mitigate the damages arising from the breach.[70] If the contract provides for liquidated damages in lieu of performance, such provisions are enforceable under Georgia law.[71]

If a surety denies a performance bond claim in bad faith, obligees may make a claim of bad faith against the surety pursuant to O.C.G.A. § 10-7-30.[72] In order to perfect a bad faith claim, the obligee must give the surety at least sixty days notice of the claim before filing such an action.[73] This notice must include a demand for payment or a perfor-

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66. Although the vouching-in procedure authorized by O.C.G.A. § 9-10-13 (2007) is also available, due to the convenience and availability of third party claims, vouching in the principal is rarely used in such cases.

67. O.C.G.A. § 10-7-24 (2000).

68. *Id.*

69. *See* O.C.G.A. § 13-6-2 (1982).

70. O.C.G.A. § 13-6-5 (1982).

71. O.C.G.A. § 13-6-7 (1982). See O.C.G.A. § 13-8-2 (1982 & Supp. 2008) for illustrations of contracts considered void as against Georgia public policy.

72. O.C.G.A. § 10-7-30 (2000).

73. *Id.* § 10-7-30(b); *see also* Columbus Fire & Safety Equip. Co. v. Am. Druggist Ins. Co., 166 Ga. App. 509, 510, 304 S.E.2d 471, 473 (1983) (holding that an obligee who files suit prematurely is barred from recovering a bad faith penalty against the surety).

mance bond claim for the surety to perform as required by the bond;[74] it is not sufficient solely to notify the surety of problems on the job.[75] It is also imperative that the demand be made at a time when payment or performance is due from the surety.[76] To recover on the bad faith claim, the obligee must bring and prevail on the underlying performance bond claim. If the surety does not have an obligation under the bond to pay the performance bond claim, it cannot follow that the surety acted in bad faith in denying the claim.[77]

Assuming that the obligee is successful on its bond claim, the court could then consider the bad faith claim. Answering a certified question from the United States Court of Appeals for the Eleventh Circuit in *Colonial Life & Accident Insurance Co. v. McClain*,[78] the Georgia Supreme Court stated that to support a bad faith claim against an insurer or a surety, the party moving for bad faith must show the surety had no reasonable basis for denying the claim.[79] If the surety is able to establish that its defense was reasonable, regardless of whether that defense is accepted, a bad faith claim cannot stand.[80] This does not mean that merely having some evidence to support its reason will insulate a surety from exposure for a bad faith claim. While there are many cases expanding and explaining when bad faith claims are appropriate under the insurance bad faith statute, there are very few decisions interpreting bad faith claims against sureties. If the obligee is successful in its bad faith claim, it can recover a penalty of twenty-five percent of the liability from the surety on the successful performance bond claim or recover all reasonable attorney fees for the prosecution of the case against the surety.[81]

74. O.C.G.A. § 10-7-30(b).

75. *See* Blue Cross & Blue Shield of Ga./Atlanta, Inc. v. Merrell, 170 Ga. App. 86, 87, 316 S.E.2d 548, 549 (1984).

76. Doran v. Travelers Indem. Co., 254 Ga. 63, 67, 326 S.E.2d 221, 226 (1985).

77. Because the bad faith claim provision against insurers, codified at O.C.G.A. § 33-4-6 (2000 & Supp. 2008), is virtually identical to the bad faith claim provision against sureties, codified at O.C.G.A. § 10-7-30, cases interpreting § 33-4-6 are instructive in the suretyship context. *See, e.g.*, *Columbus Fire*, 166 Ga. App. at 510, 304 S.E.2d at 473.

78. 243 Ga. 263, 253 S.E.2d 745 (1979).

79. *Id.* at 265, 253 S.E.2d at 746.

80. *Id.*

81. Congress Re-Ins. Corp. v. Archer-Western Contractors, Ltd., 226 Ga. App. 829, 833, 487 S.E.2d 679, 682 (1997). The Georgia Court of Appeals held that either the twenty-five percent bad faith penalty or attorney fees and expenses of litigation could be recovered from the surety, but not both. *Id.*

V. SURETY DEFENSES TO PERFORMANCE BOND CLAIMS

How a surety defends the claim can be affected somewhat by whether the principal is solvent. If the principal is solvent and the obligee has filed a performance bond claim, generally there has been a significant disagreement between the principal and the obligee about the project, and the principal is refusing to perform because of that disagreement. When the surety investigates the claim, the principal will insist that the surety deny the claim because the claim is invalid. This places the surety in the untenable position of being caught between having a claim filed by its principal against it for paying an invalid claim under the bond and avoiding a bad faith claim by the obligee for failure to pay the performance bond claim. Although the surety will investigate both the factual and legal basis for the obligee's claim, because the surety is not a party to the project and must rely upon the principal and the obligee for information, it is often difficult for the surety to discern which party is providing an accurate version of the facts. While the general agreement of indemnity gives the surety discretion to pay claims and seek reimbursement from the indemnitors, a surety frequently will not pay a performance bond claim if its investigation indicates the obligee, rather than the principal, breached the underlying construction contract because the payment could relieve the principal of any further responsibility under the contract.

