ERNSTROM & DRESTE LLP

FIDELITY & SURETY REPORTER

WINTER 2012 ISSUE 18

E&D Authors ConsensusDOCS Handbook

BY KEVIN F. PEARTREE

In early 2012, Aspen Publishers will publish the ConsensusDOCS Contract Documents Handbook, written and edited by Ernstrom & Dreste, LLP. The ConsensusDOCS emerged in 2007 as the product of a coalition of associations representing diverse interests in the construction industry to collaboratively develop standard form contract documents that advance the construction process by seeking to serve the best interests of the construction project and the construction industry. The very name, ConsensusDOCS, was intended to promote consensus among designers (D), owners (O), contractors (C) and subcontractors/sureties (S). Since its genesis in 2007, ConsensusDOCS' coalition has grown from 22 industry associations to over thirty and has published in excess of 70 standard contract documents and forms.

The book is written as a guide to the ConsensusDOCS primary standard contract document forms. It is intended for owners, designers, contractors, subco-

CONTINUED ON PAGE 2

Surety Liability: Change Order or Cardinal Change?

BY NELL M. HURLEY

A recent Florida federal court decision held that a performance bond surety had no liability to a municipal obligee where a substantial change order was issued and the surety refused to provide additional bonding. The court found that the extra work represented a "cardinal change" from the original contract and thus was not included in the bonded obligation. Likewise, the court held, because the surety had no obligation to bond the "change order" work, the obligee's termination of the principal was, under the contract, a termination for convenience, so that the surety was also relieved of its responsibility to complete the underlying contract.

In *Hartford Cas. Ins. Co. v. City of Marathon*, 2011 WL 5825503 (S.D. Fla. November 18, 2011), the City contracted with principal Intrastate Construction Corp. ("Intrastate") for work constructing "Area 3," a part of a series of wastewater treatment facilities, for the sum of just over $2 million. Hartford provided the required bonds.

About a year later, the City and Intrastate executed a change order to provide the same type of services to build another treatment plant at a different location known as "Area 7." The change order was in the amount of $2.9 million. Although Hartford acknowledged its liability for the performance bond issued for Area 3, it refused to extend the value of its bond to $5 million for the additional work in Area 7. In response, the City terminated Intrastate from its work on both Area 3 and Area 7, alleging default based upon failure to provide bonding for Area 7 as required under the contract.

Hartford sought declaratory judgment as to its obligation under the bond. The City counterclaimed for breach of contract seeking the costs of completing Area 3. Hartford's defenses to that action were that the City's claims were barred by the doctrine of "cardinal change" and that the termination of Intrastate was improper.

The Court found that the bond, in conjunction with the contract, obligated the surety for changes to the Area 3 work. However, the Court reasoned, the City did not have the unlimited, unilateral right to change the price and scope of the underlying contract. It then applied the doctrine of "cardinal change" looking at

> (1) whether there was a significant change in the *magnitude* of the work to be performed;
>
> (2) whether the change was designed to procure a totally different item or drastically alter the *quality, character, nature or type* of work *contemplated* by the

CONTINUED ON PAGE 3

IN THIS ISSUE

CONTINUED "E&D AUTHORS CONSENSUSDOCS HANDBOOK"

tractors, design-builders, construction managers, attorneys, educators and others in the building industry that use, or are considering using, ConsensusDOCS standard form documents. The book examines the elements of various ConsensusDOCS standard form contract documents, including an examination of specific contract provisions and the theory underlying the language. Further, this book examines how well the ConsensusDOCS achieve the goal of incorporating best practices and risk approaches that serve the best interest of the construction project by providing a better contractual foundation and reducing costly risk contingencies.

The treatment of the documents in this book also provides practical advice where appropriate on how to modify the documents to address project specific issues. In some instances, specific ConsensusDOCS contract provisions are compared and contrasted with relevant language in comparable standard forms, such as those produced by the American Institute of Architects. The actual language of the ConsensusDOCS documents is set forth in each chapter to assist the reader in his or her review and understanding. With the cooperation and assistance of the ConsensusDOCS organization, sample copies of each standard form are also included in the appendix to the book.

