

SURETY PROGRAM

2016 SPRING MEETING (La Quinta Resort & Club, Palm Springs, CA)
May 4 – May 6, 2016

SCOPE OF WORK

Grace Winkler Cranley

Michele Killebrew

Mike Tomeo¹

I. *WHY A SURETY NEEDS TO UNDERSTAND THE SCOPE OF WORK*

Whether faced with a termination of its bonded Principal, a Principal's request for financing, or numerous other scenarios whereby a Principal or a project may be facing performance or financial challenges, a Surety must be able to understand the scope of work of one or more of the Principal's projects, and do so as efficiently and accurately as possible. This paper will focus on why understanding the scope of work is important to a Surety, how a Surety can determine the scope of work, several pitfalls and issues to consider when doing so, and a practical guide to integrate the scope of work into a Surety's Request for Proposals.

Although there are many tasks a Surety should perform when a Principal is faced with a termination or financial distress, the single most important task is determining the financial exposure a single project termination or potential default of a Principal may create. It is important to understand what work remains. For example, when a project is near completion, the Surety might consider taking over the work to ensure that the Surety has maximum control over the cost-to-complete. However, when a significant amount of work on a project remains, if the Surety takes over the project, there is a risk of increased costs due to unforeseen site conditions, unknown design issues or unexpected events.² Additionally, if the Surety decides to take over the project, the Surety may lose the ability to limit liability to the penal sum³ and then unexpected events could drive costs in excess of the penal sum.

¹ Grace Winkler Cranley is a partner with the law firm of Dinsmore & Shohl LLP in Chicago, Illinois; Michele Killebrew is surety claims counsel with Liberty Mutual Surety in Hoffman Estates, Illinois; Mike Tomeo is an owner of Benchmark Consulting Services, LLC in Irvine, California.

² For a discussion on the consideration of completion options including takeover versus tender, see Christopher R. Ward & Patricia Wager, *Takeover*, in BOND DEFAULT MANUAL 381-409 (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht, and J. Blake Wilcox eds. Am. Bar Ass'n, 4th ed. 2015); see also David J. Krebs & Shannah Morris, *The Surety's Obligations Under the Performance Bond: To Perform or Not to Perform*, in BOND DEFAULT MANUAL 152-165 (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht, and J. Blake Wilcox eds. Am. Bar Ass'n, 4th ed. 2015).

³ Some courts have recognized that when a surety takes over a construction project upon a principal's default, the penal sum still applies to limit the surety's exposure. See *People ex rel. Ryan v. Env't'l Waste Res., Inc.*, 782 N.E.2d 291 (Ill. App. Ct. 2002); *Egyptian Am. Bank, S.A.E. v. United States.*, 13 Cl. Ct. 337 (Cl. Ct. 1987). Other courts have held to the contrary. See,

In order to properly and accurately determine that potential exposure, a Surety must gain a thorough understanding of the scope of work of one or more projects. Logically, the process of determining the scope of work of a project, and, more specifically, the remaining scope of work and any potential corrective work, is necessary in order to prepare cost-to-complete estimates, determine the length of time it will take to complete the project, and prepare bid packages for potential completion contractors.

In most cases, a Surety will want to prepare a cost-to-complete analysis of all of its Principal's bonded projects (and in some instances non-bonded projects) that have work remaining to complete. Although there are numerous items to include in a cost-to-complete, and each can be prepared in many different styles and levels of detail depending on the specific needs of a Surety, the scope of work is without question the main component of any cost-to-complete estimate. Without a thorough knowledge of the scope of work, a cost-to-complete estimate will be a useless exercise, not to mention a waste of precious time and resources.

Further, obtaining a solid understanding of the scope of work is critical if a Surety elects to takeover or tender one or more projects. For example, if the Surety chooses to tender a contractor to complete the project, the Surety will use the scope of work to have a bid package carefully prepared so that the Surety can mitigate its losses. Similarly, if the Surety is considering a takeover, the Surety will use the cost-to-competes of the remaining work to determine whether that is the right choice for the Surety (i.e. whether the risks outweigh the potential benefits). In that regard, the scope of work is an integral part of any bid package prepared by a Surety to provide to potential completion contractors. An incomplete scope of work will result in incomplete bids. The ramifications of this error can be significant; with the primary impact being increased construction costs and potential schedule impacts to a completion contractor. The challenges facing a Surety in a takeover or tender situation are many, and inaccurately analyzing the scope of work will unnecessarily add to those challenges. Getting the scope of work correct may be the single most important aspect of a Surety's investigation.

In addition to assisting with cost-to-complete estimates and bid package preparation, a thorough knowledge of the scope of work can also be of benefit when dealing with the following:

1. Determining the estimated time needed to complete the project.
2. Scope of work disputes with an Obligee.
3. Scope of work disputes or claims by Surety's completion contractor.
4. Payment bond claims of Principal's subcontractors and suppliers.
5. Preparation of ratification or hold agreements with Principal's subcontractor and suppliers.
6. Change order claims, scope dispute claims and delay/disruption claims of Principal against an Obligee.

McWaters & Bartlett v. United States., 272 F.2d 291 (10th Cir. 1959); *Employers Mut. Cas. Co. v. United Fire & Cas. Co.*, 682 N.W.2d 452 (Iowa Ct. App. 2004); *see also*, Ward, *supra* note 1, at 397-404 for a more expansive discussion.

II. DOCUMENTS NEEDED TO ACCURATELY DETERMINE SCOPE OF WORK

In order to accurately determine the scope of work of a project, a Surety must collect documentation from both the Principal and Oblige, and often other third parties (i.e. subcontractors, engineers, architects) related to the project. Although obtaining the prime contract, bid documents, and plans and specifications is clearly the place to start (and may be all that is needed if a project has just started), most likely the project will be at a state in which additional documents have been generated that will be critical in determining the remaining scope of work. The following is a list of documents a Surety should request:

1. Prime Contract.
2. Original Bid Documents.
3. Plans.
4. Technical Specifications.
5. General and Supplemental/Special Conditions.
6. Addenda.
7. Requests for Change or Change Directives.
8. RFIs.
9. ASIs.
10. Field Orders.
11. Information Bulletins.
12. Approved Change Orders.
13. Change Order Requests and Status Log.
14. Meeting Minutes.
15. Subcontracts.
16. Subcontract Change Orders.
17. Purchase Orders.
18. Payment Applications.
19. Buy-out Logs.
20. Principal's Original Bid Detail.
21. Principal's Detailed Cost Report.
22. Submittal Log and Key Submittals.
23. Product Substitution Requests by Principal.
24. Subcontractor Substitution Requests by Principal.
25. IOR Reports and Notices of Non-Compliance.
26. AOR or SEOR Observation Reports.
27. Coordination Drawings or BIM Documents.
28. Updated As-Built Drawings.

The above documents will not only assist with determining the remaining scope of work on the project and potential corrective work, these documents can also be made a part of a Surety's bid package to potential completion contractors.

III. TYPES OF CONTRACT DELIVERY METHODS AFFECTING SCOPE OF WORK DETERMINATIONS

Although not a critical component of determining the scope of work, a Surety needs to consider the type of contract and project delivery method when investigating the scope of work. For example, on a public project, the most common type of contract involves the Principal being in direct contract with an owner agency such as the Federal Government, City, County, School District, etc. The typical project delivery method in these contracts is design-bid-build. In this scenario, the scope of work is more traditional in the sense that it is outlined by the front-end bid documents, plans, specifications and addenda prepared by the Obligee, and then bid and ultimately built by the Principal. There are other contract and delivery method scenarios that can create additional considerations when attempting to determine the scope of work, such as:

A. Principal is a subcontractor to a general contractor

In this case, a Surety needs to be cognizant of how other subcontractor's scopes of work may impact the scope of work of the Principal. The opposite is also true, in that the Principal's subcontract scope of work may have a direct impact on other subcontractors' scopes of work. Situations may arise whereby the Principal's work is falling behind schedule or has been "buried" by other subcontractors due to the Principal's inability to keep pace with the project. An example would be a mechanical subcontractor's work lagging, resulting in modifications of its work scope to contend with plumbing, fire sprinkler or electrical runs installed in above ceiling spaces that may now require to be worked around or moved. Careful consideration needs to be paid to how the Principal's scope of work may need to be modified to account for impacts and as-built conditions of the project.

B. Principal is one of several multi-primes

A Principal may be one of several multi-prime trade contractors under a direct contract with a School District or an at-risk Construction Management firm. The same considerations regarding the Principal's effect on other prime trade contractors (and vice versa) as was discussed in the example of a Principal as a subcontractor come into play under this contractual arrangement. In addition, a Surety needs to pay special attention to the inclusions and exclusions of the Principal's contractual obligations in order to avoid missing scope that may wrongfully be assumed to be covered by another prime trade contractor, or equally worse, assuming that certain work is covered in the Principal's prime trade contract that is actually performed by others. These situations are more common in a multi-prime project since traditional specifications are segregated into various bid packages on the front-end, which may lead to confusion as it relates to certain overlapping or coordinated trades.

