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You Can't Do That: Completion Without Notice Discharges Surety Under AIA A312

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In a recent Maryland case, an obligee's failure to provide notice to the surety under an AIA A312 performance bond[1] resulted in the dismissal of the obligee's claim where the surety learned of the default and termination only after the work had been completed by another contractor.[2] The intermediate appellate court determined that:

1. The failure was a material breach that discharged the surety's obligation under the bond;
2. The bond language[3] did not require the surety to prove actual prejudice; and
3. The surety was prejudiced as a matter of law when it was precluded from exercising its bond right to elect a remedial option.[4]

The result reaffirms the fundamental importance of allowing a surety to exercise its options.

The matter stems from the construction of an assisted living facility that included the creation of a submerged gravel wetland ("SGW") to manage stormwater. Wildewood Operating Company, LLC ("Wildewood") contracted with Clark Turner Construction, LLC ("Clark Turner") to perform the work. An AIA A312 (2010) performance bond was issued by surety First Indemnity of America Insurance Company ('First Indemnity") with Clark Turner as principal and Wildewood as obligee. The January 2013 contract required completion within one year of work commencement.

Although Clark Turner timely constructed the SGW, in February 2014 the work was declared "not in compliance" by county officials and Clark Turner failed to correct the issues. In July 2014, Wildewood executed a contract to sell the facility to a third party, scheduled to close in November 2014. Come November, government approvals were still lacking so various parties, including Wildewood, Clark Turner, and the intended new owner (but not First Indemnity) entered into a "Work Agreement" requiring proper approvals by June 2015. When Clark Turner failed to comply, another contractor completed the work at Wildewood's expense under the Work Agreement.

Wildewood notified First Indemnity on November 3, 2015, that it was considering declaring Clark Turner in default under the bond (Section 3.1). It further advised of the property's sale and Wildewood's payment for the SGW work's completion under the Work Agreement. On November 20, 2015, Wildewood notified First Indemnity that it declared Clark Turner in default and terminated the bonded contract, stated that it had complied with Section 3 of the bond, and demanded the surety act under Section 5. First Indemnity denied the claim. In 2017, suit was commenced by Wildewood and others, seeking damages of $150,000, the amount paid for completing the work.

First Indemnity moved for summary judgment, which was granted. The motion court found that completion of the work prior to giving the surety notice under Section 3.2 was a failure to comply with a condition precedent, which deprived the surety of its right to elect a remedy under the bond, resulted in inherent prejudice, and discharged its bond obligation.

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Price Escalation Terms of Subcontract Binds Surety Despite Prime Contract Prohibition

CAVAN S. BOYLE

Contracting parties may incorporate another document into their agreement by reference and bind themselves, and non-signatories, to the incorporated document's terms. Because principals often engage sureties after executing their contracts, a full measure of surety liability may not occur until then, or much later, meaning the surety may be stuck with additional, sometimes critical, contract terms. A recent New York Appellate court decision serves as an important reminder of the potential extension of liability where price escalation terms incorporated into a claimant's subcontract were binding on the surety, despite a "no escalation" term applicable to the bonded prime contract.[1] The general incorporation of the prime contract into the subcontract was insufficient to raise an issue of fact on the matter.

The case involved a 2018 public construction subcontract between prime contractor, JBS Dirt, Inc. ("JBS"), and subcontractor Cobleskill Stone Products, Inc. ("Cobleskill"), to provide paving work to construct a municipal airport taxiway for the Village of Sidney, New York ("Village"). JBS's surety, Merchants National Bonding, Inc. ("Merchants") issued a payment bond for the project.

The subcontract expressly stated that it was subject to the terms and conditions of a June 2017

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On appeal to the Maryland Appellate Court, the decision was affirmed.[5] The court rejected Wildewood's arguments that the notice given satisfied Section 3.2 and that First Indemnity must demonstrate actual prejudice.

In a matter of first impression in Maryland, the court instead ruled that notice of declaration of default and termination under Section 3.2 prior to work completion was a condition precedent, despite the absence of an explicit "timely" notice requirement. The court reasoned that the performance bond is properly read as requiring the obligee to notify the surety of the default before engaging in self-help remedies, noting:

> "Otherwise, the explicit grant to the surety of a right to remedy the default would be operative only if the obligee chose to give it notice, thereby rendering the options in Section 5 nearly meaningless."