The ConsensusDOCS coalition has already updated certain of the primary documents since they were first introduced in 2007. Additional documents are now in the process of being updated, even as ConsensusDOCS continues to add to its family of standard form documents. These updates and additions will be the subject of supplements to this book. Information on ordering the book can be obtained at aspenpublishers.com. E&D

Um…Wait, Reserving Rights and Defenses Actually Means Something?!?!

BY THOMAS K. O'GARA

A federal appeals court, in *Sloan & Co. v. Liberty Mutual Ins. Co.*, 653 F.3d 175 (3d Cir. 2011), has held that a surety's timely general denial of a subcontractor's payment bond claim, which reserved all rights and defenses, met the surety's obligations under a pre-2010 AIA A312 Payment Bond and did not waive any defenses not specifically alleged. In addition, relying primarily on the express terms of the bonded contract, the Court found that Sloan & Co.'s ("Subcontractor") payment bond claim against Liberty Mutual Insurance Co. ("Surety") was limited to Subcontractor's pro rata share of the prime contractor's recovery from the owner, less Subcontractor's pro rata share of the prime contractor's expenses, including attorneys' fees.

After completion of a project to develop waterfront properties in Philadelphia, Pennsylvania, the owner refused to pay the prime contractor for all sums due, thereby preventing the prime contractor from fully paying Subcontractor. As a consequence, the prime contractor commenced an action against the owner for final payment, which included all amounts due to Subcontractor. Subcontractor also commenced a payment bond action against Surety.

The district court granted Subcontractor partial summary judgment against Surety for undisputed amounts owed. On appeal, the Third Circuit reversed, holding that the language of the subcontract between Subcontractor and the prime contractor limited Subcontractor's recovery to only those funds that prime contractor was, in turn, able to recover from the owner. The Court also permitted Surety to offset various claims against Subcontractor's recovery, including a pro rata share of prime contractor's expenses and costs incurred in its action against the owner, including attorneys' fees.

In *Sloan*, Subcontractor argued that Surety waived its offsets because Surety did not raise them with specificity within 45 days of Subcontractor's initial claim and that Surety's general denial and reservation of rights and defenses was insufficient as a matter of law. In interpreting §6 of the AIA A312 Payment Bond, the Third Circuit deemed Subcontractor's position untenable and held that Surety's general denial met its obligations under the Payment Bond, thereby permitting Surety to pursue its offsets.

The Court reasoned that Subcontractor's interpretation "would essentially require a surety to state every reason or contention it has or may later have in connection with a general denial of the claim lest it be precluded from asserting those defenses in the future." The Court went on to observe that since the Payment Bond requires "only a bare-bones demand for payment of a sum certain without any backup documentation," it makes no sense to "require the surety to reply with a detailed and exhaustive accounting."

The Court further rejected Subcontractor's reliance on *National Union Fire Insurance Co. v. Bramble, Inc.*, 388 Md. 195 (2005) and its progeny. The Court differentiated *Bramble* because the surety in *Bramble* never specifically refuted the subcontractor's claim. The Court also relied on an *amicus* brief submitted by the Surety & Fidelity Association of America, which explained that the A312 Payment Bond language was not intended to put sureties at risk of waiving claims to specific offsets, a clarification made in the subsequent 2010 revisions to the A312 Payment Bond.

The Court next examined Surety's liability for sums allegedly due to Subcontractor. In doing so, the Court carefully reviewed various interrelated subcontract terms and concluded that Subcontractor was

CONTINUED ON PAGE 3

CONTINUED "UM…WAIT, RESERVING RIGHTS AND DEFENSES ACTUALLY MEANS SOMETHING?!?!"

not entitled to all undisputed sums, but rather only its pro rata share of the prime contractor's recovery from the owner. The Court found that Subcontractor was not entitled to final payment because of a subcontract pay-if-paid provision requiring the owner's final payment to the prime contractor as a condition precedent to Subcontractor's entitlement to final payment. The Court rejected Subcontractor's attempt to construe this provision as a pay-when-paid provision that must be read in conjunction with the dispute resolution process for Subcontractor's final payment. The Court held that reading the two provisions together would render the plain terms of the paid-if-paid provision superfluous.