C. Design-Bid-Build vs. Design-Build

Determining the scope of work on a design-bid-build project is usually more straightforward than it is on a design-build project. The simple reason is that often on design-build projects, it can be difficult to ascertain the status of the Principal's design drawings. Given this, a Surety must consider costs to potentially complete the design drawings depending on their

state of completion. It will also be necessary to determine directly from the Obligee, if possible, the current state of the Principal's design drawings. If the design drawings are in process at the time of a default by the Principal, determining the final scope of work may be very difficult, which in turn will affect the accuracy of any cost-to-complete estimates. Particular attention needs to be given to what design drawings are provided to potential completion contractors if a Surety elects to obtain completion bids. Best practice may be to provide the Principal's most current design drawings in a bid package marked "For Informational Purposes Only" and shift the risk of completing the design drawings to the completion bidders.

D. Lump Sum vs. Unit Price Contracts

Between a lump sum contract and a unit price contract, determining the scope of work is typically easier in a unit price contract. In a typical unit price contract, there are specific bid items provided by the Obligee that outline the various scopes of work to be performed by the Principal. Often those bid items provide estimated quantities, to which the Principal provides a unit price and an extended bid price for each individual bid item. Although there are bid items that need to be priced on a lump sum basis, generally the unit price based contracts provide a more defined road-map for a Surety to prepare a cost-to-complete estimate. Further, when preparing a bid package, a Surety can provide the original bid item list and adjust the estimated quantities to reflect what work has been accepted and paid for by the Obligee, and what quantities still remain to complete. In the case of a lump sum contract, the scope of work is less defined in the sense that bidders are required to review plans and specifications to determine the scope of work, and there is no bid item list provided at bid time.

Regardless of the differences between contracts and project delivery methods noted above, a Surety must request the same documents and conduct a similar investigation in order to understand the scope of work. Further, a Surety must consider additional factors when determining the Principal's scope of work as will be addressed throughout the balance of this paper.

IV. FACTORS OR ISSUES THAT IMPACT OR CHANGE THE SCOPE OF WORK

A. Modification to Scope of Work by the Obligee

When determining the scope of work of a project, it is critical that a Surety not only obtain a thorough understanding of the scope of the original bonded contract, but also any modifications made to that scope by the Obligee. These modifications may include one or more of the following:

1. Responses to Requests for Information (RFIs)
2. Architect's Supplemental Instructions
3. Information Bulletins
4. Field Orders
5. Responses to Submittals
6. Requests for Change

There may be instances whereby any of the above Obligee modifications will have no cost impact to the project, and therefore will not need to be factored into a cost-to-complete analysis. Nevertheless, even a modification with no cost impact changes the scope of work, and therefore would need to be included in a bid package provided to potential completion contractors. In other cases, one or more of the above listed Obligee modifications may result in a Change Order Request or similar document being issued by the Principal to the Obligee, which in turn may or may not result in the Obligee issuing a Change Order to the Principal.

B. Change Order Work

When determining the scope of work in order to assist with a cost-to-complete and/or preparation of a bid package, fully executed Change Orders clearly need to be included in a Surety's analysis. A Change Order is a written order to the contractor authorizing a change in the work to be performed under the contract or an adjustment to the contract sum or contract time.⁴ Unfortunately, at the time a termination has occurred or when a Principal is in financial distress, change order related documentation can be in varying stages of completion or disarray, which can create unique challenges to a Surety. For example, an Obligee may have issued a directive in the field for the Principal to perform extra work, but no final Change Order has been executed between the parties. When preparing a bid package, a solid approach would be to advise bidders that only executed Change Orders affect the original scope of work. When attempting to prepare a cost-to-complete, the simplest way to deal with this situation may be to exclude this work from the cost-to-complete entirely, and assume that a Change Order will eventually be issued that will cover the cost of the work. A determining factor when deciding how to address this scenario may be how far along is the extra work in question.

More troubling for a Surety is the case of an Obligee directing the Principal to perform extra work that is disputed by the Principal.⁵ When preparing a loss analysis and associated cost-to-complete, it may be advisable for a Surety to assume the Principal may lose its argument that the disputed work is not part of the original scope of work, and therefore include the cost of the remaining disputed work to perform in its cost-to-complete estimate. In regards to whether disputed work should be included in a bid package, a Surety may request that potential completion contractors provide an add alternate to perform the remainder of any disputed work. This allows a Surety to segregate the cost of this work from the undisputed remaining scope of work and determine the cost of the disputed work when assessing whether to pursue a claim against the Obligee.

⁴ *LBL Skysystems (USA), Inc. v. APG-America, Inc.*, 319 F.Supp. 2d 515 (E.D. Pa. 2004); see also Armen Shahinian & Brian Kantar, *Bond, Contractual and Statutory Provisions and the General Agreement of Indemnity*, in BOND DEFAULT MANUAL 24-25 (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht, and J. Blake Wilcox eds. Am. Bar Ass'n, 4th ed. 2015); Krebs, *supra* note 1, at 191-193; Caryn Mohan-Maxfield & Bradford R. Carver, *Change Orders, Extras, and Claims: What is the Completing Surety to do? in WHEN THE WALLS COME CRUMBLING DOWN: THE CRITICAL ISSUES FACING THE PERFORMING SURETY* (unpublished paper submitted at the ABA/TIPS Fidelity & Surety Law Committee Midwinter Meeting on Jan. 21, 2011).

⁵ See, generally, *United States ex rel. Ascher Bros. Co. v. Am. Home Assur. Co.*, No. 98 C 0995, 2003 U.S. Dist. LEXIS 21388 (N.D. Ill. Mar. 20, 2003) (the contractor or surety has the burden to prove that a disputed change order is a modification to the contract and that the obligee breached those agreements).

Most bond forms waive a Surety's right to receive notice of or contest changes within the general scope of the bonded contract; however, that does not mean that a Surety consents to all changes.⁶ Generally, a "consent to changes" provision in a bond does not include material, unforeseeable changes.⁷ A modification generally falls within the scope of the original contract if potential bidders would have expected it to fall within the contract's changes clause.⁸ Disputes may arise as to whether a change is "minor" or whether the change is significant enough to justify a change in the contract price or time of completion.⁹ Cost or scheduling overruns- standing alone- are insufficient to show a cardinal change particularly where the work performed is otherwise substantially anticipated.¹⁰ Analysis of whether a cardinal change occurred requires consideration of both the magnitude and the quality of the changes.¹¹

There may also be a scenario in which a directive issued by the Obligee may be deemed a cardinal change. A cardinal change may relieve a Surety of its obligations.¹² "The modern rule

⁶ Jonathan Dunn & William McConnell, Jr., *Defining the Remaining Scope of Work in the Surety's Investigation of a Performance Bond Claim: Hardly "Elementary"*, in WHEN THE WALLS COME CRUMBLING DOWN: THE CRITICAL ISSUES FACING THE PERFORMING SURETY (unpublished paper submitted at the ABA/TIPS Fidelity & Surety Law Committee Midwinter Meeting on Jan. 21, 2011); see also *United States ex rel. Sun Constr. Co. v. Torix Gen. Contrs., LLC*, No. 07-cv-01355-LTB-MJW, 2009 U.S. Dist. LEXIS 96039 (D. Colo. Oct. 15, 2009) (a surety may be released from its obligations when "a material change between the principal and the sub-contractor, without the consent of the surety, results in prejudice to the surety's interest) relying on *Golden West Constr. Co. v. Bernadot*, 304 F.2d 753 (10th Cir. 1962); *Chrysler First Bus. Credit Corp. v. Kawa*, 914 P.2d 540 (Colo. Ct. App. 1996).

⁷ *Id.* see, e.g., *Roberts v. Security Trust & Sav. Bank*, 238 P. 673 (Cal. 1925); *Hochevar v. Maryland Cas. Co.*, 114 F.2d 948 (6th Cir. 1940); *United States ex rel. Ragghianti Founds. III, LLC v. Peter R. Brown Constr., Inc.*, 49 F. Supp.3d 1031 (M.D. Fla. 2014); *Krygoski Constr. Co., Inc. v. United States*, 94 F.3d 1537 (Fed. Cir. 1996).

⁸ *AT&T Commc'ns, Inc. v. Wiltel, Inc.*, 1 F.3d 1201 (Fed. Cir. 1993); see also *Air-A-Plane Corp. v. United States*, 408 F.2d 1030 (Ct. Cl. 1969).

