ILLINOIS CONSTRUCTION LAW

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CHAPTER 5

ILLINOIS CONSTRUCTION BONDS

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§ 5.01 INTRODUCTION

Surety bonds play an integral role in Illinois contracting. Virtually all public contracts require support by bid, performance, and payment bonds. Private projects are often backed by surety bonds. As a result, Illinois law relating to bond issues is well developed.

This chapter reviews Illinois surety law applicable to the construction industry. Bid bonds, performance bonds, and labor and material payment bonds all serve different functions, and their use raises issues and problems unique to each bond form. Illinois law addresses and provides guidance on most issues that arise under each bond. Where Illinois law is sparse or undeveloped, the authors of this chapter attempt to predict the likely path of Illinois law based on accepted case law from other jurisdictions.

§ 5.02 BONDS DISTINGUISHED FROM INSURANCE

Surety bonds are credit instruments, not insurance policies.[1] A surety theoretically accepts no risk. A surety does not promise to protect its principal from any uncertain harm or loss. A surety only promises to fulfill the contract of its principal, in return for a fee and a promise of indemnity from the principal, and, often times, related individuals. Unlike insurance, the principal contracting party always remains liable for the primary obligation; it always remains on the hook. With an insurance contract, the insured is relieved of liability, at least to the extent of coverage. With a surety bond, there is no "coverage." The surety and the principal are bound jointly and severally to perform the bonded contract. Insurance contracts are aleatory, but bonds are not.[2] The distinction between surety contracts and insurance is important to the proper consideration of surety rights in a commercial law context.

Having said that, in many respects Illinois treats surety bonds issued for compensation as insurance policies.[3] Sureties are subject to regulation under the Illinois Insurance Code.[4] Surety claims practices are subject to review by the Illinois Department of Insurance,[5] and the Insurance Code provides the exclusive right of recovery by obligees against sureties for bad faith claims practices.[6]

Construction surety bonds are of three types, each of which serves a different function in Illinois construction contracting: bid bonds, performance bonds, and labor and material payment bonds. This chapter discusses all three, as well as issues pertaining to good faith claims processing.

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[1] In re Farley, 236 F.3d 359 (7th Cir. 2000).

[2] *See generally* Restatement of Suretyship & Guarantee § 1 (1996); 74 Am. Jur. 2d *Suretyship* § 1; Black's Law Dictionary 1293 (5th ed. 1979).

[3] Fisher v. Fidelity & Deposit Co. of Md., 125 Ill. App. 3d 632, 466 N.E.2d 332 (5th Dist. 1984).

[4] 215 ILCS 5/2(e).

[5] 215 ILCS 5/121-1, 121-3.

[6] *Fisher*, 125 Ill. App. 3d 632, 466 N.E.2d 332.

§ 5.03 BID BONDS—IN GENERAL

Most municipal and government construction projects open to competitive bidding require that bidders submit a bid bond or some other form of bid security along with their bid. The bid bond serves several purposes. First, it guarantees that the low, responsive, and responsible bidder will sign a contract with the owner at the price quoted in its bid.[7] It also guarantees that the low bidder will provide the appropriate payment and performance bonds generally required for such projects. In addition, some courts have held that the bid bond is a guarantee that the low bidder will not withdraw its bid during a specified period following the bid opening, usually the period between bid opening and the owner's acceptance.

The penal sum on the bid bond is generally in the nature of a percentage of the quoted bid, although it can be for a fixed amount, and is set by the bid documents. This amount is usually 5 or 10 percent of the bid, although on federal projects it is generally 20 percent. The penal sum is an amount calculated to reimburse the owner for the difference in bid price between the low bidder's quote who subsequently fails to enter into contract with the owner, and the next low bidder's quote. It is not meant to be a penalty or a windfall to the owner, but merely a make-whole device for the owner who anticipated entering into a contract at one price, but who must then pay a higher price for the second low bidder.

Every blank space on a bid bond form is an opportunity for bidder error, which could render the bid bond invalid. Bid bond defects go to the heart of a contractor's commitment to enter into a contract with the owner, and thus any material defects will make the entire bid non-responsive. However, an owner has discretion to waive defects that do not give one bidder a material advantage over other bidders.[8]

[A] State Statutes and Rules—Capital Development Board Rules

In Illinois, the Capital Development Board (CDB) plays a major role in administering state construction projects.

Under CDB rules, bidders must provide bid security:

> All bids shall include bid security in the form of a bid bond on CDB's form, a certified check, cashier's check, or bank draft in the amount of 10% of the base bid. If a bid bond is used, the surety issuing the bond must be acceptable to CDB.[9]

The CDB applies the 10 percent bid bond requirement equally when administering grants for public construction.[10] In addition, the CDB allows bidders to

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[7] *See* **Chapter 2** for a discussion of Illinois law pertaining to bidding.

[8] *See* **Chapter 2, § 2.02[A]**, for a discussion of non-responsive bids.

[9] 44 Ill. Admin. Code § 910.120(l).

[10] 71 Ill. Admin. Code § 41.120.

remedy "technical deficiencies" in a bid within seven days after bid opening. The only listed technical deficiency related to bid bonds is "submission of a bid bond that is not on CDB's form."[11]

[B] Other State Agencies

The Illinois Environmental Protection Agency (EPA) requires a five percent bid bond. The Illinois EPA, which administers grants for environmental construction projects, imposes certain restrictions on contracts for municipalities receiving EPA grants, one of which is a bid bond for five percent of the base bid price.[12]

The rules for bid security to be given on construction projects for the various higher education Boards of Trustees also require that bid security, not to exceed five percent of the base bid price, be posted when submitting a bid. In addition, the rules allow the university to negotiate the bid security and retain such amounts as necessary to compensate it for damages suffered, or liquidated damages (if the bid solicitation specifies).[13]

[C] County and Local Governments

The Illinois General Assembly has set bid bond rules for county and local governments. The legislature has required a bid bond of not less than 10 percent of the bid for local improvements;[14] not more than 10 percent of the contract amount for sanitary districts;[15] and not less than 10 percent of the aggregate proposal for county board construction projects.[16]

[D] Illinois Bid Bond Defect Cases

The Illinois courts analyzing bid bond defects on public projects look to whether the defect was a substantial and material deviation from the bid requirements, such that the bidder gained an unfair, economic advantage over other bidders as a result of the defect. Minor defects that do not give a competitive advantage to the bidder can be waived by the contracting body.

Where the bid bond is for the wrong amount, the courts will analyze whether that defect gives a material and substantial economic advantage to the bidder submitting the defective bid bond. Because the bid bond is given, in part, to compensate the owner for the difference in the low bid and the second lowest bid, should the low bidder fail to enter into a construction agreement, the courts will analyze

[11] 44 Ill. Admin. Code § 910.120(m).
[12] *See* 35 Ill. Admin. Code § 661.302.
[13] 44 Ill. Admin. Code § 526.2047.
[14] 65 ILCS 5/9-2-103.
[15] 70 ILCS 2305/11.
[16] 55 ILCS 5/5-32036.

whether the bid bond in fact covered the bid spread. Moreover, although the appellate court in *Bodine Electric v. City of Champaign*[17] seems to propose that any defect in the amount of the bond penalty is a material defect requiring rejection of the bid, other Illinois cases, and cases from other states, argue in favor of an interpretation that, if the purpose of the bid bond is satisfied, then mistakes in form can and should be waived.

The leading Illinois case addressing bid bond defects is *Bodine Electric*. There, Bodine Electric had submitted a bid to perform electrical and security system work to the City on a police facility project. The bid instructions and a City ordinance required a 10 percent bid bond be submitted with the bid. Bodine Electric originally submitted a five percent bid bond. Bodine Electric's bid was lowest, $78,000 less than the second lowest bid. Bodine Electric's five percent bid bond was only for $49,900. Bodine Electric tendered a 10 percent bid bond five days after the bids were opened. The City's construction committee determined that they could not waive this defect in Bodine Electric's bid bond. The committee found that the five percent bid bond gave Bodine Electric an advantage because it could submit a lower bid, thereby risking less of a penalty. The City awarded the contract to the second low bidder. Bodine Electric sought and was denied injunctive and declaratory judgment and filed an appeal.

The Illinois appellate court affirmed, reasoning that a bid defect could be waived unless the variance was "material." A material defect is one that gives a "substantial competitive advantage" to the bidder over other bidders and renders the bid non-responsive. The trial court, relying on the construction team meeting minutes, determined that Bodine Electric's bid bond defect was material, because, if it decided not to contract with the City, it could have done so while risking significantly less money. Such a material defect cannot be waived by the City.

[E] Bid Bond Forfeiture Cases

One of the purposes of a bid bond is to guaranty that the low bidder who is awarded the contract will in fact enter into a contract for the bid price. The bid bond penalty protects the owner that is required to proceed with the second low bidder, should the low bidder fail to sign a contract. The amount of forfeiture or damages on a bid bond is not determined by the face amount or penal sum of the bond. Instead, the bid surety is only liable for the amount of damages actually incurred by the contracting agency. In *Board of Education, District. 303 v. George S. Walker Plumbing*,[18] the court affirmed summary judgment in favor of District 303 for $7,950, and against the surety. That $7,950 represented the amount between George S. Walker's low bid, and the next low bidder on the project.

If the successful low bid contains substantial errors, courts have allowed equitable rescission of the erroneous bid, with no forfeiture of the bid security. The

[17] 305 Ill. App. 3d 431, 711 N.E.2d 471 (4th Dist. 1999).
[18] 5 Ill. App. 3d 418, 282 N.E.2d 268 (4th Dist. 1972).

appellate court in *People ex rel. Department of Public Works & Buildings v. South East National Bank*,[19] allowed the low bidder to rescind a bid that contained an error of over 10 percent, without any penalty being taken against its bid security, in this case, a certified check. Equitable rescission of the bid and bid bond is also appropriate when the error was merely a mistake and not fraud, and the contracting agency did not substantially alter its position based on the erroneous bid.[20]

While the bid bond provides a guaranty that the low bidder will enter into a contract with the owner, it does not provide an absolute guaranty of damages to the owner for the low bidder's failure to sign the construction agreement. In *Hennepin Public Water District v. Petersen Construction*,[21] the bid documents provided that the successful low bidder was to sign the construction agreement and provide a performance bond within ten days after the contract award. The bid documents also provided that the award of the contract would not be effective unless the District was able to complete financing within 60 days after receiving bids. The District awarded the contract to Petersen Construction, but never tendered a construction agreement for signature within the 10-day period. The owner obtained financing on the 60th day after the bid opening; but did not provide the actual contracts for signature until 67 days after the bid opening. Petersen Construction refused to sign the agreement, arguing in part that the delay beyond the 10 days after the conditional contract award would subject it to liquidated damages for late completion of the project.