If the principal is insolvent and the surety's investigation reveals the principal's financial woes led to the default, the surety may concede that its principal breached the construction contract and that the performance bond claim is valid. Much to the dismay of the affected surety, the bonded principal will sometimes invite the obligee to file a performance bond claim to remove the pressure for the principal to complete the project. On the other hand, it is also very common for the insolvent principal to blame the obligee's handling of the project for his financial woes and to insist that the surety reject the performance bond claim because the obligee caused the principal to default. Some of the typical defenses offered by sureties to performance bond claims are explained below.

A. *Surety's Risk Has Been Materially Increased*

In the perfect project, the money remaining to be paid in the contract balance at the point of default would be approximately the cost of completion. In many cases, however, the bonded contractor underbid the project. This problem may be explained by the practice of governmental contracts being awarded to the lowest responsible bidder. It is not uncommon for a contractor to take on a contract that is too large or difficult for his capabilities and for the surety to be notified of its principal's default at a point when its principal is no longer financially solvent and there are no (or little) contract funds to keep the project afloat. If the surety is given notice in time, the surety may elect to infuse money into the project in the form of paying payment bond claims to laborers and materialmen on the job. Those funds may be sufficient to give the principal some financial breathing room and allow it to get the project back on track. Typically, to complete the contracted work, the surety will incur substantial losses because the remaining contract funds are insufficient to finish the project, and the cost of supplies and labor has risen since the bonded contractor's bid was submitted.

If the contract funds were severely depleted or exhausted, the surety may assert the defense that its risk was materially increased by the obligee's actions.[82] If the obligee pays the principal substantially more than the value of the work the principal has completed on the project, the risk to the surety has been increased because there are no longer sufficient contract funds to complete the remaining contract work. The same is true if the surety is not advised of substantial bonded contract increases in scope and contract price. Under Georgia law, any material change in the terms of the underlying construction contract is considered a novation and discharges the surety unless the surety consents to the change.[83] The surety is discharged even if it is not injured by the change.[84] In order to be considered a "material" change, most bonds contain language requiring the surety's consent to changes above a certain threshold level of ten to fifteen percent of the original contract amount.

Another way in which the surety's risk under the bond can be materially increased is if the surety is not notified that the obligee is considering declaring the principal in default. While sureties will generally send out periodic requests for information about the project to the obligee, the surety generally does not inspect the project site and is not aware of the day-to-day operations of the project; therefore, the surety is dependent upon the obligee and principal to make it aware of significant problems concerning its principal. The best practice is for the obligee to notify the surety as soon as it appears likely that the obligee may have to declare the principal in default on the project.

A counterclaim that often goes hand-in-hand with the defense that the surety's risk has been materially altered is that the surety is entitled to

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82. *See generally* Brunswick Nursing & Convalescent Ctr., Inc. v. Great Am. Ins. Co., 308 F. Supp. 297 (S.D. Ga. 1970).

83. O.C.G.A. § 10-7-21 (2000).

84. *Id.*; *See Brunswick Nursing*, 308 F. Supp. at 302.

an accounting of the contract funds. As a secondary obligee, the surety is entitled to credit for the remaining contract funds to avoid losses on a performance bond claim. On many projects when the principal is declared in default, the percentage of funds remaining to be paid under the contract is significantly less than the percentage of work to be performed. When the surety is forced to complete a project in which more of the contract funds have been paid than work completed, the surety is left to seek money from its indemnitors, who are generally the principal bonded contractor and its key employees, all of whom are probably financially strained or bankrupt at the time the performance bond claim is made. While the surety may be able to frequently prevail in an indemnity action, if the project problems have drained the principal as well as affecting the financial viability of its key employees, the surety is left without a remedy.

B. Subrogation

One of a surety's strongest defenses is that of subrogation. When a surety is called upon to perform its obligations under a payment or performance bond, the right of subrogation is inchoate and becomes choate upon the surety's payment of the claim.[85] If the surety steps in and completes the project under the performance bond or pays damages to the obligee, the surety becomes subrogated to the obligee's rights, including the right to be reimbursed from the contract funds.[86] The surety is also entitled under the principle of equitable subrogation to assert any claims and defenses that its principal would have against the performance bond claim.[87]

C. Conditions Precedent

There are often conditions precedent that must be met before a valid performance bond claim can be filed. For example, in Section II.D. of this Article, we examined the six conditions precedent to the obligor making a performance bond claim if the bond issued for the project is a A312 bond.[88]

It is an axiomatic condition precedent in all cases that because the surety is a secondary obligor, the principal must fail to perform under

85. Cotton States Mut. Ins. Co. v. Citizens & S. Nat'l Bank, 168 Ga. App. 83, 86, 308 S.E.2d 199, 202 (1983).

86. To the extent that the surety has paid materialmen or laborers, the surety steps into the shoes of those parties as well through equitable subrogation.