⁹ Omar J. Harb & Julie S. Alleyne, *The Contract Document Provisions Relating to the Scope of Work*, in WHEN THE WALLS COME CRUMBLING DOWN: THE CRITICAL ISSUES FACING THE PERFORMING SURETY (unpublished paper submitted at the ABA/TIPS Fidelity & Surety Law Committee Midwinter Meeting on Jan. 21, 2011); see also *Whitfield Const. Co., Inc. v. Commercial Dev. Corp.*, 392 F.Supp. 982 (D.V.I. 1975) (for an discussion on whether a change is "minor" or "major"); for additional discussion on cardinal changes see Shannon J. Briglia & Jarrod Stone, *Construction Contract Provisions Critical to the Performing Surety: Scope of Work, Contract Price, and Time of Completion*, in BOND DEFAULT MANUAL 61-63 (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht, and J. Blake Wilcox eds. Am. Bar Ass'n, 4th ed. 2015).

¹⁰ *PCL Constr. Servs., Inc. v. United States*, 47 Fed. Cl. 745, 804-06 (Fed. Cl. 2000).

¹¹ *Centex Constr. v. ACSTAR Ins. Co.*, 448 F.Supp. 697 (E.D. Va. 2006) citing *Saddler v. United States*, 287 F.2d 411, 413 (Ct. Cl. 1961); see *Peter Kiewit Sons' Co. v. Summit Construction Co.*, 422 F.2d 242 (8th Cir. 1969) (subcontract was substantially breached by changes in the scope that increased the subcontractor's costs by 300 percent).

¹² See *Hartford Cas. Ins. Co. v. City of Marathon*, 825 F. Supp. 2d 1276 (S.D. Fla. 2011); *120 Greenwich Dev. Assocs., LLC v. Reliance Ins. Co.*, 01 Civ. 8219 (PKL), 2004 U.S. Dist. LEXIS 10514 (S.D.N.Y. June 7, 2004); *Pub. Serv. Elec. & Gas Co. v. Tech. for Energy Corp. (In re Tech. for Energy Corp.)*, 140 B.R. 214 (E.D. Tenn. 1992); *Centex Constr. v. ACSTAR Ins. Co.*,

with respect to a compensated Surety is that the Surety is (i) discharged if the modification materially increases his risk, and (ii) not discharged if the risk is not materially increased, but his obligation is reduced to the extent of loss due to the modification."¹³

The cardinal change doctrine was conceived in the United States Court of Federal Claims.¹⁴ The doctrine "was created as a check on the government's ability to circumvent the competitive-bidding process by ordering drastic changes beyond those contemplated in the contract"¹⁵ A successful cardinal change doctrine defense serves to relieve a contractor (and its Surety) of performance liability when a government entity orders a change to the underlying construction contract that "effectively requires the contractor to perform duties materially different from those originally bargained for."¹⁶

To determine whether a change order is outside the general scope of the underlying construction contract so as to qualify as a cardinal change, courts look to the following factors: (i) whether there is a significant change in the magnitude of work to be performed; (ii) whether the change is designed to procure a totally different item or drastically alter the quality, character, nature or type of work contemplated by the original contract; and (iii) whether the cost of the work ordered greatly exceeds the original contract cost.¹⁷ A court must conduct a fact-intensive, case-by-case analysis of the aforementioned factors.¹⁸ The burden is on the Surety to show that the modification materially increased its risk or that some of the Surety's liability resulted from the modification.¹⁹

448 F.Supp. 697 (E.D. Va. 2006); *Aetna Casualty and Surety Co. v. LFO Construction Co.*, 615 N.Y.S.2d 389 (N.Y. App. Div. 1994); *Employers Insurance of Wausau v. Construction Management Engineers of Florida, Inc.*, 377 S.E.2d 119 (S.C. 1989); *Westinghouse Electric Corp. v. Garrett Corp.*, 437 F. Supp. 1301 (D. Md. 1977); *Edward R. Marden Corp. v. United States*, 442 F.2d 364 (Ct. Cl. 1971) (the cardinal change doctrine is not a rigid one).

¹³ *XI Specialty Ins. Co. v. Commonwealth*, No. SUCV2008-04095-BLS1, 2012 Mass. Super. LEXIS 194 (Mass. Super. July 11, 2012) citing *Town of Hingham v. B.J. Pentabone, Inc.*, 238 N.E.2d 534 (Mass. 1968).

¹⁴ *Hartford Cas. Ins. Co. v. City of Marathon*, 825 F. Supp. 2d 1276 (S.D. Fla. 2011) relying on *Am. Line Builders, Inc. v. United States*, 26 Cl. Ct. 1155, 1177 (Cl. Ct. 1992) (providing historical background of the doctrinal development of the cardinal change doctrine).

¹⁵ *J.A. Jones Const. Co. v. Lehrer McGovern Bovis, Inc.*, 89 P.3d 1009, 1020 (Nev. 2004); see also *L.K. Comstock & Co., Inc. v. Becon Const. Co., Inc.*, 932 F. Supp. 906, 937 (E.D. Ky. 1993) ("The power of the owner, be it a federal agency or a private developer, to order changes is subject to abuse").

¹⁶ *Allied Materials & Equip. Co. v. United States*, 569 F.2d 562, 563-64 (Ct. Cl. 1978).

¹⁷ *Hartford Cas. Ins. Co. v. City of Marathon*, 825 F. Supp. 2d 1276 (S.D. Fla. 2011) citing *Becho, Inc. v. United States*, 47 Fed. Cl. 595, 601 (Fed. Cl. 2000).

¹⁸ See, e.g., *id.*; see also *Wunderlich Contracting Company v. United States*, 351 F.2d 956 (Ct. Cl. 1965).

¹⁹ *John T. Callahan & Sons v. Dykeman Elec. Co., Inc.*, 266 F. Supp.2d 208, 235-39 (D. Mass. 2003).

Courts have held that the government owes a Surety the duty "to administer the contract . . . in a way that does not materially increase the risk that was assumed."²⁰ An Obligee has an implied duty not to intentionally or negligently waste contract funds and a breach of this duty is actionable by a Surety.²¹ "Any change or modification of the construction contract which materially increases a compensated Surety's risk discharges the obligation [to the extent of the modification]."²²

Whether the Surety consents to changes in the contract makes a difference to the Surety's cardinal change defense.²³ A cardinal change in the contract without the Surety's consent releases the Surety from the bond. If the Surety consents to a change, it cannot use the change to prove the cardinal change defense.²⁴ On the other hand, the Surety's lack of consent means that it can use the change to prove the cardinal change defense.²⁵ As noted above, the Surety can give advance consent in the bond. In those instances, the bond's consent clause may not state a limit on the surety's consent²⁶ or may put a limit (such as a dollar amount or percentage of the original contract price or penal sum) on the Surety's consent to contract changes.²⁷ If the bond and contract do not give advance consent, the Surety can give its consent later by some other method.²⁸ However, ignoring a request to consent to a contract change might amount to consent.²⁹ A cardinal change, however, does not arise if "[t]he contract itself explicitly

²⁰ *Lumbermens Mut. Cas. Co. v. United States*, 67 Fed. Cl. 253 (Fed. Cl. 2005); *Nat'l Surety v. United States*, 118 F.3d 1542, 1546 (Fed. Cir. 1997) quoting *U.S. Fidelity & Guar. Co. v. United States*, 475 F.2d 1377, 1384 (Ct. Cl. 1973).

²¹ *Great Am. Ins. Co. v. Sch. Bd. of Broward County*, No. 09-61636-CIV-ZLOCH/ROSENBAUM, 2010 WL 4366865 (S.D. Fla. July 30, 2010).

²² *Nat'l Surety*, 118 F.3d at 1547.

²³ *Pub. Serv. Elec. & Gas Co. v. Tech. for Energy Corp. (In re Tech. for Energy Corp.)*, 140 B.R. 214, 227 (E.D. Tenn. 1992); see also *Germania Fire Ins. Co. v. Lange*, 78 N.E. 746 (Mass. 1906).

²⁴ *Pub. Serv. Elec. & Gas Co. v. Tech. for Energy Corp. (In re Tech. for Energy Corp.)*, 140 B.R. 214, 227 (E.D. Tenn. 1992); *Mohasco Indus., Inc. v. Giffen Indus., Inc.*, 335 F.Supp. 493 (S.D.N.Y. 1971).

²⁵ *Id.*; see also *State v. Weissenburger*, 459 A.2d 693 (N. J. Super. Ct. App. Div. 1983); *Lamson v. Maryland Casualty Co.*, 194 N.W. 70 (Iowa 1923); *People's Lumber Co. v. Gillard*, 68 P. 576 (Calif. 1902); *House v. American Surety Co.*, 54 S.W. 303 (Tex. Civ. App. 1899); *Village of Newark v. James F. Leary Constr. Co.*, 194 N.Y.S. 212 (N.Y. Sup. Ct. 1922).