The District sued to recover liquidated damages under the bid bond, but the trial court entered judgment in favor of the defendant Petersen Construction. The appellate court affirmed, reasoning that the bid documents required the successful bidder to enter into a contract only within ten days after the award of the contract, or in this case, a period that could reasonably be interpreted as up to 60 days. The contractor was under no compulsion to sign a contract tendered 67 days after the award. Therefore, there would be no bid bond forfeiture.

The measure of damages where a contractor refuses to honor his bid were also addressed by the court in *Community School District 169 v. Menely Construction*.[22] There, the court considered the proper measure of damages where the low bidder on a construction project improperly withdrew or failed to perform under its bid after discovering a clerical error of over 10 percent of its bid price, compelling the School District to contract with the second low bidder. The School District requested damages in the full face value of the performance bond that Menely Construction had provided on signing the contract. The appellate court affirmed the trial court's award of $20,452.00, the difference between Menely Construction's bid, and the next low bidder who ultimately performed the work.

In rejecting the School District's argument that it was entitled to full, face

[19] 131 Ill. App. 2d 238, 266 N.E.2d 778 (1st Dist. 1971).
[20] *See* Consol. Eng'g v. State of Ill., 27 Ill. Ct. Cl. 171 (1971).
[21] 132 Ill. App. 2d 927, 270 N.E.2d 419 (3d Dist. 1971).
[22] 86 Ill. App. 3d 1101, 409 N.E.2d 66 (4th Dist. 1980).

value forfeiture of the performance bond, over $300,000, the court reasoned that the purpose of construction bonds is not to provide a windfall or punitive damages, but to compensate for actual damages incurred as a result of the breach covered by the bond. This ruling is equally applicable to bid bonds.

[F] Federal Projects—Federal Acquisitions Regulations

In the context of competitive bidding for federal construction projects, there are several relevant Administrative Code provisions. The federal bid bond requirements are:

> the bidder (1) will not withdraw a bid within the period specified for acceptance and (2) will execute a written contract and furnish required bonds, including any necessary coinsurance or reinsurance agreements, within the time specified in the bid. . . .[23]

Bid bonds on projects governed by the Federal Acquisitions Regulations (FARs) are set at 20 percent of the bid amount, not to exceed $3 million. They can be stated as a set amount, or a percentage.[24]

The federal government, by rule, can waive certain bid bond defects, when it deems appropriate. Nine circumstances allowing a procurement officer to waive bid bond defects are listed in the Code.[25]

[G] Federal Cases Under The Federal Acquisitions Regulations

The federal bid bond defect cases are decided on the issue of whether the bid bond manifests an intent by the bidder to be bound by his bid. In interpreting the FAR bid requests, the Federal Court of Claims looks to the substance of the bid bond, and the bid package as a whole, to determine the intent of the bidder, rather than looking strictly at the form of the bid bond.

For example, in the case *Excavation Construction v. United States*,[26] the Court of Claims found the bid bond to be responsive, where the bid bond error at issue contained an incorrect project number. The contractor awarded the project had inserted the project number from a prior bidding of the same project, rather than the re-bid number. The court found that, under the circumstances, there was a "reasonable basis" for the architect's award of the contract.

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[23] 48 C.F.R. § 28.001.
[24] 48 C.F.R. § 28.101-2.
[25] 48 C.F.R. § 28.101-4.
[26] 494 F.2d 1289 (Ct. Cl. 1974).

§ 5.04 PERFORMANCE BONDS

[A] The Basics

There are three parties to a performance bond. The surety issues a performance bond to an obligee, typically an owner, warranting or guarantying that its principal, the contractor, will perform his contract. The surety backs the contractor with a simple promise: If the contractor fails to perform the contract, the surety will perform the contract—all facets of the contract. Illinois courts may find a performance bond surety liable for delay damages, repair costs for building defects, and even damages arising from personal injuries.[27] The surety's obligation is coextensive with that of the principal.[28] The surety owes no more and no less than the principal. The bond language read in integration with the bonded contract terms determines the scope of the surety's liability.

The terms of the bond, read in integration with the bonded contract, fix the surety's liability. A standard bond condition clause reads:

> . . . The Condition of this Obligation is such that, if the Contractor shall promptly and faithfully perform said Contract, then this obligation shall be null and void; otherwise it shall remain in full force and effect.[29]

The negative of this promise, is that, if the principal does not perform, then the surety is liable to the obligee, but only up to the amount of the penal sum of the bond. The bond itself may attach notice conditions or other limitations on liability. Most common are suit limitation provisions, or specific time limits on warranty obligations.

[B] Illinois Public Bond Requirements

The Illinois Public Works Act (Act) requires that a performance bond be posted by any person who enters into a contract for $100,000.00 or more with the state "or any political subdivision thereof," to perform public works.[30] Cities, villages, and other municipal forms of government are "political subdivisions" of the state within the meaning of the statute.[31] Housing authorities, school districts,

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[27] *See* Board of Library Trustees v. Fidelity & Deposit Co. of Md., 101 Ill. App. 3d 1141, 429 N.E.2d 203 (3d Dist. 1981) (delay damages); People ex rel. Skinner v. Graham, 170 Ill. App. 3d 417, 524 N.E.2d 642 (4th Dist. 1988) (defective work covered); Capua v. W.E. O'Neill Constr., 67 Ill. 2d 255, 367 N.E.2d 669 (1977) (indemnity obligations for personal injuries within scope of performance bond).

[28] Village of Rosemont v. Lentin Lumber Co., 144 Ill. App. 3d 651, 449 N.E.2d 592 (1st Dist. 1986).

[29] *See, e.g.*, AIA Document A311.

[30] 30 ILCS 550/2.

[31] 65 ILCS 20/0.01 *et seq.*

community colleges, water reclamation districts, and other forms of government bodies are included as "political subdivisions" of the state, and bonds are required under the Act for their public works.[32]

[C] Public Owner Liability for Failure to Obtain Bonds

In a ruling of the Illinois appellate court in *Shaw Industries, Inc. v. Community College District No. 515*,[33] public owners who fail to obtain payment and performance bonds are deemed to be sureties.

In *Shaw*, the appellate court held that the provisions of the Bond Act are read into, and are deemed part of, every contract in Illinois to which the requirements apply. In short, even though the public owner fails to obtain a bond, the law reads the bond requirements into the contract, with the public owner placed in the role of surety. In this ruling, *Shaw* took two earlier decisions to their logical conclusions. In *Western Waterproofing v. Springfield Housing Authority*,[34] and *East Peoria Community High School District No. 309 v. Stage Lighting Co.*,[35] the courts ruled that the bonding requirements of the Public Works Act were read as an integrated part of all public contracts. The plaintiff subcontractors were found to be third-party beneficiaries of the contracts. Thus, the subcontractors were entitled to sue the public body for breach of the contract provisions requiring that bonds be posted. *Shaw* differs from the *Western Waterproofing* and *East Peoria* cases in dispensing with any consideration of whether the contract made the subcontractors third-party beneficiaries. *Shaw* found that the Act in 550/2 makes the subcontractors and suppliers third-party beneficiaries under the payment bond, by giving the subcontractors "use plaintiff" status.

The public body may also have liability to the subcontractor in tort, but only where the failure to obtain bonds is found to be willful and wanton conduct.[36] In *Emulsicoap v. City of Hoopston*, the appellate court held that government officials are shielded by immunity from ordinary negligence claims.

[D] Standing to Assert Performance Bond Claim

Performance bonds are issued to a named obligee. Performance bonds are read as contracts, and liability is not extended to third parties absent express intent. Most bond forms limit standing to enforce the bond to the named obligee, and

[32] Housing Auth. ex rel. Smith-Elsop Paint & Varnish Co. v. Holsman, 120 Ill. App. 2d 226, 256 N.E.2d 873 (5th Dist. 1970).

[33] 318 Ill. App. 3d 661, 741 N.E.2d 642 (1st Dist. 2001).

[34] 669 F. Supp. 901 (C.D. Ill. 1987).

[35] 233 Ill. App. 3d 481, 601 N.E.2d 976 (3d Dist. 1992).

[36] Emulsicoap v. City of Hoopston, 99 Ill. App. 3d 835, 425 N.E.2d 1349 (4th Dist. 1981).

a consistent line of Illinois cases enforce these provisions, express and implied.[37] In fact, the Illinois appellate court in *Board of Education, School District No. 15 v. Fred L. Ockerlund, Jr. & Associates, Inc.*, held that a school board that controlled the school under construction could not sue on a performance bond that listed the CDB, another state entity, as the bond obligee.[38]

The Illinois Procurement Code requires that building contracts in excess of $250,000.00 be let in five separate categories: plumbing, heating, ventilation, electrical, and general contract work.[39] The practice of using multiple co-prime contractors in Illinois public works raises the question of whether a co-prime contractor has standing to claim under another co-prime's performance bond. The one Illinois case on point says "no." In *J.F., Inc. v. S.M. Wilson & Co.*,[40] the Illinois appellate court held that a managing co-prime and its surety on a project were not liable to the co-prime's claims under the performance bond, which expressly named the state as obligee. The *S.M. Wilson* court held that the coordination clause and other clauses requiring cooperation by contractors did not make the co-prime contractor an intended third-party beneficiary of the managing co-prime contractor's contract and performance bond. The *S.M. Wilson* case cited other state decisions holding that co-primes do not have standing to claim under a managing co-prime's performance bond under a third-party beneficiary theory.[41]

In practice, the State of Illinois assigns specialty work prime contractors to a managing prime contractor who is charged with coordination responsibility. Where projects are delayed, specialty primes are likely to claim against the managing prime contractor and its surety for delay damages, interruption costs, and other consequential damages, given the fact that managing prime contractors have coordination and scheduling responsibilities under standard state contracts. A recent CDB contract provided: "The bonds required to be furnished under the General Conditions, Article VI, shall include all obligations relating to this Article XII." Article XII was the assignment provisions under which the managing co-prime contractor is assigned the contracts of other primes. This CDB contract also contained this supplementary General Condition: "By execution of the performance bond and labor and material payment bond, the contractor *and his surety* agree to all provisions of the Contract, including those relating to this assignment." The multi-prime form of contracting structure, and the contract language that may

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[37] *See* Rush Presbyterian St. Luke's Med. Ctr. v. Safeco Ins. Co., 825 F.2d 1204 (7th Cir. 1987) (applying Illinois law); Board of Educ., Sch. Dist. No. 15 v. Fred L. Ockerlund, Jr. & Assocs., Inc., 165 Ill. App. 3d 439, 519 N.E.2d 95 (2d Dist. 1988); Young v. General Ins. Co. of Am., 33 Ill. App. 3d 119, 337 N.E.2d 739 (1st Dist. 1975).

