Construction Law Newsletter

Published by the Section on Construction Law of the Oregon State Bar Association

Issue No. 8 June 1990

Default from the Surety's Perspective

I. Introduction

A. General description of basic surety principles.

1. Purpose: Surety's obligation under its bond is to perform and/or pay upon the contractor's inability to do so.

2. Contract among three parties: the surety, the obligee (owner or general contractor) and the principal (prime contractor or subcontractor).

3. A surety's liability under its bond is conditioned upon its principal's liability; the surety is obligated to perform under its bond if the principal defaults.

4. If the surety is required to perform and/or pay under its bond, then it is entitled to demand reimbursement from its principal/contractor for all losses incurred by it.

5. Upon payment of claims or performance, the surety is entitled to be reimbursed out of any sums owed by the obligee to the defaulting principal. Those funds are in the nature of a trust to reimburse the surety who is forced to pay on its bond. Prairie State *Bank v.* United States, 164 US 227 (1896) (surety is entitled to assert the equitable doctrine of subrogation to recover funds). Generally, the surety's equitable lien is superior to all other liens. *Pearlman v.* Reliance *Ins.* Co., 371 US 132 (1962) (Surety is entitled by subrogation to reimbursement from a fund otherwise due to the contractor but withheld by the government pursuant to the terms of the contract, even though the contractor went bankrupt and the government turned over the funds to the contractor's trustee in bankruptcy); *Henningsen v.* US *Fidelity & Guaranty Co.*, 208 US 404 (1907) (Surety's right to retained funds is superior to that of a bank loaning money to the contractor, secured by assignments of amounts to become due); *In* Re Pacific Marine *Dredging and Const.*, 79 BR 924, 928 (Bkrtcy D Or 1987) (Surety's claim to funds withheld by owner from debtor was an equitable lien under Oregon law; surety's lien was superior to competing claims of creditor with a security interest in debtor's accounts and general intangibles and claims of the debtor, in its status as a hypothetical lien creditor); United Pacifii *Ins.* Co. *u.* First National *Bank* of Oregon, 222 F Supp 243, 248-50 (D Or 1963) (Court held that the surety's rights to funds were superior to the trustee in bankruptcy); *Transamerica Ins.* Co. *u. Barnett Bank, 540* So2d 113, ___ Fla ___ (1989) (Court held that the surety's subrogation rights are superior to perfected UCC security interest).'

6. The penal amount of each bond will usually be the amount of the contract although bonds are sometimes issued in an amount less than the contract price.

7. Generally, the penal amount of the bond represents the extent of the surety's liability. If claims exceed its penal amount, then the claimants receive a pro rata share of the bond proceeds.

II. Performance Bond Surety: Guarantees to the owner/obligee that the project will be completed in accordance with the plans and specifications.

A. Surety's options upon the contractor's default are generally to complete the contract itself, obtain bids and pay for the completion of the contract up to the penal amount of its bond using first the balance of the contract price, or to tell the owner to rebid the project and pay the appropriate excess reprocurement cost.

B. Default:

1. Undisputed Default: Surety ordinarily contacts the indemnitor, the obligee and the principal; investigates the default; examines the contract documents and its bond; decides what its obligations are and how the default will be cured.

2. Options upon default.

(a) Take over and relet: When the default is not

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disputed and neither the contractor nor the surety have meritorious defenses to the obligee's claims, the surety can elect to take over and relet the contract.

(i) If the surety makes this election, it assumes responsibility for completion of the contract. The surety should be careful not to waive its penal sum. ***Copeland Sand v. Ins. Co. of N. Amer.*, 288** Or **325,332,607 P2d** 718 (1980) (Surety, by assuming the principal's role in the actual performance of the principal's contract may become responsible for performance of the principal contract and for all obligations incurred in connection with performance, notwithstanding the limits of liability; the court found that under the facts the surety did not assume performance of the contract).

(1) it may step into the shoes of the defaulted principal and subcontract the work to a completion contractor:

— it receives contract payments from the obligee and directly pays the completion contractor.

— it must enter into a contract with the completion contractor under which the contractor must agree to: (a) complete work in accordance with the plans and specifications; (b) perform all other obligations of the principal under the original contract; (c) should require it to post payment and performance bonds for completion of the work, naming the surety as obligee.

— attempt to enter into an agreement with the obligee that payments made by the surety toward completion reduce the penal amount of the bond. Surety must take care to negotiate an appropriate takeover agreement with the obligee ensuring application of remaining contract funds, earned progress payments and retainage. Further, it should get a waiver of liquidated damages.

(2) it may obtain bids for completion of the work and tender the lowest bidder to the owner. The surety is obligated to pay the owner the difference between the remaining contract balance, including retainage, and the completion contractor's cost to complete up to the penal amount of the bond.

