

Understanding Your Rights Under Performance Bonds




A Tishkoff PLC eBook



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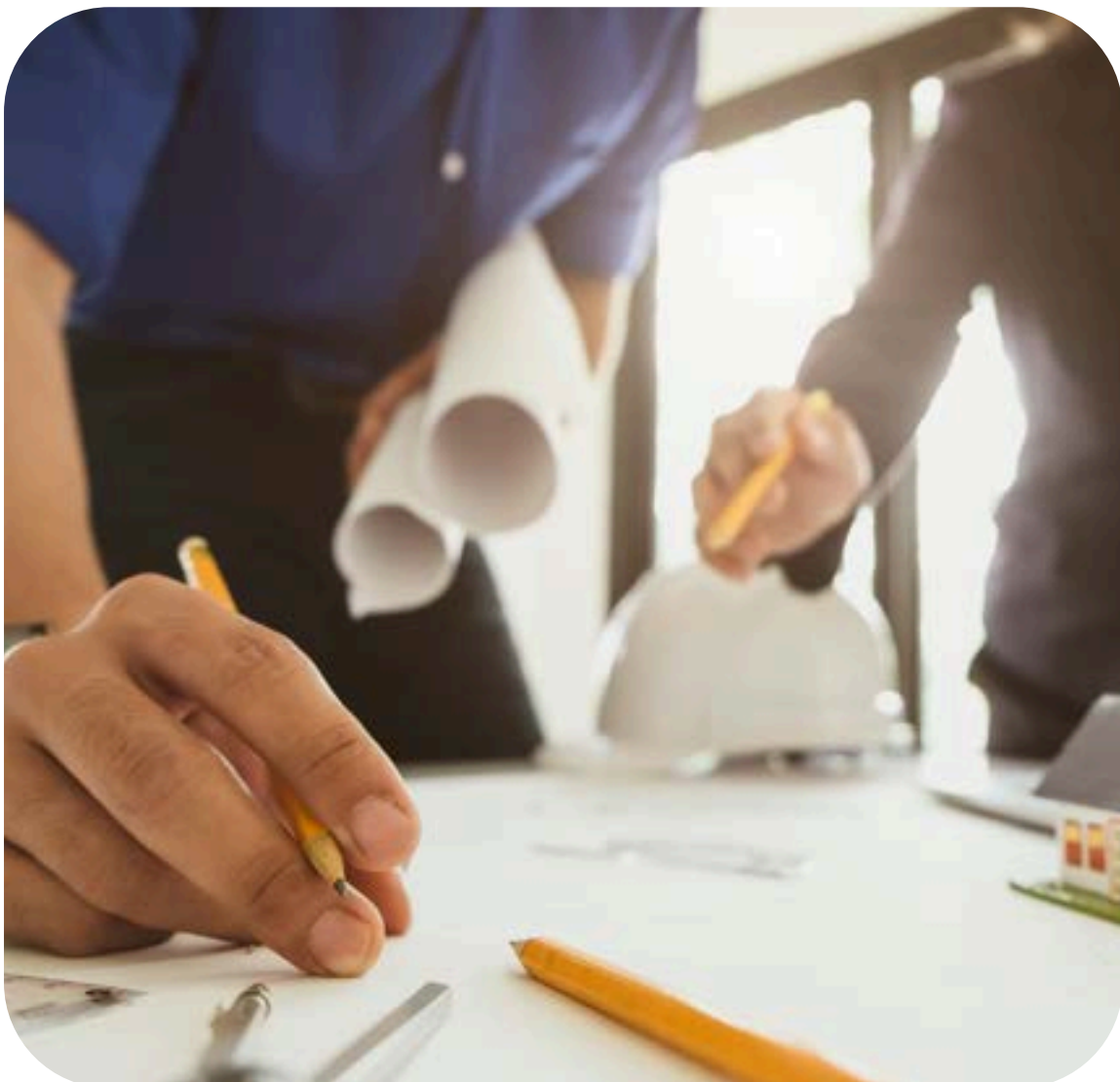
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Introduction

Performance bonds are essential instruments for mitigating risk across various sectors, especially in construction and real estate. These bonds offer a safeguard for project owners (obligees) by ensuring that contractors (principals) fulfill their contractual obligations. This comprehensive guide delves into the complexities of performance bonds, outlining the rights and obligations of all parties involved and offering practical advice for business professionals and lawyers.