[38] 165 Ill. App. 3d 439.

[39] 30 ILCS 550/30-30.

[40] 152 Ill. App. 3d 873, 504 N.E.2d 1266 (5th Dist. 1987).

[41] *See* MGM Constr. Corp. v. New Jersey Educ. Facilities Auth., 532 A.2d 764, 220 N.J. Super. 483 (1987); Van Corp., Inc. v. American Cas. Co. of Reading, 417 Pa. 408, 208 A.2d 267 (1965); Novak & Co., Inc. v. Travelers Indem. Co., 56 A.D. 2d 418, 392 N.Y.S.2d 901, 907 (1977); Buchman Plumbing Co., Inc. v. Regents of the Univ. of Minn., 215 N.W.2d 479 (Minn. 1978).

be required by branches of the state government, raise a fair question of whether the consistent body of Illinois case law limiting standing to claim under a performance bond to the named obligee may be susceptible to claims by co-prime contractors under a third-party beneficiary theory.

Claims by co-prime contractors who seek standing to claim under a managing co-prime contractor's performance bond may cite to the "use plaintiff" provisions of the Bond Act, which is read as an integrated part of all public project contracts, as a basis to claim under a public performance bond as the use beneficiary of the named public owner.[42] Although the "use plaintiff" standing conferred by the Bond Act is contained in the payment bond section of the statute, 30 ILCS 550/2, there is Miller Act case law support for a contention that a "use plaintiff" may claim under a performance bond, where the payment bond was exhausted.[43]

While the rule that only the named obligee may recover under a performance bond is well established in Illinois law, recent forms of public contracts let by the State of Illinois, using a multi-prime structure where co-prime contractors are assigned to a managing co-prime contractor who has overall project management responsibility, create a contract structure in which co-primes may be deemed third-party beneficiaries who have standing to claim under the performance bond. There are a number of cases nationwide that would support granting co-primes standing to claim under performance bonds on public projects.[44]

[E] Public Performance Bonds' Purpose

The Illinois Public Construction Bond Act requires that payment and performance bonds be posted on all Illinois projects with a value in excess of $100,000.00.[45] The Act provides an alternate remedy to that afforded by the Illinois Mechanics Lien Act.[46] The Bond Act is remedial in purpose and should be liberally construed to effectuate its purpose.[47] The performance and payment bond provisions spelled out in the Act are integrated and included as part of all public contracts that are governed by the Act.[48] Public owners and sureties issuing bonds

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[42] 30 ILCS 550/2.

[43] United States f/u/a/b Hines Lumber Co. v. Kalady Constr. Co., 22 F. Supp. 1017 (N.D. Ill. 1964).

[44] Hanberry Corp. State Bldg. Comm'n v. Aetna Cas. Ins. Co., 390 So. 2d 277 (S. Ct. Miss. 1980); Broadway Maintenance Corp. v. Rutgers, 180 N.J. Super. 350, 434 A.2d 1125 (1981); N.T. Reed Constr. Co. v. Virginia Metal Prod. Corp., 213 F.2d 337 (5th Cir. 1954).

[45] 30 ILCS 550/1 & 2.

[46] Aluma Sys., Inc. v. Frederick Quinn Corp., 206 Ill. App. 3d 828, 564 N.E.2d 1280 (1st Dist. 1990).

[47] Northwest Water Comm'n v. Carlo V. Santucci, Inc., 162 Ill. App. 3d 877, 516 N.E.2d 287 (1st Dist. 1988).

[48] *East Peoria Community High Sch. Dist. No. 309*, 233 Ill. App. 3d 481, 601 N.E.2d 976 (3d Dist. 1992).

under the Act are free to expand the scope of liability or coverage provided in the bonds,[49] but they may not agree to restrict or limit the scope of liability set forth in the Act.[50]

[F] Common Law Performance Bonds

Modern construction escrow practices have made performance bonds on private projects less popular than they once were. Most reported cases deciding issues relating to performance bonds involve public bonds. Most of the cases deciding performance bond issues involving public or statutory bonds apply with equal force to private or common law bonds, with some qualifications. Private project bonds are strictly construed. Private project bonds are not remedial in nature. The differing standards for claims under public versus private bonds was noted by the court in *Chicago ex rel. Charles Equipment v. United States Fidelity & Guaranty Co.*,[51] where the court held that a payment bond claim was valid under the public bond posted by the general contractor, but refused to hold that this ruling automatically justified a judgment in favor of the general contractor's surety against the defaulting subcontractor's surety, based on the doctrine of the law of the case, because the subcontractor's bond was a private bond. The court declined to reach the issue on jurisdictional grounds. However, the court observed that the issue of whether a finding of liability on a public bond also imposed a duty of liability on a private bond, raised "several interesting questions." The court implied that different standards applicable to public bonds might result in a finding of liability under the public bond, and no liability under the private bond.

[G] Recovery Under Performance Bonds

Performance bonds must be read as an integrated part of the underlying contract bonded to form a single contract. The terms of the bond are read as part of the contract, and the contract requirements are bond requirements. This can result in an expansive undertaking by the surety.

A performance bond requires that the surety complete the contract. In this, it is distinct from an indemnity bond, which requires that the obligee or owner incur damages for which the surety becomes liable.[52] The court in *Lakeview Trust* described the performance bond surety's burden:

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[49] Illinois Contractors Mach., Inc. v. M.J. Boyle & Co., 43 Ill. App. 2d 213, 193 N.E.2d 205 (1st Dist. 1963).

[50] Laclede Steel Co. v. Hisker-Moon Co., 279 Ill. App. 295 (1935).

[51] 142 Ill. App. 3d 621, 491 N.E.2d 1296 (1st Dist. 1986).

[52] Lake View Trust & Savs. Bank v. Filmore Constr. Co., 74 Ill. App. 3d 755, 758, 393 N.E.2d 714 (1979).

> The obligation of the contractor in legal effect becomes the obligation of the surety and the obligee need not actually incur expenses or correct deficient performance of the contract in order to be entitled to recover against the surety.[53]

An obligee's claim is mature when there is a declaration of default and termination, any cure period has expired, and the obligee has served notice of the default upon the surety before acting in any way prejudicial to the surety.

[H] Default Required

Without a declaration of default, the surety has no obligation to act, and a positive obligation not to interfere with the principal's contract rights.[54] A declaration of default is required, and communications that equivocally note breaches of the contract, without more, do not constitute a default:

> Although the terms "breach" and "default" are sometimes used interchangeably, their meanings are distinct in construction surety law. Not every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it. To constitute a legal default, there must be a (1) material breach or series of breaches (2) of such magnitude that the obligee is justified in terminating the contract.[55]

In addition to a valid default, the obligee declaring default must give the surety adequate notice of the default. The Public Bond Act does not contain specific performance bond notice requirements.[56] However, private bond forms, including the A312 Form published by the AIA, provides specific notice and meeting requirements that are a condition to an event of default giving rise to a liability under the bond. There are also common law requirements of notice to the surety following a declaration of default in a claim under a performance bond.

[I] Notice Requirements—Beware the Dragon

In Illinois, the failure to give a surety notice of a default and termination before proceeding with completion work gives the surety a complete discharge. In *Dragon Construction v. Parkway Bank & Trust*,[57] private owners hired Dragon Construction, Inc. (Dragon) to build a hardware store. Dragon fell behind in the work and a number of lien claims were filed, prompting the owner to declare a default. The owner issued notice of the default only to the principal and, before no-

[53] *Id.*, 74 Ill. App. 3d at 758.
[54] Fox Lake v. Aetna Cas. & Sur. Co., 178 Ill. App. 3d 887, 901, 534 N.E.2d 133 (2d Dist. 1989).
[55] L&A Contracting Co. v. Southern Concrete Serv., 17 F.3d 106, 110 (5th Cir. 1994).
[56] 30 ILCS 550/2.
[57] 287 Ill. App. 3d 29, 678 N.E.2d 55 (1st Dist. 1997).

tice was issued on the surety, retained a replacement contractor to complete the work. The surety received notice of the default only after the obligee had contracted with a successor general contractor to complete the project. The surety filed an action for a declaration that it was discharged from its performance bond obligations as a result of the owner's failure to serve it with notice of the default, prior to entering into a completion contract. The surety asserted that the obligee's failure to give it timely notice robbed it of the opportunity to complete the project as it saw fit. The bond itself contained a seven-day notice requirement that, the surety argued, was designed to give it sufficient time to select a successor contractor.

The trial court entered summary judgment in favor of the surety, and the appellate court affirmed, ruling that the obligee had materially breached its contract with the surety, by providing it with late notice of the declaration of default and by limiting the surety's right to complete the contract. The court held that the surety's right to timely notice in order to give it an opportunity to control the completion of the contract was a material provision of the contract which, when breached, resulted in a discharge of the surety.

Dragon broke new ground in granting the surety a complete discharge. Prior notice cases approached the extent of the surety's discharge from a *pro tanto* analysis.[58]

The surety's right to timely notice in order to investigate the sufficiency of the declaration of default and the termination of the bonded contract, as well as its right to oversee and control costs in the completion process, are valuable bargained-for rights held by the surety.

[J] Suit Limitations

In addition to notice requirements, suit limitation periods contained in performance bonds, as well as in bonded contracts, are enforceable, even on public projects involving performance bonds posted in compliance with the Act. Many bond forms contain suit limitation requirements, normally requiring that suit be filed within two years from the date of substantial completion for the last work performed on the project. In *Board of Education of Community High School District No. 99 v. Hartford Accident & Indemnity Co.*,[59] the Second District appellate court held that the surety could enforce a two-year suit limitation against a public body obligee under a bond issued under the Act. The court held that the two-year period was reasonable, that the Act did not prohibit reasonable suit limitations, and that it was not against public policy for the surety to limit its exposure under the performance bond to less than the four-year statutory limitation period found in § 13-214(a) of the Code of Civil Procedure.[60] In upholding the

[58] Blackhawk Heating & Plumbing Co., Inc. v. Seaboard Sur. Co., 534 F. Supp. 309 (N.D. Ill. 1982).

[59] 152 Ill. App. 3d 745, 504 N.E.2d 1000 (2d Dist. 1987).

[60] 735 ILCS 5/13-214(a).

two-year suit limitation, the court noted that under § 2 of the Act, payment bond claimants themselves are subject to a six-month suit limitation under the express terms of the Act.

[K] Prepayment and Overpayment Defenses

The surety has an equitable interest in the contract funds used to pay for the costs of completing the project.[61] An owner's "prepayment" of contract funds will discharge a performance bond surety to the extent that the "prepayments" prejudice the surety.[62] Prepayment in this context refers to an owner's release of contract funds without verifying that work commensurate with each pay application is in place and in compliance, or at least in substantial compliance, with design requirements.