87. *See* Autry v. Palmour, 124 Ga. App. 407, 408, 184 S.E.2d 15, 17 (1971).

88. *See supra* text accompanying note 52.

the underlying construction contract.[89] Based upon the information collected by the surety during its independent investigation of the performance bond claim, the surety may take the position that its principal did not default on the project, but rather that it was wrongfully declared in default by the obligee. This argument also ties into the defense of prior material breach, because if the obligee wrongfully defaults the principal refusing to allow it to complete the project, that conduct constitutes a prior material breach.

To the extent that notice is required to be given to the surety before a performance bond claim is filed, or to the extent that the construction contract or the bond gives the contractor a certain cure period, the obligee's failure to provide that notice or to permit the contractor to cure during the requisite time constitutes a failure of a condition precedent and provides the surety with a defense to the claim.[90] When notice is given, but the project has spiraled out of control by the time of notice and is unsalvageable, the surety may defend on the basis that the notice was untimely, amounting to a failure to provide notice.[91]

D. *Prior Material Breach*

As discussed above, if the obligee breached the contract first, the surety may assert its principal's defense that the prior material breach relieved the principal of its obligations under the underlying contract and therefore also relieved the surety of its obligations under the bond.[92] Typically the bond references and incorporates the terms of the underlying construction contract, giving the surety the same defenses as its principal.

E. *Timeliness*

A statute of limitations defense is available if a performance bond claim is not filed within the statutory period. In *United States Fidelity & Guaranty Co. v. Rome Concrete Pipe Co.*,[93] the Georgia Supreme Court held that the statute of limitations begins to run upon acceptance by the obligee and that the close-out process does not extend the limitations period.[94] Practitioners should also be mindful that statuto-

89. *See generally* Commercial Cas. Ins. Co. of Ga. v. Mar. Trade Ctr. Builders, 257 Ga. App. 779, 572 S.E.2d 319 (2002).

90. *See generally id.*

91. *See generally id.*

92. Rome Hous. Auth. v. Allied Bldg. Materials, Inc., 182 Ga. App. 233, 237, 355 S.E.2d 747, 751 (1987).

93. 256 Ga. 661, 353 S.E.2d 15 (1987).

94. *Id.* at 662, 353 S.E.2d at 16.

ry bond claims must be brought within one year of acceptance of the project,[95] while other performance bond claims are subject only to the generous twenty year limitations period for bonds.[96]

F. Fraud

Pursuant to the Third Restatement of the Law of Suretyship and Guaranty, if the obligor knows of material facts that affect the risk of the surety's undertaking, has reason to believe that these material facts are not known to the surety, and has a reasonable opportunity to make these facts known to the surety, the obligor's failure to communicate such information to the surety constitutes a material misrepresentation that discharges the surety.[97] In Georgia, fraud can be either actual or constructive.[98]

An example of actual fraud that would release the surety's obligation would be if the obligee actively conspired with the principal on an underlying contract that was worth only $50,000 to alter the requirements of the job to make a $100,000 contract amount seem reasonable to the surety. Upon issuance of the bond in the amount of $100,000, the principal is declared in default, and the obligee makes a performance bond claim, using only $50,000 of the funds to finish the project.

As an example of constructive fraud, if the obligee knows the principal's bid for the project does not include an expensive aspect of the project, but the obligee accepts the principal's bid anyway without making that fact known to the principal or the surety, with the intent of waiting for the principal to default because of the error and allowing the obligee to recover the excess as completion costs, the surety would be relieved of its obligation.

G. Failure to Join a Necessary Party

Pursuant to O.C.G.A. § 10-7-24,[99] any time a surety becomes potentially liable on a debt, the surety may give notice to the person controlling the debt to proceed to collect the debt from its principal.[100] If the person controlling the debt (the obligee, in performance bond claims) does not commence an action to collect the debt against the principal within three months from the time the surety gives notice, the

95. O.C.G.A. § 13-10-42 (Supp. 2008).
96. *See* O.C.G.A. § 9-3-23 (2007).
97. RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 12 (1996).
98. O.C.G.A. § 23-2-51 (1982).
99. O.C.G.A. § 10-7-24 (2000).
100. *Id.*

surety is discharged.[101] Because of this statute, the better practice for obligees seeking court intervention to declare it has made a proper and valid performance bond claim is for the obligor to file suit against both the principal and the surety, alleging that both have breached their contracts with the obligee. The defenses discussed above are not intended to be exhaustive of the defenses available to sureties but are merely discussed as certain defenses that are often asserted by sureties.

