CHANGE ORDER

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The Chair's Comments

Buildings are literally down to earth. Our built environment clings to the soils on this thin skin of earth crust until, eventually, water, wind and fire turn the bones of buildings to dirt.

Buildings are always symbols. Public buildings in Washington, D.C., symbolize the power of the entire nation. Shopping malls symbolize consumerism come of age. Fast food restaurants point to our mobility. Sprawling single-family residences symbolize our diffuse commitment to family life.

STEVE M. PHARR

Buildings can be symbols of hope. Simple tin or cardboard hovels demonstrate hope that tomorrow will come. More permanent structures convey builders' beliefs that others will live and work there for generations. Such structures are symbols of hope that others will follow and will have the means and spirit to care for these buildings. Recent green buildings convey hope that the earth itself may be sustained.

However, buildings can also be symbols of cynicism. Planned obsolescence. Short-term trends. In this day and age, buildings are constructed that will last only as long as some business plans' projection, only to be reduced to scrap and rubble and made into a pad for another, more profitable structure.

As lawyers working alongside buildings, we have opportunities to participate in both the hope and the cynicism of these structures. Structures that shape our horizons, hold the air we breathe and, sometimes, support our own hope or feed our cynicism. When we participate, however tangentially, in a successful, hopeful project, we can be

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Dealing with Performance Bond Sureties: The Surety's Perspective

By C. Hamilton Jarrett III

When dealing with the performance bond surety, the main thing to remember is that a surety bond is a contract among three distinct parties, each with its own agenda. The surety promises in accordance with the terms of its bond to answer for the default of its principal. The obligee is the party who is to be protected by the bond. In basic terms, the principal and the surety promise to perform the work on the bonded contract or pay the obligee up to a stated amount if the contract funds prove insufficient to complete the principal's contractual obligations.

When the prime contractor is the one who furnishes the bonds, the project owner will be the obligee and the prime contractor will be the principal. When a subcontractor provides the bonds, the subcontractor will be the principal and the prime contractor will be the obligee.

It also must be kept in mind that although the surety usually is an insurance company, the surety bond is not an insurance policy. The principal, unlike an insured, must reimburse the surety for any loss the surety may suffer by virtue of the surety having extended credit to back the principal's performance. Under a surety bond, the surety is to provide financial assurance that the principal will perform the "obligation" stated in the bond. For the performance bond, the "obligation" is that the principal will complete the work pursuant to the terms of its contract. That is why bonds frequently state, as a "condition," that if the principal fully performs the stated obligation, then the bond is void; otherwise the bond remains in full force and effect.

The Performance Bond is probably the least understood of all of the construction bond instruments. A performance bond merely provides the obligee a financial "safety net" if the principal fails to perform a bonded contract. A performance bond does not guarantee that there will be no disputes or disagreements; nor does it guarantee peace and harmony when disputes arise; nor is the performance bond designed to increase the amount of the bonded contract. Obligees should not expect otherwise.

An often overlooked or misunderstood concept is surety's right to the bonded contract funds. A surety's right of equitable subrogation was recognized by the United States Supreme Court as early as 1896 in **Prairie State National Bank v. United States,** 164 U.S. 227, 117 S.Ct. 142, 41 L.Ed. 412 (1896). The Court found that the performance bond surety by virtue of completing the bonded contract was equitably subrogated to the rights of the contractor to receive the contract funds, as well as any rights the owner may have had to the funds. This right in the

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thankful. When we are caught up in the cynicism that accompanies other building projects, we can hope not to be taken down. Some of us have a say in whether a project is hopeful or cynical. Choose well. ■

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contract balance has been recognized by the United States Supreme Court to exceed even the right to the trustee in bankruptcy. **Pearlman v. Reliance Insurance Co.,** 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962).

Moreover, it is a general principle that contract provisions imposing conditions for payment or requiring the retention of funds on work performed are for the benefit of the surety on the contractor's bond. 17 Am. Jur. 2d Contractors' Bonds Section 133. In North Carolina, it has long been held that although the owner has an interest in the contract funds, it has no right, without the consent of the surety, to exceed the provisions of the contract when making payments to the contractor. **Commercial Casualty Insurance Co. v. Durham County** 190 N.C. 58, 128 S.E. 469 (1925).

Thus, although the surety may stand in the shoes of its principal when it comes to determining the surety's obligation to perform under the bond, due to the tripartite relationship inherent in bonding, the surety also is subrogated to the rights of the obligee when it comes to the contract funds. It is the bonded contract funds which the surety uses to complete the bonded contract. Only if these funds prove insufficient does the surety incur a monetary loss.

In a non-bonded contract, the owner is keenly interested in assuring that the contractor is paid only for the value of the work it has performed, and no more. This is because the owner knows, or should know, that if the contractor defaults and is unable to complete the work, the owner has only the contract balance from which to fund the completion of the work. If that is not enough, the owner will need to draw on funds from somewhere else. Thus, for good measure the owner also requires that 5 percent to 10 percent of the value of work in place be withheld from payment in the form of retainage. Although the owner may seek recovery from the defaulted contractor for extra costs incurred in completing the work, such a recovery will never come if the contractor is insolvent. Under any circumstances, the litigation process is slow and does little to assist the owner in completing the project.

