

Courts Hold Sureties Responsible for Failure to Respond to

PAYMENT BOND CLAIMS

BY SHELLY MASTERS

Both public and private owners require contractors to post payment bonds, which guarantee a contractor will honor its obligations to pay its subcontractors and suppliers. Sureties employ rigorous underwriting requirements to reduce risk, issuing payment bonds only to contractors that provide adequate collateral and sign comprehensive indemnification agreements.

A payment bond assures the surety will pay subcontractors and suppliers if the contractor defaults. The contractor, however, remains primarily liable, as the surety is a guarantor and is entitled to indemnity from the contractor for any payment.

The American Institute of Architects (AIA) publishes the most widely used form of payment bond, the AIA A312-1984. Until early 2008, Paragraph 6 of this payment bond form included language requiring a surety to send a written

response to a payment bond claimant “within 45 days after receipt of the claim, stating the amounts that are undisputed and the basis for challenging any amounts that are disputed.”

A series of recent legal decisions strictly enforcing this requirement caused ripples of discontent in the surety industry and prompted potential claimants to take a second look at bond language when contractors default. As a result, Paragraph 6 of AIA A312 now requires a surety to respond within 60 days.

RELATED COURT OPINIONS

During the past few years, court decisions favoring bond claimants over sureties developed in Maryland, Virginia and Florida. In each case, a strict interpretation of the language of the AIA A312 payment bond form led judges to reach the same conclusion: A surety that fails to respond within 45 days waives its right to dispute the validity of a payment bond claim.

In the *National Union* case, a general contractor executed an A312 payment bond to guarantee completion of a Hyatt Regency resort. After project completion, an unpaid subcontractor notified the sureties of its bond claim. The sureties sent two responses, neither of which provided a timely and adequate dispute of the claim as required under Paragraph 6 of the A312 form. The subcontractor filed suit on the bond, arguing the sureties were precluded from raising any defense on the merits because they breached the response deadline.

The sureties countered that their failure to answer the subcontractor’s claim within



45 days was proof they disputed the claim. The sureties also contended the subcontractor's payment was not due and owing; therefore, payment of the bond claim would result in a windfall at the expense of other legitimate claimants.

Following longstanding principles of Maryland contract law, the Maryland appellate court sided with the subcontractor, holding that the plain language of the bond required the surety to respond to the claim in a timely manner, define what amounts were undisputed and list the bases for challenging the payment of any disputed amounts.

According to the court, the purpose of Paragraph 6 is to ensure subcontractors are not forced to absorb the risk of non-payment over a protracted period through no fault of their own. The court stated, "[t]o decide that the sureties, by inaction through time and effort, could dispute the entirety of a claim *ad infinitum*, would greatly undermine the bond's purpose of safeguarding those entities that supply goods and labor to the general contractor."

In Virginia, a federal court granted summary judgment to a payment bond claimant on the basis of the surety's failure to adhere to the 45-day response deadline. In the *Casey Industrial, Inc.* case, the subcontractor filed suit on a payment bond after the surety denied its claim. The surety's response identified certain bases for the denial, as well as a reservation of rights. However, the surety attempted to raise new defenses that were not included in its original response to the claim.

The U.S. district court held that the surety's failure to identify factual defenses within the 45-day period acted as a waiver of the new factual defenses. Following the Maryland decision, the Virginia court stated: "This Court remains persuaded by language in *National Union*, which stated that in that case, like this one, the surety contract did not 'simply require that the sureties state which portions of the claim are disputed and which are not; they must also delineate the grounds underlying the dispute.'"

The court, however, allowed the surety to raise legal defenses not asserted in its response to the claim based on its reservation of rights statement.

In the *J.C. Gibson Plastering Co.* case, a federal district court in Florida also adopted the rationale of *National Union*. Gibson, a subcontractor, did not receive payment from the general contractor. After giving notice of its claim, Gibson filed a lawsuit under the A312 payment bond. The court rejected the surety's argument that the 45-day period does not begin until a claimant provides proof of its claim, and it determined that bond language must "be strictly construed against the surety and in favor of the obligee."

According to the court, a request for additional supporting documentation was an insufficient response under the terms of the payment bond.

AIA A312 BOND FORM

Sureties argue these courts misinterpreted the language of Paragraph 6, unfairly preventing sureties from contesting invalid claims, and national surety associations have taken steps to modify the unfavorable bond terms.

In response, the AIA issued an interim amendment to the payment bond as "a stopgap measure to address the immediate concerns of the sureties" until it can

consider comprehensive revisions with input from all construction groups.

Although the AIA did not delete Paragraph 6, it did agree to lengthen a surety's response deadline to 60 days. It also included language aimed at eliminating any possible admission of liability on behalf of a surety that does not meet its deadline to answer a claim. The amendment does not include additional requested language that would have required the bond claimant to submit proof of its claim.

Other surety companies pursued their own stopgap measures by making custom changes to their bond forms.

Because the AIA interim bond modifications will not affect projects already under way, the court precedence described above may encourage action from subcontractors that have not been paid on time by defaulting contractors. Claimants under the unmodified A312 form should serve notice of their claims quickly and pay attention to the surety's response deadline. If the surety fails to respond adequately, a subcontractor may bring suit to enforce the bond terms.

In light of the potential for future litigation on the original A312 bond language, sureties and their bonded contractors should review their payment bonds to ensure compliance and work together to investigate and provide timely responses disputing unmeritorious bond claims.

A surety's failure to comply with Paragraph 6 creates significant liability for a contractor that agreed to indemnify the surety for amounts paid on its behalf. To the extent sureties fail to comply with Paragraph 6, bonded contractors may be able to argue that such failures nullify their indemnification obligations (i.e., contractors should not have to reimburse sureties for payments caused by the surety's failure to comply with bond terms).

For future construction projects, contractors may find it difficult to present bids for projects that require the unmodified AIA A312 payment bond form, as many sureties will no longer issue such a bond. Contractors may be forced to qualify their bids to provide for use of the interim AIA A312 form or alternative forms in order to secure bonding.

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