Please note this eBook should be used for learning and illustrative purposes. It is not a substitute for consultation with an attorney with expertise in this area. If you have questions about a specific legal issue, we always recommend that you consult an attorney to discuss the particulars of your case.



What is a Performance Bond?

In the realm of contractual agreements, a performance bond acts as a financial guarantee, typically issued by a surety company (such as an insurance company or a bank) to the project owner (obligee). This bond assures the obligee that the contractor (principal) will successfully complete the project according to the terms and conditions outlined in the contract. Essentially, it serves as a safety net, protecting the obligee from potential financial losses if the principal fails to deliver on their promises. The bond amount often mirrors the full contract price, providing a substantial financial cushion for the obligee.



It's important to note that a performance bond is not an insurance policy. While an insurance policy provides coverage for unforeseen events, a surety bond guarantees the performance of the principal. If the principal fails to perform, the surety company may take various actions to remedy the situation, such as financing the original contractor to complete the project, arranging for a new contractor to take over, assuming the role of the contractor and subcontracting the remaining work, or paying the penal sum of the bond to the obligee. Furthermore, performance bonds typically have a set duration, usually 12 months.

Purpose of Performance Bonds in Various Industries

➔ Construction

Performance bonds are indispensable in the construction industry, ensuring projects are completed on time, within budget, and to the specified quality standards. They protect project owners from financial losses that may arise from contractor defaults, such as incomplete or abandoned work, delays, or bankruptcy. Performance bonds also incentivize contractors to bid on projects they are qualified for and to perform their work diligently. In the United States, both federal and state governments have enacted laws requiring performance and payment bonds on public construction projects. The federal Miller Act of 1932 mandates these bonds for all federal construction contracts exceeding \$150,000. States have also implemented similar legislation, often referred to as "Little Miller Acts," requiring performance and payment bonds on state-funded projects. These laws ensure that contractors fulfill their obligations, protecting public funds and guaranteeing project completion.

➔ Real Estate

In real estate development, performance bonds are vital for protecting owners and investors. They provide a guarantee that contractors will deliver on their promises, safeguarding against losses due to contractor insolvency or failure to meet contractual obligations. By ensuring project completion, performance bonds help maintain the value of the real estate investment.

➔ Construction

➔ Real Estate

➔ Other Applications



➔ Other Applications

Beyond construction and real estate, performance bonds find applications in various other sectors:

- **Manufacturing:** In manufacturing, performance bonds guarantee the timely delivery of goods and the quality of manufactured products. For instance, a manufacturer might be required to provide a performance bond to ensure the on-time delivery of custom-made parts or to guarantee that mass-produced goods meet specific quality standards.
- **Service Industries:** Performance bonds are used in service industries to ensure that service providers fulfill their contractual obligations. This could include guaranteeing the completion of IT services, maintenance contracts, or consulting projects.
- **Commodity Contracts:** In commodity contracts, performance bonds guarantee the delivery of commodities as agreed upon. This protects buyers from losses if the seller fails to deliver the specified commodities due to reasons like supply chain disruptions or unforeseen circumstances.



