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Practice Update

# Comply or Else: Additional Obligees Must Comply with Conditions Precedent in Performance Bonds

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All construction project owners, lenders, and contractors take note: a recent federal court opinion offers a reminder that additional obligees on a performance bond must comply with all conditions precedent in the bond in order to enforce the bond.

As a reminder, a performance bond is a tri-party agreement – most commonly among a project owner (the obligee), contractor (the principal), and surety (the surety) – whereby the surety agrees to guarantee the principal's performance obligations under a construction contract. In other words, if the principal defaults in its performance, the surety will step in and either arrange for construction via a replacement contractor, or pay the obligee the sums necessary to do so. Of course, any lower-tier subcontractor can also procure a performance bond, and in that case is the bond principal. In that case, higher-tier parties – including prime contractors, owners, and lenders – are sometimes added as additional obligees on the bond, and are similarly entitled to enforce the bond in the event of the principal's default.

Most performance bonds, including the commonly-used AIA A312 performance bond, contain specific conditions precedent that must be satisfied before the surety is obligated to perform. The A312 in

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particular contains the following conditions precedent before the surety's obligations arise: (1) the owner must provide a notice to the contractor and surety that the owner is considering declaring a default; (2) the owner actually declares the contractor in default and terminates the construction contract; and (3) the owner pays the balance of the contract price to the surety.[1] While it is clear that the primary obligee must comply with these conditions precedent, additional obligees may not realize that these conditions precedent also apply to them as well.

The United States District Court for the Northern District of Illinois recently reinforced the need for performance bond additional obligees to comply with all conditions precedent stated in the bond in order to trigger the surety's duty to perform. In *MCM Management Corp. v. Hudson Insurance Company*[2], the court held that additional obligees are subject to the terms – including the conditions precedent – of performance bonds. In that case, a sub-subcontractor on a project (MTS) furnished a performance bond in the AIA A312 form. The parties to the bond executed an additional obligee rider, adding the prime contractor (MCM) as an additional obligee.

MTS subsequently defaulted, and the first notice that MCM sent to MTS' Surety (Hudson) was a performance bond claim, noting that MTS had already been removed from the Project and MCM had already reprocured and performed MTS' scope of work. Hudson denied liability under the performance bond, arguing that MCM failed to comply with the bond's notice requirements, thereby robbing Hudson of its contractual options for performance under the bond.

The court agreed with Hudson, holding that MCM – as an additional obligee – was subject to the bond's conditions precedent. The court explained the rationale for requiring strict compliance with conditions precedent in the bond:

> Before a declaration of default, sureties face possible tort liability for meddling in the affairs of their principals. After a declaration of default, the relationship changes dramatically, and the surety owes immediate duties to the obligee. Given the consequences that follow a declaration of default, it is vital that the declaration be made in terms sufficiently clear, direct, and unequivocal to inform the surety that the principal has defaulted on its obligations and the surety must immediately commence performing under the terms of its bond. Sureties deprived of this clear rule for notices of default would be reluctant to enter into otherwise profitable contracts... An obvious reason for [the notice requirement] was to allow [the surety] to exercise its rights under the performance bond to participate in the selection of a successor contractor. Since the [obligees] replaced [the subcontractor] with [a different subcontractor] before informing [the surety] that [the subcontractor] was to be terminated and without consulting [the surety] as to the successor, [the surety] was stripped of its contractual rights to minimize its liability under the performance bond by ensuring that the lowest responsible bidder was selected to complete the job.

Accordingly, MCM was required to comply with the conditions precedent in the performance bond before Hudson's duties were triggered.

MCM sought to argue that because it is an additional obligee, rather than a signatory to the bond itself, its status exempts it from complying with the conditions precedent. The court quickly disposed of this argument, noting that an additional obligee is essentially a third-party beneficiary of the performance bond, and a third-party beneficiary is not entitled to expand or enlarge a promisor's

obligation under a contract. MCM "cannot expect to take the benefits of the agreement without taking the obligations."

This decision is an important reminder for any performance bond additional obligee to carefully review and strictly comply with all terms and conditions of the performance bond. Otherwise, the additional obligee may inadvertently nullify the surety's duty to perform under the bond – rendering the bond essentially worthless.

This update is not intended to constitute legal advice or opinion. Akerman's construction attorneys can assist with reviewing, drafting, and complying with the terms of performance bonds and payment bonds.

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[1] As noted, performance bonds are most commonly procured by the prime contractor, but the A312 also has a clause noting that "If this Bond is issued for an agreement between a Contractor and subcontractor, the term Contractor in this Bond shall be deemed to be Subcontractor and the term Owner shall be deemed to be Contractor."

[2] 2022 WL 17583756 (N.D. Ill. Dec. 12, 2022).

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