VI. THIRD PARTY CLAIMS AVAILABLE TO THE SURETY

To protect its bargained for position of being loss-free on a bonded project when a performance bond claim is filed, generally the surety will assert a third party claim for indemnification against its indemnitors for that bond. However, before filing such a claim the surety will typically make a demand upon the principal for indemnification or for posting additional collateral security. If the principal complies with that demand and keeps the surety fully indemnified, there is no reason for the surety to resort to litigation to protect itself.

Should the principal refuse or be unable to comply in the case of the financially trouble, the surety may seek to remain loss free by filing either a separate indemnification action or a third party claim against the indemnitors in any litigation stemming from the performance bond claim. The surety's right to seek indemnification is not only contractual through the general agreement of indemnity contract, but sureties also have common law indemnity rights to the extent they are forced to pay claims for which the principal is primarily liable.[102]

The surety also has equitable remedies against the indemnitors. Under the equitable doctrine of exoneration, the surety may compel the principal to use its funds to satisfy the performance bond claim because the principal is the primary obligor.[103] The rationale underlying an exoneration claim is that by providing a bond to the principal, the surety provided a credit guarantee and did not actually undertake the risk of having losses against the bond. Accordingly, the surety is entitled under the equitable doctrine of exoneration to have its principal pay out any remaining funds in its possession to satisfy the performance bond claim before the surety must use its own funds to satisfy its obligations as the secondary obligor.

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101. *Id.*

102. *See, e.g.*, Campbell v. Rybert, 46 Ga. App. 461, 461, 167 S.E.2d 924, 924 (1933); *see also* 41 AM. JUR. 2d *Indemnity* § 20 (2005).

103. RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 21 (1996); 23 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 61:61 (4th ed. 2002).

The surety may also exercise its equitable right of *quia timet*.[104] *Quia timet* is the right to be protected against anticipated future injury.[105] Utilizing this doctrine, the surety is entitled to seek additional funds from the principal in an amount sufficient to cover its anticipated losses.[106]

A surety may also utilize the equitable remedy of a preliminary injunction to seek specific performance of the collateral security requirement of the general agreement of indemnity to protect it from losses on the bond.[107] Georgia law requires that before a trial court may grant an interlocutory injunction, the court must find that the injunction is necessary to maintain the status quo until a final hearing and find that the equities favor the party seeking the injunction.[108]

To show entitlement to a preliminary injunction, the surety must show it is necessary to issue the injunction so the surety will not be damaged or left without an adequate remedy to prevail on that claim.[109] Sureties generally resort to this remedy only if the principal is disposing of the assets necessary to stay in business or of the assets relied upon by the underwriters to determine the principal was an acceptable risk during the underwriting process.

VII. CONCLUSION

Performance bonds are vital to the construction industry for the assurance they provide to owners/obligees in the event of default by the principal. The ability of the obligee to recover on the performance bond, as this Article highlights, is not guaranteed. Rather than simply relying on the assurance provided by a performance bond, owners would be wiser to conduct their own investigation of potential contractors before entering into a contract with them. When a contractor is bonded, should the owner begin to believe that it might be necessary to declare the principal in default, the surety should be notified and allowed to work with the principal to get the project back on course. If the principal is a capable contractor, it is more likely that the bonded contrac-

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104. *In re* Farmland Indus., Inc., 296 B.R. 793, 798 n.1 (B.A.P. 8th Cir. 2003).

105. *Id.*

106. *Id.*

107. Star Ins. Co. v. Cedar Valley Express, LLC, 273 F. Supp. 2d 38, 42 (D.C. Cir. 2002).

108. Hampton Island Founders, LLC v. Liberty Capital, LLC, 283 Ga. 289, 293, 658 S.E.2d 619, 624 (2008); Ayer v. Norfolk Timber Inv. LLC, 291 Ga. App. 409, 410, 662 S.E.2d 221, 223 (2008).

109. *Hampton Island*, 283 Ga. at 293, 658 S.E.2d at 624; *Ayer*, 291 Ga. App. at 410, 662 S.E.2d at 223.

tor/principal, with the assistance of its surety, will finish the project in a timely manner within budget than would a completion contractor. If all else fails and the obligee declares a default, all parties to this tripartite agreement—the owner, the bonded contractor and the surety—will be scrambling for the contract funds to protect their own interests. As the remaining contract funds are typically insufficient to finish the project, the stage is set for competing claims by the obligee, surety, and principal against one another, as each seeks to limit its liability for the actual cost of completing the bonded contract. When it comes to performance bonds, an ounce of prevention truly is worth a pound of cure.