²⁶ *Pub. Serv. Elec. & Gas Co. v. Tech. for Energy Corp. (In re Tech. for Energy Corp.)*, 140 B.R. 214, 227 (E.D. Tenn. 1992) comparing *Roberts v. Security Trust & Savings Bank*, 238 P. 673 (Cal. 1925) and *Massachusetts Bonding & Ins. Co. v. John R. Thompson Co.*, 88 F.2d 825 (8th Cir. 1937).

²⁷ See, e.g., *Board of Education of Sault Ste. Marie v. Chaussee*, 177 N.W. 975 (Mich. 1920); *Acoustics, Inc. v. Hanover Ins. Co.*, 287 A.2d 482 (N. J. Super. Ct. Law Div. 1971); *Schnitzer v. Couch*, 279 S.W. 165 (Mo. Ct. App. 1925).

²⁸ Consent generally does not need to be in writing to bind the surety. *Trinity Universal Ins. Co. v. Gould*, 258 F.2d 883 (10th Cir. 1958); *Rutherford v. Brachman*, 40 Ohio St. 604 (Ohio 1884).

²⁹ See *Trinity Universal Ins. Co. v. Gould*, 258 F.2d 883 (10th Cir. 1958); *Federal Surety Co. v. White*, 295 P. 281 (Colo. 1930); *Hellman v. Farrelly*, 132 A.D. 151 (N.Y. App. Div. 1909) (acquiescence as consent).

provide[s] that discrepancies, omissions, conflicts and design changes would, or likely, would arise, and that the parties would address such issues during contract performance."³⁰

Other considerations when dealing with the effect of extra work modifications to the scope of work can include a Principal who has finalized a Change Order with the Obligee, but has not yet issued its subcontractor(s) a corresponding Subcontract Change Order. This may not have any net effect on a Surety's cost-to-complete necessarily, but will affect a Surety's efforts to obtain accurate ratification or hold agreements from the Principal's subcontractors, which in turn could affect the accuracy of the scope of work included in a bid package. Additionally, a Surety should pay close attention to scope changes which have been authorized by the Obligee via allowances and ensure that all copies of allowance authorizations are obtained and factored into any costs to complete analysis and included in bid packages.

C. Quality of Principal's Work

In addition to the various impacts changes can have when determining the scope of work, issues concerning the quality of the Principal's work can have significant impacts as well. During a Surety's investigation of a project, it may be determined through a review of Architect or Engineer Observation Reports or Inspector of Record's Notice of Non-Compliances (or other similar documents), that the Principal may have installed work that is not in compliance with the contract documents. If so, a Surety should determine whether the Principal disputes that the work in question is defective. If the designation of certain work as defective is being challenged by the Principal, it may be prudent for a Surety to perform its own investigation of whether the work is defective if circumstances and time allow for such a determination. Another consideration is whether the alleged defective work was performed by one of the Principal's subcontractors. The answers to these questions will dictate how best to account for alleged defective work in any cost-to-complete estimate or bid package. For example, if the alleged defective work was performed by a subcontractor, and the subcontractor agrees to complete the work, then a Surety may not need to include this work in its cost-to-complete estimate. However, if the subcontractor (and presumably the Principal) are disputing that the work in question is defective, a Surety may want to include provisions in its cost-to-complete estimate

³⁰ *United States ex rel. Raghianti Founds. III, LLC v. Peter R. Brown Constr., Inc.*, 49 F. Supp.3d 1031 (M.D. Fla. 2014) *relying on Metcalf Const. Co., Inc. v. United States*, 102 Fed. Cl. 334 (Fed. Cl. 2011); *Int'l Data Prods. Corp. v. United States*, 492 F.3d 1317 (Fed. Cir. 2007) (finding that the change fell under express warranty and upgrade clauses of the contract; thus was not a cardinal change); *Gen. Dynamics Corp. v. United States*, 585 F.2d 457 (Ct. Cl. 1978) (finding that the record did not provide for cardinal change as all changes ordered were within the scope of the contract); *SW Bell Tel. Co. v. Chrisman Constr. Co., Inc.*, 529 S.W. 2d 586 (Tex. Civ. App. 1975); *Brown-McKee, Inc. v. W. Beef, Inc.*, 538 S.W. 2d 840 (Tex. Civ. App. 1976).

and bid packages in order to account for the potential exposure if this work needs to be performed and the subcontractor refuses.

Another aspect related to the quality of the Principal's in place work and its impact on determining the scope of remaining work is what a Surety should do if it notices patently defective work that has not yet been noticed by the Oblige. Patent defects are those which can be found by a reasonable inspection whereas latent defects are hidden and often survive a project close out. An Oblige can be deemed to have waived complaints of patent defects by its acceptance of the work, taking occupancy of the project or by making final payment.³¹

Courts often will look to the performance bond together with the construction contract to determine if a Surety can be held liable on the performance bond for a breach of the construction contract by the Principal that results in latent defects.³² Further, Courts generally hold a Surety liable for defective work performed by its Principal. This liability is not always dependent upon whether the defect was discovered before or after substantial completion. Some courts have refused to distinguish between patent defects and latent defects in respect to the coverage of the performance bond.³³

D. Work Performed by Oblige

In some cases, a Surety may find that the Oblige has performed portions of the Principal's scope of work. For example, the Oblige may have been compelled to perform work with its own forces or with another contractor to address fire/life/safety issues left unresolved by the Principal. Often those measures are temporary, and therefore a Surety should include the scope to remove and replace the Oblige's temporary work with the permanent solution required by the contract documents.

Many projects include contract provisions whereby the Oblige will perform Not in Contract ("NIC") work such as audio-visual or IT systems after the Principal is complete with its work (or concurrently with the Principal performing its work in some cases). In a situation where the project is behind schedule and the Oblige is desperate to make up time, the Oblige

³¹ W. Glenn Speicher, Jr. & Carol Z. Smith, *The Surety's Obligation to Correct Defective Work and Performance of Warranty Work*, in WHEN THE WALLS COME CRUMBLING DOWN: THE CRITICAL ISSUES FACING THE PERFORMING SURETY (unpublished paper submitted at the ABA/TIPS Fidelity & Surety Law Committee Midwinter Meeting on Jan. 21, 2011) (containing an extensive discussion of patent and latent defects); see also Briglia, *supra* note 8, at 68-70 for a discussion on the consideration of completion options including takeover versus tender.

³² *Hunters Pointe Partners Ltd. Partnership v. United States Fidelity & Guaranty Co.*, 486 N.W.2d 136 (Mich. Ct. App. 1992); see *School Bd of Pinellas Co v. St Paul Fire & Marine Ins Co*, 449 So. 2d 872 (Fla. Dist. Ct. App. 1984); *City of Gering v Patricia G. Smith Co*, 337 N.W. 2d 747 (Neb. 1983); *Salem Realty Co. v. Batson*, 123 S.E.2d 744 (N.C. 1962); *City of Osceola v Gjellefald Construction Co*, 279 N.W. 590 (Iowa 1938).

³³ *Fed. Ins. Co. v. Southwest Fla. Ret. Ctr.*, 707 So. 2d 1119 (Fla. 1998) rejecting the decision in *Florida Board of Regents v. Fidelity & Deposit Co. of Maryland*, 416 So. 2d 30 (Fla. Dist. Ct. App. 1982) to the extent that the decision holds that when a construction contract is substantially completed, the surety is relieved of any further responsibility.

may proceed with this NIC work. If this occurs, a Surety should make certain it has taken into account what affect this Obligee performed work may have on the Principal's remaining work. Examples include possibly performing Principal's work out of sequence, or performing additional tasks to work around the Obligee's added NIC work.

Many construction contracts also include provisions whereby the Obligee furnishes certain items (like modular furniture or theater seating systems) that are to be installed by the Principal (known as Owner Furnished Contractor Installed, or "OFICI"). These requirements can often be buried in the contract documents, or in subsequently issued Architect's Supplemental Instructions, therefore a Surety should look for this type of work and ensure that it is included in any cost-to-complete analysis.

A Surety must also be aware of provisions in the construction contract which allow the Obligee to remove or "descope" work from the Principal and have it performed by the Obligee's internal forces or another contractor. Normally this situation is documented in a credit change order negotiated between the Obligee and Principal which results in the change in work scope being well defined; however, on a distressed project the communication between the Obligee and Principal may be so poor that the work being performed by the Obligee is not being specifically tracked and may not even be known by the Principal. More often than not, the Obligee is eager to advise a Surety when it has performed this type of work, but regardless, a Surety needs to make sure it has fully investigated all possible scenarios whereby an Obligee may have changed the scope of work and include those changes in its cost-to-complete analysis and bid packages.