Types of Performance Bonds

Performance bonds come in various forms, each tailored to specific needs and situations:

| Bond Type | Description | Applications |
|------------------|--|--|
| Bid Bond | Guarantees that a contractor will enter into a contract if awarded the bid and will provide the necessary performance and payment bonds. | Public and private construction projects where bids are submitted. |
| Payment Bond | Ensures that subcontractors, laborers, and material suppliers are paid for their work and materials. | Construction projects to protect against liens and ensure payment to all parties involved. |
| Maintenance Bond | Guarantees that any defects in the completed project will be corrected during a specified maintenance period, usually one year. | Construction projects to ensure the quality of work and address potential defects. |
| Supply Bond | Guarantees the delivery of materials or supplies according to the contract terms. | Contracts involving the procurement of goods and materials. |

| Case Description | Key Issue | Outcome |
|-----------------------------------|---|--|
| Subdivision Bond | Ensures that developers complete infrastructure improvements in a subdivision as promised. | Real estate development projects to guarantee the completion of essential infrastructure. |
| Conditional Bond (UK) | Requires proof of a contractual breach before it can be enforced. | Construction and other contracts in the UK where specific conditions must be met for a claim. |
| On-Demand/Unconditional Bond (UK) | Allows the obligee to make a claim and receive payment immediately upon demand, without needing to prove non-performance. | Construction and other contracts in the UK where immediate payment is required in case of default. |

The cost of a performance bond is typically a small percentage of the full contract price. Surety bond companies calculate the premium based on several factors, including the type of bond, the bond amount, and the applicant's risk profile. This means that larger, riskier projects will generally require higher premiums.

Project owners can also opt for partial performance bonds, which offer coverage for a percentage of the full contract value or a specified maximum sum. This can be a strategic approach for reducing bonding costs and increasing competition by allowing smaller contractors to bid on projects.

Rights and Obligations of Obligee

Obligee's Rights and Obligations

The obligee (project owner) holds certain rights under a performance bond:

➔ Demand Performance:

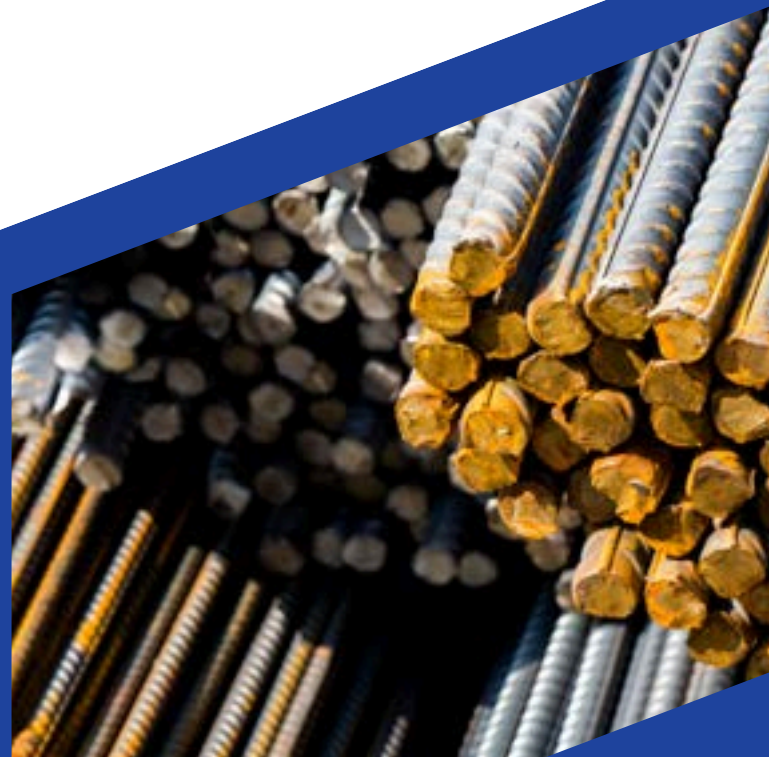
The obligee can demand that the principal (contractor) fulfills their contractual obligations.

➔ Make a claim:

If the principal defaults, the obligee can make a claim on the performance bond to recover losses.

➔ Receive compensation:

The obligee is entitled to compensation for financial losses incurred due to the principal's default, up to the bond amount.



However, the obligee also has corresponding obligations:

➔ Complying with the contract:

The obligee can demand that the principal (contractor) fulfills their contractual obligations.

