

CONTRACT LAW DIVISION

Office of the Assistant General Counsel for Finance & Litigation
A Lawyer's View of Performance Bond Sureties

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A Lawyer's View Of Performance Bond Sureties by Cecilia Carson

Protecting The Government's Interest When Dealing With Performance Bond Sureties Of Defaulted Contracts

The decision to default a contractor for non or substandard performance has just been made. No problem, the contract contains a performance bond that insures contract performance and protects the Government from additional costs, right? Well, not necessarily. The problems that arise when a contractor defaults under a contract are varied and often quite complex. This is often compounded by the program office's desire to have the contract completed by a specific deadline. In the haste to conduct a reprocurement, certain steps that may safeguard the Government's interest are sometimes overlooked, which can be particularly costly in instances where the surety of the contract elects to complete in place of the defaulted contractor. This edition of *A Lawyer's View* will help identify potential problem areas that arise when dealing with performance bond sureties of defaulted contracts and offer practical advice on what procurement officials can do to safeguard the Government's interest.



The Performance Bond

The Miller Act requires Government contracts for construction and similar services to include a performance bond for the protection of the Government in the event that the contractor is unable to complete the contract as specified. Generally, the performance bond requires the surety to pay a sum certain in the event of default, or to perform the contract to fruition. Most problems occur when the surety elects to perform; in which case, the surety essentially gains all of the rights of a contractor, including appeal rights. Because of the precarious state of the contract at this juncture, several factors may prevent the Government from realizing the benefit intended, resulting in, either, the completion contractor's failure to complete the contract timely, or substantially increased costs to the Government. The contracting officer (CO) can be

instrumental in ensuring that the benefit of the performance bond inures to the Government by taking certain precautions both, at the time of contract award, and in the event of default. At the time of contract award, the CO should take care to determine that the bond provided is adequate to meet contract specifications. If the bond is inadequate, there is little that can be done upon contract default to rectify the problem.

Although important, ensuring that the performance bond is adequate is merely the first step. Much of the CO's effectiveness at protecting the Government's interest with performance bond sureties depends on the steps the CO takes at the time that the surety's rights arise — typically upon the contractor's default of the initial contract. When the original bonded contractor gets into trouble in performing the contract, the CO and the surety have difficult decisions to make. The CO can lose rights for the Government if he or she deals with the surety extensively without entering into a formal takeover agreement. Thus, if the surety elects to complete the contract, the CO should immediately commence drafting a takeover agreement with the assistance of agency counsel, setting forth the terms and conditions under which the completion contract will be performed. The takeover agreement, rather than the performance bond itself, then becomes the primary instrument for protecting the Government against financial loss and further delay in completing the contract.

The Defaulted Contract

In order to help ensure that the all-important takeover agreement will effectively serve its purpose, the CO should take certain preliminary steps prior to drafting a takeover

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☛ **A Lawyer's View** is a monthly publication of the Contract Law Division designed to give practical advice to the Department's procurement officers. Comments, criticisms, and suggestions for future topics are welcome.—Call Jerry Walz at FTS 202-482-1122, or via e-mail to Jerry Walz@OGCMAC@OSEC

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agreement. First, care should be taken to fully document the CO's decision to terminate a contractor for default. This decision should be revisited prior to entering a takeover agreement. Claims for convenience terminations after it has been determined that default termination of the original contractor was improper, may prove costly. Sureties have been treated just as contractors, with the result that the Government was liable for "appropriate and reasonable costs." *Sentry Insurance, a Mutual Co.*, VABCA 2617, 91-3 BCA ¶ 24094; *Shipco General, Inc.*, ASBCA 36034, 90-1 BCA ¶ 22355; *Wolfe Construction Co.*, ENGBCA 5309, 88-3 BCA ¶ 21122.