E. Closeout Documents, Warranty and Maintenance

Although a Surety will rightfully focus on the "nuts and bolts" when determining the remaining scope of work of its Principal's project(s), there are other contractually required duties that will incur costs and need to be included in any scope of work analysis. These items include closeout documents such as O&M manuals and as-built drawings, as well as warranty documents and ongoing maintenance. Concerning closeout documents, if the Principal is a general contractor performing little or no work itself, the duty to provide O&M manuals typically flows to the subcontractors. Depending on the status of the project, and in particular when a project is near completion and the closeout documents are one of the last items to be provided, consideration must be given to what type of project support will be needed to collect these documents and ensure that they are compliant with the requirements of the contract before submitting to the Obligee. If the Principal is a subcontractor with a contractual obligation to provide closeout documents, a Surety must determine the status of those closeout documents and what costs may need to be incurred to complete this scope of work.

In addition to O&M manuals, the Principal will likely be responsible for as-built drawings. The obligation to provide as-built drawings has varying degrees of commitment depending on the Principal's scope of work. For instance, if a Principal is a subcontractor or prime-trade contractor performing concrete work, it likely will have little to no as-built documentation to provide. However, if the Principal is a general contractor, the duty to provide as-built documentation can be a very challenging and expensive process, especially if the as-built documentation has not been kept up regularly by the Principal and its subcontractors. When investigating the scope of a Principal's work, it is important to understand the specific as-built

requirements of the contract, determine the current status of the as-builts, and include the costs to either complete, supplement or actually perform as-built surveys in order to comply with those requirements.

Another closeout related duty that a Surety should be aware of when understanding the Principal's scope of work is post-completion maintenance. For example, long term landscape maintenance, or maintenance of mechanical equipment. Again, the depth of this analysis and what to include in a cost-to-complete analysis will be dictated by whether the Principal is responsible for this type of maintenance directly, it has a subcontractor that will perform the maintenance, or it had a subcontractor that would perform the maintenance, but that subcontractor has either refused or is no longer able to perform the required maintenance.

Finally, a Surety needs to consider the issue of warranties.³⁴ It is difficult, if not impossible, to determine what potential warranty claims may arise within one year of completion (or in some cases longer depending on the requirements of the contract). Sureties often elect to include warranty contingencies in cost-to-complete estimates, but this can be complicated by determining which subcontractors may be responsible for certain obligations (and will those subcontractors be around or even respond to warranty calls, etc.). There is no right or wrong way to attempt to address the risk of future warranty claims, and typically these types of speculative costs are not included in cost-to-complete analyses for this reason. What may be a more important and tangible effect on the scope of work is the issue of equipment (typically mechanical or electrical) that is out of warranty due to a long term delay on the project. This situation arises frequently, and can be overlooked by a Surety performing its investigation. A Surety should determine what it will cost to provide extended warranties for certain equipment on the project in order to comply with the contract requirements, and include those costs in its cost-to-complete estimate.

V. *CONSIDERATIONS AND CHALLENGES WHEN DETERMINING STATUS OF PRINCIPAL'S WORK IN PLACE AND WORK REMAINING*

So far we have addressed the reasons why a Surety needs to understand the scope of work, key documents needed to assist with understanding the work scope, the types of contracts and delivery methods affecting scopes of work, and factors such as change orders or work quality issues that may impact the scope of work. This section will address considerations and challenges when determining the status of the Principal's work in place and work remaining.

A. **Amount of Work Remaining to Complete**

It is self-evident that in order to determine the scope of work, a Surety needs to understand both the totality of the scope of work required by the contract documents, but also what work has been completed, and ultimately what work remains. This process is obviously facilitated when the work has either not yet started or is in its very early stages. In those instances, the original contract documents such as the front-end bid documents, contract, plans and specifications and addenda may be all that is required since other project documentation modifying the original scope of work has not yet been generated. Unfortunately, the majority of

³⁴ For a discussion about warranty considerations *see* Ward, *supra* note 1, at 426-27; Speicher, *supra* note 30, at 125-129.

situations facing a Surety are simply not that clean and straightforward. More often than not, a Surety steps into a situation where a Principal's project(s) is partially complete with multiple activities and trades working at the same time. Often a Surety may determine that it is most cost-effective to utilize the defaulted Principal to complete the work due to significant costs associated with mobilizing a new completion contractor at end of project and/or issues regarding required warranties. However, it is often difficult to reach an agreement with the Obligor to allow a defaulted Principal to complete work and may also be dependent on the bond form or contract terms. Further, there are also considerations when projects are at or near completion, or in the middle of punch list completion. Regardless of the status of the project, the processes used to gain an understanding of the scope of work as more fully outlined above are essentially the same, they just become more complicated depending upon the status of the project.

1. Principal's Self-Performed Work

When assessing the current status of the work, a Surety must focus on what work is being self-performed by the Principal, and the costs associated with completing this self-performed work. This exercise can be a challenge, especially in a situation where a Principal has requested financing and is continuing to perform work. As noted earlier, determining what work is to be self-performed by the Principal is easier when the Principal is a subcontractor or one of several multi-prime contractors. When the Principal is a general contractor, the lines may not be quite as defined. More often than not, a general building contractor self-performs little to no work (with common exceptions being concrete and rough carpentry) and subcontracts most of the work to subcontractors. On heavy civil engineering contracts or pipeline construction, the general may self-perform the majority of the work. A discussion with the Principal to determine which scopes of work it intends to perform is the obvious starting point, with a review of the overall scope of work, subcontract agreement scopes, buyout logs, daily logs, payroll records and other project documents in order to confirm.

Of course, the Surety faces additional costs when a defaulted Principal self-performs much of its own work and the Surety is no longer able to use that Principal. In those instances, the Surety will have to re-let certain portions of the remaining work to subcontractors which will likely increase the cost to complete. An added consideration is whether the Principal owns its equipment. The Surety should consider the equipment and whether it was or was not included in the initial bid documents and for what amounts.

For the sake of brevity, this paper will not go into depth concerning the details of how to estimate a Principal's self-performed work. Suffice it so say that a Surety will need to obtain a firm understanding of the labor being used by the Principal such as the size and number of crews, ratio of foreman/journeyman/apprentices, and scheduled duration of the remaining work. The amount of materials, cost of materials, delivery charges and schedule of deliveries will also need to be determined. Often a review of the Principal's purchase order log and review of the actual purchase orders is of assistance. Special attention should be paid to long lead items and specialty materials. Have these items actually been ordered and/or paid for? If the Surety has to address long lead or specialty materials, the Surety can encounter significant delays on the project which may create liquidated damage or other delay issues and, ultimately, a loss of contract balances on the back end. Further, the amount and type of equipment needed to install the materials will need to be ascertained, and whether that equipment is owned or rented. Finally, the type and level of

supervision, management, quality control, scheduling, and administrative assistance to support the self-performed work all need to be considered as well.

2. Principal's Subcontractors

When a Principal is a general contractor with multiple subcontractors, there are additional considerations and challenges facing a Surety when attempting to determine the remaining scope of work. Typically, the first task to perform is a review and comparison of the Principal's bid, cost report, buy-out log, subcontractor log and executed subcontracts to obtain a firm grasp on what scopes of work have been bought out by the Principal. Once it is determined what scopes of work have been bought out, an efficient way to cross-check what scopes may not have been bought out yet (whether missed by the Principal at bid time or pending further negotiations with subcontractors) is to make a list of all specification sections included in the subcontracts and compare this list to the contract specifications. This is a simple way to determine what scopes may not have been bought out (known as scope gaps). Pay particular attention to the exclusion sections of the subcontracts, and also review all change orders issued by the Principal to the subcontractors to determine whether any of these missed scope items were picked-up in subsequent change orders.

Although there are numerous scenarios that can arise related to subcontractors and the impact on the scope of work, one issue that may arise that can impact a scope of work analysis is when a Principal has been forced to replace a subcontractor. In this case, it is not uncommon for a Principal to bring on a replacement subcontractor on a time and material basis for the sake of expediency. This course of action may have a direct effect on the scope of the work if the previous subcontractor performed defective work that needs to be corrected. It can also be challenging to determine what the status of the work was when the previous subcontractor was replaced, and how much work has been performed on time and material in order to determine what is left to complete. This scenario has ramifications not only for preparing a cost-to-complete, but when preparing bid packages as well.