Since Wildewood's notice to First Indemnity happened only after the work was completed, it was untimely, the court found, meaning the condition precedent to First Indemnity's bond obligation did not occur and its obligation was thus discharged.

Wildewood's second contention was likewise unsuccessful, and the court dismissed its argument that a failure of notice under any bond section invoked the Section 4 "actual prejudice" requirement upon the surety.[6] The plain reading of the bond shows that requirement applies only to notice under Section 3.1 (regarding "considering declaring" a default) and not to Section 3.2 (regarding default and termination), said the court. The court continued:

> "Even if the bond required [the surety] to demonstrate actual prejudice to avoid liability, we conclude … [the surety] was prejudiced as a matter of law when it was precluded from exercising its rights under Section 5."

This decision is consistent with important underlying principles of surety law that protect the right of the surety to choose how to respond to an alleged default. It should be comforting to surety professionals to see additional jurisdictions reaffirm this basic precept and reject efforts to expand the surety's obligations under this commonly used industry bond form.[7] E&D

1 American Institute of Architects AIA Document A312® - 2010 Performance Bond.

2 *Wildewood Operating Co., LLC v. WRV Holding, LLC, et al.* 259 Md. App. 464 (2023).

3 Section 3.2 requires notice to the surety of contractor default and contract termination.

4 Section 5 provides the surety four specific options to meet its bond obligation once it receives notice under Section 3.2.

5 The motion court also concluded that First Indemnity was discharged when Wildewood entered into the Work Agreement, an argument not reached by the appellate court.

6 Section 4 states, in essence, that a notice failure under Section 3.1 (requiring notice of "considering declaring" a default) is not failure of a condition precedent and only releases the surety to the extent of actual prejudice shown.

7 The appellate court relied on precedent from other jurisdictions, particularly those of the D.C. District Court.

Michael F. Higgins

Experienced Attorney Joins Ernstrom & Dreste

E&D is excited to announce the addition of Michael F. Higgins to our team as an Associate. Mike brings a wide array of legal experience from over a decade of professional practice, most recently as a litigator in a respected mid-size Rochester area firm. He uses that expertise to provide counsel and exceptional advocacy for clients, delivering legal service and advice in all areas of construction and surety claims, and other complex commercial litigation. Mike's practice includes all aspects of claim evaluation, management, and resolution, including ADR, and litigation processes such as pleadings, discovery, motion practice, trial, and appeal. He is a graduate of Brooklyn Law School and University of Rochester.

With over a decade of legal experience, Mike's varied work experience also includes service teaching at two New York law schools, and positions related to civil and disability rights, and first amendment freedoms.

Mike earned his Juris Doctor degree at Brooklyn Law School in 2011, having obtained his Bachelor of Arts in Economics from the University of Rochester in 2008.

Court Admissions:

- New York
- U.S. District Court, Southern and Western Districts of New York

Practice Areas:

- Construction Law
- Surety Law
- Commercial Litigation

Education:

- Brooklyn Law School, J.D. *cum laude* 2011
- University of Rochester, B.A. *magna cum laude* 2008

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Partner Brian Streicher and Associate Mike Higgins participated in the 2024 Annual Volleyball Tournament presented by JBX, Junior Builders Exchange, held in Rochester, NY in February. Ernstrom & Dreste was a court sponsor.

"John Wick" (Todd Braggins) was summoned to eliminate the Boogeyman at the Beacon Consulting Group, Inc.'s December Annual Meeting held in Boston, MA.

CONTINUED "PRICE ESCALATION TERMS OF SUBCONTRACT BINDS SURETY DESPITE PRIME CONTRACT PROHIBITION"

quote, which was attached as an exhibit and contained a price escalation clause for the asphalt. Upon completing its work in 2019, Cobleskill sought payment per the quote's terms, computing asphalt costs based on price indexes at the time work was performed (2019) rather than at the time the quote was issued (2017). Arguing the 2017 prices applied, JBS rejected Cobleskill's payment application, and Merchants denied Cobleskill's claim.[2] Cobleskill filed suit against both JBS and Merchants. Cobleskill then moved for summary judgment, which the motion court granted.