— the owner will accept the completion contractor and is responsible for paying all contract funds to the completion contract with the surety paying costs of completion above the original contract price.

— this allows the surety to establish the completion costs upon execution of the contract between the owner and the completion contractor. The surety can then seek to have its bond obligations released. The obligee may agree if full replacement bond is given by the completion contractor to cover completion of the **work.**

— this gives the surety control over completion costs. Again, the surety must take care to negotiate an appropriate takeover agreement with the obligee ensuring application of remaining contract funds, earned progress payments and retainage; and waive liquidated damages.

(b) Finance the principal. Extremely risky because, money spent by the surety to finance does not reduce the surety's liability under its performance bond. ***Granite Computer Leasing Corp. v. Travelers Indem.*, 582** F Supp **1279** (SD **NY 1984)** (Plaintiff argued that surety had a duty to finance a failing principal; court found that when surety finances principal, it may be liable for additional costs of completion when principal defaults); ***Copeland Sand v. Ins. Co. of N. Amer., supra* 288** Or at **332-333** (payments by a surety receive no credit on the bond penalty).

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— Surety's liability under its performance bond will be reduced if the owner at the outset agrees that funds expended by the surety in financing the principal's completion will be credited against the surety's liability, if any, under the bond.

-- Advantages are that the surety is available to control costs, retain the contractor's records and equipment and keep original subcontractors and suppliers.

— Disadvantages include: administration required to supervise completion; costs of completion do not reduce the penal limit of the bond, and it is normally necessary to finance the nonbonded obligations, such as office overhead; the contractor may lose interest if it is unable to make a profit; risk of losing equitable subrogation rights if the money loaned to the contractor cannot be traced to bond claimants; possibility of incurring tax obligations as a successor employer.

— No court has yet found that surety has a duty to finance its principal. ***See, Granite Computer Leasing Corp. v. Travelers Indem., supra; Lambert v. Maryland Cas. Co.,*** 403 So2d 739 (1981), ***aff'd*** 418 So2d 553 (1982) (surety owes a duty of good faith to its principal and indemnitor, but that duty does not require a surety to continue to support its principal by providing additional bonds, advancing funds, or forebearing from exercising its legal rights.

(c) Tell the owner-obligee to rebid and simply pay the owner the excess reprocurement cost up to the penal sum.

2. Disputed Default:

(a) Principal disputes owner's declaration of default and refuses to cooperate with the surety. Surety is in a dilemma.

(i) Action by surety over principal's objections may result in impairment of surety's indemnity rights, and/or suit by principal for interference with its contractual relationship with the owner. ***City*** of ***Portland v. George D. Ward & Assoc.,*** 89 Or App 452, 750 P2d 171 (1988) (surety has a duty of good faith).

(ii) if surety fails to cure the principal's default, the surety may subject itself to suit by the obligee seeking damages for the surety's refusal to complete the project or otherwise perform under the terms of its performance bond.

(b) When faced with a dispute, the surety should carefully examine its bond and the principal's contract to determine its obligations. Investigate the default and the reasonableness of the principal's position.

(c) Blind reliance by the surety upon the principal's position without an investigation of the reasonableness of the principal's position may subject it to additional liability. ***see Continental Realty Corporation v. Andrew J. Crevolin Company,*** 380 F Supp 246 (S.D. W.Va. 1974)[2] ***but see Georgia Electric Supply Company, Inc. v. United States Fidelity and Guarantee Company, 656*** F2d 993 (5th Cir 1981).[3]

(d) Under ***Amfac Mortgage Corporation v. Arizona Mall of Temple, Inc.,*** 583 F2d 426 (9th Cir 1978), a surety may not be held liable for "bad faith" breach of its contract with the owner. The surety owes a good faith duty only to the obligee.

C. Surety's rights:

1. Contractual.

2. Common Law.

(a) Control performance, and to take over and complete the contract.

(b) Contract Balances (including retainages).

(c) Bind the indemnitor waiver of exemptions on certain property.

III. Payment Bond

The payment bond is the surety's undertaking to pay valid claims of its principal's unpaid subcontractors and suppliers. Generally, the contractor and surety "jointly

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and severally" agree with the owner that "claimants" as defined by the bond, who have not been paid within **90** days after the date on which the last work was performed, or materials were furnished, may sue on the bond *to* recover the value of materials furnished or labor performed.

A Private Projects.

1. Generally, in private sector, performance and payment bonds are not statutorily required. If no bond is given, then the unpaid subcontractors and suppliers must seek protection under the lien laws of the state.

2. If a bond is given, then most states have statutes which govern the rights and obligations under the bond.

3. Who is protected Defined by contract or by statute.

4. What is protected: The AIA payment bond on private work covers labor, material, or both, used or reasonably required for use in performing the contract.