After declaration of default, an owner has a duty to hold contract funds for the benefit of the surety.[63] An owner's release of contract funds after default affects a dollar-for-dollar release of the surety, but only where the surety can prove prejudice.

[L] The Surety's Completion Options

A performance bond surety generally has four options in its response to a performance bond claim: (1) complete the project; (2) pay over the bond penal sum; (3) tender a new contractor; or (4) do nothing, and deny the claim.[64] Of course, the surety is also free to negotiate other options with the obligee.

[1] Complete the Contract

The first option considered is completion of the contract. A completing surety steps into the shoes of the owner, its principal, and any subcontractors whose claim it satisfies.[65] The surety is entitled to require that the obligee meet all of its contractual obligations, in cooperating with the surety in completing the project. The surety may request that the obligee enter a Takeover Agreement, to memorialize the status of the project at the time of the "takeover" by the surety, in terms of scheduling, contract funds remaining, outstanding change orders, and other administrative issues. A Takeover Agreement between the owner and the surety benefits both parties by setting down for the record the status of the project

[61] Chicago Bridge & Iron v. Reliance Ins. Co., 46 Ill. 2d 522, 264 N.E.2d 134 (1970).

[62] Argonaut Ins. Co. v. Town of Cloverdale, 699 F.2d 417, 419 (7th Cir. 1983); Southwood Builders, Inc. v. Peerless Ins. Co., 366 S.E.2d 104, 106 (Va. 1986); Insurance Co. of the W. v. United States, 243 F.3d 1367 (Fed. Cir. 2001).

[63] National Sur. Corp. v. United States, 118 F.3d 1542, 1545 (Fed. Cir. 1997).

[64] Wisner & Knox, *ABCs of Contractors' Surety Bonds*, 82 Ill. Bar. J. 244 (1974).

[65] Capital Indem. Corp. v. United States, 41 F.3d 320, 326 (7th Cir. 1994).

as agreed to by the obligee and the surety, and any agreements needed between the parties relating to the completion of the project. It is common in a default situation for there to be several outstanding project management issues, outstanding change orders, disputed pay requests, lien claims, and various other open financial and administrative issues. A Takeover Agreement is a good way for the owner and the obligee to start the completion efforts with an agreed upon baseline. It provides both parties with a starting point from which to move forward with project completion.

In Illinois, the obligee is not required to enter into a Takeover Agreement absent express language in the bond or the bonded contract requiring that the parties enter into a Takeover Agreement as a condition to the surety's liability. Such provisions are rare.

With or without a Takeover Agreement, completion by the surety is often the most efficient way to meet the performance bond claim and to complete the project. Having completed the project, the completing surety subrogates to all of the rights of the obligee, the principal, and subcontractors whose claims were paid under the bond. In addition to remaining contract funds, the completing surety's subrogation rights extend to claims against third parties, including subcontractors, design professionals, and product suppliers.[66]

While direct completion by the surety may be the most efficient means of meeting a performance bond claim, it is not without risk. Ordinarily, the surety's liability is limited to the penal sum of the bond.[67] However, one Illinois case, *Fox Lake v. Aetna Casualty & Surety Co.*,[68] found that a surety that decided to complete a bonded contract under the Act is liable for the full cost of completion, even if completion costs exceed the penal sum of the bond.

In the *Fox Lake* case, the bonded contract expressly gave the surety two options in the event of a default. The surety could complete the project or pay over the bond penal sum. The court held that the surety, in choosing to takeover and complete the project, accepted the risk that the cost of completion would exceed the penal sum of the bond. If the surety chose the completion alternative, it waived its bond penal sum limitation, and would be liable for completion of the bonded contract, at whatever cost. In *Fox Lake*, the surety argued that it made a valid reservation of the right to limit its cost to the bond penal sum, in letters issued to the obligee before beginning work to complete the project. The court denied these claims, holding that there was no consideration for the reservation of rights, and that, having selected the completion option, the surety waived its bond penal sum protection.

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[66] Peerless Ins. Co. v. Cerny & Assocs., Inc., 199 F. Supp. 951 (D. Minn. 1961) (surety subrogates to obligee's claim against designer); Aetna Ins. Co. v. Hellmuth, Obatu & Kassbaum, Inc., 392 F.2d 472 (8th Cir. 1968); Westerhold v. Carroll, 419 S.W.2d 73 (Mo. 1967).

[67] Griffin Wellpoint Corp. v. Engelhardt, 92 Ill. App. 3d 252, 414 N.E.2d 941 (2d Dist. 1980); Fisher v. Fidelity & Deposit Co. of Md., 125 Ill. App. 3d 632, 466 N.E.2d 332 (5th Dist. 1984).

[68] 178 Ill. App. 3d 887, 534 N.E.2d 133 (2d Dist. 1989).

[2] Federal Takeover Agreements—Policy and Requirements

The federal government recently enacted Federal Acquisitions Regulations favoring, but not requiring, Takeover Agreements between the government, the surety, and the terminated contractor.[69] These regulations provide that the contracting officer "may" enter into a Takeover Agreement.[70] However, if the contracting officer decides to enter a Takeover Agreement, the regulations mandate provisions that "must" be included in the agreement.[71] These limit the government's ability to release contract funds to the surety, and limit the contracting officer's ability to waive delay damages.[72] The purpose of these required provisions is to limit the release of contract funds that may be subject to competing claims by the defaulting contractor's creditors.

[3] Pay Bond Penal Sum

The surety has the right to discharge its performance obligations by paying the penal sum of the bond to the obligee. This option is rarely selected by the surety. To the extent that any work has been performed under the bonded contract, the cost to complete the project is normally less than the full amount of the penal sum. By Illinois statute, the penal sum must be the full amount of the bonded contract.[73] Under the Miller Act, the penal sum of the bond is fixed by statute, but it is normally a significant portion of the amount of the value of the bonded work. Payment of the bond penal sum fixes the surety's liability and gives it the ability to avoid administrative costs or any risk of incurring liability in excess of the bond penal sum.

An alternative to tendering the bond penal sum is to pay the obligee a negotiated amount in consideration for discharge of the bond. While this is an option for the surety, the surety has no right to tender an amount less than the full penal sum in discharge of its bond. However, all things being negotiable, this is often an option pursued by the surety.

[4] Tendering a Completion Contractor

Another option available to the surety, and one that combines the efficiencies of completing the project with the certainties of fixing liability and administrative costs, is the option of tendering a contractor to complete the work. The A312 bond form makes tender one of the completion options available to the surety. However, absent an express bond provision allowing tender, an owner obligee is not required

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[69] 48 C.F.R § 49.404.
[70] 48 C.F.R § 49.404(d).
[71] 48 C.F.R. § 49.404(e)(1), (2), (3), and (4).
[72] *Id.*
[73] 30 ILCS 550/1.

to accept the tender of the contractor. A tender differs from completion by the surety. Under a tender, the owner accepts the new contractor, and a new bond in lieu of the defaulting contractor and his bonding company. A tendered contractor must be bonded to comply with the Public Works Act. A surety will seek to tender a contractor in order to avoid the risks and administrative costs of completing a project, by tendering a viable contractor and a new bonding company to complete the contract. Based on the status of the work in comparison with the amount of contract funds remaining, the surety may be able to pay a small premium to a new contractor or the obligee, and thereby arrange for the contractor and the obligee to agree to completion terms, and the surety is granted a release of liability.

[5] Deny the Claim

The surety can deny the claim, relying upon its principal's defenses or its own defenses. This option may expose the surety to consequential damages and Insurance Code penalties if its actions are found to be vexatious and unreasonable.[74]

[M] Damages Recoverable Under Performance Bonds

The performance bond warrants or guarantees the contractor's performance of the bonded contract. The surety's liability is co-extensive with that of its principal. The bond is read in integration with the bonded contract, so that the terms of the bond are part of the contract, and the terms of the contract are part of the bond. Under these principles, in Illinois the performance bond surety has been found liable for defective work, design errors, delay damages, and even personal injury damages. While historically sureties have at least some success with contending that performance bonds warranted only completion, not the quality of the completed work,[75] it is clear under Illinois law at present that the surety warrants the contractor's faithful performance of the bonded contract, including implied duties of good and workmanlike performance and, where imposed by the bonded contract, even design and safety responsibilities.

In *Capua v. W.E. O'Neill Construction Co.*,[76] the Illinois Supreme Court held that performance bond sureties may be liable for personal injuries sustained by a worker who fell off a scaffold, provided only that he could show that the injury was the result of the breach of the bonded contract. In *Capua*, the public owner asserted that the performance bond provisions covered the general contractor's indemnification duties to the owner, including covenants to indemnify the owner against loss as a result of personal injuries. The court rejected the surety's contention that the Anti-Indemnity Act[77] precluded enforcement of the

[74] Fisher v. Fidelity & Deposit Co. of Md., 125 Ill. App. 3d 632, 466 N.E.2d 332 (5th Dist. 1984).
[75] Parker Washington Co. v. City of Chicago, 267 Ill. 136 (1915).
[76] 67 Ill. 2d 255, 260, 367 N.E.2d 669 (1977).
[77] 740 ILCS 35/1. *See* **Chapter 4, § 4.02.**

indemnity provisions, and held that the performance bond covered all covenants of the bonded contract, including the indemnification and hold harmless clauses of the agreement.

Performance bonds have also been found to cover defective work claims and design errors within the scope of the bonded contract.[78]

Delay damages are also recoverable against performance bonds, including statutory bonds issued under the Act.[79] In *Board of Library Trustees v. Fidelity & Deposit Co. of Maryland*,[80] the Illinois appellate court held that a library board could recover delay damages against the performance bond surety, where the performance bond surety completed the project, but not within the time schedule. The court rejected the surety's claims that a public body, with no profit motive, cannot recover general damages for delay in the completion of a public improvement. The court held that delay damages arose from a breach of the bonded obligation, and that the surety was liable for delay damages based on a fair rental evaluation of comparable buildings to the library buildings at issue.

[N] Performance Bond Surety's Subrogation Rights

A performance bond surety that completes a bonded project subrogates to the owner's rights, the rights of its principal, and the rights of subcontractors and suppliers whose claims it paid.[81] In *Capital Indemnity Corp. v. United States*, the Seventh Circuit, applying Illinois law, stated:

> . . . as completing surety, CIC was subrogated to the rights of several parties: the original contractor, the subcontractors and suppliers, and the owner (here the District), for whom the job was completed.[82]

Historically, case law consistently upholds the surety's equitable claims to contract funds on construction projects it completed or on which it paid bond claims.[83] While some Illinois decisions take a very literal approach to the surety's right of subrogation, the weight of Illinois authority supports a broad grant of equitable rights to the completing performance bond surety. For example, the narrow reading of surety subrogation rights in *Aupperle v. American Indemnity Co.*,[84] is

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[78] People ex rel. Skinner v. Graham, 170 Ill. App. 3d 417, 524 N.E.2d 642 (4th Dist. 1988).