➔ Declaring a default:

The obligee must formally declare the principal in default before making a claim on the bond. It's crucial to emphasize that the obligee has a responsibility to ensure the contractor has actually breached their contract obligations before making a claim. This involves a thorough evaluation of the situation and proper documentation of the breach.

➔ Providing notice:

The obligee must provide timely notice of the default to the surety company.

➔ Timely declaration of default:

Delaying the declaration of default can prejudice the surety and potentially void the bond. Therefore, it's essential for the obligee to act promptly and decisively when a default becomes apparent.



Principal's Rights and Obligations

The Principal (contractor) also has rights protected by the performance bond:

➔ Receive payment:

The principal is entitled to payment for completed work according to the contract terms.

➔ Due process:

The principal has the right to a fair investigation by the surety company in case of a claim.

➔ Defend against a Claim:

The principal can defend against a claim by providing evidence of their performance or challenging the validity of the claim.

Along with these rights, the principal has obligations to fulfill:

➔ Performing the contract:

The principal must complete the project according to the contract terms and conditions.



➔ **Paying subcontractors and suppliers:**

The principal is responsible for paying all subcontractors, laborers, and material suppliers.

➔ **Reimbursing the surety:**

If the surety company pays a claim, the principal is obligated to reimburse them.

Common Scenarios Triggering a Performance Bond Claim

Several situations can lead to a performance bond claim:

- **Incomplete or abandoned work:** The contractor fails to complete the project or abandons it without a valid reason.
- **Failure to meet deadlines:** The contractor fails to meet project deadlines without justifiable cause.
- **Defective work:** The contractor's work does not meet the required quality standards.
- **Non-payment of subcontractors or suppliers:** The contractor fails to pay subcontractors or suppliers, leading to liens or other claims against the project.
- **Contractor insolvency or bankruptcy:** The contractor becomes financially unable to complete the project.



Making a Performance Bond Claim



Making a performance bond claim is a multi-step process:

1. **Identify the surety company:** Determine the surety company that issued the bond. This information is usually found on the bond documentation.
2. **File a written claim:** Submit a written claim to the surety company, providing a detailed account of the contractor's breach and the damages suffered. This should include a description of the breach, the amount of damages sought, and any supporting documentation.
3. **Provide supporting documentation:** Gather and submit evidence to support the claim, such as the contract, change orders, payment records, notices of default, photos or videos of defective work, invoices from subcontractors, and expert reports.
4. **Cooperate with the investigation:** The surety company will conduct an investigation to assess the validity of the claim. This may involve contacting the contractor for their perspective and reviewing all relevant documentation. Cooperate fully with the investigation by providing information and documentation as requested.





5. **Negotiate a settlement:** If possible, explore the possibility of negotiating a settlement with the surety company to avoid costly and time-consuming litigation.
6. **File a lawsuit:** If a settlement cannot be reached, file a lawsuit to enforce the bond.

It's important to be aware that the deadline for filing a claim may vary depending on the specific bond and the jurisdiction. Always check the bond documents carefully to ensure compliance with any time limits.

To make a valid claim under a standard performance bond, three conditions must be met:

- The owner (obligee) must formally (in writing) declare the bonded contractor (principal) in default under the contract's terms and conditions.
- The contractor must actually be in default under the contract's terms and conditions.
- The owner must have fulfilled their obligations under the contract.

Defenses Against a Performance Bond Claim

Contractors facing a performance bond claim can raise several defenses:

- **No valid default:** The contractor argues that they did not actually default on the contract.
- **Obligee's breach of contract:** The contractor claims that the obligee failed to fulfill their obligations under the contract, such as making timely payments.
- **Impossibility or impracticability of performance:** The contractor argues that unforeseen circumstances beyond their control prevented them from fulfilling the contract.
- **Wrongful termination:** The contractor claims that the obligee terminated the contract without valid grounds.
- **Statute of limitations:** The contractor argues that the time limit for filing a claim has expired.