B. Public Project.

1. Miller Act. Federal public construction projects. No delay damages.

(a) No notice requirements prior to filing suit on bond if bond claimant had a direct contractual relationship with the contractor.

(b) Other claimants must give notice of claim within **90** days after last performance or supply of materials.

2. "Little Miller" Acts. Nonfederal public construction projects.

(a) In Oregon, all claimants must give notice of claim no later than **120** days after last performance or supply of material. ORS **279.528.**

3. Surety has duty *to* make reasonable investigation of validity of claims against it or to consider reasonably the validity of its counterclaims and defenses. ***City of*** *Portland v.* ***George D.*** *Ward & Assoc., supra,* **89 Or** App at **457-8.**

4. Who is protected Class of people who furnish labor and materials *to* the project. (Distinguish from those who furnish labor or materials for performance of the project.)

5. What is protected: Similar *to* the private payment bond. However, states vary regarding whether the materials must actually be incorporated into the project to be protected.

By Joseph A. Yazbeck, Jr.

Footnotes

'Further Oregon cases: ***Wasco County v. New England Equitable Insurance Company,*** 88 **Or** 466, 172 P 126 (1918)(surety having discharged its obligations was equitably subrogated to retainage withheld by the County); *Derby v.* ***U.S. Fidelity and Guaranty Co.,*** 87 Or ***34,*** 169 P 500 (1917)(performing surety abrogated to rights of State in retained percentages); ***Wehrung v. Denham,*** 42 Or 386, 71 P **133** (1903)(retainage constitutes fund for the protection of surety; surety discharged where obligee impairs surety's rights by over-disbursing retainage); ***New Amsterdam Cas. Co. v. City of Astoria,*** 256 F ***660*** (D Or 1919)(surety's subrogation rights in retainage superior to claims of contractor's assignees); ***cf., In re Bank of Woodburn,*** 149 Or 649, 42 P2d 740 (1935)(upon payment, surety became subrogated to rights of United States and was entitled to have its claim paid first from the assets of the failed bank and prior to payments of any secured or unsecured claims and irrespective **of** any priority provisions contained in any state statute); ***Fidelity and Deposit Co. of Maryland v. State Bank of Portland,*** 117 Or **1, 242** P **823** (1926)(despite statute governing priority of liens against assets of failed bank, surety was entitled to priority by virtue **of** its subrogation of rights of State).

[2] In ***Continental Realty,*** the obligee sued the surety for failing to perform in accordance with the obligations of the bond upon the principal's default. The surety defended, stating that it had no right to proceed unilaterally and that it **was** bound to follow its principal's position that the owner was in default of the contract. The surety claimed that to do otherwise would prejudice its principal's rights. The **court,** in rejecting that position, implied that if the surety had investigated its principal's defenses, it would have rejected them and taken a different **m u m** of action. **The** murt held that the bond penalty only limits the surety's liability for the principal's breach of the underlying mntract and not the surety's liability on its bond, and therefore the surety is liable for **all** damages incurred hy the obligee, even those in **excess** of the bond penalty.

[3] In *Georgia Electric,* the murt found that it was reasonable for the surety to rely on its principal, leaving the investigation and defense of the claim to its principal, who was more familiar with the project and ultimately liable under its indemnity agreement.

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Default: The Public Owner's Perspective

Construction Law Section Meeting of March 10, 1990

A. Introduction

When a contractor appears ready to default, or has already left the job site, the owner of the project must begin a delicate process of attempting to complete the work while not jeopardiziigits own rights or the rights of the surety or contractor.

In addition, the owner must determine whether a contractor's failure to complete lies with the owner. To that extent the owner must review any claims against its architect, engineer and inspection staff.

It is key for the owner to consider not only completion of the work as detailed in the specifications but also to consider the obligations of the out-going contractor to subcontractors and members of the public impacted by the contractor's construction. Follow-on work must include responsibility for these items as well.

B. Termination

1) Right to Terminate

a) Contractual Basis

When considering termination the Owner's first move should be an examination of the grounds for termination found in the contract. Compliance with the terms of the termination clause in a contract is critical for sustaining the Owner's action.

Three common grounds for termination are:

(1) Unreasonable delay in completing the project;

(2) Failure and/or refusal to make progress payments or "endangering" the timely completion of the project; and

(3) Breach of some other contract clause.