[79] *See* **Chapter 7** for a discussion of delay claims and damages.

[80] 101 Ill. App. 3d 1141, 429 N.E.2d 203 (3d Dist. 1981).

[81] Capital Indem. Corp. v. United States, 41 F.3d at 326 (citing National Shawmut Bank of Boston v. New Amsterdam Cas. Co., 411 F.2d 843 (1st Cir. 1969)).

[82] *Id.* at 326.

[83] Alexander Lumber Co. v. Aetna Cas. & Sur. Co., 1 F.2d 430 (7th Cir. 1924); Peirce v. Garrett, 65 Ill. App. 682 (2d Dist. 1896); New York Cas. Co. v. Zwirner, 58 F. Supp. 473 (1944). *See generally* Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962); Trinity Universal Ins. Co. v. United States, 382 F.2d 317 (5th Cir. 1967).

[84] 75 Ill. App. 3d 722, 394 N.E.2d 725 (3d Dist. 1979) (surety's subrogation rights to subcontractor lien claims held ineffective where subcontractors did not actually perfect lien claims).

contradicted by cases that recognize a broad grant of equitable rights to a performing surety.[85]

The traditional equitable considerations that create a right of subrogation are present where a surety pays or otherwise satisfies claims under performance or payment bonds. Subrogation is an equitable right or legal fiction where one who, under legal compulsion, pays or satisfies the debt of another is substituted or subrogated to all of the rights and remedies of both the principal obligor and the creditor whose debt is paid.[86] However, the surety's equitable rights arise when the debt is fully discharged; there is no right of anticipatory subrogation.[87]

The right of the completing surety to step into the shoes of the owner upon project completion is significant in light of the Illinois Supreme Court ruling in *Gunther v. O'Brien Brothers Construction Co.*[88] In *Gunther*, the Illinois Supreme Court held that a public project owner's set-off rights against retainage funds following a contract default took priority over otherwise valid mechanics lien claims by subcontractors and suppliers to the defaulted contractor. The court held that the owner had the right to charge retainages with completion costs, and that these charges took priority over otherwise valid mechanics lien claims.

A more recent case, *Northwest Water Commission v. Carlo V. Santucci, Inc.*,[89] distinguished *Gunther* on the basis that its ruling only applied to retainage funds, and held that project funds that were earned but unpaid to the contractor were subject to valid mechanics lien claims, and that these lien claims were shielded from later charges by the owner for the cost to complete the project following default by the general contractor. Read together, the *Gunther* and *Santucci* cases establish a hierarchy of priorities to contract funds in the event of a contractor default: first, the owner's right to set-off completion costs against project retainages; second, earned but unpaid contract progress payments subject to valid mechanics lien claims; third, unearned contract funds in the hands of the owner that are payable to the surety; and fourth, any excess funds available after the owner's completion costs, mechanic's liens, and the surety's completion costs are credited against the contract funds. As a practical matter, a completing surety holds a subrogation claim to all contract funds, except for the funds held subject

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[85] *Capital Indem. Corp.*, 41 F.3d 320; *Alexander Lumber Co.*, 1 F.2d 430. *See also* Dix Mut. Ins. Co. v. LaFranboise, 149 Ill. 2d 314, 597 N.E.2d 622 (1992); Aetna Cas. & Sur. Co. v. Chicago Ins. Co., 994 F.2d 1254 (7th Cir. 1993).

[86] Continental Cas. Co. v. Great Am. Ins. Co., 732 F. Supp 929 (N.D. Ill. 1990); Weissman v. Weener, 12 F.3d 84 (7th Cir. 1993).

[87] Village of Crainville v. Argonaut Ins. Co., 81 Ill. 2d 399, 410 N.E.2d 5 (1980); In re Estate of Berger, 166 Ill. App. 3d 1045, 520 N.E.2d 690, *appeal denied sub nom.* Goodman v. Berger, 122 Ill. 2d 574, 530 N.E.2d 244 (1987).

[88] 369 Ill. 362, 16 N.E.2d 890 (1938). *See generally* Transamerica Ins. Co. v. United States, 989 F.2d 1188 (Fed. Cir. 1993), *reh'g denied*, 998 F.2d 972 (Fed. Cir. 1993); District of Columbia v. Aetna Ins. Co., 462 A.2d 428 (D.C. App. 1983).

[89] 162 Ill. App. 3d 877, 516 N.E.2d 287 (1st Dist. 1988).

to mechanics lien claims. Of course, if the surety paid those claims, it would subrogate to the lien claims, as well.

[O] Bankruptcy Considerations

A bankruptcy filing by the principal does not relieve the performance bond surety of its obligations. The initial consideration for the performance bond surety is whether the bonded contract has been validly terminated for default prior to the bankruptcy filing. If the bonded contract is terminated by default, the performance bond surety's obligations are only tangentially impacted by the principal's bankruptcy filing. With a pre-petition default, the better reasoned cases hold that the remaining contract funds held by the obligee are not property of the principal's bankruptcy estate, since the default terminates the principal's interest in the contract.[90] However, a number of courts do hold that the remaining contract funds remain property of the estate to the extent that the debtor retains any putative interest in the contract after default.[91]

When the debtor files bankruptcy before a bonded contract is terminated by default, the contract becomes property of the estate and the owner is barred from terminating the contract by default by the automatic stay.[92] The owner obligee is required to modify the automatic stay in order to declare a default under the contract and to make a valid claim under the performance bond.

An uncompleted bonded contract that is property of the bankruptcy estate is considered to be an executory contract under § 365 of the Bankruptcy Code.[93] Either the owner or the surety can move to compel a debtor principal's assumption or rejection of a bonded contract under § 365(d). Where a principal files bankruptcy before a contract is terminated by default, but fails to prosecute the work as a debtor-in-possession, the obligee and surety each have an incentive to compel the debtor to decide whether the bonded contract is to be assumed or rejected under Bankruptcy Code § 365. Where a contract is assumed, all of the debtor's obligations under the contract become administrative claims in the bankruptcy.[94] Where a debtor rejects the contract, the debtor loses all interest in the contract, and the default is effective as of the date of the bankruptcy filing. The surety has the right to object to assumption of the contract, where the surety's interest will be prejudiced.[95] The performance bond itself is not an executory contract. It is a commercial instrument that qualifies as a financial accommodation under § 365 of the

[90] In re Munple, Ltd., 868 F.2d 1129 (9th Cir. 1989); Moody v. Amoco Oil Co., 734 F.2d 1200 (7th Cir. 1984); In re Massart Co., 105 Bankr. 610, 613 (W.D. Wash. 1989); In re Q.C. Piping Installation, Inc., 225 Bankr. 553 (Bankr. E.D.N.Y. 1998); In re Four Star Constr. Co., 151 Bankr. 817 (Bankr. N.E. Ohio 1993).

[91] In re Glover Constr. Co., Inc., 30 Bankr. 873 (Bankr. W.D. Ky 1983).

[92] 11 U.S.C. § 362.

[93] 11 U.S.C. § 365; In re Computer Communications, 824 F.2d 725 (9th Cir. 1987).

[94] 11 U.S.C. § 502.

[95] In re C.M. Sys., Inc., 64 Bankr. 363 (Bankr. N.D. Fla. 1986).

Code.[96] A surety may not take over and complete the contract where the underlying bonded contract has not been formally rejected by the principal after it files bankruptcy.[97]

§ 5.05 PAYMENT BONDS

[A] Requirements of the Act

In Illinois, the Bond Act requires that the contractor post a labor and material payment bond with the public body as the named obligee, for the full amount of the contract.[98] The public owner is the "obligee;" the general contractor is the "principal;" and the surety issues the bond. The Act provides:

> Every person furnishing material or performing labor, either as an individual or as a sub-contractor for any contractor, with the State, or a political subdivision thereof where bond or letter of credit shall be executed as provided in this Act, shall have the right to sue on such bond or letter of credit in the name of the State, or the political subdivision thereof entering into such contract, as the case may be, for his use and benefit, and in such suit the plaintiff shall file a copy of such bond or letter of credit, certified by the party or parties in whose charge such bond or letter of credit shall be, which copy shall, unless execution thereof be denied under oath, be prima facie evidence of the execution and delivery of the original; provided, however, that this Act shall not be taken to in any way make the State, or the political subdivision thereof entering into such contract, as the case may be, liable to such sub-contractor, materialman or laborer to any greater extent than it was liable under the law as it stood before the adoption of this Act. Provided, however, that any person having a claim for labor, and material as aforesaid shall have no such right of action unless he shall have filed a verified notice of said claim with the officer, board, bureau or department awarding the contract, within 180 days after the date of the last item of work or the furnishing of the last item of materials, and shall have furnished a copy of such verified notice to the contractor within 10 days of the filing of the notice with the agency awarding the contract.
>
> The claim shall be verified and shall contain (1) the name and address of the claimant; the business address of the claimant within this State and if the claimant shall be a foreign corporation having no place of business within the State, the notice shall state the principal place of business of said corporation and in the case of a partnership, the notice shall state the names and residences of each of the partners; (2) the name of the contractor for the government; (3) the name of the person, firm or corporation by whom the claimant was employed or to whom he or it furnished materials; (4) the amount of the claim; (5) a brief description of the public improvement sufficient for identification.

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[96] In re Edwards Mobile Home Sales, Inc., 119 Bankr. 857, 860 (Bankr. N.D. Fla. 1990).
[97] *Computer Communications, Inc.*, 824 F.2d at 728.
[98] 30 ILCS 550/2.