Remedies Available to the Oblige

If a performance bond claim is successful, the obligee may be entitled to the following remedies:

- **Completion of the project:** The surety company may arrange for the completion of the project by another contractor.
- **Financial compensation:** The surety company may pay the obligee the costs of completing the project or the bond amount, whichever is less.
- **Corrective work:** The surety company may require the original contractor to correct defective work.



Arbitration

Litigation

Performance Bonds vs. Other Financial Instruments

Performance Bond vs. Bank Guarantee

While both performance bonds and bank guarantees provide financial security, they have distinct characteristics:

- **Focus:** Performance bonds primarily guarantee the performance of non-monetary obligations, while bank guarantees typically secure monetary obligations.
- **Claim process:** Performance bonds often allow for immediate payment upon demand, while bank guarantees may require proof of the principal's liability.
- **Cost:** Performance bonds generally have lower costs than bank guarantees.



Performance Bond vs. Letter of Credit

Letters of credit are another financial instrument used to secure contractual obligations. However, they differ from performance bonds in several ways:

- **Risk management:** Surety companies conduct more thorough due diligence on the principal before issuing a performance bond, compared to banks issuing letters of credit. This rigorous vetting process helps ensure that

the principal is capable of fulfilling their obligations.

- **Financial protection:** Performance bonds offer broader financial protection, including coverage for liquidated damages and payment to subcontractors. Letters of credit typically do not provide such comprehensive coverage.
- **Project completion:** Letters of credit do not guarantee project completion, while performance bonds do. This is a crucial distinction, as project completion is often the primary concern for obligees.

Case Law and Legal Precedents

Case law provides valuable insights into the interpretation and application of performance bond provisions. One notable case is *BDI Construction Company v. Hartford Fire Insurance Co.* (995 So. 2d 576). In this case, the court ruled that the statute of limitations for claims under a performance bond begins when the subcontractor's work is completed and paid for. This highlights the importance of understanding the specific timing requirements for filing a claim.



Another example is a case where a general contractor was hired for a commercial building project. During construction, the HVAC subcontractor claimed non-payment and filed a mechanic's lien against the property. The project owner triggered the bond claim process, and the surety company investigated and validated the subcontractor's claim. The general contractor sought legal advice to navigate their rights and obligations, ultimately gathering the necessary documentation to respond to the claim. This illustrates the potential complexities of performance bond disputes and the importance of seeking legal counsel.