The American Institute of Architects (AIA) Document A201 is a form often used by Owners and Contractors. If you are used to working under this document please keep in mind that there have been significant changes in the 1987 version. One major change is, a failure to promptly pay subcontractors may not be a basis for default depending on the agreement between *the Contractor and its Subcontractor.*

One source also warns that the 1987 version "provides that the Owner's remedies upon default are 'subject to any prior rights of the [defaulted contractor's1 surety.' This qualifies language found in subparagraph 14.2.3. . . which provides that the terminated contractor is not entitled to receive future payment until the completion of the contract work." Cushman and Meeker, *Construction Defaults: Rights, Duties and Liabilities,* (1990).

b) Contract must be executory

Termination for default is available only when the contract is executory, *i.e.* where some performance still remains. *Building Contractors, Inc.,* ASBCA No 14840, 71-1 BCA 8884 (1971). Thus default termination is not available where the contract is substantially complete." Tieder and Hoffar, *Proving Construction Damages.*

c) Failure to complete on time

Where a completion date is specified in a construction contract, timely performance is considered an essential element of the contract. *Ajax Company,* ENG BCA No. 3377, 76-1 BCA 11,645 (1975). If a Contractor has not completed the project by the date set in the contract the Owner may terminate the Contractor for default. *Northside-Danzi Construction Company,* ASCBCA Nos. 25058, 25238, 81-2 BCA 15,306 (1981). This assumes, however, that the Owner is not the reason for the Contractor's failure to complete on time, *i.e.*, that the Contractor's failure to complete on time was excusable. In that situation termination by the Owner probably would not be appropriate. Thus, an Owner must evaluate its own action prior to termination.

d) Waiver of Right to Terminate

A public Owner may waive its right to terminate. Waiver may occur where the specified completion date is waived and no new completion date is established. This is especially true where the Owner encourages the Contractor to complete after the contract's completion date but does not establish a new completion date. *See, Milo Werner Co.,* IBCA No. 1202-7-78, 82-1 BCA 15,698 (1982) where the government's termination for failure to complete on time was to be changed to a completion for the convenience of the Contractor.

An Owner may be held to have *constructively waived* its right to terminate and may be estopped from terminating the Contractor who has otherwise defaulted. Forbearance in termination, unless couched as a period of cure, with a specified completion date, may bar an Owner's later attempt to terminate.

If the Owner wishes to reestablish that time is of the essence it must clearly do so and state that the new completion date will be enforced.

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e) Justifiable Insecurity Regarding Contractor's Intention or Ability to Complete on Time.

If an Owner has a "justifiable insecurity" regarding the contractor's ability or intention to complete the contract the Owner may terminate for default. Discount Company *u.* United States, **213** Ct.Cl. **567,554** F.2d **435,** cert denied **434** US **938 (1977).** In the Discount case the court held that the Owner would be justified in termination where the Contractor's "demonstrated lack of diligence indicated that the Owner could not be assured of timely completion." To sustain its right to terminate the Owner will have to prove that it had reason to believe that the Contractor was incapable of timely completion of the contract. **This** may be established by comparing the percent of work left to accomplish and the percent of contract time left on the project. A failure to meet some interim completion dates may be sufficient to prove an inability to complete the entire contract on time. *Mel* Williamson, *Inc.*, ASBCA No. **22938,** 80-2 BCA **14, 631 (1980);** *Tri-State Construction* Company, ASBCA No. **22558, 79-1** BCA 13,644 **(1979);** First National Bank of Aberdeen *v.* Indian Industries, **600** F.2d **702** (8th Cir. **1979).**

The Owner may not need to prove actual impossibility but only that the Contractor's action reasonably appeared to endanger completion on time.

A Contractor's abandonment or repudiation of the project may also be the basis for an Owner's default. Such action could be considered an anticipatory breach. The Owner must be careful to attempt to get a clear and unequivocal statement from the contractor if it intends to depend on this ground for termination. See, Restatement (Second) of Law, Contracts **277.** Also see City of *Fairfax,* Virginia *v.* Washington Metropolitan Area *Transit Authority*, **582** F.2d **1321 (1978).**

f) Default for Fraud

In at least one case the government's termination due to the contractor's fraud, was sustained. See Joseph Morton Co., *u.* United States, **3** Cl.Ct. **120** (1983), 2 FPD **7,** 7 c.c. **293** (1983). In that case the court concluded:

> "It is settled law that a contract termination can subsequently be defended on the basis of an adequate cause for such termination which existed at the time; even if then unknown. . .. A Contractor engaged in fraud in its dealings with the government on a contract has committed a material breach justifying a termination of the entire contract for default."

g) Defenses to Termination

The Contractor will look to the contract and the Owner's responsibilities thereunder. The Owner's refusal to grant time extensions and or to act on its affirmative duties under the contract may provide a defense to termination. Commercial impracticability or impossibility may excuse a contractor and make termination improper and wrongful.

