ERNSTROM & DRESTE LLP

FIDELITY & SURETY REPORTER

WINTER 2011 ISSUE 17

# WILL GOING GREEN PUT YOUR "GREEN" AT RISK?

## An Uncertain Landscape for Contractors and Sureties

BY NELL M. HURLEY

Pressure to "go green" seems to be everywhere and the construction industry has experienced that pressure from almost every angle. While the espoused ideal appears laudable enough (who doesn't want to save the planet?), the complexity and uncertainty of this development has made it difficult for contractors and sureties to gauge the risks this green landscape presents.

Of special significance to the construction and surety industry is the emergence of "green building," where owners incorporate the benefits of sustainable design and construction such as energy efficiency and resource preservation. The advantages of building green can include financial incentives, perceived prestige or goodwill and, perhaps, spiritual rewards. However, efforts to support those green goals, once voluntary, are appearing in legislation, regulations and codes which can have contractual and legal implications for contractors and sureties.

While there is no consensus as to what constitutes "green building," the functional concepts of sustain-

CONTINUED ON PAGE 2

# AIA 2010 Surety Bond Form Revisions:

## A Few Words to the Wise

BY JOHN W. DRESTE

Earlier this year, the American Institute of Architects ("AIA") issued new 2010 editions of their A310 Bid Bond, A312 Performance Bond and A312 Payment Bond. The prior versions of these bond forms dated back to 1984 and had provided the basis for over two decades-worth of interpretation by the courts. The 2010 revisions effect substantial changes that should be considered by sureties. Although not an exhaustive comparison, key differences to bear in mind are discussed below.

### 2010 A310 – Bid Bond

The Bid Bond terms now mandate that the Surety's consent be obtained by the Owner and Contractor for any extension of the award process exceeding 60 days beyond the time for acceptance of bids specified in the bid documents. The prior Bid Bond form was silent on extensions of time in the bidding/award process, opening the Surety to extended exposure. The new form now creates a defense for the Surety, should consent for an extension not be obtained.

From a practical standpoint, at least in New York, bids are typically required to remain open for a period of 45 days from bid opening. Once the 45 day period expires, the new Bid Bond can remain automatically enforceable for an award extension for an additional 60 days, but any further delay must be with the consent of the Surety.

Once the bid is accepted, the Contractor is now required to obtain bonding from a Surety "admitted in the jurisdiction of the Project and otherwise acceptable to the Owner." There is still no obligation on the part of the Bid Bond Surety to follow-up with the issuance of performance or payment bonds, but this new language confirms that the Owner may insist on properly authorized and otherwise acceptable Sureties. The exposure to the Surety is specified as the difference between the amount stated in the bid of the Bid Bond Principal and any increased amount for which the Owner may in good faith contract with another party to perform the work covered by the bid. It is, however, expressly capped by the sum stated in the Bid Bond.

Thus, the new Bid Bond clarifies the limits of the exposure to the Surety and places affirmative obligations on both the Owner and Contractor to seek extended coverage should the bid and subsequent award process be delayed.

### 2010 A312 – Performance Bond

The new A312 form replaces the 1984 version of the A312.[1] The 1984 form's mandatory condition precedent that a pre-default meeting be requested and scheduled by the Owner, as well as the 20 day waiting period for a default declaration and subsequent termination, are eliminated. The obligation is now on the Surety to request a meeting, should it so desire, within five days after receiving notice that the Owner is considering a declaration of Contractor default. This meeting must be held within ten days of the Surety's receipt of the notice of this consideration of default.

1 Notably, the A311 "short forms" of both performance and payment bonds have not been revised.

CONTINUED ON PAGE 3

## IN THIS ISSUE

CONTINUED "WILL GOING GREEN PUT YOUR 'GREEN' AT RISK?"

ability, energy efficiency, reduction in the use of natural resources and negative impacts on the environment are commonly employed. Environmentally responsible design and construction have been at the forefront of local, state and federal mandates and incentives to "build green." In almost all cases, in order to receive the incentives or meet the mandates, **the building or renovation will require some third-party certification that it meets green standards**, often the U.S. Green Building Council's LEED Rating System. Such certification usually does not occur until after the project is complete.

The financial incentives for owners who build or renovate "green" may be beneficial for the construction industry since it can produce opportunities in an otherwise flat market. However, meeting the green standards, like the LEED certification or green building codes, presents a whole set of risks not previously encountered in the typical construction scenario. **Today, standard construction contracts and surety bonds do not adequately address the responsibilities and risks of green building.** Many of the "green" terms may not be defined, which can lead to ambiguity or uncertainty as to how a green goal is to be achieved. Even if the green terms are defined, the responsibilities among the various parties for their contributions to the green certification process are not identified. There can be long lead times and performance problems with many green products as technology develops, and the availability and quality of those materials are often inconsistent or unproven. Good practices for such green building have not yet been well integrated. If there is a green code or mandate in place, is compliance the responsibility of the contractor, as with other types of building codes? Most importantly, what happens if the project does not meet the third-party certification requirements? Are there specifications and warranty provisions that place the risk of the project's green performance on the contractor? What damages can the owner recover for such a failure, and from whom? As the complexity of the building and novelty of the materials and processes increase, so does the risk of catastrophic failure, such as mold.