> No defect in the notice herein provided for shall deprive the claimant of his right of action under this article unless it shall affirmatively appear that such defect has prejudiced the rights of an interested party asserting the same.
>
> Provided, further, that no action shall be brought until the expiration of 120 days after the date of the last item of work or the furnishing of the last item of materials, except in cases where the final settlement between the officer, board, bureau or department of municipal corporation and the contractor shall have been made prior to the expiration of the 120 day period, in which case action may be taken immediately following such final settlement; nor shall any action of any kind be brought later than 6 months after the acceptance by the State or political subdivision thereof of the building project or work. Such action shall be brought only in the circuit court of this State in the judicial circuit in which the contract is to be performed.[99]

The purpose of the Act in requiring payment bonds is to protect those providing labor and/or materials to public projects who do not have a right to a mechanic's lien and to "regulate claims on public monies."[100] The Act provides a separate remedy to § 23 of the Mechanics Lien Act, which allows for a lien on public funds.[101] A payment bond is executed for the benefit of those providing labor and materials, not for the benefit of the owner, although the owner derives an incidental benefit as it may prevent liens from being filed against the property and/or project funds.[102] A payment bond that adopts the statutory language included in § 1 of the Bond Act does not convert a payment bond into a performance bond, especially where a separate performance bond is provided for a particular project.[103]

In return for providing security to labor and/or material suppliers under the Act, the surety and the general contractor are protected by the notice and limitations provisions contained in § 2 of the Act.[104] This is to achieve balance between "protecting the rights of claimants and limiting the time during which the contractor and surety must worry about potential claims."[105] These limitations to a claimant's recovery will be discussed at length later in this chapter.

[B] Language of the Bond

The express provisions of the Bond Act, by the very language of the Act, are deemed to be included in every bond issued for a public construction project,

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[99] 30 ILCS 550/2.

[100] Aluma Sys., Inc. v. Frederick Quinn Corp., 206 Ill. App. 3d 828, 853-54, 564 N.E.2d 1280 (1st Dist. 1990); Board of Educ. of Community High Sch. Dist. No. 99 v. Hartford Acc. & Indem. Co., 152 Ill. App. 3d 745, 753, 504 N.E.2d 1000 (2d Dist. 1987); Board of Educ. Decatur Sch. Dist. No. 61 v. Swam, 5 Ill. App. 2d 124, 129 (3d Dist. 1955).

[101] *Aluma Sys., Inc.*, 206 Ill. App. 3d at 853.

[102] *Board of Educ. of Community High Sch. Dist. No. 99*, 152 Ill. App. 3d at 753.

[103] *Id.* at 753-754.

[104] Concrete Structures of the Midwest v. Fireman's Ins. Co. of Newark, N.J., 790 F.2d 41, 43 (7th Cir. 1986).

[105] *Id.* at 44.

whether or not the provision is actually "inserted" in the bond.[106] The public body is not authorized to accept a bond that does not, at a minimum, provide the statutory coverage contemplated under the Act.[107] However, the surety and contractor are free to broaden the scope of the bond beyond the express language of the statute.[108] The Act mandates that every public body entering into a contract for construction require the general contractor to provide a payment bond covering labor and/or material suppliers to the construction project in accordance with the terms of the Act.[109] If a public body fails to secure a bond for the project as provided by the Act, an unpaid subcontractor is authorized to bring a direct action against the public body in the form of a third-party beneficiary cause of action under the Bond Act.[110] However, since the subcontractor in such an action proceeds with authority granted him under the Act, he must comply with the requirements and limitations imposed by the Act.[111]

[C] Interpreting the Bond

In construing the bond obligation, courts first look to the language of the bond, as with any other contract, as evidence of the intentions of the parties.[112] However, where an ambiguity exists, the contract will be strictly construed against the surety.[113] In that way, the bond is treated as a contract of insurance for the purpose of construction.[114] In a number of cases, Illinois courts have found that the bond language expands the scope of liability beyond that required by the Act.

To construe the provisions of the Act, Illinois courts look to other related statutes including the Illinois Mechanics Lien Act and the Miller Act. In *M.Q. Construction Co., Inc. v. Intercargo Insurance Co.*,[115] the court stated "that statutes which relate to one subject are governed by one spirit and a single policy, and that the legislature intended the enactments to be consistent and harmonious."[116] Therefore, the *M.Q.* court held, case law construing and applying the

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[106] 30 ILCS 550/1. *See also Aluma Sys., Inc.*, 206 Ill. App. 3d at 855; Chicago Housing Auth. ex rel. General Bronze Corp. v. United States Fid. & Guar. Co., 49 Ill. App. 2d 407, 410, 199 N.E.2d 217 (1st Dist. 1964).

[107] Laclede Steel Co. v. Hisker-Moon Co., 279 Ill. App. 295 (1935).

[108] *Aluma Sys., Inc.*, 206 Ill. App. 3d at 855; Illinois State Toll Highway Comm'n ex rel. Patten Tractor & Equip. v. M.J. Boyle & Co., 38 Ill. App. 2d 38, 51, 186 N.E.2d 390 (1st Dist. 1962).

[109] Shaw Indus., Inc. v. Community College Dist. No. 515, 318 Ill. App. 3d 661, 669, 741 N.E.2d 642 (1st Dist. 2001). 318 Ill. App. 3d at 669.

[110] *Id.*, 318 Ill. App. 3d at 669.

[111] *Id.* at 672.

[112] Board of Local Improvements S. Palos Township Sanitary Dist. ex rel. North Side Tractor Sales Co. v. St. Paul Fire & Marine Ins., 39 Ill. App. 3d 255, 257, 350 N.E.2d 36 (1st Dist. 1976).

[113] *Id.*, 39 Ill. App. 3d at 258.

[114] Lesher v. United States Fidelity & Guar. Co., 239 Ill. 502, 509 (1909).

[115] 318 Ill. App. 3d 673, 681, 742 N.E.2d 820 (1st Dist. 2000).

[116] *Id.*, 318 Ill. App. 3d at 681.

Illinois Mechanics Lien Act and federal Miller Act are instructive in deciding issues under the Act.

[D] Payment Bond Liability Under the Act

[1] Standing

Statutory payment bonds warrant payment to "all persons, firms and corporations having contracts with the principal or with subcontractors."[117] The language of the Act clearly provides subcontractors in privity with the general contractor the right to recover under the payment bond. The Act also provides a right of recovery on behalf of sub-subcontractors or suppliers to subcontractors.[118] Apart from the language of the Act, courts have noted that the Act was passed at a time when the Illinois Mechanics Lien Act did not provide a remedy for suppliers to subcontractors.[119] Consequently, the supplier to a subcontractor was just the sort of "person[], firm[] [or] corporation[]" without a right to a lien that the legislature intended to protect by the passage of the Act.

The right to recover under the payment bond becomes less certain when subcontractors or suppliers are further removed from the principal. It is an open question whether a supplier to a sub-subcontractor, a fourth tier subcontractor, may recover under the Act. There is no express prohibition on fourth tier claimants, but the term "subcontractor" is not defined by the Act.

The Miller Act, however, prohibits recovery by fourth tier subcontractors or suppliers. In denying recovery for fourth tier subcontractors under the Miller Act, the United States Supreme Court stated: "Congress cannot be presumed, in the absence of express statutory language, to have intended to impose liability on the payment bond in situations where it is difficult or impossible for the prime contractor to protect himself. . . . To impose unlimited liability under the payment bond to those sub-materialmen and laborers is to create a precarious and perilous risk on the prime contractor and his surety."[120]

It is not clear whether this same rationale applies to the Illinois Act. One Illinois court holds that the purpose and policy of the Miller Act justifies applying its interpretative case law to the Illinois Act, while another court holds that Miller Act case law is inapposite.[121]

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[117] 30 ILCS 550/1.

[118] Housing Auth. of the County of Franklin ex rel. Smith-Alsop Paint & Varnish Co., 99 Ill. App. 3d 835, 880, 425 N.E.2d 1329 (5th Dist. 1970).

[119] *Id.*

[120] Clifford F. MacEvoy Co. v. United States, 322 U.S. 102, 110 (1944).

[121] *Contrast Alumna Sys., Inc.*, 206 Ill. App. 3d at 856 (Miller Act case law not pertinent), *with M.Q. Constr. Co., Inc.*, 318 Ill. App. 3d at 681 (Miller Act case law on what constitutes last day of work held probative of issue under the Act).

[2] Coverage

The Act requires, at a minimum, that the statutory bond extend to payments for "labor performed or materials furnished in the performance of the contract on account of which this bond is given. . . ." Again, the bond may provide for broader coverage, or may merely incorporate the statutory language.

Statutory payment bonds do not cover equipment rental charges (or presumably repairs to equipment) unless the equipment is wholly consumed on the project.[122] There is no recovery for rental or repair payments under private project bonds unless the repair parts and the labor connected with the repair parts were "consumed" in the project and thus "used in the prosecution of the work" under the contract.[123] Where the repair parts are not "consumed" in the project, the claim for repairs will not be allowed. In stating the rationale for this rule, the Illinois court quoted a Minnesota court: "the law was not intended to permit a contractor to go onto a bonded job with a run-down outfit and have it rebuilt at the expense of his sureties. Public contracts require the contractors to furnish their own equipment."[124] Presumably, this rationale applies to any claim for recovery of rental or repair costs where the equipment was not "consumed" in the prosecution of the work.

Of course, the bond language controls. Where the bond related to a particular project provided for payments to "all persons, firms, sub-contractors or corporations furnishing materials for or performing labor . . . *including all amounts due for materials, lubricants, oil, gasoline, coal and coke, repairs on machinery, equipment and tools, consumed or used in connection with the construction of such work* . . . ," the court held that the bond assured payment for charges associated with repair of machinery, equipment and tools used on the job.[125] Where the language of the bond provided for the payment of "prevailing wages for the work to be performed" and also for the payment of "all sums of money due for any labor, materials, apparatus, fixtures or machinery, and transportation with respect thereto, furnished . . . for the purpose of performing such work . . . ," the court found a "reasonable basis" existed for the owner to require the bond guarantee the payment of the prevailing wage and seemed to indicate it would allow such a claim to be brought on a payment bond.[126]

In *Illinois State Toll Highway Commission ex rel. Patten Tractor & Equip. v. M.J. Boyle & Co.*, the Illinois court held that an equipment seller to a subcontractor could maintain a claim under the bond for the breach of the equipment sales

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[122] *Aluma Sys., Inc.*, 206 Ill. App. 3d at 858.

[123] Arrow Contractors Equip. Co. v. Siegel, 68 Ill. App. 2d 447, 464, 216 N.E.2d 181 (1st Dist. 1966).

[124] *Id.* (citations omitted).

[125] Board of Local Improvements S. Palos Township Sanitary Dist. ex rel. North Side Tractor Sales Co. v. St. Paul Fire & Marine Ins., 39 Ill. App. 3d 255, 258-59, 350 N.E.2d 36 (1st Dist. 1976). *See also* Illinois Contractors Mach., Inc. v. M.J. Boyle & Co., 43 Ill. App. 2d 213, 193 N.E.2d 205 (1st Dist. 1963).