This concept highlights the purpose of the performance bond—to provide a ready source of funds to complete the work, should the contract balance prove insufficient. The surety and the obligee, therefore, have the same interest in preserving the contract balance. Often, however, obligees are unaware, or lose sight of this concept. It may be because the surety usually has the word "insurance" in its name. For whatever reason, obligees often fail to consider that the surety, just like the obligee, does not want the contract funds to be wasted. In fact, the surety relies upon the obligee to look after their joint interest in the contract funds.

Early communication with the surety is the key to dealing effectively with the performance bond surety. Typically, sureties will send Bond Status Inquiries to the obligee at various stages of the project. The obligee should respond promptly and accurately to these inquiries. The obligee should not simply tell the surety what it thinks the surety wants to hear. The surety is relying on this information to assess whether it may need to pay special attention to this project.

Regardless of whether the surety has specifically inquired regarding the status of the project, the obligee needs to alert the surety at the first sign of trouble. First of all, the surety has at its disposal a variety of mechanisms with which to influence its principal's performance and to preserve and protect the contract funds. For that matter, the surety may be in a better position than the obligee to ensure contract performance, but needs accurate information in order to act.

The obligee should notify the surety whenever it receives information which indicates that the principal may be failing to pay its subcontractors or suppliers; determines that the principal is prosecuting the work with insufficient labor or materials; believes that the principal's work inexplicably is behind schedule; or believes that any other condition exists which (if left unchecked) would lead to default and termination.

Armed with this knowledge, the surety is empowered to initiate an investigation of its principal. Among other things, the surety has the right to inspect the principal's books and records. The surety also has the right to require that all bonded project funds be deposited in a special trust account which requires the surety's approval for all disbursements. The obligee has none of these rights. Yet, the surety's exercise of these rights can simultaneously benefit both the surety and the obligee.

By the same token, the obligee has the right (actually the duty) to make sure that the principal is being paid in conformance with the payment terms of the bonded contract. That means that at a minimum the obligee should scrutinize the principal's payment applications to make sure they accurately reflect the quantity and quality of work performed. Experienced construction contract administrators view the balance to finish, including retainage, as more relevant than the value of the work in place. Yet, many contract administrators who undertake to analyze the work at all, merely consider the quantity of work performed as a percentage of the total quantity of work under the contract. That percentage is then applied to the contract amount in order to arrive at a value of the work in place. Such an analysis is like driving while looking in the rearview mirror.

There are many problems in the road ahead which can put the project into a ditch. For example, the principal's contract price may be too low to cover its cost of performance. Also, it is not unheard of for contractors to value work performed in the early phases of the project in an amount which is disproportionate to their actual cost to perform. Often some of the work performed by the principal is defective and will need to be replaced without additional compensation under the contract. These and other such factors will be missed if the contract administrator looks backward instead of forward.

The performance bond surety relies upon the obligee to administer the contract funds in a way which preserves a balance to finish, including retainage, which bears some close resemblance to the actual cost to finish the work under the bonded contract. In this way, the obligee's administration of the contract payment terms should benefit simultaneously the interests of the surety and the obligee. All too often, however, obligees only consider the performance bond as a way to get more money into the contract when they have paid out too much money, and the remaining contract funds are not enough to complete the work. They lose sight of, or are totally unaware of, the surety's equal right in the contract funds.

While early communication may actually ward off a default, even if it does not, it clearly will make the default process run much more smoothly. The most common complaint made by obligees once a default is declared is that "it takes too long" to get the performance bond surety to act. The prime requisite for getting the surety to do something is for the obligee to make sure that it has taken all steps necessary for the surety's obligation to arise. This means that the obligee must have properly terminated the bonded contract. Until such time, the surety is under no obligation to perform under the performance bond. In fact, if the surety performs prematurely it runs the risk of interfering with the contractual relationship of its principal, which at the very least may result in the surety's forfeiture of its right of indemnity against its principal and individual indemnitors.

Thus, the obligee must make sure that it complies strictly with the contractual provisions for termination of the bonded contract. This means that there exist grounds constituting a material breach of the contract; the obligee has afforded the principal with notice and an opportunity to cure its default as provided in the contract; and that the obligee otherwise has complied with the contractual requirements for termination. At the same time, the obligee must make sure that it follows all steps set forth in the bond. Depending upon the bond form, this may require a pre-termination meeting with the surety and its principal to discuss the principal's default. Even if such a meeting is not mandated, it is usually a good idea for the obligee initiate such a meeting. Such discussions afford at least an opportunity to develop a plan for completion of the work without inextricably setting into motion a chain of events which are certain to delay significantly the ultimate completion of the project.