For the surety, the risks are equally hazardous. If the underlying contract documents are interpreted to require that the project achieve a particular certification, the performance bond surety may be liable if it does not. In addition, the cause of the green failure may be especially difficult to determine given the additional layer of complexity that green design and construction presents. Indeed, failing to meet an energy standard may have more than one cause, for instance, building maintenance or operation, rather than design or construction. New technologies and materials may increase the likelihood of product or application failures. Since green certification is usually not determined until well after construction is complete, the options to remedy defects may be limited and expensive.

The surety industry, for its part, has largely taken a "wait and see" approach while generally avoiding projects that require specific energy reductions, efficiency levels or third-party certification. One major exception to this has been the surety industry response to the 2006 District of Columbia mandate requiring that certain public and private building projects meet specific green building objectives tied to LEED certification. Sureties, among others, objected to the requirement of a so-called "green performance bond" which guaranties payment of up to four percent (4%) of the building's costs into a city green building fund in the event of failure to meet the green criteria. Sureties argued that the bond provision operates as an enforcement mechanism and a revenue source rather than a performance bond. Although the District of Columbia has since modified the language, changing "performance bond" to "bond," the question of the surety industry's unwillingness to guaranty building performance to any green specification may create a problem for the green building movement, at least until risk allocation standards regarding green building evolve.

In the meantime, both contractors and sureties should approach green building construction with caution and careful contract review. Obviously, the more experienced and educated the contractor, designer and owner are about green construction, the more likely the project will be successful. All parties should be aware that **use of standard construction industry form documents without modification to address the risks presented by green building is fraught with peril.** At minimum, the contract should clearly state the green objectives of the project, including which standard or third-party rating system will be used to achieve them. The contract documents should also specify which party is responsible for obtaining the green certification and for the reporting and submission of the necessary documentation. Finally, the contract should delineate the contractor's role in providing such documentation and clarify the attendant time requirements.

Equally important is that the contractor carefully examines all specifications or warranty provisions that reference a particular performance standard and modify them accordingly, even adding language that expressly disclaims the contractor's representation that a particular green performance standard will be achieved. The contractor should only agree to perform in accordance with the owner-approved design, plans and specifications – warranting that its work will meet those standards, **not that the building will perform as *desired***.

Green building can be an even greater risk to a design-build contractor who is found to have warranted a specific performance level. Contract language for the design-builder must emphasize that its submittals are made for the purpose of fulfilling a particular rating system rather than as a warranty of a certain performance in the future.

Risks of delay are heightened on green building projects because of new design, technology, materials and processes, all of which may lead to unexpected change orders or field modifications, so provisions to insulate the contractor from liability for that risk may need to be added. In addition, the standard payment and warranty triggers such as substantial completion and final payment should not be tied to the green certification date, which will likely be many months after the contractor has completed its work. In a contract where consequential damages are waived, damages for failure to meet the green standard (e.g. loss of tax credits) should be specified as consequential damages, thereby protecting

CONTINUED ON PAGE 4

# Be Careful How You Arrange Your Affairs: A New York Appellate Court Holds That a Completing Surety "Arranging" for Performance May Assume Underlying Contractual Indemnification and Insurance Obligations

BY JOHN W. DRESTE

New York's Appellate Division, Second Department, has ruled that a subcontract performance bond committing a surety to "arrange for the performance of Principal's obligation under the subcontract," may obligate the completing surety to take on any and all responsibilities originally assigned to the defaulting Subcontractor/Principal. In *Caravousanos v. Kings County Hospital*, 74 A.D.3d 716 (2nd Dept 2010), the Court refused to allow a surety to escape possible liability beyond "bricks and sticks" completion, so that the Surety was potentially exposed to indemnification and related obligations for personal injuries sustained on site.

In *Caravousanos*, the bonded Subcontractor/Principal defaulted on its obligations and the Surety hired a completing contractor under a completion contract specifically providing that the completing contractor would "perform and complete" the remainder of the project work "in accordance with the terms contained in the original Subcontract." The completing subcontractor further agreed that it would "furnish at its own expense all workers compensation, general liability insurance, and other insurance as specified in the original Subcontract." The completing subcontractor did not, however, apparently obtain insurance running to the benefit of the Obligee. After Mr. Caravousanos (an employee of a separate consultant to the Surety) suffered personal injuries, he commenced suit against the Obligee and Owner. The Obligee tendered the defense to the completing contractor and its carrier, but the tender was rejected. The Obligee sued the Surety and the completing contractor, alleging an entitlement to contractual indemnification as well as breach of contract for failing to obtain insurance for the benefit of the Obligee.