[126] Illinois State Toll Highway Comm'n ex rel. Patten Tractor & Equip. v. M.J. Boyle & Co., 38 Ill. App. 2d 38, 54-55, 186 N.E.2d 390 (1st Dist. 1962).

contract and depreciation of the equipment sufficient to survive a motion to dismiss, since the subcontractor had pled that the equipment was "consumed or used in the construction of the project."[127] The court there reached its decision based on the fact that, although the statutory language may have prohibited such a recovery, the surety was unable to rely on the statute or the cases interpreting it since the surety provided "a voluntary bond . . . over and beyond the statutory requirements."[128] This case seems to be anomalous in its result, but it provides an object reminder that the language of the bond and the underlying contract determines the nature and extent of the surety's liability.

Attorneys' fees incurred by a claimant may be recoverable under a payment bond if clearly provided for in the bond or the bonded contract.[129] The court in *Capital Development Board ex rel. P.J. Gallas Electrical Contractors, Inc. v. G.A. Rafel & Co., Inc.*,[130] held that attorneys' fees may be recoverable under a payment bond, but denied the attorneys' fees claim in this case because it was not established by the bond and contract language at issue.[131]

[3] Pre-Judgment Interest

Prejudgment interest is also recoverable under the bond where the bonded obligation (e.g., payment to a subcontractor) carries an "inherent due date."[132] Interest in such cases generally is allowed from the date that suit is filed for recovery under the bond.[133]

[4] Allocation of Payments

Where a contractor owes money to a subcontractor on several accounts for several projects, some of which are bonded and some of which are not, the amount due and owing to the subcontractor under the bond may be difficult to determine. Generally, where the "debtor" contractor makes payment to its "creditor" subcontractor to whom he owes money on several accounts, the "debtor" has the right to designate the account to which the payment is credited.[134] Where the "debtor" contractor fails to designate the project to which the payment should be applied,

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[127] *Id.*

[128] *Id.*, 38 Ill. App. 2d at 54.

[129] Capital Dev. Bd. ex rel. P.J. Gallas Elec. Contractors, Inc. v. G.A. Rafel & Co., Inc., 143 Ill. App. 3d 553, 562, 493 N.E.2d 348 (2d Dist. 1986).

[130] *Id.*

[131] *Id.*, 143 Ill. App. 3d at 563.

[132] Griffin Wellpoint Corp. v. Engelhardt, Inc., 92 Ill. App. 3d 252, 263, 414 N.E.2d 941 (2d Dist. 1980).

[133] *Id.*, 92 Ill. App. 3d at 263-264.

[134] Village of Winfield ex rel. Kuhn v. Reliance Ins. Co., 64 Ill. App. 2d 253, 258, 212 N.E.2d 10 (2d Dist. 1965); *Griffin Wellpoint Corp.*, 92 Ill. App. 3d at 262.

the "first in, first out" principle is often used.[135] In other words, the "first" funds deposited into a "debtor's" bank account from a particular source or project (and remaining in the "debtor's" account at the time it makes payment to its subcontractor) will be considered the first funds out to pay the subcontractor and that payment will be applied as a payment from that same, "first," particular source. The rule is not foolproof, however, and "will not be applied where it produces an unjust result."[136]

[E] Procedural Requirements Under the Act

Section 2 of the Bond Act provides the procedural requirements that must be met including: notice, suit limitations, other requirements, and venue. These requirements protect the surety and the general contractor in return for their providing at least the statutory minimum protection under the Act.[137] The procedural requirements are jurisdictional. If a claimant fails to comply with this procedural requirement, the court may lack jurisdiction to rule upon the claim.[138]

[1] Notice

The notice provisions of § 2 of the Bond Act contain two separate and distinct requirements: timeliness and form. Every person bringing a claim under the Act, regardless of whether or not suit is filed, must provide a verified notice of claim to the "officer, board, bureau or department awarding the contract" within 180 days of the date of the last item of work performed or the furnishing of the last item of materials. A notice provided directly to the surety, instead of the entity awarding the contract, is sufficient to satisfy that aspect of the statutory requirement.[139] The term "last work," for the purpose of calculating the date from which the 180-day notice period begins to run, is not defined in the Act. Relying on the Miller Act and the Illinois Mechanics Lien Act, the only Illinois court to interpret the meaning of "last work" under the Bond Act held that corrective work or repair work is excluded from consideration in determining the date of "last work."[140] The failure of a claimant to provide notice of its bond claim within the

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[135] *Village of Winfield ex rel. Kuhn*, 64 Ill. App. 2d at 258; *Griffin Wellpoint Corp.*, 92 Ill. App. 3d at 262-263.

[136] *Village of Winfield ex rel. Kuhn*, 64 Ill. App. 2d at 259; *Alexander Lumber*, 1 F.2d 430.

[137] Concrete Structures of the Midwest v. Fireman's Ins. Co. of Newark, N.J., 790 F.2d 41, 43 (7th Cir. 1986).

[138] *Shaw Indus., Inc.*, 318 Ill. App. 3d at 672; *Concrete Structures of the Midwest*, 790 F.2d at 43; United City of Yorkville v. Lewis Constr. Co., 48 Ill. App. 2d 463, 469, 198 N.E.2d 863 (2d Dist. 1964).

[139] City of DeKalb ex rel. Int'l Pipe & Ceramics Corp. v. Sornsin, 32 Ill. 2d 284, 289, 205 N.E.2d 254 (1965).

[140] *M.Q. Constr. Co., Inc.*, 318 Ill. App. 3d at 684.

180-day period nullifies the claim and operates as a discharge of the surety's duty.[141]

The timeliness of the claimant's notice under § 2 of the Bond Act is vital to the claimant's recovery under the bond. However, where the surety bond provides greater coverage than that afforded under the Act, the surety may be deemed to have waived the limitations provisions that inure to its benefit under the Act.[142] At least one court has held that, where a surety provided a bond that, by its language, exempted those who had a direct contract with the principal from providing written notice of a claim under the bond to the principal, the surety could not rely on the notice provisions contained within § 2 of the Act in forming a defense to a subcontractor's claim.[143] In so holding, the court stated, "[the surety] asks to be permitted to issue a bond that provides no notice is required prior to suit, but when a claimant relies on that language, to avoid payment by invoking the Bond Act, which contains a notice requirement. This we refuse."[144]

The form of the notice must comply with the Act. It must be verified and must contain the following information:

1. The name and address of the claimant. If the claimant is a foreign corporation, its Illinois business address must also be provided. If the claimant does not have a place of business in Illinois, the notice should provide the address of the principal place of business of the claimant. If the claimant is a partnership, the names and residences of the individual partners must be provided;
2. The name of the general contractor (the person that has a contract with the owner);
3. The name of the person for whom the claimant furnished labor or materials;
4. The amount of the claim; and
5. A brief description of the public improvement sufficient to identify it.

Under the language of the Act, a defect in the form of the notice is not fatal to the claimant's right to maintain an action under the Act *unless* the defect prejudices the rights of any interested party.

[2] Suit Limitations and Other Requirements

Section 2 of the Bond Act provides limitations for bringing suit under the Act, along with other procedural requirements related to bringing suit. With regard to the "other requirements," the Act provides:

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[141] *M.Q. Constr. Co., Inc.*, 318 Ill. App. 3d at 686; *City of DeKalb ex rel. Int'l Pipe & Ceramics Corp.*, 32 Ill. 2d at 288. *See also* United City of Yorkville, 48 Ill. App. 2d at 469.

[142] William J. Templeman Co. v. United States Fidelity & Guar. Co., 317 Ill. App. 3d 764, 770, 739 N.E.2d 883 (1st Dist. 2000).

[143] *Id.*, 317 Ill. App. 3d at 771.

[144] *Id.*

1. No suit can be brought sooner than 120 days after the claimant last furnishes labor or material to the project unless final settlement occurs prior to the expiration of the 120 day period in which case suit may be brought immediately after final settlement;
2. Suit must be brought in the state circuit court (county) where the contract is performed; and
3. A certified copy of the bond must be attached to the suit.

The limitation provision of the Act provides that no suit may be brought later than six months after the project is accepted by the owner. This limitation provision applies even where the bond at issue provides coverage broader than that required by § 1.[145] What specifically constitutes "acceptance" by the owner is determined by the language of the bond. Where the bond, or the underlying contract incorporated into the bond, provides for a specific method of acceptance, the subcontractors may rely on that language and the surety may not discharge its bond obligations by achieving acceptance via another route.[146] In fact, the court in *Chicago Housing Authority ex rel. Chicago Bronze Corp. v. United States Fidelity & Guaranty Co.*, seems to place an affirmative duty on the surety to "take such steps as [are] necessary" to ensure that "acceptance" is achieved according to the terms of the contract.[147] Where the principal has not been defaulted and the surety has not "taken over" the project, however, it would be very difficult for the surety to "take such steps as [are] necessary" to ensure that contractual acceptance occurs. At most, the surety could urge its principal to secure contractual acceptance from the owner, in order to preserve the limitation defense based on project acceptance.

[F] Additional Defenses to Bond Claims

[1] Waiver or Release

The "equitable rule" that where a creditor releases security for a debt, the other sureties are released to the same extent, applies to the payment bond relationship in most situations.[148] Where a subcontractor provides a partial or final release of its mechanics lien rights, resulting in the release of public funds held pursuant to the public lien statute, the surety's collateral or security is impaired. A subcontractor's release of lien rights gives rise to a *pro tanto* discharge in favor of the surety.[149] At least one court has held that the Bond Act "does not contemplate

[145] *Concrete Structures of the Midwest*, 790 F.2d at 43.

[146] Chicago Housing Auth. ex rel. Chicago Bronze Corp., 49 Ill. App. 2d at 415.

[147] *Id.* at 416.

[148] Alexander Lumber Co. v. Aetna Accident & Liab. Co., 296 Ill. 500, 509, 129 N.E. 871 (1921).

[149] Board of Educ. of Bourbonnais Sch. Dist. No. 53 ex rel. Anning-Johnson Co. v. Hartford Accident & Indem. Co., 60 Ill. App. 2d 320, 324-325, 208 N.E.2d 51 (3d Dist. 1965); *Chicago Bridge & Iron Co.*, 46 Ill. 2d at 526-528; Northbrook Supply Co. v. Thumm Constr. Co., 39 Ill. App. 2d 267, 272, 188 N.E.2d 388 (2d Dist. 1963).

liability, in our judgment, in a case where a claimant has voluntarily prejudiced the rights of the surety."[150] However, where the subcontractor shows that it was "industry custom" or a contractual requirement to provide a release of its lien rights prior to receipt of payment, the courts may allow the subcontractor to proceed with a claim under the Bond Act.[151]

[2] Defenses of the Principal

Generally, the liability of a surety under a payment bond is "co-extensive" with that of his principal.[152] That means that the rights and defenses of the principal also belong to the surety.[153] Most contractual or other defenses that may be raised by the principal in defense to the claim of a subcontractor may be raised by the payment bond surety.