Another important consideration is whether the Surety can utilize the Principal's subcontractors either through assignment rights or ratification agreements.³⁵ It often may be more efficient for the Surety to use the existing subcontractors. A Surety, as assignee, may compel a subcontractor to continue performing. Alternatively, a ratification agreement provides that the Surety will pay the subcontractor the amounts that may be owed by the defaulted Principal in exchange for the subcontractor's agreement to complete the original scope of work for the original price. A Surety should be aware that a subcontractor who knows that a Surety would rather ratify the subcontract than incur the cost to re-let that portion of the project, may attempt to gain leverage over the Surety and seek payment for time-barred claims, disputed or invalid claims to keep them on the jobsite. In such instances, the Surety should attempt to reach an agreement that the parties reserve all rights in relation to disputed claims and/or change orders until the completion of the project or the subcontractor's work so that work will keep going (limiting delays and the possibility of liquidated damages). This reservation of rights may

³⁵ See, e.g., M. Tomeo & T. Tomeo, *I Smell a RATification: Benefits, Problems, and Practical Implications of Subcontractor Ratification Agreements*, unpublished paper presented at the 1997 Western States Surety Conference.

be particularly helpful should there be time-barred claims, but may be difficult to achieve, in practice.

B. Stored Materials

Although the importance of knowing the status of materials related to the Principal's self-performed work was touched on briefly above, there are additional considerations that a Surety needs to consider concerning project materials. First of all, a Surety will need to obtain an inventory of materials that are stored both on-site and off-site (either at an off-site staging yard, a subcontractor's yard or a supply house). Even if a Principal represents that it has a detailed inventory of all materials, a Surety may want to conduct an independent investigation to confirm the inventory list. Further, a Surety may want to dig deeper and verify whether the stored materials comply with the contract documents and submittals. This exercise will help the Surety be aware of situations where paid-for materials are not to be found or improper storage caused damage requiring those materials to be re-ordered at significant costs. Often a cooperative and proactive Obligee will agree to perform an inspection of the stored materials for compliance, which is preferred over a Surety performing this function since the Obligee will ultimately be making the final decision on acceptance regardless. Obtaining knowledge of the scope of stored materials is critical to any cost-to-complete analysis (and further determining the status of payment for those materials), as well as for bid packages.

C. Temporary Facilities to be Provided by Principal for Owner and/or CM and IOR

Although it typically is not a large cost item and is not technically part of the scope of work, a Surety should be aware that some contracts require the Principal to provide temporary jobsite facilities such as trailers, separate restroom facilities, copies, office supplies, water, etc. for the Obligee and/or its inspector or construction manager. The Principal's general conditions budget should include these costs, but often times does not since it was not picked up at bid time. Make sure these costs are included in any completion estimates, and include the additional time these facilities may be in place due to a delayed project.

D. Risk of Using Cost Loaded Schedules or Payment Applications to Confirm Work Completed and Work Remaining

In the interest of time, a Surety may be inclined to look at a resource loaded schedule, or even more commonly a Principal's payment application, to obtain a sense of the work remaining. This practice should be avoided for several reasons. First, as it relates to cost loaded schedules, they are often complex and expensive to prepare, and as a result are often not accurate or maintained. As for payment applications, they are a billing tool only, and although they can be helpful to obtain a very general sense of percent complete of certain line items, they should not be relied upon heavily. Front-end loading by the Principal, lack of detail of work activities and the scarcity of any meaningful detail about the actual conditions of the project are just some of the reasons why payment applications should only be used in conjunction with the other tools provided above when investigating the status of the work.

E. Investment of Time and Resources Determining the Scope of Work

A Surety will want to perform as detailed an analysis of the remaining scope of work as time will allow. This part of the Surety's investigation will assist the Surety in its decision making on how to address its Principal's default or potential default via financing decisions, re-letting a project via tender or takeover, or simply doing nothing. Further, the investigation into the scope of any remaining work may lead to the discovery of claims and defenses. Often the Surety will perform a cost-benefit analysis of how much time and resources to expend weighed against the amount of remaining work, penal sum of the bond at issue or size of the project.

F. Overpayment Issues Affecting Scope of Work

The Surety's investigation into defining the scope of work may lead to its discovery of evidence justifying a defense, or demonstrating rights or remedies that would otherwise have been unknown to the Surety.³⁶ For example, the Surety may learn of overpayments to the Principal and the Surety may be entitled to exoneration or recovery if prejudiced.³⁷ The most critical issue of establishing an overpayment defense for the Surety is whether the Surety must make an affirmative showing of prejudice and, if so, the amount of the prejudice.³⁸

In some circumstances, courts have held that if the Obligee makes payment for work not performed or obviously defective, the Surety may be partially or totally released from its payment obligations.³⁹ However, the success of the overpayment defense, like any other, depends on the terms of the contract and bond.⁴⁰ The contract language may preclude the Surety's defense of overpayment. Another consideration for the Surety is that, to be successful, the Surety must show that the payments constituted a modification of the construction contract

³⁶ Dunn, *supra* note 5.

³⁷ *Id.* noting for the premise that a surety may be exonerated by an obligee's prepayments or overpayments, *see, e.g., Am. Ins. Co. v. Heritage Constr. Corp.*, 268 F.Supp. 336 (N.D. Cal. 1966); *Pac. Coast Eng. Co. v. Detroit Fid. & Sur. Co.*, 5 P.2d 888 (Cal. 1931); *Patten & Davies Lumber Co. v. McConville*, 25 P.2d 429 (Cal. 1933); *United States f/b/o Army Athletic Ass'n v. Reliance Ins. Co.*, 799 F.2d 1382 (9th Cir. 1986); *Blackfeet Tribe v. Blaze Constr., Inc.*, 108 F.Supp. 2d 1122 (D. Mont. 2000); *see, e.g., Southwood Builders Inc. v. Peerless Ins. Co.*, 366 S.E.2d 104, 108 (Va. 1988); *Airtrol Engineering Co. v. United States Fidelity & Guarantee Co.*, 345 So. 2d 1271, 1273 (La. Ct. App. 1977).

³⁸ George Rettig & Patricia Wager, *Selected Issues Impacting the Surety's Duty to Perform, in WHEN THE WALLS COME CRUMBLING DOWN: THE CRITICAL ISSUES FACING THE PERFORMING SURETY* (unpublished paper submitted at the ABA/TIPS Fidelity & Surety Law Committee Midwinter Meeting on Jan. 21, 2011); *Southwood Builders, Inc. v. Peerless Ins. Co.*, 366 S.E.2d 104 (Va. 1988) (separate showing of prejudice to the surety is unnecessary because a material deviation establishes sufficient prejudice); *National Union Indemnity Co. v. G.E. Bass and Co.*, 369 F.2d 75 (5th Cir. 1966) (material departure from the terms of the contract deprives the surety of the inducement to perform).

³⁹ *See, generally, Herbert Constr. Co. v. Titan Indem. Co.*, No. 94 Civ. 1261 (RLC), 1996 U.S. Dist. LEXIS 6587 (S.D.N.Y. May 14, 1996); *Congregation Ohavei Shalom, Inc. v. Comyns Bros., Inc.*, 123 A.D.2d 656 (N.Y. App. Div. 1986) (a surety's rights are accorded jealous protection of the law, and any alteration of the contract to which his guaranty applies, whether material or not, will serve to discharge the surety's obligation).

⁴⁰ *Brighton Sch. Dist. 27J v. Transamerica Premier Ins. Co.*, 923 P. 2d 328, 334 (Colo. Ct. App. 1996); *see generally* J. Knox, *Quid Without Quo: The Surety's Overpayment Defense*, THE CONSTRUCTION LAWYER 3 (Oct. 1993).

materially increasing the Surety's risk.⁴¹ This defense may be available only to the extent to which the Surety is prejudiced.⁴²

The rationale for the overpayment defense comes from the understanding that when the bond was executed, the Surety agreed to be bound only to the risks to the extent set forth in the construction contract between the Principal and Obligor at the time of execution. The overpayment defense is grounded in the age-old rule that a Surety can only be held liable to the extent of its undertaking, which is to guarantee performance by the bonded Principal out of a specific contract in accordance with the terms of that contract.⁴³ The contract balance is the Surety's security for its obligation.⁴⁴ If the Principal and Obligor alter the contract, the Surety may be exposed to risks not contemplated at the time the bond was executed.⁴⁵ Put another way, improper overpayment may harm the Surety's ability to seek subrogation in the contract balance as security for the expense of completion of the contract, and also may diminish the Principal's incentive to complete the work.⁴⁶

The "modern rule" regarding overpayments- also known as the "*pro tanto* rule" – is that "a compensated surety is discharged from its obligations on the performance bond to the extent that such unauthorized payments result in prejudice or injury."⁴⁷ In order to establish a *pro tanto* discharge for a compensated Surety, however, the evidence must establish two separate factors: (1) proof of material modification to the underlying contract and (2) injury or prejudice to the Surety.⁴⁸ With regards to the first requirement, mere immaterial or technical departures from the contract, not resulting in any damage to the Surety, will not release the Surety.⁴⁹ Payment of substantial sums before they are due is a material alteration that will discharge a Surety to the

⁴¹ *Brighton Sch. Dist.* 27J, 923 P. 2d at 335 *relying on* *Argonaut Insurance Co. v. Town of Cloverdale*, 699 F.2d 417, 420 (7th Cir. 1983) ("the town is not in the construction business and there was no reason for it to think it ought to verify the engineering firm's estimates. But [the surety] is in the business of insuring construction contracts and if it was unhappy with the town's choice of engineers, or with the delegation to the engineering firm of responsibility for calculating the progress payments that were due, it did not have to agree to insure the contract"); *Mergentime v. Washington Metropolitan Area Transit Authority*, 775 F. Supp. 14 (D. D.C. 1991).