The Court, in response to a motion to dismiss, denied the Surety's attempt to avoid liability, finding that the terms of the performance bond were ambiguous, especially with regard to the term "arrange," because one reasonable interpretation would mandate that the Surety take on any and all responsibilities originally assigned to the Principal under the Subcontract, including requirements for indemnification and the posting of insurance. There was nothing within the bond itself limiting what might fall under the category of "arranging" and there was nothing to indicate a limitation to the performance of the physical work described in the Subcontract.

The term "arrange" is present in all of the AIA standard forms. Here, however, it appears that the issues were further clouded by reason of the fact that the completion contract required that the completing contractor "perform and complete the remainder of the project work originally undertaken by the Principal." It is unclear whether or not there was a takeover agreement or other understanding between the Surety and the Obligee that limited the scope and extent of the Surety's responsibilities. However, it seems the entire dispute may have been avoided had the completing contractor appropriately obtained insurance extending to the benefit of the Obligee, as well as the Surety. While it may be wise to consider adding limiting language to takeover and/or completion agreements, in this particular circumstance, the Surety could have prevented this dispute by mandating that its completing contractor obtain insurance that would extend to, and protect, both the Obligee and Surety. E&D

CONTINUED "AIA 2010 SURETY BOND FORM REVISIONS"

The revised terms eliminate some bases for absolute defenses on technicalities, such as the pre-default meeting, and expressly provide that failure on the part of the Owner to comply with the Owner's remaining notice obligations shall *not* constitute a failure to comply with a condition precedent. The Surety may still show a *pro tanto* reduction of liability to the extent it can demonstrate prejudice due to the failure of, or delay in, notices by the Owner. The new A312 also retains listed options for the surety to act based on a "reasonable promptness" standard, but the subsequent time that a surety must act after the Owner provides additional notice to the Surety of a demand to perform is shortened to 7 from 15 days. Finally, the Bond penal sum limit is specifically retained only for non-completion options, leaving the issue of the penal cap for completion by the Surety open to negotiation.

## 2010 A312 – Payment Bond

The new form clarifies that the Owner may tender to the Surety a claim, demand, lien or suit by a Contractor's subcontractors or suppliers. The new form also eliminates the 30-day waiting period for those not in direct privity with the Contractor, although such claimants must still provide notice of non-payment. The form further preserves the obligation of a Claimant to submit a formal Claim to the Surety, and also contains detailed categories of items that must be supplied, while eliminating the old "substantial accuracy" standard relating to the requirements of a Claim.

Under the 2010 form, the Surety is obligated to send an answer to the Claimant, with a copy to the Owner, within 60 days after receipt of the Claim, extended from the old 45 days. In response to unfavorable case law in several jurisdictions, the new form makes clear that a Surety's failure to respond within 60 days cannot be construed as a waiver of defenses to a Claim. However, a failure to respond within 60 days, and pay any undisputed sums, may entitle a claimant to recover reasonable attorney's fees in a subsequent suit. Finally, the trigger for the running of the one-year statute of limitations is now when a Claimant has "sent a Claim," versus when a Claimant initially gave notice of claim.

## Conclusion

In short, sureties need to be aware that these new forms are in play. The use of these forms is not mandatory and it is likely that the older forms will continue to be used to some degree. However, it is equally likely that these newer forms will begin to be seen in requests for proposal as we move into 2011. E&D

ERNSTROM & DRESTE LLP

**NEW YORK**
180 Canal View Boulevard
Suite 600
Rochester, New York 14623

Visit us online at:
WWW.ERNSTROMDRESTE.COM

**Ernstrom & Dreste also publishes the ContrACT Construction Risk Management Reporter. If you would like to receive that publication as well, please contact Mindy Moffett at mmoffett@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste's website (ernstromdreste.com).**



CONTINUED "WILL GOING GREEN PUT YOUR 'GREEN' AT RISK?"

the contractor and its surety. Flow down clauses to subcontractors consistent with these modifications should also be employed. The guiding principle is that the contractor should limit its risks, as much as possible, to those it can control.

In addition to a thorough review of the underlying contract documents, the surety is well-advised to modify the language of the performance bond to clearly limit its liability to the performance obligations of its contractor, to expressly disclaim any obligation to meet the stated green standards, and to specifically enumerate the types of consequential damages that an owner may encounter by such a failure in order to clarify that the bond does not apply to those costs.

The primary risk for both contractors and sureties is the promulgation of new results-based standards and codes in the absence of adequate modification of contractual responsibilities among the project participants. This is true regardless of the source of the new standard, since construction industry contracts require the contractor to comply with applicable laws, statutes, ordinances, codes, rules and regulations. The design-builder is exposed to even more risk if the final product does not meet codes and rules, because it assumes certain design responsibilities as well. As discussed earlier, **these "green" regulations arguably become performance specifications for the contractor, and potentially its surety, unless the contracts are modified and limited.** It is therefore critical that contractors and sureties review all contracts carefully and keep abreast of the applicable regulations and codes which require meeting environmental performance thresholds. F&D