As mentioned previously, substantial completion may also make termination wrongful. At the point of substantial completion the Owner is obligated to give the contractor a reasonable period to cure. ***As*** a general rule an Owner may not terminate for default after substantial completion. **For** example, it would be improper to terminate for default just because a few, non-material, punch list items remained to be completed. However, since the Owner has a right to a completed project a contractor's clear inability or refusal to complete the contract work may, even after substantial completion, be grounds for termination for default. Owners should be careful in such instances and may wish to complete the work themselves and deduct the cost from the remaining contract amount.

Whether or not the contractor has substantially performed is a question of fact. Courts may consider the following items:

- Whether or not the Contractor could reasonably believe it had performed pursuant to the contract;
- The extent of the defect;
- The ease of correction;
- The extent to which the contract's purpose is defeated by the unfinished work;
- The benefit to the Owner of the work already performed; and
- The urgency of the Owner's need for correction or completion.

A Contractor may be excused for delay by the following:

1) weather
2) fire
3) floods
4) other acts of God
5) strikes
6) war
7) Delay due to changing defective specifications, dealing with differing site conditions (assuming such a clause exists in the contract), failure of Owner to furnish materials or labor.
8) The Owner's wrongful work stoppage.

Note, normally the failure of the contractor to have

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sufficient funds to continue will not be grounds for excusable delay.

2. Termination Decision

a) Owner's Burden of Proof

The Owner must prove that it was justified in terminating the Contractor. This means proving compliance with termination procedures and a set of a facts to support its belief that the Contractor was in breach. If breach is of a condition other than timely completion the Owner will have the burden of proving that the breached provision was material to the contract.

b) Alternatives to Termination

Due to the extreme nature of termination the Owner should consider whether there are alternatives to termination. This process, however, should only be considered if the Owner really believes the Contractor can or is willing to continue working. In addition, such action should only be taken when to do so would not lead to a waiver situation for the Owner.

Owners about to terminate for breach, who may be concerned about their ability to prove inability to complete on time or other material breach, may wish to determine whether they have the right, under the contract, to terminate for the Owner's convenience. While there will be some termination costs involved the Owner's burden of proof is substantially less.

The down side to this proposal is that **1)** the termination for convenience costs may include payment for work performed; 2) overhead and fixed costs which cannot readily be cut off as of the date of termination; 3) if the project is federally funded, federal approval may be required prior to termination; and 4) there will be no recourse to the surety bond and uncompleted work will have to be performed at the Owner's expense.

Another option might be to use the contract's "changes clause." This clause could be used to eliminate work the contractor will not be able to complete and which can be completed at a later date. This would be a deductive change. The amount of the deductive change "is normally measured by what it would have cost the Contractor to do the work in the actual time frame and under the circumstances then applicable under the contract, rather than the contractor's original bid price or estimate. Nager Elec. *Co. v.* United States, 442 F.2d 939, 194 Ct. Cl. 835 (1971)." Cushman and Meeker, *Construction Defaults: Rights,* Duties and Liabilities (1989).

Assuming that funds are sufficient, an Owner might consider, after giving notice of defective work, completing the work itself, using retainage, as an alternative to default.

3. Termination Procedure

Termination must be accomplished in the method prescribed in the contract.

Generally, contracts require some notice and even a period in which to cure. Notice to the Contractor's Surety is also usually required. The Owner should be sure that its notice letter clearly states whether it includes the right to cure or is only a notice of the Owner's intent to terminate.

Another option, even if not provided for in the contract, would be, prior to sending the termination letter, for the Owner to send "show cause" notice to the Contractor requiring the Contractor to show cause why the contract should not be terminated.

When the Owner is ready to send the actual termination notice it is advisable that it do so by registered letter or some other formal procedure to ensure that notice was received. This would apply for notice to the surety as well.

4. Hearing Prior to Termination

If the contract and the public body's procedure are silent regarding the right to a hearing prior to termination such hearing is generally not required. In *Riblet* Tramway Co. *v.* Stichney, 523 A.2d 107 (1987) a New Hampshire court held that the contractor's ability to go to court satisfied its right to due process. Those dealing with federal contracts must be sure to read them carefully for any prior consultation or presentation opportunities.

5. Completion of Performance by the Bond Surety

a) Generally

When termination is appropriate and has been properly executed an Owner must examine its options for completion of the work.

The Owner may hire another contractor and complete the work and then be able to recover its additional costs in so completing. Tri-State, supra. The Owner may determine its costs by comparing the difference between the original contract price and the price paid to the follow-on contractor. Asheville Contracting Company, DOT CAB No. 78-29, 79-2 BCA 13,898 (1979).