Interestingly, the pay-if-paid provision did not sink Subcontractor's claim. The Court interpreted multiple provisions of the subcontract to mean that the pay-if-paid clause was modified by the final payment dispute provision. This interpretation allowed Subcontractor to pursue its remaining claim for final payment after six months of non-payment by the prime contractor. Nevertheless, the Court came full circle by concluding that a liquidated damages provision, in turn, limited Subcontractor's recovery to the prime contractor's recovery from the owner. Based upon a reading of multiple provisions of the subcontract, the Court concluded that a pro rata recovery was how the parties agreed to allocate risk in the event of non-payment by the owner.

In addition, the subcontract required Subcontractor to pay for its portion of costs and expenses incurred by the prime contractor in the prime contractor's claim against the owner. The Court held that the parties clearly intended to incorporate attorneys' fees into the contract's definition of "costs and expenses." Including attorneys' fees as a cost or expense was only natural because this language was included in a paragraph discussing procedural mechanisms for lawsuits and other forms of dispute resolution.

Finally, the Court noted that Subcontractor's lawsuit predated a new Pennsylvania law which, under these facts, would have required Subcontractor to waive any mechanic's lien rights, leaving the surety bond as Subcontractor's only avenue for recovery. The Court declined to address the impact of the newly enacted law on the case before it.

This decision represents a common sense approach to interpreting the pre-2010 A312 Payment Bond and fairly allows the parties the opportunity to litigate the merits of their claims and defenses. In addition, it serves as yet another reminder of the importance of a full evaluation and assessment of the defenses arising from the bonded contract.

CONTINUED "SURETY LIABILITY: CHANGE ORDER OR CARDINAL CHANGE?"

original contract; and

(3) whether the cost of the work ordered greatly exceeded the original contract *cost*.

The additional work in Area 7 was found to constitute a "cardinal change" to the Area 3 bonded contract because: 1) it called for the construction of a separate, second water treatment plant; 2) both Area 3 and Area 7 were part of an expansive overhaul of the City's water treatment system was not sufficient to prove that the addition of the Area 7 work was contemplated at the time the Area 3 contract and bond were executed; and 3) the cost of the Area 7 work was an increase of over 144% of the original Area 3 contract sum. Hartford was declared by the Court to have no obligation for the Area 7 work.

Turning to the City's counterclaim for Hartford's breach of contract, the Court rejected the City's argument that Hartford consented to the additional bonding for Area 7 in a letter from its then attorney-in-fact which purported to agree to the Area 7 bonding. Since there was no evidence that Hartford ever executed a bond for the Area 7 work or that a bond was recorded as required by statute, the letter was deemed insufficient to bind Hartford.

Finally, the Court found that because the City terminated Intrastate from *both* the Area 3 and Area 7 projects solely because Hartford refused to bond the Area 7 work, the City had breached the Area 3 contract. Since Hartford had no obligation to bond the Area 7 work because it was a cardinal change to the underlying contract, the Court found the City's basis for termination "spurious and improper." Under the contract, the wrongful termination of Intrastate was deemed to be one of convenience such that Hartford's liability was not triggered and it was not obligated for the completion costs for Area 3.

Although the surety in this case was successful, it required years of litigation, and still provides cautionary lessons for sureties. Both principals and agents should be reminded that contracting for additional work as a "change order" does not necessarily mean that it is included in the original bonded obligation. If the magnitude and cost of the work changes significantly, and it was not contemplated at the time of the initial contract, the change order may, in fact, be a "cardinal change" which requires separate bonding. EXD

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).