⁴² *Blackfeet Tribe v. Blaze Constr., Inc.*, 108 F.Supp. 2d 1122, 1137 (D. Mont. 2000).

⁴³ Rettig, *supra* note 37 *relying upon* *Eager v. Seeds*, 96 P. 646, 649 (Okla. 1908).

⁴⁴ See RESTATEMENT THIRD, SURETY AND GUARANTY §31 (1996); *see also* *North Am. Specialty Ins. Co. v. Chichester School Dist.*, No. 99-2394, 2000 U.S. Dist. LEXIS 10745 (E.D. Pa. 2000).

⁴⁵ See *Inland Nav. Co. v. American Surety Co.*, 227 S.W. 809 (Ky. 1921).

⁴⁶ *Blackfeet Tribe v. Blaze Constr., Inc.*, 108 F.Supp. 2d 1122, 1137 (D. Mont. 2000) *relying upon* *United States v. Continental Cas. Co.*, 512 F.2d 475, 478 (5th Cir. 1975).

⁴⁷ Rettig, *supra* note 37; *United States v. Continental Cas. Co.*, 512 F.2d 475, 477 (5th Cir. 1975).

⁴⁸ *North Am. Specialty Ins. Co. v. Chichester School Dist.*, No. 99-2394, 2000 U.S. Dist. LEXIS 10745 (E.D. Pa. 2000) *relying on* *United States v. Reliance Ins. Co.*, 799 F.2d 1382, 1385 (9th Cir. 1986); *Ramada Development Co. v. United States Fidelity & Guaranty Co.*, 626 F.2d 517, 521 (6th Cir. 1980); *Mergentime Corp. v. Washington Metropolitan Area Transit Auth.*, 775 F. Supp. 14, 19 (D.D.C. 1991).

⁴⁹ *North Am. Specialty Ins. Co.* 2000 U.S. Dist. LEXIS 10745.

extent of the prejudice.⁵⁰ With respect to the second requirement of prejudice, many courts demand some showing that the Surety was prejudiced by the overpayment.⁵¹ Courts will consider the effects of the overpayment, such as whether the unauthorized release reduced the Principal's incentive to complete the contract, thereby increasing the risk to the Surety.⁵² If unauthorized sums were ultimately expended for purposes of the contract, though, the amount at risk to the Surety might be unaffected or even reduced.⁵³

Some courts have held that the overpayment defense does not apply in cases where an Obligee has made payments under the contract in good faith and in reliance upon the Principal's representation of performance.⁵⁴ The defense may still apply if the Obligee was negligent in making overpayments to the Principal.⁵⁵ For example, where the Obligee typically will not pay the Principal until the architect or construction manager approves the payment request, and the Obligee ignores the decision of the third party professional, the Obligee may be held accountable.⁵⁶

In light of these considerations, overpayment issues may affect the Surety's determination of the remaining scope of work.⁵⁷ As noted above, a Surety may be inclined to consider a Principal's previous payment applications to determine what work is in place and what scope of work remains. Overpayments to the Principal may affect the accuracy of what is reflected on payment applications by showing that that more work has been completed than actually performed. The Surety should, therefore, be cautious in relying heavily on this type of information when determining the remaining scope of work and its cost-to-complete.

G. Contingencies

Another important consideration for the Surety is determining what, if any, contingencies were included in its Principal's bid and whether the Surety wants to include any additional

⁵⁰ *Continental Ins. Co. v. City of Virginia Beach*, 908 F. Supp. 341, 348 (E.D. Va. 1995) *citing Southwood Builders, Inc. v. Peerless Ins. Co.*, 366 S.E.2d 104 (Va. 1988).

⁵¹ *North Am. Specialty Ins. Co.*, 2000 U.S. Dist. LEXIS 10745.

⁵² *National Sur. Corp. v. United States*, 118 F.3d 1542, 1548 (Fed. Cir. 1997).

⁵³ *Id.*; *see also Argonaut Ins. Co. v. Cloverdale*, 699 F.2d 417 (7th Cir. 1983) (overpayments made by town to contractor hired to build sewer did not release surety of its obligation under performance bond where materials for which contractor received unauthorized advances not only were delivered and stored on site, but were used in completing project after contractor defaulted); *Ramada Development Co. v. U.S.F. & G Co.*, 626 F.2d 517 (6th Cir. 1980) (the surety was not released to the extent of the improperly paid retainage because the contractor applied the released funds to progress on the contract).

⁵⁴ *See, e.g., Transamerica Ins. Co. v. City of Kennewick*, 785 F.2d 660, 661 (9th Cir. 1986); *Town of East Longmeadow v. Maryland Cas. Co.*, 206 N.E.2d 54, 58 (Mass. 1965).

⁵⁵ *See, e.g., City of Kennewick*, 785 F.2d at 662 (applying Washington law and holding that an obligee was not entitled to a good faith defense because it relied on the certifications of its own employees when making improper payment, and thus acted negligently).

⁵⁶ *See Carolina Cas. Ins. Co. v. R.L. Brown & Assocs.*, No. 1:04-cv-3537-GET, 2006 U.S. Dist. LEXIS 89412 (N.D. Ga. Dec. 11, 2006) (the surety may also have recourse against third-party design professionals).

⁵⁷ For additional discussion on the overpayment defense and issues facing a Surety *see* Briglia, *supra* note 8, at 84-86; Krebs, *supra* note 1, at 198-200.

contingencies. Many factors may play into this decision. For example, weather may play a significant factor to consider in contingencies – especially if taking over the project in winter. It is often difficult to build in the proper amount of contingencies and still have an accurate cost-to-complete. Attempting to account for every possible event will affect the Surety’s decision to takeover and may ultimately result in choosing a more expensive option when those contingencies never come to fruition.

Surety will rely heavily on consultants – their experience, expertise and knowledge of the area, site conditions- to assist in its determination. The Surety may also look to its underwriters for information about its defaulted Principal since they may have additional insights that the Surety will want to consider in the cost-to-complete analysis. Experience shows that Sureties often differ in their approaches. Some Sureties shy away from including contingencies where as others rely heavily on them. Often contingencies are an easy way to throw additional money on a project when the effort to really know the true scope and cost either cannot be done or a Surety does not want to spend the resources to do so. Whether some contingency is warranted is dependent upon the facts, and using a construction consultant’s knowledge of the type of project, owner, subcontractors and all of the potential risk and pitfalls that those players may create is particularly useful.

*VI. CONSIDERATIONS WHEN ADDRESSING SCOPE OF WORK
IN SURETY’S REQUEST FOR PROPOSALS (RFP) ISSUED
TO COMPLETION CONTRACTORS*

To recap, we have addressed numerous procedures and issues to think about when determining the scope of work. As noted several times above, the tools and information provided will prove very useful when preparing a cost-to-complete estimate. In addition, we have generally noted the need to include this information in a Surety’s Request for Proposals (“RFP”). This section will provide a practical guide on how to integrate the cost of work related information and documentation into a Surety’s RFP.

Without question, the scope of work is the most critical component of the Surety’s RFP, and, in turn, can often be the most problematic. With that in mind, a major consideration when preparing an RFP is what level of work scope information should be provided to completion bidders by a Surety. In addition to providing a general description of the work (which can often be found within the contract documents themselves), a Surety will be well-served by providing as much relevant project documentation in the form of exhibits to the RFP to allow bidders to determine the remaining scope of work. Most of these documents have been addressed earlier in this paper.

In some cases, a Surety may elect to provide an exhibit prepared by its consultant summarizing the scope of work. There should be caution paid to providing such an exhibit for fear that it may be used by the awarded completion contractor to argue that certain work items were not included on the Surety’s scope summary exhibit. Although there are ways to protect a Surety from this situation such as adding “For Informational Purposes Only” to the exhibit, or including relevant language within the Completion Agreement, it may be best practice to simply not include a work scope summary exhibit and instead rely upon the original contract documents and any associated modifications to frame the scope of work. There may be an exception in unit

price contracts since a Surety can verify with the Principal and Obligees the remaining units and provide a revised bid item list for use by the completion bidders.