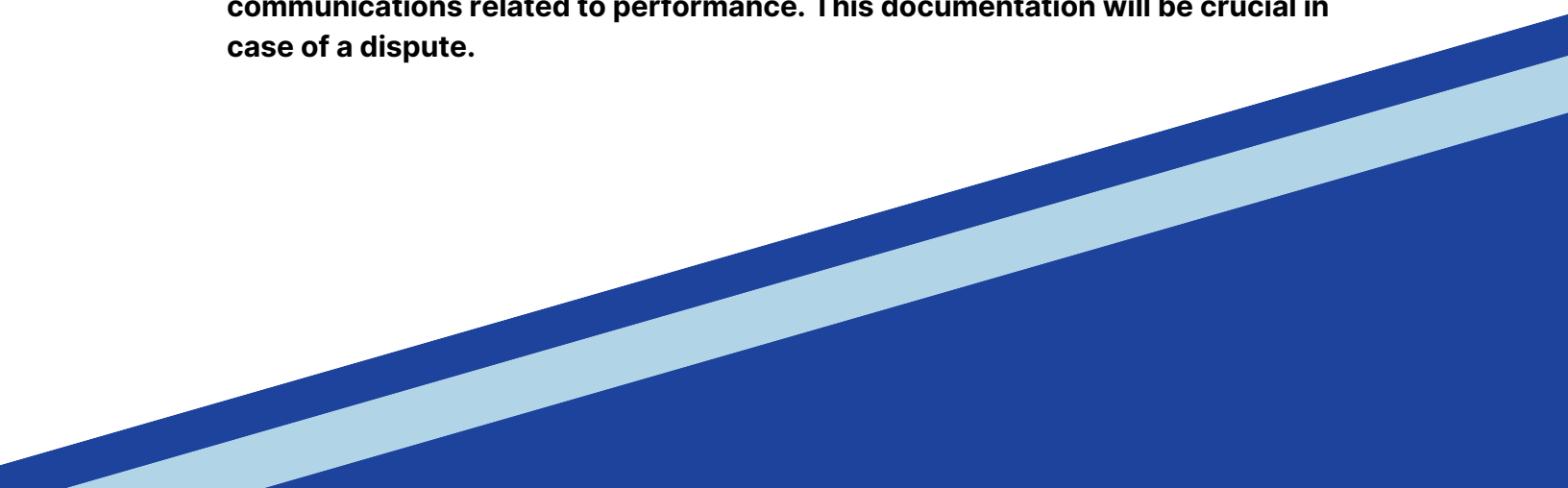
Dispute Resolution

Disputes related to performance bonds can be resolved through various methods:

- **Negotiation:** Parties can attempt to resolve disputes through direct negotiation, often the most efficient and cost-effective approach.
- **Mediation:** A neutral third party can facilitate communication and help parties reach a mutually acceptable solution. Mediation offers a more structured approach to negotiation and can be particularly helpful in complex disputes.
- **Arbitration:** Parties can agree to have their dispute resolved by an arbitrator, whose decision may be binding. Arbitration provides a more formal setting for dispute resolution and can be faster than traditional litigation.
- **Litigation:** Parties can file a lawsuit in court to resolve the dispute. Litigation is the most formal and potentially costly method of dispute resolution.

The choice of dispute resolution method depends on various factors, including the contract terms, the complexity of the dispute, and the desired level of formality.

Practical Tips and Recommendations

- **Carefully review bond terms:** Before entering into a contract involving a performance bond, carefully review the bond terms and conditions to understand the rights and obligations of all parties. Pay close attention to the bond amount, the duration of the bond, and any specific conditions or exclusions.
 - **Choose a reputable surety company:** Select a surety company with a strong financial standing and a good track record. This will ensure that the bond provides reliable financial security.
 - **Document everything:** Maintain thorough documentation of the project, including contracts, change orders, payment records, and any communications related to performance. This documentation will be crucial in case of a dispute.
- 



- **Communicate effectively:** Maintain open and clear communication with all parties involved in the project, including the obligee, the surety company, and any subcontractors. This will help prevent misunderstandings and facilitate prompt resolution of any issues.
- **Address issues promptly:** If any performance issues arise, address them promptly to prevent them from escalating into a bond claim. Early intervention can often prevent minor issues from becoming major problems.
- **Seek legal advice:** If you have any questions or concerns about performance bonds, consult with an attorney specializing in construction law or surety bonds. Legal advice can help you navigate the complexities of performance bond agreements and protect your interests.
- **Importance of contract review:** Carefully review the language of both the performance bond and the underlying construction contract. The bond's language governs the guarantees and the parties' rights and obligations, so it's essential to ensure that the bond aligns with the contract and meets your expectations.

Conclusion

Conclusion

Performance bonds are invaluable tools for mitigating risk in various industries. By understanding the intricacies of these bonds, business professionals and lawyers can protect their interests and ensure the successful completion of projects. This guide provides a comprehensive overview of performance bonds, offering practical advice and insights to navigate this complex area of law.

Key takeaways for business professionals and lawyers include:

- **Types of bonds:** Familiarize yourself with the different types of performance bonds and their specific applications to choose the most appropriate bond for your needs.
- **Rights and obligations:** Understand the rights and obligations of all parties involved in a performance bond agreement, including the obligee, the principal, and the surety company.
- **Claim process:** Be aware of the process for making a performance bond claim, including the necessary documentation and deadlines.
- **Defenses:** Understand the potential defenses against a performance bond claim to protect your interests in case of a dispute.
- **Dispute resolution:** Be prepared to engage in dispute resolution processes, such as negotiation, mediation, arbitration, or litigation, to resolve any conflicts that may arise.