The Owner may, if its contract so provides, take possession of the contractor's equipment and complete the work with its own forces. This may become a prob-

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lem, however, if the equipment does not belong to the contractor. An Owner completing in this way would measure excess costs by "applying any contractually specified equipment, material or labor rates to the remaining work on the Project performed by the Owner." Tieder and Hoffar, ***Proving Construction Damages.*** In addition to excess costs the Owner could recover incidental costs from reprocurement and interest on recoverable excess costs. ***See, Asheville, supra.*** In addition, if the contract so provides, the Owner may also recover the costs of repair as a measure of damages. ***See, Fidelity & Deposit Company of Maryland v. Stool, 607*** S.W. 2d 17 (Tex. Civ. App. 1980).

Another option, after default, is for the Contractor's Surety to complete the work. The Surety will want *to* limit its obligations to the penal sum, which is u ..lly the contract price. The Owner must negotiate and the Surety should cover the additional costs associated with hiring follow-on contractor(s). From the Owner's perspective it is preferable *to* have the Surety tender the penal sum less retainage and the remaining contract sum. This is, however, an option for the Surety. If the Surety does hire follow-on contractors it will have formally declared the original contractor to be in default and will acquire an equitable interest in the contract balance held by the Owner and may use these funds *to* decrease its obligations under the bond.

b) Working out the Takeover Agreement

An Owner must be very vigilant regarding its potential obligations and its rights upon takeover by the Surety. Specifically, the Owner should consider whether the agreement should include terms for the following issues:

- Owner to retain benefit of executed change orders;
- Owner to have right to be involved in who follow-on contractor will be;
- Owner to get a new performance bond for each new follow-on contractor. It would be best to get two bonds, a performance bond and a payment bond. This, however, is a matter for negotiation.
- Surety to agree to pay for the repair of damage created by original contractor, either through the use of City forces or through the contracts with the follow-on contractors.
- Owner should insist that time is still of the essence. If a Surety has procrastinated in finding a new contractor to complete the work the issue of liquidated damages may arise and the Owner should not assume that it must give up such damages. If it expects to collect such damages if the work is not complete on the original contract date, or such other date as the parties may agree, it should make that clear in its agreement.
- Whether the Owner or the Surety should directly contract with the follow-on contractor. This issue may relate *to* the Owner's ability and desire *to* inspect and manage the work.
- The payment by the Surety of a sum representing the difference between the original contract balance remaining under the original contract, less certain deductions (if applicable) and the amount of the successor contractor's contract plus a percentage for a contingency reserve. The contingency reserve should be available for the Owner's use. The agreement should authorize the Owner *to* withdraw monthly the difference between the amounts paid to the successor contractor and the amounts which would have been payable *to* the original contractor for that same work. The escrow account may be an interest bearing one and then the agreement should specify who gets the interest when the job is complete. It may well be the Surety.
- The Owner's right to retain retainage until the end of the project to ensure satisfactory completion. That the Surety has only the same rights *to* the retainage which the original contractor had.
- Owner's rights and obligations in regard to requesting that the successor contractor do extra work. It may be advisable to attempt *to* limit costs *to* the costs stated in the original contract.
- The successor contractor's obligation to complete all work, even extra work, with a right *to* litigate the costs when the job is completed.
- Reserve the Owner's right to contest any payments made by the Surety which reduce the penal amount of the bond.
- Surety's obligation *to* honor all obligations of its original bond(s).
- Surety's recognition of any emergency work the Owner had *to* perform while waiting for a successor contractor. Have the Surety pay any contractors hired to do this work, with the Owner repaying the Surety.
- Owner's right to retain contract amounts to cover cost of doing such interim work.
- Surety's responsibility for all other contract work outside the successor contractor's contract.
- Surety's agreement that the Owner was not responsible for delay between the default and the hiring of the successor contractor.

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c) Mitigation

Whatever method the Owner chooses for completion of the project it must mitigate its damages. This means that it must be able to state that its reprocurement efforts have been made with all reasonable speed and for a reasonable price considering the work. ***Century Tool Company, Inc.***, GSBCA No. 3999, 76-1 BCA 11,850 (1976).

In addition, the new contract must be for substantially the same work ***and under substantially the same circumstances.***

As stated in ***Blake Construction Company,*** GSBCA 4013, 75-2 BCA 11,487 (1975):

> It is an established principle in the law of Government contracts that the contractor will not be liable for excess costs of reprocurement where the contract requirements are relaxed on reprocurement and where the facts indicate that the contractor could have performed given the same relaxation in requirements.