[3] Pay-When-Paid Clauses

A pay-when-paid defense[154] is not available to a surety on a public project.[155] For the surety to rely on such a clause "runs counter to the underlying purpose of the payment bond."[156] In addition, all contracts for improvements to real property in Illinois incorporate the provisions of the Illinois Mechanics Lien Act. The Mechanics Lien Act nullifies pay-when-paid clauses in both public and private contracts, and they are not a defense to any claim under the Mechanics Lien Act.[157] Finally, on a private project, it is not settled whether the pay-when-paid is a valid surety defense.

[4] Penal Sum Limits

Where the payment bond adheres to the statutory language, the surety can generally expect that its liability will be limited to the penal sum (total amount) of the bond.[158] However, where the underlying contract did not provide for a fixed

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[150] Board of Educ. of Bourbonnais Sch. Dist. No. 53 ex rel. Anning-Johnson Co. v. Hartford Accident & Indem. Co., 60 Ill. App. 2d 320, 324-325, 208 N.E.2d 51 (3d Dist. 1965).

[151] *Chicago Bridge & Iron Co.*, 46 Ill. 2d at 531; *State of Illinois Capital Dev. Bd. ex rel. P.J. Gallas Elec. Contractors, Inc.*, 143 Ill. App. 3d at 559-560.

[152] Premier Elec. Constr. Co. v. American Nat'l Bank of Chicago, 276 Ill. App. 3d 816, 819, 658 N.E.2d 877 (1st Dist. 1995); Brown & Kerr, Inc. v. St. Paul Fire & Marine Ins. Co., 940 F. Supp 1245, 1248-1249 (7th Cir. 1996).

[153] *Brown & Kerr, Inc.*, 940 F. Supp. at 1249.

[154] *See* **Chapter 3, § 3.06[B]**, for a discussion of pay-when-paid clauses.

[155] *Brown & Kerr, Inc.*, 940 F. Supp. at 1249.

[156] *Id.*

[157] Capital Indem. Corp. v. United States, 1993 U.S. Dist. LEXIS 13200 (S.D. Ill. 1993). *See also* 77 ILCS 60.21.

[158] *Aluma Sys., Inc.*, 206 Ill. App. 3d 828, 564 N.E.2d 1280.

sum but rather provided that the contractor was "obligated to expend whatever sum was necessary to pay for all labor and materials supplied for the project," the surety was not discharged from its bond obligations even though the principal had made payments to subcontractors which exceeded the penal sum of the bond.[159]

[G] Surety's Right of Indemnity

In return for issuing bonds, the surety often requires that the principal and related individuals sign indemnity agreements to protect the surety for any loss it may incur as a result of having issued the surety bonds. Illinois courts consistently enforce a surety's right to indemnity from its principal or indemnitors.[160] Additionally, the courts have held that an indemnity contract is to be given a fair and reasonable interpretation and a surety is entitled to stand on the language of the contract.[161] Where an indemnity agreement provides that a surety is entitled to full reimbursement from its principal, such an agreement should be honored as it is a contractual obligation.[162] Further, Illinois courts have found that a surety's right to indemnification arises immediately upon the institution of a claim against the bond, regardless of the principal's liability on the underlying claim.[163] This right to indemnity may be limited only by a showing of fraud or bad faith.[164]

§ 5.06 GOOD FAITH OBLIGATIONS

The surety issuing a bond for a construction project owes the bond obligee a duty of good faith in responding to claims under the bond. Under § 155 of the Illinois Insurance Code, the surety owes a duty to the named obligee to not act in a vexatious and unreasonable manner. At least one Illinois court has held that § 155 applies to a surety, and in addition sureties are included in the definition of insurance companies in the Insurance Code.

[A] The Illinois Insurance Code

The Illinois Insurance Code applies equally to the surety writing bonds on construction projects. An insurance "company" in Illinois is defined by the Insurance Code to include a surety:

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[159] *Griffin Wellpoint Corp.*, 92 Ill. App. 3d at 257-258.

[160] Hanover Ins. Co. v. Smith, 137 Ill. 2d 304, 561 N.E.2d 14 (1990); Lamp, Inc. v. International Fidelity Ins. Co., 143 Ill. App. 3d 692, 493 N.E.2d 146 (2d Dist. 1986); United States Fidelity & Guar. Co. v. Klein Corp., 190 Ill. App. 3d 250, 558 N.E.2d 1047 (1st Dist. 1990). *See also* Continental Cas. Co. v. Guterman, 708 F. Supp. 953 (N.D. Ill. 1989).

[161] *Klein Corp.*, 190 Ill. App. 3d at 254.

[162] *Guterman*, 708 F. Supp. at 954.

[163] *Lamp. Inc.*, 142 Ill. App. 3d at 695 (citing Schroeder v. Pennsylvania R.R. Co., 397 F.2d 452, 459 (7th Cir. 1968) (further citations omitted)).

[164] *Klein Corp.*, 190 Ill. App. 3d at 255.

> "Company" means an insurance or surety company and shall be deemed to include a corporation, company, partnership, association, society, order, individual or aggregation of individuals engaging in or proposing or attempting to engage in any kind of insurance or surety business, including the exchanging of reciprocal or inter-insurance contracts between individuals, partnerships and corporations.[165]

Section 155 of the Illinois Insurance Code provides for penalties that a court can assess against an insurance company for "vexatious and unreasonable" insurance practices. That section provides:

> (1) In any action by or against a company wherein there is in issue the liability of a company on a policy or policies of insurance or the amount of the loss payable thereunder, or for an unreasonable delay in settling a claim, and it appears to the court that such action or delay is vexatious and unreasonable, the court may allow as part of the taxable costs in the action reasonable attorney fees, other costs, plus an amount not to exceed any one of the following amounts:
>
> (a) 25% of the amount which the court or jury finds such party is entitled to recover against the company, exclusive of all costs;
>
> (b) $25,000;
>
> (c) the excess of the amount which the court or jury finds such party is entitled to recover, exclusive of costs, over the amount, if any, which the company offered to pay in settlement of the claim prior to the action.
>
> (2) Where there are several policies insuring the same insured against the same loss whether issued by the same or by different companies, the court may fix the amount of the allowance so that the total attorney fees on account of one loss shall not be increased by reason of the fact that the insured brings separate suits on such policies.[166]

[B] Bad Faith Claims Against Sureties

The provisions of § 155 of the Insurance Code only apply to the named insured, in the surety context, the obligee; thus third-party claimants such as unnamed subcontractors cannot sue a surety for vexatious and unreasonable claim practices in settling payment bond claims. For example, in *Fisher v. Fidelity & Deposit Co. of Maryland*,[167] the appellate court held that the obligee on a performance bond was entitled to damages for the surety's vexatious and unreasonable delay in processing and attempting to settle a claim to complete construction on a recording studio. Fisher had entered into a contract in December 1973, with Mid-Central Asphalt for Mid-Central to build a recording studio. In order to induce the

[165] 215 ILCS 5/2(e).
[166] 215 ILCS 5/155.
[167] 125 Ill. App. 3d 632, 466 N.E.2d 332 (5th Dist. 1984).

Small Business Administration (SBA) into financing $15,000 of the project, Fisher obtained a performance bond from Fidelity & Deposit Company (F&D). The bond originally named the SBA as owner, but the court reformed the bond to reflect Fisher as owner.[168]

The Illinois appellate court in *Fisher* upheld an award of penalties under § 155 of the Insurance Code. The court reasoned that, under Illinois law, contracts for surety are treated as contracts for insurance. Under § 155, a plaintiff must allege conduct that is "wilful, wanton, malicious, reckless, intentional or in bad faith."[169] The court reviewed the trial court's judgment only for abuse of discretion. The appellate court found the surety's eight-year delay, including during two years of legal action by Fisher, and its "lackadaisical attitude" toward determining its liability, "does not demonstrate the good faith expected of a surety."[170] F&D's liability under the bond, however, was limited to the terms of the bond. The court affirmed the judgment of liability and pre-judgment interest, and § 155 damages; reversed the punitive damage award; and remanded for the trial court to recalculate plaintiff's damages based on his failure to mitigate.[171]

Courts in other states have also imposed liability on a surety for bad faith claims handling practices, whether based in tort or on a statute similar to § 155 of the Insurance Code.[172] Texas and California, however, have expressly denied remedies to a bond obligee based on the surety's bad faith claims processing, reasoning that the parties are originally of equal bargaining power and thus not in need of the court's protection, and that an obligee, unlike an ordinary insured, has a cause of action against both the surety and the bond principal.[173]

[C] Standing

On the other end of the spectrum, courts will not award vexatious and unreasonable delay damages under § 155 of the Insurance Code to contractors not named as obligees in the bond. The Illinois appellate court in *Premier Electrical Construction Co. v. American National Bank*[174] held that § 155 remedies extend only to the party insured by the instrument, not to unnamed third parties such as subcontractors.

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[168] *Id.*, 125 Ill. App. 3d at 634.

[169] *Id.* at 640.

[170] *Id.* at 641.

[171] *Id.* at 643.

[172] *See, e.g.*, International Fidelity Ins. Co. v. Delmarva Sys., 2001 WL 541469 (Del. Super. 2001) (collecting cases), where the court found a cause of action in favor of the obligee, against the surety, for bad faith. The Delaware court reasoned that the policy of allowing such actions by an obligee "would conceivably deter [manipulation and delay in payment by the surety] and compel sureties to handle claims responsibly." *Id.* at *9.

[173] *See* Great Am. Ins. v. North Austin Mun., 908 S.W.2d 415 (Tex. 1995); Cates Constr. v. Talbot Partners, 21 Cal. 4th 28 (1999).

[174] 276 Ill. App. 3d 816, 658 N.E.2d 877 (1st Dist. 1995).

Likewise, at least one federal court entered judgment in favor of the surety and against a subcontractor making a § 155 claim. The federal district court for the Northern District of Illinois in *Brown & Kerr, Inc. v. St. Paul Fire and Marine Ins. Co.*,[175] relied on *Premier Electrical* in denying § 155 remedies. In granting St. Paul's motion to dismiss, the court reasoned that the bond did not define subcontractors as insureds. Therefore, Brown & Kerr was considered a third-party to the contract, and was not entitled to a remedy for St. Paul's delay in processing its claim.[176]

§ 5.07 CONCLUSION

Overall, the law of Illinois is forthright in enforcing surety obligations in strict adherence to the terms of the bond and the bonded contract. At the same time, the law of Illinois limits surety obligations to the strict letter of its contractual undertakings. Where bonded obligations are satisfied, Illinois law vigorously guards the surety's salvage and subrogation rights.

[175] 1996 WL 464212 (N.D. Ill. 1996).
[176] *Id.* at *3.