Many obligees are slow to declare a default or even involve the surety. They often provide many opportunities to the principal to cure a perceived default, all the while keeping the surety in the dark. By the time a default ultimately is declared, the obligee may be at the end of its rope, and demand that the surety immediately takeover and complete the project. A perfectly rational owner would never consider giving a general contractor only two weeks to put together a bid for the initial work. Yet, obligees frequently will demand that the surety, who is not itself a contractor, mobilize its forces on a moment's notice, assess the nature and status of the principal's work in place, formulate a plan for the completion of the partially performed project, find a contractor to

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The Contractor's "Sledge Hammer"

The Sale of the Owner's Property (or Threat Thereof) Under North Carolina's Lien Law

By Peter J. Marino

In North Carolina, like many states, the most effective tool in the contractor's tool bag to ensure payment for work is the ability to hold the land improved as security for amounts owing. The "mechanics, laborers and materialmen's" lien has been recognized as so fundamental a tenet of North Carolina law that it is specifically provided for in the state's Constitution: "[t]he General Assembly shall provide by proper legislation for giving to mechanics and laborers an adequate lien on the subject matter of their labor." N.C. Const., Art. X, Sec. 3. The North Carolina General Assembly fulfilled this constitutional mandate by adopting Chapter 44A of the General Statutes. It is Article 2 of Chapter 44A that deals specifically with liens arising out of the construction process.

The purpose of this article is to describe the "sledge hammer" of the lien law—the process by which a contractor or material supplier can actually force the sale of the owner's real property in satisfaction of its lien rights.

An informal poll of construction lawyers and clerks of court confirms that this "sledge hammer" is almost never actually wielded. This is true because, practically speaking, the effect of the public record filing of the initial claim of lien or notice of claim of lien at the beginning of the process, or the sometimes lengthy litigation process to enforce the lien, is often enough to result in the discharge or resolution of the underlying claim before it reaches the lien judgment or foreclosure sale stage. Having said that, any respectable construction lawyer should have a working understanding of the lien foreclosure sale process in North Carolina.

To get to the point of foreclosing on the real property improved, several fairly obvious preconditions must be met. First, and perhaps most obvious, is the fact that the lien at issue must be of a type that entitles the claimant to a lien upon the improved real property. Broadly speaking, Chapter 44A provides for a lien on the real property improved in three situations:

- Where the contractor or material supplier contracts directly with the owner of the real property. See N.C.G.S. Section 44A-8;
- Where a first through third tier subcontractor or supplier perfects its subrogation based lien rights on the real property (as opposed to a lien merely on funds). See N.C. G.S. Section 44A-23; and
- Where a subcontractor or material supplier of any tier acquires a direct lien on the real property due to the owner's unauthorized payment of funds after receipt of a notice of claim of lien under N.C.G.S. Section 44A-20.

In each of the circumstances outlined above, the lien claim must be properly perfected according to the type of lien to be asserted by the claimant. While it is not within the scope of this article, strict adherence to all of the formal statutory requirements of Chapter 44A including service, required information in the lien form itself, and filing within the 120 day limitation period are an absolute must. See N.C.G.S. Section 44A Sections 10-12; 17-19, Section 23.

Assuming a lien has been properly perfected, an action to enforce the lien must be commenced no later than 180 days after a claimant last provided labor or materials to the project. N.C.G.S. Section 44A-13(a). While it is better practice to file the suit in the county where the real property is located, this is not a mandatory requirement. N.C.G.S. Section 44A-13. There may be circumstances where the property extends into more than one county. There may be other circumstances where the property is located in a different county from where the litigants reside. If the suit is filed in a different county from where the property is located, then a notice of lis pendens must be filed in the county where the property is located. Id. The lis pendens gives notice to title searchers that a lawsuit has been filed to enforce the lien, and that the lien has not expired. The lis pendens, like the lawsuit itself, must be filed within 180 days after the last furnishing of labor or materials to the site. Id. If the title to the property at issue, however, belongs to a receiver or trustee in bankruptcy, then the lien will be enforced by the court having jurisdiction over the real property. *Id.;* **RDC, Inc. v. Brookleigh Bldrs.,** 309 N.C. 182, 305 S.E.2d 722 (1983).

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perform the work, and commence productive work in even less time than that. It simply cannot be done. The obligee must be willing to provide the surety with the information that it needs to get the project moving again, and have reasonable expectations as to how long it is going to take to get the work moving.

The key to dealing with the performance bond surety boils down to this: The obligee should endeavor to keep the surety abreast of the current status of the work, including any problems which if allowed to persist would support grounds for termination; the obligee should administer the contract funds in a way which preserves a balance to finish, including retainage, which bears some close resemblance to the actual cost to finish the work; the obligee should comply with all conditions of the contract and the bond which must be satisfied before the surety's obligation will arise; the obligee should cooperate with the surety by providing it with the information its needs to get the project moving; and the obligee should be reasonable in its expectations as to how long the process will take. Keeping these principles in mind will make dealing with the performance bond surety a much smoother process. ■

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