While the Owner has the original burden of showing reasonableness in its actions, if it has made a prima facie showing then the burden shifts to the Contractor to show that the reprocurement was not reasonable and that the Contractor was harmed by any such impropriety. See ***Nello L. Teer Company v. Hollywood Gulf Estates, Inc.***, 324 F.2d 669 (1963).

d) Owner's Actions During Reprocurement by Surety

The Owner must mitigate its potential losses. This may mean storing materials or doing emergency work, with the Surety's knowledge. The latter should be done carefully and **only** if there is a real need. The Owner must also be careful when making payments to third parties. If the Owner makes a payment to a party to whom the Surety has no obligation the amount of payment will decrease the contract amount and the Surety will not be responsible for paying the Owner back.

e) Contractor Bound by Surety's Settlement with Owner

Contractor will be bound if the agreement with the Surety is reasonable. Note, however, that such agreement will not prevent the Contractor from suing the owner for improper termination in the first place.

f) Unpaid Materialmen are not Third Party Beneficiaries of the Agreement between the Owner and Surety

These individuals' rights will be determined by their contracts and by state statute. This assumes that the Owner/prime agreement is silent on making these parties beneficiaries.

g) Damages to Third Parties by Defaulting Contractor

Depending on the type of construction involved, it is very likely that the defaulting contractor damaged property to individuals along the construction **route.** For example, damaged driveways, yards, sidewalks and curbs. It is important that the Surety agree to be responsible for these items just as the original contractor would have been.

6) Owner's Damages

As discussed previously, if the Owner attempts to complete the work itself it will have a right to actual damages for the cost of completion and reprocurement.

If the agreement called for liquidated damages, and the parties cannot agree to the contrary, the Owner will generally be held to the liquidated damages amount. Owners might consider having contracts which provide for both liquidated and actual damages, depending on whether or not the damages would be ascertainable.

7) Owner's Duty to Surety

An Owner must realize that its actions may impact the obligation of the Surety. For example, if the Owner has been making payments for defective work the Surety may not be responsible for the excess costs of completion to the extent of such payments. The Owner must avoid doing anything which decreases the contract amount when there was no obligation to do so. This would include making payments to materialmen who have failed to make timely claims or otherwise preserve their rights. A soft hearted Owner may be left holding an empty bag.

8) Wrongful Termination and Owner's Liability

If an Owner wrongfully terminates a contractor it may owe the contractor damages for wrongful termination or for a termination for convenience of the Owner.

9) Damages for Wrongful Termination

If it appears that the Owner's action was an abuse of discretion the measure of damages may be whatever it takes to make the Contractor whole again, *i.e.*, prior to termination. The contractor will usually have a right to its actual expenses for work actually performed, if any, lost profit, less any credits for savings achieved in not

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having to complete.

Quantum meruit may also be a basis for recovery where the work performed was required by the contract but exceeds the amount paid. In addition, the contractor's actions may not warrant a quantum meruit award as it is an equitable remedy. For example, it might be denied to a contractor who did not act in good faith. Note, however, that case law may deny payment to a contractor who has done extra work without proper contractual authorization.

C. Conclusion

When a Surety takes over for a defaulting contractor the Owner can be placed in a difficult position as middleman between the Surety and the contractor. It is possible that these two parties will be at odds and it is important for the Owner not to appear to be acting for one party or the other. The Owner must keep its own goal in sight — that is, successful, and timely completion of the project.

The Owner must keep in mind all of the obligations of the original contractor and be sure that any successor contractors have the same obligations.

Termination is a drastic measure with a heavy burden for the Owner and should only be used when all other avenues for completion have failed.

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Historical Note — Sovereign Immunity
The Oregon Constitution and a Construction Dispute
January 22, 1990

The design, layout, building, construction and financing of public improvements are important to the State, its citizens and communities. While we practitioners think of this as a relatively recent development, a quick review of the Federal Constitution and the Oregon Constitution will show that they were among the concerns foremost in the minds of the drafters of the foundation documents of our State and our Nation at the time each of those political bodies were formed. The Oregon Constitution was adopted in 1857. Statehood followed in 1859. The United Sates was less than 100 years old and was in the midst of the industrial revolution. Railroads, canals, dams, mills, water systems, roads and bridges were looked upon as the sinew to bind the Nation and the State together and to propel it through the 19th and into the 20th century.

Capitol formation was a new phenomenon. **A** review of the territorial laws, and the sections of DD's code and Olsen's Oregon Laws dealing with public improvement display some thinking about the financing of major improvements that would be foreign to an Oregon citizen today. Special permission was granted for the organization of private companies to construct major improvements like the Bridge of the Gods at Cascade Locks and the famous Barlow Road. In many instances, these companies and railroad companies were provided with the authority to condemn land and to do other things usually thought of as uniquely governmental prerogatives. While we don't think of road building or bridge building as risky ventures today, the construction of locks, canals, roads and bridges was fraught with financial peril in the 17th and 18th centuries. Special provisions were inserted in the Oregon Constitution at Article XI, Sections 7, 8 and 9 to prevent the credit of the State or other political bodies from being pledged in support of the efforts of private companies developing the kind of conveniences that we would now refer to as "public improvements."