Brief mention was made previously to design-build projects. When preparing an RFP, a Surety will want to include the most current set of design drawings prepared by the Principal as an exhibit to the RFP. Careful language should be included in the RFP, and the subsequent Completion Agreement, specifically stating that the plans provided are for informational purposes only, and that the awarded bidder is fully responsible for completing the required design documents. Often the Principal has hired one or more design professionals to prepare the design drawings, and therefore it is prudent for a Surety to advise the bidders that the Surety has, or will, take an assignment of those contracts and assign them to the awarded bidder either directly or through a ratification agreement.

In addition to providing a general description of the scope of work in the RFP and supplementing that information with numerous documents attached to the RFP as exhibits, a Surety should conduct a mandatory pre-bid meeting and job walk with all bidders to review the project and the RFP. Although this initial project walk is helpful in providing the bidders with an overview of the project and the scope of work, the project should be made available at least one or more times for bidders and subcontractors to spend significant time ascertaining the status of the scope of work.

Concerning work self-performed by the Principal, a Surety may consider having plan sheets prepared outlining the status of the Principal's self-performed work (such as civil and structural plans highlighted to show the extent of self-performed concrete work in place). These plans should be stamped "For Informational Purposes Only" so bidders know they are ultimately responsible for determining the remaining scope of work and the cost to perform that work. Nevertheless, providing this road map in the RFP will streamline the bid process and assist the bidders with their own due diligence.

In regards to the Principal's existing subcontractors, there is often a fine line between encouraging bidders to use the Principal's existing subcontractors versus requiring bidders to retain existing subcontractors. Although there may be some unique circumstances whereby a Surety would want to require a certain subcontractor to be retained, a Surety is better served by attempting to ratify as many subcontractors as possible and allowing the bidders determine which existing subcontractors they intend to utilize. More often than not, the bidders realize the only way to be competitive is to take the risk of using as many existing subcontractors as possible.

On projects where most, if not all, of the work is being performed by the Principal's subcontractors, the majority of the remaining scope of work and the costs to complete that work will be determined based on the status of the ratified subcontractors. In that regard, a Surety should provide as many ratification or hold agreements as possible to the bidders. In addition, the bidders should be provided a detailed accounting of the existing subcontractors. By reviewing the totality of the RFP exhibits, including the subcontracts, ratification agreements and subcontractor accounting, the bidders can determine the scope of work and the associated costs to complete what is remaining. As is often the case, all subcontractors may not be ratified at the time the RFP is issued. In those cases, copies of subcontracts can be provided to the bidders along with the most accurate subcontract accounting, which can later be modified by an RFP

addendum if a ratification agreement is secured or new information is obtained that changes the previously provided subcontract accounting. This process is similar if a Surety elects to take a direct assignment of all subcontract agreements of the Principal and assign them to the awarded completion contractor.

Whether a Surety elects to provide ratification agreements, assign the subcontracts directly to the awarded bidder, or does nothing more than provide copies of the subcontracts, it is ultimately the bidders who are responsible for determining the scope of work included in subcontracts and the status of work remaining. As a result, the RFP and subsequent Completion Agreement must expressly note that completion contractor assumes all risk of quality and timely performance of existing subcontractors, as well as the completeness of subcontractors' scopes and confirmation that completion bidders have properly filled all scope gaps.

With respect to representations as to the quality of the Principal's work in place, a Surety may consider advising completion bidders in the RFP to assume all work in place is acceptable and installed per the contract documents. This approach may be the most desirable for a Surety since shifting the risk of determining what in place work may be patently defective is often difficult to perform with limited time and access to the project, which could result in large contingencies provided by bidders, or worse yet, bidders declining to bid at all. Be aware that directing bidders to assume that all work in place is compliant fits better in a takeover scenario where a Surety is involved through the end of the project and can address any discovered defects via change order with the completion bidder, but may not be as practical in a tender situation. Certain exceptions may be noted to the bidders such as including notices of non-compliance or other documentation from the Oblige that Surety agrees needs to be repaired and requiring bidders to include any and all costs necessary to correct the non-conforming work. If any of this work deemed defective by the Oblige is disputed by the Principal and/or Surety, consider having the disputed work priced as an add alternate.

Regarding latent defects, typically a Surety does not require completion bidders to include pricing for latent defects since bidders are not able to perform the type of inspection necessary to determine what latent defects may exist. It may not be advisable to shift the risk of locating and pricing all latent defects to the completion bidders since it could result in increased contingencies and unbalanced bids; not to mention be impractical given the time and extent of inspection that would be needed. If a Surety wants to tender the project and have absolutely no further involvement, then bidders could be requested to assume the risk of all latent defective work. In such a situation, it is advisable to have this priced as an add alternate and keep it separate from the base bid amount. Irrespective of what options a Surety takes in its RFP regarding both patent and latent defects, completion bidders can manage this risk by retaining all of Principal's existing subcontractors. Of course complications can arise when a completion bidder intends to replace all or some of Principal's subcontractors, which may be a deciding factor when a Surety is determining which bidder should be awarded the completion contract.

With regard to extra work and how best to address it as part of the scope of work discussion in the RFP, it is sound practice for a Surety's RFP to direct completion bidders to only price work included in written change orders executed by both the Principal and Oblige. Complications can arise when approved change order work is partially completed, but these complications can be simplified when a completion bidder intends to utilize all existing subcontractors. If the completion bidder intends to replace an existing subcontractor that has

partially completed approved change order work, the burden should be put on the completion bidder to determine the cost of remaining change order work.

If there is work that has been directed by the Obligee to be performed that is disputed by the Principal, a Surety may be best served by including add alternates as part of the RFP for completion bidders to price this disputed work. By having this scope of work separated as an add alternate, a Surety receives the benefit of competitive bidding to determine the best price to complete this disputed work. A Surety could then have the work performed by the completion contractor for the add alternate price and reserve its rights to negotiate or file a claim relating to the work. This approach works particularly well in a tender situation. The alternative is to not include any disputed work in the RFP, and if the Obligee insists the work be performed without issuing a change order, the work can be performed in the field on a time and materials basis and the costs be submitted as a claim to the Obligee by the Surety. This scenario would not be ideal in a tender, but would be possible in a takeover situation.

In order to assist with the scope of work determination to be made by completion bidders, a Surety may consider providing an inventory of materials stored on-site and off-site. Again, any such list should be marked "For Informational Purposes Only" and the risk to verify the extent of stored materials should be shifted to the completion bidder. Also, a Surety should not make any verbal or written representations regarding the suitability of the stored materials, unless confirmation has been obtained from the Obligee that some or all of the materials have been inspected and deemed compliant with the contract documents and approved submittals. If no such Obligee approval can be provided, the completion bidders can analyze the approved submittals, inspect the materials during one of the days the project is made available to bidders, and discuss the materials with the existing subcontractors, where applicable.

Finally, similar to the issue of latent defects, a Surety will need to determine whether it wishes to have completion bidders warrant only new work performed post-takeover or tender, or warranty the work previously installed by the Principal. It is more common to limit the completion contractor's warranty obligations to only the new work installed by the completion contractor and/or its subcontractors. However, the scope and obligations of warranties can be complicated when a completion contractor does not retain key existing subcontractors. A Surety may expand the completion contractor's warranty liability to include the warranty for all work performed by a ratified or assigned subcontractor utilized by the completion contractor. In addition, and particularly in a tender situation where a Surety wants to be completely released, bidders may be requested to provide an add alternate to assume the warranty obligations for all work performed by the completion contractor and any work previously installed by the Principal. Additionally, a Surety may need to include an add alternate to the RFP requesting completion bidders provide extended warranties due to delays on the project in order to satisfy the contractual warranty requirements. However, completion contractors rarely want to assume liability for latent defects or warrant work for another contractor and may seek significant compensation for assuming such exposure.

VII. CONCLUSION

One of the most important tasks the Surety must accomplish when faced with a default or potential default of its Principal is to identify the remaining scope of work on a project. This

exercise is critical to determine the Surety's performance options and in making its decision. As discussed in this paper, there are many considerations in defining the scope of work as well as an accurate cost-to-complete.

A thorough understanding of the scope of work can be accomplished by gathering the necessary documents from appropriate sources, and considering the type of contract and delivery method relating to the project. Defining the remaining scope may be complicated by certain issues such as Obligee modifications of the scope, change order work, potential overpayments to the Principal and the quality of the work in place. As such, the Surety needs to be aware of potential related issues including whether changes constitute cardinal changes to the Surety's risk, whether the Surety faces exposure for patent and/or latent defects, and how to address warranty obligations. In order to gain an understanding of all of these issues, the Surety must have a thorough understanding of the scope of work in order to address its obligations, and further, to prepare accurate cost-to-complete estimates and comprehensive completion bid packages.