Secondly, and perhaps more importantly, the CO should undertake to determine the status of the work performed up to the point of default. Meticulously documenting remaining contract requirements will help to avoid confusion that often leads to payment of equitable adjustment claims. In contracts that require the contractor to make submittals for the Government's approval, this process should include obtaining an accounting of all contract submittals and determining which have been properly submitted and which remain outstanding. In addition, COs should ascertain whether the completion contractor will be required to re-submit certain items previously submitted by the defaulted contractor. Document work that has been satisfactorily performed by the defaulted contractor and pinpoint work that the completion contractor will need to re-perform. Include estimates of work necessary to meet the original contract specifications. Finally, consider questions such as, "will the completion contractor have to perform work not specified in the contract, in order to comply with the contract specifications?" How can we account for this in the takeover agreement? When can we reasonably expect the completion contractor to complete the remaining work? This information can later be compared with the completion contractor's proposed construction schedule for verification of reasonableness and completeness. Obtain any other information that will be necessary for the successful performance of the completion contract in a



timely manner, together with the above-referenced documents. Maintain a file to assist in drafting the takeover agreement and for the purpose of informing the surety and its contractor of their responsibilities under the completion contract.

The Completion Contract

The completion contract will generally incorporate the provisions and clauses of the original contract; however, certain modifications may be necessary to accommodate re-work, changes, and to otherwise safeguard the Government's interests. Because, problems with delays in completing the contract are inevitable in many cases, COs should also anticipate potential problems in pricing change orders, contractor overhead costs and other factors that may greatly affect the ultimate contract price. For instance, the CO should not rely solely upon liquidated damages clauses to protect the Government from delay in completing the contract. Typically, the time that lapses between the default of the original contract and the reprocurement will prevent a completion contractor from completing the contract by the originally specified delivery date. Thus, the Government will be entitled to liquidated damages from the delivery date of the original contract to the date the contract is actually completed. There may be a temptation to conclude that the CO need not be concerned with the completion contractor's completion date because, in any event, the Government receives liquidated damages. Although this approach may well serve the Government under normal circumstances, it is quite risky when dealing with a completion contract. The Government will obtain liquidated damages for late completion if provided for in the contract, however, the completion contractor may propose to complete the contract by a certain date and later submit a claim for an equitable adjustment if he or she is unable to do so. Thus, rather than protecting the Government's interest, the completion contract results in the Government's potential liability to pay contract adjustment claims if the completion contractor is unable to meet its projected completion schedule. Although, it is not certain how the Board will rule on such claims, the first step

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in avoiding or successfully defending the claims is maintaining a file on the defaulted contract as discussed above. Information regarding the projected number of days to complete the work should be used to set an estimated completion date without forfeiting the Government's claim to liquidated damages stemming from the date of default. This may avoid penalty in the event that the completion contractor projects to complete the work in a shorter amount of time, but is subsequently unable to do so.

COs may also consider obtaining formulas for the purpose of pricing change orders or calculating overhead costs that will adequately compensate the completion contractor, as well as, protect the Government from paying windfalls. These formulas may be incorporated into the takeover agreement.

The Takeover Agreement

A takeover agreement is intended to outline the surety's responsibilities to complete the original contract — it should always be utilized prior to dealing with a surety that elects to complete the defaulted contract. Throughout, this article alludes to provisions that the agreement may contain. Drafting a takeover agreement is a vital part of protecting the Government's interest; thus, COs should exercise caution when drafting this document. The FAR is sparse on guidance in this arena, allowing for great flexibility; however, it also leaves room for omitting important provisions that could radically affect the Government's interest. Legal counsel can assist COs in drafting provisions that address the matters discussed above and other contingencies.

COs should give some thought to desired supervision and related issues that may effect the Government's ability to obtain quality and timely performance. For instance, consider whether to seek agreement from the surety to provide a knowledgeable supervisor to oversee its contractor's work.

The takeover agreement is a separate and distinct contractual agreement. Takeover agreements are subject to termination for default. *National Union Fire Insurance Co.*, ASBCA 34744, 90-1 BCA ¶ 22266; *Employer's Mutual Casualty*

Co., GSBCA 11003, 91-3 BCA ¶ 24202. Likewise, sureties may bring claims arising out of termination. *Traveler's Indemnity Co. v. U.S.*, 16 Cl. Ct. 142 (1988). Certification requirements apply. *National Surety Corp. v. U.S.*, 20 Cl. Ct. 407 (1990).

Conclusion

When the surety of a defaulted contract elects to complete the contract, the potential problems may be enormous. COs play a very key role in ensuring contract performance in a manner that helps to protect the Government from escalating costs. Performance bonds prove effective only when COs take additional steps to insure their effectiveness by carefully documenting the decision to terminate the original contract for default, determining the status of the defaulted contract, and by entering into a carefully drafted takeover agreement prior to dealing with the surety for the reprocurement of services.