In addition to private companies, there was a recognized need for the state to provide a road and highway system to provide for defense, and to provide a means to get the products of mines and agriculture to market. Counties assumed a much more active role in this process of road building under the Territorial Legislature and during early statehood than they do today (the authority is still there, but seldom exercised). The usual manner for establishing a road was to have the political authority declare the desire for a road between points. **A** private company, or a group of "road surveyors" appointed by the public body then took it upon themselves to survey a route. If the route was found acceptable, a centerline description was recorded, and lands to a specified width (usually set by statute) to either side of the centerline was appropriated to the use of the public. **A** private company or the public body then improved the road. The expenses of the surveyors laying out the road were subject to a claim for reimbursement to the public body.

In the late 1850s and early 1860s, there was consid-

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erable debate about how to handle such claims. A good dealofthediscussion concernedwhetherornotdisputed claims were matters for consideration by the courts, or matters for consideration by the auditor of the public body subject to appropriation and approval by its Legislative Branch. The framers of the Oregon Constitution, after considerable debate, took the position that it was inappropriate for the Legislature to consider private bills, but that claims against the Sate in terms of their general type and the budgetingfor payment were matters for the auditor and the Legislature and matters for the courts only insofar as the Legislature should choose to permit the courts to consider certain kinds of claims. That political philosophy forms the core of the reasoning behind Article IV, Section 24 of the Oregon Constitution which reads; "Provision may be made in general law for the bringing of suit against the State as to all liabilities originating **after** or existing at the time of the adoption of this Constitution, but no special act authorizing such suit to be brought or making compensation to any person claiming damages against the State shall ever be passed."

Adoption of this provision was effected by the Territorial Legislature's distasteful experience with the infamous claim of *Ewing Young.* Mr. Young was a politically prominent Oregon pioneer, well acquainted politically in a day and time when political passions ran strong. His ancestor, Joquin Young, also a politically prominent pioneer, attempted to lead a group from Portland to Astoria. While the record is unclear, it would appear that the group had no official sanction, but that the Territorial Government had expressed a desire to lay out a road between Portland and Astoria. The group spent several months in the woods of the coast range hunting and thrashing about. When they returned, they reported the route between Portland and Astoria to be impassible, and filed claims for expenses with the Territorial Legislature. A dispute developed which had substantial political overtones. The Legislature was unconvinced that Young and his associates actually intended to survey a road and refused payment of the claim. The elder Young passed away during the pendency of the dispute. Ewing, who inherited the claim, hired alawyerand sued the territory in the courts. A good deal of the evidence presented was presented by way of affidavits from members of the expedition who resided out of State at the time the matter proceeded through the courts. Many of the temtorial legislators considered the affidavits to be perjured. Apparently the court did not, and granted Young a judgment: the enforcement of which the Territorial Legislature fought as best it could. The whole experience left many of the territorial legislators bitter and disillusioned concerning the role of the courts in resolving disputes between citizens and the Government. They decided to keep processing of claims in the new state being formed firmly under the control and direction of the Legislature. Several of the statements concerning Young and his claim made by delegates to the constitutional convention made good remarks for opening and after dinner speech. One of the delegates insisted that the entire trip was nothing more than a hunting expedition in the course of which Young and his party got lost, failed to find any game and returned to report that the country was so rugged and convoluted that not even a bird could fly over it. For the original text, and a good laugh, ***See,*** Carry, ***The Oregon Constitution,*** pp. 285-288 (1926). After more than a century, Oregon's pattern of sovereign immunity and dealing with claims remains true to the intent of the framers. **A** similar debate before the Federal Government eventually lead to the formation of the United States Claims Court. That alternative solution well described in an article by Mr. Floyd D. Shimoura entitled ***The History of Claims Against the United States,*** Louisana Law Review, Vol. 45, No. **3,** p. 625 (1985) makes excellent reading. Oregon decided on its solution before the Federal Government dealt with the problem on the federal level. While the Oregon solution was in place by February 14th of 1859, the Buchanan Administration was dealing with a national crisis and couldn't spend a good deal of time to get rid of private bills brought by contractors and others. April of 1861 brought the Lincoln Administration and the Congress a more serious set of matters to deal with than a debate concerning the payment of claims. Solution to the problem for the Federal Government had to await the conclusion of the American Civil War.

William Cloran

Calendar

July 14, 1990, Ashland (location to be announced)
CLE Topic: Ethics for the Construction Lawyer

August 18, 1990, Salem (location to be announced)
No CLE, get ready for Oregon State Bar

Construction Law Newsletter
is published by
The Construction Law Section of the Oregon State Bar.

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James P. Laurick
Allen, Kilmer, Schrader, Yazbeck & Chenoweth

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