By following the practical tips and recommendations outlined in this guide, you can effectively manage the risks associated with performance bonds and ensure the successful outcome of your projects.

Questions about business law or litigation?

Contact Tishkoff

Tishkoff PLC specializes in business law and litigation. For inquiries, contact us at www.tish.law/contact/.

Check out Tishkoff PLC's **Website** (www.Tish.Law/), **eBooks** (www.Tish.Law/e-books), **Blogs** (www.Tish.Law/blog) and **References** (www.Tish.Law/resources).

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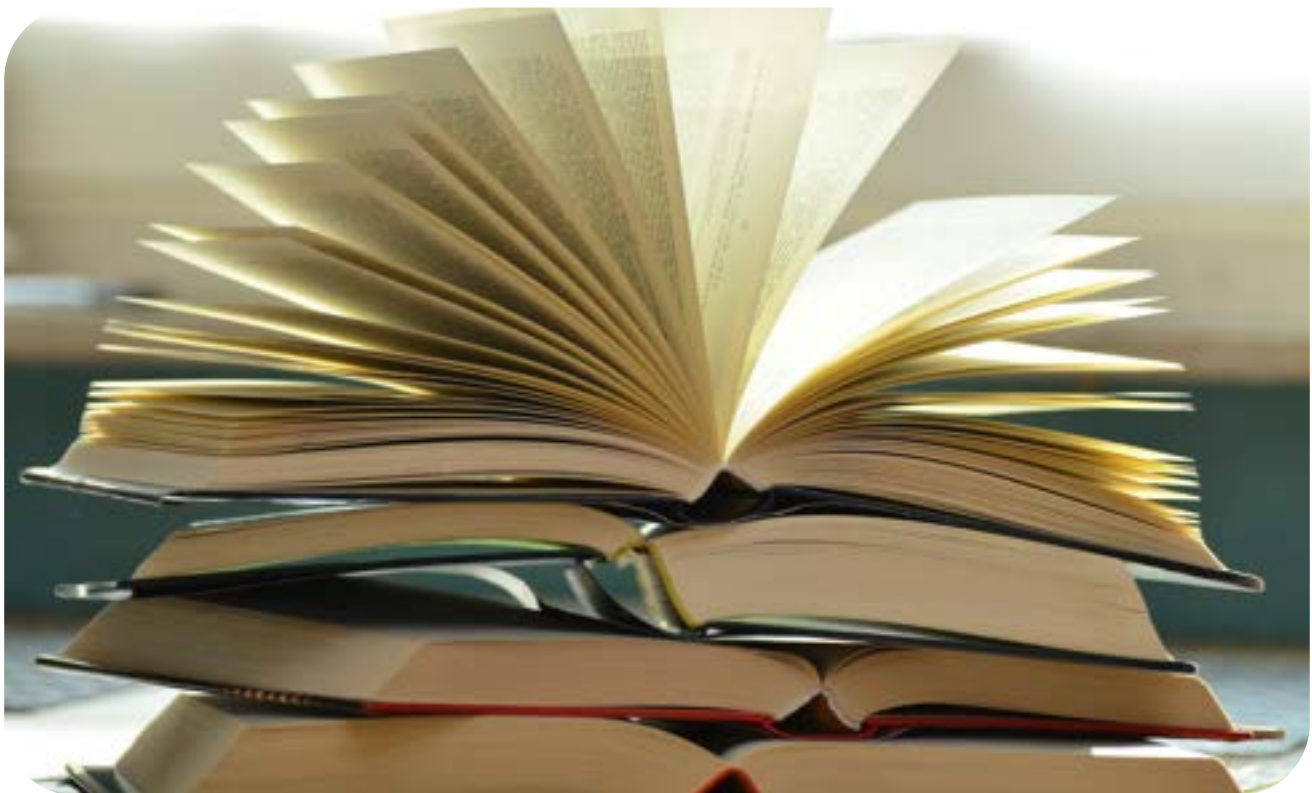
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