On appeal, JBS and Merchants argued that the Federal Aviation Administration ("FAA") Handbook, which expressly forbids price escalation clauses, was incorporated into the subcontract both by direct reference and through a standard flow-down clause, thus creating contract ambiguity sufficient to defeat summary judgment. The subcontract incorporated the prime contract stating:

> "[Cobleskill] binds itself to JBS for the performance of [Cobleskill's] work in the same manner as JBS is bound to the Village for such performance under JBS's contract with the Village."

The court was unconvinced. First, the subcontract "expressly stated what documents were included in the [subcontract] agreement," said the court, and the FAA Handbook was not listed. Second, the court explained that a subcontract's clause incorporating by reference the prime contract binds a subcontractor "only as to prime contract provisions relating to the scope, quality, character and manner of the work to be performed by the subcontractor." Because such terms do not cover price disputes, the motion court's decision was affirmed, meaning JBS and Merchants were liable for the higher prices.[3]

This result is consistent with the general rule in New York that prime contract clauses unrelated to scope, quality, character, and manner of work can be incorporated into subcontracts, but typically only to the extent the subcontract expressly refers to the prime contract term being incorporated or identifies its location in the prime contract. For example, a specific reference to the "General Conditions" of the prime contract has been found to bind the subcontractor to the prime contract's General Conditions' terms.[4] The ruling is also consistent with the general enforcement of incorporated documents where they are specifically referenced and attached, as the subcontractor's quote was here.

Sureties are likely familiar with incorporation by reference disputes regarding provisions of prime contracts related to forum selection, arbitration, and delay damages which can expand surety bond liability and costs if found applicable to them. In many such cases, the surety is arguing against the application of incorporated terms to the surety. Here, the surety sought unsuccessfully to apply the incorporated prime contract provision against the claimant/subcontractor to avoid the result of the subcontract's express incorporation of its quote.

Besides the broad construct of the general rules of incorporation by reference,[5] the case reminds sureties how important it is to ensure that they and their bonded principals are fully familiar with the important terms of the prime contract, and how they may impact liability and future options. With such knowledge, subcontracts can be specifically tailored to properly "flow down" the prime contract terms to the subcontractor, a strategy that would have avoided the result here. E&D

1 *Cobleskill Stone Prods., Inc. v Merchants Natl Bonding, Inc.*, 223 AD3d 1021 (3d Dept 2024).

2 It seems likely that JBS only became aware of the price escalation prohibition when it submitted its own application for payment to the Village which included Cobleskill's work with the escalated prices.

3 JBS and Merchants also claimed that Cobleskill's work was defective but since the Village had approved and paid JBS for the work, the court found the claim unsupported by the record.

4 *New York Tel. Co. v. Schumacher & Forelle, Inc.*, 60 AD2d 151 (1st Dept 1977).

5 At least for New York. Law on the subject can vary by jurisdiction.

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

This newsletter is intended purely as a resource guide for its readers. It is not intended to provide specific legal advice. Laws vary substantially from state to state. You should always retain and consult knowledgeable counsel with respect to any specific legal inquiries or concerns. No information provided in this newsletter shall create an attorney-client relationship.

FIRM NEWS

John Dreste earned the highest possible Martindale-Hubbell® distinction, AV Preeminent Peer Rating, 2023 Judicial Edition™. The award is based on receiving the maximum rating in both legal ability and ethical standards, reflecting confidential opinions of members of the Bar and Judiciary.

Todd Braggins attended the December 2023 Beacon Consulting Group, Inc.'s Annual Meeting in Boston, MA, where he addressed attorney-client privilege issues in surety claims (see photo of "John Wick" in this newsletter).

Todd Braggins presented at the January 2024 ABA/TIPS Fidelity & Surety Law Committee Midwinter Conference in New Orleans, speaking with others on select surety claims handling considerations related to varying contract delivery methods. Brian Streicher also attended and was a guest panelist for the "Surety Jeopardy" program session.

Brian Streicher participated in the Surety Association of Syracuse Golf Outing at Turning Stone Resort in May.

In May 2024, Kevin Peartree, Martha Connolly, and Brian Streicher presented on *"Controlling Risk in Construction and Project Delivery Systems"* to the AGC NYS Construction Leadership Academy (formerly Future Construction Leaders) at a session in Rochester, New York.

Clara Onderdonk attended the national Association of Legal Administrators (ALA) 2024 Annual Conference May 19-22, 2024, at the Gaylord Rockies Resort in Aurora, CO.